new economics FOUNDATION

A Proposed Performance and Accountability Framework for Community Development Finance in the UK

by

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research funded by the

Joseph Rowntree Foundation

July 2001

Method

This briefing forms part of research conducted by the New Economics Foundation for the report *The State of Community Development Finance 2001* launched at the Money for Change conference in Birmingham in July 2001. The research was funded and supported by the Joseph Rowntree Foundation. Danyal Sattar, Thomas Fisher and Ed Mayo were responsible for writing this briefing.

To develop the Performance and Accountability Framework we consulted widely through a reference group made up primarily of community development finance practitioners. We also reviewed international experience, and visited five CDFIs in the UK to review their management information and reporting systems.

Background

At a time of significant growth and policy interest in community development finance, it is crucial to have clear and concise ways of understanding the performance of community development finance institutions (CDFIs). CDFIs recognise that demonstrating their performance is, itself, a critical part of their mission, and that this has to be done in a verifiable way.

The policy interest in community development finance as a tool to deliver financial and social inclusion brings new opportunities. However, it also brings new dangers – that a new generation of loan funds might spring up driven by funding streams, without benefiting from the hard lessons learnt by the sector over the years.

The research by the New Economics Foundation revealed the extent of poor performance among soft-loan funds in the UK. The most significant finding was the culture of unsustainability that most soft-loan funds operate in. Soft-loan funds have experienced high closure rates (over a third of the sample identified had ceased to exist). The remaining funds often make few loans and experience high loan losses. Most are simply unsustainable.

If funds continue to perform in this way, without the ability to sustain their operations, or a clear understanding of how to reach the socially and financially excluded, policy makers may wrongly conclude that the community development finance sector is not capable of delivering economic and social outputs in a value for money way. However, while over a third of soft-loan funds in operation in the mid 1990s have ceased operations, only one of the CDFIs from that time has closed.

A second danger to the sector is that the government, in the absence of any alternative, may decide to develop its own performance and accountability framework for community development finance, for example to determine the performance of the Phoenix Fund or eligibility for the proposed tax credits. Such a framework is unlikely to meet the diverse needs of CDFIs or draw sufficiently on the extensive practical experience within the sector.

In order to deliver a high quality sector, it is therefore essential that practitioners develop proper measures of performance. This briefing reviews the kind of performance assessment that is required.

Defining community development finance

The failure of many soft-loan funds makes it essential that CDFIs are able to differentiate themselves from soft-loan funds and to substantiate their record,

including their long-term record, in ways which soft-loan funds have been unable to do. Table 1 contrasts CDFIs and soft-loan funds along a range of key parameters. If a loan fund meets the characteristics of a CDFI set out in Table 1, there is a good chance that it will be capable of sustaining itself into the future.

Table 1. Contrasting CDFIs and soft-loan funds

Characteristic	CDFIs	Soft-loan funds
Time horizon	Are long-term; they aim to be in existence for as long as needed	Are short-term; they are usually linked to a funding programme
Sustainability	Focus strongly on how their operations can be sustained	Are less concerned with sustainability issues
Funding source	Have multiple sources including banks and government sources and also private foundations and individuals	Are funded primarily by government funding programmes and banks
Ownership and control	Are independent organisations; they are often owned and controlled by local people and organisations	Are dependent organisations, often part of a local quasi-state regeneration agency that may pay part or all of their operating costs
Reporting	Make information publicly available; Carry out evaluations and make them available	Make little information available; Carry out little evaluation
Governance	Have diverse local stakeholder involvement	Generally, only have business and regeneration agency involvement

Detailed research on the performance of both soft-loan funds and CDFIs (see *The State of Community Development Finance 2001* and NEF's background report on soft-loan funds) also suggested a checklist of characteristics that make up an ideal fund.

Box 1. Checklist for an ideal community development loan fund

- Skilled and committed staff and champions; as with any business, the management team is critical.
- Independence, and effective ownership and governance structures to ensure that the fund sustains its mission and its operations.
- Over £500,000 in capital on start-up, plus access to lines of credit: funds need to be at sufficient scale to have some chance of covering their basic operating costs rapidly.
- Funds seeking to survive at a smaller scale must adopt micro-credit methodologies that significantly reduce operational costs.

- Below 10 per cent portfolio losses per annum. Higher loan-loss rates in experimental or start-up phases need not be discouraged, but high on-going loss rates without justified social or economic outputs, or without correspondingly high interest rates to cover for lending to higher risk markets, must be.
- Adequate reserves beyond start-up, with a minimum of seven per cent of capital.
- A range of funding sources including private investors and local individuals and organisations. Having to deal with a range of funders, especially private and local sources, builds discipline into the lending process. The range of funders also enables the fund better to sustain itself and grow.
- Reporting on a range of financial and social performance indicators: unless outputs are measured, value for money and cost-effectiveness cannot be ascertained nor lessons learnt.
- A broad portfolio: local funds should serve all types of small enterprise, including co-operatives and not-for-profit enterprises, but should still retain a clear market focus.

