Evaluation of Community Development Finance Institutions (CDFIs)
EVALUATION OF COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS (CDFIs)

March 2010
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EXECUTIVE SUMMARY

INTRODUCTION

Community Development Finance Institutions (CDFIs) are specialist enterprises, often operating on a not-for-profit basis, which deliver finance and other support services to enterprises and individuals. CDFIs operate on the basis of public funding of loan finance for on-lending, including the operating costs of lending activity. Concerning enterprise lending, the CDFI sector focuses on businesses – start-up and existing, for-profit and/or social enterprises – that cannot obtain finance from the mainstream banking sector. CDFIs have an explicit social welfare mission, for instance by focussing their lending within disadvantaged areas and/or amongst financially excluded groups.

Notwithstanding the organisational heterogeneity evident in the sector, CDFI numbers are estimated to have stabilised at somewhere between 70 and 80 during the last few years after a period of substantial numerical growth in the last decade. The sector’s financial size continues to grow with total capital available nearing the £600m mark and the value of current outstanding loans by the sector stood at over £330m.

GHK Consulting, supported by Bert Nicholson and Karl Dayson, were commissioned by the Department for Business, Innovation and Skills (BIS) and the Office of the Third Sector (OTS) in February 2009 to evaluate the sector in the context of HMG’s overall access to finance intervention; in order to inform UK policy on the medium- to long-term strategic role of CDFIs, and to establish the rationales for and benefits from continued funding for the sector. This Study only includes the enterprise financing activities of CDFIs (personal lending is not included within its scope) and focuses primarily on the performance of English CDFIs.

The Study methodology comprised: an international literature and policy review; national and regional stakeholder consultation; new and trend analysis of extended national sector survey data (Inside Out); a first ever national survey of CDFI business clients (and control group survey) providing a ‘Green Book’ and ‘IEF compliant’ economic impact assessment; CDFI case studies; and action research with the sector.

STUDY FINDINGS

FINDING 1: There exists strong and robust evidence for continued public sector support to CDFIs

Finding 1a) CDFIs continue to address the consistent market failure to reflect the economic and social benefits of lending in underserved markets, leading to reduced enterprise outcomes, particularly amongst disadvantaged groups and areas.

The evaluation confirms continuing market failure on two counts, and to which the funding of CDFIs is a response:

- information failure on the part of the private banking sector towards the potential viability of loan finance applicants (largely deriving from the high transactions costs to lenders associated with generating and appraising the deal flow and providing investment and aftercare support); and,
• externality failure (the social returns from CDFI loan finance exceed the private returns available to lenders).

In the case of social enterprises, evidence suggests that market failure may have reduced (especially for existing social enterprises), and that provision has been improved, both through the development and relatively rapid growth of a set of specialist providers and increased understanding of this market by the mainstream banking sector.

At the level of individual businesses, there is evidence that CDFI activity reduces information failure as individual clients move on to successfully access mainstream funding following the receipt of a CDFI loan.

The extent to which CDFIs are (or are tasked with) addressing the information failure argument (viable but unbankable businesses) and/or the externality failure (foregone economic and social benefits) in their activities is at the core of the assessment of the public benefits of support to the sector.

**Finding 1b) By servicing the demand for finance from its target markets, the sector meets a range of enterprise related public policy rationales and goals.**

A diverse range of public sector bodies view the CDFI sector as a policy mechanism for a number of public sector goals. Within enterprise policy at least four policy rationales for CDFI support are identifiable:

• enterprise growth;
• enterprise-driven regeneration;
• support for social enterprises; and,
• enterprise within under-represented groups.

This Study provides evidence of the sector’s ability to support all of these enterprise outcomes, to a greater or lesser extent, but depending on its uneven ability to evidence its impacts in a comprehensive manner. Whilst this breadth of policy goal has justified CDFIs access to a variety of funding streams over different periods, it may have done so at the cost of consistent awareness and understanding of the sector, its goals and activities.

**Finding 1c) Following this study, and through the good offices of the sector trade association (the CDFA), the sector is now able to evidence in a robust and comprehensive manner the scale and extent of its positive economic impacts. Total impact remains small scale, patchy and variegated, but represents value for money given the levels of public sector support (see Finding 3b).**

A ‘snapshot’ assessment of the gross impacts generated by the CDFI sector’s outstanding enterprise loan portfolio, some 6,500 loans, in October 2009, shows that:

• Around 2,200 business have been created, and a further 1,650 safeguarded;
• Around 13,800 jobs have been created, and a further 12,800 safeguarded;
• Around £667m of turnover has been created, and a further £834m safeguarded; and,
Around £135m of GVA has been created, and a further £169m safeguarded.

The net impacts (or additionality) of this loan activity are outlined in Table ES1.

**Table ES1: Net business, employment, turnover and GVA impacts of CDFI lending**

<table>
<thead>
<tr>
<th>Geographic area</th>
<th>Net impacts</th>
<th>All</th>
<th>Social enterprises</th>
<th>Deprived areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local community</td>
<td>Businesses created</td>
<td>1,705</td>
<td>719</td>
<td>371</td>
</tr>
<tr>
<td></td>
<td>Businesses safeguarded</td>
<td>1,372</td>
<td>505</td>
<td>469</td>
</tr>
<tr>
<td></td>
<td>Jobs created</td>
<td>3,635</td>
<td>1,689</td>
<td>1,252</td>
</tr>
<tr>
<td></td>
<td>Jobs safeguarded</td>
<td>3,618</td>
<td>981</td>
<td>1,078</td>
</tr>
<tr>
<td></td>
<td>Turnover created</td>
<td>£560m</td>
<td>£244m</td>
<td>£113m</td>
</tr>
<tr>
<td></td>
<td>Turnover safeguarded</td>
<td>£788m</td>
<td>£198m</td>
<td>£216m</td>
</tr>
<tr>
<td></td>
<td>GVA created</td>
<td>£113m</td>
<td>£49m</td>
<td>£23m</td>
</tr>
<tr>
<td></td>
<td>GVA safeguarded</td>
<td>£160m</td>
<td>£40m</td>
<td>£44m</td>
</tr>
<tr>
<td>Region</td>
<td>Businesses created</td>
<td>883</td>
<td>279</td>
<td>187</td>
</tr>
<tr>
<td></td>
<td>Businesses safeguarded</td>
<td>790</td>
<td>272</td>
<td>303</td>
</tr>
<tr>
<td></td>
<td>Jobs created</td>
<td>4,614</td>
<td>1,544</td>
<td>1,401</td>
</tr>
<tr>
<td></td>
<td>Jobs safeguarded</td>
<td>7,571</td>
<td>1,904</td>
<td>2,723</td>
</tr>
<tr>
<td></td>
<td>Turnover created</td>
<td>£301m</td>
<td>£107m</td>
<td>£43m</td>
</tr>
<tr>
<td></td>
<td>Turnover safeguarded</td>
<td>£461m</td>
<td>£129m</td>
<td>£81m</td>
</tr>
<tr>
<td></td>
<td>GVA created</td>
<td>£61m</td>
<td>£22m</td>
<td>£9m</td>
</tr>
<tr>
<td></td>
<td>GVA safeguarded</td>
<td>£94m</td>
<td>£26m</td>
<td>£17m</td>
</tr>
</tbody>
</table>

Base = 6,505 businesses (all); 2,715 businesses (social enterprises), 1,917 businesses (deprived area)

The net impacts generated vary across different policy segments and impacts but include:

- At the local level, around 1,705 additional businesses have been created, and a further 1,372 safeguarded. Around 40% of these businesses are social enterprises, and 22% of businesses have been created in deprived areas (and a further 34% of businesses safeguarded in deprived areas); and,

- At the local level, around 3,600 jobs have been created, and a similar number safeguarded. Around a third of jobs created and safeguarded are in deprived areas.

As a snapshot assessment, these figures are likely to underestimate the full ‘lifetime’, or persistence of impact, of the loans made (both until repayment has been made and after repayment).
**Finding 1d)** CDFI lending is responsible for the generation of social benefits. In this regard, the sector is actively engaged in activities to develop the standardised methodologies capable of supporting the capture and valuation of the full benefits and impacts of the sector’s lending activity.

Alongside the economic benefits generated by CDFIs, it is widely recognised that through its support for enterprise the CDFI sector generates social impacts (and social objectives are very typical within the sector).

An attempt to evaluate the social impacts of the sector in a comprehensive manner highlighted that no standardised social impact measurement methodologies are in use across the CDFI sector. Ad hoc pilots are in place, supported by the CDFA, and the sector is engaged with the Office of the Third Sector funded Measuring Social Value Project.

If these methodologies are to be employed, CDFIs will need to collect substantially more data on social impacts than is current practice.

**Finding 1e)** In the continuing efforts of the sector to deliver enterprise outcomes, and despite widespread acknowledgement of the challenge, the sector remains a long way from achieving operational sustainability and even further from achieving financial sustainability. Financial modelling highlights the continued negative correlation (or trade off) between the drive to sustainability and ‘depth of reach’ towards policy targets

Figures calculated for the CDFI sector as a whole show that median level of operational sustainability has increased from 30 per cent in 2006/07 to 39 per cent in 2008/09 and the level of financial sustainability has increased from 22 per cent to 24 per cent. The figures highlight the substantial distance still to be travelled by the sector to reach sustainability.

Financial modelling does show that a large CDFI focussing on the social enterprise lending market is able to achieve 100 per cent operational sustainability, although none of the CDFI models were close to achieving 100 per cent financial sustainability. The models also highlight the problems faced by a CDFI focussing on micro enterprise lending, which whether small or large is a very long way away from sustainability. Consequently, such a CDFI would need to access considerable amounts of external funding to cover its ongoing operating and financial costs. SME models showed that a large CDFI could move to within reach of operational sustainability.

Drivers of sustainability include:

- Increased scale of lending pot: providing greater portfolio income and facilitating larger (and more efficient) loans;
- Improved partnership working: in particular, the referral of viable businesses contributing to policy targets by partners and, relatedly, the provision of pre- and post-loan business support by partners. In this regard, the sector continues to, in most cases, express disappointment at the quality of partnerships with Regional Business Links and mainstream banks;
Increased staff efficiency: focus of effort and expenditure on loan activity, reducing other administrative activity and broader formal and informal business support to applicants and clients alike; and,

Improving portfolio performance: maximising income through loan fees and interest rates and, more fundamentally, reducing bad debt.

Reduction in very small loans: Some funders still support CDFIs in providing very small loans given their policy objectives and the potential to create a greater social and economic impact per pound of lending. Nevertheless, the cost of delivering very small loans and collecting interest and principal often exceeds the amount earned; a move away from such loans will increase CDFI sustainability.

To illustrate, in the financial model a large CDFI serving the micro enterprise market would on average be 32 per cent operationally sustainable. Keeping levels of bad debt at 12 per cent (this market will always have a higher level of risk), a 100 per cent level of operational sustainability could be achieved by increasing the scale of operations to 200 outstanding loans (from 176), by increasing income per loan to from 7.7 to 15 per cent of the value of each loan, and by increasing loan officer productivity to 20 new clients per year (from 14). For a smaller CDFI in the micro enterprise market, an increase in the number of outstanding loans from 44 to 65, in combination with the changes to staff efficiency and income per loan previously outlined, would also lead to 100 per cent operational sustainability;

Nevertheless, inherent within the drivers of sustainability are clear trade-offs between pursuing sustainability and securing ‘depth of reach’ against policy targets; for example, larger loans, lower risk clients, higher rates of interest and minimal business support all improve sustainability but are likely to reduce policy impacts. Indeed, some evidence exists of ‘mission creep’ within the sector in response to the demands of sustainability (for example, moves out of the micro enterprise market and the choice of ‘next best’ cases rather than the highest risk cases in terms of policy objectives).

Finding 1f) Initial evidence suggests that the move to sector sustainability will have been set-back by the credit crunch and recession.

The initial reported impact of the credit crunch and related recession highlights the complexity of interrelationships between these drivers and trade-offs. For example, demand for enterprise loans has increased substantially leading to greater numbers of applications. Substantial numbers of these remain unviable or outside of policy objectives but the process of initial assessment is incurring increased transaction costs. In contrast, expanded applications are also including businesses which would have previously been viewed as bankable prior to the credit crunch. Loans are being made in this instance to what, in effect, are lower risk (and probably lower cost) clients and are expected to have a subsequent positive impact on future portfolio performance. In further contrast, there is early evidence of short-term poorer portfolio performance (i.e. higher levels of loan delinquency) as the credit crunch and recession affects the viability of existing clients.

FINDING 2: The need for further research into, and the development of methodologies to assess and document, the scale of different underserved markets and the extent of latent and existing demand.
Bank behaviour, and perceptions of bank behaviour, towards business lending remain the key drivers of demand for CDFI services but the extent to which the CDFI sector meets (and generates) latent and existing demand across different underserved markets remains poorly documented and understood.

Baseline estimates of demand across target underserved markets do not exist. Formal assessment of target markets remains rare, with little systematic market research of target clients and services based largely on ‘on the ground’ knowledge and experience of CDFI staff and local business support networks.

A number of trends in provision by the sector are evident in recent years:

- The level of lending to micro enterprises has stagnated (in terms of number and value of loans);
- Value of lending to SMEs has tripled in the past three years;
- The impact of the credit crunch and the use of the sector to meet rapidly expansion of the access to finance gap. Conversion rates have remained consistent but the sector has reported strong evidence of loans to previously bankable businesses;
- Social enterprise lending has seen consistent growth and now represents the largest CDFI market segment. This growth has been dominated by a handful of large national CDFIs;
- Despite substantial expansion, geographical and sectoral coverage remains patchy with continued sizeable variations in the level and type of CDFI loan activity;
- A continuing small minority of clients represent bankable businesses that should be funded by mainstream banks but are funded by CDFIs because of inconsistent or ‘soft’ application of the criterion of mainstream bank rejection by CDFIs. Client survey suggests an estimated deadweight figure of around 10% of loans made but this is higher in the social enterprise market.

Given that little or no assessment of the scale of market failure across different market segments exists, the full potential of the sector to address underserved markets in access to finance at present remains unknown.

Any expansion of services, either geographically or to new groups, should be informed by greater levels of market research activity (and which would be enhanced by further reporting by banks on current practice and performance of SME financing), and by explicit consideration of the related social welfare benefits.

**FINDING 3:** What calculations can be made suggest that CDFIs are efficient vehicles for the delivery of capital to businesses in underserved markets. Estimates, however, of effectiveness, efficiency, and economy of the CDFI sector in enterprise lending remain hampered by the lack of comprehensive data and agreed reporting frameworks on CDFI income, expenditure by activity, outputs, outcomes and impact.

A number of factors contribute to this position:
The lack of a comprehensive cross-governmental policy framework which reflects the range of policy interests in, and expectations of, the CDFI sector and its activities;

Given the absence of such a policy framework, the lack of a full set of intervention rationales and associated evaluation frameworks detailing metrics, common indicators, monitoring procedures and data collection activities for policy evaluation;

Notwithstanding the heterogeneity and fierce independence of the members that make up the sector, there is only partial adoption by the sector of common reporting and performance frameworks as the basis of consistent and good practice.

**Finding 3a) What calculations can be made suggest that CDFIs are efficient vehicles for the delivery of capital to businesses in underserved markets.**

The study has utilised a variety of sources of empirical data to develop a simple financial model of the enterprise lending activities of CDFI, and against a variety of target markets. This model exemplifies a ‘funding gap’ between the income and costs of enterprise lending activity. Assuming the ‘maximum case scenario’ whereby this funding gap is filled by public sector sources alone (i.e. no philanthropic and additional earned income), Tables ES2 and ES3 show the public cost per unit of net economic impact delivered by the CDFI sector at local and regional level represents value for money.

**Table ES2: Estimated (maximum) public sector cost per unit of net economic impact: local community level, and on the basis of this, the amount of GVA created/safeguarded per £1 of public sector expenditure**

<table>
<thead>
<tr>
<th>Market segment</th>
<th>All markets</th>
<th>Micro enterprises</th>
<th>SMEs</th>
<th>Social enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All</td>
<td>Small</td>
<td>Large</td>
<td>All</td>
</tr>
<tr>
<td>Business created</td>
<td>£18,443</td>
<td>£30,542</td>
<td>£24,713</td>
<td>N/A</td>
</tr>
<tr>
<td>Business safeguarded</td>
<td>£22,913</td>
<td>£52,147</td>
<td>£42,195</td>
<td>£19,299</td>
</tr>
<tr>
<td>Job created</td>
<td>£8,820</td>
<td>£16,858</td>
<td>£13,641</td>
<td>£15,105</td>
</tr>
<tr>
<td>Job safeguarded</td>
<td>£8,863</td>
<td>£38,084</td>
<td>£30,817</td>
<td>£2,932</td>
</tr>
<tr>
<td>£1 turnover created</td>
<td>£0.06</td>
<td>£0.11</td>
<td>£0.09</td>
<td>£0.06</td>
</tr>
<tr>
<td>£1 turnover safeguarded</td>
<td>£0.04</td>
<td>£0.30</td>
<td>£0.24</td>
<td>£0.01</td>
</tr>
<tr>
<td>£1 GVA created</td>
<td>£0.28</td>
<td>£0.55</td>
<td>£0.44</td>
<td>£0.32</td>
</tr>
<tr>
<td>£1 GVA safeguarded</td>
<td>£0.20</td>
<td>£1.46</td>
<td>£1.18</td>
<td>£0.05</td>
</tr>
<tr>
<td>£ GVA created/safeguarded per £1 of public sector expenditure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GVA created (£)</td>
<td>£3.57</td>
<td>£1.82</td>
<td>£2.27</td>
<td>£3.13</td>
</tr>
<tr>
<td>GVA safeguarded (£)</td>
<td>£5.00</td>
<td>£0.68</td>
<td>£0.85</td>
<td>£20.00</td>
</tr>
</tbody>
</table>

The average cost of creating a business through CDFI enterprise lending is £18,400. This figure, however, varies markedly across markets; from only £9,200 in large CDFIs
dealing with social enterprises to £30,600 for small CDFIs serving the micro enterprise market. Indeed, the micro enterprise market has the highest cost at whatever scale of CDFI size reflecting the particular inability to fully cover costs through earned income in this market.

In terms of employment, the cost of creating a job is, on average, £8,800 and varies from £4,000 for large CDFIs in the social enterprise market to £16,900 for small CDFIs active in the micro enterprise market.

Table ES3: Estimated (maximum) public sector cost per unit of net economic impact: regional level, and on the basis of this, the amount of GVA created/ safeguarded per £1 of public sector expenditure

<table>
<thead>
<tr>
<th>Market segment</th>
<th>All markets</th>
<th>Micro enterprises</th>
<th>SMEs</th>
<th>Social enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Small</td>
<td>Large</td>
</tr>
<tr>
<td>Business created</td>
<td>£35,629</td>
<td>£59,002</td>
<td>N/A</td>
<td>£31,700</td>
</tr>
<tr>
<td>Business safeguarded</td>
<td>£39,815</td>
<td>£98,478</td>
<td>£20,424</td>
<td>£24,449</td>
</tr>
<tr>
<td>Job created</td>
<td>£6,950</td>
<td>£14,096</td>
<td>£6,430</td>
<td>£5,841</td>
</tr>
<tr>
<td>Job safeguarded</td>
<td>£4,235</td>
<td>£29,854</td>
<td>£867</td>
<td>£4,737</td>
</tr>
<tr>
<td>£1 turnover created</td>
<td>£0.11</td>
<td>£0.22</td>
<td>£0.09</td>
<td>£0.08</td>
</tr>
<tr>
<td>£1 turnover safeguarded</td>
<td>£0.07</td>
<td>£0.77</td>
<td>£0.02</td>
<td>£0.06</td>
</tr>
<tr>
<td>£1 GVA created</td>
<td>£0.53</td>
<td>£1.08</td>
<td>£0.36</td>
<td>£0.37</td>
</tr>
<tr>
<td>£1 GVA safeguarded</td>
<td>£0.34</td>
<td>£3.80</td>
<td>£0.06</td>
<td>£0.31</td>
</tr>
</tbody>
</table>

£ GVA created/ safeguarded per £1 of public sector expenditure

| GVA created (£)           | £1.89       | £0.93             | £2.17 | £2.78              |
| GVA safeguarded (£)       | £2.94       | £0.26             | £12.50| £16.67             |

At regional level, the most notable net impact is a greater level of jobs created and safeguarded than at the local level as a result of lower leakage at a regional, compared to local, level. Nevertheless, public sector cost to create or safeguard £1 GVA is higher than at local level.

**Finding 3b)** Overall, there remains limited data on the specific value for money in delivering across the range of policy targets, such as social enterprises generated or enterprises supported in disadvantaged communities. This provides a number of joint challenges to HMG and the sector alike.

In order to establish a more fine-tuned assessment of value for money there is a requirement for a clear policy framework within which the sector can operate, including the range and extent of public benefit it is seeking from the sector and a recognition that the achievement of any such benefits will require investment in the sector.

We would suggest that it is only within such a policy framework (and the associated intervention rationales that should follow), that the range of potential activities and delivery mechanisms on offer (for example, CITR, policy guarantee schemes such as EFG, a wholesale CDFI Fund, CRA type legislation, Futurebuilders Full Investment
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Fund, Solutions for Business, direct capital and revenue loans and grants, etc.) can be assessed for effectiveness against policy objectives and within target markets.

To support any such policy framework, the sector must accelerate improvements in standardised management information systems to allow full and robust assessment of the costs and value for money of CDFI delivery of interventions across different policy objectives. This, in turn, can then support enhanced targeting of policy impacts (including reduced levels of deadweight and displacement and greater economic and social impact).

Finding 3c) The lack of transparency of sector business models is militating against greater philanthropic and private investment and weakening policymakers confidence in their ability to secure different sets of economic and social benefits in an efficient manner.

As the sector has developed, headway has been made in diversifying its income and funding streams. Greater levels of investment from philanthropic and other private sources, including the banking sector, now exist but investors remain highly selective in the face of lack of transparency of business models, cost structures and benefits generated within the sector. Similarly, lack of transparency is increasingly untenable in a mature sector which remains a recipient of substantial public funds and support.

STUDY RECOMMENDATIONS

The Findings provide a framework for a set of Recommendations.

Recommendation 1: Continue public sector support to CDFIs: the rationale for support of CDFIs is continuing market failure to reflect the economic and social benefits of lending in underserved markets. The evaluation confirms this market failure (although there is evidence of its correction to some extent in the social enterprise market). The level of support should reflect these economic and social benefits and might best be put forward in a new cross-governmental policy framework which reflects the range of policy interests in the CDFI sector and its activities. Such support should be predicated on accelerated improvements in standardised management information systems within the sector (and which should be led by the trade association, CDFA) in order to advance enhanced targeting of policy impacts. Government should encourage and incentivise such improvements to support further moves to reduce the gaps in operational and financial sustainability characteristic of the sector.

Recommendation 2: The development of substantial intervention rationales and associated evaluation frameworks for the different (enterprise) policy objectives delivered by CDFI activity. Given the development of a policy framework within which the sector can operate (see Recommendation 1 above), it is imperative that intervention rationales and associated evaluation frameworks detailing metrics, common indicators, monitoring procedures and data collection activities be disseminated throughout the sector as the basis for policy evaluation. These should be developed rapidly by the CDFA in unison with policy bodies to support common, consistent and good practice within the sector. These should also form the basis of further development of reporting and performance frameworks for the sector as the basis of greater transparency. The lack of transparency is increasingly untenable in a mature sector which remains a recipient of substantial public funds and support.
Recommendation 3: Following the policy framework and associated differentiation of policy rationales and target markets (see Recommendation 1), undertake a review of the range of current delivery mechanisms targeted at the CDFI sector (CITR, EFG, Solutions for Business, regulatory change, etc.) should be undertaken to fully gauge their relative contribution in supporting the sector to achieve HMG’s policy objectives. The sector is subject to a diversity of support to deliver across a range of policy objectives. Given a revised policy framework, this range of support should be reviewed for continued suitability and effectiveness against policy objectives.

Recommendation 4: The sector, led by the CDFA, should continue to support the development of social impact methodologies in partnership with national social value initiatives and to evidence the full value of its activities. Social value is growing in importance as a benefit to be assessed in public policy evaluation activity and remains a core mission of the CDFI sector. Public support for CDFIs should be provided in proportion to the economic and social impact that CDFIs deliver, therefore measuring social impact is key to demonstrating a part of the return on public investment that CDFIs can deliver. The sector needs to continue development of its capacity to provide an evidence base on social impact and value, including comprehensive and common reporting procedures. It should also seek to understand the additional potential cost that may be attached to such reporting activity.

Recommendation 5: Promote further initiatives to create a fit for purpose CDFI referral system (whether within the new Solutions for Business service offer, and/or related initiatives for a universal referral system with banks). Generating sufficient volume and quality of loan applications is a key challenge for most CDFIs, and this challenge has a significant impact on their sustainability. Improving existing public sector referral systems would reduce the scale of the resources committed by CDFIs to generating demand, filtering out unsuitable applications, and providing investment readiness support. An obvious route would be to mainstream referral arrangements as part of business support provided through Solutions for Business, particularly as part of the Investment Readiness product (for instance setting targets for quality referrals by delivery organisations). Further work on a universal referral system for banks would also increase the number and quality of referrals to CDFIs.
1 INTRODUCTION

GHK Consulting, supported by Bert Nicholson and Karl Dayson, were commissioned by the Department for Business, Innovation and Skills (BIS) and the Office of the Third Sector (OTS) in February 2009 to undertake an ‘Evaluation of Community Development Finance Institutions (CDFIs)’. This Draft Final Report presents the results of the evaluation for consideration by the study Steering Group.

1.1 The Community Development Finance Institution (CDFI) sector

CDFIs are specialist enterprises, often operating on a not-for-profit basis, which deliver finance and other support services to enterprises and individuals. Concerning enterprise lending, the CDFI sector focuses on businesses – start-up and existing, for-profit and/or social enterprises – that cannot obtain finance from the mainstream banking sector. CDFIs also often have an explicit community development mission, for instance by focussing their lending within disadvantaged areas and/or amongst financially excluded groups.

The Community Development Finance Association (CDFA) – the trade association for the sector – defines CDFIs as¹:

‘...independent organisations which provide financial services with two aims: to generate social and financial returns. They supply capital and business support to individuals and organisations whose purpose is to create wealth in disadvantaged communities or underserved markets’.

A 2002 report by the UK Social Investment Forum² divided the CDFI sector into six different types of organisation:

- **Community loan funds** – the majority of the CDFI sector: organisations that provide loans to for-profit and/or social enterprises, often with an overarching social mission and sometimes focussed on a particular geographic area;
- **Micro-finance funds** – a sub-sector of the above: organisations that specialise in providing very small loans to micro enterprises;
- **Community development venture capital** – operates like mainstream venture capital but with a community development mission;
- **Social banks** – operate as mainstream banks but with strict ethical policies and social and/or environmental goals;
- **Community development credit unions** – credit unions (i.e. co-operatives owned and controlled by members with a ‘common bond’) with a particular community development mission; and,
- **Mutual guarantee societies** – formal associations of SMEs that pool their savings in banks in order to provide collective guarantees.

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¹ www.cdfa.org.uk
The wide range of organisations that could potentially be considered a CDFI makes measuring the size of the sector in the UK a challenge. The origins of today’s CDFIs have been traced to the 1980s, with the establishment of a number of innovative community organisations drawing on international experience of community loan funds. CDFIs grew in number and size organically until the late 1990s, when the embryonic CDFI sector began to attract considerable financial support from central government, primarily through the Phoenix Challenge Fund that ran from 2000 to 2006 with the aim of increasing the size and effectiveness of CDFIs.

In 2002 the trade association for the sector (the CDFA) was established. By 2003 the CDFA reported a total of 25 members\(^3\), many of whom had only begun lending in the past few years. The CDFA currently lists 74 CDFI members or associate members\(^4\), and has indicated that it is confident that this constitutes the substantial majority of the CDFI sector in the UK. Nevertheless, a 2006 estimate put the figure at closer to 120 taking into account the lending activities of local enterprise agencies\(^5\) (though many of these are classed elsewhere as soft loan funds which are distinct from CDFIs)\(^6\).

Figure 1.1 shows how the number of CDFIs and the size of the sector (measured according to the size of the outstanding loan portfolio and the size of the overall capital pot) developed between 2003 and 2008. Note, however, that this data concerns both enterprise and personal lending. During the Phoenix Fund years (in this case 2003 to 2006), the number of CDFIs identified by the CDFA increased significantly, up from 25 in 2003 to 73 in 2006. Since then, CDFI numbers have stabilised and, indeed, most recently shown some signs of decreasing.

In contrast, the financial size of the sector has grown steadily since 2003. Total capital available to CDFIs increased from £220 million in 2003 to £585 million in 2008, whilst the total value of the sector’s outstanding loans increased from £106 million to £331 million. The financial performance of the CDFI sector is analysed in more detail in Section 3 of this report.

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\(^3\) CDFA (2003) Annual Review 2003
\(^6\) JRF (2001) Promoting the Growth of the Community Development Finance Sector
1.2 Study scope and objectives

The overall aim of this evaluation is to inform UK policy on the medium- to long-term strategic role of CDFIs, and to establish the rationales for and benefits from continued funding for the sector. Note that the study only includes the enterprise financing activities of CDFIs; personal lending is not included within the scope of the evaluation. The study also focuses on the performance of English CDFIs, though the review of the sector as a whole includes a small number of CDFIs from Scotland, Wales and Northern Ireland.

The Terms of Reference for the study outlined seven detailed research objectives:

1) To consolidate and learn from the existing CDFI knowledge base through a literature review of existing theoretical and applied CDFI academic papers both from the UK and other countries with CDFI sectors;

2) To establish the direct impact on access to finance: this should include an estimation of the extent that CDFIs have increased the availability of debt finance to businesses and social enterprises in disadvantaged areas and the extent to which market failures have been successfully addressed. This will involve looking at the demand for enterprise finance from CDFIs;

3) To estimate the economic additionality of CDFIs including the impact on business creation and growth with reference to impacts on disadvantaged areas and underrepresented groups and the impact on employment creation from CDFI assisted businesses;

4) To estimate the value of economic externalities and wider social effects generated by CDFIs, including potential improvements in economic and social outcomes which operate with longer time lags;
5) To estimate distance from sustainability for different CDFIs and analyse strategies for moving towards financial sustainability, including looking at the role of effective governance and the effect of Community Investment Tax Relief (CITR) on private investment into accredited CDFIs;

6) To analyse the potential impact on CDFIs from the credit crunch and emerging economic slowdown; and,

7) To use the findings in this research to make recommendations on the development of a future CDFIs policy within the context of HMG’s overall access to finance interventions.

1.3 Method of approach

An overview of the method of approach for the study is shown in Figure 1.2. Broadly, there were three main study phases:

- **Phase 1 Scoping (February to March 2009):** The purpose of this first phase of the study was to collect the contextual information needed in order to design and implement the collection of primary data during Phase Two of the study (e.g. the Terms of Reference for the literature review). The study team met with key CDFI stakeholders from central government (BIS, OTS, HM Treasury and the FSA), together with representatives of the CDFA (see Annex 1 for a full list of consultees). Upon completion of the scoping phase an Inception Report was submitted to the Steering Group on 13 March 2009;

- **Phase 2 Primary data collection (March to December 2009):** Addressing the evaluation objectives set out in Section 1.2 has required the completion of six main research activities:
  - **Literature and policy review:** The bulk of this work was carried out through a specially commissioned literature review completed by Dr Karl Dayson from the University of Salford. A copy of the final version of the literature review is attached as Annex 2. The literature review was supplemented by an additional policy review carried out by GHK;
  - **Regional stakeholder consultation:** In order to collect contextual evidence about the CDFI sector, representatives from each of the English RDAs were interviewed (a list of consultees is provided in Annex 1);
  - **Inside Out data analysis:** The CDFA carries out an annual survey of CDFIs (Inside Out), and provided GHK with anonymous raw data from the 2006/07, 2007/08 and 2008/09 surveys, in order to provide information on the scale and scope of the CDFI sector. The timing of the survey meant that it was possible for GHK to insert a number of questions into the 2008/09 survey specifically in order to collect supplementary information on the impact of the credit crunch, the social impacts of CDFIs, and their financial sustainability;
  - **Business beneficiary survey:** The purpose of the business beneficiary survey was to collect primary data on the effectiveness and impact of CDFI support (the first time such an exercise had been attempted within the CDFI sector on a national basis). The survey was sent by GHK to all businesses with an outstanding loan (where CDFIs were
willing to provide contact information), or was sent to businesses on behalf of GHK by CDFIs. In total, the survey was sent to 3,038 businesses, distributed across 32 CDFIs. A total of 363 responses were received, 283 from business surveyed directly by GHK (a response rate of 18 per cent), and 80 from businesses surveyed through the CDFIs (a response rate of 6 per cent). More details of the methodology for the business survey are provided in Annex 3, and a copy of the survey instrument is included in Annex 4;

- Control group survey: The goal of the control group survey was to collect evidence as to the economic experiences of businesses that had had finance applications rejected by a mainstream bank but which had not accessed CDFI funding (in order to further test the extent to which the economic impacts reported by CDFI beneficiaries were additional to broader market trends). The survey was carried out by telephone with a sample of 439 businesses that had responded to the BIS Annual Small Business Survey and Business Barometer and had indicated that they had previously had a finance application fully rejected by a mainstream bank (103 surveys were completed, a response rate of 23 per cent);

- CDFI case studies: Finally, case studies of eight CDFIs were carried out in order to collect more detailed information on the operations of CDFIs and the pressures that they face. Case studies were selected in order to provide a balance of different CDFI models, with one case study of a CDFI operating at the national level, and the remainder spread across seven of the nine English regions. Consideration was also given to particular coverage of those CDFIs supporting social enterprise activity. In the instance of four case studies, the method was developed to provide a higher level of formative evaluation activity. The case studies are attached as Annex 5.

In terms of timing, these activities have taken place in stages. The literature and policy review and the regional stakeholder consultation were carried out in April and May 2009, and draft results were included in an Interim Report that was submitted on 8 May 2009. The CDFA circulated the 2008/09 Inside Out survey in June and July 2009, whilst the business beneficiary survey, case studies and control group survey were carried out between August and December 2009. Overshadowing the period of the study has been the credit crunch and economic recession; Section 7 addresses this issue explicitly although it is an underlying refrain throughout the report;

- Phase 3 Analysis of results (October to December 2009): A Draft Final Report was submitted to the Steering Group for consideration on 16 November, followed by this Revised Draft Final Report.
1.4 Structure of this report

The remainder of this report has been structured according to the evaluation questions set out in Section 1.2, as follows:

- Section 2 analyses the rationale and UK policy context for the CDFI sector;
- Section 3 presents a review of the CDFI sector, focusing on its recent financial performance;
- Section 4 provides an overview of the economic impacts of the CDFI sector, including consideration of the additionality of these benefits;
- Section 5 reviews the evidence of the wider social impacts of CDFIs;
- Section 6 explores the self-sufficiency of CDFIs, including analysis of the different models of self-sufficiency that have been adopted by the sector;
- Section 7 analyses the impact of the credit crunch and the economic recession on the CDFI sector; and,
- Section 8 presents the conclusions and recommendations of the study team.

Supporting material is included within the Annexes to the report, as follows:

- Annex 1 provides a list of consultees;
- Annex 2 contains the final version of the CDFI literature review carried out by Dr Karl Dayson;
- Annex 3 presents details of methodology used for the beneficiary survey;
Annex 4 contains the beneficiary survey instrument; and,
Annex 5 presents the CDFI case studies.
2 RATIONALE AND POLICY CONTEXT FOR THE CDFI SECTOR

This section of the report presents a review of the rationale and UK policy context for the enterprise-lending CDFI sector. This review has primarily been based on the results of a literature review that was carried out for this study by Karl Dayson at the University of Salford, supplemented by additional work by the study team. This has included: analysis of other documentary evidence (including evaluation work carried by the RDAs), and interviews with a selection of CDFI stakeholders from national government and each of the RDAs.

There follows an analysis of the rationale for the CDFI sector, including consideration of market failure arguments, and a review of the evolution of public policy in support of CDFIs, including developments at a national, regional and local level. The section ends with a set of conclusions.

2.1 The rationale for CDFIs

2.1.1 The need for external finance

The principle objective of the enterprise-lending CDFI sector is to provide finance for businesses that cannot access such funds from the mainstream banking sector. Access to external finance is an important issue for businesses, particularly for start-ups and small businesses which tend to lack retained profits that they can re-invest in the business. A 2008 study put the median average cost of starting a business at £7,500, and found that a significant proportion of start-ups required external funding to meet this need. Established firms also seek finance in order to fund growth; the same study reported that 36 per cent of SMEs had sought external finance in the previous three years. The median average amount of funding sought was estimated to be £45,000 per firm, though this varied significantly depending on the size of the business.

In terms of the sources used to access external finance, the 2008 study on SME finances referenced above found that 41 per cent of start-ups had used a credit card to cover the costs of establishing their business, whilst another 25 per cent had used an overdraft facility. Some 8 per cent made use of a commercial loan (it is not clear whether this included CDFI lending). For all SME types (i.e. not just start-ups), commercial loans were more important as a source of external finance (used by 19 per cent of SMEs in the previous three years), though credit cards and overdraft facilities remained the two most frequently used sources of external finance.

2.1.2 Access to finance barriers

For the most part, demand from SMEs for external finance is met by mainstream sources, primarily high street banks. As at June 2009, the high street banks had a

9 ibid.
total outstanding loan portfolio with ‘small’ businesses worth £46,916 million. By way of a comparison, as at April 2009, the CDFI sector as a whole had an outstanding loan portfolio with micro-enterprises (roughly comparable to the banks’ definition of ‘small’ businesses) worth £26 million. However, general trends in the mainstream banking sector, together with more structural market failures, mean that SME demand for external finance is not always met.

Two key sets of problems have been identified:

- First, there are a number of information asymmetries in the access to finance market. On the supply side, finance providers cannot always accurately assess the risks associated with a business proposition, and thus seek to mitigate them through a range of information requirements (see below). The costs of the extra due diligence where the level of risk is poorly understood also encourages finance providers to focus on large investments in established businesses, in order to achieve economies of scale. On the demand side, entrepreneurs and business owners may not be fully aware of the finance available to them, or may have negative perceptions of mainstream financial providers that prevent them from seeking investment;

- Second, the mainstream banking industry has changed in recent years. Increased numbers of mergers and acquisitions have led to the closure of local bank branches, standardised credit-scoring techniques have increasingly replaced ‘relationship banking’, and heightened competitive pressures mean that less profitable loans (particularly small loans with high relative transaction costs) are less attractive.

The following factors might inhibit a business’s or an entrepreneur’s ability to access to mainstream enterprise finance:

- Ability to offer collateral or provide another form of personal security;
- Whether the business operates in sectors regarded as risky, potentially due to high failure rates, or alternatively high or new technology areas;
- Whether the business operates in geographical areas with weak markets that might affect demand;
- The length of the business’s track record;
- The quality of the business’s management skills and their ability to develop and present a good finance proposal; and,
- Poor credit history, including the presence of County Court Judgments.

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10 British Bankers Association (July 2009) June 2009 Small Business Figures for the High Street Banks. Small businesses are defined as firms with an annual turnover of less than £1 million.
13 NEF and Bert Nicholson (2003) Analysis of the Need and Demand for Development Funding of Community Development Finance Institutions In the West Midlands.
These factors are disproportionately likely to be a problem for certain types of business and/or types of entrepreneur or business owner. For instance, credit assessment techniques may not recognise and thus be appropriately calibrated for businesses with unconventional structures (such as social enterprises)\textsuperscript{14}. Alternatively, a requirement that entrepreneurs provide collateral for a loan may prove more of a problem for individuals from groups where incomes and levels of asset ownership (e.g. a house) are relatively low (such evidence exists with respect to women\textsuperscript{15} and certain Black, Asian or Minority Ethnic (BAME) groups\textsuperscript{16}). Spatially, these barriers tend to be concentrated within deprived areas of the country where multiple causes of market failure interact and magnify the scale of the problem\textsuperscript{17}.

Research has identified the following characteristics as common features of businesses and entrepreneurs who are more likely to experience access to finance barriers, though this list is not exhaustive\textsuperscript{18,19,20}:

- Start-up businesses;
- Social enterprises;
- Businesses from the informal sector;
- Individuals from certain BAME groups;
- Women;
- Individuals in receipt of income-related benefits;
- Young or elderly people;
- Individuals with a criminal record; and,
- Residents of deprived communities.

2.1.3 The extent of market failure

A number of studies have sought to measure the extent of market failure, though from a methodological perspective this is difficult since businesses or entrepreneurs who have been unable to access finance may then close or fail to start, meaning that they are not identified through surveys of existing businesses. Furthermore, the extent of market failure is not static and on the most part is driven by the behaviour of the mainstream banking sector and its approach to business lending. Prior to 2008, for example, there was a greater willingness of banks to lend to what would traditionally

\textsuperscript{14} HM Treasury (June 2004) The Graham Review of the Small Firms Loan Guarantee: An Interim Report


\textsuperscript{18} Cosh, A. \textit{et al} (2008) \textit{Op cit.}


\textsuperscript{20} Bank of England (2000) Finance for Small Businesses in Deprived Communities
have been considered ‘sub-prime’ markets. Since the onset of the credit crunch, however, the approach of banks has arguably swung in the opposite direction, such that banks have become considerably more risk-averse, and consequently have stopped lending to businesses that would once have been considered bankable (the impact of the credit crunch and recession is analysed in more depth in Section 7).

The most recent comprehensive survey of SME access to finance behaviour was undertaken in 2007\(^ {21}\). The results of this survey indicated that, in the three years preceding the survey:

- Some 36 per cent of SMEs had sought external finance, and of these, 39 per cent had sought to access a commercial loan or mortgage (mainly from a bank);
- Of the SMEs that had applied for a commercial loan or mortgage, 11 per cent were partially rejected (i.e. they did not receive all of the money that they had applied for), and another 4 per cent were rejected outright;
- Of the SMEs that had applied for external finance but had not applied for a commercial loan or mortgage, 16 per cent did not do so because they were ‘discouraged’ (i.e. they thought that they would be rejected).

There may, of course, be good reasons why these SMEs were not able to obtain a commercial loan or mortgage, or did not even apply for finance, but in a number of cases there is evidence that the market failures outlined above in Section 2.1.2 were in part responsible. The 2007 survey of SME access to finance behaviour reported that, of the businesses that had been partially or fully rejected when seeking a commercial loan or mortgage, in 10 per cent of cases this was because the business had no/insufficient security and in 6 per cent of cases this was because the business had no/insufficient credit history (a large proportion of businesses were not able to explain why they had been rejected)\(^ {22}\).

This survey information only concerns existing businesses, but a key market for CDFIs is start-up firms seeking finance. Generally, entrepreneurs tend to draw on their own savings rather than external finance providers, and, as with established firms, where external finance is needed it is mainstream banks that meet the majority of the demand\(^ {23}\). Obtaining data on the number of potential entrepreneurs who had tried and failed to access a loan from a mainstream bank (or had been discouraged from doing so) is difficult, since it is possible that they would not have started up their business as a result, and so would remain as unmet latent demand. A 2007 BERR survey of the household population\(^ {24}\) reported that, of the people who were thinking of starting a business (equal to 11 per cent of the general population), only 4 per cent had actually sought finance. Of these, the majority (55 per cent) had applied to a bank; 33 per cent had been fully rejected and another 11 per cent had been partially rejected. The same study also found that 12 per cent of people who were thinking of starting a business reported that they would need external finance but would not approach a bank. Some 10 per cent of this sub-group of would-be entrepreneurs noted that they would not use a bank because they believed that they would be rejected.


\(^ {22}\) Ibid.


\(^ {24}\) Ibid.
A number of reports have sought to measure overall ‘demand’ for CDFI lending (i.e. the extent of market failure). Such studies have typically applied information obtained from surveys of businesses’ and entrepreneurs’ access to finance behaviour to data on business numbers and estimates of potential start-ups. Using this method of approach, a 2003 study estimated that the ‘access to finance gap’ in the West Midlands region amounted to around 19,300 existing businesses and 7,000 potential new starts. Another study into demand for CDFI support in the South East region estimated that each year around 9,400 viable businesses are refused mainstream finance and would be eligible for a CDFI loan.

A further way to estimate the scale of market failure is through analysis of CDFI lending activity. Since CDFIs generally require finance applicants to prove that they have been rejected by a bank, the scale of CDFI lending provides a good indication of the minimum size of the finance gap caused by market failure (minimum because a number of CDFIs have reported that they are unable to meet demand due to a shortage of capacity and/or resources). As at April 2009, the CDFI sector had around 6,500 outstanding enterprise loans (see Section 3 for more detail).

2.2 Public policy and CDFIs

The CDFI sector has grown organically over time in response to the demand generated by the market failures outlined above. In parallel, it has received a range of public policy support in acknowledgement of the role of the CDFI sector in improving access to finance and assisting businesses served by mainstream banks, particularly where they are located within disadvantaged communities. Today, a number of policy drivers can be identified that provide rationales for policy support to the sector; the following are particularly significant:

- **Enterprise growth**: Enterprise has been identified by the government as one of the five drivers of productivity; national economic performance, it has been argued, is in part based upon creating an environment where businesses can start, survive and grow. CDFIs have a role to play within this goal as providers of finance for businesses that cannot access the finance they need in order to fulfil their potential;

- **Enterprise-driven regeneration**: Underpinning much public policy with respect to the regeneration of deprived areas of the country has been the role of enterprise in creating jobs, generating wealth, and providing local services in disadvantaged communities. Many CDFIs originated as specialist enterprise finance providers in deprived areas, and so have been identified as important actors in the delivery of public policy regeneration goals;

- **Support for social enterprises**: Public policy has provided considerable support to the social enterprise sector in recent years, and CDFIs have been identified as important intermediaries in the social enterprise financial support infrastructure (as well as in many cases being social enterprises in their own right);

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25 NEF and Bert Nicholson (December 2003) Analysis of the Need and Demand for Development Funding of Community Development Finance Institutions In the West Midlands


Enterprise within under-represented groups: As noted previously, it has been argued that certain groups in society face disproportionate barriers in accessing mainstream finance. Public policy has often considered these groups to be a source of considerable latent enterprise growth, whilst also seeing enterprise as a route to reducing social exclusion amongst certain communities. CDFIs, many of which trace their origins to within such communities or which have developed specialisms in engaging with these communities (e.g. through outreach), have been seen as ideally placed to support enterprise growth in these areas.

The combination of these four key policy drivers has shaped public policy and funding support for the CDFI sector in recent years. With this in mind, there follows a review of CDFI policy developments at a national, regional and local level.

2.2.1 National government support for CDFIs

Starting in the late 1990s, government began to commit significant resources towards the development of the CDFI sector, recognising its potential role in addressing the policy goals outlined above. The first significant funding programme was the Phoenix Challenge Fund that commenced in 2000.

The Phoenix Challenge Fund was launched primarily in response to the 1999 Policy Action Team (PAT) 3 report into the link between enterprise and social exclusion, which concluded that market failures in access to finance were one of three major obstacles to enterprise development in deprived areas, and identified CDFIs as a potential mechanism for addressing this problem.

The PAT3 report recommended that CDFIs be granted an ‘experimental funding window’ in order to strengthen the financial base of the sector, and thus expand its ability to deliver finance to businesses. The Phoenix Challenge Fund ran from 2000 to 2006, during which time some £42 million of funds were distributed across around 60 CDFIs in the form of revenue grants to support operational costs, capital grants for on-lending to businesses, and a loan guarantee fund to stimulate banks and other organisations to lend money to CDFIs for on-lending to businesses. Phoenix Challenge Fund resources were intended to enable CDFIs to develop and test new models of outreach and delivery, whilst also building the capacity of the sector with a view to scaling up its role within the enterprise finance market.

The main phase of the Phoenix Challenge Fund ended in 2006. Central government financial support for the CDFI sector now takes the following forms:

- Government support for enterprise continues to involve measures designed to increase the availability of finance for businesses, particularly since the onset of the credit crunch. In terms of the provision of financial support to CDFIs in order to meet this goal, the most important mechanism has been the Small Firms Loan Guarantee (SFLG) scheme, relaunched in January 2009 as the Enterprise Finance Guarantee (EFG) scheme. Under the EFG, government guarantees 75 per cent of the value of qualifying business loans (ranging in size from £1,000 to £1 million, together with restrictions on the size and sector of eligible businesses), thus reducing the scale of the risk to lenders. As at January 2010,

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28 HM Treasury and BERR (March 2008) Enterprise: Unlocking the UK’s Talent
12 English CDFIs had been accredited under the EFG scheme\(^{30}\). In addition to the EFG loans made by accredited CDFIs, in May 2009 the government announced that capital lent to CDFIs by other accredited lenders (e.g. mainstream banks) could be covered by the EFG scheme. The EFG extension covered lending of up to £20 million, and was intended to stimulate bank lending to the CDFI sector;

- In 2002 the government set up the Community Investment Tax Relief (CITR) scheme with the aim of channelling investment into CDFIs for on-lending to businesses based in deprived areas or owned by disadvantaged groups. The CITR scheme allows tax relief of up to 25 per cent over five years on investments – loans, equity investments (shares or securities), or deposits where CDFIs are banks – in CDFIs. CDFIs must be accredited to receive investment through the CITR scheme and, as at October 2009, 16 English CDFIs had received accreditation\(^{31}\);

- Government also promotes the development of the social enterprise sector which, as identified above, suffers from particular market failures in terms of accessing mainstream finance. The Social Enterprise Action Plan published by the Office of the Third Sector\(^{32}\) identifies the CDFI sector as an important source of finance for social enterprises;

- In 2006 the government launched the Local Enterprise Growth Initiative (LEGI) which was intended to specifically support the development of enterprise in deprived areas. LEGI is delivered by local authorities, and there are presently 29 LEGI programmes in operation. A further £280 million will be provided to existing LEGI programmes between 2008/09 and 2010/11, with resources to be spent on a range of local projects designed to support business start-up and growth. The design of LEGI programmes has been devolved to a local level, and CDFIs have already been involved in the delivery of components of LEGI projects;

- The trade association for the CDFI sector – the CDFA – receives financial backing from BIS in order to support its work building the capacity of CDFI members; and,

- The personal lending activities of CDFIs – though not the focus of this evaluation – fall within the remit of public policy goals in respect of financial inclusion, since they typically provide finance to people on low incomes who are unable to access mainstream sources of credit. Following the publication of the Financial Inclusion Strategy\(^{33}\), in 2006 the government established the £36 million Growth Fund, administered by the Department for Work and Pensions (DWP). The

\(^{30}\) EFG accreditation is dependent upon a number of factors, including a lender’s track record of profitable lending to SMEs.

\(^{31}\) CITR accreditation is dependent upon a CDFI meeting certain conditions for the period of accreditation, including: only providing finance to SMEs, only providing finance to enterprises that have been unable to obtain finance from ‘mainstream’ providers; and directing at least 75 per cent of operations (i.e. finance and/or business support) at enterprises for disadvantaged communities (defined as being located in one of the most deprived wards or local authorities according to the 2000 Index of Multiple Deprivation, or being owned by, operated by, or serving a group ‘disadvantaged’ by their gender, ethnicity, age, religious beliefs, disability, or another defining characteristic).


\(^{33}\) HM Treasury (December 2004) Promoting Financial Inclusion
Growth Fund was awarded to third sector organisations (primarily credit unions and CDFIs) and consisted of both revenue funding to build capacity, and capital funding for on-lending to individuals. The Growth Fund was recently extended through till 2011 and additional resources were provided, bringing total investment for the period 2006-2011 to almost £100 million.

### 2.2.2 Regional support for CDFIs

A variety of different approaches have developed at regional level to support CDFIs, driven principally by the Regional Development Agencies (RDAs). CDFI policy is regularly discussed by the RDA Access to Finance Group.

The RDAs came into being in 1998 with the statutory purpose to further economic development and regeneration in their respective regions. Early activity was driven by a substantial amount of ‘legacy funding’ of national programmes including, for example, the Single Regeneration Budget. Within the lifetime of the RDAs, individual CDFIs have been recipients of a range of policy and programme funding through the RDA policy domains of ‘business, people, and place’. In 2003, just 5 per cent of financial contributions to CDFIs (revenue and capital) came from RDAs (compared to 21 per cent from banks) but, by 2008, the RDA share had risen to 17 per cent of loan capital income and 36 per cent of revenue income.

A key driver of the increased role of RDA support in CDFI activity was the end of the Phoenix Fund, in 2006, when an additional £9.5 million of DTI funding was allocated towards transitional support for the CDFI sector for the period 2006 to 2008. Critically, this funding support was administered by the RDAs (in recognition both of their developing activity around access to finance and new responsibilities for regional business support).

Arguably, these transitional arrangements have subsequently triggered two significant shifts in the relationship of RDAs with the sector: a greater emphasis on the RDAs as a source of funding and, in addition, a shift in the objectives of the majority of such funding towards, first and foremost, enterprise growth (including social enterprises) and, thereafter, enterprise-driven regeneration. Indeed, this emphasis has been further reinforced by recent additional funding activity by RDAs to support the sector in responding to the credit crunch.

Analysis of the Regional Economic Strategies published by the RDAs since the Phoenix Fund closed in 2006 provides an indication as to where their strategic priorities lie. Each of the Regional Economic Strategies prioritises enterprise development, and to varying degrees highlights the role of access to finance in encouraging business start-up, growth and survival. The RDAs have established a host of enterprise finance interventions designed to address the market failures discussed above, including schemes providing equity, loans, grants, and other forms of public support. In some cases there is also explicit recognition that market failures are particularly acute for certain groups, and thus that access to finance interventions will need to prioritise addressing such gaps.

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Across the RDAs, CDFIs have been identified as one delivery mechanism for access to finance initiatives and whilst the end of such a major programme as the Phoenix Fund was a nervous time for the sector, since 2006 the RDAs have generally been very supportive of CDFIs (despite initial misgivings by many of those in the CDFI sector). Significant amounts of investment have been provided by RDAs for CDFIs, drawing on their own Single Pot resources, coupled in some cases with allocations from the 2000-2006 EU Structural Fund programmes (Objectives 1 and 2 and the European Social Fund). Resources have been provided for both capital and revenue purposes in order to deliver finance to businesses and also to boost the capacity of regional CDFI sectors.

Moreover, in response to the credit crunch and subsequent economic recession, most RDAs have introduced special loan funds for businesses unable to secure finance from mainstream banks which, in some cases, have been delivered by CDFIs.

The future of RDA support for CDFIs is, however, somewhat uncertain, with RDAs themselves under pressure to cut expenditure, and individual CDFIs noting that whilst funding support may have increased for certain CDFIs engaged most directly in enterprise growth, others driven more by regeneration objectives have seen a reduction in support. Overall, the current position is highly fluid as RDAs respond to changes in European regional funding, react to the credit crunch and economic downturn (both through support to businesses and the labour market), and do so within a context of stronger strategic challenge to their mission and heightened prioritisation of objectives alongside budget reductions.

There follows below a short summary of post-Pheonix CDFI support delivered by each of the RDAs (see Box 2.1), based on discussions held with the CDFI lead within each organisation in early to mid 2009. A number of overall observations can be made:

- Whilst initially reported to be reluctant to provide revenue funding after Phoenix transitional funding, most RDAs have in fact continued to provide some funding, albeit at a much lower level than was the case under the Phoenix Fund. Revenue funds have generally been closely linked to the delivery of capital funds in order to support CDFI running costs, and in most cases there is an explicit condition that CDFIs work towards phasing out their need for revenue support;

- RDAs have focussed on providing capital funding for on-lending. These capital funds have typically been more complex arrangements than was the case under Phoenix, based on the principle that CDFIs manage funds on behalf of the RDA, rather than receiving a grant for on-lending as they see fit. Further details of capital funding models is discussed in Section 6, but in general RDAs have been more prescriptive as regards the details of the capital funds delivered by CDFIs, setting relatively low maximum default rates and closely monitoring portfolio performance;

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36 In late 2009 the regional reviews were circulated amongst the RDA network by the study steering group in order to provide an opportunity for the results to be updated. To date, only AWM has provided a response.

37 November 2009 in the case of Yorkshire Forward.

Generally, and most recently, loan funds have been designed according to the Solutions for Business product portfolio, which contains a ‘Small Loans for Business’ product that consists of loans of up to £50,000 for businesses with viable business plans that have been refused bank finance. In certain instances, this is causing tension. Whilst Solutions for Business products are flexible in detail, for some RDAs CDFIs are charged with delivering a particular product, and this may not match with the products and services that the CDFI has expertise and experience in providing. Ultimately, this issue reflects a tension between the individual missions of CDFIs (e.g. the types of businesses and entrepreneurs they serve and the social impacts they expect), and the needs of the funding bodies (potentially the volume delivery of a standard service, with less regard for the nature of the beneficiary);

In terms of the organisation of their financial support for CDFIs, RDAs have adopted different models. A number have funded one or two CDFIs (one in the case of EEDA and emda, two in the case of the LDA), possibly including the option for the ‘lead’ CDFI to sub-contract the delivery of loans to smaller CDFIs in the region (a hub-and-spoke type model utilising outreach expertise). Discussions with RDA representatives have suggested that this approach is seen to be simpler to manage. In other cases, RDAs have contracted the delivery of loan funds to consortia of CDFIs (e.g. NWDA and AWM), though again usually focussing on what have been judged to be the most effective CDFIs. It is recognised within the RDAs that some CDFIs have been excluded, particularly where a single contract has been awarded; indeed in some cases there is an acceptance that this may lead to consolidation in the numbers of active CDFIs;

Whilst many CDFIs focus on a particular geographical area, usually relatively small (such as a sub-region), a requirement of some RDA capital funds has been that loans are available region-wide (e.g. EEDA, emda and SWRDA), which has meant that some CDFIs have had to expand the scale of their operations considerably. Whilst this drives sector growth and expansion, and in some cases is managed through a ‘hub and spoke’ approach, there is a tension between a local outreach-driven CDFI service and a regional CDFI service which may not have a physical presence within the areas in which it operates. Moreover, rapid growth that is dependent upon a single public sector funding programme may not be sustainable.

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**Box 2.1: RDA Support for CDFI Enterprise Lending**

**London**

London is unique amongst the English regions in that Phoenix Challenge Fund resources are still available until March 2010. Revenue funding is currently being distributed to CDFIs on the basis of the number of loans made (capped at up to £2,500 per loan). In June 2008 the LDA also launched a £3 million Economic Recovery and Loan Fund, specifically in response to the credit crunch. The Fund is administered by two CDFIs, and is designed to provide loans to established businesses that cannot obtain funding from mainstream sources. The fund closes in March 2010.

In March 2010, therefore, the LDA’s two main CDFI funding streams will close. Representatives from the LDA indicated that future CDFI policy is currently being decided, but in future there will need to be a more strategic approach to sector support. One potential model being considered is to focus support on the 1-2 most active CDFIs.
(for whom enterprise lending is a core competence), though there are concerns about the current geographical coverage of the sector in London (and thus a need to build capacity in underserved areas, perhaps using a hub-and-spoke model). Moreover, it is seen as unlikely that, in future, the LDA would provide significant revenue funding for CDFIs, unless there was clear added value.

The South East

In 2002, SEEDA established Finance South East to provide businesses in the region with funding if they are unable to secure finance from mainstream sources. Finance South East currently manages a number of funds on behalf of SEEDA, including a Transition Fund aimed at SMEs facing liquidity issues as a result of the credit crunch. In 2007, in order to consolidate its work with CDFIs in the region, SEEDA set up the Inclusive Finance Community Investment Company (IFcic). IFcic is an independent umbrella company which contracts with the region’s CDFIs, and centralises back office and administrative functions.

The South West

Discussions with a representative of SWRDA have indicated that Phoenix Fund resources were solely used to build up the capacity of CDFIs in the region, and therefore resources were initially distributed across all eligible CDFIs. From March 2009 onwards, however, the RDA took a more strategic approach towards CDFIs and their role within the delivery of regional enterprise goals. The £10 million South West Loans Fund was created using SWRDA and ERDF funds in order to deliver two Solutions for Business products (small loans for businesses and finance for business) to businesses in the region. The Fund was managed on an interim basis by the national YMF Group, but from September 2009 until December 2015 will be managed by two organisations of which the largest CDFI in the region – the South West Investment Group – will manage the small loans for business element. SWRDA has only provided capital funding, however, and it is expected that revenue funds will need to be obtained from other sources (including, potentially, the delivery of other Solutions for Business support products).

The East of England

Towards the end of the Phoenix Fund, EEDA commissioned a strategic review of its approach to CDFIs which concluded that a single, region-wide CDFI be funded in order to ensure consistent regional access to finance coverage and to focus resources. Following this report, EEDA assembled a £750,000 loan pot (which was subsequently extended by a further £350,000 in March 2009 in response to higher than expected demand caused by the credit crunch). The five-year contract to deliver this fund was awarded to Foundation East, one of the leading CDFIs in the region. The loans offered through the fund have been designed according to the template of the Small Loans for Business product of the Solutions for Business portfolio. The award of the contract to Foundation East was based on an assumption that the CDFI would move towards full sustainability, though in order to support this process, Foundation East were also awarded a revenue grant of £450,000 (for five years starting in April 2008) to cover the costs of running the loan scheme.

The East Midlands

Following the end of the Phoenix Fund, emda commissioned a study looking at potential options for future RDA support for the CDFI sector. Whilst it was recognised
that Phoenix had had successes, according to a representative from the RDA, it was felt that, in future, funding had to be tied much more closely to organisational sustainability and should have much greater regional coverage. Following the publication of the review *emda* decided to create a single regional CDFI loan fund. The fund – Enterprise Loans East Midlands – includes some £3 million from *emda* (made up of remaining Phoenix Fund resources, ERDF monies, and additional RDA resources), supplemented by a requirement that the organisation delivering the Fund match-fund public sector investment. The fund is delivered to small businesses following the guidelines of the Small Loans for Business product of the Solutions for Business portfolio. Since April 2008, Enterprise Loans East Midlands has been delivered by a regional CDFI – the First Enterprise Business Agency (FEBA), who were also awarded an *emda* revenue grant of around £470,000 (for four years starting in April 2008) to cover operational costs. It is anticipated that FEBA will achieve some measure of sustainability by the end of this period.

*The West Midlands*

A consultee from AWM suggested that the RDA has one of the longest track records of the English RDAs in supporting the CDFI sector. Recognising the impact that the end of the Phoenix Challenge Fund would have on the CDFI sector, in 2005 AWM launched the three year Advantage Small Loans Programme (ASLP), a £3.7 million pot of ERDF and Single Pot capital and revenue funding that was individually awarded to six of the region’s CDFIs in order to provide transitional support post-Phoenix. This was enhanced in March 2008 with the addition of £1 million of post-Phoenix funding from BIS. In addition, some support was provided to the Fair Finance Consortium to market and promote the sector and identify/ spread best practice. In response to the credit crunch AWM injected a further £2.6 million into the ASLP to extend it through to August 2009. In September 2009 a new funding was approved, reflecting AWM’s continued support for the micro-finance sector and its commitment to ensure wider geographical coverage. The new programme will consist of a £6 million pot drawn from ERDF and AWM Single Budget funding, augmented by some local authority and private sector support. It is designed to deliver support to businesses across the region whilst also developing the capacity of the CDFI sector.

