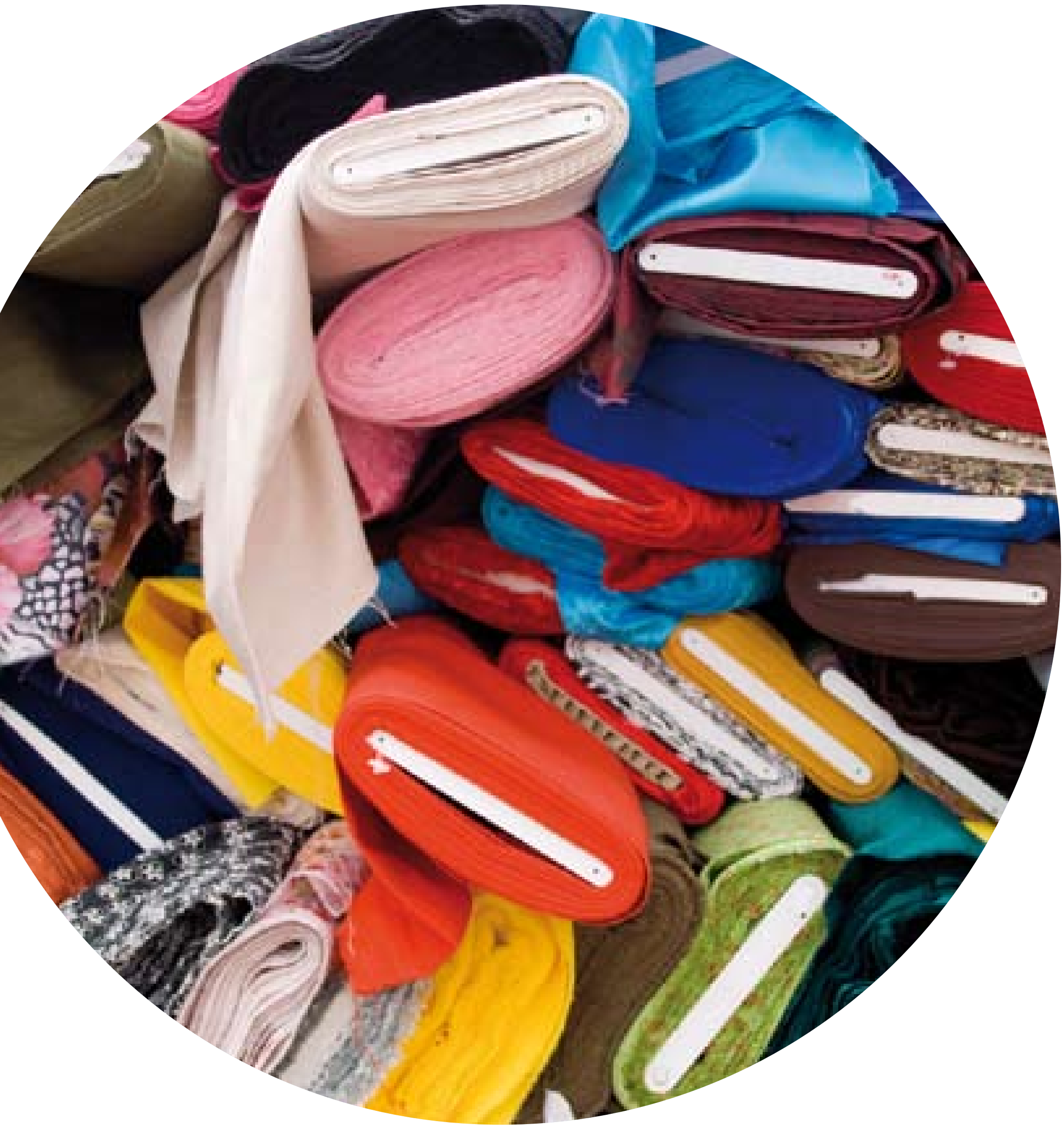
economics as if people and the planet mattered



Credit with a social mission:

why aligning the UK with the European microfinance movement matters

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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

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Executive summary

Community Development Finance Institutions (CDFIs) in the UK share a common goal: to serve the finance needs of individuals and existing or aspiring entrepreneurs who cannot access credit from the mainstream sector.

Community finance also aims to improve community cohesion by providing local services for local people, and to increase social and financial inclusion. In this sense, it shares many characteristics of microfinance, but the sector has a broader scope as it can provide or broker credit up to £100,000.

The CDFI market is typically divided into four credit lines:

1. Lending to microbusinesses (1–10 employees), often start-up enterprises, and with loan sizes below £10,000. This sector is characterised through intensive outreach activities that seek to promote entrepreneurialism among the poorest, most financially and socially excluded groups: ethnic minorities, long-term unemployed, women, and the disabled. This credit line is, in its characteristics, very similar to microfinance, although the term is not used in the UK.

2. Lending to small and medium enterprises (SMEs), with between 11 and 250 employees. Loan amounts are typically between £10,000 and £50,000. There is often an emphasis on local job creation in this lending segment.

3. Lending to social enterprises (SEs). Loan amounts vary greatly, but are on average around £60,000.[1] Broadly speaking, SE lending aims to increase local community cohesion and improve quality of life in local communities through improved living conditions, for example, transport for the elderly and disabled.

4. Personal loans for home improvement, consumer goods purchases, education or seed loans, or to cope with unexpected expenditure, such as repairs to property, for example. Loans, with the exception of home improvement loans, usually do not exceed £2000. The goal is to integrate the un- and underbanked into the financial system and to break the grip of expensive doorstep lenders and illegal loan sharks.

