www.pwc.co.uk

The Sustainability of Community Development Finance Institutions

Final Report

December 2015

This document has been prepared for our client, the British Business Bank, only. To the extent permitted by law, PricewaterhouseCoopers LLP does not accept or assume any liability, responsibility or duty of care for any use of or reliance on this document by anyone, other than the client, the Bitish Business Bank, to the extent agreed in the relevant contract for the matter to which this document relates (if any).

Contents

Executive Summary

Executive Summary

This report considers the future sustainability of Community Development Financial Institutions ("CDFIs"). CDFIs provide finance to those who struggle to obtain funding from mainstream lenders and their lending and wider activities are directed by this core purpose. Beyond this core objective, however, there is significant diversity in the way in which CDFIs operate – in terms of size of funds under management and different customer bases. Analysis suggests that the majority of CDFIs typically operate at a loss where final returns from loans underwritten (in terms of capital and interest payments) are less than the initial level of funds provided and expenditure incurred. Such losses are typically absorbed by grant funding from central government and other sources.

Against a background of relatively short-term and uncertain funding sources the CDFI sector needs to consider how to improve sustainability not least to improve its ability to attract new funding in the future. This applies to both commercial and public sources of funding. Commercial investors require a return on capital whereas specific government schemes typically require that funds have been distributed in a way that meet scheme objectives in the most efficient way.

Consultations with CDFIs indicate there are various opportunities which could lead to improved operational efficiency in the future, including improvements in back office systems, performance measures and consolidation. These changes might in turn make the sector more attractive to the public sector and commercial funders. CDFIs will also need to consider how they can continue to achieve social objectives, outside of participation in government schemes, where ("first loss") grant support might not be available.

CDFIs Represent a Broad and Diverse Range of Financial Providers.

There are over 50 CDFIs across the UK which in 2013/14 made available £175 million of loans across four markets: SMEs (£74 million), Social Ventures (£78 million), Personal Lending (£19 million) and Home Improvement (£4 million). While varying in size (£3,600 to £13.8 million in terms of loan books under management) and sources of funding (ranging from central government to social investors) CDFIs are united by a core purpose, namely to: *"lend to businesses and people who struggle to get finance form high street banks"*[1].

The relative differences in size and customer groups partly contribute to differences in management cultures, sophistication of reporting, investment criteria and service profiles and a consequent lack of standardised approaches to delivery.

[1] Definition provided by the Community Development Financial Association ("CDFA") the membership body of CDFIs in the UK.

CDFIs Are Heavily Reliant on Grant Funding.

Given their core purpose – to provide finance to people and businesses unable to access mainstream finance – not unsurprisingly analysis of the sources of CDFI funding suggests a significant dependency upon grants which represented 80% of all sources of funding in 2014. Overall CDFIs generally obtain their funding from a range of providers with the majority operating 3 to 5 funds from different sources that are often short-term in nature.

In the past ten years there has been a shift in the mix of CDFI lending with SMEs benefitting proportionately more and the share of social venture lending decreasing. This partly reflects the implementation of new government schemes aimed at improving access to finance for SMEs, for example, the Regional Growth Fund (RGF), Start-Up Loans (SUL) and the New Enterprise Allowance (NEA). In 2014 levels of grant funding associated with these programmes totalled £58m.

Around 60% of commercial funding secured by the sector is through the RGF match with the remaining 40% of funding secured from such sources as angel investors, Big Society Capital and other investors seeking a return. CDFIs are also able to supplement external funding through income generation. In 2014 CDFIs reported income generation of £39m.

Analysis Suggests that the Sector Does Not Operate on a Sustainable Basis.

There are gaps in the data available on lending losses and expenditure that are not covered in the CDFA 2014 survey. Nonetheless available data suggests that aggregate default rates are generally higher than would be expected in commercial portfolios and lending expenditure (bad debts and costs) in 2013 was £18m. In addition CDFIs incur operational expenditure (rent, staff etc.) which also totalled £18m in 2013.

Consultations with CDFIs suggest that many CDFIs (potentially up to 50% in 2015) struggle to cover their expenditure with income. This position is not sustainable at a sector level and, against a backdrop of short-term and uncertain funding streams, the impetus for change is recognised as essential if CDFIs are to continue to operate at the same scale in the future.

Data Limitations Preclude More Detailed Analysis.

While assessments at a sectoral level are informed by CDFA data – gathered from members – no information was available from this source in relation to expenditure per loan type, income per service and disaggregated default rates. A detailed analysis was therefore not possible.

This is particularly important where, for example, some government schemes are designed to target specific activities and necessary grant funding is provided to CDFIs to absorb expected or first losses and lending costs. Where CDFIs have discretion on lending activity it would be useful to disaggregate income and expenditure on these activities.

From the data available, however, there is not sufficient information to determine whether targeted activity (due to participation in government schemes) performs better or worse than other activities.

On a qualitative level consultations with the majority of CDFIs indicate that the sector does recognise the need to take action now to improve future operational sustainability – a conclusion that would not have been drawn if there were not identifiable issues with current operating practices.

CDFIs Need to Take Action to Improve Sustainability.

There are a number of options CDFIs could consider individually or collectively to improve operational performance. As recognised by the CDFIs themselves these include: consolidation, improved referral systems, central support systems, online application portals and common standards and measurement protocols.

Implementing such changes will have several benefits, not least in terms of reducing operating costs, potentially improving default rates and ultimately meeting the wider social objectives of the sector in a more efficient manner.

The CDFI sector also needs to continue to ready itself to attract a higher proportion of commercial investment where the operational and other improvements outlined above will be necessary first actions required.

Consultation with a Range of Commercial Sources Suggests Potential Interest in Providing Funding to the CDFI Sector.

Such investors would in most cases, however, expect some rate of return on that funding, suggesting that current rates of losses on lending could not be sustained if CDFIs were to be reliant solely on these sources. This implies that not only will operational improvements be necessary but potentially either (a) a refocus of activity to provide a sustainable mix of 'commercial lending' to offset higher expect losses associated with achieving social objectives or (b) identifying other sources of funding to cover first losses and/or exploring the use of existing tax reliefs.

Improvements in data collection and reporting would also allow the sector to separate the performance of its activities, excluding specific targeted activity, enabling it to better showcase track records to attract an increased proportion of commercial funding.

Conclusions

The CDFI sector is at a turning point. Expectations about future funding from existing sources are low and existing operating practices are, in many cases, unsustainable if expenditure continues to outweigh income. Increasing operational efficiency going forward may make it more likely that CDFIs could attract new forms of funding to on-lend by demonstrating the potential to reduce current default levels (or associated costs).

Attracting commercial sources, however, will be more challenging unless, and until, the sector can demonstrate longer term sustainability in the form of a return acceptable to these sources or in other ways mitigate first loss.

I. Introduction

I. Introduction

1.1 What are Community Development Finance Institutions?

Community Development Finance Institutions ("CDFIs") lend to: "*businesses and people who struggle to get finance from high street banks. They are social enterprises that invest in customers and communities.*"[2] There are over 50 CDFIs across the UK which, in the financial year 2013 to 2014, made available £175.7 million of loans to the financially underserved in SME, social venture, personal and home improvement lending markets.

1.2 Research Objectives

The British Business Bank ("BBB") commissioned PricewaterhouseCoopers LLP ("PwC") to conduct a research study of the current operating models of UK CDFIs, potential approaches to enhancing the sustainability of the sector and the likely impacts of such approaches.

In particular the BBB wanted to understand, in the context of the UK:

- The role of CDFIs and their position in the financial landscape and the nature of the loan recipients they serve;
- The performance of the CDFI sector at a macro level, including default rates, operating costs and pricing structures;
- The variability within the sector and the differences in markets served and related sustainability; and,
- How the sector can move towards a more sustainable position, including attracting commercial funding, and the impact that would have on the current operational models.

In addition, given the BBB's commitment to supporting SMEs across the UK, the BBB specifically wished to assess the above in relation to the performance of CDFIs in the SME lending market.

[2] Definition provided by the Community Development Financial Association ("CDFA") the membership body of CDFIs in the UK.

1.3 Research Scope

In order to understand the performance of CDFIs initial analysis focused upon data provided by CDFA – the UK membership body that represents CDFIs – in relation to the current performance of the CDFI sector. This analysis was supplemented by:

- A review of over 25 research reports and data sets (a full list of reports and data sets and a summary of key research insights are provided at Appendix A);
- One to one consultations with 4 representatives from 4 Government departments, an independent representative from the BBB, and staff and management from the Community Development Financial Association and the Start Up Loan Company (a list of Departments and other organisations contacted is provided at Appendix B);
- E-Survey returns from a selection[3] of CDFIs in relation to their current lending performance, sources of capital funding and customer profiles; and,
- An assessment of CDFI operating models in Australia, India, Japan and the US to identify any "best practice" approaches to operation (as summarised in Appendix C).

Based on this initial research a range of different "options for change" were developed with the objective of identifying opportunities to improve operational efficiency and attract new sources of funding.

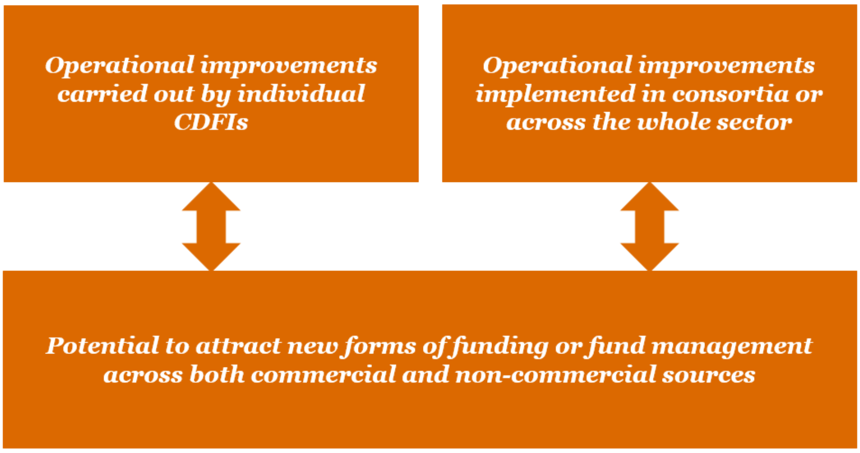
These options were subsequently presented to CDFI representatives – at four workshops across the UK - to determine their views on the potential benefits and risks of implementation. In parallel one to one discussions were held with representatives from 13 funding bodies – the majority of whom had not invested in CDFIs before – to gauge their views on these options and the likelihood of their organisations providing future funds to the sector. These bodies ranged from commercial banks (UK and non-UK owned) to UK foundations.

These consultations suggest that improvements in CDFI efficiency will have the potential to increase the operational sustainability of the sector and attract alternative sources of funding. In particular, as illustrated at Figure 1.1 overleaf, individual operational improvements, or those implemented by consortia or the CDFI sector as a whole, all have the potential to increase access to new sources of funding as well as the way in which such funds may be (efficiently) distributed and managed.

---

3 The survey was sent to 50 CDFIs of which 29 completed returns representing a response rate of 58%. Across these 29 CDFIs 23 (79%) participate in SME lending, 8 (28%) in social venture lending, 7 (24%) in personal lending and 4 (14%) in home improvement lending.

Figure 1.1: Options for Change



1.4 Structure of the Report

The rest of this report comprises:

- **Section Two: Overview of the CDFI sector** - in terms of the differences in the type of organisations involved, their activities, related income and funding sources, recipients of CDFI lending and international comparators;

- **Section Three: Current Performance of the CDFIs** - which considers the relative performance of the sector in terms of fund performance, operating costs and ongoing sustainability (or otherwise) if no operational changes are considered;

- **Section Four: Assessment of Future Sustainability** - indicating a range of options for change that might improve operational efficiency and/or attract new sources of funding to the sector. These include individual CDFI, consortia of CDFI and sector wide CDFI approaches to change;

- **Section Five: Testing Options with CDFIs and Funding** - that summarises, on an anonymised basis, the feedback from CDFI and funder representatives in relation to these options; and,

- **Section Six: Conclusions:** presenting the relative merits, risks and potential impacts of adopting the three broad scenarios for change that emerged from the above analysis and consultations.

II. Overview of CDFI Sector

II. Overview of CDFI Sector

Key Findings

- CDFIs provide lending and a range of additional services and products across four markets;
- The majority of CDFI loans are provided to SMEs and Social Ventures;
- Loan characteristics vary widely across four distinct markets;
- CDFIs tend to focus lending within their local areas;
- CDFIs currently support relatively small SME start-ups; and,
- International comparators exhibit differences in structure, performance and public sector support.

CDFIs provide lending and a range of additional services and products across four markets.

While different in size, location and services CDFIs all have a common mission to provide: "*fair and affordable finance*". As a sector some CDFIs have been in operation for over 25 years. There are currently around 50 CDFIs operating in four markets – SME, social venture, personal and home improvement lending - across the UK. In the financial year 2013 to 2014 the CDFI sector made available £175.7 million of loans across these four markets. SME lending is the most common market with 65% of CDFIs providing funding to this sector. Up to 20% of CDFIs also provide loans to more than one market. Growth over the last ten years (between 2004 to 2014) has been significant with loans to the enterprise sector alone increasing eleven fold to 13,590 and the total loan value seven fold to £74.1 million. In terms of product and service offering, whilst lending is the core activity, CDFIs offer at least 14 additional products and services. Among these, business mentoring is the most common with 50% of CDFIs offering this service in 2014.

The majority of CDFI loans are provided to SMEs and Social Ventures.

In 2014 the CDFIs disbursed £175.7 million of loans (of varying sizes and loan conditions). The majority of these loans were provided to SMEs (£74.1 million) and Social Ventures (£78.4 million). Other markets included personal lending (£18.9 million) and home improvements (£4.3 million). Within the SME market clients include microenterprises and start-ups as well as larger and / or more established SMEs. For each of these client groups repayment periods are typically around 3 to 4 years, however, the size of loans, interest payments, levels of security and default rates vary significantly.

Loan characteristics vary widely across four distinct markets.

In recent years the number of loans disbursed by the CDFI sector has increased but the average loan value has fallen. In 2014 the sector disbursed over 56,482 loans – three times as many as the 17,300 loans in 2010 – but the total value of lending fell from £199 million to £175.7 million. As a result the average loan size disbursed by the sector fell from around £11,000 in 2010 to £3,110 in 2014[4].

CDFIs tend to focus lending within their local areas.

Whereas 15% of CDFIs operate across the UK the majority (85%) of CDFIs are based and operate within specific geographical areas. In particular 45% of CDFIs focus their lending within the North of England.

CDFIs currently support relatively small SME start-ups.

Based on the E-survey results 87% of businesses supported by CDFIs in 2015 were less than 2 years old. CDFIs typically provide loans to smaller SMEs: 70% of SME customers were sole traders and 20% of SMEs have between 1 and 5 staff. This relatively small size is also reflected by turnover levels. More than half (55%) of CDFIs' SME customers have annual turnover of less than £25,000 and 27% have annual turnover between £25,000 and £50,000.[5]

International comparators exhibit differences in structure, performance and public sector support.

A review of CDFI sectors in Australia, India, Japan and US identified various differences and some similarities with the CDFI sector in the UK. The review indicates that: Australia is at the early stages of developing a CDFI sector; India has a Government-led community financing model; in Japan community financing institutions are highly decentralised, supported by capital provided by local communities rather than central Government; and the US has a matured high-impact CDFI sector enabled by Government support. Except in Japan none of these models appear to be self-sustaining (i.e. there is reliance on some form of Government support including provision of funding or legislation or both). Consequently given differences in both legislature, and the way in which financial markets operate in these countries, there appears to be limited opportunity for knowledge transfer to the UK sector.