*The North West*

First phase Phoenix Fund resources in the North West were fully allocated by April 2007. Whilst the CDFI sector was seen to have matured during the Phoenix Fund years, the NWDA was keen to take a more strategic approach to the sector going forward. An independent review was commissioned and, on the basis of this report, the NWDA set up a capital pot to be delivered by the most ‘effective’ CDFIs in the region in order to ensure that resources were delivered effectively and that CDFIs would continue to develop as organisations. Some £5 million was assembled, to be delivered according to the template of the Small Loans for Business product of the Solutions for Business portfolio. The fund is presently delivered by five regional CDFIs. In response to the credit crunch, the NWDA has set up an additional £5 million loan fund using ERDF resources, delivered by the same five CDFIs along similar lines.

The goal of the NWDA is both to provide finance for small businesses (where CDFIs are seen to have an advantage in delivery), and also to build up the capacity of the CDFI sector in the region. With the latter goal in mind, the NWDA has also allocated revenue funding for the five CDFIs delivering the two Small Loans for Business funds.
In addition to a dedicated marketing and promotion funding pot, the NWDA is funding two loan officers per CDFI until March 2011.

**Yorkshire and Humber**

At the end of the Phoenix Fund in 2006, Yorkshire Forward provided a further £0.9 million of capital and revenue funding for the CDFI sector, which ran through till March 2009 and was managed by the CDFA. With the onset of the credit crunch, the RDA used the CDFI network to deliver part of its transitional loan fund, providing a further £1.2 million of capital and revenue funding for CDFIs in the region. CDFIs were supported on the basis that they were well-placed to deliver small loans to businesses unable to access loans from mainstream banks, and also since the Phoenix Fund extension phase had finished and the RDA had not yet set up its next CDFI programme, thus leaving a funding gap.

Early in 2010 Yorkshire Forward will tender for the management and delivery of a new £10 million micro loan fund, drawing on a mixture of Single Pot and ERDF resources. This loan fund will provide loans of up to £25,000 and will be available for businesses unable to access finance from mainstream banks. Alongside this micro loan fund, also in early 2010 Yorkshire Forward, will tender for the management and delivery of a £90 million regional JEREMIE loan fund (using the RDA’s resources and investment from the European Investment Bank). This fund will provide loans of £15,000 to £150,000, and considered unlikely to be relevant for the region’s CDFIs.

**The North East**

Phoenix Fund resources were seen by One NorthEast to have had an impact on the regional CDFI sector, though at the end of the programme period there remained issues around the sustainability and effectiveness of the sector. In May 2008 the RDA launched the Regional Enterprise Loan Fund which provides small loans for SMEs in the North East, along the lines of the Small Loans for Business product of the Solutions for Business portfolio. The Fund is delivered by two organisations, though neither of these are CDFIs. In response to the credit crunch, One NorthEast recently invested some £1 million of extra resources, doubling the size of the Fund to £2 million.

The RDA is currently in the process of setting up a £125 million regional loan fund under JEREMIE (using its own resources as match funding for financing from the European Investment Bank), which it aims to have in place for early 2010. Within this, it is envisaged that the RDA will initially create a £1 million micro-loan fund to be delivered by CDFIs, who will also be paid to deliver pre- and post-loan support (i.e. revenue funding).

### 2.2.3 Local government support for CDFIs

Based on their economic development remit, and particularly where they have been designated as the accountable bodies for time-limited local area regeneration initiatives, local authorities have been responsible for the provision of finance for small businesses that cannot obtain funding from mainstream banks. Over the years, this finance has taken many forms, including grants and loans, and focussed on particular areas, communities and business types, depending upon programme or policy goals.

It is beyond the scope of this study to provide a comprehensive picture of local authority loan finance, but with the future expenditure of the RDAs uncertain and with the Review of Sub-National Economic Development and Regeneration reiterating the...
role of local authorities in economic development, the importance of the local authority sector to CDFIs is likely to increase in the future.

Local authority business finance schemes both support and compete with CDFIs. Historically, the CDFI sector has received considerable support from local authorities; many CDFIs were or still are enterprise agencies, whilst others were established using local authority resources. CDFIs still receive both capital and revenue finance from local authorities (ART recently received funding from both AWM and Birmingham City Council, for instance – see Annex 5), and in other cases have been contracted to manage and deliver local authority loan schemes. Local authorities can thus be important sources of capital for CDFIs, though these resources can also be very localised, relatively small (compared with larger RDA programmes), potentially short-term, and linked with local policy goals (which may, for instance, exclude market groups such as social enterprises). Furthermore, in some cases local authorities run small business loan schemes that effectively compete with CDFIs, particularly where interest rates are artificially low and default rates less strictly monitored (e.g. where transaction and overhead costs are not factored into decision making).

Since the end of the Phoenix Fund the most significant local authority-led enterprise programme has been the Local Enterprise Growth Initiative (LEGI), which is currently operating in 29 local areas across England, and through which a number of CDFIs have been successful in obtaining funding from LEGI programmes. For instance, GLE oneLondon is managing a business loan fund on behalf of Croydon Enterprise (the LEGI programme for Croydon), whilst other CDFIs have indicated that they have generated revenue income by delivering LEGI funded business support services.

2.3 Logic model for the CDFI sector

The evidence reviewed above has provided an overview of the rationale for CDFIs, including consideration of the public policy rationale for supporting the sector. This review provides the basis for the development of a generic logic model for the CDFI sector (shown in Figure 2.1). This model articulates the logic underpinning a CDFI, from the inputs, through the activities that these inputs fund, to the outputs, outcomes and impacts that result from the activities delivered.
The logic model shown in Figure 2.1 is, of course, a generalised representation of the CDFI sector, and the logic models for individual CDFIs will vary depending on their specific rationale and objectives. As discussed in Section 2.2, there are four key sets of rationales for CDFIs: enterprise growth, enterprise-driven regeneration, support for the social enterprise sector, and enterprise growth within under-represented groups. Depending on which of these rationales a CDFI is working towards (and a CDFI will typically tend to work towards more than rationale), the significance and details of each of the components of the logic model above will change.

Table 2.1 provides examples of how the details of the various components of the logic model shown in Figure 2.1 might change depending on the rationale(s) of a CDFI. These issues are developed in more detail in Section 6 which looks at the sustainability of different CDFI operating models.

**Table 2.1: Examples of how different CDFI rationales might affect priorities within each area of the logic model**

<table>
<thead>
<tr>
<th>Rationale</th>
<th>General enterprise growth</th>
<th>Enterprise-driven regeneration</th>
<th>Support for social enterprises</th>
<th>Enterprise in under-represented groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inputs</td>
<td>RDA enterprise</td>
<td>Community regeneration</td>
<td>Charitable</td>
<td>Charitable</td>
</tr>
</tbody>
</table>
### Rationale

**General enterprise growth**
- programmes
- Banks

**Enterprise-driven regeneration**
- funds (LEGi)

**Support for social enterprises**
- foundations
- Social investors

**Enterprise in under-represented groups**
- foundations

### Expenditure on activities

<table>
<thead>
<tr>
<th>Expenditure on activities</th>
<th>Rationale</th>
<th>Enterprise-driven regeneration</th>
<th>Support for social enterprises</th>
<th>Enterprise in under-represented groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generation of demand</td>
<td>Community outreach</td>
<td>Generation of demand</td>
<td>Community outreach</td>
<td></td>
</tr>
<tr>
<td>Loan processing operations</td>
<td>Business support</td>
<td>Business support</td>
<td>Business support</td>
<td></td>
</tr>
</tbody>
</table>

### Outputs

<table>
<thead>
<tr>
<th>Outputs</th>
<th>Expenditure on activities</th>
<th>Rationale</th>
<th>Enterprise-driven regeneration</th>
<th>Support for social enterprises</th>
<th>Enterprise in under-represented groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume delivery of loans</td>
<td>Loans within deprived areas</td>
<td>Loans for social enterprises</td>
<td>Loans for target groups</td>
<td></td>
<td></td>
</tr>
<tr>
<td>More business support needed</td>
<td></td>
<td>More business support needed</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

### Outcomes

<table>
<thead>
<tr>
<th>Outcomes</th>
<th>Expenditure on activities</th>
<th>Rationale</th>
<th>Enterprise-driven regeneration</th>
<th>Support for social enterprises</th>
<th>Enterprise in under-represented groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume start-ups/growth</td>
<td>Start-ups/growth and social outcomes (aspirations etc)</td>
<td>Social enterprise start-ups/growth</td>
<td>Start-ups/growth and social outcomes (aspirations etc)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduced access to finance barriers</td>
<td>Learning outcomes</td>
<td></td>
<td>Learning outcomes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Impacts

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Expenditure on activities</th>
<th>Rationale</th>
<th>Enterprise-driven regeneration</th>
<th>Support for social enterprises</th>
<th>Enterprise in under-represented groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business stocks</td>
<td>Business stocks in deprived areas</td>
<td>Social and environmental impacts</td>
<td>Business stocks amongst target groups</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bankable businesses</td>
<td>Social/ equity impacts</td>
<td>Bankable social enterprises</td>
<td>Social/ equity impacts</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 2.4 Key messages from CDFI evaluations

Individual CDFIs and funding programmes through which CDFIs have benefited have been subject to a number of evaluations and other research studies over the past few years. These have included the 2004 National Evaluation of the Phoenix Fund, feasibility studies and evaluations of regional CDFI programmes that have been commissioned by the RDAs, and a small number of evaluations of individual CDFIs. These evaluations have informed policy-makers at a national, regional and local level as regards their approaches towards CDFIs, and highlight the ongoing issues facing the sector from a public policy perspective. In summary, these include the following:

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Evaluation of Community Development Finance Institutions
Final Report

- Scale and coverage: Many evaluations of CDFIs – particularly feasibility studies carried out for RDAs – have stressed the need for individual CDFIs and ultimately the sector as a whole to increase both the scale and coverage of lending activity (particularly if sustainability goals are to be met – see below). As noted above, RDAs tend to require the CDFIs that they fund to provide region-wide coverage and to be able to expand in order to meet demand;

- Partnership working: Evaluations of CDFIs – particularly those focusing on regional CDFI support – tend to stress the need to improve partnership working between CDFIs, other providers of business finance (e.g. banks), and the business support infrastructure (e.g. Business Link). In particular, these relationships should act as a key source of referrals for CDFIs, and reduce the need for CDFIs to expend resources on investment readiness training for businesses;

- Capacity and capability: Evaluations of CDFIs have tended to call for improvements in the capacity and capability of the sector, particularly in relation to the governance of CDFIs. The CDFA has developed a Code of Practice that its members are expected to meet and, linked with this, has published the Change Matters performance framework for the sector which sets out good practice across three CDFI operational domains: finance, business and impact41;

- Demonstrating impact: Previous evaluations have noted that whilst there has been progress in the quality of the evidence base as to the impact of CDFIs, there is still room for considerable improvement (and as regards the measurement of both economic and social impacts of CDFIs). From a public policy perspective, the ability of CDFIs to demonstrate the full range of their impacts is crucial if the value and cost-effectiveness of the sector is to be understood and compared against other interventions in order to identify the areas in which CDFIs are best placed to deliver;

- Sustainability: The sustainability of CDFIs is a common theme running throughout evaluations of the sector. Public policy support for CDFIs is generally predicated on the principle that the sector should be moving towards sustainability, such that the need for direct public sector financial support could be scaled back or even eliminated altogether. Evaluations of CDFIs have tended to explore models through which sustainability might be fully or partially achieved, and indeed as noted in Section 2.2.2, it has been a requirement of some RDAs that the CDFIs they support be demonstrating progress towards sustainability. It is recognised, however, that there is a trade-off between achieving full sustainability and maintaining the depth and breadth of support that CDFIs typically seek to deliver in their target markets.

The evaluation questions for this study (Section 1.2) raise similar issues as regards the position of the CDFI sector, and the remaining sections of this report explore issues such as scale/coverage, impact and sustainability in more detail.

2.5 Conclusions

This section of the report has reviewed the rationale for CDFIs, and has also provided an overview of the key public policy developments in the sector over the past few years. A number of concluding observations can be made:

The rationale for CDFIs is principally one of market failure: mainstream banks do not meet the entirety of demand for loan finance from viable businesses. Market failure is particularly acute for certain types of business and/or amongst particular groups, and is also exacerbated in deprived areas. The theoretical arguments underpinning the market failure rationale remain valid; indeed, with the onset of the credit crunch these failures have arguably intensified rather than dissipated (see Section 7);

Public policy has generally been supportive of CDFIs, recognising both the market failures that CDFIs address, and the public policy goals that can be accomplished by developing the sector. Broadly, the enterprise lending activities of CDFIs can be seen to work towards four policy goals: delivering enterprise growth, facilitating enterprise growth specifically in deprived areas, supporting social enterprises, and boosting enterprise amongst underrepresented groups. The example of a logic model for the CDFI sector presented above (Table 2.1) demonstrates the interaction of these different public policy agendas;

The Phoenix Challenge Fund was the key mechanism through which central government supported the development of the CDFI sector, and was intended to facilitate both experimentation and an expansion in capacity (financial and organisational). The main phase of the Phoenix Fund finished in 2006, since when government support for the enterprise lending activities of CDFIs has focussed on indirect funding mechanisms (guarantee schemes and investment tax relief) that have only been available to accredited organisations (which make up a relatively small proportion of the CDFI sector) and direct support at a regional level;

The RDAs are now the main providers of direct financial support to CDFIs, but whereas Phoenix was a single, standardised programme, the RDAs have each adopted their own approaches in terms of: aims and objectives, organisational structure, level and type of finance, duration of support, geography of delivery, expected impacts, etc. Furthermore, funding has not been made available to all CDFIs, and in some cases there are uncertainties as to the future provision of finance;

Public policy support for CDFIs, and the evaluations of the sector that have been commissioned by national and regional bodies, is arguably based on the principle that CDFIs demonstrate progress in a number of areas, foremost of which has been sustainability (i.e. an ability to operate, within certain parameters, without need for public funding). It has generally been recognised that there is a potential tension between this goal and the various policy objectives for the sector outlined above, particularly those around enterprise growth within deprived areas and amongst underrepresented groups. The issue of sustainability – and the trade-offs that it implies – is discussed in more detail in Section 6.
3 ACTIVITIES DELIVERED BY THE CDFI SECTOR

This section of the report analyses the scale and scope of the activities delivered by the CDFI sector and explores how this has changed in recent years. The CDFI sector is then analysed within the context of the support (financial and non-financial) available from alternative providers in order to assess the added value of the sector.

The evidence used in this section of the report has primarily been drawn from analysis of anonymous raw data obtained by the CDFA through their annual Inside Out survey of the UK CDFI sector. It should be noted, however, that Inside Out data includes information concerning a wide range of CDFIs, including responses from a small number of organisations that are considerably larger than the majority of the sector. In 2008/09, for example, total outstanding lending by Triodos Bank was greater than that of the rest of the CDFI sector combined. For this reason, responses from two very large CDFIs – Triodos Bank and Bridges Community Ventures – have been removed from the analysis of data throughout this section of the report. Nevertheless, it remains the case that the averages presented are skewed upwards to some extent by the inclusion of disproportionately large CDFIs (such as Charity Bank, the Merseyside Special Investment Fund and UK Steel Enterprise), and thus that in many cases well over half of the CDFI sector falls below the averages presented.

3.1 Financial activities

There follows a review of the scale and scope of the enterprise lending activities of the UK CDFI sector, organised into sub-sections on:

- Loan fund size;
- Total size of loan portfolio, including analysis by market segment;
- The regional geography of CDFI lending;
- Average loan size;
- Loan applications and loans made;
- Security taken by CDFIs;
- Interest rates and fees charged by CDFIs;
- Bad debt rates; and,
- Other financial products offered by CDFIs.

3.1.1 Loan fund size

Fund size is a measure of the total loan pot available to a CDFI, and is made up of a combination of the value of loans outstanding, the value of loans committed but not drawn, and the value of any other capital that the CDFI has available for lending but

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42 The Inside Out survey is distributed each year to all CDFA members, and collects data on performance during the previous financial year (April to March). In the previous three years, response rates have been: 82 per cent (2006/07), 83 per cent (2007/08), and 93 per cent (2008/09)

43 Throughout this sub-section, Triodos Bank and Bridges Community Ventures have been removed from the analysis as a result of their disproportionate size relative to the remainder of the CDFI sector.
which has not been committed. Table 3.1 shows the total value of CDFI loan funds between 2006/07 and 2008/09 and, since this figure is affected by the number of *Inside Out* survey respondents, average CDFI loan fund sizes:

- Between 2006/07 and 2008/09, the total loan fund size for the CDFI sector as a whole increased by 22 per cent, from around £201 million to £246 million (though note the exclusion of two large CDFIs – Triodos Bank and Bridges Community Ventures);
- Average fund sizes also increased between 2006/07 and 2008/09 (by 25 per cent), standing at just over £4.3 million in 2008/09, from £3.5 million in 2006/07.

### Table 3.1: Total and average CDFI loan fund sizes, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>Loan fund size</th>
<th>2006/07</th>
<th>2007/08</th>
<th>2008/09</th>
<th>% change 06/07-08/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector total</td>
<td>£200,783,289</td>
<td>£202,320,041</td>
<td>£245,700,685</td>
<td>22%</td>
</tr>
<tr>
<td>CDFI average</td>
<td>£3,461,781</td>
<td>£3,967,060</td>
<td>£4,310,538</td>
<td>25%</td>
</tr>
</tbody>
</table>

*Base = 58 CDFIs (2006/07); 51 CDFIs (2007/08); 57 CDFIs (2008/09). Source: Inside Out*

Figure 3.1 shows the distribution of loan fund sizes within the CDFI sector between 2006/07 and 2008/09:

- In 2006/07, 48 per cent of CDFI loan funds were worth less than £1 million; by 2008/09 the proportion had dropped to 35 per cent;
- Relatively large loan funds (worth more than £5 million) are still rare within the CDFI sector, though increased from 17 per cent to 21 per cent of the total between 2006/07 and 2008/09 (again, excluding Triodos Bank and Bridges Community Ventures);
- In 2008/09 some 40 per cent of CDFIs had loan funds of more than £2 million, up from 31 per cent in 2006/07. Loan fund size is a key contributing factor in terms of the extent to which a CDFI is moving towards sustainability (see Section 6 for more details).
Figure 3.1: Distribution of sizes of CDFI loan funds, 2006/07 to 2008/09

Base = 58 CDFIs (2006/07); 51 CDFIs (2007/08); 57 CDFIs (2008/09). Source: Inside Out

3.1.2 Loan portfolio

Loan portfolio is a measure of the total value of the outstanding loans of the CDFI sector (i.e. loans that are in the process of being repaid). Table 3.2 shows the total value of outstanding lending, the average per CDFI, and also the deployment rate (a measure of the extent to which CDFIs’ available funds (Section 3.1.1) are deployed through outstanding loans:

- As at 2008/09, the CDFI sector as a whole had some £127 million worth of outstanding loans, up 49 per cent from £85 million in 2006/07;
- The average value of outstanding loans per CDFI increased by 51 per cent from £1.5 million in 2006/07 to £2.2 million in 2008/09;
- The average deployment rate across the CDFI sector also increased from 50 per cent in 2006/07 to 60 per cent in 2008/09.

Table 3.2: Total and average CDFI loan portfolio sizes and the average deployment rate, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>Loan portfolio size</th>
<th>2006/07</th>
<th>2007/08</th>
<th>2008/09</th>
<th>% change 06/07-08/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector total</td>
<td>£85,358,828</td>
<td>£96,808,628</td>
<td>£126,935,139</td>
<td>49%</td>
</tr>
<tr>
<td>CDFI average</td>
<td>£1,471,704</td>
<td>£1,898,208</td>
<td>£2,226,932</td>
<td>51%</td>
</tr>
<tr>
<td>Avg. deployment rate</td>
<td>50%</td>
<td>59%</td>
<td>60%</td>
<td>-</td>
</tr>
</tbody>
</table>

Base = 58 CDFIs (2006/07); 51 CDFIs (2007/08); 57 CDFIs (2008/09). Source: Inside Out

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44 Calculated by summing loans outstanding and loans committed but not drawn, and dividing by the total value of the fund
The *Inside Out* survey collects data on the value of the CDFI loan portfolio within four key market segments: micro enterprises (defined as businesses employing 0-9 people); SMEs (employing 10-249 people); social enterprises (not defined, but mutually exclusive so cannot overlap with micro businesses or SMEs); and personal lending. Personal lending is made up of loans to consumers, for instance for the purchase of consumer goods, or specifically for housing repairs (or potentially purchases). The focus of this evaluation is on enterprise lending and so data on the personal lending activities of CDFIs — though disaggregated and included in the tables below — is not analysed.

Figure 3.2 shows the proportion of CDFIs with outstanding loans in each of these four key segments. Note that CDFIs could have outstanding loans with more than one market segment; in fact between 2006/07 and 2008/09 there was evidence of diversification in the market as the average number of market segments served increased from 1.53 in 2006/07 to 1.68 in 2008/09. Key points of note with regard to Figure 3.2 are as follows:

- The proportion of CDFIs with outstanding loans within the micro enterprise market decreased slightly from 76 per cent in 2006/07 to 72 per cent in 2008/09;
- Conversely, the proportion of CDFIs lending to SMEs increased from 24 per cent of the total in 2006/07 to 42 per cent in 2008/09;
- The proportion of CDFIs lending to social enterprises dropped from 36 per cent in 2006/07 to 32 per cent in 2008/09.

**Figure 3.2: Proportion of CDFIs with outstanding loans within key market segments, 2006/07 to 2008/09**

The data presented in Figure 3.2 point towards a degree of consolidation within areas of the CDFI sector, in that the total number of CDFIs active in the micro enterprise and social enterprise lending markets has decreased in the past few years. Further analysis of the data suggests that it is the number of small scale lenders providing
loans within these two market segments that has decreased. The number of CDFIs with outstanding loan portfolios with micro enterprises that were worth less than £250,000 fell from 31 in 2006/07 to 27 in 2008/09, whilst the number with outstanding loan portfolios with social enterprises that were worth less than £500,000 (social enterprise loans tend to be larger) fell from 13 in 2006/07 to 10 in 2008/09.

The social enterprise lending market in particular is characterised by a number of CDFIs that are very large by the standards of the sector, most of which operate UK-wide (Triodos – excluded from the analysis – but also Charity Bank, Co-operative and Community Finance, and the Local Investment Fund), and it remains to be seen what effect these large organisations have on the capability of the remainder of the CDFI sector to ‘compete’ within the social enterprise market.

shows the value and volume (the number of loans made) of CDFI outstanding lending within the four key market segments shown in Figure 3.2:

- Total enterprise lending by CDFIs increased by 48 per cent between 2006/07 and 2008/09, up from £81.9 million to £121.1 million. The total number of outstanding enterprise loans also increased, albeit at a lower rate (by 9 per cent from 5,280 in 2006/07 to 5,730 in 2008/09).

- Social enterprises received the single largest amount of CDFI lending – some £54.4 million in 2008/09 (up by 42 per cent from £38.2 million in 2006/07). This increase was achieved despite the drop in the number of CDFIs operating within the social enterprise market, suggesting that those CDFIs that have continued to lend to social enterprises have significantly increased the value of their lending. As noted above, the social enterprise lending market is dominated by large national CDFIs, of which the largest four accounted for 63 per cent of the total value of lending to the sector in 2008/09;

- Between 2006/07 and 2008/09 the total value of outstanding CDFI loan funding with SMEs increased by 245 per cent from £10.7 million to £36.8 million. The value of SME lending in 2008/09 was almost £10 million greater than the value of lending to micro enterprises, a reversal of the position in 2006/07;

- The value of CDFI lending to micro enterprises increased by just 6 per cent between 2006/07 and 2008/09 (compared to an increase of 48 per cent for enterprise lending as a whole), whilst the volume of outstanding loans decreased by 2 per cent. Arguably traditionally the key market segment for the CDFI sector, as noted above, the number of CDFIs lending to micro enterprises has decreased in the past few years, which has been reflected in a stagnation in the total value of lending within the sector.
Table 3.3: Total value (£) and volume (no. of loans) of CDFI lending within key market segments, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>Market segment</th>
<th>2006/07 Value</th>
<th>2007/08 Value</th>
<th>2008/09 Value</th>
<th>% change 06/07-08/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro enterprises</td>
<td>£24,994,441</td>
<td>£23,837,255</td>
<td>£26,435,109</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>3,691</td>
<td>3,498</td>
<td>3,608</td>
<td>-2%</td>
</tr>
<tr>
<td>SMEs</td>
<td>£10,684,932</td>
<td>£17,464,305</td>
<td>£36,848,936</td>
<td>245%</td>
</tr>
<tr>
<td></td>
<td>496</td>
<td>423</td>
<td>1,092</td>
<td>120%</td>
</tr>
<tr>
<td>Social enterprises</td>
<td>£38,223,157</td>
<td>£43,627,384</td>
<td>£54,381,828</td>
<td>42%</td>
</tr>
<tr>
<td></td>
<td>668</td>
<td>666</td>
<td>749</td>
<td>12%</td>
</tr>
<tr>
<td>Enterprise lending*</td>
<td>£81,945,655</td>
<td>£93,168,907</td>
<td>£121,122,558</td>
<td>48%</td>
</tr>
<tr>
<td></td>
<td>5,279</td>
<td>4,994</td>
<td>5,732</td>
<td>9%</td>
</tr>
<tr>
<td>Personal lending</td>
<td>£3,413,173</td>
<td>£3,639,721</td>
<td>£5,812,581</td>
<td>70%</td>
</tr>
<tr>
<td></td>
<td>5,574</td>
<td>9,721</td>
<td>7,693</td>
<td>38%</td>
</tr>
</tbody>
</table>

Note: # Micro enterprise, SME and social enterprise lending does not sum to enterprise lending where CDFIs did not disaggregate enterprise lending.

Base = 58 CDFIs (2006/07); 51 CDFIs (2007/08); 57 CDFIs (2008/09). Source: Inside Out

3.1.3 The regional geography of CDFI lending

Figure 3.3 shows the geographical distribution of the outstanding loan portfolio of the CDFI sector in 2008/09, broken down by the four key market segments used previously (note that the ‘UK’ category concerns lending by CDFIs operating nationally that cannot be disaggregated by region):

- The largest volume of CDFI outstanding loans in 2008/09 was provided by CDFIs that operate UK-wide (amounting to £42.2 million in total), the majority of which was accounted for by lending to social enterprises;

- Within the regions, there are big variations in the value of CDFI lending. Total outstanding lending in the North West amounted to £20.9 million in 2008/09, whereas lending in the North East totalled just £0.7 million. It should be noted, of course, that this data concerns lending by CDFIs that only lent within the region in question; the regional breakdown of lending by nationally oriented CDFIs is not available;

- There were also variations between regions in the balance of lending across the four key market segments. In Northern Ireland and Scotland the majority of outstanding lending was with social enterprises. In the North East and the East of England, lending to micro enterprises made up the majority of the value of outstanding CDFI loans. In Yorkshire & Humber and the North West, SME lending constituted the majority of total CDFI lending.
Figure 3.3: Value of CDFI outstanding lending by region and market segment, 2008/09

Note: NW (North West), Y&H (Yorkshire and Humber), NI (Northern Ireland), LO (London), WM (West Midlands), SC (Scotland), SW (South West), EE (East of England), SE (South East), EM (East Midlands), NE (North East), and WA (Wales); UK represents national lenders

Base = 57 CDFIs. Source: Inside Out

Whilst Figure 3.3 showed the absolute value of CDFI lending by region, Figure 3.4 benchmarks enterprise lending (i.e. excluding personal lending) against the total numbers of businesses in each region (both VAT registered and not VAT registered), as one measure of the extent to which regions are, in effect, underserved by CDFIs. Note, however, that this excludes regional lending by national CDFIs, and also that there may well be variations in the actual level of demand for CDFI loans between regions:

- The average value of outstanding enterprise lending across all regions was £21.70 per business in 2008/09. Three regions – Northern Ireland, Yorkshire & Humber, and the North West – recorded above average amounts of outstanding enterprise lending per business;

- Northern Ireland is the best served of all the regions, with some £104 worth of outstanding CDFI enterprise lending per business in 2008/09. As shown in Figure 3.3, however, the majority of this total was lent to social enterprises;

- In 2008/09 there were no outstanding enterprise loans in Wales, making it the most underserved region in the UK. After this, the North East and the South East recorded the next lowest levels of outstanding enterprise lending per business in 2008/09 (£5 and £1.70 per business respectively);

- In terms of change over time, between 2006/07 and 2008/09 there were large increases in the value of outstanding enterprise lending per business in Yorkshire & Humber (up from £9.80 per business in 2006/07 to £41.60 per business in 2008/09), and the North West (up from £29.80 to £41.40 per business). Conversely, there were significant falls in the level of outstanding
enterprise lending per VAT registered business in Scotland (down from £15.40 to £11.50 per business) and the North East (from £8.50 to £5 per business).

Figure 3.4: Value of CDFI enterprise lending benchmarked against the number of businesses, by region, 2006/07 to 2008/09

Note: NW (North West), Y&H (Yorkshire and Humber), NI (Northern Ireland), LO (London), WM (West Midlands), SC (Scotland), SW (South West), EE (East of England), SE (South East), EM (East Midlands), NE (North East), and WA (Wales)

Base = 58 CDFIs (2006/07); 51 CDFIs (2007/08); 57 CDFIs (2008/09). Sources: Inside Out (lending data); IDBR/ BIS (VAT registered business stock and ratio of VAT registered to non VAT registered businesses) 45

3.1.4 Loan size

shows the average value of CDFI lending, for each of the market segments, for the years 2006/07 to 2008/09:

- Of the enterprise lending markets, loans to micro enterprises were the smallest in terms of average value (£7,300 in 2008/09), but had increased in size by 8 per cent since 2006/07 (up from £6,772);
- Average loan sizes for SMEs fluctuated considerably between 2006/07 and 2008/09, standing at £33,700 in 2008/09 (up from £21,500 in 2006/07);
- Loans to social enterprises were the largest on average, worth £72,600 in 2008/09 (having increased by 27 per cent from £57,220 in 2006/07);
- The average value of all enterprise loans (including micro, SME and social enterprise loans) stood at £21,100 in 2008/09, having increased by 36 per cent from £15,500 in 2006/07.

Table 3.4: Total and average CDFI loan portfolio sizes within key market segments, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>Average loan value</th>
<th>2006/07</th>
<th>2007/08</th>
<th>2008/09</th>
<th>% change 06/07-08/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro enterprises</td>
<td>£6,772</td>
<td>£6,815</td>
<td>£7,327</td>
<td>8%</td>
</tr>
<tr>
<td>SMEs</td>
<td>£21,542</td>
<td>£41,287</td>
<td>£33,744</td>
<td>57%</td>
</tr>
<tr>
<td>Social enterprises</td>
<td>£57,220</td>
<td>£65,507</td>
<td>£72,606</td>
<td>27%</td>
</tr>
<tr>
<td><strong>Enterprise lending</strong></td>
<td><strong>£15,523</strong></td>
<td><strong>£18,593</strong></td>
<td><strong>£21,131</strong></td>
<td><strong>36%</strong></td>
</tr>
<tr>
<td>Personal lending</td>
<td>£612</td>
<td>£374</td>
<td>£756</td>
<td>23%</td>
</tr>
</tbody>
</table>

Base = 58 CDFIs (2006/07); 51 CDFIs (2007/08); 57 CDFIs (2008/09). Source: Inside Out

Figure 3.5 shows how the distribution of CDFI average enterprise loan sizes changed between 2006/07 and 2008/09:

- Between 2006/07 and 2008/09, the proportion of CDFIs with an average enterprise loan size of below £5,000 decreased from 36 per cent of the total to 27 per cent;
- The proportion of CDFIs with average enterprise loan values of between £10,000 and £50,000 increased from 31 per cent of the total in 2006/07 to 37 per cent of the total in 2008/09;
- The proportion of CDFIs with large average enterprise loan sizes (i.e. over £50,000) has remained constant at around 10 per cent of the total. Of these, all but one CDFI operated solely in the social enterprise lending market.

Figure 3.5: Distribution of CDFI average enterprise loan sizes, 2006/07 to 2008/09

Base = 55 CDFIs (2006/07); 48 CDFIs (2007/08); 51 CDFIs (2008/09). Source: Inside Out

3.1.5 Loan applications and loans made

Demand for CDFI loans can be measured by the number of applications received each year by the sector, whilst the number of loans made provides an indication both of the
ability of CDFIs to meet this need, and indeed the viability/applicability of loan applicants. Table 3.5 shows the number of loan applications received by the CDFI sector, the number of loans made, and the resultant conversion rate, in the previous 12 months:

- Between 2006/07 and 2008/09, the annual number of enterprise loan applications received by the CDFI sector almost doubled, increasing from 2,400 to 4,150. Even allowing for a greater Inside Out survey response rate in 2008/09, this is a substantial increase in demand, and may reflect the impact of the credit crunch on the access to finance market (see Section 7);
- The biggest increase in enterprise loan applications came from SMEs (up from just 95 applications in 2006/07 to 1,220 in 2008/09). Again, to some extent this reflects wider survey coverage, but is also a feature of the changing markets of CDFIs;
- The overall conversion rate of enterprise loan applications to loans made dropped from 60 per cent in 2006/07 to 47 per cent in 2008/09. Whilst the annual number of new loans made by the CDFI sector increased (from 1,560 in 2006/07 to 1,970 in 2008/09), this increase did not keep pace with the increase in demand, reflected in the overall fall in the loan conversion rate. This pattern was repeated across all of the enterprise lending market segments.

Table 3.5: Loan applications, loans made and the conversion rate (previous 12 months), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>Market</th>
<th>2006/07</th>
<th>2007/08</th>
<th>2008/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro enterprises</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan applications</td>
<td>1,877</td>
<td>1,651</td>
<td>2,320</td>
</tr>
<tr>
<td>Loans made</td>
<td>1,102</td>
<td>893</td>
<td>1,121</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>59%</td>
<td>54%</td>
<td>48%</td>
</tr>
<tr>
<td>SMEs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan applications</td>
<td>95</td>
<td>138</td>
<td>1,220</td>
</tr>
<tr>
<td>Loans made</td>
<td>54</td>
<td>81</td>
<td>559</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>57%</td>
<td>59%</td>
<td>46%</td>
</tr>
<tr>
<td>Social enterprises</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan applications</td>
<td>426</td>
<td>394</td>
<td>518</td>
</tr>
<tr>
<td>Loans made</td>
<td>273</td>
<td>244</td>
<td>225</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>64%</td>
<td>62%</td>
<td>43%</td>
</tr>
<tr>
<td>Enterprise lending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan applications</td>
<td>2,398</td>
<td>2,272</td>
<td>4,152</td>
</tr>
<tr>
<td>Loans made</td>
<td>1,560</td>
<td>1,279</td>
<td>1,970</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>60%</td>
<td>56%</td>
<td>47%</td>
</tr>
<tr>
<td>Personal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan applications</td>
<td>6,862</td>
<td>8,627</td>
<td>14,544</td>
</tr>
<tr>
<td>Loans made</td>
<td>3,417</td>
<td>3,885</td>
<td>8,794</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>50%</td>
<td>45%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Base = 51 CDFIs (2006/07); 43 CDFIs (2007/08); 57 CDFIs (2008/09). Source: Inside Out
3.1.6 Security

In general, the CDFI sector is more likely than the mainstream banking sector to undertake unsecured lending, since, as discussed in Section 2.1, a requirement that borrowers provide security is one of the principal drivers of market failure within the access to finance market. Nevertheless, CDFIs do still require security in some cases, and are also willing to make use of a variety of forms of security. Figure 3.6 shows the average proportion of CDFI lending portfolios secured using a range of types of security:

- On average, the majority of a CDFI’s loan portfolio is totally unsecured, though the average proportion dropped slightly from 61 per cent in 2006/07 to 55 per cent in 2008/09;
- Personal guarantees were the most common type of security taken, with CDFIs reporting that, on average, 20 per cent of their lending portfolio was secured in this way.

Figure 3.6: Average proportion of CDFI lending portfolios secured using a range of types of security, 2006/07 to 2008/09

Base = 47 CDFIs (2006/07); 40 CDFIs (2007/08); 56 CDFIs (2008/09). Source: Inside Out

3.1.7 Interest rates and fees charged

Table 3.6 provides information on the average interest rate charged by CDFIs, together with the average minimum and maximum rates charged. Note that data are only presented for 2008/09 since changes in the way that the Inside Out survey collected this information make direct comparison with previous years impossible (in any case, CDFI interest rates are strongly influenced by the Bank of England base rate). The following observations can be made:

- Of the enterprise loans, the highest average interest rates were charged on loans made to micro enterprises (an average of 11.79 per cent);
- Loans made to social enterprises were charged the lowest rate of interest (the average value was 9.52 per cent). The average minimum interest rate charged for social enterprise loans was 7.57 per cent, though individual CDFIs made use of much lower rates of interest on occasions.
Table 3.6: Average CDFI interest rates charged and average minimum and maximum interest rates charged, by market segment, 2008/09

<table>
<thead>
<tr>
<th>Market segment</th>
<th>Average interest rate</th>
<th>Average minimum interest rate</th>
<th>Average maximum interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro enterprises</td>
<td>11.79%</td>
<td>10.43%</td>
<td>13.56%</td>
</tr>
<tr>
<td>SMEs</td>
<td>10.92%</td>
<td>10.31%</td>
<td>13.36%</td>
</tr>
<tr>
<td>Social enterprises</td>
<td>9.52%</td>
<td>7.57%</td>
<td>11.49%</td>
</tr>
<tr>
<td>Personal lending</td>
<td>24.39%</td>
<td>18.45%</td>
<td>28.64%</td>
</tr>
</tbody>
</table>

Base = 42 CDFIs (micro enterprises); 26 CDFIs (SMEs); 24 CDFIs (social enterprises); 14 CDFIs (personal lending). Source: Inside Out

CDFIs can also generate income on their lending activities by charging fees. The Inside Out survey collects data on three types of fee: arrangement fees, administration fees, and late payment fees. Figure 3.7 shows the proportion of CDFIs reporting that they charge these different types of fee:

- Administration fees were the most common type of fee charged (by 46 per cent of CDFIs in 2008/09), followed by arrangement fees (41 per cent of CDFIs);
- Between 2006/07 and 2008/09 there was a big increase in the proportion of CDFIs charging each of the different types of fee; the proportion charging an arrangement fee, for instance increased from 24 per cent to 41 per cent.

Figure 3.7: Proportion of CDFIs charging selected types of fee, 2006/07 to 2008/09

Base = 74 CDFIs (2006/07); 53 CDFIs (2007/08); 61 CDFIs (2008/09). Source: Inside Out

3.1.8 Bad debt rate

Bad debts are typically defined as the proportion of outstanding lending that has been written-off by the lender. Write-offs are calculated after netting off recovered capital, though of course if this happens outside of the reporting period then this would not be reflected in the data (i.e. CDFIs may subsequently be able to reduce their annual bad
debt rate). As discussed in Section 6, the loan write-off rate is key to the financial sustainability of a CDFI, since bad debts reduce the size of the capital pot available for on-lending, and indeed potentially tie-up CDFI staff in debt recovery procedures.

Table 3.7 provides an overview of loan write-off statistics for the CDFI sector between 2006/07 and 2008/09 (note that this is both enterprise and personal lending):

- The overall loan write-off rate increased slightly between 2006/07 and 2007/08 (from 5 per cent of total outstanding lending by the sector to 8 per cent), before dropping slightly to 7 per cent in 2008/09. Note, however, that the overall write-off rate is skewed by the inclusion of a number of CDFIs with very large outstanding loan portfolios and very small levels of bad debt. For this reason, comparisons between bad debt levels at individual CDFIs with the sector average should be treated with caution (instead, a comparison between CDFIs with similar market profiles would be more suitable). Moreover the data may not yet reflect the impact of the recession on write-offs (see Section 7);
- Table 3.7 also shows the distribution of loan write-off rates across the CDFI sector. In 2006/07, 62 per cent of CDFIs reported write-off rates of between 0 per cent and 10 per cent of their outstanding loan portfolio; by 2008/09 this had fallen to 53 per cent. The proportion of CDFIs with loan write-off rates of between 21 per cent and 30 per cent of their outstanding loan portfolio increased from 13 per cent of all CDFIs in 2006/07 to 20 per cent in 2008/09, suggesting that individual CDFIs may not be faring as well as the overall loan write-off rate for the sector suggests.

Table 3.7: Overall loan write-off rate (as a proportion of outstanding lending) and distribution of individual CDFI write-off rates, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>2006/07</th>
<th>2007/08</th>
<th>2008/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average overall loan write-off rate</td>
<td>5%</td>
<td>8%</td>
<td>7%</td>
</tr>
<tr>
<td>0-10%</td>
<td>62%</td>
<td>59%</td>
<td>53%</td>
</tr>
<tr>
<td>11-20%</td>
<td>19%</td>
<td>22%</td>
<td>20%</td>
</tr>
<tr>
<td>21-30%</td>
<td>13%</td>
<td>17%</td>
<td>20%</td>
</tr>
<tr>
<td>Over 31%</td>
<td>6%</td>
<td>2%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Base = 52 CDFIs (2006/07); 46 CDFIs (2007/08); 51 CDFIs (2008/09). Source: Inside Out

Loan write-off rates vary depending on the market segment served by CDFIs. Data are only available for 2008/09, and are shown in Figure 3.8:

- Of the enterprise lending markets, the overall loan write-off rate was highest for micro enterprises (equal to 12 per cent of total outstanding lending in 2008/09);
- Social enterprise lending had the lowest overall loan write-off rate, equivalent to just 4 per cent of total outstanding lending to the sector.

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46 This has been calculated by aggregating the value of bad debt reported by the sector and dividing by the aggregated value of outstanding lending. Note that the results will differ from the figures reported in Inside Out due to differences in the method of calculation and the exclusion of Triodos Bank and Bridges Community Ventures from the data.
3.1.9 Other financial products

The CDFA’s Inside Out survey does not capture information on other types of financial product offered by CDFIs, such as equity. Emerging case study evidence suggests that alternative financial products may become more common in the future as CDFIs mature and look to diversify their income streams. This issue will be explored in more detail through the case studies.

3.2 Non-lending activities

In addition to providing loans, CDFIs typically offer a range of other financial and non-financial support services to businesses which evidence suggests are, to varying degrees, integral to the lending process. The nature of the CDFI sector’s target market means that many loan applicants are not investment ready, and may need support in building up their proposal to a stage where it can go forward (e.g. through the preparation of a business plan). For a CDFI, this process forms part of the loan consideration and appraisal process, and also enhances the ability of a business to repay its loan (indeed often taking the form of both pre- and post-loan support). External business support providers (public and private sector) also have an important role to play, though again this issue will be explored in more detail as part of the CDFI case studies.

Figure 3.9 shows the proportion of CDFIs reporting that they offer a selection of business support services (defined by the Inside Out survey) to their clients:

- Across each category of business support shown in Figure 3.9 there was an increase in the proportion of CDFIs making available such support between 2006/07 and 2008/09 (though this is not to say that the absolute volume of businesses receiving support increased);
- The most common form of business support offered by CDFIs in 2008/09 was informal advice and support (offered by 89 per cent of CDFIs), followed by

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47 NEF (May 2004) Lessons From Experience: An Evaluation of Street (UK)
referral or signposting to other providers of loan finance (also offered by 89 per cent of CDFIs);

- More in-depth forms of business support (including mentoring and formal training) were offered by fewer CDFIs, though the proportions were still high – 72 per cent of CDFIs offered one-to-one mentoring to businesses in 2008/09;

- In 2008/09, 46 per cent of CDFIs reported that they offer brokerage or co-financing services to businesses, highlighting the extent to which CDFIs are prepared to lend in combination with other providers (including mainstream banks, other CDFIs, and other specialist finance providers). This issue is considered again in Section 6.

**Figure 3.9: Proportion of CDFIs offering a selection of forms of business support to their clients, 2006/07 to 2008/09**

Base = 74 CDFIs (2006/07); 53 CDFIs (2007/08); 61 CDFIs (2008/09). Source: Inside Out

### 3.3 Conclusions

The following conclusions can be drawn from this review of the lending activities of the CDFI sector in the past three years:

- In terms of the total loan fund size available to the CDFI sector, the period 2006/07 to 2008/09 marked a continuation of the long-term trend of year-on-year growth. The average size of the loan funds available to CDFIs has increased steadily;

- CDFIs are also delivering loans in greater numbers and with a higher total value than ever before. Deployment rates have increased also, suggesting that the CDFI sector as a whole is lending out greater proportions of available loan funds;

- There have been some important sectoral shifts in CDFI lending activity in the past three years. The level of lending to micro enterprises has stagnated, most likely a result of a number of smaller CDFIs ceasing to lend to micro enterprises since 2006/07. The largest increase in activity has been in the level of lending to
SMEs (a tripling in the total value of outstanding loans in the past three years), whilst CDFI lending to social enterprises has also seen sustained growth;

- In terms of the geography of CDFI lending, there are a four relatively large CDFIs that operate nationwide and specialise in lending to social enterprises (namely Charity Bank, Co-operative and Community Finance, Big Issue Invest and the Local Investment Fund). These four CDFIs account for the majority of the sector’s lending to social enterprises, a situation that may affect the ability of smaller CDFIs to ‘compete’ within the social enterprise finance market;\(^48\);

- The regional distribution of CDFI lending is highly variable. Some regions – most notably the North West, Yorkshire & Humber and Northern Ireland, and to a lesser extent London and the West Midlands – are well-served by CDFI lending, in some cases due to the availability of large capital pots, and in others a result of high deployment rates. In other regions, particularly the South East, North East and Wales, the volume of CDFI lending is much lower;

- Demand for CDFI loans – measured by the number of applications received each year – has increased sharply in the past couple of years, corresponding to the onset of the credit crunch. Whilst increasing, the number of loans made each year by CDFIs did not keep pace with this growth in demand, with the result that under half of all applications are now accepted. The data do not show whether this reflects a decline in the viability of applicants, ‘mission drift’ of CDFIs away from core markets or capital supply-side issues; we return to the issue of CDFI operating models in Section 6;

- CDFI loans are still typically unsecured, though unsecured lending as a proportion of total lending has decreased slightly over the past three years. There is also evidence that the proportion of CDFIs charging fees as part of their lending activities has increased;

- Levels of bad debt have increased marginally within the CDFI sector, but still represent a small proportion of total outstanding lending (though a number of CDFIs have very high loan write-off rates). Write-off rates vary by sector, and are much higher within the micro enterprise lending market than they are in the social enterprise lending market; and,

- Business support remains a key component of the CDFI service offer, with no evidence that the proportion of CDFIs providing some form of business support has decreased in the past few years.

\(^{48}\) Remembering that Triodos Bank and Bridges Community Ventures have been removed from the analysis of the sector as a result of their disproportionate size relative to the remainder of the CDFI sector.
4 ECONOMIC IMPACTS OF CDFI LENDING ACTIVITY

This section of the report presents an analysis of the economic impacts of CDFIs, specifically their impacts on the businesses that they support. These impacts are considered, firstly, in terms of the impacts on businesses’ access to finance behaviour, and, secondly, in terms of the business, employment and turnover effects of CDFI lending activity. Prior to this, sub-sections review the characteristics of the CDFI beneficiary sample, and the nature of CDFI outstanding lending (supplementing the analysis presented in Section 3.1). Also provided is an analysis of the value for money achieved by CDFI loans.

The results are drawn from the survey of businesses with outstanding loans with CDFIs. As noted in Section 1.3 and set out in more detail in Annex 3, a total of 363 businesses responded to the survey, out of a population of outstanding CDFI enterprise loans of 6,505. The results presented are thus representative of the population as a whole at a 95 per cent level of confidence with confidence interval of +/- 5 per cent.

4.1 Characteristics of CDFI beneficiaries

There follows an analysis of the profile of the businesses that currently have outstanding loans with CDFIs, based on responses to the beneficiary survey. Sub-sections are presented on: the legal and charitable status of businesses; whether businesses consider themselves to be social enterprises; the size of businesses; the sector of businesses; whether businesses were located in a designated deprived area; and the growth ambitions of businesses.

4.1.1 Legal and charitable status

Figure 4.1 shows the legal status of CDFI beneficiaries:

- Private company limited by shares was the most common legal status (31 per cent of the total). Sole trader (28 per cent of the total) and private company limited by guarantee (21 per cent of the total) were the next most common forms of legal status;

- A further 7 per cent of beneficiaries were Industrial and Provident Societies, and 3 per cent were Community Interest Companies. Almost all of these businesses were also social enterprises (100 per cent of Community Interest Companies and 88 per cent of Industrial and Provident Societies).
**Figure 4.1: Legal status of CDFI beneficiaries**

![Chart showing legal status of CDFI beneficiaries]

*Base = 363 businesses*

Figure 4.2 shows the proportion of CDFI beneficiaries who reported that they had charitable status:

- The majority (85 per cent) of CDFI beneficiaries did not have charitable status;
- A further 9 per cent of beneficiaries reported that they did have charitable status.

**Figure 4.2: Whether CDFI beneficiaries had charitable status**

*Base = 363 businesses*

### 4.1.2 Social enterprises

As part of the business survey, beneficiaries were asked whether they considered themselves to be social enterprises. As part of the business survey, beneficiaries were asked whether they considered themselves to be social enterprises:

![Pie chart showing charitable status]

Defined in the survey as ‘a business that primarily has social or environmental aims’
Just under half of all businesses (42 per cent) considered themselves to be social enterprises, reflecting the importance of the sector as a market for CDFI lending (see Section 3.1.2);

Some 53 per cent of businesses did not consider themselves to be social enterprises.

Figure 4.3: Whether businesses considered themselves to be social enterprises

![Figure 4.3: Whether businesses considered themselves to be social enterprises](image)

Base = 363 businesses

4.1.3 Business size

Figure 4.4 shows the current number of employees of CDFI business beneficiaries:

- The majority of CDFI beneficiaries (76 per cent) were micro businesses, employing between 0 and 9 people. In fact, most businesses are very small, with 59 per cent employing between 0 and 4 people;

- A further 14 per cent of businesses were classed as small firms, employing between 10 and 49 people. Another 1 per cent were classed as medium firms, employing between 50 and 250 people;

- Just one CDFI beneficiary was classed as a large firm (a social enterprise).

Figure 4.4: Number of people employed by CDFI business beneficiaries

![Figure 4.4: Number of people employed by CDFI business beneficiaries](image)

Base = 363 businesses
Another key consideration within business size is annual turnover. Figure 4.5 shows the current annual turnover of CDFI business beneficiaries:

- Some 25 per cent of CDFI beneficiaries had an annual turnover of under £50,000, meaning that they fell below the current VAT registration threshold (£68,000 as at May 2009);
- A further 13 per cent of beneficiaries reported an annual turnover of between £50,000 and £100,000, and another 14 per cent reported a figure of between £100,000 and £250,000;
- Just 7 per cent of CDFI business beneficiaries had a turnover in excess of £1 million.

**Figure 4.5: Annual turnover of CDFI business beneficiaries**

![Bar chart showing annual turnover of CDFI business beneficiaries]

*Base = 363 businesses*

**4.1.4 Business sector**

Figure 4.6 shows the sector of CDFI business beneficiaries (grouped according to the 2007 Standard Industrial Classification – SIC – system):

- The majority of CDFI beneficiaries were service sector businesses; just 13 per cent operated within the manufacturing sector, 3 per cent within the construction sector, and 2 per cent within the primary and utilities sector (SIC codes A and E);
- The most common SIC sector was wholesale/retail and the repair of motor vehicles, accounting for 24 per cent of beneficiaries. Specifically, 18 per cent of all beneficiaries operated within the retail sector;
- The other main service sector areas within which businesses operated included:
- Professional, scientific and technical services (11 per cent of beneficiaries, incorporating legal and accountancy services, and business support and consultancy);
- Administrative and support services (7 per cent of beneficiaries, incorporating renting and leasing services, security, travel services, and employment services);
- Other services (7 per cent of beneficiaries, incorporating personal services and the repairing of consumer goods).

Some 12 per cent of businesses operated either within human health & social work (SIC code Q) or education (SIC code P), of which 69 per cent were social enterprises.

**Figure 4.6: 2007 SIC classification of beneficiaries**

<table>
<thead>
<tr>
<th>SIC Classification</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>G: Wholesale/ retail trade, repair of motor vehicles</td>
<td>24%</td>
</tr>
<tr>
<td>C: Manufacturing</td>
<td>13%</td>
</tr>
<tr>
<td>M: Professional, scientific &amp; technical</td>
<td>11%</td>
</tr>
<tr>
<td>N: Administrative &amp; support services</td>
<td>7%</td>
</tr>
<tr>
<td>S: Other services</td>
<td>7%</td>
</tr>
<tr>
<td>Q: Human health &amp; social work</td>
<td>6%</td>
</tr>
<tr>
<td>P: Education</td>
<td>6%</td>
</tr>
<tr>
<td>L: Real estate</td>
<td>4%</td>
</tr>
<tr>
<td>I: Accommodation and food services</td>
<td>4%</td>
</tr>
<tr>
<td>R: Arts, entertainment &amp; recreation</td>
<td>3%</td>
</tr>
<tr>
<td>J: Information &amp; communication</td>
<td>2%</td>
</tr>
<tr>
<td>F: Construction</td>
<td>2%</td>
</tr>
<tr>
<td>H: Transport &amp; storage</td>
<td>1%</td>
</tr>
<tr>
<td>E: Water, waste management &amp; remediation</td>
<td>1%</td>
</tr>
<tr>
<td>K: Financial &amp; insurance</td>
<td>1%</td>
</tr>
<tr>
<td>A: Agriculture, forestry &amp; fishing</td>
<td>1%</td>
</tr>
</tbody>
</table>

**Base = 363 businesses**

### 4.1.5 Businesses in deprived areas

One of the key rationales for the CDFI sector is to provide finance for businesses based in deprived areas, since there is evidence that the market failures addressed by CDFIs are particularly concentrated in deprived areas of the country (see Section 2.1). Business postcodes obtained through the beneficiary survey were mapped in to order to identify which firms were located within the 20 per cent most deprived areas of England, Wales or Scotland. The results are shown in Figure 4.7:

- Some 29 per cent of beneficiaries were located in one of the 20 per cent most deprived areas of the country;

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50 The 20 per cent most deprived Lower Super Output Areas according to the Index of Multiple Deprivation (2007 in England, 2008 in Wales, and 2009 in Scotland)
The majority of beneficiaries (64 per cent), however, were not located in a deprived area.

Figure 4.7: Whether businesses were located within the 20 per cent most deprived LSOAs (England, Wales or Scotland)

Base = 363 businesses

4.1.6 Business growth ambitions

Finally, CDFI business beneficiaries were asked to indicate which of four statements regarding business growth ambitions most closely matched their own position (Figure 4.8):

- Around a quarter of beneficiaries (24 per cent) reported that they were focussed on ensuring the survival of their business;
- Just 2 per cent of businesses did not want to grow their business at all, and a further 25 per cent only wanted a small amount of growth;
- Just under half of all beneficiaries (44 per cent) wished to grow their business substantially.

Figure 4.8: Growth ambitions of CDFI beneficiaries

Base = 363 businesses
4.2 Profile of loan finance accessed by beneficiaries

This section of the report presents a profile of the loan finance accessed by the survey beneficiaries, and includes sub-sections on: the date that loans were received, the duration of the loans, the value of loans, and the purpose of the loans.

4.2.1 Date loans were received

Figure 4.9 shows the year that beneficiaries had received their CDFI loan:

- Since the business population for this study was based on those firms with an outstanding loan from a CDFI as at Summer 2009, it is not surprising that over half of all loans (60 per cent of the total) were made in either 2008 or 2009;
- After this, the age of CDFI loans trails off year by year, with the earliest loan having been received in 1998.

Figure 4.9: The year that beneficiaries had received their CDFI loan

Base = 363 businesses

4.2.2 Loan duration

Figure 4.10 shows the distribution of the length of loans obtained by CDFI business beneficiaries:

- There are two common loan lengths for CDFI lending: 3 to 4 years (29 per cent of the total), and 5-6 years (23 per cent of the total). Specifically, loans lasting for 36 months or for 60 months were frequently received by businesses;
- Some 6 per cent of beneficiaries reported loan lengths in excess of six years (not surprisingly, longer loans also tended to be larger);
- A further 5 per cent of CDFI loans were under two years in length, with some beneficiaries reporting very short-term loans of three or sixth months' duration.
4.2.3 Loan value

Table 4.1 shows the average loan size received by the different types of beneficiary (see Table 3.4) for a comparison with the CDFI sector as a whole:

- The average loan size across all types of beneficiary was £30,300, which compares with £21,100 for the CDFI sector as a whole, suggesting that survey respondents were more likely to have received larger loans;

- Average loan size was higher for social enterprises (£36,000) than for commercial businesses (£27,500);

- Businesses based in deprived areas recorded a higher average loan value (£38,700) than businesses based in non-deprived areas (£28,000);

- Average loan sizes varied considerably depending on business size, with micro firms receiving an average loan worth £23,800, and small firms receiving an average loan worth £57,200.

Table 4.1: Average loan size by type of beneficiary

<table>
<thead>
<tr>
<th>Type of beneficiary</th>
<th>Average loan size (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of business</strong></td>
<td></td>
</tr>
<tr>
<td>Social enterprises</td>
<td>£35,978</td>
</tr>
<tr>
<td>Commercial enterprises</td>
<td>£27,496</td>
</tr>
<tr>
<td><strong>Location of business</strong></td>
<td></td>
</tr>
<tr>
<td>Deprived areas</td>
<td>£38,680</td>
</tr>
<tr>
<td>Non-deprived areas</td>
<td>£28,027</td>
</tr>
<tr>
<td><strong>Business size</strong></td>
<td></td>
</tr>
<tr>
<td>Micro (0-9 employees)</td>
<td>£23,812</td>
</tr>
<tr>
<td>Small (10-49 employees)</td>
<td>£57,220</td>
</tr>
<tr>
<td>Medium (50-250 employees)</td>
<td>£94,000</td>
</tr>
<tr>
<td><strong>All beneficiaries</strong></td>
<td>£30,346</td>
</tr>
</tbody>
</table>

*Base = 363 businesses*
### 4.2.4 Purpose of loan

Businesses were asked to indicate how they had used their CDFI loan (Figure 4.11):

- Some 42 per cent of businesses used their CDFI loan to finance the costs of start-up, whilst another 43 per cent used it to fund growth;
- A further 6 per cent of respondents reported that they had used their loan in order to prevent business contraction, whereas another 7 per cent had used it to prevent business closure.

**Figure 4.11: The main way in which businesses used their CDFI loan**

![Pie chart showing usage of CDFI loan](image)

*Base = 363 businesses*

### 4.3 Access to finance impacts of CDFIs

In addition to the quantifiable economic impacts analysed below in Section 4.4, CDFI lending activity has an impact on the access to finance behaviour of beneficiaries. As discussed in Section 2.1, the market failure rationale for CDFIs is based on an assumption that a segment of the business population is unable to access mainstream finance, either through rejection or discouragement. Feasibly, in providing loan finance and business support, CDFIs work towards reducing the numbers of businesses unable to access mainstream finance by addressing the causes of market failure (e.g. by providing businesses with a track record of lending). This section of the report analyses businesses’ access to finance behaviour both immediately before they received their CDFI loan, and afterwards, in order to identify the impacts that CDFIs have on beneficiaries.

#### 4.3.1 Pre-loan access to finance

A key issue for this evaluation is the previous access to finance behaviour of the businesses receiving CDFI loans. As part of the beneficiary survey, businesses were asked whether, around the same time as seeking finance from their CDFI, they had applied for funding from another source (Figure 4.12):

- The majority of respondents (65 per cent) had indeed applied for investment from at least one other finance provider;
- A significant minority of respondents (35 per cent) indicated that, at the time they received their CDFI loan, this was the only source of finance that they had applied for.
In principle, CDFIs require applicants to have been rejected by a mainstream bank. Case study evidence, however, suggests that CDFIs are not rigid in this requirement, which would account for the high proportion of firms indicating that they had not even applied for alternative investment. Where businesses have characteristics or credit histories that CDFIs believe would, in all likelihood, prevent them from obtaining a bank loan, they are often content to proceed with the application without requiring proof of rejection. Consultees from CDFIs noted that to require a business to apply for funding from a bank when they would almost certainly be rejected would constitute a waste of their time and resources. Amongst marginalised and hard-to-reach groups it was also suggested that this approach could have more serious impacts in terms of building negative impressions of mainstream banks and adversely affecting levels of confidence and engagement.

Figure 4.12: Whether beneficiaries had applied for investment from an alternative provider around the same time as they received their CDFI loan

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>65%</td>
<td></td>
</tr>
</tbody>
</table>

*Base = 363 businesses*

**Businesses not applying to other lenders**

Those businesses that had not applied for investment from alternative finance providers were asked to explain why they had not done so (Figure 4.13):

- The most common reason for not seeking alternative investment was a belief that, unlike the CDFI, other investors would require collateral (mentioned by 24 per cent of respondents). A further 15 per cent of respondents reported that they believed that their lack of experience or business track record would mean that they could not obtain funding from elsewhere. Both of these explanations relate to the market failure rationale for CDFIs (Section 2.1);

- Some 15 per cent of respondents indicated that they already had a relationship with the CDFI (e.g. through a previous loan), and therefore had not applied for finance from another source;

- Some 19 per cent of respondents used the CDFI because they believed that alternative investors had less attractive terms and conditions, for instance higher interest rates. Almost all of the businesses that did not seek alternative finance for this reason were social enterprises. CDFIs are, in principle, not supposed to compete directly with mainstream banks, but by offering better terms and conditions this may not always be the case – particularly, it appears, within the social enterprise lending market. For this reason, these businesses could be
assumed to have secured finance without the CDFI even though they had not formally applied for and tested their access to a loan;

- Another 13 per cent of respondents reported that they were unaware of any alternative lenders. Almost all of these businesses were social enterprises, suggesting that some social enterprises are still unaware of the range of sources of debt finance available.

