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Tackling Financial Exclusion through Community Investment: How should the UK strengthen its community investment sector? Lessons from the US experience

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Tackling Financial Exclusion through Community Investment

How should the UK strengthen its community investment sector? Lessons from the US experience

Harvard Kennedy School: Policy Analysis Exercise

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Executive Summary

Financial exclusion is a large and growing problem in the UK. The community investment sector – focused on tackling financial exclusion – is effective but small, reaching roughly one sixth of the individuals and organisations requiring access to affordable and appropriate finance. **What factors are inhibiting the UK community investment sector's development? And what measures can be taken to enable community investment to better tackle financial exclusion?**

We answer these questions with reference to both the UK and the US community investment markets. The US has developed a large and effective community investment sector over the last four decades – and has frequently served as a reference point for UK community investment policy. Through reviews of academic and practitioner literature, and expert interviews in the US and UK, we have extracted relevant lessons from the US' successes and shortcomings, identified key constraints to the UK sector's development, and generated five policy recommendations.

What can the US community investment experience suggest to the UK?

The US experience demonstrates that specialised community investment intermediaries can effectively promote community development – but also that the majority of them cannot be fully sustainable on a commercial basis without compromising their core purpose: providing socially-beneficial financial services to the financially excluded. In recognition of this, US CDFIs benefit from far larger subsidies than UK counterparts, and would not be sustainable at scale without these subsidies. Investment mandated by the CRA has also played a crucial role, in developing the concept that banks have a responsibility to tackle financial exclusion, and in ensuring a large and reliable stream of capital for community investment. Contrary to some expectations, leading US banks have found ways to successfully incorporate CRA compliance into their business model without compromising lending standards or inflating asset bubbles. In addition, operating expenses are the key determinant of sustainability in CDFIs, and are in turn closely connected to economies of scale. US CDFIs have achieved significant scale, fostering the growth of human capital and active, coordinated support for the growth of absorption capacity at the state and local levels.

What is the current state of the UK community investment sector?

Lack of demand or absorption capacity is not a problem in the UK: there is a high and growing need for community investment from viable individuals and small businesses which are not being served by mainstream banks. While organisational capacity in the community investment sector as a whole is extremely variable, our research suggests that there exists a group of community investment organisations which are financially sophisticated, operationally mature and delivering clear social impact. The biggest constraint on the ability of these high-performing organisations to meet the need of the financially excluded is a lack of access to sufficient quantities of capital, in particular catalytic "first loss layer" grant capital.

As the sector grows, market infrastructure development will become increasingly important: particularly improved financial reporting and social impact evaluation, and increased

sophistication of systems and operations. In addition, increased local community development coordination will be essential to ensure that capital is put to its most effective use and broader positive social outcomes follow. Finally, access to granular data on financial services to disadvantaged individuals and communities is vital to better understand the problem of financial exclusion and to develop the most effective solutions.

What should be done to strengthen the UK community investment sector?

KEY RECOMMENDATION: an Opportunity Finance Fund. Access to appropriate and affordable capital is currently the key binding constraint on the growth of the most effective UK community investment organisations. A thriving community investment industry requires access to capital on appropriate and affordable terms – particularly a first loss layer of grant capital, which can catalyse large quantities of private capital into community investment. We recommend the creation of a fund to provide first-loss capital to selected high-performing community investment organisations, with £200 million to disburse over its first 5 years. This first loss capital would require a match of at least 4:1 of private funding, attracting at least £1 billion new capital into the sector over 5 years. By funding only high-impact, high-growth potential organisations, the grants will incentivize scale, efficiency and innovation in the sector.

Recommendation 2: Financial Inclusion Mandate. As publicly-regulated, taxpayer-backed utilities, banks should have a legal obligation to provide at least basic financial services to all customers, including deposits and lending where appropriate. Either by providing services themselves, or by investing in community investment organisations, banks could fulfil their responsibility to meet the needs of everyone in society rather than just the most profitable.

Recommendation 3: market infrastructure development. As the community investment sector evolves, a strong market infrastructure will be vital. In particular, industry bodies – supported by social investors and/or government – should work towards the creation of sector-wide common financial reporting standards and impact evaluation metrics, as well as the development of shared systems and platforms which enable smaller organisations to reap the benefits of scale.

Recommendation 4: local community development coordination. Coordination between community development actors is vital to achieve maximum impact. Local government bodies should play a convening and coordinating role between organisations looking to tackle financial exclusion and promote community social and economic development.

Recommendation 5: improved data disclosure. Granular area-based data disclosure by all financial services institutions is vital to understand the nature of the financial exclusion problem, to develop appropriate solutions and to evaluate their effectiveness.

Conclusion: In light of these findings, we are cautiously optimistic about the potential growth of the UK community investment sector, and the role that community investment can play in enhancing financial inclusion and economic opportunity for residents of the UK. Future research should expand upon efforts to assess the size of the problem, and re-examine binding constraints for future policy action.

Contents

1. Introduction: Financial Exclusion and Community Investment

The financial exclusion problem. Many SMEs, social sector organisations and individuals in the UK – particularly in disadvantaged communities – cannot access finance on affordable terms. This financial exclusion can perpetuate poverty and hardship, as well as impeding efforts for local economic development and community regeneration [see Appendix A]. There are a variety of reasons for financial exclusion, including persistent market failures, high transaction costs, and low bank capacity. The UK government, private sector and civil society are taking important steps to address this problem, but it seems increasingly likely that further action is required.

What is community investment?

We define "community investment" as the provision of finance at a non-exploitative rate to viable but financially excluded individuals and organisations.

Community investment: a key part of the solution. Community investment is a key channel for addressing financial exclusion. The provision of finance to viable but financially excluded individuals and organisations has a clear social benefit by generating positive externalities: avoiding cycles of debt and poverty from exploitative personal lending, empowering household economic improvement, and catalysing community economic development and regeneration. In the US, community investment organisations include CDFIs – revolving loan funds, venture capital firms, banks and credit unions with a community investment mission - alongside other actors engaged in place-based and impact investment. Community investment organisations in the UK include CDFIs, credit unions and some social banks and investors.

Figure 1: Unmet demand for community investment

Good data on community investment in the UK is scarce, the result of a combination of lack of data collection, non-standardized accounting and reporting procedures along both financial and social impact metrics, and inherent difficulties in evaluating the impact of community investment against a non-existent counterfactual. Even from existing data, however, it appears to be clear that **the need for community investment is significant, and that the UK industry is currently unable to meet more than a fraction of this need**. In 2012, total community investment lending in the UK was around £700 million; some estimates suggest that demand for community finance currently outstrips supply by a factor of 9[1].

This paper analyses the US and UK community investment landscapes. In chapter 2, we discuss our background and methodology. In chapter 3, we discuss the most relevant features of the US

[1] Gibbons, Vaid and Gardiner. 2011. "Can Consumer Credit be Affordable to Households on Low Incomes?" and Community Development Finance Association.2013. "Mind the Finance Gap: Evidencing Demand for Community Finance"

market for the development of UK community investment. In chapter 4, we analyse the binding constraints to the growth of UK community investment. In chapter 5, we make recommendations to government and individual organisations on how to address those constraints and strengthen community investment in the most efficient and effective way.

2. Methodology

2.1 Motivation: Why look to the US?

The US community investment industry has a successful and long-established history of channelling financial capital into low-income and financially excluded areas. Over 40 years, US CDFIs have had the opportunity to experiment with a variety of organisational structures, financing mechanisms and policy measures. A lower bound estimate puts of the US community finance industry at least 18 times the size of the UK community finance industry in absolute terms, or at least 3 times the size of the UK industry as a percentage of GDP[2].

While there are substantial differences in the policy, social and economic contexts of the two countries, the US experience can be used as inspiration to design effective new policy for community investment in the UK. The UK can extract valuable lessons both from the US system's successes and from areas where it still has some way to improve.

2.2 Method

For this paper we interviewed of existing academic and practitioner literature and interviews with a range of experts in the field. By synthesizing the lessons from the most up-to-date research and testing our conclusions against expert opinion, we hope to have a clear and accurate picture of the key lessons from the US and how they could be applied to the UK. A list of sources we consulted can be found in the Bibliography.

2.3 Context

This paper is the product of the Policy Analysis Exercise, the capstone project of the Master in Public Policy program at the Harvard Kennedy School of Government. Its purpose is to analyse a policy question of interest to a particular client and make actionable policy recommendations. Our client for this project was Big Society Capital, an independent financial institution in the UK with the mission of growing the social investment market. Big Society Capital helped us shape the research question, and provided us with resources and guidance, but our analysis and conclusions are entirely independent and result from our own research.

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[2] Author estimates, using 2012 data from the CDFI Fund "Industry Snapshot 2012" for the US and 2013 data from the GHK and CDFA report "Mind the Finance Gap". The US estimate is current transactions reported for FY 2012 by 350 CDFI credit unions, banks, loan funds and venture funds. The UK estimate covers lending and investments CDFIs, credit unions and SIFIs in the year 2010-2011.

3. Community investment: A Conceptual Framework

Community investment in the US and the UK shares its core purpose: the provision of finance at a non-exploitative rate to viable but financially excluded individuals and organisations. There are key differences between the two countries, however, in the policy environments, community development contexts, and in some cases the organisational forms and target markets of community investment organisations.

As such, rather than attempting to directly compare individual policies in each country, which are contingent upon contextual factors, we have developed a conceptual framework (Figure 3) that focuses on the key functional roles that are necessary in a successful community investment system[3]. We developed our findings and recommendations by applying this framework to the current situation in each country, seeking out relevant lessons for the UK from the US context, and assessing binding constraints and potential for future growth in the UK.

The framework separates the community investment process into three key components:

1. **Absorption Capacity:** To what extent can community organisations and individuals use the capital provided to them to achieve positive social outcomes?
2. **Access to Capital:** How much capital is going into the community investment industry? At what rates and under what conditions?
3. **Sector & Organisational Capacity:** How effective is the community investment industry at intermediating between supply of and demand for capital?

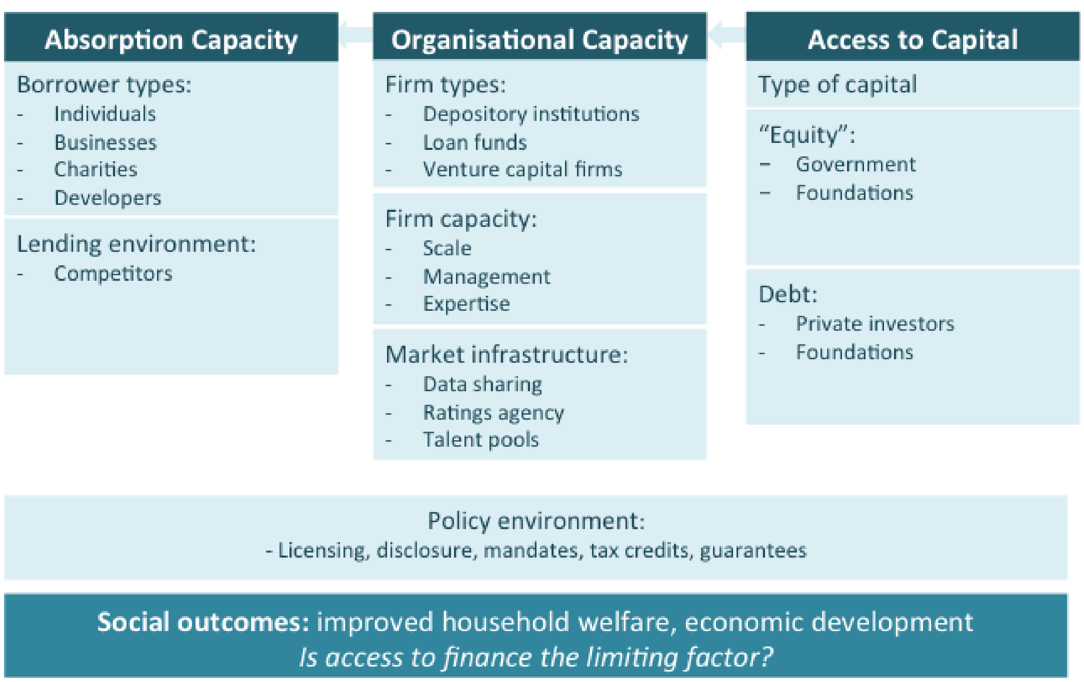

Figure 2: A conceptual framework for community investment

[3] In developing this framework, we drew from Pinksy. 2001. "Taking Stock: CDFIs Look Ahead After 25 Years of Community Development Finance".

3.1 Absorption Capacity

To assess the demand for community investment, we must consider both the **size of the need for financial services and the availability of sufficient channels and capacity to make use of that capital effectively**. The term "absorption capacity" describes the degree to which a community investment ecosystem fosters strong demand from viable borrowers: borrowers who have difficulty accessing mainstream sources of capital but who have socially beneficial uses for that capital (see Appendix A for a more thorough analysis).

Latent need for services

Borrowers may include individuals who need short-term financial flexibility to cover income or consumption fluctuations, which may otherwise not be available from commercial banks, or longer-term financing for larger purposes like homes or vehicles. Small and medium size enterprises have diverse capital needs, including working capital and growth capital; ensuring SMEs have sufficient finance provides social benefit through their relationships with employees, customers and suppliers. Non-profits constrained by asset-locks frequently have difficulty gaining access to capital that would be easily available to for-profit organisations, for routine operations or capital expenditures. Finally, developers of affordable housing or commercial properties in underserved areas often require reasonable rates and flexible terms to compete with developers of market-rate properties in similar locations.

Effective use of capital

Even in the context of significant unmet need for financial services, it is crucial to **ensure that potential borrowers are aware of the available channels for investment**, what type of product to seek in a particular situation, and which organisation is best suited to deliver that product. Community investment organisations do this work through individual marketing and sector-wide promotion, typically targeting the later stages of deal development, when a borrower is seeking out particular terms.

Strong absorptive capacity require not just social need from individual borrowers, but also **local organisations that are pro-active in mapping community needs and assembling the right players** to address a problem, producing a strategic vision for the types of services, collaboration and funding structure that would be required. This type of collaborative approach may stimulate demand that would not have materialized through efforts of a single borrower or lender alone.

Finally, the absorptive capacity for community investment also depends on the competitive environment with mainstream lenders as well as the degree to which capital is the main constraint on community development. In a market that is reasonably well served by mainstream lenders and has a limited pipeline of capital-constrained projects, the community investment sector will have difficulty achieving significant impact.

3.2 Organisational Capacity

Second, there are several determinants of **the capacity of the organisations that comprise the community investment sector to intermediate capital effectively**. Aspects of organisational capacity include the degree of financial sophistication of fundraising, management and products offered, the degree of professionalization of accounting and reporting, the ability of organisations to deliver and measure social impact, the ability to work across different sectors and co-ordinate multiple organisations, and the ability to operate in typically underserved and marginalized communities.

In addition to the strength and performance of individual organisations, we can consider whether there exists **sufficient market infrastructure to support a larger community investment sector**. A mature sector requires a strong base of information for investors and borrowers, such as data sharing on individual borrowers' creditworthiness, alongside common information or ratings of financial intermediaries themselves. In addition, it requires a base of skilled professionals with experience executing complex transactions that include multiple definitions of success aside from financial rate of return.

3.3 Access to Capital

Much of the policy conversation about community investment focuses on the question of **access to capital for community investment organisations**. Capital can take the form of either traditional debt, or grant money that plays an equity-like role in capitalizing organisations as they attempt to scale. Lending to community investment organisations may take place at market rate and under traditional terms, or deals may be structured with a loss layer that provides credit enhancement for senior lenders. Foundations sometimes provide debt financing or loan guarantees through program-related investments, which combine a mission impact with some form of financial return. There are both public sector and philanthropic sources of equity-like grant capital for community investment, typically distributed either in small amounts to a large number of organisations, or in very large amounts to jump-start a handful.

