INITIATIVE FOR RESPONSIBLE INVESTMENT AT HARVARD UNIVERSITY

Understanding Cash as an Asset Class Within a Theory of Responsible Investment

On March 4, 2011, the Initiative for Responsible Investment hosted a convening at the Harvard Kennedy School of Government to discuss the societal purposes of cash as it has evolved as an asset class and determine how responsible investors can best align their investments with these purposes. The discussion also included an examination of the financial and societal risks of cash investment misaligned with cash's societal purposes of promoting financial stability and local economic development.

Some 30 participants drawn from the money management, academic, foundation, financial consulting, and think tank worlds attended. The following summarizes the topics discussed, conclusions drawn, and possible next steps for research and practice.

Nature and Portfolio Uses of Cash

The convening began with a general discussion of the nature of cash as an asset class and its use in portfolio construction. It was observed that generally speaking cash can most simply be identified with money, which provides a simple and useful means of exchange. This could take the form of the legal tender of a country, or could also mean the balance in one's checking or savings account, which is in effect a claim against legal tender in the case of the U.S. Federal Reserve notes.

In terms of portfolio construction for institutional investors, numerous cash equivalents are available in addition to demand deposits in financial institutions. These include short-term certificates of deposit and money market accounts, which often consist of short-term commercial paper and short-term Treasury notes. Short-term bond funds can be thought of as a form of "synthetic" cash. Generally speaking, fixed-income securities with a maturity date of less than one year can be considered cash for the purposes of portfolio construction. Other, more exotic cash equivalents exist, such as auction-rate securities and structured investment vehicles. Some of these products proved particularly unstable during the 2008-2009 financial crisis, failing to fulfill their role as a cash equivalent in portfolios at that time. There are effectively different "social benefit profiles" to these various cash equivalent that responsible investors might consider.

People value different attributes of cash. Two of these attributes stand out: cash's liquidity and its stability. Within the context of a portfolio, cash's stability is an attribute that is particularly desirable. Cash's benefit is "stable value." While other asset classes may be highly liquid, they are more prone to pricing volatility. Cash also serves a valuable portfolio function in that its returns tend not to be correlated to those of other

asset classes. Cash has historically has generated predictable, low-risk, but low, rates of return, although it is an asset with risks during periods of inflation. It is often used in portfolios as a reserve of funds for which future demand is of a predictable amount at a predictable date in the not-too-distant future. This can take the form of savings or transaction accounts. Cash can also be used as a temporary pool of liquidity available for future investment in other asset classes when attractive investment opportunities arise.

What Societal Functions Do Cash Investments Serve?

In addition to its role in portfolio management and daily transactions, cash plays a variety of roles in society through its use by the institutions that hold it in safe-keeping for their customers—i.e., banks, savings and loans, credit unions, investment companies, and similar institutions. The role of these institutions parallels that of cash in the sense that they are designed to be stable institutions and the assets they hold are supposed to be readily available in liquid form to their customers "upon demand." In addition, these institutions serve a variety of socially useful roles as a provider of liquidity to their customers and communities in the form of cash loans. Cash is, in this sense, the most basic of asset classes and the simplest of means of access to finance for the broadest segments of society.

On the negative side, it can be argued that cash—or rather a society where money is a frequent medium of exchange—can effectively monetize all products and services, and people's time and activities, so as to reduce them to only their exchange value and sap them of the non-financial values we may want to encourage.

One societal role of depository institutions is to mitigate social inequality by providing access to capital in local communities. Some institutions use their management of cash deposits to provide access to capital to notably underserved regions. In particular Community Development Financial Institutions (CDFIs) have identified this purpose as core to their mission, although it is, or should be, arguably a core function of mainstream retail and commercial banking as well. Through a variety of subsidies, CDFIs are able to make cash available to poor people at a lower rate than they would otherwise be able to obtain.

