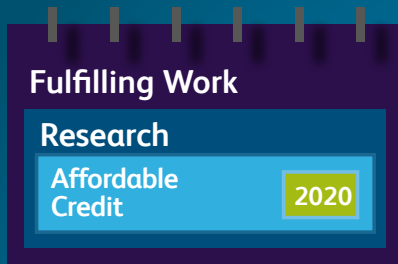




Scaling up the UK personal lending CDFI sector: From £20m to £200m in lending by 2027

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Foreword

Almost all of us need to borrow money at some stage in our lives. Credit can help with the purchase of major assets like houses and cars; allow purchases to be spread for home improvements or holidays; and smooth out unexpected income shocks when the washing machine needs replacing or the car requires essential repairs. But credit can be a thorny issue, encompassing our own upbringing and prejudices; the importance of saving, and the merits of borrowing.

People in the UK owed £1,665 billion at the end of October 2019, including £225 billion of consumer credit.¹ These figures should give pause for consideration, as while credit can be a vital tool for many people, it should never be a substitute for fair wages or a decent welfare system.

There is a significant ‘poverty premium’ in the UK consumer credit market. Those on low incomes, with limited credit history, are most likely to be excluded from mainstream forms of credit, such as bank loans or credit cards. They instead may borrow from non-mainstream high cost credit providers, paying a significant price to do so. Alternatively, they may be forced to meet their financial needs through other routes that are far from optimal, such as borrowing from friends and family or defaulting on council tax and other bills – both trends which are on the rise. These are issues of public policy, and of market failure, affecting millions of UK households.

Since 2016, the Carnegie UK Trust has grappled with the complex problem of access to credit for low income households. We convened a range of private, public and civil society organisations to explore this challenge, resulting in our “Gateway to Affordable Credit” report. Since then we have continued to highlight the importance of good, fair, affordable credit with associated wraparound services.

We saw then, and now, the potential to scale up an alternative sector of ethical, not for profit, lenders who aim to meet the needs of low income consumers fairly, by providing affordable loans

and access to other services, such as debt advice, savings products and basic bank accounts. With the support of the Scottish Government, we established our Affordable Credit Loan Fund of £2m to begin to address these issues by supporting not for profit lenders in their growth ambitions. We want to see an increase in the scale and sustainability of those providers, where the needs of the borrower are aligned with the motivation of the lender.

This excellent report by the University of Salford highlights many of these issues and examines how you achieve the step change necessary to enable these social lenders to reach many more people. Working with seven Community Development Finance Institutions (CDFIs) the research team at Salford interviewed, assessed and appraised lenders’ data. We are grateful to the CDFIs and their trade body Responsible Finance for entrusting us with their information and thoughts.

To make the step change to £200m of lending per year from a sector that has hovered around £20m for many years is a significant challenge. However, as the report suggests there are opportunities to begin to meet that challenge. The CDFI sector has operated through financial crisis and recession, it is a sector that has increasingly professionalised its outlook and practices and is open minded to the range of opportunities that can assist its growth and development. With the arrival of organisations like Fair for All Finance, new opportunities exist to address the challenges associated with operationally sustainable lending. There has never been a better time to make the step change. What is certain is that the needs of low income consumers will not go away.

We commend this report as a valuable contribution to the debate.



Sarah Davidson
Chief Executive, Carnegie UK Trust

¹ <https://themoneycharity.org.uk/money-statistics/>

Executive summary

Research overview and background

Access to credit is an essential part of modern life, but millions of UK consumers cannot access credit or have to pay a premium to access it, leaving them at greater risk of customer detriment and poverty. In the past 6-7 years, there has been a renewed interest in supporting alternatives in the form of affordable credit. The government directed £55m of Dormant Assets allocation to financial inclusion which led to the establishment of Fair4All Finance, independent of government, Michael Sheen set up the End High Cost Credit Alliance and Carnegie UK Trust set up an Affordable Credit Loan Fund out of its own endowment.

Community Development Finance Institutions (CDFIs) – not-for-profit lenders serving low income consumers – are an important part of the solution. Yet they barely register in relation to the need. In 2018, they lent £26m compared with £4.5bn by the commercial high cost credit sector. Carnegie UK Trust commissioned Community Finance Solutions, University of Salford, to determine if and, if so, how the sector can achieve a step change in growth to make a greater dent in the need and

demand for affordable credit. The central aim was to develop proposals for a step change to £200m of operationally sustainable lending by 2027. The study draws on international case studies, stakeholder interviews and financial analysis of seven of the main personal lending CDFIs.

Personal lending CDFIs in the UK

The personal lending CDFI sector serves some of the poorest and most vulnerable households in the UK, such the unemployed, benefit recipients, single parents, social housing tenants on low-incomes.

A rise in in-work poverty, welfare reform and the proliferation of online high cost credit lenders following the financial crisis, has led CDFIs to expand their target group to include low-income people in work and consumers of online high cost credit. Credit unions also form part of the affordable credit landscape but often serve a more mixed and better-off customer base as they lend to people with a track record of saving, use their members' savings and are restricted in the rate they can charge.

CDFI customers 2012-18 (%)

	2012	2013	2015	2016	2017	2018
Female	65	62	62	55	48	61
Unemployed	74	63	52	51	40	50
Benefit recipients	71			60	47	66
Single parents	26	49	42	54	28	42
Social housing tenants	71	70	56	46	43	53
HH income > £15,000	78	58	55	57		48

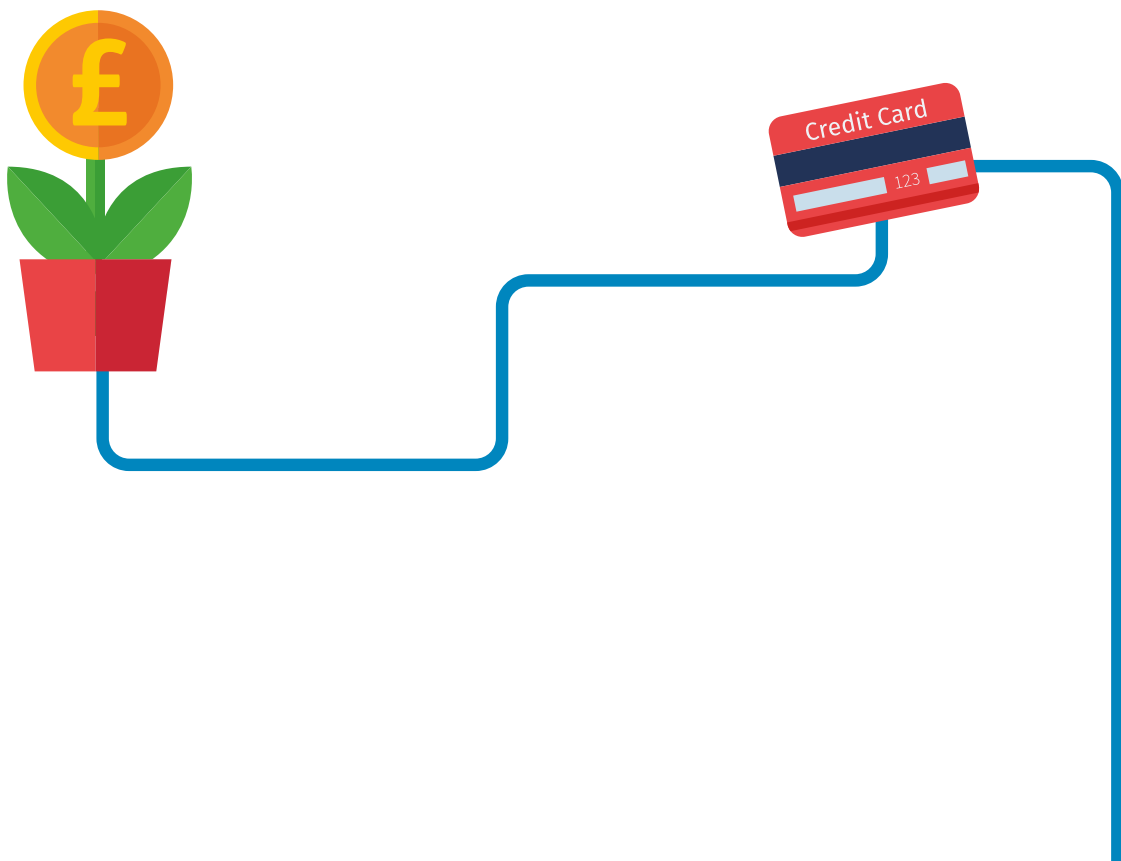
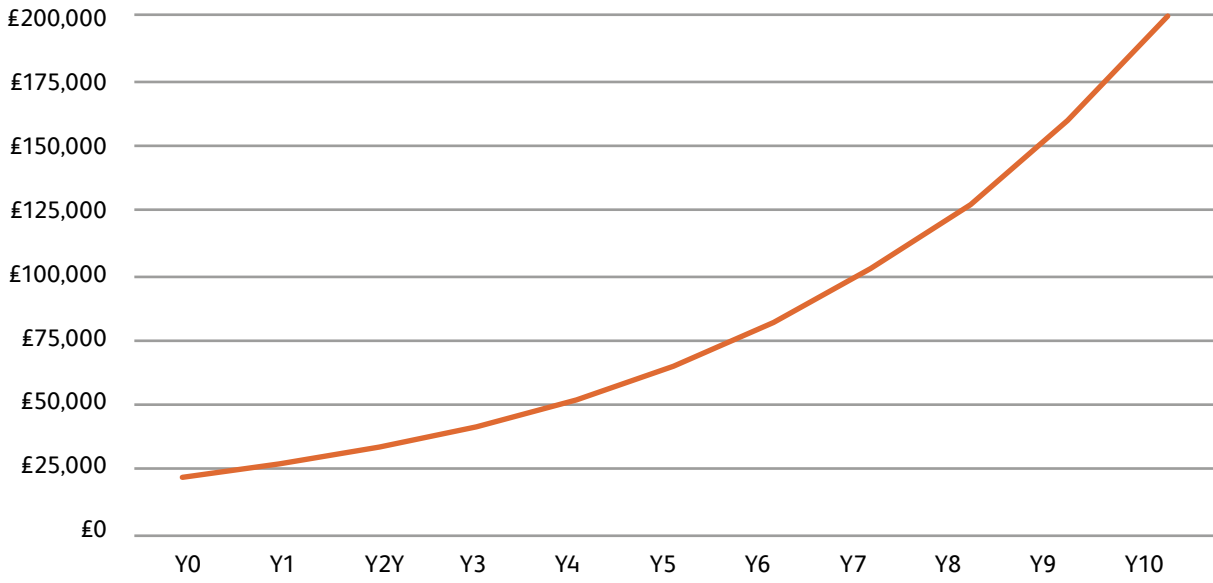
Social and financial achievements of the sector

- **CDFIs reach those most in need:** Customer data underlines the role of CDFIs as ubiquitous vehicles for reaching the most excluded. They provide small loans, typically £350 to 400 to new customers, linked savings accounts and support to people that are unemployed, in social housing, women and lone parents on low incomes. Many pay less to access credit, save regularly and improve their wellbeing as a result of accessing these services.
- **Improvements in sustainability:** The CDFIs significantly reduced their deficits, generally by growing the interest income at a greater rate than the costs. There were substantial improvements in levels of operational and financial sustainability. Most improved productivity through rationalising the lending process, including telephone lending and making efficiencies in the customer journey.
- **Uneven performance across sector:** Performance across the sector is uneven. The data suggests that some providers outperform the rest of the sector on a recurring basis in terms of productivity, efficiency and sustainability. Greater loan sizes, greater scale and low total and per loan costs all positively contribute to a stronger financial performance.
- **Need for a clear sectoral narrative:** There is a lack of a clear, sectoral narrative concerning the financial and social dimension of the sector. The participating CDFIs use different measures and ways of presenting the business models, and portfolio characteristics, performance and arrears. This makes it difficult for potential investors to assess the risks and rewards of investing. There is a lack of consistency in articulating and capturing target customer characteristics and outcomes.
- **Risks and rewards of remote underwriting:** Moving to remote underwriting and delivery, especially online, automated lending, has the potential to significantly reduce costs at least over the long term. Falls in delivery costs seemed greater than associated increases in customer acquisition costs. However, customer data and CDFI manager testimonies suggest that online borrowers are more likely to be homeowners, male, younger and less likely to be unemployed.

Scaling up the personal lending CDFI sector

- **Clear growth potential but will take longer than 10 years to reach £200 million:** Despite improvements in efficiency and sustainability, it is unrealistic to expect the sector to grow to £200m in a 10-year timeframe. This would require an annual growth rate of over 25% (see chart on p. 5). Such growth is rarely achieved even by companies operating in conventional, well-functioning markets: fewer than 10% of UK companies can be classed as high growth, achieving 20% growth annually for 3 years of more.
- **Need for significant upfront investment:** Achieving a step-change in growth will require significant upfront investment in systems and management teams. Following a 25% annual growth trajectory, the sector would need over £3.5m to cover operating costs and nearly £8m to cover capital investments in the first three years. The CDFIs are not unique in requiring such investment to scale up. Indeed, we have not come across a single example of scaling up of a microfinance institution that have not involved such investment. Even large commercial players have benefitted from substantial investment and grant funding from international development agencies in the start-up phase.
- **Need to new and different funding models:** The current capital and funding models are inadequate and insufficient to scaling up of the sector. The capital requirement to scale up is £120m after income, current cash reserves and current long-term funding. The sector will need patient and appropriately priced capital to scale up. The premium associated with paying 10% versus 6% for funding is over £1.5m in the first four years, significantly reducing their capacity to grow. Patient capital would enable them to cover their cumulative deficit for the first three years, an important stumbling block for scaling up, and strengthen their balance sheets. Lessons from Europe and the US point to the need for a mechanism to compel or require private sector partners, especially banks, to lend to and invest in CDFIs (e.g. regulatory requirements or a social compact between banks, government and affordable credit providers).

Growth annual lending to reach £200m (£ '000s)



Recommendations

1. Government provides initial investment to help sector scale up

- a. We recommend that Government and other investors provide patient capital to CDFIs with an efficient delivery model, low cost base and viable growth strategy.
- b. We recommend that Government opens up Innovate UK funding to CDFIs.

2. Mechanisms to leverage greater private investment in the sector

- a. We recommend that Fair4All develop clear, shared social outcome objectives that can inform a clear ask of private and public sector actors in terms of support for CDFIs.
- b. We recommend that Government agrees a new social compact with mainstream financial institutions and CDFIs detailing their responsibilities and contributions.
- c. We recommend that Fair4All and partners pilot a guarantee fund for new investment or investment on substantially improved terms in the sector.
- d. We recommend that Government extends the Community Investment Tax Relief (CITR) to personal lending CDFIs. Although it would likely have a modest impact on investment it is a proven mechanism that would involve little costs for CDFIs and investors.

3. Consolidation or greater coordination among CDFIs

- a. We recommend that investors encourage greater consolidation by collectively supporting only providers with cost-effective operating models and viable business models.
- b. We recommend that Government, investors and trade bodies encourage CDFIs to explore areas of collaboration.

4. Common reporting and benchmarking framework

- a. We recommend that social investors, social investment funds, foundations and Government agree on a common reporting and benchmarking framework building on the work of Responsible Finance in connection with its industry survey.
- b. We recommend that investors require all investees to sign a transparency compact to publicly report on this data.

5. Greater coordination among social investors

- a. We recommend that the social investors develop co-investment agreements to reduce costs and decrease lead-in time.

1. Research overview and background

1.1. The need for affordable credit

Access to affordable credit is an essential part of modern life for households. It helps bridge periodic gaps between income and expenditure and enables households to make large expenditure in a timely fashion. Most of us take this access for granted. We can choose between multiple providers and can access credit at low or even no cost (e.g. arranged overdraft, credit card paid on time). However, many – perhaps as many as 10-12m consumers – have few, if any, options to access credit. These consumers typically come from low-income households and have high levels of financial pressure on the household, such as having someone out of work (Worton et al, 2018). They are part of what is often called the non-standard or subprime credit market.

This group pay more to access credit, often referred to as the poverty premium. These households have fewer options and have to pay considerably more to access credit. Many of them have not built up a credit history, for example because they operate in cash or use prepayment meters rather than direct debit. It is estimated that, as a result, these consumers pay a premium of between £75 and £80 a year (Corfe and Keohane, 2018).

They are also more likely to have a poor credit rating because they have low and fluctuating incomes, which mean they need greater flexibility in repayments. This is due, in part, to the increase in insecure work. Citizens Advice estimates that 4.5m UK workers are currently in insecure work, although the trade union GMB estimate it to be around one in three of the workforce or closer to 10m people. They also have fewer if any assets, against which they can borrow.

Unable to access mainstream sources of borrowing, many in this group – around 3m²

– resort to the commercial high cost credit or subprime sector. One of the best-known examples of high cost credit was Wonga. Launched in 2008, the payday lender grew rapidly, as its online lending platform meant individuals could easily and quickly access credit. These firms charge high interest rates, due to the lack of price sensitivity among potential customers, limited competition in some market segments and the costs of delivery. Historically their business models have been predicated on repeat borrowing and a propensity among consumers to miss payments and incur additional late and default fees. For example, BrightHouse, the Rent to Own retailer, acknowledged a higher revenue yield from “high risk” rather than “less risky” customers.³ It is estimated that in 2018, 300,000 people were in debt to illegal moneylenders according to the HM Treasury,⁴ and approximately 3.6m people had borrowed from family and friends (Financial Lives Survey, 2017) not all of which will be benign, and it is highly likely that this source of credit is finite.

This lack of access to affordable credit alternatives exacerbates poverty in deprived communities. The high interest rate payment drains already scarce resources from communities, which could otherwise be spent in the local economy supporting local employment and generating tax revenue. Research has found that users of commercial high cost credit are more likely to experience customer detriment, such as unsustainable debt. The Financial Conduct Authority (FCA), found that 67% of payday loan borrowers, and 49% of short-term instalment borrower are overindebted in the UK. This is compared to 15% of UK adults (FCA, 2019). Other studies have found that they are also more likely to fall behind on rent payments putting households at greater risk of eviction (Gowans, 2018). Whichever way you look at the issue, the poor pay more.

2 <https://www.fca.org.uk/news/press-releases/fca-publishes-outcome-high-cost-credit-review>

3 See, for example, BrightHouse – Q3 16/17 Results 23 February 2017 (slide 9)

4 <https://www.gov.uk/government/news/britain-bites-back-in-the-fight-against-loan-sharks>

1.2. The affordable credit agenda

In the last 6-7 years, there has been a resurgence in interest in how to resolve the access to and provision of affordable credit. Carnegie UK Trust has played an important role in stimulating this renewal of interest in the agenda. The Trust works to improve the lives and wellbeing of people throughout the UK, with a focus on those who are disadvantaged, through supporting research within four key work areas (digital futures, enabling wellbeing, flourishing towns and fulfilling work). Within the remit of fulfilling work, Carnegie UK Trust have contributed to work on how to resolve the provision of affordable credit, most notably through their Meeting the Need for Affordable Credit (2015) report, their Gateway to Affordable Credit report (2018) and their seeding of a £1m Loan Fund established in 2018 to support affordable credit providers.

Alongside this, in 2013, the Archbishop of Canterbury, Justin Welby, announced that he wanted to outcompete Wonga and the payday-lending sector and set up the Just Finance Foundation. The charity works to support programmes that aim to improve the supply of affordable credit and help to make individuals more financially capable. The actor, Michael Sheen, launched the End High Cost Credit Alliance in 2018. The Alliance focuses on five key areas of action (alternatives to credit; public debate; regulation, policy and practice; the wider workforce; and education) to tackle high cost credit and debt in the UK. Low or no-interest schemes such as the Good Shepherd in Australia have generated considerable interest, leading the HM

Treasury to commission research into a similar UK scheme. Significantly, the government agenda has re-emerged, with the direction of £55m of Dormant Assets allocation to financial inclusion, which led to the establishment of Fair4All Finance, independent of government. Their mission is to increase the financial resilience of people in vulnerable circumstances through access to fair and affordable financial products and services. Their initial focus is on scaling affordable credit and they launched a pilot programme in July last year with five providers. Findings from their work are due out shortly.

1.3. The personal lending CDFI sector

The personal lending Community Development Finance Institution (CDFI) sector is an important part of any solution to meet the need for affordable credit. They provide small loans (around £500) and, often, linked gateway services (e.g. advice, budgeting support, savings) to households unable to access mainstream financial services, especially credit. The CDFIs deliver services through branches, online or over the telephone. The sector is composed of a diverse set of not-for-profit, non-deposit taking organisations that rely on grants, equity and loans to raise capital for on-lending. The first personal lending CDFIs emerged in the early 2000s on the back of the 1999 report by Dayson, Paterson and colleagues (1999). There are around 10-12 personal lending CDFIs that take different institutional and legal forms, including companies limited by guarantee, community interest companies and the old industrial provident societies.



1.4 Overview of research

The sector has grown significantly since its inception (Chart 1.1).

The sector grew from providing less than 2,000 loans with a value of around £1m in 2004 to nearly 46,000 loans with a value of £26m in 2018. Yet, this still barely registers in relation to the need. The commercial high cost credit sector provides (using only the most egregious definitions) £4.5bn in lending to 4.4m consumers.⁵ According to the 2017 Financial Lives Survey by the FCA, 4.1m of UK adults are in financial difficulties, around 2m are unbanked and 13m lack a savings buffer to deal with unexpected expenses.

Carnegie UK Trust commissioned Community Finance Solutions, University of Salford, to determine if and, if so, how the sector can achieve a step change in growth to make a greater dent in the need and demand for affordable credit. The central aim of the study was to develop proposals for a step change to £200m of operationally sustainable lending by 2027. The research has a dual objective:

⁵ FCA, July 2016 figures include HCSTC, Home Credit, rent-to-own, Guarantor, Running Account, Logbook, Catalogue, and store card. Specifically, this figure does not include retail finance, overdrafts, all credit cards, pawnbroking, budgeting loans and friends and family borrowing

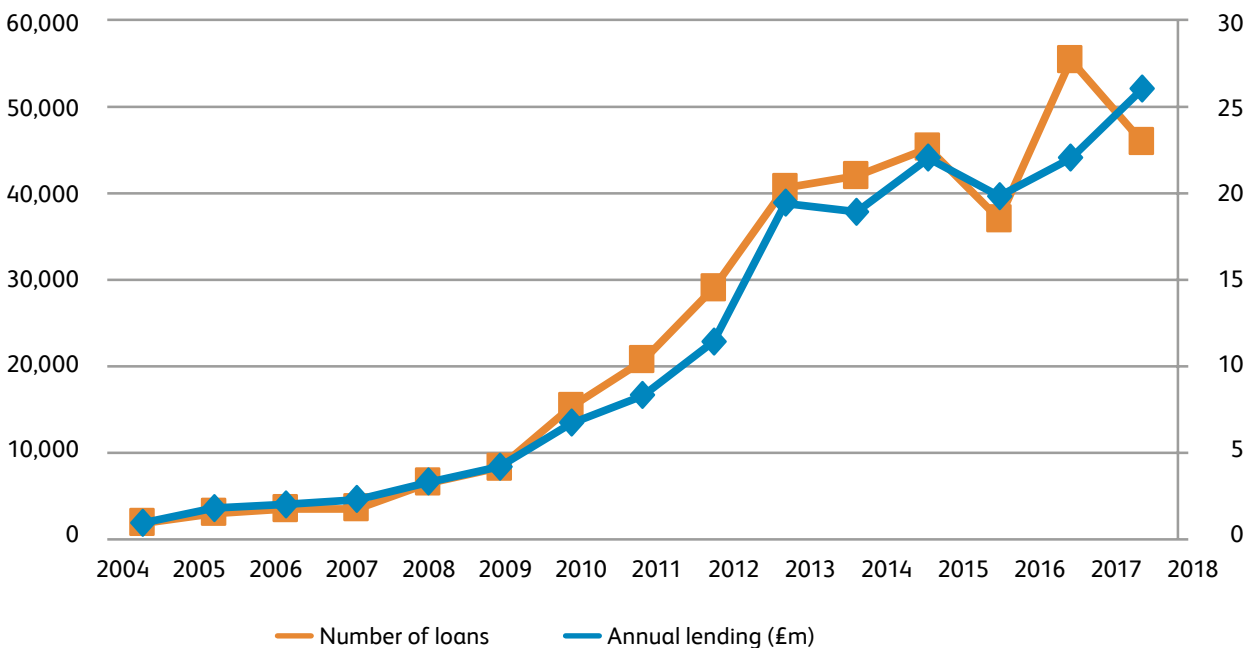
- **Conduct a contextualised analysis of social and financial achievements and strategies by the sector;**
- **Analyse and discuss potential levers to bring about step change in growth of the sector;**

Community Finance Solutions worked with MFR Rating, a leading international microfinance rating agency in the collation and analysis of the financial data. Seb Aslan and Rob Freeman from Community Investment Services Ltd worked on the case study on Community Investment Tax Relief.

The methodology applied consists of the following components:

- ✓ **Participating CDFIs:** Seven CDFIs participated in the study, including the main players with the largest loan books and greatest number of customers: Scotcash, Street UK, Moneyline-UK, Fair Finance, Five Lamps, Places for People (PFP) Financial Services and Coventry and Warwickshire Reinvestment Trust (CWRT). We estimate that these providers make up over 90% of the personal lending CDFI market.
- ✓ **Financial analysis:** We analysed financial and institutional data (see Appendix B) from the

Chart 1.1: CDFI personal lending



participating CDFIs for the period 2013/14-2016/17. We interviewed CDFI managers and chairs and reviewed business plans, budgets and management accounts.

- ✓ **Case study research:** We conducted case study research of international and UK examples which were successful and unsuccessful at scaling up (see table).
- ✓ **Interviews:** We interviewed a range of stakeholders, including social investors, civil servants, affordable credit managers and others (see Appendix B). We also interviewed customers.

The remainder of the report is organised into four chapters:

- Chapter 2 – Context – This chapter provides an overview of the market in which CDFIs operate in terms of target customers and the commercial high cost credit sector they are seeking to replace. It discusses other affordable credit providers, and government policy and support.
- Section 3 – Achievements to date – This chapter draws on the financial, institutional and interview data to assess the achievements of the sector. It considers social (generating

positive outcomes for excluded groups) and financial (ability to operate with limited subsidy) dimensions of performance

- Section 4 – Scaling up the personal lending CDFI sector – The chapter analyses and discusses the different potential pathways for scaling up the sector. It considers three different logics to scaling up: commercial (achieving financial sustainability through efficient delivery model and pricing reflecting delivery costs), public policy logic (expansion through fulfilling public policy objectives) and technological (transforming delivery, business and funding models).
- Section 5 – Scaling up – the way forward – This final chapter identifies and discusses potential pathways for scaling up. The chapter makes several recommendations.
- Section 6 – References

Additional documentation can be found in Appendices A-C:

- Appendix A – Detailed methodology
- Appendix B – List of interviewees and workshop participants
- Appendix C – Case studies

Focus	Case studies
Fintech opportunities	Blockchain Big Data Artificial Intelligence
Successful attempts scaling up	Adie (France) PerMicro (Italy) Qredits (Netherlands) Compartamos (Mexico)
Supportive government frameworks	Community Reinvestment Act (US) CITR (UK)

2. Context – personal lending

CDFIs in the UK

2.1. Introduction

Before looking at the results of the analysis, we need to understand the context in which the CDFI sector operates. This chapter is organised into four sections. Section 2.2 provides an overview of the target customers for CDFIs and the issues they face. Section 2.3 details the commercial high cost credit activities, which the CDFIs are seeking to displace. We then move on to discuss the credit unions, another important player in the affordable credit sector in Section 2.4 and government policy (Section 2.5).

2.2. The CDFI target market

The customers of the personal lending CDFI sector are among the poorest and most vulnerable households in the UK, such as the unemployed, benefit recipients, single parents, social housing tenants and low-income households (Table 2.1).