3.4 Policy Environment

Each of these three considerations – access to capital, sector capacity and absorption capacity – **relies upon an overarching policy environment that is justified by a set of social outcomes that the system attempts to address.** In both the US and the UK, policymakers have offered different justifications for the existence of a community investment sector, frequently with multiple objectives and with varying degrees of consensus across the political spectrum. However, there are common themes, including the desire to provide alternatives to predatory lending, economic development through small business growth, community development through affordable housing and commercial real estate, and broad goals of social inclusion in the wake of redlining and other discriminatory practices. As such, governments have developed a broad array of policies to advance these goals through multiple mechanisms.

Public subsidies support the flow of capital through this system through the direct provision of equity-like funds to individual organisations, bond guarantees to support borrowing, tax credits to lower the cost of capital and target deals that satisfy particular criteria, and tax-exempt status for many community investment organisations. As a result, governments also license and regulate organisations that receive public funds or tax credits, including requirements for disclosure and restricting the uses of certain assets. Governments have also stimulated private capital flows through mandated disclosure and investment by some types of financial institutions.

Taken together, we posit that this framework captures the main elements of a robust community investment sector and provides the basis for transferring lessons between the US and the UK. In the following chapters, we analyse the US community investment sector through this lens, and consider recommendations for the UK.

4. Analysis of the US

The community investment industry has developed over several decades in the US, resulting in a complex mix of institutional forms, social missions, lending practices and funding structures, as well as a wide-ranging set of supporting policies and regulations. Our approach to this report has been to assess the current state of the US community investment sector through the analytic framework outlined in chapter 3, synthesizing existing US academic literature with additional quantitative data and expert interviews. For practical purposes, **we have chosen to only represent the most relevant themes from our analysis in this chapter.**

We first discuss evidence on the effectiveness of US community investment. We then call particular attention to **5 key lessons from the US experience: subsidy levels, investment mandates, economies of scale, local community development collaboration, and the importance of data availability.**

Additional information on particular government and philanthropic support programs for CDFIs, as well as some historical context, is included in Appendix B. In addition, scholars have addressed various aspects of US community investment that may be of interest to UK policymakers, including in a number of the publications listed in the citations of this report.

4.1 Effectiveness of US CDFIs

By a variety of measures, **US CDFIs have been extremely successful in delivering vast quantities of capital to disadvantaged communities.** Empirical evaluations suggest that CDFIs are successfully “promot[ing] economic revitalization and community development through the provision of credit, capital and financial services to underserved populations and communities in

US CDFIs have **over $13 billion** in assets.

They make **over $2 billion** worth of new investments per year

the United States[4]". One report estimates that in 2013, the subset of CDFIs that received money that year from the CDFI Fund made over 24,000 loans and investments for a total of almost $2 billion[5]. As such, the US community investment market is significantly bigger than the UK. While there is no data available on the total US community investment market size, a very rough estimate using only the sub-set of CDFI Fund applicants puts the US community finance industry at least 18 times the size of the UK community finance industry in absolute terms, or at least 3 times the size of the UK industry as a percentage of GDP[6].

US CDFIs have, over more than four decades of operation, also **demonstrated new, sustainable ways of providing finance to disadvantaged communities.** They have demonstrated, for example, that financing minority homeowners and business owners can be profitable and that racial identity is not a reliable indicator of financial performance; that risk management through non-traditional methods like technical assistance can be effective; and that certain unconventional financial customers can graduate to become successful and sustainable customers of mainstream financial institutions[7]. Many larger CDFIs have also more recently pioneered innovative financing mechanisms for a wider range of socially-focused projects, such as health and education projects. As such, they have attracted mainstream financial providers into many previously underserved markets.

In addition, US CDFIs have played an important role **in exposing problems of financial exclusion and predatory lending[8] and in advocating for solutions** individually and through coalitions such as the CDFI Coalition and the Opportunity Finance Network (formerly National Community Capital) on the national scale, along with many efforts in state and regional contexts.

4.2 Access to Capital: Subsidy levels

Community investment organisations in the UK are constantly called upon to improve their financial sustainability and decrease dependence on grants from governments and foundations. While some degree of financial sustainability is crucial for the health of individual organisations and the sector as a whole, **the US experience suggests that holding community investment organisations to the same standards of financial sustainability as commercial finance**

[4] Swack, Northrup and Hangen. "CDFI Impact Evaluation". FORTHCOMING
[5] CDFI Coalition. 2014. "20th Anniversary Report: Investing in Communities and Building Strong Foundations for the Future."
[6] Author estimates, using 2012 data from the CDFI Fund "Industry Snapshot 2012" for the US and 2013 data from the GHK and CDFA report "Mind the Finance Gap". The US estimate is current transactions reported for FY 2012 by 350 CDFI credit unions, banks, loan funds and venture funds. The UK estimate covers lending and investments CDFIs, credit unions and SIFIs in the year 2010-2011.
[7] Pinsky. 2001. "Taking Stock: CDFIs Look Ahead after 25 Years of Community Development Finance."
[8] Benjamin, Rubin, and Zielenbach. 2004. "Community Development Financial Institutions: Current Issues and Future Prospects."

organisations is neither reasonable nor desirable. First, community investment organisations are intended to serve some customers that are not served by mainstream banks, but should still be able to access financial services to achieve other social benefits. As a result, it is unrealistic to expect non-profit organisations to profitably serve those customers and essentially out-compete large banks with much greater access to capital and expertise. Furthermore, if community investment organisations were able to achieve profits by selecting only the most promising of the individuals not served by banks, they would still exclude a significant number of people who could put that capital to socially beneficial uses. It is important to note that **different CDFI business models enable different levels of financial sustainability**: CDFI credit unions and CDFI banks can be much more self-sufficient as they attract much of their capital cheaply from deposits, while CDFI loan funds and CDFI venture capital firms must raise capital externally.

The US experience suggests that holding CDFIs to the same standards of financial sustainability as commercial finance organisations is neither reasonable nor desirable.

In recognition of their social benefits, US CDFIs have received significant subsidies from a variety of actors. The federal government provides support in a number of ways: debt and grants through the CDFI Fund, tax credits such as the New Market Tax Credits (NMTC) and Low Income Housing Tax Credit (LIHTC), enforcement of the Community Reinvestment Act to incentivize lending to CDFIs by banks, and most recently the CDFI Bond Guarantee Program, which essentially allows CDFIs to borrow at the same rates as the government up to a cap. To give a sense of scale, the CDFI Fund provided $1.9 *billion* between 1994 and 2014. Each of these are described in greater detail in Appendix B, but the overall lesson is that **CDFIs in particular have received substantial subsidies over a long period of time, and are not expected to sustain operations at any significant scale without regular support from foundations and government agencies**. In some parts of the US, these federal programs are supplemented by initiatives at the state and local level, which can provide support through debt or grant capital.

Foundations have also provided debt capital to CDFIs, though not at the scale of large institutional investors. Starting in the 1960s, the Ford and MacArthur Foundations, among others, pioneered a financial instrument called program-related investments (PRIs), in which foundations finance low-income loans or recoverable grants from their endowments. To-date, the Ford Foundation alone has provided $525 million in PRIs across all of its focus areas, which helps grantee organisations to establish borrowing histories and explore new business models.[9] **PRIs were crucial components of the early-stage development of CDFIs throughout the United States, alongside substantial grant money**[10].

[9] Ford Foundation. "Program Related Investments" http://www.fordfoundation.org/grants/program-related-investment

[10] Liou and Stroh. 1998. "Community development intermediary systems in the United States: Origins, Evolution and Functions."

In addition, a substantial number of CDFIs in the US are engaged in real estate development at scale, drawing upon funds associated with LIHTC and housing programs at the state and local level. These projects are generally significantly larger than the typical CDFI loan, and frequently benefit from lower default rates, due to factors including the development of a number of specialized affordable housing organisations, solid and non-cyclical demand for affordable housing, and expertise built over decades of operation. **Real estate projects, as well as individual mortgages (also a major part of some CDFI lending) provide real assets on CDFI balance sheets, allowing for greater risk tolerance than a loan book comprised solely of personal or enterprise lending**[11].

Over **85%** of US CDFI loan fund capital is from private sources, compared to **33%** for UK CDFIs

These factors have enabled US CDFIs to raise large quantities of private capital: far larger both in absolute terms, and as a percentage of total funding, than their UK counterparts. Over 85% of US CDFI loan fund capital, for example, is from private sources[12]; in 2014, **only 33% of new UK CDFI capital for on-lending – around £20m –came from non-governmental sources,** and this figure has been significantly lower in most previous years[13]. For US credit unions, only 2% of total capital is from government or philanthropy[14]; while there is no data on the entire UK market, interview evidence suggests that this proportion is significantly lower.

While real estate plays a major role in enabling some CDFIs to leverage private capital, even non-real estate US CDFIs access far greater quantities of private capital than their UK counterparts. **This ability to access private capital is driven by the scale, nature and consistency of public and philanthropic support for US CDFIs:** grants and government-guaranteed long-term debt can be leveraged with commercial capital, and extensive tax credits are used to enable CDFIs to borrow at an affordable rate.

"The answer to everything is equity"

– CDFI loan fund director, quoted in Swack et al (2012)

Permanent "equity" capital from government and foundations – grants that are used as first loss layers and levered to raise debt capital – has been particularly important for US CDFIs: it increases risk tolerance, lowers the cost of other capital, creates a cushion against losses, and allows organisations to meet the needs of their market through longer-term and riskier lending – all of which improves the risk-reward trade-off for investors seeking to lend money to community investment organisations[15].

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[11] Nef. 2008. "A model for funding and supporting CDFIs: Lessons from the United States".
[12] CDFI Fund. 2014. "CDFI Snapshot Analysis: Fiscal Year 2012".
[13] Estimated from graphs in Community Development Finance Association. 2014. "Inside Community Finance"
[14] CDFI Fund. 2014. "CDFI Snapshot Analysis: Fiscal Year 2012".
[15] Opportunity Finance Network. 2002. "Equity Equivalent Investments".

As such, there are three important features of US CDFI subsidies and financial sustainability which are interesting to compare with the UK:

- **The presence of significant real estate lending means that many US CDFIs have an inherently more financially sustainable business model than UK community investment organisations.**
- **US CDFIs are more supported than UK community investment organisations by government and philanthropy, both in terms of quantity of funds and in terms of diversity of funding types. This funding has continued over a longer time period.**
- **Government and philanthropic support for US CDFIs has enabled them to catalyse that support to attract significant quantities of private capital into the industry. Equity/grant capital has been particularly important.**

4. 3 Access to capital: Mandates & policy consistency

Perhaps the most discussed element of US policy on community investment in the UK is the Community Reinvestment Act (CRA), which compels banks to invest in the communities where they do business. In some respects, this is well-deserved attention – few observers deny the importance of the CRA in establishing the community investment field and ensuring flows of both grant and debt capital to organisations that address financial exclusion, and **the CRA is generally considered to have increased financial inclusion and have been instrumental to the development and success of the community investment sector**[16]. Nonetheless, many aspects of the CRA would not be transferable to a different context like the UK. Here, we highlight some of the structural features of the CRA which provide lessons for the UK, rather than discuss particular mechanisms of enforcement which are less transferrable.

Place-based

First, **the CRA aimed to remedy a place-based problem** - racial discrimination in mortgage lending, often termed 'redlining' in reference to neighbourhoods where banks would not lend - and as such, the legislation required a place-based remedy. Under the CRA, banks are required to invest in communities where they do business, and can fulfil this obligation in multiple ways including direct lending and investment in local CDFIs. In regions where the financial exclusion problem is based more on demographic characteristics than neighbourhood location, a place-based approach is less appropriate[17].

[16] See Appendix B.2 for a more detailed overview.

[17] Quercia et al. 2009. "The CRA: Outstanding and Needs to Improve" in "Revisiting the CRA: Perspectives on the future of the Community Reinvestment Act." US Federal Reserve Banks of Boston and San Francisco.

Effective enforcement

Second, **effective enforcement of the CRA was key to its success – both in terms of sufficient political will, and in terms of powerful mechanisms impacting core business strategy**. Banks undergo a CRA review when applying for a new licence – for opening new branches, mergers and acquisitions, or inter-state activity – which can be denied if CRA obligations have not been fulfilled. The CRA initially suffered from weak enforcement, partially because of ambiguity as to how regulators would interpret the law, and because the enforcement mechanism did not affect core business strategy.

This changed in the mid-1990s, when an increased focus on enforcement and changes in market incentives for banks produced a burst of community investment activity by regulators and banks. Changes in financial disclosure laws in the 1970s had created a substantial body of data demonstrating clear financial exclusion, used by advocates and regulators to justify increased CRA enforcement. In addition, market shifts toward consolidation of banks provided regulators with strong leverage for enforcement, since a poor CRA review could result in denied applications for mergers and acquisitions. This meant that rulings had an impact on core business interests, providing stronger incentives for action than fees, for example.

Compatible with financial stability

Third, a mandate to invest in marginalized communities **need not lead to unsafe banking practices**. In fact, the authorizing legislation makes it clear that "CRA activities must be consistent with safe and sound operations conducted by the bank"[18] . In the wake of the financial crisis, some observers wondered whether CRA enforcement forced banks to lower lending standards and take on riskier mortgage portfolios[19] . However, there is strong evidence to suggest that CRA enforcement did not play a major role in the financial crisis – lending in CRA-assessment areas constituted only 9% of higher-priced loans to low-income borrowers, and mortgage companies unregulated by the CRA accounted for the majority, and the remainder of loans were extended to borrowers outside of CRA-assessment areas[20] . In addition, analysis of subprime loan performance in zip codes with incomes just above and below the threshold for CRA enforcement showed no significant differences, evidence that the CRA did not drive risky mortgage lending in the lead-up to the financial crisis[21].

Furthermore, the CRA did not appear to damage bank profitability. 93% of CRA Special Lending Programs are profitable or breakeven[22]. The presence of subsidy and/or credit

[18] Office of the Comptroller of the Currency, US Treasury. "Community Reinvestment Act Fact Sheet" http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cra-reinvestment-act.pdf
[19] Agarwal, Benmelech, Bergman and Seru. 2012. "Did the Community Reinvestment Act Lead to Risky Lending?" NBER Working Paper 18609.
[20] Park. 2008. "Subprime Lending and the Community Reinvestment Act" Joint Center for Housing Studies, Harvard University.
[21] Kroszner. 2009. "The CRA and the Recent Mortgage Crisis" in "Revisiting the CRA: Perspectives on the future of the Community Reinvestment Act." US Federal Reserve Banks of Boston and San Francisco.
[22] Quercia and Ratcliffe.2009. "The Community Reinvestment Act: Outstanding, and Needs to Improve"

enhancement for certain investments in marginalized communities is likely to have been important in ensuring that banks were able to maintain profitable business models even when operating under the CRA mandate.

Combined with the establishment of the CDFI Fund, strong CRA enforcement provided CDFIs with consistent sources of both debt and equity capital to build on the successes of previous decades. US federal government policy toward community investment has been relatively stable in comparison to the UK policy environment. Although funding levels for the CDFI Fund have varied over time, bipartisan support for the CDFI industry has ensured continued support via the CDFI Fund and new programs like the NMTC, CMF and Bond Guarantee Program. This **stability and continuity of funding is crucial** for an industry that is particularly dependent on long-term, patient capital to achieve beneficial social outcomes.

There are four key points from the US experience that are particularly relevant to the UK context:

- **Investment mandates are an effective way to ensure long-term access to capital for community investment organisations, depending on the types and terms of investment that count towards compliance.**
- **The mandate should be targeted to the nature of the problem. The financial exclusion problem in the US was particularly place-based, requiring a place-based solution – but where the financial exclusion problem looks different, a different targeting mechanism is required.**
- **Mandate enforcement is particularly effective when targeting core elements of business strategy – the need for regulatory approval of mergers and acquisitions was crucial in the 1990s push for enforcement.**
- **A mandate to invest in marginalised communities need not imply damage to financial organisations, or overly risky lending by the financial system, as long as mandated investments can happen alongside sufficient government or philanthropic support, especially through high performing community investment organisations.**

4.4 Organisational Capacity: Scale

The US community investment industry is not only bigger in absolute terms than the UK industry – it also has a selection of much larger individual CDFIs. For example, the median UK CDFI loan fund has £2.5m net assets and £750,000 turnover[23]; 35 of UK CDFI loan funds were below £1m in 2008/9 and only 21 percent were greater than £5m[24]. In contrast, the median US CDFI loan fund has $8.3m net assets and the mean loan fund has $28.4m[25]. While the two sectors are not directly comparable because of the preponderance of real estate CDFI loan funds in the US, our

[23] Community Development Finance Association. 2014. "Inside Community Finance"

[24] GHK. 2010. "Evaluation of Community Development Finance Institutions.

