

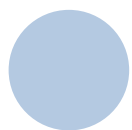


UK CDFIs – from surviving to thriving: realising the potential of community development finance

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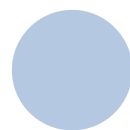
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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping 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.



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Executive summary

An earlier report from **nef** (the new economics foundation) – *Reconsidering Community Finance* (2007) – demonstrated that policy support for Community Development Finance Institutions (CDFIs) is failing. Examining the sector overall, the report highlighted the key policy areas that needed to be addressed, and argued that further research to look at practical issues faced by specific CDFIs was needed.

This latest report – *UK CDFIs: from surviving to thriving* – examines the extent to which the CDFI movement is fulfilling its original purpose to provide affordable finance to disadvantaged communities. We determine this by analysing the experience of four case study organisations. We consider this question in the context of the varying demands being placed on CDFIs by both policy-makers and funders.

We argue that the failure of the sector to realise its full potential lies in the conflicting demands placed upon CDFIs. The core functions of CDFIs – outreach and regeneration – cannot be easily reconciled with financial sustainability. The operating practices of CDFIs and the realities faced by the communities they serve mean that they are seeking to generate long-term social benefits, rather than financial profits.

In this study we address the following questions regarding the UK community finance sector:

- **What do CDFIs currently do?**

We provide a snapshot of the current market size and structure of CDFIs, the prevailing business models used and the activities currently undertaken by them.

- **What was the original purpose of CDFIs?**

We consider the original expectations for the sector, particularly in policy terms, in order to understand the evolution of CDFIs and address the challenges of sustainability, outreach, community linkages and regeneration.

- **Where have CDFIs ‘strayed’ from their original purpose?**

We ask what prospect there is for CDFIs to achieve financial sustainability while continuing to foster regeneration and provide essential support to hard-to-reach members of society.

- **What do CDFIs need to balance the competing demands placed upon them?**

Drawing on our case studies, we outline strategies used to balance the pressures CDFIs are under, both to identify lessons that CDFIs can draw upon, and to recommend how other stakeholders can better support community finance to achieve its goals.

The report concludes with a set of practical recommendations to enable CDFIs to achieve a step-change in both effectiveness and impact.

Key findings

CDFIs are lacking a political champion. Support for the sector is disappearing. Without political support, we estimate that 54 per cent of CDFIs will cease to lend

to microenterprises (lending below £10,000), which made up 76 per cent of CDFI clients in the past 12 months.

The role of CDFIs as social enterprises designed to support deprived communities through microlending imposes critical constraints on their ability to be profitable and financially independent.

CDFIs should strive to increase efficiency and not be wasteful with funds; full financial sustainability will only be achievable for some segments of the sector.

CDFIs have diverged from the remit they were designed to fulfil: to assist regeneration and to reach disadvantaged clients denied credit. Without funding, they are being pushed to generate financial profits at the expense of outreach.

CDFIs need more funding to professionalise their operations if they are to focus on their core business of providing affordable credit. Banks appear to think that this is the job of Government, and Government thinks that CDFIs should find funding for these activities from private investors, such as banks.

With the drying up of public funds, CDFIs will become wholly dependent on income generated from their interest rates, and/or on private sector investment, potentially threatening the social outreach.

In some cases, CDFIs are developing considerable sophistication and organisational maturity, with the capacity to absorb commercial funds and to pioneer new social financing models. But most CDFIs, and the sector as a whole, have yet to build a reputation and a track record sufficient to instil confidence in investors.

Current mechanisms for CDFIs to leverage in private funding, such as the Community Investment Tax Relief (CITR) and Small Firms Loan Guarantee (SFLG), are underutilised because these schemes do not provide the necessary scope to incentivise private investment. There is a need to improve these social investment instruments as a means of attracting finance to CDFIs in the future.

It was originally envisaged that the banking sector would be a natural ally of CDFIs in terms of funding, investment and referrals; however, strong partnerships are yet to emerge as a norm for the sector.

Banks are not required to engage with CDFIs. A target culture for branches and regional managers discourages voluntary commitment beyond what is seen as necessary, and as directed from above. The current voluntary approach has made very little impact on the sector. This requires far stronger legislation and incentives that will compel banks to co-operate with CDFIs.

If CDFIs are to reach out to excluded groups, social returns on investment need to be emphasised much more strongly. Current impact measurement, as reported by our case studies, usually does not go beyond the basic requirements of funders.

Recommendations

The CDFI sector continues to grow, showing signs of increasing maturity. Older CDFIs in particular are becoming more sophisticated in their business models and the measurement of their impact. But the sector as a whole is suffering from underfunding and a decline in public support.

The existing policy framework and dwindling funds will push CDFIs away from their core social objective to help disadvantaged individuals through microlending. The Government needs to acknowledge that different business models, some of which have greater social than financial returns, can work. CDFIs require appropriate and ongoing public support to succeed.

In light of the credit crunch and the growing need for fair finance, the sector requires renewed policy support. To justify this, CDFIs need to continue to improve their financial performance, better measure their social impact, and crucially, to communicate their achievements. CDFIs have demonstrated that they have the

power to advance local businesses and create employment opportunities. This expertise can be used to tackle the growing challenges of financial exclusion.

Our recommendations of what CDFIs need to fulfil their potential are as follows:

Community Development Finance Association (CDFA)

- More urgency is needed to develop a monitoring and evaluation framework that clearly demonstrates the social impact of CDFIs, so that a track record of best practice and social effectiveness can emerge. This should be a priority for the CDFA, and should be funded externally to support take-up.
- The CDFA should carry out an audit of Regional Development Agency (RDA) strategies and support, to identify where additional regional funding or partners may be required

Government

- There should be renewed financial support adapted to the varied needs of CDFIs offering microfinance. If the vital social role played by these organisations is to continue, it needs to be recognised, valued and funded on an ongoing basis.
- Government should adapt CTR and SFLG to meet the needs of a broader range of CDFIs. Reforms of SFLG have resulted in CDFIs becoming eligible for accreditation. Government would need to increase the scope of SFLG and remove the current barriers that reduce the usefulness of SFLG to the sector. Restrictions on loan sizes and on the age of businesses that are eligible should be removed.
- The Government should also adapt its regeneration strategies to reflect a broader definition of goals. For example, it should use new indicators to measure the creation of micro-enterprises or increases in self- or part-time employment that CDFIs can contribute to. This would take into account and value the social change created by CDFIs.

RDAs and Local authorities

- RDAs should work towards a 'joined-up' strategy to build the range of financial services required to combat deprivation. These are rarely offered by any single institution and not uniquely by CDFIs. A successful strategy requires partnerships between local organisations, such as banks, development trusts, credit unions, housing associations and debt advice agencies.
- RDAs should accommodate the needs of CDFIs that serve diverse market segments at the subregional level.
- RDAs should broaden their remit to focus on both regeneration and social outreach objectives when supporting CDFIs.
- Local authorities should work together with CDFIs to achieve their obligations to central Government. For example, the fulfilment of public service agreements on housing could be achieved through CDFI home-improvement loans.

Banks

- Banks should more actively invest in community finance. They should be required to meet the needs of all members of society, including the poor and financially excluded.
- Legislation may be required to compel banks to co-operate with and invest in third sector finance organisations. The ongoing credit crunch and the public money banks are receiving highlight the fact that they occupy a privileged position in the economic system – it is not unreasonable to expect them to 'give something back' to society in exchange for these benefits.

- Banks should provide technical and financial support to help CDFIs build the required infrastructure to become more professional in their dealing with banks.
- Banks should actively seek to partner with CDFIs, not least to expand their client base as people move successfully from financial exclusion to the mainstream sector. Banks could see CDFIs as a positive extension of their operations as an outreach to build new markets.

CDFIs

- CDFIs are often, and with some justification, criticised for not being transparent and professional enough. Although CDFIs are mostly young and in the formative stage, a minimum level of reporting requirements should be implemented by all.
- CDFIs need to prove their social impact beyond mere financial returns. This requires both training of CDFI staff, as well as greater funding to give CDFIs the means and the capacity to provide these in-depth assessments.
- More CDFIs should seek to become SFLG accredited. A larger SFLG-accredited CDFI could act as a mediator for smaller, regional CDFIs operating in the same area.

Introduction

As the full extent of the credit crunch has begun to emerge, access to credit has become increasingly difficult for disadvantaged communities and financially excluded individuals. The current economic climate and an associated decline in bank approvals have left many in a state of uncertainty over their future.

As banks become increasingly risk averse, they close off access to all but the most financially solvent individuals and enterprises. The blight of financial exclusion and lack of access to credit is likely to affect many more people than was previously the case. Excluded groups, including the self-employed and local entrepreneurs, could now find that banks' lending criteria make access to affordable credit difficult, if not impossible. Enterprise lending for small local enterprises is equally scarce.

In this context, the need for strong and growing microfinance organisations, or CDFIs as they are known in the UK, is acute. CDFIs emerged over the past 30 years in the UK as lenders to individuals and enterprises that have been refused credit by mainstream banks. Approval criteria for finance from CDFIs combine the soundness of the business proposal and trust. A vital part of the CDFI mission is community outreach. By providing advice and support alongside affordable finance they help build the aspirations of, and increase opportunity for, people in some of the most disadvantaged areas of the UK.

In recognition of this potential, the Government initially promoted CDFIs as a means of delivering financial inclusion, enterprise-building, and regeneration since 2001. Rhetorical commitment, however, hasn't been matched by a supportive legislative environment, or by sufficient investment. Political backing for CDFIs is waning. Private investment has been slow to increase. As a result, the nascent CDFI sector is underfunded and undersupported.

Funding for enterprise-lending CDFIs is now limited to the RDAs, distributing a small amount of residual funds from the now defunct Phoenix Fund. The Treasury's Financial Inclusion Fund will run until 2011, when this form of support will also stop. This deteriorating funding situation results in great insecurity for these organisations. Many CDFIs have to try to attract private funding as the Government believes that CDFIs should become independent of public support. But it is not clear that community-based enterprises with social objectives can or should be fully profitable.

Because CDFIs haven't received the required support, reality has fallen short of initial expectations. As political support vanishes, CDFIs are moving away from their social purpose of providing finance and support to individuals and organisations in disadvantaged communities to pursue avenues that would provide greater financial returns. The sector is continuing to grow modestly overall, but the path ahead is unclear.

CDFIs face a challenge to continue to provide an important service to their clients. They contribute to financial inclusion, regeneration, and social change for disadvantaged communities. Yet the importance of CDFIs to provide these outcomes is no longer viewed in the same light in policy-making circles.

Case studies: choice and brief overview

The four case studies – which were chosen to reflect differences in business models, market coverage, operational areas, and age – are as follows:

- **Aston Reinvestment Trust (ART), Birmingham**

Founded in 1997, ART is a pre-Phoenix Fund organisation that specialises in lending to businesses and social enterprises between £10,000 and £50,000. ART was chosen because of its longevity, its experience and success in leveraging in funds from the private sector, as well as its engagement with policy-makers.

- **Business Enterprise Fund (BEF), Bradford**

Operational since 2004, BEF lends to start-ups and existing businesses in Bradford, Leeds and North Yorkshire. Loans range from £500 to £30,000. BEF has a very unique business model, charging its clients mandatory fees for mentoring services that the organisation sees as central to its success. BEF is also part of the Local Economic Growth Initiatives (LEGI) strategies¹ in Bradford and Leeds, and hence an interesting case study for an organisation embedded in local regeneration.

- **Fair Finance, London**

The organisation is both a personal and a business lender. Operational in East London since 2005, Fair Finance is looking to expand its business lending services throughout the capital. Fair Finance was chosen as a case study as it has very good reporting practices, and because it engages in peer-group lending through partner organisations. It is also an organisation that advocates access to finance to redress social injustices rather than as part of a larger, enterprise-led regeneration drive. Lastly, it is an interesting variation of the 'money-line model', a popular business model among CDFIs combining personal and business lending with financial advice.²

- **Wessex Reinvestment Trust, South West England**

Founded in 2002, WRT has a group structure, comprising an industrial and provident society, a charitable trust, a limited company and a reinvestment loan fund. It focuses on the rural economy by supporting sustainable development and social enterprise. This includes enterprise lending and loans for home improvement as well as support to sustainable, local, food-production enterprises and networks. Apart from its rural focus, WRT is notable also for its commitment to innovative structures and financing models.

The case studies have differing operations and represent examples of the diversity of the sector. This is summarised in Table 1.

Appendix A contains the full case studies; we recommended that the reader refer to them while reading this report.

Table 1: Characteristics of case studies

CDFI	ART (West Midlands)	BEF (North of England)	Fair Finance (London)	Wessex Reinvestment Trust (SW England)
Microloans (up to £10,000)		X	X	X
Small enterprises (up to £50,000)	X	X	X	X
Medium Enterprises (over £50,000)	X			
Social Enterprises	X	X	X	X
Finance Brokerage	X	X	X	
Pred. Rural				X
Pred. Urban	X	X	X	
Consumer Loans			X	
Housing finance				X
Business advice in-house	No	Formal	Informal	Formal
Geographic coverage	Birmingham and North Solihull	Bradford, Leeds, North Yorkshire	East London/ London	11 Councils in the South West

What was the original rationale for CDFIs?

The CDFI target market and the way in which CDFIs approach their activities are quite varied. In part, these differences reflect the local and complex circumstances of regeneration and financial exclusion faced by different CDFIs.

However, CDFIs were originally designed to undertake particular *common* functions. They were founded as a means to channel credit to disadvantaged communities in order to spark a process of neighbourhood renewal through enterprise development. Access to small loans with business support was designed to provide affordable credit to low-income or deprived individuals, stimulating new opportunities and local economic development in disadvantaged communities.

The emergence of the CDFI sector

CDFIs have a long history. Many institutions existed before the late 1990s and early 2000s when the sector developed. This report concentrates on this more recent period because it coincided with official recognition, policy initiatives and financial support. The policies developed to support CDFIs to achieve goals of financial inclusion and local economic regeneration have also had unintended consequences, making the task of CDFIs more difficult.

The recognition of the value of CDFIs in enterprise promotion, regeneration and financial inclusion emerged in 1998, when the Prime Minister's Office established a range of Policy Action Teams via its Social Exclusion Unit. This saw the birth of the Social Investment Task Force in 2000, which made a series of recommendations to support development of community finance. This was the basis for subsequent policy initiatives, including the establishment of the trade association, CDFA, CITR, and the inclusion of CDFIs in the Small Business Service's Phoenix Fund targeting regeneration.

What are the key functions of CDFIs?

The CDFA defines CDFIs as follows:

*'CDFIs are sustainable, independent organisations which provide financial services with two aims: to generate social and financial returns. They supply capital and business support to individuals and organisations whose purpose is to create wealth in disadvantaged communities or underserved markets.'*³

The specific functions originally envisaged for CDFIs can be broken down in three areas:

i) *Outreach: providing affordable credit, financial business support and training to disadvantaged individuals, communities and underserved markets to create new opportunities for enterprise or employment.*

Continuing evidence of inequality, and social and economic deprivation led to the championing of community finance as a tool to reach marginalised and financially excluded individuals and communities. Deprivation is exacerbated by lack of access to basic financial services and affordable credit. This is particularly true for local, small or self-employment enterprises, which can have positive knock-on multiplier effects via job creation and asset-building within a community. CDFIs can play a role in developing an enterprising culture among out-of-work, underskilled, or economically inactive individuals.

1997	Social Exclusion Unit established to address poverty
1999	Poverty Action Teams on enterprise finance and financial exclusion
2000	Social Investment Task Force is convened with first recommendations for the sector
	First Phoenix Fund bidding round is conducted
	CITR is established to attract greater investment into the sector
2006	The Phoenix Fund is discontinued and remaining funds are transferred to Regional Development Agencies

In its current enterprise strategy, the Government specifically mentions the importance of CDFIs in this area, and states that policy-makers should pay attention to this when developing new strategies for enterprise development.⁴ It thereby gives weight to the 'outreach' component of the contribution of CDFIs towards creating social and financial inclusion. CDFIs are tools to improve the local economy as well as agents to build a stronger community.

ii) Regeneration: investing in disadvantaged communities to create local economic development and generate both social and financial returns.

CDFIs work to benefit communities through creation and support for local enterprise. The Government has long promoted regeneration through enterprise creation in deprived areas. For example, LEGI is an £283-million initiative to release the potential of deprived local areas across the country with a strategy of enterprise development and investment to boost local incomes, increase employment opportunities, and build sustainable communities. The current Government also established RDAs, designed to 'create prosperity across England' and which now have policy responsibility for CDFIs within their region.⁵ A series of government initiatives also sought ways to leverage in private monies to regenerate physically deprived areas. CDFIs which received funding were expected to target these same areas of 'multiple deprivation' and support regeneration by channelling credit to aspiring entrepreneurs in these communities.

There is an important distinction between CDFI activity for social outreach and that for regeneration. Outreach can help an individual and his or her immediate family to increase their income and build skills and job confidence, whereas enterprise-led regeneration aims to increase the number of enterprises and jobs in a specific area.

iii) Sustainability: CDFIs should operate over the long-term and be financially independent in order to be free to work for their community's benefit; able to grow the scale of their operations and therefore their impact.

An important part of the original rationale for supporting CDFIs was that they should become financially sustainable. The lack of access to finance by excluded groups was seen as a result of the lack of supply of appropriate finance, related to the consolidation of the banking sector and wholesale branch closures, particularly in disadvantaged areas. The underlying assumption was that it is not profitable to provide financial services to certain groups in society, and therefore constitutes a form of market failure that justifies public intervention. Sustainability would, in theory, allow CDFIs to increase their impact by reaching a greater number of individuals, as well as allowing more investment in regeneration, where access to commercial finance could sustain this growth.

Despite its importance, however, sustainability remains poorly defined and its meaning contested. In the context of community development finance it is typically taken to mean financial sustainability, i.e. the ability to cover costs through revenue generated from loans. Different meanings of 'sustainability' are also used, particularly with reference to the ability of CDFIs to fund viable and sustainable

businesses. This 'mission-driven' or 'social concept of sustainability' stresses the *outcome* of the work of CDFIs, where CDFIs offer a sustainable solution for their community or indeed *society*, facilitating enterprise creation, reducing unemployment, and increasing financial and social wealth.

We use the following definitions throughout the report:⁶

Financial sustainability refers to full sustainability, where all costs are covered through revenue generated from the loan operations.

Operational sustainability means that a CDFI has sufficient capital to fund its lending activities, but requires support to cover its overhead costs.

Mission-driven sustainability refers to the social outcomes of CDFIs in a broader sense, where funding may be seen in the context of benefits to society of reduced benefit claimant numbers or increased entrepreneurial activity, for example.

What do CDFIs do and where do they diverge from their original remit?

CDFIs are evolving along different lines, with the business models varying considerably, as do other aspects such as market size and geographic coverage.

The latest annual survey conducted by CDFA among its 74 members, *Inside Out 2007*, provides a valuable insight into these patterns and trends. This last CDFA report describes a slow maturation of the sector, with few new CDFIs founded since 2005, the year of the last survey.⁷

Typology – lending practices

CDFIs are generally divided into two categories – enterprise lending and personal lending. These boundaries are often quite blurred, however, especially for providers of small-sized loans. The Moneyline CDFI model for business lending, for example, is focused more on the individual than on enterprises, with lending concentrated at the lower end of the scale, and maximum loans of around £10,000.

Some enterprise lenders specialise in certain sectors, such as local food, or social enterprises. More generally, however, enterprise lending can be divided into a number of strands:

- Start-up lending
- Finance for existing businesses
- Social enterprise loans

Personal lending may also be sector-specific (or more accurately 'purpose'-specific). As with enterprise lending, there are also distinct strands of lending activity. For example:

- Consumer credit
- Back-to-work loans
- Debt consolidation
- Home improvement

Figure 1: CDFIs by age

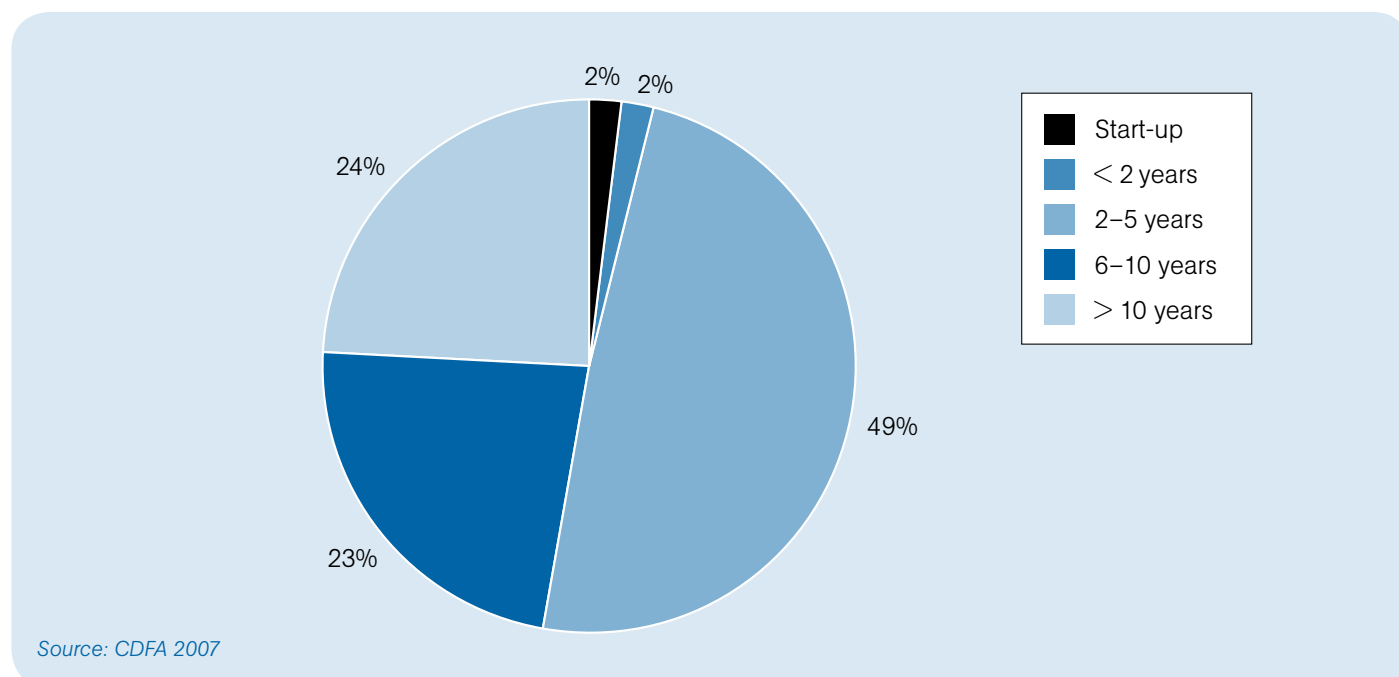


Table 2: CDFI lending types and combinations*

Type	Business lending	Social enterprise	Personal*	Housing**
1	Yes	Yes	Yes	Yes
2	Yes	Yes	Yes	No
3	Yes	Yes	No	No
4	Yes	No	No	No
5	Yes	Yes	No	Yes

* Including: purchases, household goods, personal development (back-to-work), debt consolidation, education loans

** Typically home repair and improvement loans

Table 2 describes the combinations of lending that CDFIs currently undertake.

