Esmée Fairbairn FOUNDATION

April 2005

Street (UK)

Learning From Community Finance

In recent years community leaders, charities, business people and politicians have championed the development of 'community development finance' as a way of getting finance to people and organisations that struggle to gain access to mainstream financial services. This helps build assets and develop businesses, particularly in disadvantaged areas where community finance is often targeted. This briefing follows an evaluation of Street (UK), carried out by the New Economics Foundation, and funded by Esmée Fairbairn Foundation. The evaluation report (see back page for details) has more in-depth information about many of the issues highlighted here.

Street (UK) - learning from community finance

Introduction

Street (UK) is one of the pioneers of community development finance. Over three years, it tested out the feasibility of establishing a national organisation lending to self-employed individuals and very small businesses, often operating at the margins of the mainstream economy. Street (UK)'s aim was to establish large-scale lending operations on a financially sustainable basis so as to achieve both impact and permanence. Although this original aim has not been achieved, this experience has contributed to thinking about microfinance in this country.

Street (UK)'s experience

- Street (UK) has shown that there is some unmet demand for finance among the self-employed and very small businesses. It has supported unbankable transitional or embryonic businesses in some of the UK's most deprived areas.
- Street (UK)'s services are highly valued by its clients, particularly its hands-on, friendly approach to credit assessment. Its loans have often been pivotal in helping businesses secure new opportunities and increase their turnover, profit and employees.
- Both the levels of demand and of client credit-worthiness are lower than Street (UK) originally anticipated.

Key findings

The key findings of this briefing are:

- It has proved difficult to build a financially sustainable organisation based solely on lending to micro-entrepreneurs. Diversifying products and services and building partnerships may also be necessary to achieve financial self-sufficiency.
- Micro-entrepreneurs often need a variety of financial and non-financial services, not just business loans.
- More work is needed to develop comparable performance measures, increased transparency and an open, learning culture in the sector if the performance of community finance organisations and the success factors are to be better understood.
- Long-term investment is required to build community development finance institutions. Experimentation and innovation, such as that of Street (UK), is needed to better understand markets and develop viable business models. A sense of shared risk and long-term engagement are vital ingredients for the successful funding of community finance initiatives.
- A micro-finance model which works overseas may not transfer effectively into a different environment. Great care is therefore needed when replicating a model in such circumstances.

Background

Financial exclusion

Government, the voluntary sector and others have become increasingly concerned about 'financial exclusion', which describes the difficulties that individuals and micro-enterprises face in using mainstream financial services, particularly personal or business loans from banks. The problem appears to be particularly acute in poorer communities where credit is often only available at a high price, such as from doorstep lenders and pawnbrokers.

Micro-business

Those in self-employment without a track record, and very small businesses, can find it difficult to gain access to traditional business finance. This is especially true for those working in the 'grey economy', in other words trading while receiving state benefits or not declaring all their income to the Inland Revenue.

Micro-businesses are often an important part of the local economy in deprived areas and provide income and employment for many of the UK's most disadvantaged people. In the West Midlands, Street (UK)'s main area of operation, self-employment is growing faster than any other kind of employment. With appropriate support and better access to capital, very small entrepreneurs, especially those in disadvantaged areas, can develop and grow their businesses and through this help to regenerate their local communities.

Community Development Finance Institutions

There are now dozens of community development finance institutions (CDFIs) up and down the country. Most CDFIs provide loans but each operates slightly differently and caters for different markets. Some have focused on lending to charities, social enterprises, business start-ups or individuals for personal needs while others, such as Street (UK), have focused on the self-employed and micro-enterprises. CDFIs are experimenting with different models and we are still learning about what works.

Street (UK)

Lending to micro-businesses

Street (UK) was founded in 1999. It was influenced by a Polish scheme that had built up a successful operation lending to micro-businesses. Street (UK)'s founders believed that micro-enterprises in the UK were particularly poorly served by mainstream finance providers.

