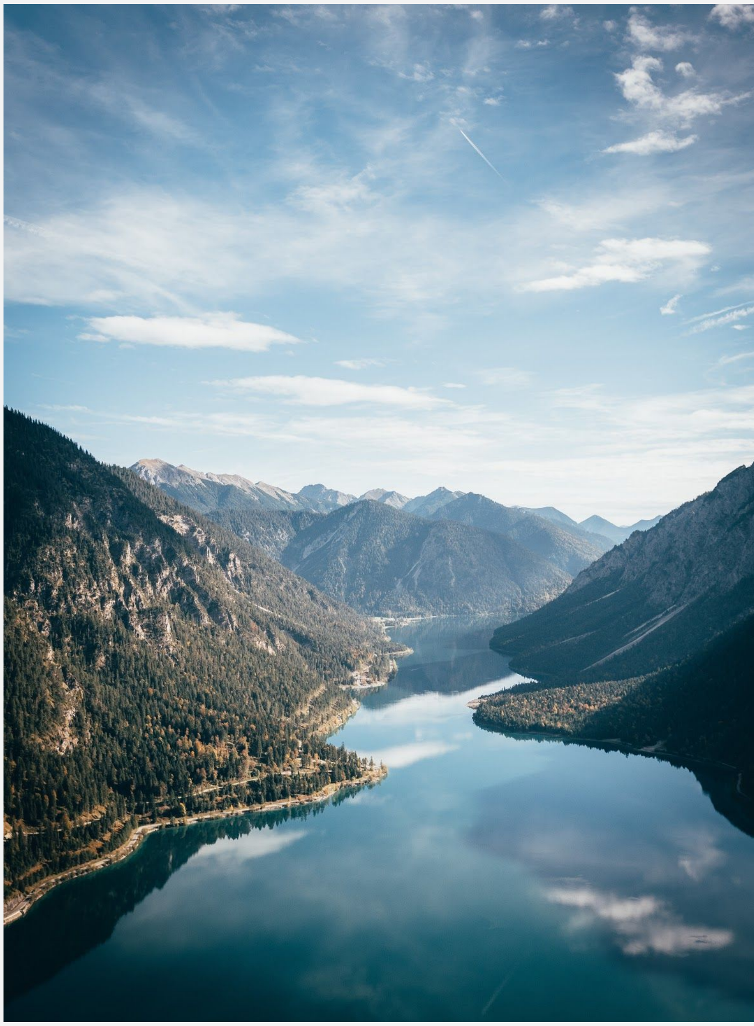
POLICY PRIORITIES TO UNLOCK CATALYTIC CAPITAL



TO SCALE THE IMPACT INVESTING MARKET

Supported by the Tipping Point Fund for Impact Investing, a project of the New Venture Fund

WHITE PAPER SERIES

Prepared by the Sorenson Impact Center
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SORENSON IMPACT | David Eccles School of Business, THE UNIVERSITY OF UTAH

INTRODUCTION

Public policy has been and continues to be instrumental in the growth of capital markets. Similarly, public policy can be a critical force in the growth of the impact investing market, where traditional capital markets converge with social impact and outcomes. Government has the authority to create critical incentives, appropriate public dollars, establish regulatory frameworks, and can provide critical capital and guarantees. All of these levers directly or indirectly influence the behavior of capital providers, particularly investor behavior and confidence.

The COVID-19 pandemic has highlighted stark disparities and inequities with respect to race, income, and geography. This broad societal recognition of the need for inclusive and equitable economic growth presents an opportunity to mobilize public and private financial resources to make lasting change in addressing the barriers faced by low-income communities, women, and communities of color. For these communities to thrive, access to capital is essential. Catalytic investment has the potential to mobilize traditional investment capital at scale to meet these crucial needs.

Catalytic capital is a powerful tool in making transformative change. It can mitigate risk and seed new ideas, both of which can lead to foster greater participation from traditional capital investment. Catalytic capital is a critical component to scale impact investments that seek to achieve positive social and economic outcomes in addition to financial return. Aside from government sources, the primary provider of catalytic capital is private foundations. However, foundation resources alone are not a sufficient source of catalytic capital to scale the amount of investment needed to meet the capital needs of communities and organizations, for-profit and nonprofit, to improve social and economic outcomes. Meanwhile, the range of private and philanthropic investors able and willing to provide catalytic capital is limited and represent a small share of total investable assets. Many investors have fiduciary obligations or investment mandates that prevent them from providing this type of capital.[1] Further, there are inefficiencies with respect to knowledge, access, and transparency with respect to catalytic capital.[2]

The Sorenson Impact Center is pleased to present a series of White Papers covering federal policy ideas designed to unlock catalytic capital to scale the impact investing market and build market infrastructure. Catalytic capital is defined as investment capital that is patient, flexible, risk-tolerant, sometimes concessionary, and which enables either or both third-party traditional capital investment or follow-on investment that would not otherwise be possible.[3] While the impact investing market has grown in recent years, additional sources of catalytic capital are needed to mobilize traditional return-seeking capital at scale to address the pressing social needs and promote inclusive economic growth in the U.S.

"Like traditional financial markets, impact investing needs enabling policies; standardized performance measurement and reporting systems; third party ratings and regulations; platforms to share market information and match capital with investments; educational programs to encourage impact investing; and easily accessible, transparent data to support investors in making disciplined investment decisions."

— US National Advisory Board on Impact Investing. Private Capital Public Good. 2014.

[1] (n.d.). Catalytic Capital - Tideline. Retrieved October 26, 2020, from Catalytic Capital
[2] (2020, October 19). What Investors Need to Know to Embrace Catalytic Capital. Retrieved October 26, 2020, from What Investors Need to Know to Embrace Catalytic Capital
[3] Derived from MacArthur Foundation: Catalytic Capital Consortium

WHITE PAPERS INCLUDED IN THIS SERIES

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About the Center

Sorenson Impact Center is an applied academic think-and-do tank focused on solving social problems through the use of data, evidence, and innovation. Housed at the University of Utah David Eccles School of Business, the Center works with public, nonprofit, and private sector stakeholders across the globe to develop and implement outcomes-driven solutions to problems. The staff includes experts in data science, finance, policy, investment, and storytelling. In addition, the Center maintains a robust student program, developing the talents of 60 graduate and undergraduate students from diverse disciplines. The Center works with partners to marshal capital for social good, empower data-driven programs, break down silos across sectors, and equip the next generation of leaders with social purpose. The white papers in this series were authored by Janis Dubno, Allison Nicholson, Kyrene Clarke, and Student Fellows Peri Brimley, David Hill, Jack Jowers, and Paige Remington.

UNLOCKING CATALYTIC CAPITAL: FEDERAL REQUIREMENTS FOR OUTCOMES-BASED FINANCING

Federal statutes that authorize outcomes-based funding have not resulted in wide adoption of these funding models. Introducing a requirement for states to expend a percentage of new money in targeted funding areas can catalyze and scale investment to improve social outcomes, creating meaningful change.

OVERVIEW

The United States has stark needs and there exist persistent disparities across racial, ethnic, gender, and socio-economic groups. Twenty-three percent of all children lived in a family that received public assistance in 2019.[1] Forty-three percent of children lived in a household where the highest educational attainment was High School.[2] The 2018 poverty rate for single-mother families was 34 percent, nearly five times more than the rate (6 percent) for married-couple families.[3] Black workers are more than twice as likely to be unemployed as white workers (6.4 percent vs. 3.1 percent), and even Black workers with a college degree are more likely to be unemployed than similarly educated white workers (3.5 percent vs. 2.2 percent).[4]

Government, philanthropy, and private entities create resources and programs to address these needs and disparities. However, we do not consistently track whether these interventions successfully impact outcomes or result in meaningful change. Shifting to outcomes-based financing models shifts funding from outputs to outcomes, ultimately benefiting those receiving the services (e.g., being placed in a higher-wage job, attending a high-quality early childhood program, or avoiding a return to incarceration).

In addition, outcomes-based financing models provide a mechanism for governments to test program effectiveness, improve public management and program outcomes, and pay for expenses and services that are aligned with their overall goals.[5] By employing outcomes-based financing models, the public sector reorients its business model, making public funding dependent on specific outcomes, rather than simply paying for activities or enrollments, as is common.[6] Tying funding to evidence-based policies produces a greater return on public investment, reduces wasteful spending, expands innovative programs, and strengthens accountability.[7]

OUTCOMES-BASED FINANCING

Because "Outcomes Funding" does not have a statutory definition or uniform application and use, this paper defines "Outcomes-based Financing" as contracts, or other financial and funding arrangements, in which payments or funding are contingent on the achievement of predefined outcomes. Outcomes-based financing may include pay for success, social impact bonds, rate cards, and pay for performance contracts or funding models, and may or may not include upfront private investor capital.

"Outcomes-Based Contracting/Results-Based Financing." The Government Outcomes Lab. Accessed October 14, 2020. https://golab.bsg.ox.ac.uk/the-basics/innovative-partnerships/.

Many ideas exist on how to increase outcomes-based financing in the public sector. This paper explores enacting a federal requirement, in certain federal funding streams, to use a portion of any new funding for outcomes-based financing. We acknowledge there is still considerable work to be done to grow the outcomes-based financing field where allowability in federal statute already exists. However, a percentage requirement for outcomes-based spending in newly allocated money does not limit the scope of additional policies aimed at incentivizing and supporting states in their shift to outcomes-based financing with current federal dollars.

Federal grants account for about one-third of state government funding and more than half of state government funding for health and public assistance. The federal government was expected to provide state and local governments around $750 billion in federal grants in fiscal year (FY) 2019.[8] Current federal statutory language allows states to use outcomes-based funding for some portion of certain federal funds, but this allowability has not been widely used. See **Appendix A** for a detailed table of outcomes-based funding allowability in federal acts.

Federal requirements for outcome-based financing is catalytic in that it would increase potential cash flows and financial returns for social impact investments across asset classes, including private first-loss investments, and in outcomes-based transactions and models. States would be able to use these federal dollars to incent greater private investment that is aligned with social and inclusive economic impact. Increasing cash flow for impact investments through an ongoing source of federal outcome payments will facilitate greater capital investment by private investors by increasing the likelihood that subordinate and recoverable first loss capital will be repaid. Ensuring reliable measurement and capacity building will provide greater transparency that will benefit market efficiency.

Ultimately, outcomes-based financing promotes more transparency and accountability in government, and is part of a larger movement “that seeks to transform how governments partner with communities and direct dollars with a human-centered, equity-driven lens.”[9] This can begin with a strong foundation and expectation from federal policymakers.

OUTCOMES-BASED FINANCING MODELS

Using outcomes-based financing models to deliver service interventions has gained significant traction in the United States. One model, Pay for Success (PFS), has been used in 14 states over the last decade, with more than 25 PFS projects launched around the country. These programs have delivered a range of interventions that address recidivism, criminal justice, maternal and child health, early childhood education, workforce development, homelessness, mental health, health, and the environment. From the launch of the White House Social Innovation Fund in 2009 and the first U.S. PFS project in New York City in 2012, the field has grown with new understanding around needed data and data improvements, service providers, contract management, expectations, systems change, and project development. New funding models and innovative outcomes-based funding structures have emerged, partially based on lessons learned from the first iteration of PFS projects.[10] Moving to a mandatory requirement will help drive greater impact, increase geographic reach, and encourage a more robust market and ecosystem for outcomes-based financing models.

EXAMPLES OF OUTCOMES-BASED FINANCING PROJECTS

Maternal and Child Health

- In 2015, the poverty rate for children in South Carolina was 27 percent, and over half of newborns were born to low-income mothers who qualified for Medicaid. South Carolina successfully utilized a PFS model to fund the Nurse-Family Partnership home visiting program for first-time mothers. Recognizing a need to address high-poverty areas, the program focused on targeted zip codes. Program goals were to improve birth outcomes, improve children's health and development, and improve families' economic self-sufficiency.[11]

Job Training/Workforce Development

- To address unemployment rates and career pathways, a state might structure a project to increase young adults' training and employability. Meeting certain performance metrics throughout the process could trigger different outcomes payments. These might include enrolling a target audience of those most likely to benefit from the program (e.g., low-wage, low-skill workers), program completion resulting in an industry-recognized credential, securing employment at a predetermined wage, and retention in employment after one or two years, still at the threshold wage.

PROPOSED POLICY

Policy Proposal: Establish requirements that states use a minimum percentage of new money appropriated for outcomes-based financing models, in certain federal funding streams; and identify additional federal funding streams to expand allowability of outcomes-based funding.

We have not seen the development of an ongoing, sustainable market for outcomes-based funding from states, despite several federal funding streams providing states the authorization to expend funds in this way. With an ongoing and stable source of funding to establish outcomes-related infrastructure in states, attract private investors, and redirect funding to paying for outcomes, there is an opportunity to grow the market and see catalytic investment into impactful activities. While there may be some reluctance to establish additional mandates on states, this proposal seeks to better focus federal tax dollars on effectively achieving positive outcomes for beneficiaries and taxpayers. Tying federal funding to achievement of positive outcomes is particularly important as the nation approaches economic recovery following the Covid-19 pandemic, which will require innovation and transformational change in how we invest both our human and monetary capital.

