The Capital Absorption Capacity of Places

A Research Agenda and Framework

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INITIATIVE FOR RESPONSIBLE INVESTMENT

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BACKGROUND

In 2010, the philanthropic collaborative Living Cities (www.livingcities.org) launched the Integration Initiative, an effort to transform the systems that shape the lives of low income people in five U.S. metropolitan regions – Baltimore, Cleveland, Detroit, Minneapolis-St. Paul, and Newark. A key goal of the Integration Initiative was to learn what is needed to move beyond piecemeal approaches to vital issues, and to engage multiple sectors – public, private, philanthropic and non-profit – in work that creates an integrated platform for stakeholders to work together on systemic change.

Central to the Integration Initiative was the investment of significant capital, in the form of grant dollars, below-market and market-rate loans, in projects that would catalyze the revitalization of underserved communities by supporting the development of businesses, jobs, housing and transportation in these regions. But as Living Cities moved from design of the Integration Initiative to implementation, it found that a number of implicit assumptions about how community investment capital gets deployed did not match the reality on the ground. For instance, the design assumed that:

- Cities would have a local community financial development institution (CDFI) with at least $50 million in assets, sufficient scale to absorb $10–15 million of debt capital;
- The local CDFI would have relevant expertise in the program area(s) chosen by the sites as their focus (i.e. not only affordable housing, but also small business, health, and mixed use transit-oriented development);
- The CDFI would already be an active participant in an integrated civic leadership that included the public and private sectors, philanthropy and community groups.

In practice, many communities did not have intermediaries with lending experience in the areas that philanthropic partners wanted to concentrate on, nor were there always lenders of sufficient scale to work with the capital that Living Cities wanted to invest. Public and private sector organizations did not necessarily have much experience working with each other. And the hard work of building a pipeline of community investment deals and bringing them to fruition generally took place deal-by-deal rather than through a coordinated process that could sustain itself over time.

As a result of this experience, Living Cities is developing a research agenda meant to illuminate the political, social, cultural, and financial elements that create capacity for the effective deployment of investment capital in underserved communities. Our focus is not on the **supply** of capital, although an adequate supply of capital is clearly fundamental. Nor are we focused specifically on the nature of, and ways to build, investment intermediaries that meet certain criteria of scale and sectoral reach. Instead, we are looking at **how communities themselves deploy investment** and create an environment that puts dollars to work on behalf of low income people. We intend to examine a variety of places, sectors and approaches and try to understand what actions can be taken—by public, philanthropic, non-profit and private sector leaders—to facilitate the flow and usefulness of community investment dollars.

This paper is the work of David Wood and Katie Grace of the Initiative for Responsible Investment at the Harvard Kennedy School and Robin Hacke of Living Cities. We appreciate the feedback of numerous colleagues and leaders in the community development field who have participated in our research, reviewed drafts of the paper and contributed their expertise to advance our thinking. We view this working paper as the basis for continuing dialogue and invite your reactions and comments. Please respond to Robin Hacke, rhacke@livingcities.org.

CAPITAL ABSORPTION CAPACITY AS A RESEARCH TOPIC

The goal of our research is to build a new framework for understanding capital absorption capacity – understood as the ability of communities to effectively use investment capital to serve pressing needs. To make community investment possible, many stakeholders – from investment intermediaries to community groups and organizations to public agencies to the philanthropic sector to the mainstream investment community – must play a part.

This research initiative is focused not on assessing the existence or absence of any specific type of institution in any given place, but rather on understanding how an integrated, multi-sector approach to community investment might deliver the goods and services that create sustainable and just communities.

We suggest the following two propositions:

- Community investment is better understood as a set of functions for the delivery of community development outcomes, rather than a network of particular institutions that manage investments.
- These functions can be performed by a wider variety of local, regional, and national actors than are typically considered when analyzing community investment.

