# Solidifying the Business Case for CDFI Nonfinancial Performance Measurement

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Measuring nonfinancial returns is a cost of doing business for community development financial institutions (CDFIs). Like any other expense, the tracking and reporting of impact must be justified by the contribution it makes to CDFI operational and strategic priorities.

In my and Colby Dailey's article "Building Scale in Community Impact Investing through Nonfinancial Performance Measurement," in the *Community Development Investment Review* and presented to the Federal Reserve Board of Governors conference in March 2011, we conjecture that more rigorous reporting practices will draw new capital into community impact investing. It was an admittedly theoretical argument, but one we hope will be supported by additional evidence over time.

For now, the business case for rigorous impact evaluation as a strategy to attract capital is a relatively weak one, at least at first glance. Because CDFIs deliver impact by statutory definition, most funders are not especially demanding of detailed evidence. Add to that the high costs and other difficulties associated with measuring and reporting, and it is hard to justify collecting and providing more information than is absolutely necessary.

To the extent there is a business case for rigorous impact evaluation, it centers on a number of factors that are more difficult to quantify. These include the four, broad benefits that three CDFIs –Coastal Enterprises, Enterprise Cascadia, and HOPE–identified during research for this article.

1. The first benefit is impact measurement's contribution to operational excellence and internal tracking. As Bill Bynum, CEO of HOPE put it, "Measurement helps us determine whether or not our efforts are achieving the desired results, and we use this to make strategic adjustments." Others concur. Maggie Kirby, development coordinator at Enterprise Cascadia, believes that "what gets measured gets done. We develop a set of important objectives for the coming year and then assess each quarter how we are performing." Likewise, Ellen Golden, managing director of Coastal Enterprises, uses the information they find from evaluation to create a vision for the future.

2. The second benefit of rigorous impact evaluation is its ability to influence the market. Bynum explains, "We use the data and analysis from our work to influence the policies and practices of government officials and agencies, banks, foundations, community development practitioners and others whose actions impact the well-being of low-income people and communities we serve." Coastal Enterprises, on the other hand, needed impact information as a tool to build credibility for their approach to community economic development.

3. The third benefit of measurement is its contribution to regulatory and investor compliance. Groups can use the information gleaned from evaluating impact to maintain certification or meet the needs of existing funders, as Coastal Enterprises does, or they can use the information to meet specific reporting requirements to investors; an Enterprise Cascadia priority.
4. Finally, impact measurement offers a competitive advantage. As Golden from Coastal Enterprises put it, "This is one way for us to distinguish ourselves from potential competitors both [locally] and at the national level."

The contribution impact evaluation makes to operational excellence and internal tracking is particularly evident and widely accepted. CARS, the independent rating system for CDFIs, is a notable example of a more inwardly focused form of impact evaluation. CARS assesses the nonfinancial impacts of the CDFIs it rates by focusing on the alignment of strategies with mission in an institution, the effective use of financing resources in pursuit of its mission, and the processes by which the organization tracks output data on its mission-focused goals. According to an April 2011 press release from the Opportunity Finance Network, which administered CARS at the time, of the 51 CDFIs that have gone through the full CARS ratings cycle (a full rating and at least one annual review), 50 percent received a ratings upgrade for "impact performance" or showed improvement in component measures.[1]

Even as the internal business case for rigorous measurement becomes more evident –ensuring what CARS calls greater "clarity and depth in CDFI decision making."–the "external" business case remains undeveloped. As CARS managers indicated at the Federal Reserve Bank conference, there is very little demand for a more quantitative and standardized method of impact evaluation that would allow greater comparability across CDFIs.

To build an external business case for nonfinancial performance measurement, it is important to ascertain whether the growth in social and impact investing might spur interest in CDFIs. If it does, rigorous impact measurement and reporting could become a factor in unlocking additional capital.

In this article I contribute a number of additional questions and next steps to the conversation about measurement that started well over a decade ago–a conversation that led to the development of CARS, the Community Investment Impact System (CIIS) at the CDFI Fund, and the CDFI Data Project, among other innovations. Colby Dailey and I noted in our initial research that the impact investors most likely to drive widespread innovation in measurement are those who, for whatever reason, care most about impact. We call this their "willingness to pay." The group also includes those most highly motivated to report impact, which we call their "willingness to disclose."[2] CDFIs are the investors that best fit this definition, hence their centrality to the development of nonfinancial performance measurement.

1 "Impact performance" evaluates how well a CDFI loan fund strives to achieve its mission.

2 We define "willingness to pay" as the "quantity of time, effort, investment earnings, or other resources that investors are willing to exchange for a preferred value of nonfinancial return." "Willingness to disclose" is defined as the "quantity and quality of reporting of nonfinancial returns that investors are willing to provide to the stakeholders to whom they are accountable".