We recognize there are several policy options to grow the outcomes-based funding market. Granting allowability to states has been a positive step towards introducing the concept at the local level, and this proposal takes the next step in scaling the outcomes-based funding market. We identify a framework for strategically selecting federal funding streams that should be targeted for outcomes-based financing. This applies to a mandatory requirement on new money allocated, or to expand allowability to additional funding streams. In both cases, we believe outcomes-based financing will see greater uptake and implementation success with additional supports and incentives, to assist states in building the infrastructure, capacity, and knowledge needed to shift existing structures to focus on outcomes.[12]

Policy Vehicles
There are multiple ways this policy change may occur, both statutory and non-statutory. Some programs may need specific authorizing statute to allow funding to be used in an outcomes-based financing model, while some programs may require amendments to statute that remove explicit prohibitions. A statute may already allow for outcomes-based financing, but barriers may exist in implementing regulations. Increasing clarity or removing burdensome regulatory requirements can facilitate states' ability to use outcomes-based financing models. Depending on the funding stream, another avenue to enact this policy goal is through language in an appropriations bill. Annual appropriations bills provide opportunities to require new money to be used for positive outcomes. It is not intended, in this proposal, that savings must accrue to the federal government, making these financing models appropriate for federal block grants.

Time Horizon for Funds

In addition to an explicit statutory requirement to utilize outcomes-based financing for a portion of newly-appropriated dollars, we recommend allowing these funds to be used over a ten-year period (no year appropriations), with either an outcomes-based contract in place by the end of the second year or outcomes payments paid by the end of the second year. This time frame allows states flexibility to structure and implement projects or restructure contracting arrangements. The time horizon also allows investors to commit to multi-year investments and for interventions that produce intermediate-term outcomes.

The percentage required to be used on outcomes-based financing will depend on the federal funding stream and the total allocation to states in that funding stream. To make a switch to an outcomes-based funding model worthwhile, it is important to consider whether enough money would be available to invest and maintain the needed infrastructure, as well as make the outcomes payments attractive to investors. Consideration should also be given as to whether the minimum percent allowed under the requirement would be sufficient for small states that receive less funding than larger states.

Allowable Expenditures

To have the most impact and catalyze the most investment, the majority of funding should be earmarked for making outcome payments; however we recognize that moving towards outcomes-based financing requires start-up investment and ongoing expenditures in other areas to ensure the necessary infrastructure and systems are in place.[13] States have varying levels of capacity to effectively track outcomes, engage in outcomes-based contracting, initiate innovative financing models, and oversee implementation. Therefore, states would be allowed to spend some of these funds to create and maintain the supporting infrastructure needed to support a shift to outcomes-based funding.

We propose allowing for 1 percent of the funding (i.e., 1 percent of the mandatory requirement) earmarked for outcomes-based financing to be used for capacity building, infrastructure development, and ongoing management of data systems. These expenditures might include personnel, training and assistance, validating performance metrics, and data collection and integration. In order to use this funding for any of these purposes, states would need to seek approval from the administering agency, and outline the details and purposes of the redirected funds.

States may need to provide ongoing funds for personnel who manage data systems, and oversee and implement outcomes-based contracts or projects. Additional costs include training for agency staff and contracted providers on how to collect, analyze, validate, and report performance data. Additionally, states may contract with an independent third-party entity to validate whether the outcome metrics have been met. Funds may also be used to update contracts, building performance requirements directly into grants and contracts with service providers.

Additionally, funds may be used to increase capacity in service providers, to improve their data collection/data infrastructure. For contracted services, governments should ensure that providers collect and report common outcome metrics so officials can compare performance and aggregate the overall program effects.

OUTCOMES-BASED DATA INFRASTRUCTURE

Integrated data systems are fundamental to an outcomes-focused infrastructure, and require significant investment. Allowable funding under this proposal may include implementing or improving any or all of the following areas: data collection; storing, securing and processing of data; or sharing, curating and publishing of data. To optimize outcomes-based contracts, data systems should seek a multi-pronged, and longitudinal approach. Estimates from the State Longitudinal Data System (SLDS) provide insight into expected costs, with several states spending from $2 to $7+ million to build their data system. Maintenance costs also vary depending on the type of system and associated staff, and states have spent almost half a million to $2 million annually. Ideally, multiple funding streams could be blended or braided together to fund such a system.

https://m.nationalskillscoalition.org/resources/publications/file/Cost-of-State-Longitudinal-Data-Systems_web.pdf

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IDENTIFYING FEDERAL FUNDING AREAS BEST POSITIONED FOR OUTCOMES-BASED FUNDING

In order to strategically select which types of federal funding should be targeted for mandatory outcomes-based funding, we considered several factors including bipartisan appeal, potential for impact and catalytic investment, and potential for implementation success.

Bipartisan appeal

Achieving better outcomes while efficiently spending government money should be an attractive goal for policymakers. However, the details and methods of how to achieve these goals create different philosophies and approaches. Capitalizing on common ground and shared values around specific funding streams could help propel action toward broader adoption of outcomes-based funding. Some framing questions we used to analyze bipartisan appeal include:

- *Does the funding stream already have outcomes-based allowability provisions, potentially indicating support for using the funds in this way?*
- *Is there current support and momentum to reauthorize the funding stream and discussion around how expenditures or outcomes might be improved, or the funds increased or redirected?*

Impact and Catalytic Investment Potential

By investing in social and other human-centric strategies, the government provides critical services and supportive structures to improve the long-term economic impact for individuals and society. Investing in preventative interventions benefits public budgets, as the government realizes a greater return on investment for addressing needs earlier, and spending less on addressing interventions for long-entrenched issues later on. Examining funding streams for their potential impact to human well-being and better outcomes is a key focus of this policy proposal. An equally important focus is the potential to unlock additional capital to scale and accelerate this positive impact. To identify impactful and catalytic funding opportunities, we asked:

- *Do expenditures address areas of high societal need that could be deployed more efficiently and effectively to improve outcomes?*
- *What amount of funding will be driven toward ensuring outcomes?*
  What types of private investments would be catalyzed from this funding stream, and will impact investors be attracted and interested in investing?

Implementation Success

Certain funding streams and the types of services or interventions they fund naturally lend themselves well to compatibility with outcomes-based funding. Because the focus is measuring improved outcomes, policy areas with accepted indicators, measurement standards, and available data for measurement lend themselves well to this policy. In addition, funding streams that are already used for contracting to private providers, as opposed to paying for governmental operations, are a good fit for performance-based contracting. Other questions we considered were:

- *Have there been outcomes-based financing projects in this area or funding stream that have seen success or limitations that we can learn from?*
- *Are requirements and uses of these funds highly prescriptive, or is there more discretion on what states may spend funds on?*

Through this analysis, and in consultation with our advisory board, we have prioritized three areas that merit further consideration for this policy: **workforce and youth development; community, family, and child development; and criminal justice and substance abuse prevention**. While we focus on analyzing the merits of each policy area separately, we also recognize that outcomes and impact of these areas are integrated, and employing an outcomes-based framework across these systems would be mutually reinforcing, particularly with regards to integrated data systems.

WORKFORCE AND YOUTH DEVELOPMENT

In recent years there has been a strong effort to improve measures used to assess performance of the U.S. workforce development system and to increase the efficiency, effectiveness, and accountability of the various programs and services funded under workforce and youth development. With a strong evidence base for interventions, measurable outcomes, and a need for innovation, the government can capitalize on existing momentum behind workforce efforts and continue shifting spending towards outcomes-based contracting. Already, some outcomes-based programs have been successfully launched in this area across the U.S, providing a solid blueprint for implementation. With nearly 40 percent of American employers saying they cannot find people with the skills they need, even for entry level jobs, there is great potential for interventions to address this “skills gap” and develop the untapped talent to fill these positions.[14] Please see Table 01, which provides an analysis of outcomes-financing readiness factors in the workforce and youth development policy area.

TABLE 01 – WORKFORCE AND YOUTH DEVELOPMENT

BIPARTISAN APPEAL	IMPACT AND CATALYTIC INVESTMENT POTENTIAL	IMPLEMENTATION SUCCESS
• Two funding streams, WIOA and the Perkins Act, have allowability language for outcomes-based funding. • When **WIOA** was enacted in 2014 by bipartisan majorities, there was broad allowability for outcomes-based contracting. However, there has been limited uptake from states. The outcomes-based allowability found in WIOA signals an appetite to move towards evidence-based and outcomes-based contracting in the space of workforce development.[15] • Bipartisan amendments to the **Perkins Act** passed in 2018 allowed the U.S. Department of Education to fund PFS initiatives that will prepare students and adults to enter the workforce.[16] • The **TANF Extension Act** was a bipartisan piece of legislation that extended funding for TANF programs. Policymakers have shown interest in measuring employment outcomes in federal programs supporting low-income individuals. Because TANF provides many of these services, it may be well situated to move towards more outcomes-based models.[17]	• Mandatory outcomes-based financing within any of these funding streams could help train low-wage, low-skilled workers to move into high-demand occupations. Funds can help scale the most effective programs, making these services more efficient and impactful. • **WIOA** funds an array of workforce development services. In Program Year (PY) 2020, almost $3.8 billion was allocated in the U.S.[18] • The **Perkins Act** allocates $1.2 billion dollars annually for states to fund secondary and postsecondary training, or career and technical education (CTE).[19] • In FY 2018 **TANF** allocated $3.3 billion of its total funding towards work, education, and training and $2.6 billion to Pre-K/ Headstart.[20] • If 10% of each of these funding streams was required to be used for outcomes-based payments it would create almost $379 million annually in outcome payments available from **WIOA** for workforce development, $120 million from **The Perkins Act** for CTE related programs, and a combined $590 million from **TANF** for workforce and youth development.	• A significant portion of funding in WIOA, TANF, and The Perkins Act is paid-out to non-governmental service providers in the form of grants and contracts. It makes sense for the government to transition towards outcomes-based contracts with grants and contracts to better ensure the efficiency and impact of public funding. • Workforce development lends itself well to outcomes-based contracting because of the easily measured performance indicators associated with this field: training completion, employment, job placement, job tenure, yearly earnings and annual increases, and benefits gained by employment (e.g., healthcare, retirement, paid time off, etc.). Data around these performance indicators can be easily tracked and assessed. • Tracking performance indicators will help to better illustrate the impact of various interventions, helping to scale the best, while increasing efficiency and impact of federal funding dollars.

COMMUNITY, FAMILY, AND CHILD DEVELOPMENT

High-quality early childhood experiences are a cornerstone for lifelong learning, laying a foundation for success. Brain development begins before birth and is most active in the first few years of a child's life. Negative childhood experiences, such as toxic stress and neglect affect early brain development and become more difficult and costly to overcome as time progresses. The U.S. has significant work to do in equitably increasing outcomes for mothers and children. For instance, between 2000 and 2015, the rate of maternal deaths increased from 17.5 per 100,000 live births to 26.4 per 100,000 live births, making the U.S. comparable to middle-income countries.[21]

When working to improve outcomes for young children, the government must also think about improving outcomes for the adults in their lives, as well as the communities in which they live. When communities and neighborhoods support adults, outcomes for the children around those adults improve.[22] These issues are complex and require significant investment, presenting an area where public-private partnerships can be utilized, as well as outcomes-based financing. The government can see significant return on investment, both monetarily by investing in preventative services instead of more costly treatment or intervention services later, and socially, through a more healthy and productive society resulting from increased opportunities and equitable interventions for disadvantaged populations.[23] Please see Table 02, which provides an analysis of outcomes-financing readiness factors in the community, family and child development policy area.