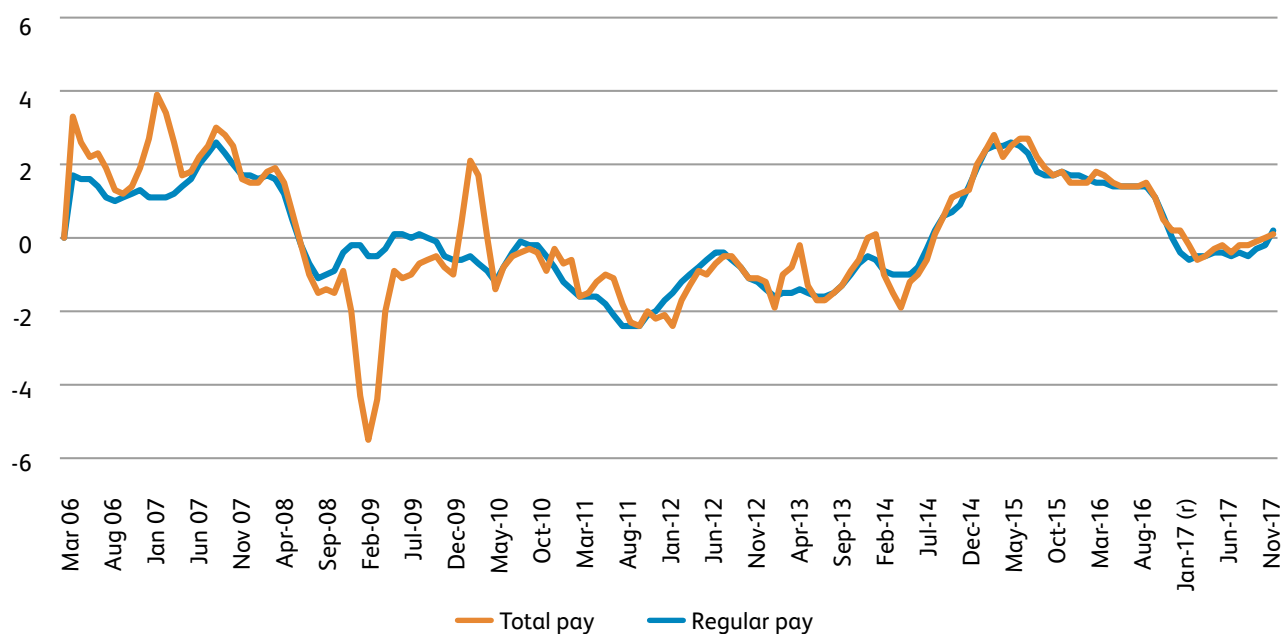
These groups have consistently made up the majority or significant proportion of the customer base of CDFIs since their inception. They are often

unable to access mainstream credit and have limited or no savings buffer to meet unexpected costs (Responsible Finance, 2017; nef, 2008; GHK, 2015). Moreover, they have made up the customer base of the traditional commercial high cost credit sector, consisting of Rent-to-Own firms (e.g. Bighthouse), home credit (e.g. Provident) and pawnbrokers, which the CDFIs have been seeking to displace.

Since the financial crisis, changes in the commercial high cost credit sector and poverty have led to a debate within the sector about who the CDFIs should serve. The emergence and rapid growth of payday lending and online commercial high cost credit firms has brought new customer groups into the market. As discussed in Section 2.3, users of these products are more likely to be male, younger, in employment and have higher incomes compared with CDFI and traditional high cost credit customers (see e.g. Social Market Foundation, 2015), most of whom are women, on benefits and low incomes. Additionally, traditional high cost credit providers, such as Bighthouse and Provident, have been shifting to lower risk, better off customers.

Table 2.1: CDFI customers 2012-18 (%)

	2012	2013	2015	2016	2017	2018
Female	65	62	62	55	48	61
Unemployed	74	63	52	51	40	50
Benefit recipients	71			60	47	66
Single parents	26	49	42	54	28	42
Social housing tenants	71	70	56	46	43	53
HH income > £15,000	78	58	55	57		48

Chart 2.1: Growth real wages 2010-18 (%)

Poverty has also changed. The number of working age adults in in-work poverty increased by more than half a million to nearly 4m from 2012/13 to 2016/17 (Joseph Rowntree Foundation, 2018). This has been especially prevalent among those in part-time employment. Since 2012/13, working age adults living in households in employment now make up the majority of people in poverty. Previously, adults in workless households made up most of adults in poverty (ibid). This is due to changes in the benefit system, especially reductions to benefits and tax credit entitlements and in the labour market.

The introduction of Universal Credit (UC) has been among the key changes to the welfare system. UC replaces the main means-tested benefits and tax credits for working age people (Salford City Council, 2017). The key features include payments being paid monthly in arrears as opposed to weekly; a greater emphasis on online administration; more stringent conditions, with sanctions for their breach and; a taper at 63% whereby benefits will be withdrawn as income increases (ibid).

UC is intended to simplify the benefit system and smooth the transition in and out of work. Despite this, many families are expected to experience losses in income, with 83% of the loss expected to fall on families with dependent children – the very customer who has been a regular CDFI

borrower. On average, couples with two or more children could potentially lose £1,450 a year, while lone parents with two children or more could lose £1,750. Reforms also hit those of working age in the social rented sector hard, and they can potentially lose £1,700 a year compared with £290 for working age owner-occupiers (2017). Analysis of vintages by one CDFI have already highlighted the greater challenge around collections when the borrower is a UC recipient, caused by fluctuations in UC income.

Alongside the changes to the welfare system, there has also been a shift in the number of individuals in low paid and insecure, work. Insecure work can be defined as those working in low paid part time or in temporary jobs who have not been in their position long enough to be entitled to all employment rights (Gregg and Gardiner, 2015). Citizens Advice estimate that 4.5m UK workers are in insecure work (not including self-employment), whilst reports for the GMB suggest it could be as high as 10m. The rise of insecure work is believed to have contributed to falling wages in the last 10 years. Chart 2.1 shows the evolution of real wages between 2010 and 2018.

Real wages fell for nearly four consecutive years (2010-14) before growing from the end of 2014 to 2016. In 2017 real wages fell again before starting to increase in early 2018. Other reasons for the fall in real wages includes low and falling levels

of unionisation, increase in self and part-time employment, a larger than usual proportion of low-skilled jobs among new jobs created, and low and falling levels of productivity.

Several CDFIs have started introducing and piloting online lending to cater to this group of younger men in employment. This is discussed in greater detail in Section 3.2. There is no consensus in the sector that the CDFIs should switch to this market segment, as some providers remain focused on serving those in the lowest 5-10% income brackets. Furthermore, those in employment have traditionally been the domain of credit unions and more recently Fintech companies, such as Salary Finance.

2.3. The CDFI competitor: Commercial high cost credit

With limited savings and unable to access mainstream credit, many low-income, financially excluded consumers borrow from commercial high cost credit providers to cover large one-off expenses (e.g. Christmas, white goods etc.) or living costs (e.g. bills, food etc.). These lenders principally cater to credit-impaired and higher risk borrowers who fail to qualify for loans or other products with mainstream financial institutions. The sector offsets this greater risk by charging higher interest

rates and fees relative to the mainstream sector. An important objective for the CDFI sector is to displace such lending, as it is associated with customer detriment and increasing the poverty premium.

Table 2.2 shows the number of customers by type of commercial high cost credit of UK personal debt.

Overall, the high cost credit sector declined in terms of the number of consumers taking out a loan from 7.7m in 2013 to 5.8m in 2015, before increasing again in 2016. The number of customers using catalogue credit and high cost short-term credit (HCSTC) has fallen significantly (30% and 53% respectively since 2013). However, the amount of outstanding debt for catalogue credit has increased significantly. Retail finance has experienced the greatest growth (28%) since 2013. The others have remained relatively stable.

It was estimated that 75% of adults have had one or more consumer credit product over the last year, and 46% can be described as still paying for credit now (Financial Conduct Authority, 2017). This can often be a result of taking out loans to cover previous debt, such as taking out a payday loan to cover the cost of credit card debt. This can lead to a debt spiral, with many juggling multiple repayments simultaneously (Dearden et al, 2010).

Table 2.2: Number of customers by type of subprime credit

	2012	2013	2014	2015	2016
Catalogue credit	2.8m	2.7m	2.0m	1.8m	1.9m
Retail finance	1.8m	1.8m	1.9m	2.1m	2.3m
Store credit	0.5m	0.5m	0.4m	0.4m	0.4m
HCSTC		1.7m	1.2m	0.7m	0.8m
Home credit	0.9m	0.8m	0.7m	0.6m	0.7m
Rent-to-Own		0.2m	0.2m	0.2m	0.2m

Source: FCA (2017) High cost credit review technical annexe 1: credit reference agency (CRA) data analysis

Table 2.3: Customer characteristics by type of credit

	Payday loans	Home credit	Catalogue credit	Rent-to-own	Guarantor loans	Logbook
Median annual income	£20,000	£15,500	£17,700	£16,100	£20,800	£23,300
Median outstanding personal debt	£3,600	£2,800	£1,300	£4,300	£7,400	£7,600
Median credit score	42	41	63	35	40	32

Table 2.3 shows the customer characteristics by type of high cost credit.

Broadly speaking, those who use HCSTC services are often on benefits and in low paid or insecure work (Financial Conduct Authority, 2017), though there is still variation across the different types.

Home credit users are more commonly women on low incomes and social housing tenants. Most pawnbroker customers are also women. Those who take out payday loans online tend to be younger and better off than other customers (PFRC, 2013). The reasons for using HCSTC options also vary between the types of service. Overall, loans are commonly used to cover living expenses, vehicle expenses, and general shopping, usually as a result of an unexpected increase in expenses or outgoings. Payday borrowers are more likely to use their loans to cover the costs of living, including car expenses (Rowlingson et al, 2014). Those who use pawnbrokers are more likely to use the money for covering household bills, and those who use home credit are more likely to do so to access bigger sums to cover Christmas and birthdays (Edmonds, 2018).

The regulation of the commercial high cost credit has tightened significantly since FCA took over regulation of the sector in 2014. This followed growing public disquiet around the cost of payday loans and a strong lobby from parliamentarians and pressure groups to tighten regulation. In 2015, FCA introduced several regulatory caps to the payday lending market, to protect customers from excessive charges. The new regulations introduced:

- ✓ an initial cost cap of 0.8% per day;
- ✓ default fees capped at £15 (protects borrowers struggling to repay);
- ✓ and a total cost cap of 100%, to protect customers from escalating debts (Edmonds, 2018).

In 2016, further regulation was introduced whereby payday lenders were also required to subscribe to a price comparison website to ensure customers can effectively research companies before taking out a loan. Alongside the tightened regulation came greater scrutiny in those forms of high cost credit where a cap was not introduced. This greater scrutiny also changed lender behaviour, having significant impacts on the home credit and RTO sectors, both of who regularly reported and monitored the FCA increased scrutiny within their annual report and investor analyst presentations.

As a result of the tightening of regulation, many high cost lending firms have since left the market. The number of payday lenders dropped to 144 in 2016, from 400 in 2014 (Smith, 2017) to 40-50 today.⁶ As well as this, following the introduction of the price cap, the cost of loans in the market has decreased, as has the number of customers being charged late fees. This has been as a result of many lenders choosing not to charge late fees, as well as there being a reduction in late payments by customers. There has also been a reduction in the number of extensions and rollovers on payday

6 <https://www.paydaybadcredit.co.uk/payday-loans-industry-worth-uk-2018/>

loans, and there has been a decrease in the average number of new loans taken out by HCSTC customers, from 6 in 2013 to 4 in 2017 (FCA, 2017). Overall, it can be said that those customers who still use these forms of credit pay less for it than they did before 2014.

On April 1st, 2019, the FCA introduced a price cap on the RTO sector, which included:

- ✓ Setting a total credit cap of 100%;
- ✓ Introducing a requirement that firms must benchmark product base prices (including delivery and installation but excluding add-ons) against retail prices;
- ✓ Preventing firms increasing their prices for other goods and services sold within an RTO agreement;

Alongside this, the FCA has introduced a ban on making the sale of extended warranties at the point of sale of the RTO agreement. The RTO industry had been in decline for several years prior to the announcement of the RTO cap. The principal players have either changed their business model, closed branches or entered administration. The main retailer BrightHouse has been unable to pay off its creditors and has closed branches and altered the customer demographic away from “higher risk” to “less risky” borrowers.

2.4. Other affordable credit providers: credit unions

Credit unions also offer an ethical alternative to high cost, short-term credit. Credit unions are mutual financial institutions that provide savings, loans and a range of services to its members. They are owned and controlled by their members, who share a common bond, usually geographical, associational or occupational. The core purpose of the credit unions is to encourage members to save, create sources of credit for the benefit of members at a fair interest rate, use members’ savings for mutual benefit and, in some cases, provide financial education (Cadywould, 2016).

In the UK, credit union numbers grew from 81 in 1982 to 389 in 2012 (Weaver, 2015). In 2014, the number had reduced to 362, although membership and assets have doubled and trebled

respectively in that time, suggesting consolidation in the market leaving fewer but larger lenders (Cadywould, 2016). Membership increased from 14,000 to over 890,000 between 1989 and 2012, and by 2014 was at 1.2m (Weaver, 2015). Despite their growth in reach, credit union market penetration has remained low in comparison to international standards (Weaver, 2015).

Table 2.4 presents some more recent statistics on the credit union sector.

Data from the Bank of England statistical returns from credit unions suggest that the process of consolidation and growth has continued. The number of credit union returns across England, Scotland and Wales fell from 360 in 2014 to just under 300 in 2017. At the same time, the number of adult members increased from around 1m to 1.2m. Levels of credit union membership remains low, especially in England and Wales, internationally. The adult credit union membership in England is equivalent to around 2% of the adult population and 3.4% in Wales. Scotland has higher levels of credit union membership of around 11% of the adult population. In comparison, the 108m credit union members in the US make up over 30% of the population. In Ireland, over 70% of the population are members of a credit union.

Lending also appears to have increased as indicated by the number and value of outstanding loans. The value of outstanding loans increased from £690m to over £840m and the number of loans from 360,000 to 370,000. The average value of outstanding loans across the three countries is £2,200.

These are significant numbers of loans and members. In comparison, the CDFIs in this sample have a combined personal loan portfolio just shy of £20m. The growth of credit unions has partly been a result of the funding received through the DWP-led Financial Inclusion Growth Fund, along with a greater public awareness campaign to widen membership. The funding was designed to help them to build capacity, invest in infrastructure and to subsidise lending to vulnerable groups (nef, 2008). Despite this, credit unions are not necessarily well positioned to provide immediate access to small loans at scale. This is because they are set up to lend to people they know, with a track record of saving, lending members’ savings restrict

Table 2.4: Credit unions England, Wales and Scotland '14-'17

	2014	2015	2016	2017
Adult members ('000)				
England	719	772	787	738
Scotland	315	328	399	399
Wales	59	62	68	65
Total	1,093	1,162	1,254	1,202
Value outstanding loans				
England	£405m	£434m	£465m	£501m
Scotland	£266m	£280m	£300m	£320m
Wales	£18m	£20m	£23m	£23m
Total	£689m	£734m	£788m	£844m
Number outstanding loans ('000)				
England	238	243	245	238
Scotland	110	111	111	119
Wales	16	18	16	16
Total	364	372	372	373
Staff members employed				
England	1,122	1,156	1,209	1,165
Scotland	385	385	444	409
Wales	130	144	141	146
Total	1,637	1,685	1,794	1,720
Number credit union returns				
England	233	218	200	181
Scotland	107	104	98	94
Wales	19	19	19	17
Total	359	341	317	292

Source: Bank of England Credit Union annual statistics

the level of risk they can take and because their lending is restricted by the interest rate cap (at 3% per month or 42.6% APR). As a result, credit union members, especially borrowers, tend to be more diverse and better-off segment than CDFIs. This is discussed in greater detail in Section 3.3.

2.5. CDFI government policy and funding

Government policy areas relevant to the CDFI sector are focussed around access to bank accounts, affordable credit, protection via

insurance and building financial resilience through savings. CDFIs open bank accounts for customers and generally insist on them being used to repay loans either weekly, fortnightly, 4-weekly or monthly. They provide affordable loans and several CDFIs also offer linked savings accounts in partnership with credit unions and banks. One has begun to offer a linked Home Contents Insurance policy with a leading Insurance company. Many have relationships in place with free debt and money advice organisations or offer benefit checker or grant finder solutions before a loan advance is made.

Government support for the sector has been uneven over the years. The government provided nearly £80m in capital and revenue funding for the affordable credit sector, including CDFIs, between 2004 and 2011 through the Financial Inclusion Fund. A hiatus in financial inclusion and affordable credit policy and funding followed until 2017. Since then Government has appointed a minister responsible for financial inclusion, set up a financial inclusion policy forum and setup a new fund utilising bank's dormant assets support the scaling of affordable credit alternatives, which will include CDFIs.

Although it closed in 2011, it is important to understand the Growth Fund, as it had important legacy impacts for the sector. In 2004, the Government launched their financial inclusion strategy, which was backed by a £120m Financial Inclusion Fund. The aim of this fund was to increase access to bank accounts, affordable credit and free money advice between 2005 and 2008 (HM Treasury, 2007). In 2006, the Financial Inclusion Fund introduced a £42m initiative- the DWP's Growth Fund – which provided support across three areas:

- ✓ Loan capital to third sector parties, such as credit unions and CDFIs, to lend to financially excluded households;
- ✓ Revenue to Growth Fund lenders to support the delivery of loans, covering administrative and staff costs and;
- ✓ Funding to develop the capacity of third sector lenders.

The Financial Inclusion Fund was renewed in 2008 until 2011, providing a further £130m. As a result, the Growth Fund received further support of £38m during this time. Between 2006 and 2012, the Growth Fund:

- ✓ supported credit unions and CDFIs with £113m, which led to 317,798 Growth Fund loans being issued with a total value of over £137m;
- ✓ mean amount borrowed by successful applicants was around £478 (Collard et al, 2011).

During this time, the Growth Fund provided CDFIs with lending capital and an effective operating subsidy that enabled them to expand their outreach. Moneyline, for example, opened 12 new branches in this time (Evans et al, 2018) often to address the mismatch of credit need and lack of supply identified in Experian's geographical mapping of supply and demand. Amongst Growth Fund borrowers, loans issued through the Growth Fund made up 55% of individuals' borrowing (Collard et al, 2011). An important legacy of the Fund is that it provided several personal lending CDFIs with a capital base, as DWP bequeathed the remaining loan capital to the CDFIs provided they use it in the spirit of the Financial Inclusion Fund.

In 2019, the UK government announced it would direct £55m of funding from dormant accounts, aimed specifically at tackling financial exclusion (in England). Fair4All was founded in February 2019 to support the financial wellbeing of people in vulnerable circumstances by increasing access to fair, affordable and appropriate financial products and services. Their initial focus is supporting the growth and support of alternatives to high cost credit, through debt, equity and grant investments supporting new, as well as existing organisations. Fair4All will also work to build partnerships with other relevant organisations in the area (such as the Financial Inclusion Commission and the End High Cost Credit Alliance). Work is currently underway on their first strategy, centred on improving access to credit, and the distribution of funds will start towards the end of 2019. In July 2019, Fair4All announced it would be piloting forms of support with five affordable credit providers, including three CDFIs.



3. Social and financial achievements of the sector

3.1. Introduction

This chapter looks at the performance and achievements of the personal lending CDFI sector to date. There are two dimensions that have come to define the sector and are important to keep in mind when considering the performance of the sector. The first is the social dimension, referring to the ability to reach those most excluded that even credit unions cannot reach through mobilising deposits, including commercial high cost credit customers as well as generating positive outcomes for this group (e.g. increased disposable income etc.). The second is the financial dimension and refers to the ability to offer loans and operate in an operationally sustainable manner at scale with limited or no subsidy. The chapter draws on the analysis of financial data collected for 2013/14-2016/17 and interviews with CDFI management, board members, investors, experts and Government.

The quantitative analysis in the chapter uses several key statistical terms:

- **Mean:** This refers to the arithmetic mean and is calculated by dividing the total by the number of CDFIs in the sample. The mean is susceptible to influence of the so-called outliers and gives equal weight to all providers regardless of size.
- **Weighted mean:** We have calculated this mean by weighting it by the outstanding personal loan portfolio of the CDFIs. The weighted mean more accurately portrays performance of the overall sector.

- **Median:** The median is the middle value of an ordered sample. It better describes typical values when there are outliers or a skewed distribution.
- **Standard deviation:** The standard deviation is a measure of variation in the sample. In normally distributed data, 68% of the data is within one standard deviation of the mean and 95% within two standard deviations. A high standard deviation suggests greater variation around the mean. For example, if the mean age is 50, a standard deviation of 25 would suggest high level of variation, as 68% of the sample would be between 25 and 75. Conversely, a standard deviation of 5 would indicate that the responses are clustered around the mean (i.e. 68% within 45 and 55 years).

The chapter is organised as follows. We start by describing and discussing the CDFIs in the sample, including size, origins, structure and strategies (Section 3.2.). Section 3.3 analyses the characteristics of the customers and customer outcomes. Section 3.4 details the loan portfolio growth and development. Sections 3.5 and 3.6 analyses the CDFIs in terms of financial sustainability, and efficiency and productivity. Finally, section 3.7 considers the capacity for growth drawing on an analysis of their balance sheets and on interviews with stakeholders.



3.2. Participating CDFIs

Seven out of the ten personal lending CDFIs in the UK took part in this study. The table below provides some key data on the sample.

At the time of collecting the data, the sample had an outstanding portfolio of around £20m and nearly 43,000 active clients. Judged exclusively on their number of employees, the participating CDFIs can be classed as SMEs. They had nearly 260 staff and 31 branches. Three of the participating CDFIs can be classed as medium firms, two are small and two are micro.

The participating CDFIs started operating in the personal lending market between 2001 and 2007. Some of the CDFIs were set up prior to this but only started making personal loans subsequently. The mean number of years in the personal lending market is 14 years. With two exceptions (Street UK, PfP), the CDFIs were set up, often with local partners, to address financial exclusion in the local area. Three were set up (Moneyline, CWRT and Fair Finance) based on the model developed by Dayson and colleagues (Dayson et al, 1999). Two were set up by social enterprises and were engaged in other activities and areas (Street UK, Five Lamps), whilst two were set up by local government and social housing landlords to serve a particular market (Scotcash, PfP).

All seven CDFIs are asset locked, mission driven firms. None have private shareholders or profit distribution. Their mission statements invariably focus on providing affordable loans in a responsible manner to low-income households without access to mainstream finance to deliver positive impacts on their lives. Some statements refer to wider services, such as basic bank accounts, advice and savings. Beyond their mission statements, there are underlying philosophical differences between the participating CDFIs about their purpose, social goal and strategy. These are namely whether the focus should be on delivering loans at scale at the lowest possible cost to customer, or on providing ancillary, more costly services and support to increase impact on customers.

The participating CDFIs largely serve cities and bigger towns in the UK, including Scotland, South Wales, the North of England, London and the West Midlands. Most CDFIs are local or regional actors (perhaps except for PfP, which is nominally national by serving PfP tenants, although there are outlier loans distributed beyond the principal operating towns or cities). There are few examples of overlap between CDFIs (e.g. Moneyline and Street both have branches in Birmingham), though the emergence of online and telephone-based lending is bringing some CDFIs into competition with each other.

2016/17	Total	Mean	Weighted mean
Number of employees	259	37	56
Branches	31	5	7
Active clients	42,906	6,129	9,680
Outstanding portfolio personal	£19.7m	£2.8m	£4.5m



Most CDFIs provide a mix of products (see table below).

Three of the CDFIs (PFP, Moneyline and Scotcash) only provide financial services aimed at the personal market. Three also provide business loans (Five Lamps, Fair Finance and CWRT). Two provide non-financial services to other businesses and organisations (Five Lamps and Street UK). Except for one CDFI (CWRT), the personal lending makes up most of the outstanding portfolio.

The participating CDFIs are constituted as companies limited by guarantees, limited companies or community benefit societies (what used to be known as the Industrial Provident Societies) and are unable to hold equity in a traditional sense, although one has altered its structure to allow it to take non-transferable equity shares. There is one exception (Five Lamps), which is set up as a company limited by shares and whose equity is 100% held by the parent charity. Almost none of the participating CDFIs can be considered as standalone personal lenders. Three are wholly owned subsidiaries (PFP FS, Street UK

and Five Lamps). A further three are CDFIs that offer multiple services (Fair Finance, Scotcash and CWRT). This is an important observation for two reasons. First, it enables some of the providers to cross-subsidise the lending activity with surplus from other activities. Second, where the personal lending arm is not audited separately, it distorts efficiency and cost measures.

The CDFIs' growth ambitions and strategies differ in three respects:

- **Level of ambition:** The CDFIs differ in level of ambition in terms of how envisioned growth rates compare with current/historical growth rates, the impact on the CDFI over the period (e.g. CDFI doubling/tripling in size) and how the growth compares with the vision for reaching £200m by 2027. Two CDFIs either do not intend to grow or have no explicit goal to grow. The remaining CDFIs have growth ambitions ranging from a steady annual growth in line with historic growth to a fourfold growth in the next three to five years significantly exceeding current growth rates.

Participating CDFIs	Personal loans	Savings ¹	Business loans	Money advice	B2B services ²
Moneyline	✓	✓			
Scotcash	✓	✓		✓	
Street UK	✓				✓
PfP	✓				✓
Five Lamps	✓		✓		✓
Fair Finance	✓		✓	✓	
CWRT	✓		✓		

Notes:

1 Provided in partnership with bank or credit union;

2 Refers to services provided to other organisations and businesses, including public sector

- **Existence of a strategy:** Some of the CDFIs express their growth ambitions in general terms, though most operate with growth targets or projections accompanied by growth strategy covering funding, route to market and business model.
- **Need for external capital:** Linked to the level of ambition, two of the CDFIs do not currently use and do not plan to use external capital to grow. The remaining CDFIs are seeking external funding to realise envisioned growth.

A strategy for growth must consider three key issues: how they are going to reach the market (route to market), the sustainability of the model (funding model) and how to obtain the capital (and in what form) to increase lending (capitalisation). The table below lists past and current growth strategies pursued by the participating CDFIs.

The CDFIs have and are pursuing various growth strategies. In terms of routes to market, most of the CDFIs are working on the transition to an online and digital marketplace. Five of the CDFIs have an online offering and a sixth operates with telephone-based lending. Only one of the CDFIs reported having explicit plans to open new branches in the coming years. Most of the CDFI board members and management interviewed believed that branch-based expansion would not be a viable growth strategy for several reasons:

- **Associated costs:** There are significant overhead costs associated with opening and running a branch. It is estimated that it takes a minimum three years for a branch to break even.

- **Changing consumer habits and preferences:** The CDFIs recognise that consumers are increasingly wanting and (some would say) demanding to interact online, though some customer groups still prefer face-to-face interaction.
- **Limited capacity:** Unlike an online platform, a branch has a ceiling on the number of loans and customers it can generate. Our data suggests that the outstanding portfolio per branch ranges from less than £10,000 to nearly £1m. This reflects the diversity of the branches in terms of maturity and location. The mean is just shy of £400,000 and the median is around £370,000.

However, CDFIs identified several challenges associated with moving online:

- **Meeting customer expectations:** Online customers have expectations for the whole process to be online and seamless, an end-to-end 24/7 process, including the underwriting, decision-making and communication, which often exceeds the ability of the provider.
- **Appropriate decision-engine:** The participating CDFIs have lacked the financial resources to invest in the R&D to produce discrete decision-engines dealing with customer groups with thin credit files and those operating in cash. In some cases, moving online resulted in rejecting previous branch-based customers and high proportion of applications requiring manual intervention. One CDFI reported that only 5% of decisions were fully automated.

Routes to market	Funding model	Capitalisation
Direct (F2F, remote)	Diversification	Recycling existing capital
Opening new branches	Sustainable pricing structure	Strengthening balance sheet
Expanding remote channels	Efficient delivery model	Social investment
Indirect	Delivering on policy objectives	Commercial borrowing
Comparison websites		
Partnership model		
White label model		

- **Higher debt levels:** Several CDFIs experienced increased levels of arrears on introducing online lending. CDFI managers identified several potential explanations: an online customer is more likely to have loans with multiple providers; the time needed to get a decision-engine right; and loan delinquency management made more difficult by the move from relationship-based lending and a more geographically disbursed customer base. In addition, the data provide by the CDFIs generally suggest that the level of repeat borrowing is lower for online than branch-based origination. Arrears levels are generally higher for new than repeat lending.
- **Lower repeat and conversion rate:** CDFIs generally have to work harder for each customer online, as repeat borrowing and conversation rate is lower than in branch. Typically, conversion rate for branch-based applications is around 50-60% compared with around 10% for online applications.
- **Marketing costs:** Marketing and customer acquisition costs are significantly higher for loans originated online compared with branch. According to data and information provided by the participating CDFIs, the marketing spend per loan is more than four times greater for online compared with branch loans. Managers and board members interviewed suggested that simply offering a lower rate than commercial high cost credit providers was not enough to attract customers. Instead, ease of use, speed of decision-making and visibility were often more important for customers. The CDFIs have experimented with several approaches, including white label online portals (e.g. Sheffield Money), price comparison websites (Affordable Lending platform) and direct marketing (e.g. social media campaigns, TV advertising etc.). Based on loan originations generated by each channel, direct marketing has been more successful than platforms and portals. The platforms do not currently offer a seamless, integrated access for applicants and can be cumbersome for the participating CDFIs.



Additionally, the move to online and telephone-based lending brings CDFIs increasingly in competition with each other, because they start providing loans at a national scale. Anecdotally, one CDFI reported significant online presence in area where another CDFI has a branch.

