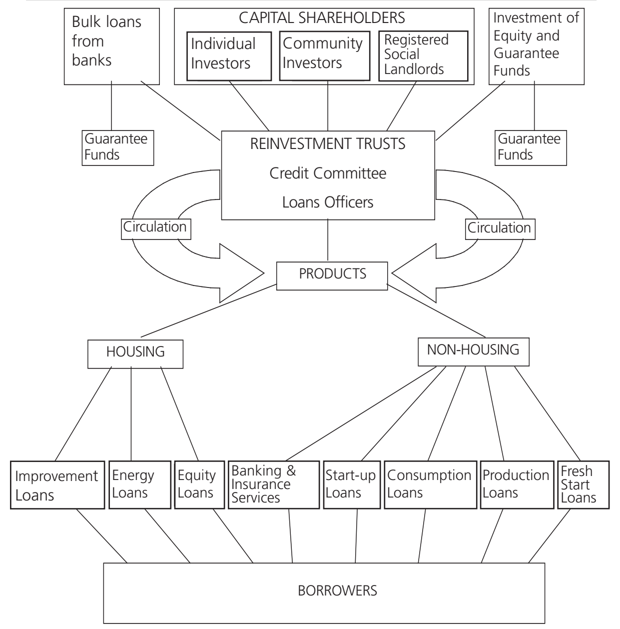
Before the creation of the CRT-based CDFI, there were few alternatives for the financially excluded. Existing community finance initiatives only provided finance for SMEs and the self-employed who did not have access to mainstream business loans. The credit union movement's ability to serve low-income households was also limited by the requirement, at that time, on saving before borrowing; and by its limited scale.

Figure 1 shows how it was initially thought that the CRT model would work. A unique feature of the CRT-based CDFI is that it would constitute a one-stop shop for the financially excluded, offering seed-corn finance for self-employment, housing loans for asset-rich, income poor households, affordable and appropriate consumption credit to help poor households make ends meet, and money and debt advice for the over-indebted.

FIGURE 1: THE COMMUNITY REINVESTMENT MODEL



Funds would be raised from individual and community investors who would entrust their capital to institutions with a high social dividend but a low-income yield. Loan capital would be raised through private and public sector grants, and through bulk loans from banks. To date, the CDFIs have mainly relied on the use and re-use of granted loan capital.

The importance of operational sustainability

One of the central premises of the CRT-based CDFIs, and of the UK CDFI sector more broadly, was that they would become largely self-sustaining in the medium to long-term. There are two key measures of sustainability: operational and financial.

Operational sustainability refers to the degree to which the CDFIs can cover their costs with income from their core activities (i.e. fee and interest rate income from their loan portfolio, and interest income from deposits), whilst financial sustainability refers to the degree to which the CDFIs are able to cover all their costs whilst raising all lending capital through recycling of existing funds and through commercial loans.

In a sense, the path towards a fully sustainable CDFI sector may be best viewed as a stepwise process where the starting point is total subsidy dependence and the arrival point is financial sustainability via operational sustainability. The CDFIs in the sample and in the UK more broadly are likely to be somewhere along this continuum. Therefore, this study mainly focused on operational rather than financial sustainability.

Becoming more financially and operationally sustainable is a question of paramount importance for the CDFIs and their funders. Enhancing the ability of CFDIs to cover their operating costs is likely to strengthen the sector's ability to withstand potential funding shortages.

Research design

Previous research into the UK CDFI sector has identified three ways in which the CDFIs can become more sustainable:

- A diverse and balanced loan portfolio may protect against changes in funding and other circumstances impacting upon certain products;
- Enhancing staff efficiency and productivity constitutes a key way to reduce costs and increase revenue without passing on costs to the customer; and
- Effective partnerships can increase the customer base through marketing and referrals, reduce costs by transferring them to the partner organisation and by accessing funding

Thus this research project analysed how five leading UK CDFIs performed in these three areas through an in-depth analysis of the performance of their loan portfolio, of their partnerships, and of the way in which their staff members spend their time and the processes and structures driving this time-use.