[25] CDFI Fund. 2014. "CDFI Snapshot Analysis: Fiscal Year 2012".

interviews suggest that even specialist US business lending loan funds are on average much larger than their UK counterparts. The mean UK credit union has £2.5m in assets[26], while the median US CDFI credit union has $35.7m in assets and the mean US non-CDFI credit union has $112.8m[27]. UK reports have suggested the importance of scale in improving CDFI's and credit unions' operational and financial sustainability[28].

While the broad diversity of organisational types and business strategies makes it difficult to make definitive statements about the determinants of organisational capacity in the community investment sector, a great deal can be inferred from studies that draw up on both industry-wide data and case studies on individual organisations.

Recent research conducted by the Carsey Institute and the CDFI Fund indicates that **scale is the key determinant of efficiency among CDFIs, primarily as a result of the importance of operating expenses in the overall CDFI cost structure**[29]. (By contrast, portfolio performance plays a limited role in overall financial performance, with the exception of a limited number of loan funds that specialize in real estate and business lending.) This finding has been confirmed by many of our interviews.

Scale is the key determinant of efficiency among CDFIs

Operating expenses are a major feature of the CDFI business model, which requires higher operating expenses than commercial lenders: borrowers who are financially viable and still excluded are likely to be harder to find and more expensive to perform due diligence on. In addition, many CDFIs invest in the provision of significant additional services to borrowers to improve the chances of repayment. Operating expenses per transaction therefore tend to be higher than that of mainstream banks. Larger CDFIs tend to have lower operating expenses as a proportion of total costs: there are inherent economies of scale as fixed operating costs can be spread over larger loan volumes, and larger CDFIs are often also able to reduce costs per transaction, creating specialised platforms and systems or hiring specialised staff to perform due diligence or technical assistance.

Scale also brings other efficiency benefits to CDFIs. In general, larger CDFIs tend to be able to take advantage of the law of large numbers, tolerating **greater portfolio risk** across a larger volume of deals. Scale can allow CDFIs to fund **increased product innovation and development**, **deliver products more consistently, and hire and retain more specialized staff**[30].

[26] Bank of England. 2013. "Introduction to Credit Union Statistics".
[27] CDFI Fund. 2014. "CDFI Snapshot Analysis: Fiscal Year 2012".
[28] GHK. 2010. "Evaluation of Community Development Finance Institutions" and Nef. 2014. "Credit Unions: International Evidence".
[29] Swack, Northrup and Hangen. 2012. "CDFI Industry Analysis: Summary Report."
[30] Swack, Northrup and Hangen. 2012. "CDFI Industry Analysis: Summary Report."

Empirical data confirms that large CDFIs benefit from significant economies of scale. This is especially true for loan funds, for which scale is highly correlated with the degree of financial self-sufficiency. Depository institutions – CDFI credit unions and CDFI banks – tend to be closer to financial self-sufficiency for structural reasons, but operating expenses and scale are still highly correlated with greater efficiency.[31]. The data suggests that larger funds, credit unions and banks benefit from lower combined interest and operating expense ratios, more leverage on their balance sheets, higher deployment ratios and lower levels of charge-offs.

Financial metrics by CDFI loan fund asset size, from US CDFI Fund applicants in FY 2012[32]

Asset Size	% of Applicants	Self-Sufficiency ratio	Leverage ratio	Combined interest/operating expense ratio	Margin
<$500k	10.3	0.107	-0.574	8.16	-1.640
$500k-$1M	8.2	0.232	2.522	14.19	-0.651
$1M-$5M	23.1	0.385	1.599	1.24	-0.348
$5M-$10M	13.1	0.540	2.258	0.382	-0.210
$10M-$50M	25.2	0.623	2.538	0.421	-0.137.
$50M-$100M	6.8	0.903	3.304	0.264	-0.094
>$100M	13.5	0.848	8.138	0.079	-0.033

Table 1: Financial metrics by CDFI loan fund asset size

While these attributes suggest that there are inherent benefits of operating at scale, there may also be confounding variables affecting the data – for example organisations with particularly strong local demand or leadership may have lower operating costs that allow them grow to more significant scale, which would invert the relationship.

In addition to financial capital, **CDFIs also require access to specialized and specific human capital to achieve and benefit from economies of scale** -- in this regard, CDFIs face similar challenges to other organisations that pursue financial and social outcomes, including some microfinance providers[33]. The community investment business model requires that CDFIs have access to employees who have particular specialized expertise: individuals who combine skills in financial management and achievement of social impact, and who can skillfully navigate both the private investment market, foundation and non-profit community and frequently the myriad

[31] Swack, Northrup and Hangen. 2012. "CDFI Industry Analysis: Summary Report."
[32] Swack, Northrup and Hangen. 2012. "CDFI Industry Analysis: Summary Report."
[33] Battilana and Dorado. 2010. Building Sustainable Hybrid Organizations.

of local government officials that may be involved with encouraging community development. In particular, CDFI loan funds require employees who have experience structuring complex deals that include federal tax credits, philanthropic loss layers and multiple lenders – experience that is often difficult to acquire outside of the community investment sector itself. Similar to other non-profit and public sector employers, CDFIs must contend with the challenge of retaining talented employees who could command significantly higher salaries in similar roles in the private sector. While there does not appear to be much academic research quantifying the problem of talent retention for the US CDFI sector at the moment, some interviews indicated that this may be a significant challenge.

It is a commonly-held premise that CDFIs can be effective because their small size and local focus means that unlike mainstream banks they can be embedded in a community, and as a result have access to additional information on borrowers. **The findings about scale raise important questions about the premise of a premium on local knowledge as a source of value for CDFIs.** If the local knowledge premise is true, then the larger a CDFI becomes, the less it would be able to benefit from these sources of information.

For individual CDFIs, then, there may exist a trade-off between the efficiency gains of scale and the value from locally generated knowledge, unless they are able to develop partnerships and networks that allow them to capture the benefits of both. Evidence from interviews suggests that there may be a bifurcated optimum: **maximum efficiency – in terms of achieving high impact at low cost - may come either when a CDFI is relatively small, enabling it to fully embed in a community and understand local dynamics, or very large, enabling it to reap the full benefits of economies of scale** – and that CDFIs operating at an intermediate size risk losing both of those benefits.

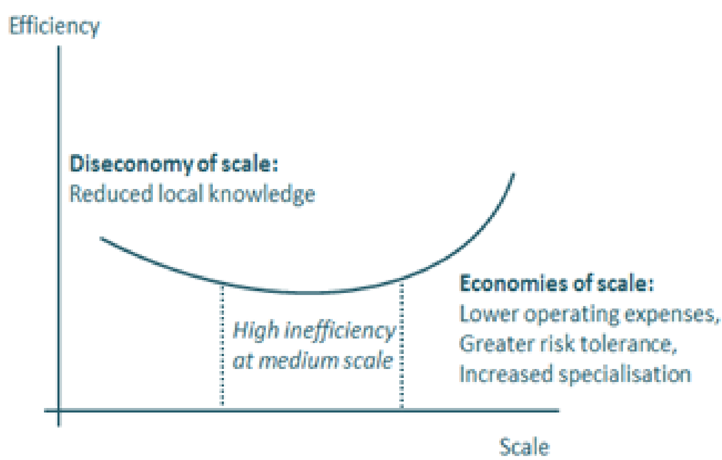

Figure 3: Optimal scale may be either very small or very large

The US has seen a sorting of CDFIs into different scales by their different functions: very large CDFIs able to reach widespread markets and offer relatively standardized products across a range of markets and structures, and smaller more localized CDFIs targeting specific, harder-to-reach communities with tailored products and intense local engagement.

While there are still a large number of small- and medium-sized CDFIs in the marketplace, as Table 1 illustrates, a large number of US CDFIs have reached significant scale. There are a number of factors that have contributed to this. First, **the market has developed over more**

than 4 decades, with ample opportunity for experimentation with business models in response to local market conditions – there were 675 CDFIs in operation in 2004[34]. Second, a handful of CDFIs benefitted from **large one-time so-called "Big Bang" investments** from private funders, enabling them to expand services and organisational capacity in one push: for example, the Ford Foundation and other donors provided $9.3 million to jump-start the Local Initiative Support Corporation in 1980.[35] Finally, many of the largest US organisations **specialize in real estate finance** for affordable housing as well as community facilities like charter schools, health clinics and child care centres. By contrast, none of these conditions have been present in the UK.

There are three main lessons in this area for the UK:

- **Scale is key for sector efficiency: operational expenses play an enormous role in determining the level of financial sustainability of an organisation, and larger organisations are able to use economies of scale to lower those expenses.**
- **Access to specialized expertise is crucial for organisations to grow and exploit economies of scale.**
- **Some of the factors that allowed US CDFIs to scale, such as long history and large investments from foundations, are not present in the UK, so a more direct set of incentives for scale may be necessary.**

4.5 Absorption Capacity: Coordinated approach

Beyond analysis of the borrowers and deals that are currently under way, some leading organisations and experts in the community investment spaces are focusing on the additional contextual factors that determine **whether there are sufficient opportunities to successfully invest capital for social and financial return**. In particular, Living Cities and the Initiative for Responsible Investment (IRI) have developed the notion of **capital absorption capacity**, as part of their interests in community investment as a funder and research institute, respectively.[36] In pursuit of social return, philanthropic funders and governments are interested in what factors aside from additional funding are necessary to improve social outcomes, and the concept of capital absorption capacity allows for consideration of local political, social, legal and organisational concerns that may affect the ability of a community to use capital productively.

For example, rather than prescribing that a foundation of particular size must be able to provide a loss layer, the framework considers the functional roles that must be played in a system, regardless of what particular actor plays that role in a given context, and **the broader governance system that can credibly assess community needs and coordinate action to address those needs**. Depending on local conditions, different organisations may take the role

[34] Benjamin, Rubin, and Zielenbach. 2004. "Community Development Financial Institutions: Current Issues and Future Prospects."
[35] Von Hoffman. 2012. "The Past, Present and Future of Community Development in the United States." In Investing in What Works for America's Communities: Essays on People, Place & Purpose," Federal Reserve Bank of San Francisco.
[36] Hacke, Grace and Wood. 2012. "Capital Absorption Capacity of Places: A Research Agenda and Framework."

of convening stakeholders to identify priorities, advocating for appropriate zoning and lending guidelines, assembling a pipeline of potential investments, explore new types of financial products, or measuring the impact of investments. The framework developed by Living Cities and IRI is detailed and specific, including guiding questions, diagnostic tools and case studies[37].

One example of this is Plan Bay Area – a long-range housing and transportation plan through 2040 for the San Francisco Bay Area.[38] The plan is the first regional effort to meet the requirements of state legislation that requires long-term planning to address population growth and reduce greenhouse emissions from vehicles. While regions in the UK may have different policy needs and objectives, the structure of the plan provides insight into the ways that regional coordination can help make the most of funding from disparate sources and coordinate actions by actors in the public, private and non-profit sectors, though many of these details must be worked out over the course of implementation. CDFIs may have roles to advance the plan itself through real estate development, or as a service provider that plays a particular role in response to individual or SME financial needs.

Another way to think about coordinating community development is the **'community quarterback' model** articulated by the Federal Reserve and the Low Income Investment Fund.[39] In this model, a single organisation takes on the task of integrating the work of many agencies to advance a holistic approach to anti-poverty and community development efforts. Practitioners point to efforts in Minneapolis and New York City as examples of individual organisations taking on these responsibilities.

The primary lesson from this analysis is that:

- **Any locality that aims to make the most of community investment must identify actors to play each of these roles, and develop an overarching governance structure and process to coordinate joint actions**.

4.6 Assessing Absorption Capacity Effectively: Data availability & disclosure

The CRA (1977) and the HMDA (1975) require US banks to disclose data on a wide variety of metrics at a very local (census tract) level. This data disclosure has enabled civil society advocates to identify key problems and lobby for solutions, has enabled community investment organisations to identify and target areas of financial exclusion, has enabled government to develop appropriate policy measures, and has enabled evaluation of the impact of community investment solutions. **Granular, place-based data disclosure, broken down by demographic indicators and types of financial services provided, has been vital in the US to enable stakeholders to identify the nature and location of problems of financial exclusion, and to**

[37] Hacke, Grace and Wood. 2013. "Expanding the Geographic Reach of Community Investment: The IFF Case Study."
[38] Plan Bay Area: Overview. http://planbayarea.org/plan-bay-area.html
[39] Andrews,and McHale. Stanford Social Innovation Review, July 2014. "Community Development Needs a Quarterback" http://www.ssireview.org/blog/entry/community_development_needs_a_quarterback

develop appropriate, targeted solutions, despite the fact that data alone is not sufficient to address the problem[40].

"We have learned from 30 years of CRA policy that what is measured gets done" –E Seidman.[41]

US data disclosure requirements, however, are incomplete: the HMDA and CRA were designed to operate in a very different financial system and have not kept up with recent financial innovations. HMDA data does not gather important data on terms and cost of loans, which is particularly relevant when assessing predatory lending; and CRA reporting requirements do not apply to bank subsidiaries, leaving large parts of the market un-measured[42].

There are three key lessons in this area for the UK:

- **Data disclosure is a vital means to understanding the problem of financial exclusion effectively and to designing appropriate solutions.**
- **Data disclosure should include granularity at the local and demographic level, as well as data on terms of loans provided as well as loans made and refused; and it should apply to all financial institutions rather than just a sub-set.**
- **Coordinated identification of financial inclusion and community development goals is necessary to specify both what data is important to collect and how it will be used.**

4.7 Overview: Notable Features of the US Market

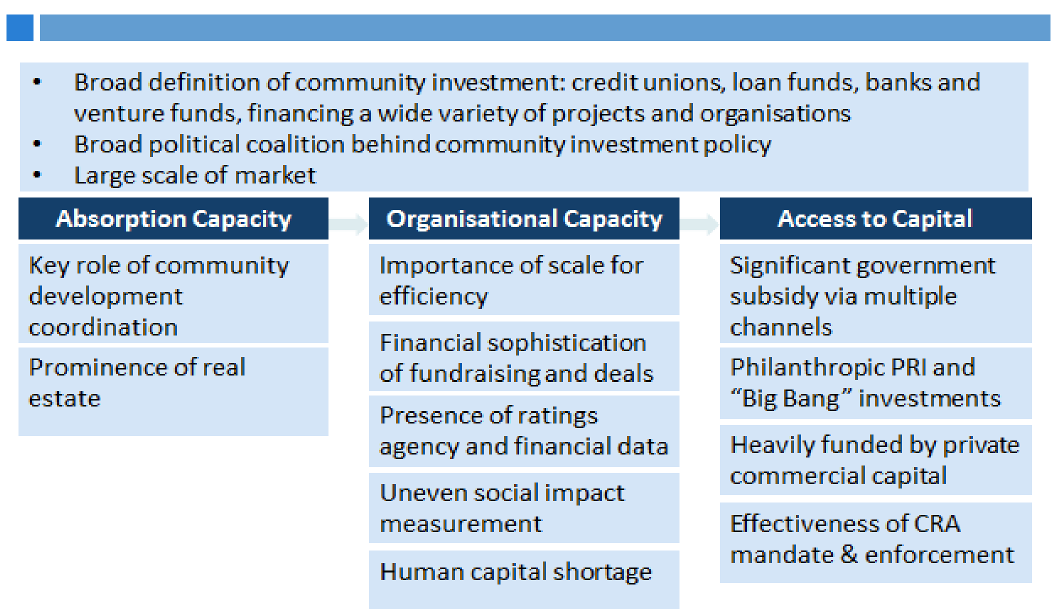

Figure 4: Overview of notable features of the US community investment market

[40] Barr. 2005. "Credit Where It Counts: The Community Reinvestment Act and Its Critics."
[41] Seidman., New America Foundation. Testimony before the Committee on Financial Services, U.S. House of Representatives, 2008, available at http://www.newamerica.net/files/CRA%20Testimony%202-13-08.pdf.
[42] Rust. 2009. "A Principle-Based Redesign of HMDA and CRA Data".

