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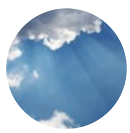


future economy

nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G7/G* summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

Since its establishment in 1986, **nef** has become the leading think-and do-tank focusing on economic well-being. We aim to build a new economy based on social justice, environmental sustainability and collective well-being.

Tackling issues of financial exclusion and access to finance has been central to **nef**'s agenda for almost a decade. **nef** helped to establish the Social Investment Task Force and is a founder of the Community Development Finance Association. *Small is Bankable*, published in 1998, proved a seminal report in raising awareness of community development finance and its role in enterprise development and local economic renewal. **nef** also published the first analysis of this industry: *The State of Community Development Finance 2001*. This report is a continuation of that work and an integral part of **nef**'s commitment to tackling exclusion and increasing access to finance.

Contents

Executive summary

Community Development Finance Institutions (CDFIs) have emerged over the past ten years to provide loans to people and enterprises excluded from mainstream finance. They were designed to create a positive cycle of investment, redevelopment and opportunity for disadvantaged communities by providing much-needed capital.

nef (the new economics foundation) helped to introduce CDFIs to the UK as a model for bringing investment into some of our most disadvantaged communities. Now, at this critical phase in the evolution of CDFIs, it is necessary to take stock and to evaluate what CDFIs have achieved.

Approximately 80 CDFIs have been established across the UK. The sector has achieved a high degree of diversity, ranging from the provision of small personal loans of £50 to social enterprise loans of £1 million. It is active in urban inner cities as well as in remote rural communities. Micro-enterprise is a key market for CDFIs, with half of the organisations focused on this activity. This study focuses on the enterprise-lending activities of CDFIs.

The future of the sector is uncertain. Government policy-makers question whether CDFIs have measured up to initial expectations. In this context, **nef** conducted a comprehensive review of enterprise-lending CDFIs in the UK to identify which policies are effective in bringing about social change. We evaluated the strengths and weaknesses of enterprise-lending CDFIs in relation to exclusion and disadvantage. We also identified the policies and operating conditions that affect CDFI outcomes. Our research addressed the following key questions:

- Have CDFIs in the UK effectively addressed issues of access to finance?
- Can CDFIs be sustainable? What size of organisation is appropriate for the communities they serve? Are expectations for the sector appropriate?
- What are the implications of the current direction of policy for CDFIs? How do they fit within the broader approach to enterprise and regeneration?
- What do the lessons from CDFIs in other countries tell us about future policy choices for the UK?

We conducted an in-depth survey, interviewing over half of all UK CDFIs, as well as banks, policy-makers and funders. We also looked to Europe and to the US to identify lessons that could be applicable to the UK. CDFIs have had a significant impact on some of our most disadvantaged communities, leveraging in millions of pounds of investment. However, few CDFIs have become sustainable, or reached a scale that allows them to fulfil their potential. Our research found that much more could be done at the policy level to support these vital outposts in some of the most disadvantaged communities.

Our research found that:

- 80 per cent of survey respondents believe that 'CDFIs have a positive impact on disadvantaged communities', and that the enterprises they support 'can make a real difference to revitalise disadvantaged communities'.

- 96 per cent believe that 'with the right support, CDFIs could be big enough to have a significant impact on enterprise in disadvantaged communities'.

- 72 per cent of CDFIs do not believe that they are able to access funding that would support increased outreach and growth.

- Only 4 per cent of CDFIs believe that Community Investment Tax Relief (CITR) provides effective finance for CDFIs.

- Over half of CDFIs believe that the devolution of oversight for the sector to Regional Development Agencies (RDAs) has had a negative impact.

Together with evidence from the US and from Western Europe, we found that if their potential is to be realised:

- Government should establish an ongoing fund to support the further development of CDFIs. Their social purpose means that many cannot be, and never will be, completely sustainable.

- Donors should make funding available over a long-term timeframe to enable CDFIs to grow and to increase their impact.

- Banks should implement a formal strategy of engagement with CDFIs to promote referrals, knowledge transfer and investment.

- CDFIs should be more transparent about their operations in order to demonstrate their effectiveness.

- RDAs should facilitate the development of partnerships between CDFIs and other agencies to encourage a more joined-up approach to enterprise finance and support.

- The Community Development Finance Association (CDFA) should continue its work on the development of common standards for CDFIs through the performance framework.

Key findings

- Evidence of continued under-investment in disadvantaged communities indicates that access to finance is an ongoing problem for small and micro-enterprises. CDFIs have a key role to provide investment in partnership with other bodies, such as housing associations, development trust associations, local authorities and RDAs.

- Expectations of the performance of CDFIs – in terms of potential growth and their ability to become sustainable – have determined the form and manner of funding and support provided to the sector. Not all expectations have been met. Initial optimism for the sector's ability to achieve these expectations, and the subsequent disappointment, have overshadowed the real achievements of CDFIs.

- There is a strong conviction that CDFIs have a positive impact on disadvantaged communities and that they play a critical role in providing access to finance. Our policy survey confirmed the belief that enterprises supported by CDFIs can make a real difference in revitalising disadvantaged communities.

- Most CDFIs remain small and are growing slowly. Their impact on disadvantaged communities is hampered by their limited scale and resources.

- In the face of current challenges, the sector is not achieving its full potential.

- Although it is clear that there are weaknesses in the current capacity of CDFIs, there are differences in the performance of individual organisations. There are currently no performance standards for the sector and few CDFIs are able to demonstrate their full impact on either individual clients or the communities they serve. This lack of transparency is a problem that CDFIs have to address urgently.

- CDFIs acknowledge that sustainability is an important long-term objective; but it is currently not achievable for most. Sustainability may only be possible for those CDFIs that provide larger, secured loans for property or social enterprises. As such, sustainability must be seen as just one of a broader set of objectives.

- High initial expectations of CDFIs have resulted in some disillusionment with the sector among donors, policy-makers and investors.

- Government policy has not provided CDFIs with the support that they need to fulfil their potential. Government funding has been short term and patchy. Support from the financial sector has also been inconsistent and often limited.

- Limited funding, a short-term outlook and inflexible policy mechanisms have stunted the development of CDFIs. As a result they are at risk of becoming victims of the ever-shifting policy cycle.

Overall, we found that CDFIs are at a critical juncture. Without renewed support the sector will become increasingly fragmented and weak. CDFIs could wither and many may disappear, providing another set-back to disadvantaged communities. With the right support from government, regional agencies, funders and banks, however, CDFIs could play a major role in addressing issues of access to finance in the UK.

Introduction

The UK has experienced an unprecedented period of sustained economic growth over the past 14 years, with the fastest rise in GDP per capita of all G7 economies since 1997. Despite the increasing wealth of British society – which has made many better off – there remains a persistent group of socially excluded individuals who are living in poverty.

In 2005, 11.4 million people in Great Britain lived in households that were below the low-income threshold. With increasing wealth has come greater inequality. Poverty is now concentrated in specific geographic areas, where disadvantage is intensified by low skills, joblessness, and underemployment. In 2005, there were 2.3 million people who wanted to be in paid work but were not. Among the many factors contributing to the decline of disadvantaged neighbourhoods are limited access to finance and appropriate business support. Financial services institutions often withdraw from low-income communities. Language barriers, poor credit history and lack of collateral further contribute to limit access to finance. Enterprise and entrepreneurial activity are stifled in this context.

CDFIs have emerged in the past ten years to address financial exclusion and problems with access to finance for enterprises. Originally developed as agents of regeneration, creating both employment and empowerment through the provision of finance to local enterprises, CDFIs were designed to create a positive cycle of investment, redevelopment and opportunity by seeding change through the provision of capital. This, in turn, would support disadvantaged individuals and facilitate the development of local enterprise, employment and wealth creation. CDFIs were intended to show that the unbanked and marginalised were bankable, and that by providing a portfolio of loans a sustainable model of operation could eventually emerge. This model relied on a virtuous cycle of increasing scale built on high rates of repayment, realism in setting appropriate interest rates, and sufficient high-quality referrals.

Ambitions for the CDFI sector are rooted in the potential to address the problem of under-investment that affects areas of disadvantage. People living in areas, characterised by financial deprivation, poor public services, low-quality housing and limited infrastructure, are more likely to be isolated and without opportunities. These 'neglected neighbourhoods' are often constrained from responding to economic stagnation and decline due to problems of poor skills and economic inactivity, compounded by bank branch closure and the lack of available finance for enterprise. As **nef**'s *Small is Bankable* report put it in 1998 'the neighbourhoods that have the most telling need for capital… have least access to it'.[1] The report went on to outline the benefits that CDFIs could bring to local communities.

The Social Exclusion Unit (SEU), established by the Prime Minister in 1997, emerged from the Government's desire to tackle issues of social exclusion relating to poverty and disadvantage. The resultant work by Policy Action Teams 3 and 14 on enterprise finance and personal financial exclusion guided UK policy to support community finance initiatives, including CDFIs, credit unions and the provision of basic bank accounts by retail banks. The subsequent Social Investment Task Force (SITF) envisaged CDFIs as a means for 'entrepreneurial value creation' in deprived communities. Inspired by international experience, notably in the US, community finance initiatives were championed as pioneering approaches to enterprise-led regeneration. The influence of the more developed Community Development Finance (CDF) sector in the US served as a benchmark for the aspirations of stakeholders. Policymakers anticipated that CDFIs could operate sustainably and achieve the scale to have a meaningful impact on social deprivation.

Policy support for the sector resulted in the provision of funding to enterprise-lending CDFIs through the Phoenix Fund, the establishment of the CDFA and the CITR credit for investment. These measures have brought us to a point where, according to the CDFA's 2005 report, *Inside Out*, CDFIs have financed over 18,000 businesses and people.[2] CDFIs have created 11,000 jobs and sustained another 88,000, while the finance provided has levered £285 million of funds from other sources. Approximately 80 CDFIs have been established across the UK, and the sector has achieved a high degree of diversity.

Government policy is increasingly focused on the effectiveness of CDFIs. While the experience of some individual CDFIs has been examined, a general review of the sector has not yet been carried out. It is timely to assess the current state of enterprise-lending CDFIs; the withdrawal of the Phoenix Fund and the shift of responsibility from central government to RDAs suggest a change in policy. Further developments, such as the proposed revision of CITR and the Commission for Unclaimed Assets' plans for a Social Investment Bank, are also significant for CDFIs.

The relatively small scale of CDFIs and issues of sustainability have contributed to a policy atmosphere that questions whether they have the capacity to achieve all that has been hoped for. Attention has increasingly focused on whether CDFIs can capably deliver cost-effective services, reach target groups, and distribute loans at the scale required to create social change. Funding streams are increasingly tied to targets, which are viewed as a test of whether the sector can realise its potential. There are very high expectations for the sector; it is still young and has been faced with short-term funding sources and diverse policy objectives. In addition, CDFIs take a variety of legal forms, thus complicating regulation and performance measurement. In light of these changes, the direction of policy for enterprise-lending CDFIs is not clear.

This report focuses on the enterprise-lending activities of CDFIs. At an organisational level there is blurring between personal, enterprise and social-enterprise lending, with many CDFIs engaged in multiple activities. With support from the Growth Fund, CDFIs are increasingly moving towards the provision of personal lending. The original intention, however, was that CDFIs would act as catalysts for enterprise in deprived areas through community-based entrepreneurs who had been overlooked by mainstream finance providers.

The objective of this report is to review the state of community development in the UK in order to document what policies are effective in bringing about social change. We assess the current state of enterprise-lending CDFIs to determine how these organisations are faring in light of their original development as a tool for regeneration. We focus our analysis on the policy level and operating context shaping CDFI outcomes. At this critical phase in the evolution of CDFIs, it is necessary to take stock and evaluate what CDFIs have achieved.

We consider the strengths and weaknesses of CDFIs and draw upon international experience to outline the current challenges and opportunities for the UK sector. Policy to develop the UK community finance sector has regularly drawn upon international examples. Community finance in the US and Western Europe is reviewed to determine effective models and lessons relevant to the UK sector.

Our research addresses the following key questions:

- Have CDFIs in the UK effectively addressed issues of access to finance?
- Can CDFIs be sustainable? What size of organisation is appropriate for the communities they serve? Are expectations for the sector appropriate?
- What are the implications of the current direction of policy for CDFIs? How do they fit within the broader approach to enterprise and regeneration?

- What do the lessons from CDFIs in other countries tell us about future policy choices for the UK?

Section 1 reviews the broader UK context of the sector and its origins, focusing particularly on regeneration, enterprise policy and housing factors that impact CDFIs. Section 2 considers the current state of the UK community finance sector, including findings from interviews and an in-depth policy survey. Section 3 considers lessons learned from the international experience of community finance in the US and Europe. Section 4 presents our conclusions and recommendations.

This report provides a timely contribution to the evaluation of the effectiveness of CDFIs. The need for a review is particularly relevant as CDFIs are at an important stage in their development.

Our findings have implications for future policy recommendations and the broader understanding of the impact of the CDFI sector.

Research method
We completed this report with support from the Hadley Trust, using a variety of research methods. The findings are a product of extensive secondary research on the UK and international context. To further inform our UK findings, we completed in-depth interviews with 19 CDFIs. We carried out a policy survey seeking the views of a wider group of CDFI practitioners as well as other significant stakeholders in the sector, including policy-makers, banks and related financial institutions, charitable foundations, and government representatives. We distributed this survey to 143 organisations in the UK community finance sector and received a 38 per cent response rate.

We also conducted a review of the US and Western European community finance sectors, interviewing selected US and European organisations. These interviews incorporated first-hand experience of the local operating environments and helped to identify the issues or practices that were particularly effective and relevant to this analysis. In total, we carried out over 40 interviews with UK, US and European CDFIs, with 8 to 10 interviews in each region.

We have included ten case studies of community finance initiatives in the US and Western Europe to highlight the different features of community finance organisations, their target groups and core activities in order to identify those aspects of their operation integral to creating successful interventions in deprived communities.

We enlisted the support of the Woodstock Institute, a Chicago-based think tank with significant experience of the sector, to carry out a review of the US community finance sector. In addition, with the CDFA, we visited over 30 US-based CDFIs in Chicago and New York in October 2006 to explore the current themes and issues relevant to this sector. The findings of these in-depth, face-to-face interviews have been incorporated into our analysis.

1. The broader context: regeneration, enterprise policy and housing in the UK

In this section, we present the wider issues shaping the context in which CDFIs operate. CDFIs have evolved to address problems of limited access to finance for enterprise in disadvantaged communities. Access to finance, however, represents just one issue contributing to decline and under-investment.

The effectiveness of CDFIs is influenced by a range of other factors that have direct impact on disadvantaged individuals, including social exclusion, enterprise policy, social housing, and benefits payment. We review aspects of these issues that shape the operating context and outcomes that CDFIs achieve in low-income communities.

Social exclusion in the UK

Social exclusion in the UK results from multiple factors that create a lack of opportunity for individuals. Unemployment, poor skills, economic inactivity, low income, family breakdown, crime, weak institutions, poor infrastructure, and limited services together restrict options and isolate residents of disadvantaged communities. In the early 1990s, these problems were exemplified by unemployment rates in excess of 10 per cent, the highest teenage pregnancy rate in Europe, and rising crime and inequality. In 1997, when Labour came to power, 4.8 million adults were suffering from multiple factors of disadvantage – including low income, low educational attainment, dependency on benefits, and poor mental or physical health.

Because of the increasing problems of unemployment and child poverty, the Labour Government launched the Social Exclusion Unit (SEU) in 1997. This broad approach was adopted to begin to tackle issues of neighbourhood decline, educational failure, and poor skill development. Housed at the former Office of the Deputy Prime Minister, the SEU adopted a cross-cutting approach to policy solutions, before being replaced by the Social Exclusion Task Force (SETF) in June 2006.

The policy focus on social exclusion has meant that the situation in the UK has moderately improved. Child poverty has fallen by 800,000 individuals since 1997. The number of people living in households below the low-income threshold has dropped by 2.5 million. The proportion of low-paid workers, the number of young people failing to reach educational standards, and the number of people who want to be in paid work but are not have all fallen in the last decade.

However, problems of multiple deprivation continue to exist. Pockets of disadvantage and poverty are concentrated in certain geographic areas, notably urban inner city centres, coastal and selected rural communities. Inequalities associated with class, income or deprivation are pervasive and can be found in all aspects of health, from infant death to the risk of mental illness. The most recent child poverty figures for 2005/6 show that 2.8 million children live in low-income households, an increase of 100,000 over the previous year. The UK has a higher proportion of its population in relative low income than most other EU countries: only six have a higher rate than the UK. One-third of all people in low-income households are now working-age adults without dependent children (3.5 million people).[3]

The Government objective to address social exclusion has resulted in a number of policies to target deprivation in communities.

Enterprise-led regeneration

The Government's commitment to reducing social exclusion has resulted in policies to promote entrepreneurship in disadvantaged communities across the UK. Policy-makers have focused on enterprise as a way of increasing national productivity, securing full employment, and narrowing the gap in economic wealth between different regions. The current Government views enterprise as a means of achieving sustainable economic development, growth and regeneration in deprived areas. Enterprise policy seeks to address pronounced gaps in entrepreneurial activity, as well as higher failure rates for businesses based in disadvantaged areas. A strategy of promoting new businesses was designed to create economic opportunities and jobs; and to contribute to innovation, growth and productivity.

UK policy on enterprise development in disadvantaged areas has evolved from the ideas of Professor Michael Porter of Harvard Business School. Porter established the Initiative for a Competitive Inner City in 1994 to spark the revival of inner cities by bringing market-based approaches to economic development in these distressed areas. A focus on enterprise through Enterprise Zones and support for small and medium enterprises (SMEs) was promoted as an alternative model in areas of industrial decline. Policies that build on this concept in the UK include the City Growth strategy and a retail-led approach to regeneration.

Enterprise-led regeneration often focuses on the stimulation of scalable high-growth enterprises. This policy supports a range of finance initiatives, such as the Small Firms Loan Guarantee, regional venture capital funds, and enterprise capital funds. These initiatives were intended to improve access to finance for small to medium-sized growth businesses. Development of a national Business Link support network was also part of a strategy to support growing businesses in order to create jobs and to promote a thriving economy. However, it has not necessarily resulted in enterprises that remain rooted in communities, create local opportunities, provide training, and generate a positive cycle of regeneration through local procurement.

The benefits of enterprise-led regeneration can be seen as wider than job creation. They include improving local service provision, building supply chains, and creating local economic multipliers that increase the local tax base, improve the physical environment, invest in the community and build social capital. For individuals, enterprise creation can mean enhanced income, improved job satisfaction and a better quality of life. While many small-scale start-up enterprises fail in the first one to three years, the resultant skill development, empowerment and business experience can significantly improve an individual's employability.

Experiences of enterprise-led regeneration have revealed the problem of how to target the disadvantaged effectively and the need to think beyond employment as a simple target. Narrow ambitions for regeneration based on employment creation and enterprise growth fail to capture the full benefit that targeted interventions can bring through skill development, training and business support. The need for the development of skills, networks, training and social infrastructure is reflected in the work of CDFIs.

In disadvantaged areas, enterprise should be understood as a micro-level activity. The enterprises most in need of support are not likely to be high-growth; they are more likely to remain local, with benefits accruing accordingly. Enterprise and entrepreneurship in the context of disadvantage are not likely to fit the classic concept of high-flying entrepreneurs. They are, rather, a reflection of the need of disadvantaged people to work, to control their income, to build skills and to move away from dependence and vulnerability.

Enterprise for all

Enterprise policy also focuses on expanding economic opportunity for disadvantaged individuals and under-represented groups. The policy of 'Enterprise for all' is used by the Government to address gaps in enterprise creation that exist between different regions, as well as between men and women, and individuals of different minority groups.

This latter focus is relevant to disadvantaged areas, particularly in inner cities, where there may be higher proportions of ethnic minorities. Policies such as the Local Enterprise Growth Initiatives (LEGI), the establishment of Women's Enterprise Units, and the Ethnic Minority Business Forum reflect concern to ensure equality of opportunity and to address market failures in enterprise start-up.

As the Enterprise for All Coalition has suggested, enterprise encompasses businesses with social missions, entrepreneurial not-for-profits, and low or no-growth lifestyle businesses rather than just high-growth ventures.[4] This policy approach understands enterprise more broadly to include other forms of entrepreneurial activity, including self-employment and social enterprise. Entrepreneurship is seen as the ability to take action, to seize opportunities and to marshal resources to achieve positive outcomes.

Individuals in disadvantaged communities may engage in enterprise in the absence of preferable employment alternatives. This form of entrepreneurship can be described as a will to make things happen and to take initiative to improve one's well-being, something not addressed by a high-growth and job-focused regeneration policy.

The perception that economic activity in disadvantaged areas is simply restrained assumes a broad capacity and a latent desire for entrepreneurship. While there is significant entrepreneurial potential in disadvantaged communities, in reality there are multiple barriers to enterprise creation that perpetuate inequality. In addition to problems of access to finance, the following factors have been identified:[5]

- There is a relatively poor climate for entrepreneurship in the UK.
- Many people have a poor and limited understanding of enterprise in its various forms.
- Certain groups, individuals or areas are unable to access appropriate support to enable start-up and development.
- Internal barriers exist, such as language, confidence, cultural background.
- Start-up can take a long time, and requires appropriate support and funding

It is clear that the availability of appropriate and high-quality business development services, amongst other non-financial services, is critical in this context. Effective interventions may require tailored, individual support that is both intensive and costly. In this respect, CDFIs are not simply providers of capital to micro-entrepreneurs; they can also generate human capital appropriate to the context of disadvantage.

Under-investment in deprived communities

Significant attention has been paid to the challenge of under-investment in disadvantaged communities. Problems experienced by both existing and start-up enterprises in low-income neighbourhoods in accessing finance are well documented. There is a clear need for alternative sources of finance to combat the failure of the market to meet the needs of ethnically diverse, self-employed or start-up enterprises. These businesses often lack equity and collateral, as well as management expertise or the financial savvy to deal confidently with bank employees. For minority entrepreneurs this may be exacerbated by a difference in culture and language. As banks increasingly withdraw from disadvantaged communities, there is further aversion to financing start-ups and enterprises in these areas, which are viewed as unprofitable and more risky.

Micro and small firms represent a substantial contribution to the UK economy. Almost 73 per cent of UK businesses are sole traders with no employees. They generated £190 billion of combined turnover in 2004. Together with small businesses (0 to 49 employees) these enterprises represent 99 per cent of the UK business stock, employ almost half of the working population, and represent 37 per cent of total turnover.[6]

Because of their importance to the economy, the Bank of England monitors the level of commercial bank lending to small businesses.[7] These annual reports indicate that lending to small firms nationally has improved since the 1990s, suggesting that access to finance is not of great concern for small businesses generally. Changes within the banking sector, however, have made it more difficult for businesses in disadvantaged communities to access bank credit.

Increasing competition and a growing drive for profitability have resulted in consolidation in the UK banking sector, reducing the number of regional and local institutions. The drive to maximise profits has meant that relatively low-margin activities, such as lending, are de-emphasised. Banks are reluctant to finance very small business loans given the high transaction costs of appraising and securing such loans. Banks increasingly use credit-scoring techniques for small-scale loans and new clients. Customers thought to be risky, such as those based in deprived areas, are more likely to be denied credit or forced to pay higher interest rates. A Bank of England report confirms that businesses in deprived areas represent a greater credit risk on average, based on the number of accounts in unauthorised overdraft. The margin on small business lending in deprived areas is higher that of lending to small business generally across Britain.[8]

Lending to small businesses in deprived areas was £1.97 billion at June 2006, representing 4.4 per cent of the national total.[9] The deprived postcodes represent 5 per cent of total sectors in Britain. They are largely concentrated in urban areas, where one might expect a higher level of business activity. However, the total number of loans and overdrafts in deprived areas decreased to 55,856 in 2006, down from 56,841 in 2003. While the value of term loans increased year on year from £836 million in 2000 to £1.7 billion in 2006, the value of overdrafts has remained relatively static at approximately £300 million since 2000. Similarly, the number of business accounts in deprived areas has increased by just 26,000 since 2000. In the year ending June 2006, bank lending to small businesses in deprived areas grew by less than the total lending to small businesses across Britain. Further, these figures do not provide an indication of the problems experienced in accessing finance for individuals without capital or credit history, issues for many start-up businesses in deprived communities.

Another issue of access to finance is branch closures. Banks are distancing themselves from disadvantaged communities. Many banks no longer have a physical presence in low-income areas, making loan application and assessment increasingly difficult for local entrepreneurs. Branch networks of both banks and building societies have been in continuous decline since the 1980s. Research published by the University of Nottingham found that Britain's least affluent inner cities and traditional manufacturing areas have lost more local high street branches than any other area since 1995.[10] Lack of availability of bank branches has clear negative consequences for low-income customers and local businesses. Britain's poorest communities have been the hardest hit.

Small enterprises and start-ups in deprived communities are often lifestyle or family businesses. These businesses are typically not high-growth enterprises, and may lack detailed accounts and knowledge of mainstream banking practices. The Bank of England found that income from self-employment is lower among businesses based in deprived areas than elsewhere. Fewer self-employed people in deprived areas have personal current accounts, and of those that do, fewer have a separate business account.[11] Small-business owners from deprived areas are less likely to own their own homes, and if they do, these properties are likely to be worth less. The Bank of England report surveyed bank managers who confirmed that these factors are likely to have a negative impact on the ability of a business to access bank finance. These micro-enterprises may be on the margins of mainstream finance, requiring intensive support and training prior to being investment-ready. These businesses are most likely to have financing needs that can be best met through CDFIs.

According to research carried out by **nef** in 2003, micro-enterprises, both registered and unregistered, experience the largest access to finance gap.[12] They are less likely to seek external finance than small businesses, and face higher failure rates when approaching banks. Informal-sector micro-enterprises provide income for some of the poorest families in the UK, including immigrant families. While small businesses are increasingly better banked, banks still decline a significant number. These could be bankable through the more relationship-driven and risk-tolerant approach to business lending adopted by CDFIs. In addition, ethnic-minority-owned businesses, particularly Afro-Caribbean and Bangladeshi, along with women-owned businesses face particular difficulties when it comes to raising bank finance.

Finally, there is a significant market for CDFIs among the unemployed interested in starting a business. Based on the proportion that seek out the self employment option under the New Deal, **nef** estimates that 10 per cent of unemployed people are interested in starting their own business. This suggests that of those 2.3 million people who wanted to be in paid work in 2005, but were not, an estimated 230,000 could be potential micro-entrepreneurs if they were given support to develop a business idea. These micro-enterprises are niche markets for CDFIs. There is a clear need for more effective and targeted business support combined with access to higher-risk loans.

Community finance and enterprise

Evidence of under-investment in disadvantaged communities indicates that access to finance is a critical problem for a selected group of small and micro-enterprises. A large body of evidence points to bank withdrawal from disadvantaged communities; an absence of targeted business support; and a high-growth-focused enterprise policy as reasons why small or minority-owned businesses miss out. In this context, CDFIs, in partnership with other institutions, have a key role to play.

CDFIs in the UK are diverse. They offer a range of products, have different target clients, and take a variety of organisational and legal forms. The trade association for CDFIs, the CDFA, defines these entities as 'sustainable, independent organisations which provide financial services with two aims: to generate social and financial returns'. It describes their purpose as two-fold: 'providing capital and support to individuals or organisations', and 'to develop and create wealth in disadvantaged communities or underserved markets'.[13] This definition reflects the current and potential role of CDFIs, including the growing emphasis on personal financial inclusion.

The initial goals set out for CDFIs focus on their potential to spark entrepreneurial regeneration. This enterprise focus is central to the recommendations of SITF: 'The CDFIs considered in this report focus specifically on financial services for businesses and social economy organisations rather than personal use….The primary activity of a CDFI is lending or investing in community revitalisation.'[14] Government funding from the Phoenix Fund, as well as the creation of CITR, also centred on the objective of CDFIs to promote enterprise creation and to develop business skills. Initial membership of the CDFA also reflected this enterprise-lending focus, with over 80 per cent of CDFIs specialising in enterprise lending, whether to micro businesses, SMEs or social enterprises.

CDFIs were originally developed as models for local enterprise lending. The approach that this entails has led CDFIs to provide training and skills to micro-entrepreneurs. The provision of business-support services is crucial to the CDF sector as it is a key enabler of micro-entrepreneurs who are often in need of highly tailored training and skills. The expense of such provision and the relationship it involves is an impediment to the mainstream banking sector providing credit to this sector.

We explore the current state of the sector in Section 2, and review how CDFIs have evolved in light of the initial expectations and the policy context.