TABLE 02 – COMMUNITY, FAMILY, AND CHILD DEVELOPMENT

BIPARTISAN APPEAL	IMPACT AND CATALYTIC INVESTMENT POTENTIAL	IMPLEMENTATION SUCCESS
• The Covid-19 pandemic has shed light on the fragile state in which many families exist. Policymakers have recognized the need, and provided additional support to businesses, communities, and families. In particular, actors across the political spectrum have identified the impact of child care on the economy, and shown bipartisan support for additional funding for child care.[24] • In March 2020, Congress allocated an additional $3.5 billion to the Child Care Development Block Grant **(CCDBG)** under the CARES Act, identifying this as an area critical to weathering and recovering from the effects of Covid-19.[25] • The Maternal, Infant, and Early Childhood Home Visiting Program **(MIECHV)** has enjoyed wide bipartisan support and was awarded over $340 million in FY 2020 for evidence-based home visiting services.[26] The Bipartisan Budget Act of 2018 provided new authority for "Pay for Outcomes" projects with MIECHV funds. We stand at an opportune time to capitalize on the success and support for these types of interventions, and to explore additional evidence-based solutions that support children and families in other federal funding streams. • While maternal and child development have seen some promising bipartisan support, there may be less consensus around large funding streams that support communities and other social services. However, if additional federal money is directed toward communities, there is an opportunity to improve transparency and accountability for outcomes in these funding streams.	• A strong case exists for investing early in child development, both to improve impact and outcomes on the individual, as well as society. Investing in children's caregivers and communities strengthens the investment by producing reinforcing and aligned outcomes. • The **CCDBG** received $5.8 billion in discretionary funding from the federal government in FY 2020 to continue supporting child care services and providing subsidies to assist low-income families in obtaining childcare.[27] • The Title V Maternal and Childhood Health Block Grant (**MCHBG**) received over $551 million in FY 2020 in federal allocation for programs and services associated with maternal and child health.[28] • The Community Development Block Grant (**CDBG**) provides grants to state and local governments to support adequate housing, a suitable living environment, and expanding economic opportunities, primarily for low and moderate-income persons. CDBG received $3.4 billion in FY 2020.[29] • The Social Service Block Grant (**SSBG**) supports a wide variety of social services that help promote self sufficiency, protect children and adults from neglect, and help individuals who are unable to take care of themselves to stay in their homes.SSBG was funded at almost $1.6 billion for FY 2019.[30] • If a small percentage of each of these funding streams was required to be used for outcomes-based financing, it would inject hundreds of millions of dollars into a market for outcomes-based payments for interventions and services associated with community, family, and child development.	• Because developmental learning is cumulative, with each stage building on the next, outcomes in this area have the potential to also be cumulative, producing significant returns if both investment and ongoing supports are offered and sustained. • Existing well-defined maternal and early outcomes for children, such as birth outcomes, have shown to be positively impacted by interventions in this area. For instance, the evidence-based program Nurse Family Partnership shows positive outcomes in indicators such as reducing child abuse and neglect, ER visits, language delays, behavioral/intellectual problems, and preterm delivery. The mothers also experience increased employment and fewer arrests. • Because the groundwork has been set for the MIECHV program with recent Pay for Outcomes allowability provisions, this should be a funding stream that could convert to a mandatory provision if funding is increased. The MIECHV program also already has accepted performance measures and state grantees have experience with contracting. • Given that the funding streams identified here are mostly block grants, they lend themselves well to allowing states to implement different outcomes-based models within a federal mandatory structure. Because block grants are non-competitive formula grants, eligible entities must submit annual applications demonstrating compliance to any statutory or regulatory rules in order to receive the funding. These funding streams give states broader flexibility to focus on outcomes and customize interventions for their communities. • To the extent that these funding streams are already being used to contract out services, they can transition those dollars to performance-based contracting.

CRIMINAL JUSTICE AND SUBSTANCE ABUSE PREVENTION

Criminal justice reform has been thrust to the forefront of the national conversation, with the growing social justice movement and increased focus on policing. Cost-effective solutions in criminal justice are critical given the significant societal and financial challenges associated with incarceration. Taking into account the direct costs of incarceration as well as indirect costs to agencies outside the justice system and the families and communities of incarcerated persons, studies estimate a national burden of almost $1 trillion dollars annually.[31] Criminal justice is a prime candidate for outcomes-based financing models, given its data availability and flexible funding streams. Across the country, municipalities and states are already implementing PFS programs targeting a variety of issues including recidivism, unemployment, and health resources for people returning from jail or prison.[32]

Mental health and substance abuse are also good candidates for increased outcomes-based financing. In these fields, there are some good indicators to help measure impact, and health care systems collect data that may be available to measure this impact. Outcomes-based financing has the potential for generating savings to the health care system, as there are great social and financial costs with these issues. For instance, The Council of Economic Advisers estimates that the opioid crisis alone cost more than $2.5 trillion from 2015 to 2018.[33] There are opportunities to create a coordinated, outcomes-focused funding approach to help families struggling with addiction or mental health challenges obtain the healthcare and other critical supports they need.[34] Please see Table 03, which provides an analysis of outcomes-financing readiness factors in the criminal justice and substance abuse prevention policy area.

TABLE 03 – CRIMINAL JUSTICE AND SUBSTANCE ABUSE PREVENTION

BIPARTISAN APPEAL	IMPACT AND CATALYTIC INVESTMENT POTENTIAL	IMPLEMENTATION SUCCESS
• **SAMHSA** (Substance Abuse and Mental Health Services) is an agency within the Department of Health and Human Services. It uses a variety of evidence-based programs which focus on prevention and limiting impact of drug abuse in communities. • **The Comprehensive Addiction & Recovery ACT** (CARA) was a bipartisan law that increased resources for fighting the opioid abuse epidemic using evidence-based methods.[35] • The **Second Chance Act** authorizes federal funding for state and federal reentry programs. It was signed into law in 2008 and reauthorized in 2018 as the **First Step Act** with strong support from both parties.[36]	• In 2017, an estimated 20 million Americans needed treatment for a serious substance abuse problem. 19% of American adults met the medical standard for a mental, behavioral, or emotional disorder that substantially interfered with major life activities.[37] • $5.5 billion in **SAMHSA** funding was distributed in 2020. The majority of distributions take the form of block grants, with some discretionary funding. $1.9 billion is specifically allocated to addressing the opioid crisis.[38] Two million people receive care in facilities that receive public funding from this formula grant each year. • Since 2009, the **Second Chance Act** has provided over 900 grants to programs across 49 states, impacting more than 164,000 lives.[39] The **First Step Act**'s budget calls for $75 million per year, which has received criticism for being insufficient.[40] • In its 2021 budget report, HHS reports providing $1.1 billion in targeted funding for mental health. They note that "The Budget prioritizes evidence-based programs, which show the greatest likelihood of achieving positive client outcomes.[41]	• These areas track relevant data and have innovative and impactful programs across the country to use as models for creating and expanding outcomes-based programs. • Examples of key performance indicators:**Substance abuse/mental health:** prevalence of drug use, hospitalization/death rates, sucide ideation/attempt/death rates, health practitioner training.[42] • **Criminal justice:** recidivism rates, substance use disorder treatment, job placement rates, housing placement rates.[43] • **The Substance Abuse Prevention & Treatment Block Grant,** the largest federal grant addressing substance use, provides one-third of all public funds spent for this purpose. As a flexible formula grant, it can be used for a variety of purposes, including providing services for hard-to reach populations and other critical services.[44] • While state and local budgets largely fund criminal justice, federal grants can be effective in providing a means to communicate priorities and expose recurring problems.[45] As of 2018, over half of the active PFS programs operating in the United States were related to criminal justice, targeting outcomes such as decreases in jail-bed days and time periods without rearrests.[46]

UNLOCKING CATALYTIC CAPITAL

By requiring states to use a portion of their funding to pay for outcomes, the federal government can catalyze additional private sector investments, primarily through increasing the cash flow available to multiple types of projects, providers, investors, and entrepreneurs. An ongoing stream of government outcome payments will catalyze additional private investment across asset classes, and make outcomes payments themselves "catalytic." Mandatory use of outcomes-based funding will help establish market depth, creating more data and information around effective interventions and outcomes. Such market depth should ultimately promote market efficiency and establish positive market-making reinforcement.

INCREASED CASH FLOWS

By requiring states to use a portion of their federal funding directly for outcomes-based funding, impact investments will benefit from increased cash flow. While this could benefit the impact investing market broadly (depending on eligibility for outcome payments), it will also facilitate a sustained market to fund additional outcomes-based financing models, including PFS and pay for performance projects.

Increased cash flows from outcomes payers could also render more confidence in the economics of the outcomes market. Catalytic funders seeking to recoup their investment with or without a return on capital will have greater confidence of repayment. Increased cash flows through outcomes payments can reduce the risk across the capital stack, improving the risk profile and potential returns for not only catalytic investors, but other investors as well, improving liquidity in the overall outcomes-based funding market.

As more outcomes-based projects are funded and able to show results, governments and investors can feel more confident in directly investing in these interventions. Improving Information sharing and data collection will also ultimately drive better and more efficient capital towards interventions that create desired social and economic outcomes. Because this policy proposal allows for funding infrastructure, states can contribute to the long-term market creation through improved data collection, integration, and analysis.

CONCLUSION

By requiring federal money to pay for outcomes, the government can attract private investment to support important social outcomes and economic goals. As discussed in this paper, targeting a small percentage of additional federal funding could unlock hundreds of millions in additional funds available for outcome payments, potentially unlocking a small portion of the trillions of assets under management in the United States. These additional dollars could provide immense capital for social impact, and bring more actors and dollars into the impact investing market.

Several PFS projects have been launched surrounding maternal and childhood health, workforce development, and recidivism, pointing to an appetite to invest in these kinds of programs from private investors. With the growing calls for government-supported activities to combat climate change and its effects, outcomes-based contracting should also be considered to deliver environmental interventions.

State and local government leadership and support is also key to successful implementation of this policy, as they must actively engage with service providers and the greater community, identifying programs and services that are good candidates for outcomes-based financing models and supporting the transition to paying for outcomes. Ultimately, outcomes-based dollars, invested wisely to produce the best outcomes for individuals and communities, produce a more cost-effective governmental and long-term economic strategy.

APPENDIX A

Examples of Outcomes-based Funding Allowability in Federal Acts

Federal Funding Source	Outcomes-based Funding Provisions	Oversight Agency
Maternal, Infant, and Early Childhood Home Visiting Program (MIECHV)	Allows states to enter into performance-based contracts for home visiting and use up to 25% of their MIECHV dollars for success/outcome payments	HHS
Social Impact Partnerships to Pay for Results Act (SIPPRA)	Allows for up to $100 million in funding for PFS projects	Treasury
Carl D. Perkins Act	Up to $1.6 million authorized as part of Innovation Grant Program that allows PFS; Also allows states to use funds allocated to Basic State Grant Program for creation, implementation, and support of PFS initiatives	Education
ESSA	Title I, Part D Title IV, Part A Allows States and Local Education Agencies to invest funds in PFS projects	Education
Hurricane Sandy Community Development Block Grant Disaster Recovery Grants	Permitted recipient states to use up to 15 percent of their federal funds in PFS arrangements	HUD
WIOA	Allows up to 15% of WIOA funds for Pay for Performance (PFP), authorizes states to invest their own workforce development funds in PFP, authorizes local workforce investment boards to invest up to 10% of their WIOA funds in PFP, and authorized state and local workforce investment boards to award PFP contracts to intermediaries, community-based orgs, and community colleges.	Labor
Second Chance Act	Awards competitive PFS implementation grants to localities through the Bureau of Justice Assistance	Justice
VA Center for Innovation	Created the Veterans Employment Pay for Success Program	Veterans Affairs
Social Innovation Fund	FY 14–FY 16 authorized to invest up to 20% in PFS efforts	CNCS

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UNLOCKING CATALYTIC CAPITAL:
U.S. DOMESTIC INVESTMENT FUND (USDIF)

Existing federal efforts to direct public and private resources to small businesses and low-income communities face limitations in meeting the needs of underserved communities and populations. A new U.S. Domestic Investment Fund can address these limitations and promote greater and more resilient inclusive economic growth. The USDIF would be dedicated solely to providing public catalytic capital to enable scaling of private investment to address domestic social and economic development needs and national economic priorities.

OVERVIEW

The Covid-19 pandemic has highlighted the vulnerability of the small business sectors as well as structural inequities that disproportionately impact women and communities of color with respect to access of capital, good paying jobs, healthcare, and housing. A robust recovery effort that addresses the short- and long-term resiliency of our economy and communities will require investment from both public and private sectors. While current examples of the federal government using public funds to catalyze additional private sector investments exist, these examples have not adequately addressed system-wide vulnerabilities and inequities that have been highlighted through the Covid-19 pandemic. A broader and more flexible strategy with respect to the financing tools employed and the communities, organizations and populations that are served will better leverage public resources to catalyze private investment in support of equitable job creation and a resilient economic and social infrastructure, including supporting strategic industries.

Within an economic development framework that is aligned with national economic priorities, the need for capital investment to address these inequities at scale will require the two largest sources of liquidity: public resources and traditional capital markets. Public-private partnerships that enlist public resources to leverage private capital investment in public good offer a potentially promising strategy, with examples of public-private partnership models that already exist to address social, environmental, and economic needs of communities. Examples include state infrastructure banks, Small Business Administration (SBA) loans, Small Business Investment Companies (SBICs), the Community Development Financial Institutions (CDFI) Fund, the Development Finance Corporation (DFC), and the former State Small Business Credit Initiative (SSBCI). In addition, federal resources have been instrumental in supporting globally recognized societal and technological advances through public-private partnerships. For example, Google, the most used search engine in the world, is the product of two Stanford graduate students' academic research in 1996.[1] The project, first dubbed BackRub, began testing with partial funds from the National Science Foundation (NSF). Today, the company is worth nearly $1 trillion.[2]

CATALYTIC CAPITAL
Investment capital that is patient, flexible, risk-tolerant, and sometimes concessionary. Catalytic capital enables either or both third-party traditional capital investment or follow-on investment that would not otherwise be possible.

In these examples, it has often been the government's allocation of “catalytic capital” that made the public-private partnership transformative. While the SBA and CDFI Fund provide capital to support small businesses and CDFIs, there are limitations with respect to the needs and the communities served and the types of financial products that they are able to offer.[3] These limitations highlight the need for an organization that supplements these existing federal efforts, catalyzes private investment with a more diverse set of financial tools, and targets underserved populations and communities. This proposal explores the merits of establishing a U.S. Domestic Investment Fund (USDIF) to fill these gaps through an inclusive development mission aligned with national economic policy priorities; a focus on low income communities, women, and people of color; greater flexibility in the financial tools it can provide; a broader range of organizations and projects it can support; and an explicit purpose to provide catalytic capital intended to leverage additional private capital to fulfil its mission.