On loss rates, even 10 per cent is high compared to community development loan funds in the US and micro-credit internationally, and reducing losses to 5 per cent over time should be the objective of most funds. Mark Pinsky of the National Community Capital Association (the US CDFI industry's trade association) comments: "In the US, where our CDFI network has default rates of less than 1.5%, much of the riskiest lending in disadvantaged areas is done with the lowest defaults because the strongest organisations are best able to take on the riskiest deals." In other words, default rates may reflect more on the lender and the credit methodology used than on the borrowers.

It is clear that not all CDFIs can meet all the criteria set out in Box 1, and that on-going development of CDFIs as sustainable and effective institutions is an essential focus for practice and policy. Table 1 and Box 1 do, however, set out performance standards that can act as aspirations for the sector. In the rest of this briefing we develop a Performance and Accountability Framework that could assess how far these aspirations are achieved. We start with the existing state of management and reporting systems among CDFIs.

Management information and reporting systems

A good management information and reporting system is central to running an effective CDFI. It makes it easier to measure, process and report the performance and impact of a fund at any particular time. A few CDFIs have good information systems. However, most have considerable difficulty getting what would be considered to be basic data out of their systems. Some struggle even to produce quarterly management accounts, let alone an information system that lets them stay on top of a substantive lending portfolio. Without such a system, organisations will find the process of producing data for indicators a difficult and time-consuming exercise. There is therefore work to do for these CDFIs, to understand the characteristics of a good management information and reporting system and get it up and running.

Evaluation

There have been a number of evaluations of individual CDFIs, but with no standard approach or method. Some evaluations have been driven by European funding requirements; others have been commissioned internally. Critiques of evaluations

have noted that they are often costly and driven by the concerns of funders, rather than those of clients or of the organisations themselves. However, in the case of the UK, evaluations have generally been embraced by CDFIs. The range of evaluations undertaken by CDFIs includes the following:

- The Glasgow Regeneration Fund has commissioned an external evaluation of its performance which tackled issues including employment, the fund's sustainability and client satisfaction.

- The Full Circle Fund aims to promote financial, economic and social inclusion for women through training, credit and development. The methodology for its evaluation focuses on measuring inclusion, both before and during the training and lending processes.

- Investors in Society (at the Charities Aid Foundation) lends to organisations with a charitable purpose. It commissioned an external evaluation that took a stakeholder assessment approach.

Clearly, it is easier to make cross-fund comparisons on issues such as regeneration and employment on which CDFIs are likely to have counterparts doing similar work. However, as the Glasgow Regeneration Fund evaluation points out, even then direct comparisons are not straightforward. It focuses on specific disadvantaged areas, while a fund like the Aston Reinvestment Trust covers the whole of Birmingham.

The Full Circle Fund has sought to get to grips with whether someone has become less excluded. Its evaluation tracks indicators such as the use of civic amenities like libraries and sports facilities, as well as indicators that focus more specifically on financial exclusion, such as financial literacy and confidence in dealing with the formal banking system.

Evaluations are part of a learning process. Although the evaluation of Investors in Society was, in general highly favourable in terms of financial and social performance, the fund felt that the evaluation process had been extremely useful in identifying those areas which still needed improvement. The Full Circle Fund, similarly, is exploring how to integrate data collection into its on-going work, at the same time as maintaining the external and independent elements of evaluation.

Benchmarks

Management information systems and evaluations help to collect data for performance indicators. Such indicators, however, only begin to make sense, firstly, in the context of the historical performance or targets of the individual fund and, secondly, in relation to benchmarks allowing for comparative assessment between funds.

In the UK there are no benchmarks which apply specifically to CDFIs; the only benchmarks they use are those used for regeneration more generally, such as cost per job created. Setting benchmarks would enable cross-learning among CDFIs and allow funders, investors and wider stakeholders to understand the costs and benefits of the work of a CDFI.

There is some sense in setting benchmarks differentiated by the markets different CDFIs serve. In the United States the national association of CDFIs has recently started to benchmark performance in this way (see Box 2). This process avoids

attempting to make broad comparisons across a diverse spectrum of very different CDFIs, which can be not only misleading but also threatening to individual CDFIs. It also opens the opportunity for peer support among genuinely similar institutions.

Box 2. Assessment of CDFIs in the United States

The National Community Capital Association is a membership organisation for some 51 community development finance institutions in the USA. *CDFI's side by side: A comparative guide* (1999 edition) measures ratios and indicators across a range of areas that reflect concerns and interests to the sector and its stakeholders. They cover areas such as:

- The size and type of CDFI, giving data on the age of the CDFI, staff, simple capital and loan totals, expenses and overheads
- Financing activity
- Capital and capital structure, exploring their resource base
- Impact covering jobs created and retained across low-income borrowers, women and ethnic minorities; technical assistance (hours); housing and community space created
- Efficiency indicators like self-sufficiency ratios, loans outstanding, expense analysis
- Indicators of growth.