The role of housing and property for community finance

The social housing sector, a key institution in many disadvantaged communities, is important to the activities of CDFIs. Both organisations have beneficiaries in common and share objectives to promote financial inclusion, skill development, and the regeneration of low-income communities; 84 per cent of financially excluded households are either housing association or council tenants.[15] The activities of CDFIs overlap with the housing sector on several fronts. Improving financial literacy, personal money management and limiting predatory lending are addressed by many housing associations that seek to control rent arrears. Some CDFIs provide affordable loans to facilitate housing repair, such as home-improvement loans or equity-release schemes, which help to improve the local housing stock.[16] CDFIs may also offer financing for social housing through small or co-operative associations. In this respect, the objectives of CDFIs overlap with those of housing associations, providing a strong basis for collaboration and collective action. This is underscored by the formation of Communities England, a new housing and regeneration agency that brings together delivery of these services.

CDFIs in the UK have been limited in the extent to which they can expand to finance housing and property. The Government has applied restrictions to property investment through the CITR tax credit, prohibiting accredited CDFIs from investing these funds in residential accommodation. There are also restrictions on the amount of investment that an accredited CDFI can make in non-residential property with CITR funds. For example, CDFIs are restricted from investing in certain types of property development. CDFIs may, however, be involved in lending for property purchase to facilitate asset building by charities or social enterprises. As such, they can play a key role in fostering community asset building. Purchase of a non-residential property by a charity for redevelopment and community use has proven to be an important lending area, particularly for larger national CDFIs.

Credit for home-building, mortgages and property redevelopment have been key drivers for the CDFI sector in the US. While expectations of the potential of CDFIs in the UK have rested on the scale of the US sector, the importance of housing in developing sustainable lending models has often been overlooked. Strategic partnerships and diversification of products and services through property are potential avenues for increasing impact and the availability of finance to CDFIs. Partnering with social landlords provides new sources of funding and positive opportunities to reach target groups. Increasing the financing of property by CDFIs allows for secured lending, product diversification, higher average loans sizes, and reduced portfolio risk. It expands opportunities for income generation, thereby encouraging sustainability. Other potential product areas include loans to housing associations, financing of property development or re-development, mortgages, and lending for asset transfer.

CDFIs in the UK are likely to remain limited in the extent to which they engage in property finance. Since the 1988 Housing Act, housing associations are primarily financed through private financial institutions on a commercial basis to buy and develop property, suggesting a limited role for CDFIs in this area. Yet it is clear that new forms of property investment could enhance the strength of CDFI loan portfolios, allowing them to achieve higher rates of operational self-sustainability. Attempts to exploit the complementary aspects of CDF and housing are increasingly being explored.

Supporting institutions: development trust associations, local authorities, and RDAs

The communities that CDFIs target are served by a range of institutions seeking to support enterprise, local economic development and regeneration. CDFIs are independent organisations that form part of a network of stakeholders with common objectives. Development trust associations (DTAs), local authorities, and RDAs are key institutions that overlap with CDFI activities, whether to provide funding, technical support, referrals, or strategic oversight. The links between CDFIs and these organisations vary in the degree of collaboration, as well as the effectiveness of partnership. It is clear that these institutions, particularly local authorities and RDAs, will play an increasing role in the future direction of the sector as responsibility for funding and support is devolved to local level. In light of this trend, CDFIs are likely to enhance partnerships with local or regional institutions.

As community-owned and led organisations, DTAs are well-placed to work in partnership with CDFIs to develop enterprise, to build local assets and to enhance community prosperity. There are 385 DTAs in the UK involved in the economic and social regeneration of communities through the provision of investment and support. These organisations are independent and not-for-profit, and are funded

THE BENEFITS TRAP

The Government commitment to 'Welfare to Work' encourages the unemployed and those who receive state benefits to empower themselves through employment; it considers work to be the best route out of poverty. The 'Make Work Pay' agenda is a move to focus on employment as opposed to state aid as the solution to poverty and exclusion. Benefits become in-work tax credits, income support is dependent on job-seeking, and policy seeks to avoid the creation of a dependency culture at all costs.

Unfortunately, getting people back into work *and* reducing poverty can be conflicting aims. The integration of state aid into the earnings and tax system has an unwelcome outcome: the benefits trap. The policy of gradual reduction in benefits as earned income rises reduces not only income support, but housing and council tax benefit, and even school meals provision. For some individuals, moving into work or better pay can mean the loss of these important sources of assistance. This discourages employment by eroding a large part of the increase in earnings. This benefits trap, exacerbated by low pay, affects the unemployed, those in low-paid work, and those in the informal economy.

Evidence on the effectiveness of a 'Welfare to Work' policy, such as through the Working Family Tax Credit, indicates that only small increases in employment have resulted. Meanwhile, for some low-income groups at high risk of poverty and exclusion, the cost of employment or better-pay has become *higher* because of the reduction in support.

CDFIs share the objective of increasing employment and income through enterprise and are therefore subject to the benefits trap challenge. They seek to reduce dependency on the benefits system through increased employment and reduction of informal, insecure work. Evidence suggests that choosing to work or starting an enterprise can be inhibited by the fear that the transition will require a costly sacrifice: the security of benefits. The employment options on offer tend to be low-paid and insecure, and the process of getting back on benefits when work dries up can be slow and uncertain. CDFIs are trying to encourage entrepreneurs to start up new businesses. Yet new enterprises frequently begin with risky and fluctuating returns. Benefits are an important form of 'insurance policy' for risky transitions into work or self-employment.

CDFIs can play an important role in building the bridge between welfare and work. Employment policy has a big impact on the effectiveness of CDFIs; the tax and benefit systems can discourage individuals from enterprise. General employment policy and the job-seekers system do not emphasise self-employment and enterprise in the way CDFIs do, despite the Government's conviction that entrepreneurialism in disadvantaged communities is an important factor in regeneration.

CDFIs are an element of the 'Welfare-to-Work' approach, providing a bridge for those who want to use self-employment to overcome exclusion. The support and close relationships provided by CDFIs are important to the success of their borrowers. This level of support can help individuals to overcome and manage concerns about loss of benefits.

through a mix of grants and earned income. Activities of DTAs include property development, provision of managed workspace, development of community businesses, community transport, employment training, and building restoration. Over half of all DTAs are based in rural or semi-rural environments, such as market or coastal towns or former coal-mining areas. However these associations are also found in inner cities, housing estates, and urban communities. In facilitating enterprise development, community asset transfer, and redevelopment, DTAs regularly work in partnership with CDFIs to secure funding. An example of this collaboration is the Adventure Capital Fund (ACF), a CDFI set up in partnership with the DTA.

RDAs play an increasing role in the funding and strategic management of CDFIs, particularly following the post-Phoenix Fund devolution of responsibility for CDFIs from the Department of Trade and Industry (DTI) in April 2006. There are currently nine distinct RDAs in England whose objectives are to further economic development and regeneration; to promote business efficiency and competitiveness; to enhance employment skills; to improve job creation; and to contribute to sustainable development. RDAs have been tasked with funding CDFIs and promoting a region-wide strategic framework for community finance. The level of engagement of RDAs with CDFIs varies across each region, resulting in inconsistent commitment to funding, technical assistance and long-term development. We examine the implications of RDA oversight for CDFIs further in Section 2. It is clear, however, that the current policy context encourages RDAs to play a larger role in determining future funding, and in supporting and promoting partnerships with CDFIs. The individual strategies of each RDA will have significant impact on the context in which CDFIs operate.

As local authorities are responsible for local services and economic development they play a key role in co-ordinating with CDFIs. They increasingly fund CDFIs that deliver key services as part of a LEGI or as part of other strategies to foster regeneration, enterprise development or financial inclusion. As leadership continues to devolve to local councils, the role of local authorities in funding local initiatives and public-service delivery continues to expand. CDFIs may increasingly look to local sources of funding and support, through referrals, partnerships, and service agreements. While this will act to further integrate CDFIs with their community, these relationships may prove complex for larger CDFIs seeking to enhance scale when their activities range across different local authorities. In addition, the strength of partnership with local authorities can vary significantly, depending on the priority given to developing this relationship.

Partnership with local and regional institutions will become increasingly important for CDFIs. With diminishing national sources of funding, CDFIs must look to regional or local agencies for support. The effectiveness of CDFIs is likely to improve with strong links to local networks and integration with local development initiatives. CDFIs may seek out formal partnerships or service delivery agreements to increase their scale and impact. Better connection to local institutions can improve awareness and marketing of CDFI services, increase referrals and generate opportunities to share resources.

In this section we considered the wider issues that shape the community finance sector. The effectiveness of enterprise-lending CDFIs is influenced by a range of other factors and institutions that impact the lives of disadvantaged individuals. These include social exclusion, enterprise policy, social housing, and benefits payments. These issues form part of the operating context and outcomes that CDFIs are likely to achieve in low-income communities. We also reviewed how enterprise-led regeneration and the policy of 'Enterprise for all' have shaped the role of CDFIs.

Evidence of under-investment in disadvantaged communities indicates that access to finance is an ongoing problem for small and micro-enterprises. In this context, CDFIs have a key role to play in partnership with other institutions, such as housing associations, DTAs, local authorities and RDAs.

2: Community finance in the UK

The CDFI sector has reached a critical juncture. Government policy is increasingly focused on whether the CDFI sector is effective. Issues of sustainability, funding, scale, regulation, performance measurement, and professional capacity are relevant in this context. Expectations of scale and sustainability regularly shape funding decisions.

At the same time, the CDFI sector has increasingly developed a mix of organisational models, providing a widening range of services. The policy focus has shifted from enterprise to personal financial exclusion. The funding environment reflects this change, with the Phoenix Fund, a key source of funding for enterprise-lending CDFIs, closing in March 2006. CDFIs are beholden to the changing policy environment and funding patterns as the sector is still young and has not yet achieved financial independence. Many are trying to adapt by preparing for private investment, by forming new partnerships, or by expanding into other areas of service provision. A specialist focus on niche markets is essential to enable CDFIs to realise future growth.

In light of this changing context, we review the current state of CDFI operations and their effectiveness. The diversity of the sector makes it important to examine a range of experiences and perspectives. The strengths and weaknesses of CDFIs are examined to determine the implications of the current direction of policy and assess how CDFIs are responding. We address a range of issues including sustainability, scale, funding, and regulation, as the sector reaches a critical stage in its development. Our objective is to review of the state of CDFIs in the UK in order to begin to document what policies are effective to bring about social change.

Expectations

Initial backing for CDFIs was based on their role of supporting enterprise development and creating economic opportunity for disadvantaged communities. While disadvantaged areas suffer concentrations of poverty and inequality that discourage private investment, they are also home to enterprising individuals with significant potential but without access to capital and management expertise. CDFIs were viewed as key instruments in bringing loan capital to those unable to access mainstream finance or those excluded from high street banks. By promoting enterprise creation, CDFIs were designed to tap into the latent initiative of disadvantaged communities, resulting in entrepreneurship, empowerment and wealth creation.

At a policy level, certain factors are considered key to the objectives of CDFIs, namely to address poverty and exclusion. These expectations are the basis on which the effectiveness of CDFIs is judged and stem from a belief in the capacity of enterprise to empower the excluded and to drive economic regeneration.

Expectations of the performance of CDFIs – in terms of potential growth and their ability to become sustainable – have determined the form and manner of funding and support provided to the sector. Not all expectations have been met. Initial optimism for the sector's ability to achieve these expectations, and the subsequent disappointment, have overshadowed the real achievements of CDFIs.

A key expectation for CDFIs, based on international experience, was their ability to become sustainable, to finance their operations through income generated

KEY EXPECTATIONS FOR THE SECTOR:

- **Access to finance:** CDFIs can provide a relationship-based lending model to address demand for finance from those excluded from mainstream banks.
- **Enterprise for regeneration:** CDFI lending will stimulate enterprise development to promote the regeneration of deprived areas.
- **Sustainability:** CDFIs should achieve sustainable business models within a reasonable timeframe, allowing them to cover the cost of operations and to reduce the need for grant funding.
- **Scale:** CDFIs should grow lending operations to a sufficient scale to have a meaningful impact.
- **Capacity building:** CDFIs should develop into robust and well-managed organisations in order to ensure a professional and efficient approach to finance provision.
- **Private investment:** CDFIs should move to private sources of finance in order to achieve scale and limit grant dependence.
- **Social impact:** CDFIs should develop appropriate measures of their performance and social outcomes.
- **Partnership:** CDFIs should link to a larger network of institutions (public and private) that contribute to efforts to overcome exclusion and disadvantage.

on loans. CDFIs that diversify their portfolios and limit default rates could, it was assumed, move towards sustainability.[17] Expectations of sustainability guided the decisions of key funders, including the Government, banks and charitable foundations, and formed the basis for assumptions about future financing of the sector. As part of the conditions of funding, CDFIs were often expected to demonstrate sustainable business plans.

Additional motives exist for encouraging a business-like approach and targeting sustainability. Apart from financial discipline, the autonomy that sustainability permits was viewed as an important mechanism to overcome a 'culture of over-dependence'. It was feared that excessive reliance on charitable giving and public funding would stifle entrepreneurialism and crowd out other finance.

While the possibility of achieving sustainability is open to debate, it is clear that the sector is not yet there. In 2005, the CDFA developed a ratio of operational self-sustainability (OSS) to measure the amount of an organisation's costs covered from earned revenue, which indicated that the average level of sustainability for the sector was 36 per cent.[18] CDFIs demonstrated a range of sustainability rates based on loan portfolio and range of services provided. The OSS ratio in 2005 included sustainability levels ranging from a low of 0.22 per cent to a high of 123 per cent, but nearly half of CDFIs had ratios of less than 20 per cent. Similarly, in 2004, a **nef** analysis of rates for CDFIs providing micro-loans showed that most had limited outreach and were not covering their operating costs.[19] A recent review carried out by Small Change for the South East Enterprise Development Agency (SEEDA) confirmed a wide variance in sustainability rates in CDFIs based in the South East, with only the largest social enterprise lenders achieving this objective.[20] Neither enterprise lenders nor personal lenders have achieved more than 60 per cent operational sustainability according to best-case outcomes. In reality, CDFIs with smaller loan portfolios are likely to have operational sustainability of less than 20 per cent.[21]

Many CDFI business models will not achieve sustainability. Certain lending models and activities preclude this objective. Small personal and micro-enterprise loans are costly to administer and generate less interest income. CDFIs are social enterprises that target a client group that banks find unprofitable. These clients require costly business support and training for which they are unable to pay.

A business approach to lending should not mean that CDFIs are expected to become sustainable at the cost of their social mission. International evidence indicates that many US and Western European community finance organisations have yet to become independent of grant support. Sustainability is determined by a number of different factors, not simply organisational form and ethos but also the markets served, the type of loans offered, and the organisational size and maturity. Sustainability may only be a possible for those organisations that engage in larger or secured loans for property or social enterprises. Cross-subsidy from fees or revenue on other activities, such as consulting services or attracting well-off clients, might support this objective. Fundamentally CDFIs serve hard-to-reach clients and provide a social service. They continue to require grant funding to carry out many aspects of their operations.

Current state of the sector

The role of CDFIs is increasingly complicated by a changing policy context and different funding priorities. The basis for measuring outcomes, originally focused on the role of CDFIs as agents of enterprise and regeneration, has shifted to personal finance. CDFIs are involved in more than the provision of credit to micro-entrepreneurs and social enterprises. They are further diversifying to include personal lending, home improvement loans, development of community property trusts, equity investments, and in selected cases, savings accounts. CDFIs are leveraging front- and back-office services and are providing non-financial services, such as training and business development. Money advice and budgeting support, bill payment, debt counselling, and management of rent arrears are also being offered.

Much of the CDFI sector is still new and varied. According to the CDFA's 2005 *Inside Out* report, over 40 per cent of CDFIs have been financing for less than two years. The report estimates that CDFIs have financed more than 9,500 businesses and individuals, leveraging an estimated £160 million in funds that have together sustained in excess of 85,000 jobs and created more than 10,000 new jobs since the sector's emergence. As of September 2005, CDFI loan portfolios had grown to £181 million. The coverage of CDFIs in the UK is by no means complete, and community finance is not yet of a scale to lend to all those who could benefit from it.

Several distinct trends are emerging in CDFI lending. the CDFA's most recent sector report indicates an increase in the absolute value of lending across all markets with the exception of lending to medium-sized businesses (50–249 employees). While CDFI lending has traditionally been dominated by loans to micro-enterprises, this is diminishing. In 2004, 61 per cent of lending was to micro-enterprises (less than 10 employees) whereas by 2005 it had dropped to 50 per cent. CDFIs are partly diversifying into loans to individuals, while loans to social enterprises are falling as a proportion of total business. While micro- and social-enterprise lending remains a core business for CDFIs, the proportion providing personal lending may soon double.

A picture of a still-maturing sector emerges. The bulk of CDFIs are either less than two-years-old or between two- and five-years-old. In 2003 and 2004, CDFI start-ups represented over 15 per cent of the sector but by 2005 there was only one start-up organisation. The proportion of CDFIs focusing on a single market fell from 80 per cent in 2004 to 60 per cent in 2005. One motive for this diversification is the desire to operate in a more sustainable fashion. The data regarding sustainability has already been presented; however it is useful to recall the wide range of sustainability rates that was revealed.

As CDFIs are responding to a new policy context, it is useful to consider briefly the policy context that shaped development of the sector.

Policy context

Support for CDFIs emerged from the Government's objective to reduce social exclusion. As part of this, Gordon Brown launched SITF in February 2000 to encourage private investment in enterprises in deprived communities. The specific remit of SITF was: 'To set out how entrepreneurial practices can be applied to obtain higher social and financial returns from social investment, to harness new talents and skills to address economic regeneration and to unleash new sources of private and institutional investment.'[23] A practical framework for investment in

Table 1: Policy steps that helped to build the CDFI sector.

1997	The Government's **Social Exclusion Unit** (SEU) is established to address poverty issues.
1999	**Policy Action Teams** (PATs) on enterprise finance and financial exclusion make recommendations leading to development of the sector.
2000	The **Phoenix Fund** bidding rounds are initiated to channel finance to enterprise-lending CDFIs.
	The **Social Investment Task Force** (SITF) is established.
2002	The **Community Development Finance Association** (CDFA) is established.
	Bridges Community Development Venture Capital Fund is launched.
	Community Investment Tax Relief (CITR) is enacted to channel investment to CDFIs.
2003	Over **£42 million** is awarded to 63 CDFIs in Phoenix Fund bidding rounds.
2005	17 CDFIs are accredited for CITR; £38 million is raised by 11 CDFIs.[22]
2006	The Phoenix Fund is discontinued; £11 million is made available for transition.
	The responsibility for oversight and provision of funding to CDFIs devolved to **Regional Development Agencies** (RDAs).

disadvantaged communities was proposed, promoting the establishment of the CDFA, the CITR, and the Bridges Community Development Venture Capital Fund.

The policy steps outlined in Table 1 helped to build the CDFI sector. The Phoenix Fund has since closed, and DTI oversight has been transferred to RDAs. In February 2006, HM Treasury agreed an additional £11 million of interim support for the sector. The CDFA and its supporters have emphasised the importance of this government funding.[24] Since then, however, no new sources of government funding for enterprise lending have been committed and the future of support for enterprise lending remains uncertain.

UK interview findings

This analysis captures the range experience of enterprise-lending CDFIs. **nef** carried out interviews to address a number of factors affecting CDFIs, from operational challenges to how they are affected by the funding and policy context. These interviews provide a snapshot of the current strengths and weaknesses of CDFIs in their efforts to support disadvantaged communities.

We completed interviews with 19 CDFIs in the UK, selecting them on the basis of their ability to represent experiences typical to the sector while ensuring a sufficient breadth to reflect its diversity. A full description of our interview method is available in the appendices.

Summary findings

The comments of CDFI representatives point to the changing nature of the policy context. CDFIs recognise that the sector has reached a crossroads and are uncertain about its future direction. A variety of issues were raised as critical to the operating environment and future development of the sector.

- CDFIs identified instability of funding as one of the main challenges they face.
- There is general agreement among CDFIs that the sector has failed to communicate the value of its impact on disadvantaged communities.
- Most CDFIs feel that the policy environment is not conducive to their success, and that Government support has been unstable and too short-term.
- CDFIs acknowledge that sustainability is important but argue that it is not fully achievable for many organisations. Given the social outcomes CDFIs deliver, full sustainability may not always be possible, or desirable.

- CDFIs feel that the transfer of funding from government to RDAs has not been accompanied by a reasonable level of strategic understanding of the sector; some RDAs lack knowledge and understanding.

- CDFIs that provide business support agree that such support is not profitable, but view it as essential in ensuring the success of their clients.

- CDFIs believe that the quality and depth of existing business support services are inadequate because most providers have a limited understanding of the needs of their target markets.

- CDFIs have found it difficult to fund capacity building; external funding for this purpose is very limited.

- Though most CDFIs consider commercial funding central to their future growth, only a limited number felt able to attract and administer it.

- All CDFIs agree that there are no common measures or definitions and performance frameworks across the sector.

- Operational challenges noted by many CDFIs include achieving good deal flows, recruiting and retaining quality personnel, and generating enough income to achieve mission.

- CDFIs consider accessing sufficient funding for revenue and capital and resolving the uncertainty about the policy environment to be the two principal challenges facing the sector over the next five years.

To reflect the range of issues addressed, we have grouped the interview findings according to specific themes: strength of demand, business support, funding, impact and performance measurement, regulation, the engagement of banks, sustainability, and policy.

Strength of demand

- Demand for enterprise lending is lower than expected.

- Other factors determine demand for loans, in particular the investment readiness of applicants and the provision of business support training.

- Relationships with other stakeholders, private or public, are key to generating referrals and improving demand.

- CDFIs use a variety of marketing tools, but strategies are limited by restricted availability of funding.

CDFIs have found that demand for enterprise lending is less than anticipated. The level of demand varies depending on geographic location, intensity of marketing, levels of competition, and the type of product offered; with personal loans achieving higher demand than business loans. CDFIs are keen to point out that the level of demand obscures the degree of development work involved to convert the desire for enterprise lending into viable loans.

Some organisations receive a high number of enquiries and applications, but investment readiness (business support) is a key constraint for loan conversion. Many indicated that referrals from partner institutions are also crucial to the quality of demand. Other factors are important, such as competition from other lenders (including sub-prime lending); lack of awareness of community finance; and the ubiquity of credit card lending. CDFIs that convert higher proportions of queries into loans include training with the provision of finance. Increasing the scale of lending operations requires a commitment to providing non-lending services. One CDFI argued that ‘you will not get a steady deal flow (of enterprise loans) without providing support’.

CDFIs use a variety of marketing tools, but strategies are limited by restricted availability of funding. The use of websites detailing product offering and application procedures, referrals from public and private organisations, and participation in relevant fairs and events are some of the marketing tools commonly used. However, most referrals have been achieved through informal relationships with key individuals in relevant institutions and not through formal agreements.

Business support

- Training and business support are important for the viability and effectiveness of community finance.
- Support to borrowers is critical but its expense limits sustainability for CDFIs.
- Other forms of existing business support are often inappropriate to the needs of clients.

CDFIs consider non-lending services to be a fundamental part of access to finance. Over half of the organisations interviewed provide free business support services. CDFIs describe business support as critical in addressing poor financial literacy, limited business skills and lack of investment readiness. The manner in which training and development is achieved varies greatly. Of the CDFIs that do not provide business support, all have a referral mechanism in place for clients. CDFIs believe that other existing training and support providers lack understanding of the target markets they serve because of the highly specific needs of female or minority entrepreneurs, informal businesses and micro entrepreneurs. Some argue that the quality and depth of existing public business support services are insufficient.

Whether to provide non-lending services highlights the challenge that CDFIs face in allocating scarce resources. Are lending services unaffordable, or can CDFIs not afford to operate without them? The conversion of demand into lending can be improved by the provision of training. CDFIs that provide business support agree that while it is not profitable, it is essential in ensuring the success and sustainability of their clients. Explicit funding for this is very limited. Organisations that provide business support fund it either from their core funding or with a grant subsidy. CDFIs often lack the capability to demonstrate the cost and the value of business support provision and wrap such services into the overall cost of lending.

Funding

- CDFIs find the current funding climate unstable and short-term in its outlook.
- CDFIs have identified a lack of stable funding as one of the main challenges they face; this impacts their ability to grow and achieve sustainability.
- The closure of the Phoenix Fund is considered a backward step.
- Few CDFIs feel ready for private funding in their current state.

CDFIs face a funding environment marked by inconsistency; it is short-term and has unrealistic expectations. Most CDFIs feel that funders and policy-makers lack a true understanding of the products, services and methodologies they use to reach target markets. CDFIs have identified a lack of stable funding coupled with a supportive policy as one of the main challenges they face; this impacts their ability to grow and achieve sustainability.

CDFIs believe that the sector is in ‘policy flux’. The Phoenix Fund represented one of the most important sources of funding for most enterprise-lending organisations. Its closure has given rise to considerable unease, due to the devolution of responsibility for funding and the absence of a clear replacement. CDFIs feel that the transfer of funding from government to RDAs has not been accompanied by a reasonable level of strategic understanding about the sector. The transition is seen by some organisations as weakening national CDFIs and imposing new costs on local and regional CDFIs, which must now build new relationships with RDAs.

CDFIs are aware that some of the funding problems they face are related to their own capacity limitations, such as a failure to communicate their achievements. They have found it difficult to fund capacity building, as external funding for this purpose is very limited. Most CDFIs find that there is little money from operations that can be used for this purpose.

CDFIs look to private sources of funding as their ultimate goal. Banks have provided grants, credit and loans that have ranged from commercial rates to interest-free. While some CDFIs have solicited private investment as part of a strategy to scale up, most felt that commercial lending terms were inappropriate to their needs, not just in terms of affordability but also due to their own limited ability to manage these obligations. Although most organisations agreed that commercial funding plays a pivotal role for their growth, some noted that they do not have the capability to absorb it, or that banks would not lend to them. Some CDFIs have diversified revenue sources by providing services that generate management fees.

CDFIs point to the instability of public policy, suggesting that the Government abandoned a 'road that was two-thirds built', forcing practitioners to 'take their foot off the gas' prior to reaching maturity. Many cite the lack of government funds as evidence of a dwindling commitment to enterprise-lending CDFIs. Practitioners who argued that the Phoenix Fund closure was not very damaging developed a strategy to diversify their pool of funders; in particular through relationships with regional actors and the provision of personal loans.

Inadequate funding to develop capacity is a source of frustration for CDFIs. They feel compelled to keep adapt to shifting policy contexts and changing priorities without support. The Phoenix Fund played a crucial role in enabling institutional development, but funding for capacity building is no longer easily accessed. CDFIs valued the simple reporting requirements of the Phoenix Fund, which gave them the ability to adapt and grow as their needs required. They contrasted this with a more fragmented current funding environment that has limited their capacity to meet their clients' needs.

Impact and performance measurement

- CDFIs would like to see a common performance measurement framework.
- The absence of information on the impact of CDFIs means that there is a lack of transparency regarding their role in disadvantaged communities.

There is widespread disappointment at the sector's inability to communicate the social outcomes achieved by CDFIs. Evaluation of the performance of CDFIs is limited by the absence of agreed measures and standards. The principal measures that are used include the number of businesses supported and the number of jobs created or sustained. Additionally, measures of financial leverage, enterprise survival rates and the level of repeat borrowing are utilised. Few practitioners have been able to engage in more formal, social impact evaluations.

A consensus exists among CDFIs that common measurement frameworks are needed, but this is difficult to achieve due to their diversity and the limited resources that organisations can devote to this endeavour. All CDFIs agree that no common measures or frameworks of performance exist for the sector and that something must be done to tackle this. The work of the CDFA to build a performance framework was welcomed as much needed. Many practitioners indicated that any evaluation is often on an ad hoc basis driven by specific funder requirements.

Importantly, our policy survey found high levels of agreement that CDFIs have a positive impact on disadvantaged communities. This was corroborated by non-practitioners, supporting the conclusion that CDFIs make a significant impact through their work. Without appropriate performance measurement, however, they lack the capacity to demonstrate this. Figures 1 and 2 highlight these responses.

Respondents emphasised the importance of CDFIs to disadvantaged communities (Figure 1). Non-practitioners agreed with the positive impact of CDFIs. However, they were more cautious in their level of agreement with this statement, perhaps

Figure 1: Response to question 'CDFIs have a positive impact on disadvantaged communities'.