Driving Robust COVID-19 Recovery

The current crisis showcases a deep and growing need for catalytic capital to drive equitable economic recovery, growth, and resiliency. While the CARES Act provided a foundation for crisis response, we believe the proposed long-term solution of the creation of a U.S. Domestic Investment Fund, which leverages private resources alongside public dollars, can create transformative change for a more inclusive, economically resilient and secure American economy.

EXISTING FEDERAL AGENCIES

SBA and Small Business Investment Companies
The SBA is primarily a loan guarantee program for private sector loans to small businesses that are a for-profit business, do business in the U.S., have invested equity and have exhausted other conventional avenues for capital, and are classified as small according to the industry guidelines established by the SBA. The SBA also administers and provides loan capital (debentures and discount debentures) to Small Business Investment Companies (SBICs). An SBIC is a privately owned and managed investment fund that is licensed and regulated by the SBA. An SBIC uses privately raised capital and SBA guaranteed loans to invest debt and equity into eligible small businesses. For every dollar of private capital raised by an SBIC, the SBA will provide up to $2 of capital with a cap of $175 million. An SBIC is required to adhere to investment criteria regarding the business that qualifies for investment, and is allowed to make equity, equity-like, and debt investments. An SBIC may not invest in project financing and may not invest more than 10 percent in a single business.

Program size: For the fiscal year October 1, 2017 to September 30, 2018, the SBIC program reported 1,151 financings, for a total of $5.5 billion (65 percent debt, 20 percent equity and 16 percent debt with equity features).

Impact to LMI Communities: Only 27 percent of the capital was provided in Low and Moderate Income (LMI) areas.[4]

Demographic Information: in 2019 only 3 percent of 7(a) loans, the SBA’s primary lending program, went to Black Americans, while 49 percent went to White Americans. SBA loans also disproportionately benefit men, 72 percent of 7(a) loans went to male-owned businesses while 14 percent went to businesses where women had more than 50 percent ownership, and 14 percent went to businesses where women represented 50 percent ownership or less.[5]

CDFI Fund

The CDFI Fund provides capital, capacity building and training to CDFIs through a number of programs: the Bank Enterprise Award, Capital Magnet Fund, CDFI Bond Guarantee Program, CDFI program, Native Initiatives and the New Markets Tax Credit program. Through these programs, the CDFI Fund provides grants, debt from the Federal Financing Bank, and financial assistance and technical assistance awards to local CDFIs nationwide.[6] In FY 2017, nearly 75 percent of local CDFI lending portfolio was targeted to low-income families, high poverty communities and underserved populations, exceeding the statutory requirement of 60 percent. In 2017, the largest number of loans by banks and credit unions was for consumer lending, while loan funds and venture funds focused on business and microenterprise loans. Banks, credit union and loan funds received the majority of CDFI capital in the form of loans and the majority of CDFI capital for venture firms was in the form of equity. Eighty percent of awardee loans went to Metropolitan Statistical Areas (MSAs) while 20 percent were in non-MSAs.[7]

DFC

The Development Finance Corporation, formerly the Overseas Private Investment Corporation (OPIC), was established in 2018 by the passage of the Better Utilization of Investments Leading to Development (BUILD) Act.[8] DFC is an international development bank that provides capital across sectors in developing countries, as well as investments in small business and women entrepreneurs in developing countries. The DFC provides equity and support to investment funds and directly into projects, direct loans and guarantees, political risk insurance, feasibility and technical assistance support.[9] In May of 2020, an Executive Order authorized the DFC, through the Defense Production Act (DPA), to reshore domestic production of resources needed to combat the Covid-19 pandemic and to strengthen domestic supply chains.[10]

MEETING A CRITICAL NEED

While these programs fill certain needs, they are not specifically addressing a critical need to foster an inclusive, resilient recovery and long term equitable growth. The SBA programs provide capital solely to qualifying small business or investment companies that invest in qualifying for-profit small business, but there are no criteria within the definition of “qualifying” that address investments in LMI areas, or businesses owned by women or people of color. Additionally, the SBA is based on a traditional and inflexible banking system that is ill-equipped to serve the unbanked due to its heavy reliance on collateral and good personal credit, qualifiers that are not always easily achieved for SMEs.[11] The CDFI Fund does have a focus on LMI areas, but provides capital solely to regulated CDFIs. Both the SBA and CDFI Fund predominantly provide capital in the form of debt, either through loan guarantees or guaranteed low interest loans, with only a small portion of CDFI capital provided as equity. The DFC has a development mission internationally and provides capital in a variety of instruments (equity, debt, guarantees) to a broader range of investment vehicles, but its domestic authorizations apply only to address the supply chain disruptions due to the Covid-19 pandemic and are subject to a two-year time limit.[12]

PROPOSED POLICY

We propose the creation of a U.S. Domestic Investment Fund (USDIF) dedicated solely to providing public catalytic capital to enable scaling of private investment to address domestic social and economic development needs and priorities.

The mission of the USDIF would be to provide domestic catalytic capital to facilitate private investment in an inclusive economic development framework and aligned with national economic policy priorities. Importantly, the USDIF would not replicate the activities of the private market but would provide capital not otherwise available. USDIF capital would incentivize private investment that otherwise would not have been possible without public catalytic capital.

The USDIF Fills Critical Gaps

The USDIF fills critical gaps that are not addressed by other other federal organizations including the Small Business Administration (SBA), the Community Development Financial Institutions (CDFI) Fund, and The U.S. International Development Finance Corporation (DFC).

- An explicit domestic development mission, aligned with national economic policy priorities, with requirements for inclusive and equitable asset allocation with respect to geography, need, and populations.
- Provision of catalytic capital specifically intended to leverage additional private capital through a broader range of financial instruments to provide flexibility to meet the needs of communities.
- A sufficient business line for grant programs, which are currently unavailable to traditionally underserved businesses and entrepreneurs.
    - While the SBA and CDFI Fund both have grant programs, they allocate only a small percentage of their budget to these programs: In FY 2019 the CDFI Fund spent about 3.2% of its budget on technical assistance (TA) grants, and the SBA spent about 3.3% of its budget on EIDL grants.[13]
- Greater flexibility to provide capital to project financing and other projects and fulfil future project financing gaps.
- Broader eligibility of authorized investment instruments and organizations (for-profit and nonprofit). The USDIF would provide capital with a broader development mission to include, impact investment funds, intermediary organizations, and local government jurisdictions seeking to raise private capital for local investment.
    - The SBA and CDFI primarily seek to address the needs of qualifying small business and local CDFIs.
- An investment strategy that would become sustainable over time.

Comparison of SBA, CDFI Fund and the Proposed USDIF

	SBA	CDFI Fund	Proposed USDIF
Development Mission	none	none	Inclusive economic development mission aligned with national economic policy priorities
Range of Products and Tools	Small business loan guarantees, loans to SBICs, small grant program	Grants, debt, financial and technical assistance, small proportion as equity	Equity and equity-like investments, subordinated debt, longer-term financial instruments, recoverable and non-recoverable grants, limited and partial guarantees and other insurance products
Range of eligible organizations and projects	For profit small businesses	CDFIs	Intermediary organizations, local investment funds and Special Purpose vehicles that invest in low-income communities and communities of color; Local government or community organizations to support local public-private partnerships.
Focus on Underserved Populations and Communities	3% of 7(a) loans went to black americans; 14% to more than 50% women owned and 14% to less than 50% women owned; 27% of SBIC capital went to LMI communities.	75% of local CDFI lending portfolios were targeted to LMI communities	Explicit focus on LMI communities, communities and people of color and women.
Distribution channels	Traditional banking system	Local CDFIs	Direct to recipients

Investment Framework

Operationalizing the USDIF's mission requires an investment framework that clearly identifies which investments would qualify as catalytic capital and which projects and organizations would be eligible to apply to the USDIF for funding. In blended finance transactions or capital structures, consideration and preference will be given to first-loss investments, subordination, and guarantees. These could include equity and equity-like investments, subordinated debt, longer-term financial instruments, recoverable and non-recoverable grants, as well as limited and partial guarantees and other insurance products designed to facilitate private sector investment into impact investment. To address immediate emergency and crisis needs, the USDIF could be authorized to expedite direct capital investment into intermediary organizations, providing rapid liquidity relief to organizations that serve the most vulnerable segments of our society, including low and middle income communities and the small business sector.

The investment framework should also provide guidance on which projects and organizations would be eligible for USDIF funding. The USDIF would not invest directly in companies, entrepreneurs, or nonprofit organizations, and the investments would be subject to size limitations.[14] Qualifying organizations and projects could include:

- Intermediary organizations and local investment funds that invest in low-income communities and communities of color, and/or small and medium sized (SME) companies;
- Special purpose vehicles, and vehicles that aggregate and pool capital for investment that direct capital in low income communities and/or invest in inclusive and equitable economic growth;
- Local government or community organizations to support local public-private partnerships that leverage additional private capital for specific project financing that seeks to improve social and economic outcomes.

INVESTMENT EXAMPLE

One example of an investment from USDIF might be a first loss capital position in a local impact debt or venture fund (a loan or venture fund with a focus on improving social and economic outcomes for historically marginalized populations).

The local fund has identified underinvested opportunities in communities of color that have been adversely impacted by the pandemic, especially with respect to small businesses owned by women and people of color. The investment could be in the form of a grant, equity, or subordinated debt. Having secured a first loss position from USDIF, or increasing its existing first loss capital, the local fund is able to raise additional private capital to invest into communities of color.

The application for investment would include the necessary requirements for data capacity and impact measurement. The application would include all the due diligence requirements needed to assess whether the investment would be repaid (with or without a return) within the required timeframe.

Implementation Support

Often local communities and organizations lack the technical capacity to explore the feasibility or implement economic development projects. The USDIF should carve out capital in the form of technical assistance grants alongside investments to support and build capacity in communities and organizations throughout the implementation process. In addition, to ensure the broadest potential impact, we recommend that both nonprofit and for-profit entities be eligible for investment, as long as the mission of the organization or its investments align with the inclusive economic development mission of the USDIF.

Qualifying Criteria

Applications for capital from the USDIF would include the following requirements:

- Demonstration that the requested investment aligns with the current development priorities of the USDIF and that the investment can be expected to result in progress towards a domestic development goal and improved social outcomes;
- Rigorous impact measurement: The USDIF could promote the standardization of measurement by selecting which measurement frameworks and performance indicators would be acceptable;
- Ability to comply with data and reporting requirements: Data collection and analysis capacity and details regarding reporting/sharing;
- Financial due-diligence: Data driven analysis and evidence that demonstrates a likelihood of return of principal (and interest) when applicable.

While it would be attractive to require a minimum leverage threshold to be eligible for funding (i.e., every dollar of USDIF investment requested must leverage an additional $3–5 in private investment), this requirement would be difficult to verify and monitor and would be susceptible to “gaming.” A leverage threshold might also incentivise transactions that achieve leverage but have less social impact.

Asset Allocation

The USDIF would be required to allocate assets in an equitable manner, consistent with other federal programs. For example, several federal formula funding statutes use the percent of poverty as a means of allocating funding among the states. There are also external databases, such as the Opportunity Atlas,[15] that could be used as part of an asset allocation formula to ensure equitable access to capital with respect to geography and need. In addition, a set aside for minimum asset allocation for investments that specifically benefit women and people of color could be considered.

Governance and Oversight

To ensure good governance and coordination with other federal agencies and spending, the governance structure for the USDIF would include:

- An investment committee (public officials and private sector investment expertise) that authorizes specific investments and manages the assets of the USDIF to optimize social and economic impact as well as financial sustainability. The committee would be tasked with aligning the USDIF to national economic policy priorities, using data driven decision making to:
    - Identify areas of need and opportunity
    - Measure the amount of private capital catalyzed
    - Measure job creation, equitable access and social impact
    - Estimate return on investments and for the Fund overall
- An Interagency Council to coordinate the activities of the USDIF with other agencies.The USDIF would work alongside existing government programs including the Small Business Administration (SBA) and the U.S. Department of Housing and Urban Development (HUD) to supplement activities by attracting additional private co-investment to support positive social and economic outcomes, and:
- A Community Advisory committee, consisting of a diverse group of community leaders, to identify the areas of greatest need and to ensure coordination with local efforts. This committee would also set priorities in terms of issue areas for projects and other financing that is issue area specific (early childhood, criminal justice, homelessness, etc.)
- Congressional Oversight: Congress could be responsible for nominating some of the individuals to the Community Advisory committee.

An annual audit by the appropriate agency Inspector General should be required to ensure the investments and activities of the USDIF align with the statute and intent. The USDIF investments could be evaluated according to indicators that are linked to economic development, inclusion, reduction of the wealth gap, and poverty reduction. These could be further developed through rulemaking. The USDIF would be required to report data regarding the impact and financial return on its investments. This will also contribute to building better data collection and transparency in the impact investing marketplace.