To generate community benefit, cash needs to come into a financial institution in a way that makes it useful. "Hot money"—that is, cash seeking the highest possible return and likely to be withdrawn at a moment's notice by depositors who are caught up in a never-ending search for ever higher interest rates—may be of limited use to a lending institution concerned about community economic development. A $1 million deposit of hot money for three months is less useful than a $100,000 checking account that is part of a long-term banking relationship.

There is a strong, natural connection between cash and the development of local economies. It was pointed out, for example, that credit unions, for example, are often limited to operation in a bounded geographic region or to serving employees at a particular institution. In addition, a substantial number of credit unions (some 900) are classified by the National Credit Union Administration as specifically serving low-

income communities. Cash has a place-based quality that is bound up with the necessity for confidence in its stability. The connection between community, confidence and stability is interesting in relation to cash.

It was also pointed out that in addition to the positive benefits of cash on local communities, there also might be negative ones. Cash relentlessly monetizes products, people, and activities, reducing them to their exchange value, sapping relationships that we might want to be encouraging.

A question was raised whether recent federal legislation that included $4 billion to guarantee bonds issued by CDFIs might suggest a level of risk to prospective investors. Others suggested that the government is not intending specifically to reduce risk, but to send an affirmative signal that CDFIs are a safe, important, and socially beneficial investment and to provide stabilization and smoothness to market transactions around cash. Such guarantees can also help break down barriers created by service providers and enable consultants to recommend community investment as part of the portfolio mix.

There are many regulatory policies in place to allow cash to be more socially efficient, which leads to implementation questions such as how to make CRA and similar strategies efficient in order to induce banks to bring more capital into local communities and have greater impact.

What Has Government Done to Protect the Portfolio- and Societal-Level Benefits of Cash?

Recognizing the basic functions of cash both in personal finance and in community economic development, governments have taken steps to assure the stability and liquidity of cash held in financial institutions and to encourage the commitment of these institutions to local communities.

Government is involved for two reasons: to prevent and to direct. To prevent bank panics and failures, in the United States, the government has created federal deposit insurance programs to assure the safety of deposits; mandated minimum capital requirements to assure the stability of depository institutions; and established bailout provisions for financially troubled institutions to assure continuity of assets when all else fails. These steps are intended to enhance the fundamental cash attributes of stability and liquidity as it functions in portfolios and through depository institutions. In addition, to assure that cash held by financial institutions is directed to the communities from which it comes (i.e., stays local) and serves under-served communities (i.e., is broadly accessible) the government has enacted a variety of programs and legislations including the Community Reinvestment Act, the Home Mortgage Disclosure Act, the Community Development Financial Institution program, and New Market Tax Credits, among others. These federal efforts are intended to direct financial institutions to use their cash deposits for the societally beneficial purposes of promoting local economic development and addressing issues of inequality of access to finance, both of which should help assure economic stability.

Government uses guarantees to address questions of risk related to cash, or at least the perception of risk. These guarantees can help otherwise reluctant investors come to understand investment vehicles, such as CDFIs, that they might otherwise shun unnecessarily.

An initiative by the Treasurer's office of the City of New York was cited as an example of cash used to serve the purposes of economic development. A city-level banking commission reviewed the community economic development records of local banks every two years, constructed a score card based on their records, and allocated cash deposits from the NYC Treasury to local banks based on these scores. In addition, the City created a large, complex, and successful Economically Targeted Investment (ETI) program that brought together a consortium of banks and others to make mortgage and construction loans in redlined areas. These came with backing from the State of New York mortgage agency. They provided cash upfront for construction costs and the City's pension fund held the longer term mortgages. This capital program enabled the city to revitalize its housing stock, which increased money to the tax rolls, and had a secondary effect of revitalizing and gentrifying certain marginalized neighborhoods that had been written off by the city.

Not all forms of cash are subject to such governmental pressure. There are, for example, trillions of dollars in money market mutual funds that are not subject to CRA regulations. These accounts have the benefit of government deposit insurance, but the institutions offering this cash investment option are not subject to government pressures to assure that these cash investments serve the communities from which they were extracted.