Fair Finance is similar to the Type 1 Moneyline model, with the exception that it currently does not provide home improvement loans. It is therefore a Type 2 organisation. As with Moneyline providers, Fair Finance focuses on a subregional level, covering several boroughs in East London for its business lending, and all of London for its personal lending. BEF and ART are examples of Type 3 lenders, which focus on business and social enterprise lending, but do not undertake personal lending. Previously, ART did lend for housing through its subsidiary ART Homes (Type 5).

WRT is a Type 5 lender. It provides enterprise lending for businesses and social enterprises, as well as home improvement loans in partnership with a consortium of local councils in its region.

CDFI business lending can be broken down by scale, as in Table 3.

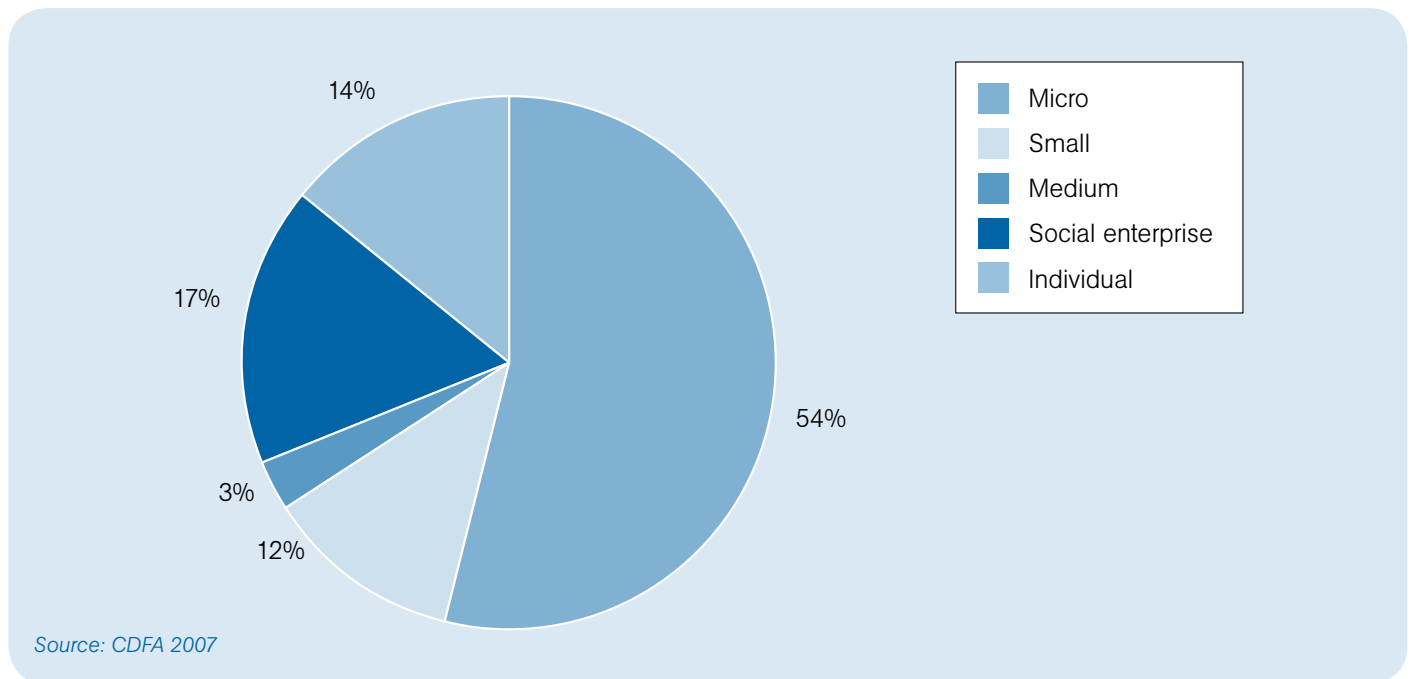
WRT historically operated as a Type A lender, though its current focus is on larger types of loans in particular to social enterprises. BEF is an example of Type B lending. Fair Finance, in contrast, focuses on the smaller-scale sector of the market, and is therefore a Type C lender – though it intends to expand into loans above £10,000 going forward. ART is situated between Type E and Type F, as it seeks to break into the segment of lending above £50,000. BEF and ART have already been part of finance packages that in total exceeded £50,000. With these larger-scale activities, CDFIs and other investors all put in a share of the total sum required, thus spreading the risk of the investment, rather like a syndicated loan in the banking sector.

The CDFA survey describes the proportional split of CDFIs serving these different markets (Figure 2).

Table 3: Business lending subtypes and loan sizes

Type	Start Up	Micro (<10k)	Small (10-50k)	Medium (50-100k)
A	Yes	Yes	Yes	Yes
B	Yes	Yes	Yes	No
C	Yes	Yes	No	No
D	No	Yes	Yes	Yes
E	No	No	Yes	Yes
F	Yes	No	Yes	Yes
G	Yes	No	Yes	No

Figure 2: Key markets



Trends in the sector: reduction of scope and increase in scale

The key trends in CDFI activity across the whole sector can be summarised as:

- A reduction in the provision of formal advice to accompany lending.
- A reduction in the importance of small-scale lending and an accompanying rise in that of larger-scale lending.
- A widening of the geographic scope of CDFIs.

Overall the CDFI sector is growing. CDFI capital and loan portfolios have grown over the last four years, with a strong increase between 2005 and 2007.⁸ Total capital assets stand at £569 million and the loan portfolio at £287 million.

Lending to micro-enterprises is decreasing in importance, with a corresponding shift to lending to larger enterprises. In terms of business size, the biggest increase in lending is for medium-sized enterprises, where the loans disbursed in the past 18 months between 2005 and 2007 increased from £795,800 to £3.2 million, or by over 300 per cent. Microlending as a share of total lending dropped by two per cent, with the value of loans disbursed in the last reporting period (2005 – 2007) dropping by nearly one per cent. This indicates an increase in average loan sizes in this sector. In addition to their lending operations, many CDFIs have also provided pre- or post-loan budget and business advice. However, CDFA data show that there has been a reduction in these activities, with more and more CDFIs concentrating on their core function of lending.

Another significant trend in CDFI lending is the increase in geographic market size: the majority of CDFIs now focus on subregional or regional markets (44 per cent), with declining numbers of CDFIs operating in only one city (five per cent). By contrast, in 2005, only 33 per cent of CDFIs covered regional and subregional markets, and 10 per cent of organisations were operating in one town/city only.

The types of business model in the sector continue to vary widely, reflecting the very different histories of CDFIs, the complexity of the markets they serve, and a combination of sector-wide issues that influence the shape of CDFIs. Sector-wide influences include the original policies detailed above, as well as changes in government funding priorities to combat financial exclusion. Specific drivers include differences in funding and operating environments, variations in RDA strategies, and local circumstances unique to a CDFI's area of operation.

A key aspect of CDFI social provision is the offer of business advice, which often

reveals critical differences in how CDFIs manage the different aspects of their remit. Advice provision depends heavily on a CDFI's business and funding model. Our case studies display contrasting approaches to such provision.

BEF has the most unique funding model in this area. It charges its clients mentoring fees for access to a package of services provided by BEF. Clients are assigned a business buddy or business mentor, get access to SAGE accounting software, and to the services of an accountant and a lawyer if need be. The rationale is to ensure that problems are detected early, and to build clients' capacity. The compulsory nature of the programme is also used as a filtering mechanism, designed to ensure that clients are serious about their business, and will not give up at the first hurdle. BEF therefore see this service as vital to the success or failure of its clients' businesses.

Fair Finance, in contrast, receives funding from the Department for Business, Enterprise and Regulatory Reform (BERR) for face-to-face debt advice as part of the Financial Inclusion Fund (for personal lending), and has strong partnerships with several housing associations as part of its *Money Matters* programme. The organisation receives funding for helping tenants with rent arrears and debt problems, which often results in these clients taking out loans from Fair Finance rather than door-step lenders or even loan sharks. For Fair Finance, therefore, the advice it offers tends towards further outreach rather than sustainability, as with BEF.

WRT, as a collection of entities, has funding and income from diverse sources. However, it remains very much dependent on public funding, in particular post-Phoenix funds provided by its RDA to the sector. Through its charity, WRT, receives grant income and the group also benefits from the *Decent Homes* initiative, receiving operational funding from a consortium of 11 councils to provide loans for home improvements.

Despite their differing motivations, in all three cases the advisory services are not funded through interest rates, which would result in a sharp increase in the cost of loans. In the past, ART has tried to provide business advice for free through a subsidiary structure, but abandoned this as there was very low take-up and it was a drain on its resources.

Current practice and past expectations

We consider the extent to which CDFIs diverge from fulfilment of the three components of their original purpose:

1. Outreach

Although outreach is perhaps the central purpose of CDFIs, sector trends indicate a decrease in CDFI lending to micro-enterprises and a general increase in average loan sizes. Overall, the CDFI movement is struggling to sustain operations most targeted on disadvantaged people – i.e. small-scale lending. Consistent with our case study findings, the difficulty of providing such lending to micro-enterprises in a financially sustainable manner is widely acknowledged. The costs associated with providing a loan are the same regardless of the size of the loan. Consequently, the smaller the loan, the larger the relative costs associated with it, and the more difficult it is to achieve financial sustainability.

One of our case studies, ART, has already ceased lending in this bracket. WRT has re-focused its lending strategy towards social enterprises and the larger-scale financing that represents.

2. Regeneration

The CDFI remit to contribute to regeneration and promote local enterprises requires CDFIs to understand local markets and the barriers to enterprise that exist at local level, but sector trends demonstrate an increase in geographic market coverage that would seem to run counter to this requirement. Some of our interview partners in the West Midlands illustrated this with the example of Business Link: BERR and the West Midlands RDA chose to regionalise Business Link's operations, shifting previously local staff to a regional centre. In the view of our interview partners, this led to a marked deterioration in the local knowledge of staff, reducing the usefulness of advice given by the organisation. When expanding their markets, it

is likely to become more difficult to build the close links to communities that CDFIs were supposed to foster.

3. Sustainability

The definition of sustainability remains ambiguous, but funders, practitioners and policy-makers strongly focus on financial sustainability. There has been a marked decline in both public and private grants available to CDFIs.⁹ The strong emphasis on financial sustainability also encourages CDFIs to prioritise financial reporting over reporting on social impact.

Financial indicators of commercial sustainability are well-understood. Portfolio yields, attrition rates and write-offs can serve as good indicators to assess the extent to which CDFIs are helping profitable businesses. A higher portfolio yield would indicate that CDFIs have good application and screening procedures to assess the viability of business proposals. Data is still in very short supply, however, in particular to reveal the wide range of performance amongst distinct CDFIs.

The trends to larger loan size and greater geographical spread are intimately related to pressures towards financial sustainability. These strategies seek economies of scale and thus lower relative unit cost.

The prioritisation of financial sustainability, however, can run directly counter to the goal of social outreach. By gravitating towards the larger, more profitable segments of the market, CDFIs may well increase their financial sustainability at the expense of their social mission. For regeneration, the picture is more complicated. However, the increase in geographical scope necessarily reduces the ability to forge strong local linkages based on good local knowledge without the requisite increase in staff numbers, which can contribute to costly overheads and erode sustainability.

What is clear is that the expectation that CDFIs should target each of these three original goals simultaneously neglects the context in which CDFIs operate. This ignores the basic tensions between seeking to achieve each of these aims. In short, if financial sustainability is to be reached, this may be at the expense of social outreach.

Aligning core mission with practice

The trends described above suggest that CDFIs have, to varying degrees, moved away from their outreach mission and to a lesser extent from that of regeneration. This appears to be an inevitable consequence of the drive towards financial sustainability.

The requirement that CDFIs function as agents of regeneration that provide outreach in a financially self-supporting manner creates important challenges and trade-offs.

Outreach

Faisal Rahman from Fair Finance summed up the problem of the financially excluded very neatly: mainstream banks and lenders provide mainstream products. The rich and the poor, however, require products that are more flexible and tailored to their needs. The rich are able to pay for these custom-made products, whereas the poor either cannot access appropriate services, or pay hefty fees and fines if they can.

What is clear is that 'outreach' should not mean that CDFIs should provide every applicant with a loan. Building the confidence to start a business is a long-term process and CDFIs are not able to do this alone. Fair Finance's partnership with StreetCred is a good example of how this task could be shared. StreetCred, a women's business advice organisation in East London, uses group-support and group-lending methodologies to build its clients' skills, knowledge and confidence. When they are ready, they can apply for a loan that is then disbursed and administered by Fair Finance. In this way, both organisations can focus on their particular area of expertise.

CDFIs should not be seen as an easy way for people to obtain credit, and the rejection of an application is not necessarily simply a question of profit over social mission. Applicants may lack business experience and core skills that loan finance alone will not address. This is where CDFIs can play a key role, provided they have the funding to support this costly work.

Regeneration

Policy to support CDFIs was partly built on their potential role in promoting regeneration by supporting local enterprise. The Phoenix Fund supported enterprise-led regeneration by funding CDFIs and other enterprise-related activities. Expectations were high, not least in the role that CDFIs could play. However, accounting for this impact has been constrained by the capacity of CDFIs, and the challenges inherent to analysis of deprivation. See Box 1 for a brief exploration of enterprise-led regeneration (ELR) policy and its relevance to CDFIs.

CDFIs often cover large areas with different levels of wealth and deprivation. At present, mapping the location of CDFI-funded enterprises is only being done in small regions, and usually is not mapped against the Index of Multiple Deprivation (IMD).¹⁰ The impact a business will have on the local economy will strongly depend on the type of business, the number of jobs created or retained, and on the business practices of the entrepreneur.

Government and some funders underestimate the challenges many CDFI clients have to overcome, which contributes to an overly narrow definition of success or failure. Especially with start-ups, clients often come from backgrounds and circumstances that act as barriers to entrepreneurship. As our interview partners from Fair Finance and BEF (both lending in this field) pointed out, clients from deprived areas frequently are lone parents, have or have had drug problems, or have been in trouble with the law, quite apart from absent financial or entrepreneurial skills.

Box 1. Enterprise-led regeneration: a simplistic concept for a complex issue?

The role ascribed to enterprise for the goal of regeneration by policy-makers has had significant implications for the CDFI sector in the last decade. The creation of CDFIs and the support they received from CITR and the Phoenix Fund was based on the perception of their potential as catalysts of regeneration.

There is a need, however, to update what entrepreneurialism and growth mean, and re-consider the effectiveness of enterprise-led regeneration (ELR) policies. Different elements of disadvantage, such as limited skills, lack of empowerment, limited access to opportunity and limited job options are just as relevant to consider as is financial disadvantage. This re-appraisal indicates that CDFIs can have a role in generating the social and human capital necessary to address disadvantage. These factors, however, are not addressed by overwhelmingly growth-orientated policy measures.

Enterprise and entrepreneurship have been viewed too narrowly by policy-makers;¹¹ they over-emphasised the importance of picking high-growth 'winners' to drive regeneration resulting in lost opportunities for employment creation and wider social benefits. Neglecting to understand deprivation in all but narrow economic terms also leads to the misrepresentation of the wide benefits of CDFIs. ELR policies imply that meaningful development is solely the achievement of narrow economic targets of job and business creation. The limitations of disadvantage mean that a growth-only focus of regeneration policy is unrealistic and will not abolish this disadvantage.

Support for regeneration needs to be long-term. A 2003 review of business-led regeneration reiterated the importance of non-financial services to regeneration policy, as well as the need for costly relationship-based lending for the provision of credit where market gaps exist.¹² Enterprise is not a straightforward concept in the case of addressing disadvantage. It needs to be seen as one necessary component of regeneration, but one that is not capable of overcoming the complex causes and consequences of disadvantage on its own.

In addition, the definition of enterprise should be expanded to take more account of microlevel activity. While these enterprises are often in most need of support and not likely to be high-growth, they are likely remain local – as are the benefits they generate.

Because of this bias towards high-growth enterprise, it is not surprising that there is little evidence of the effectiveness of ELR policies in achieving their own targets in areas of deprivation. Forthcoming **nef** research shows that areas targeted by ELR policies have not caught-up in terms of business start-ups, and the long-term unemployed have not benefitted from an increase in employment any greater than in areas lacking ELR interventions.

The reality is that much of the activity and value of enterprise in areas of disadvantage and exclusion remains under the radar. Small and medium-sized businesses represent 58.9 per cent of UK employment.¹³ A great deal of economic activity remains informal; EU estimates of the value of the UK's informal economy range from seven to 16 per cent of GDP. The networks that businesses and communities depend on are not captured by policies emphasising the number of jobs and businesses created. Just as CDFIs remind us of the importance to communities of banking services, the decline of a plethora of other key regeneration institutions from post offices to informal community ties reminds us that they are not directly addressed by current ELR approaches either. Their potential contribution to regeneration as preservers and nurtures of locality and local ambition is thus lost.

The need for a broader concept of what disadvantage means still remains, as does a corresponding sense of what the purpose of regeneration is: not simply an economic intervention but a driver of social change.

As **nef** argues in a recent report, the importance of helping people to become self-confident enough to be employable or entrepreneurial is often overlooked and not appreciated in an evaluation framework that is focused on simple targets.¹⁴ The French microfinance organisation ADIE has demonstrated that a large proportion of clients whose businesses failed were in employment two years after ADIE found finance for them.¹⁵ Currently CDFIs cannot conduct this kind of long-term research to reveal the 'multiplier' impact they have beyond the immediate success or failure of their enterprise borrowers.

At present, CDFIs struggle to build the referral networks that are paramount to their success. Instead, they are isolated and often bear the burden of enabling their own clients' success through training and other forms of support. The benefit to the wider community is not captured in their revenues, though the costs are all too

real. Hence, the value of CDFIs to regeneration efforts is constrained by their imperative to become financially sustainable.

Sustainability

The remit of CDFIs, to help people access finance, combined with the complex nature of their task, means that funders, practitioners and policy-makers have to be aware that some CDFIs – especially those catering to the lower end of the market – may need external financing on an ongoing basis. A ‘successful’ CDFI, in terms of outreach, focuses on the least profitable segments of the market.

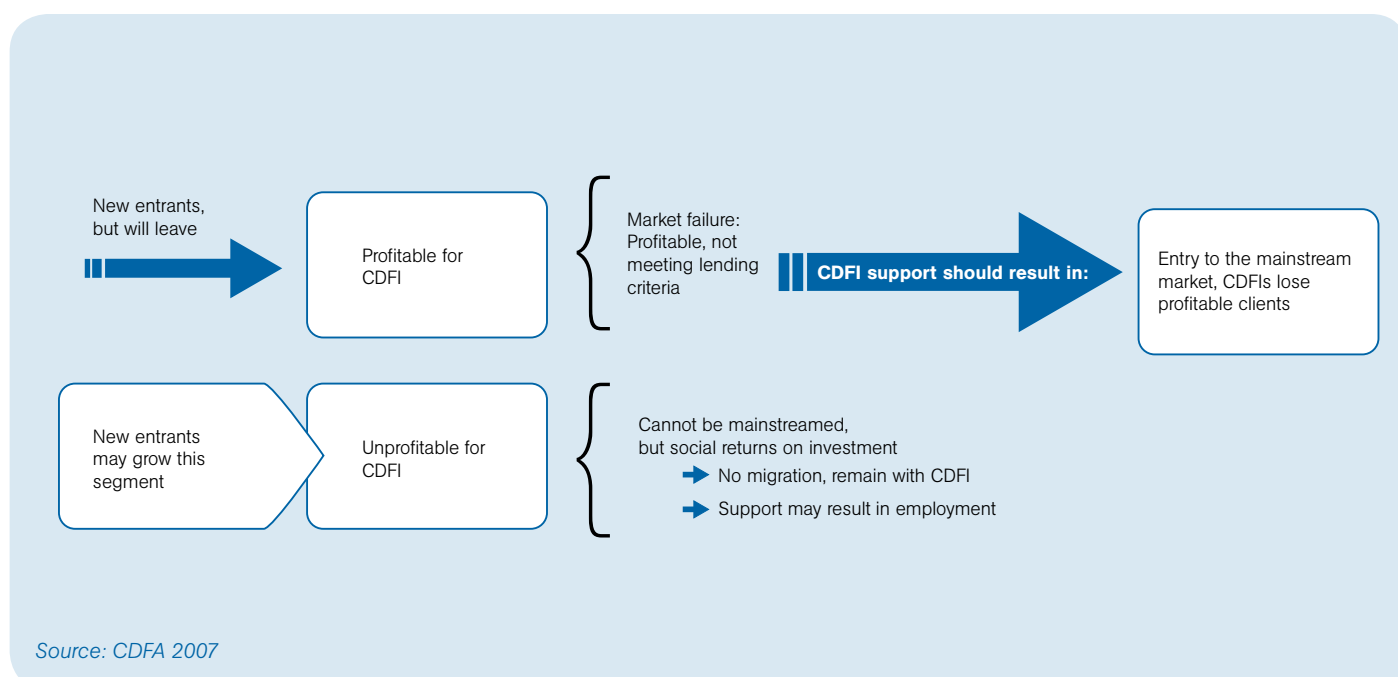
Figure 3 illustrates how CDFIs often face a conundrum in deciding whom they serve. Either CDFIs bear the costs of supporting clients with very low business skills, rendering the loans unprofitable, or rehabilitate the financially excluded who subsequently can re-enter the mainstream financial system and no longer represent a profitable source of revenue for CDFIs.