---

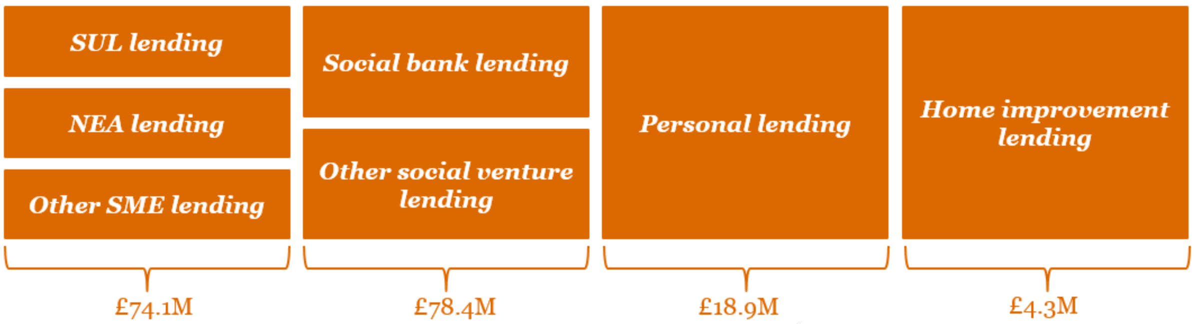
4 This fall was not "universal" across all the elements of the CFDFI SME market place as the overall average fell primarily - as detailed in the rest of this section – due to reductions in social venture lending (with typical average loan sizes above £200,000) and the onset of SULCo funding from 2013 which focuses on new SMEs start-ups with average loan sizes of £6,000 (see: https://www.startuploans.co.uk/faqs).

5 In order to both update and supplement the CDFA data in relation to CDFI performance (provided in May 2015) an e-survey of all CDFIs was undertaken with a deadline for a completion of the end of June 2015. The survey results informed both subsequent engagement with CDFIs and consultations with Funders. Thereafter a draft report of the findings was provided to CDFA in September 2015 – including these e-survey results – for their comment and corroboration at which point CDFA provided some 'revised' data sets from CDFA that have been fully incorporated into this report.

2.1 CDFIs Provide Lending and a Range of Additional Services and Products across Four Markets.

There are currently around 50 CDFIs operating across the UK. As illustrated, in Figure 2.1 below, CDFIs are active in four market segments – SME, social venture, personal and home improvement lending. As also illustrated in 2014 the CDFIs disbursed loans totalling around £175.7 million (of varying sizes and conditions) across these segments.

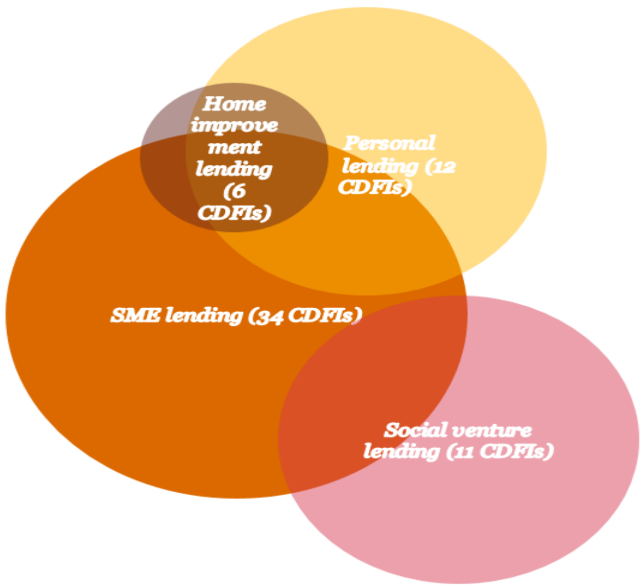
Figure 2.1: CDFI Market Segmentation in 2014



(Source: CDFA data)

As illustrated, in Figure 2.2, most CDFIs operate in the SME sector and at least one other segment. There are, however, no CDFIs that operate across all sectors.

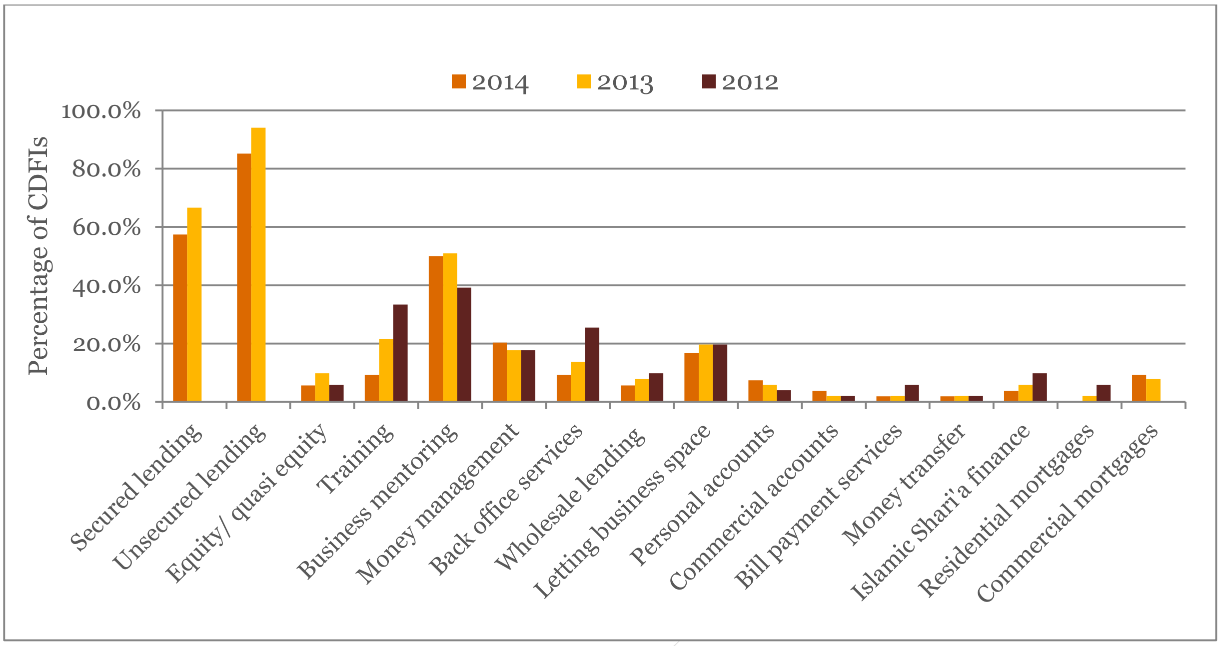
Figure 2.2: Market Participation of CDFIs in 2014



(Source: CDFA data)

As illustrated, in Figure 2.3 below, apart from secured and unsecured loans the CDFI sector delivers at least 14 other products and services ranging from money management, back office services, personal and commercial account facilities and Islamic Shari' a finance. Among these, business mentoring is the most common offering with 50% of CDFIs providing this service in 2014.[6]

Figure 2.3: Percentage of CDFI Offering Products and Services in 2012-4



(Source: CDFA data)

2.2 The Majority of CDFI Lending – in Value Terms – is Provided to SMEs and Social Ventures

As outlined, in Figure 2.4 overleaf, since 2010 around 80% to 95% of the value of CDFI lending has been to SMEs and Social Ventures.

Prior to 2013 social venture lending accounted for 70% to 80% of total loan values. This level declined in 2013 to around 39%, in large part due to the restructuring of those CDFIs which are social banks, following new capital requirements imposed by the Financial Conduct Authority[7].

---

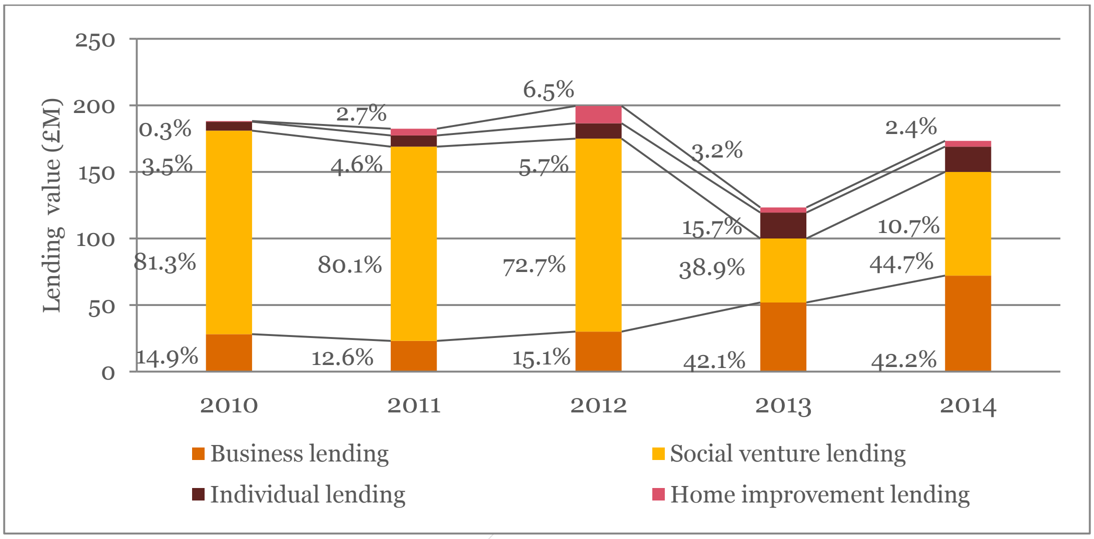
[6] Based on the information provided by the CDFA it is not possible to disaggregate the income and costs associated with the services nor, therefore, the net revenue that might be generated.

[7] Among CDFIs participating in social venture lending, there are a number of CDFIs who are also social banks. Social banks refer to banking institutions who also held charity status as registered with the Charity Commission. In mid-2013, in order to meet the new capital requirements of the Financial Services Authority – the predecessor body of the Financial Conduct Authority – the social bank CDFIs ceased to hold charitable status.

While the value of social venture lending fell in 2013 SME lending increased by 2.9 times largely due to increased Government funding for SMEs in 2012 and 2013.[8] As a result the proportion of lending by value in 2014 was 42% (for SMEs) and 45% (for social ventures) compared to 15% and 73% in 2012 respectively.

The other two elements of CDFI loan activity – personal and home lending –make up a small portion of the remaining total lending value. During 2010 and 2011 these two segments accounted for 4% and 7% of the lending portfolio.

Figure 2.4. CDFI Lending Value by Market Segment, 2010-14 (£M)



(Source: CDFA)

2.3 Loan Characteristics Vary Widely across the Four Markets.

The CDFI sector – in recent years – has disbursed a higher number of loans, however, at a lower average value. So while in 2014 the sector disbursed 56,482 loans – three times as many as the 17,300 loans in 2010 – the total value of lending fell from £199 million to £175.5 million. As a result the average loan size across the sector fell from around £11,000 in 2010 to £3,110 in 2014.

These average values, while reflecting an important overall trend, mask the diversity of loan values (and related loan conditions) within each market in which CDFIs operate and, most notably, in the SME and social venture sectors.

---

[8] As part of the Conservative – Liberal Democrat Coalition Government's aspiration to stimulate the growth of SMEs government funding to the CDFI sector increased rapidly with the launch of SULCo in 2012 and a successful application by CDFA for RGF funding in 2013.

2.3.1 Characteristics of SME Loans

As illustrated, in Table 2.1 below, the CDFA characterises SME lending activity into two distinct market segments namely microenterprises (defined as those firms or ventures with fewer than 10 employees and less than £2 million annual turnover) and SMEs (defined as firms and ventures with less than 250 employees and less than £25 million annual turnover).

Table 2.1. Characteristics of SME Lending 2014

Type	Volume	Value	Average loan size
Microenterprises	13,157	£54.0 million	£4,104
SMEs	433	£20.1 million	£46,460
Total SME Lending	**13,590**	**£74.1 million**	**£5,454**

(Source: CDFA data)

Within the category of "microenterprises" the CDFA captures, as illustrated in Table 2.2 below, three sub groups – microenterprises receiving SUL loans, microenterprises receiving NEA loans [9] and existing microenterprises receiving loans from sources other than the Start-Up Loans (SUL) and New Enterprise Allowance (NEA) programmes.

Table 2.2. Characteristics of Microenterprise Lending 2014

Type	Volume	Value	Average loan size
Microenterprises – SUL	3,038	£17.2 million	£5,666
Microenterprises – NEA[10]	8,978	£10.6 million	£1,178
Microenterprises – Existing	1,141	£26.2 million	£22,970
Total Microenterprise Lending	**13,157**	**£54.0 million**	**£4,104**

(Source: CDFA data)

[9] The New Enterprise Allowance (NEA) programme provides financial and non-financial support to help those on certain benefits to start their own business. In terms of financial support NEA recipients can receive a weekly allowance paid for up to 26 weeks (up to a total of £1,274). They can also apply for a loan to help with start-up costs. The loan has to be paid back whilst the allowance does not. In terms of non-financial support NEA recipients can apply for a business mentor who will help with developing the business idea and starting trading (https://www.gov.uk/new-enterprise-allowance).

[10] The NEA programme is delivered via two channels– one via the Department of Work and Pension (DWP) and the other via the Start Up Loans Company (SULCo). This study reports the total NEA lending that CDFIs disbursed in 2014 via both delivery channels, i.e. DWP NEA and SUL NEA. Estimates made by the CDFA indicate that of the £10.6 million NEA lending disbursed in 2014 71% was distributed via the DWP channel and 29% via SULCo. In terms of loan volume this means 84% of the 8,978 NEA loans made in 2014 were via DWP and 16% via SULCo. Despite different channels of loan disbursement there is no distinction in terms of characteristics of and policy imposed between DWP NEA loans and SUL NEA loans.

These distinctions in microenterprise lending, as illustrated in Table 2.3 below, reflect differences in the various terms required by the lending programmes and sources of capital funding rather than the nature of the microenterprise sector itself.[11]

Table 2.3. Average Loan Terms in SME Lending 2014

Type of Lending	Interest Rate	Repayment Period	Security (by loan value)
SMEs	14%	3.5 years	34%
Microenterprises – SUL	6%	3.5 years	0%
Microenterprises – NEA	12%	3 years	0%
Microenterprises – Existing	14%	3.5 years	34%

(Source: CDFA data)

As illustrated there was a significant difference in terms of both the volume and value of loans provided by CDFIs within the SME sector in 2014, in particular:

- More 'traditional' CDFI markets, such as SMEs and existing microenterprises, have average loan values of around £46,460 and £22,970 respectively; and,
- Newer less 'traditional' markets have significantly lower average loan levels of £5,666 (SUL) and £1,178 (NEA).

There is also a diversity of associated terms. For example, as indicated in Table 2.3, the interest rates and levels of security required vary considerably. Whilst repayment periods for all types of loan activity typically fall within 3 to 3.5 years:

- Interest rates vary from 6% in the SUL programme to 12% in the NEA programme and 14% for SMEs and existing microenterprises; and,
- 34% of the total value of loans disbursed to SMEs and existing microenterprises are covered by security of some form whereas 0% of SUL and NEA loans are secured.

These differences reflect not only the different characteristics of the market segments but also the conditions upon which SUL and NEA loans are discharged. The SUL and NEA programmes have a specific policy on the value of loans disbursed, namely up to £25,000 for a SUL loan[12] and £2,500 for a NEA loan.[13] Both programmes also do not require borrowers to provide security to obtain a loan.

[11] For example the SUL and NEA programme are both targeted at new business starts.
[12] About SUL loans, see: https://www.startuploans.co.uk/faqs.
[13] About NEA loans, see: http://researchbriefings.files.parliament.uk/documents/SN05878/SN05878.pdfs.

2.3.2 Characteristics of Social Venture Loans

The CDFA also draws a distinction between social venture loans in terms of whether these are provided by social banks (i.e. those CDFIs registered by the FSA) and other CDFIs. As illustrated, in Table 2.4 below, the average loan size for the former is around £609,000 significantly higher than the value of other CDFIs at around £46,000.

