



Change Matters Stakeholder Report April 2011

*The development of a performance framework
Investing in the sector
... and looking to the future*

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This report was produced with the support of the Friends Provident Foundation

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1. Introduction

Community Development Finance Institutions (CDFIs) work to fill gaps in the provision of finance for individuals, businesses and civil society. They are financial organisations that are driven by a mission to achieve positive social change and bring wealth to disadvantaged communities.

CDFIs provide finance in a range of ways including to:

- Small businesses that create jobs and offer much-needed services and amenities in Britain's most deprived inner cities and rural locations
- Individuals, including those who are unable to access the basic range of financial services
- Social enterprises that have both a social and commercial purpose
- Charities and other voluntary organisations that find it difficult to access funds elsewhere.

In turn, this finance helps create a virtuous cycle of business development, employment growth and increase in household incomes in areas that have traditionally suffered from circles of under investment, lack of opportunity, poor quality jobs and insufficient services.

The divisions of markets outlined above are comprised of SME (small and medium enterprises), personal, social enterprise and civil society lenders. The SME includes micro enterprises, which often merit their own category due to a different size of loan and loan terms.

Although CDFIs are firmly focused on their socio-economic missions, they operate with business models that seek to maximise operating efficiencies and income generating activities. By using a variety of alternative underwriting and security methodologies (such as character and cash flow based lending rather than credit scored lending) and adopting a different approach to risk, they are able to take more risk than the commercial sector and can intervene to support clients to reduce the risks of lending to them. In contrast to commercial banks, CDFIs use a variety of positive incentives to support and ensure expectations of repayment amongst their customers.

Community development finance in the UK has really emerged since the late 1990s, with nearly 50% of the **cdfa's** membership beginning their lending in the last five years. Community development finance has now passed through the set-up stage and is now into its consolidation period, which brings its own risks and challenges.

Timeline

Date	Milestones for developing CDFI sector and Change Matters	Sector Profile
2002	The Community Development Finance Association (cdfa) is established.	
2003	Investment into the sector: Phoenix Fund for enterprise-lending CDFIs. The cdfa initiates an annual survey of the sector to report on key findings.	49 members, £106m portfolio outstanding
2004	Investment into the sector: Growth Fund for low cost personal loans.	66 members, £67m of loans, £147m portfolio outstanding
2005	Initial grant from Friends Provident Foundation to the cdfa , under the project title 'Only the best will do – Indicators and benchmarks programme'.	80 members, £77m in 4,970 loans, £181m portfolio outstanding
2006	Testing of indicators and develop capacity building programme for CDFIs.	Insufficient data available from cdfa
2007	Follow-on grant to cdfa from Friends Provident Foundation, under the project title 'Only the best will do – developing self-regulation within the UK CDFI sector'. The cdfa introduces a Code of Practice mandatory for members, and continues to test benchmarks.	76 members, £105m in 5,447 loans, £285m portfolio outstanding
2008	The cdfa publishes first set of key financial ratios for the sector using data from pilot phase of Indicators and Benchmarks along with Annual Survey data, and carries out a public consultation on the performance framework process, now called 'Change Matters'.	73 members, £76m in 8,414 loans, £331m portfolio outstanding
2009	Independent assessors are trained to carry out Change Matters assessments, and the cdfa establishes an independent panel for oversight of the process. A member and stakeholder event is held to publish the results of the development so far of the performance framework.	71 members, £113m in 19,937 loans, £394m portfolio outstanding
2010	The cdfa reviews the Key Performance Indicators and begins to develop a new structure for Change Matters to increase transparency. Tools and methodologies are developed out of small working groups of CDFI practitioners to underpin the performance framework, particularly in financial ratios and impacts.	66 members, £200m in 18,900 loans, £531m portfolio outstanding
2011	Change Matters 2 is launched as a self-assessment for transparency, set against strict criteria and definitions for certification through an external assessment. Wholesale funds such as Regional Growth Fund and Big Society Bank look to require due diligence; Change Matters to provide a clear picture of performance against benchmarks to investors.	

The picture that emerges from the findings of the **cdfa**'s annual member survey by 2010 is of a sector on the move. In numbers, CDFIs have funded 54,000 individuals and businesses, created and sustained around 105,000 jobs and have lent £672m since 2003. They have also helped their customers lever an additional £600m from banks. In April 2010 the portfolio size of the CDFI sector stood at £530m^[1].

What follows is a description of the emergence of a performance framework for the UK CDFI sector and how it has been developed to serve as a self-regulatory framework using Key Performance Indicators (KPIs). (The industry term KPI is used to assess the success of a specific activity in which a business is engaged. It can be a financial or non-financial measurement used to quantify advancement towards strategic object). This common reporting standard for UK CDFIs, called Change Matters, is aimed to ensure greater transparency on varying performances, ultimately reducing costs of assessment, evaluation and reporting for both CDFIs and stakeholders.