**Figure 4.13: Why businesses had not applied for investment from an alternative finance provider**

![Bar chart showing reasons why businesses had not applied for investment from an alternative finance provider]

*Base = 128 businesses*

**Businesses applying to other lenders**

As Figure 4.12 showed, the majority of CDFI loan recipients had applied to other lenders for investment at the same time as they received their CDFI loan. Figure 4.14 presents a range of alternative sources of finance, and shows the proportion of CDFI business beneficiaries who reported that they had either not applied for funding from this source, applied unsuccessfully for funding, or applied successfully for funding:

- The most commonly used alternative sources of funding were: a loan from the business’s bank or building society (80 per cent of respondents had applied for finance from this source), followed by an overdraft (40 per cent had tried), and another bank or building society (40 per cent had tried);

- In terms of the level of success, finance ‘applications’ to friends and family were the most frequently successful (15 per cent of businesses that applied for alternative funding had successfully obtained finance from this source), followed by a government grant or loan (12 per cent of businesses had been successful), and an overdraft (10 per cent of businesses had been successful);

- Even though 80 per cent of businesses had tried to obtain a loan from their bank or building society, the level of success was just 8 per cent, suggesting that CDFI beneficiaries are indeed largely unable to access loan finance from banks.
Nevertheless, a minority of CDFI clients had, therefore, successfully obtained bank finance before applying to the CDFI for funding, raising questions about the extent to which the sector is serving truly unbankable businesses (though see Table 4.2 below).

Overall, 35 per cent of those businesses that reported that they had applied for investment from another source of finance (i.e. in addition to their CDFI) were successful on at least one occasion with any one of the sources of finance shown in Figure 4.14. Moreover, 19 per cent of the businesses that had applied for funding from an alternative source were successful with at least one commercial investor\(^{51}\) (equivalent to 12 per cent of the beneficiary sample as a whole once businesses that did not apply for any funding at all are included). Again, this suggests that a minority of CDFI beneficiaries are likely to be bankable.

**Figure 4.14: Alternative finance providers that businesses sought funding from, and the outcome**

<table>
<thead>
<tr>
<th>Provider</th>
<th>Tried successfully</th>
<th>Tried unsuccessfully</th>
<th>Did not try</th>
</tr>
</thead>
<tbody>
<tr>
<td>Friends and family</td>
<td>15%</td>
<td>23%</td>
<td>62%</td>
</tr>
<tr>
<td>Government grant/loan</td>
<td>12%</td>
<td>30%</td>
<td>58%</td>
</tr>
<tr>
<td>Overdraft</td>
<td>10%</td>
<td>80%</td>
<td>10%</td>
</tr>
<tr>
<td>Loan from business’s bank/building society</td>
<td>8%</td>
<td>92%</td>
<td>0%</td>
</tr>
<tr>
<td>Business angel</td>
<td>4%</td>
<td>96%</td>
<td>0%</td>
</tr>
<tr>
<td>Loan from another CDFI</td>
<td>4%</td>
<td>96%</td>
<td>0%</td>
</tr>
<tr>
<td>Venture capital funding</td>
<td>3%</td>
<td>97%</td>
<td>0%</td>
</tr>
<tr>
<td>Loan from another bank/building society</td>
<td>1%</td>
<td>99%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Base = 235 businesses

The issue of whether businesses could instead have obtained their CDFI finance from a commercial investor is critical to the assessment of the additionality of any economic impacts generated (see Section 4.4 below). For this reason, the 19 per cent of businesses that reported that they had successfully obtained finance from a commercial provider around the same time as they received their CDFI loan were re-contacted and asked to explain why they had chosen to proceed with the CDFI option (Table 4.2). Of these businesses:

- Around half (53 per cent) reported that their commercial investor had not been able to provide all of the finance that they were seeking, and thus that they had needed to top up this investment with a CDFI loan. In some cases this

\[^{51}\] At least one of the following: loan from a bank or building society, a business angel, venture capital, and/or an overdraft
amounted to co-investment, such that the commercial investor would not have proceeded without the CDFI’s matching commitment;

- Some 20 per cent of businesses reported that they had successfully applied for bank finance, but that the CDFI was able to offer better terms and conditions (principally a lower interest rate), and so they had proceeded with the CDFI loan instead. In these cases there are questions about the level of additionality associated with the CDFI lending – see Section 4.4;

- A further 27 per cent of beneficiaries indicated that they had secured an overdraft facility with a bank, but that this was not sufficient to meet their needs. Of these, 16 per cent of respondents had subsequently tried and failed to get another form of investment from a commercial source, and 11 per cent had not applied for finance from a commercial provider, believing that they would be unsuccessful (for examples of reasons see Figure 4.16).

<table>
<thead>
<tr>
<th>Reason for applying for CDFI loan in addition to commercial finance</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial investor would not provide the total finance needed</td>
<td>53%</td>
</tr>
<tr>
<td>Had a choice between commercial investment and CDFI loan</td>
<td>20%</td>
</tr>
<tr>
<td>Overdraft facility insufficient and failed to secure additional finance</td>
<td>16%</td>
</tr>
<tr>
<td>Overdraft facility insufficient, discouraged from applying for more finance</td>
<td>11%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

*Base = 45 businesses*

As part of the beneficiary survey, businesses were asked to quantify the value of any loan finance that they had received from alternative investors at the same time as their CDFI loan (for instance through co-investment from a bank, though note that this is not restricted to commercial providers, and matching funds could come from a government loan scheme). Figure 4.15 shows the proportion of respondents that reported that they had obtained additional loan finance:

- Just 7 per cent of respondents reported that they received a loan from another investor at the same time as they received their CDFI loan (note that, since beneficiaries were asked about loans, this would exclude overdraft facilities);

- The total value of the additional loan finance secured by these businesses was £2.7 million, at an average of £105,000 per business;

- The average leverage for £1 of CDFI lending was £3 of alternative loan finance, indicating that, where additional loan finance was secured, the CDFI tended to account for the minority share of the total lending ‘package’.
Figure 4.15: Whether businesses obtained loan finance from another investor at the same time as they received their CDFI loan

Base = 363 businesses

Finally, those businesses that had unsuccessfully applied for investment from an alternative source of finance at the same time as they received their CDFI loan (as shown in Figure 4.14) were asked to indicate why they had not been successful (the results are presented in Figure 4.16):

- By far the most common reason for rejection by an alternative investor was the business’s lack of collateral (identified as a reason by 44 per cent of unsuccessful finance applicants). This was followed by a lack of a business track record (21 per cent of respondents) and previous problems with loan repayments (17 per cent of respondents). All three of these reasons have been identified as part of the market failure argument for supporting CDFIs (see Section 2.1);

- Some 14 per cent of businesses that had unsuccessfully applied for funding reported that this was because they were told their business proposition was not viable. Specifically, a number of businesses reported that mainstream banks had informed them that they would not lend to firms in their sector (primarily restaurants and construction firms);

- The category ‘other reasons’ mainly related to businesses (typically social enterprises) that had unsuccessfully sought government grant funding, for instance because they were ineligible.
Figure 4.16: Reasons why CDFI beneficiaries had been unsuccessful in their applications for finance from alternative investors

```
Base = 200 businesses
```

### 4.3.2 Post-loan access to finance

CDFIs often also have an explicit goal to support businesses to enable them to access mainstream finance in the future. In a minority of cases this is achieved through training, but on the most part, in making available loan finance, CDFIs tackle the market failures discussed in Section 2.1. A CDFI loan may provide a business with a track record of repayment, or the loan may facilitate growth that then enables them to provide collateral for bank lending.

The issue of a 'progression' to mainstream finance was explored in the business beneficiary survey. Respondents were asked whether, since receiving their CDFI loan, they had subsequently sought further loan finance (Figure 4.17), though it should be noted that most businesses had only recently received their CDFI loan:

- Just under half of respondents (44 per cent) reported that they had no immediate plans to apply for a further loan, whilst another 26 per cent thought that they would probably do within the next 2 to 3 years;
- Some 24 per cent of businesses had already applied for a further loan.
Those businesses that had applied for further loan finance since receiving their CDFI loan were then asked to identify the source(s) of finance that they had submitted applications to, and to indicate whether their loan application had been successful. The results are shown in Figure 4.18:

- The most commonly used source of finance for a further loan was the business’s bank or building society. Some 49 per cent of respondents who had applied for a further loan since receiving their CDFI loan had applied to their bank or building society, and 19 per cent had been successful;
- An overdraft was the second most frequently accessed source of finance, with 38 per cent of respondents indicating that they had applied for an overdraft facility (16 per cent had been successful);
- Some 23 per cent of businesses reported that they had applied for a further loan from their CDFI, and 17 per cent were successful in this application.
Of particular interest are those businesses that had successfully applied for loan funding from a commercial source since receiving their CDFI loan, and in particular whether they had previously been unsuccessful or discouraged from even seeking to access commercial funding. Overall, 33 per cent of those businesses that had applied for a further loan since receiving their CDFI loan had previously successfully applied for funding from at least one commercial source. As noted in Section 4.3.1, 19 per cent of businesses had successfully applied for funding from at least one commercial source at the same time as applying for their CDFI loan, suggesting that businesses that received support from a CDFI were subsequently more likely to be able to obtain commercial funding. This is explored in more detail in Table 4.3:

- Of those businesses that had not applied for finance from a commercial source at the same time as they had applied for their CDFI loan (either because they only applied to non-commercial providers or because they did not apply for alternative funding at all), the majority (88 per cent) had not applied for further finance since receiving their CDFI loan. Another 3 per cent had applied to a commercial source, but unsuccessfully, whilst another 4 per cent had applied successfully. These businesses had previously been discouraged from applying for commercial funding, but since receiving CDFI support had sought to obtain finance from at least one commercial source;

- Amongst those businesses that had previously applied unsuccessfully for finance from a commercial provider, 71 per cent had not applied for a further loan. Some 11 per cent had applied again for a loan from a commercial source, but had again been unsuccessful. Another 10 per cent, however, had
successfully applied for funding from a commercial source after receiving a CDFI loan;

- Finally, those businesses that had previously been successful when applying for finance from a commercial provider were much more likely to have already applied for a further loan (42 per cent), and were also more likely to have been successful again if they had applied to a commercial provider (24 per cent of respondents).

Table 4.3: Post-loan access to finance status of businesses, depending on their pre-loan commercial finance application status

<table>
<thead>
<tr>
<th>Pre-loan commercial finance application status</th>
<th>Had not applied for a further loan</th>
<th>Applied but not to a commercial source</th>
<th>Applied unsuccessfully to a commercial source</th>
<th>Applied successfully to a commercial source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Had not applied at all</td>
<td>88%</td>
<td>5%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>Applied unsuccessfully</td>
<td>71%</td>
<td>8%</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>Applied successfully</td>
<td>58%</td>
<td>11%</td>
<td>7%</td>
<td>24%</td>
</tr>
<tr>
<td>All businesses</td>
<td>76%</td>
<td>7%</td>
<td>7%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Base = 363 businesses (151 businesses “Had not applied at all”; 167 businesses “Applied unsuccessfully”; 45 businesses “Applied successfully”)

Finally, where businesses had successfully sought further loan finance, respondents were asked to indicate why they had been successful (note that more than one answer could be give). The results are shown in Figure 4.19:

- Some 44 per cent of respondents indicated that they had subsequently been successful in applying for loan finance because of the track record in borrowing and repayment that the CDFI loan had enabled them to develop. As indicated in Figure 4.13 and Figure 4.16, the lack of such a track record was identified as a key reason as to why businesses had previously been unable to access loan finance, or indeed why they had not even applied for loan finance (believing that they would fail);

- Another 26 per cent of respondents suggested that the process of applying for and managing their CDFI loan had given them experience of business and financial management that left them better placed to apply for loan finance;

- Some 18 per cent of respondents specifically felt that their CDFI had improved their understanding of obtaining loan finance, whilst another 11 per cent indicated that their business had become more viable over time, thus making them a more attractive debt finance proposition.
Figure 4.19: Reasons why businesses were successful in obtaining a further loan after receiving their CDFI loan

Base = 57 businesses

4.4 Economic impacts of CDFIs

A key task for this evaluation was to carry out an assessment of the economic impacts of CDFI lending activity. Existing evidence as to the economic impacts of the CDFI sector is patchy and characterised by the application of various different measurement methodologies:

- As part of their annual Inside Out survey, the CDFA collects self-reported impact data from CDFIs who, amongst other indicators, provide data on jobs created, jobs sustained (i.e. safeguarded), and the number of businesses with increased profits. Whilst this information provides an indication of the impact of the CDFI sector, coverage is patchy and it is unclear how information is collected (and thus whether methodologies are consistent);

- Individual CDFIs collect impact monitoring data as part of their delivery of public sector funded programmes (particularly those in receipt of RDA resources). A number of these programmes or the CDFIs delivering these programmes have been subject to evaluation but, again, coverage is patchy; and,

- The 2004 evaluation of the Phoenix Fund remains the only national economic impact assessment of CDFIs, although it was hampered by the lack of data available and is increasingly out of date.

The measurement exercise carried out for this study is thus the first such comprehensive national assessment of the economic impacts of the CDFI sector. There follows a review of the methodology employed for the economic impact assessment, analysis of the gross and net additional economic impacts of the sector, and, finally, a discussion of the future economic impacts of the current cohort of
outstanding loans. An assessment of the value for money of CDFI lending, using these economic impacts, is presented in Section 4.5.

4.4.1 Economic impact assessment methodology

The economic impact assessment was designed to be compliant with the BIS Impact Evaluation Framework (IEF), most recently used as the overarching analytical framework for the 2008 RDA impact reporting exercise. With regard to economic impact assessment, the IEF stipulates that the methodology employed must be consistent with the principles of the HM Treasury Green Book and the English Partnerships Additionality Guide. Specifically, there are two key considerations:

- The exercise should focus on impacts as opposed to outputs. The logic model for the CDFI sector shown in Figure 2.1 identified a range of impacts, of which many are more appropriately described as social impacts, and are thus considered in Section 5. The main examples of economic impacts include:
  - The impact on the business stock, measured through the number of enterprises created and safeguarded by CDFI lending activity;
  - The impact on employment, measured through the number of FTE jobs created and safeguarded in businesses supported by CDFIs;
  - The impact on business income, measured through the annual turnover achieved by businesses supported by CDFIs. Through the salaries paid to staff as a result of this income, businesses then increase levels of personal/household wealth; and,
  - The impact on national GVA, measured through the GVA created/safeguarded as a result of the impacts of CDFI lending on business turnover.

- Both gross and net economic impacts need to be calculated, taking into account additionality considerations. The IEF requires the application of a consistent methodology for the calculation of net economic impacts, i.e. one that takes account of the following considerations (explored in more detail in Section 4.4.2):
  - Deadweight: The proportion of impacts that would have been achieved anyway;
  - Leakage: The proportion of impacts that benefit individuals or businesses outside of the target area;
  - Displacement: The share of impacts that have been achieved at the expense of other individuals or businesses within the target area; and,

---

55 GVA created/safeguarded has been calculated by applying a ratio of GVA to turnover to the turnover created and safeguarded as reported by businesses. The ratio (0.203:1) was derived from the 2008 Annual Business Inquiry (total GVA divided by total turnover) at http://www.statistics.gov.uk/abi/2008-data.asp, weighted according to the sectoral distribution of CDFI beneficiaries
Economic multipliers: Further economic impacts generated through the additional expenditure of assisted businesses (e.g. through supply chains), or the employees of assisted businesses.

The method of approach employed for the economic impact assessment has been based on a number of other considerations and assumptions:

- Impact data have been obtained from the results of the business survey and grossed up to the level of the CDFI beneficiary population as a whole. This population has been derived from CDFI responses to the 2008/09 Inside Out survey, which indicated that, as at April 2009, the CDFI sector had a total of 6,505 outstanding enterprise loans;

- Spatial scale is a key consideration within an economic impact assessment, since the additionality factors shown above vary depending on the geographical unit of analysis. For the purposes of this study, two spatial scales have been used throughout:
  - *The local community*: defined as an area up to 2 miles from a business's main centre of operations; and,
  - *The region*: defined as an area up to 50 miles from a business's main centre of operations.

- This economic impact assessment concerns the impacts generated by the CDFI sector's outstanding enterprise loan portfolio. The size of this portfolio, of course, is not static, and changes on a continuous basis as new loans are made and as existing loans are either repaid or written off. The economic impact of the CDFI sector, therefore, will change over time, and this report presents a snapshot of the position as at October 2009 when the business survey was conducted;

- Furthermore, impacts will continue to be generated as a result of the outstanding CDFI loans, but since these will have taken place after businesses completed the beneficiary survey, they will not be included in the study (methodological issues meant that it was only possible to survey businesses with outstanding loans). Consequently, this economic impact assessment underestimates the lifetime economic impact of a CDFI loan.

### 4.4.2 Measuring additionality

As noted above, additionality is a measure of the extent to which the intervention in question (i.e. CDFI lending activity) generates impacts that would not have happened in the absence of the intervention (i.e. if businesses had not accessed CDFI loans). Measuring additionality requires quantification of: deadweight, leakage, displacement, and economic multiplier effects. For this study, the measurement of each of these additionality components was based on primary research with businesses through the beneficiary survey (see below for further details on the methodology). Additionality

57 Note that this figure is different from that presented in Table 3.3 due to the inclusion of the lending activity of Triodos Bank

58 CDFIs were asked to provide contact details for their clients with outstanding loans. A number of businesses would have received a loan and subsequently closed, but in these cases CDFIs tended not to have accurate contact details, or were unwilling to provide information due to ongoing debt recovery procedures. Accurate contact details could also not be provided for clients that had repaid their loan.
was calculated for each individual respondent, and summed to provide a figure for the net economic impacts of the beneficiary sample as a whole.

The overall values for each of the components of additionality are shown in Table 4.4 and Table 4.5, differentiated between the six key impact indicators (additionality ratios have not been presented for GVA impacts since GVA has been calculated using turnover data, and thus the additionality ratios are the same) and the geographical scale at which they have been calculated.

Table 4.4: Additionality factors used in the economic impact assessment (local community)

<table>
<thead>
<tr>
<th>Impact</th>
<th>Deadweight (minus)</th>
<th>Leakage (minus)</th>
<th>Displacement (minus)</th>
<th>Multiplier (plus)</th>
<th>Gross to net ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses created</td>
<td>12%</td>
<td>0%</td>
<td>17%</td>
<td>7%</td>
<td>78%</td>
</tr>
<tr>
<td>Businesses safeguarded</td>
<td>8%</td>
<td>0%</td>
<td>16%</td>
<td>8%</td>
<td>83%</td>
</tr>
<tr>
<td>Employment created</td>
<td>15%</td>
<td>46%</td>
<td>15%</td>
<td>2%</td>
<td>26%</td>
</tr>
<tr>
<td>Employment safeguarded</td>
<td>5%</td>
<td>56%</td>
<td>13%</td>
<td>3%</td>
<td>28%</td>
</tr>
<tr>
<td>Turnover created</td>
<td>12%</td>
<td>0%</td>
<td>11%</td>
<td>8%</td>
<td>84%</td>
</tr>
<tr>
<td>Turnover safeguarded</td>
<td>4%</td>
<td>0%</td>
<td>10%</td>
<td>9%</td>
<td>94%</td>
</tr>
</tbody>
</table>

Table 4.5: Additionality factors used in the economic impact assessment (region)

<table>
<thead>
<tr>
<th>Impact</th>
<th>Deadweight (minus)</th>
<th>Leakage (minus)</th>
<th>Displacement (minus)</th>
<th>Multiplier (plus)</th>
<th>Gross to net ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses created</td>
<td>12%</td>
<td>0%</td>
<td>57%</td>
<td>9%</td>
<td>40%</td>
</tr>
<tr>
<td>Businesses safeguarded</td>
<td>8%</td>
<td>0%</td>
<td>55%</td>
<td>11%</td>
<td>48%</td>
</tr>
<tr>
<td>Employment created</td>
<td>15%</td>
<td>4%</td>
<td>56%</td>
<td>8%</td>
<td>33%</td>
</tr>
<tr>
<td>Employment safeguarded</td>
<td>5%</td>
<td>2%</td>
<td>48%</td>
<td>14%</td>
<td>59%</td>
</tr>
<tr>
<td>Turnover created</td>
<td>12%</td>
<td>0%</td>
<td>53%</td>
<td>10%</td>
<td>45%</td>
</tr>
<tr>
<td>Turnover safeguarded</td>
<td>4%</td>
<td>0%</td>
<td>53%</td>
<td>13%</td>
<td>55%</td>
</tr>
</tbody>
</table>
Deadweight

Deadweight can arise where the gross business, employment and turnover impacts achieved by businesses that have received CDFI support would have happened regardless of the intervention of the CDFI. For example, even if they had not secured a CDFI loan, business employment and turnover would have changed according to the general economic operating environment, or they may have been able to secure alternative investment. With regard to these issues, two points can be made:

- The economic recession has meant that the general business operating environment has largely become unfavourable, with large numbers of businesses experiencing a fall in turnover, laying off staff, and in many cases ceasing to trade. In this context, successfully obtaining a CDFI loan may actually make the difference between business survival and business failure (29 per cent of businesses reported that in the absence of the loan they would have ceased trading);

- As discussed in Section 2.1, businesses tend to seek a CDFI loan precisely because they cannot secure sufficient finance from another source. Since the onset of the credit crunch, the availability of credit from alternative sources has decreased, meaning that businesses struggling to access loan funding have even fewer options available to them. Moreover, CDFI loans tend to be more expensive than loans from, for instance, mainstream banks, meaning that it is unlikely that a business would choose to apply for a CDFI loan if it had the option of obtaining finance from another source (although a number of businesses, mainly social enterprises, reported that they had used the CDFI because it was cheaper than available alternatives).

With these considerations in mind, the level of deadweight associated with CDFI lending should, therefore, be very low, particularly in the current economic climate. For this study, deadweight was calculated using a combination of approaches:

- First, businesses were asked to estimate what their employment and turnover would have been if they had not received their CDFI loan, accounting for general economic conditions and also the likelihood that they would have received a loan from elsewhere (the gross benefit or impact);

- Second, businesses were also asked whether, at the same time as receiving their CDFI loan, they had applied for finance from an alternative source, and if so whether they had been successful. In summary:
  
  - 35 per cent of businesses had not applied for finance from a commercial provider at the same time that they received their CDFI loan. Of these:
    - 19 per cent (7 per cent of the full sample) reported that they selected their CDFI on the basis of better terms and conditions, assuming that they could have secured a loan from elsewhere, and as such the associated impact is considered, conservatively, to be deadweight;
    - The remaining 81 per cent of businesses (28 per cent of the total sample) that had not applied to a commercial lender and which had used the CDFI because there was no considered alternative are not judged to have a deadweight effect, because of the low probability of success if they had applied.
Another 65 per cent of businesses had applied for alternative finance, of which 19 per cent had successfully secured a loan from a commercial lender (12 per cent of the total sample). Of these:

- 20 per cent (2 per cent of the total sample) had selected the CDFI loan in preference to a commercial lender on the basis of better terms – and as such the associated impact is considered to be deadweight;

- In the other 80 per cent of cases of a successful application (10 per cent of the total sample) the CDFI loan was required because the commercial loan was insufficient. There is, therefore, a deadweight effect in proportion to the size of the commercial loan in the total loan. However, even where the CDFI loan is less than half the total loan value, businesses advise that without the CDFI loan the remainder of the loan would not have been secured (the CDFI loan effectively provides collateral for commercial lenders). Cases have been reported where the CDFI loan is less than 10 per cent of the total loan, but that without it the remainder of the loan would not have been forthcoming. It has therefore been assumed that where the CDFI accounted for over 30 per cent of the total value of the investment, the investment would not have gone ahead at all, and so 100 per cent of economic impacts have been attributed to the CDFI. Where the CDFI loan accounts for 30 per cent or less of the total value, gross benefits have been attributed according to the CDFI’s share of the total loan. For social enterprises with a joint loan, 100 per cent of economic benefits have been attributed to the CDFI, since it is felt that because of the weaker commercial standing of social enterprises the investment would not have gone ahead at all without the CDFI’s involvement;

- Some 81 per cent of the 65 per cent of businesses that applied to commercial lenders failed to secure a loan (53 per cent of the total sample). These businesses satisfy the normal test of additionality, and no deadweight effect is assumed.

In summary, therefore:

- Some 53 per cent of businesses demonstrate the absence of deadweight, tested by application to a commercial lender;
- Another 28 per cent of businesses are judged not to have a deadweight effect, although not tested by application;
- A further 10 per cent of businesses have a joint loan because the commercial loan was inadequate and where a possible deadweight effect occurs depending on the share of the CDFI loan in the total loan;
- Some 7 per cent of businesses are judged to have a deadweight effect by selecting the CDFI over a commercial lender on the basis of better terms, although not tested through application;
The remaining 2 per cent of businesses are judged to have a deadweight effect because CDFI loans have been used instead of available commercial loans tested by application.

**Leakage**

As noted above, leakage arises where economic benefits are generated outside of a CDFI’s target area. Individual CDFIs have very different target areas; some operate at a regional scale whilst others focus on lending in a particular city, or even a deprived area of a city. As noted above in Section 4.4.1, there are two separate areas of interest: the impact at the level of the local community, and the impact at the level of the region. Leakage is thus defined as the benefits that are generated outside of these two spatial areas.

Leakage was calculated by asking businesses to estimate the proportion of their workforce that lived less than two miles from their centre of operations (leakage at the level of the local community), and the proportion that lived less than 50 miles from their centre of operations (the level of the region). Note that leakage has not been applied to either business impacts or turnover impacts, since unless firms subsequently relocate their business elsewhere, these benefits are fixed.

**Displacement**

Displacement concerns the extent to which the impacts achieved by CDFI beneficiaries have come at the expense of non-beneficiaries, for instance if a business achieves growth by taking market share from another business in the given area of interest. To measure the scale of the displacement effect, as part of the business survey beneficiaries were asked to estimate the proportion of their direct competitors that were located less than two miles from their centre of operations (displacement at the level of the local community), and the proportion that were located less than 50 miles from their centre of operations (the level of the region).

**Economic multipliers**

Businesses supported by CDFIs may generate additional economic impacts through their supply chain expenditure or through the expenditure of their employees. The magnitude of these impacts is typically calculated by applying economic multipliers to observed beneficiary-level impacts. In the absence of detailed information on the supply chain expenditure of businesses, or the household expenditure patterns of employees, ready reckoners derived from existing research studies are used.

With regard to the multiplier for use at the local community level, a recent meta analysis of economic impact assessments carried out for the RDAs found that the mean economic multiplier for enterprise support programmes at a sub-regional level was 1.21\(^{59}\), whilst the English Partnerships Addi tionality Guide recommends the use of a multiplier of 1.05 to 1.15 for neighbourhood level interventions\(^{60}\). Since CDFI business beneficiaries tend to be relatively small (see Figure 4.5), a multiplier of 1.1 has been used for this study. With regard to the multiplier for use at a regional level, the RDA meta evaluation reported a mean multiplier of 1.44, whilst English Partnerships recommend a range of between 1.3 to 1.7. Again, given the nature of the

\(^{59}\) BIS (October 2009) BIS Occasional Paper No. 1: Research to Improve the Assessment of Additionality

population in question the lower end of the range is likely to be more appropriate, and so a multiplier of 1.3 has been adopted.

4.4.3 Gross economic impacts

Gross impacts are the impacts reported by businesses before assessing additionality as described above in Section 4.4.2. Table 4.6 summarises the gross business, employment and turnover impacts generated by the 6,505 outstanding CDFI loans, based on information derived from the business survey and grossed up to the population as a whole. Gross impacts have also been disaggregated according to whether businesses are social enterprises or whether they are located in a deprived area. At this stage in the economic impact assessment model there are no differences between local community and regional impacts.

Table 4.6: Gross business, employment, turnover and GVA impacts of CDFI lending

<table>
<thead>
<tr>
<th>Gross impacts</th>
<th>All</th>
<th>Social enterprises</th>
<th>Deprived areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses created</td>
<td>2,196</td>
<td>948</td>
<td>551</td>
</tr>
<tr>
<td>Businesses safeguarded</td>
<td>1,652</td>
<td>668</td>
<td>571</td>
</tr>
<tr>
<td>Jobs created</td>
<td>13,793</td>
<td>6,997</td>
<td>3,825</td>
</tr>
<tr>
<td>Jobs safeguarded</td>
<td>12,789</td>
<td>3,527</td>
<td>4,182</td>
</tr>
<tr>
<td>Turnover created</td>
<td>£667m</td>
<td>£304m</td>
<td>£148m</td>
</tr>
<tr>
<td>Turnover safeguarded</td>
<td>£834m</td>
<td>£209m</td>
<td>£215m</td>
</tr>
<tr>
<td>GVA created</td>
<td>£135m</td>
<td>£62m</td>
<td>£30m</td>
</tr>
<tr>
<td>GVA safeguarded</td>
<td>£169m</td>
<td>£42m</td>
<td>£44m</td>
</tr>
</tbody>
</table>

Base = 6,505 business loans (all); 2,715 business loans (social enterprises), 1,917 business loans (deprived area)

4.4.4 Net economic impacts

Table 4.7 summarises the net business, employment and turnover impacts generated by the 6,505 outstanding CDFI loans, based on the application of the additionality analysis set out in Section 4.4.2 to the gross impact data set out in Table 4.6 above. Data are presented according to whether impacts have been achieved at the level of the local community or whether they have been achieved at the level of the region. Again, net impacts have also been estimated for social enterprises or for businesses based in deprived areas of the country based on the additionality factors of these groups of businesses. Note that the additionality factors shown in Table 4.4 and Table 4.5 have been estimated using the sample of businesses as a whole, and will thus vary from those for social enterprises and businesses located in a deprived area.
Table 4.7: Net business, employment, turnover and GVA impacts of CDFI lending

<table>
<thead>
<tr>
<th>Geographic area</th>
<th>Net impacts</th>
<th>All</th>
<th>Social enterprises</th>
<th>Deprived areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local community</td>
<td>Businesses created</td>
<td>1,705</td>
<td>719</td>
<td>371</td>
</tr>
<tr>
<td></td>
<td>Businesses safeguarded</td>
<td>1,372</td>
<td>505</td>
<td>469</td>
</tr>
<tr>
<td></td>
<td>Jobs created</td>
<td>3,635</td>
<td>1,689</td>
<td>1,252</td>
</tr>
<tr>
<td></td>
<td>Jobs safeguarded</td>
<td>3,618</td>
<td>981</td>
<td>1,078</td>
</tr>
<tr>
<td></td>
<td>Turnover created</td>
<td>£560m</td>
<td>£244m</td>
<td>£113m</td>
</tr>
<tr>
<td></td>
<td>Turnover safeguarded</td>
<td>£788m</td>
<td>£198m</td>
<td>£216m</td>
</tr>
<tr>
<td></td>
<td>GVA created</td>
<td>£113m</td>
<td>£49m</td>
<td>£23m</td>
</tr>
<tr>
<td></td>
<td>GVA safeguarded</td>
<td>£160m</td>
<td>£40m</td>
<td>£44m</td>
</tr>
<tr>
<td>Region</td>
<td>Businesses created</td>
<td>883</td>
<td>279</td>
<td>187</td>
</tr>
<tr>
<td></td>
<td>Businesses safeguarded</td>
<td>790</td>
<td>272</td>
<td>303</td>
</tr>
<tr>
<td></td>
<td>Jobs created</td>
<td>4,614</td>
<td>1,544</td>
<td>1,401</td>
</tr>
<tr>
<td></td>
<td>Jobs safeguarded</td>
<td>7,571</td>
<td>1,904</td>
<td>2,723</td>
</tr>
<tr>
<td></td>
<td>Turnover created</td>
<td>£301m</td>
<td>£107m</td>
<td>£43m</td>
</tr>
<tr>
<td></td>
<td>Turnover safeguarded</td>
<td>£461m</td>
<td>£129m</td>
<td>£81m</td>
</tr>
<tr>
<td></td>
<td>GVA created</td>
<td>£81m</td>
<td>£22m</td>
<td>£9m</td>
</tr>
<tr>
<td></td>
<td>GVA safeguarded</td>
<td>£94m</td>
<td>£26m</td>
<td>£17m</td>
</tr>
</tbody>
</table>

Base = 6,505 business loans (all); 2,715 business loans (social enterprises), 1,917 business loans (deprived area)

The value for money of these impacts is discussed below in Section 4.5, which considers the efficiency of CDFIs as delivery vehicles.

4.4.5 Future impacts

Section 4.4.1 above raised the issue of the future impacts of CDFI lending, which arguably fall into two categories:

- Impacts generated after businesses responded to the beneficiary survey, but within the lifetime of the CDFI loan. Strictly speaking these benefits should be included within this economic impact assessment, and without them this is an underestimate of the lifetime impacts of a CDFI loan;
- Impacts generated after the CDFI loan has been repaid, but which can still ultimately be traced back to the effects of the CDFI loan.

With regard to the economic impacts that will be generated over the lifetime of the loan, Figure 4.20 shows the distribution of elapsed loan terms (i.e. the proportion of the total loan term that had elapsed at the time that beneficiaries completed the survey):
Just under half of beneficiaries (48 per cent) reported that under a quarter of their loan term had elapsed, reflecting the fact that over half of all loans were made in either 2008 or 2009 (Figure 4.9);

A further 26 per cent of beneficiaries reported that between a quarter and a half of their total loan term had elapsed, whilst just 12 per cent of respondents were past three quarters of their total loan term.

**Figure 4.20: Elapsed loan period as a proportion of the total duration of the loan**

Base = 363 businesses

Figure 4.20 would suggest that the economic impact data presented above potentially underestimates the scale of the benefits of CDFI lending, since a high proportion of loans have only recently been awarded to recipients. However, on balance this is unlikely to be the case, since:

- Loans tend to be a one-off payment that is invested immediately, and thus the majority of the benefits are also generated relatively soon after the loan is received;
- Where loans are used to safeguard employment or turnover, again this is a one-off impact that will be recorded immediately.

For these reasons it is not possible to extrapolate future impacts based on the economic impacts generated to date, in order to give a lifetime estimate of the impact of a loan. Moreover, the persistence of the impacts reported cannot be known, although businesses were asked what they considered would happen in the next three years (see below). New jobs or turnover created may be lost before the loan is repaid, or indeed the business may be forced to close, negating all impacts generated previously (though this raises an interesting question as to the economic value of such ‘temporary’ impacts, for example safeguarding a job for, say, three years, before it is finally lost). From a methodological perspective, this evaluation is, in effect, an interim evaluation of current CDFI outstanding lending, and the only way in which to accurately measure the lifetime impacts of the loans included in this study would be to revisit businesses once they have reached the end of their loan terms.

Looking further forward, as part of the beneficiary survey, businesses were asked whether they expected their employment and turnover to increase, decrease or stay the same over the next three years (Figure 4.21):
The majority of respondents (64 per cent) expected their employment to increase, whilst an even larger majority of respondents (80 per cent) expected their turnover to increase. Of course, businesses were asked this question in the middle of a deep recession and, where they are able to survive, it is to be expected that most would expect an improvement on their current position once the recession is over;

Some 22 per cent of businesses thought that their employment levels would stay the same, though just 6 per cent thought the same with regard to turnover levels;

Just 1 per cent of respondents expected a decline in their employment in the next three years, and 2 per cent expected a drop in their annual turnover.

Whilst these medium-term economic impacts cannot be quantified for the reasons outlined above, it is clear that CDFI beneficiaries are optimistic that the impacts generated to-date will persist for at least the next three years and may expand. Given the number of businesses that would either have ceased trading or failed to start-up without CDFI support (see Table 4.7), the medium-term persistence of the impacts of CDFI lending will be relatively high. From a purely methodological perspective, however, it should be noted that additionality will decrease as time passes, reducing the magnitude of the future net economic impacts that can be attributed to CDFIs. As businesses grow and develop track records and experience, the likelihood that they will be unable to access mainstream funding decreases; as discussed in Section 4.3.2, a number of CDFI beneficiaries have already successfully accessed finance from mainstream providers since receiving their loan. At this point, attributing growth to the intervention of the CDFI becomes increasingly difficult.

**Figure 4.21: How businesses expect their employment and turnover to change over the next three years**

A consideration of the future impacts of CDFI lending should take account of the recycling of loan capital. Unlike, for instance, grant regimes, the capital that CDFIs lend out is returned (except for losses through bad debt) and re-lent, thus generating further economic impacts. Thus far this sub-section of the report has focussed on the impacts generated by the ‘first round’ of lending, yet to properly measure the economic impact of CDFIs, future ‘cohorts’ of impacts should be included as capital is recycled. In practice, however, such a calculation would be difficult, and would need to be
modelled based on a combination of loan duration, bad debt and other variables that describe the frequency and scale with which a given amount of loan capital is circulated amongst businesses over time by CDFIs. At present this data is not available, and thus the impact of capital recycling has not been included in this economic impact assessment.

4.5 Value for money

An assessment of value for money is a core requirement of an IEF compliant evaluation, but in the case of the CDFI sector is not a simple calculation due to the range of different organisations that provide capital and/or revenue support to CDFIs and the lack of available data on the scale of public sector support for the sector. As a result, this value for money analysis has been based on a combination of the economic impact data generated through the beneficiary survey and a financial model of the enterprise lending activities of a CDFI that has been developed as part of the analysis of the sustainability of the sector (Section 6).

The financial model of the enterprise lending activities of a CDFI is set out in Section 6.4. This model uses data drawn from the 2008/09 Inside Out survey to calculate the extent to which a set of exemplar types of CDFI (based on size and market segment served) are able to cover their operational, financial and capital costs on the basis of earned income. As Table 6.6 shows, only one type of CDFI (a large organisation lending to social enterprises) is able to fully cover its operational costs, and no CDFIs are able to cover either their financial costs (operational costs plus capital lost through bad debt) or capital costs (operational and financial costs plus a notional ‘charge’ matching the costs of capital).

The resultant ‘gap’ between income and costs is equivalent to the annual value of public sector financial support needed to operate a CDFI, assuming that CDFIs do not obtain revenue finance from other sources (such as loans from other finance providers or from philanthropic donations). In reality, of course, many CDFIs have successfully generated funding in this way (see the case studies in Annex 5), but without reliable data on the average scale of this investment across the sector as a whole it is presently necessary to assume that the annual finance gap is entirely met by the public sector. Note also that this model describes the efficiency of CDFIs as ‘vehicles’ for the delivery of capital to businesses and thus focuses on ongoing operational costs and the need to provide additional ‘top-up’ finance to replace money lost through bad debt. The model thus includes the operational and financial costs associated with the recycling of capital funds, but excludes the initial injection of capital finance (which is typically provided by the public sector).

Table 4.8 and Table 4.9 show the maximum public sector cost per unit of net economic impact delivered by the CDFI sector, at a local community and regional level. Note, of course, that this is a maximum cost in the sense that it is the gap between earned income and expenditure, and may thus be partially (or even fully) met by non-public sources of finance. It should also be noted that the survey was undertaken during a recession, and that CDFI loans were being used as ‘emergency’ finance in order to keep businesses trading (hence the level of businesses, jobs and turnover safeguarded).

At a local community level, the data presented in Table 4.8 show that to create a business through CDFI lending would, on average, cost the public sector £18,400. To
create an FTE job would cost £8,800. These costs vary significantly depending on the target market of a CDFI. For example, for a small CDFI lending to micro enterprises the annual public sector cost per business created rises to £30,500, and the per job created figure is £16,900. This increased cost reflects the fact that a small CDFI operating in the micro enterprise market is less able to cover its costs through earned income (thus requiring relatively more public sector support to fill the gap); the public sector cost per business created for a large CDFI – which benefits from economies of scale – is lower at £24,700.

Table 4.8: Estimated (maximum) public sector cost per unit of net economic impact: local community level, and on the basis of this, the amount of GVA created/ safeguarded per £1 of public sector expenditure

<table>
<thead>
<tr>
<th>Market segment</th>
<th>All markets</th>
<th>Micro enterprises</th>
<th>SMEs</th>
<th>Social enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Small</td>
</tr>
<tr>
<td>Business created</td>
<td>£18,443</td>
<td>£30,542</td>
<td>£24,713</td>
<td>N/A</td>
</tr>
<tr>
<td>Business safeguarded</td>
<td>£22,913</td>
<td>£52,147</td>
<td>£42,195</td>
<td>£19,299</td>
</tr>
<tr>
<td>Job created</td>
<td>£8,820</td>
<td>£16,858</td>
<td>£13,641</td>
<td>£15,105</td>
</tr>
<tr>
<td>Job safeguarded</td>
<td>£8,863</td>
<td>£38,084</td>
<td>£30,817</td>
<td>£2,932</td>
</tr>
<tr>
<td>£1 turnover created</td>
<td>£0.06</td>
<td>£0.11</td>
<td>£0.09</td>
<td>£0.06</td>
</tr>
<tr>
<td>£1 turnover safeguarded</td>
<td>£0.04</td>
<td>£0.30</td>
<td>£0.24</td>
<td>£0.01</td>
</tr>
<tr>
<td>£1 GVA created</td>
<td>£0.28</td>
<td>£0.55</td>
<td>£0.44</td>
<td>£0.32</td>
</tr>
<tr>
<td>£1 GVA safeguarded</td>
<td>£0.20</td>
<td>£1.46</td>
<td>£1.18</td>
<td>£0.05</td>
</tr>
</tbody>
</table>

Table 4.9 shows the estimated maximum public sector cost per unit of net economic impact at a regional level. In most cases, more public sector finance is needed per impact at a regional level than at a local community level (due most especially to displacement effects). For example, £35,600 is needed to create a business at a regional level, compared to only £18,400 to start a business at a local community level. Employment impacts are different, and for jobs created/ safeguarded the public sector cost per net economic impact is lower at a regional level than it is at a local community level. As shown in Table 4.5, leakage – which only applies to employment impacts as businesses, and the turnover they generate, are considered to be geographically fixed – is negligible at a regional level (equivalent to just 4 per cent of jobs created), but much higher at a local community level (equal to 46 per cent of jobs created). The latter suggests that almost half of the jobs created by CDFI supported businesses within, for example, deprived areas, are filled by individuals who reside outside of these areas.
Table 4.9: Estimated (maximum) public sector cost per unit of net economic impact: regional level, and on the basis of this, the amount of GVA created/safeguarded per £1 of public sector expenditure

<table>
<thead>
<tr>
<th>Market segment</th>
<th>All markets</th>
<th>Micro enterprises</th>
<th>SMEs</th>
<th>Social enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CDFI size</td>
<td>Small</td>
<td>Large</td>
<td>Small</td>
</tr>
<tr>
<td>Business created</td>
<td>£35,629</td>
<td>£59,002</td>
<td>£47,742</td>
<td>N/A</td>
</tr>
<tr>
<td>Business safeguarded</td>
<td>£39,815</td>
<td>£98,478</td>
<td>£79,685</td>
<td>£26,366</td>
</tr>
<tr>
<td>Job created</td>
<td>£6,950</td>
<td>£14,096</td>
<td>£11,406</td>
<td>£8,301</td>
</tr>
<tr>
<td>Job safeguarded</td>
<td>£4,235</td>
<td>£29,854</td>
<td>£24,157</td>
<td>£1,119</td>
</tr>
<tr>
<td>£1 turnover created</td>
<td>£0.11</td>
<td>£0.22</td>
<td>£0.18</td>
<td>£0.09</td>
</tr>
<tr>
<td>£1 turnover safeguarded</td>
<td>£0.07</td>
<td>£0.77</td>
<td>£0.62</td>
<td>£0.02</td>
</tr>
<tr>
<td>£1 GVA created</td>
<td>£0.53</td>
<td>£1.08</td>
<td>£0.87</td>
<td>£0.46</td>
</tr>
<tr>
<td>£1 GVA safeguarded</td>
<td>£0.34</td>
<td>£3.80</td>
<td>£3.08</td>
<td>£0.08</td>
</tr>
</tbody>
</table>

For GVA created/safeguarded per £1 of public sector expenditure:

| GVA created (£) | £1.89 | £0.93 | £1.15 | £2.17 | £2.78 | £2.70 | £3.57 |
| GVA safeguarded (£)| £2.94 | £0.26 | £0.32 | £12.50 | £16.67 | £3.23 | £4.35 |

A value for money assessment typically makes use of benchmarks in order to compare the achieved values against similar programmes and other types of intervention. In benchmarking the performance of CDFIs, a key issue is whether to benchmark the value for money assessment set out above, which concerns the efficiency of CDFIs as delivery vehicles, or to benchmark the impact of the CDFI lending portfolio. In both cases, there is a problem in identifying the most suitable benchmark(s) for comparison, such as the ‘niche’ that CDFIs fill. For instance, other potentially similar interventions – such as RDA enterprise creation programmes, other public sector loan programmes, grant schemes, or venture capital schemes – all operate in different ways and with different end goals, making direct comparison problematic. Core to this issue is the role of capital recycling, since an assessment of the value for money of CDFI lending needs to take account of the fact that money is returned (minus bad debt) and re-lent. At present there is insufficient data available to enable an accurate assessment of the effect of loan recycling on the impacts achieved, and in any case, a benchmarking exercise is severely constrained due to the inconsistent use of models of net additionality across programme evaluations.

4.6 Control Group

In order to obtain further information on the access to finance behaviour of the CDFI sector’s target market(s), and to investigate their economic performance, a control group survey was carried out. This control group consisted of SMEs that had had, at some point, a loan application fully rejected by a mainstream bank (i.e. not partially rejected, such that they had still received some loan finance). The sample frame was derived from business contacts generated through BIS-led SME surveys (specifically the 2006/07 and 2007/08 Annual Small Business Survey and the Business Barometer surveys carried out since December 2008), and consisted of 439 businesses. In total,
surveys were completed with 103 businesses, a response rate of 23 per cent. Assuming a very large population, the achieved sample for the control group of 103 firms is thus representative of the population as a whole at a 95 per cent level of confidence with a confidence interval of around +/- 10 per cent. Additional details of the survey methodology, and the sample frame used, are included in Annex 3.

### 4.6.1 Overview of the control group

A summary profile of the control group respondents, and comparison to the characteristics of the respondents to the beneficiary survey, is shown in Table 4.10.

**Table 4.10: Comparison of key characteristics of control group survey and CDFI business beneficiary survey**

<table>
<thead>
<tr>
<th>Respondent characteristics</th>
<th>Control Group</th>
<th>CDFI beneficiaries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal status of enterprise</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private company limited by shares</td>
<td>59%</td>
<td>31%</td>
</tr>
<tr>
<td>Private company limited by guarantee</td>
<td>7%</td>
<td>21%</td>
</tr>
<tr>
<td>Sole trader</td>
<td>23%</td>
<td>28%</td>
</tr>
<tr>
<td>Partnership/ Limited liability partnership</td>
<td>12%</td>
<td>7%</td>
</tr>
<tr>
<td>Industrial and Provident Society/ CIC</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>Other</td>
<td>0%</td>
<td>2%</td>
</tr>
<tr>
<td><strong>Social enterprises</strong></td>
<td>Commercial businesses</td>
<td>82%</td>
</tr>
<tr>
<td>Social enterprises</td>
<td>17%</td>
<td>42%</td>
</tr>
<tr>
<td><strong>Number of employees</strong></td>
<td>0-9 (micro enterprise)</td>
<td>58%</td>
</tr>
<tr>
<td>10-49 (small enterprise)</td>
<td>33%</td>
<td>14%</td>
</tr>
<tr>
<td>50-250 (medium enterprise)</td>
<td>8%</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Turnover of enterprise</strong></td>
<td>£0-£50,000</td>
<td>6%</td>
</tr>
<tr>
<td>£50,000-£100,000</td>
<td>6%</td>
<td>13%</td>
</tr>
<tr>
<td>£100,000-£250,000</td>
<td>17%</td>
<td>14%</td>
</tr>
<tr>
<td>£250,000-£500,000</td>
<td>14%</td>
<td>11%</td>
</tr>
<tr>
<td>500,000-£1 million</td>
<td>15%</td>
<td>7%</td>
</tr>
<tr>
<td>£1 million-£5 million</td>
<td>17%</td>
<td>6%</td>
</tr>
<tr>
<td>More than £5 million</td>
<td>5%</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Age at loan application</strong></td>
<td>Start-up (aged less than 2 years)</td>
<td>6%</td>
</tr>
<tr>
<td>Established</td>
<td>94%</td>
<td>31%</td>
</tr>
</tbody>
</table>

*Base = 102 businesses (Control group); 363 businesses (CDFI beneficiaries)*

*Notes: Refused/ Don’t know percentages have not been included; # Loan application is: the rejected bank application (the control group), the successful CDFI loan application (CDFI beneficiaries)*
In most respects the characteristics of the control group survey respondents and the CDFI beneficiary survey respondents are different. Most notably:

- CDFI beneficiaries are more likely to consider themselves to be social enterprises (42 per cent of the total compared to 17 per cent of the control group survey respondents);
- Control group survey respondents are generally larger than CDFI business beneficiaries – just 58 per cent were micro enterprises compared to 76 per cent of CDFI beneficiaries. Moreover, 25 per cent of CDFI beneficiaries had an annual turnover of up to £50,000, compared to just 6 per cent of control group businesses;
- The businesses supported by CDFIs were much more likely to be start-ups at the time that they were funded (60 per cent of the total compared to just 6 per cent of control group businesses).

4.6.2 Analysis of access to finance behaviour of the control group

The control group sample frame was developed on the basis that businesses had at some point had a loan application fully rejected by a mainstream bank; there was no filter depending on whether businesses had subsequently successfully reapplied to their bank and/or whether they had successfully applied to another finance provider(s).

Analysis of survey responses suggests that the majority of businesses, having had a loan application rejected by a mainstream bank, had not subsequently applied for loan finance (Table 4.11).

Table 4.11: Comparison of the access to finance behaviour of the control group after mainstream bank loan application was rejected

<table>
<thead>
<tr>
<th>Summary of access to finance behaviour after rejection by mainstream bank</th>
<th>Control Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediately successfully applied to another source; no successful finance applications at a later date</td>
<td>17%</td>
</tr>
<tr>
<td>Did not successfully obtain finance immediately; successfully applied for finance at a later date</td>
<td>13%</td>
</tr>
<tr>
<td>Both successfully applied for finance immediately, and obtained further finance at a later date</td>
<td>4%</td>
</tr>
<tr>
<td>Did not successfully apply for finance immediately after the rejection, or at a later date</td>
<td>67%</td>
</tr>
</tbody>
</table>

*Base = 102 businesses*

Table 4.11 shows that:

- Some 67 per cent of businesses from the control group, having had their finance application rejected by a mainstream bank, did not successfully apply for finance from another source, either around the same time, or at a later date;
- A further 17 per cent of businesses immediately applied to another source and were successful. On the most part these businesses applied to another mainstream bank, though others used an overdraft, friends and family, or a government grant/ loan. Some 38 per cent of these businesses got the same
amount of finance that they had unsuccessfully tried to get from a mainstream bank; 29 per cent got more, and 29 per cent got less;

- Some 13 per cent of businesses did not successfully apply for finance immediately after their rejection, but did do so at a later date (defined as at least 3 months after the initial loan application). Sources included: the bank that had initially made the rejection, plus the other finance sources identified above;

- Finally, a small number (just 4 per cent) of businesses successfully applied for finance from another source immediately after their rejection, and then subsequently obtained further finance at a later date.

In comparison to the CDFI beneficiary group, reasons provided by the businesses that responded to the control group survey as to why they had had their finance application rejected by a mainstream bank were less associated with market failure (Table 4.12):

- Whilst 44 per cent of CDFI beneficiaries reported that they had had a loan application rejected by a mainstream bank because of a lack of collateral, this was identified as a problem by just 20 per cent of control group survey respondents;

- A lack of a track record was a problem for just 4 per cent of the control group, perhaps because of the small number of start-ups in the sample; and,

- Control group businesses reported a more diverse range of reasons for finance rejection, including a view that banks did not have sufficient resources to lend (linked to the credit crunch), and in a number of cases that it was actually the business that had rejected the loan on the grounds of poor terms and conditions.

Table 4.12: Reasons why businesses had had a finance application rejected by a mainstream bank (control group and CDFI beneficiary sample)

<table>
<thead>
<tr>
<th>Reason for finance application rejection</th>
<th>Control Group</th>
<th>CDFI beneficiaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of collateral</td>
<td>20%</td>
<td>44%</td>
</tr>
<tr>
<td>Lacked business experience/ track record</td>
<td>4%</td>
<td>21%</td>
</tr>
<tr>
<td>Amount of finance sought was too small/ large</td>
<td>6%</td>
<td>18%</td>
</tr>
<tr>
<td>Past problems with loan repayment</td>
<td>7%</td>
<td>17%</td>
</tr>
<tr>
<td>Told business proposition was not viable</td>
<td>10%</td>
<td>14%</td>
</tr>
<tr>
<td>Bank unwilling to lend to sector/ activity</td>
<td>6%</td>
<td>0%</td>
</tr>
<tr>
<td>Bank did not have finance to lend</td>
<td>9%</td>
<td>0%</td>
</tr>
<tr>
<td>Business rejected the bank as terms were poor</td>
<td>5%</td>
<td>0%</td>
</tr>
<tr>
<td>No reason was given</td>
<td>25%</td>
<td>12%</td>
</tr>
<tr>
<td>Another reason</td>
<td>17%</td>
<td>6%</td>
</tr>
<tr>
<td>Refused/ Don't know</td>
<td>3%</td>
<td>20%</td>
</tr>
</tbody>
</table>

*Base = 102 businesses (Control group); 128 businesses (CDFI beneficiaries)*
4.6.3 Comparison of economic impacts

One of the key purposes of the control group survey was to investigate how the economic impacts reported by businesses through the CDFI beneficiary survey compared to the economic performance of businesses that had had a loan application rejected by a mainstream bank, but had not accessed a CDFI loan. As noted above, the differences between the control group businesses and the CDFI beneficiaries mean that such a direct comparison cannot be made; as a whole, the control group businesses are much larger and more established, and might thus be expected to cope with the effects of a loan application rejection more effectively than a start-up business, a micro enterprise, or a social enterprise (the key target groups of CDFIs). The evidence is, also, of access to finance behaviour driven by a different position within the market and most especially not the issues of market failure faced by CDFI clients.

For this reason it was decided to focus on a sub-set of the control group sample which contained enough respondents to be comparable to the CDFI beneficiary sample – established micro enterprises (54 survey responses were received). Unfortunately, just 17 social enterprises and 6 start-up businesses responded to the control group survey, samples too small to enable robust statistical comparisons to be made with the responses of the CDFI beneficiaries. Consequently, it should be noted that any conclusions are not reflective of the full range of CDFI lending activities and exclude two key target markets – social enterprises and start-up businesses.

Through necessity the control group survey was only carried out with surviving businesses and, particularly in the context of the economic recession, it is quite likely that a proportion of micro businesses who were unable to access finance from a mainstream bank would subsequently have closed (and would not have been included in the survey). It is impossible to know the scale of this issue, though it should be noted that 57 per cent of established micro enterprises who responded to the CDFI beneficiary survey reported that they would have closed if they had not received their CDFI loan. Even taking account of optimism bias in CDFI beneficiary responses, it is likely that the control group sample is thus not reflective of the aggregate current position of businesses who were unable to access finance from a mainstream bank.

summarises employment and turnover change within established micro enterprises between either their rejection by a mainstream bank (the control group), or their successful obtaining of a CDFI loan (the beneficiary survey), and the present. This comparison is interesting in that it provides some indication of the possible trajectories of a selection of CDFI beneficiaries had they not received their CDFI loan. Note that a distinction is made between control group businesses that did not successfully obtain any finance after their initial rejection, and businesses that did obtain finance (immediately and/or at a later date). For the CDFI beneficiary group these two sets of businesses have been matched against those firms that did not obtain any finance other than their initial CDFI loan, and those firms that did obtain further finance, either at the same time (e.g. through co-financing), or subsequently. Key observations are as follows:

- Established micro enterprises from the control group, despite not receiving any finance, still recorded some employment and turnover growth through to the present. Slightly higher proportions of businesses receiving CDFI loans reported employment and turnover growth;
The gap in the proportion of businesses reporting employment and/or turnover growth between the control group and the CDFI beneficiary sample was greater where businesses had subsequently been able to access additional finance.

Table 4.13: Employment and turnover change since the original loan ‘application’ amongst established micro enterprises, control group and CDFI beneficiaries

<table>
<thead>
<tr>
<th>Post loan ‘application’ trajectory</th>
<th>Economic indicator</th>
<th>Comparison group</th>
<th>% of beneficiaries reporting change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Control group</td>
<td>Decreased</td>
</tr>
<tr>
<td>Did not receive any further finance</td>
<td>Employment</td>
<td></td>
<td>11%</td>
</tr>
<tr>
<td></td>
<td>Control group</td>
<td></td>
<td>11%</td>
</tr>
<tr>
<td></td>
<td>Turnover</td>
<td></td>
<td>26%</td>
</tr>
<tr>
<td></td>
<td>CDFI group</td>
<td></td>
<td>13%</td>
</tr>
<tr>
<td>Received some additional finance</td>
<td>Employment</td>
<td>Control group</td>
<td>19%</td>
</tr>
<tr>
<td></td>
<td>Control group</td>
<td></td>
<td>16%</td>
</tr>
<tr>
<td></td>
<td>Turnover</td>
<td>CDFI group</td>
<td>31%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>20%</td>
</tr>
</tbody>
</table>

Base = 54 businesses (Control group); 71 businesses (CDFI beneficiaries); note: Refused/ Don't know percentages have not been included

4.7 Conclusions

This section of the report has analysed the economic impacts of CDFI lending activity, using a methodology that is compliant with the core principles of the IEF. The key points of note are as follows:

- The business beneficiary survey provides a detailed profile of the nature of the businesses that access CDFI loans. Whilst there is considerable diversity (reflecting both the variety of ‘target’ markets served by CDFIs and, arguably, the effect that the credit crunch has had on access to mainstream finance), ‘typical’ characteristics of the CDFI client base include a relatively large proportion of businesses that are: social enterprises, very small firms (employment and turnover), service sector, and/or located in a deprived area;

- Most business beneficiaries had applied for finance from another source either instead of or in addition to their CDFI loan. Commercial providers – principally mainstream banks – were the most common source used, and in almost all cases the finance application was rejected (for reasons including a lack of collateral, a lack of a track record of borrowing and/or a poor repayment history). Where businesses had not applied for finance from a commercial provider, these same issues were cited as reasons as to why they had been discouraged from doing so. In most cases, therefore, the market failure arguments for CDFIs (Section 2.1) are confirmed by the findings of the beneficiary survey;

- A significant minority of businesses had successfully obtained finance from another source (generally commercial, but in the case of some social enterprises a charitable/ government grant), but had been unable to secure all of the capital needed. Whilst bankable, therefore, these businesses presented enough of a
risk (particularly in the current economic climate) for mainstream banks to refuse to meet the entirety of demand. In these cases, CDFIs had filled the gap;

- A minority of businesses appear to have been able to access mainstream finance, but have chosen to apply for a CDFI loan since it had better terms and conditions. Almost all of these firms were social enterprises which, as shown in Table 3.6, tend to be charged relatively low interest rates by CDFIs, perhaps making the CDFI loan more attractive than a loan from a commercial provider;

- There is evidence that obtaining a loan from a CDFI increases the likelihood that a business will subsequently apply for finance from a commercial source, and increases the chances that they will be successful. Having a CDFI loan addresses many of the causes of market failure that prevent businesses from successfully obtaining finance from mainstream banks, in particular the lack of a track record of borrowing and repayment;

- A core requirement of this study was to carry out an IEF compliant assessment of the economic impacts of CDFI lending, taking account of additionality. Impacts have been calculated at two spatial scales: the level of the local community, and the level of the region:
  - At the level of the local community, the net impacts of the outstanding CDFI loan portfolio are:
    - 1,705 new businesses created and 1,372 existing businesses safeguarded;
    - 3,635 jobs created and 3,618 jobs safeguarded;
    - £560 million of new turnover generated and £788 million of existing turnover safeguarded.
  - At the level of the region, the net impacts of the outstanding CDFI loan portfolio are:
    - 883 new businesses created and 790 existing businesses safeguarded;
    - 4,614 jobs created and 7,571 jobs safeguarded;
    - £301 million of new turnover generated and £461 million of existing turnover safeguarded.

- These impacts are a snapshot of the economic benefits of CDFI outstanding lending as at October 2009, and do not show the 'lifetime' impacts achieved by these loans. The majority of businesses expected their employment and turnover to increase in the near future, suggesting that the medium-term persistence of CDFI lending will be relatively high (though it will also become increasingly hard to isolate the cause of this growth, and thus to attribute benefits to the activities of CDFIs);

- In order to calculate the value for money associated with the net economic impacts attributed to CDFI lending, it was necessary to develop a financial operating model for a CDFI (see Section 6.4). Using this model, the maximum public sector cost per impact was calculated (maximum because no account has been made of non-public sector financial support), in order to analyse the relative efficiency of CDFI operating models. The results suggest that CDFIs are generally efficient vehicles for the delivery of capital to businesses, though the
nature of the model deployed (including the recycling of capital) means that identification of directly comparable efficiency benchmarks (e.g. compared to grant schemes or even banks) has not been feasible.
5 SOCIAL IMPACTS OF CDFI LENDING ACTIVITY

This section of the report presents an assessment of the social impacts generated by the CDFI sector through its enterprise-lending activity, and other services provided to businesses. Evidence has been drawn from a variety of sources, including the CDFA’s Inside Out survey of the CDFI sector, GHK’s own desk-based review of the sector, the results of the business beneficiary survey, and the CDFI case studies.

This review is structured into sub-sections on: defining social impacts, the social goals pursued by CDFIs, the views of CDFIs on measuring social impacts, evidence from the business beneficiary survey on social impacts, and a review of the tools available for quantifying social impacts. The section finishes with a set of conclusions.

5.1 What are the social impacts of CDFIs?

Government support for the CDFI sector, whilst primarily focussing on the economic benefits generated, has recognised the wider social impacts that accrue through CDFI support for enterprise. The PAT3 report Enterprise and Social Exclusion was explicit about the role that enterprise growth in deprived areas could have in generating social benefits:

‘There is a vital role that enterprise can play in helping to renew our poorest and most marginal communities. It helps to create jobs and stimulate activity in communities where crime and unemployment are high. It helps meet the basic needs of local people, by providing vital services like shops. Perhaps most fundamentally, it helps develop self-confidence and determination in local people and communities – the real drivers of regeneration in the long run’.

The PAT3 report also highlighted the importance of CDFIs in supporting enterprise development amongst communities and within areas where there is a market failure in the availability of enterprise finance from mainstream providers. Specifically, a component of this market failure, it was argued, was the failure of the mainstream finance sector to recognise and account for the wider social benefits of providing enterprise finance within underserved markets:

‘New financial intermediaries, such as Community Finance Initiatives (CFIs), can play a valuable role, by acting as additional sources of credit in the community, focussed on market segments that are not commercial but which offer high social returns’.