The main aim of Street (UK) was to provide permanent access to finance for low-income, self-employed people and very small businesses not seen as creditworthy by banks.

It proved a challenge for Street (UK) to raise the large-scale financing required for its ambitious business plan. However, eventually it attracted sufficient funds to start a pilot phase with a mix of support from banks, foundations and Government. Esmée Fairbairn Foundation was Street (UK)'s largest funder, providing a grant of £1,329,000.

Aims and outcomes

Street (UK)'s original aim was, over a seven-year period, to create a national organisation serving 20,000 clients and with a £40 million loan portfolio. Initial loans would be up to £3,000 and have a 12-month term. The pilot was to be run in three locations between November 2000 and November 2002 and would establish whether a permanent nationwide micro-finance operation was viable. In Street (UK)'s own words, this scheme would "help people to help themselves, offering a hand-up, not a hand out".

The first loans to micro-entrepreneurs were made in 2001. By March 2004 Street (UK) had made 259 loans totalling £600,000 and had a loan portfolio of £320,000. This was less than the initial targets for this phase, which were over-ambitious. However, Street (UK)'s work had other benefits beyond just lending, with more than a thousand micro-entrepreneurs receiving practical business advice, highlighting the need for business support services. High levels of client satisfaction were also recorded. Street (UK) has also contributed to the policy debate on how best to support the self-employed and CDFIs that work with them.

Changing the model

Although Street (UK)'s loan portfolio is less than its original target, it is broadly in line with other CDFIs serving similar markets. This may reflect what is possible in the early stages of the development of community finance.

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Derek turned to Street (UK) when he wanted to expand his business selling and renting reconditioned washing machines, tumble dryers and vacuum cleaners. He could not get a loan from the high street banks as he had an insufficient track record.

As well as providing a loan, Street (UK) advised Derek on how to grow his business, profit margins and record keeping. Derek found bigger premises and repaid his loan within six months. Today the business has three times as many customers.

For the low-income residents of the area, Derek's shop offers affordable appliances. With more space he has room for appliance repairs and is expanding his product lines. He now employs an assistant to help him look after the shop.

Derek is also taking courses to improve his business skills and, with Street (UK)'s help, has computerised his accounts and his customer database.

As a result of difficulties in establishing volume operations, Street (UK) adapted its business model by, among other things, removing the group lending element (see back page) to concentrate on individual loans to micro-entrepeneurs and focusing more on providing business support to clients. Street (UK) also began to develop other products and wholesale services.

The organisation's 2004 business plan aimed to consolidate resources and focus on expanding lending and other financial and non-financial services in the West Midlands only, while developing further wholesale services that can be sold to other CDFIs nationwide. The Newcastle office, Street (North East) is now an independent organisation, with links to Street (UK).

Definition of terms

Community Development Finance

Community development finance is sometimes known more loosely as community finance or social finance. Its role is to enable lending to, or investment in, poor communities or under-served markets. The Government, and particularly the Treasury and Department of Trade and Industry, has strongly supported community development finance as a way of encouraging entrepreneurship and regeneration in poor areas. One important strand of community development finance is to provide finance to self-employed people and micro-businesses that cannot gain access to conventional business funding.

Community Development Finance Institutions (CDFIs)

CDFIs are independent organisations that provide capital and support to enable individuals or organisations to develop and create wealth in disadvantaged communities or underserved markets.

CDFIs provide finance in order to get both a financial and social return. Most CDFIs make loans but some also offer equity investment. They focus on various markets, including social enterprises, micro-businesses and individuals. CDFIs are funded from a variety of sources, including commercial banks, charitable foundations and individuals.

Micro-enterprise

A micro-enterprise, run by a micro-entrepreneur, is a sole trader or very small enterprise, usually defined in the UK as one employing less than five people. Common examples include: hairdressers, small retailers, taxi-drivers and window cleaners. Many micro-enterprises do not have access to conventional loans, equity or banking services. Nearly 90% of all businesses by number in the UK employ fewer than 10 people and contribute nearly 20% of business-generated employment.

