EXECUTIVE SUMMARY AND FINDINGS

# The Impact of Financial Products and Services on Quality of Life

A WORKING PAPER

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Leveraging Capital for Change[SM]

# PREFACE

Mission-oriented financial institutions (MOFIs) are catalysts for economic activity and growth in some of the most distressed and underserved markets around the country. Many of these markets are predominantly composed of low- and moderate-income (LMI) people in both urban and rural areas. The institutions often provide important financial products and services, such as loans and depository products, and act as local anchor institutions in these markets. In LMI communities, they may be the only financial services providers other than check cashers and payday lenders.

National Community Investment Fund (NCIF, www.ncif.org) is a nonprofit private equity fund and a Community Development Financial Institution (CDFI). It has a mission of increasing the flow of financial products and services into underserved markets nationally and has done so since 1996 by investing in MOFIs and supporting the sector overall. To date, NCIF has invested in over 55 banks, credit unions, and other financial institutions that have generated over $7 billion in loans in underserved markets. Currently, NCIF is the largest investor by numbers in the sector and is keenly focused on the health and impact of the banks working in these markets. NCIF has pioneered its Social Performance Metrics (www.bankimpact.org) to analyze the impact of these banks via measuring outputs and nonbanking variables such as jobs created or retained, racial and gender diversity, etc. — see the *Telling the Story* report* for more information — and to increase the asset class of MOFIs.

The working paper explores NCIF's theory of change and attempts to quantify whether the availability of financial products and services has a correlation with changes in quality of life and economic activity in these markets. We realized this is a very ambitious undertaking, yet we pursued it to explore the data and move the needle forward to support the MOFI industry. We are pleased to find that, while additional research is needed, there is valuable information that can be used by various stakeholders to support financial institutions through additional investment and public policy changes — especially those working in underserved markets — such as the certified CDFI banks, minority banks, and MOFIs in general.

We hope to use this work to not only enhance our own Social Performance Metrics and support the sector, but also to seek additional capital for the industry. In the short or medium term, we hope to influence finance theory to support such institutions. Generally, financial theory optimizes expected return to risk and we posit that — by focusing on financial considerations alone — the returns used in these optimization equations are not only incomplete but also related only to short-term movements of prices, and do not incorporate the long-term effects of externalities. Accordingly, we believe we need to add Social Return (and, in the near future, Environmental Return) to the Financial Return to arrive at Total Return — which should then be optimized to Risk. Adoption of social returns into finance decision making will significantly reward long-term positive externalities and disincentivize negative externalities and encourage capital flows to sectors creating the most social return.

NCIF has collected 14 years of data on a national scale — including nearly 300 variables and 147 million data points — resulting in a massive database in support of the industry. We hope this paper acts as only the beginning of research, and that it spurs additional research and analysis by others even as we continue to refine our own research, interpret our findings, and support the sector. We believe further research is fundamental to increasing the flow of capital into underserved markets and, hence, requires significant funding from investors, government, and philanthropic foundations.

Sincerely,

Saurabh Narain
*President and CEO*

Emily Sipfle
*Director of Impact*

Michael Swack
*Professor, Carsey School of Public Policy, University of New Hampshire*

**Telling the Story* is available online: bit.ly/NCIFR15

## Mission-Oriented Financial Institutions (MOFIs)

Mission-oriented financial institutions are those that have demonstrated a commitment to supporting community and economic development within their communities. These banks generally work in LMI or underserved communities. NCIF classifies three primary types of banks as MOFIs:

- Community Development Financial Institutions (CDFIs) have received certification as CDFIs from the CDFI Fund. Certification recognizes these institutions' work in qualified tracts, based on poverty rates, unemployment rates, and the tract's median income in comparison to the surrounding community. As of December 31, 2014, there were 109 certified CDFI banks.
- Minority Depository Institutions (MDIs) are designated as such by the FDIC if the bank has at least 51% of stock held by minority individuals, if the majority of board members are minorities, and/or if the institution serves a community that is predominantly minority. MDIs often promote the economic viability of minority and underserved communities. As of December 31, 2014, there were 175 certified MDI banks.
- Quadrant 1 banks are designated by NCIF as those that have superior social performance. Quadrant 1 banks located at least 50% of their branches and provide at least 40% of HMDA lending in LMI areas. In addition to HMDA lending, banks can receive a Quadrant 1 designation through analysis of total lending. As of December 31, 2014, there were 765 Quadrant 1 banks.

