OUTCOMES-BASED FUNDING AND THE COMMUNITY FINANCE ECOSYSTEM

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Outcomes-based funding can be a powerful tool for shaping fiscal policy. Community finance plays an important role in the quest to transform funding systems toward a focus on outcomes.

In the United States, outcomes-based funding is often coupled with outcomes-based financing. Let's clarify the difference between "funding" and "financing" because although it may seem subtle (and frankly, confusing), the distinction is important for understanding how the momentum toward outcomes-based funding is currently being achieved.

"Funding" refers to making payments with no expectation of being paid back. In today's world, success is typically measured by outputs, rather than outcomes. For example, a success measure for a childcare program may be the number of low-income children served (the output), rather than the developmental milestones those children achieve by the time they leave the childcare program (the outcome). In the case of outcomes-based funding, payments would be provided only once the outcomes have been demonstrated. If funders shift toward funding only after an outcome has been achieved, where will the resources come from to support the delivery of services in the meantime? That's where outcomes-based financing comes in. In outcomes-based financing, the money is loaned to the service provider for the period of service provision. The outcomes-based investor is then repaid by the government funder when the agreed-upon outcomes are delivered.

Whether referred to as outcomes-based financing, Pay for Success, social impact bonds, or any other name, this innovative form of financing has helped catalyze the movement toward funding based on outcomes. Initially, an outcomes-based financing investor, who is confident in the eventual program outcomes, provides funds to the service provider until the outcomes are established. This allows the government to invest its resources in a program or an intervention only if it is successful, thereby transferring the implementation risk from the public sector to the investor. This transfer of risk helps to overcome political resistance governments may have to funding innovative approaches. Outcomes-based financing is the bridge to creating a world in which outcomes-based funding is the norm.

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As a tool for improving the efficient and effective use of resources to solve intractable social and economic problems, outcomes-based funding is promising. However, it has its limitations; chiefly, reliance on evidence to drive funding means that it is not likely to be used to *create* social innovation, but rather to *scale* it. For that reason, it will always need an ecosystem to support its potential. Private- and public-sector partners who invest in innovation will remain essential to both outcomes-based funding and outcomes-based financing. Fortunately, community development financial institutions (CDFIs) can be such partners when it comes to advancing outcomes-based financing.

The case has been made elsewhere in this publication regarding the considerable benefits of outcomes-based funding. There are many evidence-based strategies that we already know create better outcomes and save taxpayer money, such as early childhood education, cognitive behavioral therapy for youth offenders, assisted living in lieu of skilled nursing, energy-efficient retrofits of public housing—to name just a few.

Despite a growing movement to support evidence-based policy- and decision-making, it has been slow to gain traction within government, in part because it requires government to shift longstanding ways of operating. For example, the period of availability of annual appropriations for many federal agencies may inhibit outcomes-based funding of projects with longer time horizons.

Though more must be done to support outcomes-based funding, we can't lose sight of the importance of funding for innovation. In fact, "innovation-based funding" has greatly enhanced the adoption of outcomes-based financing in the United States.

The CDFI Fund has played an essential role in innovation-based funding. At the CDFI Fund, we support both the growth of the community finance ecosystem and the innovation potential of individual CDFIs. CDFIs are mission-driven financial organizations that come in a diversity of forms. Currently, there are more than 1,000 CDFIs, certified by the CDFI Fund, operating nationwide. There are CDFIs in all 50 states, the District of Columbia, and most U.S. territories. From regulated banks and credit unions to unregulated for-profit and nonprofit loan funds, venture capital funds, and microfinance funds, CDFIs share a common mission of providing access to capital for people and communities on the economic margins. These are often the same communities targeted by outcomes-based strategies.