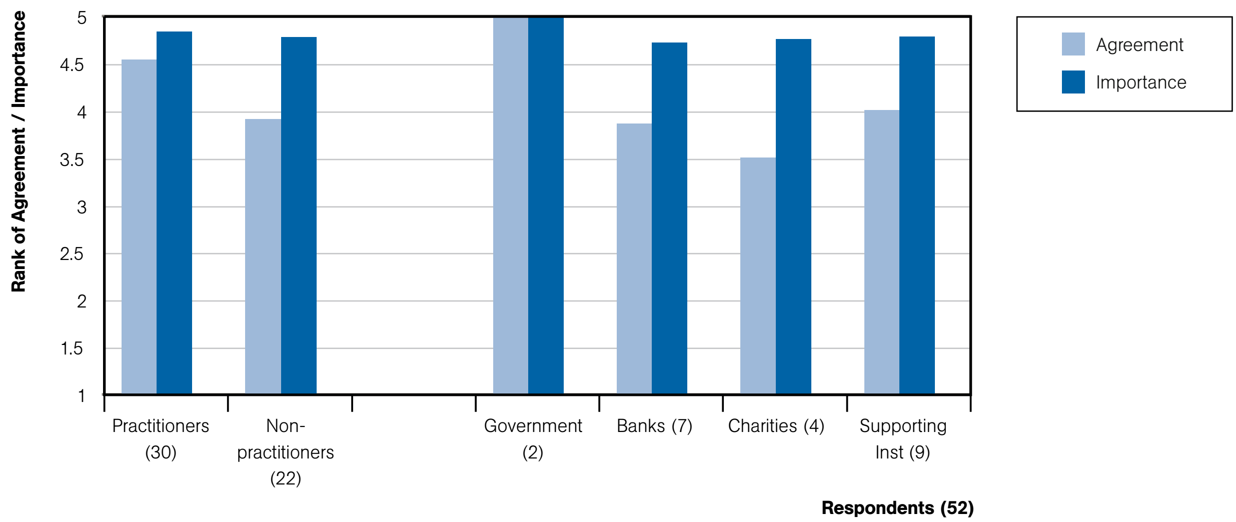
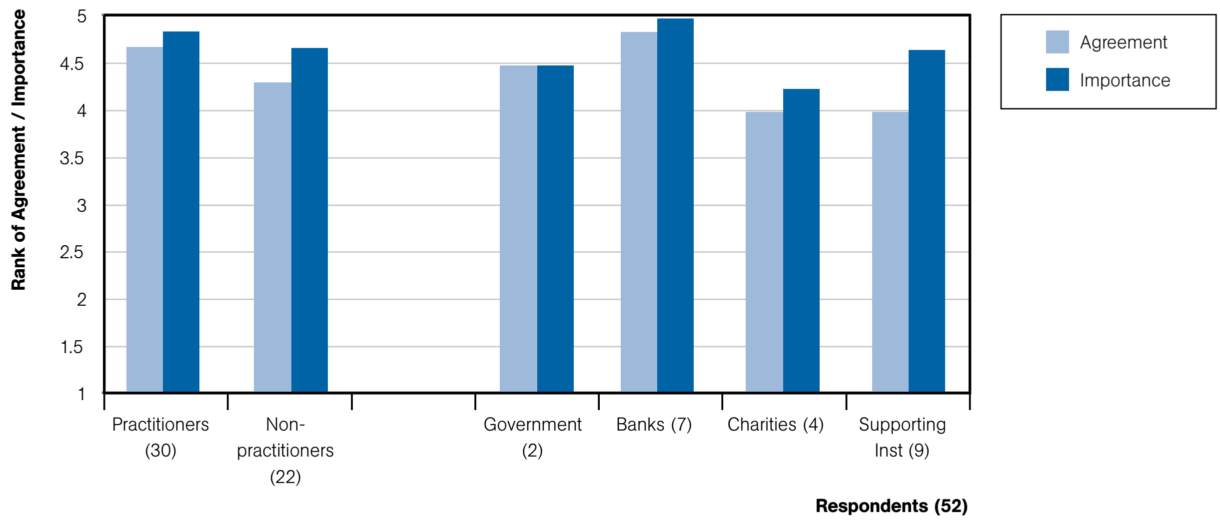


Figure 2: Response to question 'The enterprises CDFIs support can make a real difference to revitalise disadvantaged communities'.



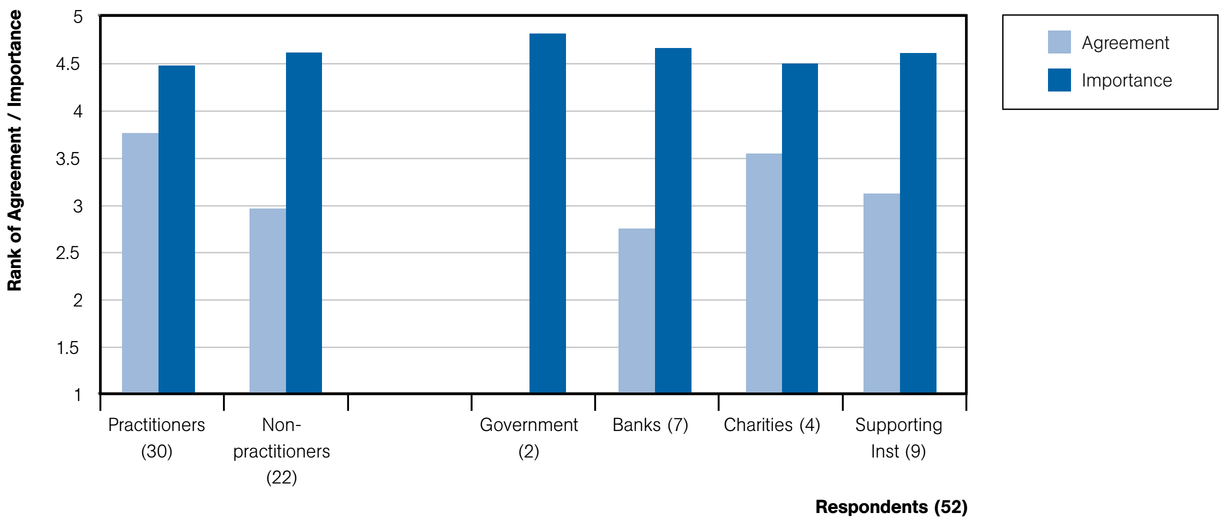
reflecting the uncertainty of available performance information. This speaks to the effectiveness of CDFIs, while confirming the need for better measures of outcomes achieved.

Similarly, CDFIs and non-practitioner groups are confident that the enterprises CDFIs support help to revitalise disadvantaged communities (Figure 2). Both groups gave a positive assessment of the impact of enterprises that CDFIs target to overcome disadvantage.

Regulation

- CDFIs are anxious that a one-size-fits-all regulatory regime would over-burden the sector and fail to account for the diversity of organisations.
- Non-CDFI representatives believe a regulatory framework would provide more strength and stability to the sector.
- Consensus does not exist on what represents 'best practice' in the sector.

Figure 3: Response to question 'Guidelines exist on good governance and management of CDFIs to generate needed credibility'.



- CDFIs are largely content with the current 'light-touch' approach.
- CDFIs accept the need to improve the transparency of their operations and to increase the rigour of reporting procedures.

A difficult balance is required of a regulatory regime that can encompass the whole CDFI sector. Currently CDFIs are not monitored by one regulatory body. They take a variety of legal forms, commonly either an Industrial and Provident Society or a Company Limited by Guarantee. As such they file their results with different bodies. CDFIs are ambivalent about proposed changes to the way in which they are regulated. They are concerned about how regulation could be adapted to fit with their diverse character. Most are happy with the current legal and regulatory requirements they face and are concerned about whether a single legal status for CDFIs would be appropriate to such a mixed sector.

No clear agreement is evident in their suggestions for an appropriate regulatory mechanism. CDFIs are anxious about burdening the sector through over-regulation at a premature stage of development. They recognise the need to build credibility in the eyes of backers and clients, but hope it would operate with a 'light touch'. They are broadly supportive of the CDFA's efforts to guide the debate on best practice and appropriate regulation. CDFIs largely favour a model of self-regulation in order to maintain the flexibility necessary to meet the needs of their target markets. A typical sentiment expressed by one CDFI was, 'we would not want to be over-regulated. What is needed are benchmarks and best practice standards.'

The idea that regulation could over-burden the sector is less evident among non-practitioners. This suggests that non-CDFI representatives believe a regulatory framework would provide more strength and stability to the sector. Unlike most non-practitioners, CDFIs agree strongly with the statement that 'Guidelines exist on good governance and management of CDFIs to generate needed credibility' Comments from non-practitioners emphasise that 'CDFIs are financial institutions and require regulation'. There is a divergence in expectations between the CDFIs and other stakeholders in the sector.

Figure 3 indicates that all groups consider the existence of guidelines on good governance to be an important factor for the credibility of CDFIs. However, non-practitioner groups are less confident that these guidelines exist. This divergence points to a demand for better standards or regulatory oversight from other stakeholders.

CDFIs accept the need to improve the transparency of their operations and to increase the rigour of reporting procedures, in order to 'give comfort to funders'. Most organisations agreed that either there are not enough standards for regular reporting or standards are not systematic enough. At the moment no common point of public disclosure for CDFIs exists. While most CDFIs believe that the CDFA is reasonably effective at reviewing and reporting on the performance of its members, it is faced with the challenge of a highly heterogeneous membership.

Currently there is no common understanding of best practice in the sector. The need for standards is tempered by the difficulty of imposing a single set of regulations on a young and diverse sector. An anticipated key benefit of agreed performance indicators is greater ease in reporting of key data. The uncoordinated reporting requirements of funders are very complex.

Bank engagement

- The commitment of banks to the sector and their level of engagement are considered inadequate.
- CDFIs would like to see more systematic and long-term backing from banks, not just in terms of investment but also in terms of capacity support and referral relationships.

Many CDFIs are frustrated with local banks; they feel banks could do considerably more to engage with CDFIs, at little cost to themselves. This frustration is heightened by the failure of banks to implement commitments to partner with CDFIs. Comments indicate that, 'Banks are doing precisely as little as they can in order to satisfy the policy-makers'. In the absence of formal commitments to provide referrals, CDFIs feel constrained by the low investment readiness of applicants.

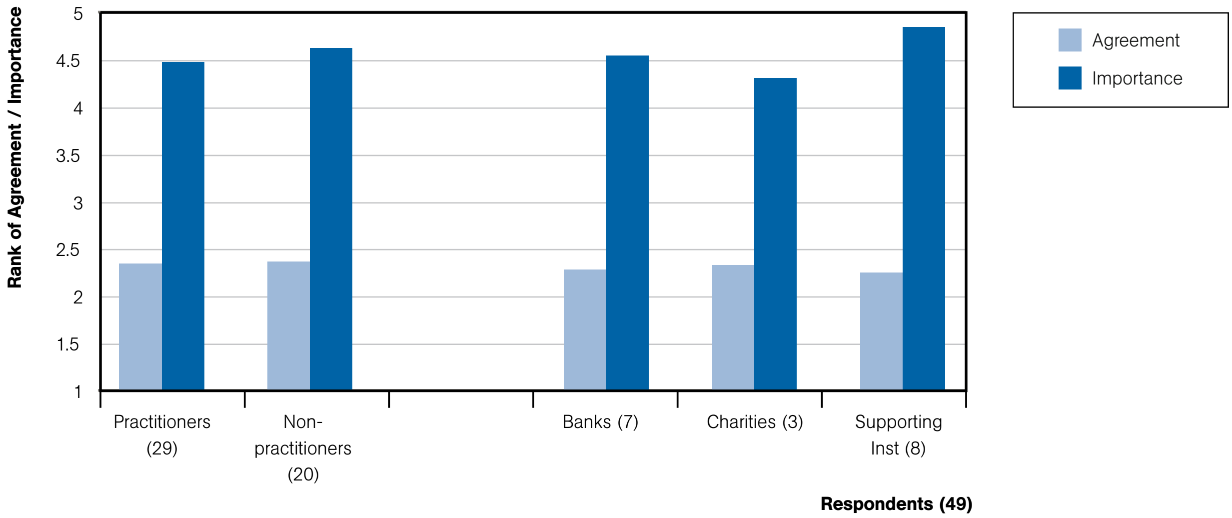
The relationships that CDFIs develop with other stakeholders are crucial to the quality of applications. Where CDFIs build effective referral relationships with local banks or other institutions they benefit from a better flow of viable applications. Referrals typically come from specific individuals in partner organisations rather than from formal agreements.

CDFIs would like greater engagement from banks through an integrated approach, rather than intermittent funding and support. Several CDFIs were positive about the performance of individual banks in providing support to community finance. However, the majority of CDFIs were critical of their approach to disadvantaged communities. Banks are viewed as inconsistent. Even where positive relationships exist they are not replicated or formalised. CDFIs would like Community Banking Services to be part of a broader strategy and not just a subset of the Corporate Social Responsibility team. Most CDFIs believe that this requires some form of legislative obligation on banks, such as the Community Reinvestment Act (CRA) in the US, to facilitate greater investment in disadvantaged communities.

The most pessimistic finding of our policy survey concerns the contribution of banks to community finance. CDFIs and other stakeholders all gave a negative assessment of banks' current engagement. Responses focused on how banks could contribute to provision of universal financial services to all members of society. These include development of a fair lending law; a CRA-style intervention; funding and stronger partnerships with CDFIs and business support agencies; and the alteration of banks' risk criteria to minimise exclusion. Banks need to increase their support of the CDFA. They should cultivate robust relationships with CDFIs to invest for the long term, make referrals, and improve their capacity to support communities that banks themselves are unable to serve.

Figure 4 shows the high ranking of the importance of banks' support, and a negative ranking (averaging below 2.5) for the current level of commitment from banks. This indicates that there remains a continuing gap in the extent to which banks are supporting and engaging with community finance.

Figure 4: Response to question 'Commercial banks and other traditional financial intermediaries are committed to CDF and to the development of this market'.



Sustainability

- CDFIs emphasise the importance of sustainability to the long-term viability and effectiveness of community finance.
- For most CDFIs, however, sustainability is not achievable.
- CDFIs believe that sustainability should not be used as the principal measure of performance.
- Scale is the preferred strategy of CDFIs to improve sustainable operation.

CDFIs are convinced of the importance of sustainability as a long-term goal. At the same time, most agree that sustainability is not achievable. CDFIs have to perform a balancing act between the financial pressures of operational sustainability and realising their social mission. For most CDFIs, the markets they target make it challenging for them to achieve sustainability given the high transaction costs involved; the intensity of business support; the required follow-up; and in some cases the cost of stimulating latent demand. As such, the value of using sustainability as an indicator of performance is questionable.

The sustainability of most CDFIs depends on a host of wider issues. Most consider the presence of good deal flows as a crucial factor: this relies on effective stakeholder relationships with public and private institutions. The nature of a CDFI's target market can determine how sustainable its operations can be. The operational capacity of a CDFI is critical to maintaining control of delinquencies and losses and relies on the presence of good quality management and staff. Continued external funding and support, especially in initial phases, is felt to be a key factor for sustainability. Long-term support is considered crucial to developing a strong presence in target markets.

Many CDFIs feel that the high interest rates or restricted client selection that sustainability would require conflicts with their social purpose. Even CDFIs that consider sustainability an achievable goal caution against an excessive focus on this outcome. Operational sustainability as an end point for the entire sector might render CDFIs indistinct from for-profit businesses, limiting their social value. CDFIs resist being measured by their level of sustainability because their mission necessitates lending with high transaction costs. CDFIs recognise this as inevitable, arguing that 'because of what we do, the failure rates will be higher than in traditional banking'.

There is no consensus on whether sustainability is achievable and desirable. Targeting sustainability provides significant benefits apart from financial discipline; it also helps to preserve organisational independence, to increase the credibility of an organisation and to reduce vulnerability to changing policy priorities.

There is also a lack of consensus among CDFIs about the provision of business support. Those CDFIs that provide support view it as a critical part of sustainability. It is considered essential to building the skills and credit-worthiness of borrowers and in so doing fulfils their mission and improves their loan portfolio. One CDFI explained that 'without this provision, there is no sustainability'. CDFIs that do not provide business support consider it important but impossible to provide without compensation or dedicated funding. In this case it is viewed as an additional cost that drags down the level of sustainability. One CDFI explained that 'in the long term it would reduce our capacity to be sustainable'. These CDFIs nevertheless recognise the need within their target group for business support, but feel that they cannot afford to provide it.

CDFIs are implementing strategies to increase their sustainability but struggle to overcome the constraints outlined above. Two factors mentioned are critical to this effort. The first is the potential to scale-up operations. Many CDFIs see enlarging operations as a means of developing cost efficiencies through increased loan volume, diversification of products, and the development of strategic partnerships. Scale is also a strategy to fulfil social mission by allowing CDFIs to maximise their outreach and impact. There are risks attached to this strategy, however. Greater scale poses a threat to maintaining local knowledge that ensures the quality of a CDFI's loan portfolio. The skills deficit of the target market suggests that the cost savings of scaling-up operations may not materialise as expected. Economies of scale may not exist when carrying out intensive, relationship-based loan provision.

The second factor considered crucial for sustainability is the policy environment. CDFIs feel that their credibility is affected by policy instability. It deters the establishment of appropriate partnerships, capacity building, and funding required to achieve sustainability. CDFIs question whether sufficient Government support exists to enable CDFIs to develop further, much less to achieve sustainability. Even those that believe the Government is sufficiently engaged with the sector perceive a shortfall in understanding of the specifics of their operating environment. Many believe that Government and funder expectations are unrealistic, diminishing the capacity of CDFIs to fulfil their mission by imposing inappropriate goals.

Policy context

- Support from Government has been unstable and too short-term.
- There is widespread fear of Government disengagement from the sector and a loss of valuable policy expertise in the transfer of responsibility to RDAs.
- CITR in its current form is considered inflexible and unlikely to achieve sufficient investment for community finance.
- CDFIs are supportive of the CDFA but are concerned about whether it has the resources to confront all of the challenges the sector faces.
- CDFIs worry that they have lost credibility in the eyes of policy-makers.

Most CDFIs believe that the current policy context indicates a withdrawal of public support for community finance. Most feel that, at present, the policy environment is not conducive to community finance. Support from Government has been unstable and too short-term.

Transfer of funding and strategy to the RDAs is perceived as a sign of disengagement. CDFIs lack confidence in the knowledge and expertise present at regional level. Comments tended to be critical. One CDFI argued that 'national government has walked away and the regions are without strategic support'. Another described policy for the sector right now as 'static, stagnant; there is no policy environment'.

The low take-up of CITR was presented by CDFIs as evidence of policy-makers' need to engage more effectively with the sector. While viewed as, 'a good and well-intentioned idea in principle', its design currently renders it of limited relevance; it fails to meet the need of the broad range of smaller CDFIs. CITR is described as too restrictive and its requirements as onerous. CDFIs do not believe that investors are sufficiently aware of CITR, or that CDFIs are of a scale to make the return attractive.

Funding is considered too short-term. Too often, public funders fail to continue supporting a CDFI after a one-off contribution. They are focused on employment, revenue and financial measures to the detriment of assessing impact. CDFIs feel that these limitations derive from a policy approach that is too politically driven, one that is far removed from the challenges facing the sector.

CDFIs are conscious of a credibility deficit: only a minority believe that funders and policy-makers perceive them as effective organisations. The reasons suggested for this negative perception are the absence of operational sustainability, low deal flows and a failure of the sector to communicate its impact. CDFIs feel that they and the CDFA should do more to improve the Government's understanding of community finance; they believe that expectations of policy-makers are misguided, particularly with respect to sustainability. Respondents pointed out that the Government has 'unrealistic expectations that the sector will be sustainable right away with some help, although no one is really measuring it'.

When asked, most organisations expressed mixed views about the effectiveness of the CDFA. They noted its success in securing transition funding, but expressed concern about whether it will be able to advocate for greater long-term funding and changes to CITR. Some organisations fear that the CDFA may not have enough capacity to tackle all of the issues. Concern centres on whether the CDFA has the resources to develop engagement at both regional and national level, and whether it can provide sufficient strategic input to policy-makers. There is general agreement that the CDFA has the 'huge task' of advocating for policy. CDFIs acknowledge that the CDFA has taken significant strides to resolve problems of communicating impact through its efforts to build a performance framework for the sector. Remarks included, 'The CDFA is doing an excellent job.' It was frequently noted that the CDFA is 'doing a good job and is getting better', in particular with the *Inside Out* publication and the survey that it undertakes.

The current policy environment has challenges. CDFIs proposed several interventions. CDFIs want to see policy-makers lift the emphasis on geographical deprivation and incorporate CDFIs into broader policies for social inclusion, including personal finance, social housing and insurance. Other suggestions included an appropriate national guarantee facility to foster investment in CDFIs and a UK equivalent of the CRA to stimulate more involvement from commercial banks.

Policy survey findings

We developed the policy survey tool to seek the views of a wider group of CDFIs as well as other stakeholders in the sector, including: policy-makers, banks and related financial institutions, charitable foundations, and government representatives. The survey supports the interview findings as it draws upon a broader stakeholder group to highlight differences in opinion and areas of consensus on issues affecting the sector.

We sent the survey to 143 individuals and received a response rate of 38 per cent with 54 respondents. Survey respondents comprised 22 non-practitioners and 32 CDFIs. Of the non-practitioners seven were drawn from the banking sector, two from Government, four from charitable foundations, and nine from other supporting institutions. Through the interview and survey process, we have collected the views of representatives from 43 different CDFIs.

The results of the survey have been presented to reveal the views of CDFIs and other stakeholders on the sector, noting particularly where opinions diverge. To reveal the gap, if any, between the current reality of an issue and its relevance to the sector, the survey asked respondents to rank the importance of issues as compared to the current state of the sector. By grouping these findings by the type of respondent a picture emerges of where expectations have not been met. It also permits examination of the difference in opinion between different stakeholder groups.

The questions posed in the survey are available in Appendix D.

The analysis presents the rankings of agreement and importance for each question. The available responses for each question were: ‘Disagree’, ‘Somewhat Disagree’, ‘Neutral’, ‘Somewhat Agree’ and ‘Agree’. We converted these to rankings, 1 to 5, which we used to generate radar diagrams. The diagrams compare the ranking of agreement with the ranking of importance for each question. The average ranking of agreement is represented by a blue line. The average ranking of importance for each question is presented as a blue area on the same graph. The gap between the shaded area, ‘Agreement’, and the blue line, ‘Importance’, provides an illustration of how far the current context falls short of stakeholders’ expectations.

Summary findings

- On most issues there is consistency in how CDFIs and other stakeholders (non-practitioners) responded to the questions.

- A divergence in opinion between CDFIs and other stakeholders was evident over the need for regulation of the sector. Those outside the sector felt a greater urgency for a regulatory structure.

- CDFIs are thought to be effective institutions; 80 per cent of respondents emphasised their positive impact, critical role in tackling access to finance and importance in disadvantaged communities.

- The effectiveness and impact of CDFIs is hampered by their small scale. This means that CDFIs are not as effective as they could be.

- Although it is clear that there are weaknesses in the current capacity of CDFIs, there are differences in the performance of individual CDFIs.

- CDFIs are dissatisfied with the quality of ongoing government support and the current policy situation.

- There is ongoing concern that the Government will lose interest in the sector and withdraw funding.

- There is consensus on the importance of sustainability, but it is felt that this must be balanced against social outcomes.

- The mainstream financial sector is viewed as one of the key potential sources of funding for the expansion of the CDFI sector. The most vivid disappointment among respondents is the lack of engagement of the banks.

- Over 70 per cent of CDFIs consider banks to be failing both the CDFI sector and its clients.

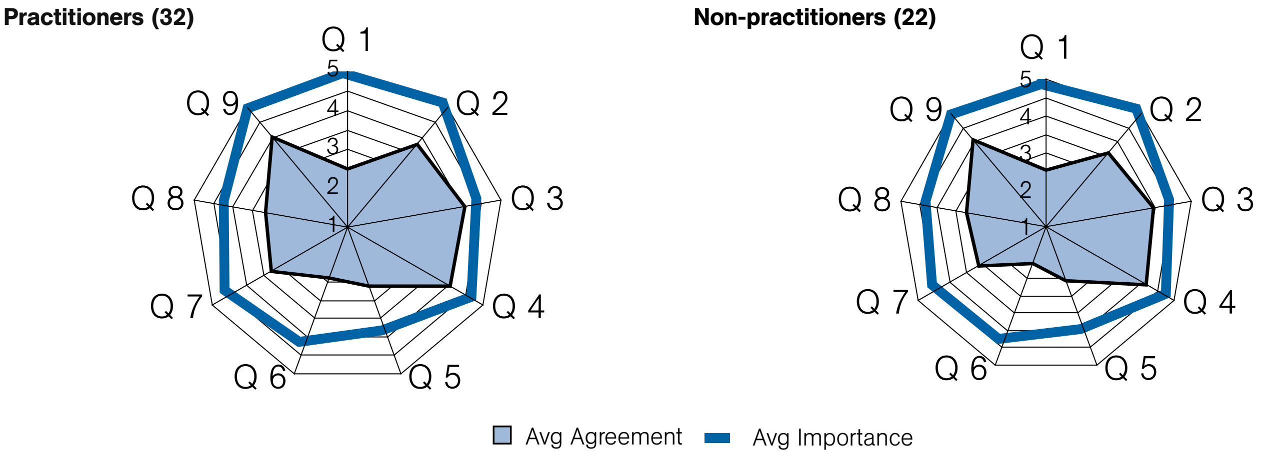
- The pattern of funding for CDFIs is fragmented; it lacks a clear strategic basis and is currently not measuring up to what is necessary.

- CITR was described by 77 per cent of respondents as ineffective and suffering from design flaws.

- Changing political cycles reduce the focus on CDFIs as important mechanisms for enterprise lending.

The findings of the policy survey are grouped according to the issues addressed: Vision, Policy, Effectiveness, CDFIs, Sustainability, Regulation, Government, Banks and Funding.

Figure 5: Vision



Q1 Community Development Finance (CDF) is recognised as an important part of the UK financial system.

Q2 CDF is recognised as an effective means to address access to finance and bring about regeneration and local development.

Q3 CDFIs are viewed as social enterprises balancing their social mission and business activities.

Q4 Key actors understand that entrepreneurs in deprived areas want and need rapid, simple access to financial and non- financial services.

Q5 Key actors recognise that the socially and financially excluded are good clients, repaying their loans on time.

Q6 Key actors use common standards for measuring CDF performance.

Q7 Key actors recognise the importance of the diversity of CDFIs in order to respond to local market conditions.

Q8 Key actors recognise the need for a balance between economies of scale and the ability to retain genuine local/community links.

Q9 Key actors recognise that business support, along with finance, is a key component in ensuring a CDFI's success in achieving its mission.

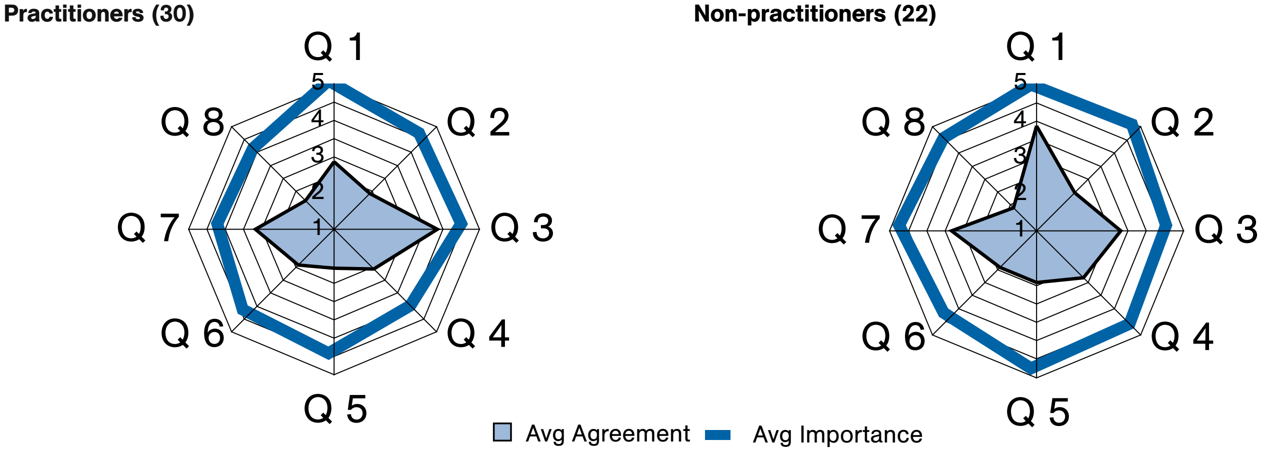
Vision

- CDFIs and other stakeholders agree that CDF is not recognised as an important part of the financial system.
- There is a continued lack of awareness of CDFIs and the challenges they face.
- CDFIs can be effective mechanisms to bring about change in disadvantaged communities by addressing access to finance issues, but there is still some way to go to realise this potential.

This section of the survey focused on the strategic vision of key actors and their understanding of the sector (Figure 5). The term 'key actors' refers to CDFI representatives, policy-makers, funders, regulators and sector representatives.