In Figure 3, two groups of clients enter the CDFI market. The first group represents those that have been wrongly rejected by banks – i.e. whose businesses will become profitable. The support received from CDFIs in the form of credit and advice should mean that these clients will move into the mainstream banking sector over time. These profit-making clients then are lost to the CDFIs, impacting negatively on their financial sustainability.

The second group of clients are those whose knowledge, experience and confidence need to be built up in order for them to become enterprising individuals. They are likely to require a lot of advice and support, for which CDFIs often do not receive any funding. These clients will very often not enter the mainstream market, but the support received may result in employment, greater confidence and increased financial skills and knowledge. The return on investment here is thus mainly social, while impacting negatively on the financial sustainability of CDFIs.

It is appropriate for CDFIs to strive for greater financial sustainability. Having independent sources of income insulates them from volatile policy cycles. Financial sustainability also increases investor confidence, and an organisation operating at or near financial or operational sustainability may find it easier to find finance for expansion or diversification. However, greater sustainability is not the same as complete financial sustainability in all circumstances.

Figure 3. CDFI clients and their impact on CDFI sustainability



Box 2. UK and US funding of CDFIs

CDFIs walk a tightrope between financial pressures and their core mission of providing capital to enterprises and people that would otherwise be denied it. Public funds supporting CDFIs in the USA are far more effectively used than in the UK. This is due to an effective combination of enabling funding structures and legislation that is lacking in this country. In the USA, consistent levels of public investment, combined with a supportive legislative framework, together trigger far more additional private funding and investment for CDFIs. In the UK, by contrast, reduced funding and uncoordinated policy severely limit the ability of CDFIs to provide capital to people and small businesses excluded from mainstream financing. With improved backing, CDFIs could contribute far more towards reinvigorating local economies and communities across the UK.

The US CDFI Fund is part of the US Department of the Treasury. This is, in itself, indicative of the importance with which CDFIs are viewed in the USA. The Fund has committed over \$800 million since it began operating in 1995. It has succeeded in leveraging an additional \$27 for every dollar invested through the fund by 2005. In contrast, in the UK, if the public money invested via the Phoenix Fund of £42 million plus the £11 million of transition payments had leveraged just 20 times more investment, it would have added over £1 billion of additional capital to UK CDFI lending. *Inside Out 2007*, the most recent CDFI Trade Association report, notes that the UK's Phoenix Fund managed to leverage £2.20 to every £1 it invested in 39 member CDFIs. Though CDFIs in some form have been in existence in the USA since the early part of the last century, the emergence of the sector into a broad and diverse body resulted directly from the legislative support it received. In 1977, the Community Reinvestment Act was passed and this laid the basis for much greater investment by banks or other depository financial institutions into areas of low or moderate income and marked by financial exclusion.

The untapped potential of greater public funding in an environment where legislation underpins CDFI partnerships with private commercial investors is explored more fully in the accompanying briefing: *A Model for funding and supporting CDFIs: Lessons from the United States*.

How to balance the three goals of CDFIs

The three objectives of CDFIs are not always compatible and in some cases are contradictory. If CDFIs cannot achieve all three goals simultaneously, there will be an ongoing need to strike the right balance.

There are non-commercial constraints to what CDFIs can do. As Steve Waud from BEF indicated, BEF welcomes all people who want to open a business, but not all people should become entrepreneurs at all costs. It should certainly not be the remit of social enterprises like CDFIs to lend to people who are not ready or are not suited to entrepreneurship more generally.

This is problematic in the target-driven environment created by funders, where success is measured by the number of loans given out.¹⁶ CDFIs that are realistic and responsible lenders – and hence turn away people – run the risk of losing funding by failing to meet their targets. CDFIs face being squeezed from both sides: financial investors demand positive financial returns, while social investors seek visible social benefits. In the context where there is a decrease in grant availability, CDFIs are increasing loan sizes. Especially in business lending, smaller loans are associated with higher risk of default and write-off, and the income generated by them is not enough to cover the time spent on drawing the loans up. Hence, there are calls for the SFLG to be expanded for CDFIs, which will be explored in detail later in this report.

CDFIs cannot be merely lenders but are also providers of support – they are social enterprises, not pure commercial ventures. This is a critical need amongst the financially excluded and is thus a vivid element of the social value of CDFIs. As we have seen, three of our four case studies have developed different ways to provide these services through distinct funding models, with the fourth ceasing to provide any business advice.

Two of our case studies engage in the microloan sector, and both of them have a business model that enables them to do so:

- BEF receives LEGL funding and its mentoring fees are subsidised for six months by Bradford and Leeds Council.
- Fair Finance cross-subsidises business lending from its personal lending arm, although this is also facilitated by its debt advice and debt reduction programme, *Money Matters*, which is part-funded by housing associations.

WRT's microlending operations are not self-supporting. The entry into smaller loan size markets and support to micro-entrepreneurs was driven by the conditions of Phoenix Fund money, in particular the on-lending requirements. Funds for associated free advice services were raised by the charity in form of grants.

ART, on the other hand, consciously concentrates on the segment of £10,000 upwards. This is not only due to the cost of lending lower amounts, but also because the Arrow Fund in Birmingham is covering this market segment. ART used to lend in this sector, but found it to be too time-consuming. It considers this segment not to be viable in the current funding situation.

If CDFIs stay true to their mission, they should, where possible, seek to stay involved in microlending and in business-support activities. But unless CDFIs find ongoing funding for these activities, it will be very difficult for them to deliver, particularly if priority continues to be given to financial sustainability.

Recognising people and circumstances: other influences on the evolution of CDFIs

CDFIs are often seen as homogenous organisations delivering homogenous services to a homogenous clientele. There is clearly much common ground and challenges shared by all CDFIs. There are also a number of other important influences that shape the way in which CDFIs operate.

These are partially generic, affecting the whole sector, such as national legislation and funding. There are also specific influences, relating to an individual CDFI, such as its geographical location, its population and levels of demand, as well as the details of particular, local, financial-exclusion strategies. These factors influence the structure of business models, organisational performance and the extent to which each CDFI can stay close to its social mission.

Our four case studies are all 'good performers': they shaped their organisations to suit the surrounding environment – but their success may in part also be explained by these local circumstances.

In this section, we examine the influence of these drivers to determine how they influence the ability of CDFIs to balance outreach, regeneration and sustainability.

Generic influences:

The key generic drivers are:

- The public funding environment and national policy
- RDA strategies
- General market developments (such as the credit crunch and bank behaviour)

Public funding and national policy

The public funding environment for CDFIs has changed greatly in recent years. Although direct public funding has largely disappeared, especially for enterprise lending, it was instrumental in shaping the sector and its influence remains strong. There have also been other programmes, such as LEGI, in which CDFIs can play a role and receive funding indirectly. Although these programmes are locally focused, the initiatives are driven by central government. We therefore address this as a generic influence, while acknowledging the different local implementation and results.

Since the birth of the sector, CDFIs have benefited directly from two large-scale funding programmes: the Phoenix Fund for enterprise lending, and the Financial Inclusion Fund for personal lending. The Phoenix Fund was one of many different programmes that tackled issues of multiple deprivation in the UK and sought to increase entrepreneurship.

The New Deal for Communities (NDC), local partnerships such as Trident in Bradford, European Regional Development Fund (ERDF) funding, Urban Regeneration Companies and the older City Challenge Programme are just some of these initiatives. Despite their differences, they share the fact that they focus on comparably small areas that are not large enough to sustain a CDFI at a commercial level. These programmes are frequently complemented by an array of business advice projects, both governmental and from the third sector, which are partially or fully funded by public money. These are either generic or targeted at

specific groups. CDFIs have benefited to varying degrees from such initiatives. Our case studies have had very different experiences.

This aspect of the external funding environment influences CDFIs in two ways. Firstly, being located in an area that has a strong regeneration or financial inclusion strategy improves access to funding for CDFIs, and also gives the CDFI a chance to be mainstreamed into existing or new partnerships.¹⁷ Interestingly, the appearance of such a funding source may encourage existing organisations to try to 'reinvent' themselves as CDFIs.

Secondly, CDFIs often rely on referrals in order to get clients; there are tremendous potential synergies from partnerships between referral organisations and CDFIs. Hence, the existence of these advice agencies, their strategy and quality and, crucially, their willingness to engage, will have a major impact on CDFIs evolution and business activities. For example, Fair Finance's business lending operations increased since October 2007, as it started building referral systems with business advice agencies in its area of operation.

Our case studies demonstrated varying levels of engagement with the diverse local regeneration structures in their areas.

ART covers all of Birmingham (and North Solihull), which has not been the target of large-scale regeneration efforts. Given the absence of regeneration funding as an option, ART has, from the outset, focused strongly on private funding, and on ensuring financial sustainability. It has had little choice but to do so. It also chose to adopt an Industrial and Provident Society (IPS) as its legal form, enabling the issuance of shares for social investors, thereby leveraging in further funds from private individuals with 'patient capital'.¹⁸

BEF, on the other hand, operates in Bradford and Leeds, both of which have been recipients of substantial LEGL funding. This benefits BEF considerably, as it receives capital funding from both cities. BEF is also aiming for financial sustainability, but with the caveat that its microlending will continue to receive external funding. BEF's drive towards sustainability is helped by these large equity injections that it can recycle as loan capital, and which it is not expected to repay.

Fair Finance operates in East and North London, in some of the most deprived areas of the country, where it has not benefitted directly from the regeneration initiatives targeted at increasing entrepreneurship. Fair Finance has, from the outset, taken a distinctive view of its mission. It sees its goals less in terms of enterprise-led regeneration, and more in terms of promoting social justice and transparent lending practices. Having initially been unable to secure major funding through the New Deal for Communities in Tower Hamlets, the organisation quickly sought other long-term sources of income.¹⁹ For example, the organisation used its ties with the Environment Trust to create a debt advice programme for tenants of housing associations (*Money Matters*). Housing associations refer clients with rent arrears for budget and debt advice to Fair Finance, who then help them consolidate their debts and offer them an alternative and cheaper source of credit. This initiative is able to achieve three goals simultaneously. While working towards its goal of greater financial inclusion through debt advice and access to cheaper credit, it helps housing associations to reduce their rent arrears, and also provides Fair Finance with a steady source of income (it receives funding from the housing associations) and potential clients. This allows Fair Finance to cross-subsidise its business lending operations.

WRT was founded to address the particular problems of rural deprivation by applying a CDFI approach to a region that had long been economically reliant on small-scale entrepreneurs. It sees the local economic situation as a result of a series of interconnected socio-economic problems:

- the lack of affordable housing and workspace;
- insufficient enabling credit; and
- low productive employment levels.

WRT develops innovative solutions to assist people in its region to build sustainable livelihoods. The different challenges of the 'Wessex' region leads this CDFI to focus on food, environment – including sustainable, affordable housing – and the arts. It particularly seeks to help communities via the establishment of social enterprises. This diversity of activities has led WRT to rely on a range of different income sources. The charity component receives grant funding aimed at supporting lending activities – through support provision to entrepreneurs for example – and to fund pilots and innovations for local credit and finance-raising. Its explicit social mission and deep roots in the community mean that it has continued to receive both philanthropic grant support from foundations, and regional funding indirectly from the RDA.

WRT did take on a significant portion of Phoenix Fund capital, seeking to expand its activities and deepen its capital base. However, this distorted its commitment to its core constituency and led to a broadening of its base of borrowers, which in part over-stretched the organisation's capacities.

As can be seen from these examples, CDFIs react to their funding environment. The absence of large regeneration funds in Birmingham forced ART to learn quickly to attract private funds. This was a lengthy process, and it may well have come at the expense of outreach, as ART ceased to lend at levels below £10,000. The only large source of central government funding earmarked for enterprise development was Phoenix Fund money. The funds that ART received helped it to expand, but it was not crucial in founding or sustaining the organisation.

Similarly, Fair Finance has become expert at finding other sources of income. It has used its social mission – rather than regeneration – as its unique selling proposition. It did receive Phoenix and Financial Inclusion Fund money, and will receive RDA funding (the remainder of the Phoenix fund money), but was from the outset aware that this would not be sufficient to bring the organisation to scale. Ties with the Environment Trust were crucial 'door openers' in furthering the social mission and getting the housing associations on board. These connections also helped attract support from the banking sector. Fair Finance thus could be described as aiming for mission-driven sustainability.

WRT's 'local rootedness' is the result of links between its founding board members and local private, public and third sectors in the form of finance institutions, local authorities and housing associations. This has enabled it to be an innovator from the start. This innovative streak, and clear social mission, has also underpinned its success as a 'mission-driven' organisation. WRT has been able to position itself as a crucible for grant-funded innovation and as a service provider to many of its peer- and stakeholder groups. This has taken on a formal role in its Wessex Home Improvement Loans business which provides a steady and valuable source of income (see Appendix A).

CDFIs that were wholly dependent on Phoenix funding from the start, in contrast, had less time and support to mature, and of course less incentive to seek alternative sources of revenue. Our case studies all found themselves in situations that allowed them to grow at their own pace in line with capacity and experience. Conversely, many CDFIs in the sector received Phoenix funds that they were expected to lend out quickly, and then had support cut off after only three years, which was not supportive of this form of evolution.

RDA's

RDA strategies will impact on the future of CDFIs. Responsibility for CDFI funding has been devolved from national government to RDAs, and they are now tasked with distributing the remainder of the Phoenix Fund.

RDAs have targets to meet in terms of closing 'enterprise gaps'. VAT-registered businesses are the most coveted prize here – this is the indicator used by government to measure the progress of RDAs. However, as **nef** pointed out in its recent report on LEGI, many newly founded enterprises in deprived areas are below the VAT level, and hence are not counted.²⁰ It is possible that this approach to measuring impact will increase the already existing trend towards focusing on medium-sized enterprises. If RDAs focus their support and funding on this segment, this trend is likely to strengthen.

RDAs are pursuing different strategies which will impact greatly on existing CDFIs and their ability to be embedded in a region-wide financial inclusion strategy.

Yorkshire Forward (YF), for example, seeks to strengthen the sector through 'nurturing co-operation', distributing the remainder of the Phoenix Fund through a subcontract with the CDFA. YF actively seeks to work with the CDFA and encourages the current benchmarking and capacity-building exercises undertaken by the trade association. BEF is in close contact with the RDA, and has benefits from RDA funding that supported its expansion into North Yorkshire.

Advantage West Midlands (AWM) is very knowledgeable about the sector and familiar with many of the discussions surrounding CDFIs. ART has good relations with the RDA, and is consulted regularly on strategy and planning. AWM has undertaken several studies on the CDFI sector in the West Midlands and is aware of the tension between outreach and sustainability. Accepting that there are still many young CDFIs in the region that need to upscale and increase capacity, AWM considers it vital to work with existing CDFIs, and to make the best use of already-invested money. Although it is considering consolidation of the sector, it is not planning to create one single regional fund. AWM also accepts that CDFIs need some way of covering their bad debt; otherwise they would be driven into a niche that seeks only to take on low-risk lenders.

The South West RDA (SWRDA) has adopted a 'simplification' strategy with two key features. First it will work with a single partner CDFI to achieve its aims, while other CDFIs will engage with the lead partner as 'subcontractors'. Secondly, the RDA seeks to develop the sector to provide cross-region community finance provision and a sound infrastructure. SWRDA feels that the post-Phoenix resources should be used so that the existing CDFIs in its region can be helped to build up their operations to ease problems of limited demand, high rates of delinquency, and support to the complementary services, such as business advice, that CDFIs struggle to finance themselves.

Co-operative approaches like these can represent a good opportunity for CDFIs to combine resources, to be marketed under one 'brand', and to expand their operations. East of England Development Agency (EEDA), and the South East England Development Agency (SEEDA) are pursuing similar co-operative paths. One umbrella organisation co-operates with existing CDFIs to achieve full coverage and to act as promoter and referral-building partner. All these RDAs accept that full sustainability is a long-term goal and that some activities may never be sustainable. By using existing capacity, they also acknowledge the importance of local knowledge and trust. CDFIs in these regions are likely to find it easier to work with their RDAs. This ongoing support and emphasis of local knowledge can also help CDFIs to better balance outreach and operational sustainability, in short, to remain true to their social mission.

On the other hand, some RDAs appear not to appreciate the need to support social outreach. East Midlands Development Agency (emda), for example, has awarded one CDFI £3 million to provide loans in the region of £10,000 and £30,000. The CDFI will match this with £2.8 million of private investment. Two loan-fund managers for the south and north of the region will assess applications referred to them by business advice agencies. emda envisages that the fund should be sustainable within four years, and to reclaim the £3 million after 10 years of operation. The segment below £10,000 will be covered by existing CDFIs; however, they will not receive further funding from the RDA. At the same time, emda acknowledges that microlending is unlikely to be sustainable. Local knowledge may well be lost in this context, and CDFIs will find themselves with little or no support from the RDA.

At the time of writing, the London Development Agency (LDA) has no discernible strategy towards CDFIs. This is likely to be partially due to an ongoing investigation into an LDA-supported CDFI, Ethnic Mutual, which has been suspended by the Financial Services Authority (FSA). While other RDAs are distributing the remainder of the Phoenix Fund to CDFIs, LDA has put the disbursement of these funds on hold. Fair Finance had expected to sign a contract for this disbursement, but it

remains unclear when the process will be resumed, resulting in insecurity over timing and funding.^{21,22}

The CDFA could play an important role here in nurturing co-operation and focusing its capacity-building efforts to ensure that RDAs are more aware of the different support and credit needs of micro-entrepreneurs.

Specific influences

Individual CDFIs will also be partly shaped by local circumstances.

These drivers include:

- The role of key people and visionaries.
- The operating environment, consisting of:
 - competition and market coverage;
 - third sector organisation partnerships; and
 - local council strategies.

Person- vs. system-driven

Like many third sector organisations, CDFIs are often driven by the dedication and vision of their staff, founders and supporters who have a significant influence on the success of a CDFI. The importance of these individuals to CDFIs is often unrecognised and undervalued.

An example for this is Fair Finance's partnership with the Royal Bank of Scotland (RBS), or NatWest originally. It appears that one person, Andrew Robinson, was central in establishing and maintaining the ties between the bank and Fair Finance. The roots of this relationship lie in the mid-1990s, when Fair Finance was still only a vague idea. Robinson established ties with the Environment Trust and subsequently with Fair Finance. He convinced his managers at NatWest to engage in community lending. RBS continued and even expanded grants to Fair Finance after it took over NatWest. Robinson also made sure that the relationship was transferred to his successor Eric Munroe when he took on other tasks.

Similarly at BEF, Fair Finance and ART, the three CEOs were described by interview partners as fundamental in driving the CDFI forward. Their dedication and experience, as well as the background knowledge from their previous careers helped them greatly to build their respective organisations, and to expand rapidly.

Visionaries play a key role throughout the third sector. These people may contribute directly to operations, or, as in the case of Robinson, be involved in funding or policy-making. The role these people play in the shaping of organisations or a whole sector are not sufficiently researched and recognised. This oversight blocks analysis of their individual impact on a CDFI's ability to raise funding.

For example, CTR as a mechanism to leverage in funds is widely seen as ineffective. But some organisations are still very successful in raising funds. ART, for example, managed to build its capital almost entirely through investment and grants. As there was no systemic mechanism in place to encourage in CDFIs in the late 1990s, the ability to leverage this private investment in must be at least in part attributed to some key people, in this case Sir Adrian Cadbury and Steve Walker.

WRT is no exception. Its investment strategies do not rely on existing investment programmes or structures, but on the ability of several key people to communicate its vision to potential funders and partners, or to engage a broad community of stakeholders. This has no doubt contributed to innovation and service delivery of different new products that are led by WRT. The Home Loan Scheme is a result of these relationships, as board members had close relationships with local authority personnel, as is the development and securing of funding for its highly successful *Financial Mechanisms* project.

It is very important that the pivotal role of key individuals is taken into account. In large part, they found a way of making things work, and not always in the most favourable circumstances. It is clear that aside from a positive and enabling policy environment, CDFIs are social enterprises that require first-rate leadership.

The 'operating environment'

CDFIs depend heavily on partnership organisations for referrals and other co-operation. Local knowledge is paramount for the work of CDFIs. Understanding the barriers that clients face, the strategies pursued by local councils, and the available market opportunities can be highly localised.