There are a number of mechanisms through which the provision of enterprise finance to these undeserved markets by CDFIs offers ‘high social returns’:

- Employment and income generation in deprived areas and disadvantaged communities: CDFIs sometimes explicitly target disadvantaged groups, whilst others focus on delivering loans in deprived areas. In some cases this forms part of their social mission (for instance the Aston Reinvestment Trust), whilst in others this focus is driven by funders (e.g. RDAs providing finance for on-lending

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to specific disadvantaged groups). Furthermore, by focussing on addressing market failures in the access to finance market (see Section 2.1 for details), even where they do not have an explicit goal to support disadvantaged groups, CDFIs can be expected to disproportionately lend to individuals with low incomes (which might have resulted in their inability to provide collateral), or some other form of disadvantage. By supporting enterprise, therefore, CDFIs may specifically reduce unemployment and boost incomes within disadvantaged communities and deprived areas, thus improving social equity and contributing towards tackling inequalities;

- **Attitudinal impacts and skills development**: The CDFI delivery model includes, to varying degrees, advice and support for businesses receiving finance (primarily around investment readiness). This support helps develop the skills and competencies of participating individuals and businesses (principally finance and business skills), which can then be applied on an ongoing basis. CDFI support to businesses, and the employment opportunities generated, may also have positive attitudinal impacts on beneficiaries. Employment has been shown to improve confidence, boost aspirations and improve health and mental well-being. The generation or safeguarding of jobs also has an important catalysing effect within socially excluded communities, for instance through the creation of positive role models (people who know an entrepreneur are more than twice as likely to enter business as those who do not). Finally, it has also been suggested that enterprise growth in deprived areas is a route to enhancing social capital and building community cohesion, which in turn has wider social benefits in terms of improved quality of life and reduced crime;

- **Local service provision**: Local services can be commercial (e.g. shops) or non-commercial (e.g. community facilities), the unavailability of which has been shown to contribute to social exclusion. Supporting the creation or safeguarding of local services in underserved markets has social benefits, for instance by improving access to such services in rural areas, or amongst particular groups for whom travel could present a problem (e.g. the elderly or disabled people). A key market segment for CDFIs is social enterprises, many of which exist to provide social services for local communities which improve the quality of life for beneficiaries (and reduce public costs associated with stress and ill health);

- **Improved physical environment**: The stimulation of enterprise contributes to environmental improvements, for instance through the re-use of vacant premises, and more indirectly through greater care for the environment by local residents stemming from improved satisfaction with the quality of the area. Businesses supported by CDFIs may also have positive environmental goals, or may operate within environmental industries.

Of course, the mainstream banking sector can and does fund large numbers of enterprises within deprived areas and amongst socially excluded groups, and generates social impacts. However, as discussed in Section 2.1, market failures in the

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63 Quoted in HM Treasury (March 2005) Enterprise and Economic Opportunity in Deprived Areas
64 Ibid.
provision of finance by banks mean that there is a gap in the availability of enterprise finance for precisely those groups for whom social returns are highest.

5.2 Social goals of CDFIs

The CDFI sector is characterised by an explicit social mission; this is a legacy of the community finance origins of many CDFIs together with the delivery requirements set by many of the organisations and individuals that have financed the sector (for example, social philanthropists). A review of the websites of CDFIs highlighted the following examples of social missions:

- To help women take control of their economic lives (WEETU);
- To help create local jobs for local people (Aston Reinvestment Trust);
- To alleviate poverty through work, to promote small business, and to reinforce local communities through business (Fredericks Foundation);
- To give people the opportunity to make a positive change in their lives [and] to provide funding for businesses and social enterprises that will improve the lives of communities, and help work towards economic development and regeneration (Gloucestershire Development Loan Fund); and,
- To finance social enterprises or trading arms of charities that are finding business solutions that create social and environmental transformations (Big Issue Invest).

The importance of these social missions varies between CDFIs, in some cases forming a general statement of intent whilst in others directly contributing to the eligibility criteria applied to enterprise lending activities. Evidence as regards the application of social missions was collected as part of the case studies. The Aston Reinvestment Trust seeks to support businesses that impact on disadvantaged areas (particularly through job creation), and will factor this social mission in as part of the appraisal of a loan application. The Fredericks Foundation also seeks to support individuals from disadvantaged backgrounds, and will thus focus support on applicants who are long-term unemployed, disabled, ex-offenders, and/or lone parents. The Project North East Loan Fund also seeks to support individuals who are able to demonstrate an element of disadvantage, for instance, a low level of educational attainment.

Generally, however, whilst the case study CDFIs looked favourably upon applications from individuals with some form of disadvantage, this was rarely an absolute necessity. The Fredericks Foundation, for example, was set up to only support individuals able to demonstrate disadvantage, but over time and particularly in response to the credit crunch had broadened its lending criteria to include businesses that could not access mainstream finance, regardless of whether they were otherwise disadvantaged. Other case study CDFIs, whilst recognising the social impacts of their lending (since entrepreneurs and business owners who were unable to access a loan from a mainstream bank were probably disadvantaged in other ways), were less explicit about how their social goals were applied, and indeed their most important lending criterion was that a business would be able to repay their loan.
5.3 Measuring social impacts: the views of CDFIs

At present there is no universal conceptual framework for the analysis of the social impacts of CDFIs (see Section 5.5), and so for this study it was necessary to collect evidence from both CDFIs and from business beneficiaries.

As part of the CDFA’s 2008/09 Inside Out survey, GHK inserted a question asking CDFIs to rate the extent to which their activities generated a selection of social impacts, following the model outlined above in Section 5.1. Table 5.1 shows the average score awarded by CDFIs to each of the social impacts, based on a numerical scale where 1 was equivalent to ‘to no extent’ and 5 was equivalent to ‘to a significant extent’:

- Attitudinal impacts were generally identified by CDFIs as the most important social benefits of their lending activity. Enabling people to have a greater sense of control over their lives was the highest scoring impact (an average score of 3.62 out of 5), following by increased self-esteem and confidence (average score 3.56 out of 5);
- CDFIs also stressed the local impact of their activities in terms of supporting the provision of local services and retaining income with local communities (average scores 3.11 and 3.51 out of 5 respectively);
- CDFIs were less sure about the extent to which their activities enhanced social capital, through increased satisfaction with the local area (average score 2.95 out of 5) or through increased participation in community activities (average score 2.83 out of 5);
- The least significant social impact reported by CDFIs was the extent to which beneficiaries would be more likely to undertake formal training (average score 2.69 out of 5).

Table 5.1: Average of CDFIs’ scoring of the extent to which they achieved a selection of social impacts (where 1 = to no extent and 5 = to a significant extent)

<table>
<thead>
<tr>
<th>Social impact</th>
<th>Average score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beneficiaries achieve a greater sense of control over their lives</td>
<td>3.62</td>
</tr>
<tr>
<td>Increased self-esteem and confidence amongst beneficiaries</td>
<td>3.56</td>
</tr>
<tr>
<td>Income retained in the local economy</td>
<td>3.51</td>
</tr>
<tr>
<td>Improved financial literacy amongst beneficiaries</td>
<td>3.27</td>
</tr>
<tr>
<td>Beneficiaries provide local community services</td>
<td>3.11</td>
</tr>
<tr>
<td>Increased propensity for beneficiaries to act as positive role models</td>
<td>3.10</td>
</tr>
<tr>
<td>Improvements in beneficiaries' health and mental well-being</td>
<td>3.05</td>
</tr>
<tr>
<td>Beneficiaries improve the quality of the local environment</td>
<td>2.98</td>
</tr>
<tr>
<td>Improvements in beneficiaries' satisfaction with their local communities</td>
<td>2.95</td>
</tr>
<tr>
<td>Businesses move from the informal to the formal economy</td>
<td>2.89</td>
</tr>
</tbody>
</table>

Evaluation of Community Development Finance Institutions
Final Report

Social impact

<table>
<thead>
<tr>
<th></th>
<th>Average score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in beneficiaries’ participation in community activities</td>
<td>2.83</td>
</tr>
<tr>
<td>Increased likelihood that beneficiaries will undertake formal training</td>
<td>2.69</td>
</tr>
</tbody>
</table>

*Base = 61 CDFIs. Source: Inside Out

5.4 Measuring social impacts: the views of business beneficiaries

The business beneficiary survey was used to collect further information on the social impacts of CDFIs. These have been analysed using the model of CDFI social impacts presented above in Section 5.1.

5.4.1 Employment and income generation in deprived areas and disadvantaged communities

As discussed in Section 4.1.5, analysis of the postcodes of respondents to the CDFI business beneficiary survey indicated that 29 per cent of businesses were located in one of the 20 per cent most deprived areas (Lower Super Output Areas – LSOAs). Without further analysis of the results of the 2007 IMD we cannot know whether this is above or below the proportion for the business population as a whole. In 2009, 3.5 per cent of outstanding loans made by mainstream banks to small businesses were to businesses located in the 2 per cent most deprived electoral wards in Great Britain, though this figure cannot easily be compared to the analysis of CDFI lending due to differences in the unit of analysis and differences in the dataset used (the data for mainstream bank lending uses an earlier version of the IMD).

As identified above in Section 5.1, CDFIs – relative to mainstream finance providers – would be expected to disproportionately support entrepreneurs and businesses from disadvantaged communities and deprived areas. To test this proposition, the business beneficiary survey asked respondents to estimate the proportion of their employees falling into a selection of disadvantaged groups (disadvantaged in the sense that employment levels and incomes tend to be below average for each of these groups, recognising that these categories are not mutually exclusive and that, within these groups, levels of disadvantage vary significantly).

Table 5.2 shows the average proportion of CDFI beneficiaries’ employees who are drawn from each of these groups, though note that these are all self-reported and may thus be subject to variations in definitions (e.g. what constitutes a disability or a formal qualification), and indeed awareness (e.g. knowledge of whether staff had criminal records). In summary, using comparator information for Great Britain as a whole for March 2009 drawn from the Annual Population Survey:

- On average, just over half (53 per cent) of CDFI beneficiaries’ employees were women. Nationally, as at March 2009 women made up 45 per cent of the employed workforce;

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66 British Bankers’ Association (2009) Lending to small businesses in deprived areas 2009
Individuals from a BAME group made up, on average, 22 per cent of CDFI beneficiaries’ employees. As at March 2009, BAME individuals made up 9 per cent of the employed workforce;

Individuals were unemployed prior to their appointment made up, on average, 33 per cent of the workforce of CDFI business beneficiaries. There are no direct comparators available for the business population as a whole;

CDFI business beneficiaries reported that, on average, 3 per cent of their workforce comprised ex-offenders. No reliable comparator data are available for the proportion of the workforce as a whole who are ex offenders;

Individuals with a disability made up, on average, 10 per cent of the workforce of CDFI business beneficiaries (compared to 12 per cent of the employed workforce nationally, as at March 2009);

On average, 28 per cent of CDFI beneficiaries’ employees had no formal qualifications. As at December 2007, 18 per cent of the national employed workforce had no formal qualifications.

Table 5.2: Average proportion of employees drawn from selected disadvantaged groups

<table>
<thead>
<tr>
<th>Business characteristic</th>
<th>Female</th>
<th>BAME group</th>
<th>Unemployed</th>
<th>Ex-offender</th>
<th>Disabled</th>
<th>No qualifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social enterprises</td>
<td>59%</td>
<td>20%</td>
<td>35%</td>
<td>3%</td>
<td>13%</td>
<td>23%</td>
</tr>
<tr>
<td>Commercial firms</td>
<td>47%</td>
<td>24%</td>
<td>33%</td>
<td>3%</td>
<td>7%</td>
<td>33%</td>
</tr>
<tr>
<td>Firms in deprived area</td>
<td>46%</td>
<td>35%</td>
<td>28%</td>
<td>5%</td>
<td>13%</td>
<td>26%</td>
</tr>
<tr>
<td>Firms not in deprived area</td>
<td>55%</td>
<td>10%</td>
<td>35%</td>
<td>3%</td>
<td>9%</td>
<td>29%</td>
</tr>
<tr>
<td>Micro businesses</td>
<td>54%</td>
<td>24%</td>
<td>33%</td>
<td>3%</td>
<td>11%</td>
<td>28%</td>
</tr>
<tr>
<td>Small businesses</td>
<td>44%</td>
<td>11%</td>
<td>32%</td>
<td>4%</td>
<td>8%</td>
<td>30%</td>
</tr>
<tr>
<td>Medium businesses</td>
<td>60%</td>
<td>13%</td>
<td>11%</td>
<td>17%</td>
<td>5%</td>
<td>32%</td>
</tr>
<tr>
<td><strong>All respondents</strong></td>
<td><strong>53%</strong></td>
<td><strong>22%</strong></td>
<td><strong>33%</strong></td>
<td><strong>3%</strong></td>
<td><strong>10%</strong></td>
<td><strong>28%</strong></td>
</tr>
</tbody>
</table>

Base = 363 businesses

5.4.2 Attitudinal and skills related impacts

As part of the business beneficiary survey, respondents were asked to score on a scale of 1 to 4 (where 1 was equivalent to ‘to no extent’ and 4 was equivalent to ‘to a significant extent’) the extent to which their involvement with a CDFI had generated a selection of the attitudinal and skills related social impacts that were discussed above in Section 5.1. The results are shown in Table 5.3, and broadly correspond to the ranking of these benefits by the CDFIs themselves (see Table 5.1):

- The highest scoring social impact of a CDFI loan was that it enabled beneficiaries to act as positive community role models (the average score was 2.55 out of 4);

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• Business respondents also awarded higher scores to an improvement in self esteem and confidence (average score 2.51 out of 5), and to an improvement in their sense of control over their lives (average score 2.47 out of 5);

• The lowest score awarded by business beneficiaries was the extent to which the CDFI loan had increased the likelihood that they would participate in formal training (average score 2.07 out of 4).

**Table 5.3: Average of business’ scoring of the extent to which they achieved a selection of social impacts (where 1 = to no extent and 4 = to a significant extent)**

<table>
<thead>
<tr>
<th>Attitudinal and skills related social impact</th>
<th>Average score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability to act as a positive community role model</td>
<td>2.55</td>
</tr>
<tr>
<td>Improvement in self esteem and confidence</td>
<td>2.51</td>
</tr>
<tr>
<td>Improvement in sense of control over life</td>
<td>2.47</td>
</tr>
<tr>
<td>Improvement in financial literacy</td>
<td>2.38</td>
</tr>
<tr>
<td>Improvement in health and mental well-being</td>
<td>2.26</td>
</tr>
<tr>
<td>Increased likelihood to participate in formal training</td>
<td>2.07</td>
</tr>
</tbody>
</table>

*Base = 363 businesses*

Analysis of businesses’ scores for the social impacts shown in Table 5.3 suggests that the characteristics of the business has some impact on the scores given (Table 5.4):

• Social enterprises scored the social impacts of CDFI lending higher than commercial enterprises;

• Businesses based in deprived areas were also more likely to award higher scores for social impacts. The gap was particularly large with regard to the scoring of an improvement in respondents’ sense of control over their lives (scored 2.59 out of 4 by businesses based in a deprived area, compared to 2.35 out of 4 by those not based in a deprived area);

• Respondents from micro businesses awarded higher scores to social impacts than those from either small or medium sized firms. The gap was particularly large with regard to the extent to which the CDFI loan had led to an improvement in their self-esteem and confidence (scored 2.64 out 4 by respondents from micro businesses, compared to just 1.5 out of 4 by respondents from medium sized firms).
### Table 5.4: Average social impact scores by business characteristic

<table>
<thead>
<tr>
<th>Business characteristic</th>
<th>Average score (all impacts)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social enterprises</td>
<td>2.46</td>
</tr>
<tr>
<td>Commercial businesses</td>
<td>2.34</td>
</tr>
<tr>
<td>Firms in deprived area</td>
<td>2.44</td>
</tr>
<tr>
<td>Firms not in deprived area</td>
<td>2.29</td>
</tr>
<tr>
<td>Micro businesses</td>
<td>2.51</td>
</tr>
<tr>
<td>Small businesses</td>
<td>1.83</td>
</tr>
<tr>
<td>Medium businesses</td>
<td>1.40</td>
</tr>
<tr>
<td><strong>All respondents</strong></td>
<td><strong>2.38</strong></td>
</tr>
</tbody>
</table>

*Base = 363 businesses*

#### 5.4.3 Community service provision

Businesses that provide some form of community service are a key target group for many CDFIs, particularly those that focus on financing social enterprises. In order to collect evidence as to the scale of this impact, as part of the beneficiary survey businesses were asked whether they provide a community service (Figure 5.1). Just under half of all respondents (47 per cent) reported that they do provide some form of community service, whilst another 39 per cent indicated that they do not. Examples of community services that were provided by respondents included the following:

- **Community or village shops**: A number of CDFIs – Co-operative and Community Finance in particular – have provided loan finance to enable community purchases of village shops/post offices, or to fund the running of such shops once purchased. As noted previously, in many such cases the CDFI loan formed part of a larger package of financial support including grant funding;

- **Community transport services**: The sample of CDFI beneficiaries included a number of providers of community public transport services, such as bus services for children with disabilities or social services transport for elderly people;

- **Training and education**: Several of the social enterprises supported by CDFIs provided training and education for young people, particularly for individuals with behavioural and/or learning difficulties. In other cases, CDFI supported businesses provided educational or training services for adults, for instance English language tuition or employability training;

- **Care services or facilities**: A number of the businesses supported by CDFIs either ran facilities or delivered services aimed at caring for people with mental illnesses, the elderly, homeless people, or other socially excluded and vulnerable groups;

- **Childcare**: Recipients of CDFI loan finance included businesses (often social enterprises) that provided childcare services within their local community;

- **Community finance**: CDFIs themselves act as investors in community development finance, for instance by supporting credit unions or even other CDFIs.
Figure 5.1: Whether businesses receiving CDFI support provide a community service

- Yes: 47%
- No: 39%
- Refused/ Don't know: 14%

Base = 363 businesses

The beneficiary survey was also used to collect data on the extent to which CDFI supported businesses spent money in local supply chains, thus supporting local economies (identified by CDFIs themselves as a key social impact of their lending – see Table 5.1). Businesses were asked to indicate the proportion of their customers who were based within the geographical ranges used as part of the economic impact assessment (Section 4.4). The results are shown in Figure 5.2:

- For all CDFI beneficiaries, on average, customers located less than two miles from a business’s centre of operations made up 27 per cent of the total customer base. In these cases, businesses served very local markets;
- A significant average proportion of CDFI beneficiaries’ customers were based more than 50 miles from their centre of operations (26 per cent), suggesting that many businesses served by CDFIs actually served large geographical markets.

Figure 5.2: Average proportion of businesses’ customers located within selected distances from their centre of operations

Base = 363 businesses
5.4.4 **Environmental improvements**

On occasions, businesses supported by CDFIs also contributed towards improving the quality of the environment in the area in which they operated. Whilst environmental improvements are not a priority for the CDFI sector as a whole, a small number of CDFIs do have an explicit goal to support such activities (particularly those that focus on funding social enterprises, such as Triodos Bank, Big Issue Invest and Key Fund Yorkshire). Again, as part of the beneficiary survey, businesses were asked whether their activities improve the quality of the local environment (Figure 5.3). Some 29 per cent of businesses indicated that they contributed towards improving the quality of the local environment. Respondents were asked to provide examples of how they contributed towards improving the quality of the local environment:

- **Recycling schemes**: CDFIs financed a number of businesses running community recycling schemes, or businesses that recycled/re-used existing materials and products (e.g. furniture);
- **Transport schemes**: A number of the community transport schemes mentioned above also noted their environmental benefits, for example by reducing the need for car journeys;
- **Environmental industries**: The social mission of a number of CDFIs includes the provision of financial support to businesses working in environmental industries (such as bio-fuels, community renewable energy projects, or the production of biodegradable packaging);
- **Environmentally conscious businesses**: More generally, CDFIs occasionally favour businesses with explicit environmentally-friendly approaches and policies, for instance firms that use environmentally friendly products or seek to source resources from sustainable sources.

**Figure 5.3: Whether businesses receiving CDFI support contributed towards improving the quality of their local environment**

![Pie chart showing responses to whether businesses contributed towards improving the quality of their local environment]

*Base = 363 businesses*

5.5 **Social impact measurement frameworks**

If the social benefits of CDFI lending activity are to be factored into an assessment of the sector’s impact and cost-effectiveness, it will ultimately be necessary to identify a
methodology for measuring social impacts more systematically and, where possible, establishing monetary values for these benefits.

5.5.1 Measurement frameworks used by CDFIs

To date, a number of CDFIs have undertaken ad hoc social impact measurement and reporting exercises. In 2005, for example, the Black Country Reinvestment Society carried out a Social Audit of its activities, part of which involved a small-scale survey of the CDFI’s staff, Board Members, investors and customers in order to ascertain the extent to which the organisation was meeting its various social objectives.

The issue of measuring social impacts was raised as part of the case study CDFIs. The majority of consultees from the case studies recognised the value of measuring social impacts, but noted that without a standard measurement methodology, it would be too time-consuming to undertake this research. Existing methodologies, it was suggested in a couple of cases, were generally inadequate and would not be satisfactory to either public sector funders or private sector investors. One case study CDFI – Project North East – had recently carried out a small survey of beneficiaries in order to collect evidence as regards the economic and social impacts of its lending activities, and other case studies published some basic impact data (e.g. jobs created) as part of their annual reporting exercises.

Though not a CDFI case study, a potentially useful model for measuring social impacts is the Capitalise Business Support (CBS) model, a project which is being developed by a CDFI (Capitalise Business Support), together with the CUBIST Research & Consultancy Group from the Business School, University of Brighton. The rationale for the development of the CBS Model is six fold:

- To improve impact measurement;
- To better demonstrate Capitalise Business Support value added;
- To assess if Capitalise Business Support are delivering their mission statement;
- To enhance strategic planning;
- To support future funding; and,
- To develop a potential product to support the CDFI sector.

The research project is being jointly funded by the CDFA and the University of Brighton, and ultimately aims to design, test and implement a prototype Social Impact Management System. The core elements of the project are to develop impact measures to demonstrate social value, tailored specifically to Capitalise Business Support. The methodology for the CBS model follows and builds on the SIMPLE (Social Impact for Local Economies) model which has been developed by the CUBIST Research & Consultancy Group and Social Enterprise London, and was previously tested on over 50 social enterprises. The CBS model employs a ‘blended value’ approach to impact, based on a number of quantitative and qualitative measures. In addition, the CBS workshops and stakeholder engagement process have led to the development of a sector-specific prototype monetised impact measure which utilises the principles of the Social Return on Investment (SROI) model and has been used to measure social impacts in other contexts (see below).

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69 Black Country Reinvestment Society (2005) Summary Social Accounts
The CBS model is currently under development and the data generated is in the process of being reviewed. The findings to date were presented at the 2009 CDFA Annual Conference, which has helped raise awareness of the model amongst other CDFIs and has encouraged other CDFIs to look at how the model can be applied (for example, during the case study visits the Fredericks Foundation reported that they are looking into the application of the CBS model).

5.5.2 Social Return on Investment (SROI)

In the past few years, the SROI methodology has emerged as a key framework for measuring social impacts, and could potentially form the basis for a standard methodology for assessing the social impacts of CDFIs.

SROI is an evaluation method developed in the US by the Roberts Enterprise Development Fund (REDF), and in recent years has been adapted for use in the UK context, primarily by the New Economics Foundation. The principle behind SROI is that conventional methods used to assess financial returns do not capture the social and environmental benefits of projects and programmes. SROI is a measure that captures the value of social benefits and represents a development of traditional cost-benefit analysis as a way of translating some of the social objectives of organisations into financial measures (generally expressed through gains or losses to public expenditure).

The ability to measure and quantify social impacts is becoming increasingly important to both the public and private sector. Over recent years there has been a wealth of research carried out on the measurement of social impacts by a range of bodies, with the launch of ‘A Guide to Social Return on Investment’70 in April 2009 marking a significant step towards standardising practice and methodology on the use of SROI. This guide is part of a wider three-year SROI project (the Measuring Social Value Project, 2008-2011) which is being run through a consortium led by SROI UK. The three-year project on measuring social value is funded through the Office of the Third Sector (OTS) and has helped organisations and institutions to demonstrate their social, economic and environmental impact. A summary of the SROI model is provided in Box 5.1.

Box 5.1: The SROI model

The 2009 Guide to Social Return on Investment starts by recognising that there are two types of SROI: Evaluative SROI (carried out retrospectively and based on actual outcomes that have already taken place) and Forecast SROI (aims to predict how much social value will be created if the activities meet their intended outcomes and therefore a forecast SROI will form the basis for a framework to capture outcomes). It is preferable to start using SROI by forecasting what the social value may be, rather than evaluating what it was, as this aids the process of creating the most efficient data collection systems which creates scope for a full analysis in the future. Both types of SROI are based upon a set of seven principles which underpin how SROI should be applied:

- Involve stakeholders: understand the way in which the organisation creates change through a dialogue with a range of stakeholders;

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Understand what changes: acknowledgement and articulation of all values, objectives and stakeholders of the organisation prior to agreeing which aspects of the organisation are to be included in the scope of the SROI calculation;

Value things that matter: clear articulation of how activities create change and evaluation of this through the evidence gathered;

Only include what is material: clear comparisons of performance and impact through using appropriate benchmarks, targets and external standards;

Do not over-claim: demonstrate the basis on which the findings may be considered accurate and honest; and showing that these findings will be reported and discussed with stakeholders;

Be transparent: the account and calculations should be independently verified;

Verify the result: use financial proxies for indicators in order to include the values of those excluded from markets.

Organisations are encouraged to carry out an SROI in six stages whilst adhering to the seven principles outlined above. The six stages of an SROI analysis are as follows:

- Establishing scope and identifying key stakeholders: it is important to have clear boundaries about what the SROI analysis will cover, who will be involved in the process and how;
- Mapping outcomes: This stage involves the creation of an impact map, or theory of change, showing the relationship between inputs, outputs and outcomes. This stage will involve engaging stakeholders;
- Evidence outcomes and give them a value: This stage involves finding data to show whether outcomes have happened and then valuing them;
- Establishing impact: Having collected evidence on outcomes and monetised them, those aspects of change that would have happened anyway or are a result of other factors are eliminated from consideration. This stage should be carried out using the notion of additionality using the HM Treasury Green Book which is comparable with impact on SROI;
- Calculating the SROI: This stage involves adding up all the benefits, subtracting any negatives and comparing the result to the investment. This is followed by a sensitivity analysis of the results;
- Reporting, using and embedding: The final step involves sharing findings with stakeholders and responding to them, embedding good outcomes processes and verification of the end report.

### 5.5.3 Monetising social impacts

The need to formally measure social impact alongside measuring economic impact is becoming increasingly important to a range of sectors, including the CDFI sector. Although the CDFI sector does not have a formal social impact framework in place, the sector could benefit from using the recently published SROI guidance and the findings from related studies which aim to apply financial proxies to social impacts – examples of such relevant studies are provided in Table 5.5.
Table 5.5: Examples of the application of financial proxies to social impacts

<table>
<thead>
<tr>
<th>Social impact</th>
<th>Financial proxy</th>
<th>Monetary value (unit)</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improved confidence as a result of employment</td>
<td>Cost of receiving confidence training</td>
<td>£995 (per person)</td>
<td>NEF (2009)(^{71})</td>
</tr>
<tr>
<td>Increased achievement of qualifications through formal training</td>
<td>Benefit to individual (estimated increase in earning potential)</td>
<td>£897.33 (benefit to individual participants)</td>
<td>The Wise Group(^{72})</td>
</tr>
<tr>
<td></td>
<td>Benefit to individual (estimated increase in earning potential)</td>
<td>Saving to state of £60,090. Saving to state per participant of £2,731.36.</td>
<td>Forth Sector Development(^{73})</td>
</tr>
<tr>
<td>Prevention of re-offending</td>
<td>Cost to criminal justice system of re-offending</td>
<td>£65,000 (per crime committed)</td>
<td>Social Exclusion Unit (2002)(^{74})</td>
</tr>
<tr>
<td></td>
<td>Cost of keeping an offender in prison</td>
<td>£37,500 (per year)</td>
<td>Social Exclusion Unit (2002)(^{75})</td>
</tr>
<tr>
<td></td>
<td>Cost of criminal damage offences</td>
<td>Average cost of £866 (per offence)</td>
<td>Home Office(^{76})</td>
</tr>
<tr>
<td></td>
<td>Cost of common assault offences</td>
<td>Average cost of £1,440 (per offence)</td>
<td>Home Office(^{77})</td>
</tr>
<tr>
<td>Improved satisfaction with local community</td>
<td>Increased levels of social inclusion for participants as a result of employment – measured through willingness to pay.</td>
<td>Benefit to participants £18,995. Benefit per participant £1,582.91</td>
<td>Fourth Sector Development(^{78})</td>
</tr>
</tbody>
</table>

\(^{71}\) NEF (2009) Coventry Local Enterprise Growth Initiative (LEGI) SROI Assessment: Workmates
\(^{73}\) Forth Sector Development (2007) Restart Social Return on Investment Report
\(^{74}\) Social Exclusion Unit (2002) Reducing Re-Offending by Ex-Prisoners
\(^{75}\) Ibid.
\(^{76}\) Home Office (2005) The economic and social costs of crime against individuals and households 2003/04
\(^{77}\) Ibid.
5.6 Conclusions

The key conclusions from this review of the social impacts of the CDFI sector are as follows:

- Alongside the economic benefits generated by CDFIs (see Section 4), it is widely recognised that through its support for enterprise, the CDFI sector generates social impacts. In comparison to the standard models for measuring economic impacts, however, methodologies for measuring the social impacts of CDFIs are poorly developed and lack consistency. This problem, of course, is not confined to the CDFI sector and is being addressed through the OTS funded Measuring Social Value Project;

- In the absence of indicators of social impacts, and as part of this evaluation, research was carried out both with CDFIs and with business beneficiaries in order to generate some data on social impacts of CDFI support. CDFIs typically have social objectives, though these range from general statements of intent through to criteria applied to lending decision-making;

- For this evaluation, the study team developed a set of social impacts and, through the Inside Out survey, asked CDFIs to rate the extent to which they delivered these benefits. The results suggest that CDFIs recognise the social impacts associated with enterprise support, particularly in terms of attitudinal effects on beneficiaries (such as confidence building and enabling beneficiaries to have a greater sense of control over their lives);

- The extent to which these social impacts were achieved was also tested with business beneficiaries. The results suggest that, whilst many businesses simply used the CDFI to access finance with limited social impacts, in other cases there were more wide-ranging impacts on beneficiaries (including the attitudinal effects identified by the CDFIs themselves). Other impacts included the employment of individuals from disadvantaged groups and deprived areas, the provision of local community services, and environmental improvements;

- At present there are no standardised social impact measurement methodologies in use across the CDFI sector. Individual CDFIs have undertaken ad hoc pieces of research, but consultees within the sector have argued that there is no universally accepted model that would meet the needs of funders and investors. The model currently being developed by Capitalise Business Support may be applicable to other CDFIs, and there are also lessons emerging from the SROI model. Nevertheless, if these methodologies are to be employed, CDFIs will need to collect more data on social impacts than they are currently doing, and which would have resource implications – a problem in the context of reduced revenue funding (see Section 6).
6 CDFI SUSTAINABILITY

This section of the report explores the issue of the sustainability of the CDFI sector. CDFIs have historically received significant amounts of public sector grant funding in order to deliver their lending activities, support that has been justified primarily on the basis of the market failures and public policy priorities discussed in Section 2. Going forward, however, there are questions about how long public sector financial support for CDFIs can and should continue, and in what form.

The first sub-section of this report presents an overview of the results of the case studies of eight enterprise lending CDFIs, providing an overview of the organisations, a summary of their business lending activities, and finally an analysis of the key features of their operational models. Following this, the section reviews the concept of CDFI sustainability and presents an analysis of different models of sustainability, drawing on the evidence from the case studies and from analysis of the results of the CDFA’s Inside Out survey. The section finishes with a set of conclusions.

6.1 Overview of the CDFI case studies

The case studies of eight CDFIs have formed the basis of the assessment of CDFI sustainability undertaken as part of this evaluation of the sector. This sub-section presents a summary of the key findings of the case studies (individual case study write-ups are presented in Annex 5), specifically looking at their overall profile, their lending activities, and their organisational models.

6.1.1 Profiles of case study CDFIs

Table 6.1 provides summaries of the profiles of the eight CDFI case studies:

- The case study CDFIs had been running for a comparatively long time; just two (Foundation East and the Fredericks Foundation) had used Phoenix Fund resources to support their establishment and/or early growth;
- The principal activity of the case study CDFIs was business lending; very few organisations had diversified into other activities and where they had (for instance personal lending in the case of Foundation East and equity provision in the case of Key Fund Yorkshire), these were very much secondary activities;
- The case studies highlighted the fact that no such thing as typical CDFI; the different company structures used by CDFIs ranged from relatively simple single organisations (e.g. Foundation East and Key Fund Yorkshire) to more complex models involving a group (e.g. ART and Cooperative and Community Finance). In a number of cases CDFIs were specialist subsidiaries or divisions of enterprise agencies (e.g. the Project North East Loan Fund);
- Case study CDFIs drew funding from diversity of sources and in some instances particular legal statuses were used in order to generate income – for instance the use of the I&PS or plc structure to issue shares;
- Half of the case study CDFIs employed between 4-5 FTE staff members, slightly under the CDFI sector average (6 FTE staff members). All but one of the case studies operated from a single location, typically a headquarters in or near a city centre. None of the case studies made use of outreach offices.
Table 6.1: Profiles of case study CDFIs (2008/09)

<table>
<thead>
<tr>
<th>Name of CDFI</th>
<th>Year established</th>
<th>Current structure</th>
<th>Target market(s)</th>
<th>Activities and product(s)</th>
<th>Size and location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aston Reinvestment Trust</td>
<td>Launched 1997</td>
<td>Group: ART SHARE and Aston Reinvestment Guarantee Ltd</td>
<td>Micro enterprises, SMEs and social enterprises</td>
<td>Business loans</td>
<td>FTE staff: 4.9</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Legal status: An I&amp;PS and a Company Limited by Guarantee</td>
<td>Birmingham and Solihull</td>
<td>FTE lending officers: 2.0</td>
<td>Operates from HQ in Aston, Birmingham</td>
</tr>
<tr>
<td>Cooperative and Community Finance</td>
<td>Launched 1973</td>
<td>Group: ICO Fund plc, ICOF Guarantee Company Ltd, and ICOF Community Capital Ltd</td>
<td>Micro enterprises and SMEs (cooperatives/employee-owned), social enterprises</td>
<td>Business loans</td>
<td>FTE staff: 4.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Legal status: plc, Company Limited by Guarantee, and an I&amp;PS</td>
<td>Throughout Great Britain</td>
<td>FTE lending officers: 1.4</td>
<td>HQ in Bristol plus 2 regional offices</td>
</tr>
<tr>
<td>First Enterprise Business Agency/</td>
<td>FEBA lending since</td>
<td>Pre-2008 CDFI was a division of FEBA (enterprise agency); ELEM is now a separate</td>
<td>Micro enterprises</td>
<td>Business loans</td>
<td>FTE staff: 4.0</td>
</tr>
<tr>
<td>Enterprise Loans East Midlands</td>
<td>c1995 ELEM</td>
<td>company</td>
<td>Throughout East Midlands region</td>
<td>FTE lending officers: 2.0</td>
<td>Operates from HQ in Nottingham</td>
</tr>
<tr>
<td></td>
<td>launched 2008</td>
<td>Legal status: Company Limited by Guarantee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foundation East</td>
<td>Launched 2003</td>
<td>Single organisation</td>
<td>Micro enterprises, SMEs and social enterprises</td>
<td>Business and personal loans (for housing</td>
<td>FTE staff: 5.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Legal status: I&amp;PS</td>
<td>Mainly start-ups</td>
<td>association tenants)</td>
<td>FTE lending officers: 3.0</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Throughout East of England region</td>
<td>Property/ land development for community</td>
<td>Operates from HQ in Bury-St.Edmonds</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>benefit</td>
<td></td>
</tr>
<tr>
<td>Name of CDFI</td>
<td>Year established</td>
<td>Current structure</td>
<td>Target market(s)</td>
<td>Activities and product(s)</td>
<td>Size and location</td>
</tr>
<tr>
<td>---------------------------</td>
<td>------------------</td>
<td>-----------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------</td>
<td>--------------------------------------------------------</td>
</tr>
<tr>
<td>Fredericks Foundation</td>
<td>Launched 2001</td>
<td>Fredericks is a single organisation, with partnerships with 2 other CDFIs (Wessex and Gloucestershire) and South London. Partner CDFIs in South West region</td>
<td>Micro enterprises, Throughout South East region and South London, Partner CDFIs in South West region</td>
<td>Business loans</td>
<td>FTE staff: 8.6, FTE lending officers: 4.6 Fredericks run from a HQ in Surrey; operates hubs in Wessex and Gloucestershire</td>
</tr>
<tr>
<td>Key Fund Yorkshire</td>
<td>Launched 1998</td>
<td>Single organisation</td>
<td>Social enterprises, Mainly established firms, Throughout Yorkshire and Humber region</td>
<td>Business loans, sometimes with small grants, Sometimes equity investments</td>
<td>FTE staff: 10.0, FTE lending officers: 2.0 Operates from HQ in Sheffield</td>
</tr>
<tr>
<td>GLE oneLondon</td>
<td>Lending since c1985, Launched 2001</td>
<td>The CDFI is a division of GLE oneLondon (an enterprise agency and a subsidiary of the GLE Group, an economic development company)</td>
<td>Micro enterprises, SMEs and social enterprises, Mainly established firms, Throughout London</td>
<td>Business loans</td>
<td>FTE staff: 11.0, FTE lending officers: 5.0 Operates from HQ in London</td>
</tr>
<tr>
<td>Project North East (Loan Fund)</td>
<td>Launched 1987</td>
<td>The Loan Fund is a division of the Project North East Group (an enterprise agency)</td>
<td>Micro enterprises, Mainly start-ups, Tyne and Wear, North Durham and Northumberland</td>
<td>Business loans</td>
<td>FTE staff: 1.0, FTE lending officers: 1.0 Operates from HQ in Newcastle</td>
</tr>
</tbody>
</table>
6.1.2 **Lending activity of the case study CDFIs**

Table 6.2 summarises the business lending activities of the eight case study CDFIs, as at 2008/09. As can be seen, there is considerable diversity across the CDFI sector as regards the design and delivery of business lending activity, in part reflecting the differences in target markets shown above in Table 6.1, and also the operational models outlined in Table 6.3 below (in particular the use of interest payments on loans as a source of income). Key observations are as follows:

- Not surprisingly, CDFIs targeting micro enterprises offered the lowest minimum loan sizes (£250 in the case of the Fredericks Foundation, and £500 in the case of the Project North East Loan Fund). Whilst these micro-sized loans clearly meet a market need, the transaction costs associated with such small loans are high relative to the income that can be generated through interest rates charged. For this reason one CDFI (ART) had recently increased their minimum loan size from £2,000 to £10,000;

- The interest rates charged by CDFIs varied significantly, even within CDFIs (for instance the rates charged to social enterprises were lower than the rates charged to commercial businesses). Interest rates are generally reflective of the target market in question, the requirements of funders, and the commercial requirements of CDFIs themselves;

- Around half of the case study CDFIs did not charge any fees. In other cases arrangement fees were charged (values ranged from 1 per cent to 5 per cent), and one CDFI (ART) charged an application fee;

- The case studies were chosen on the basis that, for the most part, they were relatively large by the standards of the CDFI sector. This is reflected in the size of the loan pots available (six of the eight had loan pots over £3 million), though none of the case studies were anywhere near as large as national CDFIs;

- Average loan sizes tended to reflect the target market, with CDFIs lending to micro enterprises recording relatively small average loan sizes (just £1,900 in the case of the Fredericks Foundation). In these cases, CDFIs tended to provide large numbers of very small loans – the Fredericks Foundation, for instance, had 260 outstanding loans in 2008/09. A different model was used by social enterprise lenders such as Key Fund Yorkshire and, particularly, Cooperative and Community Finance. These CDFIs had small numbers of relatively large loans – Cooperative and Community Finance had an outstanding loan portfolio of £1.9 million in 2008/09, distributed over just 83 businesses;

- The case study CDFIs had received between 54 and 332 new loan applications in the preceding 12 months, and in most cases had seen an increase in the number of applications since the onset of the credit crunch and recession. In many cases the conversion rate from applications to loans had also fallen (mainly due to an increase in non-viable applications), and ranged from 22 per cent to a high of 69 per cent (rates of under 50 per cent were most common);

- Levels of lending write-off varied significantly, despite these CDFIs representing relatively large examples of the sector (though target markets – a key driver of bad debt – varied between the case studies). Almost all CDFIs had experienced increases in the level of loan write-offs since the onset of the credit crunch and recession, with a negative impact on their capital available for lending.
Table 6.2: Overview of business lending activity for the case study CDFIs (all as at 2008/09)

<table>
<thead>
<tr>
<th>Name of CDFI</th>
<th>Loan details</th>
<th>Loan fund size</th>
<th>Outstanding lending</th>
<th>Activity in previous 12 months</th>
<th>Delinquency and write-off 79 (% of outstanding lending)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aston Reinvestment Trust</td>
<td>Size: £10,000-£50,000</td>
<td>£3,078,556</td>
<td>123 loans worth £2,231,917</td>
<td>Applications received: 133</td>
<td>Delinquency &lt;90 days: 14%</td>
</tr>
<tr>
<td></td>
<td>Repayment term: 6 months to 10 years</td>
<td></td>
<td></td>
<td>Loans made: 59</td>
<td>Delinquency &gt;90 days: 5%</td>
</tr>
<tr>
<td></td>
<td>Interest rate 6-12% above base rate. Avg. rate charged 11.5% (commercial firms) and 8.5% (social enterprises)</td>
<td></td>
<td>Avg. size: £17,169</td>
<td>Conversion rate: 44%</td>
<td>Write-off: 27%</td>
</tr>
<tr>
<td></td>
<td>Application fee 2%, arrangement fee 3-5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cooperative and Community Finance</td>
<td>Size: £5,000-£300,000</td>
<td>£4,040,000</td>
<td>83 loans worth £1,900,000</td>
<td>Applications received: 54</td>
<td>Delinquency &lt;90 days: 4%</td>
</tr>
<tr>
<td></td>
<td>Avg. interest rate: 5.4%, now a minimum collar imposed of 8%</td>
<td></td>
<td></td>
<td>Loans made: 12</td>
<td>Delinquency &gt;90 days: 0%</td>
</tr>
<tr>
<td></td>
<td>No fees</td>
<td></td>
<td>Avg. size: £22,892</td>
<td>Conversion rate: 22%</td>
<td>Write-off: 0%</td>
</tr>
<tr>
<td>First Enterprise Business Agency/Enterprise Loans East Midlands</td>
<td>Size: £3,000-£20,000</td>
<td>£4,302,251</td>
<td>157 loans worth £1,802,251</td>
<td>Applications received: 98</td>
<td>Delinquency &lt;90 days: n/a</td>
</tr>
<tr>
<td></td>
<td>Repayment term: 1 to 5 years</td>
<td></td>
<td></td>
<td>Loans made: 68</td>
<td>Delinquency &gt;90 days: n/a</td>
</tr>
<tr>
<td></td>
<td>Fixed interest rate of 10.25%</td>
<td></td>
<td>Avg. size: £11,479</td>
<td>Conversion rate: 69%</td>
<td>Write-off: 14%</td>
</tr>
<tr>
<td></td>
<td>No fees</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foundation East</td>
<td>Size: £500-£50,000</td>
<td>£3,564,712</td>
<td>166 loans worth £2,191,318</td>
<td>Applications received: 319</td>
<td>Delinquency &lt;90 days: 8%</td>
</tr>
<tr>
<td></td>
<td>Repayment term: 6 months to 10 years</td>
<td></td>
<td></td>
<td>Loans made: 94</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Avg. interest rate: 15% (micro enterprises)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

79 Note that comparisons of loan write-off data between individual CDFIs and with the sector average as a whole should be treated with caution since target markets are specific to individual CDFIs, and evidence (see Figure 3.8) indicates that levels of loan write-off vary depending on the market served.
<table>
<thead>
<tr>
<th>Name of CDFI</th>
<th>Loan details</th>
<th>Loan fund size</th>
<th>Outstanding lending</th>
<th>Activity in previous 12 months</th>
<th>Delinquency and write-off(^a) (% of outstanding lending)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fredericks Foundation</td>
<td>Size: £250-£20,000 (£10,000 for start-ups)</td>
<td>£522,102</td>
<td>263 loans worth £497,102</td>
<td>Applications received: 113</td>
<td>Delinquency &lt;90 days: 8%</td>
</tr>
<tr>
<td></td>
<td>Repayment term: 2 to 5 years</td>
<td></td>
<td>Avg. size: £1,890</td>
<td>Loans made: 36</td>
<td>Delinquency &gt;90 days: 0%</td>
</tr>
<tr>
<td></td>
<td>Fixed interest rate of 7%</td>
<td></td>
<td>Conversion rate: 32%</td>
<td>Write-off: 23%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5% handling fee</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Key Fund Yorkshire</td>
<td>Size: £1,000-£100,000 (£10,000-£25,000 for start-ups)</td>
<td>£5,514,177</td>
<td>103 loans worth £2,156,465</td>
<td>Applications received: 86</td>
<td>Delinquency &lt;90 days: 0%</td>
</tr>
<tr>
<td></td>
<td>Avg. interest rate: 11.5%</td>
<td></td>
<td>Avg. size: £20,937</td>
<td>Loans made: 51</td>
<td>Delinquency &gt;90 days: 0%</td>
</tr>
<tr>
<td></td>
<td>1% arrangement fee</td>
<td></td>
<td>Conversion rate: 59%</td>
<td>Write-off: 8%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GLE oneLondon</td>
<td>Size: Varies depending on fund accessed (min £1,000, max £250,000)</td>
<td>£5,117,590</td>
<td>345 loans worth £3,325,382</td>
<td>Applications received: 332</td>
<td>Delinquency &lt;90 days: 9%</td>
</tr>
<tr>
<td></td>
<td>Interest rates vary, typically fixed at 7.85% (social enterprises) or 8.81%</td>
<td></td>
<td>Avg. size: £9,639</td>
<td>Loans made: 99</td>
<td>Delinquency &gt;90 days: 32%</td>
</tr>
<tr>
<td></td>
<td>Fees vary, typically 1-2% arrangement fee</td>
<td></td>
<td>Conversion rate: 26%</td>
<td>Write-off: 7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project North East (Loan Fund)</td>
<td>Size: £500-£5,000</td>
<td>£1,100,000</td>
<td>99 loans worth £269,500</td>
<td>Applications received: 87</td>
<td>Delinquency &lt;90 days: 0%</td>
</tr>
<tr>
<td></td>
<td>Repayment term: 3 years</td>
<td></td>
<td>Avg. size: £2,722</td>
<td>Loans made: 38</td>
<td>Delinquency &gt;90 days: 8%</td>
</tr>
<tr>
<td></td>
<td>Fixed interest rate of 10%</td>
<td></td>
<td>Conversion rate: 44%</td>
<td>Write-off: 30%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>No fees</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
6.1.3 Operating models of case study CDFIs

Core to the issue of sustainability are the operating models that CDFIs employ. The diversity of the sector means that there is no single operating model for a CDFI; instead the details will vary according to local operating environments and the trajectories that individual CDFIs have followed since their establishment. The key features of the operational models employed by the case study CDFIs are summarised in Table 6.3, and reviewed below.

Capital and revenue income generation

Sourcing capital for on-lending to businesses is a key task for CDFIs, in order to replenish money lost through bad debts, and also to grow the overall size of the loan pot and increase the scale of lending activity. The majority of CDFI lending capital originated with the public sector, having been awarded as a grant (either restricted or unrestricted). Case study CDFIs noted that the availability of capital grant funding had decreased in the past few years, which was in part a driver of an increasing diversity in the range of sources of capital used. Specifically, case study CDFIs had in recent years obtained capital for on-lending from the following sources:

- **Public sector grants**: All CDFIs had accessed grant funding where available and from a wide range of sources (e.g. the Phoenix Fund, RDAs, European Structural Funds, local authorities, and other area-based regeneration initiatives, such as LEGI – see Section 2.2 for details of funding mechanisms);

- **Bank borrowing**: Loans had typically come from social banks such as Unity Trust Bank or the Cooperative Bank, but in one case had come from a mainstream bank. Overall, around half of the case studies had successfully borrowed money from a bank (social or mainstream), noting that this required a strong track record of lending, robust governance and reporting systems, and also the ability to provide ‘security’ (such as a public sector grant);

- **Philanthropy**: One of the case study CDFIs – the Fredericks Foundation – was almost entirely reliant upon philanthropic donations for its lending capital, whilst ART drew heavily on donated resources during its early developmental years;

- **Investment**: Where case study CDFIs were an I&PS or a plc they had been able to secure capital through share issues (Cooperative and Community Finance had been particularly successful in this respect). A large proportion of this investment was in part philanthropy, since investors often waived dividend payments. Consultees from such CDFIs, however, noted that the £20,000 limit (currently under review) on individual investments had been a hindrance;

- **CITR**: In recent years a number of CDFIs had channelled bank loans and other investment through the CITR scheme, and a number of case studies (Cooperative and Community Finance, GLE oneLondon) had successfully generated significant amounts of capital in this way. Other CDFIs, whilst accredited for CITR, had not made use of the option, perceiving it to be too restrictive (in terms of where loans could be provided) and too onerous (in terms of generating funds and of reporting). It was also noted that the availability of capital grant funding meant that, to date, they had not necessarily needed to make use of CITR;

- **Earned income**: Where CDFIs were able to secure sufficient revenue grant funding (see below) they were able to invest their earned income in their capital
pot. In other cases the reinvestment of interest payments was a stipulation of public sector CDFI capital funds.

Sourcing sufficient revenue funding was also identified as a key operational challenge by case study CDFIs (in many cases more of a problem than sourcing capital funding). The sources of revenue capital accessed by CDFIs were largely the same as those used to obtain capital funding (see the list above), and included a mixture of grants, investments and loans. Grant funding, though more difficult to access across the CDFI sector as a whole, was still available to the case study CDFIs, for instance linked to RDA CDFI loan funds.

Earned income was particularly important for case study CDFIs as a way of covering operational costs. The most important source of earned income was through interest payments on loans, together with fees charged in association with lending, and interest earned on invested capital. Increasingly, however, CDFIs have diversified their sources of earned income, primarily in response to the decreasing availability of revenue grants but also a result of a general ambition to grow in size. Cooperative and Community Finance, for example, earned income from managing funds on behalf of other CDFIs and from providing back office services, again to other CDFIs. Other CDFIs were paid to deliver enterprise and business support services by public sector organisations.

Marketing and client referral mechanisms

Case study CDFIs had all sought to use referral systems to reduce the costs of generating deal-flow, to varying degrees of success. Whilst a few CDFIs had established effective referral arrangements with Business Link (most notably Foundation East where it was reported that the regional Business Link service had been designed to include referrals to the CDFI), on the whole this was not considered to be a useful source of quality applications. By way of an explanation, consultees from a number of case studies reported that Business Link advisors did not consistently have necessary levels of expertise in business finance, and thus frequently referred businesses that were not investment ready. Similarly, CDFIs had had limited success in generating reliable numbers of referrals from mainstream banks. Instead, the most effective sources of referrals were: other CDFIs, social banks, specialist business support providers, enterprise agencies, and private sector introducers (primarily accountants, but also business consultants). In the absence of reliable referral mechanisms, most CDFIs also carried out marketing and promotional work in order to generate applications, though many case study organisations were uncertain as to the cost-effectiveness of this activity.

Pre- and post-investment support

One of the single biggest determinants of sustainability, it was reported, was the extent to which CDFIs provided pre- and post-loan business support. Evaluations of CDFIs have reported that CDFI staff often put more time into business support than can be afforded, given that this is typically unpaid work. Nevertheless, this work is necessary where applicants are not investment ready (for instance needing support in developing a business plan), and where external provision of business support is ineffective. Pre- and post-investment support, it was noted, improved the chances that a business would survive and thus be able to repay its loan, meaning that CDFIs to

some extent have an interest in ensuring that the support needs of their clients are met.

Most of the case study CDFIs recognised the costs associated with providing business support. Whilst informal advice and assistance as part of the application process was considered necessary, most CDFIs sought to minimise the scale of this activity as far as possible. Some CDFIs were able to offer more formal business pre- and/or post-investment support programmes (e.g. mentoring schemes), either using their own resources (GLE oneLondon), or by being paid by a public sector body to deliver such a service (Key Fund Yorkshire delivered such a programme with RDA support). More commonly, however, CDFIs referred businesses to specialist external providers/brokers, such as Business Link or enterprise agencies, though it was noted that there was no guarantee that businesses would follow this up, or that the support would prove to be effective.

All case studies had introduced stronger systems for loan recovery as part of their post-investment procedures, recognising the critical impact of bad debt on their financial operations, particularly in the context of the recession.

**Application appraisal and processing**

Approaches towards the appraisal of loan applications varied somewhat between CDFIs. Whilst some case studies were clear that applicants had to have a bank rejection letter, others also used their judgement as to whether businesses would be likely to be rejected if they were to apply (in order to save applicants the trouble of submitting an application). In most cases, CDFIs required applicants to submit a business plan, together with other supporting documentation.

Generally, applications were first appraised by a loan officer in order to check basic eligibility (against the requirements of the CDFI and/or the funder, if relevant), and potentially also to measure the loan application against the socio-economic goals of the CDFI (again, depending on how important these are to the organisation). The appraisal process also enabled loan officers to make an initial assessment of the viability of the loan proposal. All but two CDFIs (ART and Cooperative and Community Finance) required that the application and/or summary of the appraisal then be submitted to a loan panel. In some cases applicants were required to present their application to the panel, in others this was done by the loan officer (e.g. Foundation East). Panels were generally made up of external experts (e.g. bankers, social entrepreneurs), but in the case of GLE oneLondon the panel consisted of the Managing Director of the CDFI and the credit recovery manager (to ensure that decision-making was based on the needs of the CDFI).
Table 6.3: Overview of key features of the operating models of case study CDFIs

<table>
<thead>
<tr>
<th>Name of CDFI</th>
<th>Capital and revenue income generation</th>
<th>Marketing and client referral mechanisms</th>
<th>Pre- and post-investment support</th>
<th>Application appraisal and processing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aston Reinvestment Trust</td>
<td>ART has successfully borrowed money at a commercial rate for on-lending and received RDA grant funding. Some income has come from share issues. The main source of revenue income has been portfolio income, together with investments and RDA grants</td>
<td>ART operates a model based on referrals, though has not received as many as was hoped from Business Link and the banks. Supplements this with some marketing and promotional activity</td>
<td>ART seeks to externalise business support as much as possible. Tried and abandoned a separate support business, now provides a CD-ROM with document templates and advice</td>
<td>Applicants are encouraged to provide a business plan, and generally should indicate which bank rejected them (this is then followed up). The application is processed/appraised by the loan officers; a final decision is made by the Chief Executive or a Board member if a large loan</td>
</tr>
<tr>
<td>Cooperative and Community Finance</td>
<td>Share issues have been the biggest source of capital for the CDFI, though recently a large commercial loan was secured from the Co-operative Bank through CITR. Revenue income is earned through the portfolio, through invested capital reserves, through the provision of back office services and increasingly through fund management</td>
<td>Referrals through partnerships are key, and the CDFI works with other social enterprise lenders, cooperatives bodies, and other charitable foundations. Some additional marketing work undertaken, focussed on the cooperative sector</td>
<td>The CDFI seeks to minimise the amount of support provided, though loan officers will provide informal assistance during the application process. Cooperatives have access to free support from specialist providers, where the CDFI tends to refer applicants</td>
<td>Applicants are required to provide their business plan and details of their legal structure, though a rejection letter from a bank is not required. Applications are processed and appraised by loan officers; a final decision is made by the operations manager or a Board member if a large loan</td>
</tr>
<tr>
<td>First Enterprise Business Agency/Enterprise Loans East Midlands</td>
<td>Most capital has come from public sector grant streams, most recently through a regional RDA CDFI fund. CITR accredited but has not secured investment through the scheme. Revenue grants are linked to the delivery of the RDA fund, and income has also come from the loan portfolio</td>
<td>Referral mechanisms are not seen to be an effective source of demand, and instead the CDFI mostly relies on marketing and promotional activity</td>
<td>Informal advice is provided during applications; where further support is needed ELEM refers clients to the FEBA enterprise agency, or other regional (free) mentoring schemes</td>
<td>Applicants are expected to provide background information (including a business plan), but a rejection letter from a bank is not required. Loan officers process/appraise applications, after which applicants must present to a loan panel for final approval</td>
</tr>
<tr>
<td>Name of CDFI</td>
<td>Capital and revenue income generation</td>
<td>Marketing and client referral mechanisms</td>
<td>Pre- and post-investment support</td>
<td>Application appraisal and processing</td>
</tr>
<tr>
<td>---------------------</td>
<td>--------------------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Foundation East</td>
<td>Diverse range of sources of capital income, including a regional RDA CDFI fund, share issues, and a commercial bank loan. Accredited, but has not yet received CITR investment. Revenue income generated through portfolio income and a grant linked to the delivery of the RDA CDFI fund.</td>
<td>Most enquiries come through a referral network, particularly from regional Business Link service. Undertakes marketing and promotional work to raise profile within the region.</td>
<td>Aims to keep this support to a minimum in order to reduce costs. Provides informal advice over the course of the application process. From 2010 plans to introduce a (charging) post-loan mentoring service.</td>
<td>Applicants must provide background documents, though a rejection letter from a bank is not required (the CDFI is willing to judge whether they are bankable). Loan officers process/appraise applications, and then present their recommendations to a loan panel.</td>
</tr>
<tr>
<td>Fredericks Foundation</td>
<td>Capital is mainly secured through charitable donations and fund-raising, including a corporate CSR scheme. Revenue income generated through portfolio income, delivery of public sector business support projects, and charitable donations and fund-raising activities.</td>
<td>No system for generating referrals; instead demand is generated by raising the profile of the CDFI through promotional work. Relies heavily on word-of-mouth recommendations from beneficiaries.</td>
<td>Loan officers provide informal advice and support during application process. Operates post-loan mentor scheme whereby clients can receive free support delivered by a network of volunteer mentors.</td>
<td>Applications must be accompanied by documentary material (a business plan and a bank rejection letter). An initial appraisal is carried out by a loan officer; if successful then the applicant must present their application to a loan panel for final approval.</td>
</tr>
<tr>
<td>Key Fund Yorkshire</td>
<td>The CDFI has secured significant amounts of lending capital in the form of public sector grants and on-lending to social enterprises, particularly as part of regional Structural Fund programmes. No investment has been secured through CITR. The CDFI has also received large amounts of revenue grant funding, associated with the delivery of regional CDFI funds.</td>
<td>The CDFI has generated demand through referral arrangements with other social enterprise lenders (such as Charity Bank), but also undertakes a lot of marketing/promotion, including promoting the social enterprise model to businesses and entrepreneurs.</td>
<td>Seeks to minimise the amount of investment readiness training, but with start-up social enterprises a lot of support can be needed. Primarily involves informal advice offered as part of the loan development and application process.</td>
<td>Application is received and processed by a member of the loan team, then passed to a member of the finance team who assesses the viability of the proposal. A bank rejection letter is not required for start-up social enterprises. A final decision is made by a loan panel, and is ratified by the CDFI’s Board.</td>
</tr>
<tr>
<td>Name of CDFI</td>
<td>Capital and revenue income generation</td>
<td>Marketing and client referral mechanisms</td>
<td>Pre- and post-investment support</td>
<td>Application appraisal and processing</td>
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<td>-------------------------------------</td>
</tr>
<tr>
<td>GLE onelondon</td>
<td>Has been successful in securing capital from a wide range of sources, including bank loans secured at market rates (in some cases using a Phoenix Fund guarantee). Recently set up a CITR accredited wholesale fund that has secured investment from the RDA, banks, and local authorities, and is being delivered by the CDFI. Revenue funding comes from Phoenix Fund continuation (till 2010), fund management income, and portfolio income</td>
<td>The CDFI generates most of its loan applications through referrals, using a network of banks and private sector introducers (e.g. accountants). Also promotion through networks of enterprise agencies, and more general marketing</td>
<td>Currently earns enough revenue income to provide a free post-loan mentoring service, and can refer clients to free pre-loan investment readiness support (led by the RDA). Loan officers also provide informal advice and support as part of the application process</td>
<td>Applications should be accompanied by a business plan. Applicants should provide a letter of rejection from a bank, but where their profile makes them unbankable the CDFI does not require this. Loan officers appraise the application; if successful then the applicant must present their application to a loan panel for approval</td>
</tr>
<tr>
<td>Project North East (Loan Fund)</td>
<td>The CDFI's loan fund is not large by the standards of the sector, and mostly consists of remaining Phoenix Fund and European Social Fund resources, together with smaller grants. Some capital has also come from portfolio income. The CDFI has a small staff, and revenue costs so far have been met using grant funding (e.g. from the RDA) plus portfolio income</td>
<td>In order to ensure a supply of quality enquiries, the CDFI prefers applicants to be referred from within its network of enterprise agencies or Business Link. Consequently little marketing or promotional work is undertaken, other than to other enterprise agencies</td>
<td>The CDFI is purely a provider of loans and does not carry out any business support. As businesses are referred from enterprise agencies or Business Link, it is assumed that they are investment ready. For further support they can be referred to Business Link</td>
<td>Most applications are referred from enterprise agencies or Business Link, in which case business plans have already been prepared. Applicants are processed and appraised by a loan officer, who prepares a summary report. This report is then passed to the trustees of the loan fund who make a decision as to whether to proceed</td>
</tr>
</tbody>
</table>
6.2 Defining and measuring CDFI sustainability

The CDFI sector – alongside microfinance more broadly – uses two key definitions of sustainability (which have been further developed and implemented by the CDFA as part of the Change Matters performance framework):

- **Operational sustainability**: Operational sustainability describes the extent to which a CDFI is able to cover its operational costs (mainly staff and overhead costs) through income generated through its core activities (usually taken to be the interest earned on loans, any fees charged, and interest generated on invested capital reserves). As CDFIs grow and diversify, however, what constitutes ‘core’ activities also expands. The CDFI case studies shown in Annex 5 included examples of income generated through: commercial property rental, the management of loan funds for other organisations, the delivery of business support, the provision of back office services to charities and other loan funds (including CDFIs), and consultancy/training services;

- **Financial sustainability**: Financial sustainability refers to the ability of a CDFI to cover its operational costs and also meet its capital requirements (principally to replace lending capital lost through bad debt, but also potentially to increase the overall size of the loan fund) through earned income. Earned income in this respect includes the various sources identified above.

The issue of sustainability is complicated by the issue of whether public sector financial support for CDFIs (capital or revenue) constitutes grant support or payment for the delivery of a service. In order to deliver an RDA loan fund, for instance, a CDFI will probably need to employ dedicated staff, and in such cases it could be argued that revenue grant funding is simply payment for the delivery of the loan fund.