Table 1: The CDFIs studied

	CDFI A	CDFI B	CDFI C	CDFI D	CDFI E
Number of employees (FT positions)	10	12	5	11	5
Total value OLP (£ '000)	951'	202'	554'	444'	520'
Financial products (% of OLP)	PL (74) BL (26)	PL (37) BL (34) SEL (29)	PL (54) BL (46)	PL (58) BL (41) HIL (1)	HIL (100)
Loans granted by product	PL: 1262 BL: 78	PL: 202 BL: 46 SEL: 2	PL: 310 BL: 23	PL: 562 BL: 41 HIL: 4	HIL: 89
Other services	SP	DMA	..	DMA	..
Branches	3	2	2	2	1

Source: Loan portfolio data provided by the CDFIs for the financial year of April 2006 to March 2007

Notes: * Assessed on March 31 2007

Abbreviations: PL = Personal loans, BL = Business loans, SEL = Social Enterprise Loan, HIL = Home Improvement Loans, SP = Savings products, DMA = Debt and Money Advice, FT = Full-time, OLP = Outstanding loan portfolio

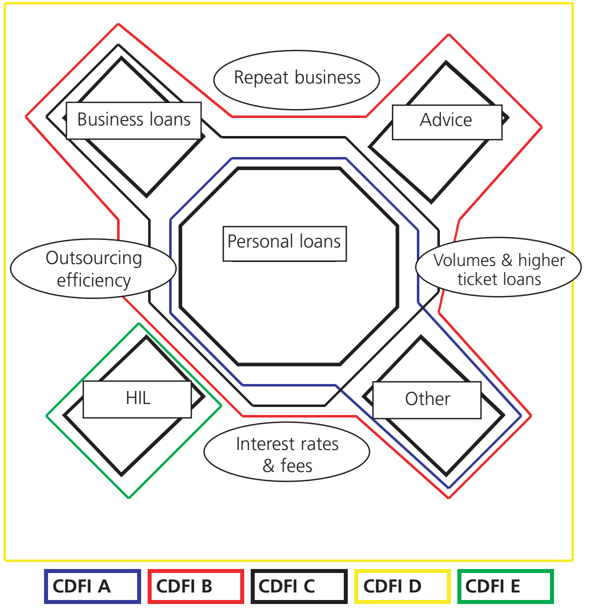
Table 1 summarises the main characteristics of the CDFIs in the study. Four of the CDFIs focus predominantly on the provision of personal loans: CDFI A-D, while CDFI E is a specialised home improvement loan provider.

FINDINGS

Towards a sustainable business model

Figure 2 depicts how the CDFIs may move towards operational sustainability. As the core business of personal lending is unlikely to become fully self-sustaining due to high transaction costs and small loan amounts, personal lending may be complemented with and part subsidised by home improvement loans, business loans, financial advice and other services (surrounding the personal lending octagon). The performance of the personal loan portfolio may also be enhanced through a set of levers as illustrated by the circles surrounding the central octagon.

FIGURE 2: CDFI OPERATIONAL SUSTAINABILITY



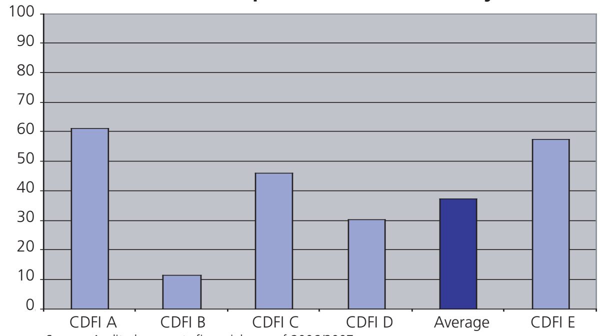
Both the development and the application of this model have been guided by a practitioner-led approach, by which the CDFI management and boards have adapted the original model to work with the local conditions and restrictions. Hence, whilst all the CDFIs still retain the core business of personal loans, the CDFIs have pursued this model to varying degrees as illustrated by the coloured lines in Figure 2. The study revealed that the CDFIs had moved along two practice models: one of specialisation and concentration of one product and one of a mixed portfolio.