These propositions are meant both to capture the existing mechanisms for bringing capital to public purpose, and to allow us to rethink how the goals of community investment are achieved in practice. Accepting these two propositions may help us develop an approach to strengthening capital absorption capacity and intervening in specific communities in ways that build on existing strengths and fill gaps in the most effective way.

This working paper is a first effort to describe the community investment ecosystem as a way to better evaluate and understand how community investment capital is absorbed and deployed in specific metropolitan regions. Part I describes the functions that must be performed in order to put capital to work in underserved communities. Part II offers an initial diagnostic framework that analysts can use to understand how functions are being performed in a given place and what is missing. With further work, we hope to create a more formal assessment tool for this purpose, as well as to understand the types of philanthropic, policy or other interventions that could expand capital absorption capacity in a given place.

PART I: DEFINING COMMUNITY INVESTMENT

We need a coherent definition of community investment in order to analyze absorption capacity. For this purpose, we can define community investment (CI) as the application of capital to build equitable and sustainable cities.

What types of outcomes are relevant? Investments that create affordable housing in underserved areas have been and remain central to CI. Recently, elements such as affordable financial services, access to healthy foods, community health clinics, charter schools, energy efficiency retrofits that lower the cost of living, small business lending, and transit-oriented development that links homes to jobs, have become part of the CI discussion. Targeted investment to revitalize urban brownfields or to create broad-based economic development is also a CI goal.[1]

Community Investment Issues and Sectors

- Access to financial services
- Affordable housing
- Arts and culture
- Economic development
- Education
- Energy efficiency
- Health and wellness
- Public safety
- Small business development
- Transit-oriented development
- Urban regeneration

Each of the community investment issues and sectors touched on above contributes to building viable and vibrant communities. The effectiveness of such investments can be analyzed by considering the extent to which they help underserved communities achieve access to food and shelter, work and leisure, health care and education, and expand people's capacity to live full and rewarding lives. In other words, community investment does not simply increase financial resources, but rather increases human capabilities, social equity and environmental sustainability. It does so by focusing on the links between local, regional, and global networks within which human capabilities take shape. Investment is only one, albeit an important, factor in supporting sustainable and equitable communities.

The capital to achieve these goals can come from a variety of private sources, including banks (CRA-regulated, CDFIs, or neither), foundations and private individuals, as well as federal, state, and local government sources. It may take the form of grants, debt, equity or guarantees and span the return spectrum from no return to below-market and market-rate investments. Delivery of this capital to achieve community investment goals requires investment capacity to identify and execute deals effectively, as well as a host of conditions –from a supportive public policy environment to engaged community leaders and institutions – in order to achieve equitable and sustainable financial and social returns.

But to understand how CI achieves these goals, we need to answer the question: *How do communities successfully and efficiently take investment capital and apply it to community development purposes?*

[1] Worth noting has been the tendency for much CI in practice to resolve to real estate investment, perhaps because the intersection of public policy in the form of tax credits and building codes, and the scalability of certain forms of housing finance, have made real estate an easier asset class in which to deploy capital, regardless of whether real estate in any specific case is the most important use of community investment dollars.

COMMUNITY INVESTMENT AS A SET OF FUNCTIONS

In order to better understand CI as a vehicle for enhancing human capabilities, social equity, and environmental sustainability, we suggest here that it may be useful to think of CI as the delivery of a set of functions rather than as a set of actors (who are, of course, engaged in delivering those functions). We propose that the following core functions are required to absorb capital and make effective community investments.

Vision and Legitimacy

Ensure that investment meets recognized community needs, and is done with the support of community actors.

- Define needs
- Engage with community
- Convene stakeholders; "table-setting"
- Determine priorities

Enabling Environment

Build the policy and support tools that allow community investment to take place.

- Set and influence policy and regulatory environment
- Apply and enforce policies and regulations
- Generate and provide data
- Provide subsidy, first loss money, and training
- Ensure availability of diverse and capable actors

Pipeline

Generate deals and projects that contribute to defined community goals.