There is no comprehensive assessment of the sustainability (operational or financial) of the CDFI sector, and indeed this exercise would be difficult for a number of reasons:

- **Variations in definitions**: Evaluations and other studies on the CDFI sector have modelled sustainability in slightly different ways, with a lack of consistency as to definitions. Specifically there is a lack of consistency as to how different sources of income should be treated (e.g. whether public sector support is a grant or a payment for services delivered), and also as to which types of expenditure should be included in the calculations (for example where within a multi-faceted organisation the limits of the CDFI should be delineated);

- **A lack of available data**: The CDFA’s Inside Out survey does not collect comprehensive data on CDFI income and expenditure, meaning that information needs to be collected from each CDFI through their published accounts, which may not be publicly available;

- **Variations in accounting procedures**: Even where published accounts are available, variations in accounting procedures means that it is not always possible to calculate sustainability. Where CDFIs are part of larger groups, separate accounts may not be available, or in other cases there are financial transfers between companies (within a larger group) that make accurate assessments of income and expenditure difficult. In other cases, however, CDFIs do not publish sufficient information in their accounts to enable a calculation of sustainability to be made; for example, by not disaggregating income or expenditure by source and/or activity.
As part of the case studies, CDFIs were asked to provide their annual accounts for the preceding three years in order to support calculations of sustainability (for the reasons outlined above this was only possible for five of the eight case studies). Table 6.4 provides two worked examples of CDFI sustainability; note that in order to preserve their anonymity it is not possible to provide more detailed information on the organisations’ lending activities (e.g. the size of the loan pot). A number of observations can be made:

- Neither CDFI had come close to achieving operational sustainability in any of the three years for which the calculations have been made (the closest was CDFI A, in 2008/09, when 40 per cent of operational expenditure was covered by earned income);

- CDFI A made progress in terms of its level of operational sustainability between 2006/07 and 2008/09 (from 20 per cent to 40 per cent), but CDFI B registered little change between the three years (the level of operational sustainability actually decreased between 2007/08 and 2008/09);

- The two exemplar CDFIs were even further away from achieving financial sustainability (as at 2008/09 earned income covered just 20 per cent and 26 per cent respectively of operational expenditure and bad debt, and across the three years in question, neither CDFI had ever reached higher than 31 per cent financially sustainable;

- Although not shown in Table 6.4, both CDFIs had successfully secured additional revenue and capital income in order to cover the deficit between earned income and expenditure, and to replenish (and even increase) the size of their capital pots.

**Table 6.4: Examples of CDFI sustainability calculations, 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>CDFI A</th>
<th></th>
<th>CDFI B</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned income</td>
<td>£60,000</td>
<td>£70,000</td>
<td>£180,000</td>
<td>£200,000</td>
</tr>
<tr>
<td>Operational expenditure</td>
<td>£300,000</td>
<td>£330,000</td>
<td>£450,000</td>
<td>£720,000</td>
</tr>
<tr>
<td>Operational sustainability</td>
<td>20%</td>
<td>21%</td>
<td>40%</td>
<td>28%</td>
</tr>
<tr>
<td>Bad debt</td>
<td>£160,000</td>
<td>£120,000</td>
<td>£430,000</td>
<td>£80,000</td>
</tr>
<tr>
<td>Financial sustainability</td>
<td>13%</td>
<td>16%</td>
<td>20%</td>
<td>25%</td>
</tr>
</tbody>
</table>

As noted above, no consistent data are available on operational or financial sustainability across the CDFI sector as a whole, meaning that the extent to which the CDFI models shown in Table 6.4 are representative of the sector is not known. A couple of the other case study CDFIs reported that they were closer to operational sustainability (and indeed had historically achieved this milestone), but other case studies recorded levels of operational sustainability much lower than those presented in Table 6.4 (as low as 5 per cent in one case). Note also that the case studies were selected on the basis that they were both mature and relatively large, meaning that they might be expected to have a higher level of sustainability than the majority of the CDFI sector.
In order to provide an indication of achieved sustainability within the CDFI sector, a model was developed based on income data from Inside Out, together with an approximate calculation of operational expenditure based on case study information\textsuperscript{81}. The results are shown in Figure 6.1, and suggest that the CDFI sector as a whole has become slightly more sustainable over time, with the median level of operational sustainability increasing from 30 per cent in 2006/07 to 39 per cent in 2008/09, and the level of financial sustainability increasing from 22 per cent to 24 per cent. Nevertheless, reinforcing the conclusions from the case studies, the CDFI sector is clearly still a long way from achieving operational sustainability, and even further from achieving financial sustainability. Potential reasons for this position are discussed below.

Figure 6.1: Estimated median operational and financial sustainability of the CDFI sector, 2006/07 to 2008/09

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure6_1.png}
\caption{Estimated median operational and financial sustainability of the CDFI sector, 2006/07 to 2008/09}
\end{figure}

\textit{Source: GHK calculations, based on Inside Out (2006/07 to 2008/09)}

6.3 Drivers of sustainability

The evidence collected through the case studies, together with the lessons from the literature review (Annex 2) and reviews undertaken of existing evaluative material on the CDFI sector suggest that there are a number of areas of good practice that contribute towards achieving higher levels of operational and financial sustainability:

- \textit{Scale of lending pot}: There was a consensus amongst consultees from the case study CDFIs that sustainability was dependent upon achieving scale. Typically, having more money available for lending means greater portfolio income, and enables CDFIs to provide larger loans which tend to be more efficient in terms of transaction costs. What constitutes suitable scale depends, of course, on the business model operated; one case study CDFI had developed a sustainable

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\textsuperscript{81} In detail: CDFI portfolio income data was obtained from the results of the Inside Out survey. Operational costs were estimated by applying a figure of £55,000 worth of operational costs (the average across the eight case studies) to each CDFI FTE staff member (obtained from Inside Out). Financial sustainability was calculated by adding reported bad debt to the operational costs. The results derived from this model were compared to actual levels of operational and financial sustainability from the case studies, and deviated by 0-5 percentage points both cases, suggesting that the model is a reasonably accurate indicator of sustainability (except where CDFIs generate significant income through non portfolio related services or where operational costs are significantly disproportionate to staff costs)
model based on a lending pot worth £8 million, whilst another believed that operational sustainability was possible based on a pot of £4 million;

- **Partnership working:** A key way in which to reduce operational costs is to externalise certain functions, which are instead delivered through partnerships. Two key functions are most suited to such a method of delivery:
  - **Generation of deal flow:** Marketing is a costly and time consuming activity for CDFIs, and so most of the case studies had sought to generate demand as far as possible through referral arrangements with ‘partner’ organisations (though to varying degrees of success). The most successful partnerships, according to the case studies, were with other CDFIs or social banks, ‘niche’ business support organisations (e.g. supporters of cooperatives), and private sector introducers, such as accountants. A recurring theme throughout the case studies was the ineffectiveness of referral arrangements with Business Link (with the exception of Foundation East). Mainstream banks were also not seen as useful sources of referrals;
  - **Business support:** As noted above, internalising business support (pre- and post-loan) is widely recognised to be an inefficient method of operation. The CDFIs that had made the most progress towards operational sustainability had all sought – as far as practicable – to externalise the provision of such support through the use of partnership arrangements. In some cases these relationships were relatively informal (referring clients to the likes of Business Link), whilst other CDFIs drew on a network of external experts (e.g. mentors). Mentors were typically paid for their services, but in the case of the Fredericks Foundation a voluntary network of experts was used.

- **Staff efficiency:** Staff costs are typically the single largest type of expenditure of a CDFI. The case study CDFIs that were closest to sustainability were relatively small organisations, with a high proportion of loan officers relative to other staff, and targets in terms of loan applications processed each month. Moreover, how staff spend their time is key to sustainability. As the literature review (Annex 2) notes, evidence suggests that CDFI staff sometimes spend time providing money and debt advice to unsuccessful loan applicants, or undertaking business support activities that should be carried out by partner organisations (see above);

- **Portfolio performance:** Maximising income from the lending portfolio is key to the sustainability of a CDFI. This can be achieved through higher interest rates and the use of fees to try to cover some of the overhead costs of processing loan applications, whilst the CDFIs that have made the most progress towards achieving sustainability are arguably also those organisations that are able to minimise bad debt through the use of security or through enhanced levels of due diligence; and,

- **Reduction in very small loans:** Some funders still support CDFIs in providing very small loans given their policy objectives and the potential to create a greater social and economic impact per pound of lending. Nevertheless, the cost of delivering very small loans and collecting interest and principal often exceeds the amount earned; a move away from such loans will increase CDFI sustainability.
The case studies of CDFIs have highlighted the diversity of operational and financial models employed by CDFIs, and thus the varying approaches to the key drivers of sustainability identified above. It is also clear that the credit crunch and recession have had a significant impact on sustainability, with all CDFIs noting that their level of achieved operational sustainability had decreased in the past year or so (this is explored in more detail in Section 7).

A key issue with regard to the extent to which CDFIs can be operationally or financially sustainable are the trade-offs that would need to be made. Case study consultees all raised this issue, and noted that, to varying degrees, they were balancing a goal to be sustainable with their own economic and social aims and objectives. Table 6.5 highlights a number of the trade-offs that might be expected to be associated with achieving operational and financial sustainability, relative to delivering a mission-focused CDFI with more depth of reach (i.e. a tendency to focus on harder to reach groups). Of course, in reality CDFIs tend not to position themselves at one extreme and most tend to sit somewhere between the two opposites, to varying degrees.

<table>
<thead>
<tr>
<th>Operationally/financial sustainable CDFI</th>
<th>CDFI with depth of reach</th>
</tr>
</thead>
<tbody>
<tr>
<td>National/region-wide</td>
<td>Local focus</td>
</tr>
<tr>
<td>Operates from single office</td>
<td>Outreach facilities in target areas</td>
</tr>
<tr>
<td>Larger loans</td>
<td>Smaller loans</td>
</tr>
<tr>
<td>Diverse range of target markets including SMEs and social enterprises</td>
<td>Focus on micro enterprises</td>
</tr>
<tr>
<td>High interest and fees charged</td>
<td>Below market interest rates/ grants</td>
</tr>
<tr>
<td>Security taken</td>
<td>Unsecured lending</td>
</tr>
<tr>
<td>Focus on near bankable viable businesses</td>
<td>Focus on businesses with greatest social/ economic impacts</td>
</tr>
<tr>
<td>Generates demand through referral networks</td>
<td>Generates demand through marketing and awareness raising</td>
</tr>
<tr>
<td>Minimal business support</td>
<td>Pre- and post loan business support</td>
</tr>
<tr>
<td>Small staff, high productivity</td>
<td>Possibly large staff, low productivity</td>
</tr>
<tr>
<td>Capital from investors and finance market</td>
<td>Capital from grants and philanthropy</td>
</tr>
<tr>
<td>Revenue from portfolio income</td>
<td>Revenue from grants and philanthropy</td>
</tr>
<tr>
<td>Low levels of bad debt</td>
<td>High levels of bad debt</td>
</tr>
</tbody>
</table>

6.4 Financial models of CDFI enterprise lending activities

Given the complexity of CDFI structures and operating models, this final sub-section presents a set of financial models of the enterprise lending activities of CDFIs, with separate models showing how the size and target market of a CDFI affect this financial model. These models focus on the enterprise lending activities of CDFIs, and thus exclude all non-enterprise lending related activities (such as personal lending and all income not directly derived from lending). The data used to populate these models
have been derived from the 2008/09 *Inside Out* survey, and thus show actual averages for the CDFI sector as opposed to normative models of how a fully sustainable CDFI would operate (but still provide a clear set of findings on current financial models). These models are, therefore, reflective of the current position of the sector which would be expected to change over time, as the credit crunch and economic recession ends and as CDFIs continue to develop.

Table 6.6 shows seven financial models: a ‘base’ model for the CDFI sector as a whole (based on sector-wide averages); and models of a set of small and large CDFIs, each broken down by the three key enterprise market segments. Details of the methodology underpinning the models, and the sources of data used, are shown in Table 6.7.

Table 6.6 highlights the extent to which the CDFI sector is still some distance from achieving sustainability (similar to the model shown in Figure 6.1, though note that this uses a broader definition of CDFI income). Of all of the models shown, only a large CDFI focussing on the social enterprise lending market was able to achieve 100 per cent operational sustainability, and none of the CDFI models were close to achieving 100 per cent financial sustainability. Taking into account the opportunity costs of providing capital to CDFIs, sustainability falls even further (32 per cent across the sector as a whole). The models also highlight the problems facing a CDFI focussing on micro enterprise lending, which whether small or large is a very long way away from sustainability. Consequently, such a CDFI would need to access considerable amounts of external funding to cover its ongoing operating and financial costs.

There are a number of key variables within the models that have a significant impact on income and/or costs, and thus levels of sustainability. For the most part these variables were discussed above in Section 6.3, and include:

- *Income per outstanding loan* – reflecting the fact that interest rates charged by CDFIs are often relatively low, and that the use of fees is not widespread, income per loan (based on *Inside Out* data) was equal to just 7.7 per cent of the average value of an outstanding loan. An increase in this value could have a significant impact on the level of income secured by a CDFI – doubling this to 15.5 per cent, for instance, would increase the operational sustainability of the base model (all markets) to 108 per cent (up from 54 per cent).

- *New loans per technical staff* – note that this value includes the time inputs of the operations manager and business support officers, and thus that the more time that is put into due diligence and/or business support, the lower the number of new loans per staff member. As noted above, decreasing the staff time commitment per loan – for instance by reducing the business support provided – could increase the number of loans processed and thus increase income relative to expenditure. Increasing the number of new loans per technical staff member from 11 a year to, say, 20 a year will increase operational sustainability to 96 per cent for the base model (all markets), from 54 per cent. However, savings from reducing staff time (especially time spent on due diligence) would be expected to increase levels of bad debt;

- *Write-offs* – write-offs reduce the size of the capital pot and thus increase the extent to which earned income has to cover financial costs as opposed to

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82 The CDFI financial model has been reviewed by experts in the field of CDFI financial operations, including representatives from BIS and the CDFA
operational costs, and/or results in a greater reliance on external funding. The level of write-offs assumed in the models shown in Table 6.6 are drawn from actual Inside Out data, but may reflect inconsistencies in reporting and also a delay in the impact of the recession. Increasing the level of write-offs from 7 per cent to, say, 20 per cent in the base model (all markets) causes the level of financial sustainability to drop from 37 per cent to 22 per cent, resulting in an annual funding gap of £623,000 (up from £315,000 in the base model).

In all probability, of course, a CDFI would adjust combinations of these drivers of sustainability, rather than focussing on one particular variable. Moreover, variations in the distance from sustainability according to the market served mean that the degree of adjustment would vary between CDFIs. In order to explore this issue, a series of scenarios were constructed in order to measure the changes that would be required for a CDFI to achieve operational sustainability. The results show the following:

- In the model shown in Table 6.6, a large CDFI serving the micro enterprise market would on average be 32 per cent operationally sustainable. Keeping levels of bad debt at 12 per cent (this market will always have a higher level of risk), a 100 per cent level of operational sustainability could be achieved by increasing the scale of operations to 200 outstanding loans, by increasing income per loan to from 7.7 to 15 per cent of the value of each loan, and by increasing loan officer productivity to 20 new clients per year. For a smaller CDFI, an increase in the number of outstanding loans from 44 to 65, in combination with the changes to staff efficiency etc. outlined for larger CDFI, would also lead to 100 per cent operational sustainability;

- CDFIs lending to SMEs are arguably much closer to achieving operational sustainability, and thus only relatively small changes to operating models are required in order to achieve 100 per cent operational sustainability. For example, if a CDFI increased its income per loan from 7.7 per cent of the value to 12 per cent, operational sustainability would exceed 100 per cent for both small and large SME lenders. For small lenders, achieving financial sustainability would require further adjustments, for instance by increasing the number of outstanding loans to 40 from 23;

- As noted previously, a large CDFI lending to social enterprises will most likely have achieved operational sustainability using the model set out in Table 6.6. Again, by increasing income per loan from 7.7 per cent of the value to 12 per cent, and by increasing the number of outstanding loans to 100, such a CDFI would also achieve over 100 per cent financial sustainability.
### Table 6.6: Financial models of the enterprise lending activities of CDFIs

<table>
<thead>
<tr>
<th>PROFILE OF MODEL</th>
<th>All</th>
<th>Micro</th>
<th>SMEs</th>
<th>Social</th>
<th>Micro</th>
<th>SMEs</th>
<th>Social</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Target enterprise market</td>
<td>All</td>
<td>Micro</td>
<td>SMEs</td>
<td>Social</td>
<td>Micro</td>
<td>SMEs</td>
<td>Social</td>
</tr>
<tr>
<td>B Relative size of CDFI</td>
<td>Average</td>
<td>Small</td>
<td>Small</td>
<td>Large</td>
<td>Large</td>
<td>Large</td>
<td></td>
</tr>
<tr>
<td>C Number of outstanding loans</td>
<td>112</td>
<td>44</td>
<td>23</td>
<td>21</td>
<td>176</td>
<td>91</td>
<td>83</td>
</tr>
<tr>
<td>D Value of each outstanding loan</td>
<td>£21,131</td>
<td>£7,327</td>
<td>£33,744</td>
<td>£72,606</td>
<td>£7,327</td>
<td>£33,744</td>
<td>£72,606</td>
</tr>
<tr>
<td>E Total value of outstanding loans</td>
<td>£2,374,952</td>
<td>£322,379</td>
<td>£767,686</td>
<td>£1,510,606</td>
<td>£1,289,518</td>
<td>£3,070,745</td>
<td>£6,042,425</td>
</tr>
</tbody>
</table>

#### INCOME

| H Income earned per outstanding loan p.a. | £1,631 | £565 | £2,604 | £5,604 | £565 | £2,604 | £5,604 |
| G Total earned income p.a. | £183,299 | £24,881 | £59,250 | £116,589 | £99,525 | £237,000 | £466,354 |

#### COSTS

| I Number of new loans p.a. | 39 | 15 | 11 | 8 | 59 | 43 | 30 |
| J Number of technical staff | 11 | 14 | 11 | 5 | 14 | 11 | 5 |
| K Number of support staff | 2.7 | 0.8 | 0.7 | 1.2 | 1.6 | 1.5 | 2.3 |
| L Total staff costs p.a. | £213,034 | £63,295 | £59,118 | £116,009 | £108,353 | £169,754 |
| M Total non-staff overhead cost p.a. | £127,820 | £37,977 | £35,471 | £55,571 | £116,009 | £169,754 |
| N Total operational costs p.a. | £340,854 | £101,272 | £94,589 | £148,189 | £288,942 | £452,676 |
| O Write-offs as a % of outstanding lending | 7% | 12% | 5% | 4% | 12% | 5% | 4% |
| P Total value of write-offs p.a. | £158,163 | £38,446 | £38,672 | £59,618 | £153,784 | £154,689 |
| Q Total operational and financial costs p.a. | £499,017 | £139,718 | £133,261 | £207,807 | £463,140 | £691,148 |
| R Notional capital cost p.a. | £77,901 | £10,574 | £25,181 | £49,549 | £42,297 | £100,723 | £198,198 |
| S Total operational, financial & capital costs p.a. | £576,918 | £150,292 | £158,442 | £257,357 | £505,438 | £544,355 | £889,345 |

#### SUSTAINABILITY

| T Income-cost gap (operational) | £157,555 | £76,391 | £35,339 | £31,601 | £209,832 | £51,942 | £13,678 |
| U Operational sustainability | 54% | 25% | 63% | 79% | 32% | 82% | 103% |
| V Income-cost gap (operational/ financial) | £315,718 | £114,837 | £74,011 | £91,219 | £363,615 | £206,631 | £224,793 |
| W Financial sustainability | 37% | 18% | 44% | 56% | 21% | 53% | 67% |
| X Income-cost gap (operational/ financial/ capital) | £393,619 | £125,411 | £99,192 | £140,768 | £405,913 | £307,355 | £422,991 |
| Y Total sustainability | 32% | 17% | 37% | 45% | 20% | 44% | 52% |
| Z1 Value of gap per outstanding loan | £3,502 | £2,850 | £4,360 | £6,766 | £2,306 | £3,378 | £5,083 |
| Z2 Value of gap per £'000 of outstanding loans | £166 | £389 | £129 | £93 | £315 | £100 | £70 |
Table 6.7: Methodological details of the CDFI financial models shown in Table 6.6

<table>
<thead>
<tr>
<th>Name of indicator</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Target enterprise market</td>
<td>Micro enterprise (0-9 employees), SME (10-249 employees)</td>
</tr>
<tr>
<td>B Relative size of CDFI</td>
<td>See H and K</td>
</tr>
<tr>
<td>C Number of outstanding loans</td>
<td>Total number of outstanding enterprise loans (Inside Out 2008/09)</td>
</tr>
<tr>
<td>D Value of each outstanding loan</td>
<td>Value of outstanding enterprise loans / Number of outstanding enterprise loans (Inside Out 2008/09)</td>
</tr>
<tr>
<td>E Total value of outstanding loans</td>
<td>C * D</td>
</tr>
<tr>
<td>F Income earned per outstanding loan p.a.</td>
<td>Annual income from interest and fees (Inside Out 2008/09) / Number of outstanding loans (Inside Out 2008/09) = £1,631, or 7.718% of value of outstanding loan (all CDFIs). 7.718% applied to average value of outstanding loans for each market group (C)</td>
</tr>
<tr>
<td>G Total earned income p.a.</td>
<td>C * F</td>
</tr>
<tr>
<td>H Number of new loans p.a.</td>
<td>Average number of new loans made per year (Inside Out 2008/09), by market segment. Average value doubled for large CDFIs and halved for small CDFIs</td>
</tr>
<tr>
<td>I Number of new loans per technical staff p.a.</td>
<td>Number of new loans made per year / Number of technical staff (Inside Out 2008/09). Technical staff = loan officers, operations manager, and business support officers</td>
</tr>
<tr>
<td>J Number of technical staff</td>
<td>H / I</td>
</tr>
<tr>
<td>K Number of support staff</td>
<td>J * Ratio of technical staff to support staff (Inside Out 2008/09) (1:0.77). Support staff = Chief Executive, administration, ‘other’. Ratio halved for large CDFIs (1:0.39)</td>
</tr>
<tr>
<td>M Total non-staff overhead cost p.a.</td>
<td>L * 1.6 (assumes overhead costs = 60% of total staff costs)</td>
</tr>
<tr>
<td>N Total operational costs p.a.</td>
<td>L + M</td>
</tr>
<tr>
<td>O Write-offs as a % of outstanding lending</td>
<td>Value of write-offs by market segment / Value of outstanding lending by market segment (Inside Out 2008/09)</td>
</tr>
<tr>
<td>P Total value of write-offs p.a.</td>
<td>E * O</td>
</tr>
<tr>
<td>Q Total operational and financial costs p.a.</td>
<td>N + P</td>
</tr>
<tr>
<td>R Notional capital cost p.a.</td>
<td>Value of outstanding lending (E) * average annual LIBOR Rate (over last 4 years) (3.3%)</td>
</tr>
<tr>
<td>S Total operational, financial &amp; capital costs p.a.</td>
<td>Q + R</td>
</tr>
<tr>
<td>T Income-cost gap (operational)</td>
<td>G – N</td>
</tr>
<tr>
<td>U Operational sustainability</td>
<td>G / N</td>
</tr>
<tr>
<td>V Income-cost gap (operational/ financial)</td>
<td>G – Q</td>
</tr>
<tr>
<td>W Financial sustainability</td>
<td>G / Q</td>
</tr>
<tr>
<td>X Income-cost gap (operational/ financial/ capital)</td>
<td>G – S</td>
</tr>
<tr>
<td>Y Total sustainability</td>
<td>G / S</td>
</tr>
<tr>
<td>Z1 Value of gap per outstanding loan</td>
<td>X / C</td>
</tr>
<tr>
<td>Z2 Value of gap per £’000 of outstanding loans</td>
<td>X / E * 1000</td>
</tr>
</tbody>
</table>
6.5 Conclusions

This section of the report has analysed the extent to which the CDFI sector is moving towards sustainability, based on analysis of case studies of eight CDFIs and the results of the Inside Out survey. The key conclusions are as follows:

- Sustainability is recognised as a key issue for the CDFI sector going forward; all of the case study CDFIs were aware of the issue, and most reported that they were aiming to be sustainable in the near future;

- Analysis of the limited data that are available on CDFI sustainability (and without standardised accounting practices it will be impossible to accurately gauge the sustainability of the sector in the future) suggests that most CDFIs are a long way from achieving operational sustainability, and even further from achieving financial sustainability. Whilst there is some evidence that the sector as a whole is very gradually becoming more sustainable, consultees from most case study CDFIs noted that the credit crunch and recession had reversed progress made in the past year or so (and indeed that the full effects may not yet be apparent). Drawing on sector data, financial models of the delivery of enterprise loans to different markets confirms the extent of and length of journey to sustainability for lending activity alone;

- The case studies of CDFIs highlighted the diversity of operating models employed by the sector (indeed since only eight organisations were investigated there are doubtless other variations), and thus demonstrates the various different routes to sustainability that may be followed for lending activity. A number of key common factors have been identified (scale, partnership working, staff efficiency and portfolio performance), but it is interesting to note that no case study CDFI had successfully operationalised each of these examples of good practice, despite in many cases seeking to do so. In part this may be a reflection of the importance of external factors on CDFI sustainability (such as the quality and configuration of the wider business support infrastructure, or the presence and behaviour of other providers of enterprise loan finance – banks, larger national CDFIs, or other public sector supported providers of loan/ grant support);

- There was a consensus amongst case study CDFIs that achieving sustainability meant accepting trade-offs in terms of achieving their economic and social aims and objectives, and as a result all case study CDFIs to varying degrees focussed on achieving a balance between sustainability and depth of reach. The financial model reviewed above demonstrates the financial implications of this trade-off. Elsewhere, commentators on the CDFI sector have argued that the drive towards sustainability entails ‘mission drift’ away from the core markets of the CDFI sector (i.e. micro enterprise lending and support for the hardest to reach groups)\(^8^3\).

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\(^{83}\) New Economics Foundation (2008) UK CDFIs – From Surviving to Thriving: Realising the Potential of Community Development Finance
7 IMPACTS OF THE CREDIT CRUNCH AND THE RECESSION

This section of the report analyses the impacts of the credit crunch and the recession on the CDFI sector. As far as possible, they are treated as two separate issues since, though closely connected, their impact on the CDFI sector has been different.

What has become known as the ‘credit crunch’ is recognised to have originated with problems with the sub-prime mortgage lending market in the US, and that subsequently spread throughout global financial markets. From late 2007 onwards the availability of credit in the UK contracted as financial institutions reacted to the growing global crisis. Banks reduced the scale of their business lending and increased the associated costs, despite substantial injections of capital by the Bank of England. The direct result of the credit crunch was the economic recession, with national GDP declining from quarter two of 2008 onwards (by quarter three of 2009, UK GDP was 6 per cent lower than it was in quarter one of 2008)\(^\text{84}\). Business closures have increased substantially, with company liquidations in quarter one of 2009 increasing by 56 per cent from quarter one of 2008\(^\text{85}\).

The remainder of this section is structured into sections on: a review of the anticipated impact of the credit crunch and recession on the CDFI sector; analysis of evidence of the performance of CDFIs during the credit crunch and recession in the US (who entered this period ahead of the UK); and a review of the emerging evidence of the impact on CDFIs in the UK of the credit crunch and recession. The section ends with a set of conclusions.

7.1 The anticipated impacts of the credit crunch and the recession on CDFIs

In theory, one can envisage at least three ways in which the CDFI sector might be affected by the credit crunch and the economic recession:

- **Access to funding:** Due to the general reduction of liquidity in the financial system (reduced availability of capital and greater lending restrictions), and the recessionary impact on corporate profits (and related CSR activity), trust and foundation investment returns, and the asset base of many social philanthropists, the CDFI sector might be expected to find it more difficult to attract funding from the private and ‘third’ sectors. Public sector funding is also subject to budgetary cuts which, though not a result of the credit crunch, may be exacerbated if resources are prioritised into alternative policy areas in response to the recession. Thus far, however, access to finance for businesses has been one such priority policy area, thus potentially leading to greater public sector support for the CDFI sector;

- **Demand for CDFI products and services:** Two implications may be juxtaposed. On the one hand, the tightened lending restrictions of the mainstream banks will lead to a greater number of enterprise loan rejections and, in turn, an expanded demand for CDFI products. On the other hand, demand for loan finance could be reduced as businesses seek to consolidate and focus on survival in the face

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\(^{84}\) Office for National Statistics (December 2009) Quarterly National Accounts: 3rd Quarter 2009

\(^{85}\) The Insolvency Service (May 2009) Insolvencies In The First Quarter 2009
of the economic recession. Both issues can also be expected to have an impact on the nature of demand for CDFI products as the type of business seeking finance changes, and the type of finance sought also evolves in response to recessionary pressures;

- **Portfolio performance**: Related to the demand for products and services above, CDFI financial performance might be improved in the long-term through deals with more ‘bankable’ clients. Conversely, as business failure rates rise in the face of the recession, portfolio performance – and the income generated from interest rates – might be expected to decline. CDFIs also generate a significant level of income from invested capital reserves (i.e. resources not loaned to businesses), which are likely to decrease as a result of historically low interest rates. Together these two sources of income are critical in financing CDFIs’ operational costs (which go towards generating future deal flows, for instance).

### 7.2 Evidence from the US CDFI sector

It is helpful to examine evidence as regards the impact of the credit crunch and recession on the CDFI sector in the US, particularly since both emerged earlier in the US, and so the impact on the US CDFI sector arguably acts as a pointer towards what may well happen in the UK in the near future.

In October 2008, the Opportunity Finance Network (the trade association for US CDFIs) began carrying out quarterly trend surveys in order to provide evidence as to the impact of tightening credit conditions and the recession on the sector.\(^\text{86}\) Table 7.1 summarises key performance indicators for the CDFI sector in the US for Quarter 4 of 2008 (October to December), Quarter 1 of 2009 (January to March) and Quarter 2 of 2009 (April to June). A number of observations can be made:

- **Demand for business loans** (as measured by the number of applications received) increased consistently across all three quarters, though showed some signs of slowing by Quarter 2 of 2009. Expected demand also shows evidence of a gradual slow-down, with three quarters (74 per cent) of CDFIs expecting an increase in demand in Quarter 2 of 2009, compared to 100 per cent in Quarter 4 of 2008. This deceleration in growth in demand could be a result of the impact of the recession, or could be a sign of a recovery in mainstream bank lending;

- **The impact of the recession on portfolio quality** does not seem to have been too serious. Rates of PAR (Portfolio at Risk) and charge-offs (roughly comparable to write-offs in the UK) are low and have not increased significantly over the course of the credit crunch and recession. Overall delinquency rates have clearly increased (52 per cent of CDFIs reported an increase in Quarter 4 of 2008), though this had improved by Quarter 2 of 2009. There are also some signs of optimism, with the majority of CDFIs expecting the quality of their portfolio to remain the same in the near future, and just 27 per cent of CDFIs in Quarter 2 of 2009 expecting it to deteriorate;

- **Around half** (45 per cent) of US CDFIs reported that they were capital constrained in Quarter 2 of 2009, a slight decrease from Quarter 4 of 2008 (55 per cent), but a sign that CDFIs are struggling to access the capital needed to respond to increasing demand. In Quarter 2 of 2009 just 30 per cent of CDFIs noted that their ability to access capital had improved, highlighting the

\(^{86}\) Opportunity Finance Network (September 2009) CDFI Market Conditions Report: Second Quarter 2009
persistence of the credit crunch and the reluctance of mainstream banks to commit sufficient levels of funding to the CDFI sector.

Table 7.1: Overview of key performance data for the US business-lending CDFI sector, quarter 3 of 2008 to quarter 4 of 2009

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Variable</th>
<th>Q4 2008</th>
<th>Q1 2009</th>
<th>Q2 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of funding applications received</td>
<td>Increased</td>
<td>79%</td>
<td>58%</td>
<td>58%</td>
</tr>
<tr>
<td></td>
<td>Stayed the same</td>
<td>18%</td>
<td>30%</td>
<td>27%</td>
</tr>
<tr>
<td></td>
<td>Decreased</td>
<td>4%</td>
<td>12%</td>
<td>15%</td>
</tr>
<tr>
<td>Expected future demand for funds</td>
<td>Increase</td>
<td>100%</td>
<td>73%</td>
<td>74%</td>
</tr>
<tr>
<td></td>
<td>Stay the same</td>
<td>0%</td>
<td>0%</td>
<td>26%</td>
</tr>
<tr>
<td></td>
<td>Decrease</td>
<td>0%</td>
<td>27%</td>
<td>0%</td>
</tr>
<tr>
<td>Portfolio At Risk (PAR) (over 30 days in arrears)</td>
<td>% of total portfolio</td>
<td>12%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Charge offs (loan write-offs)</td>
<td>% of total portfolio</td>
<td>0.9%</td>
<td>0.5%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Loan delinquency rate (portfolio in arrears or written-off)</td>
<td>Increased</td>
<td>52%</td>
<td>38%</td>
<td>34%</td>
</tr>
<tr>
<td></td>
<td>Stayed the same</td>
<td>44%</td>
<td>53%</td>
<td>28%</td>
</tr>
<tr>
<td></td>
<td>Decreased</td>
<td>4%</td>
<td>9%</td>
<td>38%</td>
</tr>
<tr>
<td>Expected future change in portfolio quality</td>
<td>Improve</td>
<td>N/A</td>
<td>18%</td>
<td>21%</td>
</tr>
<tr>
<td></td>
<td>Stay the same</td>
<td>N/A</td>
<td>48%</td>
<td>52%</td>
</tr>
<tr>
<td></td>
<td>Deteriorate</td>
<td>N/A</td>
<td>33%</td>
<td>27%</td>
</tr>
<tr>
<td>Ability to access capital</td>
<td>Increased</td>
<td>14%</td>
<td>22%</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>Stayed the same</td>
<td>48%</td>
<td>33%</td>
<td>37%</td>
</tr>
<tr>
<td></td>
<td>Decreased</td>
<td>38%</td>
<td>44%</td>
<td>33%</td>
</tr>
<tr>
<td>Whether capital constrained</td>
<td>Yes</td>
<td>55%</td>
<td>45%</td>
<td>45%</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>45%</td>
<td>55%</td>
<td>55%</td>
</tr>
</tbody>
</table>

Base = 28 CDFIs (Q4 2008), 33 CDFIs (Q1 2009), 33 CDFIs (Q2 2009); Source: Opportunity Finance Network, September 2009

In summary, in response to the credit crunch and recession, the US CDFI sector has experienced a substantial ‘spike’ in demand for loan funding which has put pressure on their capital reserves (loan pots). There has been some deterioration in the performance of portfolios but this has not, to date, impacted on the core operational procedures of the sector.

7.3 Emerging evidence of the impacts on the UK CDFI sector

Though there are positive signals that the worst phase of the credit crunch and the recession may be over in the UK, both are still ongoing, and thus it is too early to draw any firm conclusions about their effects on the CDFI sector. Moreover, the severity of the recession means that the full scale of the impacts may not yet be apparent. Despite this, there follows a review of the available evidence, at this stage based
primarily on questions specifically addressing aspects of the credit crunch and recession that were included within the CDFA’s 2008/09 Inside Out survey of CDFIs at the request of the study team (data thus relate to April 2009).

7.3.1 Access to funding

As discussed previously, the credit crunch has restricted the availability of capital from mainstream banks which, for many CDFIs, are a source of funds both for on-lending and to support revenue costs (see Section 6). Figure 7.1 shows how CDFIs reported that the ease with which they can access funding from private sector sources (such as banks) has changed as a result of the credit crunch. Just under half (49 per cent) of CDFIs indicated that obtaining such funds had become harder under the credit crunch, whilst the remaining 51 per cent suggested that it had stayed the same. Note, however, that not all CDFIs accessed private sector resources, whilst others borrowed money prior to the credit crunch which they are still in the process of lending out.

Figure 7.1: Whether the ease with which CDFIs can access funds from private sector sources has changed as a result of the credit crunch

![Diagram showing access to funding](image)

*Base = 55 CDFIs that have provided business loans since the beginning of the credit crunch. Source: Inside Out 2008/09*

The credit crunch and the recession may also have an impact on CDFIs’ ability to attract funding from non-private sector sources, including corporate donations and donations from trusts, foundations and social philanthropists. As shown in Figure 7.2, just over half (55 per cent) of CDFIs reported that obtaining funds from such sources has become harder under the credit crunch, whilst the remainder suggested that it had stayed the same. As above, it should be noted that non-private sector sources are not used by all CDFIs, and that, of those who do, not all will have done so since the credit crunch started.
Figure 7.2: Whether the ease with which CDFIs can access funds from non-private sector sources has changed as a result of the credit crunch

Base = 55 CDFIs that have provided business loans since the beginning of the credit crunch. Source: Inside Out 2008/09

The most important source of funds for CDFIs is the public sector, be it through RDAs, central government, local government, or other organisations (see Section 6). In principle, these sources are unlikely to have been negatively affected by the credit crunch or the recession, unless there is pressure on authorities to re-allocate resources ear-marked for CDFIs to other priority policy areas. Indeed, there is instead evidence that public authorities are seeking to mitigate the impacts of the credit crunch by shifting extra resources into improving access to finance, and that CDFIs are regarded as a crucial conduit through which these funds can be channelled. Most RDAs have launched business loan funds specifically in response to the credit crunch and recession, which are often managed by CDFIs. The LDA, for instance, has assembled a £3 million Economic Recovery and Loan Fund which is being delivered by two London CDFIs (GLE oneLondon and the East London Small Business Centre), and other RDAs have adopted similar approaches (see Section 2.2).

Capital, once secured, is typically invested by CDFIs whilst loan applications are received and processed. Since grants or investments usually consist of a lump-sum payment, and can be very large, the returns on these investments can be an important source of income for CDFIs. Between October 2008 and March 2009, the Bank of England base rate was cut from 5 per cent to 0.5 per cent, triggering matching falls in interest rates for savings accounts. The stock market has also performed poorly during the credit crunch and recession. The 2008/09 Inside Out survey asked CDFIs how the income earned from their invested capital reserves had changed as a result of the credit crunch (Figure 7.3). The majority (76 per cent) of respondents reported that such income had decreased, with one CDFI noting that ‘the fall in bank base rate has cut our investment income by 80 per cent’. Of course, this is only a problem for CDFIs with invested capital reserves, but in some cases this is clearly a significant issue alongside other cut-backs in funding.
Figure 7.3: How the credit crunch has affected CDFIs’ earnings from invested capital reserves

Base = 55 CDFIs that have provided business loans since the beginning of the credit crunch. Source: Inside Out 2008/09

7.3.2 Demand for CDFI products and services

The credit crunch has been characterised by a contraction in the availability of credit for businesses, particularly from mainstream sources such as banks. As seen in the US CDFI sector, intuitively this should lead to increases in demand for CDFI loans as businesses seek alternative forms of debt finance. Conversely, however, the ongoing economic recession might be expected to dampen demand for loan finance as businesses seek to consolidate and postpone investment until favourable market conditions return (though one might expect to see growth in demand for loan funding to resolve short-term cashflow problems).

Data from the 2008/09 Inside Out survey suggests that CDFIs have experienced a net increase in demand from businesses for loan finance (Figure 7.4). The majority of survey respondents (65 per cent) reported that demand had increased since the start of the credit crunch. One CDFI noted that they had experienced ‘a tripling in demand for business loans when comparing [quarter one of] 2009 to [quarter one of] 2008’. Whilst the majority of the sector reported increased demand, the mitigating effect of the recession meant that this was not always the case. Some 16 per cent of CDFIs noted that net demand had remained the same, whilst 18 per cent of CDFIs reported a decline in demand since the onset of the credit crunch. A CDFI that works with social enterprises noted that demand had only recently started to pick up after a ‘lull’ in 2008. Detailed characteristics of evolving demand for loan finance is being investigated as part of the CDFI case studies.
Figure 7.4: How overall demand for business loans has changed as a result of the credit crunch

Base = 55 CDFIs that have provided business loans since the beginning of the credit crunch. Source: Inside Out 2008/09

The primary driver of demand for CDFI loan finance is the behaviour of the mainstream banking sector (together with businesses’ perceptions of the actions of the banks). As a consultee from a case study CDFI noted, in crude terms the numbers of loan applications they receive are in inverse proportion to the willingness of mainstream banks to lend to businesses.

As part of the 2008/09 Inside Out survey, CDFIs were asked whether they had experienced any changes in the level of demand from businesses that would typically use mainstream sources to access loan finance (Figure 7.5). The majority (69 per cent) of respondents reported that there had been an increase in applications from such businesses. One CDFI (typical of a number of such responses), noted that they were “now receiving applications for funding from clients who, 12 months ago, would have been able to raise the finance they need from mainstream banks”. There is evidence that the banks themselves are encouraging former clients to seek money from the CDFI sector, with one CDFI reporting that they had ‘never had so many bank referrals’. By way of an explanation, one CDFI noted that that not only were banks lending less money to businesses, the costs of borrowing from mainstream sources had also increased to the point that the CDFI noted that ‘we are now cheaper than the banks ... as our interest rates are a lot cheaper’.
In addition to increasing overall demand, there is evidence that the credit crunch and the recession have had an impact on the types of businesses seeking loan finance from CDFIs. For the 2008/09 Inside Out survey, CDFIs were asked whether, on balance, the types of businesses requesting loans had changed as a result of the credit crunch (Figure 7.6). The majority of respondents (65 per cent) reported that they had experienced changes, with the most common being an increase in the ‘quality’ of businesses coming forward (likely to be a result of the increase in the number of applicants who would previously have used mainstream banks – see Figure 7.5).

Other examples provided by CDFIs included the following:

- A decline in the number of applications from start-up businesses and a corresponding increase in the number of applications from established businesses;
- According to one CDFI there had been ‘an increase in the number of applications for business rescue funding’, and a number of other CDFIs reported a change in the purpose of loans, with an increase in emergency cashflow requests, and an increase in loans intended to safeguard turnover and jobs, rather than to fund expansion. These would be typical responses to a recession;
- One respondent noted that they had experienced a number of enquiries from ‘newly unemployed [people] with redundancy payouts looking to start new businesses, seeking self-employment as an alternative to salaried employment’, again a direct impact of the recession;
- Another CDFI noted an increase in applications from businesses with ‘no or weak social benefit’. The scale of this issue will need to be explored during the case studies since it is feasible that, faced with a growth in the number of applications from more bankable businesses, CDFIs will eschew businesses from more challenging origins in favour of greater security of income.
Figure 7.6: Whether the types of businesses requesting loans from CDFIs has changed as a result of the credit crunch

![Pie chart showing 65% Yes and 35% No] (Base = 55 CDFIs that have provided business loans since the beginning of the credit crunch. Source: Inside Out 2008/09)

Data from the business beneficiary survey provides additional information on the impacts on the credit crunch on the types of business seeking loan finance from CDFIs. Outstanding loans were divided into two types: loans made before the credit crunch started (taken to be pre-2008), and loans made since the credit crunch started (loans from either 2008 or 2009). Table 7.2 shows how a selection of business characteristics differ between these two loan groups. Key points of note are that:

- Businesses that received loans before the credit crunch started were slightly more likely to be social enterprises (42 per cent of the total compared to 35 per cent of the total since the onset of the credit crunch);
- The average loan size decreased once the credit crunch started (dropping from £34,700 to £27,800). This corroborates case study evidence that CDFIs have sought to protect their loan portfolio by reducing risk through limiting the number of new large loans distributed;
- Since the onset of the credit crunch, a slightly higher proportion of businesses reported that they sought loan finance from a CDFI in order to prevent business contraction or closure (14 per cent as opposed to 10 per cent of firms receiving loans before the credit crunch started);
- A greater proportion of the businesses receiving CDFI loan finance since the onset of the credit crunch had previously applied for a loan from a commercial finance provider (62 per cent as opposed to 56 per cent of respondents receiving CDFI loans before the credit crunch started);
- The proportion of businesses that had successfully applied for a loan from a commercial finance provider was much lower since the credit crunch started,

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87 Though note that this is based on a sample of loans outstanding as at Summer 2009, meaning that loans made prior to 2008 of a duration under 2 years will already have been repaid. The pre-credit crunch sample will thus under-represent shorter loans, which by extension would most likely be small in value, and would have been disproportionally likely to have been obtained by micro businesses

88 One or more of: a loan from a bank or building society, a business angel, a venture capitalist, and/or an overdraft facility
however (9 per cent compared to 19 per cent of firms receiving CDFI loans before the credit crunch started).

### Table 7.2: Business client characteristics for CDFI loans made before and since the onset of the credit crunch

<table>
<thead>
<tr>
<th>Selected business characteristic</th>
<th>Before credit crunch</th>
<th>During credit crunch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportion of businesses that are social enterprises</td>
<td>42%</td>
<td>35%</td>
</tr>
<tr>
<td>Proportion of businesses located in deprived areas</td>
<td>26%</td>
<td>31%</td>
</tr>
<tr>
<td>Number of employees in the business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0 to 9</td>
<td>70%</td>
<td>80%</td>
</tr>
<tr>
<td>10 to 49</td>
<td>19%</td>
<td>13%</td>
</tr>
<tr>
<td>50 to 249</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>250 plus</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>Refused/ Don’t know</td>
<td>8%</td>
<td>6%</td>
</tr>
<tr>
<td>Age of business at loan start date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Start-up (aged under 2 years)</td>
<td>65%</td>
<td>66%</td>
</tr>
<tr>
<td>Established (aged over 2 years)</td>
<td>35%</td>
<td>34%</td>
</tr>
<tr>
<td>Loan details</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average loan size (£)</td>
<td>£34,684</td>
<td>£27,850</td>
</tr>
<tr>
<td>Average loan duration (months)</td>
<td>55</td>
<td>45</td>
</tr>
<tr>
<td>Loan purpose</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To start a business</td>
<td>44%</td>
<td>45%</td>
</tr>
<tr>
<td>To grow the business</td>
<td>44%</td>
<td>39%</td>
</tr>
<tr>
<td>To prevent business contraction</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>To prevent business closure</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Refused/ Don’t know</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Loan matched with additional investment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>11%</td>
<td>6%</td>
</tr>
<tr>
<td>No</td>
<td>89%</td>
<td>94%</td>
</tr>
<tr>
<td>Previous access to commercial finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tried successfully</td>
<td>19%</td>
<td>9%</td>
</tr>
<tr>
<td>Tried unsuccessfully</td>
<td>35%</td>
<td>53%</td>
</tr>
<tr>
<td>Had not tried</td>
<td>46%</td>
<td>38%</td>
</tr>
</tbody>
</table>

*Base = 113 businesses (before credit crunch); 216 businesses (during credit crunch)*

#### 7.3.3 Portfolio performance

Portfolio performance is crucial to the financial performance of CDFIs, since the interest earned from loans made is used both to replenish capital funds and to cover operational costs (see Section 6). The government’s reaction to the credit crunch and recession was to lower the Bank of England base rate (which fell from 5 per cent in October 2008 to 0.5 per cent in March 2009). In some cases, respondents to the Inside Out survey noted that the interest rates they charged were tied to the base rate, which, as they fell, reduced the income earned through interest charges.
More significantly, the recession has also had a negative impact on levels of bad debt within CDFIs’ portfolios, as businesses struggle to make repayments on time or are even forced to close down. Since most CDFIs do not take security on their loans, business failures can have a significant impact on loan portfolio performance. As Figure 7.7 shows, the majority of CDFIs (55 per cent) reported that levels of loan delinquency (i.e. repayment problems) increased as a result of the credit crunch and recession, though a high proportion of respondents (40 per cent) noted that there have been no notable changes. The Inside Out survey was, however, completed in June/July 2009, and there may be a time-lag in the impact on the businesses supported by CDFIs.

Figure 7.7: How the credit crunch and the recession have affected levels of loan delinquency

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55%</td>
<td>Increased</td>
</tr>
<tr>
<td>40%</td>
<td>Decreased</td>
</tr>
<tr>
<td>5%</td>
<td>Stayed the same</td>
</tr>
</tbody>
</table>

Base = 55 CDFIs that have provided business loans since the beginning of the credit crunch. Source: Inside Out 2008/09

7.4 Businesses’ views on the impact of the credit crunch and recession

It is also interesting to consider the views of CDFI business beneficiaries on access to finance during the credit crunch and recession, and specifically the role of CDFIs in comparison to the mainstream banks. As part of the business survey, respondents were asked to provide a general comment on their experiences of receiving support from a CDFI. Where they had received this support since the beginning of the credit crunch, many respondents used this opportunity to compare the service they received from their CDFI with that which they received from the bank. A selection of the comments received is as follows:

- ‘Without the assistance we received from [the CDFI] it is unlikely that the business would have got off the ground since the banks have been unhelpful in providing finance for unforeseen problems and circumstances’;
  
  [Commercial business, 0-9 employees]

- ‘The financial support made available to us at a time when the banks were unresponsive has protected jobs and ensured our survival beyond the current economic crisis’;
  
  [Commercial business, 0-9 employees]
‘After being turned down by numerous banks even though I had paid off outstanding loans with my banks with no missed payments, [the CDFI] were my last hope and really helped me to get the business started’;

[Social enterprise, 0-9 employees]

‘Banks have stopped serving the small business community and have increasingly served themselves ... I believe organisations such as [the CDFI] are vital to the small business community’;

[Commercial business, 0-9 employees]

‘[The CDFI] provided essential financial support in times when banks are refusing to help even viable businesses’;

[Commercial business, 0-9 employees]

‘At a time when banks were in panic and changing parameters on a day to day basis, the [CDFI] loan was logical and easy to understand’.

[Commercial business, 0-9 employees]

7.5 Conclusions

This section of the report has analysed emerging evidence as to the impact of the credit crunch and the associated economic recession on the CDFI sector in the UK. Though the first signs of the credit crunch emerged during mid-2007, it was not until the second half of 2008 that the financial crisis reached its full extent, and it was also around this time that the UK economy entered recession. Though there is evidence that the credit crunch has eased, and also signs that recessionary pressures on businesses are declining, both challenges are still very much ongoing problems, and the impacts on CDFIs may not yet be entirely evident.

Nevertheless, it is possible to draw some early conclusions about how the CDFI sector has been affected, which by and large mirror the experience of the US CDFI sector:

- Since the credit crunch started, the CDFI sector has experienced greater difficulty in accessing capital from private sources, and has also generated poorer returns on investment. Overall, however, the scale of the problem has, thus far, not been as great as some in the sector feared (though how this affects the sector in the medium-term at a time when public sector financial support for the CDFI sector has been decreasing, remains to be seen);

- Demand for enterprise loans from CDFIs has increased, but the scale of this growth would seem to vary considerably across geographical areas and market segments. This is, in part, a reflection of variations in the level of supply of capital to CDFIs by RDAs, most of which launched capital funds in response to the credit crunch in order to improve the supply of credit to SMES;

- There have been a number of shifts in the characteristics of businesses financed by CDFIs since the credit crunch started. Most significantly – in terms of the role of the sector – there has been an increase in the number of applications from businesses that would previously have been ‘bankable’ (i.e. able to access credit from a mainstream bank), highlighting the fluidity of the extent of market failure and the rationale for the CDFI sector (see Section 2.1);

- There is early evidence of short-term poorer portfolio performance (e.g. higher levels of loan delinquency) as the recession affects the viability of businesses.
Case study evidence suggests that CDFIs have implemented strategies to mitigate the scale of the problem, both with the existing portfolio (e.g. through the use of repayment holidays), and by factoring the current economic climate into new loan application decisions (e.g. by limiting lending to applicants operating in sectors perceived to be higher risk, or by reducing the number of larger loans made);

- In the medium-term, portfolio performance may well be boosted by the presence of a higher than normal proportion of businesses that would previously have been considered bankable, assuming that they would be more likely to repay loans;

- The shift towards bankable businesses, of course, raises questions about the social impacts of CDFI lending under the credit crunch and economic recession, and whether under pressure to reduce risks, CDFIs have, consciously or not, drifted away from their social missions. Without robust measures of social impact (see Section 5), this cannot be accurately assessed at the present time.
8 CONCLUSIONS AND RECOMMENDATIONS

Section 1.2 sets out the detailed research objectives for this study; and which have been addressed in turn through each of the previous sections of this Final Report. This final section of the report draws together the findings from the previous sections to inform a set of overarching conclusions on the strategic role of the CDFI sector as the basis for meeting the final research objective – recommendations on the development of future CDFI policy within the context of HMG’s overall access to finance interventions.

Following this introduction, a first sub-section sets out a set of study conclusions; these form the basis for a set of recommendations contained in the second, and final, sub-section.

8.1 Conclusions

Conclusion 1: The study provides strong evidence that market failures in access to finance remain (largely deriving from the high transactions costs to lenders associated with generating and appraising the deal flow and providing investment and aftercare support) and that, overall, the CDFI sector provides an efficient intervention in response to these failures. At the level of individual borrowers, CDFI activity has overcome market failure as individual clients move on to successfully access mainstream funding.

CDFIs comprise a diversity of specialist enterprises, often operating on a not-for-profit basis, which deliver finance and other support services to enterprises and individuals to achieve economic and social outcomes. The focus of this study has been the enterprise lending activities of the CDFI sector to businesses – start-up and existing; for profit and/or social enterprises; within disadvantaged areas and/or amongst financially excluded groups – that cannot obtain funds from the mainstream banking sector. Access to finance for these types of business remains underserved due to a consistent set of market failures that lead to reduced enterprise outcomes, particularly amongst disadvantaged groups and areas, and foregone or reduced economic and social impacts.

In recent years, and in line with evidence of growing sectoral maturity (fewer organisations, larger loan pots, stronger reporting structures, etc.) the capacity of the sector to service underserved access to finance markets has grown substantially. Most recently, the sector has acted as a flexible and fast moving delivery mechanism in response to an increased ‘access to finance gap’ caused by the credit crunch.

Conclusion 2: Bank behaviour, and perceptions of bank behaviour, towards business lending remain the key drivers of demand for CDFI services but the extent to which the CDFI sector meets (and generates) latent and existing demand across different underserved markets remains poorly documented and understood.

Baseline estimates of demand across target underserved markets do not exist (although CDFIs remain the repositories of much ‘on-the-ground’ knowledge). A number of trends in provision by the sector are evident:
- The level of lending to micro enterprises has stagnated: volume of loans made has not changed in recent years, fewer CDFIs are targeting this market segment, and minimum loan sizes are growing, although this is likely to reflect the demand for increased sustainability rather than a static level of demand;

- Value of lending to SMEs has tripled in the past three years: steady growth was evident prior to a recent ten-fold increase in applications;

- The impact of the credit crunch: clearly evident in the SME market; many CDFIs have been funded by RDAs to respond to the rapid (short to medium term) expansion of this finance gap. Whilst conversion rates have remained consistent with previous years, the sector has reported strong evidence of loans to previously bankable (and therefore less ‘hard to reach’) businesses;

- Social enterprise lending has seen consistent growth and now represents the largest CDFI market segment: this growth has been dominated by a handful of large national CDFIs. Indeed, evidence suggests that market failure may have reduced in the social enterprise market (especially for existing businesses), and that provision has been improved, both through the development and relatively rapid growth of a set of specialist providers and increased understanding of this market by the mainstream banking sector;

- Geographical and sectoral coverage remains patchy: Despite substantial expansion by the sector, regional analysis highlights continued sizeable variations in the level and type of CDFI loan activity. For example, a crude benchmarking of lending provides a regional average of £21.70 per business in 2008/09 but which varies from £0 in Wales to £1.70 in the South East to £41.40 in the North West and £104 in Northern Ireland;

- ‘Viable but unbankable businesses’: putting aside the effects of the credit crunch on the total size and characteristics of this group, the study highlights evidence that a small minority of bankable businesses are being funded by CDFIs through inconsistent or ‘soft’ application of the criterion of mainstream bank rejection. Client survey suggests an estimated deadweight figure of around 10% of loans made (impacts would have been achieved by businesses regardless of a CDFI loan) and this evidence is marked particularly in the social enterprise market.

Conclusion 3: By servicing the demand for finance from its target markets, the sector meets a range of enterprise related public policy rationales and goals. Both the sector and its diversity of funders would benefit from continued development of clarity and joint understanding of the range of intervention rationales and the associated measurement of activities, outputs, outcomes and impacts relevant to the sector.

The historic and organic development of the sector is reflected in its heterogeneity of company structures, organisational models, funding sources, target markets and sought after economic, social and environmental impacts. Within enterprise policy at least four policy rationales for CDFI support are identifiable: enterprise growth; enterprise-driven regeneration; support for social enterprises; and enterprise within under-represented groups. Whilst this breadth has provided access to a variety of funding streams over different periods, and the sector has made considerable headway in recent years, it still struggles to create consistent awareness and understanding of its activities and to evidence its impacts in a comprehensive manner. This process would be supported by, for example, further development of intervention
rationales and associated logic models, and their integration with sector reporting and performance frameworks. Such a process would usefully be informed, also, by input from the diverse range of public sector bodies who view the sector as a policy mechanism for a range of public sector goals.

At an organisational level, the sector exemplifies a growing level of maturity (governance, management and financial systems, sectoral consciousness, etc.) but remains highly heterogeneous, fiercely independent, and lacks transparency in its business models and day-to-day activities. Arguably this is partly symptomatic of the funding diversity to which organisations are continuously adapting but, if the sector wishes to remain the recipient of national and regional support, it will need to further strengthen its ability to support accountability for public funds. Greater transparency may also be expected to support investment from the full range of potential public, philanthropic and private funders.

Conclusion 4: Following this study, and through the good offices of the sector trade association (the CDFA), the sector is now able to evidence in a robust and comprehensive manner the scale and extent of its positive economic impacts.

A ‘snapshot’ assessment of the gross impacts generated by the CDFI sector’s outstanding enterprise loan portfolio, some 6,500 loans, in October 2009, shows that:

- Around 2,200 business have been created, and a further 1,650 safeguarded;
- Around 13,800 jobs have been created, and a further 12,800 safeguarded;
- Around £667m of turnover has been created, and a further £834m safeguarded; and,
- Around £135m of GVA has been created, and a further £169m safeguarded.

The net impacts (or additionality) of this loan activity are outlined in Table 8.1.

The net impacts generated vary across different policy segments and impacts but include:

- At the local level, around 1,705 additional businesses have been created, and a further 1,372 safeguarded. Around 40% of these businesses are social enterprises, and 22% of businesses have been created in deprived areas (and a further 34% of businesses safeguarded in deprived areas); and,
- At the local level, around 3,600 jobs have been created, and a similar number safeguarded. Around a third of jobs created and safeguarded are in deprived areas.

At regional level, the most notable net impact is a greater level of jobs created and safeguarded than at the local level as a result of lower leakage at a regional, compared to local, level.
Table 8.1: Net business, employment, turnover and GVA impacts of CDFI lending

<table>
<thead>
<tr>
<th>Geographic area</th>
<th>Net impacts</th>
<th>All</th>
<th>Social enterprises</th>
<th>Deprived areas</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Businesses created</td>
<td>1,705</td>
<td>719</td>
<td>371</td>
</tr>
<tr>
<td></td>
<td>Businesses safeguarded</td>
<td>1,372</td>
<td>505</td>
<td>469</td>
</tr>
<tr>
<td>Local community</td>
<td>Jobs created</td>
<td>3,635</td>
<td>1,689</td>
<td>1,252</td>
</tr>
<tr>
<td></td>
<td>Jobs safeguarded</td>
<td>3,618</td>
<td>981</td>
<td>1,078</td>
</tr>
<tr>
<td></td>
<td>Turnover created</td>
<td>£560m</td>
<td>£244m</td>
<td>£113m</td>
</tr>
<tr>
<td></td>
<td>Turnover safeguarded</td>
<td>£788m</td>
<td>£198m</td>
<td>£216m</td>
</tr>
<tr>
<td></td>
<td>GVA created</td>
<td>£113m</td>
<td>£49m</td>
<td>£23m</td>
</tr>
<tr>
<td></td>
<td>GVA safeguarded</td>
<td>£160m</td>
<td>£40m</td>
<td>£44m</td>
</tr>
<tr>
<td>Region</td>
<td>Businesses created</td>
<td>883</td>
<td>279</td>
<td>187</td>
</tr>
<tr>
<td></td>
<td>Businesses safeguarded</td>
<td>790</td>
<td>272</td>
<td>303</td>
</tr>
<tr>
<td></td>
<td>Jobs created</td>
<td>4,614</td>
<td>1,544</td>
<td>1,401</td>
</tr>
<tr>
<td></td>
<td>Jobs safeguarded</td>
<td>7,571</td>
<td>1,904</td>
<td>2,723</td>
</tr>
<tr>
<td></td>
<td>Turnover created</td>
<td>£301m</td>
<td>£107m</td>
<td>£43m</td>
</tr>
<tr>
<td></td>
<td>Turnover safeguarded</td>
<td>£461m</td>
<td>£129m</td>
<td>£81m</td>
</tr>
<tr>
<td></td>
<td>GVA created</td>
<td>£61m</td>
<td>£22m</td>
<td>£9m</td>
</tr>
<tr>
<td></td>
<td>GVA safeguarded</td>
<td>£94m</td>
<td>£26m</td>
<td>£17m</td>
</tr>
</tbody>
</table>

*Base = 6,505 businesses (all); 2,715 businesses (social enterprises), 1,917 businesses (deprived area)*

As a snapshot assessment, these figures are likely to underestimate the full ‘lifetime’, or persistence of impact, of the loans made (both until repayment has been made and after repayment). On the one hand loans tend to be invested immediately and impacts are generated early (and safeguarded impacts are one-off and recorded immediately) and impacts may also be ‘lost’ during the loan term (the business closes, but what of the value of the temporary impacts of delayed closure?). On the other hand, businesses were optimistic about the medium-term persistence of impacts reported and a substantial minority would have failed to start-up or ceased trading without CDFI support. Methodologically, additionality decreases with time passed but this assessment is, in effect, an interim evaluation of economic impact.

Additionally, the sector would argue strongly for continued ‘cohorts of impact’ through the recycling of loans. That is, and notwithstanding the impact of bad debt on the reduction of lending pots, loans once repaid will return to the lending pot and subsequently be re-used through further loans to businesses, thus creating a new set of economic impacts. This is reflected in our assessment of net impacts per £000 of loan, based on the levels of transactions costs, bad debts and cost of capital.
Given that little or no assessment of the scale of market failure across different market segments exists, the overall level of impact of the sector in addressing underserved markets in access to finance at present remains unknown.

**Conclusion 5:** Lack of comprehensive data on CDFI income and expenditure incurred in undertaking enterprise lending militates against a fully empirically based assessment of sector value for money. Using a combination of survey based impact data, sector data and financial modelling an estimate of value for money can be calculated. Whilst costs vary significantly depending on the target market of a CDFI, the overall conclusion is CDFIs are efficient vehicles for the delivery of capital to businesses in underserved markets. On average, at a local community level, it would cost the public sector £18,400 to create a business through CDFI enterprise lending, and £8,800 to create a FTE job.