5. Binding Constraint Analysis of the UK Community Investment Sector

As discussed in the introduction (and in more detail in Appendix B), community investment should be a key part of the solution to the problem of financial exclusion in the UK. Yet, the UK community investment sector is still small compared to the estimated size of the problem. While there are many potential ways to strengthen the community investment sector, limited resources should be allocated to address the areas where they will have the most impact. This section analyses the UK community investment sector with the framework from chapter 3, to understand what the binding constraint is on the sector's growth. We investigate three potential hypotheses:

i. There is **limited absorption capacity** for community investment.
ii. Community investment organisations do not have the **organisational capacity** to provide community investment effectively.
iii. Community investment organisations do not have sufficient **capital** to provide large-scale community investment.

If hypothesis i. is correct, then no further action needs to be taken to strengthen the community investment industry. If it is incorrect, then the limited size of the community investment industry is either because of lack of organisational capacity, lack of capital, or some combination of the two.

5.1 Absorption capacity

There are two aspects to absorption capacity: is there demand from the target population for finance, and if so, can the target population put that finance to socially-beneficial use? **We believe that there is a clear market for community investment for individuals and SMEs** who are unable to be financed by for-profit mainstream or challenger providers, and where there is a significant social benefit from providing that finance. Our interviews and lending data give a less clear picture of the extent to which there is strong absorption capacity for community investment in social enterprises and charities, so we focus on individuals and SMEs here.

Individuals

Millions of individuals in the UK do not currently have access to affordable credit. **Figures from 2011 to 2014 suggest that 7 million people – or 11% of the UK population – use high cost credit**[43]; 2.3 million people every year in the UK use home credit, paying APRs of 180-500%[44]; 1.2 million use payday loans[45] with APRs up to 7,000%[46], and at least 165,000 use illegal loan sharks[47]. The recent payday loan interest rate cap helps reduce financial exploitation, but leaves a large number of people still unable to access affordable and fair finance[48]; the FCA has estimated that

[43] Department of Work and Pensions Credit Union Expansion Project. 2011. "Feasibility Study Report".
[44] Financial Inclusion Centre.2014. "Credit and Debt" webpage.
[45] Office of Fair Trading. 2013. "Payday Lending Compliance Review: Final Report".
[46] Community Development Finance Association. 2014. "Just Finance: Fair and Affordable Finance for All."
[47] Department of Trade and Industry (DTI) and Policis. 2006. "Illegal Lending in the UK".
[48] Alexander. 2014. "Peak Payday has Passed – What Next?"

Individuals

11% of 2014 payday loan borrowers will be left without access to credit[49]. While some of this borrowing is likely to have been used to simply expand discretionary consumption, the scale and exorbitant terms of the payday loan market suggest that a significant proportion of the market face circumstances that force them to borrow at whatever rates are available – for repairs, vital purchases or short-term bridge loans - and not out of convenience or luxury.

Affordable credit is particularly constrained for lower-income individuals, individuals living in disadvantaged communities, and individuals from certain minority groups including women, some ethnic minorities, and people with disabilities[50]. The financial crisis has exacerbated the steady trend of bank branch closures – with a 46% decline in bank branches since 1990[51], concentrated predominantly on disadvantaged areas[52].

SMEs

SMEs also face significant constraints on their access to debt and equity finance, in particular given bank retrenchment since the financial crisis. Stricter credit policies mean that 20% of all SME loan applications were rejected in 2012, compared to 5% in 2004[53]. Even where loan applications are not rejected, interviews suggest that credit is often offered at terms that are unfeasible or rates that are unaffordable for the business.

The National Audit Office estimates an SME financing gap of £22 billion over 2013-2017: the gap between the amount of finance needed by SMEs and the amount they will actually receive[54]. Around 60% of SMEs do not access external finance; 40% of SMEs are "permanent non-borrowers"[55]; and 25% of SMEs finance their businesses with personal credit cards and mortgages[56]. According to BIS and HM Treasury, limited access to finance is a key factor making doing business difficult in the UK[57].

Much of the demand for SME finance is being met recent rapid growth in the alternative finance market – growing at a rate of over 150% per year over 2012-2014 – it was £1.74 billion in 2014[58]. Yet there remains a significant demand gap for community investment for SMEs: the majority of recipients of P2P lending, invoice

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[49] Financial Conduct Authority Press Release. 11/11/2014. "FCA Confirms Price Cap Rules for Payday Lenders"
[50] Smallbone et al. 2003. "Access to Finance by Ethnic Minority Businesses in the UK" and Roper and Scott. 2009. "Exploring Gender Differentials in Access to Business Finance".
[51] Campaign for Community Banking Services. 2014. "Branch Network Reduction: 2014 Report".
[52] French et al. 2013. "The Changing Geography of British Bank and Building Society Branch Networks, 2003-2012"
[53] Department for Business, Innovation and Skills. 2013. "Evaluating changes in bank lending to UK SMEs over 2001-12 – ongoing tight credit."
[54] National Audit Office. 2013. "Improving access to finance for small and medium-sized enterprises".
[55] BDRC Continental. 2014. "SME Finance Monitor Q3 2014: Management Summary".
[56] Experian. 2013. "A quarter of SMEs use personal finance to support their business".
[57] Department for Business, Innovation and Skills and HM Treasury. 2011. "The Plan for Growth".
[58] Nesta. 2014. "Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014"

SMEs

trading and crowdfunding were not previously financially excluded – rather they sought out alternative financing for reasons of ease, speed or better services[59].

Interviews with SME community lenders in the UK provide additional confirmation that there is large unmet demand for socially-beneficial finance for financially-excluded SMEs. **98% of CDFI SME customers, for example, have previously been rejected by banks[60], but interviews suggest that an increasing number of CDFI customers are viable, fundamentally bankable businesses.**

Maximum social impact: Co-ordinated community development

The analysis above demonstrates that there is a significant financial exclusion problem that could be addressed to social benefit. As such, we do not believe that a lack of absorption capacity is a binding constraint on the UK community investment industry at this time.

However, there **is substantial variation across regions in terms of both the types of financial exclusion that are most prevalent and the organisations that could potentially address those needs**. Ideally, key regional actors would develop a local approach to local challenges, coordinating the large number of organisations working toward different inter-related outcomes – financial inclusion, skills training, welfare provision, community development. Yet in many localities this is **insufficient or even non-existent, with little co-ordination between actors and the absence of a central co-ordinating body**. In the absence of other clear central bodies, local government is likely to be the best candidate to be a local coordinator of community development efforts: some Regional Development Authorities may have filled this role in the past, but there appears to be little evidence that the majority of their replacements, Local Enterprise Partnerships, are acting to coordinate local community development actors effectively.

This lack of coordination exists not only between different fields within social impact work, but also between different actors in the same field: our interviews suggest that there is insufficient coordination between CDFIs, credit unions, social impact investors and mainstream financial institutions. Recent initiatives such as the bank referral scheme and other instances of CDFI-credit union collaboration may change this dynamic.

Given the large scale of the need for community investment services at an individual level, we do not believe that lack of coordination is currently the key impediment to achieving greater impact. However as the community investment sector grows to play a greater part in community development, **efforts may be wasted and capital may be misdirected without a much stronger, more coordinated approach to community development at the local level.**

[59] Nesta. 2014. "Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014"
[60] Community Development Finance Association. 2014. "The CDFI Funding Model".

Assessing absorption capacity effectively: the role of good data

The UK has almost no firm-level data disclosure requirements for banks. The Bank of England and FSA collect and disclose industry-level data on mortgages and lending to low-income individuals and to SMEs. As of December 2013, the BBA and CML have begun to disclose net total lending data on SME lending, mortgages and unsecured personal loans at a postcode level. In addition, some banks disclose some data on their own lending activities in deprived communities, such as Lloyds and Barclays[61]. There have been many calls for increased bank disclosure over the last 15 years, including from the Social Investment Task Force[62], the Policy Action Team on enterprise and social exclusion[63], the New Economics Foundation[64] and the Financial Inclusion Centre[65].

"Current banking disclosure in the UK is uneven, not standardized and not currently broken down to specific geographical areas.[66]"

The UK **cannot hope to address financial exclusion in an efficient and effective manner without the necessary data to understand the problem**. Moves toward greater data disclosure are welcome but still insufficient. While this is not a constraint on the development of the community investment industry *per se*, it is a significant constraint on (1) policymakers seeking to develop the best policies to address financial exclusion, and on (2) community investment organisations seeking to provide services where they have the most impact.

5.2 Organisational capacity

To assess whether organisational capacity is the binding constraint to the sector's development, we ask***: is there evidence of existing community investment organisations that have the skills and expertise to deliver increased quantities of finance efficiently and effectively?***

Capacity across existing community investment organisations in the UK is extremely variable - but we believe that there exist a set of clear sector leaders (amongst CDFIs, credit unions, and impact investors) who are already managing and delivering capital in innovative and sophisticated ways, and who have the capacity to do so at greater scale. Furthermore, given current efforts to improve sector capacity and modernize sector practices – particularly amongst credit unions – we believe that the number of high-potential community investment organisations is likely to rise further and does not require urgent additional policy attention.

61 Dayson et al. 2012. "A UK Banking Disclosure Act: from Theory to Practice".
62 Social Investment Task Force. 2000, 2005, 2010.
63 Policy Action Team 3. 1999. "Enterprise and Social Exclusion".
64 McGeehan et al. 2003. "The Power of Information" and New Economics Foundation and the Woodstock Institute. 2006. "Full Disclosure"
65 Financial Inclusion Centre. 2009. "Financial Inclusion Disclosure Measures".
66 Dayson et al. 2012. "A UK Banking Disclosure Act: from Theory to Practice".

CDFIs

CDFIs vary enormously in capacity in terms of financial sophistication, financial evaluation and reporting ability, and social impact evaluation. There are some CDFIs in the UK which are not able to intermediate as effectively as possible. Over recent years, however, the literature and our interview evidence demonstrates that **a handful of CDFIs serving the three key markets – SME lending, social sector lending and individual lending – have emerged as clear leaders in terms of organisational capacity**[67]. These CDFIs have developed sophisticated capital raising channels, leveraging grant funding or guarantees and taking advantage of incentives like Community Investment Tax Relief to raise significant amounts of private capital for on-lending[68]: for example in 2014, 16 CDFIs raised commercial capital from banks (13 through the RGF, and 3 independently). Particular improvements in organisational capacity have been made over the last five years: the compliance requirements of the Regional Growth Fund, for example, have played a major role in improving the capacity of participating CDFIs by requiring high levels of due diligence, ensuring frequent and standardized reporting and audits, enabling the recruitment of specialized staff and demonstrating CDFIs' ability to use commercial funding.

There are a number of CDFIs which assess their social impact effectively, have solid financial reporting and accounting procedures, evaluate credit risk rigorously, and access capital in a sophisticated and efficient manner. We believe that these CDFIs have the capacity to drive significant growth in the community investment sector's reach and impact over coming years. As such, while some of these CDFIs may still benefit from increased financial sophistication and scale, as well as from improved social impact evaluation, we believe that the presence of these large and effective CDFIs suggests that organisational capacity is not the primary binding constraint for the next stage of the sector's development.

Credit Unions

Similarly, credit unions across the UK vary enormously in capacity: several are large and sophisticated in their credit risk evaluation procedures, financial capabilities, risk management and operating platforms, while many others have unsophisticated procedures and low capacity to intermediate capital effectively or offer a holistic range of financial services[69]. Interview evidence suggests that a lack of capacity – in terms of unsophisticated financial procedures, inefficiency and poor social impact evaluation – is a particular problem in the credit union sector. The DWP-funded Credit Union Expansion Project feasibility study suggested that around 60 credit unions, with DWP support, could have the capacity to serve financially excluded individuals effectively,

[67] Nef. 2008. "UK CDFIs – From Surviving to Thriving".
[68] Nef. 2008. "UK CDFIs – From Surviving to Thriving."
[69] HM Treasury. 2014. "British Credit Unions at 50: Response to the Call for Evidence".

efficiently and at scale[70]. As such while many credit unions could benefit from efficiency improvements – including improved payment systems, and enhanced skills of staff and board members – the evidence suggests that after the Credit Union Expansion Project has run its course there will be a critical mass of credit unions able to deliver financial services in an efficient and effective manner. Studies and interviews suggest that the UK credit union sector is currently undergoing a transition to maturity[71]. Although organisational capacity may remain low in the bulk of credit unions, we believe that growth in the credit union sector in the coming years **should be driven by the group of high-performing credit unions.** As such, we see further moves to improve organisational capacity as a less urgent priority than support for leading, high-capacity credit unions to access sufficient funding to scale.

Sector capacity and Market infrastructure

While there appears to be a sufficient critical mass of high-performing CDFIs, credit unions and community impact investors to begin to scale the community investment sector, as the market develops **we believe that a lack of market infrastructure could begin to become a binding constraint**. Key aspects of market infrastructure include the provision of capacity-building services, a centralized system for the accumulation and dissemination of industry knowledge, the provision of collective funding opportunities, sector-wide data collection and financial and social impact reporting standards, and the development of a human capital talent pipeline.

The UK has all of these aspects to some degree, with the CDFA, ABCUL, the Community Investment Coalition and other industry bodies taking on roles in capacity-building, best practice promotion, advocacy, and data collection, as well as collective fundraising in the case of the CDFA. The US experience demonstrates, however, that as the community investment sector becomes larger and more sophisticated, and raises increased amounts of funds from private organisations, market infrastructure becomes more important. The UK can learn both from the successes of US market infrastructure development, and from the areas in which market infrastructure is still lacking. In particular, the availability of standardized financial and impact metrics for individual community investment organisations, and for the industry as a whole, is important to improve managers', policymakers' and investors' ability to make effective decisions – the US still has significant work to do in this area[72].

The key market infrastructure gaps in the UK are a lack of good data on individual organisations' financial metrics or social impact; a lack of comparable social impact evaluation frameworks across organisations; a lack of common infrastructure such as payment platforms which enable small organisations to operate more efficiently; and a lack of a clear talent pipeline to bring qualified people into the sector. While this is not the most pressing need of the sector, as it expands, the development of market infrastructure will become increasingly important.

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[70] Department of Work and Pensions Credit Union Expansion Project. 2011. "Feasibility Study Report".

[71] McKillop and Wilson. 2011. "Credit Unions: A Theoretical and Empirical Overview".

[72] Swack, Northrup and Hangen. 2012. "CDFI Industry Analysis: Summary Report."

5.3 Access to Capital

To assess whether access to capital is the binding constraint, we ask whether, ***if community investment organisations had more capital – or capital on more appropriate terms – they could use it effectively.*** We find that for many community investment organisations, poor organisational capacity is the key constraint on their growth and success – but that **access to capital is a key binding constraint on the high-performance community investment organisations** discussed above, and that increased access to long-term grant and affordable debt capital would be catalytic to sector growth.

Different UK community investment organisations access capital in different ways: credit unions and social banks can rely on member deposits for the majority of their capital, while CDFIs must raise all their capital from external sources. There is evidence that CDFIs are severely constrained by a lack of capital[73]", and that credit unions lack capitalisation for funds for on-lending[74].

***"Constraint in the supply of funding remains a major barrier to scaling the CDFI sector"-* CDFA**[75]

The calls from the sector appear to be substantiated by evidence from individual organisations. Many CDFIs and credit unions are reporting extremely high demand for appropriate and affordable finance from SMEs and individuals – demand that many, according to our interviews, are currently unable to meet. Evidence from certain individual CDFIs, for example, suggests that annual lending targets are easily being exceeded and are only limited by access to funds for on-lending. This phenomenon appears particularly pronounced in some of the highly sophisticated and mature CDFIs discussed above, suggesting that with increased capital, they would have the capacity to meet the high need for services.