The CDFIs with ambitions to scale up recognised that this required moving towards greater financial sustainability through different mechanisms:

- **Remote delivery:** The CDFIs saw delivering parts or all of their services remotely as an important element of a sustainable model due to the financial costs and capacity constraints associated with opening branches. Most foresaw retaining all or most of their branches but for telephone and online lending to be the main source of lending in the future.
- **Pricing:** The CDFIs with aspirations to grow set their pricing to be financially sustainable. The remaining CDFIs faced internal restrictions, such as political and reputational considerations, to increasing rates or operated on a very small scale.
- **Diversification:** Two of the CDFIs generated significant income from other sources than lending. One explicitly pursued a strategy of diversification to subsidise its lending activity. The other saw the personal lending activity as a standalone activity not requiring cross-subsidisation, though it recognised that the assets of the other parts of the business strengthened its overall balance sheet.
- **Efficient customer journey:** Most of the CDFIs had been making changes to the customer journey, including open banking, downloading electronic bank statements, online pre-application and electronic signature of contract.

The CDFIs saw the pursuit of financial sustainability as largely conditioned by the context in which they operated. In the absence of long-term, patient, low cost capital and significant grant funding, four of the CDFIs relied on external borrowing. The remaining CDFIs relied on the recycling of existing capital and grant funding to finance their loan capital.

Table 3.1: Customer characteristics participating CDFIs and credit unions (%)

	Credit Unions ¹	Participating CDFIs
Unemployed	9	48
Social Housing tenants	27	57
Benefits Recipients	–	69
Women	–	72
Hh income less than £15,000	35 ²	55
Single parents	6	46

Table 3.2: Wellbeing measures (2014/15-16/17)

	14/15	15/16	16/17
Reduced financial stress	50%	50%	52%
Improved happiness	69%	61%	-
Improved health	27%	22%	-
Improved confidence	62%	53%	-
N	4	4	2

¹ Martin, C. (2018) *Use of credit and financial resilience. Analysis of the Scottish Household Survey* Ipsos MORI Scotland & Carnegie Trust

² < £20,000, not £15,000

3.3. Customer outreach and outcomes

Personal lending CDFIs aim to “serve those caught between market failure and exploitative lenders” (CDFA, 2010) and often serve marginalised groups. They can be said to lend to those facing multiple disadvantages either by virtue of place or other characteristics. Traditionally they have served women, unemployed people, social renters, and those in receipt of welfare support. Table 3.1 compared customer characteristics of the participating CDFIs with customers of credit unions. This is a relevant comparison, as CDFIs are often seen to be uniquely placed to serve the most vulnerable households. We have used the 2016/17 data for the participating CDFIs.

The participating CDFIs serve a more vulnerable market proportionately compared with credit unions, not necessarily by volume. Nearly half of the CDFI customers are unemployed compared to just under 10% of credit union customers, and 30% more CDFI customers live in social housing. Nearly half of CDFI customers are single parents compared with 6% of credit union customers. In 2018, Responsible Finance reported that:

- 23,230 customers had used a high cost lender in the last year
- 14,740 customers were helped to pay bills, existing debts and for emergencies
- 19,310 customers were supported in paying for special and unexpected events

There are three features of personal lending CDFIs that may generate positive customer outcomes: they lend in a responsible manner, lending only what customers can repay; they provide ancillary services, namely opening linked savings accounts and bank accounts for customers; and they charge a considerably lower interest rate to customers compared with comparable commercial high cost lenders. We hypothesise that these features may translate into the following customer outcomes: overall improved wellbeing; increased disposable income; and improved financial resilience. Here we draw on data collated from the CDFIs to estimate the social impact of the sector for the period 2013/14-16/17 in these three outcome areas.

Table 3.2 shows some measures of improved wellbeing collected by some of the CDFIs.

Table 3.3: Impact of participating CDFIs on displacement high cost credit (2013/14-16/17)

	13/14	14/15	15/16	16/17
# new customers	7,177	8,424	8,137	10,038
% CDFI customers using commercial HCC	41% ¹	27% ²	38% ¹	27% ²
# CDFI customers stop using commercial HCC	2,943	2,225	3,092	2,710
Reduced financing costs³				
Provident	£482,958	£343,955	£470,207	£425,067
Satsuma	£660,388	£481,189	£663,575	£597,782
Reduced financing costs per new customer				
Provident	£164	£155	£152	£157
Satsuma	£224	£216	£215	£221
N	7	7	7	7

1 Based on figures from the Responsible Finance Industry survey

2 Based on data reported in Dayson et al (2010)

3 Calculated for a £500 loan repayable over 12 months

Not all the participating CDFIs measure wellbeing in their reports. Many use interview data to demonstrate the positive changes the support has had to their customers' lives. For the CDFIs that have included wellbeing, many use a reduction in financial related stress and improved financial skills, confidence and self-esteem as their measure. Other measures included improved happiness and improved health. On most of the measures, most clients reported improved wellbeing. The greatest increase was in overall happiness, whilst only around a quarter reported improvements in health.

CDFIs can make an important contribution to reducing the poverty premium faced by low-income households by charging a lower interest rate than commercial high cost credit providers. We calculate this by estimating the proportion of CDFI customers that stop using commercial high cost credit. This figure is taken from the Responsible Finance's annual survey (the 2014 and 2016 report on the number of customers that have stopped borrowing). For the remaining two years, we have used data from a longitudinal survey conducted of

CDFI customers in 2009 (Dayson et al, 2010). We then multiply this by the difference in price for a home credit and online high cost loan respectively.

Table 3.3 shows the calculation of the displacement of commercial high cost credit providers.

The data suggests that the CDFIs have reduced the financing costs for its new customers of £400,000 – £500,000 for home credit and £500,000 – £600,000 for an online equivalent. The average savings per customer replacing high cost credit with a CDFI loan ranges from £150 to over £220.

The CDFIs can play a potentially important role in improving the financial resilience of households. The most direct way they can do this is by opening savings accounts for customers and encouraging them to save. Two CDFIs offer linked savings accounts with banks or credit unions. We estimate the net increase in the number of households saving as a result of this intervention

Table 3.4: Increased financial resilience (2013/14-16/17)

	13/14	14/15	15/16	16/17
# customers opening savings accounts	2,154	1,723	3,054	1,954
Amount saved per customers (£)*	£467	£467	£467	£467
Total amount saved by customers (£)	£1,005,916	£804,641	£1,426,518	£912,518
% that did not save previously**				
Low	50%	46%	44%	44%
High	59%	57%	53%	53%
Net increase in # households saving				
Low	1,077	793	1,344	860
High	1,271	982	1,619	1,053
Net increase in # amount of savings				
Low	£502,959	£370,331	£627,648	£401,620
High	£593,557	£458,594	£756,073	£491,751
N	2	2	2	2

*Estimated based on data from one CDFI; **Based on proportion of three lowest income brackets with no savings using the savings and assets survey

by subtracting an estimated proportion that would have saved anyway (drawing on propensity to save among low income households).

Table 3.4 shows the estimated increase in savings.

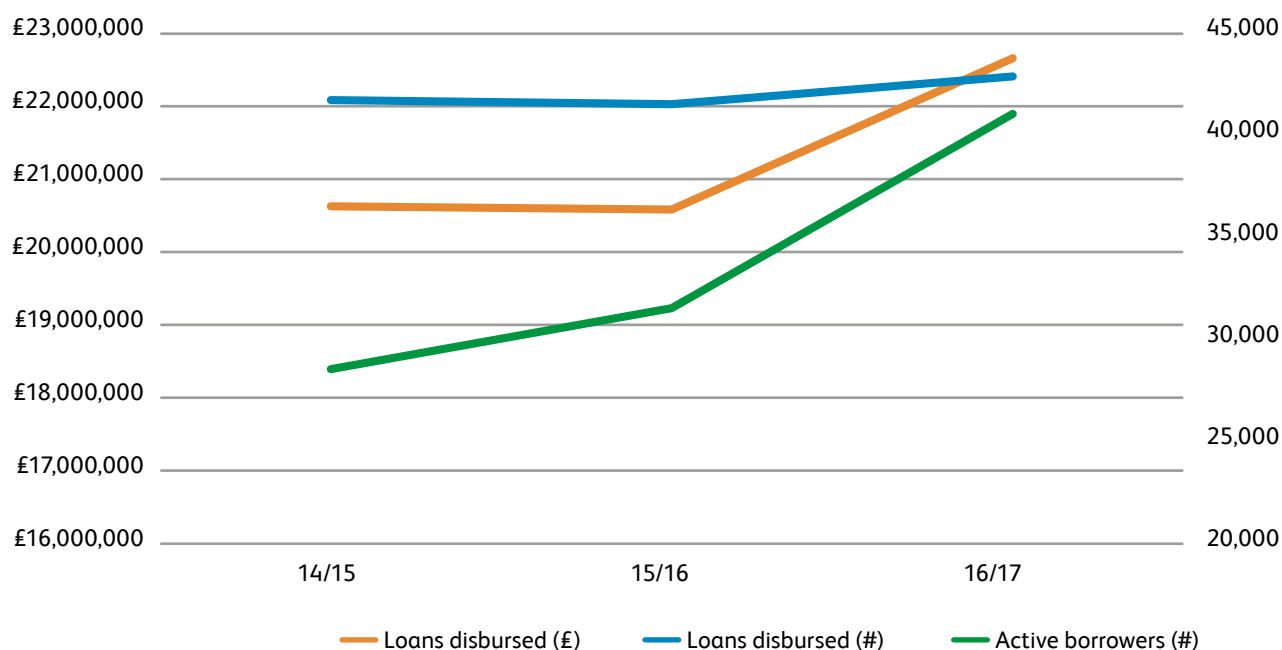
The data indicates that the CDFI sector plays an important role in improving the resilience of customers. We estimate that between 800 and 1,600 customers that otherwise would not save start saving as a result of the CDFIs opening accounts for and encouraging them to save. This leads to an increase in the level of savings of between £370,000 and £760,000. This may lead to reduced reliance on local support services and the welfare system, such as the social fund. Savings might also enable households to take a more planned approach to borrowing by reducing the need to resort to loans to cover emergency expenses.

3.4. Loan portfolio growth and development

This section focuses on the size, nature and development of the personal loan portfolio of the participating CDFIs. The CDFIs in the sample provide short-term unsecured loans of a value of £400-£800 for consumption purposes at an APR ranging from around 7% to 25%. One of the CDFIs also offers a flexible credit product similar to an overdraft.

Chart 3.1 shows the number of personal loans and active clients (right axis) and the value of personal lending (left axis) issued by six of the participating CDFIs for the years 14/15 to 16/17.

Lending increased over this period. The amount lent increased from £18.4m to £21.9m, equivalent to nearly 20% growth. Similarly, the number of loans increased from over 36,000 to nearly 44,000 or around 20%. The number of active clients (i.e. a

Chart 3.1: Lending by CDFIs 14/15-16/17**Table 3.5: Mean amount lent (2014/15-16/17)**

	14/15	15/16	16/17
Mean	£597	£580	£557
Weighted mean	£537	£546	£556
Median	£488	£504	£573
Standard Deviation	£198	£154	£183
N	6	6	6

borrower with an outstanding amount) increased by only 3% from around 42,000 to 43,000. This difference in growth suggests that a significant proportion of loans were issued to existing rather than new customers.

Table 3.5 displays the average amount lent by the CDFIs for the period.

The median and mean amount lent was around £560-570 in 2016/17 with average amount lent ranging from £270 to £800 among the participating CDFIs. This is surprisingly high. In comparison, the 2017 Responsible Finance

survey reports that the average amount lent by personal lending CDFIs is £400. The mean for the aggregate data (i.e. dividing the total amount lent by the number of loans) is around £500. Two of the CDFIs, and one in particular, lend significantly larger amounts than the other CDFIs, driving up the average. Furthermore, the CDFIs have high levels of repeat borrowing. Drawing on data from five of the CDFIs, the level of repeat borrowing is very high (typically 60-70%). Repeat borrowers tend to borrow larger amounts. The mean size of a first-time loan is just shy of £400 and the median is £360, significantly lower than the average.

3.5. Sustainability

Financial sustainability has become an increasingly important aim for the sector. Since the end of Growth Fund II in 2011, there has been no central government capital or revenue funding for affordable credit. More generally, central and local government funding has been increasingly scarce since the financial crisis and austerity. Moreover, the costs of subsidising loan interest rates are prohibitive. Sustainability generally refers to the ability of providers to cover costs with interest rate and fee income from borrowers and other operating income but without subsidies.

We start by looking at the aggregate income statement for the participating CDFIs for the period (table 3.6).

The immediate observation we can make is that the bottom line for the participating CDFIs improved. The deficit before donations fell by 40% from £1.1m to £0.7m, whilst the deficit of £460,000 after donations turned into a small surplus of around £80,000 by 2016/17. This was largely accounted for by an increase of around £700,000 in donations and non-operating income.

The growth in interest and fee income, of around £2m, outstripped the growth in operating costs, around £1m. Other operating income fell significantly by nearly £2m. This reflects a greater focus on personal lending as the main activity among the CDFIs and suggests that this activity is increasing its sustainability.

Table 3.6: Aggregate CDFI income statement (£000)

	14/15	15/16	16/17	% change
Interest/fee income on loans	£7,905	£9,252	£9,925	26%
Interest/fee income on investments	£77	£80	£62	-20%
Other financial income	£20	£129	£1,102	5,400%
Financial expenses	£667	£785	£807	21%
Net financial income	£7,335	£8,675	£10,281	40%
Other operating income	£2,875	£1,485	£938	-67%
Operating expenses	£9,620	£9,647	£10,627	11%
Net loan provision expense	£1,756	£1,507	£1,891	8%
Non-operating income	£0	£213	£584	100%
Net income before donations	-£1,165	-£781	-£714	-38%
Donations in cash	£707	£559	£791	12%
Net income after donations	-£458	-£222	£77	83%

In this section, we will look at two dimensions of sustainability (Table 3.7).

First, we calculate the ability of providers to cover costs with income generated from the loan portfolio (financial income). The greater the ability to do this the less the CDFIs have to rely on grant or other trading income. The ratio will also be lower for CDFIs that deliver other services but do not separate out the associated costs. Second, we calculate the ability of CDFIs to cover costs with income generated from the loan portfolio and other trading activities (but not grant income). This measures the sustainability of CDFIs that pursue this through diversification or cross-subsidising lending activity.

Table 3.8 shows the sustainability measures only taking into account financial income.

The participating CDFIs' ability to cover operating costs and bad debts with financial income increased from 14/15 to 16/17. Both the level of operational and financial sustainability improved between 10 and 18% depending on

the measurement. Six out of the seven CDFIs improve their operational sustainability ratio. Four improve their level of sustainability by increasing interest income, by more than operating expenses and bad debt, whilst two significantly cut costs and bad debt. When we weight the data by the CDFIs' share of personal lending, operational and financial sustainability are higher and increases by a greater rate than the simple mean, reflecting that larger providers are outperforming smaller CDFIs. This might suggest economy of scales effects.

The level of operational sustainability for the latest year ranges from around 60% to over 100%. One CDFI has operational sustainability ratio over 100% throughout the period, meaning that it covers all its operating costs (excluding financing costs) with income from the loan portfolio. The CDFIs receiving grants and engaged in other trading activities generally display lower rates than those that exclusively do personal lending. Other sources of income are decreasing over the period from nearly £3m to £1m.

Table 3.7: Sustainability measures

	Financial income	Financial & operating income
Operating costs	Operational sustainability	Operational sustainability plus
Operating & financing costs	Financial sustainability	Financial sustainability plus

Table 3.8: Operational and financial sustainability (%)

	14/15	15/16	16/17	% change
Operational sustainability				
Mean	72	85	82	14%
Weighted mean	76	88	90	18%
Financial sustainability				
Mean	69	81	78	13%
Weighted mean	72	82	85	10%

Table 3.9: Operational and financial sustainability plus (%)

	14/15	15/16	16/17	% change
Operational sustainability plus				
Mean	83	93	87	5%
Weighted mean	98	103	99	1%
Financial sustainability plus				
Mean	80	89	83	4%
Weighted mean	93	96	93	0%

Table 3.9 shows the extent to which the CDFIs can cover their costs drawing on both financial and operating income.

Unsurprisingly the CDFIs can cover a greater proportion of costs with operating as well as financial income. The percentage of costs covered increased from 14/15 to 16/17. The proportion of operating costs the CDFIs were able to cover without grant ranged from around 60% to 110%. Financial sustainability (i.e. taking into account financing costs) levels were lower than the level of operational sustainability.

3.6. Efficiency and productivity

Efficiency and productivity are intimately linked to financial sustainability. Provided loan delinquency is kept at sufficiently low levels and the pricing structure reflects delivery costs, the more loans the CDFIs can generate with each unit of resource (staff or otherwise) the more sustainable and scalable their model. This is especially important for the personal lending CDFI sector where amounts are small. In this section, we consider measures for both staff and cost-efficiency.

Table 3.10 displays the number and value of personal loans disbursed per loan officer in 2016/17 for six of the CDFIs (one did not submit data on value and number of personal loans disbursed). One CDFI did not submit historical data on the number of loan officers so we only show the data for 2016/17.

As indicated by the high standard deviation, there was considerable variation in the sample. The loan officers of four of the CDFIs originated around 320-340 loans and £160,000-£250,000 each per year. Two of the CDFIs displayed considerably higher loan officer productivity rate. One operates with a flexible loan product involving additional advances to customers, increasing the number of loans issued. The second operates exclusively with remote underwriting. Conversely the remaining CDFIs operated predominantly with F2F underwriting at the time.

Table 3.11 shows the evolution of loan officer productivity for the five CDFIs that have provided historical data on number of loan officers and personal loans disbursed.

Again, the data highlights the variation in the sample. Four of the CDFIs increase their loan officer productivity in terms of value and number over the period, as indicated by the median value. The loan officer productivity of the outlier CDFI with significantly higher productivity fell during the same period making the mean remain largely unchanged. The increase in productivity is largely a result of rationalisation. The number of loan officers for these five CDFIs fell by 15% from 101 to 86 from 14/15 to 16/17, whilst the number of loans issued decreased by 2% from 32,445 to 31,737 for the same period. The amount lent increased by 14% for the same period as some CDFIs lent larger amounts. The increase in productivity among most of the CDFIs was due to the introduction of online and telephone-based lending towards the end of the process as well as efficiencies in the customer journey (electronic signature, telephone pre-screening etc.).

Table 3.10: Loan officer productivity (2016/17)

	Mean	Weighted	Median	SD
Number of loans issued	539	652	335	443
Value of loans issued	£310,088	£385,818	£188,170	£311,256

Table 3.11: Loan officer productivity (2013/14-16/17)

	13/14	14/15	15/16	16/17	% change
Number of loans					
Mean	553	529	543	550	-1%
Weighted mean	632	595	594	577	-8%
Median	260	287	299	330	27%
Value of loans					
Mean	£257,214	£278,530	£291,546	£345,941	34%
Weighted mean	£266,888	£293,901	£307,176	£365,521	37%
Median	£175,332	£161,920	£162,743	£203,555	16%

Table 3.12: Cost per loan (2014/15-16/17)

	14/15	15/16	16/17	% change
Mean	£344	£316	£265	-22%
Weighted mean	£304	£270	£257	-15%
Median	£263	£258	£246	-7%
SD	£245	£221	£147	-29%
N	6	6	6	

Table 3.12 details the operating costs incurred by the CDFIs for each personal loan disbursed. Financing costs and bad debts are not included in the calculation.

There is considerable variation in the cost per loan across the sample as highlighted by the relatively high standard deviation. The cost per loan ranges from less than £100 to over £450. There are two outliers that explain this variation: one that has a flexible loan product (that works like an overdraft), which greatly increases the number of loans issued, and one that delivers significant other activities but did not separate out its personal lending arm for

the period. The remaining four CDFIs have costs per loan ranging from £150 to nearly £400. Still, the highest cost per loan among these CDFIs is nearly three times greater than the lowest cost per loan. Falls in the number of loans issued increased the cost per loan. CDFIs which did not separate out their lending activities from other activities had a greater cost per loan.

Out of the six CDFIs providing this data, four reduced their cost per loan between 10% and nearly 50% from 14/15 to 16/17. One of these CDFIs achieved a reduction in cost per loan due to a reduction of 22% in operating expenses. For

Table 3.13: Operating expense ratio (2014/15-16/17)

	14/15	15/16	16/17	% change
Mean	51	49	49	-4
Weighted mean	48	44	46	-4
Median	49	43	45	-8%
SD	26	25	21	-19%
N	7	7	7	

another, the increase was linked to a doubling in loans issued linked to the introduction of a flexible additional lending product allowing customers to take out smaller, multiple loans up to an agreed credit limit. For the last two CDFIs, the growth in loans disbursed outstripped the growth in operating expenses. Two CDFIs experienced increases in the cost per loan. For one, the costs increased at a greater pace than the loans disbursed, whilst another CDFI experienced both a fall in lending and an increase in costs.

Table 3.13 shows the operating expense ratio for the CDFIs in the sample. This ratio – operating expense over total gross outstanding portfolio (includes both personal and business) – indicates efficiency by measuring the administrative and overhead costs incurred to deliver loans. A lower ratio suggests a higher level of efficiency.

It is important to note that the ratio is sensitive to variations in loan delinquency write-off policy, as it affects the gross outstanding portfolio. Some of the CDFIs in the sample only write off debt when the debtor is deceased, or when all loan delinquency procedures have been exhausted. Others write off debt when past a certain number of days past due. In some cases, we have observed significant differences between outstanding loan portfolio and loans disbursed for some CDFIs.

The results suggest that the sector is becoming more efficient as the mean, weighted mean and median operating expense ratios fell from 14/15 to 16/17. Three of the CDFIs improved their score by between 12 and 21% due to cutting costs and increasing lending respectively. Four of the CDFIs increased their score suggesting they reduced their level of efficiency

In comparison, the average for the MFIs in the EMN 2016/17 survey was 34 in 2016 and 26 in 2017. Around 70% of the MFIs in the survey scored below 20 and only 8% were above 50. The Western European average was 39 for 2017, which similar to the rate of the CDFI in the sample. The reason why European MFIs may perform better on this ratio is that they are engaged in business lending, resulting in larger portfolios, and Western European MFIs significant in-kind subsidies, including volunteers and free premises, reducing their operating costs.

3.7. Capacity for growth

This final section will consider the sector and participating CDFIs' capacity to scale up. We examine the balance sheets of the participating CDFIs and discuss the barriers to growth drawing on interviews with CDFI managers and stakeholders.

We start by analysing the aggregate balance sheet for the participating CDFIs (Table 3.14). The perceived strength of the balance sheet influences the sector's ability to attract investment and funding.

The outstanding portfolio makes up most of the assets for the participating CDFIs. The loan portfolio made up over 70% of the total value of assets. This reflects that the CDFIs are primarily orientated towards lending and that the CDFIs have few fixed assets. This was followed by cash and bank deposits, which was 15% of total assets in 2016/17, down from 22% in 2014/15. The CDFIs have limited value in fixed assets (around £1m or 4% of total assets) because they do not engage in secured lending and do not own any office premises or real estate.

Table 3.14: Aggregate CDFI balance sheet (£000)

Assets	14/15	15/16	16/17	% change
Cash and bank deposits	£5,631	£4,528	£3,460	-39
Short-term financial assets	£0	£0	£0	-
Net outstanding portfolio	£17,338	£19,276	£17,329	0
Gross portfolio	£20,766	£22,131	£21,901	6
(Loan loss reserve)	-£3,427	-£3,855	-£4,571	33
Accrued interest	£1,104	£794	£1,315	19
Other short-term assets	£430	£1,049	£471	10
Long-term financial assets	£700	£400	£0	-100
Net fixed assets	£828	£1,048	£1,073	30
Other long-term assets	£0	£0	£64	100
Total assets	£26,234	£27,119	£23,659	-9
Liabilities and equity				
Short-term loans	£1,719	£3,157	£2,601	50
Other short-term liabilities	£3,070	£2,167	£1,880	-39
Long-term loans	£12,452	£12,241	£9,577	-23
Total liabilities	£18,118	£19,585	£16,548	-9
Paid-in capital	£1,180	£1,180	£1,180	-
Reserves	£1,540	£1,860	£1,693	10
Total retained earnings	£6,272	£6,346	£6,727	-1
Total equity	£8,992	£9,387	£9,601	7
Total equity and liabilities	£26,234	£27,119	£23,659	-9

On the liabilities and equity side, liabilities made up more of the aggregate balance sheet (£16.6m or 65%) than equity (£9m or 35%). This is because of the limited ability (to date) of CDFIs to take equity. Retained earnings made up most of the equity (around 68%). Long-term loans make up 72% of liabilities and 46% of equity and liabilities.

The balance sheet shrunk slightly over the period. The combined assets decreased from £26.2m to £23.6m over the period, a decrease of around 9%. This was accounted for by a £2m decrease in cash and bank deposits from £5.6m to £3.4m (nearly a 40% fall). The gross portfolio increased but this was £20.8m to £21.9m but this was cancelled out by a similar increase in loan loss reserve. On the liabilities and equity side, there was a corresponding fall in liabilities, especially short-term liabilities.

Efficient and effective assets and liabilities management is required by the CDFIs to ensure that they can make their financial obligations as well as make the most efficient use of assets to generate a return. We now turn to the analysis of the various ratios and indicators concerning such management.

Table 3.15 shows the net portfolio to assets for the participating CDFIs. This is a measure of how much a provider is allocating to lending. A low measure would suggest inefficient use of assets or the use of assets for other income generating activities, whilst a high measure would indicate insufficient liquidity.

The data shows, as noted above, that the CDFIs are allocating most – around 60-70% – of their assets to lending. The ratio ranges from around 40 to over 95. The ones with the lowest scores generally tend to have greater liquidity in the form of levels of cash or other short-term assets. Three of the CDFIs experienced significant growth in this ratio. Two grew their loan portfolio considerably, whilst one significantly reduced its cash and bank deposits.

Table 3.16 shows the equity to assets. This ratio is an indicator of solvency and the ability of organisations to meet their obligations and absorb losses. A higher ratio indicates greater level of solvency and ability to absorb losses.

Table 3.15: Net loan portfolio to assets (2014/15-16/17)

	14/15	15/16	16/17	% change
Mean	63	63	71	13
Weighted mean	68	69	75	10
Median	69	75	73	6
N	7	7	7	

Table 3.16: Equity to assets (2014/15-16/17)

	14/15	15/16	16/17	% change
Mean	38	33	48	26
Weighted mean	16	21	30	88
Median	63	41	71	13
N	6	6	6	

Table 3.17: Debt to equity (2014/15-16/17)

	14/15	15/16	16/17	% change
Mean	0.5	0.5	0.3	-45
Weighted mean	1.2	1.2	0.8	-35
Median	0.1	0.1	0.2	152
N	6	6	6	

The equity to ratio increased slightly over the period. This is because average loan portfolio has decreased, whilst the level of equity has remained unchanged. One CDFI reported a negative, though improving, ratio over the period due to being in negative equity due to accumulated losses. Three of the CDFIs displayed relatively stable ratios over the period. One CDFI significantly improved ratio through reduction in value of assets, primarily portfolio, whilst the level of equity increased. Another experienced a reduced ratio because the portfolio increased whilst the level of equity remained stable.

Table 3.17 displays the debt to equity ratio for six of the participating CDFIs. (The seventh CDFI was a wholly owned subsidiary not retaining any earnings or any other form of equity). This ratio measures the extent to which the CDFIs have leveraged their own funds to finance their portfolios. It indicates how much of a cushion there is to absorb losses.

The main takeaway from this table is that the level of leverage is low and falling. This is an important observation because the CDFIs will need significant leverage to achieve a step change in growth. The weighted mean and mean values range between 0.3 and 0.8 and fell by over 30% in the period. The ratio varied significantly between individual CDFIs from negative scores to 2.5. Some of the CDFIs have very low ratios, close to zero, because they do not rely on loans to finance the lending activity. One of the CDFIs was also in the process of restructuring its liabilities resulting in a temporary reduction in liabilities in the period.

This is significantly lower than with community finance institutions in comparable contexts. For example, in Europe, non-bank microfinance institutions had a ratio of 4.1, whilst NGO microfinance institutions had a leverage of 2.3.

There are several explanations for this difference:

- **Lack risk sharing mechanisms:** There are more public risk sharing mechanisms in Europe, such as public guarantees, which enables MFIs to access more debt finance. There are also more public loan schemes, especially on a European level, which the sector can access.
- **Greater commitment by banking partners:** The level of commitment from banking partners is greater in Europe. Banks provide significant amount of debt finance as well as other forms of finance.
- **Lack junior debt:** Some of the CDFIs reported that they do not have much additional capacity to take on more senior debt. Lenders and investors are apprehensive about providing junior or subordinated debt.

Table 3.18 displays the financial expense ratio for the sample. This ratio measures the total interest expense incurred by the CDFI over its loan portfolio. It indicates the financial expense incurred to fund the portfolio. A higher ratio indicates higher financial costs relative to the loan portfolio.

