findings

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Promoting the growth of the community development finance sector

The Government has identified community development finance for enterprise as a priority within its strategies to address social exclusion, neighbourhood renewal and wider regeneration. A team of researchers led by the New Economics Foundation investigated the current performance of community development finance institutions. They identified barriers to growth and explored how performance can be enhanced. The study found:

- **Community development finance institutions (CDFIs) control £500 million of assets for lending and other investment in the UK. Since 1998 their assets have grown by more than 30 per cent.**
- **CDFIs are independent organisations, often rooted in their local economy and accountable to a range of stakeholders. They are committed to serving their communities in the long term.**
- **Community development finance differs from the subsidised credit delivered by ‘soft-loan funds’ to enterprises. These funds currently control £50 million in assets, but are often unsustainable. Many have closed down.**
- **A change in practice, not least among the agencies that support them, is necessary for existing soft-loan funds to become more effective and sustainable. They can learn from the practice of CDFIs.**
- **CDFIs that perform well have skilled and committed staff and effective ownership and governance structures. They had adequate capital to start with and draw on a range of funding sources, including private and local individuals. They maintain loan losses below 10 per cent and adequate reserves against risk.**
- **Only a few CDFIs have adequate management information and reporting systems. A number have used evaluations effectively to assess their performance and impact.**
- **Recent years have seen rapid policy developments for community development finance. Delivery of effective and flexible policy tools is now a priority.**
- **The sector also faces barriers to its growth. There is no agreed framework for reporting performance and accountability. CDFIs face an uncertain regulatory environment. Banks do not disclose detailed information about their lending activities in under-invested areas.**

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Introduction

'Community development finance institutions' (CDFIs) are specialist enterprises that contribute to wider community development by delivering credit and related services to excluded groups. They often operate as mutual and non-profit entities. The demand for community development finance comes from micro- and small businesses, including social enterprises, and from individuals.

Policy development

Since 1998, community development finance has seen a period of rapid and intense policy development:

- Two of the Policy Action Teams that developed the Social Exclusion Unit's *National Strategy for Neighbourhood Renewal* focused on community development finance. Financial exclusion received similar attention in Scotland, Wales and Northern Ireland.
- The new Small Business Service (SBS) received a mandate to promote enterprise (including micro- and social enterprise) among under-represented and disadvantaged groups.
- The Phoenix Fund under the SBS aims to distribute £90 million over three years in financial support for CDFIs and other initiatives promoting enterprise development.
- The Bank of England has reviewed bank lending for small businesses in disadvantaged communities.
- Regional and local authorities are developing strategies for enterprise finance.
- In 2000 the Social Investment Task Force proposed five recommendations for enhancing investment in enterprises in under-invested areas. All five recommendations are currently under development.

The researchers conclude that this intense phase of policy innovation now needs to be followed by a period of implementation, consolidation and appraisal, with a clear focus on delivery. Although, credit unions have also received significant policy attention, this research focused on enterprise finance.

Growth of CDFIs

In 1998 previous research by the New Economics Foundation ('Community investment in the UK', *Findings* Ref: N38) identified five categories of CDFIs: credit unions, community development loan funds, micro-finance funds, mutual guarantee societies and social banks. Since then major changes have happened within some of these categories, and a range of new models and instruments are emerging, including those for community development venture capital.

The core markets for CDFIs - such as micro-enterprise, small and medium-sized businesses, social enterprises and charities - are all growing. There are also a number of apparent gaps or opportunities for community development finance, such as equity capital (or its equivalent) for social enterprises and charities.

Since 1998 the assets of CDFIs have grown by more than 30 per cent. The growth rate among loan and micro-finance funds has been 29 per cent, while assets of social banks have grown by up to 85 per cent. Together CDFIs (including credit unions) now control about £500 million of assets for loans and other investments within the UK.

The bulk of the growth in assets has come from CDFIs that were already operating in 1998. New loan and micro-finance funds contributed just 5 percentage points of the overall growth in assets of 29 per cent. However, these new funds are likely to experience rapid growth in the near future. The capital provided by the Phoenix Fund will contribute further to the rise in CDFI assets.