POTENTIAL TO UNLOCK CATALYTIC CAPITAL

The mission of the USDIF is to provide catalytic capital within an inclusive development framework aligned with national economic policy priorities. In addition, it could incentivize additional subordinated investments through the provision of first loss capital and/or insurance and partial guarantees. While it is difficult to precisely estimate the amount of private investment that every dollar of catalytic capital would incentivize, we can look to examples of existing public dollars that have a track record of catalyzing private investment.

EXAMPLES OF PUBLIC DOLLARS CATALYZING PRIVATE INVESTMENT

$1 : $3–4

Estimated $1 of DFC investment catalyzed $3–$4 of private sector investment[16]

$1 : $8

$1 of State Small Business Credit Initiative (SSBCI) capital leveraged $8 of private sector investment[17] (see SSBCI case study, page 9)

$1 : $4

A multiple of $4.1 of private sector capital for every $1 of development funding offered to development and philanthropic funders through blended finance[18]

Since an investment goal of the USDIF would be to become sustainable over time through the recycling of loan repayments and gains, the ability of the USDIF to provide catalytic capital would, theoretically, be ongoing. If managed such that the Fund grows over time, the amount of catalytic capital that would be unlocked would also grow, helping to achieve scale. Further, one of the barriers often cited regarding the availability and access to catalytic capital has been inefficiencies with respect to information and knowledge regarding the types of catalytic capital that are available and who is providing capital.[19] Information gathered through the activities of the Fund and made public through a transparent reporting process would enhance the growth of, and access to, not only public catalytic capital, but capital provided by foundations and other entities.

POLICY IMPLEMENTATION

Congress has historically established entities similar to the USDIF, such as the DFC, CDFI Loan Fund, and SSBCI. Given the impact of the Covid-19 pandemic on the small business sector, nonprofit sector, low income communities, and communities of color, the timing could be right to gain momentum for public funding that incentivizes additional private sector capital investment. The existing health, economic, and social crises have positioned the case for strong public support of economic stabilization, growth, and resiliency. While public-private partnerships resonate with members of both parties, concerns regarding “corporate welfare” or increasing social spending (a “hand out”) should be addressed. Mitigating these concerns are the economic development focus (with an inclusive lens), the combination of public and private dollars, and the intent to achieve sustainability through a revolving asset mix (repayment will fund new investments). Additionally, research surrounding the “shutting out” of businesses owned by people of color from accessing financing may mitigate concerns by emphasizing how the USDIF would play a role in leveling accessibility to financing. Further, in an effort to achieve economic resiliency in growth throughout the U.S. we argue that the USDIF would support agendas related to national economic security. The magnitude of need, and the directive to invest in low income communities and communities of color may also mitigate arguments that the government should fund these needs alone, rather than employing a public-private partnership model.[20]

Authorizing a new agency, however, might be difficult. One option is to house the USDIF within an existing agency, such as the Department of the Treasury or the Commerce Department. The State Small Business Credit Initiative (SSBCI) is housed at Treasury, however funding is allocated to states and not directly to projects. If the USDIF were placed in the Commerce Department, it might make sense to house it within the Department's Economic Development Agency. While it might be preferable to establish the USDIF as an independent agency, one possibility is to establish the USDIF initially as a task force within one of these agencies as a recovery tool, and redirect unspent CARES Act funding or new recovery funding to support its initial activities and investments. This would allow time to get the USDIF off the ground quickly and the Task Force could develop the infrastructure needed to sustain an ongoing domestic development investment fund. However, identifying upcoming reauthorizations might be the most expedient strategy for implementation.

One rationale for creating a separate agency, rather than expanding the mandate of existing organizations, is that it is often difficult to change behavior of existing bureaucracies and cultures towards a new mission.

The USDIF will work alongside existing programs such as the SBA and CDFI Fund, to provide additional avenues of capital for historically marginalized individuals, as well as the systems that support them. If consolidation were an option, we would argue that the SBA and CDFI programs could come under the umbrella of the USDIF; however, since that is likely not feasible (especially with respect to the SBA), we recommend a coordination function to collaborate with the activities of the SBA and CDFI Fund, as outlined previously. Another option to consider is to consolidate the CDFI Fund under the USDIF within the Department of Treasury.

Potential Funding Opportunities

Initial funding for the USDIF could include a combination of recovery funding (both additional or unspent), new appropriation, reallocation of existing appropriation, and/or issuance of a 30-year U.S. Treasury Social and Economic Resiliency Bond.

> For instance, data from the Balances of Budget Authority Budget for FY 2020 shows that over $1 trillion in unspent, unobligated balances were carried over from 2019 to 2020 by federal agencies, supporting the idea of reallocating existing funding. Additionally, at the end of 2020 the Department of Commerce held $10,188 million in obligated unexpended funds and $8,519 million in unobligated unexpended funds, and the Department of Treasury held $60,730 million in obligated unexpended funds and $302,529 million in unobligated unexpended funds.[21]

To the extent that obligated balances are not used by the end of their available term, they might be a source of funding along with the unobligated balance. The USDIF, as an ongoing Fund should be authorized for at least 15–20 years, in order to pursue its long-term mission and achieve sustainability. Because capital would be predominantly in the form of investment, sustainability of the USDIF could be achieved through a combination of a smaller ongoing appropriation and return of principal and interest.

CASE STUDIES

The following are examples of organizations that have similar missions and functions as the proposed USDIF.

01

Bank of North Dakota

The Bank of North Dakota (BND) was established in 1919 with $2 million in capital from the sale of state bonds, and an operating policy stating that the Bank shall be "helpful to and to assist in the development of state and national banks and other financial institutions and public corporations within the state and not, in any manner, to destroy or to be harmful to existing financial institutions."[22] At the end of 2019, BND had $7.2 billion in total assets and $169 million in annual income.[23] BND offers loans, bank services, and student loans and refinancing options. Over the last ten years, the amount of lending per capita by small community banks (those under $1 billion in assets) in North Dakota has averaged about $12,000, compared to $9,000 in South Dakota and $3,000 nationally; additionally, North Dakota community banks averaged 49 percent more lending for small businesses over the last decade than those in South Dakota and 434 percent more than the national average.[24]

02

Business Development Bank of Canada (BDC)[25] (Fiscal Year 2019 in Review)

BDC is Canada's bank established to support entrepreneurs, created in 1944.[26] BDC offers financing through business loans, venture capital, growth & transition capital, growth equity, and intellectual property-backed financing, as well as advisory services. BDC works with 62,000 entrepreneurs across Canada, has committed $36.5 billion exclusively to business owners, and has a 94 percent satisfaction rate. BDC has total assets of $30.7 billion. BDC's primary public policy mandate is to support Canadian entrepreneurship, giving particular consideration to the needs of SMEs. A research report from 2019 conducted by Statistics Canada's Economic Analysis Division in collaboration with BDC compared the performance of SMEs that received financing and advisory services from BDC with that of similar businesses that were not BDC clients, from 2008–2015. Results showed that after one year, businesses who were also clients of BDC reported the following in comparison to non-BDC clients:[27]

Higher revenue growth

businesses who received both financing and advisory services were 9.3 percentage points higher, only financing was 8.0 percentage points higher, only advisory services was 7.7 percentage points higher;

Higher employment growth

employment growth of client firms was 4.3 percentage points higher than that of non-clients one year after clients received both BDC financing and advisory services;, and

Greater survival rates

advisory services only was 11 percentage points, financing and advisory services was 8 percentage points higher, only financing was 7 percentage points higher.

03

FMO - Dutch Entrepreneurial Bank[28]

FMO is the Dutch Entrepreneurial Bank, founded in 1970. FMO offers loans and syndications, private equity, guarantees and trade finance, and technical assistance. FMO is a public-private partnership, with 51 percent of the shares held by the Dutch State and 49 percent held by commercial banks, trade unions, and other members of the private sector. As of 2019, almost €3 billion was invested in developing countries as a result of FMO's activities; €1.7 billion on FMO's own books, €297 million using public funds, and FMO mobilized €868 million from third parties[29]. FMO holds $9.411 million in total assets, and $3.1 million in shareholder's equity.[30] In 2019, FMO's investments supported an estimated 646,000 direct and indirect jobs (2018: 615,000), invested a total of €798 million in reducing inequalities (2018: €958 million), exceeding the target of €790 million, and increased the number of SME loans in outstanding loan portfolios of FMO clients to 1.4 million (2018: 1.3 million).[31] Despite its success, FMO has identified specific challenges they face including increasing the risk of tax avoidance by financing the agribusiness sector, funding projects linked to sectors with a bad reputation (e.g. mining in western Africa), splitting financial commitments between non-renewables and the energy transition, reducing their own profits by scaling up private investment, distorting commercial debt markets versus attracting private investment, and shares falling into questionable hands.[32] Despite these challenges, FMO has had successes.

04

State Small Business Credit Initiative (SSBCI), U.S. Department of Treasury[33]

Established by the Small Business Jobs Act of 2010 and terminated in 2017, the State Small Business Credit Initiative (SSBCI) provided nearly $1.5 billion to support financing for small businesses through state agencies.[34] SSBCI programs included capital access, loan guarantees, collateral support, loan participation, and venture capital. Between 2012 and 2015, the SSBCI supported 16,919 small business loans and investments ($8.4 billion in new capital). 42 percent went to small businesses located in low- or moderate-income census tracts, and 80 percent went to businesses with ten or fewer employees. 190,400 projected jobs were created or retained (63,891 created, 126,509 retained) within two years of loan or investment closing, as reported by businesses, and states reported $8.02 in new financing for every dollar of SSBCI funding expended.

05

State Infrastructure Bank Pilot Program

The State Infrastructure Bank (SIB) Pilot Program was established by Section 350 of the National Highway System Designation Act of 1995 through U.S. Department of Transportation. The SIB program is a revolving fund mechanism for financing a wide variety of highway and transit projects through loans and credit enhancement.[35] As of September 2001, 32 States (including Puerto Rico) have entered into 245 loan agreements with a dollar value of over $2.8 billion. As of March 31, 2011 federal capitalization is $661,437,612 total with federal funds requiring an 80–20 federal/non-federal match from the participating state.

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UNLOCKING CATALYTIC CAPITAL: COMMUNITY REINVESTMENT ACT (CRA)

The Community Reinvestment Act has the potential to increase bank provision and facilitation of catalytic capital in support of low- and moderate-income communities. This proposal explores ways in which CRA could expand the pool of catalytic capital providers and enhance LMI community investment readiness. We discuss the limitations of CRA, including the ratings and evaluations process, regulatory consensus, and additional incentives outside of the CRA.

OVERVIEW

The Community Reinvestment Act (CRA) was enacted in 1977 as an affirmative obligation to "encourage federally insured banks and thrifts to help meet the credit needs of their communities, including low- and moderate-income (LMI) neighborhoods, in a manner consistent with safe and sound banking practices."[1] CRA came in response to evidence of redlining and disinvestment efforts, and was designed to directly prevent redlining, encourage community investment, and allow communities to recover by providing equal access to credit. The CRA regulatory agencies monitor CRA compliance through an evaluation and ratings process. This process includes determination of which financial products, activities, and services qualify for CRA credit.

This paper outlines three policy options within the CRA that could potentially unlock additional catalytic capital from financial institutions. In addition, these policies would create incentives for more innovation in community development through financial institutions, greater cross-sector collaboration, and better transparency on outcomes and impact reporting. The three policy options are as follows:

01 Expand the application of the CRA to include the non-bank financial sector.

02 Define catalytic capital investments as a qualifying activity under CRA.

03 Define qualifying CRA expenditures for technical assistance hours, grants, or investments to improve, standardize and scale local capacity and impact measurement practices.

CRA SNAPSHOT

Banks are evaluated and given a rating based on their performance meeting the credit needs of local communities in which they are chartered.

- **Regulating bodies**: The three federal CRA regulators are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDCI), and the Federal Reserve System (FRS).
- **CRA Ratings:** Banks are assigned one of four ratings: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance.
- **Three categories evaluated:** Lending, Investment, and Services.*
- **When Ratings Matter:** CRA-regulated entities submit CRA ratings when applying for mergers, acquisitions, or new branch openings.

*Note: The OCC New Rule (issued May 2020) implemented a "single metric" which would combine all qualifying CRA activity under one evaluation metric.

In response to the Covid-19 pandemic and resulting economic crisis, credit-related services must be equally provided to LMI communities to ensure economic recovery and stability in historically marginalized communities. LMI communities are not just disadvantaged by unequal access to banking services, but are also shut out of other financial services including insurance (required for mortgage and automobile purchase), savings, money transmittal, and securities services on non-predatory terms. Acknowledging not just the dramatic shifts in the financial sector since the original CRA in 1977, but also the existing Covid-19 crisis, we must consider more effective solutions to address the credit access and economic inequities faced by LMI populations.[2]

Potential to unlock catalytic capital:
Each of the policy options intends to bring CRA-regulated entities into the impact investing market. The first policy option targets expansion of CRA to non-bank financial entities and provides an opportunity to leverage CRA to better accommodate significant changes in the financial services industry that have occurred since the CRA's original enactment in 1977. The second and third proposed policy options would impact institutions currently regulated by the OCC, FDIC, and FRS and subject to CRA, and would complement each other. The second policy option is targeted at direct CRA allowance and provision of catalytic capital, and the third policy option is targeted at leveraging CRA to build local capacity needed to support catalytic capital investments. The primary goal of these policies is to expand and redirect a portion of CRA capital towards catalytic capital to strengthen LMI communities.