## The Status Quo

The willingness of CDFIs to measure and disclose nonfinancial performance is primarily a function of accountability. Simply put, CDFIs deliver the information that stakeholders (i.e., investors and regulators) demand. The demands of these stakeholders differ significantly. On the one hand, banks motivated by Community Reinvestment Act (CRA) stipulations are the least demanding capital providers to CDFIs. Most CDFIs demonstrate CRA compliance simply by being registered with the Treasury Department, thereby satisfying the most pressing need for banks. Moreover, banks are primarily financially motivated and are less willing to pay for community impacts than many other investors.

Government entities such as the CDFI Fund are more committed to tracking impact, and demand more information from CDFIs as a result. Recipients of CDFI support, including New Markets Tax Credits, are required to report annually on community impacts to CIIS. However, these metrics are relatively limited–focused only on jobs created, affordable housing units developed, and capacity created in community facilities–and are neither attributable to the reporting entity nor available publicly. Here again, CDFI certification provides the key indicator of mission consistency, and impact evaluation essentially takes place upfront.

Foundations, on the other hand, generally demand the most accountability for their capital. Because foundations strive to deliver focused and deliberate social impacts in their own right, including by force of law in the case of program-related investments, they often expect detailed documentation of related outcomes from CDFIs. For example, all Pacific Community Ventures (PCV) foundation limited partners specify exactly what social impacts are required to be tracked and reported.

## New Sources of Capital Might Create New Incentives

Because accountability remains the primary factor in driving non-financial performance measurement practices, the business case for tracking and reporting impact is tied directly to new sources of capital and investors in CDFIs. But their interests are unclear. Do these new investors resemble banks, government entities or foundations in terms of their willingness to pay for non-financial return? What additional data are they likely to demand?

Uncertainty has not stopped a number of CDFIs from experimenting with new, often complex financial mechanisms to attract nontraditional sources of capital. Some of the targets of these activities are socially responsible impact investors, including high-net-worth individuals, family offices, and donor-advised funds. For example, the New Hampshire Community Loan Fund raises $4 million each year from individuals. Coastal Enterprises, in Maine, and Enterprise, a national housing lender, both offer CDFI notes to social investors with the goal of raising more than $10 million. It remains unclear whether these investors are likely to be as demanding of rigorous impact evaluation as foundations.

A second group of prospective new investors, albeit a less immediate target, are financially driven entities such as pension funds. On the face of it, we would expect these organizations to have an interest in impact evaluation more closely aligned with banks. But because those who invest in community development do so by mandate, they generally demand more rigorous performance tracking and reporting. For example, PCV's third $40 million equity fund includes an allocation from the California Public Employees Retirement System (CalPERS), which rigorously evaluates and measures its performance against three key metrics: investment in businesses in areas with limited access to capital; company ownership or management by women or minorities; and employment of workers from low- and moderate-income (LMI) communities. For CalPERS to fulfill its evaluation and reporting obligations, PCV is required to complete a detailed annual impact survey for each of its portfolio companies.

Investors that are less demanding of nonfinancial performance information will remain as core supporters of CDFIs. However, to attract capital from some of the most promising new providers, it is important to consider–or even anticipate–their potential to require broad disclosure of non-financial performance. Some CDFIs are already taking this leap of faith. Enterprise, for instance, is seeking to expand its investor base beyond traditional CRA-motivated investors through its efforts to attract retail investors to the Enterprise Community Investment Note. To do so, it is gearing up to collect new metrics, comply with the Impact Reporting and Investment Standards, an initiative of the Global Impact Investing Network, and enhance its capacity to tell a more compelling quantitative and qualitative story. Enterprise believes it can better evaluate the ultimate success of its supported projects with a more robust impact assessment program.

## Are We In This Together?

Individual CDFIs will need to decide for themselves if the prospect of attracting additional capacity justifies greater investment in impact evaluation and reporting. But presuming at least some new investors are likely to demand more impact data, is the CDFI industry, collectively, interested in developing more standardized, rigorous, and cost-effective measurement tools?

If new investors bring to the table increased demands for accountability, and a higher willingness to pay for impact, then the answer is probably yes. It would be helpful for all CDFIs if they could leverage a "category" story to attract prospective investors–a broader understanding of the entire sector's performance, cultivated through consolidated industry-wide reporting. Smaller CDFIs, in particular, would benefit from the economies of scale a standardized effort at measurement would bring.

Greater standardization would also create more robust industry benchmarks, identify and develop best practices, and provide investors with real choices through greater comparability. Benchmarks would provide CDFIs with a quantitative barometer against which they could measure their impact. An example is the National Community Investment Fund annual report on financial and social performance, which ranks CDFI banks on measures including the proportion of lending in LMI areas. Once we know which CDFIs have the greatest impacts, we can recognize and replicate their efforts, following the lead of the Wachovia Wells Fargo NEXT Awards for Opportunity Finance. And if the field presents quantitative impact data that are standardized, and therefore genuinely comparable, investors can make more informed choices.