- Spot opportunities
- Pull together projects and deals
- Predevelopment and development
- Leverage public resources
- Assemble capital, including identification and blending of sources
- Structure and underwrite investments
- Align deals and projects with vision and goals

Management and Monitoring

Manage portfolio to ensure financial and social performance.

- Loan servicing
- Portfolio management
- Workouts and problem solving
- Data collection and evaluation
- Social impact monitoring
- Organizational capacity building

Innovation

Learn and apply the lessons of CI to create durable networks that can strengthen CI practice and carry it through to new areas.

- Identify and explore emerging needs/fields
- Create new products
- Build platforms for ongoing collaboration
- Identify and attack barriers

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These functions do not predetermine what a successful community investment ecosystem looks like or the specific actors involved. Certain functions may be best performed by local, regional, or national actors; institutions not conventionally understood as community investors may be best placed to achieve specific goals. Further, there is potential for new technologies or innovative collaborations to deliver functions more effectively.

Each of these functions can be broken down into smaller tasks—i.e. there are a number of different roles and actions that go into ensuring that there is municipal and regulatory support for community investment, or that tie various subsidies and private and nonprofit actors together to generate good deals.

As noted, the goal of this framework is to portray an integrated ecosystem that allows for the effective deployment of CI. The relationship of the individual deal to the city's broader ecosystem is complex. At the most fundamental level, the health of the ecosystem affects the operation of the deal, and conversely, deals in the aggregate contribute to a stronger or weaker ecosystem. Actors in an ecosystem make tradeoffs between institution-building and deal completion that may affect the health and functioning of the overall ecosystem.

Community Investment Actors

- Foundations
- High Net Worth Individuals and Family Offices
- Banks (national, community)
- Insurance Companies
- Community Development Finance Institutions (CDFIs)
- Intermediaries
- Master Developers and Redevelopment Authorities
- Developers (for-profit and not-for-profit)
- Anchor institutions
- Government (local, state, regional, national)
- Civic Organizations

A FRAMEWORK FOR MOVING THE CI FIELD FORWARD

The community investment field appears to be at an inflection point. The need for effective community investment has skyrocketed after the financial crisis. Changes in the banking industry, potential federal and state regulatory reforms, newly interested investors who have yet to deploy capital, and the urge to expand out from traditional real estate CI investments have all helped provoke reflection and a desire to reshape CI for the coming decades.

This framework, we hope, is a step in moving the CI field forward. We think that by focusing on functions, and by identifying the many paths through which stakeholders engage with the field and with each other, we can help build an analytical model for understanding how CI works and how it can be strengthened.

Our work to date has led us to focus on the systems that make transactions possible. These systems require collaboration across the public, private and civic sectors, and research suggests there is significant value in building platforms that enable this collaboration. We emphasize that not all CI functions are necessarily best delivered by local actors, though they do require local communities to see CI as important and legitimate. We have tried to capture the multiplicity of local, regional, national, and ostensibly international investors, for-profit and non-profit investment intermediaries, real estate developers, political agencies, community groups, and others that can come together in different configurations to deliver CI functions in specific communities.

The challenge implicit in this framework is in reimagining what it means to have a successful CI system at scale. We recognize that each region will have unique strengths and gaps. A better understanding of the underpinnings of the CI ecosystem may open up unexpected opportunities for transformational, systemic change.

CAVEATS TO THE DRAFT FRAMEWORK

As noted, this framework is a work in progress, on which we are soliciting input from experts in the field. We would like to highlight a few issues which are particularly challenging for making this sort of framework useful to community investing:

- As the list of community investment issues and sectors suggests, community investment encompasses diverse issues, from affordable housing to small business development to arts and culture. In order to assess functions in a particular community, it will be necessary to specify the issue areas being considered, as some functions may be performed effectively in the affordable housing sector but not in the small business arena, and so on.