The ratio fell across the sector suggesting a fall in financing costs. On average the ratio is 3.6. This is below the equivalent ratio for non-bank MFIs (7.4) but above NGO MFIs (3.0) in the EU. There is considerable variation across the CDFIs. Three of the CDFIs have a ratio of zero because they do not use debt finance to fund the portfolio. One CDFI was reducing its financing costs because it was in the process of raising external funding to replace a bank loan it had already paid. The three remaining CDFIs displayed financial expense ratios ranging from 4 to 14.

Table 3.18: Financial expense ratio (2014/15-16/17)

	14/15	15/16	16/17	% change
Mean	4.8	3.3	3.6	-25
Weighted mean	5.3	4.5	4.5	-15
Median	1.8	1.5	0.0	-100
N	7	7	7	

Table 3.20: Top management in CDFIs (2016/17)

	Mean	Weighted	Median	SD
Number of senior managers	3	2.9	2	1.5
% top managers	10.6%	7.4%	9.1%	7.7%

The interviews with the CDFI management and board members highlighted several factors reducing the capacity for growth:

- **Deteriorating circumstances for customers:** Welfare reform and the increasingly precarious nature of work had, it was widely agreed, resulted in stagnant, uncertain and fluctuating incomes, increased consumer debt levels, and declining credit scores. This created difficulties for CDFIs in serving this group as customers were more likely to fall in arrears and require greater flexibility in repayment. In some cases, the introduction of UC made it more difficult to prove loan affordability for female applicants, as the payments would often go directly to male partner. The CDFIs were also more likely to decline loans, even for repeat customers, on grounds of affordability and responsible lending.
- **Thin management teams:** Although investors and stakeholders were generally impressed by the effectiveness and capacity of the executive management, they thought that the CDFIs lacked the necessary depth in management teams to support the senior management teams and boards to drive growth. This meant that the executive management and the CEO

did not have enough capacity to focus on the strategic development of the organisations. The CDFIs had between one and four senior managers with an average of three managers (Table 3.20).

- **Lack viable mechanisms:** All the CDFIs currently lack sustainable models to achieve a scale up in line with the ambitions set out in this report and accepted need for affordable credit. On the one hand, branch-based expansion is costly and potentially at odds with changing customer requirements. On the other, online and telephone-based mechanisms require considerable investment in marketing and the appropriate platforms (e.g. price comparison websites etc.).
- **Mismatch funding need and existing supply:** Interviewees from both CDFIs and investors recognised that there was a mismatch between the funding needs for CDFIs and the current social investment provision. On the demand side, CDFIs needed patient low-cost capital to invest in systems and key staff. On the supply side, there were difficulties in investing in CDFIs because of insufficiently strong balance sheets, insufficient granularity of reporting and monitoring capacity, over-exposure of some

social investors to the CDFI sector and a lack of a clear narrative and profile of the CDFI sector. This resulted in high finance costs, limited deal flow and a slow process to fundraise.

- **Lack sectoral narrative and leadership:**

The CDFI sector lacked, it was felt by several stakeholders, a common voice and way to present aggregate data in a coherent way. We believe this is corroborated by the significant challenges we encountered in collecting financial data from the CDFIs. They vary considerably in how they measure and report data (especially regarding loan delinquency). Linked to this, the sector needed a more clearly articulated USP and offering, possibly linked to

its ability to serve those most excluded. There was also a sense that the sector needed an independent champion, though it was noted that Michael Sheen could potentially fill this role.

- **Capacity to experiment and innovate:** There was a sense among CDFIs that they lacked the resources and capacity to experiment with different products, delivery mechanisms and business models. There was no room for failure, so the organisations could only tweak their product and approaches. Yet they sensed that customers might benefit from radically different products and support.



4. Scaling up the personal lending CDFI sector

4.1. Introduction

Growth in terms of a business model normally refers to the number of employees, value of assets or level of turnover. In the UK, firms are classed as SMEs if they satisfy two of these three criteria.

	Employees	Turn-over	Net assets
Medium-sized	< 250	< £25.9m	< £12.9m
Small	< 50	< £6.5m	< £3.26m

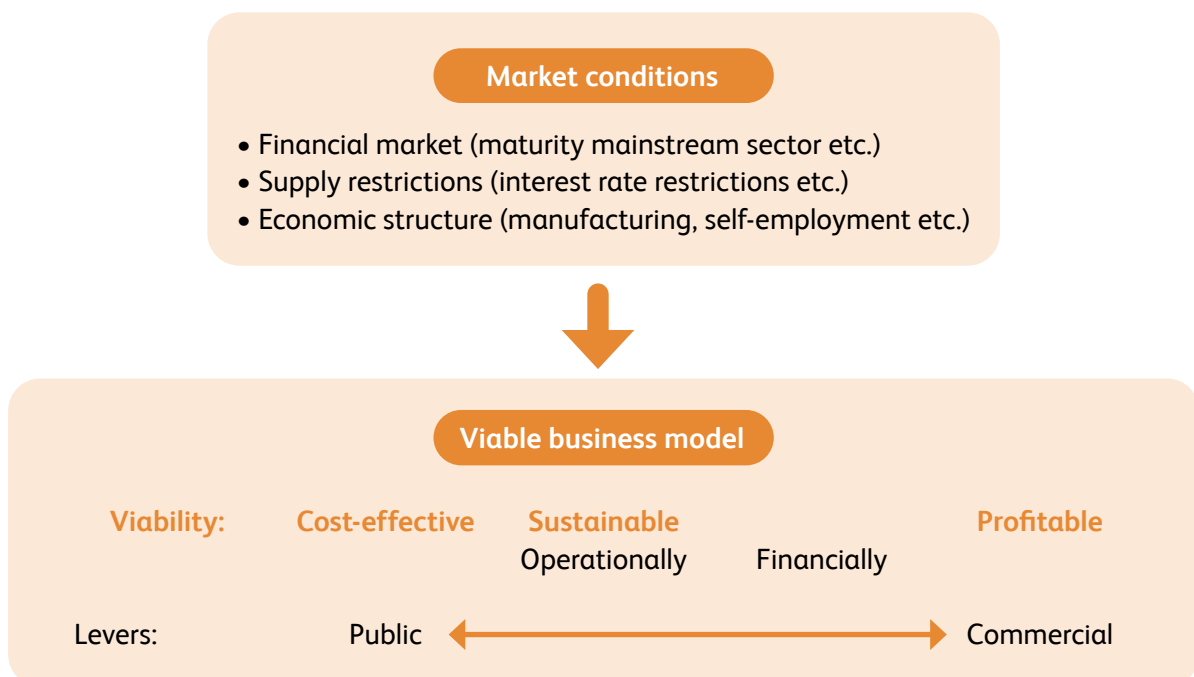
By this definition, two of the CDFIs are medium enterprises, whilst five are small. In this report, we define growth as an increase in the value of annual lending, given that the emphasis is on meeting a market need rather than generating tax revenue or contributing to economic growth. As illustrated below, we argue that the market conditions help determine the business model the CDFIs can pursue.

A viable business model in this context ranges from merely being cost-effective (relative to other interventions) to being able to generate a profit. In the middle, providers can reach financial operational or financial sustainability (i.e. cover operating and financing costs rather than generate a return). Market conditions, such as interest rate caps, employment structure and the maturity and size of the formal financial sector, influence the nature and extent of the demand as well as the ability of providers to generate income to cover costs (see Vik, 2019 for a more in-depth discussion).

Linked to these, there are three distinct logics to scaling up, which we will explore in this chapter:

- **Commercial logic:** In the microfinance industry there has been a drive for institutions to become financially self-sustainable, often driven by international development agencies. Whilst the sector has grown dramatically through this logic, tensions have emerged between the social mission and raising capital by providing commercial returns to the investors.⁷

⁷ The most spectacular example of this being the IPO in 2013 of Mexican microfinance provider Compartamos, which enriched private investors with returns on equity exceeding 50%



- **Public policy logic:** CDFIs in Europe and, to some extent, in the US, have scaled up through strong links to public policy objectives and debates. For example, Maria Nowak, the founder of Adie in France, played a significant role in passing regulation more conducive for self-employment as well as legislation enabling microfinance institutions to lend. This has led to a sustained level of public funding and strong partnerships with mainstream financial institutions.
- **Efficiency logic:** The rapid growth of the Fintech sector brought about by the combination of the financial crisis, technological breakthroughs and changing consumer habits and preferences is likely to change the way in which financial services are developed, delivered and used. The Fintech sector operates on the belief it can scale up rapidly through changing expectations and transforming operational models.

This chapter seeks to answer three questions, based on case study research and financial sensitivity analysis:

- Where is the sector currently heading and when will they reach £200m?
- What would a £200m personal lending CDFI sector look like?
- What levers to scale up are available and how effective might they be?

4.2. Current trajectory

Before turning to how the sector and its stakeholders can use the three different logics to scale up the personal lending CDFI sector, we need to examine its current trajectory against the ambition of £200m by 2026/27. Chart 4.1 shows the current growth trajectory for the participating CDFIs based in their annual growth rate for 13/14-16/17. It falls a long way short, only reaching £50m by 2027.

The CDFIs in the sample will just exceed £50m in annual lending by the end of the period. This despite growing by just over 9% annually. Chart 4.2 shows when the participating CDFIs will reach £200m at this growth rate.

Chart 4.1: Current growth trajectory 16/17-26/27 (£m)

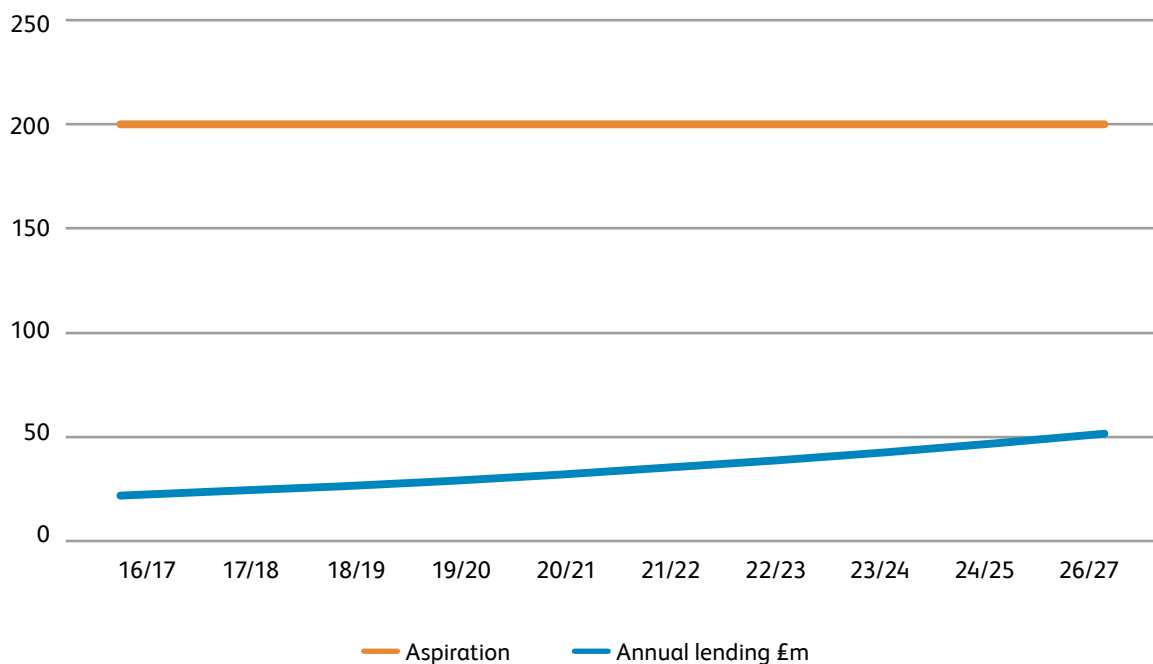
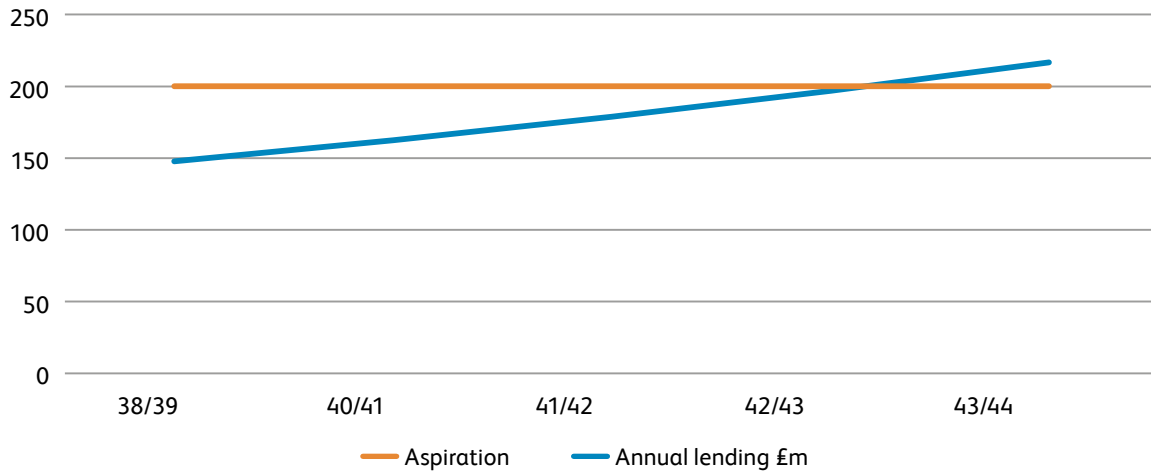
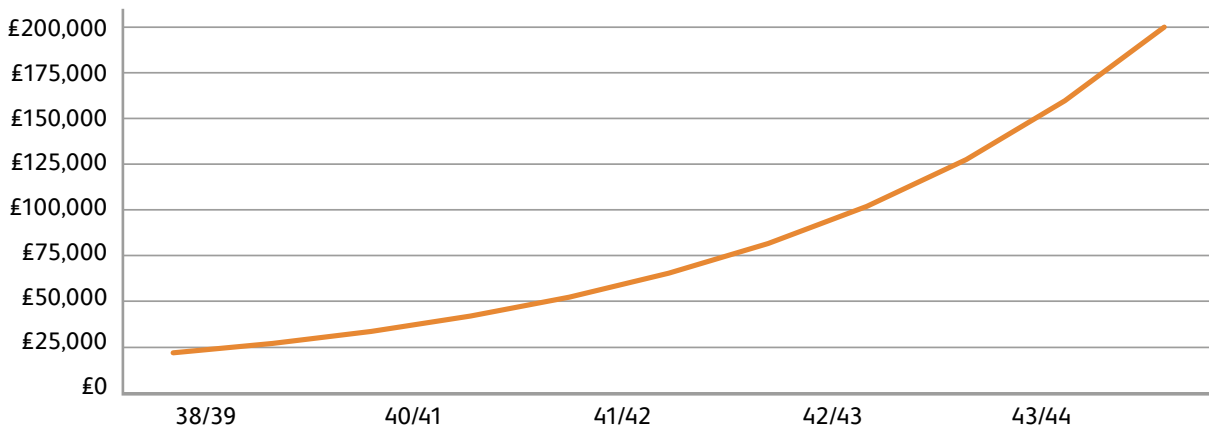


Chart 4.2: CDFIs reach £200m ambition**Chart 4.3: Annual lending (£ '000s)**

At their current rate of growth, the CDFIs would only reach the £200m ambition sometime in 2042/43. Whilst this may be disappointing, it is important to put this in context. Chart 4.3 shows the steady rate growth trajectory under which the CDFIs would reach £200m. It is assumed that the CDFIs retain their respective market shares.

Reaching this level of lending within a ten-year period would require the CDFIs to grow at an average annual rate of nearly 25%. In other words, we would be requiring these CDFIs to be high growth firms, or gazelles. OECD defines high growth firms as companies with average annualised growth in employees or turnover greater than 20% per annum, over a three-year period, with a minimum of 10 employees at the beginning of the growth period (see Lee et al, 2016). Yet, Lee et al (2016) conclude that less than 10% of UK firms can be classed as high growth firms based on this definition. Indeed, according to Du and Bonner (2017), between 1998

and 2013 the proportion of high growth firms in the UK never exceeds 2%. Further, it is very difficult to sustain such growth over a longer period. Less than 40% of high growth firms continued to grow after the initial high growth period. The remainder stagnated, declined or exited the market. Moreover, mergers and acquisitions are an important component for growth for many high growth firms, with around 20% of high growth firms undertake some form of acquisition as part of growth (Lee et al, 2016). However, we here would expect the CDFIs to rely exclusively on organic growth. Finally, we also expect the CDFIs to grow exclusively serving the domestic market, whilst high growth firms more generally may also grow targeting international markets.

Before turning to how this growth could be capitalised, we turn to what a sector lending £200m would look like. We conduct the financial sensitivity analysis only for the five CDFIs with an expressed objective to scale up. We forecast the income and expenditure for these CDFIs based on

the following assumptions:

- ✓ We use the current operating costs as a base and assume that these increase at the rate of inflation (2%), whilst other financial income, operating revenue and financing costs remain constant;
- ✓ We assume the market share, loan portfolio characteristics (e.g. average loan size, term and bad debts) and pricing of individual CDFIs remains unchanged;
- ✓ In line with their business plans, all CDFIs grow almost exclusively through remote delivery channels (combination of online and telephone);
- ✓ All the CDFIs grow at 25.4% per year (the annual growth rate required to hit £200m within 10-year period);
- ✓ Depending on the loan officer productivity and the channel, the CDFIs incur the following direct costs associated with growth:
 - Loan officer salaries (£25,000) + on-costs (15.8%: NIC + 2% pension contribution);
 - 0.25 admin officer support per loan officer (£17,000 + 15.8% in on-costs);
 - A branch costs around £45,000 in rent and running costs and can host 3 loan officers;
- A telephone loan officer requires around £4,900 in office rent and running costs (the same assumed for administrator)
- FT middle manager (at £40,000 + on-costs) needed for every 10 loan officers & administrators
- CDFIs incur £2.50 credit check cost per application
- ✓ We assume that a telephone-based loan officer can do double the number of loans as a branch-based loan officer with the same level of admin support (0.25). For online lending, we assume that a loan officer can process 1,100, which is the average for the three CDFIs that provided this data for their online lending.
- ✓ As the CDFIs grow, they have to spend more on building the executive management team and the board, including recruiting more executive directors and increasing pay to attract and retain talent. Below we have estimated ballpark management and board cost at five stages by annual lending.

Annual lending:	£10m	£25m	£50m	£75m	£100m
Number executive directors	2	3	5	8	8
Cost per executive director	£60,000	£80,000	£100,000	£125,000	£150,000
Total cost executive directors	£120,000	£240,000	£500,000	£1,000,000	£1,200,000
Cost chief executive	£75,000	£100,000	£125,000	£150,000	£175,000
Number non-executive directors	5	6	8	8	8
Director's fee	£5,000	£10,000	£15,000	£20,000	£25,000
Director costs	£25,000	£60,000	£120,000	£160,000	£200,000

- ✓ In addition to direct delivery costs and increased management and governance costs, we assume that the CDFIs will have to increase their IT spend and capital expenditure (see projections in table below).

Projected percentage of gross income spent on...

IT & data analytics	3%
--------------------------------	----

Capital expenditure	3%
----------------------------	----

- ✓ Spending on IT and data analytics is another important area of expenditure to support expansion. It was also an area identified as a barrier to expansion in the previous chapter. It is difficult to assess the need for IT spend across the CDFIs, as they will have different needs and vary in terms of past IT investment. It is estimated that the private sector on average spends just over 3% of gross revenue on IT. We assume the CDFIs similarly will need to spend around 3% on IT.
- ✓ Although not shown in the income statement, there is an ongoing need for capital expenditure to support expansion (e.g. investing in assets, equipment etc.). High cost commercial credit providers spend in the region of 3-5% of turnover on capital expenditure. We assume that the CDFIs will similarly have to invest in the region of 3% of gross income on such expenditure.
- ✓ Given the emphasis on growing through telephone and online lending, the CDFIs will have to spend a significant amount on marketing. It is estimated that the now defunct online payday lender Wonga spent 19.2% and 17.3% of costs and profit on marketing in 2010 and 2011, respectively (Beddows and McAteer, 2014). This translates into a cost of acquisition per new customer of nearly £67 (Beddows and McAteer, 2014). In comparison, the four CDFIs providing data on marketing, on average spent less than 5% of gross income. On average, the four CDFIs that provided this data has a marketing spend of £6.2 per loan originated in branch and £31.8 per loan issued remotely (telephone or online). We use this data

to calculate the marketing spend based on the growth per delivery channel.

- ✓ Given the level of growth required to reach £200m in 10 years, it will not enough for the CDFIs to rely on repeat borrowers. Based on the current level of repeat borrowing among the CDFIs, we estimate the number of loans to new borrowers (see table below). This is important because loans to new customers are significantly smaller and have higher default rates. We recognise that there is anecdotal evidence suggesting that repeat borrowing is lower for remote lending channels than for branch. However, we do not have systematic data on this to take this into account in the financial modelling.

Table 4.1 shows the size and composition of the upscaled sector in terms of amount lent, number of loans, delivery channels and number of staff and branches.

Based on the average amounts lent by the CDFIs for new and repeat customers, we estimate that the sector would have to issue just over 415,000 loans annually to reach £200m. To sustain an annual growth of 25.4%, the participating CDFIs would have to make significant number of loans to new customers, especially in the first year. This has a material impact on the bottom line, as new customers are more likely to default and borrow smaller amounts.

In line with the business plans of the CDFIs, most of the growth would come through remote lending channels (online and telephone). Remote lending will surpass branch-based originations already in the second year. By the end of the period, remote lending will make up 90% of loans issued. We estimate that CDFI staffing levels will increase from 269 today to 777. In comparison, credit unions in England, Wales and Scotland have 1,720 employees managing 373,000 loans of a value of £840m. It is important to note that some of these members of staff work on other activities, as some of the CDFIs operate with multiple products and services.

Table 4.2 shows the income and expenditure by year. We also include capital expenditure although this normally shown in the balance sheet of the providers.

Table 4.1: Size and composition of upscaled sector (Y1-Y10)

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
Amount lent	£27.2m	£33.7m	£42.0m	£52.4m	£65.3m	£81.6m	£102.1m	£127.7m	£159.8	£200.1m
# of loans	54,867	69,559	86,729	108,261	135,261	169,119	211,578	264,821	331,587	415,313
New loans	26,103	26,188	37,683	43,380	56,985	69,123	88,127	109,024	137,510	171,452
% new loans	48%	38%	43%	40%	42%	41%	42%	41%	41%	41%
By channel										
Remote	25,221	37,611	53,210	73,595	99,182	131,693	173,606	226,173	290,921	372,794
% remote	45%	54%	61%	68%	73%	78%	82%	85%	88%	90%
Branch	30,646	31,948	33,519	34,666	36,078	37,427	37,972	38,648	40,667	42,519
# of staff	277	298	324	354	393	441	498	570	662	777
# of branches	32	33	34	35	37	38	38	39	40	42

Table 4.2: Income statement CDFI sector

£'000s	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
Amount lent (£m)	£25.9m	£32.5m	£40.8m	£51.1m	£64.1m	£80.4m	£100.8m	£126.5m	£158.6	£198.8m
Expenditure										
Current costs	£11,491	£11,720	£11,955	£12,194	£12,438	£12,687	£12,940	£13,199	£13,463	£13,732
Marketing costs	£776	£1,115	£1,527	£2,032	£2,933	£3,905	£5,165	£6,713	£8,624	£11,050
IT expenditure	£356	£446	£559	£701	£879	£1,102	£1,382	£1,732	£2,172	£2,723
Gov & management	£142	£254	£399	£575	£997	£1,293	£1,803	£2,287	£3,315	£4,183
Direct delivery costs	£836	£1,663	£2,774	£4,152	£5,663	£7,737	£10,284	£13,536	£17,790	£23,141
Total spend	£13,580	£15,198	£17,214	£19,653	£22,908	£26,725	£31,572	£37,466	£45,363	£54,829
Income										
Gross fee & interest income	£11,857	£13,346	£16,736	£20,987	£26,318	£32,982	£41,388	£50,890	£65,082	£81,613
Bad debt	-£1,612	-£2,021	-£2,534	-£3,177	-£3,983	-£4,994	-£6,261	-£7,849	-£9,841	-£12,338
All other financial income	£104	£104	£104	£104	£104	£104	£104	£104	£104	£104
Other operating income	£963	£963	£963	£963	£963	£963	£963	£963	£963	£963
Total income	£11,312	£13,911	£17,170	£21,256	£26,379	£32,801	£40,857	£50,953	£63,610	£79,480
Net income before financing costs	-£2,268	-£1,287	-£43	£1,604	£3,470	£6,077	£9,284	£13,487	£18,248	£24,650
Net income after financing costs										
2% interest rate	-£3,164	-£2,412	-£1,311	£250	£2,744	£5,411	£8,625	£12,698	£17,309	£23,517
5% interest rate	-£3,362	-£2,660	-£1,621	-£140	£2,257	£4,830	£7,897	£11,775	£16,161	£22,075
6% interest rate	-£3,428	-£2,742	-£1,725	-£270	£2,095	£4,637	£7,654	£11,467	£15,778	£21,596
7% interest rate	-£3,493	-£2,825	-£1,828	-£401	£1,932	£4,443	£7,411	£11,159	£15,396	£21,115
8% interest rate	-£3,559	-£2,907	-£1,931	-£530	£1,770	£4,249	£7,169	£10,852	£15,013	£20,634
10% interest rate	-£3,691	-£3,072	-£2,138	-£791	£1,445	£3,862	£6,683	£10,236	£14,248	£19,674
Capital expenditure	£339	£417	£515	£638	£791	£984	£1,226	£1,529	£1,908	£2,385
Net income after capital expenditure	-£3,371	-£2,665	-£1,619	-£127	£2,278	£4,814	£7,885	£11,785	£16,166	£22,094

In aggregate terms the participating CDFIs only generate positive net income after current financing costs when they surpass £40m in annual lending. This suggests that, as the CDFIs reach a certain scale, per unit costs fall. This well documented effect is referred to as economies of scale. Whilst the CDFIs cover current and direct delivery costs, they are unable to cover the additional spend on marketing, IT and governance and management, which are all important to scale up. They are only able to cover capital expenditure after surpassing £50m in annual lending. This reflects that the CDFIs, like other high growth firms, would require significant upfront investment in systems, processes and management to grow. We will discuss their ability to cover financing costs later when we address the capital required to lend at this scale.

In gross terms, there is a cumulative shortfall before financing costs of over £3.6m. If we take into account the estimated capital expenditure required, this would increase to £7.8m. In other words, the CDFIs would require significant upfront investment and support to get to a stage where they can break even and that is before we consider the financing costs associated with such an expansion.

Below the aggregate picture, there are some important drivers of cost and sustainability. First, size of loan is an important determinant of the ability to cover costs. The two CDFIs generating a surplus in year one after current financing costs, provide considerably larger loans. One of them also has significant other financial income and operating income, without which it would be running a deficit in the first two years. At the other end, one of the CDFIs offer very small loans and only generates a surplus after financing costs on surpassing £15m in lending. Second, a low cost-base and cost per loan positively affect sustainability. One provider is very close to covering its costs in year 1 despite offering small loans because of its low cost-base. A further provider has a high cost-base and small scale, making it more difficult to cover costs.

The capital requirements to reach and sustain £200m in lending in a ten-year timeframe would be substantial. Chart 4.4 estimates the annual needs for capital to sustain a ten-year steady growth trajectory to £200m. We assume that the CDFIs retain their respective shares of the market and that everything else remains unchanged (e.g. interest rates etc.) There are three lines in the chart: the gross capital need in green (assuming CDFIs have no capital); taking into account cash in hand (orange); and factoring in cash in hand and outstanding balances of long-term funds (blue).