The 'operating environment' of CDFIs consists of:

1. other CDFIs and loan funds in the area;
2. local council strategies in their geographic area of operation; and
3. third sector partnerships.

In examining this environment for each of our four case studies, we considered the way they shape their business model to fit local conditions, including the services they do and do not provide. A business model that works in one setting may not be suitable in another.

This is verified by the diversity of business models that exist, even among similar types of CDFI. For example, not all 'Moneylines' charge the same interest rates, although they follow the same lending approach. South Coast Moneyline (SCM), for example, charges 26 per cent APR on its business loans, whereas Leicester Moneyline (LML) only charges 17.3 per cent APR. To a certain extent, this will reflect internal preferences, but these internal preferences will be shaped by local markets and funding conditions.

Competition and market coverage

An important influence on the business model is the existence of other loan funds in the area. CDFIs will assess the means people have of accessing affordable credit in their area, and target their approach accordingly. This 'competition' may not necessarily come from other CDFIs, but could be Local Enterprise Agencies or banks covering small and medium-enterprise (SME) lending.

Birmingham, for example, has a number of CDFIs and soft loan fund providers. The Arrow Fund covers the microloan segment, and Street UK undertakes personal lending. This makes it logical for ART to concentrate on the market of £10,000 and above, and towards business lending.

For Fair Finance, the situation is slightly more complex. It is the only non-exploitative personal lender (i.e. excluding door-step lenders and loan-sharks) in London, but faces competition for business lending from organisations such as Hackney Business Venture (HBV) and soft loan funds. As most of its clients are unbanked, they do not have recourse to credit card lending.²³ Fair Finance obviously targets this market as there is no other lender doing so, and it is in accordance with its core mission. If HBV, with its focus on larger loans, did not operate in the same area, Fair Finance might have adapted its business model to target this market segment as well.

BEF, on the other hand, is the only affordable lender in the Bradford area, allowing it to cover a range of loan levels, from micro (£500–£10,000) to medium enterprise (£30,000 and more).²⁴

WRT has virtually no overlap in its coverage, bar the presence of South West Investment Group (SWIG) providing enterprise loans in Dorset. More significant is the fact that WRT has an overtly rural focus, and a considerable portion of its activities are geared towards support for social enterprises. Though it has grown to include Bristol in its activities, particularly for the home improvement loan service, this rural focus of WRT sets it apart from its competitors.

These different market situations have clearly influenced the shape and form of the CDFIs. It is likely that CDFIs throughout the country have been similarly influenced. To date, the extent of existing market coverage (and more general market research into the potential market and its needs) has been neglected in discussions about the success of CDFIs. But it can be the make or break of a CDFI to be able to identify market niches and find funding at the same time.

Third sector organisations

The extent of CDFI partnerships with third sector organisations also varies according to business models and local circumstances. For example, a CDFI such as BEF that undertakes post-loan business advice will rely much more on partnership organisations for referrals.

Fair Finance uses third sector organisations for both referrals and business advice, and has recently been particularly successful in building referral and advice structures for its business lending in North and East London. Clients are either referred from the organisations directly to Fair Finance, or Fair Finance will send an applicant to one of these organisations if their business plans need reworking, or the applicant needs business training.

ART, on the other hand, has found it difficult to build these referral structures, which may relate to the types of clients it works with. Its focus is on existing SMEs and social enterprises, businesses that are less likely to turn to third sector business advice agencies than micro-enterprises. Co-operation with Business Link is not seen as very fruitful, as the organisation has recently changed the way it operates. As mentioned earlier, instead of having local offices, it moved to a regional strategy (covering the West Midlands) where advisors are unfamiliar with local circumstances. Rather than formal linkages, ART relies more on word-of-mouth, marketing, and referrals from accountants and banks. The CEO and loan officers acknowledge that referrals remains one of the organisation's biggest challenges. It is possible that, with the planned re-launch of Birmingham City Council's financial inclusion strategy (see below), this situation may change.

The relationship of WRT to local third sector organisations is central to understanding its mission and evolution. The CDFI originated when a number of third sector organisations came together to tackle and reverse the decline of the area. Third sector organisations remain crucial partners in various aspects of WRT's activities. Business loan delivery partners include Food Links, while supporters of social enterprise and micro-enterprise include the Community Enterprise Unit, the Prince's Trust, as well as Business Link agencies in Devon, Cornwall, and Somerset. The ability of WRT to adapt and evolve to the needs of its target constituency relies on relationships with other agencies that engage with these sectors.

Of our case studies, it appears that those with emphasis on outreach (BEF, Fair Finance, and WRT) have closer ties to third sector partners. In WRT's case, this is a clear connection, as third sector stakeholders were paramount in shaping the organisation.

In the other two cases, the existence of these relationships supports both of them in fulfilling this mission – but did not cause these organisations adopt this mission. Unlike other influences, such as the existence of sources of finance in the area, it is unlikely that a CDFI will be driven to a certain lending segment through the presence of these advice organisations.

Local councils

Although RDAs are the responsible body for CDFIs, local councils can influence a CDFI if they are part of a broader financial inclusion strategy.

Ideally, CDFIs would work with local councils to ensure their work is grounded in existing financial inclusion strategies. It is a natural partnership, as local councils also aim for economic regeneration and greater financial inclusion. It was a surprise to find that only two of our four case studies had close ties with local councils.

BEF is integral to LEGI programmes in Bradford and Leeds. We spoke to Richard Hudson from the Bradford programme, who said that its LEGI bid was focused

strongly on local financial exclusion and BEF was part of the original bid. It would have founded its own loan fund if BEF had not existed.

WRT also works closely with local authorities in an approach that reflects its founding mission to address rural economic problems. In all areas of its activities, WRT involves or is a direct partner with local government. Eleven councils support and have benefited from the home-lending programme in meeting public service agreement targets for housing standards. Local authorities also act as partners to WRT's enterprise-lending operation. WRT, through its *Wessex Community Assets* entity that was constituted as an IPS in 2007, also engages with some local councils in its work to support communities that wish to utilise Community Land Trusts.

Two other case studies, ART and Fair Finance, on the other hand, have few links with local councils.

ART had some ties when it started trading and received a grant at that time from City Challenge and from Birmingham Council, but has not maintained a partnership with Birmingham City Council since the Economic Development Department was closed. The Council rekindled its activities on financial inclusion about a year ago, and is seeking to expand its current focus on personal finance advice and debt to the provision of credit. It also hopes to involve ART and enterprise lending in this process. But prior to this, the Council admits to not having been very proactive, meaning that ART did not become part of a concerted financial inclusion strategy.

Fair Finance has also received very little support from councils, but has been less active in seeking it out. There are many different strategies in the local councils Fair Finance works within, but Fair Finance prefers to be independent of these initiatives.

Whatever the reasons or motivations of ART and Fair Finance, they are not integrated in any financial inclusion strategies initiated (or not) by their local councils. It may be that the council's strategies are simply not compatible with the CDFI; however, to combat financial exclusion and to have a comprehensive, joined-up strategy, close ties should be developed by both sides. CDFIs, especially when targeting the lower end of the market, benefit greatly from being embedded in local referral networks. If there is no financial inclusion strategy for the CDFI's targeted market, then CDFIs will face much more of an up-hill battle, as the problem will not be recognised by local authorities and support mechanisms will be lacking.

The influence of location of CDFIs and that of key individuals has so far been neglected in the analysis of the sector. In this chapter, we sought to explore the role of founders and 'visionaries', of connections between CDFIs and their local partners, but also how generic influences will impact on CDFIs serving different market segments. More research is needed to understand these influences better. Demographics, culture, and the economic situation of areas of operation are just some of the factors that we could not address within the remit of this report.

Enabling CDFIs: what do they need?

Earlier in this report we have argued that a central tension exists between different aspects of the original CDFI remit. We have also seen how both generic and specific forces have shaped the way that CDFIs have responded to these tensions in the context of their local environment.

The central question that remains is: if CDFIs are to achieve their social mission, what do they need to make this possible?

Any solution will require practitioners, the CDFA, funders and national government to work together.

This section will explore these needs, which can be split into three sections:

a) Stronger mechanisms for financing

Current mechanisms for CDFIs to leverage in private funding are the Community Investment Tax Relief Scheme (CITR) and the Small Firm Loan Guarantee (SFLG). They are currently underutilised, partially because CDFIs are too new to make full use of them, but also because these schemes do not provide the necessary scope to incentivise private investment. In addition, there are innovative forms of social investment that are emerging, which also need greater promotion. Again, these may only be suitable for more mature CDFIs, but there is a need to increase awareness of these instruments so that CDFIs can work towards utilising them in the future.

b) Capacity building to improve impact monitoring

As with all third sector organisations, CDFIs need to prove their impact beyond mere financial returns. This requires both training of CDFI staff, as well as greater funding to give CDFIs the means and the capacity to provide these in-depth assessments.

c) Building relationships with the mainstream financial sector

CDFIs should improve banking relationships. These ties are not yet very deep and systemic. It was envisaged, however, that banks would take a far stronger role in the CDFI sector. In this last section we explore why this relationship has not yet emerged and what would need to be done to make it happen.

Bearing in mind that many CDFIs are still in the formative stage, not all of these needs will apply to the same extent, nor will all CDFIs be able to implement them fully. They should all, however, recognise the importance of these issues and opportunities and seek to shape their business model accordingly in the future.

Building conducive investment vehicles

As mentioned throughout this report, ongoing external funding is required if CDFIs are to fulfil their social purposes. The current funding structure, however, puts an undue emphasis on financial sustainability. CDFIs should strive towards increasing efficiency and not be wasteful with funds, but full financial sustainability will only be achievable for some segments of the sector. In order for CDFIs to reach this goal, there is a need for external investment, both for-profit and social investment. The next section explores those options CDFIs currently have and what could be done to improve on them.

CDFIs as social enterprises in an emerging social investment sector

In some cases, CDFIs are developing considerable sophistication and organisational maturity, with the capacity to absorb commercial funds and to pioneer new social financing models. In recent years, considerable attention has been focused on the potential for social enterprises and alternative financial

structures to further social goals, and how the private sector can contribute to these aims. New structures for unlocking finance for social activities are being proposed, such as a social equity capital market and a social investment bank. Social venture capital funds already operate, seeking investments with both social and financial return on a venture capital basis.

WRT has been at the forefront of exploiting innovative social finance models by developing and marketing new structures to attract investors. It demonstrated this leadership through its *Financial Mechanisms* project, a grant-supported pilot to explore new mechanisms to attract investment to social enterprise. One of these was ECOS Homes Ltd, a novel investment-raising approach for a series of housing developments that are low-energy impact in design and usage. Operating as a social enterprise, ECOS Homes Ltd has succeeded in raising loan finance from individuals and a bank totalling £2.6 million to support this work. For its next stage of developments of 80 buildings, an IPS was established to attract investment via shares in the IPS to raise an intended £2 million. WRT has partnered with ECOS Homes Ltd throughout this process and has been central to the design of these structures. Apart from establishing new legal forms for social enterprises to raise capital as an IPS, this work is exploring how different forms of finance, including equity, can be utilised more effectively and appropriately than simply relying on one, loan finance.

The exploitation of innovative forms of financing, sometimes comprising equity and loan components, was an important factor in the rapid growth – of organisational scope and outreach – that CDFIs experienced in the United States. So called ‘quasi-equity’ enabled CDFIs to attract and sustain investment on terms that were appropriate to their needs, being both relatively long-term and with clear and stable financial commitments.

As UK CDFIs grow, they have ambitions to spread geographically and are seeking to scale-up their lending operations to benefit from the lower marginal costs of lending at higher levels of turnover. This was a notable finding of **nef**'s 2007 report, *Reconsidering UK Community Finance*.²⁵ CDFIs in the UK also need to seek new financing tools with a greater urgency, as sustained government support, is lacking (Box 1).

In the next section, we will discuss some of the available public options promoted by Government as potential sources of finance for CDFIs.

CITR: reform of a toothless tool?

With the drying up of public funds, CDFIs will become wholly dependent on income generated from their interest rates, and/or on private sector investment, potentially threatening the mission outreach. CITR was created to encourage private investment, but has so far been toothless, with incentives not strong enough to encourage investors to engage with the sector. Most CDFIs, and the sector as a whole, have yet to build a reputation and a track record sufficient to instil confidence in investors. As we have seen, however, the type of business most CDFIs undertake, microlending, may not be conducive to increasing this confidence. This is partially the result of misguided expectations, but also of misguided CDFI policy.

As pointed out in our earlier research, the UK CDFI sector is based on the US funding model, where obvious geographic discrimination in the housing market made it easier for policy-makers to engage the banks in funding the sector through the Community Reinvestment Act.²⁶ This was an inherent advantage for the CDFIs, as loans were collateralised by housing. Over time, CDFIs then moved into personal and business lending, allowing for a paced and more secure entry into these markets.

In the UK, in contrast, CDFIs started with business lending, which is more risky, especially for start-ups. There is no collateral, and businesses often struggle. Personal lending is equally insecure. Clients are financially excluded and more likely to have low levels of financial literacy and budgeting skills. This is different from the situation in the USA, where many individuals are excluded from the mortgage market on account of their race or their geographic location.²⁷

Without the advantages enjoyed by their US counterparts, CDFIs in the UK need more backing, more safeguarding mechanisms and more sustained funding.

The Government's tax credit instrument of choice, although well intentioned, has so far failed to deliver. The CDFA describes an increase of CITR investment, but only from £38 million to £40 million over an 18-month period. Most experts we spoke to (both practitioners and public sector representatives) found CITR to be ineffective. The process is too onerous and time-consuming for CDFIs who have limited resources and capacity. It is also limited with regard to the kinds of investments that are eligible for the scheme.

Perversely, the CITR's long list of exceptions (e.g. no investment in property is eligible) often deters investment. Particularly problematic has been the prohibition on using CITR for residential purposes, which prevents CDFIs from becoming involved in mortgage lending that proved so catalytic for the US markets.

Only 21 CDFIs are currently accredited under CITR, indicating that it is either not a worthwhile exercise, or that capacity and capability are lacking. Whereas the capacity issue could and should be addressed, the complexity of the scheme will remain a deterrent for many.

SFLG

The SFLG is another mechanism for CDFIs to leverage funds in, albeit indirectly. Under the SFLG, loans made to businesses are covered by BERR for up to 75 per cent of the value. Accredited organisations can lend to businesses up to 5 years old and with a maximum turnover of £5.6 million. Loans are between £5000 and £250,000, thus covering a wide range of the markets that CDFIs cover. Given the tensions between sustainability and outreach that have been discussed, it is important that smaller loans are also included with SFLG mechanisms.

CDFIs are now eligible to become SFLG lenders, and one of our case studies, BEF, was accredited in February 2008. Since then, BEF has made five loans under SFLG. It did not find the accreditation process difficult, and the application criteria were seen as straightforward. As organisations have to show three years of annual accounts, more and more CDFIs will become eligible for SFLG accreditation.

There are several limitations to SFLG, however. For example, the lender has to demonstrate for each loan that the organisation would not have accepted the loan application without collateral. At first sight, this appears surprising, as CDFIs mostly deal with clients who cannot provide security. After consultation with the CDFA and several CDFIs, however, BERR decided to keep this in place for CDFIs, as the organisations have stated that collateral is important for larger and repeat loans that would otherwise represent a risk for their portfolio. On the other hand, it means that smaller, high-risk loans will not be covered, and the SFLG cannot be used to broker finance deals in these cases. Whilst the rationale for this requirement is understandable, a change is desirable in order to promote the outreach and social impact work of CDFIs.

As we have already highlighted, the reduction in microlending activities by CDFIs is partially due to the lack of funding available for this high-risk work that creates social rather than financial returns. The SFLG could be harnessed to help solve this problem. Investors' confidence and willingness to fund this segment would be boosted if they knew that a public fund shouldered part of the risk, thereby improving their risk/return ratio. Although financial returns on investment will not be high, this could still trigger greater commitment of funders in this sector as part of a social investment strategy.

Another restriction is that businesses applying for the SFLG cannot be older than five years. The limit appears arbitrary, and runs counter to many CDFIs that focus on deprived areas. Social enterprises, for example, still find it difficult to obtain loans from banks, even after five years of operation, which may be due to a combination of grant dependency and reluctance by banks to lend to organisations with a different approach to profit. Social enterprises wanting to upscale and commercialise hence turn to CDFIs for investment, and this is quite likely to be more than five years after their launch. They often require larger loans, and the SFLG would be very useful for this purpose.²⁸

The SFLG also does not solve the problem of increasing a CDFI's capital base, but it can stimulate finance brokering for 75 per cent of the loan. This is the percentage covered through the SFLG, and investors can provide these monies risk-free. Finance brokering helps CDFIs and other investors to spread the risk of an investment. It also gives them the opportunity to build their reputation through a portfolio of successful business ventures catalysed by CDFIs.

More CDFIs should seek to become SFLG accredited. This will need to be part of the maturation required of the sector, as it learns to make the best use of existing instruments. BERR has suggested that one larger SFLG-accredited CDFI could act as a mediator for smaller, regional CDFIs operating in the same area.²⁹ This would also foster co-operation to ensure full market coverage. This seems a sensible idea, but the Government would need to increase the scope of the SFLG and remove the current barriers that reduce its usefulness to the sector.

Capacity and capability: reporting and impact monitoring

CDFIs as third sector organisations need to demonstrate their impact beyond financial returns. As social enterprises, their mission is to have a social impact. Measuring this impact is complex and requires capacity and capability, but it is an essential task.

Reporting and impact monitoring are high on the agendas of the CDFA, the Government, as well as funders and investors. CDFIs are often, and with some justification, criticised for not being transparent and professional enough. Although it is true that most CDFIs are still young and in the formative stage, a minimum level of reporting requirements should be implemented by all. Not all CDFIs are currently required to submit accounts by law, but this is simply best practice.

Beyond this, additional disclosure of information relates to two different issues: financial sustainability and impact.

Financial sustainability is of importance to investors who see CDFIs as entities that should be independent of grants, and expect a return on their investment. Impact, on the other hand, may be of greater importance to organisations that prioritise the social remit of CDFIs over a monetary return, or define a return on investment in terms of social impact. Both are important for policy-makers and practitioners seeking efficient solutions to financial exclusion. Any investors, whether they aim for social or monetary returns on investment, will need to have confidence that the organisation is capable of delivering these goals.

There are good arguments for CDFIs to leverage funds in from the private sector, both in terms of efficiency and independence of political funding cycles. But the requirements of different types of investors – particularly financial versus social – will vary greatly.

To access for-profit investment requires a detailed breakdown of lending activities over several years, and a strong business model that instils confidence in the organisation's ability to generate a sufficient monetary return on investment. Although this is technically possible for CDFIs to do, the priority given to financial sustainability is putting an undue emphasis on these accounts.

If CDFIs are to reach out to excluded groups, social return on investment needs to be emphasised much more strongly. Measuring the social impact of CDFIs work is, however, complex, long-term and time-consuming. Current impact measurement, as reported by our case studies, usually does not go beyond the requirements of funders. Generally, only the number of loans given out, and the number of enterprises created or sustained are monitored. Data may also be broken down by gender and age, as well as by ethnic minority status. Where applicable, CDFIs also trace the number of loans by business type (micro, small and medium, social enterprises). There is no impact tracking over the long term, however, and impact on the individual and their households is only tracked qualitatively through case studies.

This type of impact measurement clearly needs to increase. Not only will it provide social (and commercial) investors with a greater understanding of the impact of

CDFIs, it will also help CDFIs themselves to identify where they ought to improve to maximise impact.

There are two important factors that are usually neglected by the Government and investors when demanding better reporting practices:

1. While it would be ideal for CDFIs to implement computer-based monitoring from the start, many have not done so, not least because of a lack of funds and of capacity. Also, the low volume of clients and loans disbursed in the first stages of a CDFI's operation will not yield significant results. Loans can run over several years, so that meaningful data is only collectable after some time has elapsed. Survival rates of businesses after the loan has finished are unlikely to be captured, unless the client takes out a repeat loan. Additionally, even established CDFIs, such as ART, find it very time-consuming to contact clients and ask them the questions that are specified by their funders. Fair Finance is in the process of developing a sophisticated computer-based reporting system, and has been a pioneer in publishing its lending statistics on its website. This is a great achievement for a young CDFI, which is helped by the fact that its clients often have short-term personal loans, allowing the organisation to produce meaningful statistics in a relatively short time-frame.
2. As third sector organisations, CDFIs have to find a balance between administration and creating monitoring and evaluation systems, and service delivery. Most try to keep their overheads low, as this frees up more money for delivery. This issue is relevant for many third sector organisations, but it needs to be addressed, both in terms of methodology and in terms of the capacity and resources needed to do this work.

In some organisations, such as WRT, serving a variety of markets and offering an array of products, creating a comprehensive reporting system may represent an insurmountable logistical challenge. WRT has never had a systematic reporting approach, and has developed reporting in response to the necessities of grant providers and public funding requirements. This challenge is exacerbated by the range of activities WRT is engaged in, which means that any single metric of social or financial performance is unable to represent fully the performance of the overall organisation. The structure of its four entities means that separate accounts are filed with separate boards, with the work done in partnership *between* them being governed by service agreements and clear contracts.

To establish what is possible for simpler structures, we looked at repeat clients in Fair Finance's personal lending operations to see which information would be available, how long it would take to extract this information, and what kind of conclusions could be drawn from the data. We chose personal clients, as their loan terms are shorter, which increases data availability. The research yielded interesting results. Some quantitative and qualitative trends emerged, which would be useful for market research and product refinement. One of the impacts of personal lending that demonstrates greater financial inclusion, for example, is the reduction in interest rates for clients, and hence the increase in disposable income and how it is used. This, however, requires an in-depth spending analysis that goes beyond the core purpose of the application interview, which is to assess whether the client can afford a loan and its ability to repay it.