High impact suggests capital constraints: CDFIs in the RGF programme created jobs at a cost that was **one tenth** of the program average.

In addition, the impact that community investment services have when compared to other services can be interpreted as an indicator of the "shadow price of capital" – that is, the extent to which access to capital is a constraint on community investment organisations achieving social impact. If CDFIs and credit unions have the capacity to make significant impact, but are constrained by a lack of credit, then the investments that they do make should be extremely effective (because only the most effective cases may be being funded). The example of the RGF suggests that this might be the case: in 2014 the average cost to government per job created by CDFIs under RGF was £3,700, which is only 10% of the

[73] Community Development Finance Association. 2014. "Inside Community Finance"
[74] HM Treasury. 2014. "British Credit Unions at 50: Response to the Call for Evidence".
[75] Community Development Finance Association. 2014. "Inside Community Finance"

average cost per job for the entire RGF programme.[76] While government funding already made up 44% of new CDFI funding for on-lending in 2014, the vast majority of this was through RGF and Start-Up Loans.

Clearly, the problem is not an abstract "lack of capital" per se, but a lack of suitable capital. In particular, the major gap is for grant/equity capital to provide a "first loss layer" for lending portfolios. As discussed in chapter 4.2 (and further in Appendix A), community investment is inherently more costly and more risky than mainstream financial activity: if clients were sufficiently viable and profitable to be served by mainstream profit-making financial institutions, they would not be financially excluded. Relative to the US, community investment in the UK is particularly costly, since it does not including affordable housing finance (with lower risk and default rates). As such, bad debt rates are higher for community investment organisations – some interviews suggested rates of 15%-25% for even the highest performing CDFIs, for example. This is high enough that it is not possible to incorporate the expected cost of bad debts into the interest rates charged to customers while still ensuring that loans are affordable and non-exploitative.

Community investment organisations therefore cannot be fully commercially financially sustainable. **For each portfolio of lending, a "first loss layer" is required: reserve capital which can be used to absorb the initial losses on loan portfolios without impairing the community investment organisation's ability to repay its creditors** (such as private investors, in the case of CDFIs, or individual depositors in the case of credit unions). The necessary size of the first loss layer depends on average default rates among the client base of the community investment organisation, as well as the organisation's operating expenses.

A loss layer can take the form either of a grant or a guarantee – some CDFIs, for example, have structured their own loss layers in funds using guarantees such as the EIF and the Enterprise Finance Guarantee, and some CDFIs have accessed the Regional Growth Fund which has an inbuilt loss layer of 50% government grant funding. Without access to sufficient and consistent loss layer capital, CDFIs and credit unions cannot access other sources of capital which they are then able to on-lend. This pressure not only reduces total lending - constraints in funding and pressures to be fully financially sustainable on a commercial basis have forced some credit unions and CDFIs to alter their lending mix to reach more profitable clients at the expense of their social mission[77].

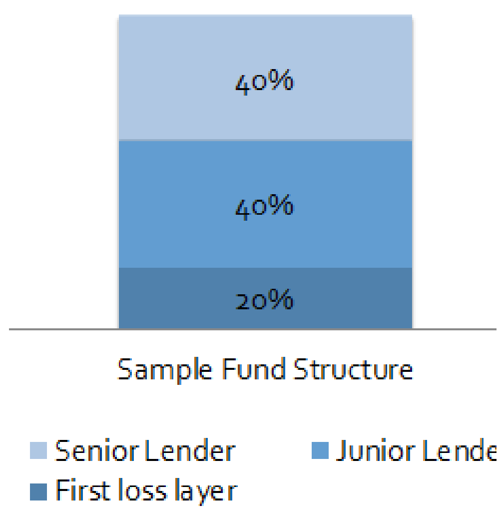

Figure 5: Example fund structure for a CDFI

[76] Community Development Finance Association. 2014. "Inside Community Finance"

Existing government schemes at the national and European level have provided this to some community finance organisations – most notably in CDFI SME lending, with the Enterprise Finance Guarantee Scheme, the Regional Growth Fund and various European Investment Fund guarantee schemes. The success of these schemes should be built upon to provide a consistent stream of first loss capital open to all types of community investment organisations.

A "first loss layer" of equity capital is necessary but not sufficient to ensure that community investment organisations have enough capital to operate effectively. Access to long-term debt capital is also important, in particular for organisations which make longer-term loans. A first loss layer of equity capital can help bring low-cost debt capital into the market by enhancing the risk-return trade-off; in addition, as the market develops further, access to the capital markets through bond issuance may become an option for larger organisations.

Even in the presence of a suitable first loss layer and other incentives (e.g. CITR) which create an attractive risk-return profile for potential investors, interview evidence suggests that it can still be difficult for CDFIs and credit unions to attract commercial capital. Loan sizes are likely to be small and returns low, and processes to access guarantees and tax relief can be complicated and time-consuming. **With high transaction costs and low loan sizes and returns, it appears that many banks may be reluctant to invest time and resources in commercial investments in community investment organisations.**

5.4 Summary

Our analysis suggests, therefore, that access to appropriate capital – particularly equity/grant capital for a "first loss layer" – is the key constraint on the development of the UK community investment sector. While there are severe weaknesses in the organisational capacity of many UK community investment organisations, we believe that there are enough high-performing organisations which are ready to scale and increase their impact – and this number should increase on completion of the major capacity-building initiatives underway, particularly in the credit union sector. *We emphasize, therefore, that the problem of capitalization applies primarily to the select group of high-performing CDFIs and credit unions which are able to put that additional capital to good use.*

To enable UK community investment organisations to raise additional private capital and grow quickly, additional equity capital for high-performing organisations would be beneficial.

[77] Nef. 2008. "UK CDFIs – From Surviving to Thriving".

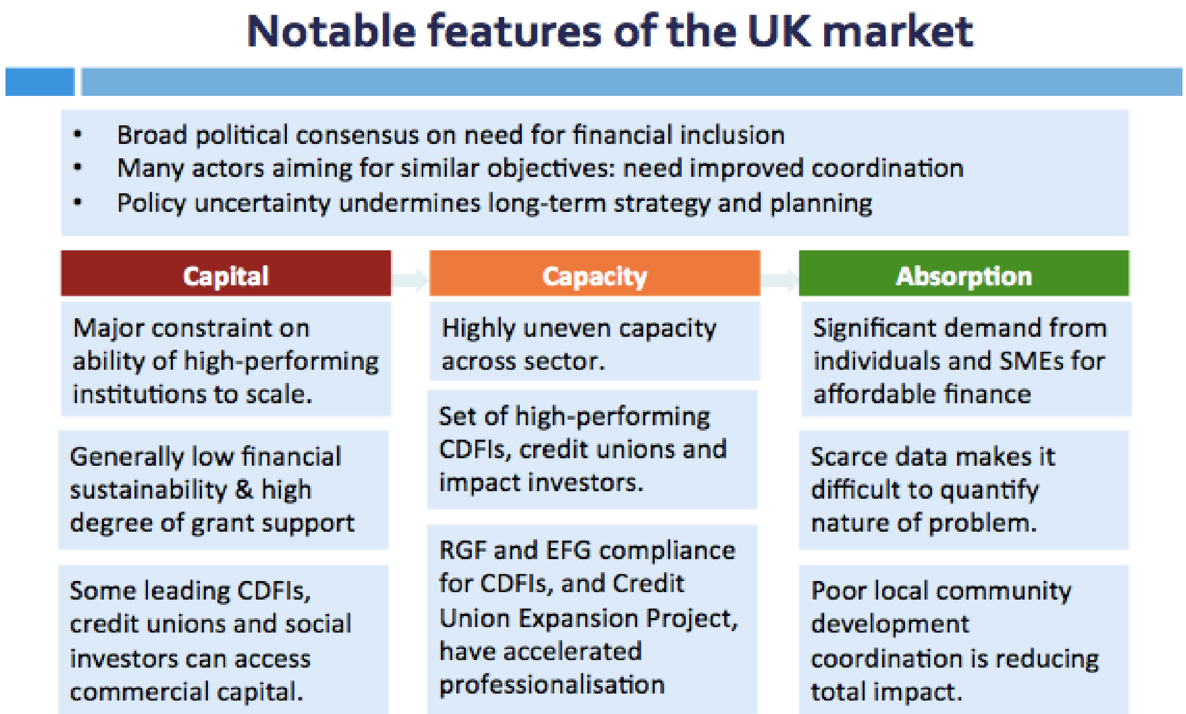

Figure 6: Summary: Notable features of the UK community investment market

6. UK Policy Recommendations

Our analysis of the UK market suggests that there is a high and growing need for community investment, and that insufficient access to capital for high-performing organisations is the biggest limitation on the ability of the community investment sector to meet that need[78]. As such, our key recommendation is the creation of a **government-funded Opportunity Finance Fund, which would provide first loss layer capital to high-performing CDFIs, credit unions and other community investment organisations.**

We then make four supplementary recommendations which we believe are also important for sustained growth and impact of the sector: **creating a financial inclusion mandate, building better market infrastructure, improving local community development coordination, and improving data disclosure.**

[78] As discussed in chapter 5.2, there are severe weaknesses in the organisational capacity of many UK community investment institutions. We believe that this should not be a problem in the near term: there are enough high-performing institutions which are ready to scale, and it is these institutions that lack capital and should be provided with more. Furthermore, there is extensive capacity-building currently underway in the UK credit union sector in particular, and we believe that it could be premature to recommend further capacity-building before seeing the outcome of the Credit Union Expansion Project.

6.1 Capitalisation and organisational capacity: An Opportunity Finance Fund

The key current problem in the community investment industry is a lack of access to sufficient quantities of long-term capital that can be used as a "loss layer" to absorb bad debt and leverage private capital. This applies in particular to CDFIs and some impact investors, which must raise all their capital externally; but the lack of access to grant capital and long-term debt capital also impacts the ability of credit unions to leverage funds to maximum impact.

While various government schemes have provided some grant capital to UK CDFIs and credit unions over time (including the Phoenix Fund, the Financial Inclusion Fund, RDA funding, and the RGF), and other new capitalisation schemes like the Lloyds Credit Union Development Fund are a step in the right direction, **the absence of a long-term dedicated programme of government support like the CDFI Fund in the US makes it difficult for UK community investment organisations to access private capital markets.**

There is a role for government in meeting this need (as discussed further in Appendix A). In addition, there is high impact potential from government involvement in providing catalytic first loss capital, as demonstrated by the success of the UK Regional Growth Fund VI – where SME lending CDFIs received £30m of government grant funding matched with £30m debt funding from 2 private banks.

An attempt by government to capitalise community investment organisations must balance the following criteria:

1. **Amount of capital attracted to industry (total)**
2. **Likely efficiency of use of capital (incentives created for efficiency and innovation)**
3. **Cost to government**

Each of these criteria presents challenges for policymakers, since over-emphasis on any one criterion may damage the overall performance of a capitalisation initiative. Government funders want to maximize the impact of the capitalisation: too much capital directed to the industry involves an opportunity cost elsewhere, and too few criteria on funding may encourage inefficiency and waste. On the other hand, setting stringent reporting and performance criteria for grantees provides strong incentives for innovation and increased efficiency, but also imposes compliance costs on grantees – and if criteria are too stringent (for example, criteria to match private against public funds), some highly effective community investment organisations may be excluded. The option that we propose below is an attempt to find the appropriate trade-off between these criteria, maximising social impact while taking into consideration limitations on availability of funds.

Opportunity Finance Fund: overview

Function	Provide first loss layer grant capital to high-performing community investment organisations
Purpose	Catalyse large quantities of capital flows into efficient and effective community investment organisations
Size	£200 million, to be disbursed over 5 years
Match Funds	At least 4:1 match of private funds to Fund grant required.
Recipients	Any non-profit targeting financial inclusion. Selected competitively on basis of growth potential, social impact and financial performance.

Figure 7: Key aspects of Opportunity Finance Fund proposal

Proposal overview

We propose an "opportunity finance fund" which provides grant/equity capital to selected high-growth potential and highly effective UK community investment organisation. This fund is inspired by the example of the CDFI Fund in the US as well as individual capital-raising initiatives by UK CDFIs and credit unions, and the success of the recent Regional Growth Fund.

The Opportunity Finance Fund would be made up of **grant money**, which would be allocated to individual community investment organisations as a **first loss layer**. An Opportunity Finance Fund grant would be required to be **matched at least 4:1 by private capital – depending on the type of organisation applying for funds and target program outcomes, this capital could be market rate, subsidized or grant. Any community investment organisation would be eligible** to apply for funding, but criteria would be competitive: the fund would make large awards to a small number of organisations, selected for their **high growth potential, strong financial performance and strong social impact**. As such, the fund would act as a driver for scale, efficiency, effectiveness and innovation in the community investment industry.

We propose an **initial fund size of £200 million, to be disbursed over 5 years** with a maximum disbursement of £50m in any calendar year (but no minimum disbursement, if community investment organisations fail to satisfy the necessary impact and financial soundness criteria). Toward the end of the five-year fund period, an evaluation would assess the extent to which the fund has been successful and, if so, the amount with which it should be endowed for the following five-year period.

With the 4:1 match requirement, a fund size of £200 million implies **a total injection of at least £1 billion of capital into high-performing UK community investment organisations over five years**, or on average about £200 milllion of new capital per year. To contextualise this figure:

this is a little larger than the total UK CDFI lending in 2014[79], and about half the size of total new credit union lending in 2014[80].

The administration of the fund should be decided based on three criteria:

1. Independence from organisations applying for funds
2. Strong financial evaluation/investment capacity
3. Strong social impact evaluation capacity

Government funds as a catalyst: the Match Funds Requirement

We have selected a 4:1 match funds requirement as a benchmark for the fund. Match funds would be required to be funds from non-government sources, but could be funds of any type, ranging from fully market-rate debt to non-repayable grant funding. Creating a match funds requirement is important for two reasons:

(1) to **leverage government funds**, using them as a catalyst for greater impact, and

(2) to create **incentives for efficiency and effectiveness** from community investment organisations, as private investors/philanthropists will also need to verify the organisation's financial and social returns before investing.

The 4:1 benchmark was proposed with reference to existing organisations in the UK as well as evidence from the US. Deals structured by individual **UK SME lending CDFIs, using grants or guarantees as a loss layer (and sometimes using CITR to augment private investor returns), have managed to attract private capital at a multiple of 4x or 5x of the loss layer.** The Regional Growth Fund VI, which certain UK SME lending CDFIs were able to access, had a 1:1 match of private bank funding against government grant funding. This was a successful proof of concept, but our interviews and analysis suggest that government grant funding can be much more highly leveraged to maximise impact. In the US, the typical multiplier on the NMTC program is 8x, while the CMF requires a 10x private-public multiplier: we believe this level is too high for all but the most financially sustainable UK organisations, because the NMTC and CMF largely apply to real estate CDFIs, which are able to lever larger quantities of private capital due to their secured lending portfolio.

We allow for flexibility in the **type and terms** of private financing which can be used as the match for the Opportunity Finance Fund equity loss layer. Community investment organisations can bring in a match that is purely market rate debt funding, purely grant funding, or any combination. The rationale is as follows. The government wishes to (1) multiply the impact of any funds it spends on community investment, and (2) incentivize the flow of funds to the most effective organisations. Effectiveness and cost-effectiveness are not synonymous: the impact that an organisation can achieve at a given cost depends on the population that the organisation is serving. Some community investment organisations which serve more marginalized

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[79] Community Development Finance Association. 2014. "Inside Community Finance"

[80] Bank of England. 2013. "Introduction to Credit Union Statistics".

populations are unlikely to be able to raise the other 80% of their funding in the form of repayable interest-bearing funds: their bad debt rates plus operating costs are likely to exceed 20% of total portfolio. As noted above, the match requirement would be for any type of funding, which provides flexibility for the fund and allows funders to draw upon existing processes for selecting the grantees or lenders that they believe will be most effective. We believe that this will mean that social investors, foundations or other grant-makers will invest in these higher-cost, higher-loss community investment organisations *only when they demonstrate significant social benefit* from their activities. As such, **match funding from grants will be attracted to the most socially-useful community investment organisations, just as match funding from for-profit investors will be attracted to the most financially-sustainable community investment organisations.**

Competitive allocation: stimulating scale and efficiency through selection criteria

While there is a strong rationale for government subsidy to the community investment industry (discussed in Appendix A), any subsidy also creates a danger of encouraging inefficiency and waste. The Phoenix Fund of the 2000s, for example, was designed to fund a large number of new CDFIs to allow for local specialization and experimentation with new business models; similarly, government funding to credit unions has frequently focused on disbursing to as many organisations as possible.