This paper will focus on the microbusiness-lending segment of UK CDFIs, which have very similar characteristics and goals to European microfinance organisations, as evidence gathered by the European Microfinance Network (EMN)[2,3] and research carried out by **nef** reveals.[4,5]

- Both Microfinance Institutions (MFIs) in Europe and the UK typically operate on a regional or local scale.

- Most organisations only started trading in the last decade.

- MFIs target one or more of these groups: women, the unemployed, immigrants, youth, ethnic minorities and the disabled.

- The majority of MFIs focus on start-ups and microbusinesses.
- Outreach remains the greatest challenge for MFIs.
- Eighty per cent of MFIs do not offer consumer/personal loans, savings products or similar.
- Very few MFIs in the EU 15[5] are operationally sustainable, some of which are government bodies. The vast majority of MFIs depend strongly on public funding.
- In the EU 15, MFIs focus on social inclusion and self-employment creation as their mission.[6]

In spite of these similarities, the term 'microfinance' is not used in the UK, and the sector isn't aligned with the broader microfinance movement. Furthermore, UK microfinance is not distinguished from other credit lines offered by UK CDFIs, although social mission and cost structures of microfinance lenders differ from those institutions lending to SMEs and SEs.

- Compared to SME and SE lending, loan sizes in MFIs are small, averaging £8,500, whereas average loan sizes for SME and SE lending are around £28,000 and £66,000 respectively. This results in higher costs per loan and a lower return on investment, limiting the profitability of MFIs.
- The social mission of microfinance adds further costs to these institutions. Their goal is to reach out to the socially and financially most excluded people and to build their aspirations and skills. These outreach and training activities are time- and cost-intensive for organisations with very little financial and human resources. Although core to their mission, most MFIs struggle to cover the costs for these activities from income generated through their lending activities.
- Very little is known about the demand for microfinance in the UK. In general, it is low and variable. As a rule, the vast majority of the population is banked. Most microentrepreneurs will have access to personal consumer credit, such as overdrafts, that can be used to cover costs for such small enterprises. It is vital to undertake a survey to establish the size of the market in order to serve it appropriately.

The lack of demand information and the lack of distinction between lending streams creates problems for the microfinance sector in the UK, especially in relation to financial sustainability. There is a perception by Government and private investors that CDFIs can and should be financially sustainable, i.e. independent of grants and public funding. Because of the higher costs incurred by microfinance, however, this is unlikely to be achievable. This puts the UK microfinance sector under threat, and there are already signs of contraction.

- The average loan size for lending to microentrepreneurs is steadily rising, as CDFIs gravitate towards the more profitable segments of the market.
- Many organisations have reduced the formal provision of crucial outreach and support services.
- Some CDFIs previously disbursing loans below £10,000 have ceased to do so.

These trends run counter to the mission of CDFIs seeking to provide finance to all aspiring entrepreneurs.

This negative development needs to be stopped if microfinance is to fulfil its role as a facilitator of social and financial inclusion. Explicitly using the term 'microfinance', and distinguishing the sector from other credit lines, would have beneficial effects for microfinance in the UK for three reasons:

1. There is a broad consensus among governments and researchers in Europe that microfinance is unlikely to become independent from public funding and financially sustainable. Reaching out to the poorest and most excluded is a costly undertaking, but has strong social benefits, as microfinance can greatly contribute to the integration of these groups into society, and the alleviation of poverty. It is accepted that the costs of outreach and training activities cannot be covered through the revenues generated through the lending operations. This is not recognised in the UK. Using the term 'microfinance', and the evidence provided by research into European microfinance would help alleviate the pressure for microlending organisations to become financially sustainable.

2. By not aligning the sector with the microfinance movement, CDFIs are missing out on political lobbying and advocacy power. Currently, microfinance in the UK is not assigned to any government department, leaving it without a political champion that would support it and help it to develop the social impact measurement systems that are so needed. It is therefore of high importance that the Community Development Finance Association (CDFA) and CDFIs operating in the microfinance sector work together to network and lobby policy-makers in order to create appropriate policies.

3. By tapping into existing microfinance networks, such as EMN, and increasing co-operation and networking among microfinance lenders in the UK, CDFIs could learn from each other and improve their lending methods, funding strategies, and impact measurement methods. Innovating and piloting new methods is time-consuming and costly, and there is a danger that these efforts undertaken by pioneering organisations will not be replicated by different organisations, simply through the lack of awareness of the ideas and practices other organisations. Demonstrating social impact is also paramount for securing social investment.

Recommendations

The CDFA

This negative development needs to be stopped if microfinance is to fulfil its role as a facilitator of social and financial inclusion. Explicitly using the term 'microfinance', and distinguishing the sector from other credit lines, would have beneficial effects for microfinance in the UK for three reasons:

- The CDFA should develop a typology of CDFI-lending based on loan size and target market.
- It should prioritise social impact measurement – both in regards to implementation as well as lobbying for funding to carry out pilot schemes that then can be rolled out across the sector.
- It should join the EMN.

The Government

- The Government should recognise the social benefits of microfinance and not focus solely on financial sustainability for CDFIs.
- Microfinance should be championed by one government department – either the Department of Work and Pensions (DWP) or the Department of Communities and Local Government (DCLG).
- The Government should also, jointly with the CDFA, launch a survey to establish demand for microfinance and enterprise lending and funding needs.

CDFIs

- CDFIs should increase their co-operation and share more information, especially in regards to innovative lending methodologies.