Confidence in the current level of strategic vision and engagement with the sector is limited. CDFIs feel that while key actors may be familiar with CDFIs, this does not result in appropriate action to support and advance the sector. Numerous comments from respondents highlighted a continued lack of awareness of CDFIs and the challenges they face. One individual noted, 'The role of CDFIs is probably insufficiently appreciated.' Another observed, 'The community finance message is still below the radar screen, and it is not well communicated.' Some questioned whether stakeholders really grasp the needs and difficulties of the market that CDFIs serve: 'I am not convinced that everyone recognises the difficulty that a small proportion of entrepreneurs have in accessing finance.' Respondents highlighted that despite the rhetoric, supportive policy often fails to materialise.

Figure 6: Policy



Q1 The UK policy environment is supportive of CDF.

Q2 CDFIs, their goals, diversity of structures and finance delivery mechanisms are well understood by policymakers.

Q3 The CDFA is a strong trade association that effectively represents its members' interests.

Q4 Appropriate tax treatment is provided to encourage the development of CDF.

Q5 The Community Investment Tax Relief (CITR) is well designed to provide finance to CDFIs.

Q6 The CITR helps CDFIs to achieve sustainability.

Q7 CDFIs can and are willing to charge the interest rates needed to cover the high costs of making small loans.

Q8 The structure of the benefits system facilitates the work of CDFIs to encourage disadvantaged individuals to engage in enterprise.

Policy

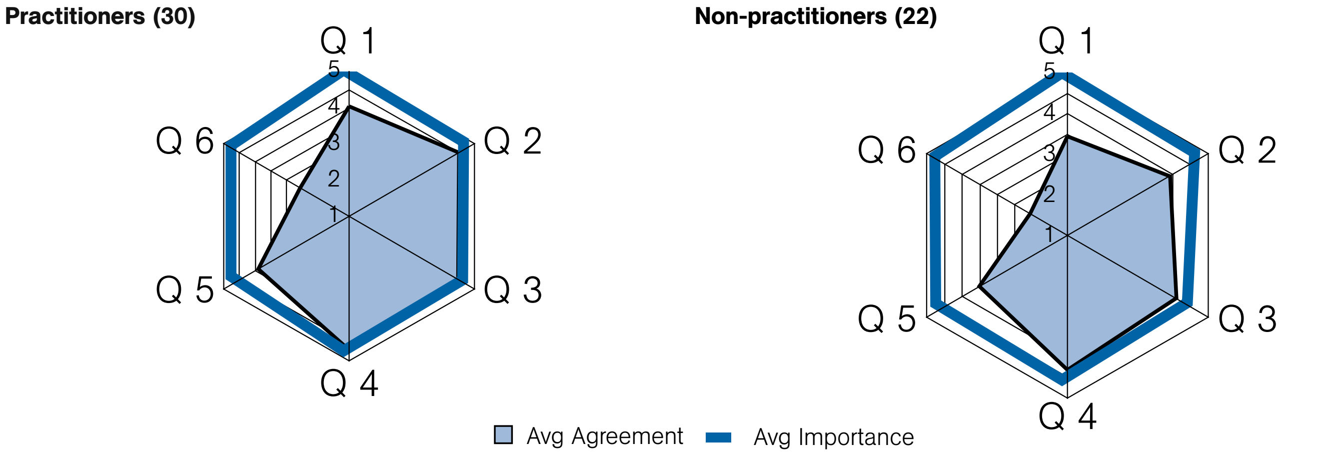
- CDFIs are more negative about the current policy climate than other stakeholders.
- CDFIs are ambivalent about whether interest rates should be set high enough to cover the costs of loan provision.
- Only 4 per cent of CDFIs agreed that CITR is well designed to generate more finance and investment; 77 per cent of all respondents viewed CITR as ineffective and suffering from design flaws.

Survey questions examined the significance of the policy context and its effectiveness (Figure 6). Respondents were asked how the CDFA, the CITR, and broader public policy, such as the benefits system, impacted outcomes of the community finance sector.

The survey findings are not positive about the current policy environment. CDFIs provide a particularly negative assessment. This is evident in their dissatisfaction with the quality of government support. One individual noted, 'The demise of the Phoenix Fund and devolution to RDAs has led to an inconsistent approach to funding the CDFI sector.' Another observed, 'I think the Government is supportive, but it has now moved on to the next new and interesting thing.' In some areas, such as CITR and employment policy, non-practitioners shared CDFIs' negative perception. Some comments reflect this. 'The CITR does not help achieve sustainability.' 'There are complexities in its operation which can be discouraging.' 'CITR is a valuable tool, but for a comparatively mature sector.' CDFIs are more supportive of the CDFA as a 'strong trade association' than non-practitioners.

The findings also indicate a limited willingness among CDFIs to charge 'interest rates needed to cover the high costs of making small loans' (Q7). This finding provoked CDFIs to comment that 'passing on high interest rates defeats the purpose of assisting the target market' and, separately, that there is 'no point the CDFI just being a loan shark!' This frustration concurs with the interview findings, which suggest that CDFIs believe many key actors have a limited appreciation of their social mission.

Figure 7: Effectiveness



Q1	CDFIs are effective institutions for the provision of finance and non-financial services to enterprises in disadvantaged areas.	**Q4**	The enterprises CDFIs support can make a real difference to revitalise disadvantaged communities.
Q2	CDFIs have a positive impact on disadvantaged communities.	**Q5**	CDFIs have strong links to their local communities.
Q3	CDFIs are critical institutions to address financial exclusion.	**Q6**	CDFIs are now of a scale to make significant impact on enterprise in disadvantaged communities.

Effectiveness

- CDFIs are believed to have a positive impact on disadvantaged communities, are critical institutions in addressing access to finance, and support enterprises that can make a difference, as emphasised by 80 per cent of respondents.
- Only one in three CDFIs agreed that they are now 'of a scale to make significant impact on enterprise within disadvantaged communities'.
- The overall impact of CDFIs is hampered by their small scale. CDFIs are not as effective as they could be.

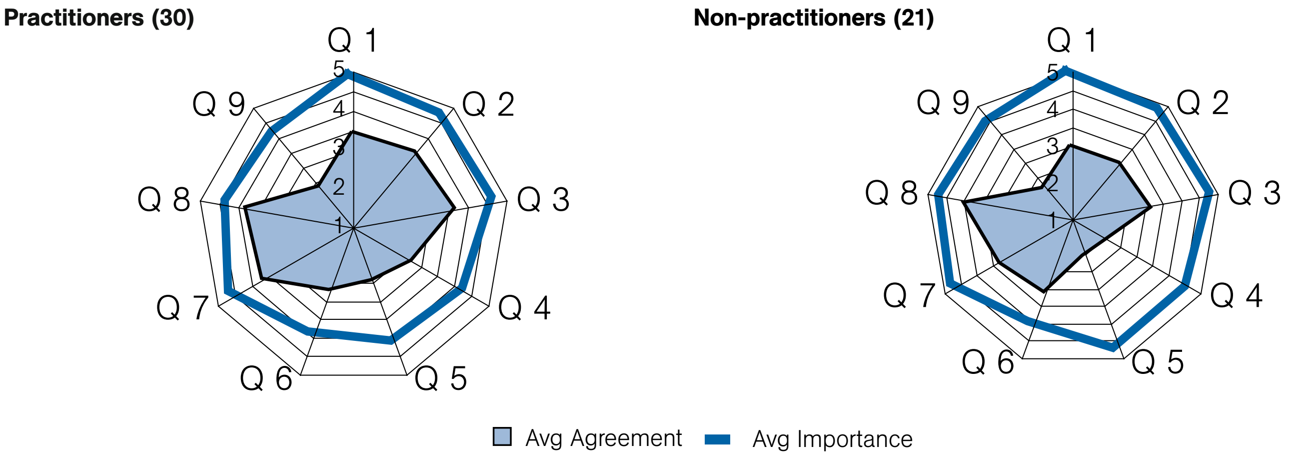
This section considers whether those involved in the sector believe the contribution of CDFIs to be an important part of the regeneration of disadvantaged communities.

CDFIs are considered effective institutions. Their positive impact, critical role in tackling access to finance and importance to disadvantaged communities was emphasised by 80 per cent of respondents. However, findings indicate that the effectiveness and overall impact of CDFIs is hampered by their small scale. CDFIs are not as effective as they could be.

Concerns emerged about whether current CDFIs can build a sector that is effective and of a scale to make a significant impact. Comments emphasised the youth of the sector, warning that 'some CDFIs are trying to run before they can walk'. 'CDFIs are growing but they are still very new in their history, their reserves and their ability to be sustainable.' The diversity of CDFIs was highlighted to suggest that most are 'too small, scattered and worried about their own survival and meeting the terms of their funders to be focused on the most effective way of tackling financial exclusion'.

Other stakeholders echoed these concerns, some of whom suggested that 'there are too many CDFIs that do not have sufficient critical mass for sustainability.' There was also concern about the immaturity of loan portfolios and the comparatively narrow product range on offer. Others were more critical, stating 'Generally CDFIs are badly managed, inefficient, non-professional. Unsurprising in a young sector, but aspirations are not set high enough.' However, another pointed out, 'Most CDFIs in the UK will need more funding assistance to develop.' And ultimately, 'CDFIs remain the last point of call for communities susceptible to financial exclusion.'

Figure 8: CDFIs



Q1 Board members of CDFIs have the vision, capacities and clarity needed to support CDFIs in becoming strong institutions with significant reach and impact.

Q2 CDFIs are scaling-up and are mobilising resources to develop the sector.

Q3 CDFIs are strengthening their institutional capacity and are training their staff to build a business-like organisational culture.

Q4 CDFIs have agreed common financial & operational performance standards that serve as the criteria for government and donors in providing financial support.

Q5 CDFIs have agreed common social impact standards that serve as the criteria for government and donors in providing financial support.

Q6 CDFIs that are not able to meet the industry standards for successful operation stop their activities.

Q7 The CDFI sector has a strong core group of institutions that represent best practice.

Q8 As CDFIs develop they offer a wider range of services to their target markets.

Q9 CDFIs serving high-risk entrepreneurs have built organisations and loan-delivery systems that enable profitable operations.

CDFIs

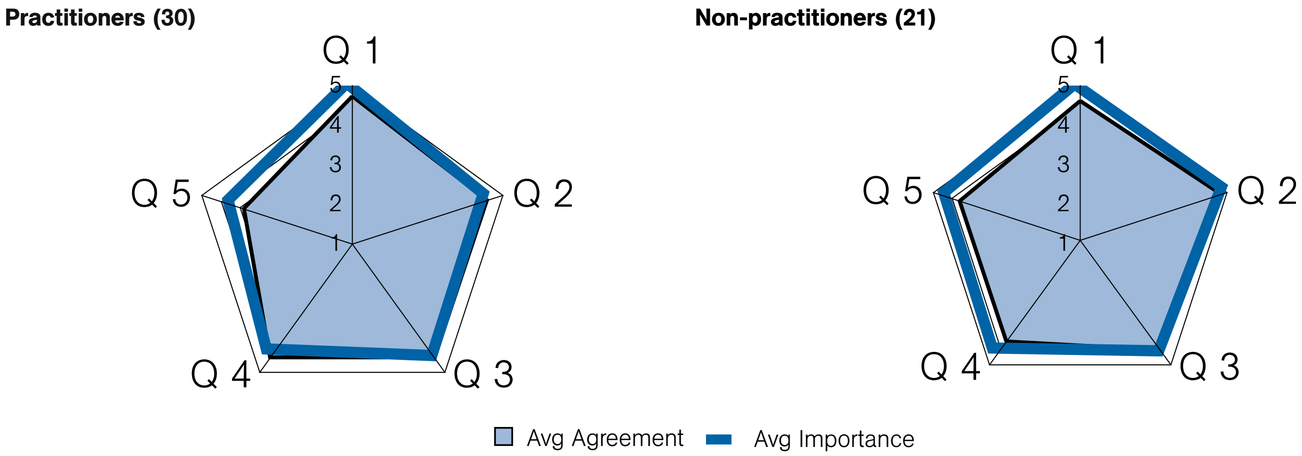
- There are weaknesses in the current capacity of CDFIs, particularly in establishing and meeting financial and operational standards.
- The diversity of organisations makes a general assessment of CDFI operations difficult. There are differences in the performance of individual CDFIs.

This section examined whether CDFIs are operating in the best manner. The capacity, growth and operational standards of CDFIs were considered to determine how effective these factors are (Figure 8).

The capacity of CDFIs is considered insufficient, both by CDFIs and a broader range of stakeholders. Respondents agreed that as CDFIs develop they need to offer a wider range of services to their target markets. Although it is clear that there are weaknesses in the current capacity of CDFIs, respondents found it difficult to generalise about the organisational performance of the sector.

There is wide variance in the performance of individual CDFIs making a general assessment of CDFI operations difficult. 'There are varying levels of achievement.' One respondent noted, 'Some CDFIs have moved into the norming stage of development, and a very few are beginning to perform.' Another confirmed, 'Some CDFIs will be exemplars of good practice, but there are equally many that do not attain such standards.' Respondents highlighted that the quality of boards of directors can vary significantly, with many individuals acting in the capacity of volunteers.

Figure 9: Sustainability



Q1 With the right support, CDFIs could be of a scale to make significant impact on enterprise in disadvantaged communities.

Q2 Greater scale is critical to achieving a higher degree of sustainability.

Q3 It is important for CDFIs to achieve operational sustainability.

Q4 A CDFI's sustainability should be judged against its social outcomes, which may justify some level of use of grants and subsidies.

Q5 In the future CDFIs will increasingly adopt non-grant forms of finance.

Sustainability

- Sustainability is a long-term goal for community finance in the UK.
- However, 90 per cent of CDFIs believe that, 'sustainability should be judged against social outcomes, which may justify some level of use of grants and subsidies.'

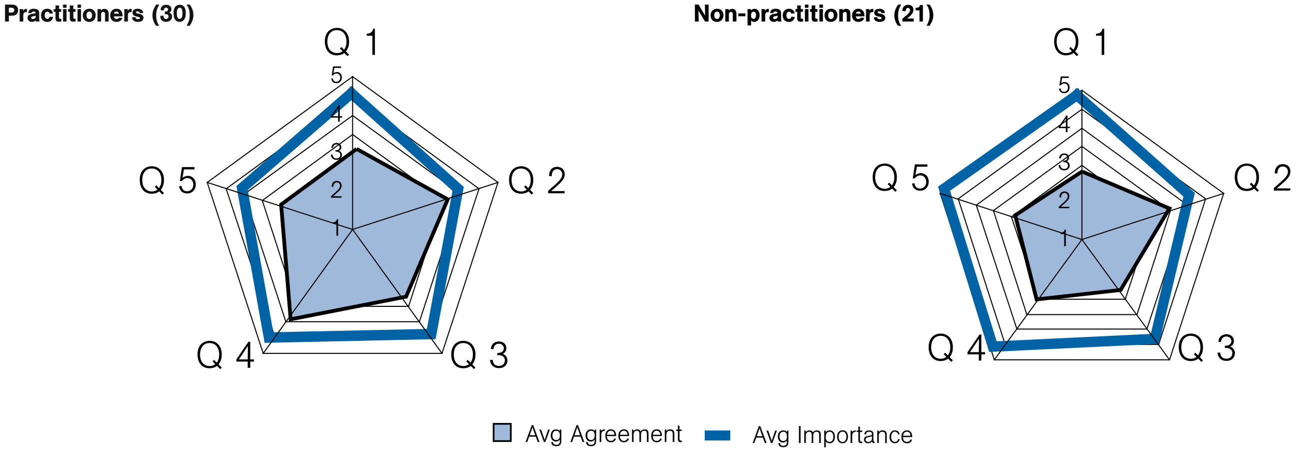
The interview findings show that there is disagreement about sustainability (Figure 9). This set of questions examined how significant sustainability is as an issue and whether grants to CDFIs are still considered legitimate. The importance of scale to sustainability and impact was also raised.

The importance of sustainability was widely shared. However, there is still significant debate on this topic. The complexity of the issues was highlighted: 'Although scale is crucial to sustainability, scale does not result in sustainability.' 'Sustainability will not be able to be achieved in certain markets.' Another noted, 'Sustainability of any finance provider is essential, however penalising the target market with high interest rates increases the potential for failure and bad debts.'

Though there is belief in sustainability, it is felt that this must be balanced against social outcomes. One bank representative argued that while CDFIs need to be large enough to generate income to cover operating expenses, the nature of their work means that 'it is wholly acceptable that public sector grant funding is used to subsidise this area of work'. Others agreed that 'grants could be used to improve customer training and business skills'.

Disagreement centred on the extent to which sustainability is an appropriate aim. Some comments identified the need for sustainability to insulate CDFIs from shifts in the political climate. It was also argued that there is a need for CDFIs to further diversify their activities. Others considered grant finance to be essential and justified as it reflects the social benefits that CDFIs provide: 'Given the nature of their work to engage with vulnerable people in society, it is wholly acceptable that public grant funding is used to subsidise activities."

Figure 10: Regulation



Q1 Legal and regulatory structures exist to ensure soundness and stability of CDFIs.

Q2 A self-regulating legal system for CDFIs would be appropriate.

Q3 There are sufficient and appropriate reporting requirements for the CDFI sector.

Q4 Guidelines exist on good governance and management of CDFIs to generate needed credibility.

Q5 The legal and supervisory framework for CDFIs responds well to the different sizes and structures of the organisations.

Regulation

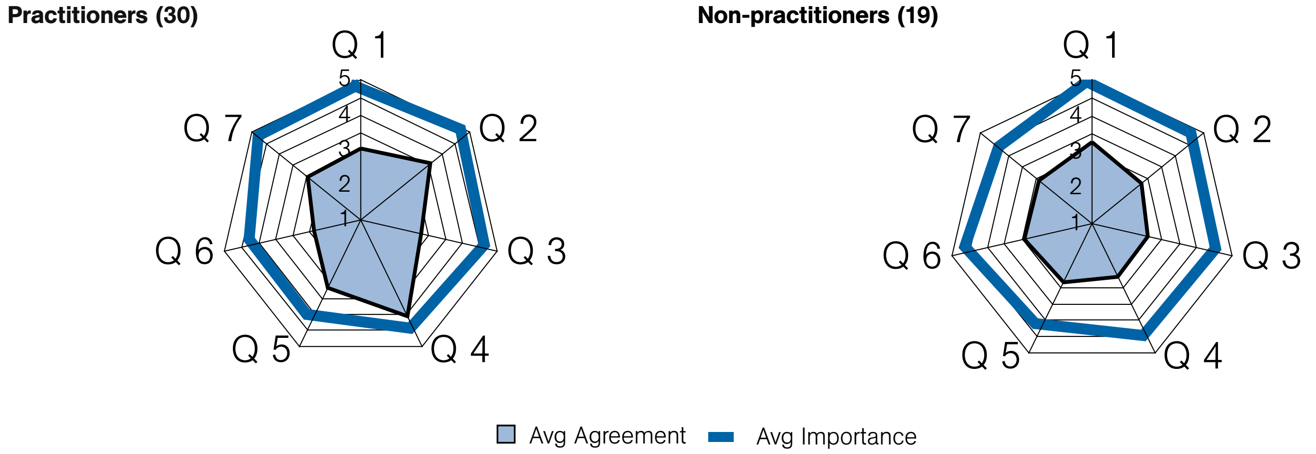
- Stakeholders feel a greater need than CDFIs for a common regulatory structure to be put in place.
- CDFIs should be more transparent about their operations in order to demonstrate their effectiveness.
- CDFIs fear regulation that would over-burden the sector.

As the sector matures, there is growing demand for a single regulatory regime to cover CDFIs. This section examines how the current regulatory requirements for CDFIs are viewed; and whether they are considered appropriate and effective.

The survey findings indicate overall dissatisfaction with the current level of regulation (Figure 10). Stakeholders, such as funders and policy-makers, advocate a stricter regulatory system. However, CDFIs feel a more stringent regulatory regime would pose significant risks. They commented that guidelines seeking to encompass the needs of different CDFIs would be problematic, risking 'over-burdening' the sector, whereas a 'light touch…has to be right at this stage'. CDFIs are anxious that it would reduce their adaptability to local needs.

Stakeholders disagree. They indicated that the credibility of CDFIs is in question and that transparency is limited. 'If CDFIs are to attract private finance then a credible regulatory framework together with good governance are required.' One bank commented that the onus has to be on CDFIs to develop greater transparency and rigour in their operational procedures, a fact recognised by CDFIs in the interviews. Others were blunt in their assessment, arguing that as financial institutions CDFIs 'require regulation'. A key practical obstacle remains the diversity of the sector, though it was acknowledged that this is largely a product of the different characteristics and needs of target markets.

Figure 11: Government



Q1 Government bodies responsible for financial sector policy-making assist CDFIs by providing supportive policies and financial resources.

Q2 Government funding of CDF has been positive and effective.

Q3 Government has given appropriate attention to increasing the institutional capacity of CDFIs.

Q4 The Phoenix Fund was well designed and effectively met the needs of the sector.

Q5 The Growth Fund is well designed and effectively meets the needs of the sector.

Q6 The devolution of oversight to RDAs has been a positive step and will improve the sector's ability to address problems of access to finance.

Q7 In building policies, regulations and incentives for CDFIs that serve the financially excluded, policymakers encourage a wide range of institutions to build sound, responsive financial services for the financially excluded.

Government

- Over half of CDFIs believe that the devolution of oversight for the sector to RDAs has had a negative impact.
- Stakeholders are concerned about the Government's ongoing commitment to the sector.

This section examined how effectively the Government has supported the sector and whether specific policies have had a positive impact on community finance.

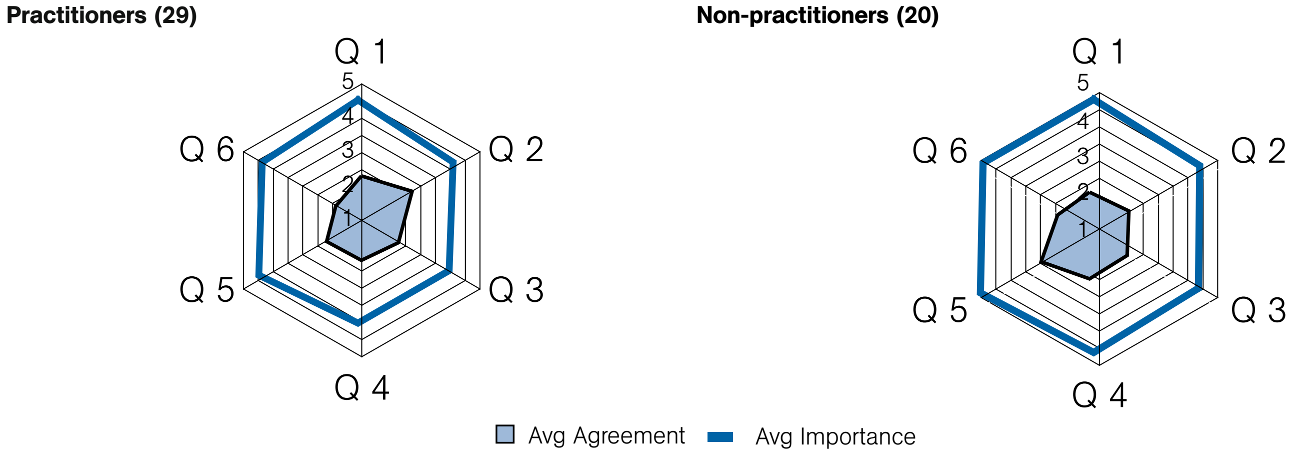
Findings for the role of Government reveal a difference in opinion between CDFIs and other stakeholders over the Phoenix Fund and the shift to RDAs (Figure 11). CDFIs were much more supportive of the Fund, considering it well designed and effective at meeting the needs of the sector.

CDFIs were far less convinced than other stakeholders that devolution to RDAs will help the sector. 'The jury is still out on the devolution of funding to RDAs.' Only one comment, from a supporting institution, welcomed the transfer of responsibility to RDAs because it would place oversight closer to the communities in which CDFIs operate.

However, there was a large gap between the importance given to government policy and the extent to which respondents felt that it was supportive. One respondent noted that 'government policy appears to be back-tracking, having achieved success with the Phoenix Fund.' Another argued that 'most interventions have been poorly designed, forcing CDFIs to lend out money within a very short time limit to match government budget cycles.'

There is significant concern about the future commitment and direction of policy. CDFIs are disillusioned with government support, as they also indicated in the interviews. There is ongoing concern that the Government, 'will lose interest in the sector and reduce funding'. The short-term nature of funding and other support was highlighted. Respondents observed that 'the best thing the Government could do for the sector is to actively promote and support it in the long term.'

Figure 12: Banks



Q1 Commercial banks and other traditional financial intermediaries are committed to CDF and to the development of this market.

Q2 Traditional financial institutions increasingly recognise CDF as a potential market, and try to serve it.

Q3 Commercial banks have undergone the significant changes in attitudes, organisation and lending technologies that enable them to play major roles in CDF.

Q4 Commercial banks are proactive in seeking to partner with CDF initiatives.

Q5 Commercial banks provide significant funding and support to the CDF sector.

Q6 Commercial banks keep and disclose sufficient information about the markets they serve.

Banks

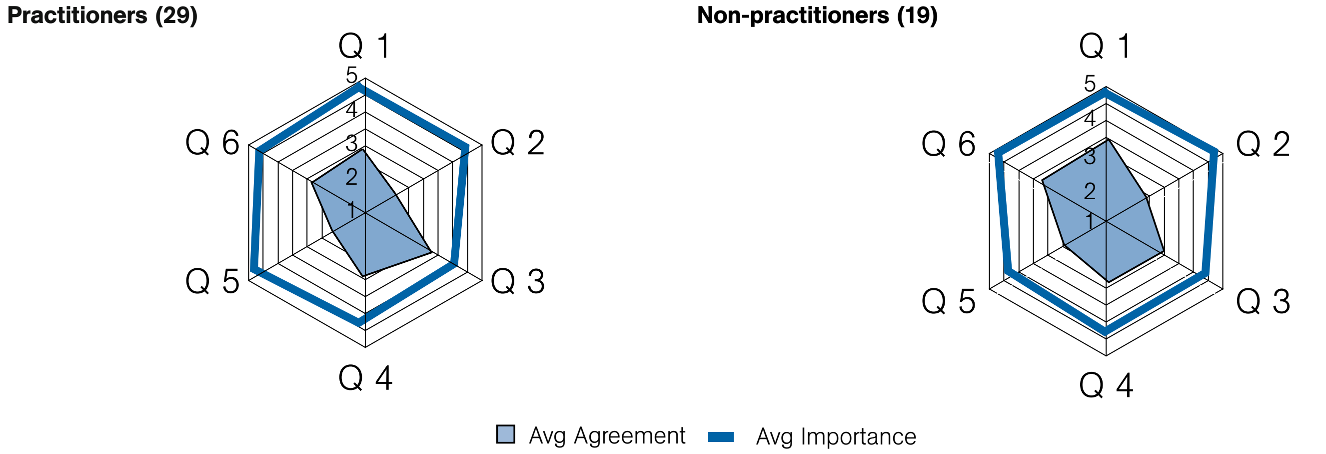
- Over 70 per cent of CDFIs consider banks to be failing both the CDFI sector and its clients.
- The mainstream financial sector is viewed as one of the key potential sources of funding for the expansion of the CDFI sector. The most vivid disappointment among respondents is the lack of engagement of the banks.

The mainstream financial sector is viewed as one of the key sources of funding that could build the CDFI sector to sufficient scale. This section of the survey considered the role of banks and whether they are fulfilling their potential to engage with the sector (Figure 12).

The lack of support from banks is a disappointment. 'As profit driven organisations we can only really expect window dressing from banks, which is what we get.' Banks 'make the right noises' but provide little actual funding. In addition, banks are cited as 'disclosing nothing' about activities in disadvantaged communities, while 'excluding the majority of our clients from opening a bank account'. Commercial banks are also cited as being 'poor at referral of potential CDFI clients'. A greater obligation upon banks to CDFIs is favoured by the findings of the survey. This area of enquiry showed the highest gap between the importance of an issue and its current status.

CDFIs did identify the positive relationships that some banks have cultivated. 'Some banks have recognised the need to develop clear strategies for assisting CDFIs to meet their target markets.' However, a frequent complaint was that the rhetoric of commercial banks' involvement is 'significantly at odds' with the reality, particularly in terms of providing funding, developing appropriate and systematic referrals mechanisms and disclosure of lending. Comments by other stakeholders echoed the disappointment in the commitment of banks and cited the CRA in the US as a potential mechanism to improve the current situation. 'The US community finance movement benefited from the Community Reinvestment laws. Unfortunately there is no such legislation in the UK. This is a major problem.'