CATALYTIC CAPITAL
Investment capital that is patient, flexible, risk-tolerant, and sometimes concessionary. Catalytic capital enables either or both third-party traditional capital investment or follow-on investment that would not otherwise be possible.

Changes to CRA could have a profound impact on financial institutional spending. The OCC estimates that all banks provided $482 billion of CRA lending in 2017 (~4.1 percent of bank deposits).[3] Currently, community development lending ($103 billion in 2018) and single-family mortgage lending ($95 billion in 2018) account for the greatest dollar volume of lending under the CRA.[4] These are followed by small business, multifamily, and small farm lending. The CRA has proven to be a powerful instrument to channel funds, for example, a total of $55 billion of CRA capital went through CDFIs within 2013 alone.

Greatest Dollar Volume of Lending under CRA

$482 billion of CRA lending, 2017

$103 billion Community development mortgage lending, 2018

$95 billion Single-family mortgage lending, 2018

Following our policy proposals, we have included additional context on the current state of CRA, with discussion on the potential limitations to the effectiveness of CRA as a mechanism to unlock catalytic capital in the impact investing market, without also including other changes to the CRA. We view this context to be a critical element in assessing the CRA's ability to influence bank behavior, and ultimately influence greater participation in the catalytic capital and impact investing markets. These considerations discuss the limitations of CRA using the existing ratings and evaluations process, a need for regulatory consensus, and the consideration of incentives outside of the CRA.

PROPOSED POLICY OPTIONS

01 Policy Option #1: Expand the CRA to include the non-bank financial sector

We recommend expansion of the CRA to include non-bank financial entities, including credit unions, mortgage companies, online lenders, student-loan servicers, and possibly insurance companies. This policy proposal is an effort to modernize the CRA based on significant changes in consumer financial services, and looks to extend essential consumer products to LMI consumers (including transaction, credit, savings, investments, and insurance services) in an equal, fair, and transparent manner.[5] By broadening the types of entities covered, the CRA can help reduce "informational externalities and entry delay by competitive lenders inherent in lending to LMI neighborhoods," effectively improving LMI credit market efficiencies and promoting more equitable access to credit related products and services.[6]

At minimum, we recommend a robust evaluation of expansion of the CRA to all federally insured depository institutions (commercial banks, savings and loan associations, savings banks, and credit unions).

CRA and the Evolution of the Financial Sector
The financial sector has evolved considerably since the original CRA legislation was passed in 1977. Research suggests the CRA in its current form might be insufficient in its reach and oversight of institutions responsible for providing critical financial services and access to credit, particularly services available to LMI populations.[7]

Technological innovations have played a significant role in the evolution of the banking sector, contributing to a shrinking cash economy and the rise of branchless banking services and online financial lenders. There has also been a significant increase in alternative, non-bank lending actors that are not subject to CRA, while at the same time, a decline in the number of banks and thrifts due to consolidation.[8]

EVOLUTION IN THE BANKING SECTOR:

Reasons to expand the CRA to include non-banks financials are based on several evolutionary changes in the banking sector that have weakened the application of CRA:

- Establish regulatory consistency among different types of financial institutions and across units of a single institution
- Address vertical disintegration, particularly in the mortgage market and increasing share of mortgages made by independent mortgage companies
- Mitigate the impacts of consolidation, regulatory changes, expansion and technology on geographical assessment areas

The banks and thrifts that still exist, and are subject to CRA, tend to be larger and more geographically disbursed (over 6 percent of U.S. bank branches closed between 2008 and 2016).[9] Under the current CRA, banks can place up to 100 percent of their CRA benefit into their home community (designated “assessment area”), resulting in CRA hotspots and CRA (e.g., credit) deserts.[10] Evidence also shows that in terms of percent of loans to LMI borrowers and smallest businesses, large banks significantly trailed their smaller peers.[11] Following the passing of the Gramm-Leach Bliley Act, banks have been able to elect to become a Financial Holding Company, the growing use of which allows banks to reduce CRA obligations.[12] Aside from direct credit services, we must also consider the role credit-related services play in accessing credit. For example, without access to property insurance and mortgage insurance, an individual cannot access a loan to become a homebuyer.

“As the share of the nation’s deposits held by regulated depository institutions and the share of home mortgage loans made by them have declined markedly in recent years, the potential impact of the Community Reinvestment Act has declined.”[13]

75% of national financial assets are currently held in non-bank financial institutions in the U.S..[14]

56% of home loans were made by independent mortgage companies in 2019.

58% of refinance loans were made by independent mortgage companies in 2019.[15]

$71B Mainstream credit unions have increased their market foothold with business lending growing from $4 billion in 2000 to $71 billion in 2018, with evidence showing credit union LMI services lagging behind CRA-regulated banks.[16]

$1.2T Insurance companies collected $1.2 trillion in premiums in 2018, with property and casualty insurance making up over half of this amount.[17]

As banks have continued to grow in size, in tandem with non-CRA regulated institutions, competition has also inevitably grown. This competition has lead to a cycle of constant cost-cutting and increased scrutiny of product-by-product profitability which, in the context of CRA, has resulted in a shift away from more specialized products for LMI communities in favor of products that fit into banks’ more general audit, compliance, credit, and budget process.[18]

Increasing competition by non-CRA regulated actors has ultimately made it more challenging for CRA-regulated banks to balance their exposure and maintain market share. Because the loan size in CRA lending tends to be smaller than the average size of non-CRA loans, CRA loans are, in general, less profitable for banks to underwrite. For example, a bank is required to perform the same underwriting for a $100,000 loan compared to a $1 million loan; considering a 3 percent origination fee, that would result in origination fee revenue of $3,000 compared to $30,000 for the same amount of work.[19] Therefore, the obligation of a CRA-regulated bank to conduct CRA activity puts them at a disadvantage compared to unregulated financial entities that can focus on larger and more profitable loans.[20] This competition puts pressure on CRA-regulated entities to effectively compete by either pursuing higher loan volume or increased pricing on CRA loans - neither of which support equitable offerings to LMI communities.

Finally, in regards to whether or not CRA has resulted in higher risk exposure for CRA-regulated entities, and that expanding it would increase overall market exposure, research shows that this concern does not hold up.[21] Research shows that increased lending to LMI borrowers as a result of CRA has not contributed to higher default or delinquency rates.[22]

Method to Implement Expansion

Statutory expansion of the CRA would require congressional action. Either way, this proposal will require a multi-agency regulatory effort. In terms of the appropriate regulating body for entities not currently regulated by FDIC, FRS, or the OCC, expansion of the CRA could look to the Consumer Financial Protection Bureau (CFPB) which regulates entities larger than $10 billion and/or the National Credit Union Association (NCUA) which regulates credit unions. When considering expansion and application of CRA to other financial institutions, it will be necessary to “replicate the statute, assigning responsibility for examination and enforcement to regulators (to the extent the firms involved are subject to regulatory supervision), or to surrogates such as the U.S. Department of Housing and Urban Development.”[23]

To ease implementation, we recommend leveraging existing data sources. For existing CRA evaluation, regulators rely on Home Mortgage Disclosure Act (HMDA) data. Given a majority of mortgage companies and credit unions already publicly report HMDA data on their lending activity by demographic characteristics of their borrowers, the application of CRA to these entities would not require new data reporting requirements.[24] Application of CRA to insurance companies would require a comprehensive data reporting requirement.[25]

We recommend using the example of Massachusetts Community Reinvestment Act (see page 6, "Case Study: Massachusetts CRA Expansion to independent mortgage companies and credit unions") as a roadmap to expand national CRA law to banks, credit unions, and independent mortgage companies. In line with Massachusetts, we recommend differing levels of regulatory burden for community lending obligations based on institutional size, consistent with the existing CRA and proposals regarding the regulation of credit unions.[26]

Recommending a Phased CRA Expansion

We recommend consideration of a phased adoption, that would begin implementing CRA regulation with new entities based on size and sophistication.[27] First, we recommend expanding CRA to apply to credit unions, taking example from Massachuesetts. To ease this transition, the first phase of expansion should target the largest credit unions which, similar to large banks, have greater internal capacity to manage CRA regulatory requirements. Moving to intermediate to small sized credit unions, similar to the existing CRA application to small to intermediate sized banks, we recommend a streamlined CRA exam that focuses on lending, which is similar to the existing CRA treatment of intermediate to small sized banks. Should the transition to regulate credit unions under CRA go successfully, the case to expand CRA to other non-bank institutions would be strengthened. Given that robust and sufficient data is already available in the mortgage market through HDMA, the application of CRA to mortgage lenders should be the next stage of expansion.

As expansion is implemented, adjustments could be made as regulators and financial entities adapt to the new regulations. A measured, step-by-step transition might provide a greater probability of success than a sudden and comprehensive overhaul.

Should policy-makers consider broader expansion to non-bank entities, CRA obligations could be fulfilled by establishing partnerships with banks and thrifts that currently meet CRA regulation standards, or by partnering with organizations such as Community Development Financial Institutions (CDFIs), Minority Deposit Institutes (MDIs), etc. A market-based approach could be taken to create tradeable obligations to meet CRA requirements, along the lines of "cap-and-trade," wherein organizations subject to CRA would either have to fulfill the obligation themselves or pay other institutions to fulfill their CRA quota, similar to the approach taken in the emissions market.[28] This approach, while needing additional review and analysis, might work to support greater participation, collaboration and partnerships within the community development and impact investing landscapes.

Challenges to Implementation

The primary challenge in implementing this proposal will be alignment among the existing CRA regulating bodies (OCC, FDIC, and FRS) and alignment and implementation of CRA-like statute among the appropriate regulating bodies of non-bank financial, where they exist, (in some cases, for example payday lenders, there lacks a singular body of regulation, with separate regulatory requirements state-by-state).[29] Some have suggested that simply including language consistent with the CRA, a "relatively broad affirmative mandate to serve," within a statute that is standard-setting in terms of responsibilities of companies coming to the Federal Reserve Discount Window, could be a powerful first-step towards expansion.[30]

Alternative solutions will be required for financial services that operate under different or limited supervisory regimes, such as insurance companies and other alternative lenders. Any solution should take advantage of existing regulatory systems with “the aim of achieving equity in result” by maintaining the “principles of the responsibility paradigm...that is consistent with and builds on existing and improved consumer-oriented obligations and protections.”[31] For state-regulated entities, we can look to national legislation that establishes principles, a regulatory floor, and a back-up regulatory regime if states fail to adopt the regulatory minimum.[3]

CASE STUDY

Massachusetts CRA Expansion to independent mortgage companies and credit unions.

The state of Massachusetts successfully expanded the CRA to include banks, independent mortgage companies, and credit unions, which can be a model for expansion at the federal level. Massachusetts CRA-regulated entities can earn one of five ratings: Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, and Substantial Noncompliance. In addition to exam sections that are similar to federal exams, Massachusetts also includes more rigorous tests on fair lending and abusive lending.

Massachusetts Chartered Banks and Credit Unions:
Most recently updated in the 2016 Community Reinvestment revolution (209 CMR 46.00), the Massachusetts Division of Banks (DOB) includes an evaluation for CRA compliance and for compliance with the Equal Credit Opportunity Act (ECOA), the Home Mortgage Disclosure Act (HDMA), and other consumer protection and fair lending laws and regulations. Massachusetts chartered banks and credit unions are subject to a lending test, investment test, service tests, community development test, and strategic plan evaluation. Massachusetts expansion of CRA to credit unions is based on asset sizes and complexity of the credit union.

Mortgage lenders:
As of the 2007 Mortgage Lender Community Investment regulation (209 CMR 54.11), mortgage companies chartered in Massachusetts and mortgage companies chartered in other states but operating in Massachusetts, making 50 or more home mortgage loans in the two previous calendar years, must undergo CRA examinations. Examinations for mortgage companies include a lending test (number and percentage of home loans issued to LMI borrowers and communities), services test, and an optional investment test.[33]

Applying more rigor to CRA ratings and review:
Differing from the current CRA, the Massachusetts CRA ranks entities on a scale of five performance ratings instead of four and embeds consumer protection and fair lending responsibilities into the evaluation process. In addition to performance and tests and standards to evaluate CRA performance, the DOB reviews Massachusetts chartered banks and credit unions for evidence of discriminatory lending practices, evaluated through review of credit applicant treatment based on race, color, religion, national orgin, ethnic origin, sex, martial status, age, sexual orientation, physical impairment, source of income, and property location.[34] In the mortgage company exams, Massachusetts includes a section called “loss of affordable housing” which reviews whether or not lending activity has contributed to LMI borrowers losing housing, in addition to a services test that “establishes expectations that mortgage companies must market to underserved populations and locate branches in LMI tracts.[35] The most recent Massachusetts CRA ratings are as follows:

- 131 Massachusetts banks have CRA ratings as of 2019: 23 (17.6%) are rated “Outstanding,” 18 (13.7%) are rated “High Satisfactory,” 88 (67.2%) are rated satisfactory, and 2 (1.5%) are rated “Needs to Improve.”
- 61 Massachusetts credit unions have CRA ratings as of 2019: 2 (3.3%) are rated “Outstanding,” 7 (11.5%) are rated “High Satisfactory,” 52 (85.2%) are rated “Satisfactory,” and none are rated below “Satisfactory.”