^[1] Source: *Inside Out* 2010

2. Early years of investment into Change Matters (2005-2007)

One of the cornerstone investors in the **cdfa** was Friends Provident Foundation, which was attracted by the idea of developing a UK-wide framework for benchmarking the performance of members of a young sector that was reaching out to the financially excluded. The creation and development of Change Matters would not have been possible without the support of the Friends Provident Foundation whose foresight and understanding has been much appreciated by the **cdfa** over many years.

The CDFI sector itself was supported in its early days by a mixture of public and charitable finance and, in some instances, social investment. As the industry body the **cdfa** knew that once the sector became established CDFIs were going to have to attract a broader range of funders, including commercial investors. This would ensure CDFIs could become sustainable, permanent businesses able to deliver their mission of creating wealth in every disadvantaged community in the UK.

To do this, CDFIs would need to be able to report their performance against a comparative framework so that potential investors could make appropriate choices depending on their own risk appetites. The **cdfa** recognised that the framework needed to work in the sector's different markets yet have a commonality of reporting which would provide a cohesive, understandable structure across the industry. It began to develop that framework under a working title 'Only the best will do', with three key objectives:

- To establish core organisational performance and impact indicators for CDFIs, which are understood and supported by key stakeholders and the CDFI sector
- To develop a transparent, transferable set of benchmarks against which UK CDFIs can measure their performance against their peers
- To enable the **cdfa** to disseminate the output from the project and to support CDFIs, funders and other stakeholders in learning from the experience

The difficulty in the early days of the sector was that performance data hadn't emerged as the industry was in nascent form. With the support of Friends Provident Foundation and the Department of Business, Enterprise and Regulatory Reform, the **cdfa** developed research on the sector and published it each year in 2004, 2005 and 2006 in its 'state of the sector' publication *Inside Out*. However it was not until 2006 that clear performance, trends and developments emerged.

From 2006-7 the **cdfa** focused on developing a draft framework and consultation. A period of desk and action research led to formulation of the first draft of the performance framework which was piloted in the different sector markets. While the core of the framework centred on financial indicators of sustainability, portfolio quality

and solvency, these factors build on a solid organisational foundation demonstrating that the performance indicators were produced in a robust, reliable and resilient environment.

The next stage in the development of the framework focused on testing the framework with site visits with **cdfa** member CDFIs. The aim of these visits was two-fold: to test the effectiveness and robustness of the framework and to begin to populate the framework with data to lead to benchmarks.

CDFIs which took part in the pilot were recognised for doing so during the Association's annual conference *Money for Change* in 2007.

3. Key findings after the first pilot project (early 2008)

The first pilot project created many more questions than answers in terms of how to assess the CDFI sector through the performance framework. The approach to creating it had been slow and consultative. To ensure the framework was fit for purpose it was continually developed and refined. By working in this iterative way the **cdfa** was able to address the initial questions raised by CDFIs and other stakeholders, and yet move the framework forward.

To begin with, once feedback from the pilot had been gathered and analysed, it was revised and amended. Initially the framework consisted of five domains:

- Finance
Looking at sustainability & profitability, asset & liability management, portfolio quality, solvency, capital & liquidity and efficiency & productivity
- Organisation
Looking at human resources, strategic planning and budgeting, risk management, financial practices & statutory requirements and signs of growth
- Operations
Looking at policies, systems, procedures and reporting requirements
- Market Awareness
Looking at research and analysis, marketing strategy, outreach, pipeline management, client capacity building and market visibility
- Impact
Looking at mission test, outputs, outcomes, hard and soft impacts

A number of practical recommendations, suggestions and adjustments were made including ideas for capacity building inputs, format for feedback following site visits, a number of areas for further works and development (such as on MIS and Chart of accounts or similar guidance) and ways for using the framework as a developmental tool as well as a test of performance.

Organisation, Operations and Market Awareness were supporting domains to help ensure that the data reported under the Finance and Impact domains was valid and reliable. They were also designed to assess whether the organisation that supplied the data was implementing the necessary policies, systems and procedures to meet good practice standards. One outcome of the pilot was to consolidate these into one section called business practice.

This means the framework was now comprised of three core areas: finance, impact and business operations. Other work included further refinement of the finance ratios, development of clearer principles in the business operations and impact domains and consolidation of the business operations domain into a smaller number of topics.

The framework did provide individual data and analysis on each CDFI, and was intended to measure key performance indicators consistently and transparently. To measure the performance of the sector, benchmarks were needed to assess relative success. At the end of the first pilot project, sector-wide data (from *Inside Out* and the pilot Change Matters visits) was analysed by CDFI experts to set the 2008 financial benchmarks for the sector - see Table 1.

This became the starting point to truly begin measuring and assessing a CDFI's relative performance for each market within the sector.