Chart 4.4: Capital required for £200m lending (£'000s)

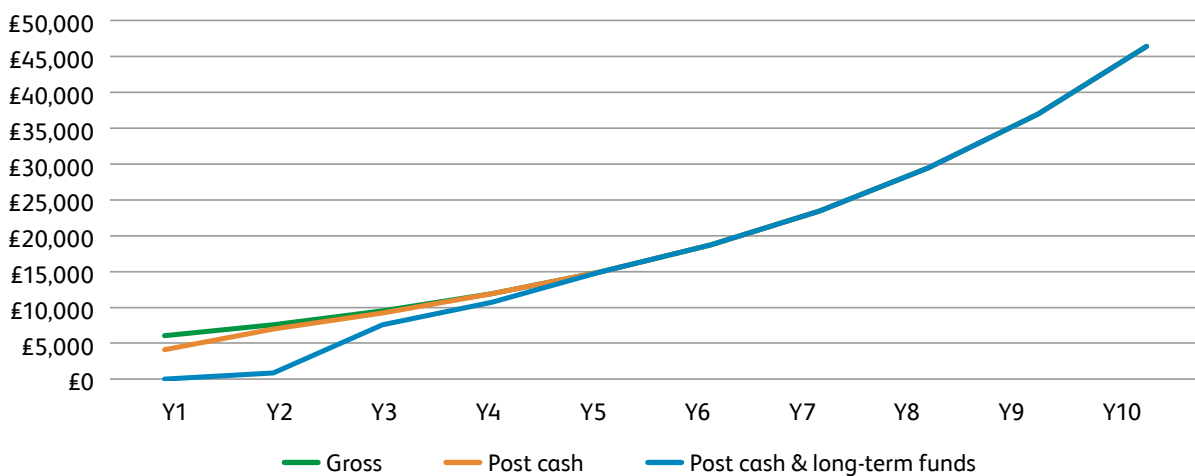
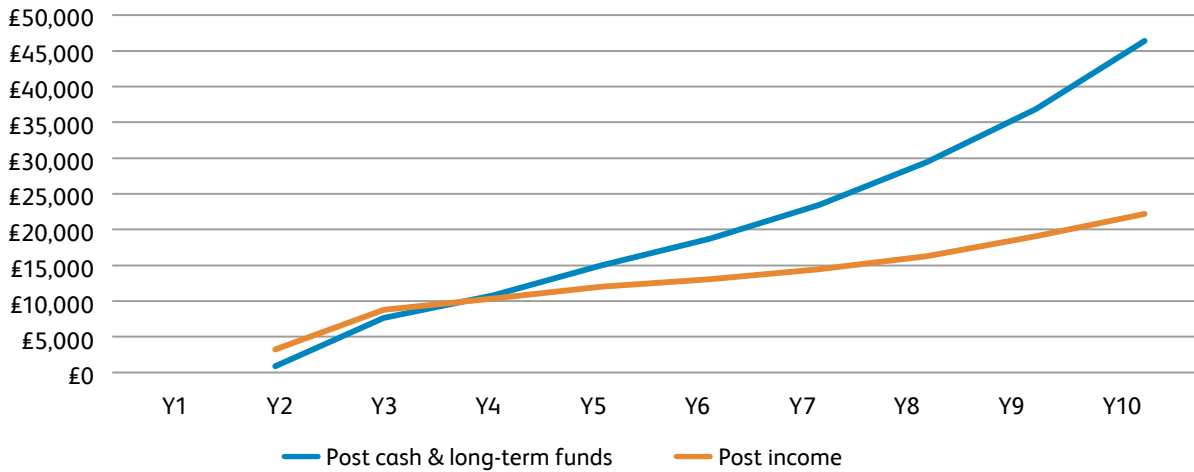
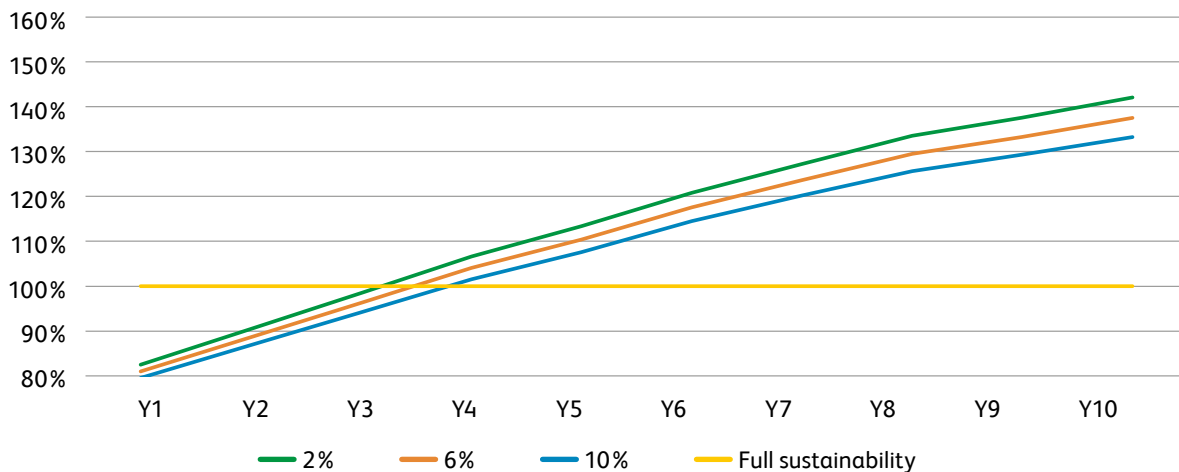


Chart 4.5: Capital need after income (£'000s)**Chart 4.6: Financial sustainability at different financing costs**

The capital needs after recycling are considerable. The gross need for capital starts at around £6.4m in year 1 and increases significantly to over £45m by year 10. The gross need for capital is over the period is nearly £205m. The current levels of cash in hand and long-term loans would only fully cover the first two years of growth and 20% and 10% of the capital for the third and fourth year. Thereafter, the CDFIs would have to make up the shortfall through net income, grant funding, loans or equity-like investment.

Chart 4.5 shows the capital required after using cash in hand, long-term funds and net income against the capital need after using cash in hand and long-term funds.

In aggregate terms the CDFIs only start generating net income in year 3 so the capital need would remain at £1.5m in year 2. Further, we assume the CDFIs could cover the first year of

capital through existing funds and loans. The chart indicates that the CDFIs would be able to cover around less than half of their capital needs through their net income. The remaining gap in funding would still be significant at nearly £120m.

As net income, existing cash in hand and long-term funding commitments are not sufficient to cover the need for capital, it is natural that at least some of this shortfall will be bridged by borrowed capital. Chart 4.6 shows the financial sustainability of the participating CDFIs if they had to borrow capital to fill the need for capital at 2%, 6% and 10%. (There are CDFIs in the sample that pay all these rates for some or all their finance).

The level of interest rates charged by social investors and other organisations lending to the CDFIs significantly affects the financial sustainability at the sector. By the end of the period, the level of financial sustainability is nearly

10% lower if the CDFIs pay 10% rather than 2%, and 5% if they pay 10% rather than 6%. To put this in context, the CDFIs would have to pay an extra £1.5m in the first four years at 10% compared with 6% and over £8m over the 10-year period. This additional financing costs would reduce what the sector could invest in improving services or reducing costs for the end-user. In short, they need cheap and patient capital.

4.3. Levers for growth

We now turn to the possible levers for growth. We estimate the impact of these levers in terms of capital required (plugging capital gap or otherwise reducing capital need) and sustainability (i.e. increasing net income).

4.4. Commercial levers

Overall the expectation is for CDFIs to cover their operating and financing costs through income generated from interest and fee income paid by their customers. In other words, they should be financially sustainable and not rely on grants and subsidies. This expectation stems in part but not wholly from the international microfinance sector where there is a broad consensus since the early 2000s that MFIs should be financially sustainable. The work of Carnegie, the End High Cost Credit Alliance and Fair4All all supports operationally sustainable lenders. International microfinance, then, provides some important lessons in using a commercial logic to scale up:

✓ **Importance initial support:** Even in international microfinance, as few as 20-25% MFIs report not using subsidies in some form (D'Espallier et al, 2013). Instead, there is an ongoing transition from subsidy dependence to financial sustainability. International aid agencies continue to play an important role, including in loan guarantees and technical assistance. Compartamos, an MFI in Mexico, that has reached full sustainability received significant initial support, around US\$6m, in technical assistance, grants and subordinated debt from aid agencies to support it to scale up (see Appendix C for case studies).

✓ **Efficient business model:** International experience suggests that financially sustainable MFIs have an efficient underlying business model, based on an efficient operating model (keeping costs low) and commercial pricing policy (pricing for risk and costs). Compartamos had lower costs and charged comparatively higher rates than other MFIs in the region.

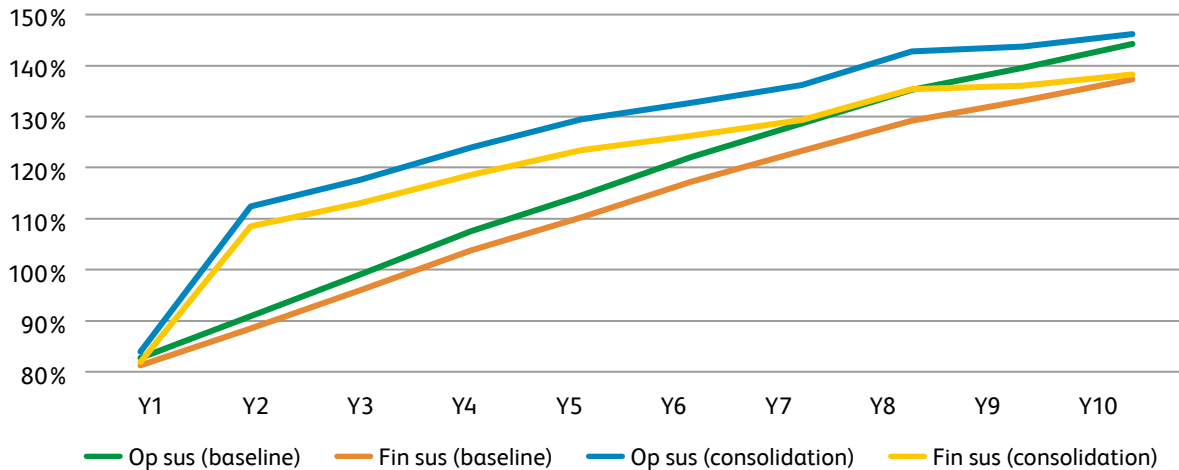
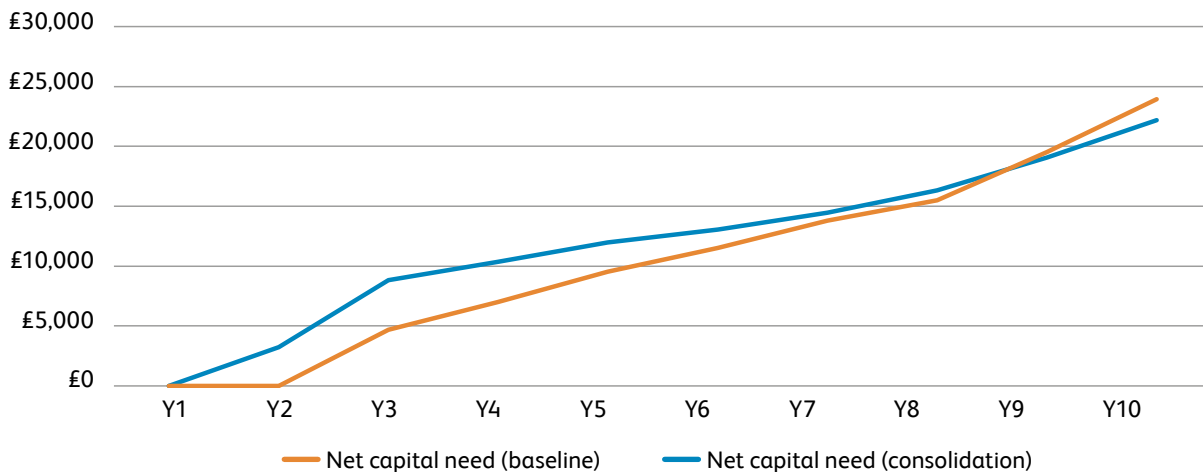
✓ **Institutional transformation:** As MFIs outgrow their current funding arrangements, many seek to undertake institutional transformation to access capital markets and deposits. Compartamos converted into a for-profit to access capital markets (e.g. shares, equity) and then into a bank to raise capital through deposits. Institutional transformation has raised concerns about mission drift, as some MFIs have been seen to be generating profits and dividend payments on the back of the exploitation of customers through excessive pricing.

Some of these levers are not relevant to CDFIs, at least not at the current stage. Institutional transformation, for example, would either contravene the importance of the not-for-profit status (by becoming listed or for-profit) or be unsuitable at this current stage (i.e. transforming into deposit-taking institution or bank). Instead, we consider three other commercial levers: consolidation, improved productivity and increased pricing.

4.4.1. Consolidation

Mergers and acquisitions are an important part of growth in many sectors. To model this lever, we assume that the personal lending activity is concentrated in the two most sustainable and efficient CDFIs. One CDFI takes on all the branch-based lending, whilst the other takes on all the remote lending. We assume that CDFIs only take on the portfolio, the loan officers and the branches (i.e. none of the managers). Such an acquisition would not affect the total volume of lending in the sector but could affect the level of sustainability and efficiency.

Chart 4.7 shows the impact of such a consolidation on the ability of the sector to cover operating costs (operational sustainability) and financing costs at 6% (financial sustainability).

Chart 4.7: Impact of consolidation on sustainability**Chart 4.8: Impact of consolidation on capital need (£'000s)**

A consolidated sector significantly outperforms the current sector. After displaying similar levels of sustainability in the first year, a consolidated sector would reach financial sustainability already in the second year, compared with year 4 for the current sector. In absolute terms, a consolidated sector would generate a surplus of £2m in its first three years compared with a loss of nearly £4m for the current sector. A consolidated sector would have significantly lower costs due to economies of scale in back office, middle management and head office costs. In addition, there would be an immediate effect of consolidation on productivity in the short term, as CDFIs with higher productivity take over the portfolio of CDFIs with lower levels of productivity.

Over time, the current sector would catch up with a consolidated sector, nearly matching its sustainability level by year 10. This is due to higher income resulting from some of the

CDFIs subsumed charging higher rates than the CDFIs taking over. Furthermore, the consolidated CDFIs would face greater management and governance costs as they would grow considerably in size (surpassing £50m and £140m in lending respectively). In addition, there would be sunk costs associated with such a take-over, which we have not included here.

Chart 4.8 compares the need for capital after net income, cash in hand and outstanding long-term funds for the baseline and a consolidated sector.

In the short to medium term, consolidation would significantly lower the capital requirements, required to build scale. In the first eight years, a consolidated sector would require £16m less in capital than the current sector, owing to a greater net income compared with the current sector for the first eight years. In the last two years, the consolidated sector has greater

Chart 4.9: Impact of increased productivity on financial sustainability (%)

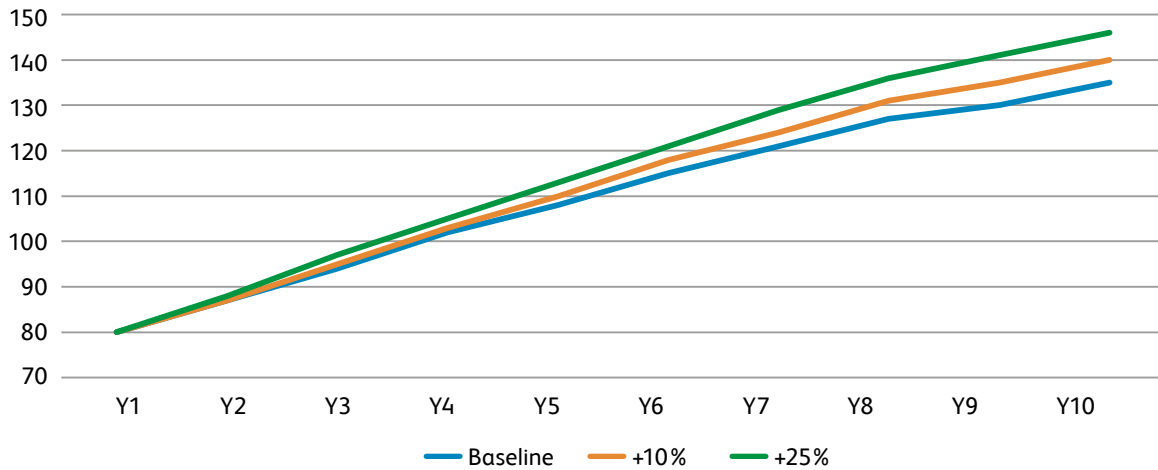
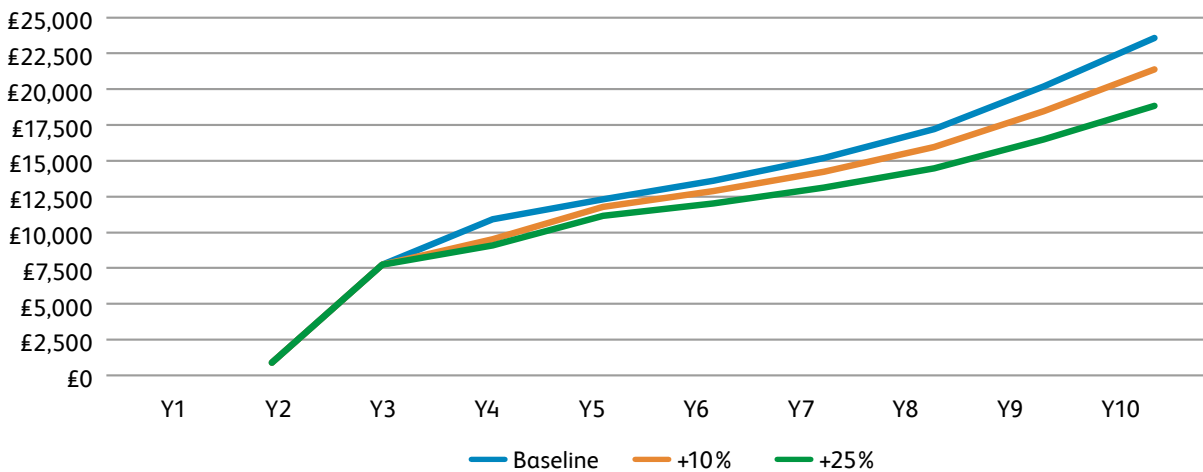


Chart 4.10: Impact of increased productivity on capital requirements (£'000s)



capital requirements because of a comparatively lower net income, which in turn is due to higher management and governance costs and lower interest rate income. However, cumulatively, the need for capital is nearly £15m less for the consolidated sector over the 10-year period.

4.4.2. Improving loan office productivity

Improved productivity is intimately linked to growth, because it translates into greater efficiency, which, in turn, improves competitiveness. We define productivity in a narrow sense as the number of loans disbursed per loan officer. We estimate the impact of 10 and 25% increases in loan officer productivity on the sustainability of the sector separately for remote (online and telephone) and branch-based delivery.

Chart 4.9 shows the impact of improved productivity on sustainability. The chart

compares operational sustainability and financial sustainability for current and improved productivity.

Improving productivity by 10 and 25% improves the level of operational and financial sustainability over time. Over time, increasing loan officer productivity by 10 and 25% increases financial sustainability by over 5%. If the CDFIs increased the loan officer productivity by these rates, they would increase the surplus generated over the 10-year period by over £8m and £17m respectively. This is largely due to lower direct delivery costs and associated supervisor and administrator costs. Clearly it is not realistic for all the CDFIs to reach a higher loan officer productivity rate from year one. It would require additional investment in systems and processes for some of the CDFIs and may also be linked to the scale of the providers. Further, it assumes that CDFIs take on same level of breakdown of manual intervention, auto-decline

and auto-approval. Nevertheless, even small improvements in productivity generate significant effects on the bottom line. If the CDFIs were able to increase productivity by 1% year on year, they would have achieved a 5% uplift in their level of financial sustainability by year 10.

Chart 4.10 compares the required capital after cash in hand and income for increased productivity and baseline.

Because of the significant improvements in the financial sustainability ratio the capital requirements are also considerably lower. Cumulatively the need for capital is between £9m (10% increase) and £17m (25% increase) lower over the 10-year period compared with the baseline scenario. This is because higher productivity lowers costs and increases net revenue.

4.4.3. Pricing

Pricing is one of the most important and controversial elements of using a commercial logic to scaling up. Here we estimate the increases in interest rates required to be financially sustainable from year 1.

	Current	Financial sustainability
Average APR*	175.5%	203.93%

*Average for five CDFIs in financial forecasting only;

There is a £1.7m shortfall in interest and fee income to cover the operating and current financing costs. This would involve an increase of around 16% in interest income. If all the CDFIs increased their current APR by this, it would lead to an APR of 203.93%, which is still significantly below the rates charged by commercial high cost credit providers. As an example, this would mean a £500 loan over 52 weeks would cost £367 in interest. This is slightly misleading in that some CDFIs might have grants to cover some non-lending activities included in the financial data.

4.5. Public policy levers

In Western Europe and the US, MFIs have scaled up through fulfilling public policy objectives around inclusion and self-employment. MFIs in these countries are addressing a market failure, as markets do not operate efficiently, preventing people with viable business propositions to access finance or due to positive or negative societal externalities (e.g. welfare costs etc.). The market as it stands does not serve certain groups or generate certain outcomes. The MFIs are often perceived as being a more cost-effective way of achieving these goals relative to other interventions rather than being fully financially sustainable. In Europe it is linked to a market failure, as lending to certain segments and purposes is not commercially viable because of interest rate restrictions.

There are four main lessons from the use of public policy levers to scale up from the US, UK and Europe (case studies can be found in Appendix C):

- ✓ **Not only government:** There tends to be multiple private and public sector interests involved in supporting MFIs to achieve public policy goals. The government often provides limited direct investment and instead focuses on compelling mainstream financial institutions to support MFIs. In the USA, banks can fulfil their regulatory requirements under Community Reinvestment Act (CRA) through partnering with and supporting the CDFI sector.
- ✓ **Common understanding of roles:** A form of social compact or common understanding of roles and objectives governs the actions and roles of the different parties. There is a clearly defined target group and a set of outcome goals. In the case of Adie in France, there is a social compact between government, Adie and the banks. Adie lends to groups unable to access mainstream finance in a cost-effective, but not financially sustainable, manner. Therefore, government provides a supportive regulatory framework and guarantees, whilst banks provide revolving credit and grants. Once they have built up a positive credit history, Adie moves the customers on to partner banks. Qredits in the Netherlands works closely with the largest banks in setting the upper limit for its SME loans (below which banks cannot operate) and there is a referral partnership.

- ✓ **Multiple forms of support:** The public policy logic is most effective when involving multiple forms of support, including risk sharing mechanisms, grants, technical assistance, staff secondment, referrals, office sharing and revolving credit. The experience of CITR suggests one tool (i.e. tax credit) is insufficient in itself. In the US, the CDFI Fund offers multiple forms of support, including bonds, guarantees, technical assistance and loans. PerMicro in Italy can operate out of bank branches and access revolving credit facilities from banks.
- ✓ **Identified providers:** The MFIs involved in fulfilling public policy objectives are clearly identified. In some cases, such as with the US CDFI Fund and CITR, MFIs have to be certified or accredited to access support. In Italy, France and Netherlands, there is a single national microfinance provider. Common for the providers is that they are often not-for-profit and subject to some form of asset lock.

In this section, we discuss the potential effectiveness of four potential public policy levers: tax incentive, guarantee fund, government equity/patient capital and grants covering head office costs.

4.5.1. Community Investment Tax Relief

There is a tax relief for organisations and individuals investing in UK business lending CDFIs called Community Investment Tax Relief (CITR). Investors receive income or corporate tax relief worth 25% of the money invested in accredited CDFIs and spread over five years. Retail CDFIs (i.e. those lending directly to small businesses) can raise up to £10m and wholesale CDFIs can raise £20 under the scheme. The CDFIs have to onward lend the funds to SMEs in disadvantaged communities.

We model the extension of CITR to personal lending CDFIs. It would have the following features

- Enable retail CDFIs to raise £10m and wholesale CDFIs to raise £20m under the scheme;
- Provide investors with income or corporate tax relief worth 25% of investment and spread over five years;

Extending the CITR could potentially have two impacts on the CDFIs. First, it could attract additional investment to the sector from new and existing investors. Second, it could reduce the financing costs for the CDFIs as existing corporate investors would use the tax relief to reduce the interest charged to CDFIs.⁸

	Low	High
Investment under CITR	£5m	£10m

It is estimated that around £5-10m could be raised under CITR annually based on the historical experience of the business lending CDFI sector. A proportion of this would likely be existing investors starting to lend to or invest under CITR. It is difficult to estimate that additionality of the CITR, but we believe it would be relatively modest. Due to state aid rules, the tax relief and total interest rates cannot exceed what the investor would have charged if a commercial rate had been applied. Investors we have spoken with also suggest that the scheme would be more effective once the sector achieves greater scale. However, it is possible that combined with other interventions and the current interest in the sector, that the scheme would generate greater investment into the sector.

As illustrated earlier, the interest rate charged significantly influences sustainability. If investors were to reduce the rate charged by 5% this could make a difference of hundreds of thousands in financing costs from year one to millions in year 10. Additionally, the set-up costs for individual CDFIs would likely be modest – around £3,000⁹ – unless the CDFIs are seeking to attract significant investment from retail investors, which may involve considerable additional costs to cover legal work, regulatory compliance and prospectus (possibly in the tens of thousands).

8 In practice (for corporate investors) there is no State Aid where the total interest charged on the loan and yearly tax relief is equal to or less than what would have been charged if a deemed commercial rate had been charged. This essentially means that corporate investors are getting the same return that they would have if they had lent to the accredited body at a commercial rate. As such, the benefit is passed on to the CDFI in the form of cheaper capital.

9 This is what a consultancy company charges for conducting the accreditation process on behalf of a CDFI.

4.5.2. Guarantee fund

Guarantees are an important tool for increasing the supply of credit to underserved markets and for improving the financial sustainability of financial intermediaries. There are various forms of guarantees, which may be provided by governments, international donors, foundations and other organisations. Some, such as the UK Enterprise Finance Guarantee, guarantees up to a given proportion of outstanding facility balance to end-users (normally small businesses) to encourage greater lending by reducing the risk for the lender. Under the EaSI programme, EIF guarantees up to a maximum of 80% for each loan defaulting up to a cap rate of maximum of 30% for microcredit provided by banks and MFIs. Other guarantees are used to guarantee loans from or investment by banks or other investments to MFIs. This is typical for the guarantee schemes set up by international donors to enable MFIs to access more and different forms of finance.

Here we assume that the guarantee fund would provide a guarantee for loans to and investment in personal lending CDFIs for 10-50% of realised loss of principal. The fund could have the following features:

- ✓ Guarantee loans to CDFIs fulfilling minimum criteria for financial and institutional viability and robustness of underwriting and loan delinquency procedures;
- ✓ Cover up to £20m of outstanding balance of lending/investment for each investor;
- ✓ Cover loans and investments by investors that are new to sector or substantially different or increased lending or investment by existing investors (to increase additionality);

Guarantee funds may improve the capacity of the sector to scale up in two ways. First, it may enable the CDFIs to access finance at better terms (e.g. lower rate, different structure). Second, it may increase additional funding that they otherwise would not be able to access. In either case it involves a role for Government.

We have examined various guarantee schemes. Leverage effects vary considerably across different schemes. In the US, guarantees for CDFIs for real estate lending leverage effects are as high as 26-30. Most of the US CDFI Fund

programmes leverage at least US\$8 per dollar invested. Guarantees aimed at more marginal, often rural markets have lower leverage, such as the GRAD Loan Guarantee Fund in Ethiopia, which has a leverage of 2.5. The EU microfinance EaSI guarantee has a leverage of 3.6 for its microfinance activity.

It is difficult to assess where on this scale a guarantee fund for personal lending CDFIs would be on this scale. We judge such a fund to be unlikely to leverage funding equivalent to the US CDFI sector, as this sector is heavily engaged in real estate lending, has a larger philanthropic investment sector and benefits from greater and more sustained government support. We assume that the fund would cover around £20m of investment at any time and would have a leverage of between 2.5 and 3.6.

	Low	High
Size of guarantee fund	£20m	£20m
Multiplier	2.5*	3.6**
Additional investment	£50m	£72m

*Average for GRAD Fund Ethiopia;

**Average leverage of EaSI Guarantee;

The resulting £50m to £72m would make a significant contribution in filling the net £120m capital gap over the period.

4.5.3. Government providing patient capital

National governments, international aid agencies and foundations have played an important role by providing long-term, low cost patient capital to enable MFIs to scale up and access capital. We model that government provides £20m in quasi equity to the sector structured as long-term subordinate debt at a low return (see table on following page).

Y1-3	Y4	Y5	Y6	Y7	Y8	Y9	Y10-15
0%	2%	2.5%	3%	3.5%	4%	4.5%	5%
£0	£0.4m	£0.5m	£0.6m	£0.7m	£0.8m	£0.9m	£1m

Access to such long-term, patient capital would improve the financial sustainability of the CDFIs and contribute to the capitalising of the sector. It would also enable CDFIs to hire staff or make capital investment without having to cover the costs immediately (see table below).

Impact of patient capital on bottom line

Patient capital	£20m
Cumulative deficit Y1-3	-£3.6m
After capital expenditure Y1-3	-£7.8m
Net patient capital	£8.6m

In aggregate terms, the patient capital would enable the sector to cover its cumulative deficit for the first two years, though one of the CDFIs accumulate a deficit exceeding its allocation of patient capital. As such it would remove an important stumbling block for scaling up. The remaining funds would account for around 7% of the need for capital. More strategically important than this, the patient capital would enable the sector to attract additional investment.