- CDFIs should also actively seek to market their social impact to social investors by adopting impact measurement systems. This will also help them to avoid mission drift.

Introduction: Community Development Finance and microfinance

CDFIs in the UK share a common goal: to serve the finance needs of enterprises and aspiring entrepreneurs who cannot access credit from the mainstream sector. From initial lending operations focused mainly on social enterprises, the sector has grown and taken on many different forms.

Lending to microenterprises and SMEs has increased since 2001, following the Government's provision of the Phoenix Fund that sought to support enterprise-lending CDFIs through grants. This fund closed in 2006 and residual monies were transferred to the Regional Development Agencies (RDAs). Since then, there has been no significant new financial support for enterprise lending.

This puts CDFIs under pressure to become financially sustainable, although (as we argue in our report *UK CDFIs: From surviving to thriving)* it is questionable whether all CDFIs can and should do so.[7]

As the name 'community development finance' suggests, CDFIs look at a community as a whole. **nef** (the new economics foundation), instrumental in setting up the community finance sector in the UK, describes community finance as an innovative way 'to channel investment into disadvantaged communities'. Finance is 'delivered by CDFIs, with the aim of generating vibrant and wealthy neighbourhoods, where local enterprise provides increased incomes, jobs and services for local people.'[8] They aim to fill a gap left behind by banks which deem investment in certain areas and certain business types as too risky. Typically, CDFIs will only accept clients that have been rejected by banks. Unlike the highly streamlined credit-scoring systems provided by banks – using indicators such as post code, demographics and previous credit history, and primarily dealing with clients via call centres – CDFIs use a trust – or relationship-based approach, meeting with each client to go through their accounts and plans in-depth. They take into consideration the individual's situation, considering a person's character as well as his/her business proposal. This approach shares many characteristics with the global microfinance movement.

The CDFI market is typically divided into four credit lines:

1. Lending to microbusinesses (1–10 employees), often start-up enterprises, and with loan sizes below £10,000. This sector is characterised through intensive outreach activities that seek to promote entrepreneurialism among the poorest, most financially and socially excluded groups: ethnic minorities, long-term unemployed, women, and the disabled. This is called microfinance elsewhere, but although this sector shows the same characteristics, the term is not used in the UK.

2. Lending to SMEs, with between 11 and 250 employees. Loan amounts are typically between £10,000 and £50,000. There is often an emphasis on local job creation in the promotion of this lending segment.

3. Lending to SEs. Loan amounts vary greatly, but are on average around £60,000.[9] SE lending aims to increase local community cohesion and improve quality of life.

4. Personal loans for home improvement, consumer goods purchases, education or seed loans, or to cope with unexpected expenditure, for example, by water damage or similar. Loans, with the exception of home improvement loans, usually do not exceed £2,000. The goal is to integrate the un- and underbanked into the financial system and to break the grip of expensive doorstep lenders and illegal loan sharks. This paper will focus on the microenterprise-lending segment of UK CDFIs, as this segment is under particular threat in the UK.

Despite these clear distinctions, there is no deeper typology of the different market structures in these four segments. Microfinance, with its commitment of outreach to the poorest and most excluded people, is not treated differently to other segments. The term is not used, and the sector is not aligned with the European movement.

Whereas the holistic approach of the UK sector is to be applauded in that it seeks to cater to the finance requirements of all enterprises not served by banks, the non-alignment with the microfinance movement is creating a threat to this credit line. There is a lack of distinction in finance needs and impact of the different lending strands, and misconceived ideas on financial sustainability of CDFIs. This is resulting in a contraction of the microfinance sector, and a decline in outreach activities. As we argue, these problems could be greatly reduced if the sector were to align itself with the broader microfinance movement.

Microfinance in the UK and Europe: same difference

Microfinance as a global movement started in Bangladesh in the 1970s, and has since made its mark around the world in its aim to alleviate poverty.

Clearly, organisational structures, scope and impact of MFIs vary between countries and regions: a loan of £5,000 in Romania will go a lot further towards establishing a microenterprise than it would in the UK, and market sizes and demand will differ greatly. Microfinance in Western Europe, or the EU 15, is very different from microfinance in the Eastern European member states. Comparing CDFIs lending to microbusinesses with MFIs in the EU 15, however, reveals great similarities between the two. Characteristics collected in a bi-annual survey carried out by the EMN demonstrate this.[9]

- MFIs in Europe typically operate on a regional or local scale.
- Most organisations in Western Europe only started trading in the last decade.
- MFIs target one or more of these groups: women (51 per cent), the unemployed (38 per cent), ethnic minorities (37 per cent), immigrants (31 per cent), youth (22 per cent), and the disabled (21 per cent).
- Seventy-five per cent of MFIs' stated mission is social and financial inclusion as well as entrepreneurship promotion and job creation.
- The majority of MFIs focus on start-ups (86 per cent) and microbusinesses (61 per cent).
- Outreach remains the greatest challenge for MFIs.
- With the exception of some MFIs (especially in the UK), most MFIs do not offer consumer/personal loans, savings products or similar (80 per cent in 2005 – the 2006 survey did not provide a percentage).
- In 2005, no MFI in the EU 15 could cover its operation costs through earned income. The vast majority depend on the public sector to fund 76–100 per cent of operational costs. Some organisations appear to have achieved this in 2006, but it remains a challenge for the majority of MFIs.[11]

There is no comparable survey carried out for microfinance organisations in the UK, but a search on the CDFA website, as well as the research for our reports on CDFIs[10,11] reveal a great overlap of characteristics between CDFIs lending to microenterprises.