Table 1 - 2008 Benchmarks

Benchmarks 2008	Loan fund self-sufficiency	Operational Self-sufficiency	Gross Yield	Portfolio at Risk (PAR 30+)	Annual W/O	Loan Officer Productivity	Operating Expense Ratio
Individual/personal	60%	65%	15%	*	15%	500	45%
Microfinance	35%	40%	16.50%	*	9%	100	64%
Small Business	50%	55%	14.50%	*	12%	82	48%
Social Enterprise	48%	75%	5.50%	*	3%	20	18%

** Due to lack of consistency in PAR reporting across the sector, no benchmarks were published.*

The six financial areas each have one or several associated financial ratios:

Financial Indicators	Key ratios to support these indicators
<p>1. Sustainability and profitability</p> <p>Is this CDFI organisationally sustainable? If not, is its service impact sufficient to persuade funders to bridge the gap? How resilient is this organisation to loss of support from key funder(s)</p>	<p>Loan fund self-sufficiency</p> <p>Operational self-sufficiency</p>
<p>2. Asset and liability management</p> <p>Does this organisation handle its assets and liabilities efficiently? Is it efficient at raising capital for its operations?</p>	<p>Yield on gross loan portfolio</p>
<p>3. Portfolio quality</p> <p>Does this CDFI make good loans and / or investments? Does it monitor and report to key stakeholders on its portfolio quality? Does it make adequate provision for write-offs?</p>	<p>Aged Portfolio at Risk (PAR)*</p> <p>Write-off</p>
<p>4. Solvency</p> <p>Can this CDFI afford to pay its liabilities? Has the organisation built up sufficient reserves to continue operating?</p>	<p>Current Ratio</p> <p>Operating Reserves</p>
<p>5. Capital and liquidity</p> <p>Has the CDFI access to sufficient and appropriate capital to allow it to continue operating? Is the CDFI deploying its loan / investment capital for the purposes intended?</p>	<p>Commitments</p> <p>Deployment</p>
<p>6. Efficiency and productivity</p> <p>Are the CDFI loan officers working efficiently? Are CDFI staff working efficiently and cost-effectively? Are the CDFI's costs reasonable?</p>	<p>Loan officer productivity</p> <p>Averaged disbursed loan size</p> <p>Operating expenses ratio</p>

* PAR shows only capital that has not been repaid, in an aged breakdown

In total, these areas provide a picture of how well a CDFI is performing in relative terms with respect to finance and business operations. By taking an aggregate of the data it is possible to home in on issues particular to each market; these are useful for investors and CDFIs to take capacity building measures.

4. Using Change Matters findings to capacity-build the sector (2008-2010)

The next phase of the framework was named Change Matters, and as this programme developed the **cdfa** was able to attract additional capacity building funds or matched funding from a variety of stakeholders including Esmee Fairbairn, CAF, Lankelly Chase Foundation, Lloyds TSB, DWP and Barclays Bank. This fitted in well with the continued focus on refining the benchmarks and KPIs supported by Friends Provident Foundation.

To help build capacity in the sector, the **cdfa** delivered courses on delinquency management, building good governance, demonstration of impact and business planning. Training grew to include technical courses on lending, portfolio management and accountancy, and non-technical courses including people management skills and marketing.

Bursaries were given for courses and small grants given for activity ranging from mentoring to rebranding, improving policies and governance systems, upgrading management information systems and investing in additional staff posts.

CASE STUDY

1. Foundation East

Foundation East is a CDFI lending in the East of England. Their aim is to be best at providing loans in the East of England. They are an Industrial and Provident Society that has charitable status. The size of the portfolio at 31st March 2010 was £1,195,455, comprising 137 loans, with an annual write off rate of 20%. In terms of outcomes, the society created 29 jobs in 2010, and saved 42.5 jobs. They lent £181,255 to start up businesses, £232,000 for businesses expanding and £27,000 for businesses that are recovering.

2. Need for grant

Following a Change Matters visit, Foundation East wished to implement a recommendation within their Change Matters report to improve their strategy and business planning. By the **cdfa** funding this work Foundation East could maximise their community impact. In turn, this would support Foundation East to engage funders and stakeholders. The ultimate aim was to strengthen the long-term sustainability of Foundation East, particularly as they have a client group that comes from a large geographical area, which is sparsely populated. This requires Foundation East to focus efforts on specific clients so that the resource is not spread too thinly.

3. The package

A grant of £5,000 was provided by the **cdfa** and this was matched by Foundation East. The terms of the grant were to provide a learning report six months after the completion of the inputs and to provide a 5% contribution back to the capacity building fund.

4. The impact

Foundation East was able to create two strategic work streams:-

- Lending to financially excluded businesses to enable job creation and job safeguarding leading to: -
 - Local economic growth
 - Provision of local services
 - Empowerment of individuals
 - Improvement of access to mainstream finance

- Developing Community Land Trusts, as this: -
 - Empowers individuals in a community to take action
 - Eliminates the negatives of fallow land, land misuse and run down areas
 - Promotes regeneration
 - Raises community self regard
 - Delivers new opportunities for the community

This has resulted in a clear business plan and the creation of Key Performance Indicators (KPIs) to reach the strategic work streams. To achieve these challenging strategic work streams the CDFI will need to expand their loan book to lend to businesses that could lead, for example, to local economic growth. Foundation East has a target KPI to expand the loan book to £5.7m and this will be targeted to the four areas they wish to engage in from their strategic work streams. To ensure that Foundation East can continue to lend in these areas, they need to be able to maintain their loan fund. The main threat is the non-repayment of loans, which would mean that the CDFI is not able to recycle funds. The response to this challenge is for Foundation East to have a target KPI to maintain annual write off rates below 23%. The size of the loan book and the write off rate are two important KPIs to ensure Foundation East meets its two strategic work streams.