NCIF has long analyzed the social and financial performance of MOFIs — providing insights to bankers, investors, and regulators as well as researchers and public policy practitioners interested in the industry.

For example, NCIF works with mission-oriented banks to gather in-depth information on their activities and performance to create individual analysis for the banks as well as industry analysis. In our most recent report, *Telling the Story: The Impact of the Reporting Banks and the Mission-Oriented Banking Industry,* NCIF provides data on 24 banks. The report highlights the banks' Social Performance Metrics and overall impact in their communities. Findings include:

- 73% of all lending information supports the banks' community and economic development goals, per the Mission Intensity metric. These loans included loans to LMI individuals, loans in LMI areas, loans to nonprofit and faith-based organizations, loans to minority- and women-owned businesses, and more.
- In 2013, the banks' lending contributed to the creation of 10,609 jobs in their communities.
- The banks offer innovative products and services to their clients to meet particular needs, such as small dollar loans and check cashing services that are tailored to economically vulnerable communities.
- 44% of deposit accounts have balances less than $1,000, suggesting lower-income and higher-touch clients.

# Top Five Findings

**FINDING 1**

There is a positive correlation between bank and credit union presence and activity and quality of life, as defined in this working paper.

**FINDING 2**

The relationship between quality of life and the presence and activity of banks and credit unions has been relatively consistent between 2000 and 2013.

**FINDING 3**

Banks and credit unions are less likely to be operating within lower-income areas, suggesting that these areas have less access to the quality of life benefits associated with the presence and activity of financial institutions.

**FINDING 4**

Tracts where CDFI banks operate are different than other tracts in terms of demographics, financial institution activity, and HMDA activity.

**FINDING 5**

The presence and activity of banks and credit unions is associated with improvements in unemployment and poverty rates.

# Executive Summary

NCIF has a mission of increasing the availability of responsibly-priced financial products and services in underserved and low- and moderate-income (LMI) markets to catalyze the economic development of those communities across the country. To meet this mission, NCIF works with mission-oriented financial institutions (MOFIs) — primarily banks — across three business lines:

- Investments to the institutions through equity investments or deposits
- Lending to impactful projects working with bank partners
- Research to support mission-oriented banks and attract additional capital to the industry

To date, NCIF has invested in more than 55 institutions operating in LMI and underserved communities — creating social impacts while also generating competitive financial returns. To understand the social returns of its investments, NCIF has created a series of Social Performance Metrics that serve as proxies for the impact of an institution. NCIF's existing bank portfolio demonstrates exceptional social performance, with a median Development Lending Intensity (DLI) of 65% and a Development Deposit Intensity (DDI) of 86% — both of which surpass the performance of the majority of banks in the country. Additionally, investee banks have a median Mission Intensity score of 84% demonstrating an exceptional commitment to lending that supports their community and economic development missions.

NCIF's theory of change is that banks and other financial institutions are important contributors to development in their communities by helping deliver capital and aiding financial stability. NCIF supports them to enable this development. Importantly, because of the structure of banks, investments in them have compounding impacts — potentially turning equity investments into 8-10 times that amount of lending in their communities. In particular, NCIF works with mission-oriented banks, which focus on LMI areas or underserved populations to support lending and development in these distressed areas.

With this theory of change in mind, NCIF undertook this project with three primary goals:

1. To make the case that the increased availability of financial products and services may relate positively with an increase in the quality of life in their markets.
2. To enhance the NCIF suite of Social Performance Metrics based on the findings generated — adding ways to track and compare the performance of financial institutions.
3. To create a Social Return Index as a comprehensive way to quantify the social returns of financial institutions — adding to the understanding of finance theory[1]. The Index aims to provide information to encourage additional investment into impactful institutions.