The Opportunity Finance Fund, in contrast, would take a different approach: **with many diverse players now present in the UK community investment industry, the time has come to target the industry leaders, enabling the most efficient and sophisticated organisations to scale.** In a typical profit-driven competitive market, the highest-performing organisations would be able to scale by raising equity & debt capital to drive internal growth or M&A activity; in a non-profit market like the community investment industry, growth capital needs to come partly from public or philanthropic/social investor sources.

With many diverse players now present in the UK community investment industry, the time has come to target the industry leaders, enabling the most efficient and sophisticated organisations to scale.

Through highly selective funding allocation criteria, which examine both financial and social impact performance, as well as requiring rigorous reporting and management standards, an Opportunity Finance Fund could ensure that only the most efficient and effective organisations receive this significant government subsidy. This would not only be the most effective use of government funds – it would also stimulate the next phase of development in the community investment market, by enabling the most effective organisations to scale and by incentivizing less effective organisations to develop more sophisticated procedures and target better financial and social impact measurement and outcomes. While there is a countervailing concern that overly selective criteria may nearly every organisations from accessing these funds, the stringent criteria would be matched by larger allocations, incentivizing organisations to make the investments of time and capital to compete for the funds.

A flexible approach: agnostic to organisational form

Most community investment organisations in the UK – non-profits seeking to tackle financial exclusion by serving marginalized customers – are currently credit unions or CDFIs. It may not be the case, however, that these forms are the most efficient at meeting all the diverse needs of financially excluded individuals and enterprises. Innovation in the for-profit UK financial sector is currently rapid – the growth of the P2P lending market being a case in point – and, with access to start-up or growth capital, it is possible that we would see similar innovation in the non-profit community investment market. As such, an Opportunity Finance Fund should be agnostic to organisational form: **as long as an organisation is not purely for-profit and is credibly committed to the goal of increasing financial inclusion, it would be eligible to apply for funding.**

As discussed in chapter 5.2, different types of community investment organisations have different funding models and so require different types and quantities of external capital. As such, different types of organisations would be expected to use the fund in different ways. Non-depository institutions like CDFIs are likely to make use of larger chunks of grant capital to attract private debt funding; in contrast, depository institutions like credit unions or social banks may only require a small first-loss grant, which they could combine with member deposits to leverage far larger multiples of private debt capital.

"Opportunity Finance": the importance of branding

We have used the term "community investment" throughout this report, reflecting the dominant terminology in the UK and US literature and policy debate. Yet, our interviews and other research have suggested that this term does not effectively communicate the purpose of community investment (as defined here) either to potential investors or the broader public. In addition, it can often connote specific institutions – for example, only CDFIs – rather than the broader landscape of organisations seeking to address financial exclusion. A common brand for the community investment industry is extremely important to improve customer and investor awareness and to increase public and political support.

We recommend the adoption of a different term by the capitalisation fund we propose. Inspired by the US experience, we recommend the "Opportunity Finance Fund", but the exact name is less important than its key features:

1. **Accurately conveys purpose of fund:** to give financially excluded individuals and enterprises – particularly those in disadvantaged areas – access to affordable financial services, providing the opportunity to avoid financial hardship, improve household welfare and contribute to community growth and development. However, it is important to prevent the creation of stigma around the use of these services, which could be a deterrent to customers and investors.

2. **Avoids perception of inefficiency or obsolescence**: The term "community investment" can come with connotations of inefficiency or waste, and as such can dissuade investors and policymakers. In addition, along with preventing perceptions about patrons of the borrowing organisations, the brand must be reflected in a smooth customer experience for borrowers.
3. **Avoids implication of restriction to one type of organisation:** while inspired by the CDFI Fund in the US, we do not call this fund the CDFI Fund to avoid the perception that only organisational members of the CDFA could apply.

Predictability and continuity

While government financial support for UK credit unions and CDFIs has been significant over the last decade and a half, funding sources, quantities and criteria have varied over time (the Phoenix Fund, the RDAs and most recently the Regional Growth Fund being the key examples). **Predictability and continuity of public support are fundamental for long-term planning by community investment organisations.** This is important both for organisational strategy and for raising private capital. It is particularly relevant when organisations consider major changes to scale or scope of service, such as expanding into new markets or offering new products. An organisation must be confident that it will have sufficient funds to make the full transition. Similarly, raising private capital for lending over a long period requires a matching long-term layer of first loss capital. An Opportunity Finance Fund would have to balance individual organisations' needs for predictability and continuity of funding with the need to incentivize efficiency by funding recipients.

How should Big Society Capital be involved in the Opportunity Finance Fund?

Big Society Capital has a clear interest in the development of the community investment/opportunity finance sector, in accordance with its purpose to "develop and shape a sustainable social investment market in the UK[81]". BSC has stated its intent to ***"support dedicated social investment capital pools which are tailored to the needs of the financial inclusion sector"[82].*** While BSC's mandate as currently interpreted may make restrict practical involvement in an Opportunity Finance Fund, we believe that BSC could play an important part in this initiative, given a strong interest in the promotion of financial inclusion, and probable mission alignment with an Opportunity Finance Fund.

We identify three separate ways in which Big Society Capital could play an important part in this initiative, which we believe would be most useful, and what changes may be necessary to allow BSC to play this role:

1. Capitalise Opportunity Finance Fund
2. Manage/administer Opportunity Finance Fund
3. Lend as junior lender to community investment organisations who have received capital from Opportunity Finance Fund

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[81] Big Society Capital website: FAQs. Available at http://www.bigsocietycapital.com/faqs
[82] Big Society Capital. 2014. "Financial Inclusion and Social Investment".

1. Capitalise Opportunity Finance Fund

BSC's funding was obtained from dormant bank and building society accounts, with part of the purpose of these funds to be used to promote financial inclusion. Investing in an Opportunity Finance Fund would be well aligned with BSC's mission. BSC has interpreted its mandate that it must seek a financial and a social return, in order to remain financially self-sustainable. As such, capitalising the Opportunity Finance Fund – which would provide "loss layer" capital and therefore not generate a financial return – may be interpreted as outside BSC's current scope of operation.

2. Manage/administer Opportunity Finance Fund

BSC is clearly an organisation which meets the criteria outlined above for the fund manager: independent of recipient organisations, and with strong expertise in both financial and social impact evaluation. Managing an Opportunity Finance Fund would be well aligned with BSC's mission to support the development of the social investment market. It is unclear, however, as to whether this would be problematic with respect to BSC's role as a social investment wholesaler: it is only allowed to invest in SIFIs which then go on to invest in social sector organisations. Most of the organisations applying for funding from an Opportunity Finance Fund would not be SIFIs: rather, they would be frontline social sector organisations investing directly in individuals, enterprises and communities. While it is clear that BSC investing its own capital in frontline organisations would be problematic (see below), it is less clear as to whether it remains problematic as a fund manager.

3. Invest alongside Opportunity Finance Fund

BSC's investment policy currently requires it to make some sort of financial return alongside a social return. As such, the presence of a "loss layer" tranche provided by an Opportunity Finance Fund would allow BSC to invest in community investment organisations as a junior lender, receiving a positive but below-market rate of return. This would fit with BSC's mission of helping develop the social investment market (considering some aspects of community investment to overlap with social investment).

This type of involvement would not have the catalytic impact of capitalising the fund directly: there are likely to be other social investors who may invest as junior lenders alongside an Opportunity Finance Fund. In addition, in many cases this would compete directly with SIFIs and as such would clearly contravene BSC's mission of investing only as a wholesaler: some organisations applying to an Opportunity Finance Fund may be SIFIs, but many are likely to be frontline organisations.

6.2 Access to Capital and bank involvement: the Financial Inclusion Mandate

As discussed in the Introduction (and further in Appendix A), financial exclusion is a growing problem as banks raise credit standards, reduce relationship banking services and reduce costly low-loan-value lending.

As regulated utilities, guaranteed by the taxpayer and providing vital financial services, banks should have an obligation to meet the needs of all customers, not just the most profitable.

Banks have recognised this obligation in the case of the Basic Bank Account: recognising the social benefit, all banks now offer a Basic Bank Account, usually at a loss -and the number of individuals without a bank account in the UK has plummeted[83]. This obligation should also apply to the provision of low-cost loans to viable customers.

We propose **a Financial Inclusion Mandate** to apply to all banks in the UK. Inspired by some aspects of the CRA, **this mandate would require banks to ensure that all individuals and organisations have access to a certain set of basic financial services**, including cheap and fair current accounts and affordable lending products (the nature of which should be determined in more detail by future research). This mandate could be conceived of as a direct or indirect payment banks make to extend the reach of the financial system, in exchange for government-provided protection of the financial system.

Banks could fulfil this mandate obligation either by providing these services directly, or by investing in other organisations to enable them to provide these services. As with the CRA, this could include investments in community investment organisations. In this way, if community investment organisations are able to meet customer needs more effectively – by, for example, engaging in relationship banking or providing better technical assistance – then banks can effectively outsource their obligation to provide financial inclusion services to community investment organisations. As in the US, various types of investments could fulfil the mandate requirement – with, for example, capacity-building grants, grant capitalisation, subsidised loan funding and market-rate loan funding all counting for different amounts toward the requirement.

When combined with first loss layer capital from the Opportunity Finance Fund and tax relief from CITR, we believe that – as is the case in the US with the CRA – **bank profitability would not be significantly adversely affected by having to invest in community investment organisations**. As such, the financial burden of meeting the needs of the financially excluded would be partially borne by banks but primarily borne by government.

The correct enforcement mechanism for this mandate should be the subject of future research. We note that the CRA-style enforcement mechanism – of preventing banks from merging or

[83] Rowlingson and McKay. 2013. "Financial Inclusion Annual Monitoring Report 2013".

opening new branches – would not be appropriate for the UK due to the high concentration of the banking market and the trend for bank branch closures rather than openings. We emphasize, however, that **the US enforcement mechanism has been particularly successful by targeting a bank's business model rather than levying fines, which can often be internalised by banks as simple costs of doing business.**

6.3 Strengthening Organisational Capacity: Enhancing Market Infrastructure

While we believe that there are currently enough high-performing community investment organisations to kick-start the sector's growth, as the sector develops, the gaps in market infrastructure are likely to become more of a problem.

We believe that the following are the most important aspects of market infrastructure which need to be developed and/or strengthened in the UK:

- **(1) Common financial reporting frameworks**
- **(2) Common social impact evaluation methods and reporting frameworks**
- **(3) Industry-wide database on financial and social metrics of individual organisations**
- **(4) Sharing of systems such as payment platforms**
- **(5) Building training programs and talent pipelines for industry human capital**

Furthermore, coordination across different parts of the community investment sector should become more extensive, meaning that efforts in developing market infrastructure in one area can also be applied to benefit the rest of the sector.

The institutionalisation of common financial reporting procedures for different types of community investment institutions, alongside a central database of firm-level data, would be a major step in enabling investors, the public and the government to understand community investment better, improving information flows and therefore catalysing capital flows into the sector. Common social impact evaluation reporting would allow comparability across organisations, enabling socially-motivated investors and the government to better decide how to support the most effective organisations. Sharing of systems such as payment platforms would enable smaller organisations to reap economies of scale while remaining local to their communities.

Some of the work to standardize reporting has already begun through trade bodies – the CDFA has already taken significant steps to aggregate social impact among CDFIs – and some large investors may have sufficient leverage to push for a single standard. However, **the most logical and likely source of common reporting would be a government agency, ideally connected to the establishment of an Opportunity Finance Fund to incentivise participation.** On the other hand, investment in common platforms for payment or information systems may be more effective when conducted by **smaller subsets of actors with particular needs and objectives.**

In addition, as the community investment sector grows there will be increased demand for skilled professionals who are able to balance the need for both social and financial returns on investment. This problem can be addressed by **developing a strong pipeline of talent into the sector at both the entry-level and directly from the private sector.** At the entry level, one approach involves collaboration with universities to establish degree programs, internships and mentoring. Once employees enter the sector, training and support are crucial elements of skill acquisition, and can be delivered either by industry associations or academic institutions. Finally, retaining the best talent requires flexibility in compensation and clear pathways for promotion, just as in any competitive industry.

What role could Big Society Capital play?

With a mandate to be a champion of the social investment market, supporting SIFIs to become more robust as well as promoting best practice, sharing information, and embedding social impact assessment into investment decision-making, BSC could certainly play an important role in the development of market infrastructure for the community investment industry.

In particular, these areas would be ripe for BSC's leadership or participation:

1. **Development and promotion of a set of common social impact metrics which could be used across all fields of social investment**
2. **Investing in efforts to build capacity through common payment platforms, enhanced training programs, etc.**

6.4 Improved Absorption Capacity: Community Development Coordination

Just as there is no single model for community investment around the globe, there cannot be a single model for community investment applied throughout the UK. Each locality, whether defined by jurisdiction or not, must assess its own set of stakeholders and map them against the key functions of a successful community investment system: vision and desired goals, local policy champions, deal pipeline construction, product innovation, system management and monitoring. This may include a combination of government, business and non-profit leadership, and the community investment intermediary may be a CDFI, credit union, bank or other social impact investment intermediary, depending on the particular context. **Making the most of available capital requires clear alignment and coordination among all of these actors.**

In many localities, the obvious actor to play this role would be the local government entity with responsibility for community social and economic development. In some areas, a leading foundation or social sector organisation may be more effective. **We recommend that local government should play this role – but that, if it does not, local community development actors should come together to identify the key coordinating or convening body in their area, ensure funding for dedicated staff, and to develop improved local coordination plans for financial inclusion and community development.**

6.5 Understanding Absorption Capacity: Data Disclosure

As discussed in chapter 5, UK data disclosure on financial exclusion is inadequate to identify the nature of the financial exclusion problem or to design appropriate solutions. Recent voluntary postcode-level data disclosure by certain mainstream banks has been a step in the right direction. It remains, however, insufficient.

UK bank data disclosure should be at the firm level, should be at a more granular (and more useful) geographic level than the postcode, and should cover a wider range of indicators both in terms of demographic characteristics of borrowers and rejected borrowers, and in terms of types of financial services provided and refused to different customers[84]. In addition, to understand the nature and degree of financial exclusion fully, it is necessary to have disclosure not just from banks but from all institutions providing financial services, including community investment organisations and alternative finance providers. In principle, **the key point of disclosure should be to understand how investment flows – or does not flow – from various sources to different communities and individuals in need.**

A recent report by academics at Coventry University and Newcastle University[85] sets out more detailed recommendations for the type of data disclosure required in the UK to adequately understand and address financial exclusion problems: we support these recommendations here.

We emphasize, however, that disclosure is a vital step forward but not an end in itself: it is only useful to the extent that it enables further action to be taken to remedy problems of access to finance.

[84] Henry et al. 2014. "Tackling Financial Exclusion: Data Disclosure and Area-Based Lending Data"

[85] See Appendix B for an evaluation of data disclosure carried out by different financial institutions, from Henry et al. 2014. "Tackling Financial Exclusion: Data Disclosure and Area-Based Lending Data"

7. Conclusion

Tackling financial inclusion requires collaboration on a variety of different methods between a large variety of different actors. Community investment is one important channel to tackle financial exclusion. In this report, we have laid out our analysis of the binding constraints to this sector's growth, drawn lessons from the successes and limitations of the US, and developed some ideas for how to stimulate community investment in the UK.