## Ongoing Challenges

CDFIs face numerous challenges in tracking and reporting performance that must be readily acknowledged and carefully considered moving forward. Although these challenges vary across CDFIs and CDFI sectors, they can be summarized as follows:

1. **Cost:** Cost is a, if not the, principal challenge. Penelope Douglas, the founder of PCV, has spoken publicly of the expense incurred in PCV's early years to develop a capacity to rigorously evaluate impact; $250,000 out of an operating budget of $1 million. Many smaller CDFIs are struggling to survive day to day, and simply don't have resources to spare.
2. **Political and operational realities:** For many CDFIs, the presently weak business case for impact evaluation not only tempers additional effort, but often motivates less reporting. The CDFI industry has grown in the past few years driven not by additional investors, but by new or more generously funded public policies. Why do anything to jeopardize that success, CDFIs ask. What's more, innovations in measurement and reporting must overcome regulatory challenges. For example, The CDFI Fund is working to provide more robust and transparent data to the public, in line with the Transparency Act, yet it also must work within the constraints of the Privacy Act and the regulations of both the U.S. Treasury and the Office of Management and Budget. These sometimes competing mandates make measurement and reporting improvements daunting.
3. **Disparate investor preferences:** Another persistent challenge is the wide diversity of preferences of CDFI investors for nonfinancial return. Not only do certain investors, such as banks and foundations, have a very different willingness to pay for impact, but they invest in a wide variety of issue areas, from education to affordable housing, and seek different types of returns (e.g., number of classrooms built vs. number of students served). These disparate preferences, which also tend to be highly place-based and parochial, complicate the development of consistent and efficient measurement practices.
4. **Lack of standard practices:** Finally, there is no industry standard for measurement and reporting on which to build, and technical challenges persist. As a result, there are no recognized best practices to learn from and few economies of scale to drive down cost.

## Next Steps

The traditional investment industry sets a high bar for quality financial performance measurement and disclosure. Reported data should be longitudinal, benchmarked to peer groups, audited by a third party, reported regularly and predictably, and evaluated using a fully disclosed methodology. All of these fundamentals are theoretically achievable when measuring nonfinancial performance. However, the field has a long way to go–not least to close the tremendous gap between this type of rigorous impact evaluation and the generally accepted business case for CDFIs in providing it.

With this in mind, six steps would move the field in the right direction.

***Developing a deeper understanding of future new investors.*** CDFIs should pool their knowledge of and experiences with new investors, as well as with those that are seriously inquiring about the sector. By identifying what attracts these investors to CDFIs, the community impacts they care about, and the nonfinancial performance information they are likely to demand, the field can develop impact evaluation and reporting practices that align with these goals, and that are likely to attract additional capital.

***Identifying consistent social impacts across the different types and strategies of CDFIs.*** If CDFIs focus on similar social impacts–for example, providing access to capital to particular groups, serving the underbanked, lending to mission-oriented organizations, or creating jobs for residents of economically distressed communities–standardization and economies of scale in impact evaluation become more likely. There may be considerable crossover between CDFIs, or very little, depending on the granularity of the impact in question. Regardless, any opportunity for standardization is likely to be beneficial.

***Reaching agreement among investors in CDFIs on a more focused and consolidated set of nonfinancial objectives.*** This would better facilitate standardization, not only between CDFIs, but also within them, where the discrete, inconsistent demands of investors often create inefficiencies. If possible, investors should limit the specificity of their demands for social performance information where this puts an unreasonable burden on CDFIs. And investors should always question whether, as a group, they can agree on a shared set of data that meets all of their needs.

***Securing additional support for field-building from foundations and other funders.*** This could include underwriting initiatives to better understand the fundamental incentives that drive the practice of nonfinancial performance measurement, or support for CDFIs to develop user-friendly tools that enable thorough reporting. Significant and much-needed funding has been directed to the development the infrastructure enabling the evaluation and reporting of impact. The field should now turn its attention to building a critical mass of users, which will ultimately lead to financial sustainability in impact measurement.

***Addressing privacy issues.*** The CDFI Fund is working on a new categorization method that retains privacy as required by law but provides a more standardized way to measure and report impact. More research in this area is needed.

***Adopting voluntary principles and practices for CDFIs to encourage a consistent quantity and quality of impact evaluation and reporting.*** A set of standards would move the industry forward and in part anticipate and diffuse regulatory action mandating more robust reporting. These standards should not require CDFIs to undertake impact evaluation in a prescribed manner, using a single tool. Rather, they should be high-level principals to which CDFIs can adhere in a manner that suits them best. These might include core requirements for consistent reporting of quantitative data over time, in a predictable manner, using a methodology that is fully disclosed.

## Conclusion

Impact evaluation is the subject of growing attention, including in this journal, because mainstream investors are increasingly looking for opportunities to achieve both financial and social returns.

To the extent CDFI nonfinancial performance evaluation and reporting strategies remain underdeveloped, there is a need to further investigate whether this is hindering the ability of the industry to capitalize on new investor interest.

If, as I suspect, the business case for impact evaluation as a capital attraction strategy is more robust than currently presumed, CDFIs should work toward improving data integrity and transparency as a way to build the field.

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