5. Learning points

There were two main learning points for Foundation East.

- Use of external consultants enabled board and staff to reflect on their progress to date, through action planning.
- A strengthening of the board and staff, through open communication.

A formal consultation on the performance framework was held in late 2008 and although there was a limited engagement in the process, the essence of the responses clearly indicated that the framework was fit for purpose. A number of stakeholders were beginning to ask CDFIs to undertake Change Matters visits to assure them that the organisations they were funding had undergone a rigorous review.

By now the **cdfa** had trained two external assessors for Change Matters. Their procedure was to review a set of documents submitted by the CDFI, followed by a site visit and a written performance framework report approved by the **cdfa**. The assessor reported against a particular framework, which included comparison of the CDFI's financial ratios with the 2008 benchmarks.

By 2009 self-regulation development (in the form of benchmarking from Change Matters visits) was supported by the Department of Business, Information and Skills in addition to Friends Provident Foundation. This increase in funding meant the number of visits could increase from an average of five to 12 a year over the next two years, a significant milestone which allowed the **cdfa** to collect enough data on KPIs to report comprehensively on strengths and weaknesses of the sector and establish the next version of appropriate benchmarks.

5. Challenges and opportunities for the sector (2009)

What had emerged from analysis of Change Matters reports by the end of 2008 was that CDFIs within each market sector (personal, SME, micro and social enterprise/civil society lending) fell into three distinct profiles:

(a) Well established CDFIs

These CDFIs had established and developed organisational infrastructures, a clear route to market and a track record of lending. They were the most likely of all the groups to be investing in research and development, to have accessed and deployed external sources of capital, be benefiting from increasing operating efficiencies and achieving greater scale. They were most likely to require additional capital as they grew. However, this group continued to struggle to ensure their customers had access to quality business support and financial advice to complement the finance they provided, and they required revenue funding to cover the costs of this support.

(b) CDFIs still maturing and developing their business model

In the main, these CDFIs had been operating less than five years. They had invested in organisational development, product refinement and testing routes to market. They still had some way to go before their models were mature and they had effective routes to market. These organisations had used, and continued to require, grant support for both revenue and capital to consolidate their business model and refine their products. These newer entrants offered a variety of business support and money advice services in their delivery. If this were to remain a significant part of their business model, payment for these kinds of services would continue to be a crucial part of their funding.

(c) CDFIs experimenting with different approaches

This included regional providers who were testing different markets, with a notable movement from direct lending towards carrying out back office support for other CDFIs and/or developing more mentoring functions for potential and existing clients.

These profiles provided a critical steer to the **cdfa** in recommending appropriate investment into the sector.

In 2009, there was a crisis in the sector: lack of sustainability, intensified by the wider economic environment. It had been assumed (in 1998-9) that within ten years the CDFI sector would be sustainable. In 2009 the main stakeholders of the sector were

government, banks and charitable trusts. All of these players were asking why sustainability had not been achieved.

CDFIs had historically been supported by Government and charitable trusts, mainly through revenue funding. The rationale put forward was to create sustainable CDFIs, and to make this happen stakeholders recognised they would need to invest in the sector for ten years. In reality, by 2009, CDFIs were struggling. Investors began to realise that a decade was too short a period of time to build sustainable institutions working in challenging areas of financial deprivation.

Government had to re-consider their position, and to do so they commissioned an economic review of the policy intervention that involved funding the CDFI sector. The analysis was undertaken by GHK, a research specialist in public policy and microfinance. They approached this using a standard methodology to assess numerous policy interventions. This included analysis of a sample of CDFIs, assessing their business models to review the economic effectiveness of the policy interventions.

Specific recommendations to the sector were made in the GHK report on the need for strategic planning, monitoring and enhanced reporting on performance. It was recommended that the sector needed to undertake this work to prove the need for continual revenue investment in the sector. Critically for the sector, though, the report argued compellingly that CDFIs were a necessary part of the financial inclusion marketplace.

GHK report findings: how CDFIs address market failure ^[2]

CDFIs address the consistent failure of the market to reflect the economic and social benefits of lending in underserved markets. This leads to reduced enterprise outcomes (e.g. fewer and under-capitalised businesses and foregone economic benefits), particularly amongst disadvantaged groups and areas.

The social returns from CDFI loan finance exceed the private returns available to lenders ('foregone economic and social benefits').

The national evaluation confirmed that theoretical arguments underpinning the market failure rationale for policy support to CDFIs remained valid; indeed, during the onset of the credit crunch these failures have intensified rather than dissipated.

For individual businesses, CDFI activity is reducing information failures [information failure on the part of the private banking sector towards the potential viability of loan finance applicants (largely deriving from the high transactions costs to lenders

^[2] Source: EVALUATION OF COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS (CDFIs), GHK, March 2010

associated with generating and appraising the deal flow and providing investment and aftercare support);] as individual clients go on to successfully access mainstream funding following receipt of a CDFI loan. The main reason given is that, crucially, a CDFI loan enables enterprises to develop and demonstrate to subsequent lenders a track record in borrowing and repayment.