In particular, we have concluded that the UK community investment sector is primarily limited – at this time – by a lack of access to appropriate and affordable capital directed to community investment, for high-performing CDFIs, credit unions and community impact investors. We attempt to address this with a recommendation to create an Opportunity Finance Fund, which would provide first loss layer capital to selected highly-effective, high-growth-potential organisations targeting financial inclusion. In addition, we would require banks – as publicly-supported, publicly-regulated utilities – to play a part in financial inclusion through a Financial Inclusion Mandate, requiring them to provide certain financial services to all customers either directly or via investment in a community investment organisation.

As the UK community investment sector develops, the US experience suggests that a lack of sufficient market infrastructure – in particular, adequate financial and social impact reporting frameworks, common systems and platforms, and a human capital pipeline into the industry – could become a serious constraint on the sector's effectiveness, efficiency and scale. In addition, local actors in the UK should coordinate more effectively to work towards common goals on financial inclusion and community development.

It should be clear, however, that our results and recommendations are contingent upon the data and information we have acquired through reviews of literature, quantitative analysis and expert interviews. As we have noted, the availability of data on financial exclusion in the UK, as well as data on community investment organisations in the US and the UK, is extremely limited. Our conclusions and recommendations should be re-examined as new information arises.

In addition, we have identified a number of areas which would benefit from further research. Tax credits have been a strong incentive for community investment in the United States, but so far uptake of CITR has been lower than expected – identifying which changes, if any, would stimulate use of this credit would be valuable for future legislation. Greater transparency of lending policies and disclosure of banking data would provide a much more accurate picture of the current state of financial exclusion, and which targeting mechanisms would most effectively provide support where it can have the most impact. Adapting the absorption capacity framework to the UK context would provide a template to assess which agencies are best suited to coordinate community development efforts. Finally, further research can build upon the existing literature on social impact measurement, ideally producing a metric that can be applied to a wide variety of community investment organisations to compare relative impact and stimulate social investment.

We emphasize that there are already tremendous efforts under way to address the challenges of financial exclusion in the UK, and there has been significant progress even in the past few years. The confluence of increasing societal pressure to highlight the importance of financial exclusion and the energy present in the community investment sector in the UK provide cause for optimism.

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B: List of Interviews

US:

1. **James Carras**, Adjunct Lecturer in Public Policy, Harvard Kennedy School and Principal, Carras Community Investment
2. **Beth Lipson,** Executive Vice President, Strategic Initiatives, Opportunity Finance Network
3. **Matthew Royles,** Marketing and Development Director, Aeris Insights
4. **Julia Sass Rubin,** Associate Professor, Edward J. Bloustein School of Planning and Public Policy, Rutgers University
5. **Jon Schwartz,** Operations and Ratings Manager, Aeris Insights
6. **Karl Seidman,** Senior Lecturer in Economic Development, School of Urban Planning, Massachusetts Institute of Technology
7. **Michael Swack,** Faculty Director, Center on Social Innovation and Finance, Carsey School of Public Policy, University of New Hampshire
8. **David Wood,** Director, Initiative for Responsible Investment, Kennedy School of Government, Harvard University

UK:

1. **Callum Anderson,** Research Assistant, Community Development Finance Association (CDFA)
2. **Dr. Lindsey Appleyard,** Research Fellow at the Centre on Household Assets and Savings Management, School of Social Policy, University of Birmingham
3. **Rachael Barber,** Head of Community Development EMEA, Citigroup
4. **Matt Bland,** Policy Manager, Association of British Credit Unions Limited (ABCUL)
5. **Emilie Goodall,** Director of Projects, Impact +, Bridges Ventures
6. **Irene Graham,** Executive Director, Business Finance, British Bankers' Association
7. **Theodora Hadjimichael,** Policy and Research Manager, Community Development Finance Association (CDFA)
8. **Mark Hambly,** Director of Programme Delivery, Capital for Enterprise
9. **Dr. Nick Henry,** Senior Research Fellow in the Center for Business in Society, University of Coventry
10. **Nicholas Nicolaou,** Managing Director, GLE oneLondon
11. **Louise Nixey,** Policy Advisor, Enterprise Policy Team, Growth and Productivity Team, HM Treasury
12. **Scott O'Brien,** Senior Manager, Lending Solutions, British Business Bank
13. **Tim Pearse**, Senior Policy Adviser, Cabinet Office
14. **Simon Rowell,** Head of Strategy and Market Development, Big Society Capital
15. **Danyal Sattar,** Development Director, Big Society Capital
16. **Katie Smith,** Policy Advisor, Enterprise Policy Team, Growth and Productivity Team, HM Treasury
17. **Paul Stephenson,** Executive Director, External Affairs, British Bankers' Association
18. **Olinga Taeed,** Professor in Social Enterprise, University of Northampton
19. **Dr. Steve Walker,** CEO, Aston Reinvestment Trust

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Appendix A: Theory: financial inclusion and the role of community investment

A.1 Why is financial inclusion important?

Financial inclusion is the provision of financial services at affordable rates and on appropriate terms to all individuals in society. Kempson and Collard[86] define a financially inclusive society as one in which everyone has the ability to:

- Manage day-to-day financial transactions
- Meet one-off expenses
- Manage a loss of earned income
- Avoid/reduce problem debt

A major part of financial inclusion is access to affordable and appropriate credit, to enable individuals and enterprises to perform the functions above. Access to affordable and appropriate credit is important for a variety of reasons. For individuals, access to affordable credit is important to avoid poverty and hardship, to improve household welfare and to empower financial independence. Individuals may require credit to make large purchases, to smooth out income fluctuations, or to pay for unexpected expenses[87]. For organisations – SMEs and social sector – access to finance on appropriate terms is important to meet working capital needs and to finance growth.

The impact of financial inclusion can be high: empowering citizens to live independently, and spurring economic growth, employment and community regeneration.

A.2 Why does this problem exist?

Financial exclusion is caused by a combination of persistent market failures, high transaction costs and lack of bank capacity, as well as marginalization caused by structural social and economic inequalities.

1. Market Failure: Imperfect Information for Financial Institutions

Credit rationing is a common feature of financial markets in situations of imperfect information. Where it is difficult for lenders to obtain information about borrowers' creditworthiness, lenders cannot distinguish between those who are more or less likely to repay loans ("adverse selection"). As such, provision of credit is rationed to groups where imperfect information is a

[86] Kempson and Collard. 2012. "Developing a vision for financial inclusion"

[87] The Financial Inclusion Taskforce was set up in 2005 with improving access to affordable credit as part of its mission.

problem – and individuals and enterprises that are creditworthy are often left without access to credit[88].

Individuals

Lower-income individuals are less likely to be able to provide evidence of their creditworthiness: they may have a less frequent or less well-documented history of transactions with financial institutions; and they may be less able to provide statements of past income or guarantees of future income (particularly if working on an ad hoc basis e.g. with zero-hours contracts, and/or if receiving some or all of earnings in cash).

Enterprises

SMEs are also less likely to be able to provide evidence of their creditworthiness than larger or more established corporations. Different types of SMEs face different information gaps: young businesses without an established track record find it difficult to prove repayment intentions or earnings potential; small or informal businesses may have incomplete transaction records as a result of ad hoc record-keeping and/or a predominance of cash transactions; and SME cash flow is likely to be more uneven than comparable larger businesses. SMEs operating in disadvantaged areas are particularly likely to be identified as high-risk or sub-prime as a result[89].

The low average transaction size for individuals and small businesses compounds these problems. Even relatively low costs of information-gathering and monitoring are likely to be a large proportion of the overall transaction size, making it more difficult to overcome information problems while still remaining profitable. In the absence of good information on creditworthiness, assets can be used as collateral to obtain loans. Lower income individuals are less likely to own assets to provide as security; this is also often true of SMEs[90] (particularly young businesses), especially those operating in lower-income or disadvantaged areas.

2. Market Failure: Imperfect Information for Borrowers

Many SMEs and individuals are unaware of alternative credit sources and only approach major retail banks for loans[91]. Without clear information channels directing individuals and enterprises to potential alternative lenders, financial exclusion may remain a problem even when there is sufficient supply of capital for these borrowers.

3. Transaction costs

Providing credit to low-income borrowers and investment in SMEs is inherently more expensive than financing higher-income individuals or larger companies, because the average transaction

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[88] The initial theory was developed in Stiglitz and Weiss. 1981. "Credit rationing in markets with imperfect information". More recently, evidence of imperfect information in UK credit markets has been found by Cressy and Toivanen. 2001. "Is There Adverse Selection in the UK Credit Market?" among others.

[89] Appleyard. 2011. "CDFIs: Geographies of Financial Inclusion in the US and UK."

[90] 20% of SME employers who had difficulties raising finance stated that insufficient security was the reason in the Department for Business Innovation and Skills' 2011 "Small Business Survey 2010".

[91] Department for Business, Innovation and Skills and HM Treasury. 2014. "Consultation Outcome. SME Finance: help to match SMEs rejected for finance with alternative lenders".

size is smaller. Fixed transaction costs – due diligence, investment administration, etc. – thus represent a higher proportion of the overall transaction. As a result, the smaller the average transaction size, the less financially viable the transaction becomes.

4. Lack of bank capacity/expertise

In some cases, mainstream banks may simply lack the capacity and/or expertise necessary to understand financing needs, evaluate creditworthiness and develop appropriate financing options for customers in disadvantaged areas. For example, up to 10% of RBS' declined SME banking clients were later found to be suitable for bank finance[92].

5. Structural Marginalization and Positive Externalities

Even with all the requisite information for borrowers and lenders, and with transaction cost problems overcome, it still may not be possible to make investments in some organisations or individuals on a profit-maximising basis. In many cases, these individuals and organisations are likely to be from disadvantaged groups or located in disadvantaged areas. As such in many cases, it is structural barriers rather than inherent characteristics of the individual or organisation which limit their viability as a loan prospect: systemic inequalities of opportunity, for example, or declining local economies.

In these cases, there can be significant social benefits ("externalities" or spill-over effects) from providing affordable finance to viable individuals and organisations even if it is not profit-maximizing. Affordable loans to small businesses can finance job creation and help sustain other local businesses upstream and downstream in the supply chain; the effect on employment and local business growth can have a multiplier effect in the local economy, promoting community economic and social regeneration. Affordable loans to social sector organisations can enable them to access working capital or to scale up their operations, enabling greater social impact to be achieved. And affordable loans to individuals can help avoid cycles of predatory and exploitative lending, reducing poverty and financial hardship.

A.3 How can this problem be addressed? The role of community investment

Community investment – broadly defined – seeks to fill the gap left by mainstream finance.

Community investment is a cousin of social impact investment, seeking to use financial capital to achieve a double bottom line of social and financial return. In the case of community investment, the social return is the economic and social development of underserved communities, by providing finance at a non-exploitative rate to individuals and organisations excluded from mainstream financial markets. Different causes of financial exclusion require different solutions, and community investment may not be the optimal solution for all of these groups.

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[92] Royal Bank of Scotland. 2013. "RBS Independent Lending Review".

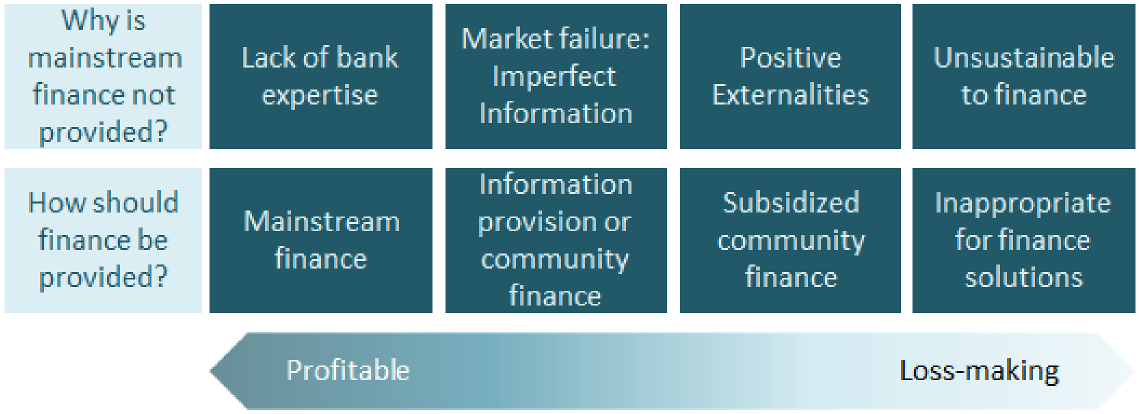

Figure 8: Market failures and finance solutions

Some individuals and firms are viable, bankable, **but unbanked simply because of a lack of bank expertise or capacity**: they could be served profitably by mainstream financial institutions. Community investment can play a role in demonstrating how to serve individuals and firms profitably in disadvantaged areas, and "graduating" these customers onto mainstream financial institutions. Many credit unions in the UK are playing this role, attempting to develop new business models to serve excluded customers sustainably without requiring subsidy. Other financial innovations, including alternative finance providers such as crowdfunding, P2P lending and invoice trading, can also play this role.

Some individuals and organisations are creditworthy, **but imperfect information market failures** mean that they are unable to find appropriate financing. To some extent, this market failure can be rectified by better information sharing between financial institutions and better information provision to potential borrowers. Yet information problems are impossible to completely eliminate, meaning that many creditworthy individuals and firms will remain excluded from mainstream financial markets. Community investment – finance provided under relationship banking models, and/or with the benefit of local knowledge, and/or provided at subsidized rates, and/or alongside technical support – is one way of serving these markets.

Some individuals and organisations are viable, in that they can pay back some or all of the principal & interest on an investment – but not at market rates. In some cases, there are **positive externalities from providing this finance** anyway: if it enables individuals to withstand fluctuations in income without significant hardship, or if it enables firms to employ people, grow and serve their local economy. In these situations, the provision of community investment at subsidized rates is justified.

Finally, some individuals and organisations have complex needs for whom financial market solutions are inappropriate. Community investment can help those who are on the margins of financial inclusion – supporting individuals, small businesses and charities who are able to be at least partly financially sound. However, **for areas or groups suffering from extreme**

marginalization and disadvantage, market-based finance solutions are not enough. Community investment should not be considered as appropriate for all the financially excluded: for many, a more holistic approach involving improving equality of opportunity and removing structural barriers to success is required.

Nonetheless, the need for community investment is still significant, and the UK industry is currently unable to meet more than a fraction of this demand. In 2012, community investment organisations (primarily credit unions and CDFIs) delivered £0.7 billion of community investment to individuals, SMEs and social enterprises who were excluded from mainstream finance: **one-sixth of the estimated total need** of £5.45-£6.75bn[93]. A 2011 estimate suggests that credit unions and CDFIs – two of the main providers of affordable credit to financially excluded individuals – would need to expand to **4.5x their current size** to provide sufficient affordable credit to lower-income households[94], lending around £2 billion per year.

In the presence of significant market failures, further government support is required for the community investment sector to make a significant impact on the need for fair and affordable finance in disadvantaged areas.

The role of government

By definition, market failures will go unaddressed without outside intervention, and community investment can intervene to correct three important market failures: a lack of bank expertise in serving profitable low-income consumers and firms, an imperfect information market failure, and a market failure where there are positive externalities from finance provision. As it stands, however, the community investment sector in the UK requires additional support to address these market failures effectively.

The case for public support for community investment is strong. Finance is a key ingredient in spurring sustainable community development and regeneration. The provision of affordable, fair finance to businesses and social enterprises in disadvantaged communities enables businesses to continue operating, creates and safeguards jobs and generates business growth. The provision of affordable, fair finance to financially excluded individuals enables individuals to avoid financial hardship or financial exploitation, improve their quality of life with home improvements or access to goods and services, and develop improved financial skills.

Together, these outcomes result in strong positive economic and social impact: increased entrepreneurship, business growth and employment growth in communities, helping to create diverse and resilient local economies; reduced levels of poverty and financial hardship; and an overall increase in individual empowerment, independence and quality of life[95].

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[93] Community Development Finance Association.2013. "Mind the Finance Gap: Evidencing Demand for Community Finance"

[94] Gibbons et al. 2011. "Can consumer credit be affordable to households on low incomes?"