- They operate on a regional or local scale.
- They are as young as their European counterparts.
- The focus of lending below £10,000 is on start-ups and self-employment.
- They have a strong outreach element to increase entrepreneurialism among women, ethnic minorities, the disabled and the long-term unemployed.

- Outreach (creating demand and ensuring perseverance of microfinance clients) is challenging and requires organisations in the UK to develop innovative approaches.

- Microfinance operations are usually cross-subsidised from other income streams, or financed through public grants or social investment.

There are also some differences:

- The UK has the highest interest rates among the EU 15, with an average of 14.5 per cent for microenterprises.[15] The remainder of countries charge only between 4 and 10 per cent.

- Provision of formal advice services have declined steeply in the UK (Table 1) and fall far short of the 70 per cent of European MFIs that offer training and counselling services.

- Although no CDFI in the UK is currently fully financially sustainable, government support is much lower, and no microfinance programme is fully paid for by public money. Most microlenders in the UK rely on a mixture of private investment or grants, public money, and cross-subsidising their microfinance programmes from other income streams (e.g. service provision in debt counselling to housing associations or local councils). Higher interest rates also serve to cover the high unit costs. Yet, this support and financing model is not enough to fully realise the outreach component of microfinance.

These differences stem largely from the aforementioned lack of distinction between lending types in the UK. Subsumed under one heading, their finance needs and their potential to become financially sustainable are all assumed to be the same. Sustainability for microfinance in a European context, however, is unlikely to become a reality.

Differentiation: necessary to be holistic

Despite the similarities between microfinance and CDFI microenterprise lending, the sector seems reluctant to use the term and align itself with the microfinance movement.

Only very few organisations deliberately use this term to distinguish themselves. However, a typology that would seek to differentiate between the different credit lines is urgently needed.

- Compared to SME and SE lending, loan sizes in microfinance are small, with an average of £8,500. They are also often relatively short-term (usually up to two years), resulting in a low portfolio yield. SME and SE lending have much higher yields, as the terms are longer and loan values substantially higher. SME and SE lending thus provides CDFIs with steadier income streams.

- Unit costs for microfinance are also higher, as the administrative procedures are the same, regardless of loan size. This makes the provision of smaller loans unattractive for organisations that find themselves under pressure to become financially sustainable.

- The social mission of microfinance adds further expenses to these institutions, driving unit costs even higher. Their goal is to reach out to the socially and financially most excluded people and to build their aspirations and skills. This requires building strong ties to these communities, as well as providing intensive face-to-face training and support services. These activities are time- and cost-intensive for organisations with very little financial and human resources. Most MFIs struggle to cover the costs for these activities from income generated through their lending activities. For lenders to social and small enterprises, these costs are usually lower as these entrepreneurs are less likely to be in need of such intensive mentoring and supervision.

The Government and funders do not recognise these differences in costing models. This lack of distinction, combined with the assumption that CDFIs can all reach sustainability, presents a real threat to microfinance.

The situation is exacerbated by the low and variable demand for microfinance. The vast majority of the population in the UK is banked, and has access to personal credit from mainstream banks. Where finance requirements for setting up microbusinesses are low, access to credit cards and overdrafts can cover the start-up costs.

The demand for microfinance hence is limited to:

- The unbanked: people without a bank account.

- The underbanked: people with a personal bank account, but with a flawed or non-existent credit history that makes them too high-risk for banks to extend credit to. This frequently includes immigrants with no credit history in their host country, but also people with County Court Judgements against them.

- People who cannot provide any collateral.

Table 1: Average loan size, value and loan numbers by market segment: enterprise lending only.[19]

Market	Average deal size (in the past 12 months)	Loan volume*	Loan volume as % of total	Loan numbers	Loan numbers as share of total (%)
Micro-enterprise	£8,520	£25m	31.7%	3691	76%
Small businesses	£28,000	£7.7m	9.8%	455	9.3%
Medium businesses	n.a.*	£7.9m	10.0%	41	0.8%
Social enterprises	£66,500	£38.2m	48.5%	668	13.8%

** The data are not broken down for medium enterprises*

Of these groups, only a limited number will want to become self-employed or be suitable for it. This further decreases the potential demand for microfinance. In addition, there are no surveys available which provide an estimate of demand for enterprise credit outside of the mainstream banking sector by. This makes it even more difficult for CDFIs to target their services for this market group.

This lack of information is crucial, especially in the current credit crisis. It is as yet unclear how many people will lose access to their overdrafts and credit cards, and to what extent the potential demand for CDFI credit will increase. Current figures provided by the Bank of England and the British Bankers Association indicate a continued, albeit slower growth of credit provision,[15,16] but it is too early to judge the full fallout from the crisis. Anecdotal evidence gathered by **nef** from CDFIs indicates an increase in inquiries and applications. This makes a large-scale inquiry into the demand for community finance a priority in order for the sector as a whole to plan, and to tap into adequate funding sources in order to cover the likely rise in demand for capital.[17]

The consequences of these issues for microfinance in the UK are evident – the sector, still in its infancy, is already contracting. Overall, there is a marked trend towards larger loans, with some CDFIs moving out of microfinance lending (below £10,000). Loan sizes to microenterprises have increased steadily, with the average loan now at £8,520 (up from £5,248 in 2004, or nearly 64 per cent).

