Community Finance Solutions

Research funded by:

BARCLAYS

Lloyds TSB

HOUSING CORPORATION

Community Finance Initiatives - A Policy Success Story

Research by Dr Karl Dayson, Community Finance Solutions at the University of Salford

Introduction

As banking services have expanded across the country, the gaps in provision have risen in importance. In response Community Finance Initiatives (CFIs) have addressed both the accessibility of services and their affordability.

Independent of the state and usually operating on a not-for-profit basis CFIs offer an alternative way to deliver financial services within deprived communities. But how successful are they? And is the public and private investment worth continuing?

Different types of CFIs

Credit Unions - A savings and loan organisation operating within a 'common bond' of either spatial and/or employment or association.

Community Development Finance Institutions (CDFIs) - Loan funds using risk capital and grants usually lending to business and social enterprises.

Community Reinvestment Trust (CRT) - A form of CDFI that lends for personal and enterprise needs

Savings and Loan Schemes (SLS) - A partnership between housing association(s) and a mainstream finance provider. Similar rules to credit unions but delivery is through the mainstream provider's outlets

Policy Background

Policy Action Team (PAT) 3 - Enterprise Report

Enterprises struggle to be created or prosper in deprived areas partially because of limited individual savings. Consequently these areas are more reliant on external finance. CFIs have a role as 'a bridge between deprived communities and the mainstream economy'.

Social Investment Taskforce Report

Regeneration programes'compensates people for being poor', thereby suffocating entrepreneurship and 'encouraging a grant culture'. The report recommended an investment tax credit, a venture capital fund and greater freedom for charities to invest in CDFIs. All these have been delivered.

Mary has had years of being in and out of jobs and on benefit and so did not have the capital or credit rating to secure a business start up loan from a bank for her business. Salford Money Line has turned her life around with a loan to start up a clothing alteration business. Mary is out working everyday now. *Salford Advertiser 18.9.03*

PAT 14 - Access to Personal Finance Report

This made a direct link between financial exclusion and deprivation. It recommended new and alternative means to deliver financial services, liberalisation of credit union legislation with greater protection for members savings, and more innovation such as SLS, and engagement by the banks.

Credit Union Report (Goodwin) and other progress

- Promotion of larger more sustainable credit unions with common bonds open to all who live and work in an area.
- Trade association emphasising professionalism and good management.
- 100% share protection for all members introduced.

Purpose of Research

To provide evidence based analysis of CFIs' progress. The researchers addressed five crucial questions:

1. Are they serving deprived markets?
2. Could they do better?
3. Are they sustainable?
4. If not, why not?
5. In conclusion are CFIs worth supporting and what should be the nature of future support?

An initiative of THE UNIVERSITY OF SALFORD

Community Finance Solutions

Outline methods

Case study research focused on six CFIs:
3 CRTs - all from urban deprived communities
1 CDFI - established enterprise lending only
1 SLS - partnership between a housing association and a building society
1 Credit union - Live and Work common bond in deprived inner city.
Research employed:
Client profiling through using CFI records
Financial comparison of CRTs
Time Sheet analysis of how staff spend their day
Semi-structured interviews with key actors.

Are they serving deprived markets?

129 business clients from 3 CFIs and 251 personal customers of 5 CFIs were reviewed

Business Customers

Investment Capital

In total £1,741,773 was loaned to 101 clients. Supplementing this was £217,801 in personal investment by clients, though 85 loans were issued to clients without capital

Support for New Starts

68% of applicants were new starts predominantly seeking less than £5000 to purchase equipment/vehicles. 64% of new start applicants secured a loan

Nature of applicants

19% of applicants were women. At one CRT 25% had either County Court Judgement and/or were using a moneylender
Only 25% were manufacturers, of remainder 57% were general services, 10% media, and 8% retail

Purpose of Loan

44% were for equipment/machinery or vehicles, 50% was for cash flow/capital injection and only 6% for property related expenditure

Amount levered in/job creation

Due to CFI loans £855,000 was levered in. In addition to each applicant, 111 other jobs were created, and 352 jobs were preserved. This equates to £3762 in loans for either saving or creating a job. This indicates that the CDFIs' loans can deliver a cost effective public benefit in terms of job creation and sustainability.

Personal Customers

Client profiling (figures for CRTs in brackets)
51% claimed housing benefit (50%)
71% received some state benefit (65%)
19% owned a car/motorbike (26%)
39% borrowed less than £250 (30%)
41% of loans were for decorating/furniture (38%)
19% of loans were for clearing debts (25%)
43% did not have a bank account (62%)
16% had CCJs (26%)
22% used a moneylender (35%)
66% were women (58%)
36% were single (34%)
55% had children (57%)
33% were single parent households (42%)
46% were unemployed (44%)
Average weekly income was £153 (£150)
49% were in debt (65%)
87% had no evidence of savings (90%)

CFI Profiles

What works where and why?