The findings for the four CDFIs delivering personal loans suggest that a high degree of specialisation and single-mindedness lead to higher innovation and efficiency gains in particular products. However, the degree to which the CDFIs can specialise depends on the nature and magnitude of deprivation. In areas where poverty exists only in pockets among more affluent areas – such as the area in which CDFI D operates – there is a challenge of reaching appropriate scale to allow for specialising in personal lending in particular. In areas where there are great levels of deprivation evenly spread, the CDFIs may be in a position to specialise in personal lending. This could be the case for CDFI A and CDFI C, and to a lesser extent to CDFI B.

How sustainable are the CDFIs currently?

This research project analysed how sustainable these different CDFIs were. Chart 1 displays the total activity earnings (fees and interest income, and bank interest earned or paid) as a percentage of total overheads (staff, overhead and governance related costs) by CDFI.

Chart 1: Operational sustainability



Source: Audited accounts financial year of 2006/2007

The chart suggests that the CDFIs in the sample are some way away from covering their costs exclusively through the income generated from their loan portfolios. The most sustainable CDFIs in the sample are able to cover just over 60% of their costs through interest rates, fees and bank interest earned. However, they are performing reasonably well vis-à-vis other UK CDFIs. Four out five either come close to, or surpass the performance of Aspire in Northern Ireland and Street UK, whilst three also perform better than the average operational sustainability of the UK CDFI sector according to the latest CDFA industry survey (36%).

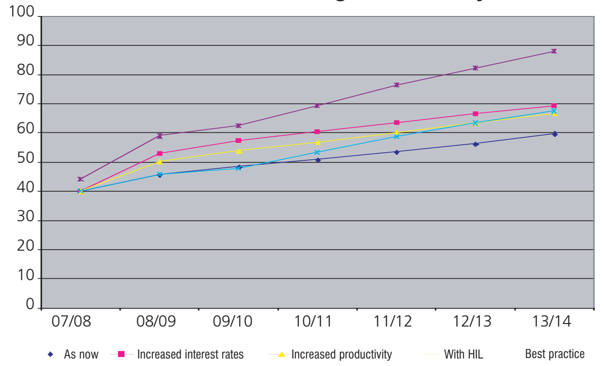
How sustainable can the CDFIs become?

However, given that the personal lending CDFIs are relatively young organisations at an early stage in their development trajectory, future activity may be more interesting than current performance. Therefore, the study attempted to project several possible development trajectories for the CDFIs for a seven-year period. These draw on the basic cost structure, loan and product portfolio mix and funding streams for the CDFIs for the financial year of 2006/2007 factoring in expected growth patterns. (For more details, please consult main report)

To improve their sustainability the CDFIs have a set of levers at their disposal. They can lower costs by boosting staff productivity (increased productivity), they can increase the income earned on their products by raising the interest rates charged (increased interest rates) and they can add new products or alter the mix of products offered (with HIL). The latter lever refers to adding home improvement loans (a higher ticket, low-risk product funded by numerous local authorities to improve local housing standards) to the CDFI's product portfolio.

Chart 2 projects the future performance of the personal lending CDFIs (CDFIs A to D) – as measured by the average operational sustainability ratio – depending on which of the above mentioned levers they use.

Chart 2: Enhancing sustainability



The results of the financial modelling indicate that over time the CDFIs are improving their performance even if they do not alter the way they operate (see 'as now' above), providing they can grow their personal loan portfolio at 10% and keep their business loan portfolios constant.

That said the CDFIs can make considerable improvements by using any of the above mentioned levers. In particular, raising the interest rates (to 31.9%) and introducing an upfront administration fee (of 5%) payable by the customer positively tilts the income/cost ratio for the CDFIs. Also raising loan officer productivity, measured by the number of loans granted per full-time loan officer, raises the sustainability considerably, crucially without adding to the costs for clients.

Finally, adding a higher-ticket, low-risk loan product in the form of the home improvement loan can make a significant contribution to the long-term sustainability of the CDFI sector as shown in the graph above. The home improvement loan is offered to low-income home owners as a means of improving the standard of their housing. Many councils fund such schemes through paying subscription fees and subsidising interest rates, making them an attractive option for customers and CDFIs alike.