The research team's progress toward these goals is presented within the full working paper, with some highlights included here. The research goals were ambitious and NCIF is encouraged by the directionality of the findings that demonstrate a positive association with the presence of financial institutions and quality of life. NCIF anticipates that the full working paper and its findings will spark important discussions and move MOFIs and impact investors forward to more fully consider social returns — as well as financial returns — in their decision making. The research team also expects this research will support the use of delivery channels for financial products and services that use technology solutions to better serve communities.

Each of the goals is considered in more depth, accompanied by an introduction to the findings.

[1] Prevailing financial theory — particularly Modern Portfolio Theory — attempts to maximize a portfolio's expected return for a given amount of portfolio risk (or, equivalently, minimize risk for a given level of expected return) by carefully choosing the proportions of various assets. See the work of Henry Markowitz for foundational text on Modern Portfolio Theory. Others have also considered ways of incorporating social and environmental returns into financial decision making. See, as an example, Jed Emerson's concept of blended returns, recent trends in socially responsible investment, and investment with Environmental, Social, and Governance (ESG) considerations.

## 1. Making the Case for Financial Institutions and the Increased Availability of Financial Products and Services

As an impact investor, NCIF looks beyond financial performance — making investments that meet the need to double or triple the bottom line — to create social and environmental returns as well as financial returns. In particular, NCIF supports banks and credit unions because of their ability to multiply the impacts of an investment. Given that banks and credit unions are able to raise additional funding via deposits, every dollar of equity invested in them can be turned into $8 to $10 in lending.

As noted above, NCIF's portfolio demonstrates strong social performance as seen through the NCIF Social Performance Metrics and impact stories collected from the banks. This research effort seeks to move beyond these measures, however, to build on the existing body of knowledge, make the case for increasing the availability of financial products and services, and emphasize the important role banks and credit unions play in communities. Given that banks and credit unions are the primary providers of such services, the research team focused on their association or correlation with quality of life.

The research efforts uncovered insight confirming positive relations supporting NCIF's theory of change. **Finding 1** shows there is positive correlation between the presence and activity of banks and credit unions and the quality of life in the surrounding areas (as the team has defined quality of life). Additionally, **Finding 2** notes that the relationship was relatively consistent between 2000 and 2013 — before, during, and after the Great Recession. Banks and credit unions are important elements associated with quality of life within the community and, as such, their ongoing activities should be supported — particularly in LMI areas that could benefit from improvements in quality of life. This is especially important, as **Finding 3** highlights that banks and credit unions are less likely to be operating in lower-income areas and, therefore, these communities may have less access to the benefits associated with an improved quality of life.

**Finding 4** focuses on a particular subset of geographies — comparing Census tracts with and without a Community Development Financial Institution (CDFI) bank operating. Here, the research team finds the two sets of geographies have statistically significant differences, including that tracts where CDFI banks are operating have lower household income, higher unemployment rates, and lower total Home Mortgage Disclosure Act (HMDA[2]) single-family lending.

**Finding 5** compares two other geographies: Census tracts that were "distressed" (and remained so) and Census tracts that were distressed and have improved. Tracts that improve[3] are associated with greater bank and credit union activity overall. Looking at data over time, the research team also observed that tracts with banks and credit union presence were more likely to "jump" from distressed to not distressed over the study period.

Taken together, these findings represent substantial additions to the understanding of how banks and credit unions interact with their communities. Furthermore, it makes the case for the importance of these institutions, particularly in LMI areas — potentially extending the positive relationship to quality of life.

## 2. Enhance the Social Performance Metrics to More Broadly Capture Institutions' Impacts

NCIF's Social Performance Metrics are a set of data points designed to quantify the social performance of banks. As noted below, NCIF uses the metrics to guide internal investment, help others identify investments and track their portfolio's social performance, and support mission-oriented banks through better information on their own impacts.

The working paper builds on the past successes of the Social Performance Metrics in two ways:

- The findings add nuance to the understanding of how banks and credit unions interact with their communities. For example, the research team used a data-driven method to approximate bank and credit union service areas. This allowed for an expanded understanding of the geography examined to gauge the impact of an institution — moving beyond the address of the branch to include a more realistic service footprint.
- The findings lay the foundation for the creation of new metrics that integrate the findings of the working paper.