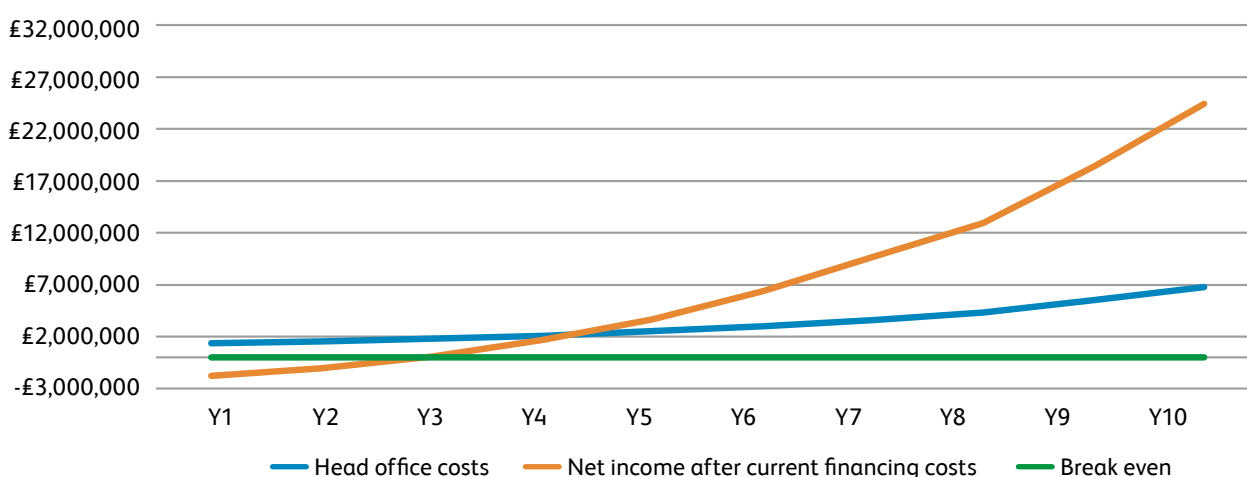
4.5.4. Funding head office costs

In some European countries, such as France and Belgium, MFIs may not be able to be fully sustainable because of restrictions on interest rates. Adie in France has its head office and central costs funded through grants, whilst the interest income covers the direct delivery and capital costs associated with the lending. We investigate the implications of having the public, private or charitable sector covering the head office costs of the participating CDFIs. We include the following items in head office and central costs:

- Audit, legal and professional fees;
- Head office rent and costs;
- Bank and other charges;
- Printing and stationary;
- Executive directors;
- Middle management;

We have excluded the remuneration of non-executive directors as we consider it unlikely for Government or foundations to cover such a cost. Chart 4.11 compares the head office costs and the current net income (after current financing costs).

Chart 4.11: Impact of head office cover on bottom line



Covering the head office costs would make an important contribution to the bottom line of the participating CDFIs in the first 2-3 years. It would cover nearly 80% of the deficit in year 1 and all the deficit in year 2. Over time there is less of a need for covering head office costs as the sector makes a surplus after financing costs. We would argue there would be two contextual factors that make up the rationale for covering head office costs for CDFIs. First, there is a stronger social orientation in terms of depth of outreach, social outcomes or other obvious impediments to commercial viability (e.g. interest rate cap, need for investment-readiness support for customers etc.). Second, related to this, there may be considerable goodwill and in-kind support from private and public sector (e.g. free premises, secondment of staff, board members etc.). There is no obvious impediment to a commercial orientation in personal lending CDFIs, as the market is not price sensitive and customers do not require (and generally do not want) extensive support to take out a loan.

4.6. Technological levers

The rapid growth of the Fintech sector brought about by the combination of the financial crisis, technological breakthroughs and changing consumer habits and preferences is likely to change the way in which financial services are developed, delivered and used. The Fintech sector operates on the belief it can scale up rapidly through changing expectations and transforming operational models. We have and are already seeing some examples of the disruption they can bring about. For example, Wonga revolutionised the high cost credit market and the expectations of its customers through providing instant online access to small loans. This was enabled by an automated lending process and enhanced data pool and made viable through pricing and high rejection rates. There are also examples of potential disruption in the affordable credit sector. Fintech companies, such as Salary Finance, provide payroll deduction lending to employees of large companies, traditionally the preserve of the credit union movement.

There are three developments that epitomise and embody this Fintech revolution (see case studies in Appendix C):

- **Blockchain:** Widely hailed as among the greatest recent technological innovations, blockchain uses a peer-to-peer network which rids financial transactions of a third party, such as banks, for mediation (Ikeda and Hamid, 2018). In a blockchain, blocks are ordered block by block with each block referencing to the previous one and its fingerprint, and new ones are created by using algorithms, which ensures the consistency and validity. As well as a block's fingerprint, each block contains content relating to transactions or data, as well as the technical data concerning the block. Because anybody can check any proposed transaction against the blockchain, this approach removes the need for a central authority and thus for participants to have confidence in the integrity of any single entity. Blockchain offers a range of benefits to organisations because they are: distributed widely in a precisely controlled fashion; highly efficient; robust in rejecting unauthorised changes; characterised by high level of privacy and confidentiality; secure for data; enabling significant reduction of operational costs; and highly transparent. However, the technology is still in its infancy and there are few examples of its implementation.
- **Big data:** Defined as “datasets that are too large for traditional data-processing systems and that therefore require new technologies” (Provost and Fawcett, 2013, quoted in Power, 2014), Big Data is widely used by financial institutions, including detecting fraud, credit underwriting, delinquency control, marketing and customer behavioural insights. Due to data sets growing rapidly in part because they are increasingly gathered by cheap and numerous information-sensing mobile devices such as software logs, cameras, microphones and mobile phones, Big Data offers large amounts of information that can be beneficial for organisations. Accuracy in Big Data may lead to more confident decision making, and better decisions can result in greater operational efficiency, cost reduction and reduced risk. The use of Big Data is already widespread among larger financial service providers.

- **Artificial intelligence:** Artificial Intelligence (AI) can broadly be summed up as technologies that have adaptive and predictive power capable of autonomous learning. This enables it to recognise patterns, anticipate future events, make decisions and communicate with other people (Deloitte, 2018). In financial services, AI is being used in several areas, including customer interaction (e.g. chat bots), regulatory compliance and investment (e.g. asset management). Although AI has a long way to go in terms of its sophistication, examples of its use in finance are already beginning to emerge.

There is unquestionably a lot of hype around the Fintech sector. After all, financial institutions have engaged in technological innovation since WWII and before. But there are three key developments that underpin this latest wave of innovation:

- High speed internet connections, allowing for cloud computing and online platforms;
- Exponential increases in computing, unlocking algorithms and data sources;
- Widespread adoption of smartphones, providing a new channel for 24/7 services via apps.

In this section, we will be focusing on the cost-effectiveness of online lending.

4.6.1. Online lending

The personal lending CDFI sector has sought to introduce online lending in addition to or instead of its branch-based offering. This has largely been an attempt to reduce and control costs, scale up and stay relevant in response to changing consumer behaviour and preferences. As discussed in Section 3.2, five out of the seven CDFIs in the sample have introduced some form of online lending in the last 4-5 years or so.

Discussions around online lending often conflate delivery channel (online, branch, telephone) and underwriting methodology (automated, manual). Yet, any combination of underwriting and delivery channels is possible. Indeed, none of the providers have a fully automated online decision engine but operate with varying degrees of manual intervention. All the CDFIs engaging in online lending were seeking to automate decision-making as far as possible. Yet the CDFIs still intervene manually in 50-80% of online applications. Conversely, providers that had not moved into online lending had introduced online preapplication screening and collecting data remotely ahead of branch-based loan interviews.

For the purposes of this discussion, we focus exclusively on automated lending done online. This model is also believed to offer the greatest cost savings, not requiring loan officers or high street branches. Table 4.3 compares the cost and portfolio structure for online and branch lending.

Table 4.3: Cost and portfolio characteristics by channel¹

	Online	Branch
Portfolio characteristics		
Mean loan amount²	£445	£632
Bad debt provisioning	19.4%	15.1%
Repeat lending	10%	70%
Conversion rate	8%	60%
Running costs		
Branch running costs³	-	£45,000
Loan officers per branch³	-	3
Loan officer productivity	-	365
Customer acquisition cost	£31.7	£6.2

¹ Estimated using management information and management testimonies from 5 CDFIs;

² Estimated using data on mean loan amount for repeat and new customers;

³ Estimated based on management information from two CDFIs

Online and branch-based lending differ significantly. The level of repeat borrowing is much lower for online compared with branch lending – 10 compared with around 70%. This has important implications because repeat customers are lower risk, borrow larger amounts and have a higher conversion rate. Moreover, a low conversion rate means that online lenders have to attract and screen a larger number of applications than branches, which increases costs. Customer acquisition costs are also five times greater online relative to branch. Whereas a high street presence increases visibility, providers have to spend considerable on marketing to establish a digital presence. Online loans also appear to be greater risk. Management interviews suggest that online customers have higher levels of debt, which can be hard to accurately determine in a fast-moving market, and it can be more difficult to collect debt due to greater geographical spread and a reluctance among online customers to interact via telephone or F2F.

For branch-based lenders face significant costs linked to opening and running a branch. Management information and interviews suggest that annual branch running costs are in the region of £45,000, whilst it costs around £20,000 in set-up costs. According to one manager, it takes around three years for a branch to break even. Typically, a branch has around three loan officers who can underwrite around 365 loans a year each.

The table on p.56 compares a fully branch versus fully online CDFI sector originating £200m in lending annually. We use the respective portfolio and cost indicators from the above table. For the remainder we use the same assumptions as with the rest of the modelling (see Section 4.2). For the sake of simplicity, we have not included head office costs.

As expected, the cost structure of branch and online differ significantly. The costs are significantly lower (nearly £10m lower) for online compared with branch. Loan officer salaries and branch running costs make up the bulk of the costs for branch-based lenders. Their acquisition and credit

reference fees are likely to be much lower relative to online lenders. Given the higher bad debt ratio for online lending, net fee and interest income is greater for branch-based lenders.

It should be noted that automated lending is currently not a realistic prospect for the CDFI sector. As mentioned above, most applications – as many as 80% - still require manual underwriting.

Apart from cost and portfolio structure, there is evidence from the high cost credit market to suggest that online customers differ from F2F delivery. Evidence from FCA and others suggest that online borrowers are more likely to be younger, male and employed compared with more traditional F2F high cost credit, such as home credit and rent-to-own.

Table 4.4 displays customer characteristics for 2016/17 by delivery channel for three CDFIs, the only participating ones to record customer characteristics by delivery channel

It is difficult to compare the data. The CDFIs do not necessarily record data by delivery channel and use different definitions, especially for age and income, and different methods of collecting such data. Two of the CDFIs used management information on customers, whilst one drew on customer survey data. The data suggests that online customers are more likely to be homeowners (8% compared with 3%) and less likely to be unemployed (42% online vs. 55-59%) for F2F channels. Online customers are possibly also younger, though it is difficult to tell given the use of different age categories.

In the interviews, three of the CDFIs involved in online lending reported that the customer characteristics had changed after introducing online lending. The traditional customer base for personal lending CDFIs consisted of single mothers and men on welfare benefits. Reportedly, online customers were younger, more single men, more people in employment and in private rented accommodation.

£ '000s	Online	Branch
Amount lent	£200m	£200m
Number of loans	449,438	316,456
Number loan officers		867
Number administrators	308	217
Number middle managers	26	90
Number branches		289
Customer acquisition costs		
Cost per loan	£31.7	£6.2
Total cost	£14,247	£1,962
Underwriting costs		
Conversion rate (%)	8%	60%
Applications needed	7,490,637	527,426
Credit reference fees	£2.5	£2.5
Credit reference costs total	£18,727	£1,319
Running costs		
Branch running costs	£0	£13,005,029
Office running costs	£1,626	£1,497
Staff salaries		
Loan officers	£0	£25,100
Administrators	£6,060	£4,267
Middle managers	£1,188	£4,183
Total running costs	£8,874	£48,052
Total costs	£41,848	£51,333
Portfolio performance		
Net fee & interest income	£94,865	£99,926
Bad debt provisioning (%)	19.4%	15.1%
Net income*	£53,018	£48,594

*Before overhead and finance costs

Table 4.4: Customer characteristics by delivery channel

		Online A	F2F A	F2F B
Female	71%	Female	73%	71%
Age		Age		
18-29	25%	18-24	12%	11%
30-39	36%	25-34	38%	39%
40-49	18%	35-44	23%	23%
50-59	12%	45-54	16%	15%
60-69	6%	55-64	7%	8%
70+	3%	65-74	5%	4%
		75+		1%
Housing tenure				
Owner occupied	8%		3%	3%
Social rented	52%		65%	57%
Private rented	30%		23%	28%
With family/friends	9%		8%	11%
Other	1%		1%	0%
Marital status				
Married	11%		11%	
Single parent	33%		44%	39%
Living with partner	9%		14%	19%
Couple with children	10%		17%	9%
Single	22%		74%	33%
Other	15%		2%	
Children in household	59%		61%	60%
Household income				
£0-£6,000	9%	Less than £5k		3%
£6,000-£12,000	23%	5-10k	24%	18%
		10-15k	34%	31%
£12,000-£18,000	38%	15-20k	23%	25%
£18,000-£24,000	19%	20-25k	11%	14%
£24,000+	12%	25-30k	5%	6%
		30k+	3%	4%
Employment status				
Unemployed	42%		55%	59%
Employed	39%		40%	37%
Self-employed	1%		0%	1%
Student	1%		1%	0%
Other	17%		5%	4%
In receipt benefits			55%	85%
Reasons for loan				
Home improvement	24%		24%	
Household goods	15%		18%	
Debt consolidation	2%		7%	
Special occasions	31%		20%	
Holiday	8%		13%	
Vehicle repair/purchase	6%		23%	
Other	13%		3%	
N/sample size	4,991		7,752	886

They also often had better access to credit and higher levels of debt:

“Sure, so our typical branch customer, 70 per cent of our customers are female, single, children, social housing, a typically vulnerable type customer where they need a lot of financial handholding for want of a better word. Online it’s working, it’s about a 60/40 split to male, you wouldn’t necessarily identify them as financially illiterate, it’s more about easy cash, however they do have large amount of it, of debt, so the indebtedness is much, much higher. I think it’s a different type of vulnerability, because of the access to easy credit, so I think you’ve got different risks, and different problems with both types of demographic in terms of what can we do to help them.”

CDFI manager

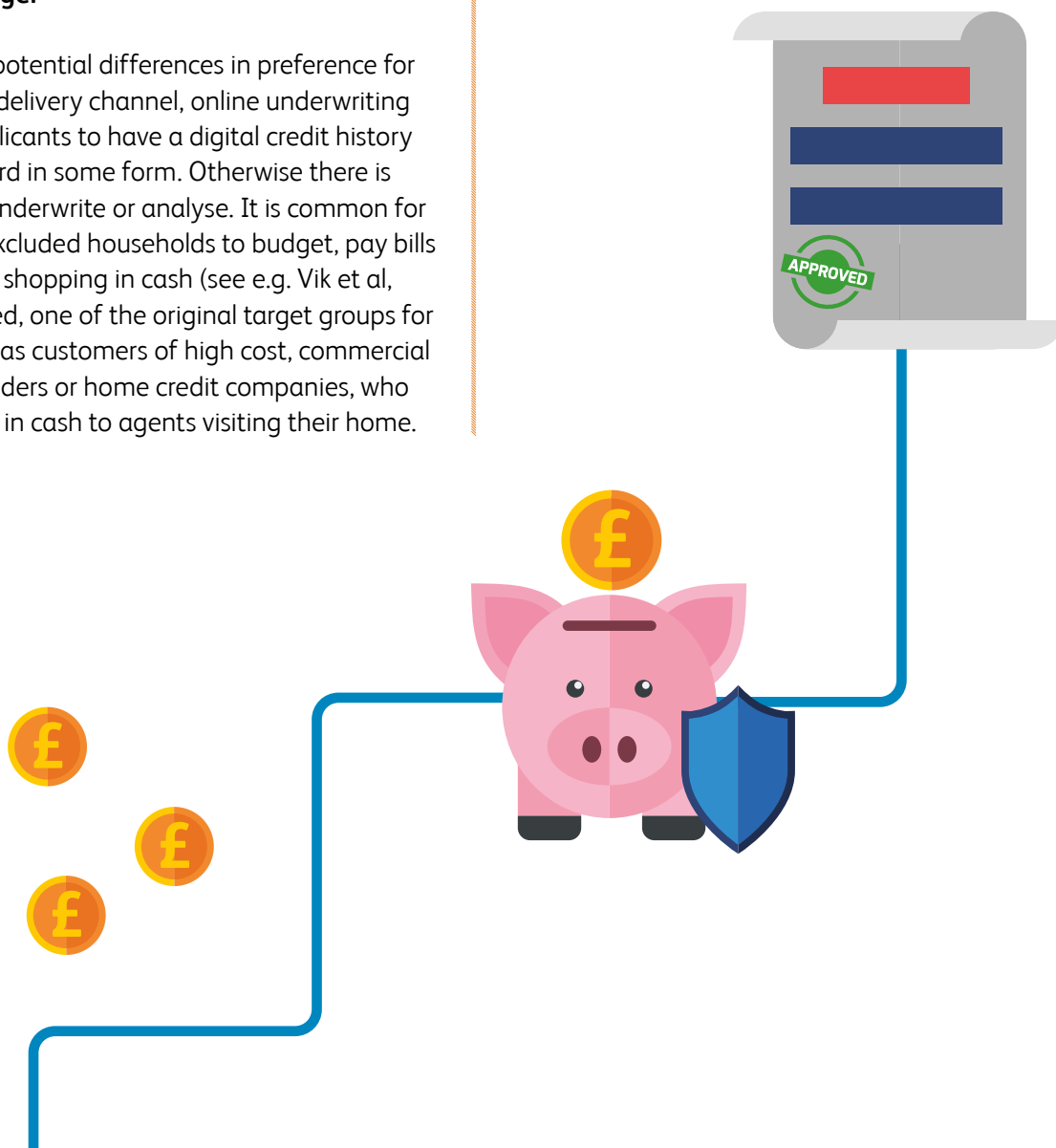
Apart from potential differences in preference for a particular delivery channel, online underwriting requires applicants to have a digital credit history or track record in some form. Otherwise there is nothing to underwrite or analyse. It is common for financially excluded households to budget, pay bills and do their shopping in cash (see e.g. Vik et al, 2018). Indeed, one of the original target groups for this sector was customers of high cost, commercial doorstep lenders or home credit companies, who repaid loans in cash to agents visiting their home.

One CDFI found that it could not award loans it would have approved through a F2F interview for this reason.

“Regular branch clients noticed that we had an online offering and started going online. However, whilst we would have been able to serve them in the branch, they were getting rejected online. They did not go back to the branch.”

CDFI manager

To address this, the decision engines of four of the CDFIs referred declined applicants to telephone or branch-based underwriters to collect further information, analysis and decision-making. This would suggest that manual intervention might increase the depth of outreach of online lending.



5. Conclusion and recommendations

This project analysed the social and financial achievements of the UK personal lending sector and discussed the levers and potential for the sector to significantly scale up to provide £200m in annual lending in a ten-year timeframe. We make the following observations based on this analysis and discussion:

💡 **CDFIs reach those most in need:**

Customer data underlines the role of CDFIs as ubiquitous vehicles for reaching most excluded. Despite transitioning to online and remote lending channels, which tends to attract a younger, more male, better-off customers in employment, half or more of the CDFI customers are unemployed, in social housing, women, lone parents and on low incomes. The CDFIs provide small amounts, typically £350 to 400 to new customers, generating significant cost savings and encouraging many of them to save. Most of the customers self-report improvements in wellbeing as a result of the service.

💡 **Improvements in sustainability:**

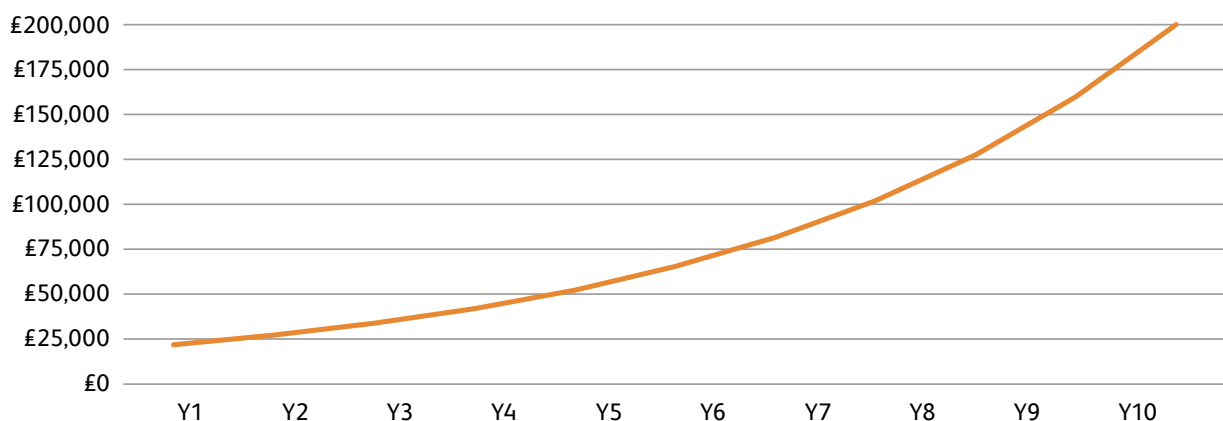
We observed improvements in terms of sustainability. The CDFIs significantly reduced their deficits, generally by growing the interest

income at a greater rate than the costs. There were substantial improvements in levels of operational and financial sustainability. Most of the CDFIs improved productivity through rationalising the lending process, including telephone lending and making efficiencies in the customer journey. The median cost per loan fell by 7%. We also observed improvements on related measures on efficiency and sustainability.

💡 **Clear potential for growth but £200 million in 10 years unrealistic:**

Despite improvements in efficiency and sustainability, we see it as unrealistic to expect the sector to grow to £200m in a 10-year timeframe. This would require an annual growth rate of over 25% (see chart below). Such growth is rarely achieved even by companies operating in conventional, well-functioning markets. To put this into perspective, only 1-2% of UK companies can be classed as high growth – achieving 20% growth annually for 3 years or more. We would be expecting the CDFIs to exceed this growth without relying on international markets and M&As, important sources of growth.

Growth annual lending to reach £200m (£ '000s)



Need for significant upfront investment:

Achieving a step-change in growth will require significant upfront investment in systems and management teams. Following a 25% annual growth trajectory, the sector would need over £3.5m to cover operating costs and nearly £8m to cover capital investments in the first three years before generating a surplus. The CDFIs are not unique in requiring such investment to scale up. Indeed, we have not come across a single example of scaling up of a microfinance institution that have not involved such investment. Even in international microfinance, large commercial players, such as Compartamos in Mexico, benefitted from substantial investment and grant funding from international development agencies in the start-up phase.

Need for new, patient investment models:

The current capital and funding models are inadequate and insufficient to support scaling up of the sector. The gross cumulative capital requirement to scale up is £205m and after income, current cash reserves and current long-term funding is £120m. The sector will need patient and appropriately priced capital to scale up. The premium associated with paying 10% versus 6% for funding is over £1.5m in the first four years, which would significantly reduce their capacity to grow and invest. Patient capital – provided over 10-15 years – would enable the CDFIs with breathing space to cover its cumulative deficit for the first three years, an important stumbling block for scaling up, and would strengthen their balance sheets. This, as well as a form of guarantee, could help leverage in external capital. Additionally, lessons from Europe and the US point to the need for a mechanism to compel or require private sector partners, especially banks, to lend to and invest in CDFIs. This can be in the form of a regulatory mechanism, requiring banks to fund support of customers at risk of customer detriment or use part of FCA levy, or a new social compact between banks, government and affordable credit providers.

Uneven performance across sector:

Performance across the sector is uneven. The data suggests that some providers outperform the rest of the sector on a recurring basis in terms of productivity, efficiency and sustainability. Greater loan sizes, greater scale and low total and per loan costs all positively contribute to a stronger financial performance. Financial modelling also suggests a consolidated sector would outperform the current sector. One provider is very nearly fully financially and operationally sustainable throughout the period with income from the lending activity.

Need for a clear sectoral narrative:

There is a lack of a clear, sectoral narrative concerning the financial and social dimension of the sector. On the financial side, the participating CDFIs use different measures and ways of presenting the business models, and portfolio characteristics, performance and arrears. This makes it difficult for potential investors to assess the risks and rewards of investing. On the social side, greater consistency in articulating and capturing target customer characteristics and outcomes would potentially enable making more of the USP of the CDFI sector in reaching the most excluded.

Risks and rewards of remote underwriting:

Moving to remote underwriting and delivery, especially online, automated lending, has the potential to significantly reduce costs at least over long term. Falls in delivery costs seemed greater than associated increases in customer acquisition costs. However, it does raise questions about target group. Consumers of online high cost credit have tended to consist of more male, younger customers on higher incomes versus the traditional base of customers (e.g. women, lone parents etc.). Customer data suggests that online borrowers are more likely to be homeowners and less likely to be unemployed. CDFI manager interviews indicate a higher proportion of younger, male consumers in work. There is potentially a risk of serving same group as or being perceived to serve customers that might be better served by other affordable credit providers, especially credit unions and new Fintech players targeting employees.

Great market uncertainty:

There appears to be uncertainty concerning the CDFI target market. The stakeholder and practitioner interviews, as well as publicly available evidence, points to increasingly difficult circumstances for CDFI target customers combined with tightening affordability requirement. CDFIs reported having to reject increasing number of repeat customers due to worsening of circumstances. Additionally, Universal Credit, which is likely to have a significant impact on affordability and debts, has yet to be fully rolled out. There is also uncertainty surrounding Brexit and any economic fallout.

Based on these observations, we would make the following recommendations:

1. Government provides initial investment to help sector scale up:

If the sector is to achieve significant scale to rival and displace commercial high cost providers, the CDFIs will need considerable upfront investment to cover investment in infrastructure, IT and data systems, and senior management structures. Examples from the Developing world, such as Compartamos in Mexico, suggest that even when MFIs have cost-effective operating models and viable business models, they need significant initial support to get off the ground.

- a. We recommend that investors including Governments, Fair4All Finance and others provide patient capital to CDFIs with an efficient delivery model, low cost base and viable growth strategy.
- b. We recommend that Government opens up Innovate UK funding to CDFIs.

2. Mechanisms to leverage greater private investment in the sector: The funding managed by Fair4All and current social investment will not be enough on its own to enable the sector to achieve a step change in growth. Indeed, our case study research from Europe and the US indicates that the private sector, especially banks, contribute with significant capital, technical assistance, volunteers and grant funding to MFIs. In countries where government and mainstream

financial institutions are engaged in supporting affordable credit, there is often a clearly defined role and purpose for MFIs in terms of target customers and customer outcomes. Banks are also compelled by regulation or a social compact to invest. Finally, there are risk sharing mechanisms, such as guarantees, to reduce the risk for the investor. There is evidence to suggest that risk-sharing mechanisms, such as guarantees, could be an effective mechanism for attracting new investors to the sector.

- a. We recommend that Fair4All develop clear, shared social outcome objectives that can inform a clear ask of private and public sector actors in terms of support for CDFIs. Fair4All is already developing a theory of change, which could inform this work.
- b. We recommend that Government agrees a new social compact with mainstream financial institutions and CDFIs detailing their responsibilities and contributions.
- c. We recommend that Fair4All and partners pilot a guarantee fund specifically for organisations that invest in the sector for the first time or organisations significantly expanding or improving the terms of their support (e.g. reduced rate, longer term etc.)
- d. We recommend that Government extends the Community Investment Tax Relief (CITR) scheme to personal lending CDFIs. Although it would likely have a modest impact on investment, at least in the short-term, it is a proven mechanism that would involve limited costs for CDFIs, investors and Government.

3. Consolidation or greater coordination among CDFIs: As the CDFIs move to serve customers through telephone or online channels, there is a greater case for M&As or at least greater coordination among the providers. This is because remote provision potentially brings the CDFIs into competition with each other, especially if they grow to the scale envisioned in this study. This risks the potential duplication of social and public investment, especially public funds. Furthermore, our modelling suggests a consolidated sector could potentially be more sustainable and efficient than the current sector. There are several areas for potential collaboration, including white label

solutions and shared technology platforms, shared call centres, joint procurement, common products, common label, agreeing geographical distribution of operation and shared delinquency management functions. The work on the European Code of Good Conduct for Microcredit Provision, which has involved developing pan-European standards for business lending MFIs, under the European Commission may be a good approach to this.

- a. We recommend that Government and investors encourage greater consolidation by collectively supporting only providers with cost-effective operating models and viable business models.
- b. We recommend that Government, investors and trade bodies encourage CDFIs to explore areas of collaboration.

4. Common reporting and benchmarking framework:

The CDFIs operate with different reporting standards, especially regarding arrears and write-off. This lack of standardisation makes it more difficult for potential investors to understand the sector, which was often pointed out by investors.

- a. We recommend that social investors, social investment funds, foundations and Government agree on a common reporting and benchmarking framework building on the work of Responsible Finance in connection with its industry survey. This framework should capture indicators pertaining to the social and financial dimension (see table opposite).
- b. We recommend that investors require all investees to sign a transparency compact to publicly report on this data.