The increase in loan sizes indicates a move away from outreach to the most excluded groups, which typically require very small loans (often as low as £500, e.g. to buy material to sew and sell clothes). Similarly, the percentage of CDFIs offering one-to-one mentoring and advice has dropped from 69 per cent in 2004 to 47 per cent in 2007. Most other advice services have declined as well, especially those usually provided for free (e.g. informal advice over the phone) or which require dedicated staff time and programmes, such as one-to-one mentoring and advice (Table 2).

Table 2: CDFIs offers of support 2004–2007[20]

% of CDFIs who offer support	2004	2005	2007
Training courses	21%	50%	47%
One-to-one mentoring/advice	69%	68%	47%
Peer mentoring	31%	33%	26%
Informal advice on the phone	79%	85%	42%
Informal advice via e-mail	62%	71%	93%
Informal advice during loan processing	88%	88%	95%
Brokerage/co-financing services	15%	44%	51%

These developments are largely due to the unrealistic demands for microfinance operations to be financially sustainable and the lack of recognition of the role of microfinance as a promoter of social and financial inclusion. Due to its focus on microentrepreneurs, many of whom are sole traders, the benefits of microfinance will first and foremost be *for individuals and their families*. Unlike SMEs or SEs, which generate local multiplier effects by creating employment and investing in the local community, microentrepreneurs increase their own income and subsequently that of their family. There are, however, *wider benefits for society*, as microfinance can reduce the number of benefit claimants (and hence expenditure), which will increase the tax base, promote greater integration of individuals into society, and create role models for others. (Table 2).

Stakeholders in the UK sector need to recognise that microfinance can be a sustainable solution for society as a whole, even if the delivering organisations are not financially viable in themselves. As the UK-based microfinance institution Women's Employment and Enterprise Training Unit (WEETU) in Norwich points out:

> *Government and corporate bodies should be lobbied to provide long-term funding and support so that providers can produce long-term strategies to target the increase of social and financial inclusion in disadvantaged communities. More banks and financial institutions should be encouraged to lend financial support […] as these communities will be potential clients […]*[21]

The organisation demonstrates in recent research that its model can be especially helpful to increase the number of women entrepreneurs, one of the Government's own goals, and to bring women into employment:

> *Since 2003 WEETU has supported more than 5,000 poor women, helped launch more than 200 enterprises, and helped more than 2,000 women into employment. The loan repayment rate stands as 96 per cent.*[22]

WEETU estimates that for every pound spent, the social return on investment based was £5.80, based on the reduction in benefits payout and increased taxes paid to the government (see box 2 for more information on social return on investment).[23] This represents a nearly six-fold return on investment – and, as the repaid loan can be used again to support another woman, represents efficient investment and recycling of public money.

Such a clear demonstration of impact is still rare in the sector. This is caused by a vicious circle of, on the one hand, a lack of recognition by Government and funders that microfinance in Europe is largely a social intervention rather than one that directly increases economic performance data in deprived communities. On the other hand, these social impacts need to be demonstrated by CDFIs, but there are no funds to develop suitable tools. Most currently available tools, however, are unfit for this purpose and hard data, such as generated by WEETU, are still rare. This is partially caused by a lack of funding, which again leads back to funders' emphasis' on financial sustainability.

The lack of differentiation between different outcomes and different funding needs for microfinance and other credit lines results in a highly unsuitable funding environment. This puts undue pressure on CDFIs engaging in microfinance to become financially sustainable, leading to a contraction in the sector.

Without the acceptance of the need for public funding, microfinance lending in the UK is likely to disappear over the next decade, with the exception of a few, small organisations which have carved out a niche; 76 per cent of current CDFI clients could loose access to finance.

Coming into the fold: benefitting from alignment with microfinance

The problems and issues pointed out earlier demonstrate the difficulty that microfinance is in at the moment, but also points to the benefits of aligning the sector with the wider microfinance movement.

The advantages are threefold:

1. Researchers and governments in the rest of Europe recognise that microfinance in developed countries, and thus in the UK, is unlikely to ever be fully financially sustainable.[24,25,26] If the UK Government accepted this, and as a consequence provided better funding models for microfinance, CDFIs would be able to concentrate on their social mission.

2. Aligning the sector with the microfinance movement will improve lobbying and advocacy. Currently, microfinance in the UK does not have a political champion, adding to the problems of CDFIs operating in this market.

3. In addition, microfinance lenders need innovative ways to ensure clients succeed in their businesses, and they need to develop stable funding streams. Networking opportunities provided through alignment with other microfinanciers would enable CDFIs to exchange best practice on impact measurement, exchange ideas for novel lending methods that could increase the success of microfinance lending in the UK, and seek advice on how to best attract social investment.

Outreach: investment for greater social inclusion, prosperity and efficiency
Microfinance can play a great role in increasing people's skills-base, their aspirations, and their employability. Even if their business undertaking fails, there is an increased likelihood of microfinance clients finding jobs afterwards, as they have demonstrated initiative, have become more entrepreneurial, and have learned new skills, such as project and financial management. As well as the clear social benefits, this will result in reduced benefit payments and an increase in tax revenues.

> *Microfinance programmes in Western Europe are not and possibly will not become profitable, but make economic sense. The average costs for someone supported within a microfinance scheme – particularly since the monetary support is interest-bearing and repayable – are often below the cost for one year of support in the traditional social welfare system, where costs thereby incurred are "lost" subsidies.* [27]

Evidence for the impact created by microfinance supported by a prescient government is demonstrated by the highly successful French microfinance organisation ADIE: 80 per cent of its clients are either in employment or running their own businesses two years after having received loans and training from the organisation.[28] The organisation provides tailored one-to-one support to its existing clients, and engages in nationwide marketing campaigns to encourage people to approach ADIE for advice and support. To cover its costs, ADIE receives a subsidy of around €2,000 per client to fund its operations. By helping 80 per cent of its clients into employment or self-employment, ADIE justifies this subsidy as it creates a substantial saving in social welfare costs to the Government.