In addition, the rise of interstate banking has meant that the definition of local community has become blurred. As a result, in many instances cash continues to be sucked out of local communities by big institutions. Cash deposited in local branches is transferred by the bank, through intermediaries, insurance companies, or custodians, to other parts of the country.

Similarly, non-financial corporations routinely sit on huge reserves of cash, in addition to the cash that flows through their operating treasury accounts. These cash reserves are carefully managed to maximize financial returns, often in small increments. Is any consideration given to their ability to generate community benefit? Other institutions, such as custodians for the finance industry, can manage cash flows to generate fractional returns for themselves on each transaction, which has little to do with the more place-based uses of cash by financial institutions.

In addition, other trends tend to uncut the local nature of banking. For example, technological innovations such as the offering of banking services through cell phones—which may effectively render obsolete a physical banking facility—underscore the tendency of technological advances to undercut the personal and place-based natural virtues of financial institutions as an intermediary for cash deposits.

How Do We Know When Cash Is Performing Well As A Responsible Investment?

The complex relationship between the benefits of cash and defining measurements that can capture those benefits was the afternoon's topic. In short, how can goals be set for the responsible investment of cash and how do we know if and when we are reaching them?

We began with a review of the National Community Investment Fund's Social Performance Metrics for banks. NCIF has worked with the Home Mortgage Disclosure Act (HMDA) data to determine what percentage of mortgages provided by all 8,000 banks in the U.S. went to home-owners in low-income neighborhoods, a metric it refers to as "lending intensity." It also analyzes the percentage of a bank's branches located in these neighborhoods, a metric it calls "development deposit intensity." NCIF has identified 398 institutions scoring well on these two metrics. It has also begun to evaluate other factors such as jobs creation, community facilities established, local partnerships, and basic services provision.

Many community economic development goals are only realized over the medium to long term. Changing the lives of people is a long-term process and some broad longitudinal measures are necessary to capture these changes and to measure these successes. Measurement of actual improvements in people's livelihoods are increasingly a concern in the microfinance community around the world. The early metrics developed to measure success in microfinance lending focused on how much was lent, how many loans that represented, and what was the repayment rate was. Now there is intense interest in understanding whether the lending resulted in a significant positive effect on individual livelihoods.

Alternative measures of impact might look at regional metrics around human capital. For example, Southern Bancorp, located in the Mississippi River Delta and serving some of the poorest regions in the country, is attempting to the longitudinal impacts of its community economic development activities. Southern has three transformational 20-year goals for the communities it serves, including reducing the poverty and unemployment rates by 50 percent and improving high school graduation rates 50 percent. They have realized that simply increasing the amount of money flowing into a community is not necessarily a good thing. Southern Bancorp is looking into nontraditional finance services, such as helping to create social service providers and funding charter schools. They measure success with intermediate benchmarks such as trends in housing quality, health, and crime, and employ two different sets of external evaluators to assess their performance relative to their financial and social goals.

Studies have been done citing, for example, the reduction of crime in regions served by a successful community development credit union, and the improvement in a variety of social indicators in CDFI-financed, employee-owned mobile home parks. More academic study of what impacts can and should be tracked is needed. In general, more emphasis should be put on measuring *outcomes* rather than *outputs*.

Different types of measurement are preferred by different types of investors. Foundations may want measurements related to their specific missions (e.g., affordable housing, empowerment of underprivileged children, energy efficiency and the environment). Individuals may be more interested in specific positive anecdotes and stories. Larger organization may want more systematic data on outputs or outcomes. Some don't need additional data at all: once they have done their initial due diligence on the social side they trust that that the financial institution's social mission will continue to be achieved.

Certain building blocks must be present in every community to increase the likelihood that investments will produce social benefits. There is an important role for the presence of an overall vision around a particular topic, such as economic development, shepherded by a strong community leader.

What Can We Do To Change Current Investment Practice with Regards to Cash?

What then are the obstacles for investment committees that might want to emphasize the stability and liquidity benefits of cash on a portfolio level and the abilities of cash to promote financial stability and community economic development at a societal level?