Enterprise CDFI - Concentration on established businesses and making loans in excess of £20,000. Year-on-year average size of loans increasing due to being embedded in local networks, professionalism of staff, and focus on achieving sustainability. Seen as a leading CDFI but risks staff attention being drawn towards broader policy discussions and meetings with statutory and strategic agencies.

CRTs - All have strong customer focus and design products and delivery to match client base. Client profiling shows they are serving the financially excluded. Perceive competition as moneylenders who charge upwards of 176%APR and interest rates reflect this reality. Have demonstrated the need for their personal loans and the take-up of enterprise lending is increasing. Some evidence of overlap between personal and business borrowing by clients.

Credit union - Client base is slightly wealthier, more stable, and older than that at CRTs. Encouragement of savings central to CU ethos but this may deter those who are currently using moneylenders without the need to save before borrowing. Of the CFIs the credit union had the strongest sense of community ownership.

SLS - Relatively low development costs and linkages to mainstream providers. Removes 'poor man's bank' stigma incurred by other CFIs. However, there was only limited take-up of loan products and 50% of loans were in arrears.

Improving Delivery

Keeping it Simple - Clients get confused with too many advice and delivery agencies. Either CFIs need to offer a full range of services, including savings, or provide joint single access points.

All Business is Personal - Micro-entrepreneurs rarely separate their individual and business accounts. Services and processes should reflect this reality.

Know your Market - The CRTs were all reaching the most deprived communities but evidence of market research was scant. CFIs need to ask whether their processes are designed for them or their customer?

Location, Location, Location - Those with physical locations in places where the clients congregated grew faster. Remote providers rarely got repeat business.

Are they sustainable?

With widely different business models, regulatory frameworks, and stages of development it is impossible to directly compare the CFIs.

The enterprise CDFI is moving towards 70% operational sustainability i.e. the ability to cover its revenue costs through income streams. It believes the remaining 30% can be raised from public sources and altruistic organisations and individuals. It seeks to keep costs down by making a moderate level of high value loans. To date it has missed its original target budget due to the extent of advice it provides to its client group.

The Credit Union is reliant on the interest on loans to members for most income, must produce a surplus to pay a dividend to members and satisfy the Financial Services Authority (FSA). Currently most of the staff costs are met by public funds, though the credit union is prepared to reduce staffing if needed. Sustainability is dependent on expanding the business and reducing bad debts.

With only limited direct expenditure and no plans to be independent, the SLS is not pursuing sustainability. Most costs are hidden within the partners' standard activities.

Business plans for the CRTs indicated that sustainability would occur in about five years. Comparing the performance of the CRTs against their original budgets, all 3 surpassed their year 1 targets. On year 2 *(see table below)* the two older CRTs missed their goals, while the newer CRT reached its income target but overshot its expenditure figures.

Ratios	Year 2 Budet	Year 2 Actual
Total cost per loan	£284	£435
Staff cost per loan	£139	£237
Average loan	£1044	£784
Bad debt & provision	£6.77	£9.33
Annual income per loan	£112.16	£81.94
Cost Income	£2.53	£5.3

As the table shows, the CRTs are struggling to match their income because the average size of the loan is 25% lower than expected, while the staff costs are 62% above estimates.

Bankrupted in 1998 David has suffered two heart attacks and was struggling to pay off several debts including a loan of £800 on which a doorstep lender was charging an APR of 80%. He had a bank account but no facility to borrow. PART negotiated reduced settlement figures with creditors and approved a loan, which David is able to pay back at £20 per week. *Guardian G2 28.3.01*

Why are they missing targets?

Have they been too successful?

In reaching the financially excluded, CRTs found that the clients unstable personal finances have resulted in much smaller loans being requested and erratic repayments.

Limited interest rates?

The least successful CRT had its interest rates capped at 15%, while the credit union has a legal limit of 12.68%. This restricts the capacity to engage in higher risk lending or limits operating income. The most successful CRT charges 29% APR with no detrimental impact on its lending business.