Table 2.4. Characteristics of Social Venture Lending 2014			
Type	**Volume**	**Value**	**Average loan size**
Social Banks	109	£66.4 million	£609,071
Other CDFIs	261	£12.0 million	£45,954
Total Social Venture Lending	**370**	**£78.4 million**	**£211,8546**

(Source: CDFA data)

As illustrated, in Table 2.5 below, given the much lower volumes of loans, and their higher value, significantly greater levels of security are sought in this sector with, however, (compensatory) lower rates of interest and longer repayment periods compared to the SME sector.

Table 2.5. Average Loan Terms in Social Venture Lending 2014			
Type	**Interest rate**	**Repayment Period**	**Security (by loan value)**
Social Banks	n/a	n/a	99%
Other CDFIs	8%	5.5 years	61%

(Source: CDFA data)

2.3.3 Characteristics of Personal and Home Loans

Finally, in regard to personal and home loans volumes, values and terms also vary. For example, as illustrated in Table 2.6:

- Average personal loan sizes are typically around £450 at interest rates of around 67%, on unsecured terms with payment periods of 11 months; whereas,

- Home loans are on average around £7,300 at rates of interest of 8% mainly on a secured basis and repayment periods of over 6 years.

Table 2.6. Characteristics and Average Loan Terms – Personal Lending and Home Loans 2014						
Activity	**Volume**	**Value**	**Average loan size**	**Interest Rate**	**Repayment Rate**	**Security (by loan value)**
Personal Lending	41,938	£18.9m	£450	67%	11 Months	0%

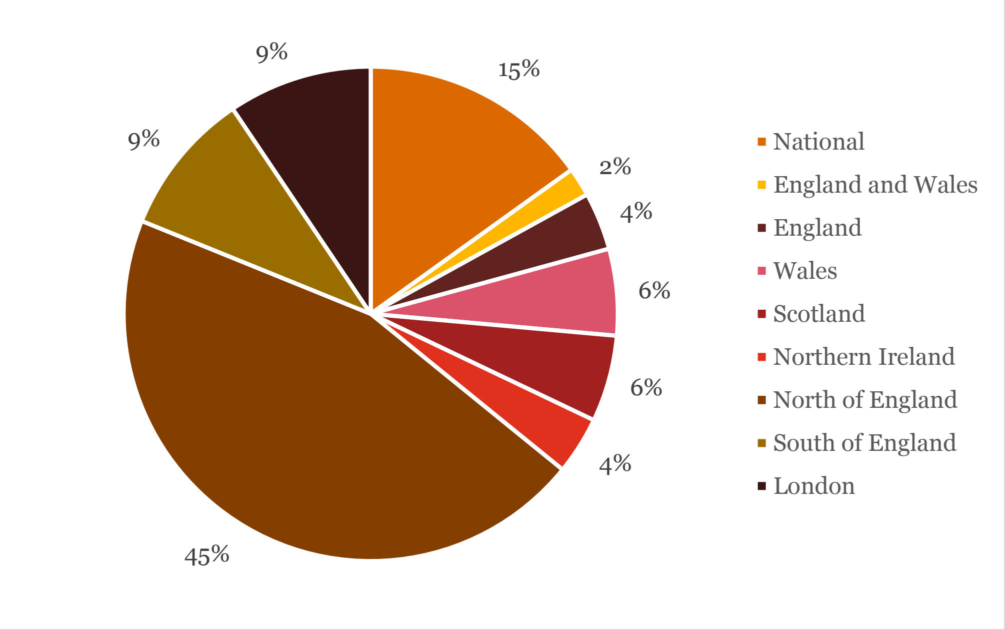
Home Improvement Lending	584	£4.3m	£7,343	8%	6 Years	77%

(Source: CDFA data)

2.4 CDFIs Tend to Focus Lending within Their Local Areas.

Whilst located across the UK the majority of CDFIs operate within specific regions. As illustrated, in Figure 2.5 below, while 15% of CDFIs operate on a national basis the remaining 85% only provide services at a regional level with 45% of these CDFIs being based in the North of England.

Figure 2.5: Geographical Distribution of CDFIs in 2014



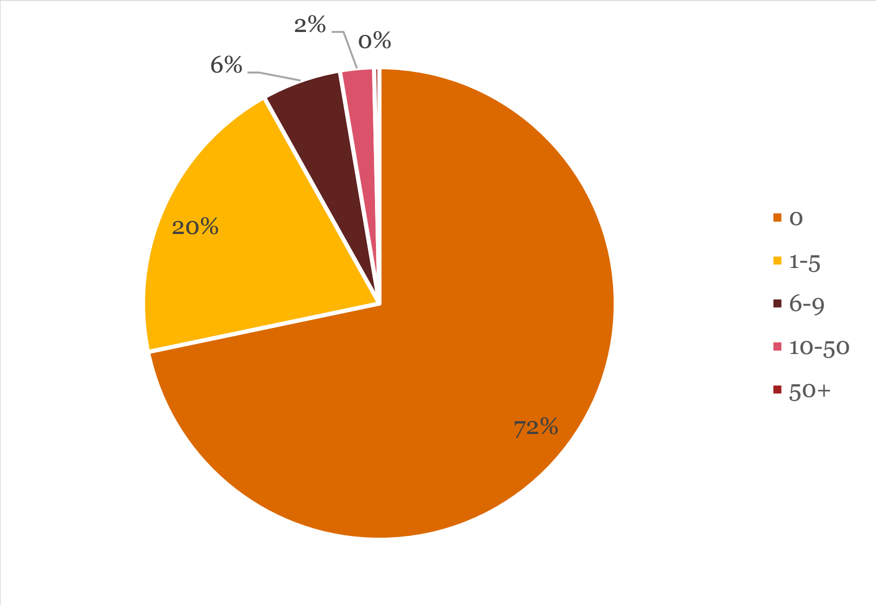
(Source: E- survey)

2.5 CDFIs Currently Support Relatively Small SME and Start-Ups.

Based on the E-survey results 87% of businesses supported in 2015 were less than 2 years old. CDFIs typically provide loans to smaller SMEs: 70% of SME customers were sole traders and 20% of SMEs have between 1 and 5 staff.[14]

[14] The SME Finance Monitor (see http://bdrc-continental.com/products/sme-finance-monitor/) in both 2013 (Q1 to Q4) and 2014 (Q1 to Q4) records that 74% of all SMEs surveyed (n = 20,036 in 2013 and 20,055 in 2014) have 0 employee and 22% have between 1 and 9 employees. This is broadly similarly to the CDFA SME profiles of 70% SME customers being sole traders and 26% having between 1 and 9 employees. The SME Finance Monitor also includes data on the age of SMEs indicating that 20% of SMEs in 2013 and 2014 are less than 2 years old. This is different to CDFIs – with 87% of business supported in 2015 being less than 2 years old – suggesting a focus on the “new start-up” segment of SME market place.

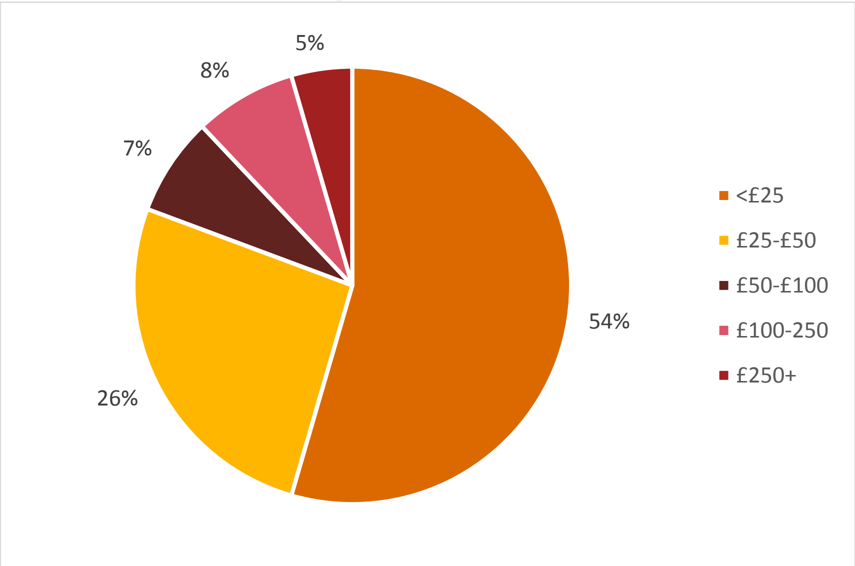
Figure 2.6: Employment Level of SME Loan Recipients



(Source: E-survey)

The focus on start-ups is also reflected by turnover levels. As illustrated, by Figure 2.7 overleaf, based on the responses to the E-Survey - in relation to annual turnover categories of loan recipients - more than half (55%) of CDFIs' SME customers have annual turnover of less than £25,000 and 27% have annual turnover between £25,000 and £50,000. Only 7% have turnover between £50,000 and £100,000 and 6% between £100,000 and £250,000.

Figure 2.7: Turnover of SME Loan Recipients



(Source: E-survey)

2.6 International Comparators Exhibit Differences in Structure, Performance and Public Sector Support.

A review of CDFI sectors in Australia, India, Japan and US identified various differences and some similarities with the CDFI sector in the UK (as detailed in Appendix D). As indicated below each territory has different characteristics to the UK: Australia is at the early stages of developing a CDFIs sector; India has a Government-led community financing model; in Japan community financing institutions are highly decentralised, supported by capital provided by local communities rather than central Government; and, the US has a mature high-impact CDFI sector enabled by Government support. It would appear, however, that with the possible exception of Japan, the CDFI sectors in these countries – similar to UK CDFIs – are not yet self-sustaining. Coverage of losses appears to require some form of public sector intervention in terms of either direct government funding or indirect legislative support with the latter providing more certainty of funding but, from the limited discussions with international consultees, not necessarily any greater assurance of operational efficiency.

In the United States:

- The US has a mature high-impact CDFI sector enabled by Government support with more than 800 certified CDFIs including 492 loan funds, 177 credit unions, 176 bank holding companies, banks or "thrifts" and 13 venture capital funds;
- The key to success of US CDFIs is their dependence on foundation and government agencies support for funding which, in turn, is driven by the Community Reinvestment Act,
- The Community Reinvestment Act makes it mandatory for banks to invest in the community where they do business which is considered critical to the sustainability of CDFIs.

In India:

- India has a Government-led community financing model;
- Funding comes from 5 major public and private sources including banks and ministry sponsored funding schemes; and,
- The Government's emphasis on financing SMEs is via a mandate on priority investment sectors.

In Australia:

- Australia is in the process of developing a CDFI sector. This process is being led and heavily supported – in both financial and non-financial terms – by the Government;

- There are a small number of 'proto-CDFI' organisations operating since the early 2000s but they are less developed compared to CDFIs in the US or UK; and,

- The nascent CDFI sector has yet to define its market segments or development strategy.

In Japan:

- Community financing institutions are highly decentralised in Japan, supported by capital provided by communities (including citizens, local organisations and private investment) rather than central Government; and,

- Default rates are often very low across different types of institutions enabled by the high trust of investors in community business which enables low interest rates and lending without collateral (only guarantors needed) whilst maintaining high repayment rates.

III. Current Performance of CDFIs

III. Current Performance of CDFIs

Key Findings

- CDFIs currently receive short term capital funding from a wide variety of mainly grant and non-commercial sources;
- CDFIs endeavour to cover their operating costs through a variety of income sources;
- At an individual level some CDFIs struggle to cover their costs with annual income; and,
- Overall the current position of the sector appears unsustainable.

CDFIs currently receive short term capital[15] funding from a wide variety of mainly grant and non-commercial sources.

As a reflection of the diversity of CDFI activities – and also the lack of any regular sources of capital – CDFIs over the last five years have attracted capital funding from a wide range of bodies including national government, local authorities, commercial banks, non-governmental bodies, social investors, individuals and European Union sources. While the value of funding from these sources has significantly increased – from £33 million in 2010 to £91 million[16] in 2014 – around 80% of the capital received in 2014 was in the form of grants. In addition these sources of capital funding tend to be short-term and project - or purpose – specific: over half of this current funding, including significant capital funding from the RGF programme, is likely to run out by the end of 2016.

CDFIs endeavour to cover their operating costs through a variety of income sources.

Total income from all CDFI activities was around £39 million in 2014. 17% of this income was generated from grant and other sources. The remainder comprises interest repayments from loans, fees from managing funds and a range of other services such as mentoring, business support and consultancy. Income from lending is the largest source of income at 40% and fees provide another 18%.

15 Given that government funding is typically set within the context of public sector budgetary cycles CDFI funding from such sources – at European, national and local levels - is usually between 3 to 5 years duration.

16 This includes funding for all CDFI services.

At an individual level some CDFIs struggle to cover their costs with annual income.

CDFA data from 2013 suggests that total CDFI income was £34million and total expenditure £36 million[17]. The updated E-survey data from CDFIs suggests that across all markets 50% of the 26 CDFIs that responded did not cover their expenditure with the income they generated in 2015.

Overall the current position of the sector appears unsustainable.

There are several factors that suggest the current "as is" position is unsustainable in operational terms. The diversity, and related cost structures associated, suggests a degree of replication and inefficient use of resources (which is manifest, for example, in relation to a wide variety of different IT systems, variations in back office functions and lending standards and practices). Funding sources are short term, not guaranteed and place a heavy reliance on securing public funding. Annual losses appear to vary by size and nature of funding again suggesting opportunities to improve performance overall.

3.1 CDFIs Currently Receive Short Term Funding from a Wide Variety of Mainly Grant and Non-Commercial Sources.

CDFIs attract capital funding to on-lend from a range of sources. Since 2010 there have been at least 8 main sources of funding for capital to on-lend that CDFIs have benefited from, namely:

- The public sector including central and local government;
- Commercial banks operating in the UK;
- Non-governmental organisations including trusts/ foundations and housing associations;
- Social investors;
- Individuals; and,
- European Regional Development Fund ("ERDF") and other EU funding.

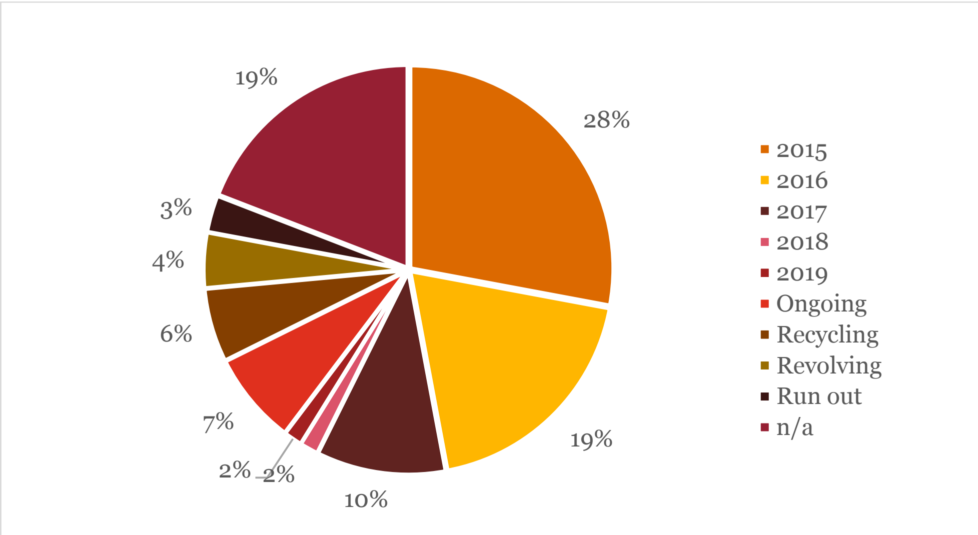
In addition CDFIs can participate in other government schemes, such as the Enterprise Finance Guarantee that, while not providing capital for on-lending, do support the provision of loans with a government backed guarantee. In 2014, over £7.5 million was drawn by CDFIs, utilising this Scheme.