The 'credit crunch' showed the sector to be a flexible and fast moving delivery mechanism, able to respond to an increased scale of demand as access to mainstream loan finance became much harder for a range of businesses.

Charitable trusts meanwhile were taking an individual approach to investment in the sector. Each trust reviewed their own strategic objectives out of which they carried out due diligence of individual grant applications from the sector. CDFIs have had to compete against a myriad of other approaches to creating wealth in deprived communities. This was leading to a decrease in the amount of revenue funding from charitable trusts in the CDFI sector.

Another main group investing in the sector were Regional Development Agencies. By no means uniform in funding CDFIs throughout the UK, those who did often provided revenue and associated capital grants, which could be recycled after lending. This gave a critical investment to the sector particularly in the North West, North East and Yorkshire and Humber. One distinctive feature was the impetus to form consortia of CDFIs to lengthen the reach and impact of this sort of regional investment. Over time these regional consortia were also able to look to European regional development funds as another grant source contributing to revenue and capital, which could also be recycled.

The other main investors providing support to the sector were banks. In 2009 the level of investment in CDFIs by the banks was £4.3m (source: *Inside Out 2010*) through provision of semi-commercial capital. Each deal was highly structured and normally in favour of the bank. This was less helpful for the institution building still so essential to the sector, mainly because it only provided limited if any revenue support. At this relatively young stage of the sector, CDFIs were not able to survive on income solely from the loan fund (Loan Fund Self Sufficiency). For CDFIs to be able to continue to deliver they needed revenue funding as well. This in turn presented a challenge for the banks as they undertook their due diligence, which is normally based only on portfolio performance.

6. A sector campaign for investment (early 2010)

In the wider financial sector, the credit crisis in 2009/10 created both opportunities and threats to the CDFI sector. The threat was that government chose to focus on supporting the mainstream banks. The plight of CDFIs became a lesser issue and the urgency with dealing with the sector's potential funding crisis was not a priority for government. However, the opportunity was that if CDFIs could rise to the challenge of providing appropriate finance where the banks were unable to, then the CDFIs could be part of the government support package to ensure finance was being provided to businesses and individuals. The sector could play a vital role in moving the economy out of the recession and back in to growth.

The sectoral response, led by the **cdfa**, was to put forward a campaign to state the case for increased capitalisation of the sector. In its action plan it asked for increased support and renewed partnership with the banking sector, Regional Development Agencies, charitable trusts, Local Authorities and central Government, arguing that this innovative sector can continue to be a credible force for social change with a central role to play in helping the communities most badly affected by the recession to help themselves.

The target was £200 million. The challenge from the stakeholders was – without regulation, does the sector have a robust business practice and the strategic ability to take on this level of capitalisation?

In response the **cdfa** commissioned GHK to conduct an in-depth review of Change Matters, with the objective of looking at ways that the **cdfa** could better use the evidence it gathers about the sector, taking into account concerns of fair-minded comparison and the issues of a still relatively emerging sector. The resulting report recommended a number of fundamental changes to develop Change Matters further in areas around transparency of portfolio health, operational self sufficiency and better demonstration of impacts. These were implemented by the **cdfa** throughout late 2010 and early 2011.

During 2010 the **cdfa** worked with an External Panel formed of stakeholders (including funders and a representative from the FSA), to review data to analyse current performance against existing KPIs. It also reviewed the **cdfa**'s adherence to best practice in providing continued professional development for Assessors and in ensuring that the methods they use for carrying out these visits were of the highest standard.

7. The growing case for impacts (late 2010)

The GHK recommendations for moving the sector into a more robust position echoed the areas most often cited by the assessors during CM visits:

- *Lack of clarity around inputs and expenditure on activity in clearly representing loan fund self-sufficiency and organisation self-sufficiency.* As more CDFIs took on activity additional to lending, it was not always easy to differentiate how healthy their loan portfolio was or whether it was being propped up by non-finance-related income.
- *Consistent definition and methodology for measuring portfolio at risk.* This issue put the investibility of the sector at risk without a consistent measure and consistent reporting across the sector. The **cdfa** had to acknowledge this in every *Inside Out* report, and it was raised in a significant number of CM assessor recommendations.
- *Lack of data capture and impact reporting.* Despite the fact that most CDFIs work to reach financially excluded markets, GHK had to extrapolate data to reach a compelling argument for the value of CDFI activity. If every CDFI measured and reported on their specific outputs and outcomes, related to their mission and with some consistency across the sector, a much more focused picture could emerge, which could assist the sector in leveraging in government and other funds related to social outcomes and economic efficiencies.

During 2010 the **cdfa** put together a series of focus groups on each of the aspects above. The results fed in to the next version of the performance framework: definitions and a worksheet to calculate inputs and expenditure on activity (breaking them down to clearly depict portfolio against other activity); a PAR methodology and tool; market-specific indicators for the sector to use in capturing data to report on outputs and outcomes; and a logic model to depict a CDFI's mission-specific activity across a spectrum of inputs, activities, outputs, outcomes and impacts.