Figure 13: Funding



Q1 Funders see that CDF is about long term investment in people and institutions, rather than short-term projects.

Q2 CDFIs are able to access appropriate funding to allow increased outreach and growth.

Q3 CDFIs are now moving towards non-grant forms of finance.

Q4 Funders understand that many different methodologies and legal structures provide effective CDF services to the financially excluded.

Q5 Funders have in place cost-effective, non-bureaucratic mechanisms that enable support for institutions.

Q6 Funders provide financial and other support in a form that fosters increased institutional capacity.

Funding

- Survey respondents are critical of the current funding climate.
- Practitioners are pessimistic over the capacity of funders to provide resources according to the needs of CDFIs.
- Just 10 per cent of CDFIs agree that funders ’have in place cost-effective, non-bureaucratic mechanisms that enable support for institutions’.

CDFIs are adapting to the winding up of the Phoenix Fund, previously the single most important source of funding. This section examined how stakeholders believe CDFIs should respond to this situation, and what forms of funding should be promoted. It also considered how well funders are supporting the sector.

According to a majority of respondents, the pattern of funding lacks a clear strategic basis and is currently not measuring up to what is necessary. A picture of fragmented and uncoordinated funding emerged. Funders are described as ’in withdrawal‘ and CDFIs are increasingly pessimistic about future funding. CDFIs’ major complaints focused on funding being too short-term and on the onerous reporting requirements. One CDFI indicated that ’as much as 15 per cent of staff time can be devoted to dealing with funders, particularly overly bureaucratic reporting.’

However, CDFIs did indicate that classing all funders together is not appropriate. Some individual funding organisations have been very supportive. ’On the whole grant funders have been pretty good and generous with the CDFI sector in the UK.’ Also some major private charitable funders were cited as ’having their act together‘ with better understanding of the nature of the market, the ability of local CDFIs to deliver, and the risks that are involved early in their development. But a coordinated approach remains necessary.

Conclusion

The shortfall between expectations for the sector and its development to date poses risks. The findings support the effectiveness of CDFIs in disadvantaged communities. Despite this, the relative youth of the sector along with its limited scale and sustainability threatens to undermine the policy and funding commitment to further development. Public support for grant funding will dwindle if the outcomes of CDFIs are not evident. CDFIs are increasingly expected to attract private investment funds.

CDFIs are facing new challenges. The devolution of oversight to RDAs and the end of the Phoenix Fund have been problematic. Policy incentives are changing. The Growth Fund is an example of new priorities which require CDFIs to demonstrate sustainability as part of a business plan.[25] CDFIs are suffering from the short-term nature of policy cycles, which mean that they are no longer at the top of the agenda. Changing political emphasis reduces the focus on CDFIs as important mechanisms for enterprise lending. There is the additional concern that funders are applying a time horizon that is too short to allow CDFIs to realise their objectives. Operational challenges related to limited capacity also exist. Funding for capacity building and technical development is scarce and not consistently provided. Staff training and retention, IT infrastructure, and management training are important parameters that influence the effectiveness of CDFIs and should not be overlooked.

The level of ongoing commitment from the Government is a key concern for the sector. Support for community finance from key actors, such as funders and policy-makers, is vital to ensure further development. In addition, the measures by which success or failure are evaluated need to be based on legitimate goals and timelines. Sustainability as a prerequisite of the operation of CDFIs needs to be judged against social impact. Sustainability may not be a realistic goal for many organisations. Without additional grant support, these CDFIs will very likely disappear.

3: Lessons from international experience

This section focuses on the experience of community finance in the US and in Europe. The UK community finance sector has drawn from examples from other foreign contexts, particularly the US. For this reason, we review community finance in the US and in Europe to determine effective models and lessons relevant to the UK sector. We review international case studies to outline the current challenges and opportunities facing these sectors, and what this tells us about future policy choices for the UK.

Community development finance in the US

The CDFI industry in the US has emerged in the past three decades as public and private sector institutions responded to gaps in access to financial resources in distressed lower-income and minority urban and rural markets. As mainstream financial institutions failed to serve these communities, CDFIs developed as niche institutions serving very specific markets and needs. They specialise in developing products and services that provide access to retail bank accounts, affordable housing finance, and small business capital while placing a strong emphasis on building the capacity of the markets they serve through high levels of hands-on financial-literacy training, housing counselling, and entrepreneurial technical assistance.

Summary findings

The US has been a point of reference for development of the UK community finance sector. It has been in existence for much longer and achieved greater size, scale and diversity of products. In general, CDFIs in the US are better integrated with strategies and institutions for regeneration of low-income communities. Despite its success, community finance in the US continues to struggle with issues of capacity, sustainability and scale. There are key lessons to be learned from community finance in the US:

- Although the CDFI industry in the US is dwarfed by the mainstream financial services industry, the sector plays a significant role in filling gaps in access to financial resources to underserved markets.
- The bulk of CDFI dollars loaned go to housing-related activities, such as affordable housing development and mortgage lending.
- In its early years, the CDFI industry in the US was largely capitalised with government or foundation resources, which have continued to play a key role to support the sector.
- The CRA served as an incentive for banks and thrifts to provide low-cost loans and investments to CDFIs, which were able to leverage these resources to finance activities that mainstream institutions found too risky.
- CRA regulation has played a significant role in developing a robust commitment from banks. The CRA has provided the foundation for investment and partnership of banks with CDFIs in the US.
- Another key factor was the federal government's establishment of the CDFI Fund

in 1994 in the Department of Treasury. The Fund provides financial grants and technical assistance awards to CDFIs.

- Recently, sources of capital have been a particular concern. Government funding for the CDFI industry has been consistently threatened in recent federal budgets. Foundation support has waned and become increasingly competitive.

- Banks increasingly provide CDFIs with additional competition for markets and resources. Many mainstream lenders are focusing resources on lower-income and minority markets.

- CDFIs have specialised in and focused on different niche markets to maximise impact and realise growth through specific expertise.

- The industry has moved to better use data and standardised systems of evaluation to document the state and impact of the industry and of specific CDFIs.

- A key challenge for the CDFI industry going forward is the issue of scale and sustainability. Many CDFIs that serve hard-to-reach populations are not fully sustainable, and continue to rely on grant funding.

Structure of the sector

The CDFI industry is made up of a diverse set of institutions that to varying degrees provide a mix of financial products, services and capacity building to disadvantaged communities. The four basic types of US CDFIs are:

1. Community development banks

2. Community development credit unions

3. Loan funds

4. Venture capital funds

Community development banks and credit unions are regulated financial institutions with the ability to take deposits and offer loan products. Community development banks are for-profit entities whose focus is to provide targeted lending and investment geared towards the redevelopment of distressed communities. The main source of capital for community development banks is deposits received from individuals and institutions and government grants, deposits, and investments.

Community development credit unions (CDCUs) are non-profit co-operatives that provide affordable financial services to individuals without traditional bank accounts and help these individuals develop assets. CDCUs specialise in providing low-cost deposit accounts in communities not served by mainstream financial institutions and often extend credit at more flexible terms. CDCUs are primarily capitalised by member deposits, but also receive capital investments from other sources, such as mainstream financial institutions. CDCUs offer consumer loans, vehicle loans, mortgages, and small business loans to distressed markets and often lead the way in product innovation. CDCUs were among the first institutions to offer low-cost, short-term consumer loan products to compete with high-cost payday lending operations.

Community development loan funds are not depository institutions, but are non-profit organisations that leverage investments by outside sources such as banks, corporations, and government agencies to provide lending for small business development, housing, micro-enterprise, or community facilities in distressed markets. These loan funds also provide significant levels of technical assistance to their clients. Such assistance can include training in property management, bookkeeping, or developing a business plan. This technical assistance not only builds the capacity of loan fund clients, but also is felt to help improve loan performance.

The role of property in US community finance – a model for the UK?

Lending for housing has long been an integral part of the community finance sector in the US. A variety of community development corporations, loan funds, and community banks are involved in financing property purchase and redevelopment for community benefit. Credit for home-building, mortgages and other property-related financial services have been key drivers of CDFI development. CDFIs' property lending in the US amounted to $6.8 billion, or roughly £3.5 billion, in 2004, forming a major component of the lending portfolios of CDFIs. CDFI financing for housing was 56 per cent compared to just 17 per cent for business financing. Property lending and investment forms the backbone of the CDFI sector in the US. The provision of property finance enhances the security and return of CDFIs' asset portfolios.

Given the structure of the UK social housing market, including its ownership, financing methods and government policy, the UK inhabits a different context. The total lending of CDFIs in the UK as of 2005 was £53 million. Average loan sizes are smaller, and tend to be focused on enterprise development or personal finance needs.

Unlike the US, the UK lacks a government-sponsored facility such as Freddie Mac to provide support to development of housing for low- and moderate-income groups. Freddie Mac operates in the wholesale market to increase the provision of affordable rental housing and mortgages to low-income individuals.

CDFIs in the UK may be able to benefit by innovating in the housing market. A small but growing number of CDFIs offer home improvement loans. But the structure of the UK mortgage market renders it unfeasible for CDFIs to benefit from providing typical housing finance products as they would have to compete with private financial institutions. But a secondary market could be created, for example, in the equity of affordable homes, so as to facilitate investment in the renovation of housing in disrepair. Other creative measures, such as the creation of real estate investment trusts (REITs) open to housing associations and CDFIs could facilitate further investment in the renovation of low-income housing and development of community housing solutions. This area of CDFI innovation needs stronger policy support to enable further diversification.

Community development venture capital funds (CDVCs) are for-profit entities that also leverage investments from outside sources, such as foundations, mainstream financial institutions, and the federal government to provide equity investments or equity-like loans for business development in distressed communities. Equity investments are direct infusions of cash that rapidly growing businesses with limited regular cash flow need to expand. Venture capital firms provide such investment in exchange for a portion of ownership in the business. Venture capital funds often have a high level of expertise in the industry in which they invest and provide extensive hands-on assistance and knowledge to help the growing business. In the US, CDVCs try to achieve a double bottom line that looks at both the financial performance and the social impacts of investments.

Size of the sector

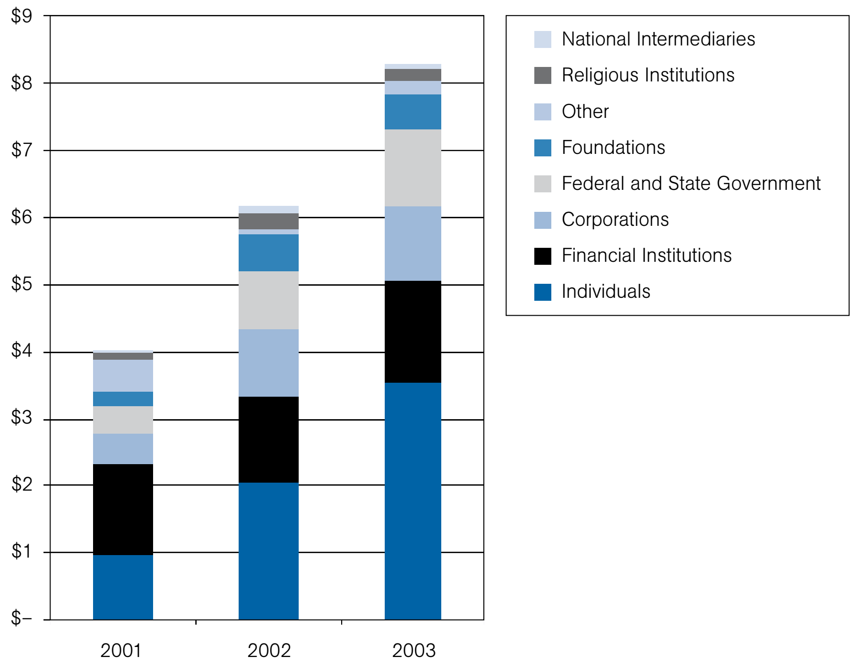
Although the CDFI industry in the US is dwarfed by the mainstream financial services industry, the sector plays a significant role in filling gaps in access to financial resources to underserved markets. In 2004, community development banks averaged $105 million in assets, while the average size of community development loan funds was just under $6 million. Venture capital funds had an average size of $5.4 million, and CDCUs had an average asset size of $2.3 million. Despite their modest size, these institutions effectively target underserved markets. In 2004, 70 per cent of CDFI clients were low-income. Roughly 58 per cent were minority, and 61 per cent were women. The bulk of CDFI dollars loaned out go to housing related activities such as affordable housing development and mortgage lending. In 2004, 56 per cent of CDFI financing outstanding, or $1.9 billion, went to the housing sector. The second-largest sector served was lending for small business development, which accounted for 17 per cent of total CDFI financing dollars outstanding, or $571 million. The third-largest sector was consumer lending which includes loans to individuals for such purposes as health care, debt consolidation, or automobile finance. These loans accounted for 15 per cent of CDFI financing outstanding, $512 million.[26]

In its early years, the CDFI industry in the US was largely capitalised with government or foundation resources, but changes in government policy and the financial services industry have led to shifts in the sources of financial support. Originally, mainstream financial institution participation was limited and typically involved participation in loan pools for affordable housing development and mortgage lending. The CRA was passed in 1977 to promote lending and investment by depository financial institutions in low- and moderate-income markets. In its early years, however, the CRA's effectiveness was limited largely by weak regulatory enforcement. Substantial changes to CRA regulation in 1995 altered the way banks were monitored for their community reinvestment performance. As related to CDFIs, the updated CRA regulation added specific components that examined banks for their levels of community development lending and investments and grants. In this form, CRA regulation has played a significant role in developing a robust commitment from banks to support the community finance sector. The CRA has provided the foundation for investment and partnership of banks with CDFIs in the US.

This change served as an incentive for banks and thrifts to provide low-cost loans and investments to CDFIs which were able to leverage these resources to finance activities that mainstream institutions found too risky to finance directly. In FY 2004, banks, thrifts, and credit unions were the largest contributor to CDFI capitalisation, making up over 37 per cent of all CDFI debt capital compared to 6 per cent for foundations and 4 per cent for the federal government. Depository financial institutions were even more significant contributors to community development loan funds where they accounted for 56 per cent of debt capital. In FY 2004, foundations and the federal government were major supporters of the CDVCs contributing 45 per cent and 21 per cent respectively to their overall debt capital.[27]

In addition to direct capitalisation, banks also often act as key partners with CDFIs in other ways. Such partnerships can take the form of deals where CDFI lending fills the gap between what the bank feels comfortable lending and the amount of equity a borrower brings to the table. CDFIs often provide subordinated debt in a multi-layered deal and/or pre-construction financing. Banks can also provide services to CDFIs such as filling board seats, sitting on loan approval committees, and providing technical assistance. Such partnerships typically occur when banks fund particular CDFIs.

Figure 14: Sources of investment capital to US CDFIs 2001-2003 ($billions)



Data from CDFI Data Project – www.cdfi.org

The graph in Figure 14 depicts the sources of CDFIs' investment capital for on-lending over a three year period between 2001 and 2003. A breakdown of investment capital data for 2004 and 2005 was unavailable. However, in aggregate there is an increasing trend with $12.5 billion of investment capital provided in 2004 and $14.3 billion in 2005. Information from three of the major US CDFI types is incorporated: community development banks, loan funds and venture funds, with data from community development credit unions excluded. The 'Individuals' category is significant because of the number of depositors holding funds at community development banks. Data for grant funding over this same period is not reported to the CDFI Data Project but represents additional funds channelled to the sector.

Government investment into capital for on-lending, from both federal and state sources, is substantial but represents a relatively small part of CDFIs' total investment capital. Banks and other financial institutions make a significant contribution, accounting for $1.5 billion in 2003. Corporations in the US, representing another private source of investment, commit substantial investment that was worth over $1 billion in 2003. In the UK their contribution remains negligible.

What this table suggests is the important role that the CRA has played, provoking significant large-scale investment from private sources. According to the CDFI Fund, each investment dollar it provided in 2005 leveraged in $27 in private and other non-CDFI funds. The Fund also provides significant grant and financial support to assist which is additional to these investment funds.

Growth of the sector

The 1990s was a key period of growth for the CDFI industry in the US. The decade saw the largest net increase in the number of new CDFIs, particularly community development loan funds. Strengthening CRA regulations and improving the implementation of the regulations have been credited as a substantial factor spurring this rapid growth.

Another key factor was the federal government's establishment of the CDFI Fund in 1994 in the Department of Treasury. The Fund provides financial grants and technical assistance awards to CDFIs and implements the Bank Enterprise Award (BEA) programme. The BEA programme rewards banks and thrifts which are active in community development including the support of the CDFI industry. In 2006, the Fund in its various programmes awarded over $26 million to CDFIs and $12 million to banks and thrifts. The Fund also implements the New Markets Tax Credit programme which permits taxpayers to receive a credit against federal income taxes for making qualified equity investments in designated Community Development Entities (CDEs). Substantially all of the qualified equity investment must in turn be used by the CDE to provide investments in low-income communities. Charitable foundations have also continued to support the sector through the provision of subordinated debt, or patient capital, to assist both CDCUs and community development loan funds to build their balance sheets.

A third significant factor spurring the growth of the CDFI industry in the 1990s was the increasingly significant role played by CDFI trade associations such as the Opportunity Finance Network, the Association for Enterprise Development, the Community Development Venture Capital Alliance, the National Federation of Community Development Credit Unions and their umbrella organisation, the Coalition of Community Development Financial Institutions. These associations served to develop policy and best practices around the community development finance industry. Trade associations led the way in promoting the critical importance of scale and sustainability to the future of the industry; professionalising the management of CDFIs; collecting industry-wide data to document the financial condition and impact of CDFIs; developing ways to increase levels of investment in CDFIs and diversify sources of capital; and advocating for government policies that support the CDFI industry.

Current challenges

The CDFI industry in the US has faced significant challenges recently. Sources of capital have been a particular concern. Foundation support, a traditionally strong source of funding for the CDFI industry, has waned and become increasingly competitive in recent years. Government funding for the CDFI industry from sources such as the CDFI Fund and the Small Business Administration have been consistently threatened in recent federal budgets. Additionally, CRA regulation has been changed to potentially weaken bank support of CDFIs. Changes implemented by federal banking regulators put less emphasis on the importance of critical community development loans and investments for banks with assets between $250 million and $1 billion.[28]

We should note, however, that the nature of the financial services industry has also changed providing CDFIs with additional competition for markets and resources. Technological advances in loan underwriting, product delivery channels and risk-based pricing have led many mainstream lenders to focus increased resources on previously underserved lower-income and minority markets. In some cases CDFIs find themselves competing with bank and non-bank lenders in areas such as mortgage loans to borrowers with damaged credit, small consumer loans, and small business loans of under $50,000.[29] Unfortunately, in many cases, these non-CDFI loans have abusive features that put borrowers in worse situations than they were previously. Often, when these borrowers reach CDFIs, they are much more difficult to serve because of foreclosure or bankruptcy situations.

Another concern for CDFIs is the ability to develop and retain high quality staff, particularly management. The increasingly complex and global financial services industry now requires that CDFIs increase the level of sophistication of their staff in order to access capital markets and finance projects. It is difficult for many CDFIs to retain high quality staff, which are often poached by larger banks or other industries with the ability to offer better salaries.

These challenges have required the CDFI industry to respond in a number of different ways. The increasingly competitive nature of CDFI funding has demanded that the industry develop more sophisticated mechanisms for documenting the overall state of the industry and the impact created by individual CDFIs. Traditionally, CDFIs have relied on first-order impact data showing the number of housing units developed or the number of jobs created tied to specific loans. However, these measures of impact are becoming insufficient in convincing investors of the social impacts of specific CDFI activities, and many are demanding more sophisticated and difficult-to-quantify measures of impact including direct benefits to low-income households and neighbourhood effects.[30] Some believe, however, that it may be inappropriate for an individual CDFI to be asked to provide second- or third-order impact data because of the complexity of those analyses. It is felt that such research should be conducted at a field wide level by a major research institute or consultant. A larger question is whether it is appropriate to expect major third-order impacts from an industry that is small in relation to the powerful exogenous forces that impact low-income communities and low-income households.

The industry has moved to better use data and standardised systems of evaluation to document the state and impact of the industry and of specific CDFIs. The CDFI Data Project (CDP) is an effort undertaken by a group of CDFI trade associations to collect standardised data from CDFIs on their lending activities and financial condition. CDP produces an annual report documenting the state of the CDFI industry. The CDFI Fund has begun collecting detailed institution-level as well as transaction-level data through its Community Investment Impact System (CIIS). Additionally, the Opportunity Finance Network has developed a CDFI Assessment and Rating System (CARS). CARS uses an independent third party to rate a CDFI on its 'impact performance' and its 'financial strength and performance'. The intent of CARS is to create a standardised measure of CDFI performance that increases transparency for investors.

Another key challenge for the CDFI industry going forward is the issue of scale and sustainability. Scale is critical for both individual CDFIs and for the industry as a whole. For CDFIs, scale is a critical component of becoming sustainable entities and involves reaching economies of scale through increasing the volume of customers served, reducing costs, and enhancing efficiency.[31] The ultimate goal is for CDFIs to be able to deliver services without a heavy reliance on subsidy and to cover costs through programme-related revenue. However, achieving such sustainability has challenged some of the fundamental aspects of the industry. Many CDFIs in the US that serve hard-to-reach populations are not fully sustainable, and continue to rely on grant funding.

Building economies of scale within CDFIs may require expanding beyond the typically tight focus on smaller and difficult-to-serve markets, raising additional capital, increasing levels of product standardisation and specialisation, and developing products and services that can be delivered efficiently. Staying true to the CDFI mission of targeting those markets that are hardest to serve may entail taking on more profitable clients and using revenues from those loans to subsidise serving less profitable clients.

The CDFI industry in the US has been successful because of its ability to effectively fill gaps in access to financial services in underserved markets. Critical to this success have been a government framework through the CRA that provides some level of direct financial support, but, more importantly, also provides incentive for mainstream financial institutions to support the CDFI industry through direct financing and technical assistance. Also critical to the success of the CDFI industry in the US has been the presence of trade associations and intermediaries who have developed and aggressively promoted best practices around the success and sustainability of the industry. Going forward, some of the biggest challenges the industry faces include documenting to investors the impact that individual CDFIs and the industry as a whole have on economic development in distressed communities and efficiently growing to scale and reducing reliance on outside subsidy.

The following case studies examine five CDFIs or intermediaries who have been successful at reaching underserved markets and filling gaps in access to capital. The case studies describe the background of each institution and the products and services they offer. They then discuss some of the ongoing challenges each institution faces. The objective of the case studies is to illustrate best practices and key lessons from the US CDFI field that may be relevant to the UK sector as it continues to develop.

Case Study 1: Appalachian Regional Commission

The Appalachian Regional Commission (ARC) is a quasi-government organisation based in Washington DC that was created by the US Congress in 1965 to support economic development efforts in the Appalachian region of the United States. Appalachia is a large region in the eastern United States that spans parts of 13 states from upstate New York in the north to northern Mississippi in the south. The region is mountainous and largely rural with few major urban centres. Appalachia is one of the poorest regions of the US, and economic growth in the region has consistently been hampered by a heavy reliance on a declining extractive economic base; relative physical and economic isolation; and generally low levels of education and advanced job skills training among the regional population.

Broadly, ARC is charged with four goals:

1. Increase job opportunities and per capita income in Appalachia to reach parity with the nation.

2. Strengthen the capacity of the people of Appalachia to compete in the global economy.

3. Develop and improve Appalachia's infrastructure to make the region economically competitive.

4. Build the Appalachian Development Highway System to reduce Appalachia's isolation.

To reach these goals, ARC provides funding to states for infrastructure improvements, such as highways, sewers, and schools. Additionally, ARC funds many local economic development initiatives through grants to revolving loan funds (RLFs) and development venture capital funds. The loan funds tend to be public bodies organised at municipal and county levels, and the venture capital funds independent, private organisations. These funds are intended to promote business development and innovation in the region, to stabilise and grow the regional economy, and to create and retain jobs.

In the area of community development finance, ARC sees itself as having a number of distinct roles as a regional leader. While ARC provides funding to regional CDFIs, the agency sees this as a small part of its regional role in filling gaps in access to credit and capital for Appalachian entrepreneurs. ARC regularly develops and promotes best practices in local economic development. It works with small and inexperienced loan funds to employ nationally accepted methods for extending credit to underserved markets. ARC works regularly with national CDFI trade associations to help build the capacity and scale of state-wide networks of micro-lenders. It also works to connect regional CDFIs to key strategic partners, such as foundations, national intermediaries, and federal agencies. Additionally, ARC acts as a leader in researching, developing, and promoting policy.

A key example of the work ARC has done to promote regional community development finance is through its capitalisation of revolving loan funds and development venture capital funds. ARC-funded RLFs use grants to make loans to businesses with difficulty accessing capital from mainstream financial institutions. These RLFs are generally operated by quasi-government organisations that oversee economic development in smaller areas, which can be as large as multiple counties. Generally, ARC-funded RLFs provide gap financing to start-up or existing businesses often in economically distressed parts of the region. Gap financing are loans that help business owners bridge the difference between total necessary debt financing on a project and the amount a bank is willing to lend. The availability of such financing is an incentive to lenders who may not be willing to take on the total project debt. Since the RLF grant programme's inception in 1977, the 38 ARC capitalised loan funds have made 1,570 loans for over $104 million. A fundamental goal of RLF lending is the creation or retention of local employment. Between 2002 and the first quarter of 2006, loans from ARC capitalised revolving loan funds helped create over 3,600 jobs and retain over 8,300 jobs in the region.

ARC also provides grants to development venture capital funds. An ARC-funded assessment of regional gaps in access to capital for small business development identified a dearth of equity investment in the region. In response to this, ARC began an entrepreneurship initiative that focused on promoting the growth of CDVCs in the region. ARC initiated a partnership-building effort through a series of conferences focused on access to equity capital in rural markets that brought together foundations, financial institutions, and economic development organisations. ARC also worked with the Community Development Venture Capital Alliance to enhance the capacities of area CDVC management teams. Additionally, as of October 2004, ARC had granted $4.4 million to 13 CDVCs (11 active funds) in seven states in the region. These funds have a total capitalisation of $96 million and have invested $13.6 million in 59 regional businesses. These investments have created over 1,000 jobs in the region.[32]

ARC is an economic development agency coordinating a multi-state effort to revitalise a distressed region of the country. This is a multi-faceted effort that in part relies on providing grants that capitalise CDFIs, but also involves connecting local CDFIs to best practices and partners outside the region and developing and promoting policy. ARC

Case Study 1: Appalachian Regional Commission (cont'd)

sees its key challenges as coordinating efforts among states with different economic development objectives and dealing with changes in leadership at state level. Its current priority is to help regional development venture capital funds grow through accessing untapped investors outside of the region.

The ARC is a key example of the importance of a regional economic development intermediary that takes a leadership role in facilitating growth and innovation in the community development finance sector. ARC's role is particularly relevant given the significant regional gaps in access to capital from mainstream financial institutions and the relative isolation of many local loan funds. While ARC provides funding for local revolving loan funds and development venture capital funds, its true value to the regional CDFI industry is its ability to leverage this role as funder to bring nationally recognised best practices to the region; to connect local CDFIs to national intermediaries, funders, and policy-makers; and to conduct research that is used to develop forward-looking policies. It is in these ways that ARC has helped increase the capacity of the regional industry and enhanced economic development in Appalachia.

Lessons for the UK

- CDFIs may work best when viewed as one key part of an integrated local development strategy.
- Regional management of CDFIs can be positive when well-coordinated, appropriately resourced and funded, and linked to a broader strategy, providing lessons for UK RDAs.
- CDFIs may benefit from linking into a broader local economic development framework to formalise partnerships and link with established institutions

Case Study 2: Pacific Community Ventures

Pacific Community Ventures (PCV) is a community development venture capital fund that began operation in 1999 as Silicon Valley Community Ventures. PCV is based in San Francisco, CA. It serves the entire state of California, but has a specific focus on the Bay Area, Los Angeles, San Diego and the Central Valley. The organisation's goal is to invest in businesses located in or near low- and moderate-income communities with the intent that these investments will generate a social return as the businesses create good jobs and skills training for lower-income individuals. In addition to financing business development, PCV also provides advisor services to firms in the Bay Area and in Los Angeles. PCV has raised two private equity funds (PCV Investment Partners LLC I and PCV Investment Partners LLC II) worth $20 million and has made equity investments of over $10 million in nine active companies. PCV also currently provides advisory services to over 20 businesses that it does not directly finance.[33]

In its initial years, PCV focused its investment on businesses in underserved markets in the early stages of development. However, these companies often lacked experienced management structures. PCV refined and tightened its investment approach to focus on more proven businesses in the expansion stage. These businesses are located in or near low- and moderate-income (LMI) communities and must also hire from LMI communities. These companies must have more established products and markets and well-defined growth strategies.