Establishing an accurate assessment area for Massachusetts chartered credit unions

The federal CRA assessment area designation is defined by geographies where the bank has a physical location (office, branch, atm, etc.) and/or the surrounding geographies in which the bank has originated or purchased a majority of its loans. The expansion of CRA to Massachusetts chartered credit unions allows for credit unions whose membership by-law provisions are not based on residence, to use their membership as the assessment area, instead of a geographical area.[36] Under this regulation, a credit union can define their assessment area to be defined by either their field of membership or by the county or counties they serve (e.g., if the credit union serves firefighters, the assessment area could be defined by wherever the firefighters live).[37]

Potential to Unlock Catalytic Capital

Put simply by the former head of OCC, Eugene Ludwig, "because nonbank financial institutions now hold more financial assets than banks and thrifts, the current CRA is tapping a declining share of the financial services sector."[38] By expanding CRA activity beyond currently regulated banks, this policy will unlock additional sources of capital for community development (arguably catalytic in itself), particularly capital intended for LMI populations.

In terms of potential impact of expansion of CRA, we should also look into the economic benefits of CRA. According to a study by Harvard, the additional scrutiny of lending in CRA designated assessment areas as a result of CRA regulation was equivalent to a 1.3 percentage point reduction in unemployment.[39] The impacts of the CRA on home ownership rates can be significant. The Federal Reserve of Philadelphia estimates when a neighborhood census tract loses CRA eligibility, the volume of purchase mortgage originations by CRA regulated lenders can decline by as much as 20 percent, and subsequently this decline is partially backfilled (approximately half) by greater involvement from riskier and more costly lending by nondepository institutions that are not subject to CRA.[40] Similarly, evidence shows generally positive effects of CRA neighborhood eligibility on the growth of small businesses, particularly in terms of loan originations in lower-income neighborhoods.[41] Small business growth and home ownership are not only positive indicators of access to credit, but also can be powerful drivers of local wealth and job creation.

Expansion of the CRA to non-bank financial institutions will increase equitable access to financial services and products necessary to retain and grow wealth, such as homeownership and employment through small business growth.

02 Policy Option 2: Define catalytic capital investments as a qualifying activity under CRA.

We propose a clarification to the existing CRA regulation and proposed CRA modernization, which seeks to normalize catalytic capital as a qualifying activity under CRA. CRA-qualifying catalytic capital refers to financial capital (equity, loan, grant) that is patient (length of commitment), flexible, risk tolerant, and/or sometimes concessionary (as defined by position in the capital stack), and which enables either or both, third-party traditional capital investment or follow-on investment that would not otherwise be possible. In particular, we recommend greater clarification, use and acceptance of CRA-eligible activity aligned to impact investments, particularly the provision of equity and equity-equivalent capital into financial intermediaries that better serve LMI communities.

This recommendation may also include provision of what is known as “second-chance” capital, or capital that is provided to individuals that have been declined capital and otherwise would not have been considered, including checking, savings, and money market accounts, certificates of deposit to meet a variety of deposit needs of a community, and lending activity including commercial and small business loans, consumer real estate mortgages, down payment assistance and home equity loans, and vehicle and other consumer loans.[42] Consistent with the CRA regulation, we recommend that any provision of catalytic capital is consistent with safe and sound operations.

Examples of catalytic capital activity that could be classified as a qualifying CRA Activity:

ENHANCING CAPACITY OF EXISTING ORGANIZATIONS SERVING LMI POPULATIONS:

Equity Equivalent (EQ2) Investment is a capital product for community development financial institutions (CDFIs) and their investors. EQ2 is a long-term deeply subordinated loan with features that make it function like equity. It is a financial tool that allows CDFIs to strengthen their capital structures and leverage additional debt capital. This enables them to increase lending and investing in economically disadvantaged communities.

QUALIFYING PUBLIC PRIVATE PARTNERSHIP:

In October 2020, The Woodforest CEI-Boulos Opportunity Fund closed on a $1.33 million equity investment into the Sharswood Ridge Opportunity Zone project in Philadelphia. The Sharswood community is a federally designated “food desert” and “severely distressed” area. This mixed-purpose project will bring affordable housing, retail including a grocery store, a bank branch, and an urgent care medical clinic to the community. The project is expected to generate more than 200 construction jobs and over 200 permanent jobs.*

PARTICIPATION IN OUTCOMES-BASED FINANCING:

Broader participation in outcomes-based financing for community development. Under this CRA qualifying activity allowance, we foresee additional incentives for banks to participate in the growing market of outcomes-based financing, particularly in the more subordinate capital stack position or through provision of letters of credit.

*See footnotes.[43]

Allowing for CRA eligibility for catalytic capital investments will better align these types of public/private partnerships with community development best practices and result in greater impact.

Benefits to LMI Populations

We recommend that the definition of qualifying catalytic capital activity must either primarily or exclusively benefit LMI communities, or intermediary organizations and funds that invest in LMI communities. Careful consideration should be given as to whether the qualifying language includes “primarily” as opposed to “exclusively,” as robust arguments for both exist. Including “exclusive benefit to LMI'' offers a way to reduce subjectivity and ensure clarity around qualifying activities. Reducing subjectivity has been a major consideration in recent CRA reform activity. However, using language to “exclusively benefit” also excludes potential investments, such as mixed-use investments, that can have substantial positive impact to a community, while also being more attractive to investors due to diversification of risk.

Potential to Unlock Catalytic Capital
If financial institutions are given the ability to receive CRA credit for "catalytic capital" investment as a qualifying activity, regulated banks might have more incentive to pursue impact investments that they otherwise might find unattractive, such as first-loss/subordinate capital, more risk tolerant, patient capital. Guidance on CRA credit for catalytic capital could help incentivize more bank capital (particularly equity capital), flowing into organizations that serve LMI communities such as Community Development Financial Institutions (CDFIs), Community Development Corporations (CDCs), Minority Deposit Institutions (MDIs), and other organizations that benefit from community expertise and provide critical financial products and services.

ADDITIONAL OPPORTUNITIES AND BENEFITS

- *Organically grow the impact investing market.* This policy will give CRA-regulated entities flexibility and incentive to engage in non-traditional CRA transactions that otherwise might not have been allowable or considered under existing CRA guidance. Examples could include CRA credit for taking a subordinate position in a social impact bond, or committing patient capital (over 5 years) to a community development project (and receiving credit for each year of commitment), or funding an innovative financial service such as piloting postal banking.[44] Participation and scale provided by financial institutions will help to normalize and grow impact investing activity.
- *Incentive for innovation.* This policy could create an avenue for innovation within the CRA for banks to contribute dollars to broader community development, particularly efforts aside from affordable multifamily housing, which within a bank's assessment areas can "double count" toward CRA requirements, earning both multifamily and community development lending credit.[45]

Challenges to Policy Implementation
There has been criticism of expanding CRA-qualifying activities, with particular reference to large infrastructure projects (for example, federally funded highway projects[46]), Opportunity Zone investments, and concerns around eligible activities that do not have an exclusive impact on LMI populations. This challenge will be particularly relevant when defining eligible catalytic capital activity.

> Mitigation: We recommend a pre-approval process, as provided in the new OCC Rule (May 2020), and as suggested in the September 2020 FRS Advanced Notice of Proposed Rulemaking. This process would establish transparency among the banking community, set precedence on qualifying catalytic capital activity, and allow a pathway for innovation. In time, this process will improve market efficiency and coordination, an important step in bridging the gap between CRA and impact capital.

At this time, it is also unclear how this policy would interact with the new OCC Rule issued in May 2020, including the new allowance in the OCC Rule that provides for "added multipliers for complex and innovative transactions," which has not yet been clearly defined.[47] Furthermore, the impact of an Advanced Notice of Proposed Rulemaking (ANPR) issued by the FRS could pose additional challenges given the changes in bank behavior that result from changes to the bank evaluation and ratings process, which is under review and not known at this time. Prior to the new rule, the 1995 CRA revisions emphasized lending (50 percent weighting) over community development investments and retail (25 percent each). Lending included home mortgages and small business loans, however community development lending was only used to enhance the lending score. Should the qualifying activity of "catalytic capital" be considered "community development" it might be necessary to revise how community development activity is taken into the overall lending test to create an incentive.[48] See Limitations of CRA Regulation at the end of this document.

With respect to concerns around increasing bank activity through the CRA, there has been criticism about the CRA's role in the subprime mortgage crisis; however, there has been very little evidence that this is the case.[49] Providing credit for catalytic capital that is subordinate/higher-risk might raise a red flag under this criticism. However, one way to mitigate this would be to limit the amount of capital that is placed in higher-risk activity. CRA-qualifying activity is still subject to the credit approval process at the bank, which would still be responsible for determining an acceptable level of risk on a transaction by transaction basis.

MULTIPLIERS: USE AND CONSIDERATIONS

Using a Multiplier to Incentivize Catalytic Capital

To help incentivize CRA-regulated financial institutions to provide catalytic capital, we could consider a multiplier for additional CRA credit, however we would like to provide additional context around considerations on the potentially distorting effects of a multiplier. A multiplier was introduced in the OCCs regulation with the following definition, "the quantified value of the activity for purposes of applying the general performance standards to the bank's activities will be increased by a multiplier during the evaluation period but only if the bank has properly obtained confirmation by the OCC."[50] Consistent with the OCC's final rule, if a multiplier is included as part of this provision, we suggest it be applied only with pre-approval by the appropriate regulating body.[51] We also suggest that the multiplier not be applied until the amount of community development activities (qualified dollar values of its current period) exceeds the amount in the prior exam period.[52]

EXAMPLE OF "CATALYTIC CAPITAL" MULTIPLIER

An Equity Equivalent (EQ2) is a CRA-eligible instrument that allows credit for the additional private capital the EQ2 investment leverages. One example of how a multiplier might work is the following: Suppose a CRA bank makes a $1 million first loss investment that facilitates and de-risks an additional $3 million private sector senior capital investment. The bank would receive credit for its investment, plus 50% of the private sector capital that it leveraged, for a total credit of $2.5 million.

Additionally, we could consider multipliers that are based on the amount of additional private sector capital leveraged through the catalytic investment, with certain considerations as described below. In this context, a multiplier, or an incentive outside of the CRA (such as a tax credit), is likely necessary to change the behavior and preferences of CRA-regulated financial institutions to pursue catalytic capital investments, (see, "Consideration of the Limitations of CRA to Unlock Catalytic Capital" at the end of this document for more information). However, a multiplier incentive will require further consideration with respect to unintended adverse consequences of a multiplier. First, multipliers on certain activities might create incentives for investment activity that does not align with market needs, (see "Case Study Example: Challenges of Multipliers").[53] This consideration is particularly relevant to fixed rules of applying multipliers, which is why we suggest an approach that requires review by the appropriate regulating body.

Challenges of Multipliers

> "The problem with multipliers is that they do not adjust for relevant Performance Context factors (see author's Fourth Comment dated April 8, 2020). For example, a fixed rule of applying a multiplier of two for investing in a CDFI minority bank Certificates of Deposits as compared to no multiplier for traditional Mortgage Backed Securities (MBS) secured by loans to LMI borrowers may be flawed if the bank being evaluated is in a market where affordable housing is the most critical credit need. In that case, MBS secured by loans to LMI borrowers are the primary vehicle for providing affordable housing, whereas the funds provided to a minority bank may or may not be used for that purpose."
>
> See comment memo submitted on OCC/FDIC CRA NPR: "The 75% Solution to Optimal CRA Reform".

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Consideration should also be given to potential gaming and market distortion that could occur with the use of a multiplier. For example, if leverage is used to determine a multiplier, the bank could receive additional credit for providing both a commercial rate loan and a subordinated "catalytic" loan to the same project or enterprise, with the intent to claim their commercial loan as leverage and the mechanism by which leverage is determined.[55] Consideration should be given to whether or not a multiplier would result in less community development activity overall or a loss of community development transparency, two primary concerns expressed by comments responding to the OCC's most recent ANPR prior to the rule issued May 2020.[56] Additional restrictions on multipliers were suggested by community groups, industry, and public commenters including a recalibration of multipliers including a regular public feedback process.

With more exposure to the transaction, the CRA-regulated entity making the catalytic capital investment would have an incentive to support financial performance. Having multiple types of exposure is not uncommon in the catalytic capital market. For example, private foundations are major providers of catalytic capital. One way that catalytic capital is derisked is by pairing different types of capital in the same transaction. This approach is consistently implemented at the Bill and Melinda Gates Foundation, where Program Related Investments (loan, equity investment, or guarantee, made by a foundation in pursuit of its charitable mission, often used as catalytic capital) are de-risked by pairing investments with programmatic grant capital to support expected financial and social returns.[57] CRA financial institutions could take a similar approach by supporting catalytic capital investment dollars with grant dollars, and receiving CRA credit for both.