7. Re-framing the performance framework (2010-11)

The **cdfa** pulled together the findings from GHK and the outputs from the working groups described above, and created Change Matters 2 (CM2), the next phase for the sector's performance framework. This key re-structure could now allow CDFIs to express their mission *and* how they address market failure in the introductory executive profile. It used the same financial ratios, but set out clear definitions supported by tools such as the Inputs and Expenditure on Activity and the PAR methodology. As it came together it was clear that the most effective presentation would be as a self-assessment, with room for the CDFI to comment on their own performance set within the framework. The new framework transparently provides best practice KPIs.

Leading on impacts with a logic model

In order to distil the information so that potential investors can see key essentials of a CDFI's business, CM2 uses a logic model similar to that set out in GHK's report (see Table 2, overleaf).

This, combined with an executive summary, will allow a CDFI to provide stakeholders with a consistent presentation of information across the sector.

Table 2 – Logic Model

Inputs	→ Process	→ Outputs	→ Outcomes	→ Impacts
<p>Inputs are the resources (finance, people, buildings, capabilities etc) that are needed for the organisation to carry out its work.</p> <p>In the case of CDFI's, financial inputs include all income - from the portfolio, provision of other financial services, investments and other earned income.</p> <p>Note that the Logic Model will ask for a breakdown between these, divided into Earned Revenue Financial Services, Earned Revenue Other, and Revenue from External Sources. This may be worked out in the Inputs & Expenditure on Activity worksheet to enable a quick summary of LFSS.</p>	<p>What has to be done by the organisation to produce outputs.</p> <p>In financial terms this is shown by the allocation of expenditure.</p> <p>In business terms this will be determined by procedures and operations following a clear strategy.</p>	<p>Outputs are the direct results of processes / activities of the organisation.</p> <p>For a CDFI this includes number and value of loans disbursed and the portfolio outstanding.</p> <p>It can include a breakdown of financial services delivered to particular communities of interest.</p>	<p>Outcomes are the new situation(s) that the organisation is aiming to bring about.</p> <p>Measurements of outcomes show the degree of organisational effectiveness, rather than its size, efficiency or productivity.</p> <p>Hard outcomes are those which are quantitative – where we can count something.</p> <p>Soft outcomes are qualitative, subjective, relying on people's experience or feelings. Both are absolutely valid – which we use depends on what we are trying to measure.</p>	<p>Impacts are all the changes which result from an activity or programme including intended as well as unintended effects, negative as well as positive and long term as well as short term effects.</p> <p>Whereas an outcome is a change resulting from project outputs, impact refers to broader, longer-term change and relates to the organisation's overall aim.</p>
<p>EXAMPLE</p>	<p>EXAMPLE</p>	<p>EXAMPLE</p>	<p>EXAMPLE</p>	
<p>Finance: Earned Revenue Financial Services Earned Revenue Other Revenue from External Sources Staff Premises</p>	<p>Outreach/ Marketing Loan applications Loan disbursal Arrears Management Advice Services Other Services</p>	<p>Number of loans Loan value Social: by gender, ethnicity, disability etc Economic: by employment status Environmental: loans to green businesses etc</p>	<p>Jobs created and safeguarded Financial literacy Reduced barriers to lending (e.g. establishment of loan repayment history) Social: empowerment, confidence</p>	<p>Unique according to each CDFI's mission and activity to support that mission, but might include getting the unemployed into jobs, how long they remain in them and how their quality of life is improved or improving household welfare and broader effects on the community or local economy.</p>

8. New KPIs and trends from 2010

Thanks to funding that enabled over 30 Change Matters visits in 2009 and 2010 the **cdfa** was able to analyse a substantial amount of new data from across the sector. This provided enough evidence to significantly and robustly update the KPIs based on the data set created from Change Matters reports and *Inside Out*. **Impact standards** that logically follow from the outputs and outcomes, **financial standards** that reflect the financial probity and **business standards** that demonstrate the organisational rigour. In totality the finance, impact and business areas provide a full picture of a CDFI's performance. CDFIs are now not just able to assess their relative performance within the marketplace, but can present investors with a holistic assessment report. Just as importantly, reporting against these standards will allow the **cdfa** to better understand issues impacting on the sector's ability to reach them.

Impact standards

This non-financial KPI sets out whether and to what extent a CDFI meets its mission test and, by doing so, creates relevant outputs and outcomes.

In the majority of Change Matters reports the recommendation was that CDFIs need to improve their impact reporting, reflecting a sector-wide lack of consistency on the reporting of outcomes and low level of ability to present impacts. To address this the **cdfa** worked with groups of CDFIs to agree a set of key indicators by market. Each group created its own set of indicators and approaches to measurement. From 2011 we expect improved and consistent reporting on outcomes for the sector.

Financial Ratios

The KPI ranges for these financial ratios were updated from 2008, showing ranges agreed to be reflective of current performance to a reasonable standard.