[2] The Federal Financial Institutions Examination Council (FFIEC) collects and makes available data reported due to the Home Mortgage Disclosure Act (HMDA). Data points cover a range of information on mortgage lending, and include type of loan, purpose of loan, borrower characteristics, loan characteristics, and actions taken regarding the loan.

[3] "Distressed" tracts refer to those with unemployment and poverty rates above the national median. Tracts that "improve" move from above-median rates to below. Learn more on the "jumping tract" methodology in the full working paper.

## 3. Lay the Groundwork for a Social Return Index

Generally, Modern Portfolio Theory focuses on optimizing returns to risk. Further, returns are generally focused on short-term financial returns — forgoing considerations of positive social or environmental externalities and not discounting the financial return for the negative externalities associated with irresponsible behavior. This has potentially skewed the results of the theory's optimization equations.

The Social Return Index is an effort to create a quantifiable measure of social return by capturing some of the complex characteristics of financial institutions' interactions with their communities. The Social Return Index will be a composite of different characteristics of financial institutions and their surrounding Census tracts — capturing social performance over time. Then, ideally, finance theory will start incorporating this measure of social return into the Total Return calculations and then into the optimization calculations:

$$\textit{Total Return} = f(\textit{Financial Return} + \textit{Social Return} + \textit{Environmental Return} + \varepsilon)$$

The full working paper explores methodologies to examine the characteristics of institutions that can be incorporated as determinants of social return. While additional work is needed to create a Social Return Index, the team is encouraged by the potential. Ultimately, the Social Return Index aims to provide a mechanism to enhance the flow of capital to banks and credit unions that provide important products and services, particularly in LMI communities.

### A Strong Data Foundation

For the research effort, NCIF created a database incorporating variables on demographics, economic activity, quality of life, HMDA activity, and financial institutions' presence and activity in their communities. The database includes nearly 300 variables collected over 14 years — totaling 147 million data points. Much of the data exists nationally from 2000-2013, making it a robust data set from which to test hypotheses and draw conclusions on the role of financial institutions in their communities.

The database was analyzed to develop the findings within the working paper, but will also be useful in future explorations. NCIF has long used data to better understand MOFIs and the communities in which they are working by a) providing analysis to banks to help them understand and communicate their own social performance; b) providing information to investors to help them identify potential investments and track the performance of existing investment portfolios; and c) providing information to regulators and public policy practitioners, encouraging them to support these institutions through regulator action and the reduction of regulatory burden.

Going forward, NCIF will continue to utilize this database to provide information to these audiences and create analysis on the role of financial institutions in their communities.

## Using Data to Improve Communities

The findings presented in here — and more fully in the complete working paper and ongoing research — will be beneficial to a range of audiences, including bank and credit representatives as well as supporting stakeholders such as investors, regulators, and researchers. The following calls to action provide guidance on how each group can use the working paper to support banks and credit unions — particularly those operating in LMI areas.

**Bank and Credit Union Representatives**

**Differentiate and benchmark —** Knowledge on quality of life improvements can be used by mission-oriented banks and credit unions to make the case for their important work in LMI communities as they seek support from investors and the public sector. In addition, banks and credit unions should continue to benchmark their social and environmental performance, promoting high standards.

**Produce social returns in addition to robust financial performance —** Banks and credit unions are encouraged to further their efforts in working in underserved communities, as the findings demonstrate the positive improvements in overall quality of life that are associated with the presence of financial institutions.

**Investors**

**Enhance financial and philanthropic investment into MOFIs —** The findings make the case to investors that financial institutions are important components of their communities, and are associated with positive quality of life. To support communities, investors interested in social impacts should pursue investments in banks and credit unions — particularly those working in economically distressed communities.

**Increase the flow of capital, considering social returns —** The research also proposes the foundations for a Social Return Index, which is intended to capture and succinctly convey the social impacts of banks and credit unions in addition to their financial performance. NCIF encourages investors to begin to more comprehensively consider the impacts — both social and financial — of their investments.