Data analysis could be speeded up by the use of computerised systems, and custom-made reports, but this requires money, training and investment in custom-made software and machinery that CDFIs are unlikely to be able to finance through revenue created from their lending operations.

CDFIs can and should trace their lending activities, and seek to make it easy to track repeat clients. There is a wealth of information hidden in client files, but extraction and analysis is beyond the capacity of CDFIs. Impact analysis requires dedicated or unrestricted funding to create appropriate systems, and it requires time. Both are in short supply.

Banks – a special relationship?

It was originally envisaged that the banking sector would be a natural ally of CDFIs in terms of funding and referrals, and many of our interviewees thought this should still be the case. After all, supporting CDFIs would be positive for banks' reputations, and by migrating from CDFIs, enterprises would actually be providing banks with a business opportunity in the longer-term. Banks would fund CDFIs to make clients bankable. However, strong partnerships are yet to emerge as a norm for the sector.

Banks can work directly and indirectly with CDFIs. They could be part of the referral system CDFIs need in order to source good-quality applications, or they could fund a CDFI, either through investment (CITR, SFLG) or through loans (commercial, soft loans, or social investment).

Direct partnership

Currently, partnerships between banks and CDFIs are centred on funding rather than referrals. Out of the four CDFIs we spoke to, none had a mainstreamed referral system in place, i.e. referrals from banks to CDFIs were rare or non-existent. Referrals from CDFIs to banks were more common, especially when brokering finance deals in which banks would provide part of the funding.

All our interview partners mentioned that they originally hoped to have greater involvement with banks. On first sight, the partnership seems obvious: the major connection between banks and CDFIs lies with those credit applications that a bank rejects but that could succeed with a loan from a CDFI, and possibly migrate to the bank in the future. There are many reasons why these referral systems are difficult to build.

One is policy related. In simple terms, banks are not required to engage with CDFIs. A target culture for branches and regional managers discourages voluntary commitment beyond what is seen as necessary, and directed from above. This, at least, was the view of many of the practitioners and banking staff that we spoke to. At the local level, where co-operation should occur most naturally, staff is hindered by the aforementioned target culture and cost constraints, as well as by personnel changes. If a CDFI builds a local relationship with a branch manager who is then transferred to another branch, the relationship is severed, and has to be rebuilt from scratch.

Whatever the reasons, the crux is that banks will first and foremost consider a loan in relation to the profit they can make, i.e. the interest rate charged minus the time and administration costs used (although banks usually charge arrangement fees to cover part of their administrative costs). A CDFI, on the other hand, will take into consideration social 'profits' as well. Banks, unlike CDFIs, are not held accountable by their shareholders for community impact, whereas CDFIs are required to demonstrate this impact and, as we have seen, this may negatively affect financial returns in some cases.

It might be expected that CDFIs and banks would work together closely to get as many people as possible in business. This could entail, for example, a brokerage fee that CDFIs pay to banks for referring clients, and vice versa. However, this requires far stronger legislation that will compel banks to co-operate with CDFIs. The current voluntary approach and investment incentives (CITR) have made very little impact on the sector.

It would also be expected that the fact that people who are, in the eyes of banks, not creditworthy can and do repay loans and run businesses profitably would lead them to realise that they are foregoing profit opportunities. This would suggest that co-operating with CDFIs in a systemic and sustainable way should be a logical thing to do: CDFIs can deal with those people who are rejected by the banks to help them start their business, prove themselves, and then migrate to mainstream banking, thus expanding the bank's potential market.

Banks' co-operation with CDFIs could therefore lead to desirable social and financial goals: increased financial inclusion will help banks increase business, as they gain new clients that generate profit for them. The Australia and New Zealand Banking Group Ltd (ANZ) in Australia has already recognised that the financially excluded, once included, can become 'normal' clients, who create business for the bank.³⁰

But there are different, more practical reasons why rolling out a nationwide referral system is difficult. Barclays undertook a pilot study on referral systems in 2004, and drew the following conclusions from it:

- The number of credit applicants turned away was very low.
- Linking managers to CDFIs suffered because of a lack of a feedback loop from CDFIs, so managers became disengaged and unaware of effectiveness of their referrals.
- Given its complexity and diversity, it was also difficult to explain the CDFI sector to staff.

Barclays concluded that better communication and/or an incentive structure was necessary, but also that demand was fundamentally lacking. However, the lack of demand (i.e. the low number of rejections) is probably a reflection of Barclays' lending policy in the SME sector, and may not be applicable to other banks.

At the same time, Barclays also argued that partnerships with CDFIs have to be commercially sustainable, at least in the mid-term, and that there needs to be a clear vision on the side of CDFIs to develop this kind of strategy.³¹

CDFIs need to be trained to work more efficiently and to create a more systemic network. They are still mostly small organisations with a limited capacity to handle a large volume of applicants and in-depth partnerships with several banks. As local knowledge is so important to their operations, this small size may be an advantage.

This could also address a potential image problem – banks seem reluctant to send referrals to small and unknown organisations and fear reputational repercussions if the CDFI does not act (in a bank's view) professionally, or worse, encounters financial problems. A larger 'branded' umbrella CDFI, such as SEEDA is envisaging, may well circumvent this.

The problem, as in other areas, is the funding of the necessary upgrades and installation of systems. There is an expectation from banks that CDFIs should build these systems on the back of their existing business activities. However, providing feedback and progress reports on clients is complex. CDFIs need more funding to professionalise their operations if they are to focus on their core business of providing affordable credit. Banks appear to think that this is the Government's job, and the Government thinks that CDFIs should find funding for these activities from private investors, such as banks.

Clearly, this needs to be resolved, and banks should get involved far more seriously in the sector: the ongoing credit crunch and the public money they are receiving highlights the fact that they occupy a privileged position in the economic system – it is not unreasonable to expect them to 'give something back' to society in exchange for these benefits.

The problematic relationship between banks and CDFIs is also due to a culture clash. Potential clients and banks find it difficult to engage with each other. Clients may have been rejected before, or may never have had contact with banks. They will not necessarily understand the financial language of bankers, something that is not unique to the financially excluded, of course.³² Staff, on the other hand, will find it difficult to deal with someone who does not know what a standing order is, or perhaps how to create a business plan. The extent of this mutual misunderstanding will, of course, vary, but in general banks and the financially excluded are not well acquainted with each other.

A lesson that can be drawn from our four case studies is that CDFIs can act as catalysts for brokerage deals, or as reference agencies that would help the client to open a business account. Steve Waud, for example, mentioned that BEF sometimes acted as a 'clearing house' for businesses that banks are reluctant to lend to because of fear of money laundering. Any business that is largely cash-based and dealing in components, for example, would find it difficult to open a business account or obtain credit from a bank, as money laundering is a big problem in

the Bradford area. However, once BEF has checked the client's background, ascertained its commitment to the business and accepted it as a client, banks are far more likely to allow it to open an account.³³

Indirect co-operation

The other area of co-operation between banks and CDFIs is in investment or loans. Currently, as we have seen, there is little investment through CITR in CDFIs.

One way of achieving greater co-operation and promotion of CDFIs is through the investment provided by banks to CDFIs. Banks could see CDFIs as an extension of their operations, as outreach and as a means of exploring – and helping to build – new markets. The current assumption of banks that people who have a blemished credit record – i.e. a County Court Judgment (CCJ), a defaulted loan, or irregularities in repayment, even dating back decades – will never change their ways is a very narrow interpretation of human behaviour.³⁴

The danger with increasing co-operation is that CDFIs become the 'soft loan arm' of banks, with increasing standardisation of lending criteria that would not be suitable for their social mission. The way banks rate creditworthiness is not suitable for CDFIs – indeed, it is precisely their quantitative, 'arms-length' approach that leads them to reject many of the clients with whom CDFIs are able to work successfully. The greater flexibility that CDFIs have is their advantage in combating financial exclusion.

An effective partnership would require new legal procedures in which banks cannot be held responsible for a failed CDFI. CDFIs are currently not FSA regulated, which can act as a deterrent to increased co-operation. However, this fact is beneficial for their flexibility and adaptability to challenges and local circumstances. FSA regulation – as called for by the Treasury, for example.³⁵ – could severely limit this autonomy

Set against this picture, some CDFIs have achieved a level of maturity and sustainability that fulfils the lending criteria of commercial banks. ART, for example, has secured a credit line of £1 million from Unity Bank, greatly expanding its capital base for lending. Our other case studies either have not chosen this path so far, or have not yet acquired the same track record as ART.

A commercial loan can be advantageous for CDFIs as it further proves their viability. At the same time, as with every loan, there are risks involved, such as a sudden contraction in demand through an expansion in small-business lending by banks.

Having said this, it is important to remember that commercial loans are only suitable for CDFIs that can function on broadly commercial terms, i.e. for those that do not focus disproportionately on microloans and small start-ups. As we have seen, it is highly unlikely that these activities can be ever viable. There is thus too great a risk for microlending CDFIs to take on a fully commercial loan.

Conclusions

This report assesses the current operations of CDFIs in light of the three elements of the sector's core mission:

1. **outreach** to the financially excluded;
2. contributing to the **regeneration** of areas suffering deprivation; and
3. the achievement of long-term (financial) **sustainability** for their operations.

A focus on financial sustainability is leading CDFIs to move away from their social mission of outreach, and is also likely to be negative for local regeneration strategies. Outreach is expensive, time-consuming and often negative for the financial sustainability of CDFIs. Providing small loans to the financially excluded will never be a lucrative activity, which is why the mainstream financial sector is reluctant to enter this market. Insisting on financial sustainability forces CDFIs to follow the same commercial logic as mainstream banks, and runs counter to their basic social purpose. The continuing prioritisation of financial sustainability will see this worrying situation further deteriorate, as loan sizes increase, geographical coverage increases (in scale, but not in depth), and outreach based on local knowledge declines.

Despite these fundamental tensions, CDFIs continue to evolve in distinct ways. The different CDFI models addressed by this report reveal a range of approaches to developing specialist and niche expertise for lending, which, given the operating context, may be appropriate to the needs of each CDFI's respective constituency. This is not achievable without strategic partnerships with all types of local stakeholders, however, including private companies, public agencies and third sector organisations. At present these relationships are often *ad hoc*, based on personal rather than institutional linkages and widely variant in different parts of the country.

The growing sector is now marked by greater maturity and the related diversification of markets which CDFIs have evolved to operate in. However, the policy drivers for CDFIs have now shifted with the demise of the Phoenix Fund. This places sustainability at the front of the three key components of the CDFI mission, which is likely to have negative implications for outreach and, to a lesser extent, for regeneration initiatives.

Given these trade-offs between aspects of the CDFI mission, and the current lack of mechanisms to ensure that CDFIs are fully embedded within local networks, it is important to ask what CDFIs can be expected to deliver.

The key lessons of this report are:

- The role of CDFIs as tools to support deprived communities imposes critical constraints on their (financial) independence.

The potential of CDFIs to pursue outreach and catalyse regeneration needs to be tempered by recognition that this limits their financial freedom and constrains their efforts to achieve financial sustainability.

- Policy therefore needs to recognise the trade-offs CDFIs face, the diversity inherent to the sector and the breadth of challenges they confront.

Different market segments, such as microlending, impose particular demands on the lender in terms of associated costs and services to support micro-entrepreneurs. This recognition should go hand with an appreciation of *social return*.

- The definition of 'sustainability' should be broadened to incorporate CDFIs that have a more explicit and costly commitment to social outreach.

CDFIs focusing on supporting larger enterprises – rather than small-scale lending – have shown considerably more financial resilience and autonomy. For example, our case study ART has increased its minimum loan size and views itself very much as an agent of regeneration. Conversely, Fair Finance has very effectively chosen strategic partners to provide skill-building and training support to clients. This permits Fair Finance to sustain its goal of supporting micro-entrepreneurs and small-scale personal lending.

- CDFIs need to update how they consider and represent their own function within communities.

CDFIs need to re-focus their strategic efforts to identify their unique purpose in a specific local context.

- The current public bodies supporting CDFIs have not developed their capacity to sustain CDFIs in their social mission.

RDAs vary greatly in their knowledge of and engagement with community finance. Some RDAs see CDFIs as partners with other organisations addressing issues of deprivation, enterprise support and financial exclusion, but this best practice is not universally applied.

Despite the fact that they face common challenges, CDFIs operate in very different environments and have taken different approaches. There is a need to develop a typology of CDFIs that describes the different approaches that have emerged. Without a more robust understanding of their various functions, CDFIs will continue to be pushed to prioritise financial sustainability.

As a first step in this direction, we group CDFIs into three broad categories:

1. CDFIs focusing on regeneration and SMEs. Their coverage can be regional or larger urban areas. ART would be an example of this lending category.
2. CDFIs focusing on social outreach and microlending. Here, coverage requires a strong local presence and 'returns' are more likely to be both social and financial. Fair Finance works in this segment.
3. Large, national organisations which provide finance to social enterprises.

Each of these three groups requires a different business model to succeed, but the tendency to see CDFIs as a homogenous group has obscured this fact.

For example, regeneration-focused CDFIs require support to build strategic partnerships with local organisations. This is particularly true in areas where RDAs are consolidating responsibility for the range of third sector and public bodies that have regeneration objectives.

Microlending CDFIs need a high degree of local presence and knowledge, as they not only have to be very informed about local circumstances, but also need to build relationships of trust with the clients they target. The challenge of operating with this client group depends on a building mission-driven sustainability, where financial returns are seen in the context of accompanying social returns.

By being clear about these different forms of CDFI – or developing a 'typology' of CDFIs – it is possible to dispel the confusion surrounding the objectives of CDFIs, and to enable funders and policy-makers to be more realistic in their assessment of funding needs, the potential for financial sustainability and degree of social impact.

Recommendations

The CDFI sector continues to grow, showing signs of increasing maturity. Older CDFIs in particular are becoming more sophisticated in their business models and the measurement of their impact. But the sector as a whole is suffering from underfunding and a decline in public support.

The existing policy framework and dwindling funds will push CDFIs away from their core social objective to help disadvantaged individuals through microlending. The Government needs to acknowledge that different business models, some of which have greater social than financial returns, can work. CDFIs require appropriate and ongoing public support to succeed.

In light of the credit crunch and the growing need for fair finance, the sector requires renewed policy support. To justify this, CDFIs need to continue to improve their financial performance, to better measure their social impact, and crucially, to communicate their achievements. CDFIs have demonstrated that they have the power to advance local businesses and create employment opportunities. This expertise can be used to tackle the growing challenges of financial exclusion.

Our recommendations of what CDFIs need to fulfil their potential are as follows:

CDFA

- More urgency is needed to develop a monitoring and evaluation framework that clearly demonstrates the social impact of CDFIs so that a track record of best practice and social effectiveness can emerge. This should be a priority for CDFA, and should be funded externally to support take-up.
- The CDFA should carry out an audit of RDA strategies and support, to identify where additional regional funding or partners may be required

Government

- There should be renewed financial support adapted to the varied needs of CDFIs offering microfinance. If the vital social role played by these organisations is to continue, it needs to be recognised, valued and funded on an ongoing basis.
- Government should adapt CTR and the SFLG to meet the needs of a broader range of CDFIs. Reforms of the SFLG have resulted in CDFIs becoming eligible for accreditation. Government would need to increase the scope of the SFLG and remove the current barriers that reduce its usefulness to the sector. Restrictions on loan sizes and the age of businesses that are eligible should be removed.
- The Government should adapt its regeneration strategies to reflect a broader definition of goals. For example, by using new indicators to measure the creation of micro-enterprises or uplift in self- or part-time employment that CDFIs can achieve. This would take into account and value the social change created by CDFIs.

RDAs and local authorities

- RDAs should work towards a 'joined-up' strategy to build the range of financial services required to combat deprivation. These are rarely offered by any single institution and not uniquely by CDFIs. A successful strategy requires partnerships between local organisations, such as banks, development trusts, credit unions, housing associations and debt advice agencies.
- RDAs should accommodate the needs of CDFIs that serve diverse market segments at subregional level.
- RDAs should broaden their remit to focus on both regeneration and social outreach objectives when supporting CDFIs.
- Local authorities should work together with CDFIs to achieve their obligations to central Government. For example, the fulfilment of public service agreements on housing could be achieved through CDFI home improvement loans.

Banks

- Banks should be more active in investing in community finance. They should be required to meet the needs of all members of society, including the poor and financially excluded.
- Legislation may be required to compel banks to co-operate with and invest in third sector finance organisations. The ongoing credit crunch and the public money they are receiving highlight the fact that they occupy a privileged position in the economic system – it is not unreasonable to expect them to ‘give something back’ to society in exchange for these benefits.
- Banks should provide technical and financial support to help CDFIs build the infrastructure required to become more professional in their dealing with banks.
- Banks should actively seek to partner with CDFIs, not least to expand their client base as people move successfully from financial exclusion to the mainstream sector. Banks could see CDFIs as a positive extension of their operations as an outreach to build new markets.

CDFIs

- CDFIs are often, and with some justification, criticised for not being transparent and professional enough. Although most CDFIs are young and in the formative stage, a minimum of level reporting requirements should be implemented by all.
- CDFIs need to prove their social impact beyond mere financial returns. This requires both training of CDFI staff, as well as greater funding to give CDFIs the means and the capacity to provide these in-depth assessments.
- More CDFIs should seek to become SFLG accredited. A larger SFLG-accredited CDFI could act as a mediator for smaller, regional CDFIs operating in the same area.

APPENDIX A: Case studies

Methodology

We have taken a qualitative approach to consider the challenges facing CDFIs that are often discussed but are rarely contextualised and examined in depth. This considers the role practitioners and policy-makers can play in realising the potential of the CDFI sector. We hope to inspire CDFIs through our case studies, not because these necessarily represent best practice, but because they display innovative ways of addressing problems common to the whole sector, and do so from the perspective of different market segments in the CDFI arena. As with our previous report, we focus our research primarily on enterprise-lending CDFIs.³⁶

The four case studies were based on a series of semi-structured in-depth interviews with:

- key staff members of the CDFIs, including senior managers;
- local partner organisations, such as business support agencies (both third and public sector-supported, as well as for-profit advisors);
- relevant policy-makers and institutions, such as local councils, RDAs, BERR and the Treasury; and
- commercial banks who may fund or partner with our case studies

In interviews with CEOs and staff we gathered views on the evolution and current and future roles of these four CDFIs, as well as the sector in general. We also sought to explore the issues relating to the wider local and regional setting in which the CDFIs operate – i.e. how their locality and circumstances have influenced the present structure and pathways to their success.

External partners were interviewed, including banks, referral agencies, government ministries and national banks to establish what they expect from CDFIs and how they view them strategically.

1. Aston Reinvestment Trust (ART)

Established in 1997, ART is one of the pioneers of the CDFI model. Eighty per cent of its lending is to SMEs and the remainder to social enterprises. ART describes its mission as ‘relief of poverty through enterprise – local jobs for local people’. ART is thus strongly regeneration-focused.

Since its inception, ART has lent over £6 million to more than 350 borrowers and enabling them to create or protect 2900 jobs in the Birmingham and North Solihull area. ART is funded by individual philanthropic, corporate and public sector investment. From its launch until 2006, ART made loans of £2000 upwards, but in 2006 decided to restrict its loans to £10,000–£50,000 only, as it sought to increase the returns on its lending and become less dependent on public sector funding. Currently, ART covers 80 per cent of its operational costs, excluding bad debts, from earned income.³⁷

The evolution of ART

The idea for ART was conceived in the late 1980s, when Birmingham, and Aston specifically, were hard hit by recession and the decline in manufacturing in the area which led to rising levels of unemployment and very low entrepreneurial rates. With the decline in business activity and rising crime, banks and building societies began to move out. Their numbers dropped from 28 to 3 in the area of Aston and New Town. The remaining businesses in the area were hard hit by the closures, leading to further deprivation.

The Aston Commission, chaired by Sir Adrian Cadbury and established in 1989, sought to address this problem of low entrepreneurialism. The aim was to provide a link between the local population and the banking sector to stop and reverse the decline of the area. The overarching mission was and still is 'the alleviation of poverty through enterprise and the creation of local jobs for local people'. Research carried out by the Commission recommended the founding of ART. The initial area of operation, Aston and New Town, was quickly expanded to cover all of Birmingham and North Solihull to achieve an appropriate scale to become sustainable.

In spite of the many regeneration activities targeting the area, most notably the New Deal for Communities (NDC), ART initially struggled to bid successfully for funds to become operational. An application to the 1993 City Challenge programme was unsuccessful. Other local regeneration schemes such as City Action Team and the Training and Enterprise Council also gave some funding to ART; however, the geographical level of these initiatives was always too small to help ART grow and establish itself. In ART's view, these initiatives to stimulate enterprise in Birmingham's deprived areas have broadly been unsuccessful. King's Norton estates and Aston for example received £54 million over 10 years as part of the NDC, but still has the lowest enterprise activity rates. Steve Walker believes that part of the reason was that rather than providing business development support for clients and helping them to find new markets, regeneration activities focused on physical changes, such as increased security measures.

In 1996, ART established a small board with Adrian Cadbury as Chair and David Brooks as Deputy Chair. They also put together a small research team, consisting of Pat Conaty and Danyal Satar, who was then Secretary for the UK Social Investment Forum (UKSIF). In spite of this progress, ART was still not operational. It was purely funded by research funds provided by NatWest, the Learning and Skills Council, and Birmingham City Council.