Sustainability and profitability

The initial introduction of this ratio was challenging for members as they were mainly grant dependent. However, more recent Change Matters reports indicate that many CDFIs have developed their ability to calculate the figure within their own management reports and use it for strategic planning. This puts CDFIs in a position of being able to make appropriate decisions for their own sustainability against a backdrop of a changing economic and political climate.

Asset and liability management

Individual CDFIs set their own interest rates and use the yield on gross portfolio to manage their asset. Trends continue to show that yield in personal lending is consistently higher, partly due to a higher interest rate, but also a narrower gap in rates between lenders. In contrast, the interest rates charged by enterprise lending CDFIs vary greatly, indicating greater challenges in managing the asset. This demonstrates that enterprise lending remains a high risk area and requires additional input to support portfolio management costs.

Portfolio quality

In the first iteration of the benchmarks, PAR was not reported as there was a lack of confidence in the data put forward. The approach of the **cdfa** has been to consistently encourage members to carry out best practice in PAR reporting, through training and other development support such as grants to improve management information systems. The trend now is towards better reporting – a majority of members were able to report PAR – which is vital for a young sector that is still proving itself. Consistency in reporting will lead to improved management of delinquency as well as revealing where different approaches are taken.

The other key ratio is write off. KPIs are set relatively low compared to average reported figures, and vary depending on market. The biggest challenge remains in some members not reporting this information, though this too has improved from 2008. The **cdfa** is supporting its members to put in place appropriate policies to ensure that there is an understanding of write off. We anticipate that write-off reporting will improve as more members utilise these guidelines, particularly as this area is scrutinised to determine investment readiness.

Solvency

The majority of CDFIs assessed through Change Matters reveal a reasonable current ratio. However, during the last two years there has been a rationalisation of the sector; at least 14 CDFIs have closed due to lack of funding or there have been mergers as small organisations were unable to maintain their business. However, despite consolidation in the number of CDFIs, between them they operate 175 retail outlets (*Inside Out 2010*) and total lending activity – as well as the number of CDFI customers – continues to rise.

A further trend is a real variance in the levels of operating reserves. It is difficult to describe trends, as there is such a wide range from zero reserves to 153 months' worth of operating costs (which could reflect a gap between expected funds or a recent influx of grant or capital reported as reserves). In the charitable

sector there is also a wide range; however, there are appropriate policies that provide justification for the levels and CDFIs are expected to follow a reserves policy.

Capital and liquidity

The expectation is for deployment to be between 60-80%. In recent Change Matters reports, the actual ratio is wider, from 50-95%. Members are making more informed decisions and are using the deployment ratio to assess how well they are managing their portfolio. In more sophisticated CDFIs, these ratios are used as the basis for a liquidity policy and procedure. This ensures that there is consistency in the way capital is managed and it provides management with a tool to help assess when to raise capital. This is a sign of a maturing sector.

CDFIs have started to raise capital in a range of different ways, including taking on debt finance from banks and other finance providers. However, the risk is that this does not build the balance sheet of the CDFI and is not helpful for the institution building that is still required in many parts of the sector.

Efficiency and productivity

One variable affecting a CDFI's sustainability is staffing levels/ loan officer productivity. The majority of the enterprise lending is highly labour intensive, and requires skilled ability to analyse business propositions. It has been recommended to many CDFIs to review how to reduce the level of time required to analyse the different types of loans. (The **cdfa** offers loan officer training and recommends sharing of best practice).

One trend in the personal lending market is that the small size of the average disbursed loan shows that CDFIs are reaching out to people who are in need of these types of loans. To accommodate this high level of service there have been a range of tools introduced to speed up the process of managing these smaller loans. This has included separating out some of the functions of operating a CDFI; for example, one loan officer may be given the responsibility to manage delinquencies. However, this is an expensive model to run.

The operating expenses ratio and earned revenue ratio are used to assess the ability of the model to operate. The operating expenses ratio has decreased, illustrating how the sector has increased its ability to increase income and/or has had to reduce expenditure. These types of rationalisations have taken place alongside an increase in earned revenue ratio. CDFIs have had to increase their productivity; however, this has not always been through income from interest rates. Rather, CDFIs have started to deliver contracts for a range of different

providers and they are paid by the results. This is moving towards a social enterprise model of operating.

Business standards

This is now being included as a KPI area, with the expectation that a CDFI demonstrates adherence to the sector's code of practice (a condition of **cdfa** membership). Its key commitments and principles include general areas of good governance that are relevant to all social enterprises, such as fiduciary duty and the appropriate skills to review business plans and budgets.

9. Change Matters 2 (CM2) - improving sector transparency

The next iteration of the Change Matters framework, CM2, reflects a more methodological approach to the assessment. It takes the shape of a self-assessment and provides guidance and transparent methodology throughout.

Rather than providing documentation and undergoing a site visit from which a report is written, the new format of self-assessment reflects other accreditation systems such as Customer First and Community Foundation Quality Accreditation. CM2 has a set of specific questions for each section of the framework, and allows the CDFI to insert a text explanation to any financial ratios. This will be key for those who work in different markets, with specific criteria in contracts that affect portfolio yield, or to explain variances from KPI ranges. The self-assessment is returned to the **cdfa**, who then follow up with a site visit to audit the information and gain further insight through interviews with board and key staff in order to produce a corporate assessment report.