ADIE is not alone in receiving substantial government funding; 42 per cent of MFIs in the EU 15 receive 76–100 per cent funding of their operational costs from European governments, and few organisations can cover their operational costs on the back of their lending operations.[29]

There is consensus among researchers and practitioners in the EU that microfinance and its outreach activities are unlikely to be financially sustainable in industrialised countries. Maria Nowak, CEO of ADIE states:

> *I hope that in 5-10 years, with the increase and diversification of our activity we will be able to cover the cost of credit. Business advice (…) will have to be subsidized. We consider it as an 'inclusion service' to be financed by the public sector.*[30]

However, government support for enterprise-lending in the UK has essentially dried up, and CDFIs are required to become independent of public funding. This will be difficult to achieve for any CDFI, regardless of the type of market it serves,[31] but for microfinance, this will in all likelihood be impossible.

Political support for microfinance – a champion for the smallest

There is no distinction between lending streams in the UK; lending to microbusinesses is treated exactly the same way as lending to SEs or to SMEs. This is despite the fact that impacts of microfinance – at least in the short and medium terms – are more likely to be *social*, than *economic*. Microfinance impacts the individual rather than the economy of the community in which they live.

This problem is partially a result of the lack of political championship for the sector, which will not be rectified until the microfinance stakeholders lobby for support on the basis of its social benefits, rather than its potential to assist large-scale regeneration of deprived areas through job-creation (as is the case for SMEs and SEs).

Currently, political support is only available for personal finance as well as SME and SE lending, although enterprise lending support is in decline.

The Department for Business, Enterprise and Regulatory Reform (BERR) concentrates on increasing entrepreneurialism and job creation, i.e. the lending segment above £10,000. Success is measured by increases in the number of VAT-registered businesses, and requires organisations benefitting from BERR support (RDAs and CDFIs) to report back on these numbers. Turnover generated by self-employment and microenterprises is often below the VAT-registration threshold of £67,000, and hence will not be counted as successful outcomes of CDFI work.[32] Also, self-employment is often a route into employment, and hence is not within the focus of BERR which seeks to increase the number of enterprises long-term. The positive effects of microfinance as a pathway to long-term employment are thus neglected.

The Department for Work and Pensions (DWP) concentrates on access to affordable credit for personal finance (e.g. to break the power of doorstep lenders and loansharks). Enterprise-lending CDFIs are thus not directly supported by the DWP. Some CDFIs operating both in microfinance and personal lending benefit from DWP money, as it allows them to subsidise their microfinance operations.

The Department for Communities and Local Government (DCLG) also looks at financial exclusion. It does not have a specific fund for CDFIs (unlike, for example, the DWP's Growth Fund), but access to finance is part of its remit to increase housing regeneration (through the decent homes standard) and job creation. It focuses on physical regeneration, for example, community asset management and building renovations. SEs benefit from these initiatives, as do SMEs. Microenterprises are unlikely to benefit from DCLG's activities directly.

The segment of CDFIs' activities that is not catered for is microfinance. The benefits that microfinance can provide for social inclusion are still under-represented in government thinking. Although access to affordable credit is highlighted in the last National Action Plan for Social Inclusion (NAP), microfinance, or CDFIs, are not mentioned as a tool to promote social inclusion. In France, on the other hand, the national inclusion plan makes specific mention of microfinance and its benefits for increases in social inclusion. The Government provides dedicated support to the sector through its social cohesion fund – *Fonds de Cohésion Sociale*.[33]

EMN, of which only five CDFIs are members, lobbies for the inclusion of microfinance into these plans in the whole of Europe, as 'MFIs providing finance, training and mentoring services to persons suffering from social exclusion are directly concerned by the programmes and initiatives undertaken by the Member States',[34] Yet, in the UK, microfinance has not found its way into the NAP. The initiative by EMN would have been a great opportunity for the CDFA to advocate for greater emphasis of microlending CDFIs, and encourage CDFIs to make their views heard. However, although the CDFA collaborates with EMN, it is not a member of the network.

Lobbying and advocacy are badly needed in order for policy-makers to realise the potential of microfinance for social inclusion, and the financial viability restrictions that microfinance faces in the UK. There is a need to create a policy framework that provides stable funding which allows these microfinance activities to take place in a more conducive environment. Social returns on investment, as they are attributed to microfinance, are greatly undervalued and under-measured in the UK. Government should view microfinance as tool to help people back into (self-)employment and to overcome social exclusion. For this, however, it needs to move away from short-sighted indicators of loans disbursed, enterprises founded, and increases in VAT-registered businesses, which do not measure outcomes directly. At the same time, the CDFI sector must increase its efforts to demonstrate social impact, and the CDFA should speed up the development of its best-practise framework in this respect.

The whole CDFI sector, and its main umbrella organisation, the CDFA, should increase its lobbying activities to ensure that microfinance takes its rightful place in government thinking: as a promoter of social inclusion.

Learning from each-other

It is not only in the sustainability and policy arena that the CDFI sector is missing out by not aligning itself with the microfinance sector. Practitioners lending to microbusinesses and seeking to reach out to groups such as immigrants and the long-term unemployed would benefit from a greater exchange of ideas and innovations regarding three areas:

1. Innovative lending methods to ensure perseverance of their clients – especially as most loans will not be collateralised.