Some of the banks and building societies have played a critical and active role in supporting CDFIs. Their support has included capital and revenue grants, secondees or ex-banking recruits, referrals and co-financing. However, CDFI partnerships with banks have yet to achieve full commercial viability like that found in the USA and developing countries. No UK bank has yet established a specialised subsidiary equivalent to the community development corporations in the United States.

Soft-loan funds

Community development finance differs from the subsidised credit delivered by 'soft-loan funds' to enterprises (see Table 1). Such funds have usually been established by the public sector or various enterprise support agencies, often with help from the banks.

The researchers estimate that there are up to 200 loan and equity funds in the UK established primarily to provide last-resort lending for small and medium-sized enterprises (SMEs). The vast majority of these funds are soft-loan funds, and many have performed poorly.

Of the total sample of 148 funds surveyed by the researchers, 35 per cent had ceased to exist. Included in this sample are funds that received support from banks, as identified in a survey by the British Bankers' Association in 1998. 43 per cent of these funds had closed within two years.

The reasons for closure include high loan losses, the end of revenue funding programmes that supported them, and the lack of will to survive. They often operate in a funding and policy environment that is little concerned with how their operations will be sustained. This is reflected in the performance of the 65 existing funds the researchers reviewed.

- The average number of loans per year made by a fund was 17. Most funds lent between £25k and £50k per annum.
- 95 per cent of the clients were first-time borrowers – there was little repeat lending. This meant that many borrowers who were still unable to secure bank loans did not have access to a further loan.

Table 1: Contrasting CDFIs and soft-loan funds

Characteristic	*CDFIs*	*Soft-loan funds*
Duration	Long-term; aim to be in existence for as long as needed	Short-term; typically linked to a funding programme
Sustainability	Have a strong focus on how their operations can be sustained	Less concern with sustainability issues
Funding source	Multiple sources; banks and government sources but also private foundations and individuals	Primarily government funding programmes and banks
Ownership and control	Independent organisations; can involve ownership and control by local people and organisations	Dependent organisations, often part of a local quasi-state regeneration agency, that may pay part or all of their operating costs
Reporting	Information is publicly available; evaluation available	Poor information availability; little evaluation
Governance	Diverse local stakeholder involvement	Business and regeneration agency involvement

- Typically, the funds targeted start-up, micro-, small and medium-sized enterprises, with relatively small loan sizes. Just 17 per cent lent to co-operatives and 12 per cent to other social enterprises.
- Default rates were high. 39 per cent of the funds had default rates of 11 to 20 per cent, and 24 per cent default rates of over 20 per cent (compared with an average default rate of 12 per cent among the CDFIs surveyed).
- Most funds were unable to bring in income to cover these losses. Interest rates and lending charges were often low and did not cover even basic operational costs.
- Impact was poorly measured, so that there is little evidence whether money invested in soft-loan funds is well spent. Less than half the funds produced any publicly available information.

To make the existing soft-loan funds more effective and sustainable will require a change in their practice and in the funding and policy environment in which they operate.

Building sustainability

Analysing the performance of loan funds provided insights on how soft-loan funds might be transformed and the performance of CDFIs enhanced, as well as guidance for establishing new funds.

The commitment and drive of fund managers is critical. An effective ownership and governance structure is also essential for sustaining a loan fund's operations and, equally important, its mission. Governance is enhanced by:

- Independence, including from any form of interference in lending operations;
- a diverse governance structure;
- members with a strong stake in the local community. Many CDFIs are therefore structured as mutual Industrial and Provident Societies.

Loan funds based on a clear understanding of their target market performed better. They identified the key problem: is it access to finance or its cost, or both? If access to finance is the problem, then loan funds can charge higher interest rates to cover more of their costs. Many loan funds unnecessarily exclude social enterprises.