Micro-finance

Micro-finance is the provision of financial services, such as loans, to low-income people who cannot gain access to mainstream financial institutions. It has proved successful in some developing countries and in Eastern Europe, by providing people with the capital needed to build up assets, small businesses and create jobs.

Learning points for community development finance

1. It has proved difficult to build a financially sustainable organisation based solely on lending to micro-entrepreneurs. Diversifying products and services and building partnerships may also be necessary to achieve financial self-sufficiency.

- No non-commercial business model has yet succeeded in providing micro-finance on a large scale and in a financially sustainable way in the UK. Street (UK) aimed to take a 'big bang' approach and invested heavily in a branch network and management but could not generate the volume of lending to cover the costs of this large-scale infrastructure. Other CDFIs have taken a more gradual approach. Neither model has yet proved itself - this is still a developing sector.

- Low loan volumes mean that interest and fees from lending are insufficient to cover costs. With a small loan portfolio, economies of scale and financial sustainability are difficult to achieve.
- To become sustainable micro-finance lenders could consider:
  - diversifying into new products and services, such as investment loans and leasing;
  - developing new markets, such as small businesses, social enterprises and individuals, where returns from lending may be higher;
  - cutting costs through more streamlined business processes and technology;
  - achieving economies of scale through partnerships or mergers, or developing micro-finance within established organisations.

Lower lending volumes

Although Street (UK) has made far fewer loans than it first hoped, its lending performance is not too dissimilar from other CDFIs serving similar markets, such as Aspire in Northern Ireland and the East End Microcredit Consortium in London. Both these CDFIs, however, serve a much narrower geographical target market than Street (UK) intended to.

Marketing

Developing consumer awareness is an ongoing challenge for CDFIs. The financial service sector is a crowded marketplace where consumer credit companies compete to get people to buy loans. Street (UK) and other microfinance organisations have a very distinctive loan product: more responsible loans that are tailored to fit a person's capacity to repay. However, these organisations cannot afford the marketing efforts of the commercial players. Street (UK) found local newspaper advertisements the most effective form of marketing, but they are expensive.

New markets - USA experience

In the USA, which has more experience of community development finance, no organisation has managed to build financially sustainable micro-credit operations. The successful CDFIs have diversified into new areas to increase their loan fund size, such as small-business lending, personal savings and loans, housing lending and loans to non-profits and social enterprises. There are of course different financial arrangements and regulations in the USA.

2. Micro-entrepreneurs often need a variety of financial and non-financial services, not just business loans.

- Many micro-entrepreneurs need other products for both business and personal purposes, such as savings, insurance, leasing and consumer loans. Many also need wider business support before they are ready to take on a loan, such as advice on how to develop a cash flow statement or guidance on business strategy.
- The wider business support needed takes time and costs money. These extra resources need to be taken into account by organisations setting up micro-finance funding.
- Street (UK)'s experience suggests that a specialist service for micro-entrepreneurs - such as an offshoot of the Government-funded small business advice service Business Link - would be beneficial.

Smaller target market

Street (UK) started out aiming to provide loans for micro-enterprises but realised that the target market was able to

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When Leigh and her daughter Yvonne needed funding to open their hairdressing salon in Handsworth, Birmingham they came up against a brick wall.

The couple had identified a gap in the market in their neighbourhood, where all the hairdressers specialised in Afro-Caribbean styles even though there was still a significant white European population locally.

"I was passed from pillar to post by both banks and other start-up organisations, who looked at our mother-daughter partnership and decided one of us was too old and the other one too young," says Leigh.

Leigh used her benefits money to help finance the new venture but an advertisement in the local paper led her to Street (UK). Within two weeks the business was analysed, a plan was written and a loan arranged.