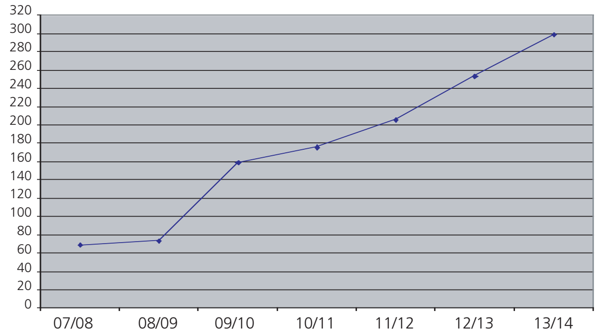
By combining all these measures, the CDFIs can enhance their sustainability by over 20%. However, these average figures hide considerable discrepancies between the different CDFIs. The improvements that individual CDFIs can make depend on the starting point of the CDFIs (i.e. interest rates charged, current loan officer productivity) and product mix (i.e. a high reliance on contractual income negatively affects the operational sustainability ratio). We also found that high overhead costs relative to activity earnings (interest income from bank deposits, income from interest and fees earned) can act as a break on sustainability.

Future capital requirements and models of recapitalisation

Potentially the greatest challenge for the CDFI sector is the access to funding for on-lending. Therefore, the study analysed capital requirements and different models of funding the growth of the sector. Chart 3 displays average capital requirements for the four personal lending CDFIs.

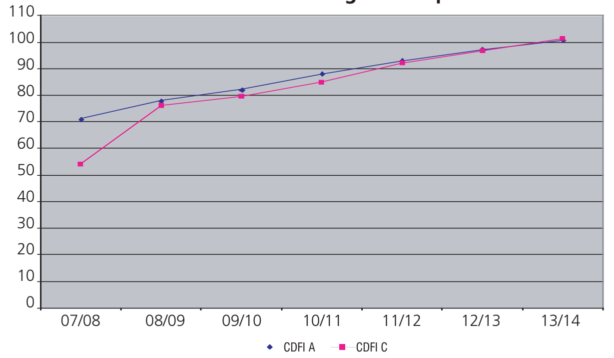
An analysis of future capital requirements and of the different models of recapitalisation suggests that raising loan capital purely through recycling existing funds is an unviable strategy to fund future expansion of the CDFIs in the sample. Already in Year 1 (2007/2008) of operation without granted or borrowed loan capital, even when incorporating all the above-described improvements, the CDFIs in our sample experience an average shortage of in excess of £60,000.

Chart 3: Future capital requirements



Given the funding gap described above, the study modelled the implications of borrowing part of the future loan capital (at a 7% interest rate). As the path towards full sustainability is a step-wise process – from total subsidy dependence to operational sustainability to financial sustainability – this analysis focused on the two CDFIs closest to full operational sustainability: CDFI A and CDFI C.

Chart 4: Borrowing loan capital



Whilst borrowing capital for on-lending is, ceteris paribus, likely to lead to a decline in sustainability, two of the CDFIs may be able to borrow as much as 30% (CDFI A) and 60% (CDFI C) of their future capital requirements and may still reach full sustainability in the course of a seven-year period – providing the CDFIs raise interest rates and loan officer productivity, and introduce the home improvement loan.

Enhancing staff efficiency and productivity
As we have seen above, raising loan officer productivity is a powerful tool for boosting the sustainability of the business model. We now turn to how the CDFIs can raise productivity of their lending staff. To measure loan officer productivity and analyse the drivers of efficiency and productivity, we analysed data from timesheets completed by CDFI staff during a three week period.

There appears to be a set of norms for maximising staff efficiency and productivity. We found a strong correlation between the time the lending staff spent on direct customer contact and loan officer productivity. Provided there is sufficient demand for the products of the CDFI, by organising the non-lending in such a way as to maximise the exposure of the lending staff and by allowing non-lending staff to step in for interviews when necessary, the CDFI can raise the loan officer productivity considerably.

Further, our findings suggest that part of maximising lending staff exposure to potential customers also lies in outsourcing administrative aspects of arrears control and possibly other areas to external companies. In terms of outsourcing administrative parts of arrears control, it does not appear to detrimentally affect arrears levels.