2. Best practice in impact measurement, urgently needed to demonstrate the social benefits of microfinance to give greater force to political lobbying.

3. Sources of social investment and how to best access these.

Innovative lending methods

It is difficult to engage disenfranchised groups and to ensure their perseverance, i.e. that they do not give up on their businesses too quickly. This is not only to avoid would-be entrepreneurs ending up in a worse position than before (through debt incurred from the remaining outstanding loan), but also to avoid losses for CDFIs. Organisations use a variety of means to do so, with some of the techniques originating in developing countries, and being adapted to a European setting. Examples include WEETU's lending circle methodology, based on group lending, or the provision of buddies and mentors who aid clients through the process of starting-up and running a business.

Currently, these innovative methods of lending and providing support risk being sidelined in the CDFI sector. During the research for our main CDFI report, interview partners expressed the view that 'microfinance' would not work in the UK, or only in isolated instances.[35] The proof cited was the failure of the circle lending method of Street UK, an adaptation of Fundusz Micro in Poland.

Some organisations in the UK, however, have been successful in adapting this methodology. StreetCred in London and WEETU in Norwich have introduced enterprise circles, self-selecting groups of women who help each other to build their businesses. After a minimum of three months, members can apply for a loan. The application has to be supported by every member of the enterprise circle, but the organisation does not hold the group accountable for the repayment of instalments. Other organisations using elements of this methodology include:

- The London Rebuilding Society
- Community Finance CIC
- Prowess
- Rootstock

There may well be more organisations, but because of the lack of a network among microfinance organisations in the UK, this information is not readily available.

The arguments in favour of experimentation with group lending and peer support cannot mask the fact that some microlending practices may not be applicable to the context of an industrialised country. But by rejecting or neglecting the wealth of the microfinance methodology, CDFIs could miss out on new lending ideas, networking opportunities and business models that are successful in other countries, and that further their goals of increasing entrepreneurialism among excluded groups. The evidence provided by WEETU is a clear indicator of the organisation's success.

As there is no recognition of microfinance activities on a broader scale, the exchange of ideas is hindered. Of course, in many cases, lack of funding and the pressure to become sustainable prevents organisations from actively engaging in the exchange of information due to constraints on capacity and finances. A central website, or regular seminars for example, would make access to this information and to networking opportunities easier. The CDFA could play a role here by increasing the functionality of its website to promote idea exchange and discussions.

Box 1: Lending circles – a controversial method?

The lending circle methodology used by many Asian and African organisations consists of two elements: provision of collateral and business support. Clients provide collective collateral by guaranteeing each others' loan, usually in villages with a close-knit community. The underlying idea is that these clients know each other well and thus can assess if a person will be able to maintain payments and make a success of their business. If a person fails to provide a payment, the other members stand in and provide the funds. This serves as collateral for the MFIs, but also as a means of incentivising members to repay the loan. Repayments are made during regular meetings, which also serve to provide mutual business support. Ideas and tips on how to run and improve businesses are exchanged, and achievements and progress are celebrated.

Fundusz Micro used this approach to great success in Poland, but Street UK failed in seeking to copy the Fundusz Micro model on a national scale. The failure, however, may be due to faults in design rather than in the method per se. It was an ambitious project to start a national MFI in the UK. Demand is lower and geographically more unevenly spread than in Poland. There is a clear need to adapt methodologies, but it would be to the loss of the microfinance sector in the UK to reject these ideas outright.

For many microfinance lenders in the UK, it may also be of great benefit to join EMN with its commitment to information exchange and furthering best practice. Its annual conference, exchange visits, research groups, training courses and newsletter provide a wealth of information for practitioners. In addition, EMN seeks to increase its political lobbying activities, adding weight to the sector across the continent.

Impact measurement

The sector urgently needs to develop methods that demonstrate the impact of microfinance. There are two reasons as to why this should be treated with urgency.

First, without demonstrating that their work has an impact, CDFIs will find it difficult to present governments and funders with a case for supporting them. Pressures are increasing on the third sector to demonstrate the difference that it makes, and CDFIs will not be exempt from this.

Secondly, impact measurement is also a way for organisations to check if they are reaching their clientele and hence fulfilling their social mission. Discussions around financial sustainability often distract from the fact that CDFIs are social enterprises. It should be a natural activity to regularly check performance against stated social goals.

Furthermore, social impact measurement is also a form of market research. It allows organisations to improve their products to meet their clients' needs. This not only helps towards bringing about greater social and financial inclusion, it also feeds back into creating stronger revenue streams.

There are already tools that seek to assist third sector organisations in general in measuring their impact, and there are several initiatives to adapt these to the microfinance sector. Looking at these examples can help inspire ideas and thereby decrease the duplication of efforts. The production of hard data demonstrating the monetary value of investment, such as provided by WEETU or ADIE, can convince social investors and public funders to support microfinance.

Some organisations, such as Triodos Facet in the Netherlands, and CERISE in France, seek to create comprehensive impact measurement frameworks that demonstrate the improvement in the quality of life of entrepreneurs and their families, or environmental impacts.

Such in-depth frameworks may seem ambitious for a fledgling sector as small as the one in the UK. In addition, many existing tools are currently targeted at MFIs in developing countries. This should not stop MFIs in the UK using these as inspirations to design their own version of social impact measurement.