In 1996, it was decided to finally operationalise the organisation, and Steve Walker was recruited as CEO from Barclays' small enterprise lending operations on a two-year secondment. He met the requirements through his experience in small-business lending in deprived areas. Although he was not knowledgeable on social enterprise, he was a strong supporter of relationship banking, and the concept of ART captured his imagination. In 1997, ART launched officially, and Steve Walker joined the organisation formally in 1998. The Chair of the Board, Ian Clegg, thinks that Steve Walker's personality, dedication, vision and experience were paramount in making ART the successful organisation it is today.

The business plan called for funding through social investment. The plan was to raise £500,000 in the first year, and to lend £200,000. Only £330,000 was raised through social investment, but this money was then used to leverage a further £170,000 from the local area initiatives supported by the government office for the region. Private sector contributors saw their money as a grant rather than as an investment on which to expect a return. Raising the money was time-consuming, and contributions, for example by some banks, were in many cases very low.

[Initial experiences in operations](#)

ART was, like many other CDFIs, very cautious in the beginning, and declined 19 out of 19 applications that had resulted from referrals from one agency. ART struggled to build a referral network that would result in high-quality applications. Many organisations, such as Business Link, referred applicants who did not truly believe in the business plans put together. As a result, ART introduced personal vetting. The quality of the applications improved. ART started to build a reputation in the social enterprise market, also profiting from the fact that only the Local Investment Fund, Industrial Common Ownership Fund (ICOF) and Investors in Society were lending to social enterprises at this time.

Armed with this success and reputation, ART was successful in securing an EU grant of £200,000, to offer loans up to £40,000 to social enterprises. At the same time, social change, brought on by the change in government, triggered philanthropic investments by millionaires. With this money, ART launched the Key

Loan Fund in 2000, to specifically offer loans up to £50,000 to social enterprises. ART became the most renowned lender to social enterprise in the area, attracting further investment. Building on this reputation and success, ART started borrowing capital from banks and charitable foundations at commercial rates in 2001. Recently, ART secured credit lines with Unity Trust Bank of £500,000, partially through using CTR. This money is purely for lending, as banks would currently not fund revenue costs.

The Phoenix Fund changed things substantially for ART. Already in business, ART could use the money to experiment in terms of scale and operations. Politically, Steve Walker was strongly involved in the Small Business Task Force and Phoenix Fund Round 2, contributing to decision-making on how the money should be distributed to CDFIs. This involvement allowed the organisation to get ahead of the game.

Main sources of income

Income generated from loans currently covers a large part of ART's costs. Bad debts are covered by capital funds provided by the public sector. In terms of investment, ART has a distinct advantage over newer CDFIs as trading started purely based on private social investment. After this initial learning, having developed scale, ART now finds itself in a position in which funding can be easily leveraged in – either through private charitable foundations, or through commercial loans. Steve Walker believes that to provide 100 per cent funding for new CDFIs through the Phoenix Fund did not do the sector any favours, as the new organisations did not learn from the beginning to lever additional funding in.

Sustainability

ART is currently covering 85 per cent of its operational costs, with income from interest the single major source. The interviewees believe that this has only been achievable because of the scale ART has reached. This scale also allows them to significantly undercut current market interest rates which have increased as a result of the credit crunch. However, this is not what ART wants – a CDFI should provide loans for people who cannot go to banks. To increase outreach whilst minimising risk, ART has applied for SFLG accreditation. Steve Walker sees the SFLG as crucial for the future of the sector.

ART's business model

Legal structure

After initially having a three-company structure, the operation was streamlined, with all trading activity going through ART Share, an IPS. This helped tighten operations, with accounts now being filed by the group rather than by three independent companies.

Board and governance

The Board plays a very important role in ART's development and strategic direction. In 1998, ART rewrote its business plan, and established a Board of Directors with considerable experience. The make-up of the Board has changed over the years, reflecting the different needs of ART through its life. Initially, people with experience of access to finance and access to policy arenas were important. Later, the Board composition changed to include people with stronger lending experience.

The priority of the Board is to deliver the business plan's objectives, which centre on forward planning, achieving sustainability, and regeneration and job creation. From the Board's point of view, sustainability takes priority.

Products

ART specialises in loans between £10,000 and £50,000 for SMEs and social enterprises. ART hopes to be able to raise the maximum loan size to £100,000 in the future. ART seeks to encourage social-enterprise lending through interest rates. Social enterprise rates stand at 6 per cent above the Bank of England (BoE) rate, whereas the interest rates for SMEs are at 6–12 per cent above base. Both interest rates are declining.

Business advice

ART tried to provide in-house business advice to reduce risk and improve businesses. ART Development Services (ADS) was set up as a ring-fenced company to deliver these services; however, the strategy was not successful. ART could never prove that the free advice given to clients made any difference, and borrowers were not engaged. There were also thoughts about charging for these services, but the feeling was that if people did not accept the advice on a free basis, they would not pay for it either.

Referrals

Around 50 per cent of clients are referred to ART by external organisations, an increase in recent years, such as Business Link, accountants, intermediaries, and occasionally from banks. Often, ART is part of a package of financiers, but an important one as some projects would not get off the ground without ART's buy-in. Brokers receive one per cent of commission from ART for creating the deals.

Around 50 per cent of clients contact ART through word-of-mouth and self-generated marketing, such as events, exhibitions and lunches. Of the 50 per cent that are referred, the loan officers thought that Business Link would usually send good applicants, as a business advisor would improve on the business proposal. The volume of referrals, however, is low. Bank referrals are far more varied in quality. ART has introduced a new application form that replaces the business plan. By using a question-and-answer format it enables it to obtain the information it needs in a standardised format. Under this scheme, an applicant showing merit is referred back to Business Links or to the brokers for business advice and business planning if required.

Applications are judged on viability and social impact, for example, the number of jobs that will be created or safeguarded in the area. One of the reasons why ART has moved away from lending below £10,000 is the low impact it would have on employment figures. Most of these proposals are for lifestyle or sole-trader businesses, and thus would not generate the employment impact that is the remit of ART.

Well over 70 per cent of all applications are for start-up businesses. They mostly have very little or no experience. They apply for amounts that they believe they will be given rather than giving a clear assessment of what they need to start the enterprise. The biggest need of clients is education or training on the financial side of business. Many people are not aware of the time that needs to be put into a small business, and find it difficult to separate business and private lives.

Demand

There is no identifiable consistent line of demand over 10 years of operation in ART. Peaks and troughs are not governed by variation in funding; the difficulty is to bring demand to ART. Marketing remains a problem and the extent to which CDFIs are promoted as a source of finance. Fluctuations are created through a combination of pressure on banks to refer clients (increasing the deal flow) or by engaging in small-enterprise lending (decreasing referrals), and economic conditions. A few years ago, many banks were more focused on small enterprises, thereby reducing the potential deal flow for ART. In the current situation, risk aversion has increased, which could result in more business for ART.

ART is absolutely convinced that there is demand out there that it could tap into if CDFIs had the support necessary to become part of the standard list of potential sources of funding within other institutions. Personal lending, used for enterprise purposes, is also still a big hindrance to expand trading.

Partnerships

The main criterion for ART to rank its partnerships is the ability to create awareness for its work and to build referral networks. As observed with many other CDFIs, ART has difficulties establishing long-lasting fruitful partnerships. Building a referral network is time-intensive, and it can fall apart very quickly as such networks are person-driven. With every change in personnel in banks, business advice organisations etc., the networks have to be rebuilt.

Government partnerships

Steve Walker is well embedded in national policy networks, and has been a member of the Small Business Investment Taskforce, advising on various issues, which in turn secured ART an in-depth knowledge of the Taskforce's future plans. Similarly, ART works closely with Advantage West Midlands (AWM).

On a local level, Birmingham City Council should have been, in Steve Walker's view, a major partner. However, this partnership did not emerge, with disappointing results regarding enterprise stimulation, business support and business policies in general. As the Birmingham Council admitted, financial inclusion was not high on its agenda in recent years. However, there are plans to develop a strategy and work very closely with ART and other CDFIs.

The RDA

AWM has played an active role in supporting CDFIs in the area, viewing small enterprises as key to raising employment levels. It established the Regional Finance Forum (RFF) as an advisory body to AWM in 2001 with a vision to 'ensure that innovation, entrepreneurship and business growth are not adversely affected due to a viable business being unable to access appropriate finance'.

AWM has recently become more focused on growth than on employment however, with the RDA's headline target being to close the 11 per cent gap in Gross Value Added (GVA) between the West Midlands and the UK average. This has meant a change in focus on funding businesses with growth or 'high-growth' potential rather than start-ups.³⁸

Regarding the future, many questions remain open in regards to the RDA's strategy towards CDFIs in the West Midlands. The central debate at RDA level is whether to pursue a policy of consolidation and rationalisation, mirroring the restructuring of Business Link, with one major regional CDFI bringing together the other smaller organisations. This would, however, result in the loss of local knowledge that ART and other representatives of the CDFI sector see as paramount for the success of CDFIs.

Role of business support services – Business Link

Business Link in the West Midlands was recently restructured and consolidated from five regional Business Link offices to one centralised office. There is concern over what effect this will have in terms of the quality of referrals to CDFIs and the support given to clients in the region. This is mainly because many of the regional advisers with local knowledge of small businesses in their area have now either been made redundant or moved to a central call centre. As one Business Link interviewee put it, a successful referral:

'... [It] can come down to local knowledge and questioning technique of the person on the phone'.³⁹

ART had similar concerns about Business Link. It finds it difficult to build a good referral network with the organisation.

Third sector partnerships

Partnerships with the third sector serve more for information exchange, and do not result in many referrals.

ART is a member of the Fair Finance Consortium. It serves as a network platform. The website is of more use for microlending and personal finance rather than the bracket that ART is targeting.

The partnership with BSSEC (Birmingham and Solihull Social Economy Consortium) is largely to increase development support and deal flows from social enterprises, but so far not many loans have resulted from this.

Banking relationships

As Steve Walker pointed out, the main problem with banks is referrals. In an ideal world, ART should be inundated with deals from the banks.

ART's relationships with banks on a higher level were mostly established through Ian Clegg and Steve Walker's connections with NatWest and RBS respectively. The impression was that it was a top-down approach – headquarters instructing branches to work with ART. These relationships with the National Community Affairs managers were key to the initial partnerships with banks. To work with individual branches remains difficult as these are driven by targets and scorecards, on which CDFIs don't rank very highly. The current market situation has seen a reverse in that banks are working more jointly, but there have not, as yet, been any concrete outcomes.

In regards to funding, NatWest, Barclays and Unity Bank have provided major funding over the years. The new credit line with Unity Bank is a welcome expansion of these previous experiences.

ART Homes

In the very beginning of ART trading, there was a perception that there would be a market to lend to housing associations for maintenance and repair purposes. ART Homes was conceived to fill this gap. The new business model of ART Homes relied on the Council funding the company initially, and with further funds being levered from the private sector. ART Homes was then to make loans to private households who could not get loans from banks, for home maintenance and improvement. Birmingham City Council did support ART Homes with £1million, and it won an award, which led other local authorities to take a keen interest in the structure. However, private sector matched funding never materialised, as the repayment timeline was over 25 to 30 years, with little immediate return on investment. ART Homes was thus not sustainable. The company was sold to Mercian Homes for a nominal fee, and the model was extended to many other local authorities.

The success of ART

As Ian Clegg put it, the success of ART is based on two factors. On the one hand, the external environment is conducive to ART's trading. On the other hand, ART was very lucky to attract and retain a good mixture of visionaries and practitioners, who had the stamina and the enthusiasm to continue to work even during periods of great frustration in dealing with various government departments. Also, the strategy to have a portfolio of mixed industries has paid off in regards to risk-spreading.

Although CDFIs are in existence for some time, Clegg still sees them as person-rather than system-driven – they are not yet seen a standard part of the financial toolkit available to potential borrowers. In addition, enterprise-lending CDFIs would have lost out to the current government focus on personal debt and personal lending.

ART stands by its enterprise-lending model and has no intention of adopting a Moneyline model, as it believes it best to concentrate on its area of expertise. The organisation would not be big enough to take on more areas.

2. The Business Enterprise Fund (BEF)

BEF was founded in 2004 to increase entrepreneurial activity in the deprived areas of Bradford. It now also covers Leeds and North Yorkshire. It lends to start-up and existing businesses, as well as to social enterprises, with loans between £500 and £30,000. Its mission is to increase aspirations and to create viable businesses that help the individual and the community. It is heavily involved in Leeds and Bradford's LEGI programmes.

At the time of the interviews, BEF had made 29 loans between January 2007 and January 2008. BEF had 65 loans outstanding, with a value of over £1 million

Evolution of BEF

BEF is the brainchild of Malcolm Swallow, who has worked in business support since the early 1980s, and was involved in the predecessor of Business Link as Financial Package Advisor and Contract Manager. He worked closely with the Bradford Chamber of Commerce. As per the governmental requirement for Chambers and Business Links, the Chamber joined Business Link as a partner. This requirement pushed the Chamber into business support work for the first time.

The Chamber became aware of the increasing difficulties in accessing finance faced by existing and start-up entrepreneurs. It wanted a loan fund that would cover all of Bradford to ensure equal access to credit, unifying existing loan funds and initiatives. BEF was established as the vehicle to deliver this. BEF was also thought of as a vehicle to build people's aspirations, to reach deeply into the community and to provide very small loans. It is part of the business model to accept a default rate of around 10 per cent. The Board will challenge the operational team if they have a significantly lower rate.

BEF took on the shape of a CDFI because of the Phoenix Fund. An initial application for Round 2 Phoenix Fund was rejected, as the plans were not yet in a shape that would have led to a successful outcome. BEF was invited to apply for Round 3, however, and after improving on the business plan, its bid was successful. When the money was awarded, the initial assumption was that the attrition rates would be high and the Fund's existence short-lived.

BEF started trading in November 2004. Steve Waud was hired to operationalise the Fund; he designed the business plan, other operational policies and started lending within one month of trading start.

The initial money from the Phoenix Fund was lent on quite quickly. The Fund saw this as a sign of a thriving fund that reaches its target audience, and made more money available, bringing the capital up to £670,000. To fund its mentoring model, BEF applied for additional resources and received a further £300,000 from the SBS and the ERDF.

At the time of BEF's creation, Bradford was the target of several regeneration activities, such as Trident, and Newlands Partnership. Residual money from loan funds in these programmes was transferred to BEF. Money was also transferred from Labels (Leeds and Bradford Enterprise Loan Scheme) which led to BEF's expansion into Leeds in October 2005. The total capital was now £1 million. When Bradford Council applied for LEGI, BEF's success in lending the money to create successful start-ups triggered the inclusion of BEF in its LEGI bid. The fund had received a total of £1.525 million so far. Similarly, Leeds included BEF in its LEGI bid, and the fund was awarded £200,000 in April 2007. BEF also received residual funding from the Phoenix Fund through the RDA, bringing the total capital up to around £2.8 million over 3.5 years.

In April 2007, BEF expanded its area of operation into North Yorkshire, when Yorkshire Forward transferred transitional funding to BEF.

BEF has avoided relying on private and social funding, as it fears the strings attached may compromise its mission. The impact of CITR would not be very effective, and philanthropic founders would only be of interest if they were to lend or invest significant amounts at reduced interest rates. Instead, the organisation is relying on its £2.8 million fund, and is exploring the possibility of setting up the first socially driven venture capital fund. This is still in the early stages and hence cannot be explored further within the timeframe of this research.

Regeneration dynamics/environment

Bradford has been the target of varied regeneration programmes, following the decline of its main industries and the riots of 2001.

As pointed out above, money left over from these programmes have benefited BEF. Bradford has also secured the biggest LEGI bid, with funding until 2011. As

Richard Hudson from the Bradford Council explained the bid as centred strongly on combating financial exclusion and abolishing the barriers that would-be entrepreneurs face. It was clear from the outset that BEF would play a strong role in it. The Council does not expect a pay-back of the money invested in BEF, but it is ring-fenced so that it can only be lent to Bradford citizens.

Business model

Board and governance

The organisation is governed by a Board of Directors, and an advisory group.

The Board's composition of current or former board members of the Chamber is coincidental, but BEF has benefitted from the board members' excellent networks and expertise, reaching deep into the Bradford community

The advisory group's members are all practitioners in the field, reaching from LEGI representatives to a representative of Provident. Through this practical experience, the advisory group has a vital role in deciding the shape of the organisation, especially with regard to community outreach.

Application process, fees and rationale for the business model

BEF was always envisaged to be based on a compulsory, fee-based mentoring and buddy programme, following a model that several US CDFIs have adopted and that showed promise in bringing attrition rates down and increasing business survival rates.

Each client is assigned a business buddy or a business mentor, depending on loan size. They spend four hours each month with the clients, and should ideally be available at very short notice. The fees also pay for a service package including, on an as-needed basis, accountancy and legal services, SAGE bookkeeping software, bookkeeping advice etc. The fees for buddies and mentors reflect the cost of these services in the free market, i.e. the clients pay largely for services they would require in any case.

Mentors and business buddies both require extensive practical experience, although the breadth of experience differs between the two. BEF trains mentors and buddies to assess a client's will and stamina to go ahead with the business.

Mentors work with clients above £10,000, and the costs here can be as high as £220 per month, but is set flexibly to reflect that clients in this loan bracket may have previous business experience, and the fee is reviewed regularly with the client. Mentors should have significant business experience across one or two industry sectors. They have to be able to produce financial forecasts, cash flows, balance sheets, profit and loss accounts, including relevant legal issues (such as licensing, regulation, certification etc).

Buddies were introduced when it became clear that the level of support required for loans below £10,000 required a different set of skills. Buddies also have a far stronger role in community outreach, in networking, visiting community groups, advertising the funds in the target market. Clients pay up to £75 for this service.

The comparably high fees and application process are geared towards deterring clients who are not serious about their proposal or do not believe in its success.

The fund also assists (for free) in the production of the business plan to get a real picture of the client's ideas. In some cases, this assistance alone is sufficient to find the client mainstream finance.

If the loan panel approves the plan, the client will then learn how much they will have to pay in mentoring fees. This practice is criticised by some, arguing that BEF doesn't sell the fee package very well, or appropriately. Many potential clients would be deterred by this. Leeds and Bradford LEGI subsidise the mentoring fees for the first six months as it believes it would otherwise deter too many potential clients. If it was to redo the partnership, it would cancel all the fees.

Both Malcolm Swallow and Steve Waud fear that this approach may impact on BEF's strict vetting policies and increase its attrition rates, as well as the number of clients receiving a loan when they are not (yet) ready for it.

Richard Hudson, on the other hand, argues that most clients coming to BEF from LEGI-supported initiatives are already in touch with a business support agency. The Council is thus even thinking about abolishing the mentoring scheme for LEGI clients.

But the fees not only act as a deterrent, there are also designed to give people ownership of the package, to criticise and flag issues if they are not satisfied with the service they receive.

BEF's model appears to be very successful as it does not struggle to get the volume of deals it needs; it struggles to get high-quality proposals. Its failure rate, according to Steve Waud, is at eight per cent which is far lower than the CDFI average of 25 per cent.

This might well be at the expense of outreach, i.e. it will not attract people who may need to be coached extensively to take a step towards entrepreneurship. However, if BEF would reduce vetting, the failure rate might well go up.

Operations

Steve Waud, as Fund Director, is responsible for designing and adapting the operational policies as required. His background is in reshaping and reforming businesses, hence he has considerable experience in improving business performances. He introduced very clear operational policies and audit trails to ensure clear decision-making rules, clear governance and clear accountability to avoid potential discrimination or favouritism. At the same time, stringent operational policies also ensure accountability to the funders and internal governance structures to demonstrate the orderly and efficient manner of spending.

Main sources of income

BEF charges interest rates at around eight per cent above the BoE base rate. Different products have different interest rate structures and have been tailored to suit clients' varying circumstances.

Income is largely derived from the interest rates and mentoring fees (89 per cent). An additional 11 per cent are derived from brokerage fees, where BEF finds finance for a client. Ideally, Steve Waud would like to see this expand, but BEF currently does not have enough capacity (time and staff) to do so.

Sustainability

Steve Waud stated very clearly that BEF would be client/market driven, rather than funder driven. Outreach would go beyond fulfilling requirements of funders, or sustainability goals. The fund could be running sustainably with the money available, but it would have to scale down activity and focus on existing clients rather than to continue to reach out to those hardest to reach. On the other hand, BEF aims to become sustainable in its operational costs by 2010 for larger loans. However, to work commercially on outreach and microlending is not sustainable at reasonable interest rates, as default rates and costs of servicing the loans would be too high.

Steve Waud thinks that this small-scale lending will always have to be publicly funded, although there is pressure from the Government to become sustainable. BEF's mission is to help people who face significant barriers, and it is proud when it achieves it, but it can only do it because it has received funding to support these activities.

Products

BEF tries adapting its products to clients' circumstances as much as possible. Products are varied to suit clients' needs, from start-up and microlenders to equity investment schemes. Fees and interest rates vary to reflect the different risks associated with different business types and models.

Relatively recently, BEF introduced peer-group guaranteed loans for all loans under £10,000. This means that applicants have to demonstrate that their friends, family and other relatives believe in their business and in them to pull it through. This idea was adapted from Project Enterprise in New York, a Grameen-style operation that is highly successful.

Security

Technically, all loans are secured, as they are personal loans. Four loans are secured through collateral, in one case through a mortgage on the client's daughter's house. BEF also provides lease purchase products. It concerns mostly cars, but it has also funded a fat fryer and a mobile food van. This not only serves as risk minimisation for the client and the organisation, but also increases accessibility to funding for clients and provides income for BEF.

Business model Leeds:

The Leeds model is largely the same as in Bradford and for the geographical area it covers, but here, BEF works together with the Leeds Credit Union in delivering LEGI. Loans below £5000 are dealt with by the credit union. Leeds LEGI also covers the mentoring and buddy fees for the first six months. At the time of writing, there were 30 clients through this LEGI programme. As the programme only started in summer 2007, an evaluation has yet to take place.