Whilst the organisational diversity of the sector complicates matters, there remains a basic failing within the sector to agree, utilise and report against a full and common set of definitions of income and expenditure (including against sources of income and activities undertaken). The study has utilised a variety of sources of empirical data to develop a simple financial model of the enterprise lending activities of CDFI, and against a variety of target markets. This model exemplifies a 'funding gap' between the income and costs of enterprise lending activity. Assuming the 'maximum case scenario' whereby this funding gap is filled by public sector sources alone (i.e. no philanthropic and additional earned income), Tables 8.2 and 8.3 show the public cost per unit of net economic impact delivered by the CDFI sector at local and regional level represents value for money.

<table>
<thead>
<tr>
<th>Market segment</th>
<th>All markets</th>
<th>Micro enterprises</th>
<th>SMEs</th>
<th>Social enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Small</td>
<td>Large</td>
</tr>
<tr>
<td>Business created</td>
<td>£18,443</td>
<td>£30,542</td>
<td>£24,713</td>
<td>N/A</td>
</tr>
<tr>
<td>Business safeguarded</td>
<td>£22,913</td>
<td>£52,147</td>
<td>£42,195</td>
<td>£19,299</td>
</tr>
<tr>
<td>Job created</td>
<td>£8,820</td>
<td>£16,858</td>
<td>£13,641</td>
<td>£15,105</td>
</tr>
<tr>
<td>Job safeguarded</td>
<td>£8,863</td>
<td>£38,084</td>
<td>£30,817</td>
<td>£2,932</td>
</tr>
<tr>
<td>£1 turnover created</td>
<td>£0.06</td>
<td>£0.11</td>
<td>£0.09</td>
<td>£0.06</td>
</tr>
<tr>
<td>£1 turnover safeguarded</td>
<td>£0.04</td>
<td>£0.30</td>
<td>£0.24</td>
<td>£0.01</td>
</tr>
<tr>
<td>£1 GVA created</td>
<td>£0.28</td>
<td>£0.55</td>
<td>£0.44</td>
<td>£0.32</td>
</tr>
<tr>
<td>£1 GVA safeguarded</td>
<td>£0.20</td>
<td>£1.46</td>
<td>£1.18</td>
<td>£0.05</td>
</tr>
</tbody>
</table>

**£ GVA created/ safeguarded per £1 of public sector expenditure**

| GVA created (£) | £3.57 | £1.82 | £2.27 | £3.13 | £4.17 | £6.25 | £8.33 |
| GVA safeguarded (£) | £5.00 | £0.68 | £0.85 | £20.00 | £25.00 | £5.00 | £6.67 |
Table 8.2 highlights, for example, that the average cost of creating a business through CDFI enterprise lending is £18,400. This figure, however, varies markedly across markets; from only £9,200 in large CDFIs dealing with social enterprises to £30,600 for small CDFIs serving the micro enterprise market. Indeed, the micro enterprise market has the highest cost at whatever scale of CDFI size reflecting the particular inability to fully cover costs through earned income in this market. In terms of employment, the cost of creating a job is, on average, £8,800 and varies from £4,000 for large CDFIs in the social enterprise market to £16,900 for small CDFIs active in the micro enterprise market.

Table 8.3: Estimated (maximum) public sector cost per unit of net economic impact: regional level, and on the basis of this, the amount of GVA created/safeguarded per £1 of public sector expenditure

<table>
<thead>
<tr>
<th>Market segment</th>
<th>All markets</th>
<th>Micro enterprises</th>
<th>SMEs</th>
<th>Social enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Small</td>
<td>Large</td>
</tr>
<tr>
<td>Business created</td>
<td>£35,629</td>
<td>£59,002</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Business safeguarded</td>
<td>£39,815</td>
<td>£98,478</td>
<td>£79,685</td>
<td>£26,366</td>
</tr>
<tr>
<td>Job created</td>
<td>£6,950</td>
<td>£14,096</td>
<td>£11,406</td>
<td>£8,301</td>
</tr>
<tr>
<td>Job safeguarded</td>
<td>£4,235</td>
<td>£29,854</td>
<td>£24,157</td>
<td>£1,119</td>
</tr>
<tr>
<td>£1 turnover created</td>
<td>£0.11</td>
<td>£0.22</td>
<td>£0.18</td>
<td>£0.09</td>
</tr>
<tr>
<td>£1 turnover safeguarded</td>
<td>£0.07</td>
<td>£0.77</td>
<td>£0.62</td>
<td>£0.02</td>
</tr>
<tr>
<td>£1 GVA created</td>
<td>£0.53</td>
<td>£1.08</td>
<td>£0.87</td>
<td>£0.46</td>
</tr>
<tr>
<td>£1 GVA safeguarded</td>
<td>£0.34</td>
<td>£3.80</td>
<td>£3.08</td>
<td>£0.08</td>
</tr>
</tbody>
</table>

At regional level, the most notable net impact is a greater level of jobs created and safeguarded than at the local level as a result of lower leakage at a regional, compared to local, level. Nevertheless, public sector cost to create or safeguard £1 GVA is higher than at local level.

Conclusion 6: In addition to the economic benefits noted above, CDFI lending is also responsible for the generation of social benefits. Whilst robust, aggregate measurement of the social impacts of the sector remains under development, the sector is actively engaged in activities to develop the standardised methodologies capable of supporting the capture and valuation of the full benefits and impacts of the sector’s lending activity.

Alongside the economic benefits generated by CDFIs, it is widely recognised that through its support for enterprise the CDFI sector generates social impacts (and social objectives are very typical within the sector). The extent to which these benefits are delivered and impacts achieved were tested with both CDFIs and business
beneficiaries. The breadth of impacts identified included: attitudinal effects on beneficiaries; employment of individuals from disadvantaged groups; the provision of local community services; and, environmental improvements.

The attempt to evaluate the social impacts of the sector in a comprehensive manner highlighted that no standardised social impact measurement methodologies are in use across the CDFI sector. Ad hoc pilots are in place, supported by the CDFA, and the sector is engaged with the Office of the Third Sector funded measuring Social Value Project. If these methodologies are to be employed, CDFIs will need to collect substantially more data on social impacts than is current practice.

**Conclusion 7: In the continuing efforts of the sector to deliver access to finance public policy goals, and despite widespread acknowledgement of the challenge, the sector remains a long way from achieving operational sustainability and even further from achieving financial sustainability. Key drivers of sustainability are recognised (economies of scale, the externalisation of deal flow and business support activities, staff efficiency, and portfolio performance) but financial modelling highlights the continued negative correlation (or trade off) between the drive to sustainability and ‘depth of reach’ against policy targets. In addition, initial evidence suggests that the move to sector sustainability will have been set-back by the credit crunch and recession.**

Figures calculated for the CDFI sector as a whole show that median level of operational sustainability has increased from 30 per cent in 2006/07 to 39 per cent in 2008/09 and the level of financial sustainability has increased from 22 per cent to 24 per cent. The figures highlight the substantial distance still to be travelled by the sector to reach sustainability.

Drivers of sustainability include:

- Scale of lending pot: providing greater portfolio income and facilitating larger (and more efficient) loans;
- Partnership working: in particular, the referral of viable businesses in policy targets by partners and, relatedly, the provision of pre- and post-loan business support by partners. In this regard, the sector continues to, in most cases, express disappointment at the quality of partnerships with Regional Business Links and mainstream banks;
- Staff efficiency: expenditure and focus on loan activity, as against other administrative activity and broader formal and informal business support to applicants and clients alike; and,
- Portfolio performance: maximising income through loan fees and interest rates and, more fundamentally, reducing bad debt; and,
- Reduction in very small loans: Some funders support CDFIs in providing very small loans given their policy objectives and the potential to create a greater social and economic impact per pound of lending. Nevertheless, the cost of delivering very small loans and collecting interest and principal often exceeds the amount earned; a move away from such loans will increase CDFI sustainability.
To illustrate, in the financial model a large CDFI serving the micro enterprise market would on average be 32 per cent operationally sustainable. Keeping levels of bad debt at 12 per cent (this market will always have a higher level of risk), a 100 per cent level of operational sustainability could be achieved by increasing the scale of operations to 200 outstanding loans (from 176), by increasing income per loan to from 7.7 to 15 per cent of the value of each loan, and by increasing loan officer productivity to 20 new clients per year (from 14). For a smaller CDFI in the micro enterprise market, an increase in the number of outstanding loans from 44 to 65, in combination with the changes to staff efficiency and income per loan previously outlined, would also lead to 100 per cent operational sustainability.

Inherent within the drivers of sustainability are clear trade-offs between sustainability and ‘depth of reach’ against policy targets; for example, larger loans, lower risk clients, higher rates of interest and minimal business support all support sustainability but are likely to reduce policy impacts. Indeed, some evidence exists of ‘mission creep’ within the sector in response to the demands of sustainability (for example, moves out of the micro enterprise market and the choice of ‘next best’ cases rather than the highest risk in terms of policy objectives).

The initial reported impact of the credit crunch and related recession highlights the complexity of interrelationships between these drivers and trade-offs. For example, demand for enterprise loans has increased substantially leading to greater numbers of applications. Substantial numbers of these remain unviable or out of policy objective but the process of initial assessment is incurring increased transaction costs. In contrast, expanded applications are also including businesses which would have previously been viewed as bankable prior to the credit crunch. Loans are being made in this instance to what, in effect, are lower risk (and probably lower cost) clients and are expected to have a subsequent positive impact on future portfolio performance. In further contrast, there is early evidence of short-term poorer portfolio performance (i.e. higher levels of loan delinquency) as the credit crunch and recession affects the viability of existing clients.

Conclusion 8: Ultimately, the study has exemplified the relative efficiency of the delivery of enterprise lending by the CDFI sector across a range of enterprise lending policy goals. Yet two major caveats must be put forward at this stage: total impact remains small scale, patchy and variegated against a poorly specified set of underserved markets; and the evidence suggests that a concerted move to achieve full operational (let alone financial) sustainability by the sector is likely to be accompanied by reduced policy benefits. Overall, there remains limited data on the relationship between financial efficiencies and effectiveness and economy in delivering across the range of policy targets. This provides a number of joint challenges to HMG and the sector alike.

HMG needs to provide a clear policy framework within which the sector can operate, including the range and extent of public benefit it is seeking from the sector and a recognition that the achievement of any such benefits will require investment in the sector. Such a framework, therefore, needs to differentiate and update policy rationales and target markets for potential CDFI activity. For example, evidence suggests that certain market failures may have been corrected in the social enterprise market whilst the ability to access finance in micro enterprise markets may have stagnated, or even worsened, over recent years.
We would suggest that it is only within such a policy framework (and the associated intervention rationales that should follow), that the range of potential activities and delivery mechanisms on offer (for example, CITR, policy guarantee schemes such as EFG, a wholesale CDFI Fund, CRA type legislation, Futurebuilders Full Investment Fund, Solutions for Business, direct capital and revenue loans and grants, etc.) can be assessed for effectiveness against policy objectives and within target markets. For example, either the direct payment to CDFIs for Solutions for Business service provision or the ‘mainstreaming’ of investment ready referrals into Solutions for Business is likely to generate greater volumes of enterprise lending and greater sector sustainability but some limits to depth of reach (especially in stimulating enterprise in disadvantaged communities). In contrast, policy guarantee funds can support greater depth of reach through higher risk lending but are likely to lead to further distance from sustainability. A wholesale CDFI Fund could support substantial expansion in the scale of impact of the sector in underserved markets but without careful thought could reinforce patchy regional coverage based on the expansion of existing delivery capacity. Across the balance of these and other support mechanisms, there remains the danger of displacement within target markets between different sources of public funds (with some existing evidence of just such occurrences).

To support any such policy framework, the sector must accelerate the development of clear and consistent procedures of data collection on income, expenditure by activity, outputs, outcomes and impact to allow full and robust assessment of the costs and value for money of CDFI delivery of interventions across different policy objectives. Policymakers need to be confident of their ability to acquire different sets of economic and social benefits in the most efficient manner from what is now arguably a maturing sector. Similarly, whilst there is evidence of progress in achieving greater levels of investment from other philanthropic and private sources, including the banking sector, such investment remains highly selective in the face of the lack of transparency of cost structures and benefits generated within the sector.

8.2 Recommendations

The conclusions outlined in Section 8.1 provide a framework for a set of Recommendations.

**Recommendation 1: Continue public sector support to CDFIs:** The rationale for support of CDFIs is continuing market failure to reflect the economic and social benefits of lending in underserved markets. The evaluation confirms this market failure (although there is evidence of its correction to some extent in the social enterprise market). The level of support should reflect these economic and social benefits and might best be put forward in a new cross-governmental policy framework which reflects the range of policy interests in the CDFI sector and its activities. Such support should be predicated on accelerated improvements in standardised management information systems within the sector (and which should be led by the trade association, CDFA) in order to advance enhanced targeting of policy impacts. Government should encourage and incentivise such improvements to support further moves to reduce the gaps in operational and financial sustainability characteristic of the sector.

**Recommendation 2: The development of substantial intervention rationales and associated evaluation frameworks for the different (enterprise) policy objectives delivered by CDFI activity.** Given the development of a policy framework within which the sector can operate (see Recommendation 1 above), it is imperative that
intervention rationales and associated evaluation frameworks detailing metrics, common indicators, monitoring procedures and data collection activities be disseminated throughout the sector as the basis for policy evaluation. These should be developed rapidly by the CDFA in unison with policy bodies to support common, consistent and good practice within the sector. These should also form the basis of further development of reporting and performance frameworks for the sector as the basis of greater transparency. The lack of transparency is increasingly untenable in a mature sector which remains a recipient of substantial public funds and support.

Recommendation 3: Following the policy framework and associated differentiation of policy rationales and target markets (see Recommendation 1), undertake a review of the range of current delivery mechanisms targeted at the CDFI sector (CITR, EFG, Solutions for Business, regulatory change, etc.) should be undertaken to fully gauge their relative contribution in supporting the sector to achieve HMG’s policy objectives. The sector is subject to a diversity of support to deliver across a range of policy objectives. Given a revised policy framework, this range of support should be reviewed for continued suitability and effectiveness against policy objectives.

Recommendation 4: The sector, led by the CDFA, should continue to support the development of social impact methodologies in partnership with national social value initiatives and to evidence the full value of its activities. Social value is growing in importance as a benefit to be assessed in public policy evaluation activity and remains a core mission of the CDFI sector. Public support for CDFIs should be provided in proportion to the economic and social impact that CDFIs deliver, therefore measuring social impact is key to demonstrating a part of the return on public investment that CDFIs can deliver. The sector needs to continue development of its capacity to provide an evidence base on social impact and value, including comprehensive and common reporting procedures. It should also seek to understand the additional potential cost that may be attached to such reporting activity.

Recommendation 5: Promote further initiatives to create a fit for purpose CDFI referral system (whether within the new Solutions for Business service offer, and/or related initiatives for a universal referral system with banks). Generating sufficient volume and quality of loan applications is a key challenge for most CDFIs, and this challenge has a significant impact on their sustainability. Improving existing public sector referral systems would reduce the scale of the resources committed by CDFIs to generating demand, filtering out unsuitable applications, and providing investment readiness support. An obvious route would be to mainstream referral arrangements as part of business support provided through Solutions for Business, particularly as part of the Investment Readiness product (for instance setting targets for quality referrals by delivery organisations). Further work on a universal referral system for banks would also increase the number and quality of referrals to CDFIs.

Recommendation 6: The need for further research into, and the development of methodologies to assess and document, the scale of different underserved markets and the extent of latent and existing demand. Simple cost benefit frameworks for target markets are now in development yet the extent of such markets remains relatively unknown. Formal assessment of target markets remains rare, with little systematic market research of target clients and services based largely on ad hoc knowledge and experience of CDFI staff and local business support networks. Any
expansion of services, either geographically or to new groups, should be informed by greater levels of market research activity.

**Recommendation 7:** A joint initiative by the CDFI sector with mainstream banks to support understanding of bank behaviour across target markets and the role of CDFIs in the financial landscape to recover some of the historical progress made before the credit crunch. Interim evidence in the Phoenix Fund evaluation, and post-Phoenix Fund developments, has highlighted the growing reputation and track record of the CDFI sector in relation to mainstream financial providers, including greater partnership activity. These developments have continued but it is the case that any joint message of access to finance provision to entrepreneurs and business owners has been substantially damaged by the credit crunch. Specific joint initiatives should be developed to redress this position and continue the development of the message of a ‘seamless ladder’ of access to finance provision across the public and private sector.

**Recommendation 8:** A further review of the impact of the credit crunch and recession on the enterprise lending market in general and CDFI activity and sustainability in particular. Whilst the credit crunch has introduced a different – and expected to be temporary – market failure into the enterprise lending system (based upon lack of funds not transaction costs), evidence suggests that i) bank behaviour in these markets may see structural change and ii) the credit crunch and associated recession will have a range of future impacts on CDFI activity and sustainability. It is important that any structural changes and changes in the associated policy context be documented and understood as part of policy development procedures.

**Recommendation 9:** The widespread dissemination of study findings. As only the second and, to date, most comprehensive ever national evaluation of the enterprise lending activities of the CDFI sector, it is important that the HMG CDFI Stakeholder Group works in unison to support widespread dissemination of key findings and messages. This might include, for example, the CDFA disseminating lessons on the journey to sustainability such as through a set of regional workshops on ‘The Move Towards Sustainability: Potential, Prospects and Pitfalls’ and/or a session at its Annual Conference.
ANNEX 1: LIST OF STUDY CONSULTEES

There follows a list of the stakeholders who have been consulted as part of this evaluation. Separate lists are presented for stakeholders consulted to provide contextual information, and stakeholders consulted as part of the case studies.

**Contextual stakeholders:**
- Bernie Morgan (CDFA);
- Claire Thompson (emdca);
- Gary Pennington (NWDA);
- Graham Duncan (LDA);
- Harry Glavan (CDFA);
- Jonathan Marshall (BIS);
- Keren Jones (SEEDA);
- Kirsten Masson (EEDA);
- Jules Mann (CDFA);
- Michael Cook (Financial Services Authority);
- Nandini Munnien (OTS);
- Neil McGuinness (One NorthEast);
- Patrick Palmer (AWM);
- Robin Edwards (SWRDA);
- Rosemary Mitchell (OTS);
- Rupert Gill (HM Treasury);
- Seb Aslan (BIS);
- Simon Riley (Yorkshire Forward);
- Tina Boye (LDA).

**Case study stakeholders:**
- Alain Demontoux (Cooperative and Community Finance);
- Alan McCabe (Project North East Loan Fund);
- Ann Oldroyd (Key Fund Yorkshire);
- Bob Wallis (Fredericks Foundation);
- Charles Dodwell (Fredericks Foundation);
- Ian Fulthorpe (Project North East Loan Fund);
- Katy Ford (Foundation East);
- Matt Smith (Key Fund Yorkshire);
- Nicholas Nikolaou (GLE one London);
- Peter Wood (Foundation East);
- Richard Tyas (FEBA ELEM);
- Steve Walker (Aston Reinvestment Trust).
ANNEX 2: CDFI LITERATURE REVIEW

Introduction
This literature review of academic, policy and consultancy literature on Community Development Finance Institutions (CDFI) has been produced by the University of Salford, supported by GHK, as part of the National Evaluation of Community Development Finance Institutions for the Department of Business, Innovation and Skills (BIS) and the Office of the Third Sector (OTS).

CDFIs are independent organisations that lend and invest to individuals and businesses in deprived areas and underserved markets with limited or no access to mainstream finance.

This review is comprised of four sections. Following this Introduction (Section 1), Section 2 reviews the UK policy context for support to, and development of, the CDFI sector. This context includes the rationale for intervention and overviews of such recent development interventions as the Phoenix Fund, the Social Investment Task Force and on-going Regional Development Agency activity. Section 3 reviews the current scale and status of the UK CDFI sector, including current parameters of performance, evidence of impact, and sector sustainability.

In the final section (Section 4), international microfinance experience is reviewed – globally, in the US and in Europe – prior to concluding on some key principles and factors for UK CDFI sector development.

UK Policy and the CDFI sector
In 1998 the Social Exclusion Unit published a report that set out the need for a National Strategy for Neighbourhood Renewal. The goals for the strategy would be:

- To bridge the gap between the most deprived neighbourhoods and the rest of England; and,
- In all the worst neighbourhoods, to achieve lower long-term worklessness; less crime; better health; and better educational qualifications.

The report proposed that one of the building blocks of the National Strategy should be 18 cross-cutting Policy Action Teams (PATs), set up to take forward an intensive programme of policy development. PAT 14 focused on access to personal finance and PAT 3 focused on enterprise development.

Reporting in November 1999, PAT 3 argued that access to finance is more difficult in deprived communities because of the limited amount of personal equity in those localities, which makes them more reliant on external finance. This is aggravated by a more precarious local economy, the proportionally higher cost of making small loans, and ‘cultural distance’, making banks and other business support organisations seem

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unapproachable and uninterested. PAT 3 reported further that this was a particular problem for women as they often begin with lower income and assets.

**Market failure in access to business finance**

In reporting these findings, PAT 3 reflected the main justification for intervening to enable existing businesses and aspiring entrepreneurs to access business finance - that credit markets by themselves do not ensure efficient and equitable distribution of business loans (Marshall, 2004). In particular, five factors have been identified as obstructing an efficient and equitable functioning of business finance markets:

- **Information asymmetries**: Much of the literature on small businesses suggests that information asymmetries (i.e. that the lender has less information than the borrower about the viability of the business proposition) are a key source of market failure in the provision of loans to small and medium enterprises (e.g. Berger and Udell, 2002; Elyiasiani and Goldberg, 2004; Baas and Schrooten, 2006; Smallbone et al, 2003). The lack of complete information makes it difficult to verify, at a cost deemed reasonable by the lender, that the firm in question has a viable business project which, in turn, has seen UK banks typically resort to secured lending and credit scoring. The implication of this is that firms falling into this category may be rejected for a loan because they are unable to raise collateral, even if they have a viable and profitable business proposition;

- **High transaction costs**: Transaction costs, or the costs of participating in a certain market, associated with lending to small and micro enterprises are high. The costs per loan for small and micro enterprises may in some cases be prohibitive for mainstream lenders as the borrowing firms may require considerable technical assistance and support before they are ready to take on a loan. Moreover the costs associated with collection and underwriting are also high. For example, for the CDFI Aspire it cost £1.4 to lend £1 (Forster et al, 2006), and for Street UK it cost £2.80 to lend £1 (NEF, 2004);

- **Geography**: Research suggests that self-employed and aspiring entrepreneurs find it more difficult to access bank finance. The self-employed in deprived areas are less likely to have a bank account, less likely to be able to produce financial accounts of their business and are less likely to operate in sectors covered by government loan guarantee schemes (Bank of England, 2002). They also have lower incomes and fewer savings (Bank of England, 2002). Many firms also have a customer base of low-income households (Ram and Jones, 2008). That said there is little conclusive evidence suggesting outright redlining or discrimination of deprived areas. In its last report on the access to bank finance for small firms in deprived areas, the Bank of England (2002) concluded that small firms in deprived areas that already had business accounts had similar access to loan facilities relative to the small business population in general. However, on average they also paid more for this access (the average lending margin in deprived areas was 3.2% compared with 2.8% in non-deprived areas.) In a more recent study, Cosh et al (2008) found that when controlling for business characteristics they did not find a significant difference between firms in deprived areas and access to finance relative to non-deprived areas;

- **Gender**: Female-owned businesses have lower levels of capitalisation and lower ratios of debt finance compared to their male counterparts (Carter et al, 2007, Roper et al, 2006). Women are also more likely to perceive access to finance as a barrier to starting up a business. In their econometric analysis of
female entrepreneurs and access to finance, Roper et al (2006) find that “being a woman increases the probability that an individual will perceive financial barriers to business start-up by 7.5 percentage points” (Roper et al, 2006, p.17). This is important because the same study found that perceived financial barriers have an effect on business start-up. Interestingly, being a woman does not increase the probability that individuals will experience difficulties in obtaining start-up finance, rather this is function of homeownership and region (living in the Northern England tends to have a negative influence on difficulty in obtaining start-up finance). This would suggest that there is no inherent discrimination in the underwriting processes of banks. Rather, women are at a disadvantage because they have less capital and are less likely to be a homeowner (survey data suggests that businesses with greater assets tend to experience fewer rejections, Fraser, 2004);

- **Ethnicity:** Research suggests that ethnic minority-owned businesses, Black African and Caribbean in particular, experience greater difficulties in accessing bank loans relative to the general business population (Smallbone et al, 2003; Ram and Jones, 2008). In their econometric analyses of survey data of ethnic minority and white SME data, Smallbone et al (2003) found that Black African and Caribbean business ownership has a negative and significant influence on access to bank finance at the start-up phase. Fraser (2004; 2005) analyses access to finance more generally (not only for start-up) and finds that ethnic minority entrepreneurs are less likely to be able to access finance and are more likely to be rejected but that this is a product of the risk profile of the business (size, sector, availability of collateral, etc). This would suggest that there is a market failure in access to finance among ethnic minority groups but this is not purely related to ethnicity, but is also related to the fact that ethnic minority businesses are concentrated in highly competitive sectors with slender profit margins and high failure rates (Ram and Jones, 2008; Fraser, 2005).

**Supporting the CDFI sector**

There remains a long-standing belief in enterprise-based regeneration among policymakers (Goggin et al., forthcoming) and the last decade has seen government policy based upon fostering entrepreneurship and self-employment in deprived neighbourhoods and among low-income groups as opposed to tax-based income distribution (Affleck and Mellor, 2006).

In addition to enticing mainstream banks to reduce access to business finance gaps through such schemes as the Enterprise Finance Guarantee (previously the Small Firms Loan Guarantee), the government has also recognised the role of specialist business support and financial intermediaries (especially those in the third sector) in supporting the supply of business finance in deprived areas and underserved markets.

CDFIs are a type of finance organisation that provide loans and support to businesses and individuals who have had trouble getting finance from the usual sources such as banks and building societies. Linked to their roots within community development and the third sector, CDFIs seek through their lending to create economic, social and environmental benefits in deprived areas and across disadvantaged communities.

In its recommendations, PAT 3 focused on the importance of creating “experimental ‘funding windows’ to strengthen the financial base of [Community Finance Institutions] and similar initiatives” (Neighbourhood Renewal Unit, 2000, p.14).
The Phoenix Fund and post Phoenix RDA support

The major governmental response to the recommendations of PAT3 was the launch of the Phoenix Fund, a funding instrument for promoting enterprise in disadvantaged communities. Comprised of several distinctive elements, the key aims of the fund included: encouraging innovative forms of business support for disadvantaged communities, and building the capacity of organisations involved in enterprise development. Two elements in particular provided direct support to the CDFI sector:

- A Development Fund to promote innovative ways of supporting enterprise in deprived areas; and,
- A Challenge Fund providing CDFIs with revenue support, capital for on-lending and loan guarantees to encourage commercial and charitable lending into CDFIs.

The rationale for government support, through Phoenix, for the community development finance sector was founded upon three distinct challenges (GHK, 2004):

- Market imperfections in the provision of finance to individuals and SMEs in disadvantaged communities as a result of information failures and market entry barriers;
- Entry barriers in the market for financial provision, exacerbated by information failures, leading to the current weaknesses observable in the community development finance sector; and,
- Achievement of wider social and economic benefits, such as equality of opportunity, development of local markets and regeneration.

The Phoenix Fund closed in 2006, having provided funding of around £55m to the CDFI sector in the intervening years. At its end, responsibility for financial support of the CDFI sector was transferred to the Regional Development Agencies (RDAs), along with some £11m of funding for the period 2006-2008.

Currently, each RDA is developing its own approach to continued support to the sector, principally through access to finance and business support routes but, additionally, through regeneration and inclusion programmes. For example, in August 2009, ONE North East announced approval by HM Treasury of its £125m JEREMIE (Joint European Resources for Micro to Medium Enterprises Initiative) venture capital fund. Within this fund a number of North Eastern CDFIs will share access to a wholesale fund of £1m to provide micro-loans to regional start-ups and businesses. It is expected that this fund will be 'topped up' over a number of years and, in addition, CDFIs will be funded under the new regional business support structure for bringing the smallest of firms into the business support system. In a number of other regions, such as the East Midlands and the South West, funding is being channelled through regional and consortia-based CDFIs.

RDAs remain the most significant revenue funders for enterprise CDFIs (over £2m in 2008), although their share is dropping, but only 17% of the sector’s loan capital (£5.5m) was sourced from RDA funding in 2008 (CDFA, 2009).

90 Full sets of evaluation material is available at http://www.berr.gov.uk/whatwedo/enterprise/enterprisesmes/building-enterprise/enterprising-people/Phoenix%20Fund/page37783.html
The Social Investment Taskforce

The findings of PAT 3 also formed part of the evidence base for the subsequent Social Investment Taskforce (2000) and its recommendations, including:

- **The creation of a Community Investment Tax Relief (CITR) credit to entice private investors to invest in third sector lenders.** Based on this recommendation, the Government introduced the CITR in 2002 (see [http://www.hmrc.gov.uk/specialist/citr_guidance.htm](http://www.hmrc.gov.uk/specialist/citr_guidance.htm)), which has provided an additional funding stream for CDFIs. Nearly £50 million has come to the sector through the CITR scheme (Goggin et al, Forthcoming) although, to date, CITR has mainly benefited social enterprise lenders. As of June 2004, the social enterprise lenders Charity Bank and Triodos had received 90% of the capital raised (HM Treasury, 2005);

- **The development of a UK Community Development Venture Capital (CDVC) model to support growth businesses in under-invested communities and areas.** In response to this recommendation, the first CDVC, Bridges Ventures, was launched in 2002 (see [http://www.bridgesventures.com/](http://www.bridgesventures.com/));

- **Charitable trusts and foundations should be given greater opportunity and freedom to invest in CDFIs.** Based on this recommendation the Charity Commission issued guidance on investment in CDFIs in 2001;

- **Greater disclosure by banks on the nature and amount of lending and investment in low-income areas.** In 2005, the Social Investment Taskforce (2005, p. 8) reported that “while RBS/ NatWest has disclosed more information than previously, there is still a dire need, nearly five years after publication of the Task Force report, for banks to engage in comprehensive disclosure.” More broadly, however, Goggin et al (forthcoming) argues that “banks and CDFIs are increasingly finding ways of working together in mutual beneficial ways”;

- **The sector should be supported through the creation of a trade association.** The Community Development Finance Association (CDFA), supported by BIS, was launched in 2002 and currently has in excess of 70 members.

In summary, and in recognition of the potential delivery mechanism offered by the CDFI sector in supporting access to business finance, government has aimed to boost the geographical coverage of such lenders, increase the capacity of the sector to take on additional lending and to promote the long-term sustainability of the sector.

The UK CDFI Sector

**Filling a business finance gap**

CDFIs are independent and self-regulated, and most are affiliated to the CDFA as a trade body. In their delivery of business finance to deprived areas and underserved markets, CDFIs ability to serve this market segment is facilitated by at least three tools:

- **Targeting:** Many CDFIs explicitly or implicitly target deprived groups and communities. Most CDFIs only lend to businesses that have been rejected by banks. Depending on the particular funding arrangements some of the training

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91 There are exceptions to this as many are subsidiaries to enterprise agencies. For example Business Finance Solutions, a CDFI in Greater Manchester, is part of 'Manchester Solutions'.
and loan capital may also be reserved for certain groups or neighbourhoods. Finally, CDFIs also tend to lend smaller amounts than banks and at higher rates. Out of the over 900 CDFI business loans issued under the first two rounds of the Phoenix Fund, 40% were made to women, 30% to ethnic minorities and 70% to businesses and start-ups in deprived areas (GHK, 2004);

- **Lending methodology:** Although only 4% of UK CDFIs have replaced traditional guarantees with group guarantees (which many international micro-finance institutions have), they do operate with a different lending methodology compared with banks. For example, 59% of the CDFIs in the CDFA 2008 survey did not require any form of loan security (CDFA, 2009);

- **Training and advice:** CDFIs offer a range of training and advisory services to help applicants reach a stage where they can take out a loan. According to the 2008 CDFA survey, 89% provide informal advice by phone or email, 87% provide informal advice during the underwriting process, 72% of CDFIs provide one-to-one mentoring and advice, 41% offer training courses and 22% offer peer mentoring (CDFA, 2009).

The first annual report on the sector *Inside Out – The State of Community Development Finance 2003* was published in May 2004 by the Community Development Finance Association (CDFA) which, itself, was only launched in 2002. No estimate was provided for the total number of UK CDFIs in existence although other sources suggested a current figure of around 80 institutions (GHK, 2004). The CDFA reported that over half of CDFIs were either yet to begin financing activities or had only begun so in the last 2 years. A third of CDFIs had been lending for more than 5 years. GHK’s survey of Phoenix Fund applicants identified approximately 10 institutions lending prior to the 1990s; almost two-thirds of respondent CDFIs (24) had started loan activity due to funding by Phoenix.

Today, most of the over 70 CDFIs currently operating in the UK were set up in the late 1990s with financial and technical support from the government and other organisations. Indeed, CDFA (2009) reports a continued trend of consolidation within the sector – no new lenders reported in the previous year and 65% of respondents have now been lending for more than 5 years. Nevertheless, whilst this consolidation is mirrored by multi- and pan-regional growth in coverage, CDFA (2009) continues to suggest lack of geographical coverage in all markets.

**CDFI Lending**

In 2008, investment and loan portfolio growth grew by 15% to £331m, continuing the growth of previous years. Capital assets grew by 2.8% in 2008 (CDFA, 2009). The sector largely focuses on providing business loans to aspiring and existing entrepreneurs unable to access finance from the mainstream banking sector (Table 1).
Table 1: The UK microfinance sector

<table>
<thead>
<tr>
<th></th>
<th>Personal loans</th>
<th>Housing loans</th>
<th>Enterprise loans</th>
<th>Social enterprise</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of loans</td>
<td>7,406</td>
<td>303</td>
<td>3,921</td>
<td>1,346</td>
<td>12,976</td>
</tr>
<tr>
<td>Total value OLP (£ m)</td>
<td>3.0</td>
<td>0.6</td>
<td>40.0</td>
<td>230.0</td>
<td>273.6</td>
</tr>
<tr>
<td>% CDFIs offering...*</td>
<td>14</td>
<td>3</td>
<td>69</td>
<td>17</td>
<td>...</td>
</tr>
</tbody>
</table>

Source: CDFA 2008 survey of UK CDFIs (CDFA, 2009)
Notes: * Based on CDFA 2007 survey as these figures not released for 2008 survey; OLP = Outstanding Loan Portfolio

Social enterprise lending is the largest activity by far, though it should be noted that around 80% of the total outstanding loan portfolio is accounted for by one lender. Enterprise lending is the second greatest activity as measured by outstanding loan portfolio and covers micro, small and medium enterprises. With an outstanding loan portfolio at £23.5 million spread over nearly 3,500 loans, lending to micro-enterprises constitutes the largest part of enterprise lending. Lending to small enterprises account for £8 million and medium enterprises account for £8.4 million.

From 2000 up until recently the sector was largely capitalised by the government through the Phoenix Fund and subsequent RDA support (see Section 2.2.1 above). In 2008, funds under management provided almost half of CDFI capital followed by RDA sources (17%) but which were almost matched by a significant increase from banks and building societies (14%) (CDFA, 2009). A further £50 million has come to the sector through the Community Investment Tax Relief (CITR) scheme (Goggin et al, Forthcoming).

**Expectations to and the performance of UK CDFIs**

Similar to the global microfinance movement, UK CDFIs operate according to a so-called double bottom line. On the one hand they are expected to contribute to the regeneration of deprived communities by creating self-employment and employment opportunities through lending to small and micro enterprises without access to loans through the mainstream financial sector. On the other hand, there is an expectation that they can and should be self-sustaining (see e.g. Forster et al, 2006) or that they should at least not rely on public subsidies, raising instead private philanthropic and yield-based investments.

Dayson (forthcoming) has developed a theoretical matrix for understanding the performance parameters for UK CDFIs. According to this matrix, CDFIs can be positioned according to the extent to which their business models and strategies focus on financial (horizontal axis) and social performance (vertical axis).
The main driver for Type A CDFIs is their social mission. They believe that their organisation cannot or should not be financially self-sufficient. This type of CDFI may operate in hard-to-serve markets where outreach is important or they may also be new CDFIs. CDFI Type B is the ideal type, financially self-sufficient but with a strong emphasis on social mission. With the exception of Charity Bank and Triodos, Dayson (forthcoming) holds that no CDFIs have reached this stage. Type C is the most problematic CDFI as they do not emphasis their social mission nor are they managed well financially. According to Dayson (forthcoming) most of the former soft loan funds could fall into this category. Few, if any, CDFIs pursue the Type D model in which the operations are mainly driven by sustainability. Social mission is only emphasised if it does not come at the expense of sustainability.

Research on the performance of CDFIs alongside these two axes has mainly focused on financial rather than social performance. By providing loans, technical assistance and advice to existing businesses and aspiring entrepreneurs, CDFIs are hypothesised to have a positive impact on several levels:

- **Household level:** provide the ability for individuals to successfully start a business, including a path into employment for previously unemployed people. This may lead to increased self-esteem and well-being, with potentially positive ripple effects for the rest of household;

- **Business level:** increased business sales and profitability, enhanced ability to capitalise on market opportunities and the implementation of more efficient production;

- **Community level:** including employment opportunities for local population, which in turn helps prevent population decline. This may be a direct effect as the client firm hires new employees or safe-guards existing jobs, or it may be an indirect effect in the form of spillover effects resulting from trading links between the
borrowing firm and local suppliers. Moreover, if the businesses are more stable as a result of support from a CDFI, then they are more likely to pay their bills to other businesses for goods and services.

The economic and social impact of CDFI loans

To date, there has been relatively little research conducted on the impact of CDFIs – over and above some inspiring individual loan case studies – on client households, businesses and the communities where these reside. In 2008, CDFA (2009) reported almost 7,000 businesses financed, 16,000 jobs created and over 70,000 safeguarded by the sector since 2003. Over the period over £350m of loans has been matched by the value of leveraged funds. It remains the case, however, that no full economic impact assessment of the sector has been undertaken to date.

In 2004, GHK (2004) conducted an evaluation of the Phoenix Challenge Fund, which provided revenue support, capital for on-lending and loan guarantees to business lending CDFIs. The evaluation found that the sector had a positive impact on all three levels of household, business and community. On an individual level, clients reported to have benefited through enhanced business management skills, increased individual income and personal empowerment. On a business level, business loan clients reported experiencing increased sales and profit as a result of the loan and the business support provided by the CDFIs. GHK (2004, p.38) estimated that “CDFI activity [supported by the Phoenix Fund] generated some 1,160 net direct and indirect full-time equivalent jobs.” These jobs were created at the cost of £4,800, deemed low relative to the cost of employment generation through regeneration and economic development programmes.

A recent analysis by the CDFA (2009) found that in a subset of 30 members receiving Phoenix Fund investment to the tune of £17.6m from 2000-2006, portfolios had grown to £30.7m – representing a leverage ratio of £2.06 against every £1 invested.

In their study of 45 client businesses of three UK CDFIs, Mosley and Steel (2004) estimate that each loan contributed to 0.67 exits from unemployment over a two-year period. However, given that the sample was very small and unlikely to yield statistically significant and robust evidence, it is questionable how much weight can be assigned to this evidence. A larger longitudinal research study of the impact of CDFIs on client households and businesses in the UK due to be published next year (Dayson et al, forthcoming), may shed some more light on the impact of microcredits on deprived communities and the businesses operating there.

The sector and sustainability

Most of the research and empirical work on CDFIs has focused on how (Dayson et al, 2008), whether, and if (Nissan and Thiel, 2008; Thiel, 2008) the sector should become sustainable. There are two key measures of sustainability:

- **Operational sustainability**: the ability of a microfinance institution to cover its costs with income from its core activities (i.e. fee and interest rate income from its loan portfolio);
• **Financial sustainability:** the ability of a microfinance institution to cover its costs if it had to raise 100% of its loan portfolio through recycling existing funds and through borrowing funds at the market rate (CGAP, 2003; CDFA, 2006).

There are a number of factors that make lending to financially excluded businesses difficult.

First, the actual size of the market and the potential demand for business loans are uncertain. Research suggests that CDFIs have often over-estimated the size of the market (NEF, 2004; Forster et al, 2006). In the case of Aspire – a pioneer business lending CDFI operating in Northern Ireland between 1999 and 2005 – after five years of operation the CDFI had only reached 23% of the expected 600 customers and less than 20% of the projected outstanding loan portfolio (Forster et al, 2006). Combined with lower than expected average loan amounts, this meant that the CDFI fell well short of its expectation of covering 96% of operating costs with interest rates and customer fees. At its peak, the CDFI reached an operational sustainability ratio of 32%. In its final year of operation it had a ratio of 14%. The researchers evaluating Aspire point to numerous factors accounting for the relatively low demand (Forster et al, 2006):

- The target market was much smaller than the CDFI expected. The self-employed only accounted for about 13% of the economically active population in their target area;
- There was a lack of referrals from partner organisations, so the CDFI had to conduct concerted marketing efforts;
- The products were inappropriate for established microenterprises, because they were too short term and the interest rates were too high, thereby discouraging a key potential target group;
- There was a lack of interest in taking out group loans. Expected to account for 70% of Aspire loans, very few group loans were ultimately made; and,
- The stepped lending process proved difficult. Repeat loans had poor repayment as repeat loans were often taken out to survive rather than grow.

Street UK, an ambitious business lending CDFI based on a model used by the large Polish microfinance institution (MFI) Fundusz Mikro, experienced similar problems. This was the most ambitious attempt in the UK to establish a commercially viable business lending CDFI based on international experience. Yet the number and value of loans fell short of the expectations (NEF, 2004). Between 2001 and 2004 it made 259 loans of a value of £600,000 and had 148 outstanding loans of a value of £304,000. This was considerably less than the projected 3,400 loans, 1,904 current clients and the outstanding loan portfolio of £3.7 million.

Numerous factors accounted for the large discrepancy between projected and actual performance (NEF, 2004):

- There was a lack of local embeddness and links with local partner organisations resulting in few referrals;
- The market was smaller than expected; and,
- There was a lack of investment readiness among microenterprises.
Second, loan amounts in CDFI enterprise lending, especially micro-enterprise lending, are relatively small. This is especially the case for micro-enterprise lending which is the single-biggest category of CDFI enterprise lending in the UK (CDFA, 2009). The average loan amount for Aspire was £2,350 (Forster et al, 2006) and just over £2,300 for Street UK (NEF, 2004). The average loan size for microenterprise lending in the UK was £9,889 in 2008 (CDFA, 2009), suggesting that Street UK and Aspire were operating in too small a field with their focus on loans below £5,000 (small and medium enterprise lending average loan size was considerably higher at £31,398 and £256,666 respectively; CDFA, 2009).

Yet the administration and underwriting costs per loan for small loans are similar to larger loans. This raises the cost per pound lent so many CDFIs subsidise the cost of small loans from the provision of larger loans. For the microenterprise lender Aspire it cost £1.4 to lend £1. In the case of Street UK it cost £2.80 to lend £1. Indeed, the cost per loan may often be higher as micro enterprises may require considerable technical assistance and support before they are ready to take on a loan (see, for example, Forster et al, 2006).

The above-described factors suggest that reaching self-sufficiency may be a greater challenge for CDFIs operating in a developed country setting with a relatively small and challenging market, than for MFIs in developing countries with a much larger market. It also suggests that the pathways to increased sustainability and viability differ from the global microfinance movement, whose conventional pathways are reaching scale, charging interest rates reflecting costs of delivery and keeping default rates low through sound and effective follow-up with delinquent borrowers. Specifically, research points to three pathways towards sustainability.

- **A mixed and balanced portfolio:** consisting of higher-ticket as well as smaller loans may prove important in producing a more resilient and sustainable CDFI sector. Research into the performance of CDFIs such as Aspire and Street UK has cast doubts on the viability of specialised CDFIs. The size of any CDFI target market is likely to be small given that financial exclusion is a fairly marginal phenomenon.

  Moreover, specialised CDFIs may prove more vulnerable to changes in the funding priorities of changing governments as well as structural changes affecting demand for certain products. By offering a range of products, the CDFIs may diversify and spread risks, possibly making them more resilient to changing circumstances. By balancing risk and profit in this way, there is a possibility for cross-subsidising of certain products, indefinitely or in periods (Dayson et al, 1999). This has particular implications for microenterprise loans which are characterised by slender or negative profit margins, owing to small loan amounts and resource-intensive properties.

  This appears to be supported by international research. In the case of the US sector, NCCA (2004 cf. Forster et al, 2006) found that the CDFIs with the largest business portfolios (US$1 million+) also had the largest overall portfolio (average of $59 million) suggesting multi-sectoral community finance institutions are best placed to achieve large-scale microlending;

- **Partner organisations:** as CDFIs often lack the infrastructure and financial capacity to service all their needs, partner organisations could potentially play an important role in increasing lending and reducing operating costs in numerous ways. Partnerships can increase the number of clients through marketing and
referrals. Referrals are an important source of potential customers, particularly for business lending. The then specialised business lender, Street UK growth was seriously hampered by the lack of referrals from banks and business organisations owing to lack of partnerships (NEF, 2004).

Marketing their products to potential clients is a vital activity for CDFIs in order to reach a large pool of customers. However, marketing campaigns, such as TV and newspaper adverts and canvassing target markets, can be very costly. Moreover, reaching a small audience, often distrustful of financial marketing, can be difficult. Housing associations, job centres and other organisations may offer the CDFIs channels to pools of potential clients.

Partnerships can also potentially lead to a reduction in costs by transferring certain costs to the partner organisation. For example, costs may be reduced by using Business Link to help potential clients do preparatory work, such as ensuring they have appropriate identification papers, a business plan and are able to complete a loan application form before visiting the CDFI;

- **Utilisation of employee time:** despite limited research in this field, the way in which CDFIs use their employees may be of considerable importance for the performance of the sector (Dayson, 2005; Dayson et al, 2008). Dayson et al (2008) find a strong correlation between the time lending staff spend on direct customer contact and loan officer productivity. Crucially, it is an important way to reduce costs and increase revenues without passing on the costs to the customer in the form of increased interest rates and other fees. In addition, such exercises may highlight important added-value in the form of services offered in addition to loans. Previous research reveals that CDFI employees spend considerable time on money and debt advice to unsuccessful loan applicants (Dayson, 2005).

In summary, following substantial support, the UK CDFI sector is experiencing organisational maturity and expansion of activity, partly though increased diversity of funding. Evidence of impact exists but lacks comprehensiveness and common pathways to sustainability remain under development.

**Microfinance and international experience**

The birth and growth of the UK CDFI sector is clearly a product of factors specific to the UK, such as the failure of the soft loan funds and sustained government support of enterprise based regeneration through the sector. Yet the business models, the lending methodologies and the expectations of the sector originate in part from the global microfinance movement.

**The global microfinance sector**

Today, in excess of 1,200 Microfinance Institutions (MFIs) serve an active client base of between 130 (Daley-Harris, 2006) and 190 million people (Peachey and Roe, 2006). Globally, the microfinance movement encompasses a broad range of institutions, including banks, credit unions and NGOs, and many are operating with mainstream lending methodologies, including physical security (especially in agriculture). The microfinance sector seeks to empower its clients to escape poverty by offering financing for working capital and productive assets. At the same time the sector largely aims to cover its operating and, to a lesser extent, capital costs with income from interest rates and customer fees.
There is a plethora of literature on the impact of microfinance in the developing world (e.g.; Coleman, 1999; Zaman, 2001; Mosley and Steel, 2004; Khandker, 2005). This literature suggests that access to microcredits increases income and educational spending (Mosley and Rock, 2004), lifts client households out of poverty (Khandker, 2005), empowers female borrowers (Zaman, 2001; Khandker, 2005) and reduces income variability (Zaman, 2001).

Nevertheless, the determination of the impact of microfinance is highly contentious and fraught with methodological complexities (see e.g. Von Pischke and Adams, 1980; Karlan and Goldberg, 2007; Meyer, 2008). The main problem has been selecting an appropriate control group to isolate the impact of microcredits. There is an emerging consensus in the academic literature that impact assessments should move toward experimental research design where the allocation of households to control and treatment group is random (see Karlan and Goldberg, 2007; Meyer, 2008), though this is often difficult to do in practice and is ethically problematic.

Generally, the studies which more closely resemble experiments suggest that the impact of microfinance is smaller or even on occasions negative (Giné and Karlan, 2007; Coleman, 1999) compared to those applying less rigorous methodologies (Khandker, 2005; Mosley and Steel, 2004). However, it is acknowledged that identifying the direct impact is problematic and needs to be placed into a context of local circumstances, a developing economy and the absence of a Welfare State.

A central premise of the global microfinance movement is the search for institutionally and financially viable models for delivering microcredits to low-income producers and entrepreneurs allowing them to grow and improve their economic activities. The soft loans funds in the UK (Goggin et al, Forthcoming) and subsidised credit programmes in the developing world (Adams, 1972) often had a short life-span and an inefficient and unproductive allocation of credit.

In an international context, institutional and financial viability has been nearly synonymous with financial sustainability. Conversely, as we discuss below, viability has to a greater degree been seen as the ability to produce returns for investors through sound portfolio management by the US CDFI sector and cost-effectiveness relative to public employment programmes by the Western European sector.

There is a clear expectation among funders and policy-makers that MFIs should be or should move towards operational or financial sustainability by embracing non-concessionary interest rates reflecting the costs of delivery and, at least to a greater degree, relying on loan capital raised from commercial loans or from deposits from clients (Adams, 1972; Adams and Von Pische, 1992). To guide the MFIs towards this goal, a plethora of manuals and technical guides on financial management and ratios has been published by the World Bank and other international development agencies over the last decade (e.g. CGAP, 1998; CGAP, 1999; CGAP, 2003; Helms and Grace, 2004).

Given that the global data we have on MFIs is incomplete and largely based on self-reporting, we cannot be certain of the degree to which MFIs have adopted this new paradigm. Nevertheless, available data from the Microfinance Information Exchange (2006a, 2006b, 2006c, 2007) suggest that the sustainability paradigm influences lending methodologies and business models of several hundred institutions serving millions of low-income households.
Out of the 101 Asian MFIs surveyed for the Microbanking Bulletin in 2005, who lent US$4 billion to 22.5 million households, half had already reach full financial sustainability, while another quarter had reached 80% financial sustainability (Microfinance Information Exchange, 2006a). The MFIs were able to reach or move towards full sustainability through reducing costs or through raising interest rates and fees to reflect cost of delivery (Microfinance Information Exchange, 2006a).

Similarly, there is evidence of a decreasing reliance among Latin American MFIs on granted loan capital, as commercial funding increased by 16% between 2003 and 2005, and deposits grew by 38% in 2005 (Microfinance Information Exchange, 2006b). The 150 Latin American MFIs surveyed by MIX display average operational and financial sustainability ratios in excess of 100% (Microfinance Information Exchange, 2006b).

The sustainability paradigm is also dominant in the Eastern and Central Asian microfinance sector, guiding both donor policy and MFI practice (Bateman, 2003; Microfinance Information Exchange, 2006c; Microfinance Information Exchange, 2007; Hartarska et al, 2006).

**The US CDFI sector**

The US CDFI movement was founded in the early 1970s and was primarily capitalised by religious institutions and, to a lesser extent, individuals (Pinsky, 2001). There are four types of CDFIs in the US (CDP Publication Committee, 2007):

- **Community Development Banks:** These are for-profit deposit-taking corporations with community representation on boards that target low and middle income communities;
- **Community Development Credit Unions (CDCUs):** CDCUs are mutual, not-for-profit, deposit-taking financial institutions;
- **Community Development Loan Funds:** These organisations serve microenterprises, small businesses, housing and community service organisations. They tend to be not-for-profit with community representation on their boards;
- **Community Development Venture Capital Funds:** Offer equity with debt targeting small and medium businesses in deprived areas.

Table 2 compares the outstanding loan portfolio – a key indicator of size of financial institutions – for the UK and the US CDFI sector.
The US CDFI sector, even when adjusted for the size of the economy, is considerably larger than that of its UK counterpart. This is to some extent accounted for by the inclusion of Community Development Banks, which do not exist in the UK, and Community Development Credit Unions, which are not considered as part of the community finance sector in the UK. Nevertheless, even discounting the contribution of Community Development Banks and CDCUs, the Community Development Loan Funds and Community Development Venture Capital Funds still account for £2 billion in outstanding loan portfolio compared to £273.6 million in the case of the UK.

A more interesting observation is that the composition of the loan portfolio is considerably different. While housing loans are a marginal activity for UK CDFIs, accounting for 1.1% of the total value of the outstanding loan portfolio, in the US housing loans constitute the single-largest activity for US CDFIs. Housing loans are an important driver of sustainability for two reasons. First, they are relatively large amounts. In 2006 the average housing loan for the US CDFI sector was US$55,000 (CDP Publication Committee, 2007). Second, they generally have very low default rates often below 1%.

The US CDFI sector “grew incrementally through the 1970s and 1980s, but expanded dramatically and aggressively in the 1990s” (Pinsky, 2001, p.30). In 1993, 300 CDFIs managed around US$2 billion, while in 2000 there were 500 CDFIs managing US$6 billion (Pinsky, 2001). Brown and Nissan (2007) point to three factors accounting for this growth.

First, there was a strengthening of the Community Reinvestment Act (CRA) in the early 1990s. 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. To illustrate the importance of these changes to the CRA regulation for the
CDFI sector, between 1977 and 2001 financial institutions under the CRA entered into more than 370 agreements with CDFIs of a value of US$1 trillion (Pinsky, 2001). Of these agreements, 98% were made after 1992 and only 2% were made between 1977 and 1991 (Pinsky, 2001).

Second, the US Federal Government established the CDFI fund at the Department of Treasury in 1994. Since its creation, the CDFI Fund has awarded US$864 million to CDFIs. Even controlling for the difference in the size of the US economy, this investment is considerably larger than the Phoenix Fund. The CDFI fund has attracted private-sector investments totalling US$16 billion through the New Markets Tax Credits.

A third and final factor to account for the growth of the CDFI sector through the 1990s is, according to Brown and Nissan (2007), the role played by the CDFI trade associations. In addition to developing and disseminating best practice, they have also been important in developing data collection and assessment tools, such as the CDFI Assessment and Rating System (CARS). CARS assesses the social impact and financial strength and performance of individual CDFIs. It produces a score for social impact (AAA, AA, A and B) and for financial strength and performance (1-5). AAA 1 is the highest score and B 5 is the lowest score. The purpose of CARS is to increase investment in CDFIs by decreasing transaction costs of investing or donating and by offering an assessment of financial risks and social impact. To date 46 CDFIs have been subject to CARS assessment. CARS is a proprietary fee-based system whereby the investors pay a subscription fee to receive financial and social performance data on one or several rated CDFIs. Around 20 investors are currently subscribing to CARS.

**The European microfinance sector**

In Europe, microfinance institutions are defined as institutions providing loans of up to €25,000 to micro enterprises. They are predominantly operated to contribute to enterprise development, as 55% of European Microfinance Network survey respondents had either job creation and entrepreneurship, or small and medium enterprises, and economic development as mission statements (Jayo et al, 2008).

Microfinance, specifically, is linked into two policy objectives of the EU:

- To improve access to finance for small and medium enterprises as part of the regional development agenda; and,
- Micro enterprise as a means to promote social cohesion.

The most notable initiative by the EU is Joint Action to Support Micro-finance Institutions in Europe (JASMINE), which is a pilot initiative developed by the European Commission, the European Investment Bank (EIB) and the European Investment Fund (EIF) to provide effective support for the promotion of microcredit in the EU.

In 2007, the expanded EU microfinance sector made over 42,000 loans to a value of €394 million (around £355 million) and had in excess of 120,000 clients (Jayo et al, 2008). The European microfinance sector is dominated by three large MFI s created before 1996. Combined ADIE (France), Finnvera (Finland) and Fundusz Mikro (Poland) accounted for 70% of the 27,000 loans disbursed in 2005 (European Commission, 2007a).
European microfinance is characterised by a dichotomy (Dayson et al, 2008). On the one hand, we have the Central and Eastern European microfinance model which on the whole follows the current microfinance orthodoxy in focusing on sustainability, profitability and scale (Bateman, 2003; Hartarska et al, 2006). On the other, we have the Western European model of state-subsidised support.

The Central and Eastern European microfinance sector has its origins after the fall of the Berlin Wall. Foster et al (2004 cf. Hartarska et al, 2006) estimate that the sector has in excess of 500,000 borrowers and US$1 billion in assets. Although it is a relatively young sector – none of the 108 MFIs submitting data to MIX in 2006 were older than 14 years and half had just started within the past 6 years (Microfinance Information Exchange, 2006) – the sector is growing rapidly in scale and appears to be moving towards full sustainability. The Eastern European and Central Asian microfinance sector has generally followed the current microfinance orthodoxy in focusing on sustainability, profitability and scale (Bateman, 2003; Hartarska et al, 2006).

This development orthodoxy has also been emphasised by international development organisations wanting to develop the sector with the possible implication that MFIs not emphasising the abovementioned indicators would find it more difficult to find development funding (Bateman, 2003). As a result, the non-bank MFI sector in Central and Eastern Europe as a whole is self-sustaining according to figures from the Microfinance Information Exchange (2006c, 2007).

In 2007, the Western European microfinance sector disbursed in excess of 26,000 loans, equivalent to €300 million (around £270 million). ADIE is by far the largest MFI, though it is important to point out that it is practically the only MFI in France, whereas the UK, Germany and most other European countries have numerous MFIs. ADIE is an interesting model which in many respects epitomizes the sector as a whole: focus on enterprise development, limited focus on sustainability and an overarching and explicit aim is for clients to move on to use mainstream banking services.

The European microfinance sector has experience double digit growth in lending since the EMN started surveying the sector in 2003 (Jayo et al, 2008). Jayo et al (2008) argue that this growth has been driven by a range of factors. In some countries, such as France and Finland, the growth of lending has largely been driven by increased coverage of large and existing MFIs. In other countries, such as Spain, the growth has been caused by commercial banks moving into the market. However, in most countries the growth has been driven by the entry of new institutions in the market. This apparent lack of consolidation in the European sector is evidenced elsewhere (see Evers and Lahn, 2007) and is symptomatic of the focus of the sector.

“The Western European microfinance [sector] has…a strong focus on social inclusion and pays less or almost no attention to its profitability” (Evers and Jung, 2007, p.10).

The European Commission (2007b) expert panel on microcredit note that non-bank MFIs in the EU 15 are to a large extent reliant on grant funding.

It is often taken for granted by national governments and the EU that there is not a potential for reaching full operational or financial sustainability for the sector (Guichandut and Underwood, 2007). Indeed, many of the practices, such as offering
extensive technical support in addition to lending and the notion of clients graduating to borrow from banks,\(^{92}\) may run counter to reaching sustainability. Moreover, the regulatory framework, especially caps on interest rates, may limit the possibility of closing the gap between delivery costs and customer fees. German law, for example, prohibits charging very high or usurious interest rates (Mark and Tilleßen, 2007). Thus, there has not been a considerable move towards sustainability (Evers and Jung, 2007; Guichandut and Underwood, 2007). Instead, there has been a general focus on the cost-effectiveness of microfinance compared to state-run welfare programmes.

That said the EU microcredit expert group argue for an increased focus on operational performance and that “non-bank [MFIs] should work on their operational performance with a view of becoming more sustainable” (European Commission, 2007b, p.4).

**Lessons for the UK CDFI sector**

We would argue that international and UK experience suggest that the future development of the UK CDFI sector should be guided by three overriding principles:

- **Support**: CDFIs are still relatively new organisations and there is no evidence to date to suggest that they have not performed better than the soft loan funds they replaced. However, they still need support if they are to become embedded in their communities and the financial landscape more generally. This is likely to involve a number of actions, including stronger partnership and continued financial investment;

- **Performance**: A focus on operational performance should be a defining characteristic of the sector in the future. Reducing the cost per loan issued through scale, outsourcing back-office services, increased staff productivity and better partnering will be important to ensure longevity of operations;

- **Transparency**: Transparency in terms of operational performance and economic and social impact is crucial to strengthen investor confidence. Above all it is important that this transparency is complete and not selective. An example of best practice in the UK is Fair Finance who publish their audited accounts on their website as well as a disclosing their lending by ward, ethnicity and gender.

More specifically we would suggest that the following factors could aid in creating a strong and transparent UK CDFI sector:

- **Product mixture**: In the absence of large markets in any one segment (microcredit, personal loans, etc), product diversification is a potentially important pathway to enhanced sustainability as evidenced by the US sector and its broader range of products and services. In particular, the US sector has a much heavier involvement in housing loans which has a positive impact on sustainability as well as in preserving and creating affordable and sustainable housing in low and moderate income communities. Therefore, we would argue that there is a case for more research into the feasibility of delivering higher-value loans, especially housing loans, on a greater scale than is the case today. There may, for example, be opportunities for the UK sector in terms of linking into the nascent Community Land Trust movement in the UK;

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\(^{92}\) Research on the UK CDFI sector by Dayson et al (2008) suggests that repeat clients are an important driver of sustainability.
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- **Funding models.** The growth of the US CDFI sector, in particular, has been underpinned by its funding or recapitalisation models. The sector has proven effective in obtaining philanthropic capital, maybe particularly from religious associations and individuals, and it has also benefited from long-term funding from the CDFI fund (since the mid-1990s albeit at varying levels) and from financial institutions through the CRA (since 1995). Initiatives in the UK continue to try to create similar reliable, long-term sources of funding and loan capital for the UK CDFI sector. There remains, however, a need to research and develop mechanisms for the provision of loan capital and development funding over the medium and long term to support the growth of the UK sector. This may include examining some of the models used in the US, including CRA and the CDFI fund, but is could also include a guarantee fund among other mechanisms. Even if CDFIs did not exist there would be a need for financial support for new businesses. At present the UK neither offers the extensive grant regimes found in parts of Europe nor provides sufficient finance for MFIs and CDFIs, as in France and the USA;

- **Push for standards even if unpopular.** A trade association must be willing to push for the standards necessary to strengthen the credibility of the sector even if that is unpopular among some of its members. When the US CDFI trade association, the Opportunity Finance Network (OFN), started its push for stronger focus on performance in the late 1980s, the organisation lost around one third of its members. Yet, OFN's members and the sector are probably larger and better performing because, at least in part, of OFN's stance and focus on performance. Internationally there has also been a strong push for higher standards. However, as with the banking sector (The Banking Code) it may be preferable to have an independent body to oversee minimum standards and complaints;

- **Relationship with business advisors and banks.** CDFIs can either market or rely on third-party introduction. Given that most of their potential clients have been declined by the banks it would beneficial to have a binding referral system. To work, the banks will rightly demand universal coverage of CDFIs and minimum standards in customer service. Business advisors need to be retrained to ensure they understand the benefit of working with a CDFI and performance assessed on the basis of referrals made that lead to loans being issued;

- **Charges.** CDFIs need to charge realistic interest rates to clients to improve their chances of sustainability. If funders want rates artificially suppressed than they must be expected to fund this gap.

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ANNEX 3: SURVEY METHODOLOGIES

This Annex to the report provides additional detail on the methodology of the CDFI business beneficiary survey and the control group survey.