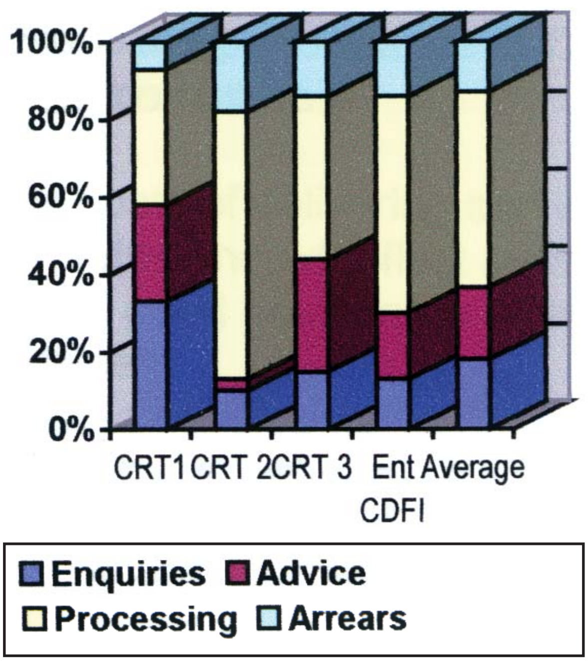
Difficulty opening new markets?

All CRTs were expecting to make home improvement loans linked to regeneration projects. To date these schemes have not materialised, removing a key source of relatively stable income.

Doing the job of others?

All the CFIs believe the main reason for missing targets was the need to undertake advice and support work with customers. This has taken considerable staff time thereby preventing other activity. To test this hypothesis a staff timesheet analysis was performed.

Clearly the major staff task is loan processing (50%). From the diagram it is apparent that considerable efficiency savings are possible as one CFI is twice as efficient as another. The effect of many smaller loans is evident in CRT1 with 33% of its time spent on enquiries. Whilst the 19% of time spent on advice-related tasks supports the case that CFIs are engaged in what should be other organisations' tasks.



Community Finance Solutions

Overcoming Barriers and Making Improvements

Relationships and referrals

There are too many asymmetrical partnerships with enterprise agencies making minimal effort to understand the needs of CFIs regarding referrals. Nor was there evidence of changing practices to reflect the arrival of CFIs. Instead, advisors sought to blame CFIs for taking too long to assess cases or for requesting more information. Governmental and strategic agencies need to think about dovetailing support and access to finance.

For individuals, advice agencies wanted to preserve their independence and some were reluctant to work with CFIs. A few advised clients to de-prioritise CFI debts because they were less likely to pursue legal action.

Grant culture

Business support advisors remained wedded to grants rather than loans for their clients. Loans challenge their self-perception of helping entrepreneurs, while CFIs are in effect 'checking' the work of advisors when assessing business plans. This distorts the relationship and requires further investigation.

IT failures

Significant efficiency enhancements require investment in IT. By developing tailored IT, CFIs missed the opportunity to share costs and resources. Notably the quality of management information was questionable.

Banks and Building Societies

The support of Banks and Building Societies has been crucial in the development of CFIs, whether through secondments, premises, or intellectual engagement. Less progress has been made on relationships with local bank branches, where the delivery of basic bank accounts or referrals of declined customers are needed.

Credit union relations

CRTs and credit unions often have an estranged relationship. This should end. They are complementary services that could be delivered through a single retail outlet.

Equality and diversity

Worryingly many CFIs replicate existing hierarchies and procedures, especially in business lending. CFI staffing at all levels should reflect the local community.

Succession problems

With small staff complements CFIs are reliant on key personnel. One CRT suffered because of a lack of management continuity. All staff need training and succession contingency plans should be drafted.

Community engagement

Some CFIs lack genuine community accountability. Only the credit union and the CRTs had training for community directors. A rolling recruitment and training programme is required to sustain community focus.

Mutually Compatible - Sustainability and Public Policy

CFIs are constantly seeking to balance economic and social objectives. The latter is not cost free. If policy makers want to avoid CFIs only focusing on the balance sheet and thereby shifting to a less risky client base, it may be necessary to adjust the concept of sustainability. The main risk is connected to bad debts, therefore a CFI that can cover all revenue costs less an agreed level of bad debts could be classified as 'public interest sustainable'.

Do CFIs Deserve Further Support? YES but:

Continued support should be conditional both to improve the performance of CFIs and deter a dependence culture.

Self-help

1. Reduce costs of delivering services
2. Interest rates should reflect market drivers
3. Exchange good practice on arrears management
4. Continue to develop new products, such as home improvement lending services

Principles for Future State Support

- Any new funding model should be linked to delivery, while encouraging efficiency.
- If the government want CFIs to engage in high risk lending they should fund this separately.
- Encourage innovation through the use of pump-priming initiatives.