Loan funds need sufficient capital to cover their basic operating costs. Funds that had over £500k in capital to start up with, plus access to credit, performed better. Smaller funds have to use forms of 'micro-credit' (such as 'peer lending', 'stepped lending' or local mutuality) that significantly reduce their operating costs.

Funds with a range of funding sources, including private investors and local individuals and organisations, also performed better. Having a range of funders makes growth and sustainability more likely, in part because dealing with a range of funders also builds in discipline to the lending process.

Effective financial management requires high quality accounting, control and reporting systems as well as adequate reserves against loan losses.

Barriers to growth

The research identified existing barriers to the growth of good practice, including the lack of an agreed framework for reporting performance and accountability, and an uncertain regulatory environment (see below). Further barriers to growth are the lack of a trade association of CDFIs, and the lack of detailed reporting by banks on their lending operations in disadvantaged areas. The latter would enable more rigorous local partnerships to support enterprises, and help the banks themselves develop market information on investment opportunities in such areas.

Performance and accountability

There were no systematic benchmarks for assessing the performance of the sector. Only a few CDFIs had adequate management information systems. Some CDFIs have used evaluations effectively to assess their performance and impact.

Consultation among practitioners in the sector, and comparisons with CDFIs in the United States, suggested a more effective framework for performance and accountability would involve:

- Reporting against a list of core indicators measuring financial performance and social impact, as well as accountability. Such indicators would need to be developed in partnership with key stakeholders.
- Using other indicators, with equal prominence, that particular CDFIs believe best reflect their mission and performance.
- Reporting against a range of benchmarks, which are not viewed in isolation, but form part of an overall perspective on the sector.
- Continued use of evaluations, both external and internal.

The diverse and under-developed management information systems of most CDFIs will need transforming to deliver on such a framework.

Regulation

CDFIs have developed in the context of a regulatory 'benign neglect'. The advantages have been easier start-up conditions for new CDFIs and room for CDFIs to innovate and experiment. The disadvantages have been the regulatory uncertainties that CDFIs face.

Interviews with regulators and practitioners in the UK, and comparisons from international experience, suggested the need to develop a clearer and enabling regulatory framework. Most CDFIs still operate at small scale and their key need is for permissive regulation, which offers an established model or choice of models for doing business, with the maximum flexibility of operations. Measures to achieve this include:

- Clarifying and easing regulation governing credit unions, charities and industrial and provident societies;
- Reducing the cost of registering industrial and provident societies, which is significantly higher than for companies;
- Existing regulators, such as the Financial Services Authority, building their capacity and their understanding of the sector.
- Introducing a new legal form for social investment funds that would enable CDFIs to access some of the £2.5 billion of funds in mainstream investment markets that are screened against social or environmental criteria;
- Introducing a recognised status or exemptions for CDFIs under EU banking directives.

Experience from the USA and Canada suggests that self-regulation by an association of CDFIs could be an effective and responsive way to complement any statutory regulation. To achieve this, CDFIs in the UK will have to build their own capacity to act as self-regulators.

About the study

The research was conducted in 1999 and 2000 by the New Economics Foundation and the University of Birmingham. The research fell into four major components:

- The sample of loan funds was identified from two previous surveys and additional desk research. A questionnaire was sent to each fund and often followed up by phone. The quantitative survey was complemented by ten casestudies (five of soft-loan funds and five of CDFIs) based on visits, interviews and available documentation.
- To develop the performance and accountability framework the researchers consulted widely through a reference group made up primarily of CDFI practitioners. They also reviewed international experience, and visited five CDFIs to review their management information and reporting systems.
- Research on regulation was conducted through interviews with regulators, legal experts and practitioners, complemented by comparisons from international experience.
- Other components of the research were undertaken as part of the research process for the Social Investment Task Force.

How to get further information

The state of community development finance 2001 ISBN 1 899407 383 is available from Central Books, tel: 0208 986 4854, price £9.95 email mo@centralbooks.com. More detailed background reports on the performance and transformation of soft-loan funds, the performance and accountability framework, and regulation are available at www.neweconomics.org.

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