The study E-Survey[18] results suggest that close to half of capital funding streams[19] the sector received in the financial year 2015 are – in the view of those CDFIs who responded – due to run out by the end of the

[17] The CDFA did not collect expenditure data in their 2014 member survey.

calendar year 2016. As illustrated, in Figure 3.1 below, 3% of the capital funding streams have already run out as at June 2015 and 47% are due to run out by the end of the calendar year 2016.

Figure 3.1: Run out rates of 68 capital funding streams received in FY 2015 (n=25)



(Source: E-Survey)

3.2 CDFIs Endeavour to Cover Their Operating Costs through a Variety of Income Sources.

The CDFIs generate income from two sources:

- **"Earned income"** which refers to the income CDFIs can generate from their activities including lending, managing funds, providing mentoring and business support services and investing capital, and,
- **"Other income"** that refers to sources such as donations or grants (from local governments or social investors for example).

---

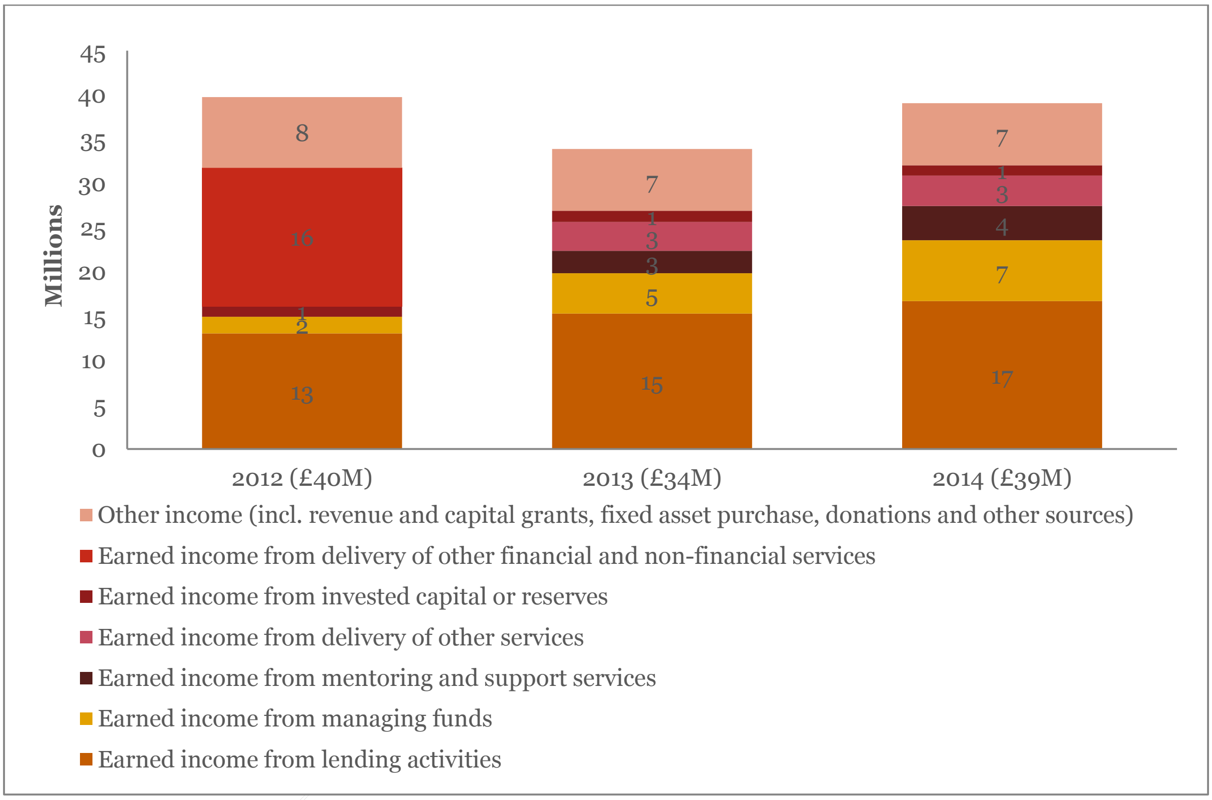
[18] As indicated previously the survey was sent to 50 CDFIs of which 29 completed returns representing a response rate of 58%. Across these 29 CDFIs 23 (79%) participate in SME lending, 8 (28%) in social venture lending, 7 (24%) in personal lending, and 4 (14%) in home improvement lending.

[19] This funding comprises a range of sources including, for example, ERDF, LEP SME loan funds, Housing Associations and Trusts.

The majority of CDFI income is generated from "earned income". As illustrated, in Figure 3.2. below, earned income – which reached a level of £32 million in 2014 - made up the majority, around 80%, of CDFI total income between 2012 and 2014.

Lending activities generated the largest and growing share of total income (of £39 million in 2014) comprising 40% of total income between 2013 and 2014. Income from managing funds[20] also tripled from 5% in 2012 to 18% by 2014. Other earned income (including income from mentoring) remained relatively stable in terms of value between 2013 and 2014.

Figure 3.2: Breakdown of Income of the CDFI Sector, 2012-14 (£M)



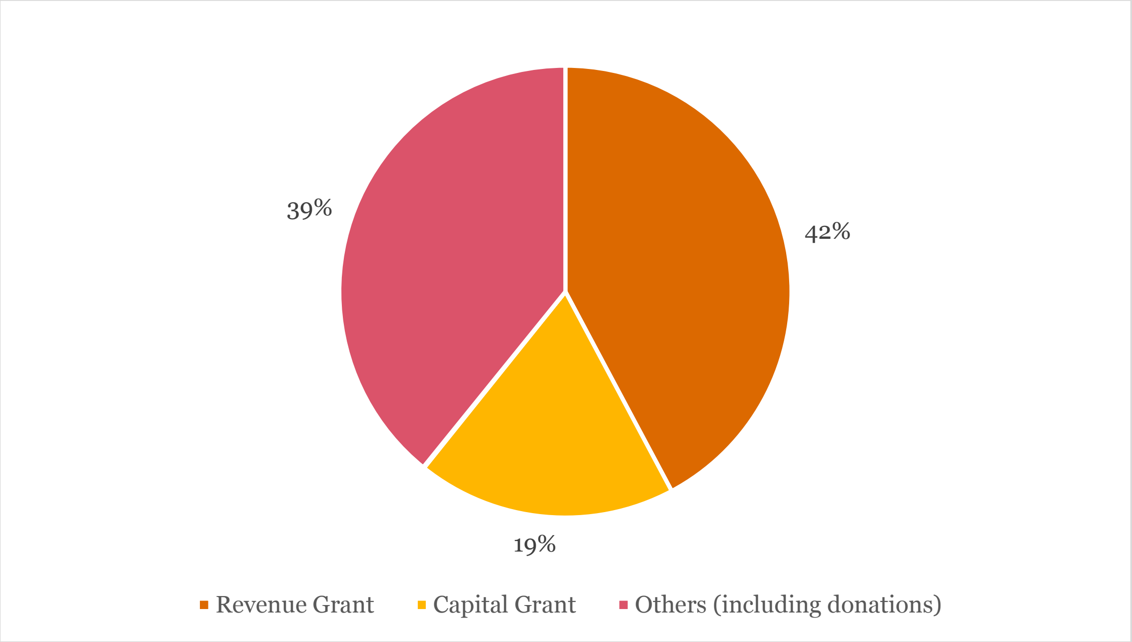
(Source: CDFA data)

In 2014 the value of "other income" was £6.6 million. As illustrated, in Figure 3.3, 42% of this income was revenue grant to support CDFIs with their operations; 19% was capital grant to help with CDFI capital funding; and, 39% was other unlisted income including donations.

---

[20] CDFA's definition of: *"income from managed funds"* refers to the fee that CDFIs receive from the fund providers in lieu of collecting interest on a loan. The fee collected varies depending on the agreement and contracts between CDFIs and the fund providers and can, for example, be a flat fee or a fee based on the volume of loans disbursed.

Figure 3.3: Other Income of the CDFI Sector, 2014 (£M) / Total: £6.6M



(Source: CDFA data)

The E-survey provided more detail about the breakdown of earned income. Within lending activities CDFIs can generate 2 types of earned income – earned income from interest and earned income from revenue:

- **Interest earned** refers to the amount of interest that CDFIs receive from lending activities, i.e. the interest payments on loans, which CDFIs can retain in their businesses without returning to investors or sources of capital funding; and,

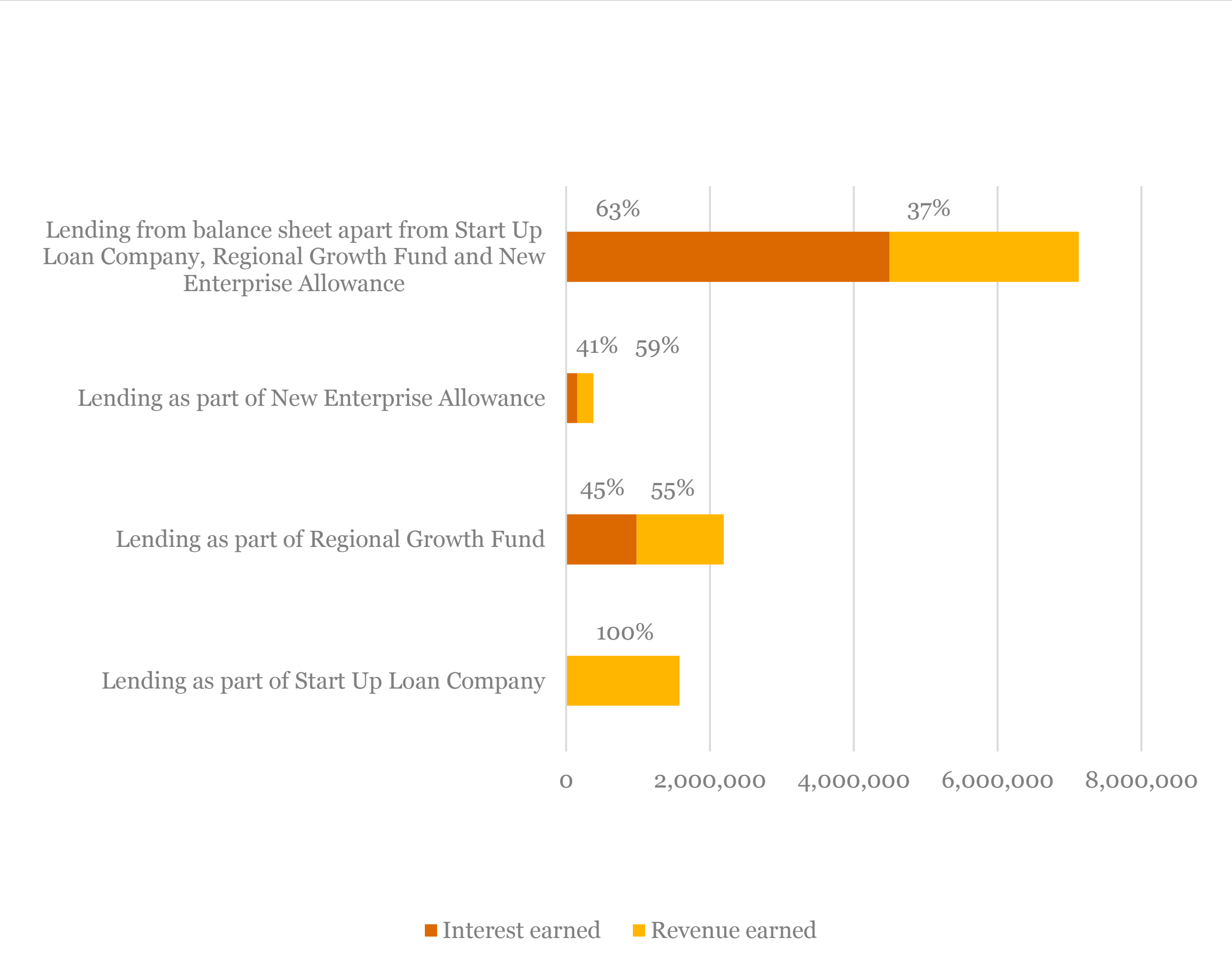
- **Revenue earned** refers to the amount of fees that CDFIs receive from lending activities which is either (a) paid by the investors to CDFIs as part of the capital funding contract or (b) paid by borrowers to CDFIs as part of arranging and processing the lending contract.

Figure 3.4 indicates the breakdown of earned income from lending activities into earned interest and earned income. In all other lending activities, apart from SUL lending, CDFIs earned income both from interest and revenue. [21]

---

[21] For example, CDFIs earned 45% of RGF income from interest and 55% from revenue and 41% from interest and 59% from revenue under NEA programme. For SUL CDFIs only receive revenue funding.

Figure 3.4: Income Earned from Lending Activities (£11.3M) FY 2014/15 (n=25)[22]

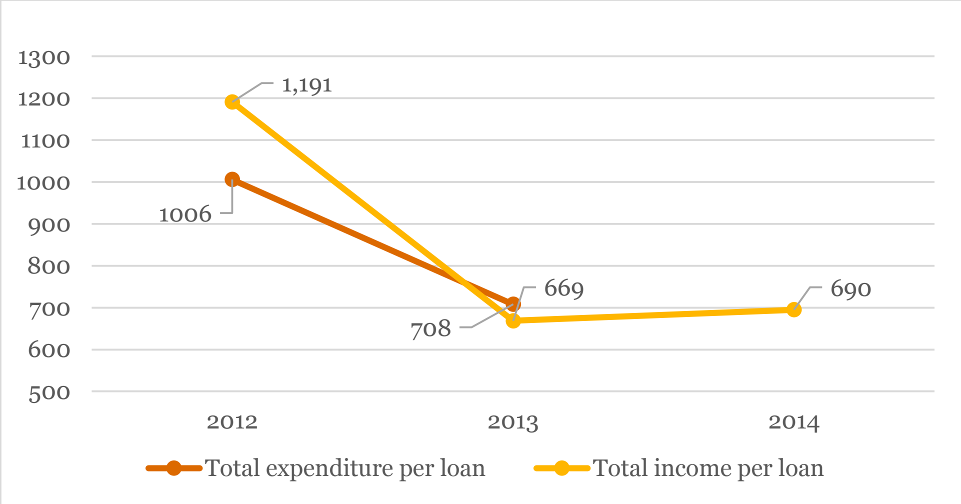


(Source: E-survey)

Finally – over the whole sector – it would appear that income per loan has decreased by around 40% from £1,000 in 2012 to £690 in 2014. As illustrated, in Figure 3.5, while the total value and number of loans increased this impacted more on income (falling to £669 per loan) than expenditure (falling to £708 per loan).

[22] Interest generated from SUL loans is not retained.