Social dimension*

- Gender
- Employment status
- Ethnicity
- Housing tenure
- Household type
- High credit use
- Receipt means-tested benefits
- Take-up ancillary services

Financial dimension*

- Service & fee overview**
- Arrears***
- Cost per loan
- Mean/median loan amount
- income statement
- Balance sheet

*Broken down by delivery channel

**Including for ancillary services

*** This could involve using the definitions from the Bank of England credit union returns (3-6 months, 6-9 months, 9-12 months and more than 12 months in arrears)

5. Greater coordination among social investors:

The level of interest rates charged by social investors into CDFIs are considerable. This ultimately has to be passed on to the customer. There are several investment managers and funds overseeing a relatively small pot of funding. A greater level of coordination and cooperation across the social investment sector might contribute to reducing this cost. This could for example include having a central fund/relationship manager for CDFIs, which may be hosted by one organisation but whose costs are shared by the group. This may also take the form of a co-investment facility.

- a. We recommend that the social investors develop co-investment agreements to reduce costs and decrease lead-in time.

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Appendices

A. Detailed methodology

The team conducted a financial analysis of the historical performance and development of the participating CDFIs over the period covering 2013-2017. The analysis focused on the financial performance, assets and liabilities, and loan portfolio and growth.

Financial Performance		Indicators
<ul style="list-style-type: none"> Sustainability Efficiency Productivity 	<p>The sustainability of the CDFIs will be assessed through a dynamic analysis of the trend of their profitability results, of their efficiency and productivity levels, and their revenues and cost structure.</p>	<p>ROE; ROA; Net Interest Margin; Operational Self-sufficiency; Financial Self-sufficiency; Portfolio Yield; Other Products' Yield; Financial income ratio</p> <p>Financial expense ratio; Provision Expense Ratio; Profit Margin; Portfolio to Assets Ratio; Average Outstanding Loan Amount; Avg. Disbursed Loan on p.c. GDP; Staff Allocation Ratio; Loan Officer Productivity; Staff Productivity; Operating Expenses Ratio; Cost per Borrower</p>
Solvency and assets and liabilities management		Indicators
<ul style="list-style-type: none"> Solvency Funding Assets and liabilities management 	<p>The capital adequacy and its capacity to absorb losses and support growth will be assessed, together with the capitalization strategy.</p> <p>The diversification of funding sources and CDFIs' refinancing capacity will also be assessed here. The exposure to market and liquidity risks will be included in the analysis.</p>	<p>Cost of Funds Ratio; Current Ratio; Liquidity over Total Assets Ratio; Cash Ratio; FX Net Open Position as % Equity; Debt to Equity Ratio; Equity to Asset Ratio; Capital Adequacy Ratio (MFR); Capital Adequacy Ratio (Regulatory)</p>
Loan portfolio growth and quality		Indicators
<ul style="list-style-type: none"> Loan portfolio concentration Loan portfolio quality Credit risk coverage 	<p>The loan portfolio evolution will be analysed, both in terms of growth and quality.</p> <p>The exposure of the CDFIs to credit risk will be assessed by analysing: the trends in the assets structure and the evolution and quality of loan portfolio, highlighting any potential concentrations;</p> <p>The adequacy of the credit risk coverage will also be analysed.</p>	<p>Loan portfolio growth rate</p> <p>Clients growth rate</p> <p>Client retention/dropout rate</p> <p>Portfolio at Risk 30 (PAR 30)</p> <p>Portfolio at Risk 90 (PAR 90)</p> <p>Write-off Ratio</p> <p>Restructured Loans Ratio</p> <p>Average Credit Risk Ratio</p> <p>Loan Loss Reserve Ratio</p> <p>Risk Coverage Ratio (PAR 30)</p>

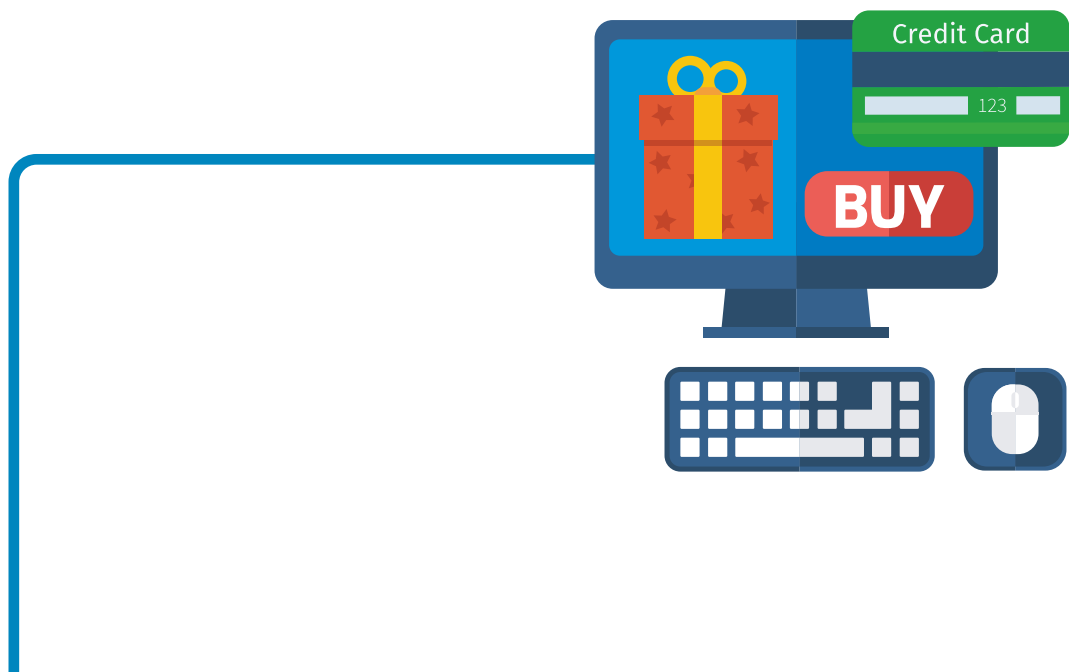
The achievements of the participating CDFIs were contextualised through an institutional and financial history of the participating CDFIs covering:

- Philosophy, aims/vision;
 - Origins (e.g. original aims/vision, partners);
 - Institutional and legal set-up (including how this may have evolved over time);
 - Number/nature of partnerships (e.g. referrals, technology/skill transfer, funding);
 - Delivery channels (i.e. branch, partner premises, online, phone);
- Product offering (delivery of other financial and non-financial services to financially excluded customers, such as business and housing loans);
 - Diversification (delivering products outside of financially excluded customers, such as back-office services, consultancy, delivering public contracts and trading)
 - Governance structures (e.g. evolving board role and composition etc.)
 - Professionalization (e.g. use of volunteers, formalisation of processes etc.);



B. List of stakeholders consulted

- Alistair Grimes, then Chair, Responsible Finance
- Jennifer Tankard, then Chief Executive, Responsible Finance
- Charlotte Matthews, Head Consumer Credit & EU Retail Unit, HMT
- Annika Tverin, National Lottery Community Fund
- Niall Alexander, Carnegie UK Trust
- Tom Lake, Fair4All Finance
- Rebecca McCartney, Big Society Capital
- Alastair Davis, Chief Executive, Social Investment Scotland
- Robert Hewitt, Senior Policy Advisor for the Inclusive Economy Unit
- James Broderick, chair of the Taskforce on Social Impact Investment
- Rowena Young, then executive director Just Finance Foundation
- Jonathan Flory, Social Finance
- Trevor Watson, Chair Five Lamps trading company
- John Tackaberry, Chair Street UK
- Chris Smyth, Chief Executive Leeds Credit Union
- James Berry, CEO Bristol Credit Union
- Steven Henderson, Chair Scotcash
- Angela Clements, Chief Executive Fair For You
- Nigel Draper, Chair Moneyline
- Graem Oram, then CEO Five Lamps
- Dhiren Master, Salary Finance
- Michael Royce, Money and Pensions Service
- Sacha Romanovitch, Fair4All Finance
- Jake Eliot, Money and Pensions Service
- James Salmon, Big Issue Invest
- Gillian Dickson, Esmée Fairbairn Foundation



C. Case studies

Blockchain

- Pioneering technology initially developed as part of Bitcoin
- Technology based on decentralised system for transferring and holding data and assets without third party verification
- Currently least developed but seen as technology with potentially greatest impact

Relevance

- Could potentially significantly reduce transaction costs, especially for small amounts
- Financial service providers are making significant investment in area

Key data on Blockchain

Year invented: 2008

Applications	Cryptocurrencies Smart contracts	Micropayments Real-time payments
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Undeveloped but potentially transformative technology

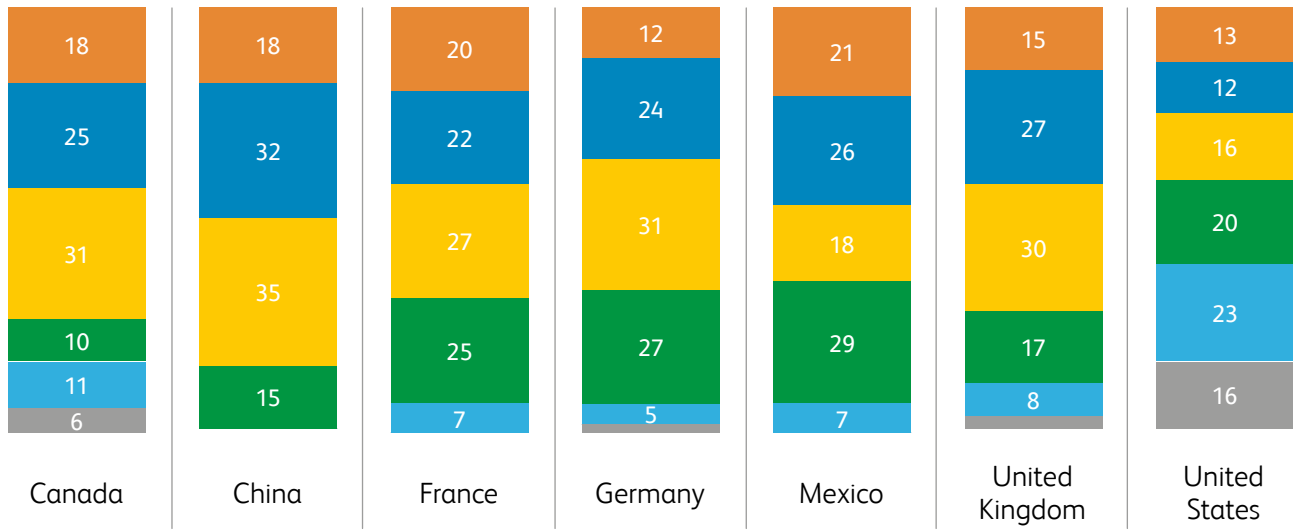
Widely hailed as among the greatest recent technological innovations, blockchain uses a peer-to-peer network which rids financial transactions of a third party, such as banks, for mediation (Ikeda and Hamid, 2018). In a blockchain, blocks are ordered block by block with each block referencing to the previous one and its fingerprint, and new ones are created by using algorithms, which ensures the consistency and validity. As well as a block's fingerprint, each block contains content relating to transactions or data, as well as the technical data concerning the block.

Because anybody can check any proposed transaction against the blockchain, this approach removes the need for a central authority and thus for participants to have confidence in the integrity of any single entity. Blockchain offers a range of benefits to organisations because they are: distributed widely in a precisely controlled fashion; highly efficient; robust in rejecting unauthorised changes; characterised by high level of privacy and confidentiality; secure for data; enabling significant reduction of operational costs; and highly transparent.

Companies are investing significantly in blockchain because of its perceived potential. The chart below shows the estimated level of investment of companies (surveyed by Deloitte in 2018) in 2019.

Approximate blockchain investent organisations will make in the next calendar year

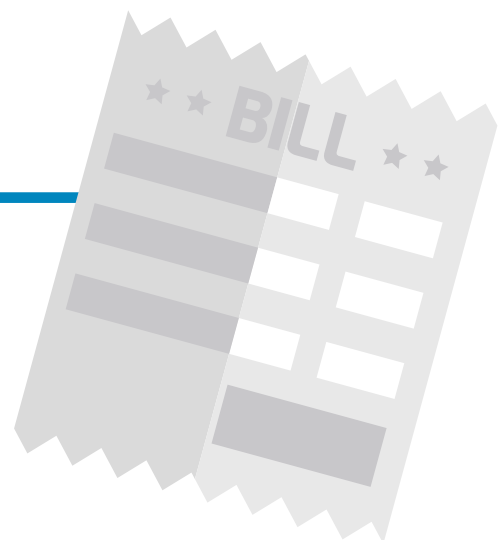
■ No investment
 ■ <\$500,000
 ■ \$500,000 to <\$1M
 ■ \$1M to <\$5M
 ■ \$5M to <\$10M
 ■ >\$10M



Overall, of the companies who took part in Deloitte’s global Blockchain survey, nearly 40% of respondents said they plan to invest over US\$5m over the next year. In the UK, over 40% planned to invest more than US\$5m and over 60% more than US\$1m.

Within financial services, blockchain is seen as having the potential to dramatically reduce the cost of transactions (Iansiti and Lakhani, 2017). For example, Circle is a start-up that provides a platform powered by Blockchain to receive and send money globally without any added fee (Ikeda

and Hamid, 2018). Blockchain is also potentially beneficial for customers as well as institutions. Blockchain in tandem with other technologies can streamline this process by building shared digital identity storage that any finance institution can use. This is beneficial for institutions because it can assist in the verification of their customers, and it is beneficial for customers, because the security guarantees data will be protected (Ikeda and Hamid, 2018). Despite the potential benefits and the considerable investment in blockchain, the technology is still in its infancy and there are few examples of its implementation.



Big Data

- Analysis and use of data of scale beyond capacity traditional data-processing capacity
- Involves use of non-traditional data sources captured from increasing range devices
- Widely used in financial services industry but requires significant investment and analytical capacity

Relevance

- Potential to increase speed and quality of lending decisions
- Use of non-traditional data sources may enable automated lending to consumers with thin credit files

Key data on Big Data

Year invented: N/A

Applications	Fraud detection Underwriting	Customer acquisition Market intelligence
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Widely used but requires significant investment, skills and capacity

Big Data can be defined as “datasets that are too large for traditional data-processing systems and that therefore require new technologies” (Provost and Fawcett, 2013 cf. Power, 2014). It is different from conventional datasets because it involves greater volume, variety and velocity, often referred to as the three Vs (see table on p. 73).

Big Data is linked to the proliferation of data collected from various devices, including smartphones, wearable devices and other items able to collect and exchange data (i.e. Internet of things). These data sources contain a high number of data points (rather than a snapshot) and can be captured and analysed in real time. The data from these sources are typically combined with more traditional data sources (e.g. credit history, land registry etc.) to create new datasets. Given the importance of data in financial services, it is not surprising that Big Data is widely used by the sector, including:

- **Fraud detection:** The immediacy and scale of Big Data is used by many financial firms to detect and prevent fraud. Data on past purchasing behaviour, location and IP address

detection to is widely used to assess fraud risk. For example, the online lender Oportun uses non-traditional data, such as age of email addresses and telephone history, to identify fraudulent loan applications.

- **Customer service:** Financial firms are increasingly using Big Data to improve the efficiency and quality of their customer service. For example, CapitalOne use historical call data and transactional data to predict the reasons for customer calls to smooth out the customer service process.
- **Lending decisions:** Big Data can potentially reduce the risk associated with lending to consumers with thin or no credit files. For example, the US online lender Avant, which specialises in near- or subprime customers, combines credit reference data with various other non-traditional sources to create a dataset consisting of over 800 variables.

Globally, the financial services industry invested US\$9bn in Big Data in 2018 (Lux and Delepine, 2019) because of its potential advantages in terms of greater speed and accuracy in predicting consumer behaviour. In turn, this could enable more targeted and cost-effective marketing (reducing customer acquisition costs), reduced loan

The three Vs of Big Data

Data volume	<p>Data volume increases every day at a rate of 2.5 exabytes, or 2.5 billion gigabytes</p> <ul style="list-style-type: none"> • The volume of Wal-Mart's hourly transaction data is 67 times that of what is contained in the Library of Congress • Smart meters in China alone will generate 13.3 trillion readings in 2020 • Twelve terabytes of tweets are created each day
Data variety	<p>Content comes from more diverse sources and formats</p> <ul style="list-style-type: none"> • Data can come from smartphones, sensors, RFIDs, GPS devices, transactions, and more • Data can be in the form of databases, video, speech, social-media posts, links, tweets, text messages, and more
Data velocity	<p>Faster analytics unlock value and reduce risk</p> <ul style="list-style-type: none"> • Organisations are analysing millions of trading events per day to identify securities fraud • Organisations are analysing hundreds of video feeds in real time to identify security threats

delinquency rates, lower attrition rates and greater efficiency of underwriting. Big Data, some argue, can also potentially enable greater customer retention by providing offers to customers at a time they are predicted to be looking for finance.

However, there are numerous challenges with Big Data. There is the potential for the analysis of Big Data to exclude certain groups from accessing financial services, as well as creating an unequal divide in data sharing. Those who have worse credit scores and rely on analysis of other data have to give up more of their privacy than those

with better credit scores. From the point of view of financial service providers, smaller community lenders are potentially at a disadvantage in using Big Data. They may lack the financial resources and analytical skills to access and analyse datasets at such a scale. Improved fraud detection among larger financial firms may make smaller firms a soft target for fraudsters (Lux and Delepine, 2019). Similarly, smaller lenders may be left with disproportionately more high-risk customers as larger lenders (subprime or mainstream) use their improved credit analytical capabilities to capture lower-risk consumers.



Artificial Intelligence

- Technologies capable of autonomous learning
- Often used to replace human involvement in customer interactions, identifying patterns and routine business operations
- Widely used in financial services industry

Relevance

- Can reduce the need for human involvement in customer interaction
- Potential to improve sustainability of provision of personalised advice to consumers on lower incomes

Key data on Artificial Intelligence

Year invented: N/A

Applications	Investment advice Fraud detection	Regulatory compliance Customer interaction
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Potential to reduce cost of personalised advice and customer interaction

As technology rapidly advances and becomes cheaper to implement, Artificial Intelligence (AI) is seen as having a role to play in financial services. AI can broadly be summed up as various technologies that have adaptive and predictive power, and can demonstrate autonomous learning. This includes machine learning – computer programmes that can learn and improve from experience without being programmed – and robotic process automation – robots performing routine business processes by following simple decision-making rules. Adaptivity, prediction and autonomous learning enable machines to recognise patterns, anticipate future events, make decisions and communicate with other people (Deloitte, 2018).

There is significant investment in AI in the UK and globally. UK AI companies received over £800m in investment in the first six months of 2019 already surpassing the amount invested during the whole of 2018 and a six-fold increase on 2014. According to the International Data Corporation (cf. Seeley, 2019), the banking sector is set to spend around US\$5bn on AI systems globally in 2019 alone.

Within financial services, AI can have a range of applications (see table below).

There are three key potential benefits of AI systems for financial services:

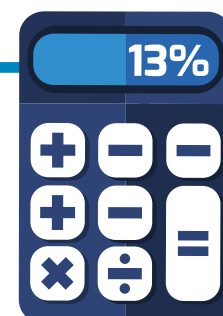
- **Reduce costs of personalised advice:** Providing advice through robo-advisors or machines can potentially significantly cut costs in advice provision. As noted above, this has enabled asset management firms to provide advice to customers it would not be able to provide through human advisors. A potential application in the CDFI sector would be to provide budgeting support and debt advice to applicants using AI, which is often too costly for CDFIs to provide.
- **Reduce costs routine interactions and operations:** AI can potentially significantly reduce costs associated with routine interactions with customers (e.g. answering questions, providing balances etc.) by replacing human staff interaction. This is already widespread in financial services already.

Use	Description	Benefits
Investment	Robo-advisors powered by AI have potential to automate asset management & can eliminate financial advisors from investing process.	Lowers cost asset management Potentially enables access to advice for ignored consumers Eliminates human error & conflict of interest Ensure regulatory compliance.
Customer engagement	Through Big Data & machine learning, AI chat bots can help customers with issues & applications, & make product recommendations	Attract millennials & those who prefer less human interaction Increases engagement as less embarrassment & fear judgement Can tailor recommendations. Can integrate & therefore operate through social media.
Fraud detection & risk management	Predict fraud based on analysis of patterns	Helps card providers to only replace cards likely to experience fraudulent activity Prevent customers from closing accounts, strongly correlated with number of times cards replaced.

- **Detect patterns not visible to human eye:** Through machine learning, enabling autonomous learning, AI can identify patterns not visible for human analysts. This can improve fraud detection and replace or supplement human intervention.

Although potentially transformative for the financial services industry, there are some important drawbacks of AI. Privacy concern and cybersecurity are very important in these discussions about potential risks linked to future use of artificial intelligence and machine learning. AI is potentially vulnerable to software crashes,

cyberattacks and system failure, affecting quality of service provision. The data used to make advice and recommendations more relevant can also be used for purposes that could be considered an invasion of a person's privacy. On one hand, users appreciate the advantages of having one-on-one experiences with companies. On the other hand, analytics empowers businesses to collect and use consumer data in ways that were unimaginable just a few years ago. New data protection laws, such as GDPR, limit the access, use and storage of data, making partnerships with tech companies harder to manage.



Adie (France)

- Pioneering French Microfinance Institution (MFI) founded in 1989
- Provides business and professional loans, insurance and BDS to social excluded groups
- Among largest and most influential MFIs in European microfinance, serving as a model for MFIs elsewhere in Europe (MikroStart in Belgium and Afi in Greece)

Relevance

- Achieved more than tenfold growth in lending in less than 10 years using public policy logic
- Relied on partnerships with banks and a supportive government framework

Key data on Adie

Year founded	1989	Loans disbursed	16,089
Country	France	Active clients	51,026
Branches	132	OLP	€134m
Products	Business loans Quasi equity Insurance BDS	Employees Volunteers	516 1,391

Data from 2017

Expansion through public policy logic

The chart on p.77 shows the growth in the number of loans (left axis) and the outstanding loan portfolio (right axis) since 1996.

Adie has grown significantly over the past decades. Between 1998 and 2008, alone, the MFI experienced more than eightfold growth from 1,600 to nearly 13,000 loans, close to the target for the personal lending CDFI sector. Adie has not achieved this through pursuing operational sustainability. Instead the organisation grown due to two factors:

- **Supportive government framework:** Adie's growth has been underpinned by a supportive government framework. In 2001, in response to advocacy work by its charismatic founder Maria Nowak, the banking law was modified to allow not-for-profit organisations to lend to unemployed and welfare benefit recipients for business creation or professional development.

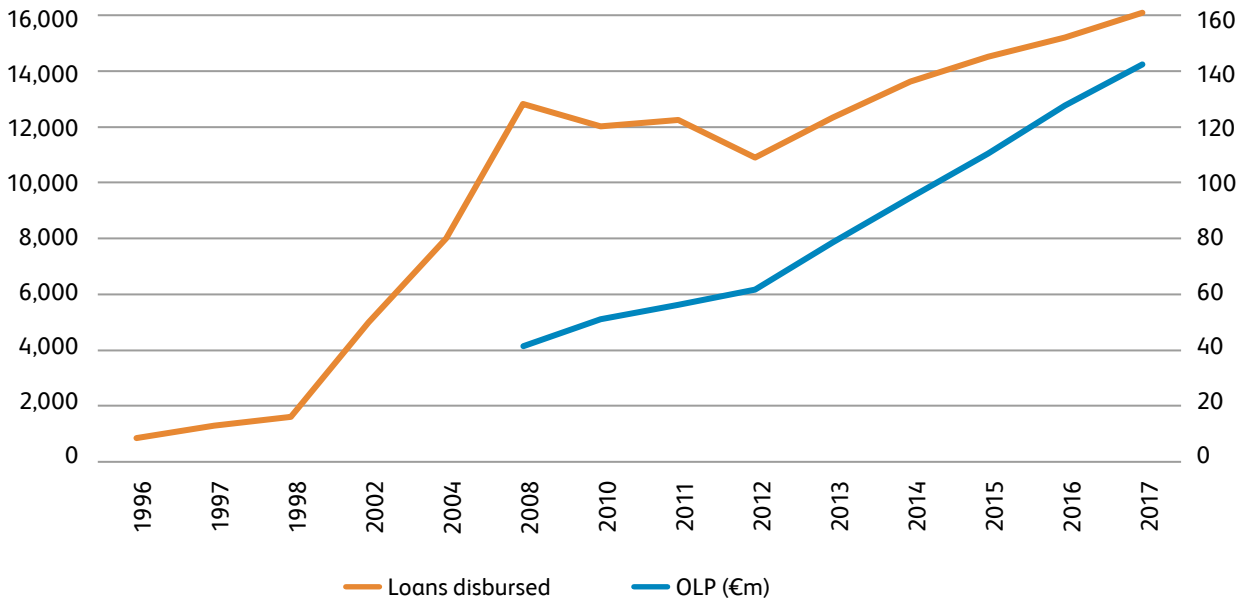
Prior to this, Adie had to lend in partnership with banks. Additionally, the government supports Adie through a public guarantee fund, tax relief and grant funding. In particular, the government has provided grant funding to support its' headquarter operations.

- **Partnerships with banks:** The banks have been important players in supporting Adie to grow. They were supportive of Adie's advocacy efforts to change the banking law. The banks are an important source of loan capital for the MFI. As of December 2014, the outstanding loans from partnering banks amounted to nearly €90m. Additionally, partner banks provide grants, soft loans and volunteers.¹

Apart from capital for on-lending, there have been three ingredients that have been essential to support the scaling up of Adie: risk sharing mechanisms (first loss guarantees), grant funding

¹ Volunteers agree to work a minimum of 32 days a year for Adie

Growth Adie 1996-2017



to support growth and investment (e.g. to open up new branches) and a supportive regulatory framework (e.g. tax relief, ability to lend directly). In turn, these elements are underpinned by a mutual understanding of the roles and expectations of the state, the banks and Adie. There is a clearly defined market that banks and other financial institutions are unable to serve in a commercially viable manner, largely due to the interest rate cap.² This segment consists of socially excluded groups who need access to finance to access self-employment and employment opportunities. Adie can serve this market in a cost effective, but not financially sustainable manner. Hence, the government provides a supportive policy and regulatory environment as well as some grant funding to enable Adie to operate in the market. Additionally, banks provide extensive support in the form of loans, grants, risk sharing and technical assistance. In return, Adie passes customers on to banks for subsequent loans and services.

² Interest rates for consumer loans are capped at 20%

Transferability of lessons

Although there are lessons to be learnt from Adie, there are factors limiting the transferability to UK personal lending CDFIs, namely:

- Adie only provides loans for the purposes of setting up your own business or accessing employment, the support of which is traditionally stronger among policy-makers than consumption.
- Adie operates in a space where there is a clear market failure, created in part by the interest cap, and government and the financial sector recognise this. In the UK, there is a sector that is able to serve this market (albeit at a higher price).



Compartamos (Mexico)

- Large Mexican Microfinance Institution (MFI) founded in 1990
- Provides personal and home improvement loans, insurance and savings predominantly to female microentrepreneurs
- Has displayed remarkably high growth rates since being founded

Relevance

- Grew from 65,000 to 1m clients in less than 10 years through institutional transformation
- Example of scaling up through commercial logic, though has been accused of exploiting clients to provide financial return to investors

Key data on Compartamos

Year founded	1990	Active clients	2.5m
Country	Mexico	OLP	£850m
Branches	586	Employees	16,133
Products	Personal loans Home improvement	Insurance Savings	

Data from 2017

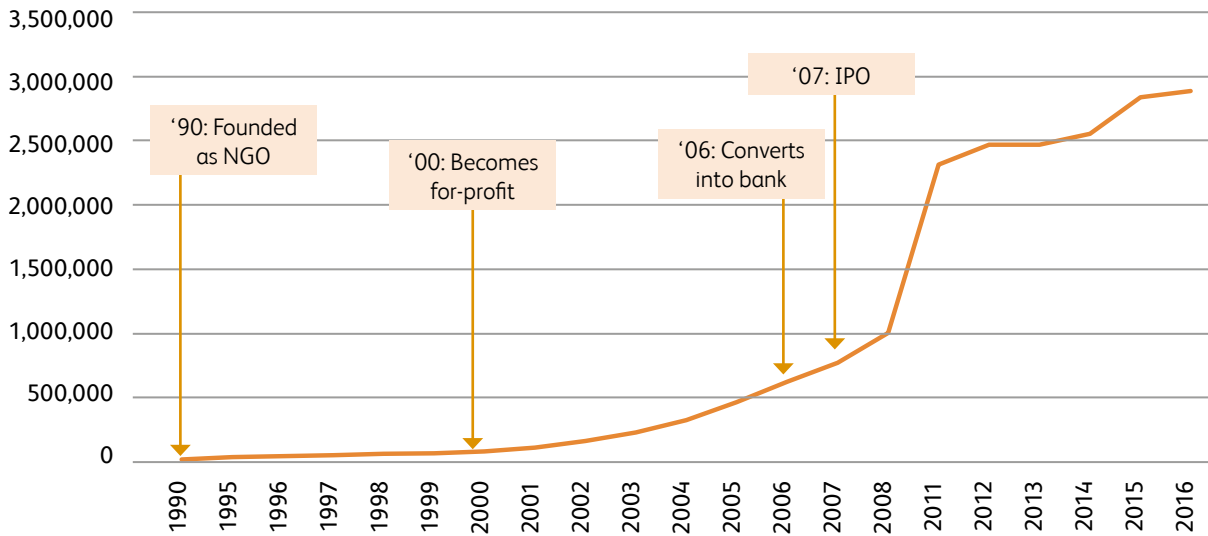
Overcoming growth constraints through institutional transformation

The chart below shows the growth in the number of active borrowers of Compartamos since 1995. It also highlights the institutional transformations it undertook over the period.