CDFIs are then split into six different peer groups from two broad categories:

1. CDFIs with *business* as a primary financing activity, with total capital of
    - 1.1. less than $2 million
    - 1.2. $2 million to $7 million
    - 1.3. more than $ 7 million
2. CDFIs with *housing or community services/facilities* as a primary financing activity, with total capital of
    - 2.1. less than $4 million
    - 2.2. $4 million to $15 million
    - 2.3. $15 million or over

Performance and Accountability Framework

Responding to this research, CDFIs in the UK clearly welcomed the idea of indicators to measure performance, especially indicators of social performance, output and outcome: having a menu of such indicators would make performance assessment more straightforward. However, the idea of having a common set of indicators met with scepticism.

The US approach of comparing performance by target market, such as funds serving micro-enterprise start-ups, is attractive. However, the limited number of CDFIs in the UK counts against this. While it would be possible to split them into different groupings, and compare within these groupings, sample sizes would be small and it would be inappropriate to apply any statistical analysis.

What indicators do enable is better cross-checking between CDFIs of their own relative performances. While it will always be possible to say that the local circumstances are different and organisations are different, it should be possible to compare performance within broad bands.

In this context, CDFIs expressed a preference for external evaluation, such as social audits, as the best way to demonstrate performance in a verifiable way. Given the diversity of missions and the early development and growth phase in which many CDFIs find themselves, external evaluation would appear to serve this purpose well.

On the basis of these views, we have drawn up a proposed Performance and Accountability Framework for CDFIs (Table 2). This includes a base list of core indicators which can be used at different levels. They can be used as a menu, with some classified as essential and others as useful. They can also be combined, with equal prominence, with other indicators that particular CDFIs believe best reflect their mission and performance. Alongside these indicators, we set out benchmarks. These should not be viewed in isolation, but with explanation and as part of a wider range of benchmarks and comparators that allow CDFIs to be viewed as a coherent whole.

Next Steps

Given the diverse and underdeveloped state of the management information systems of most CDFIs, many CDFIs need to develop substantially before they can get to the stage where they can generate even the basic indicator sets listed in the Performance and Accountability Framework.

CDFIs should report on additional indicators that better reflect their individual mission and purpose (particularly aspects of their social performance) and should give these equal prominence. As with a social audit, there may be good opportunities for CDFIs to engage their stakeholders in setting such indicators.

CDFIs should also continue to commission evaluations, even jointly to reduce the costs. CDFIs should carry out external evaluations, especially of impact, at least once every three years and move towards low-cost non-validated internal evaluation every year.

Core indicators and benchmarking work best when based on a shared standards. The evolving association of CDFIs is best placed to advance core indicators and benchmarking across the sector, in collaboration with stakeholders such as banks and other investors. It can also help its members develop effective management information and reporting systems. Over time, it is likely that full membership of an association or eligibility for advantages such as the Community Investment Tax Credit will require that CDFIs produce, and make publicly available, performance assessments of this kind.

The aim should be that by the end of 2002, all CDFIs publish an agreed set of performance and accountability indicators.

Table 2. Performance and Accountability Framework for CDFIs

Cate-gory	*Theme*	*Essential indicators*	*Useful indicators*	*Benchmark*

Financial perfor-mance	Loan structure	Since founding (or separate date justified as a base year): • Total loans (number) • Number of loans per year • Amount of loans (£) • Average loan size (£) • Average loan term (years) Also, • Number of employees currently • Number of loan officers currently	For the last financial year: • Total loans (number) • Number of loans per year • Amount of loans (£) • Average loan size (£) • Average loan term (years)	• Always in relation to the size of organisation
	Income, loan losses and costs	Since founding (or separate date justified as a base year): • Loans lost/written off (percentage of total lending) • Average portfolio delinquent Also, • Total portfolio at risk	For the last financial year: • Loans written off • Total income (£) • Income from clients (interest and fees) • Other income • Total costs (£)	• Loan losses: Below 10 per cent for high performing funds. • Average loan losses per year could be reported in the following bands: 0-10%; 11-20%; 21% and above.
Social perfor-mance	Impact	Since founding (or separate date justified as a base year): • Full-time equivalent (FTE) jobs created • FTE jobs retained • Enterprises or organisations created • Enterprises or organisations supported	Since founding (or separate date justified as a base year): • Enterprise survival rates • Training or business support days extended • Geographical or sectoral breakdown	• Always in relation to the market segment targeted. • Number of jobs created • Loan amount per job
Account-ability	Manage-ment and gover-nance	For the last financial year: • Breakdown of board and/or advisory groups, between bank, state/quasi-state, enterprise agency, business representatives and community groups, • And by gender and ethnicity.	• Disclosure of external evaluations or social audit	• Reporting on these figures in annual report