You will find CDFIs in markets that traditional financial institutions do not serve regularly, if at all. Some markets are geographically defined and characterized by high rates of poverty, unemployment, and other measures of economic distress. Other markets are thought of by traditional investors as inefficient to serve or higher in risk, such as the small-business market. Many markets served by CDFIs are driven by government funding and are therefore less attractive and more difficult to underwrite for conventional lenders, such as community health centers and charter schools. Where there are gaps in access to capital and high social returns to be had, you will find CDFIs.

CDFIs do not act alone. They are a collaborative force that brings together diverse private- and public-sector investors in ways that mitigate risk, reduce inefficiency, and make it possible for profit-maximizing investors to engage more fully in distressed or underserved markets. CDFIs do this by engineering transactions and taking risk positions that allow private sector investors to realize risk-adjusted rates of return.

Since 1994, the CDFI Fund has supported the growth and capacity of CDFIs through its various programs. Unlike most federal programs, the CDFI Fund provides funding at the enterprise level, rather than the project level. Like a venture capital investor, it evaluates the strength of business plans and management teams and provides flexible funding that must be leveraged with matching funds from other sources. By enhancing the net assets of CDFIs through this funding, the CDFI Fund allows them to take risks, innovate, and build financial strength—all in pursuit of their mission to solve tough economic and social problems. To date, the CDFI Fund has provided more than $2 billion directly to CDFIs.

Thus, it's no mystery that CDFIs were among those who were first on the scene as the concept of outcomes-based financing, then referred to as social impact bonds, made its way to our shores in the United States. In 2011, The Rockefeller Foundation, having made a pioneering program-related investment in the first social impact bonds in Peterborough, England, wanted to test this new innovation in America. Whom did it turn to? Nonprofit Finance Fund (NFF), a certified CDFI that has received considerable support from the CDFI Fund over the years.

The Rockefeller Foundation grant was used to explore the feasibility of this new approach to social finance and to investigate how it might be adapted for the U.S. market. At that stage, there was no evidence that it would succeed. In fact, for many reasons, such as unconventional primary and secondary sources of repayment, it looked like a long shot. However, NFF was in a position to play a catalytic role in testing the concept, jump-starting the practice, and advancing its development. In 2012, it received a grant from the CDFI Fund to make subordinated debt investments in three of the earliest Pay for Success transactions in the market, incentivizing other investors and further fueling the development and practice of the Pay for Success field.

Since then, other agencies have leveraged the power of CDFIs to support the Pay for Success model. In 2014, when the Corporation for National and Community Service's Social Innovation Fund provided grants through the inaugural competition of its Pay for Success program, nearly 40 percent of the $12 million available went to CDFIs—an indication of their readiness and capacity to take on development of this new financial instrument.

One of the first Pay for Success transactions to be completed in the United States was in Cuyahoga County, home to the city of Cleveland. The targeted problem was homeless families with children. Evidence shows that children with homeless caregivers spent considerably more time in out-of-home foster care than children with housing-secure caregivers. This extended time in the child welfare system has historically resulted in poor

outcomes for the most vulnerable families and has led to higher costs for local government.

In Cleveland, many local partners came together to create a program to reduce the time children of homeless parents spend in foster care and to accelerate the process of reconnecting children with their parents or caregivers in stable, affordable housing. When no conventional financial institutions stepped forward to finance the Pay for Success transaction, not even the local bank, two CDFIs collaborated with several nonprofit and philanthropic partners to close the deal. The senior debt was taken on fully by the Reinvestment Fund, with NFF holding a subordinate position along with other subordinated debt investors.

The financial strength and innovative capacity of CDFIs has enhanced the development of outcomes-based funding in the United States. Movement toward outcomes-based funding at all levels of government will aid in the accomplishment of more wisely spent taxpayer dollars. However, outcomes-based funding can succeed only to the degree that there is a pipeline of innovative, evidence-based solutions—and if flexible partners are available to finance transactions that build this evidence. The way in which the CDFI Fund invests in CDFIs supports them to be good partners, to innovate, and to discover what works.

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