Within three months the business was turning a profit and Leigh had come off benefits. The salon is now employing a trainee and Leigh and Yvonne have rented a room in the salon to a franchise business offering women's nail services.

access highly priced (150%+ APR) and often inappropriately structured consumer credit from 'doorstep lenders'. The issue became one of securing market share rather than meeting an unmet demand. Street (UK) estimates that only 10% of the businesses applying for a loan are ready for investment.

Leasing

Street (UK)'s experience working with micro-enterprises has shown that they often need a variety of financial products, not just loans. For example, leasing services are very valuable for micro and small businesses because they provide more flexible access to equipment and provide greater security for lenders. But micro-enterprises or those with a poor credit history often find it difficult to enter into leasing agreements.

Insurance

Insuring tools or equipment or getting public liability insurance is essential for micro-businesses but can be expensive. Street (UK)'s clients were particularly poorly served by mainstream providers in this area.

3. More work is needed to develop comparable performance measures, increased transparency and an open, learning culture in the sector if the performance of community finance organisations and the success factors are to be better understood.

- The community development finance sector is still relatively young and to date lacks publicly available accurate, standardised performance data. This makes it hard to know whether organisations are cost effective and to fully understand their impact.
- Performance indicators can improve efficiency, promote best practice and act as an incentive for improvement. They include financial information, such as interest rates and loan repayment rates, and social information, such as the number of clients reached, their poverty level and the long-term impact on their lives and on the wider economy. The Community Development Finance Association plans work on performance indicators in the coming two years.
- Benchmarking among peer-group CDFIs can provide an incentive to improve performance.
- Clearer information on the performance of CDFIs is likely to generate greater confidence and investment in the longer term.
- Developing such management information should also help promote a learning culture.

Cost effectiveness

Is micro-finance in the UK a good investment? How much does it cost to provide loans and support to this target market? And are the benefits worth the costs? These are crucial questions. However, it is not yet possible to make a definitive judgement on the cost-effectiveness and the ultimate financial and social returns of micro-finance in the UK. Street (UK) has ended up developing a range of activities beyond micro-lending: business support, policy work and services for other CDFIs. To understand the cost-effectiveness of Street (UK) and other similar CDFIs, one needs to assign costs to different activities. Street (UK) has yet to develop a cost accounting system which would allow a separation of unit costs by activity. Such activity-based cost accounting should be encouraged within the sector if one is to draw meaningful conclusions about costs and make cross-sector comparisons.

Repayment rates

Street (UK) has put a strong focus on delinquency management. It originally aimed for at least a 95% repayment rate and a 5% ultimate default rate, in line with international micro-finance lenders. Delinquency, that is failure to make payments as they fall due, and an indicator of ultimate default, became a problem early on, with about half of all borrowers failing to make repayments on time. New delinquency management systems pushed up payment rates significantly, so that by the end of 2003 83% of borrowers were making their monthly payments on time. Street (UK)'s ultimate default rate depends on progress with debt recovery but is currently estimated at between 7.5% and 12.5%. This compares well with many small business lenders.

> *"Even if a venture has not lived up to initial hopes, it should not necessarily discourage funders from taking similar risks in the future. Such investments can be important, not only because of their direct impact but also the lessons learned."*

Self-sufficiency?

Street (UK) has made limited progress towards financial self-sufficiency so far. In March 2004 it had an operational self-sufficiency level of 7% (income from interest and fees represented 7% of its operating expenses). Most other CDFIs are also experiencing problems in becoming financially self-sufficient.

CDFIs that cover a higher percentage of their costs from earned income seem to be those lending to social enterprises or consumers by either developing larger, sustainable loan funds or limiting transaction costs. For example, Industrial Common Ownership Finance (ICOF), which lends to co-operatives, has been generating 40-50% of its operating costs from loan client revenues for some time with the balance of its income coming from investment returns, consultancy fees and back office services.

> 4. Long-term investment is required to build community development finance institutions. Experimentation and innovation, such as that of Street (UK), is needed to better understand markets and develop viable business models. A sense of shared risk and long-term engagement are vital ingredients for the successful funding of community finance initiatives.