**Regulators**

**Support MOFIs —** Given that MOFI activity has a positive correlation with an increase in quality of life, especially in underserved markets, additional public-sector assistance should be considered.

**Researchers and Public Policy Practitioners**

**Support MOFIs via additional public-sector assistance —** Given that MOFI activity has a positive correlation with an increase in quality of life, especially in underserved markets, additional public sector assistance should be considered.

**Additional research —** The findings open the door to future research opportunities, including new explorations based on data collected, additional exploration of the methodologies utilized, and the focus on different geographies or bank and credit union subsets. NCIF hopes that the working paper helps spark a broader interest in research to make the case for banks and credit unions — particularly those working in LMI areas — and help develop the Social Return Index.

## Access the Full Working Paper

To access the full working paper, visit the NCIF Publications page to download a copy: **bit.ly/NCIFImpactReport**

A physical copy may be requested by contacting NCIF at marketing@ncif.org.

# NCIF Social Performance Metrics — an Introduction

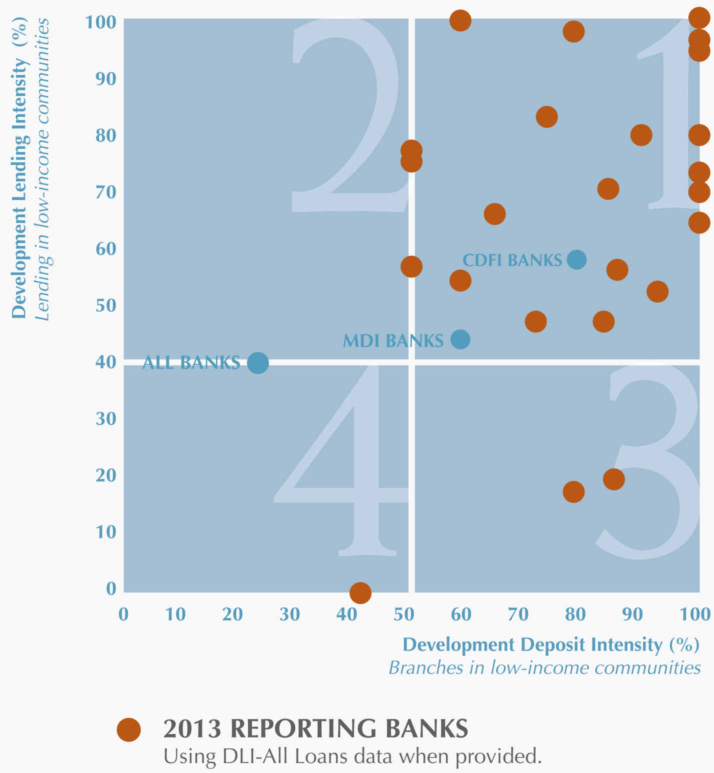
NCIF has developed clear, compelling, and broadly accepted Social Performance Metrics (SPM) for mission-oriented banks, with the following objectives:

- To inform investors about the social impact of potential and existing investments;
- To help bank management evaluate a bank's progress toward achieving its mission objectives;
- To demonstrate the importance of the industry to regulators and legislators;
- To show consumers the effect mission-oriented banks have in their community.

NCIF created the metrics in 1996 and has developed them over time to meet the needs of its bank partners and investor partners. Today, there are four core metrics supported by dozens of additional data points collected from partner banks. The core metrics are:

- **Mission Intensity**
  Working with partner banks, NCIF creates the Mission Intensity score as a measure of the percentage of a bank's lending that supports their mission. The mission-oriented banks with which NCIF works demonstrate median Mission Intensity scores of 81.4%, signifying a high commitment to their community and economic development missions.
- **Development Lending Intensity (DLI)**
  The percentage of an institution's lending that is in qualified distressed Census tracts, as identified by the Treasury's CDFI Fund. This metric can be created based on publicly-available HMDA data for all banks, as well as on all lending through information reported to NCIF by partner banks. In 2013, NCIF Network reporting banks had a DLI of 63.6%, signifying that nearly two-thirds of their lending was in qualified areas.
- **Development Deposit Intensity (DDI)**
  The percentage of the institution's branches in the same communities. In 2013, NCIF Network reporting banks had a DDI of 85.7%, showing strong commitment to locating in and serving LMI areas.
- **Quadrant Score**
  Combining DLI and DDI, an institution's quadrant score highlights overall concentration in LMI areas. While approximately 10% of all banks receive the highest rank of Quadrant 1, 87.5% of NCIF Network reporting banks are Quadrant 1 banks.