Figure 3.5: CDFIs Income and Expenditure per Loans, 2012-14 (£)



(Source: CDFA data)

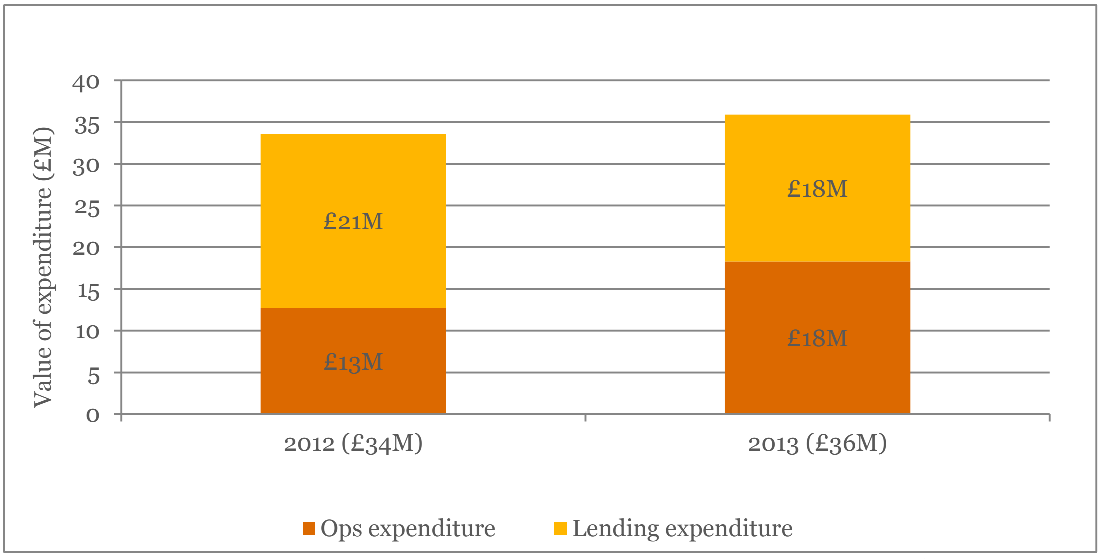
3.3 At an Individual Level Some CFDIs Struggle to Cover Their Costs through Annual Income.

Expenditure levels, as illustrated in Figure 3.6, appeared relatively stable at £34M in 2012 and £36M in 2013[23]. Expenditure in the CDFI sector – as defined by the CDFA - is divided between lending and operational expenditure:

- **Lending expenditure** refers to the costs incurred in the provision of lending activities (including bad debts); and,
- **Operational expenditure** that relates to all the non-financial costs of operations including staffing, administration, rent, utilities and transportation as well as related non-cash adjustments like depreciation and amortisation.

[23] Expenditure data for 2014 is not available as it was not part of the CDFA survey in 2014.

Figure 3.6: Expenditure of the CDFI Sector, 2012-13 (£M)

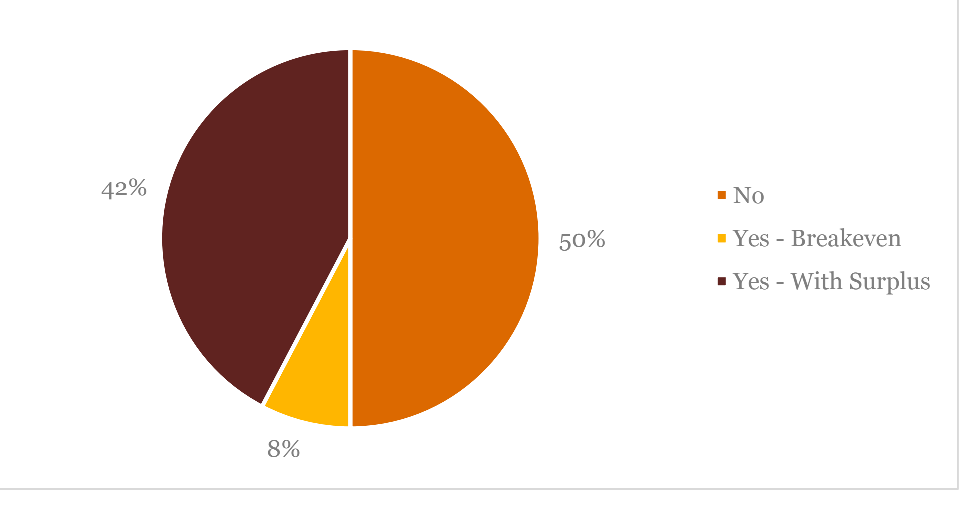


(Source: CDFA data)

In part losses or defaults are expected given CDFI clients have been unable to access commercial sources of finance. The level of such losses does appear to differ both by fund size and related funding sources with significant variations in loans written off as write offs and arrears in 2014 of between 0% to 100%.

In addition as illustrated, in Figure 3.7 below, among the 26 CDFIs who responded to questions in the E-survey concerning costs, 50% stated they could not cover their expenditure with the income they generated in 2015. 8% were at breakeven point and 42% of CDFIs indicated they generated a surplus.

Figure 3.7: CDFIs Answers to the Question: Did Your Income Cover Expenditure in FY 2015? (n=26)



(Source: E-survey)

3.4 Overall the Current Position of the Sector Appears Unsustainable.

As detailed in this section and recognised by other observers the CDFI sector has: "*been unable to diversify funding in a way as to move towards an industry wide sustainable funding model*".[24]

Previous analysis in 2010 by GHK[25] identified a range of options to improve the future sustainability of the sector including:

- Standardisation of accounting and enhanced management skills;
- Referrals by commercial banks;
- Lower cost base through operational efficiencies and higher loan values; and,
- The development of various services to improve the investment readiness of loan applicants.

While some of these recommendations have been taken forward since 2010 recent analysis by the BBA[26] suggests the sector as a whole: "*has not been able to make a significant strike towards a long term sustainable funding environment and operational capability*". While the purpose of this study is not to evaluate why such changes have not occurred it is apparent that there are various opportunities to implement changes in the way that CDFIs operate – on an individual, collective or sector wide basis – which might increase future operational efficiency and competitiveness. Consideration of such options is provided in the next section.

---

[24] "Banks and CDFI Funding": A Report to the British Bankers Association, July 2015.

[25] "Evaluation of Community Finance Institutions (CDFIs) – a Report for the Cabinet Office and BIS, 2010.

[26] "Banks and CDFI Funding": A Report to the British Bankers Association, July 2015.

IV. Assessment of Future Sustainability

IV. Assessment of Future Sustainability

Key Findings

- CDFIs that are most reliant on specific sources of government funding may face a reduction in activity or closure if they do not diversify their funding or improve sustainability;
- Addressing sustainability can be approached at three levels: individual CDFIs, consortia of CDFIs or across the sector as a whole; and,
- There are a wide range of options for change– at each of these levels - that now could be considered by CDFIs and Funders.

CDFIs that are most reliant on specific sources of government funding may face a reduction in activity or closure if they do not diversify their funding or improve sustainability.

In the context of the potentially significant reductions in capital funding to the CDFIs (identified by CDFIs in the E-Survey) by the end of 2016, and based on various discussions with individual CDFIs, there are various potential scenarios resulting from a reduction in funding for SME on-lending. Some CDFIs will continue to operate in specific marketplaces at current levels of lending. Other, predominately larger CDFIs will seek, in consortia, alternative forms of funding and to operate more efficiently than present as well as at higher average loan or equity levels with attendant reduced levels of risk. The rest may face significant reductions in public sector funding and are likely – if no collective action is taken or alternative funding sources are identified – to either reduce in size and/or close operations altogether.

Addressing sustainability can be approached at three levels: individual CDFIs, consortia of CDFIs or across the sector as a whole.

Improved future sustainability could be driven by both operational improvements and new sources of funding. The likelihood of achieving either or both is likely to vary in terms of both options for change and likely impact when considered at individual, consortia and sector levels.

There are a wide range of options for change – at each of these levels – that now could be considered by CDFIs and Funders.

These include attracting new funders and or members at a local CDFI level, adopting common back office functions across consortia and setting up a new Fund for the sector.

4.1 CDFIs that Are Most Reliant on Specific Sources of Government Funding May Face a Reduction in Activity or Closure if They Do Not Diversify their Funding or Improve Sustainability.

In addressing future sustainability initial consideration was given to a ***"do-nothing"*** scenario – i.e. in the absence of any of these options being taken forward "what will happen anyway" – especially in the context of the expectations expressed by E-Survey respondents of the potentially significant reductions in capital funding to the CDFIs by the end of 2016.

Establishing a do-nothing or status quo position, and the consequences going forward, is important for at least two reasons:

- Allowing CDFIs to understand the relative benefits of implementing change (compared to not doing so); and,

- Considering the effects of future external factors (such as the reduction in current sources of funding identified by around 50% of E-Survey respondents by the end of 2016) that might inform the types of changes CDFIs may wish to consider.

In relation to the above it is apparent that the CDFIs depend on a significant proportion of public sector funding which in the future may not be available from current sources.

Without "perfect foresight" it is always a matter of speculation what might happen in the future, the specific sources of funding to the sector that may change and the precise implications of those adjustments in funding on individual CDFIs, which will inevitably differ. To illustrate, however, what impacts might a occur if, for example, UK Central Government funding to the sector were to be reduced by 50%, matched UK commercial sources were to fall and ERDF and other sources remained at current levels, total funding to the sector would fall by 38% from £91 million to £56 million. Based on various discussions with individual CDFIs it was concluded that there are three possible outcomes resulting from such a reduction in funding:

- Some CDFIs will continue to operate in specific marketplaces (such as personal loans and home improvements) at current levels of lending because the nature of their operating model, sources of capital and relative profitability will allow them to do so without necessarily requiring to undertake any fundamental change;

- Other, predominately larger CDFIs will seek, in consortia, alternative forms of funding and to operate more efficiently than present as well as at higher average loan or equity levels with attendant reduced levels of risk; and,

- Other CDFIs will face significant reductions in public sector funding and are likely – if no collective action is taken or alternative funding identified – to either reduce in size and/or close operations altogether.

Assuming, that CDFIs most likely to experience one of the first two outcomes might continue to operate as currently (in the specific market sectors) and the consortia approaches lead to different but more sustainable operating approaches, it is apparent CDFIs most likely to experience the third outcome are at "highest risk" from a reduction in a current source of funding.

4.2 Addressing Sustainability Can Be Approached at Three Levels: Individual CDFIs, Consortia of CDFIs or Across the Sector as a Whole.

Given the above the purpose of considering different future operating options was to assess the benefits to the sector of any practical changes which might:

- In themselves improve the future operational sustainability of the CDFIs (i.e. that might increase efficiency); and,

- Could lead to new sources of funding (and specifically non-grant capital).

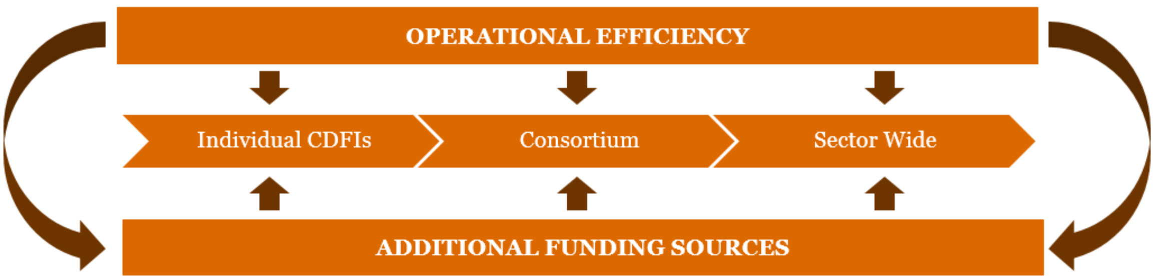
These options are interdependent – improvements in operational efficiency are likely to attract new forms of funding and, in turn, new funders might require such operational efficiencies to be put in place.

Based on an initial "long-listing" exercise, as illustrated in Figure 4.1, it was apparent that a range of options could be undertaken:

- By either individual CDFIs, consortia of CDFIs and on a sector wide basis; and,

- On an operational efficiency basis or as a means to securing additional funding.

Figure 4.1: Options Analysis



4.3 There Are a Wide Range of Options for Change that Could Be Considered by CDFIs and Funders.

4.3.1 Individual CDFIs

In regard to operational efficiency options - and recognising the variety of organisations and processes, objectives and activities of CDFIs across the sector - operational and governance reviews were identified as two routes to improving sustainability on the grounds that:

- Reductions in existing operational costs and/or losses will necessarily require consideration of current processes and funding policies;
- Changes in either or both can be undertaken on an individual organisational basis; and,
- Everything else being equal reductions in future grant funded sources will necessitate such change or risk, as in the past, closure of individual CDFIs.

In relation to "funding options" consideration could be given to accessing new funding sources (than direct Central Government sources) through either new members (such as, potentially, local Housing Associations and/or Local Authorities) or in other ways seeking to develop new local markets where the skills of individual CDFIs could be applied to address SMEs and other needs (such as affordable credit sources for local housing association residents).

Consideration could also be given to mergers at a local level where efficiency gains could be delivered through economies of scale (and associated reductions in staff and back office systems).

Similarly, on a short-term basis, funds might be derived from the sale of any secured and/or high performing elements of any given portfolio (although this will require the development of secondary markets with associated due diligence procedures which suggests, given the relatively small size of individual CDFI portfolios let alone loan values, significant discounts being applied).

4.3.2 Consortia

Some CDFIs are already considering working together in consortia to secure funding from sources such as Big Society Capital. It is anticipated that part of the benefits to such an approach would be the adoption of common back office functions and loan standards which, in turn, would (in principal) generate economies of scale and reduced losses. Implementing these types of operational efficiencies could also be adopted by other groups of (similar) CDFIs.

In regard to funding options there may be greater potential, through consortia approaches, to secure new sources of funding from:

- Attracting new co-founders across LEPs, Housing Associations and Local Authorities across multiple CDFI areas (particularly as Local Authorities continue to implement unification and transformation policies across areas covering more than one CDFI); and,

- Sales of joint portfolios which in value terms might, in turn, support greater investment in operational efficiencies.

Another alternative option that might be considered under the Consortia approach is a "Regional Bank model". This option is drawn directly from the example of the German Savings Banks which currently focus on providing finance (and securing such finance) within defined geographic areas to local SMEs (with revenues below 10 million euros).

As indicated in a recent analysis[27] of these Banks: *"although Savings Banks operate independently in their respective regions, they are all members of the Savings Banks Finance Group, which plays a key role in efficiently processing the essential downstream activities that any large banking organisation requires. Thus they can operate flexibly at local level whilst offering advanced facilities compatible with a universal bank".* Adoption of this model would require the CDFIs to become subsumed (or at minimum their back office functions to be centralised) within such structures and potentially operate with a specific focus and origination role.

4.3.3 Collectively

The additional options identified under this sector wide approach – under operational efficiencies – would firstly be a greater degree of consolidation (and consequent economies of scale as well as potentially cross subsidisation across the sector as a whole). The other option suggested was a national on line platform. This has already been considered within a separate study by the CDFA.[28] As announced in the 2014 Autumn Statement and reflected in the Enterprise Act Legislation, however, the Government is in the process of implementing a national referral platform for all non-bank lenders.[29]

In regard to additional funding options (to those already identified under individual and consortia approaches) potential options include:

---

[27] "The German Sparkassen", Simpson Associates, 2013.

[28] CDFA together with Unity Bank and others have also identified the benefits of a common nationwide platform, namely: *"(i) enable scale and cost efficiency through leverage of a central loan servicing platform; (ii) provide an effective platform through which community investment by grant giving organisations, corporates, government bodies and other social investors can be efficiently distributed across this network and into SMEs and micro enterprises; (iii) create an powerful mechanism through which borrower referrals can be distributed to suitable lenders across the CDFI network".*

[29] Which in practice could be used at an individual CDFI level as well depending on the operating structure that might emerge.

- Greater potential to attract funding such as EU and other non-central government sources;

- An "endowment fund" that would cover operational losses on an annual basis assuming that such losses will continue even if other non-funding and funding options were adopted;

- A separate retail fund (of funds) structure whereby CDFIs would bid into commercial sources of funding with other lenders to distribute loans on a national basis (with agreed arrangements to cover loss levels);

- A technical assistance fund to assist SMEs become "investment ready" through relevant capacity building prior to receipt of loan or equity funding with the operational costs of such a fund being supported by government grants and commercial funders; and,

- Changes in legislation to adopt the principles adopted within the US as detailed at Appendix C.