[95] See Appendix A for a more detailed logic model.

Appendix B: An overview of the US CDFI sector

B.1 CDFIs and the policy environment: A brief history

While the community investment sector in the US can be understood within the context of a much longer tradition of community and neighbourhood development efforts, organisations with structures like modern CDFIs emerged in the 1970s. These organisations were founded as part of broader movements for civil rights and social justice, and cities with the strongest activist presence and community organisations frequently still have the most mature CDFI ecosystems today. Most organisations focused their initial efforts locally, under the hypothesis that there were viable depositors and borrowers that banks weren't serving due to widespread stigma against certain communities and limited information. In addition, the US community investment sector has a heavy emphasis on financing individual mortgages and the construction of multi-family dwellings, in part because of the limited scale of social housing and tax credit programs.

Building upon the initial success of the first wave of CDFIs, a complex system of public policies has evolved over time, designed to support different elements of the community investment framework outline above. The system as a whole has shifted in response to changes within the sector and broader macroeconomic trends in the US economy. Many of the policies share an emphasis on the spatial dynamics of community investment, whether targeting tax credits at areas that are designated as underserved, requiring that banks invest in neighbourhoods where they do business, or implicitly assuming that CDFIs benefit from local knowledge that is not accessible to commercial lenders.

Taken together, the set of policies designed to support the community investment sector provide powerful incentives for investment, combining both mandate and subsidy in pursuit of social goals that include financial inclusion, community and economic development. The success of the sector reflects the hard work of advocates and managers to build individual organisations as well as the strength of the broad political coalition that backs enabling policies, which includes affordable housing advocates, real estate developers, and mainstream financial lenders. However, many observers have pointed out that the sector must constantly evolve to meet new social and market conditions, and suggested significant changes in key policies. The following sections outline key components of the US community investment sector through the lens of the framework outlined above.

B.2 Access to Capital

The vast majority of the policies designed to support the community investment sector are designed to facilitate the flow of private capital to CDFIs, which depend upon affordable rates and flexible terms to provide services to markets that are otherwise not served by mainstream institutions. While there are many institutions that invest in community investment in a given year, **most investments are motivated by one or more of the following three factors: mandate, mission and yield.**[96]

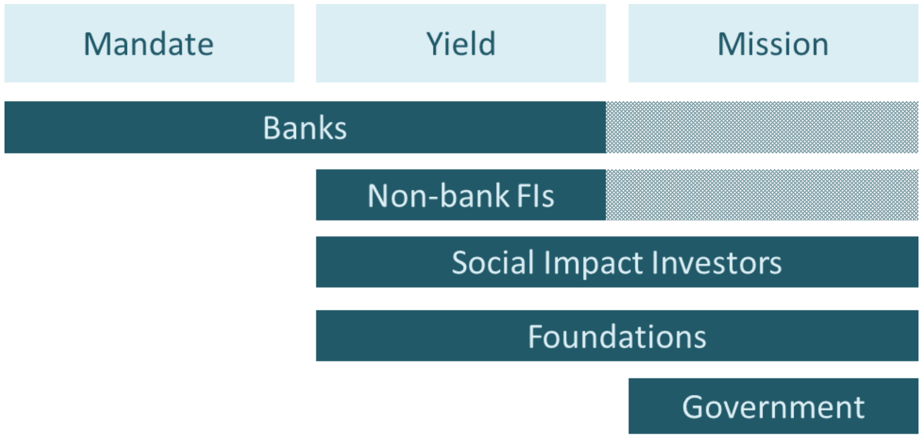

Figure 9: Motives of different investors in CDFIs

Mandate concerns include the obligations of depository institutions subject to the Community Reinvestment Act, which requires them to reinvest in the neighbourhoods in which they do business, either directly or through investments in CDFIs. Other financial actors not subject to an official mandate may also engage to pre-empt the extension of formal obligations. Socially motivated "**mission"** investors include religious, foundation and public sector organisations, as well as retail and institutional investors with an ESG focus, and may take the form of grants or of program-related investments that are repaid. Finally, there are some **yield**-motivated investors who purely seek market return, for whom the typically low inherent returns on CDFI deals are augmented by tax credits and credit enhancement. Among the three, mandate has historically been the largest, followed by mission and trailed by pure yield motives, at least with regard to CDFIs.

17% of CDFI loan fund capital comes from government, compared to **43%** from banks and other private corporations.

Primarily as a result of policy initiatives, private capital is a major source of financing for US CDFIs. In 2012, 17% of CDFI loan fund capital was from government, compared to 43% from private corporations/banks; only 1.6% and 0.2% of CDFI credit union and CDFI bank capital respectively was from government, compared to 15% and 14% respectively from private corporations/banks, and 38% and 57% from deposits[97].

[96] Pinsky. 2001. "Taking Stock: CDFIs Look Ahead After 25 Years of Community Development Finance" December 2001.
[97] CDFI Fund. 2014. "CDFI Snapshot Analysis: Fiscal Year 2012".

The next sections outline policies that affect the availability of debt and equity-like capital for community investment purposes, as well as tax credits that lower the cost of capital for a given transaction.

Equity Capital

US CDFIs have historically built up their equity primarily from grants from foundations and government, as well as contributing to its growth through retained earnings. The 274 CDFI loan funds for which 2012 data are available have $3.3 billion dollars of equity between them[98]. (Note that as CDFIs are non-profits, their equity capital does not pay dividends and there is no secondary market.)

CDFI Fund

The CDFI Fund Financial and Technical Assistance program provides direct federal funding to CDFIs: equity/grant or debt investments of up to $2m per CDFI per year can be awarded, and must be matched by a private investment of the same size and type in that CDFI. In 2014, $160 million was invested in awards of financial and technical assistance, and since 1994 CDFI fund awards have totalled $1.4 billion[99]. Awards can be used for either capital for on-lending or revenue to cover operating costs; they are primarily used as sources of long-term debt or grant/equity capital.

Capital Magnet Fund

In 2008, Congress established the Capital Magnet Fund (CMF) as part of the Housing and Economic Recovery Act. The CMF has served as a source of equity capital for CDFIs and non-profit housing developers. In 2010, the CMF allocated $80 million in grant awards to 23 organisations[100], with the requirement that the funds be used for affordable housing or related community development projects, and that total project size must be larger than 10 times the CMF award, ensuring that the grants are highly leveraged. Similarly to other grant sources, the CMF awards are used to provide direct financing, loan loss reserves, or to capitalize revolving loan funds, with only 5% of the award eligible for operating expenses.

Equity-Equivalent Capital (EQ2)

The US CDFI funding market has also developed an innovative equity-like structure – the EQ2 "equity equivalent" – to enable CDFIs to attract more long-term capital than is available from grant funding alone. EQ2 capital is fully subordinate to all debt of the CDFI, carries an interest rate, but is on a rolling term and therefore an indeterminate maturity[101]. Although more recent data is not available, in 2002 CDFI loan funds had an average of 2-3% of total capital in the form of EQ2 investments[102]; and by 2001, mainstream financial institutions had made over $90 million worth of EQ2 investments in CDFIs[103]. With higher risk but lower coupon than traditional debt,

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[98] CDFI Fund. 2014. "CDFI Snapshot Analysis: Fiscal Year 2012".
[99] CDFI Fund. 2014. "CDFI Program Award Book: FY 2014".
[100] Capital Magnet Fund Impact Assessment, CDFI Fund, US Treasury. March 2014.
[101] For the full description please consult Opportunity Finance Network. 2002. "Equity Equivalent Investments"
[102] Pinsky. 2002. "Growing Opportunities in Bank/CDFI Partnerships".
[103] Pinsky. 2001. "Taking Stock: CDFIs Look Ahead after 25 Years of Community Development Finance."

the EQ2 investment is only attractive to investors either as a social product or to the extent to which it allows them to meet CRA obligations.

Debt

Community Reinvestment Act

Few policies have attracted as much attention in the community investment sector as the Community Reinvestment Act of 1977 (CRA). The CRA was passed in response to the well-documented pattern of racial discrimination in lending known as "redlining", a term that refers to the red ink used to indicate neighbourhoods in which mortgages would not be insured by the Federal Housing Administration in the decades following its creation in 1934. The CRA mandated that depository institutions must invest in the neighbourhoods where they do business, a standard that is enforced by regulators that assess three major criteria: lending, investments and services. Organisations that performed poorly on their CRA assessment could potentially be denied approval for branch openings and closing. That being said, banks were only compelled to make investments that they deemed 'safe and sound', and enforcement of the CRA was relatively lax until the mid-1990s.

At that point, several factors aligned to make CRA enforcement much more significant: banks were increasingly interested in the possibility of mergers and acquisitions due to changing regulations, community activists could draw upon decades of data released under the Home Mortgage Disclosure Act, and the Clinton administration strongly supported the concept of community investment. Thus, when a bank was denied approval for a branch opening on the basis of a CRA assessment, depository institutions took CRA compliance much more seriously.

While banks and credit unions can meet CRA obligations in a number of ways, including both investing in CDFIs and lending to disadvantaged areas directly, lending to a CDFI has a number of advantages. First, CDFIs specialize in serving markets where other institutions have less knowledge and experience, so they should have better information about which projects are sustainable in a given market. In some cases, CDFIs may have better information about projects because they are locally based and connected to community institutions in a way that commercial organisations may not be. Second, CDFIs have expertise structuring complex community development deals for housing and community facilities, in which foundations or the CDFI itself provides a loss-layer that reduces the risk for a senior lender. Finally, sophisticated CDFIs are adept at securing and deploying tax credits like LIHTC and NMTC, which also lower the cost of lending for commercial banks. As such, lending to a CDFI not only makes it easier to conduct certain types of transactions, but also provides opportunities to participate in deals that a commercial bank could not otherwise access at all.

Empirical analysis by a range of US sources, alongside interviews with US experts, suggest that the CRA has been extremely important in attracting private capital to community investment. Estimates suggest that lending to ethnic minority communities was up to 20% higher than it would have been without the CRA in the 2000s[104]; and that this increase in lending has not negatively impacted profitability[105].Nonetheless, while the CRA has been lauded for increasing investment in low-income and heavily minority communities, there are substantial concerns about whether the regulations have kept pace with changes in the structure of financial markets. In particular, the growing importance of non-depository financial institutions – which are not required under the CRA to reinvest in their communities - and the removal of many restrictions on inter-state banking practices that enabled a significant wave of bank consolidation – which reduces opportunities to challenge a merger approval on CRA grounds – have led many advocates to argue that major changes must be made for the CRA to remain a significant factor in community investment.

Foundations and Program-Related Investments

Foundations have also provided debt capital to CDFIs, though not at the scale of large institutional investors. Starting in the 1960s, the Ford and MacArthur Foundations, among others, pioneered a financial instrument called program-related investments (PRIs), in which foundations finance low-income loans or recoverable grants from their endowments. To-date, the Ford Foundation alone has provided $525 million in PRIs across all of its focus areas, which helps grantee organisations to establish borrowing histories and explore new business models.[106] PRIs were crucial components of the early-stage development of CDFIs throughout the United States, in addition to substantial grant money[107].

Tax Credits: Low Income Housing Tax Credit (LIHTC)

While state and local governments have provided various kinds of subsidy to CDFIs for many decades, one of the first major subsidy initiatives at the federal level was the Low Income Housing Tax Credit (LIHTC), established in 1986. Designed as an alternative to existing programs for public and subsidized housing, the LIHTC program provides tax credits to investors who finance the development of affordable housing, with a specific proportion reserved for renters who earn less than either 60% or 50% of the area's median income, depending on the project and proportion.[108]

Since its inception, the LIHTC program has funded the creation of 2.4 million affordable rental units, though there is continued debate about the role of LIHTC in relation to other efforts to develop affordable housing. While only applicable to a specific subset of the community investment sector – the CDFI loan funds which finance real estate development - LIHTC does provide a valuable incentive for private investment to flow to community development projects,

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[104] Joint Center for Housing Studies, Harvard University. 2002. "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System".
[105] Quercia and Ratcliffe. 2009. "The Community Reinvestment Act: Outstanding, and Needs to Improve"
[106] Ford Foundation. "Program Related Investments" http://www.fordfoundation.org/grants/program-related-investment
[107] Liou and Stroh. 1998. "Community development intermediary systems in the United States: Origins, Evolution and Functions."
[108] Benjamin, Rubin, and Zielenbach. 2004. "Community Development Financial Institutions: Current Issues and Future Prospects".

and created an opportunity for CDFIs to play a role as intermediaries that earn service charges on the deals they structure.

Tax Credits: New Markets Tax Credit (NMTC)

The New Markets Tax Credit (NMTC) program was established in 2000 as a complement to LIHTC. The CDFI Fund accepts applications for NMTC allocations from Community Development Entities (CDEs), and awards the credits based on competitive criteria designed to maximize the impact of the credit.[109] CDEs receive grants or loans from investors in exchange for tax credits over a 5-year period. CDEs then make debt or equity investments in Qualified Active Low-Income Community Businesses.

Investments financed with NMTCs can be used for business operations or for the development of real estate, including commercial, industrial, mixed-use or community facilities like health centres and charter schools. Investments can be either rural or urban, but must be in census tracts that are designated as low income by program criteria. CDFIs often serve as CDEs for NMTC transactions, since deal structure is frequently complex and requires a specialized set of legal and financial expertise to carry out. The NMTC program has deployed a large amount of capital: about $31 billion in public expenditure from 2003-2012. Based on the project data, the CDFI Fund estimates that every $1 of NMTC allocation attracts about $8 of private capital, which frequently includes multiple lenders and potentially a philanthropic loss layer.[110]

CDFI Bond Guarantee Program

One of the newer policies designed to facilitate access to debt financing is the CDFI Bond Guarantee Program, which was created in 2010. $525m of CDFI bonds were raised under the Bond Guarantee Program in FY 2014 alone[111]. The CDFIs selected for the program sell government-backed bonds through the Federal Financing Bank, which can access funds at the similar rates to Treasury bonds with similar maturity and structure, giving CDFIs a low-cost way to access long-term funding. Due to the scale and complexity of the bond issuances, the program is primarily used by organisations that serve as intermediaries for the broader community investment sector, and either borrow directly on behalf of other CDFIs or use the funds to on-lend to CDFIs. Any loans financed with CDFI bonds must be aligned with the programmatic mission of the community investment sector, broadly defined.

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[109] Abravanel et al., The Urban Institute, Metropolitan Housing and Communities Policy Center. 2013. "New Market Tax Credit (NMTC) Program Evaluation"

[110] CDFI Fund. 2014. "CDFI Fund Releases Ten Years of Public Data on New Markets Tax Credit Investments".

[111] CDFI Fund. 2014. "Treasury Guarantees Additional $200 Million in Bond Funding for Nationwide Community and Economic Development Projects".

B.3 Organisational Capacity

Data and Ratings

Independent and reliable information on the performance of borrower organisations is crucial for any financial market operating at scale. While individual organisations and investors might be willing to operate on a relationship and reputational basis for investment in the early stages of a market, when substantial uncertainty is unavoidable, achieving significant growth requires that new investors can easily acquire information on the performance of various organisations that is reliable and consistent across the sector. While CDFI credit unions and banks are subject to reporting requirements of their own, the broad diversity and more flexible structure of loan funds make them particularly difficult for investors to assess.

To address this gap in information on loan funds in particular, the Opportunity Finance Network created the CDFI Assessment and Ratings System (CARS) in 2004, which subsequently became an independent non-profit organisation called Aeris Insight in 2014. Aeris provides ratings, data, analysis and advisory services to investors, focusing on both impact and financial performance.[112] The financial performance criteria are based on the CAMEL analysis used by regulators to rate banks, and impact performance is measured by how well an organisation pursues its stated goals, rather than an attempt to quantify social impact directly. CDFIs request and pay for ratings by Aeris, and more than 80 loan funds are currently rated. Investors can also subscribe to data on the industry as a whole, or ratings reports for individual organisations.

[112] Aeris Insight, Inc. 2014. "Inside Aeris Ratings, Eighth Edition."