Current interpretations of ERISA can pose a serious problem, with their inappropriately narrow definitions of fiduciary duty. A potential solution involves the reversal of the definition of fiduciary duty and defining it so that concerns for financial stability and economic development are a positive obligation of fiduciaries. Both Fair Pensions in the United Kingdom and the Network for Sustainable Financial Markets are both working in this area. Ultimately, changes in interpretation of ERISA by the Department of Labor or of existing law by the courts will be necessary for widespread change.

Academic research should be encouraged on the societal benefits implicit in cash investment allocations, the differing societal implications of different cash investment options, the relationship between community-oriented cash investments and their financial performance, the measurement of societal benefits created by various types of financial institutions to which cash investments are allocated, and similar topics. One way to encourage such research might be to create the equivalent of the Moskowitz Prize for academic papers on such topics.

A concerted effort could be made to focus on certain key levers for change. These would include:

- Raising the awareness of financial consultants about the nature of and demand for community-oriented uses of cash.
- Increasing the availability of, and the ease of accessibility to, community-oriented products for cash investments.

- Promoting the concept of banking with community banks with public officials, including state treasurers.
- Developing a set of agreed upon measurement of social returns for different forms of cash investment in communities.

The question of messaging around cash and cash investments needs to be more seriously addressed, including questions such as who within the mainstream financial community is the most appropriate audience, what kind of language should used to address these key players, and what educational tools would work best. Potential solutions include:

- Appealing to those who may not think of themselves as "social investors" but who would be sympathetic to the notion of social returns, all others factors being equal.
- Conducting in-depth messaging research on what argument gatekeepers and those in the philanthropic community are most open to at the current time. Because of the disruption of the economy, this may be a moment when assumptions have been challenged and alternatives have appeal.
- Distilling into "three sentences" a message that everyone could use when discussing the social impact of cash as an investment class.
- Leveraging the roll-out of the government's $4 billion CDFI bond guarantee program as an opportunity for education that may alleviate fears about the stability of CDFIs and create partnerships.
- Linking cash and community-oriented investments to a broader understanding of how investments create economic development and enhance the lives of people.

How should we go about persuading people to consider the social function of cash as an investment class? The normative assumption of the conversation has seen community investment as beneficial to social welfare; but one must also recognize the context within which fiduciaries have to meet funding requirements. Every dollar that isn't earned means fewer resources for beneficiaries or, in the case of foundations, for grantees. We have to reassure investment committees that their financial goals can be met, while acquiring this additional benefit. Discussions don't need to center around arguments of higher yield, but can include demonstrations and examples that illustrate how responsibly-invested cash instruments fit appropriately within a total portfolio of investments. The notion of breaking out the different financial and social returns of asset classes is particularly valuable here, because it opens up the discussion of what mix of products is necessary to create a well-performing portfolio and what administrative or transactional obstacles might exist towards creating one that includes community investment.

Possible Next Steps

A series of concluding thoughts on possible next steps was solicited from the group. They fell into three primary groups:

Research and Strategy

- Promote academic research and case studies on cash and community economic development.
- Strengthen and propagate arguments about blended value development of persuasive metrics. Agree on the top five metrics for social improvements as a baseline.
- Review which forms of cash investment most benefit CDFIs.
- Develop a comprehensive strategy with product, policy, and language, and approach the strategy as a campaign with core objectives and tools.
- Bake full cost accounting into system.

Messaging

- Generate a compelling, clear, and succinct story about why some forms of banking are better for communities than others, and be conscious about tailoring the message to the audience.
- Eliminate the holier than thou attitude.
- Remember the macroeconomic issues, which mean that people are unsettled and potentially open to new possibilities.
- Develop language on returns and portfolio construction that talks to mainstream portfolio managers in their terms.

Product

- Determine the capacity and nature of institutional investor demand.
- Work with mainstream investors to define an appealing and workable product that can be easily accepted and implemented.
- Develop a subordinated debt product that could help fund CDFIs.
- Reduce transaction costs for CDFI products.