V. Testing Options with CDFIs and Funders

V. Testing Options with CDFIs and Funders

Key Findings

- CDFIs recognise both the need to embrace and the potential benefits of working more collectively; and,
- Funders – particularly those that have not engaged with the sector before – see merits in funding CDFIs but are unwilling to take a "first loss" position.

CDFIs recognise both the need to embrace change and the potential benefits of working more collectively.

Based on e-survey returns and follow up meetings with a range of CDFIs it is apparent that there is consensus that a more collective if not sector wide approach needs to be considered and implemented to improve future sustainability at both an operational level and in order to be more attractive to funding sources.

Funders – particularly those that have not engaged with the sector before – see merits in funding CDFIs but are unwilling to take a "first loss" position.

Interviews with 13 funding representatives suggest there may be appetite to fund CDFIs – and in certain instances through a joint fund operated by such funders – as long as there is clarity over the first loss position being adopted by **another** party.

5.1 CDFIs Recognise Both the Need to Embrace Change and the Potential Benefits of Working More Collectively.

Analysis of which of the options identified[30] might be practical (and acceptable) to both CDFIs and potential funders was based on:

- The initial study e-survey returns and 4 follow-up workshops with CDFIs; and,
- Interviews conducted by PwC with representatives from 13 funding bodies – ranging from commercial banks (UK and non-UK owned) to UK foundations – to elicit their views on each scenario.

[30] As detailed in the previous section in terms of individual consortia and sectoral wide changes.

From the E-survey a number of enabling factors – as illustrated in Table 5.1 overleaf - were identified as necessary for either individual CDFIs or the sector as a whole to move towards sustainability.

Table 5.1 - Key enabling factors for CDFIs

Key Factor likely to improve own CDFI	Key Factor to improve the future sustainability of Sector
• Increase access to capital and/or contribution to first loss	• Increase access to capital overall
• Improved referral systems;	• Increased size/ reduction in numbers of CDFIs through M&A;
• Consolidation;	• Improved referral systems;
• Diversification; and,	• Consolidation of central support systems;
• Online application portal.	• Online application portal; and,
	• Common standards.

To supplement these findings over 30 CDFIs from across the UK were engaged through workshops, or via remote review of the proposed options, to gather feedback on:

- Perceived opportunities and barriers to sustainability of the CDFI sector in the future; and,
- The desirability of identified 'change options'.

The heterogeneous nature of the CDFI sector is reflected in the range and variety of detailed views captured. For instance, collaboration is perceived to offer more benefits to smaller CDFIs seeking economies of scale, yet present greater concerns for larger CDFIs most commonly expected to 'take the lead'. In addition, whilst some felt that individual CDFI change would represent significant progress from the 'as-is' scenario, others felt that they had largely exhausted the efficiencies that could be achieved within their funding means.

Table 5.2 - CDFI Feedback on Options

	Individual CDFIs	Consortia	Sector Wide
Advantages	Seen by most as desirable as a means to enabling sustainable growth; Majority see themselves as ready to work in this way; The need to improve individual performance is already being driven by external factors such as new regulations (FCA) and requirements of funders and funding sources; and, CDFIs believe they can achieve better results with more support, (i.e. provision of external standards and best practice to enable benchmarking).	This approach is being adopted already by some CDFIs; Seen as a good option for achieving scale where there are synergies in focus, values and ways of working; Recognised as providing a stronger platform for accessing new sources of funding; and, Considered to be potentially even more desirable for operational / back office synergies.	Majority consider this desirable given the potential to increase the volume of capital available to the sector, provided funding is flexible, affordable, focused on impacts and accessible to all types of CDFI; Majority believed they are ready to embrace the option; and, Some appetite to think more broadly about potential funders and to create propositions that are more attractive to the private sector.
Disadvantages	This is seen by several as a short term solution and difficult to achieve within their funding means; Not seen as a desirable route to growth into new areas or geographies (compared with collaboration); and, The availability of suitable capital that can be accessed is seen as the primary barrier to this approach.	Some concerns that consortia working will dilute localism of individual CDFI's 'offer' and mean local needs are unmet; A small number would require further clarity on the benefits to their individual organisation before being able to adopt consortia working; and, Some have also noted the need for additional resources to support the implementation and management of "centralised" enabling technology and common processes.	Some concerns raised about funder requirements creating burdensome reporting and operational requirements; Risk perceived that may result in more homogenous CDFI propositions, with less local responsiveness to local needs; and, Residual need for investment readiness support in some cases.

5.2 Funders – Particularly Those Who Have Not Engaged with the Sector before – See Merits in Funding CDFIs but Are Not Willing to Take a First Loss Position.

Telephone interviews with 13 funders - only 6 of whom are actively funding the UK CDFI sector currently - explored:

- Current funding of CDFIs (in the UK or overseas) and performance of investments to date;
- Appetite to either continue supporting or start supporting UK CDFIs in the future, and their requirements in order to do so; and,
- Views on the approaches to sustainability and other suggestions for supporting the sector.

Across the 13 funders interviewed there is some consistency in the 'requirements' that any proposal from a CDFI, a consortium of CDFIs or the sector as a whole would need to meet in order to access existing sources of funding. Table 5.3 overleaf summaries these requirements and feedback and comments on the three broad approaches to change.[31]

[31] It is important to note in Figure 5.3 that the ways of working "today" are mutually exclusive whereas the responses to future support approaches are not.

Table 5.3 – Potential Funder Feedback

Individual CDFIs	Consortia	Sector Wide
# funders working in this way today: 6	# funders working in this way today: 2	# funders working in this way today: 2
# funders offering future support: 7	# funders offering future support: 6	# funders offering future support: 8
Those funders currently prepared to consider individual CDFIs on their own merits against funder criteria are largely content to continue on the same terms and requirements in the future; In some exceptions CDFI investments to date have required an "unacceptable" level of subsidy/ write off and would not be repeated; Those who would consider lending in the future indicate that this would be more likely where a senior debt position could be held by the bank, or where some other provision for first loss was available (such as a guarantee fund); Some preferences were also expressed towards concentrating on the 'larger' CDFIs or those who are nearest to achieving a sustainable business model; and, In the cases where funders have not previously lent to CDFIs, future funding would require Board approval.	Those supportive of this scenario see it as an opportunity to achieve economies of scale and more efficient lending; Clarity would be required over the first loss position i.e. the funders consulted were not willing to cover such losses; Consortia working is seen by some as a potential driver for achieving common standards in back office and other areas, with others seeing this commonality as a prerequisite for any consortia based lending; and, For some, this option is perceived as introducing unacceptable cost and complexity, compared to working with individual CDFIs.	This scenario received most interest and was proactively suggested by a number of funders; Reference was also made to the previous RGF fund and the certainty and clarity offered over a fixed time frame; Many would still want to take a 'hands on' role in investment decisions made and in governance and due diligence processes; All those expressing interest specified the need for first loss provision in order to draw in their own and other new supplies of capital, with the majority specifying the need to be the senior lender to a fund of this nature; Some concerns raised about the risk that any funding would not be deployed if other work was not conducted to support the development of the underlying pipeline; and, Some limited stated preferences to fund as a sole lender directly.

VI. Conclusions

VI. Conclusions

Key Findings

- There are three scenarios that could be considered and actioned to improve operational sustainability; and,
- In each scenario there are a series of steps that now must be taken in order to ensure sustainability – common to all of them is agreeing acceptable first loss levels or portfolio mixes that still enable social objectives to be achieved.

There are three scenarios that could be considered and actioned to improve operational sustainability.

The analysis undertaken suggests that some of the current public sector funding sources may not be replaced in the future, 'doing nothing' will lead to greater instability and, consequently, there are likely to be benefits to the sector in considering operational change. Such changes include (1) improvements by individual CDFIs, (2) collective change by the sector and (3) the realisation of opportunities to attract new funders to the sector.

In each scenario there are a series of steps that now must be taken in order to ensure sustainability – common to all of them is agreeing acceptable first loss levels or portfolio mixes that still enable social objectives to be achieved.

While the scenarios do differ in terms of relative benefits and risks – with the potential to attract alternative external funding and support offering the greatest benefits in terms of future sustainability – it is unlikely that any of these can be implemented unless there is clarity over both the level of future anticipated losses from future funding and the sources of support which might cover such losses. This in turn suggests that CDFIs need to demonstrate expected losses (by different types of lending) and seek to engage sources that might cover such losses. In the absence of such sources consideration will be required as to whether CDFI portfolios could be operated with a mix of commercial and social objectives.

6.1 There are Three Scenarios that Could Be Considered and Actioned to Improve Operational Sustainability.

In this last section consideration is given to the scenarios that could lead to greater sustainability in terms of:

- Key characteristics and actions required for their implementation;
- Potential impacts; and,
- Consequent merits and risks associated with future implementation.

As detailed in the previous sections the research and, in particular, consultations with CDFIs and funder representatives, suggests there are three broad scenarios that could be considered in improving the current sustainability of CDFIs in operational, funding and related impact terms:

- ***Scenario 1:*** Individual "***internal***" action by CDFIs to improve their operational efficiency and potentially attract further funding from "external" sources;

- ***Scenario 2:*** Collective "***internal***" action by CDFI consortia, or the sector as a whole, to institute such internal change again with the objective of securing new forms of funding; and,

- ***Scenario 3:*** Collective action by "***external***" funders to provide capital to either individual CDFIs or consortia or activities across the CDFI sector.

In drawing judgements[32] – in qualitative terms – about the potential impacts of each scenario consideration has been given to a range of factors that are likely to affect outcomes, namely:

- **Operational costs**; from an individual CDFI perspective compared to the current "status quo" position with a positive impact leading to an improved net cost position in relevant unit cost terms or lower fee/ transaction costs per loan or service;

- **Improved (financial) performance**; which recognises that, irrespective of any operational cost changes, the potential to change the terms, types of loans and other services and recipients of support could improve the net revenue position of any given CDFI;

- **Ease of implementation**; which recognises both the length of time that may be required to successfully implement any change as well as the relative one-off costs and other resources required. Consequently the longer the timescales and higher resource costs involved the lower the ease of implementation;

- **Increased access to capital**; again relative to the status quo whether a given scenario is likely to lead to CDFIs potentially accessing sources of funding – which in the absence of the scenario – would be unlikely to be available;

- **Risks**; which describe the factors that might cause any given approach to fail or otherwise not lead to the outcomes anticipated (such as not identifying a first loss position under scenario three); and,

[32] The presumption in drawing these judgements is that "doing nothing" is not an option i.e. as indicated previously, at Section 3.5, the current position of the sector appears to be unsustainable.

- **Impact;** in terms of the effects (taking account of the factors above) upon future sustainability and, ultimately, upon the SME, Social Venture and other markets.

In the absence of information concerning the relative costs and associated financial projections scoring of each scenario (against these criteria) is based on high, medium and low values.

6.2 Scenario One: Individual Action

The critical changes envisaged under this scenario are threefold, namely:

- Consideration of the future internal efficiencies that could be implemented going forward in relation to operational sustainability of each CDFI in terms of how and who it lends to;

- Identifying likely default or "first loss" levels – given the above and the extent to which local, regional or national sources (including European Commission/ European Investment Bank) might be available to cover these; and,

- Developing investment cases to external funding sources that reflect both of the above.

It is recognised from the four workshops conducted with various CDFI representatives that the appetite and ability to implement such change will differ across individual CDFIs. Although, given the current performance profiles, this does not imply that only those with larger scale portfolios are likely to be able to implement these changes and/ or attract future funding.

Table 5.1 overleaf outlines the potential impacts of this scenario. As illustrated this is a relatively low cost, low risk but also low impact approach to securing sustainable operational change.

Table 6.1: Relative Effects of Scenario One: Individual CDFI Change

Criteria	Impact		Commentary
Operational costs	**Low**		The potential to realise significant cost savings at an individual CDFI level is small given the limited staff and other resources used to operate CDFIs currently.
Improved performance	**Low**	**Medium**	This will require a rebalance between financial and social objectives but could lead to reductions in risks, better net returns and lower losses/defaults if average current performance was met in more cases than currently.
Ease of implementation	**Medium**	**High**	In relative terms, compared to other scenarios, internally led change is likely to be readily implemented (however this may not be matched by "funders" appetite to engage).
Increased access to commercial capital	**Low**		In broad terms, and assuming a relative change in performance to current "average levels", many of the CDFIs might still find it difficult to access new forms of funding from commercial sources unless the "first loss" position is resolved.
Risks[33]	**High**		This is the least risk scenario given the relatively low level of change, partnership agreement and additional sources (and terms) of capital involved.
Impact	**Low**		In the context of receiving additional private sector funding through changes in lending and other policies it is anticipated that there will be only limited interest from commercial sources (except where "first loss" is resolved).

[33] Risks are defined as having a high (green) impact when they are likely to be low risks to failure and vice versa.

6.3 Scenario Two: Collective Action

The steps suggested under this approach will involve:

- In principal agreements by CDFIs to work together to examine across regions, activities and loan types (or portfolios) where economies of scale and common performance uplifts might be achieved;

- The development of consortia (and where appropriate new legal structures) that best achieve such economies and performance change recognising that this will also involve cultural changes in the way CDFIs operate; and,

- Parallel soft-market testing with potential funders (from both the private and public sectors) to frame consortia proposition(s) for future funding that have the greatest likelihood of success (against consortia capabilities).

From the outcomes of the workshops it is anticipated that many CDFIs are prepared, on an in principal basis, to consider this approach not least because they recognise that future joint working arrangements could offer operational cost savings as well as improving their (collective) prospects of securing alternative funding sources. The extent to which "common performance standards" would emerge is probably more likely where there are existing commonalities between partners in terms of service profiles and funding approaches, however, this does not preclude regional consolidation. As in all scenarios, however, the "first loss" issue will also require to be addressed.

Table 6.2: Relative effects of Scenario Two: Collective Action

Criteria	Impact		Commentary
Operational costs	**Medium**		It is anticipated, subject to the level of integration of operational activities and numbers of CDFIs involved, that the potential for economies of scale will be derived at operational and staff levels.
Improved performance	**Medium**	**High**	Based on the analysis at Sections II and III the potential to improve performance could be realised through consortia focused on similar activities and, as importantly, common performance targets at or above current levels.
Ease of implementation	**Low**	**Medium**	While such consortia approaches have, or are being considered, establishing common principles and potentially merging functions may take time and one-off costs to implement.
Increased access to commercial capital	**Medium**		Subject to performance criteria being met the funders consulted anticipated that such consortia approaches were likely to be more attractive in both "deal size" and reduced risk terms.
Risks	**Medium**		There are various implementation risks to successful agreement and partnership arrangements which have not been explored by this study.
Impact	**Medium**		Relative to the first scenario there appears to be greater scope to realise operational efficiencies and access to new capital sources.

6.4 Scenario Three: External Funders

In this scenario it will be important to undertake a series of sequential steps, namely:

- Convening interested funders and potentially others (known to BBB and CDFA) to determine whether they may be willing to consider developing this concept and, in particular, resolving the issue of "first loss" and what terms they might collectively seek from the CDFIs;

- Subject to the above CDFA responding, through its membership, as to whether the initial terms might be acceptable (again "in principal") and the structure, cultural changes and timescales to developing a proposition to the funders to take forward this scenario; and,

- Collective agreement and development by all parties (i.e. funders, CDFIs and the public sector) to implementation.

As reflected, by Table 5.3 overleaf, this scenario is the highest impact but also highest risk approach identified. The risks relate primarily to whether any collective approach by both funders and CDFIs could be reached and on what basis "first loss" might be resolved (without which this scenario as others could not be taken forward). Similarly, even where agreement on this issue is identified, there will remain two fundamental points to resolve, namely:

- How to agree collective terms across funders that have different individual performance metrics and objectives; and,

- What structure and process to engage CDFIs (and potentially others) in seeking funding – i.e. collectively, individually or through a hub and spoke approach that might be based on regional, activity or other thematic splits.