As an NGO, Compartamos made considerable progress in scaling up. In 1995, within five years of being set up, the organisation reached over 17,000 active clients. In the subsequent five year, the MFI grew to reach over 64,000 active clients. During this period, Compartamos received significant support – over US\$6m in technical assistance, grants and subordinated debt – from international donors and investors to scale up. In 1997, Compartamos reached financial self-sufficiency, being able to cover operating and financing costs with income generated from the loan portfolio. The MFI largely achieved this through keeping operating costs low, relative to other institutions, and by charging comparatively higher interest rates. However, the MFI decided to undergo two institutional transformations to overcome constraints around product offering and financing:

- **Becoming for-profit:** In the late 1990s, Compartamos concluded that its status as NGO would constrain its future growth. NGOs were restricted in their ability to access commercial finance, especially capital markets (e.g. shares, equity). Hence the MFI became a for-profit entity in 2000. This enabled it to grow sevenfold within five years through two bond issues. Compartamos nearly doubled its annual growth rate from 24% (1996-00) to 46% (2000-06).
- **Converting into bank:** In 2006, the MFI became a bank, allowing it to offer a wider range of services (e.g. insurance, savings), raise capital through deposits and put it in a stronger position to access finance through capital markets. In 2007, Compartamos raised capital through a controversial IPO. Shareholders, including international charitable investors and private investors, sold 29.9% of Compartamos' stock at 12 times their book value to new investors providing existing shareholders with net profits of US\$460m. This was controversial because of the level of profits, the nature of investors (charitable investors) and the level of

Compartamos active clients 1995-2017



interest rates, which were higher than many other MFIs. The MFI grew rapidly in the years following the IPO and converting into a bank. It nearly doubled the number of clients between 2006 and 2008, and again between 2008 and 2011.

Compartamos, then, achieved a step change in growth from a small, subsidy-dependent organisation to a large-scale and major player nationally and internationally. With initial support from international charitable funders, the MFI developed a cost-effective pricing and delivery model able to generate returns to attract private investors. To be able to capitalise on this, the organisation underwent a series of institutional transformations. Although highly successful in scaling up, the route that Compartamos took, especially the IPO, was highly controversial. The MFI has been accused of charging excessively high interest rates of poor people to generate profits for investors.

Transferability of lessons

Although an interesting case of upscaling relying on a commercial logic, there are some important limitations to the transferability of the lessons to the UK personal lending context:

- There is a much larger market for MFIs in Mexico than in the UK, as the country is poorer and financial markets are less developed.
- Possibly due to restricted client access to other forms of finance, Compartamos' arrears rates are considerably lower than for UK CDFIs (around 3%).
- There is already a developed commercial high cost credit sector in the UK catering to this market segment.



PerMicro (Italy)

- Leading Italian Microfinance Institution (MFI) founded in 2007
- Provides business and personal loans, insurance and BDS to social excluded groups
- Only licensed financial institution serving microfinance market

Relevance

- Has been achieving 30-40% annual growth
- Managed to pursue expansion into new areas through partnerships with banks keeping operating costs low

Key data on PerMicro

Year founded	2007	Loans disbursed	7,104*
Country	Italy	Active clients	7,093*
Branches	15*	OLP	€40m**
Products	Business loans Personal loans Loan insurance	Employees	62**
		Volunteers	60**

*Data from 2015; **Data from 2018

Expansion through public policy logic

The chart on page 81 shows the growth in the number of loans (left axis) and the outstanding loan portfolio (right axis) between 2013 and 2015.³

The MFI achieved 30-40% annual growth in lending over this period. Additionally, PerMicro reached nearly 100% operational sustainability and 75% financial sustainability in 2015 despite operating under interest rate restrictions. Much of this is down to the partnership arrangements it has with several banks.

PerMicro has a partnership model with the banking system in Italy and positions itself as a step towards bankability by serving “unbankable” consumers to help them become bank customers. PerMicro borrows from various banks in order to fund and disburse loans to clients. It has active,

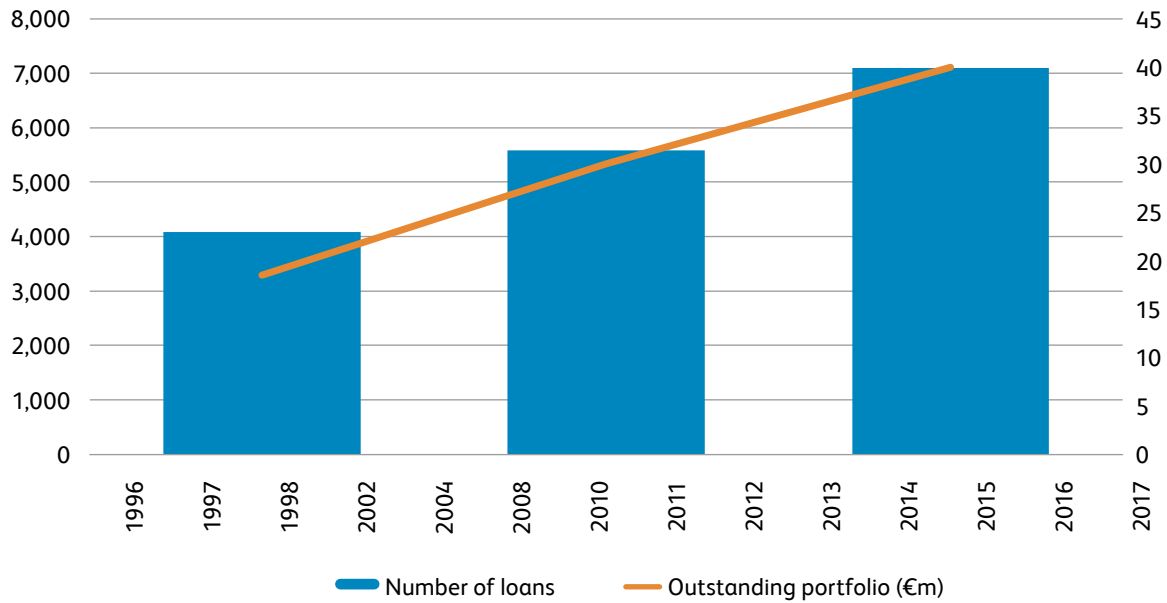
voluntary partnerships with Monte dei Paschi di Siena (from 2007), Banca Regionale Europea (from 2009), BNL - Gruppo BNP Paribas (from 2011), Banca Prossima (from 2013) and CEB (from 2014). PerMicro needs bank loans to fund its operations and to disburse microloans. This strategy allows the MFI to increase the number of clients. PerMicro engages the following forms of partnerships:

- borrowing from banks,
- having banks participate in their equity and
- sharing front-office, back-office, branches, ATMs and IT with banks (Cozarenco 2015).

Sharing offices with BNL allows PerMicro to reduce its operational costs, but the bank partnership model they use is still expensive for PerMicro as the banks earn high interest on their loans (Cozarenco 2015). Working in partnerships with banks provides:

3 Publicly available data on PerMicro has been difficult to come by

Growth PerMicro 2013-15



- funding (not determinate cost),
- credibility (to third parties),
- and operational/commercial support

Having a bank providing equity allows the MFI to increase its client base and improve its overall performance- the model, though expensive, is sustainable and efficient. Sharing office space with bank branches greatly reduces operating costs for PerMicro and allows them to expand to new regions more easily as a result.

For example, in 2012, BNL bought shares of PerMicro and opened a creditline in favour of PerMicro. Further, PerMicro's headquarters and five branches are hosted in BNL offices across Italy (Cozarenco, 2015). They support PerMicro in their selection of funding instruments. BNL offers PerMicro's products to their own clients, whilst PerMicro offer BNL based products to clients who are both interested and suitable. The partnership also led to the formation of the Associazione PerMicroLab Onlus. This is an initiative where retired executives mentor microentrepreneurs

(Cozarenco, 2015). They share web marketing and joint communication, and many BNL retirees are involved in the activities of PerMicroLab. In 2014, of the 2,913 microcredits disbursed by PerMicro, 592 (or 20.3%) were sourced from BNL (Cozarenco, 2015).

Transferability of lessons

Although there are lessons to be learnt from PerMicro, there are factors limiting the transferability to UK personal lending CDFIs, namely:

- PerMicro operates in a space where there is a clear market failure, created in part by the interest cap, and government and the financial sector recognise this. In the UK, there is a sector that is able to serve this market (albeit at a higher price).

Qredits (Netherlands)

- Pioneering Netherlands Microfinance Institution (MFI) founded in 2009
- Provides mortgage, subordinate and overdraft facilities to start-ups and SMEs
- Among largest and most influential MFIs in European microfinance

Relevance

- Achieved eightfold growth in lending seven years through a branchless, technology platform
- Relied on partnerships with banks and government support

Key data on Qredits

Year founded	2009	Loans disbursed	2,329
Country	Netherlands	Active clients	4,120
Branches	1	OLP	€110m
Products	Microcredit SME loan Mortgage Flexible Subordinate loan	Employees	66
		Volunteers	600

Data from 2017

Expansion through public policy logic

The chart on page 83 shows the growth in the number of microloans (blue line), SME loans (orange) and total (green) issued by Qredits since it was founded in 2009.

Qredits has grown six-fold since being set up in 2009 with an annual growth rate of 27%. Over the same period, the loan portfolio grew eightfold. The MFI reached operational sustainability in 2015 and a financial sustainability ratio of nearly 100% in 2015.

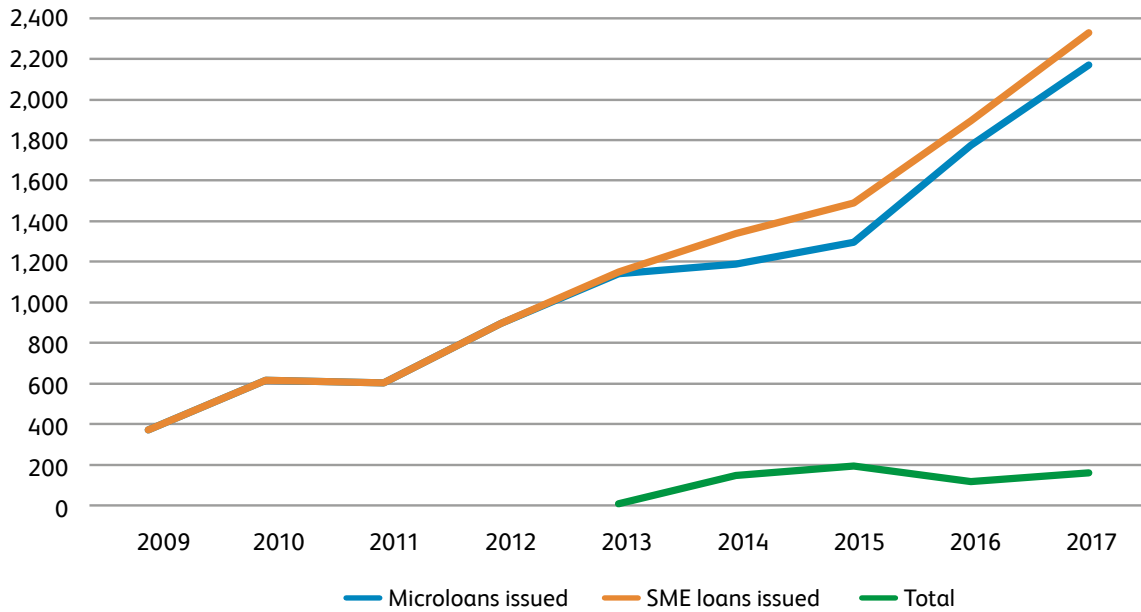
There are several factors that may have contributed to the growth of Qredits:

- **Close links with banks:** Qredits works in close partnership with banks. Banks refer unsuccessful applicants to Qredits, co-finance larger business loans, provide funding and sit on its board. Qredits coordinate and agree with

banks on lending limits and provides training of bank call centre staff to support effective referrals. Three banks also contributed a total of €1.2m in set-up funding for Qredits.

- **Technology-based delivery model:** The MFI operates with a branchless model, in which loan officers conduct field visits to applicants. There is an online application process which reduces the number of applicants. Some loans are also approved online. In addition, Qredits draws on a large group of volunteer mentors to support customers and applicants in developing their business plans.
- **Support by government:** Although Qredits today is financially sustainable, the Dutch government played an important role in supporting the set-up of the MFI. It provided €0.4m in initial operational funding as well as a subordinated loan of €15m. This enabled Qredits to grow and access other forms of funding.

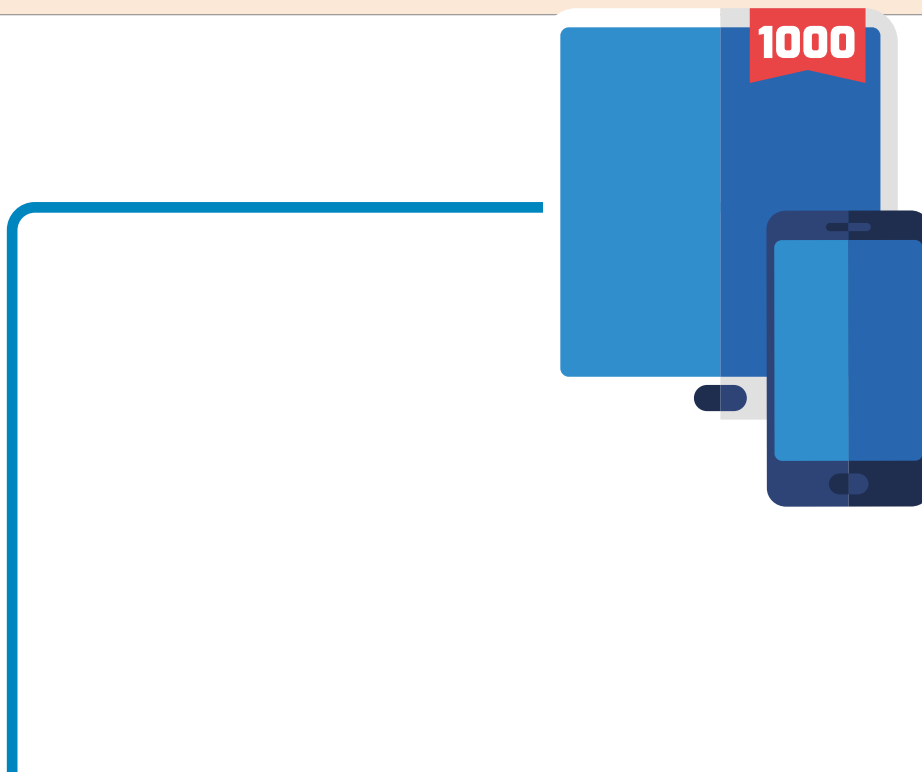
Loans issued by Qredits (2009-17)



Transferability of lessons

Although there are lessons to be learnt from Qredits, there are factors limiting the transferability to UK personal lending CDFIs, namely:

- Qredits only provides business loans, the support of which is traditionally stronger among policy-makers than consumption.
- Qredits operates in a space where there is a clear market failure, created in part by the interest cap, and government and the financial sector recognise this. In the UK, there is a sector that is able to serve this market (albeit at a higher price).
- Although we have not analysed the determinants of sustainability of Qredits, clearly being able to offer higher ticket loans (up to €250,000) will benefit the MFI through greater interest income per loan to cover underwriting costs.



Community Reinvestment Act (CRA) (USA)

- Act designed to discourage redlining and encourage banks to lend in all communities
- Banks receive CRA rating, which may affect ability to engage in M&As, open branches or expand into other states
- Can fulfil CRA obligations through supporting and investing in CDFIs

Relevance

- Much-discussed regulation incentivising banks to support CDFIs
- Attributed with significant increase in bank funding of CDFIs from \$12.7m to \$1.7bn in 20 years

Key data on CRA

Year introduced	1977	Country	USA
CRA tests	Lending test Service test Investment test ⁴	Regulatory bodies	Office of Comptroller Federal Reserve FDIC

FDIC = Federal Deposit Insurance Corporation

CRA important in scaling up US CDFI sector

In 1992, the Clinton administration made the enforcement of the CRA stricter and made CDFI expansion a key objective. Three years later CRA regulation recognised CDFIs as qualifying investments and borrowers facilitating investment in the sector. The sector expanded considerably over this period. According to data from the largest CDFI trade body (Opportunity Finance Network), borrowing to US CDFIs grew from US\$140m in 1994 to US\$1.7bn in 2013. The chart below shows the evolution of the average proportion of that borrowing by source.

The proportion of funds held by CDFIs from individuals and religious foundations has decreased significantly between 1994 and 2013. Conversely, the proportion of borrowed funds from banks increased substantially in the same period. In absolute terms, the amount received from banks increased from US\$12.7m in 1994 to US\$1.7bn in

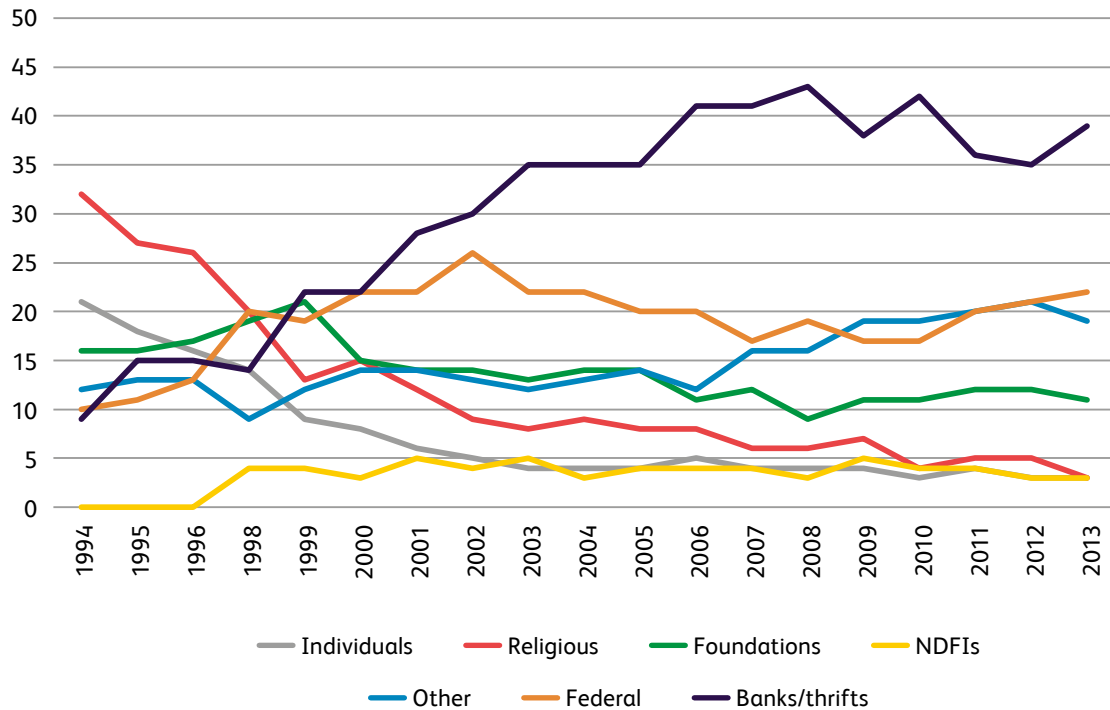
2013. This has to a large extent been attributed to the changes in CRA in 1995. Between 1977 and 2001, financial institutions under CRA entered over 370 agreements with CDFIs of a value of US\$1tn, 98% of which were made after 1992 (Pinsky, 2001).

Federal funding also increased, especially from 1994 to 2002. This is because of the establishment of the CDFI Fund, a Federal government fund providing loans, grants and capital to US CDFIs. In addition to encouraging banks to invest in and support CDFIs, the Act has also been attributed with enabling the sector to leverage other funding. Having the regular support from the banks makes CDFIs look more appealing to private and public funders (Seidman et al, 2017) and therefore helps them to find support elsewhere.

The CRA has contributed to the expansion of the CDFI sector by providing a regulatory obligation for banks to serve all communities and recognising the CDFI sector as a means to fulfilling CRA requirements.

⁴ These tests examine: institution's provision of mortgage, small business and community development loans (lending test); its provision of retail banking services; and investment in organisations conducting work in low- and moderate-income communities

Average source of borrowed funds for US CDFIs 1994-2013 (%)



Transferability of lessons

There are lessons to be learnt from CITER. However, there are factors limiting the transferability to personal lending CDFIs, including:

- **Timing and context:** The context in which the CRA was introduced is rooted in civil rights movement; history of segregation and on the back of evidence of redlining based on race. It was also designed for a market with many small, regional banks and at the time of branch-based expansion. None of this can be said to apply to the UK today.
- **Regulatory culture:** US regulatory authorities have historically been more prone to intervening in financial markets than is the case in the UK.
- **Real estate lending:** Mortgage or real estate lending has been a major part of the expansion of the US CDFI sector. Housing finance lends itself to scaling up in that it is secured and comparatively lower risk. However, housing loans have for various reasons been negligible in the UK CDFI sector.

CREDIT



Community Investment Tax Relief

- Tax relief scheme introduced in 2002 to encourage private investment in under-invested communities
- Enables investor to invest in accredited CDFI to reduce income or corporation tax liability
- Funding on-lent to support enterprise lending to disadvantaged end-beneficiaries

Relevance

- Established mechanism to incentivise private investment in UK CDFI sector
- Provides potential model for personal lending tax relief

Key data on CITR

Year introduced	2002	Accredited CDFIs	34
Loan limit		Departments	
For-profit	£100,000	Policy lead	HM Treasury
Not-for-profit	£250,000	Accreditation	Office of CIC Regulator
Investment limit		Investment raised	
Retail	£10m	Total	£145m
Wholesale	£20m	2017	£16m

Fulfil objective but limited impact CDFI sector

CITR works as follows:

- **Investors:** Individual and corporate investors receive income or corporate tax relief worth 25% of the money invested and spread over five years. They can invest in accredited CDFIs through bank deposits⁵ (account for two thirds of investment under CITR), shares (account for less than 5%) or via a loan (most common mechanism for non-bank accredited CDFIs).
- **Accredited CDFIs:** To be eligible to receive investment under CITR, the organisation needs to be accredited by the Office of the CIC Regulator (under Department for Business, Environment and Industrial Strategy) as a wholesale or retail CDFI. A wholesale CDFI can raise up to £20m to lend to other CDFIs, whilst a retail CDFI can raise up to £10m to lend directly to businesses. The accredited CDFIs

have to onward lend 75% of the investment (i.e. has to matched with new lending).

- **End beneficiaries:** The end beneficiaries can receive loans of up to £250,000 (non-profit enterprises) or £100,000 (for-profit). They have to be SMEs in disadvantaged community. This is defined as enterprises located in the 35% most deprived areas or owned and operated by, or intended to serve, individuals recognised as being disadvantaged on account of their characteristics (e.g. gender, ethnicity etc.).

Recent research suggests that the scheme is viewed favourably within government.⁶ As the only relief with a clear policy focus to provide finance for businesses based in or supporting disadvantaged communities, the view of HMT remains that the scheme is well targeted and its key objective, i.e. providing finance into disadvantaged communities, has been met. It is also a component of BEIS Access to Finance policy. Additionally, the scheme has avoided falling foul of state aid rules through State Aid de minimis (as aid

⁵ In which case, accredited organisation needs to be a bank

⁶ Aslan, S., Freeman, R. and Henry, N. (2018). *Community Investment Tax Relief (CITR) and the Responsible Finance Sector*. March 2018

levels less than €200,000 to individual investors over 3-year period) meaning there is no requirement to formally report State Aid levels to Commission.

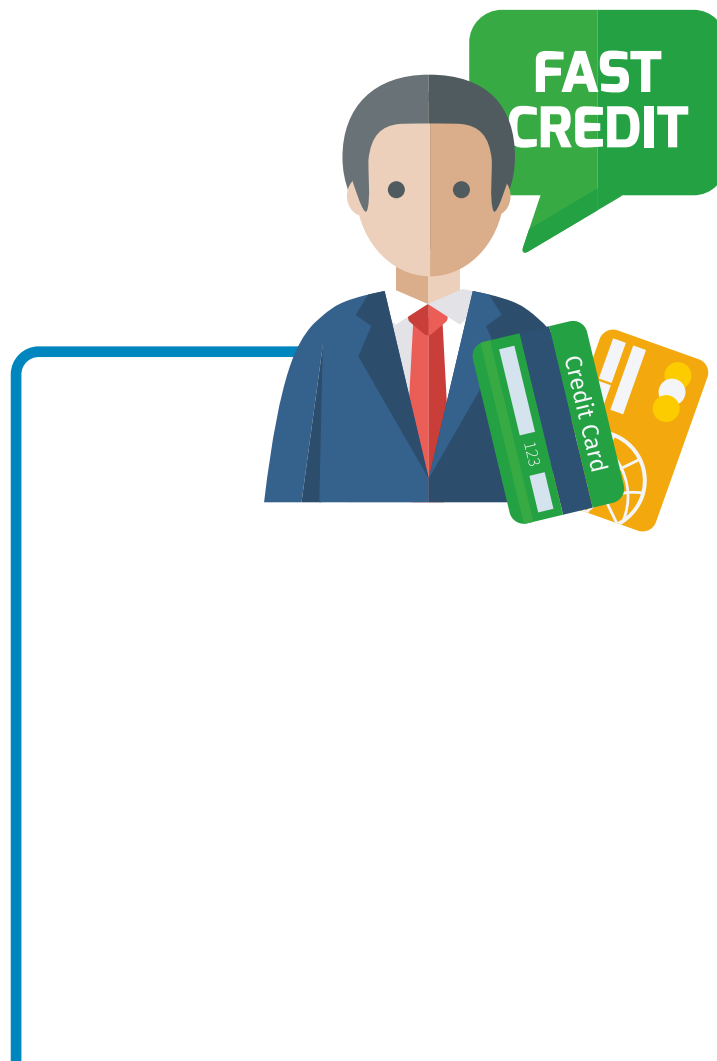
However, the scheme has fallen significantly short of government expectations of raising £100m annually to support the CDFI sector. Since 2002, it is estimated that the scheme has raised £145m in total or less than £10m annually. Moreover, of this, two thirds have been raised by two large social banks. There are a number of reasons for the lower than expected uptake, including lack of awareness and understanding of CITR, competitor schemes, restriction of CITR investment limits and complexity.

The CDFIs have found the scheme to be most effective when used in combination with first loss guarantee (e.g. Regional Growth Fund). The fact that CITR can now be used alongside the Enterprise Finance Guarantee (EFG) is believed to be an opportunity to significantly increase use and effectiveness of the scheme. To take full advantage of the scheme, it is also necessary for the CDFI to be able to generate sufficient levels of new lending to fulfil 75% criteria.

Transferability of lessons

There are lessons to be learnt from CITR. However, there are factors limiting the transferability to personal lending CDFIs, including:

- There are not currently any first loss cover mechanisms (i.e. equivalent to EFG) for personal lending, which could hamper its effectiveness
- There is a clear-cut public policy case for intervention. There is a market failure (i.e. viable businesses go unfunded), whereas the market enables households to access finance albeit at a higher price.
- There is clear cross-party for supporting businesses in disadvantaged communities, unlike consumer lending, which is controversial and seemingly at odds with other policy objectives (i.e. saving etc.)



About Carnegie UK Trust

The Carnegie UK Trust works to improve the lives of people throughout the UK and Ireland, by changing minds through influencing policy, and by changing lives through innovative practice and partnership work. The Carnegie UK Trust was established by Scots-American philanthropist Andrew Carnegie in 1913.

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About Community Finance Solutions

Community Finance Solutions (CFS) is an award-winning independent research unit specialising in financial and social inclusion, and community asset ownership. Located within the University of Salford, CFS offers independent research and advisory services to social landlords, local authorities, national government, charities and other organisations and agencies. Founded in 1999 by Professor Karl Dayson and Dr Bob Paterson, CFS was established to help empower communities to solve local problems relating to land and financial inclusion. Between them they developed solutions for securing community ownership of land and also models for the provision of loans to low income households who found themselves excluded from mainstream lending. These solutions have gradually extended over time and now CFS remains at the forefront of pioneering social research.

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