PCV tracks both the financial performance of the firms it has invested in as well as the social returns on investment. Financial performance is tracked by looking at metrics such as quarter-to-quarter revenue growth and profitability as well as by tracking other performance targets identified by PCV staff and the CEOs of the respective companies. PVC recently completed two successful exits of companies in which it has invested and is well positioned for other successful exits. As of 2005, PCV LLC I and II had achieved competitive internal rates of return compared to funds of similar vintage.

PCV has also worked with a consulting firm to develop a set of criteria it uses to measure social returns on its investments. PCV annually interviews employers and analyses quarterly reports to gather data on:

- Job training and employee skill development

- Employee retention and advancement
- Provision of quality jobs
- Wealth-creation mechanisms
- Local hiring practices
- Company location and economic reach
- Employee demographic characteristics

These metrics are designed to help PCV investors understand how effectively firms are meeting 'double bottom line' requirements. PCV's 2005 report on its social returns on investment shows that companies in the PCV-financed portfolio have increased their number of 'designated employees' from 1,173 to 1,531 between 2004 and 2005. A designated employee is one whose starting wage was below a certain level and resides in an LMI community or was referred by a welfare agency. Designated employees at PCV-financed companies earned an average or $13.18 per hour, a number well above living wage ordinances designated in the surrounding areas. Additionally, 100 per cent of designated employees are offered health benefits and paid vacation and holidays. A growing number of companies also offer wealth-building mechanisms, such as retirement plans, stock options, and profit sharing, to designated employees.

In addition to direct equity financing of growing enterprises, PCV offers advising services to business in traditional industries such as product wholesaling and manufacturing that have the potential to bring significant economic and employment gain to LMI communities. Nearly 70 per cent of these businesses have less than $3 million in annual revenue and all have fewer than 100 employees. PCV uses volunteer business advisors – senior business professionals who typically have over 10 years experience in helping small businesses grow. PCV provides one-on-one business advising where the advisor helps the company refine areas such as strategic planning, financial planning, and sales and marketing strategies. In 2005, PCV advised 23 companies in the San Francisco and Los Angeles regions. PCV believes that the success behind its advisory services lies in a number of factors. It considers such services 'venture capital with out the capital' as advisors invest significant levels of time and expertise instead of money. Additionally, PCV has been able to attract senior and seasoned advisors and effectively match advisors and advisees. One of the challenges seen by PCV is the significant time commitment required from advisors who serve on a volunteer basis and advisees who are running a growing business.[34]

PCV is a key example of a development venture capital fund that has cultivated a successful model of delivering equity investment to high-growth firms in lower-income communities while documenting the social impacts of these investments. PCV has developed sophisticated metrics to measure social returns so it can clearly communicate the impact of its equity investments to funders, and it has done this while generating competitive rates of return. PCV has also developed a successful programme for delivering business advisory services to less high-growth-potential firms whose success will nonetheless have an impact on economic development in LMI communities.

Lessons for the UK

- Providing related advisory services may be an effective means of raising additional revenue and attracting resources and expertise.
- Developing an effective means of social impact measurement is essential to demonstrate outcomes and raise additional funds.

Case Study 3: Shorebank

Shorebank is an integrated and regulated depository financial institution that is credited as being the first 'community development' bank. Its focus is on providing investment that stabilises disinvested and underserved neighbourhoods. It was founded in Chicago in 1973 and has offices in Chicago, Detroit, and Cleveland. The bank currently has nearly $2 billion in assets. It specialises in lending to small businesses, real estate lending for multifamily housing, and single-family mortgages to lower-income and minority communities underserved by mainstream financial institutions. The bank also offers consulting and other services that help promote community development.

Shorebank's lending activity in Chicago has focused primarily on making loans to single-family and multifamily properties in LMI and minority communities. The bank has traditionally been a smaller player in lending for single-family properties. In 2005, Shorebank originated less than 600 of the nearly 295,000 loans on single-family properties in Cook County, IL. While Shorebank's single-family lending volume is small, it has been able to effectively target minority and underserved markets for their lending. These borrowers and communities have been saturated with high-cost, often predatory, mortgage credit from non-bank mortgage finance companies, and there are few bank lenders making low-cost mortgages. African-American borrowers accounted for 80 per cent of Shorebank's single-family loans in 2005 compared with just over 19 per cent county-wide. Additionally, 92 per cent of Shorebank's single-family mortgages went to communities greater than 50 per cent minority, compared to less than 44 per cent for all loans in Cook County.

While Shorebank has been a minor player filling a critical niche in single-family-mortgage lending, it is the county's most significant bank lender when looking at multi-family housing in lower-income and minority markets. Shorebank's approach to multifamily lending has been to view it as an entrepreneurial opportunity. It sees ownership of rental properties as a way to create a class of business owners who have an investment in the community. The bank has also effectively followed borrowers and retained them as they purchase other properties or refinance existing loans.

County-wide in 2005, Shorebank was the fourth-largest multifamily lender trailing only major banks Citibank, Washington Mutual and Mid-America Bank. However, Shorebank's focus is lending to minority communities, and it is far and away the largest multifamily lender to neighbourhoods greater than 80 per cent minority. It originated over 13 per cent of the total number of multifamily mortgages to these communities; the next largest lender originated just over 5 per cent.

While Shorebank has been a clear leader in multifamily lending and is filling a significant niche in single-family lending, it has struggled to find similar success in small business lending and retail accounts. While the bank has been an active originator of loans guaranteed by the US Small Business Administration and has in the past had success in lending to minority entrepreneurs seeking franchise opportunities, Shorebank generally has had difficulty gaining significant market share in the highly competitive small business lending arena. Part of the reason for Shorebank's struggles is the nature of the business community in the area on which the bank focuses. Many of these communities do not have a strong commercial retail presence, so the overall market for lending is smaller. Additionally, the bank has difficulty lending to suburban and out-of-area businesses with city locations. It also has questions about how to develop a successful line of retail banking services. While in 1973, Shorebank was the only bank serving its community, now a number of large banks have offices in South Shore. There are returns to scale in retail banking which raises the issue of Shorebank's competitive advantage in this arena.

Moving forward, Shorebank sees a number of key challenges. It is looking to find a niche in small business lending where it can utilise its expertise in serving specialised, underserved markets. It is also looking to expand retail services and single-family-mortgage lending. Shorebank has identified a need to expand, but is finding challenges in raising the necessary equity capital while staying true to its mission of community development. While there are still social equity investors willing to invest, these investors increasingly want clearly defined exit strategies.

Shorebank is one of the most successful examples of a community development bank. It effectively identified a niche, multifamily lending in lower-income, minority communities, and successfully became the leader in delivering such loans to that market. It has been able to retain that leadership while getting social returns through promoting local ownership and investment in multifamily housing, building the entrepreneurial capacity of its borrowers, and successfully retaining these borrowers as they refinance or purchase new properties. As it looks to grow, Shorebank has been challenged to develop similar success in other niches such as small business lending and retail services.

Lessons for the UK

- Property lending is a key mechanism for sustainability of loan portfolios in the US.
- Establishing and exploiting a niche market is fundamental to success.
- Building in-depth understanding of target clients can be a competitive advantage, providing further business opportunities.
- Success in the long term could mean proving the viability of low-income clients for mainstream financial institutions.

Case Study 4: Community Investment Corporation

The Community Investment Corporation (CIC) is a Chicago-based non-profit mortgage lender that specialises in providing purchase and rehabilitation loans for multifamily rental properties throughout region. CIC was created in 1974 by some of Chicago's major financial institutions who were looking for a way to pool risk in order to better target lending to Chicago's underserved markets. In its early years, CIC focused on the rehabilitation of small multifamily properties (1–4 units). By the early 1980s, however, CIC identified a significant lack of access to credit for larger multifamily rehab projects and began a multifamily lending programme. Although the programme initially served only the City of Chicago, CIC has since expanded to cover the entire six-county Chicago metropolitan area. The expansion of both CIC's service area and its loan programme has helped CIC serve its mission to be a leading player in neighbourhood revitalisation through innovative financing programmes.

CIC's lending capital comes from a pool of funds to which major financial institutions contribute. CIC has 48 investors, 45 of which are banks that have pledged $560 million through 2010. CIC's loans must be approved by a loan review committee. Those who sit on the committee are from investing financial institutions that must represent at least 51 per cent of total dollars in the pool. CIC functions as a blind loan pool which eliminates any potential conflict of interest between CIC's lending and that of the investing institutions. CIC originates loans and regularly bundles these mortgages into pools. Collateral trust notes are sold to investing institutions up to the amount that the investor has committed and equal to the share of the overall pool held by the investing institutions. For example, if an institution has pledged 5 per cent of the CIC's overall loan pool, it would purchase 5 per cent of whatever pools are issued. All interest earned on loans is returned to investors. CIC is able to remain self-sufficient by taking a modest origination and servicing fee.

CIC offers both standard adjustable rate loan and fixed-rate loan products similar to those offered by mainstream financial institutions. Innovation in loan products is driven by changes in market demand, competition, and investor insights. For example, the initial adoption of a 3–5-year adjustable rate loan was driven by investors who wanted to limit long-term risk. CIC recently adopted a flex fund programme which allocated $100 million for risky projects that may exceed standard underwriting criteria, but will allow CIC to price these deals at a market rate.

In addition to its multifamily lending, CIC offers property management training for owners of multifamily properties to ensure that they are well equipped with the knowledge to better market, manage, and maintain their property. Many of CIC's borrowers own only one rental property and lack training and experience in property management. These training courses are offered to both clients and non-clients and cover topics such as fair housing laws, property maintenance, rent collection, and bookkeeping. These seminars prepare borrowers for many of the challenges of property management and are felt to improve loan performance. CIC charges a modest fee for these sessions. In 2006, 620 attendees participated in property management training through CIC.

In its history, CIC has made over 1,200 multifamily loans totalling $647 million to rehab 34,000 units of housing. CIC's multifamily lending has provided affordable housing to more than 110,000 Chicago-area residents. In 2006, CIC approved 62 loans for $56 million. Of the units financed in these projects, 92 per cent had rents affordable to households earning 50 per cent of the area average income. In FY 2006, net return to investors was 4.6 per cent – 1.2 per cent above the rolling average three-year treasury rate. Beyond standard measures such as loan volume and number of units rehabbed, CIC uses a number of other assessment criteria to measure impact. The importance of many of these criteria has changed over time. For example, in Chicago during the 1980s there was an abundance of dilapidated and abandoned buildings in many neighbourhoods, and simply finding owners to take on buildings and return them to productive use was considered a success. Today, vacancy is not as big a concern, and impact is measured by looking at the ability to keep rents at an affordable level; preserving the existing rental housing stock; and the ability to produce quality units. CIC also looks at the number of minority owners and contractors used in the rehabilitation, and these are criteria considered for receiving a loan.

CIC is an example of a community development loan fund specialising in multifamily housing rehabilitation. It has been able to grow to scale, become sustainable, provide a competitive return on investment, and achieve impact. CIC has successfully identified a niche for financing the renovation of smaller, affordable rental properties and has been able to effectively engage local financial institutions as long-term partners as both investors in its loan pool and key advisors on its loan review committee. It has responded to input from investors and to changes in the market when developing and modifying products and services. It has also successfully developed and implemented seminars to train borrowers and non-clients in property management. Such training has not only helped borrowers become better customers, but adds social impact.

Lessons for the UK

- Partnership and engagement of banks can be critical to building sustainability.
- In-depth understanding of underserved markets can reveal market opportunities.
- A successful loan fund can cross subsidise costly social activities such as training.

Case Study 5: Community First Fund

Community First Fund (CFF) is a community development loan fund that serves a 13-county region of roughly three million people in south central Pennsylvania. The area is a mix of smaller urban areas around 100,000 in population, and towns and rural areas. The primary focus of the Fund is lending for small business development. CFF estimates that 90 per cent of its lending goes to small business development.

CFF's primary focus is lending to businesses that have been open for less than two years and expanding businesses that have been unable to access capital. Its core clients are those who mainstream banks find difficult to serve. These businesses often have difficult accessing loans between $50k and $200k. CFF does more than simple gap financing and is considered the senior lender on a number of deals, but on larger deals, CFF provides capital that is leveraged to attract bank financing.

CFF has yet to feel competitive pressure from banks and feels that it is just beginning to tap the market for these small business loans. Whereas the old CDFI model might have been to graduate its clients to bank services, CFF has recognised a need to keep good clients in order to subsidise the riskier clients. CFF feels that its knowledge of the local market gives it a distinct advantage over the larger banks entering the market that are based outside the region. Additionally, CFF spends upwards of 20+ hours per client on technical assistance before the loan is made, something banks do not do. This high level of technical assistance raises transaction costs, but it prepares business owners for the borrowing process and improves loan performance. CFF has built a significant level of loyalty among its existing client base and believes these strong relationships combined with good products will help it retain higher performance and profitable clients.

CFF has recently undertaken a major effort to become self sufficient. Its strategy focuses on increasing levels of income earned through fees and interest by shifting away from micro-lending towards larger loans. CFF has found that there are no economies of scale with micro-loans, and that the more loans it originated the more losses it incurred. Over the next five years, CFF hopes to increase its portfolio size by increasing average loan amounts as opposed to the number of businesses financed. To accomplish this, however, the Fund needs to raise additional capital.

CFF's strategic goal is to raise additional capital with the hopes of quadrupling the loan fund to $25 million by 2010. Part of its strategy has been not to solicit donations under $1 million. This is a significant change for CFF. As recently as five years ago it had never received a donation of $1 million. Part of the growth and sustainability strategy was to get rated by CARS through the Opportunity Finance Network. Being rated through CARS was felt to improve CFFs ability to access capital. By going through the CARS process, CFF realised that it did not have an effective way to measure social impact. In the past, CFF looked at job creation and business start-up numbers in underserved markets, but it is still searching for better ways to measure social impact. The Fund hired a consultant to enhance how it views and measures social impact.

CFF foresees one of its largest challenges being difficulty in raising the human resources capital needed to hire and retain high quality employees that are necessary for implementing its sustainability model. It continues to compete with banks for employees and rarely has the resources to pay higher salaries.

CFF is a mid-sized community development loan fund that provides small business loans to entrepreneurs in mid-sized cities in south-western Pennsylvania. It is an example of a CDFI going through the process of reaching scale and achieving sustainability. It is doing so by moving away from micro-lending and cultivating and retaining more profitable clients who take out larger loans. It does this by offering competitive products, building relationships through extensive technical assistance training, and having strong knowledge of local markets. As CFF attempts to grow to scale, it has been challenged to establish metrics for effectively measuring social impact and is working to do so in order to better attract the large capital investments necessary to reach scale. Scale is also necessary to attract and retain high quality staff necessary to effectively develop and maintain profitable lending relationships and lead fund expansion.

Lessons for the UK

- Relationship-based lending can be a competitive advantage when done well.
- Training and investment readiness improves loan performance.
- Higher income clients can cross subsidise service provision to disadvantaged groups.

- Graduating strong clients to banks will undermine sustainability.
- Micro-loans do not offer economies of scale.
- Adopting external standards of performance improves ability to raise funds.

Conclusion

These case studies illustrate a number of key elements that have led to the success of the CDFI industry in the US:

- The Appalachian Regional Commission has served as an intermediary leading regional economic development efforts and linking local CDFIs with national best practices.
- Pacific Community Ventures is a development venture capital fund that has created a set of metrics to document social returns on investment. It provides substantial levels of technical assistance to borrowers and other business owners whose success will benefit lower-income communities.
- Shorebank is a community development bank that has identified a market niche in the community it serves and has become the leading lender in that market.
- The Community Investment Corporation has successfully built long-term financial and advisory relationships with major area banks while growing to scale and becoming sustainable.
- The Community First Fund has used its knowledge of local markets to reach business owners and to successfully build long-term lending relationships.

These CDFIs are also going through many of the growing pains experienced by the industry as it moves forward. As CDFIs attempt to grow to scale, many struggle to develop sophisticated measures of social impact that investors are increasingly demanding. In attempting to grow, many CDFIs are balancing the need to attract and retain more profitable clients while still reaching those most in need yet difficult and costly to serve. CDFIs are also challenged to grow through developing new products and niches where they can become market leaders. Finally, CDFIs must find ways to attract and retain high quality staff to lead institutions and the industry to scale and sustainability.

Community development finance in Europe

A shift from an industrial-based economy to a service-oriented economy has resulted in increased unemployment in Western Europe. Enterprise creation and self-employment are seen as powerful tools for employment generation. Micro and small enterprises are central to this task given their importance to the economies of Western Europe. According to the European Commission, these enterprises represent 90 per cent of the two million enterprises created per year[35] One-third of these start-ups are by unemployed entrepreneurs. Due to high levels of joblessness microfinance has become a key mechanism to stimulate development of small enterprises in the absence of traditional sources of finance.

In response to these macroeconomic changes, since the 1970s, a wave of new finance organisations working for the social economy were established across Europe. These organisations operate with a variety of organisational models, including banks dedicated to the social economy, such as Triodos Bank in the Netherlands, JAK and Ekobanken in Sweden, and Banca Etica in Italy. However, the vast majority of social economy organisations have taken the form of associations (as in Belgium and France); co-operatives (as in Italy and Belgium); or not-for-profit organisations and foundations. These forms are a result of the high capital thresholds required to become a licensed bank, as well as the combination of the social and financial goals of these organisations.

Among these social economy organisations, an increasingly dynamic microfinance sector began operating in Western Europe.[36] The majority of the organisations operating today are young, making microfinance a fairly new phenomenon in the region. According to the 2006 European Microfinance Network (EMN) survey, 70 per cent of 110 microfinance organisations have only been in operation since 2000.[37] Microfinance is viewed as a social tool that combines several important aims: social and financial inclusion, job creation, economic empowerment, and regional development. In Western Europe, microfinance encompasses the provision of micro-loans, insurance, savings products, transfer services and non-financial services. Clients include entrepreneurs and low-income households who cannot access finance from mainstream sources. The bulk of microfinance institutions engage in microcredit, which is the provision of very small loans for micro-enterprise development, otherwise known as enterprise lending. However, only 16 per cent of microfinance institutions focus solely on microcredit, with the remaining 84 per cent engaged in a number of different employment and social welfare activities.

This section provides an overview of the characteristics of microfinance in Europe. Our analysis pays particular attention to themes of relevance to the UK community finance sector, namely: demand and marketing; business support provision; results and impact; regulation; funding; sustainability and scale; and the policy environment. These themes are reviewed through reference to five key European case studies (6–10), including ADIE and the Cigales Network in France, WWB in Spain, Network Credit Norway, and the Tante Agaath mechanism in the Netherlands. These case studies highlight key features and lessons learned in the European context that might shape future policy for the UK community finance sector.

Summary findings

Like the UK, most European microfinance organisations are local or regional and operate on a relatively small scale. According to EMN, a total of 27,000 micro-loans worth €210 million were made by micro-lenders in EU15 countries, involving 48,000 active borrowers at the end of 2005. Most organisations have an annual loan output of fewer than one hundred loans. France is an exception, where microfinance institutions are national and achieve the greatest degree of coverage and outreach. On the whole, European microfinance has a strong focus on social inclusion and is less concerned with profitability to limit recourse to grant funding. Currently many microfinance programmes are not sustainable and are not striving to become so. This means that government and public institutions are the main source of funding for microfinance, with organisations more easily able to obtain access to social funds. Other key findings include:

- Very few lenders in the EU15[38] are operationally self sustainable.
- Micro-lenders depend on the public sector to cover costs of operation, while the majority of loan capital is provided by both the public and private sectors; 42 per cent of micro-lenders receive 76 to 100 per cent of their operating funds from public sources.
- 28 per cent of institutions made less than 20 loans per year, though this number reduced from over one-third in 2004. The number of lenders making between 51 and 100 loans per year is also increasing.
- Most European micro-lenders provide loans ranging between €50 and €5,000, with an average loan amount of €7,700. This shows that most lending institutions are still small and relatively new, continuing to experiment with delivery models for their target market.
- The average interest rate charged by European micro-lenders was 10 per cent, ranging from as high as 22 per cent to as low as 5 per cent. The UK has a higher average interest rate at 14 per cent, in part due to the absence of interest rate restrictions that are in place in most countries.
- The majority of lenders provide individual loans, but some also use a group lending method. The sector remains dominated by micro-enterprise loans.
- A majority of organisations provide training and technical assistance to clients, with 75 per cent providing pre-loan business support
- Western European microfinance is growing but not as quickly as had been hoped. The three main constraints for growth identified by European micro-

lenders were: lack of funding to cover operational costs, a lack of client demand, and a lack of institutional capacity

- Obtaining clear information on the operational performance of micro-lenders remains difficult, particularly with reference to repayment rates, portfolio at risk, and loan write-offs. This may be due to under-developed management information systems

In Western Europe, microfinance is recognised as an extension of the public sector, and is a key tool to achieve social change. A primary goal of microfinance is social: to achieve poverty alleviation through the creation of enterprise or employment opportunities. As such, there is increasing availability of funding and support available for microfinance, particularly through the European Union. In addition, in Europe there is a ceiling on the interest rates that microfinance institutions can charge. This cap means that microfinance institutions are limited in the extent to which they can achieve full cost recovery, controlling expectations of sustainability. However, the relative youth and small size of most institutions, with growth rates below what might be expected of an emerging sector, is similar to the UK.

Demand

Entrepreneurship is a secondary option for many Europeans, who prefer employee to self-employed status. The most recent Flash Eurobarometer survey reveals the citizens of the EU15 countries have a consistently lower preference for self-employment, with only 45 per cent in favour, as compared to 61 per cent in the US. There was a lesser degree of commitment to entrepreneurship amongst EU citizens. Almost 60 per cent of EU citizens have never considered setting up a business compared with 44 per cent in the US. A recent household survey in England found that three-quarters of respondents were not involved in any sort of self-employment and were not considering starting a business, buying into one or becoming self-employed.[39]

In Europe there is also less activity to start up new enterprises. The Eurobarometer survey reported that 4.5 per cent of EU citizens (compared to 13 per cent in the US) are currently taking steps to start a business, have set up a business or have taken one over in the last three years.[40] The findings range from six per cent in the UK and Ireland to less than two per cent in France. There is likely to be less demand for enterprise finance in Western Europe, including the UK, than in the US or in Eastern Europe.

Western European microfinance institutions are shaped by a structural difference in the nature of demand for microfinance. A study carried out by the East-West Exchange on Microfinance, found that the potential clientele for microfinance in Western countries is a far smaller segment of society than in Eastern Europe, given higher living standards and the greater development of mainstream financial services generally available.[41] In addition, micro-entrepreneurs have more options to finance their business projects compared to developing countries, where interest rates are much higher and microfinance has thrived as a result.[42] This reduces the potential volume of lending for microcredit. The demand that is generated is skewed towards less viable borrower groups who require greater support and training in accessing finance. This resembles the target market of CDFIs in the UK, with individuals unable to access mainstream finance requiring additional mentoring and support.

Outreach

Reaching clients and stimulating demand has been a challenge for most micro-lenders in Europe. Some organisations, primarily those that have reached more mature stages of development, have been more successful in doing this than others. An example of this is the *Association Pour Le Droit A L'Initiative Economique* (ADIE), considered in Case Study 6., The three most commonly used marketing tools to mobilise demand are: community outreach, public relations and referrals. Other approaches include through contacts, word of mouth, training fairs and conferences.

Case Study 6: Adie (*Association Pour Le Droit A L'Initiative Economique*)

Adie (*Association Pour Le Droit A L'Initiative Economique*) is a French network association that provides micro-loans and business support to long-term unemployed individuals and those on long-term benefits that are excluded from the job market and from the traditional banking system, in order to set up new enterprises. Created in 1989, it works nationally, with a special focus on deprived areas, adapting the microcredit lending modality to the French context. Unlike many other microfinance institutions, Adie has been in operation for 18 years and has significant outreach. Strong partnerships at a national level allow it to have maximum impact. Adie also engages very actively in advocacy work, using its experience to propose facilitative policy and improvements to the existing regulatory system governing microfinance delivery and micro-enterprise in France.

France is one of the European countries where microfinance is most developed in terms of volume of micro-loans, and the Adie network is responsible for almost all of this activity.

As at the end of October 2006 and since 1989, Adie had delivered a total 42,000 loans for a total amount of over €100 million, had financed the creation of over 35,000 enterprises, and had created about 42,000 jobs. In 2005 alone, it loaned 6,740 micro-loans to a total value of €18 million, financing 5,891 enterprises and creating 7,069 jobs, at a loss rate of 3.8 per cent and a repayment rate of 93.5 per cent.

In that year, the survival rate of financed enterprises at three years was 64 per cent, and at two years 54 per cent. Its 'rate of insertion' (individuals that have received support from Adie in the past five years that continue to operate their enterprises or are engaged in salaried work, without receiving welfare benefits) was 75 per cent.

It is estimated that about 80 per cent of Adie's clients are referred by its varied pool of partners.

Adie takes great care in maintaining its relationship with its partners and developing new ones. It has developed a guide and an information module for its employees about managing partnership relationships. It also organises a yearly microcredit week when it engages in a massive information campaign with about 100 stands in public places.

An essential component of Adie's work is the provision of free, tailored, one-to-one business support to micro-entrepreneurs. This includes support in the preparation of business plans through specialist partners and business advice organisations, as well as post-loan support in administrative aspects of running an enterprise, management, commercialisation, marketing, integration to the financial system, and organisation of exchange circles of micro-entrepreneurs. It is estimated that the cost of this support per entrepreneur is nearly €2,000, which is fully subsidised by national, regional and local governments, as well as by the EU.

Adie also provides a variety of other support services through negotiations and partnerships with private and public sector actors such as a negotiated availability of very-low-cost, second-hand computers and low-cost training in specialised aspects of enterprise operations.

Having started with only three volunteers and no start-up capital, Adie's structure today involves 300 paid employees and 1,000 volunteers organised in 22 regional delegations, 110 branches present in all 100 departments (similar to but smaller than counties) in metropolitan France and managed by the regional delegations, and 380 contact points where credit officers receive clients once every week.

Adie has been able to achieve an impressive scale through patience, pragmatism, and the links it has developed with key public and private organisations. Partner banks today represent Adie's main source of funding with regard to loans, and it is its public sector partners, including national, regional and local government organisations, that subsidise its business support activities.

Business support

The provision of business support in addition to finance is one of the characteristics of microfinance in Western Europe, where this is considered an essential part of the service offered to clients. In the EMN survey, 75 per cent of organisations offer pre-loan support. In most cases this service is fully subsidised, and in some cases it is funded through private sector contracts. These organisations offer advice on a range of topics including marketing, sales, cash flow, bookkeeping, costing and pricing, legal issues, taxation, writing business plans, conducting feasibility studies, goal setting, and time management.

The importance placed on business support in Western Europe is distinct from the UK, where there is disagreement as to whether business support is too costly or a necessary service for community finance. Business support is a key factor that influences the degree of sustainability an organisation can achieve. Western European microfinance institutions view business support as essential to develop successful micro-entrepreneurs, particularly those from hard-to-reach or disadvantaged communities. As the ADIE example highlights, the required level of support can cost up to €2,000 per entrepreneur. A key difference in Europe is that business support is often fully funded through public sources of grants, and institutions are often linked into a network of business support agencies through partnerships. As the case study of Network Credit Norway highlights (Case Study 7), some microfinance institutions offer business support, whilst ensuring the sustainability of their loan fund, by separating these activities into two organisations.

Results and impact

Social impact

Measuring the impact of microfinance activity is challenging for many organisations. A recent survey found that the most commonly monitored indicator of impact by European microfinance institutions is the number of jobs created and sustained.[43] Indicators of employment are augmented by the number of businesses supported, their survival rate, profitability and change in self-confidence among loan recipients.

The indicators that provide a full view of social impact are the least monitored. In Europe, impact measurement is increasingly taking place on an organisational basis, given the absence of generally agreed indicators in the region. Some

Case Study 7: Network Credit Norway (NCN)

Network Credit Norway (NCN) was launched in Oslo in 1997 and in Bergen in 2000 under the guidance of the Norwegian People's Aid, the humanitarian organisation of the Norwegian trade union movement. From April 2003, it started providing business support, micro-loans and a savings scheme, as a new independent co-operative, to entrepreneurs willing and able to repay their loans, among them refugees and immigrants. The micro-loans are given through its loan fund, Foundation Microinvest, which was established in September 2003 in partnership with Cultura Bank (an ethical savings bank) and the Hordaland County Council, to operate the lending and savings part of the programme.

Although together they are most commonly known as the Network Credit Norway, the NCN and Foundation Microinvest operate as two separate legal entities, with a shared Chief Executive but with separate boards of directors (although some are shared members), providing respectively business support and finance as separate organisations. The original idea behind this separation was to promote the sustainability of the lending operations.