Mr A was an unemployed single man who had lived in Derby for many years. His only income was benefit of £82 per week.

His weekly payment to a sub-prime lender was £49 per week (ie £212 per month). By taking out a loan from derbyloans over 24 months he not only reduced his monthly repayments to £84, giving an increase in disposable income of £128 per month, but he should be free of debt after the 2 year period of his loan. His loan was paid direct to the sub-prime lender.

In addition he has opened a basic bank account to pay direct debits to derbyloans and is now paying his utility bills in the same way. *Derbyloans annual report 2004*

Community Finance Solutions

Towards a New Model of State Support

Community Finance Initiative Service Delivery Payment (CFISDP)

The research has exposed the amount of time CFIs spend advising and supporting their clients. As we have noted, this time has had a severe impact on the sustainability of the CFIs. Although a proportion of this work should be undertaken by other agencies, it is also evident that the accessibility of CFIs means they attract clients not served elsewhere. Though the former issue can be can be addressed through closer integration of existing providers by their funders, the latter calls for more innovation. On reflection it would be better to allow public finance to follow a client's preference. Therefore, CFIs who support such clients through business or personal advice, financial literacy or financial/economic inclusion services, should be rewarded. We propose that such a payment, which we have called a Community Finance Initiative Service Delivery Payment (CFISDP) would be awarded to CFIs to reflect the additional social/financial inclusion costs arising from advising and supporting customers above an agreed norm for the award of a loan. For example:

It is envisaged that the approach to assessing the level of payment will be dependent upon the need of the individual quantified by appropriate management indicators (time spent on activity and cost of support) and related to the 'norm' measurement for that particular activity. To prevent dependency the 'norm' figure would incorporate an efficiency driver, which the government department would update annually.

The payment would be nationally administered from a central government department, which would set up a system to approve payments above the 'norm'. The CFI would be required to have an annual budget/corporate plan, which would indicate the planned additional costs of management so that actual payments can be predicted.

The alternative to this approach is that CFIs will gradually shift to more mainstream activities, or they will continue to seek funding from other grant providers, (but our research indicated evidence of 'donor fatigue'), or they will wither, attempting to balance financial needs against an unfunded and over burdensome social agenda.

Bad Debt Guarantee Insurance Fund (BDGIF)

CFIs are invariably involved in high risk loans lending and to date this has been underwritten by the provision of 'free' capital usually in the form of government grants. However, with the introduction of the Community Investment Tax Relief (CITR) the government is signalling a change to a more commercial capital funding structure. With less free money many CFIs will seek to protect their financial position, such as tightening lending criteria, improving collection of recalcitrant loans or raising interest rates. All these may be desirable, but they could result in more conservative CFIs evolving and departing from higher risk lending to start-up enterprises or hard to reach groups.

To counteract this we propose a Bad Debt Guarantee Insurance Fund (BDGIF). To access this a CFI would need to have lent to a specified 'high risk customer' who has defaulted on the loan. The CFI would make a claim to the (BDGIF) and providing they followed their previously approved procedures they would receive a proportion of the outstanding arrears. The proportion payment is to encourage CFIs to robustly pursue the loan prior to any application for the shortfall. To minimise administration the BDGIF could be created as a sub-set of the Small Firms Loan Guarantee Scheme.

Financial Inclusion Phoenix Fund

There has been universal acclaim from many CFIs for the Small Business Service's Phoenix Fund, which provides grant funding, both revenue and capital for CDFIs lending to enterprises. The Phoenix Fund was particularly effective due to its relatively light regulatory burden, its flexibility, highly supportive civil servants and its encouragement of innovation. The Treasury's announcement of a new fund to improve financial inclusion is to be welcomed and we recommend that it operates on a similar basis to the original Phoenix Fund, though restricted to CFIs engaged in innovative and partnership based solutions to financial exclusion. We believe this would create a step-change in non-governmental initiatives and begin to address the issues being raised by the DTI's Over-indebtedness Taskforce.

Conclusion

CFIs have proven they can reach deprived communities but at a financial cost that cannot be absorbed in their businesses model. Maximising their potential requires genuine partnership and a public funding regime that rewards efficiency and good performance.

Located at the University of Salford Community Finance Solutions is a research and development group that promotes, develops and supports Community Reinvestment Trusts (CRTs) and other community finance initiatives. CFS is also the acknowledged leader in helping community finance initiatives evaluate their performance, and work with statutory authorities and housing associations to develop strategic approaches to financial inclusion.
In recognition of their groundbreaking work CFS was awarded the North West Innovative Enterprise Award for 2002/3.