03 Policy Option #3: Define qualifying CRA expenditures on technical assistance (hours, grants or investments) that support catalytic capital investments and/or improve, standardize, and scale impact measurement practices.

Research shows the benefits of community-led economic development in creating more resilient and inclusive economies.[58] However, communities often lack the technical expertise and/or resources needed to develop and implement strategic economic plans, particularly those that require innovative and sophisticated development and financing options (as has been seen through the implementation of opportunity zones). On the capital side, we see that CRA transactions with high community impact are often not approved because the bank does not receive credit sufficient to justify the effort.[59] An incentive that encourages CRA expenditures on technical assistance could help bridge critical information and readiness gaps that often impede community-led innovation and investment, while providing sufficient CRA credit to make the engagement and transaction worthwhile.

CRA-regulated banks can currently receive CRA credit for providing technical assistance on financial matters to nonprofit, tribal, or government organizations serving LMI housing or economic revitalization and development needs, as well as to small businesses or community development organizations.[60] However, even though direct support made through philanthropic community development grants receives some CRA credit under the Investment Test, the dollar volume of grants often pales in comparison to the dollar volume of investments.[61] This reality makes these grants unappealing to banks trying to reach their CRA requirements in the most economically efficient way possible.

CURRENTLY ALLOWABLE ACTIVITY UNDER "CRA COMMUNITY DEVELOPMENT"

Investments can include economic development activity such as:

- Job creation including permanent job creation, retention, and/or improvement for LMI persons or initiatives that include provisions for creating or improving access by LMI persons to jobs or job training or workforce development programs
- Community or tribal-based child-care
- Educational, health, social services to LMI populations
- Workforce development or job training programs targets to LMI persons
- Affordable housing for LMI individuals
- Activities that revitalize or stabilize LMI areas, designated disaster areas, or underserved or distressed nonmetropolitan middle income geographies

Over the long term, investing in community-led economic development, including investment readiness, will contribute to more sustainable and inclusive economic growth. Inclusive economic growth will support increasing individual wealth and product/service sophistication, resulting in greater credit needs. Because CRA-regulated entities will benefit from growing needs for their services and products, this type of CRA-incentivized activity should be viewed as a win-win for both locally served CRA communities and the CRA capital providers. Within the context of improving market readiness, we have identified three primary needs behind community-led economic development:

01. Community development planning

This includes support to develop community-driven economic development efforts aligned with activities that already qualify for CRA Community Development Credit (see "Currently allowable activity under CRA Community Development").[62]

02. Community investment readiness

Building community capacity required to attract external investment.

03. Improved data and measurement infrastructure

Improve internal data and measurement infrastructure, impact measurement and impact measurement practices at CRA-eligible partner organizations (e.g., CDFIs, SBICs, 501(c)3s, etc.) to help attract public and private social capital.

Incentivising CRA credit for improved data and measurement infrastructure could foster greater adoption of impact measurement among community organizations and the banking and impact investing community more broadly. Accepted methods could include OFN's CDFI Assessment and Rating System (CARS), IRIS, or GIIN.[63] Activities to improve impact measurement processes and data could include building out robust reporting standards, improving internal and external processes, and covering third party evaluation expenses. and marketing efforts to improve impact measurement processes and data.

In addition to general provision of CRA credit for technical assistance, in certain cases, this CRA allowability could be mandated where the impact of an activity is unknown and/or requires additional technical assistance or impact measurement. Another solution could be to require technical assistance and/or impact measurement for CRA activity that has either been recently included as "qualifying" or activity that requires pre-approval by the CRA regulating body (an option for pre-approval was included in the new OCC Rule and the ANPR issued by FRS). For example, additional technical assistance could be required when paired with another incentive such as the use of CRA capital in qualified opportunity zones.

Potential to Unlock Catalytic Capital

While this policy does not directly unlock catalytic capital, it would help grow the market for the catalytic capital in two ways.

First, direct technical assistance would help support communities that are on the demand side of catalytic capital. As with any financial market, problems can exist on the demand side (or accepting side) of catalytic capital and the impact investing market more broadly, including lack of willingness to seek investment, lack of knowledge among investees, and lack of general investment readiness among those that seek investment.[64] With improved capacity, local communities would be better able to attract and accept catalytic capital, alongside other forms of external capital.

Second, more robust local outcome and impact measurement infrastructure might ultimately incentivize more catalytic, impact-first investments by CRA-regulated and non-CRA-regulated entities, particularly if the entity was part of the community-led economic development process. In this way, we hypothesize a spillover effect for this policy to create more impact investing market readiness, transparency, and efficiency. Accurate and robust impact measurement is a necessary component of impact investing transactions, across asset classes, but particularly to impact-first investments. With more adoption and normalized practice, we can more accurately predict and measure social returns of a given transaction. In this way, this policy proposal helps to build market infrastructure and contributes to the growth of the impact investing market.

Challenges to Policy Implementation
Regulatory oversight must be included as part of this solution to ensure that any credits being claimed are being used to drive community-led economic development and/or improve impact measurement infrastructure internally at the bank claiming credit, or externally at CRA partners.

For impact measurement implementation specifically, CRA-regulated banks and regulators should agree upon a common framework and suggested methodologies (e.g., IRIS+, CARS, GIIN, etc.) for impact measurement to ensure that adoption of impact measurement practices also supports market standardization. We do not recommend mandating any one particular framework until a commonly accepted and standardized impact measurement methodology exists.

Examples of how technical assistance can support catalytic capital investments
Community Development. The Federal Reserve Bank of St. Louis prepared an introduction on the importance of community development to promote economic growth and financial stability in communities across the country, especially those in LMI areas. Two case studies ("Community Collaboration Spurs KIPP: St. Louis" and "Memphis Organization Lifts Voices of Community") show how community-led development can attract investment to a local area.[65] By supporting community-led development, CRA financial institutions can help support local economic growth, while building their internal pipeline of eligible CRA investment.

Impact Measurement: One of the first public examples of CRA using impact measurement in the underwriting process was in 2006, when the Merrill Lynch Community Development Fund implemented the use of the CDFI Assessment and Rating System (CARS), a comprehensive, third-party analysis of impact performance and financial strength, to place $93 million with community development financial institutions across the U.S.[66]

CONSIDERATION OF THE LIMITATIONS OF CRA TO UNLOCK CATALYTIC CAPITAL

CRA as a Mechanism to Influence Bank Behavior
The goal of this white paper is to propose policy options that would influence CRA-regulated bank participation in the impact investing market by way of providing "catalytic capital." While achieving this goal will require incorporation of the policy concepts outlined above, it will also require a significant shift in behavior and decision making at financial institutions. A shift in behavior would require a regulatory incentive (a "carrot") or a regulatory requirement (a "stick"). Despite broad agreement that the CRA has been somewhat successful in changing bank behavior towards reinvesting deposits back to where they are sourced, we would like to note some potential limitations around the effectiveness of CRA as a mechanism to unlock catalytic capital in the impact investing market, without additional measures designed to change bank behavior by way of a regulatory "carrot" or "stick."[67] Of note, we discuss the limitations of the existing ratings and evaluations process, the need for regulatory consensus, and consideration of behavior incentives that live outside of the CRA.

First, one of the primary mechanisms the CRA utilizes to influence bank behavior is the CRA evaluations and ratings system (including assessment areas and performance standards). Under the most recent

CRA rating system (prior to the new rule issued independently by the OCC in May 2020), there were five evaluation methods that varied between the FRS, FDIC, and OCC: small bank evaluation, intermediate small bank evaluation, large bank evaluation, community development test, and strategic plan.[68] Each method evaluates respective banks in a unique way, incorporating factors such as a bank's previous CRA ratings.

Regulatory agencies use the CRA rating system to incentivize good performance by allowing poor ratings to slow potential merger activity and halt bank branch expansion plans. However, in 2019, 98.7 percent of banks received either outstanding or satisfactory CRA ratings.[69] Evidence also shows that since CRA ratings became public, CRA noncompliance ratings have decreased from a high of 10 percent in the early years to 2 percent or less in recent years (1990–1996).[70] Under the existing ratings system, given that most banks receive a passing rating, there is little incentive for CRA-regulated banks to increase their community reinvestment efforts or adopt new catalytic capital practices, even if the activity qualifies, due to existing understanding and complacency around acceptable action to achieve a passing rating.

The current treatment of the CRA ratings systems was largely a result of the 1995 interagency CRA revisions, which put new emphasis on "production over process," rewarding CRA activity by dollar and unit volumes. This change drastically reduced regulatory burden and resulted in increased CRA lending, but it is not clear that this increased quantity of activity actually led to more impact and strengthened communities. With priority placed on volume, banks have moved in favor of CRA products with economies of scale, leaving little incentive to develop niche products, participate in complex or innovative deals, or emphasize impact over profit.[71] Without incentives for niche products, banks have little motivation to tailor offerings to community needs, "the greater the variety of activities desired, the less weight each gets, thus opening the possibility that some activities will not yield a sufficient payoff to warrant any significant attention by the banks."[72]

Because of these limitations, the policy options described above might have limited uptake unless there is also a change to the CRA evaluation and ratings process. While outside the scope of this paper, potential suggested modifications to the ratings mechanism that might shift bank behavior could be additional rigour applied to the evaluations and rating process, with particular attention to anti-discrimination practices and consumer lending protection. Additional modifications could include a limitation on the number of outstanding ratings that are given in each ratings cycle, reduced insurance premiums for those banks that receive outstanding ratings, or other incentives for outstanding ratings.[73]

Current CRA Context and Impact to Ratings Mechanism

Changes to the CRA evaluation and ratings process have been a major component of discussions to revampt and modernize the CRA beginning in 2018. In 2019, the OCC and FDIC released a Notice of Proposed Rulemaking (NPR) to modernize CRA legislation.The OCC acted alone in releasing a Final Rule concerning CRA regulations on May 20, 2020 with new regulations going into effect October 1, 2020. Changes include the enumeration of CRA-qualifying activities, how banks will determine assessment areas, the establishment of new performance standards, and increasing data collection requirements. In September 2020, the FRS released its own Advanced Notice of Proposed Rulemaking, which differs significantly from that of the OCC.[74] For example, the OCC rule includes implementation of a single dollar volume metric (which could significantly change the type, quantity, volume, and location of CRA activity). There are still questions as to how the final rule will be implemented, which could create challenges with respect to quantifying the eventual impact of any CRA policy change.

Prior to the OCC rule, there was broad bipartisan support for responsible modernization, including support among the nation's largest banks and most progressive community advocates.[75] Failure to agree on a joint rule could result in confusion and inefficiencies among banks, community partners, and present a risk of regulatory arbitrage, (for reference, the OCC oversees about 70 percent of CRA activities, while FDIC/FRS are responsible for the remaining 30 percent). Some research suggests that rather than a radical overhaul as proposed by some of the agencies, perhaps what must happen to make the CRA more effective is a refinement of performance measures and associated ratings.[76] Given the CRA evaluation process is the primary mechanism that exists in CRA to shift bank behavior, consent and coordination around this process would be a prerequisite to using CRA to unlock catalytic capital through financial institutions.

Failure to achieve consensus among the regulating bodies in the foreseeable future will limit any attempt to make changes to CRA. While the regulating bodies are currently at odds around CRA reform, we would like to note that building consensus among the regulating agencies has historically taken time to achieve. For example, during the early 1990s reform process, the FRS took about two years to sign onto the 1995 reform.[77] For the purpose of consensus, we recommend revisiting the original intent and purpose of the CRA, while acknowledging key themes and questions such as the emphasis on people or places, addressing access or fairness, and reviewing whether or not evaluations be based on processes, outputs, or outcomes.[78]

Both the FDIC and FRS have been hesitant to issue new CRA regulation during the Covid-19 pandemic, which could pose an additional delay to any final rules made by the FDIC or FRS. With these limitations in consideration, significant departure from interagency consensus warrants thorough assessment of the outcomes related to bank behavior as a result of having multiple evaluation processes within the CRA-regulated market, particularly among financial institutions that are subject to regulation at multiple agencies.

Solutions to Influence Bank Behavior Outside of CRA

Finally, a change to the CRA evaluation process alone might not be sufficient to influence broader bank participation as providers of catalytic capital in the impact investing market. The banking industry is structured around the prospect of profit, without which, "banks are unlikely to make major investments to promote and produce a product on a sustained basis."[79] It would be prudent to acknowledge other factors existing outside of CRA that affect bank behavior: capital requirements, interest rate environment, changes in tax laws, and technological innovations.[80] Ultimately, the decision of CRA regulated entities to provide catalytic capital will be based on the combination of these factors, not the least of which is the risk tolerance applied to all investments. Consequently, changes to the CRA that are designed to promote greater bank participation in catalytic capital investment must also make the activity attractive to banks to do so within the confines of their investment frameworks.

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