Demand and referrals

It is the buddies' task to market the organisation to potential clients. They contact community organisations, liaise with a variety of organisations to establish referral structures, and try to spread the word in deprived areas. Buddies have been in place for one year only; the organisation is still learning how to best pitch the fee-based packed to potential clients. As interviews with coaches from the BizFizz programme have shown, it has not yet reached maturity, as many of the coaches' clients see the fees as unjustified and a deterrent, not because they are not serious about their business plans, but because the sums to pay, added to the usual repayment time of two years, seems overwhelming to them.

Impact

As part of its LEGI reporting duties, BEF collects information – largely demographic data – on its clients.

BEF monitors the individual client's progress, but outside of the reporting requirements for LEGI, no further aggregate analysis is undertaken. BEF also prepares a case study for every client, partially for LEGI, but also to celebrate the success these people had in overcoming the obstacles they were faced with. To this end, Steve Waud introduced the Bizz Awards, a celebration of entrepreneurs who succeeded against the odds.

Other impacts would be observed through the mentoring process, for example, to increase a client's business profit and hence their financial stability.

An independent consultant conducts an annual customer satisfaction survey regarding the mentoring programme. BEF takes this anonymous feedback very seriously and has made adjustments to improve the programme.

Partnerships

BEF is well connected with organisations and institutions giving business advice and helping people to become entrepreneurs.

The main purpose of partnerships is to establish referral structures, to ensure a steady flow of customers from trusted sources. These are not as fruitful as was hoped and so a lot of energy is put into outreach by the fund itself.

BEF has an excellent track record of establishing and maintaining partnership with government actors. It is mostly connected to the local councils, as well as to the RDA. Because of the ties with the LEGI programme, there is so far limited contact to other government agencies. Reporting to other agencies is undertaken through the LEGI administration in Bradford and Leeds, and there is currently no requirement and/or capacity to apply for further funding.

Relationships are stronger with business support networks. In general though, a culture of co-operation, similar to what LEGI in Bradford tries to create, has yet to emerge. Most agencies still work towards the goals and outputs that are set for their organisation and the goal of the LEGI programme to break this silo-mentality has not been achieved so far.

The partnership with the RDA Yorkshire Forward as the new responsible body for CDFIs is still emerging, but works very well. Yorkshire Forward turned its attention to CDFIs about 18 months ago. Its attention was drawn to BEF, among other things, because of the Bizz Awards. The RDA is seeking to consolidate all its finance activities in the region under the heading 'Finance Yorkshire', and there will be a CDF element to that. There are also efforts to increase co-operation between CDFIs, a development that Steve Waud thinks will be necessary for CDFIs to increase their voice but also to prove their impact for government and the RDA.

Third sector partnerships

These partnerships centre on referrals; BEF is trying to establish ties with organisations targeting minorities and disadvantaged groups. Referrals from these organisations are not yet very numerous.

In addition, it has a close and hybrid relationship with CDFA. CDFA is helping BEF to set up its measuring and evaluation systems, to introduce benchmarks etc. BEF also has a contract with CDFA for the distribution of residual Phoenix Fund money.

Banking partnerships

BEF would like to have stronger partnerships with banks, especially in terms of referrals. It is still surprised that banks won't refer those clients they do not want to lend to. This, however, Steve Waud perceived as a nationwide problem. Referrals would only issue if there was something in it for the banks, so BEF is brokering finance deals with banks for its clients.

BEF's success

There is certainly not one answer to BEF's success. Interview partners have also pointed out the great importance of Steve Waud. His experience and dedication was and is paramount to building and driving BEF forward.

Steve Waud thinks BEF's success was a combination of the operational policies, the mentoring model, and being in the right place at the right time.

The availability of public money and the solidity of the business model also contributed to the rapid increase in loan numbers and funds. SBS's satisfaction at the outcome of the first funding round, and the additional money received from them triggered other public funding in turn.

3. Fair Finance

Fair Finance is a CDFI operating mainly in East London since 2004. It specialises in personal lending and micro-enterprises, and its mission is to redress social injustice and to promote transparent lending practices. With a strong link to housing associations, Fair Finance is a variation on the Moneyline model that seeks to combine business and personal lending with access to finance for home improvement. In keeping with our focus on enterprise lending for this report, we will omit analysis of personal lending operations.

Evolution

Fair Finance started as the brainchild of the Environment Trust, dating back to 1997. Initially, the Trust got involved in microfinance as a result of a co-operation with an organisation called Account 3 which seeks to give loans to women to start up small enterprises. The type of enterprises were not big enough for business plans and required very small loans, which made accessing credit

particularly difficult (e.g. £250 to become a driving instructor, or to buy cloth for a sari business).

Around this time, Bob Paterson got involved. He undertook initial research on microfinance in East London, with the aim of setting up the East End Reinvestment Trust through the NDC. This application for NDC money failed, however, as the NDC focused more on estate renewal than on enterprise promotion.

The Trust was undeterred by this and sought different sources of funding instead. In 1999, Faisal Rahman, the CEO, started to work in microfinance at the Environment Trust. He set up the microcredit programme with an added debt-advice component. Initial experience showed the necessity of this advice. One of three applicants was over-indebted and needed debt advice to take on further loans. Others were in need of credit, but could not access it.

These extremes led to the idea of a holistic financial intervention programme, to create a financial services campaign rather than simply offering different kinds of financial service products. This idea is also centred on transparency and accountability, thus making the organisation a vision for the financial sector as a whole. The goal is to design products that increase financial inclusion.

The idea for Fair Finance was born out of this thinking, and the organisation was formed in 2004; lending started in April 2005.

Regeneration funding

The organisation did not receive much regeneration money. In the first year, Tower Hamlets sponsored the organisation with a £67,000 grant over two years for core funding, to match funding it received from the ERDF for its microfinance work. This, however, did not leverage other regeneration funds in, in spite of the fact that Fair Finance was described by the Phoenix Fund as the most successful microcredit programme in London.

Fair Finance was successful in getting Phoenix funding, which in turn led to ERDF funding. Another interesting and unique feature was the connections that were established with housing associations: Fair Finance receives money for debt advice from these organisations. Most connections were established through cold calling, but the association with the Environment Trust was a door-opener for many of these relationships.

It also managed to secure some funding from banks, although this was not large-scale.

Business model

Fair Finance sees itself as more than a CDFI; it seeks to strongly promote financial inclusion and financial literacy. Hence, the loan application process is advice-driven and does not necessarily result in a loan. It combines personal and business lending with a strong advice component.

This advice approach is evident in Fair Finance's partnerships with housing associations. It runs the *Money Matters* programme, which seeks to advise housing association tenants on debt. Several housing associations pay the organisation to provide a certain number of hours of debt advice for interested tenants. Not only does this provide Fair Finance with a source of referrals, it also ensures a steady stream of income for the organisation whilst furthering its goal to increase financial literacy.

Fair Finance has a comparably high portfolio yield of 25 per cent. As Faisal Rahman explained, this is due to the low default rate (5 per cent for business and 10 per cent for personal lending), which in turn is due to the product fit that provides the flexibility and variety that poor people need.

Board and governance

The Board of Directors represents both community and business ties. All members have close ties with the boroughs in which Fair Finance operates, and their backgrounds allow them to contribute to the strategic planning of the organisation.

Fair Finance also always has an advisor who it hopes to then invite to serve on the Board when a vacancy opens. There are currently nine members on the Board, a size which Faisal Rahman considers to be appropriate for the organisation.

Sources of income and sustainability

Fair Finance wants to be sustainable and to continue to grow. The focus here is on clients rather than funding. Faisal Rahman plans to reach scale by increasing outreach. He describes his organisation as fully client-focused. Most funding Fair Finance receives is unrestricted, with the exception of public funding contracts. It seeks to recycle restricted public funding quickly to be able to use it freely to further the organisation's goal.

Faisal Rahman is convinced that both product lines can be sustainable, but as they are still growing and business systems are still being built, loan officers can't work to scale yet. Initially, 20 per cent of income was covered by interest payments, rising to ca. 40 per cent last year. For the current year, he expects to cover 50 per cent. The number of loans is also rising very quickly, from an initial 150 loans to 400 in the third year of operation.

In 2007, Fair Finance received a total of £591,027 in funding from various partners. About £110,000 is unrestricted funds, giving the organisation scope for developing independently of funders' requests.

Public funding, from BERR and the DWP was quite substantial, with £168,124 in revenue, and £84,000 in capital. The DWP is part-funding the face-to-face debt advice Fair Finance provides. The LDA also supported Fair Finance with £90,000 for capital, and £50,000 for revenue. In addition, Fair Finance received grants of £95,181 from the ODPM/ERDF and £25,000 from Tower Hamlets. Funding from housing associations came to £30,000, which is tied to the *Money Matters* programme

Fair Finance is growing fast. The turnover in the first year (2005/2006) was £400,000; in the second year (2006/2007) it was at £700,000; and Faisal Rahman expects a turnover of ca. £1.2 million for the year 2007/2008.

Interest rates

Interest rates are set to reflect operational costs and, to some extent, risk. Current interest rates are at 21 per cent for personal lending, and 15–19 per cent for business lending, depending on loan size. For larger loans, the interest rates may drop to 15 per cent. Fair Finance is currently reviewing interest rates based on its three years of experience. The review will take into account costs per loan and seek to balance it off with competitors' offers and sustainability consideration.

Application process

The application process for both personal and business lending aims to be as quick as possible while taking the time to listen to the clients and to understand their situation. Typical turnaround times for business and personal loans are 10 days and 24 hours respectively, although business applications can take up to three weeks, as Fair Finance checks that the client has obtained all legal documents pertaining to the business.

Clients from both product lines are sometimes rejected with the request to either prove their ability to save (personal lending) or to attend business planning seminars or similar (business lending). Many rejected applicants never return, but those that do then usually receive a loan.

Business lending products

There is no minimum limit for business lending. The average business loan is at £3000, with the loan terms between 28 and 30 months. In the last financial year, Fair Finance lent around £75,000 to businesses.

Business lending has a similar amount of capital outstanding as personal loans. By volume, the business lending operations are much smaller. In the last 4–6 months, Fair Finance has begun to co-operate very closely with debt advice agencies for referrals, an approach that appears to be very fruitful. The new system is far more

sustainable in terms of loan evaluation, applicant motivation and hence in terms of business success. Until April last year, 70 per cent of applicants heard about Fair Finance through word of mouth. Now, 80 per cent come through the referral network. Of these referrals, 80 per cent of proposals are viable.

In three years of operation, Fair Finance has made ca 80 business loans. The numbers have vastly increased over the last few months as a result of the referral network, and the expansion of the operating area. The default rate for business lending is at five per cent, arrears are usually at 15 per cent.

Security

Fair Finance clients usually cannot provide security for their loan. To reduce the risk, and to increase commitment of the client, Fair Finance is currently piloting a scheme where the client is asked to provide a personal reference. If repayment problems occur, the organisation will call the referee to discuss why this problem may be occurring, and the referee in turn can contact the client to influence him or her.

Fair Finance will continue to lend in the microsector, but is aware of the limitations of the sustainability of microfinance lending in industrialised countries. The organisation seeks to grow in scale, but also to cross-subsidise its microlending with larger loans.

Peer group lending

One of Fair Finance's partners, Street Cred, offers peer group loans – where each member of the group co-signs the loan – to poor women in the area. Fair Finance provides the funds but the administrative side of managing the peer structure lies with Street Cred. The failure rate with these kinds of loans is high, so Fair Finance sees it as part of an outreach work rather than as a source of income.

Client base – business lending

Fair Finance does not track the age of clients, but the loan officer estimates that the majority is between 25 and 40; 95 per cent of clients belong to an ethnic minority, with 60 per cent of the loans going to women. The business loan officer believes that women are usually more serious about business.

Most clients are banked, and have access to personal credit that can be used for business purposes. However, many become indebted through credit cards and overdrafts and see an enterprise loan as a solution to their debt problems.

Clients would benefit most from financial education, and from being part of a community. The latter can be beneficial in terms of support, but also for confidence-building and coaching.

Demand

Demand appears to be sustained for both personal and business lending, although the referral structure and creation of deal flow is varied. Referrals for personal lending are largely through word of mouth (ca 70 per cent) and advertising (30 per cent). Until recently, this applied to business lending as well, but the newly created partnerships with business advice agencies now provide up to 80 per cent of all referrals.

Partnerships with Business Link have, as in the other case studies, not been very fruitful. In Faisal Rahman's opinion, Business Link is like an enterprise agency and refers to itself rather than to other organisations. Hence, Fair Finance is looking to engage with more community-orientated organisations, such as Account 3 and others.

The biggest problem for Fair Finance's business lending, as with other CDFIs, is the quality of the applicants. If clients have a good business idea, but do not demonstrate the necessary skills to open and run a business, Fair Finance will, at most, offer a personal loan. The organisation values the ability to think critically in its staff, and has been successful with this approach. Several clients starting out with personal loans have migrated to business loans.

Impact

In spite of its excellent reporting practice, Fair Finance is not monitoring detailed impact on clients' lives at this stage. For repeat clients, incomes and repayment rates are reviewed, and figures audited. This concerns mostly personal loans, as there are not yet repeat loans for business clients. Fair Finance has only recently made longer-term loans that can bring more insights to business lending. As part of our research, we tracked the impact of personal lending on clients' lives, which we discuss in the main report.

Partnerships

Of all four case study organisations, Fair Finance has the most partnerships with business advice agencies, both from the third and for-profit sector.

Third sector partnerships

One crucial partnership of course exists with the Environment Trust. Without it, Fair Finance probably would not exist as it had the money, the clout and the opportunity to help the CDFI come into being, and to set up the *Money Matters* programme. Considerable funding streams result from this programme.

Fair Finance has links to many third sector organisations, especially for its business operations. Some of the links, such as with Street Cred, and Account 3 (two organisations targeting ethnic minority women for microcredit lending) are historical and have evolved through the ties with the Environment Trust.

For business lending specifically, the business loan officer has built ties since October 2007 with business advice groups and centres across East London, with the express aim of building referral systems. There is no selection process to establish which organisations should be contacted. Relationships are built through cold calling. Whether or not the partnership will persist depends solely on the outcome, i.e. the number and quality of referrals from these organisations. It is too early to undertake an in-depth quantitative assessment of these partnerships. However, we have spoken to three organisations, Street Cred, Exquisite Consultancy and South East Enterprise. All three of them were satisfied with the partnerships, although the depth and extent of their satisfaction depended on the length of the partnership and the strategic alignment of their goals.

Street Cred sees the partnership with Fair Finance as very important and successful as it helps it focus on its core business of business advice, whereas Fair Finance provides the loan administration.

Exquisite Consultancy was very satisfied with the relationship. It has ties with many credit providers and works also with banks, so a relationship with a CDFI, or social lender (such as One London) is not new. Its experience in leveraging in funds for clients helps Fair Finance, as Exquisite Consultancy see it as one of many providers from which to choose.

South East Enterprise provides business advice (both pre-start and post-start) for the Lewisham Council, and as part of this seeks finance for its clients. It works closely with all high street banks, as well as Greater London Enterprise (GLE) and One London. Fair Finance is not one of its main credit providers; South East Enterprise will contact Fair Finance when other doors have been closed. The partnership is still very new, making further assessment difficult.

Government partnerships

Fair Finance has little contact with government agencies, either local or national. It receives funding through the Financial Inclusion Fund, and was a recipient of Phoenix funding. Connections with the LDA are currently dormant due to the LDA's problems with its CDFI strategy.

The aforementioned matched funding from Tower Hamlets is the only contact Fair Finance has with the Borough.

Banking partnerships

Fair Finance has close ties to the RBS, especially in product development. This again has historical origins, and the connection with the Environment Trust proved

fruitful. Andrew Robinson, then manager at the RBS, was convinced of the need for banks' involvement in the CDFI sector. He gave a grant to Fair Finance to experiment with, allowing the organisation to use it as it saw fit – with good result. Robinson was also vital in the sense that he created a strong CDFI element to RBS's small-lending section, and made sure the partnership between RBS and Fair Finance stayed alive when he moved on to another position.

Barclays is funding Fair Finance through a grant of £30,000. Otherwise, Fair Finance has no ties with banks.

Competition

Fair Finance faces different competition situations for both product lines. It is the sole social personal lender in London, and is expanding its areas of operations to cover all of London to take account of this.

For business lending, however, the decision is different. There are many other organisations in Fair Finance's area of operation, such as HBV, who provide business loans. Fair Finance concentrates already on the lower end of the spectrum to provide loans for those people rejected by other CDFIs. To exploit this advantage, Fair Finance made the strategic decision to expand the area of operation for business loans to include Camden, Waltham Forest and Lewisham. This expansion took place in August 2007, and the first loans from these areas have been made.

Future issues

Fair Finance aims to raise private investment through the provision of high rates of return. The goal is that the loan interest rates would pay the investment back. Faisal Rahman predicts that there will be a mixture of philanthropic finance combined with increased scale of operations, i.e. increased coverage of operations costs through interest rates.

The goal is to raise around £5–£10 million over the next few years, through a small number of large investors. The premise of Fair Finance as a social investment vehicle remains. This will form the basis of an agreement of the appropriate rate of return.

Fair Finance's success

Fair Finance's success is certainly grounded in its visionary approach and the dedication of the CEO, Faisal Rahman, and staff. Its partnership with the Environment Trust was also crucial in its origin, but this vision will certainly make it very appealing to investors. Through the *Money Matters* programme, DWP funding and the high volume of personal lending, Fair Finance can also generate a steady stream of income helping it to cover its costs. The popularity of the organisation also suggests that its products are suitable for the requirements of its targeted market.

4. The Wessex Reinvestment Trust (WRT)

The Wessex Reinvestment Trust was founded in 2002 and became operational in 2003. Its core mission is to provide finance and support to small and social enterprises, as well as voluntary organisations, specifically for local food production, renewable energy and local community development. It operates across 11 counties in the South West of England, making it one of the few rural CDFIs. It gives out loans between £1000 and £50,000 to eligible enterprises, including social enterprises, and administers a home improvement loan scheme for 11 councils. It is also known for its innovativeness in developing new financial mechanisms for social enterprises.

Mission and challenges

The emergence of WRT's mission, its success and the challenges it now faces can be understood by looking at the evolution of the organisation; it was born out of a range of mostly third sector organisations and their representatives that were confronting rural economic decline. This decline was manifested in the collapse

of the rural food and agriculture economy, the absence of financial services, and unaffordable housing and workspace. The WRT approach was to develop co-operative innovative solutions that would lead to a systemic change in financing (social) enterprise rather than simply alleviate existing problems.

WRT supports social enterprises and micro-entrepreneurs in the fields of food and agriculture, affordable housing, sustainable development and renewable energy. The evolution and experiences of this CDFI highlight the national and local policy issues that community finance now faces. WRT's evolution also demonstrates common operating challenges, in particular securing sufficient viable demand to be sustainable. Current operations have diverged from the original concept and WRT's initial strategic priorities, highlighting how both operating context and policy environment have shaped community finance solutions.

Evolution

WRT was founded following a feasibility study that identified gaps in the provision of finance to small businesses, social enterprises and voluntary organisations. The study and the resulting business plan for WRT sought to apply lessons from the CDFI sector to a unique rural setting. Backers and funders included the Countryside Agency, the Housing Corporation and Lloyds TSB; Community Finance Solutions at the University of Salford contributed to the analysis.

The feasibility study was a result of a continuing decline in the rural economy of the area. The rural economy has been a significant provider of self-employment, and its decline resulted in higher unemployment levels, with more and more low-paid and insecure jobs available. The South West of England, like much of rural Britain, had undergone a series of crises in the 1990s and early 2000s, resulting in decreases in agricultural activity and tourism as sources of income, out-migration due to increased housing prices, and the resulting decline in local communities and entrepreneurial activity, exacerbated by bank and post office closures.

The study investigated and linked challenges of underemployment, lack of access to credit to enterprise and property (re)development in the adjacent areas of Devon, Dorset and Somerset, dubbed 'Wessex' in the report. It was argued that these problems could not be tackled in isolation.

The solution developed to bridge this gap was a Wessex CDFI, comprised of distinct organisations who would provide finance to micro-enterprise, rural entrepreneurs, social enterprise and housing developments. These companies together represent the WRT 'family' and its activities: Wessex Reinvestment Trust, a charitable company limited by guarantee; Wessex Reinvestment Society, an IPS; Wessex Community Assets Limited, also an IPS; and the Wessex Core Company which now trades under the name of Wessex Home Improvement Loans and is a company limited by guarantee.

The four challenges WRT seeks to address to reverse the decline of the area are the following:

1. Increasing start-up and growth finance for rural small enterprises.
2. Providing support to the food sector, in particular protecting its diversity.
3. Providing affordable and appropriate workspace.
4. Developing and providing access to affordable housing.

The CDFI was to sit in the middle of a web of public and third sector agencies that already existed and tackled the challenges of rural regeneration, but often in an overlapping and uncoordinated fashion. This strategy of combining the expertise of banking, social housing and public sector professionals was from the outset reflected in the choice of directors and board membership. WRT was envisaged as a coordinator and central point of referral for partner agencies with which the CDFI's potential clients were already engaging.

WRT's mission fits with the predominantly third sector origins of its Board

members. This is reflected in its relatively limited relationships to more mainstream regeneration and business support organisations, such as the South West Regional Development Agency (SWRDA) and Business Link. Some local authorities were involved from the outset, such as Devon and Somerset county councils, though these depended heavily on personal relationships with key staff in those authorities. Relationships to county councils have now been formalised in a partnership with 11 councils in a consortium via the Wessex Core Company providing home improvement loans to the councils' constituents.