If you are interested in utilising CFS' services or require further information on CFS please contact
Jennifer Powell on 0161 295 4454
or email j.e.powell@salford.ac.uk

Community Finance Solutions

Recommendations to:

1. National Government

Alleviating poverty and promoting enterprise is a national government priority. Much has been achieved since the PAT reports, particularly with regard to encouraging enterprises and supporting CDFIs and now it is necessary to spread good practice and co-ordinate the disparate activities. Action is now required to take CFIs into the mainstream and to achieve this a new industry wide funding regime needs to be created.

It is recommended that national government introduces a means to ensure CFIs continue to support and finance individuals and enterprises in deprived communities. To achieve this three potential sources of funding should be examined:

1. A system of financing the additional support and advice services provided by CFIs (Such a system - a Community Finance Initiative Service Delivery Payment is outlined overleaf).
2. A means to underwrite the high risk lending performed by CFIs. This will help CFIs secure loan capital finance from banks and building societies.
3. Using the Treasury's proposed Financial Inclusion Fund as a specific time-limited fund aimed at encouraging innovation and partnership-working, in the delivery of financial inclusion products and services.

2. Regional Government

Devolution means that substantial decision making, particularly in respect to enterprise lending will now be taken by the devolved administration and Regional Development Agencies (RDAs)

It is recommended that: if the devolved administration and the RDAs become responsible for providing revenue support to the CFI sector that national government mandates the RDAs to launch dedicated regional funds for Community Finance Initiatives.
Regional government should:

- Recognise that financial inclusion is central to economic regeneration in deprived communities;
- Each devolved administration and RDA should develop a strategy for supporting the development of CFIs in their region;
- Provide ring-fenced funding for CFIs;
- Encourage strategic partnerships between CFIs and enterprise support/personal finance advisors.

3. Mainstream Financial Institutions

Banks and building societies have provided significant gap finance and in kind support to CFIs, which as an endorsement has been crucial in bringing public and charitable institutions into the sector. *It is recommended that* banks and other mainstream lenders should:

- Continue to support CFIs and in addition achieve a better convergence between their mainstream business interests and those of CFIs;
- Support of CFIs should stretch throughout the banking sector and not be reliant on a few banks;
- Banks should lobby government to guarantee that any investment in CFIs, in the form of revenue or capital support, could qualify for the Community Investment Tax Relief (CITR).

4. CDFIs and other CFIs

Considerable experimentation has taken place over the last 5 years through the formation of new entrants into what is now a fast growing sector. Over half commenced business in the last two years and of those nearly half are start-ups and have yet to begin lending activity. Evidence from this research indicates that as the sector reaches maturity CFIs must aim to decrease transaction costs and increase their impact by reaching more customers in larger areas and/or a broader range of services.

It is recommended that CFIs should:

- Diversify into new markets and products and/or extend their coverage and in doing so adopt realistic expectations of growth and performance;
- Seek to share good practice, particularly with regards to minimising arrears;
- Concentrate on becoming more efficient through improving management systems and streamlining operations;
- Develop better means to measure the social impact of their lending.
- Develop a more strategic collective approach to help CFIs develop and understand themselves and each other. This would also benefit funders and government.

5. Housing Associations

Social housing providers including Housing Associations are increasingly housing the financially excluded and are developing and supporting affordable financial services in communities where they work and are very often the largest social enterprise.

It is recommended that Housing Associations should:

- promote and/or become community investors in CFIs as this work fits into the government's drive to build sustainable communities and the social inclusion agenda. It is also in the Housing Associations' business interest to adopt this approach;
- Ensure investment decisions into CFIs are based on a clear strategy.

6. Trade Associations

The Community Development Finance Association (CDFA) - the UK wide trade association for CDFIs and the credit union trade bodies are in a position to take a view across the who CFI sector and can understand about their operations and performance and make appropriate recommendations to national and regional government.

It is recommended that the CDFA and credit union trade associations should work together to:

- Set up in collaboration with CFIs an industry-wide process to report on the performance of the sector;
- Promote examples of good practice regarding partnership building and efficiency improvements;
- Promote positive financial inclusion policy agendas.

7. Enterprise support agencies and money/debt advice services

If CFIs are to be successful in improving economic regeneration and financial inclusion they require the full support and cooperation of enterprise agencies and personal finance advisors.

It is recommended that enterprise support agencies and money/debt advice services should:

- Develop strategic partnerships and referral networks with CFIs. These should incorporate clear objectives and expectations on both sides
- Ensure all staff are conversant with the strategic partnerships and the importance of making referrals to CFIs.

Published by the University of Salford 2004 ISBN: 0902896687