- Start-up CDFIs are likely to be risky and experimental. Funders need to recognise this.
- Because of this experimentation, funders and CDFIs need to remain open to the possibility that business models may have to change over time. A sense of shared endeavour and long-term commitment is needed by funders working with CDFIs.
- Even if a venture has not lived up to initial hopes, it should not necessarily discourage funders from taking similar risks in the future. Such investments can be important, not only because of their direct impact but also the lessons learned.
- As with many new ventures, establishing a CDFI takes time and funders may need to commit to five to seven years before a clear view of the likely outcomes can be gained.
- A range of sources of investment may be needed in the longer-term to support different CDFI activities (e.g. commercial loans for on-lending, subsidy for business support for borrowers) enabling them to be sustainable.
- In the future, funders are likely to develop more specific assessment criteria for the performance of CDFIs.

Esmée Fairbairn Foundation's funding of Street (UK)

Esmée Fairbairn Foundation (EF) is one of the UK's largest independent grant-making foundations. As part of its grantmaking programme the Foundation likes to consider work that others may see as too risky, perhaps because it breaks new ground. EF's grant of £1,329,000 for core funding of Street (UK) was a very large grant by the Foundation's general standards.

The aim of the grant was to operate a pilot programme, given that micro-finance on the level that Street (UK) was proposing was untested in the UK.

Margaret Hyde, Director of EF, said: "The Foundation realised it was taking a risk in making such a large grant to an organisation without a track record in the UK, but believed the risk was worth taking given the potential impact. We have valued the opportunity to work with Street (UK) and learned a lot from its testing and development of the lending model."

5. A micro-finance model which works overseas may not transfer effectively into a different environment. Great care is therefore needed when replicating the model in such circumstances.

- Micro-credit thrives in some countries. But in the UK the financial sector and consumer credit industry is highly developed. This means that a smaller lender's chances of success may be lower than in developing countries.
- Although the differences in the UK market mean the overall demand for micro-finance is less than overseas, there is still a gap in the market for micro-finance, particularly among the self-employed and very small businesses.

Overseas examples

Street (UK) was founded following the example of Poland's Fundusz Mikro and other international micro-finance schemes. Fundusz Mikro had 15,000 clients using a 'group lending' model and was financially self-sustaining after five years of operation.

The modern day pioneer of micro-credit was Grameen Bank in Bangladesh, which was set up in the 1970s and has lent money to thousands of poor village entrepreneurs on a 'group lending' basis.

Group lending

One of the problems encountered by Street (UK) was that group lending proved to be much more difficult to put into practice in the UK than in developing countries. In group lending, a group of borrowers effectively guarantee each other's loans. If one borrower fails to repay, all the group members are penalised.

This approach has been found in developing countries to reduce transaction costs and benefit individual borrowers by introducing them to a network of support. But in the UK it has proved much harder to implement. Factors working against it include the UK's different social fabric and difficulties in potential borrowers forming groups that had a sufficiently diversified risk profile. Further, in the UK poorer people can often access credit, for example through credit cards or door-step lenders, although this may prove expensive. Such borrowers are rarely willing to guarantee each other's loans as they can get individual loans elsewhere.

Street (UK)'s problems in promoting group lending does not mean it is not feasible in a Western context. Some UK micro-finance organisations have run types of peer-group lending schemes with a focus on the importance of the mutual support these groups offer rather than the guarantee mechanism.

For the full evaluation report, conducted by the New Economics Foundation, visit the Esmée Fairbairn Foundation website: www.esmeefairbairn.org.uk

Other sources of information

Street (UK)
www.street-uk.com
This includes the document: *'Street UK Lessons Learned'*

Community Finance Development Association
www.cdfa.org.uk

CGAP
www.cgap.org

Aspire Micro-Finance
www.aspire-loans.com

HM Treasury
Promoting Financial Inclusion Report (2004)
www.hm-treasury.gov.uk

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