Finally, we also found that the loan officer productivity is crucially linked to the proportion of repeat clients. The CDFI which displayed the greatest loan officer productivity also had the greatest proportion of repeat clients. Repeat business involves lower transactions costs and generally constitutes a smaller risk for the CDFI. It is considered crucial therefore to design products and procedures in a way which entices customers to return.

Creating and supporting effective partnerships
Effective partnerships are another way in which the sector can enhance its sustainability. Partner organisations can increase the client base of a CDFI through referrals and marketing. In addition, the willingness of a partner organisation to donate loan capital and buy other services from a CDFI is determined by how effective they perceive the partnership and how reliable they perceive the CDFI to be. Hence, as part of the study we conducted a survey of a sample of 27 partner organisations.

The primary partner organisations of the CDFIs in the sample are local governments, housing associations, banks and building societies. The cooperation mainly centres on marketing, funding and making referrals to the CDFIs. Many of the local authorities also cooperate with the sector on the provision of home improvement loans.

On the whole, the partner organisations perceive the CDFIs to be reliable and trustworthy partners, while there is less consensus on the degree to which their partnership is effective and helps them achieve their goals. Local authorities appear most uniform in the extent to which their partnerships with the CDFIs are formalised, in their knowledge of loan products and processes, and generally display the highest level of satisfaction.

CONCLUSIONS AND RECOMMENDATIONS

Lessons on sustainability from international experience
Compared to the UK sector, the international community finance sector has achieved a far greater degree of maturity and sustainability. This experience highlights three important lessons for the UK sector:

1. *Charge interest rates and fees which more closely reflect the costs of delivering the products:* Early international community finance programmes provided loans with heavily subsidised interest rates. As a result, the programmes made a considerable loss per loan. Once external funding dried up the programmes ceased to exist, losing all the related learning. Ultimately it was the small urban traders and small farmers relying on loan funds who paid the price for the discontinuation of loan funding.
2. *Keep arrears at manageable levels through sound underwriting procedures and effective follow-up of delinquent payers:* High loan delinquency rate has often been a leading cause of de-capitalisation and insolvency of microfinance institutions internationally. This is because loan delinquency leads to both a drop in interest income and increased costs (debt collection is costly). International evidence suggests that delinquency rates are not related to size of loan portfolio or rate of growth; rather, they depend on sound underwriting and follow-up procedures
3. *Make loans based on ability to repay:* Although community finance initiatives have charitable goals, the granting of loans needs to be based on a sound screening process. For certain households a loan may not be the right solution to their problems. International research suggests that in the absence of productive investment opportunities borrowing may in fact have a negative impact on the household.

Creating conditions for sustainability: recommendations for funders, policy-makers and CDFI managers
Our research suggests that many of the levers to enhance the sustainability and viability of the CDFI sector are in the hands of the CDFIs themselves. They can grow their loan books through marketing, effective partnerships and appropriate product design, they can cut costs through improving the efficiency with which certain products are delivered, they can add new products and they can increase interest rates and increase or introduce administration fees.

Specifically, our findings suggest that there are certain structural and process-related changes which are likely to have a positive impact on the sustainability of the CDFI sector:

1. *Charge interest rates which more closely reflect the costs involved in providing loans in order to reduce reliance on subsidies and ensure longevity of operations*
2. *Given its strong link to staff productivity, take steps to maximise lending staff's exposure to potential customers*
3. *Capitalise on links with other CDFIs to enhance innovation and reduce costs*
4. *Make the case for developmental rather than only sustaining funding given the importance of appropriate premises and the cost-saving potential of investing in outsourcing mechanisms*

However, funders and policy-makers also have a considerable role to play in shaping the future prospects of the CDFI sector. In particular, we believe that funders can underpin the future sustainability of the sector by offering:

1. *Development grants to stage-manage productivity improvements, especially to facilitate the implementation of cost-saving and efficiency enhancing outsourcing mechanisms by smoothing potential implementation barriers*
2. *Development grants to launch new products, including for R&D, marketing and feasibility studies, especially for higher ticket, lower risk loan products (home improvement loans, car loans etc)*

The results of the financial sensitivity analysis of the different recapitalisation models show that the sector's further expansion is dependent on capital being made available in the form of capital grants and loan finance. The mix of funding instruments will depend on the level of maturity and sustainability of the individual CDFI, loan finance being more appropriate for the CDFIs further down the sustainability continuum.