- We do not have a fully articulated vision of what a sustainable and equitable community looks like, nor do we have specific measures for achievement across CI sectors such as access to finance, health care, or transit. It is clear that community investment strives to achieve a vision where all individuals can maximize their human potential as well as access necessary goods and services. Defining success is still elusive.

- Ideally, we would hope to articulate and propose intervention strategies to improve the delivery of functions to underserved communities. The draft framework as its stands is more of a diagnostic tool, and further research, elaboration and testing will be required to develop intervention strategies.

- Finally, we do not have a clear sense of how to determine when a place has “enough” capital absorption capacity, i.e. what an acceptable scale of capital absorption capacity looks like and how can we measure whether the functions are being achieved to a great enough extent to make a real difference in outcomes. In a world where subsidy is scarce, this is a particularly tricky question, as needs will outstrip addressable demand, which itself will in most cases outstrip community investment resources.

With these caveats in mind, we suggest below how this framework could be used to diagnose the extent of capital absorption capacity in a given community.

PART II: EXPLORING COMMUNITY DEVELOPMENT FUNCTIONS IN A PARTICULAR PLACE: A DIAGNOSTIC

This framework should inform efforts to evaluate capital absorption capacity in a particular place, both to determine what capacity exists and where there are gaps in functions. Here we offer a set of questions that translate the functions framework into a diagnostic tool that researchers can use to evaluate CI absorption strengths and weaknesses in a given community.

The questions below assume a high level of familiarity with the functions framework. The diagnostic tool, in a simplified form, could also be adapted for use as self-evaluation by actors in a particular place.

The goal of the diagnostic is to evaluate where there is room for improving absorption capacity, and which stakeholders are best positioned to build this capacity. The questions would be used to guide interviews with key actors in the CI space in local communities, as well as potential actors identified by people familiar with the area in question. They would be supplemented with case histories of deals, and publicly available information on markets and market demand, institutions, and public policies, in order to create a holistic description of the CI market ecosystem.

Enabling Environment:

- What is the biggest barrier to getting community investment deals done? Do barriers vary by issue area or location?
- What public policies at the city, county, state, regional, or national level enable community investment? Inhibit community investment from being done? (It might help to work through this by sector or issue area and geographic reach)
- On what sets of data do people draw to identify needs and opportunities for community investment? What data is missing?
- What mechanisms exist for coordination and collaboration?
- Which organizations participate in CI capacity development?
- What tools exist to boost capacity (subsidy, training, coordination)?
- What is the quality of individual and institutional talent involved in the region's CI activities?
- Are there particular kinds of money (e.g. use of Section 108, CDBG, PRIs) associated with the region? Policies (subsidies/regulations) that tend to be used? Locally specific sources of CI (e.g. housing trust funds)?

Vision and Legitimacy:

- What signs are there of public, private, and civic engagement in community investment? What do people see as community investment? What "dynamic" (issues, actors) is driving current topics of interest or engagement?
- How are community investment opportunities prioritized? Who has influence over this process?
- What institutions are singled out as leaders? What evidence is used to identify them as leaders?
- Which sectors are seen as engaged or disengaged?
- What forums exist that bring stakeholders together? Where is there potential for such forums?
- What examples of shared visions of community investment can they point to?
- What is the role of the local/community voice? How are actions taken in low-income communities legitimized (or not)?
- Are there areas without shared vision? How, if at all, is blame allocated for disconnection?

Deals:

- How do “good” deals get identified?
- What criteria guide the selection?
- What is the quality of deal vetting (e.g. initial underwriting, knowledge and availability of local capital sources)?
- Gather examples of deal management. Who takes the lead in predevelopment/development, who is at the table?
- Who aggregates and invests capital? Are they local, regional, national?
- How do people assess end users’ capacity to borrow or take equity investment? To what do they attribute this capability?
- Gather examples of deal structures. Account for types of money, policies, and how access to subsidies, deal construction is achieved.
- “In what sectors(s) is the pipeline strongest? Weakest? Why?”
- “How efficient is the system at moving deals through the pipeline? What facilitates/inhibits progress?”