For more information please visit, **www.ncif.org.**



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NCIF has drawn substantial support from external partnerships during the course of this research, and this research would not have been possible without it. The NCIF team would like to thank all partners who supported the project. In particular, NCIF would like to thank:

**Tony Berkley, Vice President, Strategy and Impact at Prudential Foundation** and formerly of the W.K. Kellogg Foundation. Tony believes in the mission-oriented banking sector, its importance in communities, and the data-oriented work being done by NCIF. Throughout the life of this research, he served as an advisor and source of support for NCIF above and beyond his role on the Advisory Board. The team is grateful for his personal interest in this work and in enabling us with part funding from the W.K. Kellogg Foundation.

**Steve Reider, Founder and President of Bancography.** Steve provided data to the project as well as substantial guidance in thinking through methodological questions. In particular, NCIF relied on Steve's assistance in crafting the decay methodology — a variation of which is used by Bancography. Steve is a personal champion of data-driven impact analysis and the team greatly appreciates the number of hours he has invested in this work.

**Members of the Advisory Board.** NCIF convened an Advisory Board made up of industry experts and practitioners to provide input on the project. NCIF's Advisory Board provided input to ensure that a) analysis undertaken was methodologically strong and appropriately addressed the goals of the project, and b) findings generated are meaningful and useful for practitioners. Members of the Advisory Board provided thought- and action-provoking feedback during the program, greatly improving the research team's outcomes. NCIF is proud to include the following individuals on the Advisory Board:

- Alden McDonald, President and CEO, Liberty Bank and Trust
- B. Doyle Mitchell, Jr., President and CEO, Industrial Bank
- Cathie Mahon, President/CEO, National Federation of Community Development Credit Unions
- Cliff Rosenthal, Former Assistant Director of Financial Empowerment, CFPB
- Ellen Seidman, Senior Fellow, Urban Institute, and former Director, Office of Thrift Supervision
- Greg Bischak, Program Manager, Financial Strategy and Research, CDFI Fund
- Hewson Baltzell, Chief Operating Officer, Just Capital, former Head of Product Development, ESG Research, MSCI, Inc.
- Jody Rasch, Senior Vice President, Moody's Corporation
- Mark Ricca, President and CEO, First American International Bank
- Mary Houghton, former President, ShoreBank Corporation
- Michael Berry, Director of Policy Studies, Federal Reserve Bank of Chicago
- Paige Chapel, President and CEO, Aeris
- Preston Pinkett III, President and CEO, City National Bank of New Jersey
- Robert Weissbourd, Founder and President, RW Ventures
- Steve Lydenberg, Partner, Strategic Vision, Domini Social Investments, LLC
- Steve Reider, Founder and President, Bancography
- Tony Berkley, Vice President, Strategy and Impact, Corporate Social Responsibility, Prudential Financial, Inc. (formerly of W.K. Kellogg Foundation)

## ABOUT NCIF

National Community Investment Fund (NCIF) is a 501(c)(4) nonprofit investment fund that invests in mission-oriented banks and other financial institutions in order to increase access to services and catalyze economic development in low-income and underserved communities. As an impact investor, NCIF supports the mission-oriented banking industry by investing capital. Additionally, NCIF creates innovative business opportunities and facilitates the flow of funds from mainstream, philanthropic, socially responsible, and public sources. NCIF supplies research and impact metrics for banks and their investors and encourages collaboration through the NCIF Network. We aspire to transform the financial industry so responsible services are accessible to all and investments are valued based on social and environmental impact as well as financial performance.

### NCIF IMPACT MODEL

## NCIF RESEARCH TEAM


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