Table 6.3: Relative Effects of Scenario Three: External Funders

Criteria	Impact		Commentary
Operational costs	Medium	High	The extent to which operational efficiencies are likely to be delivered will be influenced by the terms of funding support and the incentives these provide to implement a sector wide or "hub and spoke" approaches to change.
Improved performance	Medium	High	As in the case of operational costs the potential to realise improvements will, in part, be a function of the common/performance measures set by the funders and the conditions attached to any agreements on "first loss" guarantees.
Ease of implementation	Low		The lack of existing precedent, conceptual nature of this scenario and absence of collective discussions between funders suggests significant time if not resource will be involved.
Increased access to commercial capital	High		Under this scenario there is the greatest potential to maximise the (central) level of capital available and ease of draw down if and when any such fund was established.
Risks	Low		Given the potential complexity and parties involved as well as current uncertainties as to the "offer", lack of identified brokerage role and commitment to change by CDFIs and funders there is a high risk of failure.
Impact	High		Of all the scenarios considered this offers the greatest potential for longer term sustainability.

Appendices

Appendices

Appendix A. Market Review and Key Insights

Background materials in support of the study include 27 reports and data sets as indicated in Table A.1.

Table A.1. Background Materials

Reports/ Data	Source
Cabinet Office, Jan 2015, Scaling Community Lenders: The Role of Social Investment https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/393613/Scaling_Community_Lenders_-_The_Role_of_Social_Investment.pdf	HM Treasury British Business Bank
Data: Bank of England, April 2015 (latest), Trends in Lending http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx	Department for Business, Innovation & Skills
Data: BIS, Mar 2015, Small Business Research Survey 2014 https://www.gov.uk/government/publications/small-business-survey-2014-businesses-with-employees	Department for Business, Innovation & Skills
GHK, March 2010, Evaluation of Community Development Finance Institutions (CDFIs)	Community Development Finance Association
CDFA, September 2014, An Economic Impact Tool for the Community Finance Industry	Community Development Finance Association
Leeds City Region Enterprise Partnership, Aug 2014, Access to Finance Literature Review	PwC
BIS, Dec 2013, SMEs: The Key Enablers of Business Success and the Economic Rationale for Govt Intervention https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/266304/bis-13-1320-smes-key-enablers-of-business-success.pdf	PwC
National Audit Office, Nov 2013, Improving access to finance for small and medium-sized enterprises	PwC

Reports/ Data	Source
http://www.nao.org.uk/report/improving-access-to-finance-for-small-and-medium-sized-enterprises/	
Data: BDRC Continental, SME Finance Monitor http://bdrc-continental.com/products/sme-finance-monitor/	PwC
Data: Capital for Enterprise (CfEC): https://www.gov.uk/government/organisations/capital-for-enterprise-ltd	PwC
Data: BBA general https://www.bba.org.uk/news/statistics/ SME: https://www.bba.org.uk/news/statistics/sme-statistics	PwC
Data: British Private Equity & Venture Capital http://www.bvca.co.uk/ResearchPublications.aspx	PwC
Data: CDFA Annual Survey Data 2012-2014	
BIS, Aug 2014, Help to match SMEs rejected for finance with alternative lenders: summary of response: https://www.gov.uk/government/consultations/sme-finance-help-to-match-smes-rejected-for-finance-with-alternative-lenders	Department for Business, Innovation & Skills
Data: Performance data of CDFIs under BBB Financial Guarantee Scheme	British Business Bank
Data: BBB Customer Journey Data	British Business Bank
US – Lyell Sakaue & Anna Stansbury (Harvard Kennedy School), Mar 2015, Tackling Financial Exclusion through Community Investment: How should the UK strengthen its community investment sector? Lessons from the US experience	US Treasury Community Development Finance Association
US – US Government CDFI Fund http://www.cdfifund.gov/who_we_are/about_us.asp & Fact Sheets http://www.cdfifund.gov/who_we_are/factsheet.asp	PwC
US – Information from US Treasury's resident expert on the CDFI Fund	US Treasury
India – Market analysis: SME Financing in India	PwC India
India – Mudra Bank: Can it finance small businesses in India? http://www.bbc.co.uk/news/world-asia-india-	British Business Bank

Reports/ Data	Source
32408546	
Japan – Mitsubishi Corporation http://www.mitsubishicorp.com/jp/en/pr/archive/2011/html/0000012094.html, Nippon foundation, Qatar Friendship Fund http://www.qatarfriendshipfund.org/en/ and a list of other 12 community funds	PwC Japan
Australia – Foresters Community Finance: http://foresters.org.au/ - loans to organisations and individuals SEFA - Social Enterprise Finance Australia: http://sefa.com.au/ - set up to provide social impact investment for social enterprises but have actually taken their mandate much wider to support any small business that supports community Good Shepherd Microfinance: http://www.goodshepherdmicrofinance.org.au/ - loans to individuals primarily through community service organisations but also a few pilot 'retail shopfronts' Foresters, SEFA and another organisation, Social Ventures Australia, are part of the Commonwealth Govt's Social Enterprise Development and Investment Fund (SEDIF): http://employment.gov.au/videos/social-investment-social-enterprise-development-and-investment-funds-sedif-december-2012 SEDIF progress report provides an overview of the funds' structures (in terms of their social enterprise development funds): http://docs.employment.gov.au/system/files/doc/other/sedifprogressreport2013_2.pdf	PwC Australia

Key insights from the background materials are summarised in Table A.2.

Table A.2. Key Insights from Research Reports

Research Report	Areas of Focus	Key Findings	Key Recommendations
Scaling Community Lenders – The Role of Social Investment (January 2015)	Focus on the payday lending market from the perspective of the community lending sector comprising over 400 credit unions, approximately 12 CDFIs and a small number of other lenders. Explored the following three hypotheses: • Community lenders have limited access to the capital they require to scale; • Community lenders have immediate demand for investment; and, • Social investment can play a role in meeting some of this demand. The study undertook a survey of 20 community lenders and 100 sector experts.	Over the last five years the community lenders surveyed have raised over £13m of investment at rates up to 10%. Capital has been provided by over 20 different investors including: • Mainstream and social banks; • Trusts and foundations; • Social investment funds; • Housing associations; and, • High net worth individuals. The study identified three contributing factors restricting community lenders wider access to capital: • Limited track record of taking on and repaying investment; • Varying investor confidence in the operating model; and, • A lack of clear articulation of the social impact of providing loans to the recipients. In terms of demand for investment – 14 organisations identified the need to take on investment representing £3m to £53m of investment demand over the next two years split between: • Loan capital for onward lending (particularly for CDFI's as non-deposit taking organisations they are heavily reliant on income from loan repayments); and, • Development capital for infrastructure improvements and expansion.	The study identified that social investment could be used to meet community lenders need for investment demand and the type of investment required was likely to vary according to the organisation's stage of growth: • Start-up stage – capital of less than £500k required which could be met through direct investment by social investors or existing funds; and, • Growth stage – capital ranging from £0.5m to £5m along with technical assistance to support their development plans. The study notes that this demand is unlikely to be met via existing funds given lack of sufficient capital, the fact they are not established to meet long term demand, or structured to provide the combination of loan and development capital required and may not have the expertise required to inform investments. Given

Research Report	Areas of Focus	Key Findings	Key Recommendations
			this gap in the investment market a wholesale investment fund led by a specialist fund manager could be established. The study notes that "analysis of potential investors identified that social investment could support a fund of £10m to £25m".
Evaluation of Community Development Finance Institutions (CDFIs) – Executive Summary (Feb 2010)	Evaluation of the CDFIs' enterprise financing activities in England for the Department for Business, Innovation and Skills (BIS) and the Office of the Third Sector (OTS). The study methodology involved: • Literature and policy review; • National and regional stakeholder consultations; • Analysis of the national sector survey data (Inside Out); • National survey	The following three key findings were identified: • Strong evidence exists for continued sector support to CDFIs, due to: ➢ CDFIs continued role in addressing the information and externality market failures of lending to enterprises in underserved markets; ➢ CDFIs ability to meet a range of enterprise related public policy rationales and goals including enterprise growth, regeneration, support for social enterprises and enterprise within under-represented groups; ➢ Ability to evidence robust economic impacts of 1,705 additional businesses and 3,600 jobs created in net terms and representing value for money given levels of public sector support; ➢ The ability to generate social benefits, however, these are currently not collected or reported in a standardised way; ➢ The sector continues to suffer from poor operational and financial sustainability (39% and 24% respectively). This is more pronounced for those CDFI's focusing on micro enterprise lending vs. social enterprises; and,	The study provided a framework for the following recommendations: • Continue public sector support to CDFIs via the development of a policy framework in light of the continued market failure affecting lending in underserved markets; • Development of intervention rationales and evaluation frameworks for the different enterprise related policy objectives delivered by the CDFIs; • Review the range of support provided by the CDFIs for continued suitability and

Research Report	Areas of Focus	Key Findings	Key Recommendations
	(including control group survey) of CDFI business clients; • Green Book and IEF compliant economic impact assessment; • CDFI case studies; and, • Sector specific research.	➢ Sector sustainability has been set-back by the credit crunch and recession resulting in increased demand for enterprise loans and hence higher transaction costs to the CDFIs and higher levels of loan delinquency. • Need for further research to understand the scale of underserved markets (e.g. baseline estimates of demand) and extent of latent and existing demand in the sector; and, • Estimates of performance suggest CDFIs are efficient vehicles for delivery of capital to businesses in underserved markets (the average cost of creating a business ranges between £9,200 to £30,600) but a lack of comprehensive data exists to aid reporting around outcomes and impact. This lack of transparency is contributing towards the lack of philanthropic and private investment in the sector and weakening policy-makers confidence in the ability of CDFIs to secure different types of economic and social impacts efficiently.	effectiveness against the policy objectives/ policy framework identified above; • The CDFA should continue to support the sector to develop social impact methodologies and to evidence the full value of its activities; and • Promote further initiatives to create a suitable CDFI referral system – either within the existing Solutions for Business service offer and/or related initiatives for a universal referral system with banks.
Access to finance literature review – Leeds City Regional Enterprise Partnership (August 2014)	The study provides an overview of a literature review on existing research on access to finance issues in the SME finance market. The focus is on the supply and demand for different types of finance both nationally and within the Leeds City Region (LCR) in order to inform the size, scale and type of	<u>Supply issues:</u> *Lending* • Lending to SMEs across the UK has been declining since 2009 with the flow of new bank term lending to SMEs falling by 23% between 2009 and 2012; • British Banking Association (BBA) data shows that bank lending to SMEs in the Yorkshire & Humber (Y&H) region fell by 4% between 2011 and 2012; • The majority of LCR businesses seeking finance are looking for amounts below £50,000. The average size of loans under the JEREMIE Business	

Research Report	Areas of Focus	Key Findings	Key Recommendations
	funding gaps.	Loans Fund is higher at c. £90k-£95k; and, • Lending from CDFIs in the Y&H region has however increased from £7.8m in 2010/11 to £12.5m in 2012/13 (£3.12m to £5m in the LCR over the same period). The average size of loans is c. £11,300. *Equity / venture capital finance* • Only around 1% of SMEs use equity as a source of finance (e.g. venture capitalists or business angels). The proportion rises to 2.5% when mezzanine finance is also considered; • The Rowlands Review (2009) estimated that up to 3,000 viable SMEs each year with suitable growth capital may be unable to raise the finance required for growth; • Venture Capital (VC) investment in the Y&H region fell by £348m between 2010 and 2012 – a fall of over 70%, over double the national average. Y&H region also has the smallest level of VC investment of all English regions accounting for 2% in 2012; and, • £17.5m equity linked finance has been invested in over 25 LCR companies and Seedcorn finance of over £6m has been invested in 12 LCR SMEs by Finance Yorkshire. *Finance gaps persist* • Analysis by Deloitte (2013) suggests a £22bn potential gap by 2017 between the amount of finance available to SMEs and the amount they actually need; • Research for Money & Co (2014) found that the average medium sized business has a funding gap of c. £69,960 and the average small firm has a funding gap of £11,750;	

Research Report	Areas of Focus	Key Findings	Key Recommendations
		• Research for the Community Development Finance Association (CDFA) and RBS Group identified a funding gap for businesses seeking community finance is estimated at £1.3bn representing 103,000 businesses that are unable to access finance. In the LCR the funding gap is estimated at £156m rising to £552 by 2016; • Research suggests the parameters of the equity gap stretch from £250,000 to £2m. This equity gap has worsened for innovative technology based firms due to blockages in business angel investment and early stage private equity – extending up to £15m for sectors requiring complex R&D or large scale capital expenditure; and, • Research for the LCR Enterprise Partnership found that 55% of stalled projects in the City Region were seeking under £100,000, while approximately 10% were seeking sums of over £500,000. Evaluation evidence suggests that public sector intervention in finance markets can deliver a range of economic benefits and a good return on investment. For example: *Nationally* • The evaluation of the Enterprise Finance Guarantee Scheme (2013) showed that the scheme had delivered a net economic benefit of £1.1 billion; • The National Evaluation of Community Development Finance Institutions (2010) found that on average, a £1 investment would return £3.57 worth of new GVA or safeguard £5 worth of existing GVA in the local economy; and, • The RDA Impact Assessment (2009) found that the individual enterprise support schemes (which include access to finance schemes) covered by the evaluation had delivered 29,000+ net new jobs created/safeguarded; 1,900 new businesses created and 17,000 businesses assisted. These schemes also achieved returns of £12 GVA per	

Research Report	Areas of Focus	Key Findings	Key Recommendations
		£1 public sector money invested. *And in the Leeds City Region* • As of June 2014 the JEREMIE programme had supported 297 investments in 195 SMEs with total value of £38.7m, creating over 1,850 jobs; • Local CDFIs have invested £12.5m in over 1,100 social and community ventures creating c. 2,800 jobs since 2010/11; • The £25.7m Business Growth Programme has to date achieved private sector leverage of 1:8 for projects under £100k and 1:9 for those above; and, • The LCR Growing Places Fund has allocated £17.5m in 8 projects that will create over 1,000 jobs, an estimated GVA boost of £147m and over £100m private sector leverage. <u>Demand issues:</u> The use of 'core' forms of finance fell in quarter 1 2014, continuing a long-term decline from the start of 2012 (down from 23% in 2013 as a whole and from 29% in 2011). There continues to be a gap in the use of external finance between those with employees and those with none. A lack of investment and finance readiness is preventing some SMEs from accessing finance whilst SME's do not often know where to look to find venture capital. For example, only 19% seek advice when applying for a loan whilst just 34% of SMEs know where to find venture capital. Many SMEs face obstacles to obtaining finance: Less than half of all SMEs use external finance, with bigger SMEs more likely than smaller SMEs to be	

Research Report	Areas of Focus	Key Findings	Key Recommendations
		using external finance. Finance is a disproportionately important obstacle for high growth firms compared to other businesses. Geographical disparities exist with the venture capital market with investment concentrated in London and the South East. Market failures provide the rationale for public intervention in SME finance markets. Market failures persist mainly relating to asymmetric or imperfect information. For example: • Finance providers often have imperfect information on the likely returns on their funding; • A debt financing gap for businesses lacking track record and collateral; and, • SMEs may not fully understand the potential benefits to their business of raising finance or their likely chance of success in gaining finance. Emergent demand for growth finance from social and community ventures has highlighted a number of market failures in the social investment market (information and transaction costs on the supply side and poor investment readiness on the demand side).	
SMEs: The Key Enablers of Business Success and the Economic Rationale for Government	This paper sets out the current issues facing SMEs in the UK and presents the evidence that underpins Government intervention in these areas.	There were an estimated 4.9 million private sector businesses in the UK at the start of 2013, of which 99.9% were SMEs. The SME population in the UK has grown by around 14% since the start of 2008. SMEs in the UK accounted for 59.3% of private sector employment and	Interventions should be designed to support businesses preferences and needs: • In order to be effective policy interventions should be delivered in a way which