3. *Capital grants for loan capital to support continued up-scaling of personal lending to benefit a larger number of financially excluded households*
4. *In the medium to long-term, the funders may want to consider offering funds for on-lending in the form of loan finance for the CDFIs, which would allow for recycling of funds for re-lending to CDFIs*
5. *An appropriately designed guarantee fund to underwrite bad debts may convince the mainstream banking sector to lend to the CDFIs and limit the use of scarce public funding.*

The report is available in full at the website of CFS http://www.communityfinance.salford.ac.uk

About CFS:
Located within the University of Salford, Community Finance Solutions (CFS) is an award winning independent research and development unit engaged in promoting and developing integrated solutions for financial and social inclusion, and community asset ownership.

For more information about CFS and its work, please visit http://www.communityfinance.salford.ac.uk/

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Measuring Sustainability - UK CDFIs

Research by Dr Karl Dayson, Pål Vik, Bob Paterson and Anthony Salt.

INTRODUCTION

This launch document summarises the findings and policy recommendations of a research project into the UK Community Development Financial Institution (CDFI) sector. It discusses a research project conducted by Community Finance Solutions (CFS) at the University of Salford, which was funded by Lloyds TSB. The project aims to identify, analyse and disseminate best practice in promoting a sustainable CDFI sector based on an in-depth analysis of five leading UK CDFIs.

STUDY CONTEXT AND METHODOLOGY

Introduction
Since the 1970s a combination of technological innovation, financial market deregulation and the movement to electronic payment of salaries has made banking services widely available for the vast majority of UK households. Today more than 95% of UK households have some kind of bank account, whilst more than 90% have a current account. Yet a sizable group of as many as 1.5 million UK low-income households are either totally excluded from accessing, or live on the margins of, mainstream financial institutions. This phenomenon, called financial exclusion, disproportionably affects vulnerable groups, such as lone parents, the elderly, ethnic minorities and disabled people.

Unable to access the services of the mainstream banking sector, financially excluded households often resort to doorstep lenders. The high interest rates and sometimes predatory lending practices of these types of lenders may leave the households at risk of over-indebtedness and further social exclusion. Also, the higher costs associated with managing a household budget on a cash-basis, rather than through a bank account, potentially reduce the disposable income of these households

Financial exclusion has been prioritised since the election of the Labour government in 1997, beginning with the Policy Action Team 14 report in 1999, advising the government on policy interventions to combat financial exclusion. One of these interventions was to support third sector lenders in an effort to offer affordable loans and transactional services to excluded households through granted loan capital and other subsidies. There are two main types of third sector lending institutions:

- **Credit unions:** Financial co-operatives owned and controlled by their members. Credit Unions offer savings, loan and insurance products to their members who all share a 'common bond' (e.g. geographical, occupational)
- **Community Development Financial Institutions (CDFIs): CDFIs** are a new type of community finance organisation lending and investing in deprived areas and underserved markets unable to access mainstream finance.

The Community Reinvestment Trust Model
Lloyds TSB has been a key supporter of financial inclusion interventions, especially the CDFI finance model called a Community Reinvestment Trust (CRT). The model was developed by Community Finance Solutions at the University of Salford and the first CRT-based CDFI was launched in July 2000 in Portsmouth.

Today, thanks to Lloyds TSB's, and others' commitment, more than a dozen CRTs, or more popularly known as "Moneylines" or CDFIs, operate across the UK benefiting more than 10,000 low-income households with affordable loans, bank services and financial advice.

The creation of the CRT as a vehicle for offering affordable finance for low-income households was based on the realisation that many low-income households often had no choice but to resort to loan sharks and doorstep lenders, whose high interest rates and often predatory lending practices left the households at risk of over-indebtedness and further social exclusion. A way out of unemployment and deprivation through self-employment was often hampered by the lack of start-up capital.

An initiative of THE UNIVERSITY OF SALFORD