CDFI business beneficiary survey

The purpose of the business beneficiary survey was to collect data on the effectiveness and impact of CDFI support. The survey involved the completion of two discrete research activities:

- The creation of a database of CDFI business beneficiaries (i.e. the population) from which the survey sample frame could be drawn; and,
- The completion of surveys with the sample of CDFI beneficiaries.

An overview of the activities undertaken as part of these two research activities is presented below.

Creating a database of CDFI business beneficiaries

At the outset of the study it was recognised that there was no database of CDFI business beneficiaries, and thus that this would need to be assembled by the research team, working with the CDFIs themselves. A total of 59 CDFIs had outstanding loans with businesses (it was decided to use outstanding loans since records for loans that had been repaid or unpaid were likely to of poor quality). Starting on 25 June 2009, these CDFIs were contacted first by letter and second by telephone and asked to provide encrypted databases of contact details for all of their business beneficiaries. In the event this exercise proved to be unexpectedly challenging and protracted, with many CDFIs either unwilling or unable to provide the information requested, in some cases due to concerns of data confidentiality. By early September 2009 it was necessary to stop contacting CDFIs in order to finalise the survey, by which point:

- 21 CDFIs had provided GHK with beneficiary contact information, consisting of 1,618 businesses;
- A further 11 CDFIs would not provide GHK with beneficiary contact information, but were willing to send the survey out on behalf of GHK to all of their clients. In total this amounted to a further 1,420 businesses;
- The remaining 27 CDFIs were either unwilling or unable to provide beneficiary contact details, and also would not provide information on the number of businesses with outstanding loans.

Due to the large number of CDFI non-respondents, it was not possible to calculate the total number of businesses with outstanding loans at the time of the survey (i.e. the population). Instead, the population was derived from the results of the 2008/09 Inside Out survey which, as set out in Section 4, indicated that CDFIs had a total of 6,505 outstanding loans. The sample frame consisted of the 3,038 contactable businesses, based on information provided by the CDFIs. Given the strong likelihood of a low response rate given the nature of the businesses in question and the possible impact of the recession on firm closures, it was decided to survey all of the businesses within the sample frame, in order to achieve a statistically robust sample. It is possible that
the sample frame used is not representative of the population as a whole, but without
detailed beneficiary information on either the population or the sample frame (CDFIs
could not supply any data on business characteristics), such a comparison is not
possible.

Surveying CDFI business beneficiaries

The survey of business beneficiaries started on 18 August 2009, and consisted of a
number of phases:

- The 1,618 businesses for which GHK had contact details were initially sent a
  postal survey (1,011 businesses) or, if an email address was available (607
  businesses), were sent a link to a website where an online version of the survey
could be completed;
- The remaining 1,420 businesses were contacted by CDFIs, and were either sent
  a postal survey or were sent an email containing a link to a website where an
  online version of the survey could be completed;
- The non-respondents for which GHK had an email address were all re-contacted
  via email and asked to complete the survey. Non-respondents for which GHK
  had a telephone number were re-contacted and if possible a telephone interview
  was completed; otherwise businesses were asked to complete the survey online
  or were re-sent a postal version of the survey.

The cut-off point for the business beneficiary survey was 3 November 2009, by which
point a total of 363 responses had been received, equal to an overall survey response
rate of 12 per cent. Regarding this figure, a number of points can be made:

- A total of 283 businesses were contacted directly by GHK, equal to a response
  rate of 18 per cent. A further 80 responses were received from businesses that
  were contacted by CDFIs, equal to a response rate of just 6 per cent. The
  relatively low response rate suggests – though this cannot be confirmed – that
  not all CDFIs sent surveys to all of their business beneficiaries, despite being
  asked to do so;
- The contact information provided by the CDFIs was generally of poor quality,
  with errors including incorrect contact information. Furthermore, businesses that
  were contacted by telephone reported that they had either never had a CDFI
  loan or had finished repaying it. The scale of this problem is not known given
  the fact that only a small proportion of businesses within the sample frame either
  responded or were contacted by telephone (thus providing an opportunity to
  check for contact details/ loan history);
- The effects of the recession on the sample frame are also unknown, but are
  likely to have been significant. CDFIs typically could not indicate which
  businesses had ceased trading (despite the fact that they had outstanding
  loans), generally because their records were not up-to-date. A number of the
  CDFIs consulted as part of the case studies, however, believed that a significant
  – though unquantified – proportion of their clients had closed.

Overall, therefore, the beneficiary survey was carried out with a total of 363 businesses
out of a population of 6,505. The results are thus representative of the population as a
whole at a 95 per cent level of confidence with a confidence interval of +/- 5 per cent.
Control group survey

As set out in Section 1.3, the purpose of the control group survey was to collect evidence as to the experiences of businesses that had had loan finance applications rejected by a mainstream bank, but which had not then accessed CDFI finance, in order to test the extent to which the economic impacts reported by CDFI beneficiaries were reflective of wider economic trends.

The sample frame for the control group survey was populated using businesses that had responded to the BIS Annual Small Business Survey and Business Barometer and had indicated that they had, at some point, had a loan finance application rejected by a mainstream bank. Out of an initial sample frame of 532 businesses, 93 were subsequently removed on the basis that, once contacted, they reported that:

- They had either been partially successful in their loan finance application (22 businesses); or,
- They had never actually applied for loan finance, despite their responses as part of the BIS surveys (71 businesses). In these cases it is possible that the interviewee could not recall their finance application.

Removing these ineligible businesses left a sample frame of 439 contacts. Between 26 November 2009 and 9 December 2009 each of these businesses was contacted by telephone and asked to complete the survey instrument, or was given the option of completing an online version of the survey. Up to five attempts were made to contact each business. In total:

- Some 103 surveys were completed, equal to 23 per cent of the revised sample frame;
- A further 61 contact telephone numbers were unusable (potentially including businesses that had closed), in 54 cases the relevant contact was unavailable, and 80 businesses refused to complete the survey. Of these businesses, it is likely that a proportion would not have been eligible for the control group (for the reasons outlined above), but this cannot be confirmed;
- The remaining 141 businesses were still being processed (e.g. had not received five attempts at contact, or an interview appointment was being set up) when the deadline for the control group survey (9 December 2009) was reached.

The population for the control group survey is those businesses that have been had a loan finance application rejected by a mainstream bank. As discussed in Section 2.1.3, quantifying the number of such businesses is impossible, though the number is likely to be very large. Assuming a very large population, the achieved sample for the control group of 103 firms is thus representative of the population as a whole at a 95 per cent level of confidence with a confidence interval of around +/- 10 per cent.
GHK Consulting has been commissioned by the Department for Business, Innovation and Skills (BIS) and the Office of the Third Sector (OTS) to carry out an evaluation of Community Development Finance Institutions (CDFIs). The government wishes to understand what further support it could provide for organisations like [the CDFI] based on the positive impact they have on local businesses and communities. As part of this assignment we are carrying out a survey of businesses that have received financial support (e.g. a loan) from [the CDFI], in order to measure the impacts of the service that CDFIs provide. [The CDFI] has indicated that your business has an outstanding loan with them, though they have not provided us with any further details.

We would be very grateful if you could spare 20-25 minutes of your time to answer a number of questions about [name of CDFI] and the loan that you received from them.

Your responses will be treated in the very strictest of confidence and will not be made available to any third party that would enable the identification of any individual respondent. The information that you provide will only be used for this evaluation.

SECTION 1: BUSINESS BACKGROUND

What is the name of the business? WRITE IN:

............................................................

And what is the postcode of the business? WRITE IN:

............................................................

What is the legal status of the business? Is it a... (TICK ONE):

- Sole trader □
- Private company limited by guarantee □
- Private company limited by shares □
- Public Limited Company □
- Partnership □
- Limited Liability Partnership □
- Community Interest Company (CIC) (Limited by guarantee or shares) □
- Industrial and Provident Society (cooperative or community benefit) □
- Trust □
- Unincorporated Association □
- Another legal status (WRITE IN) □

............................................................

Refused/ Don’t know □
Does your business have charitable status? TICK ONE:

Yes ☐
No ☐
Refused/ Don’t know ☐

Do you think of your business as a social enterprise, by which I mean a business that primarily has social or environmental objectives? TICK ONE:

Yes ☐
No ☐
Refused/ Don’t know ☐

What year did the business start trading in? WRITE IN:

...................................................

Refused/ Don’t know ☐

What is the main activity or main service provided by the business? WRITE IN:

..................................................

Refused/ Don’t know ☐

Which of the following statements best describes your growth ambitions for the business in the next 2 to 3 years? TICK ONE:

You are focused on ensuring the survival of the business ☐
You do not wish to grow the business beyond its current size ☐
You wish to grow the business a little ☐
You wish to grow the business substantially ☐
Refused/ Don’t know ☐

ACCESSING FINANCE FROM [THE CDFI]

How did you first become aware of [the CDFI]? TICK ONE:

Referred by a bank or a building society ☐
Referred by a government business support organisation ☐
Referred by a private sector organisation ☐
Referred by a third/ voluntary sector organisation ☐
Referred by friends or family ☐
Saw publicity material produced by [the CDFI] ☐
Internet search ☐
Other (WRITE IN):

...................................................
Refused/ Don’t know □

Please provide the following information about the loan that your business received from [the CDFI]? WRITE IN:

Value of loan or investment £..................................................

Loan or investment start date: .......... (month) ........... (year)

Original duration of loan (in months):.................................................

Refused/ Don’t know □

Which of the following FINANCIAL products did you obtain from [the CDFI]? TICK ALL THAT APPLY:

A single loan □

Multiple loans (WRITE IN HOW MANY): □

........................................................

Another form of investment (e.g. an equity stake) (WRITE IN): □

........................................................

Refused/ Don’t know □

What will you do or what have you done with the loan from [the CDFI]? TICK ONE:

Used for business start-up □

Used for business growth □

Used to prevent business contraction □

Used to prevent business closure □

Other WRITE IN: □

........................................................

Refused/ Don’t know □

Before you obtained this loan or other investment from [the CDFI], did you try to obtain a loan or another type of investment from another source? TICK ONE:

No (GO TO 2.6) □

Yes (GO TO 2.7) □

Refused/ Don’t know (GO TO 2.9) □
If you did not try to obtain a loan or another type of investment from another source, was this because you... (TICK ALL THAT APPLY):

- Were unaware of any alternative investors
- Thought alternative investors had less attractive terms and conditions
- Did not think you would be able to obtain a loan or investment from another source due to a lack of business experience or track record
- Did not think other investors would give you a loan or investment because you lacked collateral
- Did not think other investors would give you a loan or investment of the size you needed
- Already had a relationship with the CDFI
- Another reason (WRITE IN):

NOW GO TO 2.9

If you tried to obtain a loan or another type of investment before you obtained your loan from the CDFI, which of the following sources did you approach? TICK ALL THAT APPLY:

<table>
<thead>
<tr>
<th>Source</th>
<th>Did not try</th>
<th>Tried successfully</th>
<th>Tried unsuccessfully</th>
</tr>
</thead>
<tbody>
<tr>
<td>A loan from your bank or building society</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A loan from another bank or building society</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A loan from another CDFI</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Venture capital funding</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A business angel</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Friends and family</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A government grant or loan</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>An overdraft facility</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Other (WRITE IN):</td>
<td></td>
<td>□</td>
<td>□</td>
</tr>
</tbody>
</table>

NOW GO TO 2.9

**Note:** If you tried to obtain a loan or another type of investment before you obtained your loan from the CDFI, which of the following sources did you approach? TICK ALL THAT APPLY:

- A loan from your bank or building society
- A loan from another bank or building society
- A loan from another CDFI
- Venture capital funding
- A business angel
- Friends and family
- A government grant or loan
- An overdraft facility
- Other (WRITE IN):

**Refused/ Don’t know** □
If you were unsuccessful in obtaining a loan or another type of investment from any of these sources, was it because... (TICK ALL THAT APPLY):

- The amount of finance you were seeking was too small or too large
- You lacked business experience or a track record
- You lacked collateral
- You had experienced loan repayment problems in the past
- You were told that your business proposition was not viable
- Another reason (WRITE IN):
  ................................................................................................................

- No reason was given by the investor or lender
- Refused/ Don’t know

In addition to the loan or other investment from [the CDFI], did you receive a loan from another investor at the same time? TICK ONE:

- Yes (GO TO 2.10)
- No (GO TO 2.11)
- Refused/ Don’t know (GO TO 2.11)

What was the value of this other loan? WRITE IN:

£...................................................

- Refused/ Don’t know

Did you receive any other help from [the CDFI]? TICK ALL THAT APPLY:

- Advice regarding obtaining finance from a bank or building society
- General financial advice
- Business planning advice
- Mentoring (i.e. in-depth one-to-one support)
- Signposting towards other providers of business advice and support
- Training or access to training materials
- Other (WRITE IN):
  ................................................................................................................

- Refused/ Don’t know

Since you received the loan or other investment from [the CDFI], have you sought to obtain a further loan or another type of investment? TICK ONE:

- Yes another loan (GO TO 2.13)
- Not yet, but you are planning to in the next 2 to 3 years (GO TO 3)
- You have no immediate plans to apply for a loan (GO TO 3)
Refused/ Don’t know (GO TO 3) □

If you have sought to obtain a further loan or another type of investment, which of following sources of finance did you use? TICK ALL THAT APPLY:

<table>
<thead>
<tr>
<th>Not tried</th>
<th>Tried successfully</th>
<th>Tried unsuccessfully</th>
</tr>
</thead>
<tbody>
<tr>
<td>Another loan from [the CDFI]</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A loan from another CDFI</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A loan from your bank or building society</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A loan from another bank or building society</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Venture capital funding</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A business angel</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Friends and family</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>A government grant or loan</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>An overdraft facility</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Other WRITE IN:</td>
<td>□</td>
<td>□</td>
</tr>
</tbody>
</table>

Refused/ Don’t know □

If you have successfully obtained a further loan or other investment since your initial loan or other investment from [the CDFI], was this because... (TICK ALL THAT APPLY):

- The loan from [the CDFI] provided you with a track record of borrowing and repayment □
- [The CDFI] improved your understanding of obtaining finance □
- You gained experience of business and financial management from running your business □
- Another reason (PLEASE PROVIDE DETAILS):
  ........................................................................................................
  Refused/ Don’t know □

THE IMPACTS ON YOUR BUSINESS

Including yourself, how many people are employed at your business? (WRITE IN):

When you first applied for the loan:........full-time..........part-time
Now:........full-time..........part-time
Refused/ Don’t know □
If you had not received the loan from [the CDFI], how many people do you think would be employed at your business now? WRITE IN:

.........full-time........part-time

The business would have closed □
The business would not have started □
Refused/ Don’t know □

Are you willing and able to provide actual data on your business’s annual turnover or would you rather make use of more general turnover bands? TICK ONE:

Happy to provide actual turnover data (GO TO 3.4) □
Would prefer to use general turnover bands (GO TO 3.6) □
Refuse to provide information or don’t know turnover (GO TO 3.9) □

Please indicate your annual turnover... (WRITE IN):

When you first applied for the loan £..........................
Now £..........................

If you had not received the loan from [the CDFI], what do think your current annual turnover would be? WRITE IN:

£..........................

The business would have closed □
The business would not have started □
Refused/ Don’t know □

NOW GO TO 3.9

If you would rather not provide your exact turnover, please indicate which of the following bands your annual turnover falls within... (TICK ONE):

When you first applied for the loan Now

£0-£50,000 □ □
£50,000-£100,000 □ □
£100,000-£250,000 □ □
£250,000-£500,000 □ □
£500,000-£1 million □ □
£1 million-£5 million □ □
£5 million-£10 million □ □
Over £10 million □ □
Please could you estimate by how much your annual turnover has changed between when you first applied for the loan and the present day... (WRITE IN):

- Increased by ..........%
- Decreased by ..........%
- Stayed exactly the same □
- Refused/ Don’t know □

If you had not received the loan from [the CDFI], how do you think that your annual turnover would have changed by now? WRITE IN:

- Increased by ..........%
- Decreased by ..........%
- Stayed exactly the same □
- The business would have closed □
- The business would not have started □
- Refused/ Don’t know □

What proportion of your turnover is spent on employee salaries? WRITE IN:

- When you first applied for the loan.................................%
- Now.................................%
- Refused/ Don’t know □

Looking forward to three years time, in all likelihood how do you think that your business’s employment and annual turnover will change? TICK ONE:

<table>
<thead>
<tr>
<th>Increase</th>
<th>Decrease</th>
<th>Stay the same</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment □</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Annual turnover □</td>
<td>□</td>
<td>□</td>
</tr>
</tbody>
</table>
- Refused/ Don’t know □

Please estimate the proportion of your DIRECT COMPETITORS who are located within the following ranges (ANSWERS SHOULD ADD UP TO 100%):

- Less than 2 miles from where you are located............................................%
- Between 2 and 10 miles from where you are located............................................%
- Between 10 and 50 miles from where you are located............................................%
- More than 50 miles from where you are located............................................%
- Refused/ Don’t know □
Please estimate the proportion of your CUSTOMERS who are located within the following ranges (ANSWERS SHOULD ADD UP TO 100%):

<table>
<thead>
<tr>
<th>Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 miles from you</td>
<td></td>
</tr>
<tr>
<td>Between 2 and 10 miles from you</td>
<td></td>
</tr>
<tr>
<td>Between 10 and 50 miles from you</td>
<td></td>
</tr>
<tr>
<td>More than 50 miles from you</td>
<td></td>
</tr>
<tr>
<td>Refused/ Don’t know</td>
<td></td>
</tr>
</tbody>
</table>

Please estimate the proportion of your SUPPLIERS who are located within the following ranges (ANSWERS SHOULD ADD UP TO 100%):

<table>
<thead>
<tr>
<th>Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 miles from you</td>
<td></td>
</tr>
<tr>
<td>Between 2 and 10 miles from you</td>
<td></td>
</tr>
<tr>
<td>Between 10 and 50 miles from you</td>
<td></td>
</tr>
<tr>
<td>More than 50 miles from you</td>
<td></td>
</tr>
<tr>
<td>Refused/ Don’t know</td>
<td></td>
</tr>
</tbody>
</table>

Please estimate the proportion of your current EMPLOYEES who live within the following ranges (ANSWERS SHOULD ADD UP TO 100%):

<table>
<thead>
<tr>
<th>Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 miles from you</td>
<td></td>
</tr>
<tr>
<td>Between 2 and 10 miles from you</td>
<td></td>
</tr>
<tr>
<td>Between 10 and 50 miles from you</td>
<td></td>
</tr>
<tr>
<td>More than 50 miles from you</td>
<td></td>
</tr>
<tr>
<td>Refused/ Don’t know</td>
<td></td>
</tr>
</tbody>
</table>

Of your current employees (including yourself), please estimate the proportion (if any) who fall into the following groups (WRITE IN):

<table>
<thead>
<tr>
<th>Group</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Female</td>
<td></td>
</tr>
<tr>
<td>From a Black and Minority Ethnic (BME) community</td>
<td></td>
</tr>
<tr>
<td>Unemployed prior to their appointment</td>
<td></td>
</tr>
<tr>
<td>Ex offenders</td>
<td></td>
</tr>
<tr>
<td>Individuals with a disability</td>
<td></td>
</tr>
<tr>
<td>Individuals without formal qualifications</td>
<td></td>
</tr>
<tr>
<td>Refused/ Don’t know</td>
<td></td>
</tr>
</tbody>
</table>
On a scale of 1 to 4 (where 1 means “not at all” and 4 means “significantly”), how much of an impact has your business’s involvement with [the CDFI] had on you personally or, as far as you are aware, any other employees of your business, in terms of... (TICK ONE PER STATEMENT):

<table>
<thead>
<tr>
<th>Not at all</th>
<th>Significantly</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

- An improvement in your or their financial literacy? ☐ ☐ ☐ ☐
- An improvement in your or their self esteem and confidence? ☐ ☐ ☐ ☐
- An improvement in your or their sense of control over your or their life? ☐ ☐ ☐ ☐
- An improvement in your or their health and mental well-being? ☐ ☐ ☐ ☐
- An increase in your or their ability to act as a positive role model in your or their community? ☐ ☐ ☐ ☐
- An increase in the likelihood that you or they will undertake formal training leading to a qualification? ☐ ☐ ☐ ☐

Refused/ Don’t know ☐

Does your business do any of the following? (TICK ONE):

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>☐ ☐</td>
<td>☐ ☐</td>
</tr>
</tbody>
</table>

- Provide a community service? PLEASE DESCRIBE: ☐ ☐
- Improve the local environment? PLEASE DESCRIBE: ☐ ☐

Refused/ Don’t know ☐

In a sentence or two, please describe what the support and investment from [the CDFI] has done for you and/or your business (WRITE IN):

.................................

Thank you for your time
ANNEX 5: CDFI CASE STUDIES

Aston Reinvestment Trust

Origins and development to the present

The origins of Aston Reinvestment Trust (ART) lie with the Aston Commission that was established in the late 1980s to investigate the problems facing Aston ward in inner city Birmingham. The Commission reported that local residents were struggling to access bank finance, and that this was acting as a barrier to entrepreneurship and business growth. Research carried out by the Commission recommended the creation of a community based finance institution that would raise money from public and private sources for on-lending to local businesses in order to meet this need. Following a design and development phase, ART was established using a £40,000 donation from the Barrow Cadbury Fund, and was officially launched in 1997. In its first year of operation, ART then raised £330,000 from social investors, and £170,000 from various local area-based regeneration initiatives. Revenue funding to support operational costs was obtained from banks.

ART steadily grew in size from 1997 onwards, in 1999 securing EU funding for a Key Loan Fund to support lending to social enterprises. In 2000, recognising the limits to growth from focussing on a small number of inner city wards, the CDFI expanded its coverage to include all of Birmingham and North Solihull (subsequently extended to all of Solihull). Also in 2000, ART diversified into personal lending with the establishment of ART Homes, a loan fund that lent to homeowners who were unable to finance repairs for their properties (ART Homes was subsequently sold to Mercian Housing in 2005). By 2001 ART had grown sufficiently to be able to borrow finance from commercial lenders at market rates. Phoenix Fund capital funding was secured in 2003, and when it expired in 2006, the RDA for the region – Advantage West Midlands – stepped in with a £4 million, three year Advantage Small Loans Programme which provided ART (alongside other regional CDFIs) with both capital and revenue funding. At the time of writing, the Programme was in the process of being renewed.

Rationale and target market

The rationale for ART remains much the same as it was when the CDFI was founded in 1997, namely:

‘To provide loans for viable small businesses and social enterprises throughout the Birmingham and Solihull areas when the banks are unable to help or have done all they can’.

ART also has a set of specific goals which guide its approach to lending:

- To support local jobs for local people;
- To provide much needed services in local communities;
- To provide equal opportunity for access to finance for enterprise;
- To encourage the take-up of loan finance in the third sector; and,
- To promote a culture of social investment.
The target markets for ART are micro businesses, SMEs and social enterprises (excluding retail businesses). Businesses must be based in Birmingham and Solihull, making ART one of the more geographically focussed CDFIs (certainly given its size). As the mission statement for the CDFI indicates, ART will only support businesses that have not been able to secure any or all of the funding that they need from a mainstream bank. Where businesses are judged to be clearly unbankable, applicants do not need to prove that they have had a finance application rejected by a bank. In other cases, applicants must indicate each of the sources of finance that they attempted to use; members of the ART team will then contact the relevant individual for confirmation. Through its lending criteria, ART also seeks to operationalise its social goals, specifically targeting businesses with a social mission (e.g. employing local people or providing a local community service).

**Financial products provided**

With the sale of ART Homes in 2005, ART now only provides business loans. Loans range in size from £10,000 to £50,000 (regardless of whether applicants are commercial firms or social enterprises) with repayment terms of between 6 months and 10 years, depending on the purpose of the loan. Security is not required but can be taken (typically where businesses are seeking loans over £25,000); on the most part personal guarantees are used but ART also has loans secured by charge over property and debentures.

Table 1 shows how the volume and value of outstanding lending by ART changed between 2006/07 and 2008/09, and for 2008/09 how this compares with the average for the CDFI sector as a whole. Between 2006/07 and 2008/09 the volume of lending by ART remained relatively constant, and was above the CDFI average. The value of lending increased, as did the average size of loan (though both were still below the CDF average in 2008/09). When ART first started, the minimum loan size was around £2,000, but in 2006 a decision was made to impose a lower limit of £10,000 since below this, it was felt, the financial returns were insufficient to cover costs (and thus impacted on the CDFI’s strategy to be sustainable – see below).

**Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>Aston Reinvestment Trust</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of outstanding loans</td>
<td>123</td>
<td>122</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£1,899,571</td>
<td>£2,063,340</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£15,444</td>
<td>£16,913</td>
</tr>
</tbody>
</table>

**Source:** Inside Out

The interest rate charged on business loans ranges from between 6 per cent to 12 per cent above the Bank of England base rate, with the exact value determined on a case-by-case basis (factoring in risk and whether the applicant is a repeat customer). In 2008/09, the average interest rate charged to commercial businesses was 11.5 per cent, ranging from 10 per cent to 20 per cent. For social enterprises the average rate charged was 8.5 per cent, ranging from 5 per cent to 20 per cent. ART also charges an upfront application fee of 2 per cent (offset against the arrangement fee and
refundable if the loan is not made), and an arrangement fee of between 3 and 5 per cent of the value of the loan. Furthermore, since ART is a mutual society owned by its members, borrowers must first become shareholders (the minimum subscription is £250), which is then redeemable upon full repayment of the loan.

Loan application and appraisal procedure

Loan applicants are required to submit an application form, potentially with an accompanying business plan. Applications are initially considered by a member of the loan team, a process that includes an assessment of the applicant’s background (e.g. the presence of CCJs), the viability of the business proposition, and the eligibility of the business (matched, for example, against funders’ requirements). Applicants are then interviewed, and a more detailed appraisal takes place of the applicant and their proposal. ART does not use a loan panel to make a decision regarding loans. Once the loan team has made a recommendation, for loans below a certain level (currently £20,000) a decision as to whether to proceed is by a sanctioner within the ART team; otherwise the decision is made by a member of the Board.

Non-financial services provided

From the outset, ART’s operational model was based on the principle that business support would not be provided, since the cost incurred would make the CDFI unsustainable. Instead, pre- and post-loan business support would be provided by a range of external organisations, including Business Link and other public and private business support providers, and ART would focus on the mechanics of processing and delivering loans. Over time, consultees from ART noted, it became clear that this model was not entirely successful, principally since businesses either would not use the support provided, or where they did, the quality was often inadequate.

In response to this problem, in 2004 a pilot business support arm to ART was created – ART Development Services Ltd – using Phoenix Fund resources. This company provided post start-up support to loan applicants. Consultees from ART, however, reported that this was not a success, primarily due to a lack of integration with the pre start-up support service provided by Business Link. By 2006 ART Development Services had stopped providing support, and instead ART developed a CD-ROM that provides information and advice on business start-up, growth and management, including, for instance, templates for a business plan and cash flow forecasts.

Demand for finance

Consultees from ART suggested that, before the onset of the credit crunch, demand for loans had stabilised, after increasing steadily from the establishment of the CDFI. Bank behaviour was identified as a key driver of demand, and since the credit crunch started the withdrawal of capital had led to a sharp increase in interest, particularly from businesses that would previously have been bankable. Demand for loans from social enterprises, it was noted, had not reached the levels anticipated by the CDFI. In 2008/09, social enterprises constituted 14 per cent of the volume and 15 per cent of the value of outstanding lending. Consultees from ART attributed this to a continuing expectation amongst social enterprises that grant funding can be obtained instead of loan finance, together with an inherent caution within the sector as regards investment and expansion (particularly in the current economic climate).
Table 2 shows how the number of loan applications received and the number of loans made (in the previous 12 months) by ART changed between 2006/07 and 2008/09, and how this compares to the average for the CDFI sector as a whole in 2008/09. The number of applications received in 2008/09 almost doubled from the number received in the previous year, and consultees from ART noted the impact that the credit crunch has had on demand. In 2008/09 the conversion rate for ART was on a par with the CDFI sector as a whole.

Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Aston Reinvestment Trust</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Loan applications received</td>
<td>80</td>
<td>69</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>37</td>
<td>51</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>46%</td>
<td>74%</td>
</tr>
</tbody>
</table>

Source: Inside Out

The operational model outlined above – with business support provided on the most part by external organisations – was also intended to apply to ART’s system of generating referrals. It was originally intended that banks and business support providers would refer viable but unbankable firms to ART, thus reducing the costs of marketing. Consultees from ART report that this model has, by and large, not been as successful as was hoped, with business support providers often referring unsuitable loan candidates. Business Link, it was suggested, tended to focus on providing generic support and generally was not able to ensure that businesses were investment ready. Banks were also reported to have been poor at referring businesses to ART, though since the onset of the credit crunch it was noted that the number of bank referrals had increased.

Alongside the operation of a referral network, ART also undertakes marketing activity to generate demand for loans. Activities include hosting business events, advertising in local newspapers and magazines, radio adverts, and the distribution of promotional material (particularly during the credit crunch). ART also seek to utilise the networking activity of senior staff, for example through the Chief Executive’s role within the Birmingham and Solihull Social Economy Consortium – a network serving the needs of social enterprises.

Organisational structure and capacity

ART (Aston Reinvestment Trust) is the trading name of a group consisting of two separate companies: ART SHARE (Social Help Association for Reinvesting in Enterprise) Ltd and Aston Reinvestment Guarantee Company Ltd. ART SHARE is an I&PS and the parent for the Guarantee Company (a company limited by guarantee). As an I&PS, ART SHARE can raise capital through withdrawable share issues. The Guarantee Company covers the costs incurred as a result of bad debt within the lending portfolio, and also acts as a cash reserve against which to lever in investment (e.g. by banks). Investors may also choose to waive dividends earned on shares in the
ART SHARE I&PS in favour of the Guarantee Company, thus providing a further source of income (in the event that a dividend was paid).

ART operates from a headquarters in Birmingham, located within Aston (the historical target area for the CDFI). As Table 3 shows, ART has employed 4.9 FTE staff for the past three years, making the CDFI slightly smaller than the sector average. ART employed 2 FTE loan officers, the same number as the average for the CDFI sector as a whole.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Aston Reinvestment Trust</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>4.9</td>
<td>4.9</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>2.0</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: Inside Out

Lending capital income

Since its launch in 1997, ART has steadily accumulated capital for on-lending from a wide range of sources, both to expand the scope of its activities and to replace capital lost through bad debt. Since the Phoenix Fund finished in 2006, ART has obtained capital from a number of sources:

- **Capital grants**: In comparison to many other CDFIs, ART has not historically been reliant on capital grants in order to build up funds for on-lending. Since the end of the Phoenix Fund in 2006, ART has accessed capital from AWM as part of the RDA’s Advantage Small Loans Programme, though this programme finished in 2009 and, at the time of writing, is still in the process of being renewed. It is believed that the new programme will include a financial contribution from Birmingham City Council alongside AWM Single Programme/ERDF resources;

- **Share issues**: As an I&PS, ART can receive investment of between £250 and £20,000 in the form of withdrawable share capital, though the amount of finance secured through this route has been relatively modest in recent years;

- **Capital loans**: Outside of CITR, ART has successfully secured loans for on-lending from a range of organisations (including Charity Bank);

- **CITR**: ART was accredited under CITR in 2003, and has sought to secure investment through this mechanism, though reports that the amount of finance secured to date has been less than was anticipated. The most significant CITR investment generated by ART was a loan from the Unity Trust Bank.

As at 2008/09, ART’s loan fund was worth £3.1 million, of which outstanding loans accounted for £2.2 million. As noted above, ART has a policy of maintaining a guarantee cash reserve (mainly to cover loan losses), though with a deployment rate of 78 per cent in 2008/09, the CDFI had a higher proportion of its capital committed through lending than the sector average.
Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Aston Reinvestment Trust</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£3,247,569</td>
<td>£2,892,790</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£1,899,571</td>
<td>£2,063,340</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>59%</td>
<td>72%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Bad debt

Keeping bad debt to a minimum is a priority for ART in order to ensure that capital funds are not depleted, and since interest earned on loans is one of the main sources of revenue income for the CDFI. As Table 5 shows, levels of bad debt were relatively constant between 2006/07 and 2007/09, but increased sharply to reach the equivalent of 27 per cent of the CDFI’s outstanding lending portfolio in 2008/09 (compared to 7 per cent for the sector as a whole).

Consultees from ART noted that the market within which the CDFI operates is particularly high risk, with a large proportion of lending going into very small businesses, often start-ups, based in deprived areas. Various measures have been implemented to minimise this risk – including the use of business support – but consultees from ART have argued that there will always be a higher rate of defaults within their target market. The recession has had a particularly severe impact on loan repayment and rates of bad debt, despite the use of repayment holidays in some cases.

Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Aston Reinvestment Trust</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>16%</td>
<td>3%</td>
</tr>
<tr>
<td>Written-off</td>
<td>13%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since many CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
Revenue income

Revenue income is needed in order to cover ART’s operational costs. Historically, ART has accessed revenue support from external organisations (for instance through the Phoenix Fund), but relative to the majority of the CDFI sector, ART has sought to cover costs through earned income. Revenue income is generated through a range of sources:

- **Revenue grants**: In recent years, ART has successfully obtained revenue grants from a range of sources, including Barclays Bank and AWM, though the amount of finance secured in this way has been relatively small;

- **Portfolio income**: Income earned on the lending portfolio – through interest repayments and arrangement fees charged – has traditionally been ART’s principal way in which to cover operational costs;

- **Invested capital**: Though ART holds some cash reserves, income from interest generated on these investments has not traditionally been a significant source of revenue income, particularly with the Bank of England base rate at its current level.
Cooperative and Community Finance

Origins and development to the present

Industrial Common Ownership Finance (ICOF, as Co-operative and Community Finance was known at the time) was started in 1973 by a small group individuals seeking to create a fund that would lend to co-operative ventures. Co-operatives, it was argued, often struggled to obtain finance from mainstream banks due to their distinctive company structures and goals, which banks did not fully understand, or perceived to be too high risk.

ICOF grew steadily through the 1970s and 1980s, most notably with the injection of £250,000 of capital funding from central government in 1976 following the Industrial Common Ownership Act, and through the 1980s as a result of local authorities entrusting ICOF with the administration of their own co-operative loan funds. In 1987, ICOF plc was created as a subsidiary of ICOF Ltd with the goal of generating additional capital by means of a public share issue. Some £550,000 was raised, with shares redeemable after 10 years (the share issue was repeated in 1997 when the fund was boosted to £1.1 million, and again in 2007 when the fund increased in size to £1.3 million).

Following a strategic review, in the early 1990s ICOF took the decision to diversify into new markets, specifically in response to growing interest in the social enterprise sector which, again, was perceived to be underserved by mainstream banks. Existing capital was largely tied to the worker co-operatives sector, and so in 1994 a new fund was created through the establishment of an I&PS – ICOF Community Capital (ICC) – to serve organisations engaging in economic activity to fulfil primarily social, mutual or community objectives. Initially, £450,000 was raised through the issue of withdrawable membership shares.

A consultee from Co-operative and Community Finance indicated that they had applied for finance under the Phoenix Fund, but were rejected on the grounds that the organisation did not need additional capital or revenue funding. As a result, the CDFI continued to grow using existing investment mechanisms, and also began to investigate other sources of funding, including the RDAs. ICOF was renamed Co-operative and Community Finance in 2005, which is now the trading name for the CDFI.

Rationale and target market

The rationale for Co-operative and Community Finance remains broadly the same as it was when ICOF started lending in 1973. The ‘mission’ of the CDFI is to:

‘Encourage local economic regeneration by enabling people to create, own and democratically control the businesses in which they work, or which operate in their local community’.

In terms of target markets, this mission encompasses co-operatives, employee-owned businesses, and social enterprises. The principle eligibility criteria for loan applicants are thus company structure and values/ objectives. Start-ups and existing businesses are eligible for funding, except where funds have a specific geographic focus (e.g. legacy funds from local authorities), Co-operative and Community Finance delivers loans nationwide. It is not a requirement that applicants must have had a finance
application rejected by a mainstream bank; instead, the CDFI sees itself as serving a particular market niche that has historically been underserved by mainstream financial providers.

Financial products provided

The only financial product offered by Co-operative and Community Finance is a business loan. The minimum loan size is £5,000 (the interest generated through smaller loans is thought to be insufficient to support the costs of lending), and the maximum value extends as far as £300,000, though this depends on the loan fund from which finance is drawn. Co-investment is common, and Co-operative and Community Finance will often provide matching loan finance alongside other CDFIs (principally Triodos, Big Issue Invest, and The Social Enterprise Loan Fund). Primarily through its lending to village shops, Co-operative and Community Finance also matches grant funding provided by the likes of the Esmée Fairbairn Foundation (managed by the Plunkett Foundation).

Table 1 shows how the volume and value of outstanding lending by Co-operative and Community Finance changed between 2006/07 and 2008/09, and for 2008/09 how this compares with the average for the CDFI sector as a whole. Overall, Co-operative and Community Finance has a lower than average number of outstanding loans, and a lower than average value of outstanding loans, though the total average size of loan is slightly larger than for the CDFI sector as a whole.

Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Co-operative and Community Finance</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of outstanding loans</td>
<td>70</td>
<td>82</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£1,820,000</td>
<td>£2,121,000</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£26,000</td>
<td>£25,866</td>
</tr>
</tbody>
</table>

Source: Inside Out

Interest rates for loans are determined by the CDFI’s Board, and are typically tailored to the applicant. As at 2008/09, the average interest rate charged was 5.4 per cent, though rates ranged from 2.5 per cent to 11 per cent. Lower rates are historical and reflect the use of variable rates pegged to the Bank of England base rate. Since the onset of the credit crunch, Co-operative and Community Finance has implemented a ‘collar’ of 8 per cent, meaning that even where rates are variable, the minimum interest rate charged cannot fall below this value. It is anticipated that interest rates will increase in the future, in order to mitigate the losses caused by the credit crunch.

Loan application and appraisal procedure

Loan applications are received by Co-operative and Community Finance’s loan officers. Applicants are required to submit copies of their business plan and memorandum and articles of association, and on the basis of this information the loan officer assesses whether the applicant is eligible for funding. If so, the loan officer will then visit the applicant to ascertain more information about the loan purpose, and submit a recommendation to the operations manager for a decision on whether or not
to proceed. Large loans (worth at least £50,000) are also dependent on approval from the CDFI's Chairman.

Non-financial services provided

In terms of non-financial products offered, Co-operative and Community Finance has a policy of minimising the provision of business support as much as is feasible. Advice is provided during the application appraisal process, and informally on an ongoing basis, but unlike many other CDFIs the organisation does not provide formal investment readiness training or business mentoring. In part this is a recognition of the fact that this would be unpaid work and would thus affect the financial model operated, but a consultee from Co-operative and Community Finance also stressed that there is relatively limited demand for such activity. The CDFI's clients – mainly established businesses and, by nature of the eligibility criteria (e.g. no sole traders), relatively larger firms – tend to be more experienced than the clients served by other CDFIs. Furthermore, the co-operative sector is well-served by other business support organisations from which firms can access tailored advice and support (e.g. the Co-operative Enterprise Hub).

Demand for finance

The steady growth of Co-operative and Community Finance over time has in part been a reflection of the growing level of demand for loan finance from within the CDFI's target markets. A consultee from Co-operative and Community Finance suggested that the number of co-operatives and employee owned businesses is increasing, as is the number of social enterprises. Over time, demand has also emerged from new niche markets, most recently from community-owned village shops, but in the future potentially from community-owned urban shops and village pubs.

Table 2 shows how the number of loan applications received and the number of loans made (in the previous 12 months) by Co-operative and Community Finance changed between 2006/07 and 2008/09, and how this compares to the average for the CDFI sector as a whole in 2008/09. The CDFI receives a below-average number of applications each year, reflecting the relatively niche nature of its target markets. The conversion rate varied significantly by year, but in 2008/09 was well below the average for the CDFI sector as a whole.

Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Co-operative and Community Finance</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Loan applications received</td>
<td>36</td>
<td>32</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>20</td>
<td>32</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>56%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Co-operative and Community Finance generates loan applications through a number of routes. Partnership working and relationships with other related organisations are considered to be the most important source of demand. As noted above, the CDFI co-
invests with other CDFIs, and has an informal referral mechanism in place with Futurebuilders (though this has not yet generated any loan applications). Co-operative development bodies refer co-operatives seeking finance, the Plunkett Foundation generates demand for loans from village shops, whilst the Baxi Partnership has recently referred a number of employee-owned businesses. Business Link is not seen as a useful source of referrals, in part because they are organised regionally (whereas Co-operative and Community Finance operates nationally), but also because of a perceived lack of expertise in the area of finance for social enterprises and co-operatives.

In addition to referrals, Co-operative and Community Finance does its own marketing and promotional work. This includes press releases, adverts in selected journals, and promotion at events and conferences. Marketing is focussed within media most relevant to the target community.

Organisational structure and capacity

Since 2005, Co-operative and Community Finance has been the trading name for a group of companies, reflecting the evolution of the organisation over time and the need for specific legal entities for the various sources of funding. Co-operative and Community Finance is a private company limited by guarantee, under which sit two subsidiary firms: ICO Fund plc and ICOF Guarantee Company Ltd. Alongside – but independent to – the holding company is ICOF Community Capital Ltd, an I&PS that generates finance through withdrawable shares. The ICOF Guarantee Company Ltd is largely funded by the annual interest waived by shareholders, and is used to cover capital losses by ICOF Community Capital Ltd.

Co-operative and Community Finance operates from a headquarters in Bristol, with regional offices in Southampton and Wales. As at 2008/09, the CDFI employed 4.6 FTE staff, compared to an average of 6.1 FTE staff for the CDFI sector as a whole, suggesting that as an organisation, Co-operative and Community Finance is relatively small by the standards of most CDFIs. In 2008/09 there were 1.4 FTE lending officers employed at Co-operative and Community Finance, compared to an average of 2 FTE lending officers for the CDFI sector as a whole.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Co-operative and Community Finance</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>4.0</td>
<td>3.0</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>2.0</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Source: Inside Out

Lending capital income

Over time Co-operative and Community Finance has accumulated capital for on-lending from a variety of sources, and the capital pot to which the CDFI has access has grown steadily. Compared to most CDFIs, Co-operative and Community Finance has not relied too heavily on public sector grants to obtain capital for on-lending,
though some funds have been generated in this manner (mainly from local government). The key sources of capital funding in recent years have been:

- **Capital grants**: Co-operative and Community Finance has benefited from gifted capital from a number of sources in recent years, including EEDA (following delivery of the RDA’s Capital for Community Ventures scheme) and Avon and Bristol Co-operative Finance;

- **Share issues**: As reviewed above, share issues have historically been the most important source of capital income for Co-operative and Community Finance, and the CDFI has continued to generate resources through this mechanism;

- **CITR**: Co-operative and Community Finance has been relatively successful in generating investment through the CITR scheme. From the outset the CDFI decided to obtain CITR resources from a single investor, in order to avoid spending time and resources generating small amounts of finance from a large number of investors. A £1 million loan was obtained from the Co-operative Bank in 2003, topped up in 2008 by an additional £600,000 loan from the same source. Representatives from the CDFI reported no difficulties in identifying eligible businesses for lending using these CITR resources.

As at 2008/09, the CDFI’s loan fund was worth £4 million, of which outstanding loans accounted for £1.9 million, and capital reserves accounted for a further £2 million (a deployment rate of 50 per cent). As shown in Table 4, in 2008/09 this meant that Co-operative and Community Finance had a slightly smaller loan fund than then average for the CDFI sector as a whole, and a lower deployment rate.

**Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>Co-operative and Community Finance</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£3,893,000</td>
<td>£4,036,000</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£1,820,000</td>
<td>£2,121,000</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>49%</td>
<td>56%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

Co-operative and Community Finance also manages loan funds on behalf of other organisations. At present the CDFI is managing two funds: the £1.3 million Co-operative Loan Fund (on behalf of the Co-operative Group), and, along with the London Rebuilding Society, the £1.8 million London Objective 2 Funding for Growth fund (on behalf of the LDA). The ability to manage these funds was dependent upon Co-operative and Community Finance being registered by the FSA as authorised and regulated to manage investments on behalf of others. A representative from the CDFI stressed that fund management had become a critical source of income in the last year or so as income from loans and from investments decreased (see below).
**Bad debt**

Co-operative and Community Finance focuses on maintaining a low level of loan delinquency and write-off, in order to ensure that the capital fund is not depleted. Table 5 shows the value of loan delinquency and write-offs as a proportion of outstanding lending by Co-operative and Community Finance between 2006/07 and 2008/09. Overall, the CDFI has a very low rate of both loan delinquency and loan write-off; in the case of the latter, there were no loan write-offs in 2008/09. Since the onset of the credit crunch and recession, the CDFI reports that it has not experienced a notable increase in the level of bad debt. In 2009/10 (i.e. since the last *Inside Out* reporting period), the CDFI has had one business closure leading to a loan default. Consultees from Co-operative and Community Finance suggested that their target market was probably better able to cope with the effects of the recession than other businesses, primarily, it was argued, since employee-ownership provides more of an incentive to take any difficult decisions needed in order to ensure company survival.

![Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09](image)

<table>
<thead>
<tr>
<th></th>
<th>Co-operative and Community Finance</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>n/a</td>
<td>0%</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>n/a</td>
<td>0%</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>n/a</td>
<td>0%</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>n/a</td>
<td>0%</td>
</tr>
<tr>
<td>Written-off</td>
<td>2%</td>
<td>0%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

**Revenue income**

Co-operative and Community Finance generates revenue income from a diverse range of sources, and, indeed, a consultee from the CDFI stressed that this diversity is important given the vulnerability of individual income streams to changing economic circumstances (e.g. the credit crunch). In recent years income has come from the following sources:

- *Portfolio income:* Historically this has been the main source of revenue income for the CDFI, but in the last year the credit crunch and recession have adversely affected income generated. In part this has been due to a drop in demand and a marginal increase in the level of bad debt, but the key reason has been the drop in interest rates, caused by the pegging of historical variable interest rates to the Bank of England base rate;

- *Invested capital:* Co-operative and Community Finance seeks to maintain relatively large cash reserves which are invested in order to generate income.

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Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
(partly to cover revenue expenditure). The credit crunch has had a significant negative impact on these investments (a 80 per cent drop in income), primarily as a result of the decline in the Bank of England base rate.

- **Income from funds under management**: As noted above, Co-operative and Community Finance currently manages two loan funds, and is paid according to the level of lending activity;

- **Back office services**: The provision of back-office services for other CDFIs used to be a significant source of income for Co-operative and Community Finance, but in recent years the sector has increasingly taken these back in-house, and now the CDFI only provides such services for Big Issue Invest and Radical Routes.
First Enterprise Business Agency/ Enterprise Loans East Midlands

Origins and development to the present

The First Enterprise Business Agency (FEBA) was established in 1989 to provide enterprise support to deprived communities, with a particular emphasis on serving the Black, Asian or Minority Ethnic (BAME) community. The enterprise agency was initially funded by Nottingham City Council, but by 1993 had diversified sufficiently to set up as an independent company limited by guarantee. Over this time, despite retaining its focus on Nottingham, FEBA also began to grow into other areas of the East Midlands region.

In 2002 a decision was made to establish a CDFI arm to FEBA that would provide loan finance to the enterprise agency’s client base (though it is understood that FEBA had been lending since around 1995). In order to achieve the scale thought necessary to operate the CDFI, FEBA secured some £1.3 million of Phoenix Fund capital finance, backed with £200,000 of revenue finance. These resources enabled FEBA to grow its CDFI lending activity significantly between 2002 and 2006, backed with additional resources secured from the regional European Objective 2 programme. By 2006/07, FEBA’s CDFI arm had a capital fund of some £2.8 million for on-lending, and had expanded to cover the whole region.

Following the end of the Phoenix Fund in 2006, the RDA for the East Midlands – emda – decided to create a regional CDFI loan fund, in order to continue providing loans to small businesses that were unable to access finance from mainstream banks. The RDA assembled a pot of £3 million using Phoenix Fund extension finance together with Single Pot and ERDF monies. The contract to manage and deliver this regional loan fund was tendered and won by FEBA in March 2008. Consultees from emda have indicated that this decision was based on the fact that FEBA was best placed deliver region-wide, and was also felt to have made progress towards sustainability. Under the terms of the contract, FEBA committed its existing capital pot and loan book to the new regional CDFI fund – named Enterprise Loans East Midlands (ELEM) – which was officially launched in June 2008.

The launch of ELEM caused FEBA to move away from providing business loans, and the organisation is now solely focused on its enterprise agency functions (i.e. providing non-financial support to businesses). ELEM is a separate company with a dedicated staff (most of whom worked for FEBA prior to joining ELEM), who deal specifically with providing loans through the emda contract. Since June 2008, no new loans have been issued through the FEBA loan fund, and all existing loan repayments are gradually being paid into the new ELEM fund (this transfer process will be complete in approximately five years). From June 2008 onwards, therefore, ELEM has replaced FEBA as the designated CDFI (thus the focus of this case study will be on ELEM, drawing upon elements of FEBA where relevant).

Rationale and target market

As noted earlier, ELEM was established as part of the development of a regional CDFI loan fund. ELEM aims to provide loans to both existing businesses and people starting up a business. The purpose of the CDFI is to support individuals with a viable business idea who require finance. Importantly, ELEM is not solely a lender of last resort since it is not a requirement that applicants must have had a finance application rejected by a mainstream bank prior to approaching the CDFI. ELEM provides loans to
start-ups and small businesses (typically family run or with two to three employees) with the majority being retail, catering and other service associated businesses. Social enterprises are not a target market. ELEM also provides loans to businesses and entrepreneurs from disadvantaged communities and under-represented groups. Businesses must be based in the East Midlands region. Other than this the only other eligibility criterion employed by the CDFI is that applicants must be able to provide a 30 per cent financial contribution, with the loan fund providing the remainder. This requirement was introduced by ELEM to help instil greater responsibility and commitment between the client and the conditions of the loan.

Products and services provided
The only financial product offered by ELEM is a business loan – the CDFI only lends to businesses and does not offer any personal lending or equity investments. Loans typically range from between £3,000 and £20,000, repayable over a 1 to 5 year period. Table 1 shows how the volume and value of outstanding lending by the CDFI (pre-2008 all FEBA and post-2008 FEBA and ELEM) changed between 2006/07 and 2008/09, and for 2008/09 how this compares with the average for the CDFI sector as a whole. Overall, FEBA/ ELEM has a higher than average number of outstanding loans (157 in 2008/09 compared to an average of 112 for the CDFI sector as a whole). The average loan size for FEBA/ ELEM is almost half that of the CDFI sector average, reflecting the fact that the organisation tends to focus on start-ups and small enterprises.

Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>FEBA/ ELEM</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of outstanding loans</td>
<td>111</td>
<td>119</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£1,310,095</td>
<td>£1,299,712</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£11,803</td>
<td>£10,922</td>
</tr>
</tbody>
</table>

Source: Inside Out

Interest is currently fixed at 10.25 per cent for the full loan term for all clients. This fixed rate was recently introduced by the CDFI – in agreement with emda – to replace the previous rate of Base Rate plus 5 per cent (which due to falls in the Base Rate had led to unsustainably low rates of interest). No fees are charged as part of the loans, and lending is 100 per cent unsecured.

Loan application and appraisal procedure
Loan applicants must complete an application form and must provide a business plan covering all aspects of the proposed venture, a minimum of two years cash flow forecasts and bank statements for the last six months. Applicants then work with a dedicated ELEM loan advisor to assemble the full loan application. ELEM advisors are expected to manage their own time and to provide appropriate support to loan applicants, meaning that the depth of support provided will vary. Finished loan applications are then pitched by the applicant to the CDFI’s loan panel (three to four people from varying backgrounds) which makes a decision as to whether to approve the loan. Consultees from ELEM reported that around 25 per cent of applicants are
rejected by the panel; the CDFI notes that it is planning to employ a due diligence officer to complete more detailed background searches on applicants and make recommendations to the panel in order to reduce the rejection rate.

**Non-financial products**

ELEM does not formally provide any non-financial services, although free advice and guidance is provided by the ELEM loan team as part of the application process (see above). More formal business support services are available to the CDFI’s clients through the FEBA enterprise agency, including one-to-one business advice and business training. This division of responsibilities enables ELEM to concentrate on lending, and to refer most other enquiries to FEBA. Where loan clients require formal post-loan support, ELEM tends to refer them to mentoring schemes in operation across the region.

**Demand for finance**

Consultees from ELEM reported that they receive around 200 to 250 loan enquiries per year, though these are of varying quality. It was also noted that once these businesses realise that there is 30 per cent compulsory contribution, a number do not follow through with an application. ELEM has a target set by emda to deliver 80 to 90 loans per year.

Table 2 shows how the number of loan applications received and the number of loans made (in the previous 12 months) by the CDFI (pre-2008 all FEBA and post-2008 FEBA and ELEM) changed between 2006/07 and 2008/09, and how this compares to the average for the CDFI sector as a whole in 2008/09. In 2008/09 the CDFI received 98 loan applications which is greater than an average of 86 applications received for the CDFI sector as a whole and nearly three times more than the number of applications received (34) by the CDFI in the previous year. The number of loan applications received fell significantly in 2007/08, primarily due to uncertainty over the outcome of the regional CDFI fund bid.

**Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>FEBA/ ELEM</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Loan applications received</td>
<td>97</td>
<td>34</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>45</td>
<td>34</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>46%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

ELEM generates loan applications through a number of routes. These include marketing and promotional activity that is directly paid for by the CDFI (including advertising in local newspapers, bus campaigns, posters in community centres, leaflets and through the CDFI’s website), though consultees reported that it is difficult to say how effective this marketing is as it is not directly monitored. A consultee at ELEM indicated that a considerable level of demand is generated by word of mouth through
successful applicants showing/informing others of the loans which inspires others to
enquire and potentially apply for finance.

ELEM does not have any formal referral arrangements in place to generate loan
applications, though consultees from the CDFI reported that a small number of
referrals are received annually from Business Link. Representatives of ELEM argued
that this relationship is not as effective as it could be and believed that Business Link
may not place ELEM at the top of the referral list for potential applicants (compared to
other schemes available in the region), primarily due to a lack of awareness.

Organisational structure and capacity

ELEM operates from headquarters in Nottingham which is shared with the Enterprise
Agency FEBA, though has access to FEBA’s agents located across the region. As
shown in Table 3, as at 2008/09 ELEM employed 4 FTE staff, including 2 FTE loan
officers. The CDFI is thus relatively small by the standards of the average for the
sector as a whole (6.1 FTE staff). The number of lending officers increased from 0.5
FTE to 2 FTE staff on the basis of the award of the emda loan fund contract.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>FEBA/ ELEM</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>3.0</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: Inside Out

Lending capital income

As noted previously, from 2002 onwards FEBA grew its CDFI capital pot using a
combination of national and regional capital. In 2008 this was supplemented by
resources provided by emda as part of the new regional CDFI fund (ELEM). The CDFI
recognises that the key to achieving scale and sustainability is the accumulation of a
sufficient capital pot for on-lending, and so has actively sought to obtain additional
funds where available. Compared to many other CDFIs, FEBA/ ELEM has generated
capital through a relatively narrow range of sources:

- **Capital grants**: FEBA then ELEM has historically been successful in accessing
capital grants for on-lending. Historically the CDFI received £1.3 million of
capital finance under the Phoenix Fund, matched with a similar amount of
funding from emda through the regional Objective 2 programme. As noted
previously, in 2006 FEBA was awarded the contract to manage a new regional
CDFI fund (ELEM), which has so far provided £2 million of public sector capital
grants (with £1 million of funding to draw on in arrears for lending within the
region’s ERDF areas);
- **CITR**: FEBA is accredited to receive investment under the CITR scheme, but
consultees from the CDFI reported that, to date, no funding has been raised in
this way. The main reason, it was suggested, was that FEBA had historically
had sufficient grant capital available to meet demand, and that with the move to
a regional CDFI, *emda* had provided enough capital to meet the expanded demand.

Table 4 shows the development of the FEBA/ ELEM loan fund between 2006/07 and 2008/09. The year 2007/08 was something of a hiatus for the CDFI as it awaited the establishment of the regional loan fund. By 2008/09 the addition of *emda* resources increased the size of the capital pot to around £4.3 million, of which £1.8 million had been lent to businesses.

**Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>FEBA/ ELEM</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£2,697,095</td>
<td>£2,299,712</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£1,310,095</td>
<td>£1,299,712</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>50%</td>
<td>57%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

**Bad debt**

Table 5 sets out the value of loan write-offs as a proportion of outstanding lending for the CDFI (pre-2008 all FEBA and post-2008 FEBA and ELEM). The data show that levels of loan write-off at FEBA/ ELEM increased between 2006/07 and 2008/09, and the CDFI notes that the credit crunch and recession has had a negative impact on the incidence of bad debt. In 2008/09, FEBA/ ELEM’s loan write-off rate was 14 per cent, with consultees from the CDFI noting that their lending market – start-ups and small businesses – tends to have a higher loan default rate than other CDFI markets (a proportion of write-offs are also subsequently recovered).

Similarly, consultees at ELEM reported that they are seeking to improve the regularity of loan repayments in order to reduce levels of loan delinquency. The CDFI closely monitors its clients and maintains regular contact in order to identify any repayment problems. ELEM also accepts reduced repayments, provided they are made regularly. Where problems develop, ELEM has recently engaged two firms of debt collectors to work on repayment arrears (both are paid by commission on a no-win no-fee basis. Whilst it is early days, there has been some success in reducing the level of bad debt, and ELEM will also employ solicitors for legal action and to get charging orders on property (if clients have assets).

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95 Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
Table 5: Value of loan write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>FEBA/ ELEM</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Written-off</td>
<td>3%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Revenue income

ELEM is a relatively small organisation (see Table 3) and, with the separation between the CDFI and FEBA (now the enterprise agency), is focussed on the provision of loans. Consequently, the need for revenue funding is arguably relatively small in comparison to other, larger CDFIs with a wider remit. To date, FEBA/ ELEM has generated revenue income from a range of sources:

- **Revenue grants**: FEBA received around £200,000 through the Phoenix Fund to cover operational and developmental costs. Under the terms of the contract with emda, ELEM will receive around £110,000 in revenue support each year from 2008 through till 2012;

- **Portfolio income**: Interest payments on loans are seen as a key source of revenue income for ELEM, but the increase in the level of bad debt and the drop in the Bank of England base rate have had an adverse effect on the income generated in this way. In the same way, ELEM has also seen income generated on capital investments decrease with the drop in the base rate.
Foundation East

Origins and development to the present

The Suffolk Regeneration Trust (as Foundation East was initially called) was launched in 2003 in response to a feasibility study into the establishment of a community finance institution in Suffolk that was commissioned by a consortium of funding bodies (including Suffolk County Council and EEDA, the RDA for the East of England region). The study identified a lack of provision of business and personal finance within rural areas in Suffolk, and developed a business model for a CDFI to meet this need.

On the basis of this feasibility study, some £390,000 of Phoenix Fund resources were secured (capital and revenue funding), together with match funding from EEDA and money from the EQUAL programme, to set up a CDFI. The Suffolk Regeneration Trust started lending in Suffolk in Spring 2004, but in response to demand from outside of the county, and with access to capital that was not tied to any particular area, the CDFI quickly expanded into neighbouring counties and at present operates throughout the East of England region.

In early 2008, Foundation East successfully bid for the contract to deliver EEDA’s regional CDFI loan fund. The fund totals £750,000 and will run from April 2008 until March 2013, supported by a further £450,000 revenue allocation. In March 2009, EEDA channelled a further £350,000 into the loan fund specifically in response to the credit crunch. The award of this contract marked a significant milestone in the development of Foundation East, in part because it required the CDFI to be able to deliver a standard business loan service across the East of England region.

Rationale and target market

Foundation East was initially set up in order to address a shortfall in the provision of business and personal finance within rural Suffolk. Over time the CDFI has broadened the scope of its activities, but the core of this rationale remains. The current mission of Foundation East is to:

‘Contribute to social inclusion through: 1) developing and delivering accessible financial products and services for businesses and individuals; and 2) engaging in the development of Community Land Trusts to provide local communities with access to and benefit from land and property assets’.

The target market for Foundation East’s lending activity is thus broad, and includes businesses (commercial and social enterprises) and individuals seeking personal loans. Business loans are, in principle, only available to businesses that cannot obtain a bank loan, or that need additional funding to match a bank loan. Foundation East does not always require applicants to prove that they have had a finance application rejected by a bank; in such cases the CDFI makes an assessment based on an applicant’s profile (e.g. their credit history or their business plan) as to whether, in all likelihood, they would be rejected were they to seek finance from a bank. A consultee from Foundation East noted that to force a business to apply to a bank and be rejected before proceeding would waste their time and substantially delay the loan application.
process. Loans are also available to social enterprises (voluntary organisations, charities, cooperatives, and non-profit groups) that cannot access a grant (and that would not be able to obtain finance from a bank).

Personal loans are only available to tenants of four Suffolk and Essex based Housing Associations (Colchester Borough Homes, Colne Housing Society, Havebury Housing Partnership, and Suffolk Housing Society). As with business lending, applicants for personal loans must be unable to borrow money from a bank.

As the mission statement for Foundation East indicates, alongside its lending activity, the CDFI also seeks to employ a Community Land Trust model in order to develop land and property for the benefit of local communities. Potentially, this can include the development of affordable housing and/or business workspace, both of which were identified as being in short supply in the original feasibility study for Foundation East. Being large capital projects, Community Land Trust development opportunities are approached on a case-by-case basis by Foundation East, to be taken forward as and when opportunities arise and suitable funding can be obtained. To date, two Community Land Trust projects have been initiated by the CDFI (Miles Ward Court and 154 Chediston Street, both in Halesworth, Suffolk).

Financial products provided

As noted above, Foundation East offers both business and personal loans. Business loans range in size from £500 to £50,000 (regardless of whether applicants are commercial firms or social enterprises), with repayment terms of between 6 months and 10 years. Security can be taken but is not required. Loans can be used to cover start-up costs, property or equipment acquisition, cash flow requirements, and business growth costs.

Table 1 shows how the volume and value of outstanding business lending by Foundation East changed between 2006/07 and 2008/09, and for 2008/09 how this compares to the CDFI sector as a whole. The data show that the volume and value of lending by Foundation East increased substantially between 2006/07 and 2008/09 (a tripling in the value of outstanding lending). Compared to the CDFI sector as a whole, Foundation East makes an above average number of loans, but the average size of these loans is significantly below that of the sector as a whole. Generally, the CDFI serves the micro enterprise market, which in 2008/09 accounted for 81 per cent of outstanding lending by value and 91 per cent of outstanding lending by volume of loans.

Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Foundation East</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of outstanding loans</td>
<td>63</td>
<td>n/a</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£670,557</td>
<td>n/a</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£10,644</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Source: Inside Out*
The interest rates charged on business loans vary depending on the risk profile of the applicant. The average interest rate charged for commercial enterprises was 15 per cent in 2008/09, though for micro enterprises the rate charged ranged from 9.5 per cent to 22 per cent. For social enterprises, the average interest rate charged was 12 per cent, though in some cases the interest rate was 10 per cent. For loans over £3,000, Foundation East charges an arrangement fee of 2 per cent of the value of the loan, with a minimum value of £100. For loans under £3,000 there is a fixed £50 arrangement fee.

Personal loans provided by Foundation East range in size from £250 to £3,000, and are intended to cover back-to-work costs and home/family expenses. The average interest rate charged on personal loans was 22 per cent in 2008/09. In 2008/09, Foundation East had £173,000 of outstanding personal lending, which, as Table 1 shows, means that business lending accounted for the vast majority of the CDFI’s loan portfolio (93 per cent of the total value of outstanding lending).

**Loan application and appraisal procedure**

Loan applications are processed by Foundation East’s loan officers. A credit search and identity check is carried out to ensure that the details contained in an application are correct. The loan officer then assesses whether the funding proposition is viable, which includes an assessment of the viability of the proposal and a check to ensure that financial calculations are realistic. Credit history is examined, but consultees from the CDFI stressed that this is viewed subjectively, in that they will always seek to ascertain the cause of any past credit problems (as opposed to a bank which, it was suggested, would automate this process). After appraising the application, the loan officer will then prepare a summary and present this to a loan panel. Loan panels consist of three individuals (a Foundation East Director then individuals drawn from banks, Business Link and/or legal firms, together with local social entrepreneurs or business consultants), who make a decision as to whether to proceed with the loan or not.

**Non-financial services provided**

Foundation East also provides non-financial services alongside business and personal loans. Business loan applications typically must be accompanied by a business plan and details of financial accounts, which, the CDFI argues, means that applicants are already to some extent investment ready. Beyond this, Foundation East provides advice informally as part of the application process (e.g. explaining terminology), but seeks to keep the scale of this service to a minimum, and will if necessary refer applicants to Business Link if significant support is required.

From January 2010, Foundation East will launch a mentoring scheme to provide a more formal post-loan business support service. A network of regional business mentors has been established by the CDFI and, for a charge, businesses with a loan will be able to access support from a mentor. The mentor scheme will pay for itself through the business charges, and thus there is no cost to Foundation East.

**Demand for finance**

Demand for loans from Foundation East is primarily driven by the extent to which mainstream banks are lending to businesses within its target geographical area (the East of England region), since the CDFI’s target market is mainly defined by a failure to
secure bank finance. Consultees from Foundation East suggested that, at first, demand for loans was low, but that as the profile of the CDFI grew, the number of applications increased. Since the onset of the credit crunch, consultees from Foundation East report that the level of demand has grown substantially, with a marked increase in the number of businesses that would previously have been able to secure finance from banks. There have also been some shifts in the profile of applicants, with fewer numbers of start-ups seeking finance.

Table 2 shows the number of loan applications received and the number of loans made (in the previous 12 months) by Foundation East in 2008/09, and how this compares to the average for the CDFI sector as a whole (data from the previous two years were not available). Foundation East receives and approves a far greater number of business loan applications than the CDFI average, though its approval rate is considerably below average. In part this is a reflection of fact that the CDFI tends to lend to micro enterprises and, as suggested by Table 1, distributes a relatively large number of smaller loans.

Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Foundation East</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07 2007/08</td>
<td>2008/09 2008/09</td>
</tr>
<tr>
<td>Loan applications received</td>
<td>n/a n/a</td>
<td>319 81</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>n/a n/a</td>
<td>94 39</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>n/a n/a</td>
<td>29% 48%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Foundation East generates most of its business loan applications through referral networks and relationships. Consultees from the CDFI reported that one of the most significant of these referral relationships is with the regional Business Link service, which generates a significant number of referrals (though the ‘quality’ of these applications is variable). Referrals also come from private sector sources (e.g. accountants), chambers of commerce, enterprise agencies, job centres and banks and building societies (mainly the three banks/ building societies that are members of Foundation East).

Foundation East also undertakes marketing activity to generate loan applications. Loan officers are expected to attend regional business events (e.g. events organised by Chambers of Commerce) and to market the CDFI to appropriate external bodies (such as those listed above). Other mechanisms that have been used – to varying degrees of success – have included press releases, radio advertising campaigns, and adverts placed in local newspapers.

Organisational structure and capacity

Foundation East is the trading name for Foundation East Ltd, an I&PS and an exempt charity. The I&PS structure was chosen since it reflected the social mission of Foundation East and enabled the CDFI to generate income through membership share purchase. Foundation East operates from a headquarters in Bury-St-Edmonds. As at
2008/09, the CDFI employed 5.5 FTE staff, compared to an average of 6.1 FTE staff for the CDFI sector as a whole. Of these staff, 3 were lending officers, compared to a sector average of 2 FTEs.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Foundation East</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>6.4</td>
<td>n/a</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>3.2</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

**Lending capital income**

Foundation East was only established in 2003, and has thus had a relatively limited amount of time to accumulate capital for on-lending. As noted above, the CDFI was started with capital funding from the Phoenix Fund and from EEDA, since when the organisation has sought to access further capital grants and to make use of alternative sources of lending finance. Since the Phoenix Fund finished in 2006, Foundation East has obtained capital for on-lending to businesses from the following sources:

- **Capital grants:** Grants have provided the majority of Foundation East’s loan pot since the establishment of the CDFI, though there is an acknowledgement that obtaining further finance may become harder in the future. Since the end of the Phoenix Fund, the most significant capital grant obtained by Foundation East was the £750,000 (since extended to £1.1 million) provided by EEDA for the RDA’s regional CDFI fund through till March 2013. In addition, in recent years Foundation East has secured capital grants from Norwich City Council (as part of their LEGI programme) and Cambridgeshire Business;

- **Bank lending:** Recognising that grant funding will become more difficult to obtain in the future, in 2008/09, Foundation East sought to access capital from private sector lenders. An agreement was successfully concluded with the Unity Trust Bank to use the £750,000 EEDA grant as a loan loss reserve enabling access to draw-down capital over the next few years;

- **Share issues:** As an I&PS, Foundation East is able to generate investment through share issues (up to a maximum of £20,000 per investor). To date, only a modest amount of capital has been raised through share issue, but in 2007, Foundation East achieved CITR accreditation which it regarded as an important way in which to incentivise investment. However, by 2008/09, Foundation East had raised just £24,600 through CITR investment, attributing this to a lack of time spent on promotion and marketing, principally due to the perceived complexity of the process and concerns over lending eligibility using CITR resources. In 2009/10, Foundation East intends to raise a further £30,000 through CITR by marketing itself amongst philanthropic-minded individuals and businesses in the region, however it was noted that the £20,000 ceiling for investment in an I&PS was a disincentive for larger investors;

- **SFLG/ EFG:** Though not a source of capital income *per se*, the SFLG scheme enabled Foundation East to recoup capital lost through bad debts. Consultees from the CDFI noted that in 2008, Foundation East had lent significant amounts
of money using the SFLG, and that under the recession these loans had performed worse than would be expected (this was in part attributed to firms’ perception that the loan was backed by the government and thus that it was more acceptable to default on repayment since this would have less of an impact on Foundation East).

Alongside capital income for its business lending activities, Foundation East has also secured finance for personal lending and Community Land Trust property development activity:

- **Personal lending:** Capital for on-lending to housing association tenants is largely provided by the Housing Associations themselves, and amounted to around £30,000 between 2006/07 and 2008/09;

- **Community Land Trust developments:** Capital for property developments is obtained on a case-by-case basis as and when needed. Miles Ward Court was developed using grants/finance from EEDA, Suffolk County Council, the Adventure Capital Fund, and the Government Office for the East of England. Grant funding has also been secured from EEDA for a second housing/retail development. It is envisaged that future Community Land Trust developments could be financed using capital obtained from private sector sources secured against the CDFI’s properties.

Table 4 shows the size of the loan fund available to Foundation East, the value of outstanding lending, and the overall deployment rate (note that this covers both business and personal lending since disaggregation is not possible). By 2008/09, Foundation East was relatively large by the standards of the CDFI sector, with a loan fund of £3.6 million. The deployment rate was higher than the CDFI average.

**Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>Foundation East</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£1,147,446</td>
<td>n/a</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£734,088</td>
<td>n/a</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>68%</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

**Bad debt**

Foundation East focuses on maintaining a low level of loan delinquency and write-off, in order to ensure that the capital fund is not depleted. Table 5 shows the value of loan delinquency and write-offs as a proportion of outstanding lending by Foundation East in 2006/07 and 2008/09. Overall, in 2008/09 loan delinquency and write-offs were

---

97 Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
relatively high within Foundation East. Consultees suggested that this was a result of their target group, with its focus on micro enterprises. Furthermore, the CDFI believes that levels of bad debt have increased since the onset of the credit crunch, and also that the SFLG scheme exacerbated the situation by, in some cases, acting as a disincentive for repayment (see above).

Foundation East seeks to both minimise loan delinquency and seek the recovery of lost funds in cases of loan default. Where repayments are missed, Foundation East has a specialist recovery officer who contacts businesses to clarify the cause of the problem. Where necessary, repayment holidays or interest-only periods can be used to provide temporary assistance.

Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Foundation East</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>0%</td>
<td>n/a</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>1%</td>
<td>n/a</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>1%</td>
<td>n/a</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>22%</td>
<td>n/a</td>
</tr>
<tr>
<td>Written-off</td>
<td>16%</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: Inside Out

Revenue income

Revenue income is needed in order to cover Foundation East’s operational costs. Revenue costs were initially covered by grants from the Phoenix Fund and also through the EQUAL programme. Foundation East now generates revenue income from a range of sources:

- **Revenue grants**: Grants have been a key way in which Foundation East has covered its operational costs. The contract awarded by EEDA in 2008 to run the RDA’s regional CDFI loan fund included a five year revenue grant worth £450,000. Revenue grants have also been provided by the organisations that provided capital grants (e.g. Norwich City Council) in order to cover the operational costs of delivering their loan fund allocations;

- **Portfolio income**: Foundation East also generates revenue income from interest earned on loans, arrangement fees charged, and interest earned on invested capital;

- **Property related income**: From the outset, Foundation East’s financial model was based on securing revenue income from its Community Land Trust property developments. To date, only the Miles Ward Court scheme has been completed (opened in March 2008). In time, the CDFI expects to generate some rental income from the 8 business units, though it is not thought that this income will ever achieve significant scale, and the value of the property is principally as an asset against which to borrow money from the private sector.
Fredericks Foundation

Origins and development to the present

The Fredericks Foundation was established in 2001 by an entrepreneur with a particular interest in supporting entrepreneurship within disadvantaged groups. From the outset, the Foundation was intended to provide loan finance to individuals seeking to start their own business, but who were unable to access finance from mainstream banks. Initially the Fredericks Foundation considered itself to be a charity providing finance to disadvantaged individuals, but grew as an organisation and in 2004 joined the CDFA and was recognised as a CDFI.

The Fredericks Foundation started up using donations from its founder, together with other philanthropic and charitable donations, from individuals and businesses. Grant funding (capital and revenue finance) was received through the European Social Fund and through the Phoenix Fund. Consultees from the Fredericks Foundation emphasised the importance of the Phoenix Fund allocation in boosting the CDFI’s loan issuing capacity. Over time the Fredericks Foundation also received capital and revenue finance from SEEDA (the RDA for the South East), and through the delivery of loan fund and enterprise support projects elsewhere in the country.

A milestone in the development of the Fredericks Foundation was reached in October 2008 when the CDFI entered into a partnership with the Gloucestershire Development Loan Fund, a CDFI operating across Gloucestershire. This partnership formalised what had previously been an informal relationship between the two organisations, and was prompted by the Fredericks Foundation’s need to expand as existing capital reserves were becoming depleted and public sector grant support in the region was decreasing. Moreover, as an organisation the Fredericks Foundation has an ambition to expand across Southern England (excluding Cornwall) through the development of a series of ‘hubs’ located in major urban areas (supported by a head office). Basing these hubs on existing CDFIs is seen as quick and cost-effective way of achieving this expansion. In April 2009, the Fredericks Foundation entered into a second CDFI partnership, this time with the Wessex Reinvestment Society (which covers Devon, Dorset and Somerset). Under the terms of these partnerships, the two CDFIs have been renamed (Fredericks Gloucester and Fredericks Wessex respectively), and the Fredericks Foundation now manages the loan funds of the two organisations. This case study, however, only provides information on the Fredericks Foundation.

Rationale and target market

The overall mission statement of the Fredericks Foundation is:

‘To alleviate poverty through work, to promote small business, and to reinforce local communities through business’.

The CDFI was established by an entrepreneur with an ambition to assist disadvantaged individuals enter into self-employment through the provision of finance and business support. The organisation focuses on disadvantaged individuals, for instance the long-term unemployed, individuals with a disability, ex-offenders, and lone parents. Since the onset of the credit crunch and recession, Fredericks Foundation has broadened its objectives to include supporting existing micro businesses that need finance but cannot obtain support from mainstream banks, though again focussing on disadvantaged applicants.
The target market for the Fredericks Foundation is broad and incorporates entrepreneurs and small businesses from a variety of backgrounds. Most importantly, applicants must be able to demonstrate that they have made a genuine application for funds to a mainstream bank, and that they have had the application turned down. Geographically the Fredericks Foundation now directly covers all of the South East region and London.

Financial products provided

The core financial product offered by the Fredericks Foundation is a business loan. The minimum loan size is £250, and the maximum size is £10,000 for start-ups and £20,000 for established businesses. The duration of the loan is normally between 2 and 5 years, depending on the size. Table 1 shows how the volume and value of outstanding business lending by the Fredericks Foundation changed between 2006/07 and 2008/09, and for 2008/09 how this compares to the CDFI sector as a whole. The total outstanding loan portfolio stood at just under £500,000 in 2008/09, having decreased slightly since 2006/07. The number of outstanding loans, however, was considerably above the CDFI average (263 in 2008/09). Overall, the Fredericks Foundation delivers large numbers of relatively small loans (the average loan size is around £1,900). In 2008/09 all loans were with micro enterprises.

Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Fredericks Foundation</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of outstanding loans</td>
<td>276</td>
<td>267</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£594,275</td>
<td>£507,002</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£2,153</td>
<td>£1,899</td>
</tr>
</tbody>
</table>

Source: Inside Out

Historically, the Fredericks Foundation charged a relatively low rate of interest (2 per cent above the Bank of England base rate). The decline in the base rate resulted in the imposition of a fixed interest rate of 7 per cent. On top of this, all successful loan applicants are required to pay a 5 per cent ‘handling fee’ to the CDFI, the cost of which is added to the loan repayment schedule. Security is not a requirement of the loan, and in 2008/09, the Fredericks Foundation’s loan portfolio was 100 per cent unsecured.

Loan application and appraisal procedure

All applicants seeking finance for start-up are required to submit a loan application form, evidence of a bank refusal, a business plan, a cash flow forecast, a credit report, previous bank statements, and proof of identity. For existing businesses, the CDFI also requires the applicant to submit annual accounts, current management accounts, and business bank statements.

Once an application and all supporting evidence is received by the Fredericks Foundation, the applicant is allocated a client manager who appraises the application and in some cases may ask the applicant for further information. Following this initial check, the client manager works with the applicant on the Business Plan, ultimately
taking a decision about whether to refer the applicant and application to a Funding Panel for further consideration (the Panel comprises Trustees of the Fredericks Foundation, volunteer mentors, and strategic partners – generally representatives of funding bodies running particular enterprise projects). If applicants successfully pass this initial stage then their application is put forward to the Funding Panel where the applicant is invited to talk through the business plan and their need for finance, and a final decision is made as to whether to approve the loan.

Loan enquiries are generally made to the Fredericks Foundation’s central office in Surrey, and if relevant are passed to Fredericks Gloucestershire or Fredericks Wessex for appraisal. Both Fredericks Gloucestershire and Wessex also receive direct loan enquiries.

**Non-financial services provided**

The Fredericks Foundation provides non-financial services alongside business loans, in addition to the informal advice provided as part of the application process (e.g. explaining terminology). The CDFI offers business guidance and support to all individuals who have accessed loans through a volunteer mentor scheme. The services of a mentor are available to all clients who are lacking the experience in key skills required to set up and run a business. Mentors provide advice to clients (either by telephone, email or face-to-face) on issues such as marketing, book keeping and time management. The Fredericks Foundation draws upon a network of experienced volunteer mentors from a range of backgrounds (including businesses and the Princes Trust), who as volunteers are not paid for the support that they provide (it is instead considered a philanthropic activity).

In addition to the mentoring scheme, the Fredericks Foundation has also been contracted by public sector bodies to deliver business advice schemes to particular disadvantaged groups (for instance individuals in South London with mental health problems or individuals with a disability in Wandsworth in London. These activities are, however, undertaken separately to the day-to-day loan operations of the CDFI.

**Demand for finance**

Consultees from the Fredericks Foundation reported that at the outset demand for loans was low, but that as the profile of the CDFI grew, the number of applications increased. Since the start of the credit crunch, consultees from the Fredericks Foundation reported an increase in demand for business loans, though this was in part a result of the fact that the CDFI widened its loan availability to include both existing businesses and start-ups.

The Fredericks Foundation principally generates loan enquiries through recommendations and word-of-mouth communication, particularly by loan recipients. Marketing activity is small-scale, and staff promote the CDFI at charitable events. There are no systematic referral arrangements in place.

Table 2 shows the number of loan applications received and the number of loans made (in the previous 12 months) by the Fredericks Foundation in 2008/09, and how this compares to the average for the CDFI sector as a whole. The Fredericks Foundation received 113 applications in 2008/09, more than the average for the CDFI sector as a whole. Of these applications, the CDFI approved around 32 per cent.
Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Fredericks Foundation</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Loan applications received</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: Inside Out

Organisational structure and capacity

The Fredericks Foundation is a company limited by guarantee and a registered charity. The CDFI operates from a headquarters in Surrey. As shown in Table 3, the Fredericks Foundation is a relatively large organisation (these figures exclude the two partner CDFIs). In 2008/09 the organisation employed 8.6 FTE staff, compared to an average of 6.1 FTE staff for the sector as a whole. The number of lending officers (5 FTE staff) was also considerably above the sector average (2 FTE staff). As noted above, the Fredericks Foundation also uses the services of a network of volunteer business mentors.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Fredericks Foundation</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>8.0</td>
<td>9.6</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>5.0</td>
<td>5.2</td>
</tr>
</tbody>
</table>

Source: Inside Out

Lending capital income

Since its creation in 2001, the Fredericks Foundation has built up a capital pot for on-lending from a number of sources (primarily public sector grant support and charitable donations). In order to support its expansion, the Fredericks Foundation is actively seeking to diversify its income sources, most recently by assuming management responsibilities for the funds run by two other CDFIs (in Gloucestershire and Wessex). The key sources of capital income used by the Fredericks Foundation have been as follows:

- **Capital grants:** Initially, the Fredericks Foundation benefited from grants from the Phoenix Fund and from the European Social Fund, subsequently followed by post-Phoenix support from SEEDA. On the whole, however, the CDFI has not been able to access large amounts of capital grants from public sector bodies;

- **Charitable donations:** The Fredericks Foundation continues to receive capital donations from its founder, as well as other socially-minded individuals and companies (see below under revenue income for further details of corporate fundraising activities);
• *CITR/EFG:* At present the Fredericks Foundation is not accredited to receive investment through the CITR scheme, but consultees from the CDFI have indicated that it will seek accreditation during 2010 in order to generate capital for on-lending. The Fredericks Foundation is also understood to be considering the application of the EFG scheme.

Table 4 shows the size of the loan fund available to the Fredericks Foundation, the value of outstanding lending, and the overall deployment rate. Overall, the Fredericks Foundation has a relatively small capital pot by the standards of the CDFI sector (worth just over £500,000 in 2008/09), reflecting the fact that the CDFI has not historically had access to large public sector capital grants, or been able to secure substantial private sector investment or access bank loans. The deployment rate for the Fredericks Foundation, however, has typically been very high, indicating that available capital is quickly distributed through loans.

**Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>Fredericks Foundation</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£594,275</td>
<td>£981,652</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£594,275</td>
<td>£515,652</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>100%</td>
<td>53%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

**Bad debt**

Table 5 shows the value of loan delinquency and write-offs as a proportion of outstanding lending by the Fredericks Foundation in 2006/07 and 2008/09. Over time, the level of loan write-offs has increased, standing at 18 per cent of the outstanding loan portfolio in 2008/09 (attributed by consultees to the effects of the recession), compared to 7 per cent for the CDFI sector as a whole.

Despite its focus on disadvantaged individuals, the Fredericks Foundation seeks to ensure that loans are repaid in full. Consultees noted that repayments on loans are a way of instilling financial discipline and providing funding for future clients, though it was also suggested that the target market makes a certain level of bad debt inevitable. The Fredericks Foundation maintains regular contact with loan clients and encourages them to report any difficulties with repayments – reduced repayments are accepted by the CDFI as the Fredericks Foundation takes the view that some payment is better than no payment at all. Consultees at the CDFI emphasised the need to improve default rates across its client base and as such the CDFI has introduced a new computerised system which allows greater efficiency in recognising any missed payments. The Fredericks Foundation is working to achieve lower default levels by

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98 Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
tightening existing lending procedures and broadening the product range to include higher value and less risky products for employed individuals both with start-ups and existing businesses.

Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Fredericks Foundation</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Written-off</td>
<td>9%</td>
<td>10%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

Revenue income

The Fredericks Foundation secures revenue income from a relatively large number of sources:

- **Revenue grants**: Historically the Fredericks Foundation received revenue support through the Phoenix Fund, and once this finished from SEEDA as part of the Phoenix transitional phase. Elsewhere, the CDFI has received income from public sector bodies to cover the costs of service delivery, for instance from Wandsworth Borough Council to deliver business advice to disabled residents of Wandsworth, and from the LDA to deliver business advice to individuals in South London with mental health problems;

- **Charitable donations**: As well as a source of capital for on-lending, charitable donations are used to cover the Frederick Foundation’s revenue costs. A range of income streams are used, including support from the CDFI’s founder (including the provision of free accommodation), financial donations from philanthropic individuals, and fundraising activity. The Fredericks Foundation also runs a ‘1 per cent club’, whereby companies (there are currently 13) donate 1 per cent of their profits to the CDFI (including in-kind contributions such as computer hardware or software);

- **Portfolio income**: The Fredericks foundation earns income from the loan portfolio through a combination of interest payments on loans and through invested capital reserves. The low rate of interest charged (formerly base rate plus 2 per cent), together with the relatively high level of bad debt, means that this is not a significant source of income, however;

- **Income from funds under management**: The Fredericks Foundation manages a fund for the Action for the Blind charity, which provides a very small amount of revenue income;

- **Pro bono work**: The Fredericks Foundation has been comparatively successful in benefiting from pro bono work from individuals and companies, particularly in
relation to the network of volunteer experts. As noted above, the CDFI also has the use of free accommodation for its headquarters.
Key Fund Yorkshire

Origins and development to the present

The South Yorkshire Key Fund (now trading as Key Fund Yorkshire) was established in 1998 as a joint venture between the Development Trusts Association, the Sheffield Community Enterprise Development Unit, and the South Yorkshire Community Foundation. The Key Fund was initially established to manage the distribution of South Yorkshire Objective 1 grant funding to small community groups.

As the organisation developed expertise in financing social enterprises and community groups, grant funding for the social economy in South Yorkshire in the early 2000s began to draw to a close, and a gap was identified for a CDFI providing grant/loan finance to social enterprises. In 2002 Key Fund South Yorkshire was established as a company limited by guarantee. In April 2002 the Key Fund for the Social Economy (KFSE) was launched as the organisation's principal funding stream for supporting and financing social enterprises, drawing on a range of sources of finance (such as the Objective 1 programme), including £1 million of capital funding from the Phoenix Fund. Key Fund South Yorkshire also secured £250,000 in revenue funding through Phoenix in order to build up organisational capacity; consultees from the Key Fund stressed the importance of these resources to the development of the CDFI, particularly since they enabled the organisation to expand outside of South Yorkshire. In 2007, Key Fund South Yorkshire was renamed Key Fund Yorkshire to reflect the organisation's region-wide coverage (South Yorkshire now accounts for just 35 per cent of lending activity).

Rationale and target market

The aim of Key Fund Yorkshire is to supply investment and loan finance to the social economy in Yorkshire and the Humber, in order to contribute towards relieving poverty, distress and disadvantage, and to assist in the regeneration of communities. The CDFI also has specific goals to encourage emerging social enterprises and to challenge existing businesses to think beyond traditional boundaries (e.g. in relation to accessing loan finance instead of grant finance).

Social enterprises form the main market for Key Fund Yorkshire, though funding is also available for community or voluntary organisations. The CDFI operates across the Yorkshire and Humber region, though legacy funding means that some funding streams can only be used in specific geographical areas (e.g. South Yorkshire). Key Fund Yorkshire only supports social enterprises that cannot obtain finance from mainstream banks, and, in general, requires a rejection letter to prove this (although some new start social enterprises are permitted to complete a self-certification proforma). In general, Key Fund Yorkshire positions itself as a provider of 'lead-in' finance to social enterprises; that is, finance intended to support businesses during start-up or early growth. This focus thus reduces the extent to which the CDFI is in competition with mainstream banks and larger national CDFIs serving more established social enterprises.

Financial products provided

Key Fund Yorkshire provides loan, grant and equity finance, including combinations of types of funding. The CDFI seeks to be innovative in terms of the financial products that it provides, both reacting to market demand and reflecting the organisation's growing experience of enterprise finance provision. At present, a range of financial
products are offered, tailored to meet the needs of various segments of the social enterprise finance market:

- **Growth fund**: finance of between £10,000 and £25,000 for start-ups or social enterprises with growth plans. A loan may be accompanied by a grant of up to £5,000, with a maximum 1:4 grant/loan ratio;
- **Loan fund**: loan finance only of between £1,000 and £100,000 for established social enterprises;
- **Equity fund**: investments range from £5,000 to £50,000.

The provision of grant funding is a reflection of the continued availability of grant funding for social enterprises, but consultees from Key Fund Yorkshire noted that the amount of grant funding provided has been decreasing in the past few years. Social enterprises can only access a grant once, after which time only pure loan finance is provided.

Table 1 shows how the volume and value of outstanding lending by Key Fund Yorkshire changed between 2006/07 and 2008/09, and for 2008/09 how this compares with the average for the CDFI sector as a whole. Overall, Key Fund Yorkshire has a lower than average number of outstanding loans and a lower than average value of outstanding loans. Average loan size (£20,900 in 2008/09) was also slightly lower than for the CDFI sector as a whole.

<table>
<thead>
<tr>
<th></th>
<th>Key Fund Yorkshire</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of outstanding loans</td>
<td>94</td>
<td>103</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£1,871,190</td>
<td>£2,156,465</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£19,906</td>
<td>£20,937</td>
</tr>
</tbody>
</table>

Source: Inside Out

Interest rates for the loans are carefully considered by the Key Fund Yorkshire, and set according to a combination of commercial needs, the requirements of funders, and the ability of the market to meet the rate charged. As at 2008/09, the average interest rate charged was 11.5 per cent, though rates ranged from 6.5 per cent to 18.5 per cent. An arrangement fee of 1 per cent of the investment is also charged.

**Loan application and appraisal procedure**

Loan applications are initially appraised by members of Key Fund Yorkshire’s loan team, who work up the application into a loan proposal. The proposal is then passed to a member of the finance team, who makes an assessment of whether the loan application is a viable prospect. The appraisal process is designed to be strong on due diligence, but based on relationship banking rather than credit scoring. Company searches are carried out to identify the history of company Directors and an ID check is also completed. The Key Fund does not complete individual credit checks on applicants. If the proposal passes these first checks it is passed to a loan panel that is made up of representatives of the Key Fund Yorkshire Board of Directors and external
organisations/ individuals (banks, social entrepreneurs, business experts etc). The CDFI Board ratifies the decision of the loan panel.

**Non-financial services provided**

In terms of non-financial products offered, consultees from Key Fund Yorkshire stressed that investment readiness is an important issue for their social enterprise target market. A high proportion of social enterprises, it was noted, are not fully investment ready, and with the decline in the availability of grant funding and the impact of the credit crunch, these applicants are forming an increasing proportion of the total. Support is provided to social enterprises as part of the application process, for instance by providing advice on marketing activity or company structure, but Key Fund Yorkshire noted that this can take up too much of a lending officer’s time, and so such support is carefully managed and a system of referral operated where possible.

**Demand for finance**

Demand for loan finance from social enterprises has been growing in recent years, according to representatives of Key Fund Yorkshire. In part this is reflection of increasing interest in social enterprises, which the CDFI itself promotes where possible (by highlighting the value of the social enterprise model to businesses). It was also suggested by Key Fund Yorkshire that social enterprises are increasingly willing to make use of debt finance, recognising that grant funds are becoming rarer (and in some cases are tied to loan finance).

Whilst a number of banks were becoming more willing to lend to social enterprises, it was noted that social enterprises are still frequently unable to access mainstream debt finance due to a lack of security or poor investment readiness. This was seen as a particular problem for pre-start or start-up social enterprises. A consultee from Key Fund Yorkshire reported that the credit crunch has made banks even less willing to lend to social enterprises, with the result that demand for CDFI loan finance had increased sharply over the past year or so (though conversely the recession has meant that a lot of larger social enterprises are consolidating rather than seeking to grow). However, the quality of this demand, it was suggested, had deteriorated, with applicants typically less investment ready than had previously been the case, requiring more work in order to make the loan feasible.

Table 2 shows how the number of loan applications received and the number of loans made (in the previous 12 months) by Key Fund Yorkshire changed between 2006/07 and 2008/09, and how this compares to the average for the CDFI sector as a whole in 2008/09. In 2008/09, Key Fund Yorkshire received 86 loan applications, compared to an average of 81 applications received for the CDFI sector as a whole. Between 2006/07 and 2008/09 the number of applications received by the CDFI doubled from 43 to 86.

**Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>Key Fund Yorkshire</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan applications received</td>
<td>43</td>
<td>71</td>
</tr>
</tbody>
</table>

217
Key Fund Yorkshire generates demand for loans primarily through its own marketing activities. A consultee from the CDFI noted that referral systems have not proved effective to date. Relationships have been established with large social banks (principally Charity Bank and the Unity Trust Bank), but business support organisations such as Business Link were not considered to be a particularly productive source of enquiries, principally due to concerns over the extent to which such businesses would be investment ready. Other CDFIs in the region had provided referrals, and indeed the approach favoured by Yorkshire Forward in its support for CDFIs in the region is one of collaboration (see below).

Organisational structure and capacity

Key Fund Yorkshire operates as a single legal entity, and is the trading name for Key Fund (South Yorkshire), a company limited by guarantee since 2002. The CDFI operates from a single office in Sheffield. As at 2008/09, the CDFI employed 10 FTE staff, compared to an average of 6.1 FTE staff for the CDFI sector as a whole, suggesting that as an organisation, Key Fund Yorkshire is relatively large by the standards of most CDFIs. In 2008/09 there were 3.5 FTE lending officers employed at Key Fund Yorkshire, compared to an average of 2 FTE lending officers for the CDFI sector as a whole.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Key Fund Yorkshire</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07 2007/08 2008/09</td>
<td>2008/09</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>9.1  7.5 10.0</td>
<td>6.1</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>3.5  3.5 3.5</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Lending capital income

Over time the lending capital held by Key Fund Yorkshire has increased steadily, and the CDFI has a goal to continue this trend in the future in order to both replace lost capital and grow in size. Since the main phase of the Phoenix Fund finished in 2006, Key Fund Yorkshire has obtained capital from a number of sources:

- Capital grants: The main sources of capital for Key Fund Yorkshire have been public sector funders in the region, particularly Yorkshire Forward which has historically provided financial support for both CDFIs and for lending to social enterprises. Key Fund Yorkshire has thus been able to access lending finance through the Phoenix Fund transitional phase (the management of which Yorkshire Forward devolved to the CDFA), and by successfully winning contracts to deliver social enterprise loan funds managed by Business Link South Yorkshire and Charity Bank in the North (both of which have been created by investment by Yorkshire Forward and ERDF finance);
CITR/ EFG: Key Fund Yorkshire is not accredited under either the CITR or the EFG schemes. In relation to CITR, a consultee from the CDFI suggested that they would consider this as a future source of income, but that to date they had not had the capacity to apply for accreditation, and in any case the availability of capital grant funding to date had meant that this was not a priority.

In 2008/09, Key Fund Yorkshire had had access to a loan fund worth some £5.5 million (Table 4), an increase of around £2 million from 2006/07. Relative to the CDFI sector as a whole, the capital pot available to Key Fund Yorkshire is of above-average size.

Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Key Fund Yorkshire</th>
<th>CDFI sector average</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>2006/07 2007/08 2008/09</td>
<td>2008/09</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£3,507,897 £4,718,944 £5,514,177</td>
<td>£4,310,538</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£1,871,190 £1,996,899 £2,156,465</td>
<td>£2,226,932</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>60% 44% 47%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Bad debt

Key Fund Yorkshire focuses on maintaining a low level of loan delinquency and write-off, in order to ensure that the capital fund is not depleted. Table 5 shows the value of loan delinquency and write-offs as a proportion of outstanding lending by Key Fund Yorkshire between 2006/07 and 2008/09. Key Fund Yorkshire has the same proportion of loan write-off to that of the CDFI sector as a whole. It was reported that loan repayments are closely monitored, and where deadlines are missed, loan officers contact businesses to identify the cause of the problem. Potential corrective measures include repayment holidays and loan repackaging. It was suggested by Key Fund Yorkshire that the social enterprise sector is also less prone to loan repayment problems than the markets served by other CDFIs. Culturally, it was also reported that the social enterprise sector in Yorkshire and Humber forms more of a community, such that businesses are more aware of the impacts on other regional firms should they default on their loan.

Table 5 also shows that levels of loan write-off at Key Fund Yorkshire increased between 2006/07 and 2008/09. Consultees from the CDFI noted that the credit crunch has had an adverse effect on loan repayment, though it was suggested that, to date, there has not been a significant increase in the number of businesses closing.

Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

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<tr>
<th>Key Fund Yorkshire</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>0%</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>0%</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>0%</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>4%</td>
</tr>
<tr>
<td>Written-off</td>
<td>3%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Revenue income

Revenue income is needed in order to cover Key Fund Yorkshire’s operational costs, and is generated through a number of income streams:

- **Revenue grants**: Key Fund Yorkshire has historically received significant revenue grant support to cover the costs of its operations, typically in association with the delivery of public sector capital grant funds (see above). Specifically, these have included revenue grants to deliver the funds managed by Charity Bank in the North, Business Link South Yorkshire, and Phoenix Fund transitional funding;

- **Portfolio income**: Key Fund Yorkshire also generates income from interest earned on loans, arrangement fees charged, and interest earned on invested capital.
GLE oneLondon

Origins and development to the present

GLE oneLondon is a subsidiary of the GLE (Greater London Enterprise) Group, a London-wide economic development company that was originally founded in 1982. From around 1985 onwards, GLE began providing loans to businesses, focussing on meeting the needs of entrepreneurs and companies that were excluded from mainstream finance provision. In 2001, GLE launched oneLondon in order to consolidate the company’s enterprise and community development activity, including the provision of loan finance. GLE oneLondon currently delivers a range of enterprise services alongside loan provision, including start-up support, business training, and advice on international trade.

In some respects, GLE oneLondon operates a different model from most other CDFIs. In 2000, GLE established the pan-London London Business Loan Fund, backed with finance from the LDA (the RDA for London) and HSBC. Under the Phoenix Fund, oneLondon was granted a guarantee facility (as opposed to capital funding), one of just four CDFIs to do so, which enabled the further leverage of funding from banks. oneLondon also accessed Phoenix Fund revenue funding to support the development of a new CDFI wholesale fund, backed by CITR accreditation, for on-lending to other retail CDFIs. The Phoenix Fund thus had a significant impact on oneLondon, with a consultee from the CDFI noting that the lending activities of the organisation grew to become much more significant than they were prior to the scheme.

Since the end of the Phoenix Fund in 2006, the most significant milestone in the development of GLE oneLondon has been the creation of the London Business Loans Wholesale Loan Fund. The Wholesale Fund is operated by a separate company – London Business Loans (Wholesale) Ltd – which is accredited to receive investment through the CITR scheme. The Wholesale Fund is available for on-lending directly by GLE oneLondon, and can also be accessed by other loan retailers (mainly CDFIs but potentially also other non-bank lenders) for on-lending to SMEs in London. GLE oneLondon is itself a retailer, and is also managing the delivery of Wholesale Fund loan facilities provided by a number of London Borough Councils (namely Westminster, Bexley and Lambeth which, between them, contributed a total of £785,000 to the loan fund). Importantly, the LDA has used the Wholesale Fund as a mechanism for distributing its credit crunch/ recession triggered Economic Recovery Fund, the responsibility for the delivery of which has been shared between GLE oneLondon and the East London Small Business Centre.

Alongside the Wholesale Fund, GLE oneLondon still operates legacy capital funds (collectively termed the ‘Retail Fund’), consisting of funds provided on a grant or loan/ overdraft facility by, amongst others, HSBC/ HBOS and Business Link London. GLE oneLondon also manages funds on behalf of other organisations (outside of the Wholesale Fund), and is currently delivering the Croydon Enterprise Loan Fund, a LEGI-funded enterprise support scheme.

Rationale and target market

The rationale for the lending activity of GLE oneLondon is much the same as it was when the CDFI was launched – to support start-up and existing businesses that are unable to access finance from mainstream banks. Target markets are micro businesses, SMEs and social enterprises, and GLE oneLondon operates across
London. The principal lending criterion for GLE oneLondon is that applicants must have had a finance application rejected by a bank. The CDFI does not require a letter of rejection as proof, however, though consultees stressed that businesses would be unlikely to use their services rather than those of a bank, given their relatively high interest rates.

GLE oneLondon’s use of external funds also means that more detailed lending criteria are set by individual funders. These target markets tend to be defined geographically, usually by local authority (e.g. Lambeth, Croydon or Bexley), though can also vary by business type (commercial or social enterprise), or business age (start-up or established company). Historically, GLE oneLondon has also delivered funds with particular demographic foci, for instance particular BAME groups, or female entrepreneurs.

Financial products provided

GLE oneLondon delivers a wide range of enterprise support activities, whilst other areas of the GLE Group provide other financial products (such as equity finance). The loan finance service of GLE oneLondon (i.e. the CDFI) only provides business loans (no personal loans). Loan details vary depending on the fund being accessed:

- GLE oneLondon’s Retail Fund provides loans ranging from between £1,000 and £100,000 for established businesses and from between £1,000 and £250,000 for social enterprises. Lending to start-ups has recently been suspended;
- The Wholesale Loan Fund provides loans ranging from £20,000 up to between £75,000 and £250,000 depending on the target market (social enterprises can access the largest loans), and whether applicants are able to provide property as security. Loans are typically repayable over either 7 or 15 years;
- The other funds managed by GLE oneLondon (Croydon Enterprise Loans and the schemes managed on behalf of Lambeth, Bexley and Westminster Borough Councils) all have specific loan size ranges.

Table 1 shows the volume and value of outstanding lending by GLE oneLondon between 2006/07 and 2008/09, and how this compares to the CDFI sector average in 2008/09. By the standards of the CDFI sector, GLE oneLondon is a very large lender, with over three times the number of outstanding loans than the CDFI sector average. The total value of outstanding lending was also considerably above-average (£3.3 million in 2008/09), though Table 1 also shows that the average size of loan distributed by GLE oneLondon was considerably smaller than the average for the sector as a whole (£9,600 compared to £21,100 for all CDFIs). The majority of loans provided by GLE oneLondon are borrowed by micro enterprises, which, typically, require less capital than SMEs or social enterprises.
Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of outstanding loans</td>
<td>324</td>
<td>328</td>
<td>345</td>
<td>112</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£2,733,963</td>
<td>£3,497,072</td>
<td>£3,325,382</td>
<td>£2,374,952</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£8,438</td>
<td>£10,662</td>
<td>£9,639</td>
<td>£21,131</td>
</tr>
</tbody>
</table>

Source: Inside Out

The interest rates charged on loans also vary according to the loan fund accessed, and are determined by GLE oneLondon and/or the funders providing the capital for on-lending. GLE oneLondon’s Retail Fund typically charges a fixed rate of 8.81 per cent (7.85 per cent for social enterprises), together with an arrangement fee of between 1 per cent and 1.5 per cent (maximum £500). The Wholesale Fund charges a fixed rate of between 8.81 per cent and 11.31 per cent, together with an arrangement fee of 2 per cent. Details vary for the funds managed on behalf of the London Boroughs, ranging from a fixed interest rate of 5.85 per cent for the Croydon Enterprise Loan fund, up to a fixed rate of 8.81 per cent and an arrangement fee of 3 per cent for the Bexley enterprise loan fund.

Loan application and appraisal procedure

GLE oneLondon uses a single application form, and then allocates applicants to the most relevant fund (replacing the previous system whereby applicants had to specify which of the various loan funds they wished to use). Applications are processed by a loan officer, and must be accompanied by background information including bank statements and a business plan (a template is available for download on the GLE oneLondon website). On the basis of the application, loan officers then make a decision about whether to proceed; if so, applicants must then present to a loan panel for final approval. The loan panel is made up of the Managing Director of GLE oneLondon and a specialist credit recovery manager; consultees from the CDFI highlighted the effectiveness of the model, arguing that only using internal staff meant that the needs of the CDFI were fully factored into the decision-making process. The presence of the credit recovery manager on the panel, it was suggested, also ensured that the decision as to whether to approve an application was in part based on the experience of an individual with an expertise in bad debt.

Non-financial services provided

At present, GLE oneLondon offers a free mentoring service to businesses, using an external network of business mentors. This scheme is designed to provide post-loan support to businesses in order to improve their performance (and thus reduce the likelihood that they will default on payment). The mentoring service is funded using internal revenue income, though were the scale of this income to decrease, the offer of free mentoring would potentially have to end (perhaps to be replaced by a charging service). Until March 2010, the LDA also funds a London-wide Access to Finance Programme under which CDFIs like GLE oneLondon are paid to refer businesses to specialist providers of investment readiness training (such as enterprise agencies), meaning that the CDFI is able to offer access to additional free support for its clients.
Demand for finance

Consultees from GLE oneLondon reported that the primary driver of demand for loans has been the business lending behaviour of mainstream banks, both in terms of the amount of capital available, and the terms and conditions attached (e.g. whether security is required). Since the onset of the credit crunch, a consultee from GLE oneLondon reported that demand for loans has increased significantly. Related to this, large numbers of applications have been received from businesses that would previously have been able to access bank loans. The number of entrepreneurs looking to start businesses was also reported to have increased, as individuals look to use redundancy payments to become self-employed.

Table 2 shows how the number of loan applications received and the number of loans made (in the previous 12 months) by GLE oneLondon changed between 2006/07 and 2008/09, and how this compares to the average for the CDFI sector as a whole in 2008/09. In 2008/09 the CDFI received an above-average number of loan applications (332 compared to an average of 81 for the sector as a whole). Table 2 also demonstrates the impact of the credit crunch on demand for GLE oneLondon loans, with the number of applications doubling between 2006/07 and 2008/09. The conversion rate (i.e. the number of loan applications approved) dropped from 51 per cent in 2007/08 to 29 per cent in 2008/09.

Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>GLE oneLondon</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Loan applications received</td>
<td>162</td>
<td>179</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>86</td>
<td>91</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>53%</td>
<td>51%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Referrals are the main way in which GLE oneLondon generates loan applications. Various routes are used, though the most important are referrals from elsewhere within the GLE Group (including from within GLE oneLondon itself). Other London-based enterprise agencies also generate referrals, as do other CDFIs. GLE oneLondon also operates a network of introducers – generally accountants and individuals from within banks – who refer good candidates to the CDFI (potentially for a small arrangement fee). Business Link was not seen to be a useful source of referrals, with a consultee from GLE oneLondon noting that business advisors rarely understood the CDFI model, and in any case were generally not able to identify investment ready businesses, thus resulting in poor quality referrals.

GLE oneLondon also undertakes marketing activities in order to raise its profile within the business community. Specifically, staff attend events run by enterprise agencies and other business support providers, whilst the CDFI has also run advertising campaigns (though questions their effectiveness). GLE oneLondon also relies upon other CDFIs in London to promote their services if they are unable to support
businesses themselves (particularly since GLE oneLondon are pan-London whereas the alternatives tend to be geographically-focussed).

Organisational structure and capacity
The organisational structure for GLE oneLondon is different to that of most other CDFIs. The CDFI is part of GLE oneLondon, an enterprise-focussed subsidiary of the GLE Group (which provides a broader range of economic development services). GLE oneLondon is a private company limited by guarantee, and is an accredited lender under the EFG scheme. A separate company – London Business Loans (Wholesale) Ltd – operates the lending wholesale fund described previously, and is listed an accredited CDFI under the CITR scheme (instead of GLE oneLondon). Instead, GLE oneLondon manages the Wholesale Loan Fund on behalf of London Business Loans (Wholesale) Ltd.

GLE oneLondon operates from a headquarters in London. Table 3 shows the numbers of staff employed by GLE oneLondon to manage and deliver lending activity. Relative to the rest of the CDFI sector, GLE oneLondon is a large CDFI, employing almost double the average number of people in 2008/09, and with 5 FTE loan officers (compared with an average of 2 loan officers for the CDFI sector as a whole). The size of GLE oneLondon is very much a reflection of the scale of its lending, together with the investment readiness business support services provided in addition to loan distribution.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th><strong>GLE oneLondon</strong></th>
<th></th>
<th><strong>CDFI sector average</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
<td>2008/09</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>7.0</td>
<td>19.0</td>
<td>11.0</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>5.0</td>
<td>6.0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

Lending capital income
As described above, from the outset GLE oneLondon have adopted a more commercially-minded approach to accessing capital funding than the majority of the CDFI sector. For example, the CDFI did not obtain any direct capital grant funding through the Phoenix Fund, instead receiving a guarantee facility to lever in bank finance. In recent years, capital finance has come from a number of sources:

- **Capital grants**: GLE oneLondon has received some capital grant funding for on-lending, including resources provided by Business Link for London, and also from the LEGI-funded Croydon Enterprise programme;
- **Capital loans/ overdrafts**: Both GLE oneLondon and London Business Loans have accessed loans/ overdrafts for on-lending to businesses. GLE oneLondon’s retail fund, for example, includes an overdraft facility of £500,000 from HSBC that was accessed in 2007 for on-lending to businesses (at the time this was secured under SFLG). The London Business Loans Wholesale Fund received a £2.25 million loan from the LDA as part of the Mayor’s Economic
Recovery Fund that was launched in 2009 (Barclays provided an additional loan of £750,000);

- **CITR**: London Business Loans (Wholesale) Ltd is accredited to receive investment under CITR. The fund initially received equity investment worth £510,000 from its three founders (GLE oneLondon, the LDA and Kingston Smith). Subsequently the fund was boosted by a CITR backed loan from the Co-operative Bank that was worth £3 million, and a loan worth £100,000 from Kingston Smith. London Business Loans (Wholesale) Ltd expects to secure further CITR investment in the future, though consultees from GLE oneLondon noted that the profile of CITR is still insufficiently high amongst investors, making attracting investment a time-consuming process.

In 2008/09, GLE oneLondon had had access to loan funds worth some £5.2 million (Table 4). Relative to the CDFI sector as a whole, the capital pot available to GLE oneLondon is of above-average size.

### Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>GLE oneLondon</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£5,632,963</td>
<td>£7,093,777</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£2,733,963</td>
<td>£3,497,072</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>49%</td>
<td>52%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

**Bad debt**

GLE oneLondon focuses on maintaining a low level of loan delinquency and write-off, in order to ensure that the capital fund is not depleted. Table 5 shows the value of loan delinquency and write-offs as a proportion of outstanding lending by GLE oneLondon between 2006/07 and 2008/09. Overall, the CDFI has the same level of loan write-off as the sector as a whole, though loan delinquency of at least 90 days, expressed as a proportion of outstanding lending, was considerably above the average for the sector as a whole in 2008/09. Consultees from GLE oneLondon noted that loan delinquency has increased as a result of the recession, but also that their systems were robust enough to ensure that the risk of bad debt was kept to an acceptable minimum.

GLE oneLondon employ a specialist credit recovery manager who is responsible for dealing with repayment arrears. Previously this had been the responsibility of loan officers, but it was felt that it would be a better use of their time to generate loan applications, and also that a separation between the individuals responsible for developing loans and the individual responsible for pursuing late payments would be more effective. As noted above, the credit recovery manager also forms one half of

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100 Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
the loan approvals panel, ensuring that their expertise forms part of the decision-making process as to whether to proceed with loans.

Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>GLE oneLondon</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>n/a</td>
<td>6%</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>n/a</td>
<td>4%</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>n/a</td>
<td>2%</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>n/a</td>
<td>6%</td>
</tr>
<tr>
<td>Written-off</td>
<td>n/a</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Revenue income

Revenue income is needed in order to cover GLE oneLondon’s operational costs which, as shown in Table 3, include a large team of loan officers and other members of staff. Historically, GLE oneLondon received significant revenue support in the form of public sector grants, for instance through the Phoenix Fund. As these sources of finance have become more difficult to access, the CDFI has diversified its income streams, and now draws revenue income from the following sources:

- **Revenue grants**: Until March 2010, GLE oneLondon will receive between £2,000 and £2,500 from the LDA for each loan awarded (using the RDA’s remaining Phoenix Fund resources), which the CDFI notes has been a valuable source of revenue income in the past year or so;

- **Portfolio income**: Interest earned on loans and arrangement fees charged constitute an important source of income for GLE oneLondon, though it was noted by the CDFI that they are constrained in the interest rate that can be charged both by the requirements of funders and their own social goals in terms of improving access to loan finance;

- **Invested capital**: Interest earned on invested capital – particularly the Wholesale Loan Fund – is an important source of income for the CDFI, and the drop in the Bank of England base rate has had an adverse effect on this source of revenue income;

- **Income from funds under management**: GLE oneLondon – and its associated wholesale loan fund company – has been designed to generate income through fund management, which is then used to cover operational costs. As the Wholesale Loan Fund has grown this has become an increasingly important source of income for the CDFI.
Project North East

Origins and development to the present

Project North East (now the Project North East Group) was launched in 1980 by two individuals seeking to stimulate employment and economic activity in the North East through enterprise development. Over time, Project North East expanded the scale and range of its activities, and what is now the Project North East Group includes divisions focussing on third sector development, property management, enterprise support, and consultancy.

As part of its enterprise support remit, in 1987 Project North East established the Northern Youth Venture Fund, a charity focussing on lending to 18-29 year olds to help them set up their own businesses. Over time, the lending activity of Project North East increased in both scale and scope, and was recently consolidated to form the Project North East Loan Fund, a specialist CDFI loan division within the Project North East Group. The Loan Fund has largely been developed using external grant funding, most notably £200,000 from the Phoenix Fund, together with resources from the European Social Fund. Since July 2009, the CDFI has also been involved in a £1 million CDFI microloan fund pilot project, part of a broader Regional Enterprise Loan Fund that was set up by the RDA for the region, One NorthEast (see below).

Rationale and target market

What is now the Project North East Loan Fund was initially set up to assist young people aged 18-29 wanting to become self employed by providing them with loans to help them establish their own business. The rationale for the Loan Fund is generally the same as it initially was – to provide finance to assist business start-ups, focussing on individuals who cannot obtain finance from mainstream sources.

Over time the target market for the CDFI has broadened, and now extends to anyone aged over 18 who can demonstrate an element of disadvantage (social, financial and/or educational) in their background. The Loan Fund also seeks to support individuals who, without finance, would be unemployed. Start-ups are the main recipients of lending; at present around 95 per cent of loans are with businesses that started within the previous 12 months. As a result, almost all of the CDFI’s loans are also with micro enterprises, together with a small number of small businesses (no social enterprises). Geographically, the Project North East Loan Fund lends to individuals and businesses based in Tyne and Wear, Northumberland and/or North Durham (i.e. most of the North East region, excluding Tees Valley and the remainder of County Durham). Loans are also only available to individuals who can prove that they have been rejected by a mainstream bank.

Financial products provided

The only financial product offered by the Project North East Loan Fund is a business loan. Loans range in size from £500 to £5,000, meaning that the CDFI is focussed on the micro-lending market. The repayment period for the loans is three years, and the interest rate charged is typically fixed at 10 per cent. There are no fees charged, and the loan portfolio is currently 100 per cent unsecured.

Table 1 shows how the volume and value of outstanding lending by the Project North East Loan Fund changed between 2006/07 and 2008/09, and for 2008/09 how this
compares with the average for the CDFI sector as a whole. Overall, in 2008/09 the Loan Fund had a slightly lower than average number of outstanding loans, and a much lower than average value of outstanding lending (around £270,000). In keeping with the focus on micro enterprises/ start-ups, the average loan size for the Project North East Loan Fund was considerably below average (£2,700 in 2008/09). Between 2006/07 and 2008/09 the volume and value of lending by the Loan Fund dropped, a trend attributed by consultees to declining demand, primarily as a result of the mechanism through which the Loan Fund currently receives loan applications (see below).

### Table 1: Volume and value of outstanding (business) lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Project North East Loan Fund</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>No. of outstanding loans</td>
<td>178</td>
<td>141</td>
</tr>
<tr>
<td>Value of outstanding loans</td>
<td>£493,000</td>
<td>£307,000</td>
</tr>
<tr>
<td>Average size of loan</td>
<td>£2,770</td>
<td>£2,177</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

### Loan application and appraisal procedure

The mechanism through which the Project North East Loan Fund generates loan enquires is detailed below. The application process requires that applicants submit a loan application to the Loan Fund team, with supporting documentation. This documentation is expected to include a business plan with financial forecasts, together with information needed for identity checks. As set out below, applications are also generally expected to include a letter of recommendation from a business advisor, since the CDFI relies upon a system of referrals in order to generate quality applications.

Once an application is received, loan officers at the Project North East Loan Fund carry out a credit enquiry on applicants, followed by an interview designed to assess the capacity of individuals to run their own business and to explore the viability of the business proposition. The Loan Fund officer responsible for the application then prepares a report on the basis of the application, the business plan and the outcome of the assessment interview. This report provides detail on the proposed business, the people involved, the funding package including any grants, what financial information has been provided in support with comments where appropriate, and a summary including a recommendation as to whether to approve the application. These reports are then submitted to the Trustees of the Loan Fund who jointly make a decision as to whether to proceed with the loan.

### Non-financial services provided

The Project North East Loan Fund does not provide any non-financial services, and instead focuses on the management and delivery of loans. Where support is needed by loan applicants, they can be referred to the relevant division of the Project North East Group, which provides a range of enterprise agency services (including specialist start-up support, mentoring and training). In the past, staff from the Project North East
Loan Fund have inputted into the design of these wider services to ensure that they meet the needs of loan applicants.

**Demand for finance**

As Table 2 shows, in general the Project North East Loan Fund receives a larger number of applications each year than the average for the CDFI sector as a whole (87 applications in 2008/09 compared to an average of 81 applications for the CDFI sector), reflecting the focus on relatively large numbers of micro loans. Nevertheless, consultees from the Loan Fund noted that there has been a drop in the number of applications received, particularly in 2007/08 when the CDFI received just 33 loan applications.

**Table 2: Number of (business) loan applications received and loans made (previous 12 months), 2006/07 to 2008/09**

<table>
<thead>
<tr>
<th></th>
<th>Project North East Loan Fund</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan applications received</td>
<td>118 33 87</td>
<td>81</td>
</tr>
<tr>
<td>Loans made (drawn down)</td>
<td>71   33 38</td>
<td>39</td>
</tr>
<tr>
<td>Conversion rate</td>
<td>60% 100% 44%</td>
<td>48%</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

The reason for the decline in the number of applications received shown in Table 2, it was argued, was primarily the result of the way in which the Loan Fund generates demand for its products. Almost all loan applications are received through referrals from enterprise agencies in the region; indeed, the CDFI generally will not accept ‘speculative’ applications. This system is used to ensure that applicants are, as far as possible, investment ready prior to their application (specifically through the production of a quality business plan). The Project North East Loan Fund undertakes almost no marketing activity, except to ensure that enterprise agencies are aware of the service.

Prior to 2007, most applications were received through referrals from the Project North East Group, specifically the enterprise support agency. Consultees argued that this referral route worked well, as applicants were receiving good quality business advice and support from the enterprise agency, specifically in relation to assembling quality business plans.

Since 2007, in line with the requirements of the Solutions for Business product portfolio, enterprise support within the region has been centralised and is now led by Business Link North East. Under this new system, potential loan applicants who have been working with the Project North East Group must now be referred initially to Business Link. Business Link advisors now charge new entrepreneurs a fee to develop a business plan (potentially £300), which may be unable to pay. Furthermore, it was argued, the business plans that are produced are often of poor quality, since the support provided is not of the same standard as was provided by the Project North East Group. Loan advisors at the Loan Fund must now spend more time reviewing business plans to assess the suitability of the applicant, placing strain on the system and reducing the overall number of applicants that can progress. The
introduction of this new system (which was initially delayed) meant that 2007/08 was a very poor year for the Loan Fund (see Table 2), though as Business Link North East becomes more established, the situation may improve.

Organisational structure and capacity

As described above, the Project North East Loan Fund is a specialist division of the wider Project North East Group. The Loan Fund operates from the headquarters of the Project North East Group, in Newcastle. Day-to-day management and delivery of the Loan Fund is carried out by two part-time managers, both of whom are qualified bankers with over 50 years lending experience between them. As shown in Table 3, the Project North East Loan Fund thus has the equivalent of 1 FTE staff member, considerably below the sector average of 6.1 FTE staff members.

Table 3: FTE staff, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Project North East Loan Fund</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07 2007/08 2008/09</td>
<td>2008/09</td>
</tr>
<tr>
<td>No. of FTE staff</td>
<td>1.0      1.0      1.0</td>
<td>6.1</td>
</tr>
<tr>
<td>No. of FTE lending officers</td>
<td>1.0      1.0      1.0</td>
<td>2.0</td>
</tr>
</tbody>
</table>

*Source: Inside Out*

Lending capital income

The Project North East Loan Fund has been built up over time through injections of capital from a number of sources. Overall, consultees from the CDFI reported that accumulating additional capital is not their primary concern, and instead that they are focussed on ensuring sufficient quality demand to lend out the capital that they presently have available. In recent years, the Loan Fund has received capital from the following sources:

- **Capital grants:** The CDFI received capital grants as part of the Phoenix Fund, which then enabled the Loan Fund to lever in European Social Fund resources. Together these two sources of income have provided the majority of the Loan Fund’s capital pot. In 2008 the Loan Fund received a small grant to deliver loans to start-up businesses in Northumberland;

- **Portfolio income:** The Loan Fund is also topped up using income from interest payments on loans and interest generated through invested capital reserves. With a small team, the CDFI does not require much revenue income and so, unlike a number of other organisations in the sector, the Project North East Loan Fund can re-invest interest income into the capital fund.

As Table 4 shows, in 2008/09 the Project North East Loan Fund was worth some £1.1 million, having decreased from £1.2 million in 2006/07 (the result of a relatively high bad debt rate – see below). Relative to the CDFI sector as a whole, the Project North East Loan Fund is a relatively small fund.
Table 4: Value of loan fund and deployment rate (business and personal lending), 2006/07 to 2008/09

<table>
<thead>
<tr>
<th>Project North East Loan Fund</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
</tr>
<tr>
<td>Value of loan fund</td>
<td>£1,213,000</td>
</tr>
<tr>
<td>Value of outstanding lending</td>
<td>£493,000</td>
</tr>
<tr>
<td>Deployment rate</td>
<td>42%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Bad debt

As Table 5 shows, the Project North East Loan Fund has a relatively high level of loan write-off (write-offs were equal to 30 per cent of the value of outstanding lending in 2008/09, compared to 7 per cent for the CDFI sector as a whole). The level of bad debt has remained relatively constant over the past three years, suggesting that the recession has not yet had a significant impact on the CDFI, and that loan defaults are more a feature of the CDFI's target market.

Consultees from the Project North East Loan Fund stressed that their target market – start-up businesses by disadvantaged individuals who have been unable to access finance from mainstream banks – mean that a relatively high level of loan write-offs are to be expected. Indeed, the CDFI is prepared to take on a relatively high level of risk to support those applicants that are both deserving and likely to have a reasonable chance of success.

Nevertheless, it was reported that loan repayments are closely monitored, and where deadlines are missed, loan officers contact businesses to identify the cause of the problem. Although the Project North East Loan Fund is prepared to take on a relatively high level of risk to support its deserving applicants, it does seek to minimise the level of loan delinquencies. Where loan holders fail to meet repayments and fail to offer alternative contributions or work with the Loan Fund towards a satisfactory repayment programme, the CDFI will consider legal redress. In such cases, an independent agency is employed to pursue the delinquent borrower via the courts system. Legal action is taken towards obtaining a County Court Judgement against the delinquent party for the amount outstanding.

Note that the data presented on bad debt is not disaggregated according to the lending market (see Figure 3.8) since CDFIs tend to operate across markets. Nevertheless, it should be stressed that the sector-wide average is skewed by the presence of large CDFIs lending to social enterprises which tend to have a negligible bad debt rate, and thus comparisons between individual CDFIs should be treated with caution.
Table 5: Value of loan delinquencies (business lending) and write-offs (business and personal lending) as a proportion of outstanding lending, 2006/07 to 2008/09

<table>
<thead>
<tr>
<th></th>
<th>Project North East Loan Fund</th>
<th>CDFI sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006/07</td>
<td>2007/08</td>
</tr>
<tr>
<td>1-30 days delinquency</td>
<td>0%</td>
<td>n/a</td>
</tr>
<tr>
<td>31-60 days delinquency</td>
<td>0%</td>
<td>n/a</td>
</tr>
<tr>
<td>61-90 days delinquency</td>
<td>0%</td>
<td>n/a</td>
</tr>
<tr>
<td>&gt;90 days delinquency</td>
<td>12%</td>
<td>n/a</td>
</tr>
<tr>
<td>Written-off</td>
<td>31%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Source: Inside Out

Revenue income

Revenue income is needed in order to cover the operational costs of the Project North East Loan Fund. As Table 3 shows, the organisation is very small by the standards of the CDFI sector, and so operational costs are estimated to be around £85,000 a year. Revenue income has been generated through the following sources:

- **Revenue grants:** The Loan Fund has historically received revenue grant support through the Phoenix Fund, followed from 2006 onwards by grant support through One NorthEast as part of Phoenix Fund transitional support. Most recently the CDFI has been taking part in One NorthEast’s Microloan Fund Pilot, which has generated additional revenue income;

- **Portfolio income and invested capital:** These two sources of income are key to covering the CDFI’s operational costs, but consultees reports that the drop in the Bank of England base rate has had an adverse effect on the level of income received. As a result, alternative sources of investment are being investigated.