Main sources of income

The main source of revenue funding has been via the RDA mechanisms where CDFIs are part of an increasingly formalised consortium. This contributes to the enterprise lending of the Wessex Reinvestment Society. The other major components of income are funding from charitable and philanthropic organisations, such as the support provided by the Esmée Fairbairn Foundation and the Friends Provident Foundation. The Esmée Fairbairn Foundation and Lloyds TSB originally put up the capital for the start-up CDFI, following on from their support for the feasibility study. However, the establishment of the CDFI coincided with the Department for Trade and Industry's (DTI's) SBS support to the sector via the Phoenix Fund. The opportunity to apply for this considerable and generous support led to a shift in the intended business model and market priorities of WRT, which continue to have far-reaching consequences.

WRT business model and company structure

WRT chose a group structure to best suit its social mission. The umbrella charity (WRT) heads the group that consists of two IPS (Wessex Reinvestment Society and Wessex Community Assets) and one company limited by guarantee (Wessex Home Improvement Loans). The group structure was developed to allow the different challenges to be addressed by dedicated entities within the WRT 'family', along with a charity that could attract further grants, public support or private investment seeking to benefit the region or to foster innovative new financing approaches.

Board(s)

The group has separate Boards for each entity, though there has always been considerable overlap in the responsibilities taken on by Board members via steering groups. In spite of some of managerial problems that coordinating disparate contributions involve, there is a clear consensus among current and past Board members that the vitality of the Board, in particular the members' varied backgrounds in relevant sectors has provided a real strength and foundation for WRT's ability to be responsive to the needs of the region.

The structure of the group and its products

The WRT Group, through its different entities, is involved in an impressive range of activities and has never simply been a lender. Apart from enterprise lending, the home improvement loans product and the Financial Mechanisms project demonstrate the value of the WRT Group's approach, harnessing its innovativeness and the strengths of a board comprising such varied and extensive experience of the related sectors.

Wessex Reinvestment Trust – the charity

Each entity is tasked with a different role. WRT is a charity which allows grants to be channelled to the goals of the overall group, subsidising innovative projects and activities that support WRT's overall mission. These activities include financial and technical assistance, and business advice or training consultancy geared toward employment opportunities for the unemployed or those in financial need. The charity carries out tasks with the sister entities via formal agreements and has been a crucial structure to enable key grant-funded innovations, such as the home improvement loans and the Financial Mechanisms project.

Wessex Reinvestment Society

Wessex Reinvestment Society (WRS) provides enterprise lending for social enterprises and SMEs. When founded in 2002, its initial focus was to support social, environmental and ethical enterprise, in particular within rural communities. Lending from £1000 to £50,000 for up to five years, it is focused on providing loans that

would not be funded by the banking system and that create or protect jobs in rural areas. A fixed interest rate of 12 per cent is charged.

As of 2007, over 60 loans totalling £490,000 had been made. The loan book is predominantly in micro-enterprise loans, totalling £370,000 from 64 loans in 2006, whereas five loans worth £36,000 were outstanding to social enterprises. Since trading began, the cumulative total of 72 loans until 2006 was £510,000. WRT does not charge fees for related services. Loan officers often provide free critical support to applicants in developing their business plans and during repayment periods.

The Phoenix funding led to the inclusion of all enterprise sectors within the Wessex catchment area. The money was lent out successfully, but the high rate of delinquency and insufficient viable demand had a distortive effect on the organisation which continues to face high levels of bad debts. As a consequence, WRS has refocused on the social enterprise sector.

From 2006 to 2007, the value of loans fell from £399,288 to £301,150. This reflects the consolidation and re-focusing of the lending activities of WRS. The provision for bad debts over the same period grew from £102,122 to £160,900 in 2007. The principal source of funds in 2007 remained Phoenix capital, plus capital from Esmée Fairbairn Foundation and Lloyds TSB.

The charity helped this strategic re-assessment as the grants channelled through this organisation could be used to pilot new innovative financial mechanisms to raise capital for social enterprise. This gives WRT a new role as financial intermediary. WRT was one of the first IPS to adopt new model rules allowing for the issuing of share capital, which is now sanctioned by the FSA. The establishment of this model also represents a modest revenue stream from fees for the licensing of these rules.

Wessex Core Company – Home Improvement Loans

Wessex Core Company exists to provide Wessex Home Improvement Loans (WHIL) to people with housing needs. In partnership with a coalition of 11 county councils across the Wessex region, the Core Company receives financial support to develop appropriate products aimed at financing home improvement. The councils refer potential clients and also task WRT with developing loan products to assist homeowners to achieve the Government's Decent Homes Standard. Thus the councils benefit through improved housing conditions in their authority areas. To further promote the uptake of these loans, the councils pay three per cent of the six per cent interest charged on the home loan credit.

The Home Improvement Loan product and business is of key significance to WRT's overall operations. It provides steady revenue and has been highly successful, with no defaults on a lending product charging six per cent for home improvement activities. The financial input from authorities in the consortium is justified by the tangible social dividend of houses brought up to the Decent Homes Standard. The Housing Association Charitable Trust also backed the development of this product. The marketing is undertaken by the authority partners. Over 160 loans have been made, with only a single loan in arrears.

By early 2007, loan values were worth over £500,000. New referrals were exceeding a rate of 20 per month, while loan applications outstanding were of a similar size to the value of loans already made. The total fund was worth £2.625 million. There are plans to examine the possibility of bank finance. The sale of the rights to the loan product to London Rebuilding Society also generated income. Eighty-five per cent of clients rated the service provided as excellent, and three-quarters of the loans were to people classed as 'vulnerable' according to Government measures.

This product allows WRT to generate a steady income stream, benefit from a consistent referral system and a clear definition of the social output sought and attained. The scheme allows for flexibility to develop products tailored to clients' needs, including a sharia-compliant loan scheme specifically for Bristol City Council, which provided £140,000 specifically to support provision of these loans. Its development depended at the beginning on the close relationship between a board member and one of the original consortium councils. Through its success, the

product is now fully embedded into the existing consortium structure, and does not rely anymore on individual relationships.

Wessex Community Assets – Community Land Trusts

Wessex Community Assets is a recently constituted IPS (2007) that exists to support the provision of affordable housing in rural communities. It was specifically created to hold land to enable community land purchases. This has emerged from the pioneering work done in the WRT Group to utilise community land trust structures. It has enabled the group to be the south west partner of Carnegie UK as part of a national project to develop action research on community land trust housing. WRT undertakes a survey of rural activity in affordable housing, an appraisal of potential projects, supports an advisory group, and disseminates reports.

Financial Mechanisms project

The Financial Mechanisms (FM) project demonstrates the value of the group structure WRT employs, specifically the freedom afforded by the use of the WRT charity. The charity structure allows WRT to pilot financial innovations and effectively test new developments of its business areas. The charity is thus a conduit for grant funding to projects which have a credible claim to impact on the whole sector and benefit the CDFI itself. The new legal models that the FM project has developed represent this combined benefit. The project, which was funded by Esmée Fairbairn and Friends Provident with £89,000, ran over one year and was completed in January 2008.

The Financial Mechanisms (FM) project sought to develop innovative mechanisms to increase the flow of investment in community initiatives and social ventures where loan finance was inappropriate. This was explicitly to address the need for finance-raising for community asset projects, and to examine how CDFIs can generate income in a post-Phoenix environment.

Two structures were developed to enable social investment:

The Community Asset Projects, seeking to find finance for community land trust housing developments, and the Enterprise Investment Project for investment into enterprises focused on social or environmental issues. Both structures were registered as IPS with FSA approval. They issued investment prospectuses to attract funding for four pilot projects which have now been completed. For one project, ECOS Fund Ltd, over £630,000 has been raised so far. The findings of the project have also identified key issues for local investment that can be of value to other CDFIs. This building and sharing of expertise through pioneering approaches represents another groundbreaking role that projects like the FM project can play. If appropriate marketing is conducted, and a clear benefit can be identified from investing, then the FM project findings show that such approaches can give genuine independence and freedom to community groups relative to other forms of backing. It represents a revenue-raising service, and is valuable intellectual property for the WRT group.

The appointment of a Development Manager to explicitly consider marketing and product development in 2007 demonstrates the strategic shift within the organisation to positioning WRT as a financial intermediary for investors looking to realise financial and social returns.

Demand for lending

Like many other CDFIs, WRT struggles to find viable applications for its loans. This is exacerbated by the increase in lending remit through the Phoenix Fund, and its location in a rural area with a natural low population density. The £500,000 received through the Phoenix Fund had to be lent on very quickly, leading WRT to making all enterprise sectors eligible for lending. This resulted in high-delinquency rates, totalling in £185,000 for micro-enterprise lending in 2006 with write-offs of £85,193 in that year. Its focus on rural areas has strong implications for the core sustainability of its business lending operations, which remain reliant on local government funding and grants from charitable organisations.

Partners: WRT's role in relation to stakeholders

The overall consensus was that, although WRT's partner base is very broad, the number of effective formal partnerships focused on delivery was relatively low. However, the nature of the Board means that there is a broad base of backers who have developed a long-term relationship with WRT and who look to it to test pilots and innovativeness in the community finance field. Consistent with its origins, some of the most effective partnerships that WRT has are where it enables innovative financial solutions to support other third sector or public partners.

This role also enables WRT to both generate and sustain grants and profitable partnerships.

Referrals

Though considerable effort was made to develop referral partners for enterprise lending upon receipt of Phoenix funding, WRT has not developed a thriving referral network. Banks have played a role as funders but not as effective referral partners. Reflecting links from board members, Barclays' financial inclusion fund has backed WRT, as has Lloyds TSB in the past. Business Link agencies in the counties covered by WRT and Charity Bank are also referral providers, but the level and quality of enterprise-lending demand has remained below a sustainable threshold.

There has now been a shift to identify more appropriate points of referral, adapted to the specialised sector WRT targets. The current strategy is to build on WRT's increased prominence gained through high-profile projects such as the FM work, and the interaction of board members with clients. Thus the WRT Group is developing a brand and niche focused on its social mission and innovativeness to deliver sustainable and social development in a rural setting.

Competition

The WRT Group does not consider itself to be in competition with other CDFIs, and there is extremely little overlap in service provision with other CDFIs in the region. Instead, other CDFIs increasingly refer applicants to WRT if they feel they cannot handle this enquiry.

Strategy of the RDA

SWRDA is seeking to develop a comprehensive strategy to increase coverage and capacity of CDFIs in the region. It views the current structure as overly fragmented, too small-scale, and with insufficient shared infrastructure. Thus, it sees it as the duty of CDFIs to utilise the investment and capital already deployed with a more coordinated strategy to raise their profile, stimulate demand and improve their sustainability.

Robin Edwards, SWRDA's Business Finance Programmes Manager described its policy as a 'simplification' strategy. The RDA does not want to seek to replace the existing mechanisms, but plans to use the residual Phoenix funds to nurture co-operation between the existing CDFIs to provide complete market coverage. As part of this strategy, it will develop a common marketing packages and products, and are about to launch a joint website.

The approach of the RDA is to elect one CDFI as its contractual partner, and cascade support to other CDFIs as subcontractors or subpartners of the elected CDFI. This also serves to encourage their participation and coordination with each other and ultimately greater professionalism without sacrificing the social role that they have to play.

The RDA pursues a three-tiered strategy to systematically increase the capacity and coverage of CDFIs, whilst reducing the comparably high levels of delinquency. This includes funding of revenue support and advice services. In the last stage, the RDA will also examine the provision of capital for loan books to absorb an envisaged increase in demand through improved marketing and coverage.

There is some concern amongst board members about the appropriateness and value of the RDA's simplification strategy. WRT, spanning three counties, sees quite considerable differences in the regions within the South West, and the organisation itself is distinct in its mission and the products and services it provides when compared to other CDFIs. Ultimately, the WRT Group remains reliant on public and

charitable sources of income. These sources have narrowed in the wake of the Phoenix Fund, so the ability to demonstrate the social value of supporting WRT entities individually or via innovative projects becomes even more important to the continued success of WRT.

Sustainability

WRT's enterprise-lending activities are a long way away from operational sustainability. So far, fees for services such as training of social enterprise managers, and royalties from intellectual property of the innovations developed within the WRT Group, are not sufficient to cover operating expenses. The sourcing of income through grants reflects a key dilemma that WRT encountered when trying to expand its lending with Phoenix funding. This challenge was to develop a capital base to match larger-scale lending, in particular via increased lending frequency.

Though WRT has targets to achieve sustainability within the next two and a half years, it is not a fixed, formal goal. As Debbie Stewart, acting Chief Executive, pointed out, in a fluid financial environment, it is probably counter-productive to commit to rigid targets, particularly given the disappointment in previous years. This led to the shift in focus back to social enterprise and a broader diversification, but not to the forms of enterprise lending it sought to perform with Phoenix funds. This includes recycling income from both Home Improvement Loans product (though the revenue funding to it is ring-fenced) and income from the provision of services, including service-level agreements between the Group's entities. The Group also expects to rely on grants for the foreseeable future.

Key success factors; what does the future hold?

The experience and approach of WRT reveals the tensions inherent in the CDFI sector, but also provides an intriguing case study of how innovative approaches and a proximity to the needs of its sector can allow a CDFI to retain its value and purpose.

The tempting offer of Phoenix funding, whose priority was on-lending, led to WRT over-reaching and developing a loan portfolio with high delinquency rates. Lending strayed ever-farther from the core expertise, knowledge and mission of the WRT Group. The priorities and goals of the organisation were distorted by the policy support provided, perversely weakening the CDFI in terms of its social value and relevance.

WRT is an example of how a CDFI with a clear social mission had to adapt due to the conditions tied to policy support. It had always set out to become a viable lending operation, but its priorities were shifted by its changing landscape and the unanticipated low levels of viable demand. This mission-drift was detrimental to its operations, as the demand in its rural setting was not viable for the enterprises it sought to expand its lending toward. This reflects a lack of understanding of local operational circumstances by far-off policy-makers that we address more generally in the main report.

The valuable lesson of WRT is its experience of innovation; this is done with a focus on achieving its social goals and has stimulated operational success. The valuable home improvement loan business evolved from the organisation's closeness to its eventual partners. The councils' understanding of WRT's capacity to coordinate their efforts to achieve housing Public Service Agreement targets has grown into a large-scale and profitable business strand. The more deliberate visionary role of the WRT Group, in terms of the FM project, has enabled it to be a leader in mapping out a new terrain of social investment and an accompanying potential role for all CDFIs to be conduits for socially geared investment into local regions.

Thus WRT demonstrates how community investment can be done in a novel and more appropriate fashion than the private or public sector had previously envisaged. Though its innovative outlook is challenging for management and co-ordination, WRT's ability to keep its organisational focus closely tied to its mission has allowed it to develop new ways of addressing those needs, something which has in turn benefited the CDFI itself.

Appendix B: list of interviewees

ART

Aston Reinvestment Trust	Steve Walker (CEO) Ian Clegg (Deputy Chairman, Board) Martin Edmonds (Loans Manager) Andy King (Loans Manager) Stuart Egginton (Operations Manager) Christine Smith (Administrative Officer)
Advantage West Midlands	Mike Watts (Business Finance Executive)
Business Link	Anthony Andrews (Sector Manager, Business and Professional Services)
Fair Finance Consortium	George Keenan (Head of Development)
Birmingham City Council	Jacqui Kennedy (Director of Regulatory Services)

BEF

BEF	Stephen Waud (CEO) Malcolm Swallow (Technical Fund Manager) Steve Colwell (Board member; RBS Associate Director Business Development)
Barclays	Diane Hirst (Local Business Manager)
CDFA	Peter Newnham (Head of Regions – North)
BizFizz	Natalia Fernandez (National Co-ordinator) Andrew Gibson (BizFizz Coach) Celia Hickson (BizFizz Coach)
Bradford LEGI	Richard Hudson (Enterprise Business Co-ordinator)
Yorkshire Forward	Henry Rigg (Enterprise Development Officer)

Fair Finance

Fair Finance	Faisel Rahman (CEO) Kudejah Ali (Loans Officer – personal lending) Riccardo Aguglia (Loans Officer – business lending)
CCLA Ltd	Andrew Robinson (Director, former Head of Community Development Banking at RBS)
The Environment Trust	Lorraine Hart (Research and Development Officer)

Exquisite Consultancy	Ony Okosa (Senior Consultant)
Barclays	Jenna Eastlake (Senior Financial Inclusion Manager)
StreetCred	Iseail MacKinnon (Project Manager)
Newlon Housing Association	Sunita Parbhakar (Assistant Director, Housing Services)
South-East Enterprise	Jeremy Hedger (Business Advisor)

WRT

Wessex Reinvestment Trust	Martin Smith (former Chief Executive)
	Debbie Stewart (Co-founder, Acting Chief Executive)
	Alison Ward (Development Manager)
	Katherine Wiltshire (Home Loans Development Manager)
	Annie Popham (Investment Manager)
	Bob Paterson (Co-founder and Board Member)
	Tim Crabtree (Co-founder and Board Member)
South West RDA	Robin Edwards (Head of Business Team)

Government

Treasury	Samuel Amissah (Savings and Investment Team)
BERR	Mark Hambly (Director, Capital for Enterprise Ltd)

RDAs

East of England Dev. Agency	John Wilkinson
East Midland Dev. Agency	Claire Thomson
South East of England Dev. Agency	Kate Annison

Endnotes

- 1 The Local Economic Growth Initiative (LEGI) is a government programme aiming to boost entrepreneurialism in the most deprived areas in England.
- 2 Unlike other Moneylines, Fair Finance does not currently provide specific home improvement loans.
- 3 CDFA website: <http://www.cdfa.org.uk/cmframe.php?prmid=1200#whatis>
- 4 Department for Business Enterprise and Regulatory Reform (2008): *Enterprise: unlocking the UK's talent* (London: BERR).
- 5 <http://www.englandsrdas.com/>
- 6 The Small Change Partnership (no date): Financial Exclusion in the South East of England: Summary (Guildford: SEEDA).
- 7 Because of an adaptation of the survey period to coincide with the financial year, there is an 18-month gap between the current report and the last one.
- 8 This may be partially due to the longer reporting period included in this year's CDFA survey.
- 9 CDFA (2008) *Inside out: the state of community development finance* (London: CDFA).
- 10 There is not even a UK-wide map for the location of all CDFIs against the index – a noteworthy exception here is the research undertaken by CDFA and Yorkshire Forward.
- 11 Westall, A. (2006) *Enterprise for all: progressing the agenda* (Bedford: Enterprise for all Coalition).
- 12 North, D., Smallbone, D., Lyon, F. and Potts, G. (2003) *Business-led regeneration in deprived areas: a review of the evidence base* (London: Centre for Enterprise and Economic Research at Middlesex University).
- 13 Enterprise Directorate (no date) Small and Medium Enterprise Statistics for the UK and Regions (London: BERR).
- 14 Lawlor, E. and Nicholls, J. (2008) *Hitting the target, missing the point: how government regeneration targets fail deprived areas* (London: nef).
- 15 Adie (2007) *Rapport d'activite 2007* (Paris: Adie).
- 16 Ramsden, P. (2005) *Evaluation: The Phoenix Fund Development Fund* (Final Report) (London: BERR).
- 17 Note: this says nothing about whether or not the regeneration drive will actually lead to large-scale and long-term economic impacts. It will help the CDFIs and their clients.
- 18 An industrial and provident society is an organisation conducting an industry, business or trade, either as a co-operative or for the benefit of the community. Source: FSA website, http://www.fsa.gov.uk/pages/doing/small_firms/m_sr/societies/index.shtml
- 19 An interview partner from the Environment Trust mentioned that the NDC initiative changed focus away from enterprise regeneration to estate renewal, where Fair Finance's mission did not fit in.
- 20 Lawlor, E. and Nicholls, J. (2008) op. cit.
- 21 We have been unsuccessful in obtaining an interview with the LDA on current and future activities around CDFIs.
- 22 We have not had feedback from One North East and North West Development Agency.
- 23 However, subprime credit card lending is on the increase, representing a new competitor for business lending.
- 24 So far, BEF has not lent beyond £30,000, but has mechanisms in place to be able to do this.
- 25 Brown, J., Nissan, S. (2007) *Reconsidering UK Community Finance* (London: nef).
- 26 Nissan, S (2008) *A model for funding and supporting CDFIs: Lessons from the United States* (London: nef).
- 27 Thomas, W., Brown, J., Bush, M. and Smith, G. (2006) *Full disclosure: why bank transparency matters*. (London: nef).
- 28 CDFA (2008) op. cit.
- 29 Communication via email.
- 30 ANZ (2007): Progress Loans Update (Melbourne: ANZ).
- 31 Telephone communication on the 26 November 2007 between Sargon Nissan and Jenna Eastlake, Senior Financial Inclusion Manager, Barclays Corporate Affairs.
- 32 *The Economist* (2008) Getting it right on the money 3 April 2008 (Economist: New York).

- 33 This is also another example of the kind of obstacles that clients have to overcome on their route to entrepreneurialism.
- 34 Dawnay, E. and Shah, H. (2005) *Behavioural economics: seven principles for policy-makers* (London: **nef**).
- 35 Telephone conversation on 8 April 2008 between Veronika Thiel and Samuel Amissah, Head of Mutual Policy, HM Treasury.
- 36 Brown, J., Nissan, S. (2007) op. cit.
- 37 Steve Walker, 'Community Finance and ART – Lessons from the First 10 Years', Presentation to University of Birmingham, 7 November 2007.
- 38 Interview with Business Link West Midlands, 3 March 2008.
- 39 Interview with Business Link advisor, 3 March 2007.

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Written by Veronika Thiel and Sargon Nissan (August 2008)

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