The NCN provides comprehensive free training and business support, and micro-loans. Business support includes a choice of evening and day/short and long training courses on aspects of enterprise set-up and management, such as business planning, budgeting, and marketing, through a pool of mostly subcontracted specialists. The training and business support aspects of NCN's services are fully-subsidised with public funding.

Once a client is considered investment-ready, the NCN assists him/her in forming a network group of between four and seven individuals who are in the process of starting micro-businesses. Each network group is required to save 10 per cent of the amount they wish to lend to a member, which is deposited in a common account – the Group Fund. The savings function as security for the loans given, and the network group has a common liability for all loans given to its members._

Continued business support within the groups is offered through a facilitator, a group member trained by the NCN. The facilitator provides advice to the group and is the contact person between the group and the staff at the NCN.

Additionally, the NCN organises a monthly meeting in the Micro Business Chamber targeted at the members of network groups, but also open to any other interested entrepreneurs. These meetings offer an opportunity to exchange ideas and experience, with specific business-related themes discussed as part of the agenda.

Case Study 8: The Spanish *Fundación Laboral WWB en España* (WWB)

The Spanish *Fundación Laboral WWB en España* (WWB) is a not-for-profit foundation that belongs to an international organisation, Women's World Banking, aimed at integrating and promoting women in self-employment. Since 1989, WWB has been providing women entrepreneurs who do not have access to mainstream financing with comprehensive business support, conventional loans and micro-loans through agreements with public sector bodies and partner banks. It works in all 17 regions of Spain with a permanent central office in Madrid.

WWB assists its women clients in the preparation of finance proposals, while the ultimate decision whether or not to approve a requested loan remains with its partner banks. Once a WWB client has taken a loan with one of the partner banks, the relationship between the bank and the WWB client becomes direct, and WWB remains involved only through on-going business support in the form of capacity building, marketing and commercialisation.

WWB has started to produce an annual impact evaluation that includes a questionnaire to clients measuring service satisfaction. This survey measures the impact of service on individual and household incomes, savings, and family relations. It also measures local economy and employment impact using more conventional indicators – for example, the number of businesses created and supported, the number of jobs generated, the number of loans granted, and the number of supply chains created or reinforced in the local areas where the supported enterprises trade – and enterprise survival rates after the end of loan periods.

WWB has provided comprehensive business support in aspects of business planning, marketing and commercialisation, to over 3,000 women. Its support is also available virtually through its support website www.autoempleomujer.com. The website provides practical advice on setting up a business as well as news of relevant policy and legislation and market events; it also offers a direct consulting service via e-mail. Since its launch in 2002, about 23,000 users have benefited from this virtual service, including 890 women who have received business and financial support.

WWB's business support activities are fully subsidised through contracts and agreements with a diversity of public and private sector entities (80 per cent/20 per cent respectively).

organisations have begun to carry out an annual impact evaluation, either through the use of client surveys or via external evaluation consultants.

This is exemplified by the experience of both Adie in France and WWB España (Case Study 8). Some of the indicators of performance and impact used by Adie include: 1) organisational performance indicators such as default rates, number of financed enterprises, enterprise survival rates, number of jobs created, rate of insertion; and 2) social impact measures such as socio-professional situation of clients pre and post support, level of qualification, and geographical situation.

Institutions that track impact indicators are those with a broader mission of social and financial inclusion. Western European microfinance institutions carry out impact surveys less frequently than Eastern European institutions, regardless of the indicators used. This may be related to the young age of the sector in the West and lack of funds available for this type of work. Linked to international microfinance, Eastern Europe has benefited from significant funding, expertise and adoption of performance measurement standards as a result.

The absence of common definitions and the inconsistency of approaches to data-gathering in Europe make assessment and comparison of the effectiveness of microfinance institutions relatively difficult. While most microfinance institutions would like to measure their impact more comprehensively, in practice they face many obstacles. These include:

- Lack of funds to cover the time and development of tools to measure impact.
- Lack of knowledge and skills.
- A diversity of products delivered, markets targeted and sources of funding used by an organisation which complicates a clear strategy for impact measurement.
- The number and variety of circumstances influencing the economic status of clients.

Operational performance

Microfinance organisations are often reluctant to report on operational performance, either because of lack of complete information or concern about use of the data. In EMN's survey, the response rate to questions on operational performance was the lowest. This may be due to poor management information systems, along with differing methods for recording information. Organisations were more capable (or willing) to provide data on their default rate and bad debts, along with the average rate of repayment. Fewer organisations provided details of their portfolios at risk, rescheduled loans and write-offs.

Reporting on operational performance is still patchy and relatively weak in Europe. The East-West Exchange on Microfinance found that microfinance institutions do not generally provide full information on loan portfolio performance. This is often because of confidentiality concerns; the difficulty and cost involved in separating micro-lending portfolio data from the rest of the institution's loan portfolio; weak management information systems; and insufficient attention to the importance of portfolio quality.

Developing best practice and indicators of impact and performance is a key objective for European microfinance. Performance standards are being developed by both EMN and the UK-based CDFA. A working group on benchmarks and performance measurement as part of the East-West Exchange programme has begun to identify the range of performance measurement initiatives in operation internationally. This working group seeks to define indicators that are applicable to the European context.

Regulation

Specific banking regulations affect the way in which microfinance institutions operate in Europe.[44] For the purpose of creating 'a competitive level playing field', two EU banking directives (1977 and 1989) established the rules for EU Member States. They specify that only credit institutions with bank licenses are permitted to take deposits. Exemptions from these banking directives were granted to selected institutions, provided the member countries introduced a request prior to implementation. The first directive lists a series of financial institutions and categories – such as the main national public banks as well as credit unions in the UK and Ireland – that are exempt from these directives.

Although the EU banking directives impose a banking license for the deposit-taking business, more importantly, a number of countries also limit lending to licensed banks. This was initially implemented in Germany and was then adopted by France, Portugal and Spain. This credit monopoly prevents organisations making loans even when they are working with their own funds. This challenge obliges social finance organisations in these countries to work with or through a mainstream bank. The need to work in partnership with formal banking institutions has shaped the way in which microfinance in Europe has evolved.

For example, WWB in Spain is able to provide finance to its women clients only through strong partnerships with licensed banks in the country. To accommodate this regulatory context, WWB works in partnership with nine licensed banks, which provide conventional loans and micro-loans directly to WWB's clients. Six of the nine existing bank partnerships have been agreed with *Cajas de Ahorro* (savings banks). These are credit institutions subject to the same regulations as commercial banks, but organised as private not-for-profit foundations. Savings banks do not pay dividends, but rather donate a significant percentage of their profits (25 per cent on average) to community projects known as *obra social*, including microfinance programmes. WWB has channelled over 900 loans with a total value of €23 million through its partner banks.

Funding

Domestic sources of funding

A significant number of Western European micro-lenders rely on public funds to cover their operational costs, with other funding sources representing a relatively small proportion. They receive funds from public sources, the private sector and charitable foundations. Some organisations, particularly social banks, generate earned income through interest rate charges and other loan fees. Loan capital is primarily funded by public sources; private sources of funding that are available are focused on loan capital rather than revenue costs of micro-lenders. Public funding is expected to play an ongoing role in supporting the development of the European microfinance sector.

European funding

Microfinance has increasingly been recognised by the EU member states and among European institutions as a key tool for social inclusion and employment generation. As a result, there is increasing availability of support and funding targeted at initiatives and institutions supporting micro and small enterprises.

Example of European funding sources

- The European Commission has funded a number of microfinance initiatives through its DG Enterprise, DG Research and DG Employment and Social Affairs Units.

- The European Investment Fund has a Microcredit Guarantee Window which represents one of the most important EU support programmes for addressing microfinance institutions exclusively.

- Up to 2006, the European Social Fund (ESF) had been – and will continue to be in the budget period (2007–2013) – one of the most important funding opportunities for microfinance organisations explicitly addressing social exclusion. The EQUAL initiative, which was ESF's laboratory for testing new approaches tackling discrimination and exclusion, will be absorbed by the ESF in 2007.

- In the 2007–2013 budget period the European Commission and EIF will set up a special credit facility focusing on microfinance and SME creation. This new initiative, JEREMIE, will be part of the European Regional Development Fund (ERDF). It will enable regional and local ERDF managing authorities to transform parts of the budget, normally reserved for grants, into loan capital. The capital will be assigned to selected 'potential financial intermediaries', including microcredit institutions, authorised to disburse loans at the local level. JEREMIE will also provide financial support for advisory and technical assistance activities.

The typical funding profile of a European microfinance institution is exemplified by the case of Adie in France (Case Study 6). In 2005, the operations and institutional development of Adie were financed 41 per cent by local governments and 31 per cent by state/public entities, of which 8 per cent was through the management of a state repayable grant for unemployed and 10 per cent was through specific state-funded contracts for young employees. A further 17 per cent was funded by the European Commission, with only 11 per cent of funds attracted from the private sector. Adie hopes that the margin realised through an increase in the interest rate on its loans will cover 11 per cent of its operations in 2007.

Funding is a main challenge for NCN, as resources tend to be short term (Case Study 7). For this reason NCN, and particularly the lending side of its services, seeks to become operationally sustainable in the future. NCN is also considering charging a small fee for the training it offers. It seeks to continue to increase the efficiency of its lending and repayment, and has set up a fund that it hopes will be capitalised with contributions from independent social investors as well as from private sector organisations. It is also developing a 'package' for municipalities who want to raise funding locally and use NCN as a service provider for training, materials, support services, loan and savings management, networking and follow up. However, NCN continues to receive funding from the European Union. It recently received funding from ESF to build a national microfinance network of women entrepreneurs and to continue its advocacy with the Government to change some of the obstacles women entrepreneurs face.

Sustainability

At present, no microfinance organisation in Western Europe has achieved operational sustainability. Although sustainability is a long-term objective for many lenders, structural, cost and legal environments create barriers to sustainability. In most cases it is also seen as unrealistic because of the high costs of outreach in target markets. A strong focus on social mission may preclude sustainability. Policy and regulatory constraints, such as interest rate caps in the range of 5 to 8 per cent, also limit this option.

There is an ongoing debate about the meaning of sustainability in Europe; what are the full costs of micro-lending; and who should bear these costs and how these costs should be borne. For some, sustainability is about ensuring long-term presence for individuals in need, while for others it signifies an organisation's ability to cover its operational costs.

The public sector plays an important role in covering these costs. However, many organisations fear that public commitment will not be long-term enough to ensure their continued presence in disadvantaged communities. Concerns about the reliability of public funding echo those voiced by CDFIs in the UK.

By contrast, Eastern European microfinance institutions have a very strong focus on operational sustainability. They follow the notion that sustainability is critical for reaching a larger number of target clients. For that reason, Eastern European organisations are in most cases operationally self-sustainable; they are able to cover the costs of their operations from revenue earned on their assets, mostly interest and fee income on loans.

The case studies reflect the European view of sustainability. Adie believes that achieving full sustainability is not realistic in the context of current market factors (Case Study 6). These include the low volume of operations and low density of clients relative to the volume and density in developing countries; the relatively high cost of staff; the difficulty of applying cost-coverage interest rates, and the need for providing business support along with finance. Despite this, it is constantly working towards increased operational self-reliance, particularly of its lending activities. Adie has recently increased the interest rates it charges, and will attempt to separate its lending and business support activities with two different cost centres. This reflects the step taken by NCN to separately cost its lending and business support activities (Case Study 7).

Spanish WWB business support activities are fully subsidised through contracts and agreements with a range of public and private sector entities (80 per cent/20 per cent respectively). It believes that, while achieving sustainability is unrealistic for an organisation of its kind in Spain, its full reliance on public sector funding for its operations makes it vulnerable. That is why WWB is presently seeking and designing new products and services that will generate income and make it more able to respond to changes in public sector priorities (Case Study 8).

Scale

The scale of microfinance operations in Western Europe is relatively small; the sector is comparatively young. However, despite its youth, the sector is not growing as fast as one would expect from an emerging industry in the initial phase of development. When compared to the international microfinance industry, largely based in developing countries, growth rates are below average. This highlights the different context for international microfinance operations, which can tap into a large pool of latent demand for business loans in the absence of a well-developed banking sector.

Despite this distinction, the growth rates in Europe have increased year on year in terms of numbers of loans issued. In 2005, there was an increase of 15 per cent in the number of loans disbursed in EU15 countries. In Europe, there has also been increasing interest on the part of governments and the private sector to support microfinance development. There is still further room for the private sector, and commercial banks in particular, to play an active role in increasing the scale of European microfinance organisations. The private sector could participate more directly in the funding and institutional capacity building of microfinance organisations in the region.

Case Study 9: Clubs d'Investisseurs pour une Gestion Alternative et Locale de L'Epargne Solidaire (CIGALES)

The French ***Clubs d'Investisseurs pour une Gestion Alternative et Locale de L'Epargne Solidaire*** **(CIGALES)** comprise groups of individuals (*cigaliers*) in a locality involved in the provision of 'solidarity risk capital' through the mobilisation of savings. The clubs support new and existing small and micro-enterprises that are economically viable and that contribute to employment creation, local and cultural development, and the protection of the environment. Most of the supported enterprises lack access to finance from the traditional banking sector, and so the CIGALES also contribute to their financial inclusion. Additionally, they provide invested enterprises with business advice and mentoring which are considered key components of their support.

Each club is comprised of 5 to 20 individuals (on average 12) from a locality; they come together to save collectively for investing locally. While economic viability is one of the criteria used in selecting an enterprise for support, the expectation of return is not necessarily. In fact, only around 20 per cent of investments on average receive financial returns during the life of a CIGALES – generally between 5 years and no more than 10. What therefore mainly moves a CIGALES investment is a sense of solidarity with the locality as well as the knowledge or expectation that at least eventually the invested enterprises will be profitable.

The first CIGALES club was created in 1983. Today, about 100 CIGALES are active throughout the country each year under the aegis of the Federation of CIGALES, which was created in 1985. The Federation holds the right to the 'CIGALES' name and therefore all such clubs must be members either individually or, where a regional association exists, through that body.

Clubs are formed according to article 1873 of the French Civil Code and governed by two 1970's laws, which allow a group of individuals to voluntarily come together for the purpose of saving, to produce an ethical investment. These laws also allow an investment club to open a joint bank account in the name of the CIGALES and to deposit its collective savings in the expectation of placing the funds in selected enterprises according to the Charter and ethical code of the CIGALES.

A favourable fiscal disposition has also been in place since 1995 to encourage individuals and investment clubs to invest in the formation or to increase the capital of a local enterprise. It provides for a tax deduction equal to 25 per cent of the financial investment/payment during a fiscal year. The deduction cannot be used jointly with other similar facilities.

Policy environment

Europe provides a constructive policy environment for microfinance. Most European countries now have policy recognition of small and micro-enterprises and have included enterprise support programmes in their national action plans. The European Commission has also launched a number of initiatives through its DG Enterprise, DG Research and DG Employment, Social Affairs and Equal Opportunities, and has been stimulating member states to move towards new funding strategies, to move away from grants as a sole means of financing the sector.

However, the degree of friendliness of these policies to microfinance varies between countries in the region. Some policy contexts are conducive to microfinance but rather unstable, while others are not conducive to the maximisation of impact of the organisations working in the sector. To provide an overview of the type of policy instruments available to support microfinance institutions in Western Europe, we review a selection below:

- Guarantees. There are national guarantee schemes for small firms in Germany, Finland, the Netherlands and the UK, with the Dutch being particularly successful. At EU level, EIF also issues guarantees to national schemes that in turn provide guarantees or loans to entrepreneurs. There is also a very strong culture of mutuality particularly in Italy, where businesses join together to form a Mutual Guarantee Society in order to pool their savings thus enabling them to attain better terms on external finance.

- Special regulatory and policy frameworks allow for the creation of specific financial instruments for the social economy. In France, for example, specific legislation allows for the creation of local investment clubs (CIGALES) in which members save a regular monthly amount in a common fund from which they agree to invest in projects they have identified (Case Study 9).

CIGALES is a potentially viable model of financial solidarity that could be implemented in the UK. However, a number of contextual factors require examination.

- The tradition of community and financial solidarity in the UK, keeping in mind that for a CIGALES to work, all members must be equally committed and willing to contribute their finance and knowledge with invested enterprises.
- Existing policy incentivising the activity (for example, in France the presence of a fiscal incentive).
- Existing suitable legislation and regulation/legal structure(s) allowing for the creation of groups coming together to engage in collective savings and invest locally.
- The best financial support to provide (loans/risk capital) based on an analysis of the small and micro-enterprise culture in the UK and whether these welcome or are reluctant to welcome external sources of capital/sharing ownership of their businesses.
- Partnerships between microfinance and support organisations/programmes with commercial banks. In some countries, links between commercial banks and micro- and small-enterprise-minded organisations are very strong. This is particularly the case of organisations in France, Spain, and Portugal where non-banks are restricted or not allowed to extend loans.
- Interlinking policy, such as in Ireland, is considered to have the most helpful social benefits structure permitting a gradual change in the benefits status of borrowers. This involves a four-year tapering welfare support programme to assist a person move from unemployment into self-employment. There is a need to explore similar flexibility for the UK benefits system to allow individuals to maximise enterprise opportunities.
- Fiscal incentives. In some countries, such as in the UK and the Netherlands, tax incentives are provided to individuals or corporations that invest in small and micro-enterprises either directly or through intermediaries. Some tax incentives are more targeted than others, for example, the UK CITR which specifically targets enterprises in deprived areas, as compared to the Dutch TAR. (Case Study 10) which targets SMEs and micro-enterprises more generally.

Case Study 10: The *Tante Agaath Regeling* (TAR.)

The *Tante Agaath Regeling* (TAR.) is a Dutch fiscal measure that stimulates business angel and private investor financing in new and up to 8-year-old enterprises or private companies (called BVs) in the Netherlands. It was introduced in January 1996 as part of a tax plan package of measures to encourage entrepreneurialism, of which the TAR represented the key component. The scheme was modified and broadened in 2001 with the new Dutch income tax regime (IB 2001), becoming *Regeling Durfkapitaal*.

This fiscal measure was devised with the aim of creating employment through increased entrepreneurial start-ups and of filling a market gap in the provision of start-up capital for first-time entrepreneurs. It was also the result of research that suggested that there were a high number of private individuals willing to invest in third-party entrepreneurial projects. This tax incentive sought to facilitate the connection between private individuals as lenders and financially excluded enterprises.

An investor can be any private individual or 'business angel' who wishes to invest in new firms, except for the spouses or business partners of supported enterprises. The scheme can be used by any one enterprise for up to five years.

A private individual is encouraged to make finance accessible to starting entrepreneurs in two ways. In the 'direct variant' of the scheme, taxpayers can loan money directly to start-up entrepreneurs. In the 'indirect variant', they can invest money in an officially recognised TAR fund (appointed commercial banks), which in turn finances start-up entrepreneurs.

The scheme consists of three fiscal instruments: (1) a tax exemption for the capital yield tax with maximum of €52,110 applying to both direct and indirect investments; (2) a tax deduction of 1.3 per cent for direct investments, and (3) a personal tax deduction for losses on direct investments which acts as a partial guarantee on investment. The overall budget has been around €16 million every year.

Conclusion

European microfinance differs from UK community finance in several respects. In Western Europe, microfinance is viewed as an extension of the public sector with the primary objective of achieving social change. Organisations predominantly have a social mission to reach low-income and unemployed individuals by fostering opportunities for enterprise. As part of this, there is a strong emphasis on business support, networks, and training that microfinance institutions offer. Support services, while costly, are recognised as valuable in reaching target communities, and are well-funded accordingly. Significant local, national and regional public funding is available to support microfinance in Western Europe.

A further distinction from the UK is the approach to sustainability. Sustainability in Western Europe, while important to ensure efficiency of operations, does not imply independence from grant funding. No microfinance institution in Western Europe has achieved operational sustainability. While sustainability may be a long-term goal for many microfinance institutions, there are barriers in the form of cost structures and the regulatory context. The case studies we have considered highlight the need for a more realistic approach to sustainability in the UK. Many of the organisations reviewed have adopted the pragmatic assessment that sustainability is not realistic at this stage in their development. As such, micro-lenders rely on public funds to cover their operational costs. Unlike in the UK, public funding is expected to play an ongoing role in the development of the microfinance sector, particularly as constraints such as interest rate caps limit full cost recovery. While measures to attract private finance are in development, public funds are the dominant form of support, and a range of EU initiatives exist to support the sector.

At the same time, both Western European and UK institutions continue to struggle with similar issues of scale, how to expand outreach, generate client demand, and build institutional capacity. With less appetite for enterprise start-up or self-employment, microfinance institutions have to work harder to generate demand and build an enterprising culture. Clients are drawn from amongst less viable or 'unbankable' borrowers who require additional mentoring and support. As a result, growth has been slower in both regions as compared to Eastern European or other international contexts. Social impact measurement has also been difficult in both regions. This capability has not been well-funded. Individual European microfinance organisations are beginning to carry out individual audits of organisational social outcomes, but this is still quite patchy in the UK. The development of common standards for performance and impact measurement would benefit both the UK and European contexts.

4: Conclusions and recommendations

CDFIs are at a point in their development where the future of the sector is uncertain. CDFIs are increasingly under review to determine whether they are effective in creating enterprise-led regeneration. The findings from our research have highlighted the characteristics of enterprise-lending community finance in the UK. We have considered the operational context and policy environment for CDFIs, identifying the challenges and opportunities they face.

Conclusions

This study set out to address four key questions. The findings from UK and international interviews and case studies provide significant insights into the issues raised.

Have UK CDFIs effectively addressed issues of access to finance?

The evidence from our interviews and the policy survey of stakeholders for CDFIs in the UK indicates two important points about CDFI effectiveness:

1. CDFIs have a positive impact on disadvantaged communities by enabling access to finance. They meet the need of a target community for loans combined with training and support.

2. In the face of current challenges, the sector is not achieving its full potential. CDFIs are not as effective as they could be.

CDFIs are considered effective institutions. There is a strong conviction that CDFIs have a positive impact on disadvantaged communities and that they are critical institutions to address issues of access to finance. The policy survey found that the enterprises supported by CDFIs can make a real difference in revitalising disadvantaged communities. Evidence of under-investment in disadvantaged communities indicates that access to finance is an ongoing problem for small and micro-enterprises. CDFIs have a key role to play in meeting the needs of excluded individuals, particularly women, minorities, and those requiring additional support to become investment-ready.

But most CDFIs remain small and are growing slowly, struggling to make a significant contribution to enterprise development. Impact is hampered by small scale and limited resources. Most CDFIs remain local or regional in scale. CDFIs involved in micro-lending to enterprises have not reached sustainability.

The sector's achievements, particularly in terms of committing capital, are largely dependent on a small group of national CDFIs that make social-enterprise loans. These well-established CDFIs have had the most success in developing institutional capacity, moving towards operational self-sustainability, establishing robust loan portfolios and relationships with providers of funding, investment and referrals.

Judging CDFIs' organisational effectiveness is difficult. Generalising across the sector is inappropriate because of the diversity of CDFIs. It is clear that there is weakness in the current capacity of CDFIs, but organisational performance varies greatly. There are currently no performance standards in place. Few organisations can demonstrate their full impact upon clients and the communities served. A barrier to developing better performance measurement is the limited resources endemic to the sector. Funders are contributing to this fragmented situation by overlooking support for this function and imposing different reporting requirements in an uncoordinated manner.

Lack of transparency is a problem that CDFIs have to address urgently. Currently the information that the CDFA gathers on its members is inadequate to make robust funding or investment decisions. Data is limited to aggregate information reported by the CDFA. Individual organisations each approach data-gathering and reporting differently. A standard performance framework, such as the one in development by the CDFA, could provide the evidence of social gains created by community finance.

Can CDFIs be sustainable, and what size of organisation is appropriate for the communities they serve? Are expectations for the sector appropriate?
Sustainability and scale have to be judged as part of a broader framework of objectives. CDFIs lend in the most challenging of circumstances. By definition, CDFIs have a social mission to serve hard-to-reach individuals that banks have deemed unprofitable. In many cases, these operating conditions limit sustainability. Sustainability is determined by a number of different factors, including markets served, loans offered, and type of services provided.

There is acknowledgement within the sector of the importance of sustainability as a long-term objective, but currently it is not achievable for most CDFIs. In reality most CDFIs may only be able to cover less than 20 per cent of their operating costs. Many CDFI business models will not achieve sustainability. Small personal and micro-enterprise loans are costly to administer and generate less income. International evidence indicates that many CDFIs in the US and in Western Europe remain dependent on grant support. Sustainability may only be possible for CDFIs involved in larger, secured loans for property or social enterprises.

Business support enables entrepreneurs to realise their potential when credit is accompanied by training. The availability of business support is crucial to the viability of many loans and therefore to the sustainability of CDFIs. At the same time, business support is costly to provide. Business Link and other existing business support mechanisms are largely inadequate for the highly specialised needs of CDFI clients. There is an opportunity for CDFIs to provide tailored advice with microcredit specific to micro-enterprises, sole traders and the self-employed.

In this context, public funding is necessary to support the activities of CDFIs. This has been recognised in Western Europe and in the US, where robust mechanisms exist to support the sector. The funding environment has become increasingly challenging in the UK.

New sources of private finance may also help to support the sector. However, significant capacity building will be required to ensure that CDFIs are ready to absorb and to manage these funds. Currently many CDFIs do not have the management expertise and business model to absorb private investment. Even some of the most financially robust institutions that utilise commercial funding still rely on public guarantees to attract it.

Scale is not a panacea; it is suggested as a strategy to improve outreach, impact and sustainability. Many CDFIs seek greater scale for these reasons. However, operating on a larger scale may not realise those goals due to the low investment-readiness of demand, the high transaction cost of lending and the specialised needs of target clients. Lending to disadvantaged individuals does not produce economies of scale. The section of society served by CDFIs does not respond to orthodox banking practices; CDFIs are targeting the unbankable. As such, plans to build scale should be considered on an organisation by organisation basis. CDFIs will increasingly need to consider their competitive advantage in meeting the needs of their target clients. Specialisation, combined with effective partnerships, may be more effective than simply targeting larger-scale operation.

High initial expectations for CDFIs have resulted in some disillusionment with the sector among donors, policy-makers and investors. However, some of these expectations have proven to be unrealistic.

The needs of the target market render the demand for enterprise lending very costly to meet. Expectations for CDFIs to grow revenue and to increase scale while simultaneously deepening social impact may be too ambitious. CDFIs operate in diverse environments which do not respond to a single model. Pressure to improve revenue can limit resources to develop capacity, implement performance measurement and provide the business support that is integral to most CDFIs' operations.

Government policy has not supported community finance sufficiently to allow many expectations to be addressed. Funding has been short term and patchy. Support from the financial sector has also been inconsistent and often limited. The CDFI sector is still very young. Key steps, such as developing social impact indicators, establishing performance standards, and building partnerships with other local institutions, are only just beginning to emerge. In the absence of future funding, the sector will weaken and many CDFIs will disappear.

What are the implications of the current direction of policy for CDFIs? How do they fit within the broader approach to enterprise and regeneration?

The current policy context is challenging for CDFIs. While early initiatives were supportive of the sector's development, the policy environment has become unstable and short term in focus. Policy cycles have shifted, and CDFIs are no longer at the top of the agenda. Enterprise lending is no longer emphasised as a core solution to disadvantage.

Government funding for enterprise lending was too short-lived. The devolution of strategic oversight to RDAs has meant that experience and knowledge at national level has been lost. CDFIs are now further fragmented, with different approaches in each of the regions. Future funding has not been confirmed and CDFIs are struggling to cope as a result.

CITR has had limited impact. It has not functioned to promote the growth of small and younger CDFIs, which make up the bulk of the sector. It has been inflexible and difficult to administer for all but the most established organisations. Reform is necessary to enable it to be a more effective method to attract investment into community finance. The steps the Treasury is taking to revise CITR are welcome in this respect. As the CDFA has argued, CITR could be expanded to foster further development of the sector and attract much needed additional funds. New initiatives such as the Commission for Unclaimed Assets' proposed Social Investment Bank could be positive measures to ensure ongoing development of the sector.

The emergence of personal financial exclusion as a policy priority has shifted the focus away from enterprise's contribution to disadvantaged communities. Issues of personal financial exclusion and enterprise finance often overlap, particularly when target communities are the same. However, this policy shift has altered the 'road map' for many CDFIs. The availability of funding for personal financial products that combat predatory lending means that some CDFIs have adjusted their business models. Funding for enterprise lending is increasingly scarce in this environment.

There appears to be a diminishing importance of CDFIs in government approaches to exclusion and deprivation. Their lack of sustainability means CDFIs still depend on grant funding. The policy cycle means priorities continuously shift. The community finance sector is struggling to develop in the absence of sustained support from either government or private funders. Unlike the US, there is not a positive framework like that of the CRA to drive strategic bank partnership and investment in the sector. Without sufficient funding, there will be rationalisation within the CDFI sector.