With the potential alternative of external regulation, CM2 provides a credible framework which enables and facilitates the growth of the sector, giving investors and stakeholders the key information they need to make investment decisions. If the programme proves itself it may well negate the need for an external set of formal regulations.

With performance framework evidence provided by the members driving the standards, the **cdfa** will be much better placed to leverage funds into the sector. Stakeholders and funders will be able to rely on a consistent set of KPIs for investment decisions.

Incentives such as funds available only to members of the **cdfa** who meet key performance indicator targets, and capacity building offers to those who have yet to achieve these, will facilitate engagement by all members of the **cdfa**.

10. Why (and how to) invest in the sector

The CDFI sector provides socially-driven finance to those who cannot get it from high street banks. CDFIs lent £200m in 2010, financing 3,600 businesses and 15,300 individuals, creating and safeguarding 8,600 jobs.^[3] Demand for CDFI lending skyrocketed during the economic crisis as banks tightened their criteria for both business and personal lending. But in order to maintain and increase the level of service they provide, CDFIs will have to tap into new sources of funding to replace those previously provided by the Regional Development Agencies, DWP and other public sources.

In order to achieve maximum economic and social impact, CDFIs need a capital injection to meet increased demand for finance as well as support for organisational capacity building. Because CDFIs serve inherently risky markets, they carry out extensive due diligence checks when vetting applicants. CDFI customers, turned down by mainstream lenders for being unviable or not worth the time, often require extensive up-front and ongoing business or financial capability support and advice.

Social objectives are typical within the sector, and more could be gained through partnerships which deliver on shared objectives through investment in CDFIs, including enterprise-driven regeneration and enterprise within under-represented groups. Measuring social impact is key to demonstrating a part of the return on public and philanthropic investment that CDFIs can deliver

The social returns from CDFI loan finance exceed the private returns available to lenders, which is why this is such a critical focus for the new Change Matters framework.

With the right support, CDFIs will continue to innovate and develop. Some of the products in development in different markets include access to savings, insurance and budgeting products for individuals, home improvement (or green) loans, leasing, equity, “accommodation” and support packages for small and micro businesses and long-term and quasi-equity products for social enterprises. One of the key challenges will be to continue to secure the right mix of grants and investment to increase generated income and cover any shortfall with grants and contributed income.

There are also signs of increasing segmentation of the functions of lending, creating opportunities to drive efficiency and improve services: as different parts of the outreach, underwriting, portfolio management process and capitalisation of CDFIs are separated, specialists are emerging to provide particular services. A number of back office

^[3] Source: *Inside Out* 2010

providers offering varying levels of management and underwriting have developed and continue to grow in effectiveness. A number of organisations that tested direct provision of lending have now transformed themselves into front office providers providing a pipeline of customers for the CDFIs they work with and crucial pre and post loan support. This synergy is proving effective for growth.

There are current or emerging opportunities for making significant inputs in the UK market, and the **cdfa** is working on behalf of its members to gain access to investment that is most appropriate to the different markets and social and economic returns. This investment will be linked to demonstration of good performance, which makes the CM2 a critical vehicle for collating data on impact, financial and business performance.

Regional Growth Fund, Big Society Bank, New Enterprise Allowance and a proposed **cdfa** Progress fund are all opportunities to drive capital into particular markets; the government's announcement of extending the Community Investment Tax Relief (CITR) scheme was welcome news in March 2011. CITR was devised to encourage private investment into the CDFI sector by allowing accredited CDFIs – of which there are currently 15 – to offer investors 5% per annum tax relief over five years. Investment raised must be for lending to business in disadvantaged communities.

As noted throughout this paper, lending capital must be supported by operational delivery, and revenue funding for this is more difficult to secure. The combination of attracting capital and associated revenue costs is what will trigger the most significant growth towards sustainability in the sector. CDFI's continue to seek investors for pre-investment and post-loan support, covering the costs of delivering finance, and developing CDFI assets. There is scope for aligning social outcomes with this, which can be demonstrated through CM2.

Other options of technical support are appropriate in some cases as they can contribute to a CDFI's portfolio growth and quality, developments in governance and more strategic marketing, through support such as:

- Staff secondment
- CDFI board or committee participation
- Mentoring and leadership support
- Participation in risk analysis and due diligence training
- Development of referrals and networking
- Assessment of the potential for a shared back office service
- Sector wide marketing and profile raising
- Market analysis

11. Conclusion

The development of a robust CDFI performance framework provides the opportunity to promote a transparent monitoring system that reflects the typical areas of regulation in other financial services. Change Matters 2 was launched at the House of Commons in March 2011 and will take the sector to the next level – with intensive support from The Royal Bank of Scotland Group, another exciting development in our trajectory.

When we started out creating Change Matters, the financial crisis of 2007-9 and its ramifications could never have been imagined. But as we are now looking at completely new funding horizons, having CM2 in place ensures the sector will be better equipped for investment and reporting on returns both financial and social, and become stronger than ever before.