Management and Monitoring:

- How can impact be measured? Who can measure it? Is it being measured and if so, measured well? Who might use these measurements?
- Who can serve the role of advocate for social equity and/or environmental goals?
- What structures exist, or could be developed, to monitor progress against plans and adjust them as necessary?
- What skills do public, private, civic stakeholders have to pull together and keep plans on track? Where are those skills lacking?
- What happens when projects or investments run into trouble?
- How do we single out those people, organizations, and networks that can serve these goals?

CI Innovation:

- Who is thinking creatively about new fields for social investment? How are new topics generated and explored?
- Where do people see capabilities for developing tools and mechanisms for financing community needs? Opportunities for new tools?
- What structures are in place to ensure systems rather than one-off deals? How stable are those structures? How open to innovation?
- How can we determine the appropriate scale for community investment? How can we judge whether enough addressable demand is being met?

COMMUNITY DEVELOPMENT FINANCE ECOSYSTEM ANALYSIS

The results of the diagnostic, combined with collateral research, may serve as the basis for place-based reports on absorption capacity in a CI ecosystem. These reports could inform stakeholder decision-making on CI in a particular place, and also make possible comparisons of capacity in different regions and contexts.

Proposed Table of Contents

I. Local market context

- Market analyses, if they exist, with notations on their original purpose and sponsors
- Demographics: population size, growth, composition
- Local government organization: city/county dynamics, key policies, state policy environment
- Economy: dominant industries, unemployment, job quality
- Poverty dynamics: concentration, size of population
- Spatial dynamics
- Level of CRA requirement
- Sector-specific indicators (e.g. housing prices, percentage of homeownership, homelessness, monthly payments vs. income, housing stock, foreclosure rates; vacant land; inventory of small businesses by number of employees; industry cluster analysis)

II. The place

- Overview of actors engaged in community investment
- Overview of investment activity
- Highlight signature CI deals, opportunities, initiatives
- General description of what the local (or otherwise engaged) actors say about capacity

III. Functions

How are key functions (as described above) accomplished? Focus on where research and interviews have identified capacity or lack of capacity to deliver. In each piece, link specific actors to functions.

- <u>Enabling Environment</u>: What policies, tools and mechanisms have people singled out as most useful, most needed? How do they evaluate the general cultural disposition towards CI in a given place?
- <u>Vision and Legitimacy</u>: Who is and how are they defining CI goals? What does the table look like, what priorities have been set? How is the community voice considered?
- <u>Deals</u>: Describe exemplary deals, or deals that haven't gotten done or fallen through. Specify local idiosyncrasies that favor one sort of deal over another. Who are the players that tend to be involved in most deals? What are the usual capital sources?
- <u>Management and Monitoring</u>: How does the deal management function work? Who plays the various roles, and who speaks for social equity and benefit in the deal management process? What evaluation has been done?
- <u>Innovation</u>: Is there something new going on that reveals capacity to innovate? Are there specific innovations worth highlighting and sharing?

IV. Historical overview of Community Investment in the place

- Timeline of development of functions and institutions
- Brief history of a few exemplary deals
- Brief history of failures to address exemplary need
- Are there unique aspects to the functions that make or have made this region particularly effective or ineffective?
- How involved or invested is the community in engaging in community investment and developing a vision for their community? How has it changed over time, if at all?

V. Questions to consider

Description of where there are opportunities for:

- Intervention and table setting
- Capacity building
- Innovation
- Engagement with new stakeholders
- Policy development
- Data provision

Answers to questions including:

- What resources (local and extra-local) could be repurposed to better effect?
- Where are there case histories or networks on which to build?
- Which local actors need to be engaged?
- Which extra-local organizations could be brought in to increase capacity?
- What information or research is needed to make better decisions?