CDFIs make a positive impact on disadvantaged communities. But community finance is not high growth or the sole solution for unemployment. Some micro firms and forms of self-employment can provide flexibility, additional sources of income and skill development for individuals excluded from formal work. Even micro-enterprises that fail can develop business skills and build an enterprising culture, contributing to an area's regeneration.

CDFIs can build upon their links to hard-to-reach groups by taking on partnerships with other institutions confronting these challenges. There is a clear opportunity for CDFIs to work with housing associations to meet the needs of micro-enterprises and the self-employed.

DTAs, local authorities and RDAs are seeking to promote regeneration. CDFIs have specific skills and knowledge that they can bring to these organisations.

CDFIs can be effective service delivery partners. Where scale and revenue are limited, CDFIs could consider specialisation into niche markets, while working in coordination with other service partners to maximise impact. Alternatively, multiple CDFIs in a region could partner with each other to rationalise some costs and present a united face to potential partner institutions and funders. The model of a Community Banking Partnership championed by **nef** has been effective in bringing together a range of organisations providing complementary services.

What do the lessons learned in other international contexts tell us about future policy choices for CDFIs in the UK?

UK community finance has regularly referred to international examples to inform policy development and consider best practice.

Expectations for CDFIs in the UK were largely based on US models of community finance. With three decades of development, the CDFI sector in the US has grown to be of significant size. The sector plays a significant role in filling gaps in access to finance for underserved markets. CDFIs in the US have a diversified range of products, including an important focus on property lending. The-second largest activity is lending for small business development. Increased specialisation and an in-depth understanding of niche markets have resulted in successful lending models. CDFIs have learned how to cross subsidise less profitable activities with fees or revenue from successful products. CDFIs are well integrated into regeneration strategies, forming key partnerships with other local or regional bodies. Banks have engaged with the CDFI sector, providing a critical source of investment and expertise, largely as a result of CRA legislation. Long-term government support, in the form of the CDFI Fund, has also helped to develop the sector.

However, CDFIs in the US continue to face challenges. They struggle with issues of sustainability, capacity, and scale. The funding environment has become more challenging. New methods of performance measurement are increasingly required by donors to demonstrate effectiveness. CDFIs struggle to recruit and maintain high quality staff. In addition, where they have proven that low-income markets can be profitable, they face increasing competition from formal banks. Many CDFIs in the US that serve hard-to-reach populations are not fully sustainable, and continue to rely on grant funding.

Lessons for the UK from the US context include:

- The CRA has played a significant role to develop a robust commitment from banks. It has provided the foundation for investment and partnership of banks with CDFIs in the US.
- Long-term funding support from the CDFI Fund was a key factor in development of the sector. The Fund provides financial grants and technical assistance awards to CDFIs.
- Specialisation in niche markets to build expertise can be a competitive advantage.
- Mechanisms such as the New Markets Tax Credit programme have helped to drive investment into the sector.
- Larger loans for property, affordable housing and financing neighbourhood redevelopment are often key to sustainable loan portfolios. Cross subsidy through a balanced portfolio of broader and more secure lending can facilitate micro-loan provision.
- CDFIs serving hard-to-reach markets continue to require grant funding.
- CDFIs may benefit from partnerships with regional or local institutions as part of a broader regeneration strategy.

- Developing an effective means of social impact measurement is essential to demonstrate outcomes and raise additional funds.

Western Europe presents a different model of community finance. Like the UK, the sector remains small and of relatively limited scale. The sector is comparatively young, with the majority of organisations in operation since 2000. Microfinance is viewed as an extension of the public sector with the primary objective of achieving social change. Organisations predominantly have a social mission to reach low-income and unemployed individuals. As such, microfinance has a strong focus on social inclusion and is less concerned with profitability. Many microfinance organisations recognise that sustainability is not possible with current lending models, and very few lenders in Western Europe are operationally self-sustainable. Micro-lenders rely on the public sector to provide funding and there are significant funds available to support operating costs. The European policy environment is very supportive. European institutions have partnered with savings banks and other formal financial institutions. They have recognised the importance of business support provision, and a majority of CDFIs in Western Europe offer these services. They have increasingly specialised and focus on targeting specific disadvantaged communities. At the same time, they are often involved in providing a range of employment and social services in addition to microcredit.

The sector is facing challenges of slow growth, limited capacity, and small scale. Most organisations have an annual loan output of fewer than one hundred loans. European microfinance institutions struggle with social impact and performance measurement. They are still limited in their reporting on financial details, such as portfolio at risk and loan write-offs.

Lessons for the UK from the Western European context include:

- Recognising the social value of community finance for hard-to-reach communities limits unrealistic expectations of short-term sustainability.

- A supportive policy environment with access to a range of funding and support mechanisms is conducive to the long-term development of the sector.

- Formalising partnerships with banks helps to develop effective operating models.

- Separating lending and business support activities can be an effective way to build a sustainable loan portfolio.

- Appropriate sources of public funding are necessary to promote a robust community finance sector.

UK CDFIs SWOT Analysis

Strengths

- CDFIs reach excluded individuals who are not served by the formal financial sector.
- CDFIs are able to target specific needs not met by existing business support services.
- CDFIs can be effective in disadvantaged communities.
- Micro-enterprise has positive outcomes through development of business skills and encouraging an enterprising culture.

Weaknesses

- The scale of CDFIs in the UK is still small.
- CDFIs have grown more slowly than expected.
- The current capacity of most CDFIs is inadequate.
- Funding has been short term and project driven.
- Policy environment is increasingly unsupportive.
- Few CDFIs have achieved operational self-sustainability, and this may be unrealistic for many.
- Most CDFIs are unfamiliar and/or unprepared for private investment.
- CDFIs do not report transparently on their outcomes.
- Sector-wide performance standards are not in place.

Opportunities

- Partnerships with the financial sector could increase referrals, investment and expertise.
- CDFIs could be better integrated with DTAs, housing associations, and local authorities.
- A programme of awareness would expand general knowledge of CDFIs.
- Revision of CITR could improve flexibility and drive future investment.
- A programme of long-term public funding would kick-start the sector.
- CDFA performance framework will bring new credibility to CDFIs.
- Creation of a Social Investment Bank to coordinate funding and investment in the sector.

Threats

- An excessive focus on sustainability may cause the social mission to be undermined.
- Absence of appropriate funding will result in weakness and rationalisation of the sector.
- Excessive focus on private investment will exclude majority of small CDFIs.
- Ongoing lack of transparency of CDFI performance could undermine credibility.
- Policy-makers lose interest in CDFIs resulting in the deterioration of current organisations.

Recommendations

CDFIs

- Performance measurement must be developed and linked to common standards for the sector.
- CDFIs should be more transparent about their operations in order to demonstrate their effectiveness.
- Developing social impact measurement would allow CDFIs to communicate outcomes more effectively.
- CDFIs should look to private investment as a long-term goal but should not expect it to replace other forms of funding support.
- They should develop deeper partnerships with the private sector, whether banks or other businesses with an interest in disadvantaged communities.
- CDFIs should consider a wider range of local partnerships with housing associations, development trusts and local authorities.
- Strategies to improve revenue and lower costs need to be explored further, such as property lending, generating advisory fees, and sharing back-office functions.
- CDFIs should separate the costs of different activities to determine their impact on the business model and allow for different funding sources, whether grant funding or investment.
- CDFIs should consider separating activities into different but associated entities, such as a for-profit loan fund and a charitable enterprise.

Government

- Original expectations for the CDFI sector were unrealistic. These should be revised to focus on the ongoing development needs of this sector.
- DTI should establish a central point of information to ensure that RDAs are able to make use of previous policy experience.
- CITR should be expanded to enhance property lending for regeneration, social housing development and personal lending activities. CITR funds could also be used to support the operating costs of CDFIs.
- CITR needs to be better publicised to encourage greater take-up by investors.
- Banks should be mandated to engage actively with community finance, along the lines of the CRA in the US.
- Government should consider an ongoing fund to support capacity building of CDFIs.

Regional Development Agencies

- RDAs should facilitate strategic partnerships for CDFIs so that they can more effectively address issues of enterprise finance.
- RDAs should provide funds for capacity building, and focus on the development of smaller CDFIs.
- RDAs should work with CDFIs to develop a model of business support tailored to the specific issues affecting entrepreneurs in disadvantaged areas.

Funders

- CDFIs still need grant funding to carry out much of their work. Without this they will wither and many will disappear with serious consequences for people in disadvantaged communities.

- Funders, in partnership with the CDFA, should coordinate reporting requirements to ease the burden on CDFIs.
- Funding should be made available over a long-term timeframe to enable CDFIs to grow and increase their impact.
- Funding for CDFIs needs to support revenue as well as capital costs.
- Funding for capacity building of CDFIs is critical.

Banks

- A formal strategy of long term engagement with CDFIs should be implemented to promote referrals from mainstream banks, knowledge transfer and investment in CDFIs.
- Banks should move away from ad hoc grants through CSR budgets and develop significant, long-term programmes of investment.
- They should disclose the amount and pattern of their lending in disadvantaged communities to identify where partnership with CDFIs would be more effective.
- Banks should seek out opportunities to partner with effective CDFIs to better serve the needs of unbanked individuals and enterprises.

Community Development Finance Association

- The CDFA should continue its positive work on the development of common standards for CDFIs through the performance framework to improve measurement systems.
- It should develop an awareness and education strategy to inform and attract new private funders to CDFIs.
- The CDFA should encourage greater transparency from CDFIs through the development of a common information point for performance indicators, similar to the Microfinance Information Exchange.
- It should aim to develop an independent rating mechanism in the long term to encourage best practice, perhaps adapting models in use in the US.

Conclusion

nef's research shows that CDFIs are having a positive impact on disadvantaged communities. But CDFIs have not met the initial expectations and are not living up to their full potential. Many of their shortcomings are due to an unsupportive policy environment. Limited funding, a short-term outlook and inflexible policy mechanisms have all stunted development of the sector. Ten years after their emergence in the UK, CDFIs are now at a critical juncture. Unless action is taken they are at risk of becoming victims of the ever-shifting policy cycle.

To develop an effective CDFI sector, a long-term approach to funding and support is required. Expectations need to be more realistic and shift to a longer time horizon in keeping with the nature of the social change CDFIs are designed to support. Policy mechanisms should be redesigned to maximise flexibility. CDFIs should be encouraged to develop partnerships with existing local institutions in the communities they serve. Banks should be pushed strongly to invest in the sector on the basis of the pivotal role this has played in the US and elsewhere. The CDFA has a continued role to play in increasing the rigour of reporting and performance measurement for the sector. Above all, policy-makers and practitioners should understand that CDFIs are social enterprises that are unlikely to be entirely independent of grant support if they are fulfilling their purpose and maximising their social outcomes.

Without renewed support for the sector, it will become increasingly fragmented and weak. CDFIs will likely wither and many may disappear, providing another set back to disadvantaged communities.

Appendix A: Research method

UK Research

The findings are a product of extensive secondary research on the UK and international context. To develop our UK findings, we completed in-depth interviews with CDFIs and carried out a policy survey. Through the interview and survey process, we collected the views of representatives from 43 different CDFIs.

We developed the policy survey to seek the views of a wider group of CDFI practitioners as well as other significant stakeholders in the sector, including: policy-makers, banks and related financial institutions, charitable foundations, and government representatives. We sent the survey to 143 recipients and received a response rate of 38 per cent with 54 respondents. Survey participants comprised 22 non-practitioners and 32 CDFIs. Of the non-practitioners seven were drawn from the banking sector, two from Government, four Charity representatives responded and nine participants were drawn from other supporting institutions.

We completed interviews with 19 CDFIs in the UK. We selected CDFIs for interview on the basis of their ability to represent experiences typical to the sector while ensuring a sufficient breadth to reflect its diversity. The organisations interviewed provide one or a combination of products, with ten (52 per cent) organisations providing micro-loans; five (26 per cent) SME loans; five (26 per cent) social enterprise loans. One organisation also provides housing loans in addition to social enterprise loans, and three others provide personal loans in addition to micro-loans. The proportion of personal lending by volume and value for two of the three organisations is greater than that of micro-enterprise lending.

Ten (52 per cent) of the interviewed organisations also provide some kind of business support, from formalised training and one-to-one tailored advice to more informal support through the life of the financial commitment.

Three organisations (16 per cent) work nationally (with focus on England); three work regionally (16 per cent); eight work sub-regionally (42 per cent); and one works locally. One organisation works solely in Scotland, and one in just one region of Scotland. In terms of regional spread, three work in London; three in the West Midlands region; two in the east of England; one in the North East; one in the South West; one in Yorkshire and the Humber, and one in the North West.

Most of the interviewed organisations use a group company structure, with 52 per cent registered as Companies Limited by Guarantee and 26 per cent as Industrial Provident Societies (IPS). Some of these operate with charitable status as well, and one organisation is registered only as a charity.

All interviewed organisations have been financing for at least one year, with the majority (59 per cent) having been established during the 2000s; 24 per cent in the 1990s; 6 per cent in the 1980s, and 12 per cent in the 1970s.

International review

In addition, we conducted a review of the US and Western European community finance sectors. We carried out interviews with selected US and European organisations involved in their respective community finance sectors. These interviews incorporate first-hand experience of the local operating environments and help to identify the issues or practices that are particularly effective and relevant to this analysis. Eight to ten interviews were carried out in each region. In total, we carried out over 40 interviews with UK, US and European CDFIs.

International case studies

The report also includes ten case studies of community finance initiatives in the US and the EU. These highlight the different features of community finance organisations, their target group and their core activities in order to identify what aspects of their operation are integral to creating successful interventions in deprived communities. The objective of these case studies is to highlight particular aspects of their activities and operating environment that are instructive for CDF in the UK.

To carry out a review of the US community finance sector, we enlisted the support of the Woodstock Institute, a Chicago-based think tank with significant experience of the sector. In addition, with the CDFA, we visited over 30 US-based CDFIs in Chicago and New York in October 2006 to explore the current themes and issues relevant to this sector. The findings of these in-depth, face-to-face interviews were incorporated into our analysis.

Appendix B: CDFIs interviewed

- Aston Reinvestment Trust (ART)
- Black Country Enterprise Loan Fund
- Bridges Community Ventures
- Bristol Enterprise Development Fund
- Change
- Co-operative & Community Finance
- DSL Business Finance
- East London Small Business Centre
- The Enterprise Fund
- Fair Finance
- Foundation East
- London Rebuilding Society
- Pembrokeshire Lottery
- The Prince's Trust
- Social Investment Scotland (SIS)
- Street North East
- Street UK
- The West Yorkshire Enterprise Agency Limited
- Women's Employment, Enterprise and Training Unit (Weetu)/Full Circle

Appendix C: Interview questions

Demand and marketing

1. How would you characterise the level of demand for the product(s) you offer?
2. What is your estimate of demand for the next 1, 3 and 5 years?
3. Has your organisation carried out market research? If so, what did this indicate about your target client group?
4. Do you think your organisation has a good understanding of demand issues? What are these and how do they affect your business model?
5. How many applications for finance has your organisation received since start-up? In the past 12 months?
6. What marketing strategies have/do you use? Do you feel that they are effective?

Business support and investment readiness

1. Is investment readiness of enterprises an issue? Explain.
2. Do you provide business support? If yes, at what stage and what type?
3. How is business support funded? How does this affect your business model?

Funding

1. What are your organisation's principal sources of revenue and capital funding?
2. What are your main challenges in fundraising?
3. Do you feel funders and policymakers understand the products, services and methodologies you use to reach your target market(s)? Explain.
4. What impact if any will the closure of the Phoenix Fund and other Government sources of funding have on your operations?
5. What impact, if any, will the transition of funding and strategy to the RDAs have on your operations?
6. Are you CITR accredited? If not, why not?
   - If so,
     - Have you raised any investment under CITR?;
     - Are you planning to raise investment in the future?
   - How effective is the CITR in incentivising investment in the sector?
7. What role will commercial sources of finance play in your fundraising? Is commercial finance an option you would consider, why or why not?
8. How easy or difficult has it been to fund your institutional development & capacity building? Explain.

Results/Impact

1. How do you measure your social impact?
2. Do you have a system for performance measurement? Describe.
3. Do you think the sector has common measures of performance? Are these effective?
4. How effective is the sector to demonstrate the social outcomes it achieves?

Regulation & Reporting

1. Is existing legal and financial regulation sufficient for the community development finance sector?
2. What form should regulation take, if any? What impact would this have on the sector?
3. Are there sufficient standards for regular reporting in the community development finance sector?
4. How effective is the CDFA to review and report on the performance of its members?
5. Could transparency for the sector be improved, if so how?
6. Is there a common understanding of best practice for the sector?

Sustainability

1. To what extent do you think effective community finance institutions should be operationally sustainable? Why is it important or not?
2. What factors determine how achievable sustainability is?
3. How does the provision of business support and training (if applicable) affect your ability to achieve sustainability?
4. How does meeting the needs of your particular target market affect your ability to achieve sustainability?
5. What are the biggest constraints your organisation faces to achieve operational sustainability?
6. What sustainability strategies have you considered e.g. market diversification, income generating activities, partnerships, cost-sharing, increased cost-efficiencies?
7. How does the policy environment in the UK affect (or not) your potential sustainability?
8. In your opinion, how much importance the government and funders give to the operational sustainability of CDFIs? Is this justified?
9. Is achieving scale important to you? What strategies have you considered to make it happen?
10. How reasonable is the focus on scale? Is there a limit to the scale a CDFI can achieve without losing its roots in the community? What are the advantages and disadvantages of scale? How will achieving scale affect your ability to achieve social outcomes?
11. What are the main challenges your organisation will have to face in the next 5 years?

Policy environment

1. How would you describe the present policy environment for community finance in the UK?
2. Generally, are CDFIs seen as effective institutions by funders and policymakers? Why or why not?
3. What could Government do better to promote the CDFI sector?
4. Are there any aspects of policy that are lacking at the moment which would facilitate CDFI activity?
5. Does the CDFA represent its members effectively at a policy level?
6. How would enhanced bank disclosure on lending into disadvantaged areas affect your operations?
7. What role do commercial banks play for the community development finance sector?
8. Do you work in partnership with commercial banks, and if so, how?
9. Are commercial banks sufficiently active to meet the needs of disadvantaged communities?
10. How could UK banks better engage with issues of financial exclusion generally, and with CDFIs in particular?

Appendix D: Policy survey questions

The policy survey contained a set of statements regarding community development finance, grouped in thematic sections. First, respondents were asked to indicate whether they agreed with the statement. Second, respondents were asked to rank the level of importance of the issue in question to community development finance in the UK.

Answers were chosen from: Disagree; Somewhat disagree; Neutral; Somewhat agree; Agree; and Don't know

1. Vision

Q1 Community Development Finance (CDF) is recognised as an important part of the UK financial system.

Q2 CDF is recognised as an effective means to address access to finance and bring about regeneration and local development.

Q3 Community development finance institutions (CDFIs) are viewed as social enterprises balancing their social mission and business activities.

Q4 Key actors understand that entrepreneurs in deprived areas want and need rapid, simple access to financial and non- financial services.

Q5 Key actors recognise that the socially and financially excluded are good clients, repaying their loans on time.

Q6 Key actors use common standards for measuring CDF performance.

Q7 Key actors recognise the importance of the diversity of CDFIs in order to respond to local market conditions.

Q8 Key actors recognise the need for a balance between economies of scale and the ability to retain genuine local/community links.

Q9 Key actors recognise that business support, along with finance, is a key component in ensuring a CDFI's success in achieving its mission.

2. Policy

Q1 The UK policy environment is supportive of CDF.

Q2 CDFIs, their goals, diversity of structures and finance delivery mechanisms are well understood by policymakers.

Q3 The CDFA is a strong trade association that effectively represents its members' interests.

Q4 Appropriate tax treatment is provided to encourage the development of CDF.

Q5 The Community Investment Tax Relief (CITR) is well designed to provide finance to CDFIs.

Q6 The CITR helps CDFIs to achieve sustainability.

Q7 CDFIs can and are willing to charge the interest rates needed to cover the high costs of making small loans.

Q8 The structure of the benefits system facilitates the work of CDFIs to encourage disadvantaged individuals to engage in enterprise.

3. Effectiveness

Q1 CDFIs are effective institutions for the provision of finance and non-financial services to enterprises in disadvantaged areas.

Q2 CDFIs have a positive impact on disadvantaged communities.

Q3 CDFIs are critical institutions to address financial exclusion.

Q4 The enterprises CDFIs support can make a real difference to revitalise disadvantaged communities.

Q5 CDFIs have strong links to their local communities.

Q6 CDFIs are now of a scale to make significant impact on enterprise in disadvantaged communities.

4. CDFIs

Q1 Board members of CDFIs have the vision, capacities and clarity needed to support CDFIs in becoming strong institutions with significant reach and impact.

Q2 CDFIs are scaling-up and are mobilising resources to develop the sector.

Q3 CDFIs are strengthening their institutional capacity and are training their staff to build a business-like organisational culture.

Q4 CDFIs have agreed common financial & operational performance standards that serve as the criteria for government and donors in providing financial support.

Q5 CDFIs have agreed common social impact standards that serve as the criteria for government and donors in providing financial support.

Q6 CDFIs that are not able to meet the industry standards for successful operation stop their activities.

Q7 The CDFI sector has a strong core group of institutions that represent best practice.

Q8 As CDFIs develop they offer a wider range of services to their target markets.

Q9 CDFIs serving high-risk entrepreneurs have built organisations and loan-delivery systems that enable profitable operations.

5. Sustainability

Q1 With the right support, CDFIs could be of a scale to make significant impact on enterprise in disadvantaged communities.

Q2 Greater scale is critical to achieving a higher degree of sustainability.

Q3 It is important for CDFIs to achieve operational sustainability.

Q4 A CDFI's sustainability should be judged against its social outcomes, which may justify some level of use of grants and subsidies.

Q5 In the future CDFIs will increasingly adopt non-grant forms of finance.

6. Regulation

Q1 Legal and regulatory structures exist to ensure soundness and stability of CDFIs.

Q2 A self-regulating legal system for CDFIs would be appropriate.

Q3 There are sufficient and appropriate reporting requirements for the CDFI sector.

Q4 Guidelines exist on good governance and management of CDFIs to generate needed credibility.

Q5 The legal and supervisory framework for CDFIs responds well to the different sizes and structures of the organisations.

7. Government

Q1 Government bodies responsible for financial sector policy-making assist CDFIs by providing supportive policies and financial resources.

Q2 Government funding of CDF has been positive and effective.

Q3 Government has given appropriate attention to increasing the institutional capacity of CDFIs.

Q4 The Phoenix Fund was well designed and effectively met the needs of the sector.

Q5 The Growth Fund is well designed and effectively meets the needs of the sector.

Q6 The devolution of oversight to RDAs has been a positive step and will improve the sector's ability to address problems of access to finance.

Q7 In building policies, regulations and incentives CDFIs that serve the financially excluded, policymakers encourage a wide range of institutions-large and small, traditional and untraditional, existing and new-to build sound, responsive financial services for the financially excluded.

8. Banks

Q1 Commercial banks and other traditional financial intermediaries are committed to CDF and to the development of this market.

Q2 Traditional financial institutions increasingly recognise CDF as a potential market, and try to serve it.

Q3 Commercial banks have undergone the significant changes in attitudes, organisation and lending technologies that enable them to play major roles in CDF.

Q4 Commercial banks are proactive in seeking to partner with CDF initiatives.

Q5 Commercial banks provide significant funding and support to the CDF sector.

Q6 Commercial banks keep and disclose sufficient information about the markets they serve.

9. Funding

Q1 Funders see that CDF is about long term investment in people and institutions, rather than short term projects.

Q2 CDFIs are able to access appropriate funding to allow increased outreach and growth.

Q3 CDFIs are now moving towards non-grant forms of finance.

Q4 Funders understand that many different methodologies and legal structures provide effective CDF services to the financially excluded.

Q5 Funders have in place cost-effective, non-bureaucratic mechanisms that enable support for institutions.

Q6 Funders provide financial and other support in a form that fosters increased institutional capacity.

Further reading

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Advisory group

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- Bernie Morgan, Chief Executive Offices, CDFA
- John Cray, Department of Work and Pensions
- Dr John Taylor, Director, **nef** consulting

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17 The experience of Street UK and Aspire to develop micro-credit lending portfolios provide relevant lessons for this market, namely that: the market size for micro-lending is smaller than anticipated and standalone micro-lending cannot achieve self-sufficiency. For the full recommendations see: Esmee Fairbairn briefings "Aspire – Microloans for Business," April 2006 and "Street UK: Learning from Community Finance," April 2005.

18 CDFA (2005) op. cit.

19 **nef** (2004) *Attracting clients: the challenge of marketing CDFIs in the UK* (**nef**: London).

20 SEEDA (2006) *Financial Exclusion in the South East of England* (SEEDA: Guildford).

21 Small Change has found a clear relationship between average loan sizes, term, portfolio outstanding and sustainability. CDFIs with portfolios outstanding of over £300K have sustainability of between 20 – 60 per cent. CDFIs with portfolios of less than £300k have sustainability of less than 20 per cent.

22 CDFA (2005) op. cit.

23 Source SITF quote

24 A representative of the Royal Bank of Scotland emphasised the important of public funding: "Government support – at a national and regional level – has and always will continue to be critical. Without addressing such market failure, banks would continue to find it difficult to support the very organisations that help those that banks can't." '£11m Eleventh Hour Rescue for CDFI sector', *Social Enterprise*, February 2006, p. 5.

25 The Growth Fund was proposed by the Chancellor of the Exchequer in 2004 to provide a £36 million fund to reduce personal financial exclusion through affordable personal loans via third sector lenders. CDFIs are increasingly incorporating personal lending into their work as a result of both personal finance demand and funding available to address it.

26 CDFI Data Project, *Providing Capital, Building Communities, Creating Impact.*

27 Ibid.

28 Recent news in this area is not all bad for CDFIs however. After years of trying to unsuccessfully zero out the CDFI Fund appropriation, the Bush Administration has recognised the bi-partisan support for the Fund in Congress and included a real, though modest appropriation for the Fund in the President's 2008 budget proposals. It is likely that the line item will be increased substantially by Congress during the budget negotiations. Moreover, the major threat to CRA, the Office of Thrift Supervision reducing the incentive for large banks to make community development investments, has been rescinded and the OTS has now fallen back into line with the other three federal bank regulators preserving the investment test for large banks.

29 Moy K, Okagaki A (July 2001) 'Changing Capital Markets and Their Implications for Community Development Finance' *Capital Xchange* (Brookings Institution: Washington DC).

30 Zielenbach S (2004) 'Measuring the Impact of Community Development' *Communities and Banking Fall*: 3-9 (Federal Reserve Bank of Boston: Boston, MA).

31 Ratliff G, Moy KS (December 2004) 'New Pathways to Scale for Community Development Finance' *Profitwise News and View* (Federal Reserve Bank of Chicago: Chicago, IL).

32 Internal ARC data on Development Venture Capital Funds in Appalachia.

33 Douglas P, Sirull B, November P (May 2006) 'Development Investment Capital: Three Steps to Establishing an Asset Class for Investing in Underserved Markets' (Pacific Community Ventures: San Francisco, CA).

34 PCV (April 2006) Report on Pacific Community Ventures Business Advisor services: Advising for Change (PCV: San Francisco, CA).

35 European Commission (2003) *Microcredit for small businesses and business creation*.

36 While there are various community finance institutions in Western Europe, they are more commonly known as 'microfinance', which we will use throughout this section.

37 Underwood T (2006) *Overview of the Microcredit Sector in Europe* (European Microfinance Network: Paris, France).

38 The EU15 are the fifteen European Union members prior to the recent accession of Eastern European nations in 2004 and 2007.

39 SBS Household *Survey of Entrepreneurship* 2005

40 Flash Eurobarometer *Survey on Entrepreneurship* 2004.

41 Working Group One Final draft report.

42 Evers J, Lung M, Lahn S (2007) *Status of microfinance in Western Europe* (EMN: Paris, France).

43 EMN, MFC and CDFA (2006) Working Group One on 'Social and financial exclusion map'. '*Exclusion to Inclusion through microfinance: learning from East to West and West to East.* This programme is also known as the East-West Exchanges on Microfinance.

44 Fisher T, Bush T, Guene C (2001) *Regulating microfinance: a global perspective* (**nef:** London) in association with INAISE and the Woodstock Institute.

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This report was written by Jessica Brown and Sargon Nissan of the Access to Finance team at **nef** (the new economics foundation). Geoff Smith of the Woodstock Institute and Maritza Tucker, Independent Consultant carried out the US and European case studies.

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