Research Report	Areas of Focus	Key Findings	Key Recommendations
Intervention (December 2013)		48.1% of private sector turnover at the start of 2013. The key enablers of business success can be grouped into three clusters: • Internal capacity and capability to grow – a limiting constraint in 67% of microbusinesses; • The external environment, including the market in which the business operates – a factor in 45% of micro businesses; • The vision of the business owner in relation to growth – related to 72% of micros. The main obstacles to success reported by SMEs related to the external environment, including access to finance including: • On the supply side - market failures mainly relating to asymmetric or imperfect information affect the supply of finance to SMEs; and, • On the demand side - SMEs may not fully understand the potential benefits to their business of raising finance, or their likely chance of success in gaining finance. However, the external environment also presents opportunities for growth e.g. via exporting and public procurement. In terms of access to finance: • Less than half of all SMEs use external finance, with bigger SMEs more likely than smaller SMEs to be using external finance; • Ability of SMEs to access finance is important for: funding business investment, ensuring businesses reach their growth potential, and for facilitating new business start-ups. Whilst a lack of finance can constrain	meets businesses preferences. For example mentoring has been identified as suitable way of engaging with SMEs. Mentoring has been shown to deliver benefits across a range of areas, including leadership skills and business planning. Those SMEs that have used or are currently using a business mentor, report that it can boost their business performance in terms of sales/profit; • Encouraging SMEs to take up business support initiatives in order to encourage better outcomes; and, • Designing effective policies to support growth needs to consider the target businesses, the type of support provided, the timing of support and at what geographical level support should be delivered. The study identifies: “the need for partnership based, regional delivery and the value of holistic support, which combine business

Research Report	Areas of Focus	Key Findings	Key Recommendations
		cash flow and hamper businesses' survival prospects; • Empirical studies have found a positive relationship between start-up capital and growth after controlling for characteristics of the business founder; • In addition, a study by Aghion et al. (2007) found that higher finance development is associated with increased new firm entry in certain sectors and higher growth amongst those new firms. However, these studies do not necessarily provide evidence of a causal relationship; • Total lending to SMEs peaked in early 2009; since then it has fallen by more than 20 per cent in real terms. Over the same period SMEs have built up significant cash balances, and as of June 2013 were net lenders to the banking system at over £30 billion; and, • Evidence suggests the decline in the volume of lending to SMEs is caused by a reduction in demand as well as a contraction in supply. For example, overdraft application rates and term loan application rates each fell by almost a third from 2001-04 to 2008-09. On the supply side the loan and overdraft rejection rates increased significantly during the financial crisis i.e. 2008-09 onwards. In addition the study identified further structural issues affecting the supply of and demand for finance: • Dependence of SMEs on banks – as awareness of alternative forms of finance is low; • The concentration of the UK banking sector – meaning the four largest banking groups had a combined market share of 85% of SME current accounts; • Lack of supply of long-term debt finance products and unsecured lending products which meet SME needs; and,	development and leadership development, provided over a continuous time". At the same time the study notes the lack of evaluation of many of the business support policies in the UK and elsewhere and therefore it is difficult to learn what the most effective forms of intervention are. Hence suggesting: "the need to design and implement robust evaluations to enable Government to learn what policies are effective at supporting sustainable growth and for this to inform future policy design and delivery in the business support area".

Research Report	Areas of Focus	Key Findings	Key Recommendations
		• Capital constraints in the banking sector – resulting in less capital being available for SME lending.	
Improving Access to Finance for Small and Medium-Sized Enterprises (November 2013)	This report by the National Audit Office provides an overview of the current size of the UK SME market. The need for access to finance and current performance of existing SME funds including the Start-up Loans Fund and Finance Guarantee Scheme. .	Key facts: • There are 4.79m SME firms in the UK with fewer than 250 employees and turnover of less than £50m; • Most SMEs are very small: almost three-quarters are sole traders and partnerships, while there are only around 30,000 SMEs that employ 50 staff or more; • The potential gap, by 2017, between the amount of finance available to SME's and the amount they need is estimated to be £22bn; • 38% of SMEs that are less than five years old have their bank loans rejected; • 14.1 million people in the UK are employed in SMEs; • £170 billion of outstanding lending to SMEs has been provided by UK financial institutions, of which around £17 billion is in the form of overdrafts; • £120 million of funding is available to support start-up companies in the form of small loans (typically around £5,000) under the Start-up Loans scheme; • £100,000 average loan under the government's Enterprise Finance Guarantee scheme; and, • 52 per cent of SMEs are aware of the principal bank and government initiatives designed to improve access to finance.	The Departments should: • Take the lead in simplifying responsibility within government for addressing SME finance issues, ensuring that a more integrated approach is taken to analysing data and research and turning this insight into policy interventions; • Articulate the specific impact they want to make through the programme of interventions; • Devise, for all schemes, success measures for the short, medium and longer term that would enable them to demonstrate and justify the merits of the schemes and associated investments; • Introduce a more rigorous process for making changes to schemes in response to evaluations undertaken; and,

Research Report	Areas of Focus	Key Findings	Key Recommendations
		BIS commissioned a significant amount of research and analysis into the financing challenges facing SMEs. This research found: • The flow of new bank term lending to SMEs fell by 23 per cent between 2009 and 2012, but this was partly caused by constrained demand; • Seventy per cent of SMEs whose loan application is rejected receive no alternative finance, and younger and smaller firms are worst affected; and, • The 'funding' gap (the difference between the funding required by SMEs and the funding available) is £10 billion to £11 billion but, subject to some significant assumptions about the state of the economy, may reach about £22 billion by 2017.	• Develop and make better use of existing data sources. This will allow them to generate better information to be used in evaluations of the relative costs and impact of schemes. The Business Bank should: • Take a flexible approach, implementing and withdrawing schemes in an agile way to reflect movements in the market; • Align any new interventions with BIS's broader policy priorities, as set out in BIS's Industrial Strategies, based on an understanding of what is working; and, • Target SMEs' lack of awareness of issues such as the loan appeals process and alternative sources of funding.
Help to Match SMEs Rejected for Finance wit Alternative	This report presents the findings from the Governments consultation (which ran until April 2014)	Evidence suggests that the majority of SMEs only approach their main bank for finance, with around 40% giving up their search if they are unsuccessful. A proportion of the SMEs that are rejected are viable businesses, and are rejected because they do not meet the risk profiles of the largest banks. The result is a market failure of imperfect information, whereby in many cases	Next steps: • The Government has decided to legislate for a mandatory process in the

Research Report	Areas of Focus	Key Findings	Key Recommendations
Lenders: Summary of Responses (August 2014)	regarding how to match SMEs rejected for finance from mainstream banks with alternative lenders such as challenger banks and other sources of finance. In addition to asking whether the government should legislate for a mandated process for forwarding rejected SMEs' information, the consultation asked a number of questions regarding how such a system should be implemented, including: • Which lenders and types of finance should be in scope of the requirement to forward rejected SMEs' information; • What information about SMEs should be should be shared, and what protections should be in place for this information; • Views on the government's preferred approach that SMEs'	challenger banks and other providers of finance are unable to offer finance to smaller businesses because: • They are not aware of their existence; and, • SMEs are similarly unaware of the existence of these alternative sources of finance. Overall there was widespread support for the Government's proposals to improve access to finance for SMEs from respondents to the consultation. Key issues raised included: • Strong overall support for the government's overarching goals and for the proposal of a mandated information sharing process, which many respondents believe will bring greater choice to SMEs and support greater competition in the provision of finance; • A number of other key themes emerged including the importance of ensuring that SMEs have full control over the process and their information and that the information forwarded on SMEs should be kept to a minimum - enough only for alternative lenders to identify possible SME lending opportunities and to begin discussions with those SMEs; and, • Respondents emphasised the need for SMEs' details to be properly protected when they are forwarded on to a platform with information being provided to reputable providers of finance and that SMEs cannot be the subject of excessive or dubious approaches by third parties through the platforms. In addition the importance that businesses are not at risk of unsolicited credit checks that could damage their credit "footprint" was highlighted.	Small Business, Enterprise and Employment Bill, where SMEs will be forwarded on to platforms that will help them be linked up with alternative lending opportunities; • The requirement to forward on SMEs that are rejected for finance will capture the largest UK SME lenders, and the majority of lending to UK SMEs; and, • SMEs' information will be forwarded to private sector platforms that will be designated by the government on the basis of these platforms meeting clear minimum standards that focus on ensuring that SMEs are in control and properly protected throughout the process.

Research Report	Areas of Focus	Key Findings	Key Recommendations
	information is forwarded to a private sector platform or platforms; and, • What criteria the government should use for designating platforms to receive SMEs' information. The government received over 45 responses to SME finance: help to match SMEs rejected for finance with alternative lenders. Respondents included major banks, challenger banks, alternative finance providers, business groups, trade associations and smaller businesses.		

Appendix B. List of Consultations

The study – as indicated in Table B.1 below – was supported by inputs from a series of consultations with 4 representatives from 4 Government departments, an independent representative from the BBB, the Community Development Finance Association and the Start Up Loan Company.

Table B.1. List of Consultations

Department/ Organisations
Department for Business, Innovation and Skills
HM Treasury
Cabinet Office
British Business Bank
CDFA
Start Up Loan Company

Appendix C. Assessment of the CDFI Sector in the US, India, Australia and Japan

International Comparator	Key Characteristics	Key Differences from the UK CDFI Sector
United States	Operating for more than four decades CDFI sector in the US seeks to mitigate the lack of capital investment in disadvantaged communities, and the problems of financial exclusion and predatory lending. There are more than 800 certified CDFIs working in communities across the US, including 492 loan funds, 177 credit unions, 176 bank holding companies, banks or thrifts, and 13 venture capital funds. US CDFIs have over £8.3B in assets and provide over £1.28B investment per year. Market segments include business lending, individual lending including individual mortgages, and real estate lending, in which real estate lending and individual mortgages provide CDFIs with real assets. Housing related lending is the main segment with around 50% of funding goes to social housing. A significant share of loan fund, around 85%, is from private sources. US CDFIs can access private investments thanks to their scale and the consistent support from the government and foundations. The key to success of US CDFIs is its dependence on foundation & government agencies support including: ➢ *From US Government:* debt and grants through CDFI Fund including £1.2B during 2004-14, tax credit e.g. New Market Tax Credits and Low Income Housing Tax Credit, policy e.g. Community Reinvestment Act incentivising banks to lend to CDFIs, CDFI Bond Guarantee Programme to cap the borrowing rates; and, ➢ *From foundations:* Ford Foundation (with £335M financing) and MacArthur Foundations finance low income loan and recoverable grants from their endowments. In particular, the Community Reinvestment Act (CRA) makes it mandatory for banks to invest in the community where they do business, which is considered critical to the development of CDFIs.	• Government support to build scale of the sector and increase credibility of CDFIs; • Government support in the form of mandatory investment in CDFIs by commercial banks; • Increase in quantity and quality of individual lending; • Expansion to investment in real estate; and, • Strategy to attract private investment.

International Comparator	Key Characteristics	Key Differences from the UK CDFI Sector
	93% of CRA lending programmes are profitable or breakeven, indicating the policy does not appear to conflict with banks' drive towards profitability.	
India	Community financing in India comes from 5 major groups of institutions: 1) traditional banks, 2) ministry sponsored funding schemes, 3) SMEs oriented public financial institutions, 4) private/ community based financial institutions, and 5) funds for ventures and enterprises. While all mentioned institutions are involved to different degree in community financing, there are two key institutions: ➢ *Microfinance Institutions within 'Private/community based financial institutions':* specialise in banking services for low-income groups or individuals, and provide account services to small-balance accounts, and offering small-amount transaction services which are below the minimum levels of commercial banks; and, ➢ *Micro Units Development & Refinance Agency (MUDRA) within 'SMEs oriented financial institutions':* the Government is setting up MUDRA through a statutory enactment. MUDRA would be responsible for developing and refinancing all microfinance institutions lending. The Bank would partner with state level and regional level co-ordinators to provide finance to Last Mile Financiers of Micros and SMEs. The sector is highly regulated and supported by the Government through the Central Bank and investment mandates which have shaped the development across 5 groups of community financing institutions. Compared to public support, private sector involvement is far less well defined or visible.	• Government support through provision of funding and via a network of ministries and SMEs oriented financial institutions; and, • Government's emphasis on financing SMEs via a mandate on priority investment sectors.
Australia	Community financing is relatively new in Australia. Whilst there are a small number of 'proto-CDFI' organisations operating since early 2000s, such as Maleny Credit Union, Foresters ANA Friendly Society and the Traditional Credit Union, they are less developed compared to CDFIs in the US or UK. Australia was described as 'a significant exception among developed western	Newly established CDFI sector which depends on government support and financing for growth.

International Comparator	Key Characteristics	Key Differences from the UK CDFI Sector
	countries' with a need to support the institutional development of CDFIs. CDFIs has grown in number in the past decade supported by government funding and policy initiatives to stimulate jobs, community facilities and financial services for low income people, especially the indigenous communities. Australian CDFI sector has yet to define its market segments or development strategy; notably: ➢ *Financial Management Programme (FMP) & CDFI pilot*: the Government has run Financial Management Programme (FMP) to providing access to finance, mitigating financial exclusion and helping build financial capability. FMP included a CDFI pilot first in 2009 targeting vulnerable people and communities. The Pilot was extended in 2013-14 with £1.53M funding. No further announcement has been made regarding the development or extension of the pilot. ➢ *Social Enterprise Development and Investment Funds:* on the social investment side the Government launched the Social Enterprise Development and Investment Funds (SEDIF) in 2010. Via SEDIF, the Government provided £10.2M grant funding matched by private investment to create a £20.7M investment pool. SEDIF activities have received continuous support from the government and private investors.	
Japan	Non-profit community finance, which complement market-based for-profit finance, is an integral part of Japanese economy. Community finance institutions set social missions as the priority of their activities. Community financing institutions are highly decentralised, supported by strong knitted communities. The default rates are often very low across different types of institutions. Typically only guarantors are required. ➢ *Non-profit & cooperative financial institutions/ NPO Banks:* There are around 13 NPO banks which are legally not banks but money lenders, supplying loans between £15K to £65K at interest rates typically between 1-3%, and at most 5%, over 1-10 years. They attract capital from citizens, NGOs and Coops and provide loans to community business	• Decentralised model with support and capital provided by communities (including citizens, local organisations and private investments) rather than central Government; and, • High trust in solidarity community enables low interest rates and lending without collaterals (only

International Comparator	Key Characteristics	Key Differences from the UK CDFI Sector
	and entrepreneurs who have difficulties accessing banks. ➢ *Citizen Banks/ Shinkumi banks: a*im to support social entrepreneurs starting up their businesses with loans at low interest rate and without collaterals; among the first institutions in Japan to serve women, elderly, handicapped & other disadvantaged borrowers. ➢ *Credit unions (e.g. Japan kyojo kumiai, Iwate Consumers Credit Cooperative, etc.):* provides loans for consumption to individuals and for debt adjustment to people in debt and has few incidents of defaults. ➢ *Community (venture) funds (e.g. Hokkaido Green Fund, Osaka Community Business Fund, etc.):* raise fund and directly invest in community development projects with social objectives, rather than providing loans to social entrepreneurs or individuals under-served by banks. ➢ *Private sector foundations*: provides funding to projects that benefit communities.; e.g. Mitsubishi Foundation, offering grants to activities related to academic research and social welfare, provided over £1.8M in 2014; Qatar Friendship Fund of £64M offers financial assistance to a number of projects in the fields of child education, healthcare, and fisheries.	guarantors needed) whilst maintaining high repayment rates.

.