As Geert Jan Schuite from Triodos Facet puts it succinctly:

> *If African, Latin American, Asian MFIs are already starting to monitor, manage and report their triple bottom line performance, why should European MFIs stay behind?* [36]

In addition, if social impact measurement systems are put into place at the time of inception, measurement will become part of the culture of the organisation. Even if data samples are initially small, their analysis will provide information and lessons for the future.

Box 2: Examples of impact measurement systems implemented in Europe and elsewhere

Triodos Facet (Netherlands)

Triodos works with the Global Reporting Initiative to roll out triple bottom line reporting into microfinance. Triple bottom line reporting has been developed initially for the for-profit business world and combines reporting on financial, social, and environmental issues. It supports the Transparency and Sustainability in Finance project, of which two phases are completed. In Phase 1, Triodos and GRI introduced the concept to ten MFIs and discussed in which areas new indicators had to be developed. In Phase 2, these indicators were further refined and applied to the organisations. They received technical assistance in implementing these indicators across their planning, marketing and reporting departments, and the results were included in their annual reporting.

One outcome of the report is a comprehensive list of indicators, as well as a website (www.tblmicrofinance.com) that gives further information and factsheets as to how best to implement the system. The initiative acknowledges that most of the participating MFIs were in developing countries, but gives some suggestions on how to best adapt the method to Europe.

CERISE: Social Performance Indicators Initiative (SPI Tool)

CERISE is a French network for exchanging practice in microfinance. The organisation has developed a self-assessment tool with which microfinance organisations can carry out an internal self-assessment of their social impact. CERISE is continuously working to improve on the survey by seeking feedback and input from practitioners. The questionnaire is centred on four dimensions:

1. Outreach to the poor and the excluded
2. Adaptation of services and products to target clients
3. Improving client's social and political capital
4. Social responsibility of the institution

Most of the participating organisations so far are in developing countries, but the questionnaire can be adapted to suit an organisations model and mission. In research carried out to assess the accuracy of the self-assessment, there was little divergence between the results produced by the MFIs and the external assessors, indicating the relevance of the questionnaire and its ease of use.[37]

This tool is especially useful for organisations that fear they have succumbed to mission-drift under pressure to become financially sustainable. While greater efficiency and diligent budgeting should be part and parcel of any third sector organisation, their charitable status, and their goal to promote social and financial inclusion should still be the main driver for these organisations. A self-assessment can highlight to an organisation where a drift may have occurred and focus efforts to rectifying this. Further information can be found at:
http://www.cerise-microfinance.org/homeuk.htm

Integra – client surveys

Integra is a Slovakian microfinance organisation operating in Slovakia, Serbia, Kenya and the Sudan.

Since 2001, it has carried out client impact surveys that trace the progress of each client across a whole loan cycle. The survey consists of four questionnaires that are filled in at various stages of the loan cycle:

1. An intake form
2. A social baseline survey
3. A business impact form
4. An exit form

Each Integra client undergoes training, and the first part of the questionnaire is filled out before the client joins. The second part is completed during training; the third part at the beginning of the loan. The second and third parts are repeated in the middle and at the end of the loan cycle, and again one year after completing the loan to measure change. The exit questionnaire is filled in at the end of the loan cycle.

The questionnaires are very comprehensive in their detail, and in some cases may appear too intrusive for UK organisations. Many clients refuse to fill in the information relating to savings and income. Integra does not use specific incentives for clients to fill in these sheets. Their repeat clients especially are happy and willing to complete these.

Due to the survey cycle being stretched out across the loan cycle, clients should not feel unduly burdened by having to complete the questionnaires. As CDFIs in the UK mature and businesses take out repeat loans, surveys such as these can provide an invaluable source of information. Even though responses will be few initially, setting up the system from the beginning sets best practice in integrating impact measurement into the system from the outset.

nef – Social Return on Investment (SROI)

Social Return on Investment, or SROI, was originally developed by the Robert Enterprise Development Fund (REDF) in the USA, and **nef** has co-developed a global framework of this methodology to put a financial value on social intervention. Since 2003, **nef** has been working on adapting this framework to the UK context and helping organisations apply this tool to demonstrate their social impact.

SROI is a very flexible tool, allowing organisations to use a format that suits their capacity and their requirements. Organisations can undertake a self-guided version using a free **nef**-developed guide, or they can buy in expertise from consultants. The DIY-guide is available at http://neweconomics.org[38]

The basic premise is that of engaging stakeholders, for example clients, into describing how they define success of the intervention. For a CDFI, this would mean asking clients how their lives have changed since they started their businesses. Some organisations will find it challenging to put monetary values against such indicators as increased confidence, especially when time and money is tight. Many smaller organisations have used SROI with great success, however, demonstrating the adaptability of the method.

In 2005, WEETU carried out an SROI in co-operation with **nef**. The result was encouraging: the social value generated per client was £12,391, with the total close to £3.8 million above grant funding. For every £1 invested in WEETU, £5.80 of social value is created.

For many organisations, implementing such tools may seem daunting. However, organisations that believe they can help people overcome the barriers to enterprise they face should have the confidence in themselves to take on this challenge.[39]

The sector needs to think big and be bold if it is to ensure its survival, and social impact measurement is at the heart of this. Without it, many organisations will find themselves unable to secure future funding.

Attracting social investment – branding for the future

The ongoing credit crisis will no doubt have an impact on the way we finance economic activity and enterprises. Current data indicates a slow-down rather than a cessation of lending activities by banks, but anecdotal evidence gathered for this paper indicates an increase of inquiries and applications for CDFI loans. Any increase in applications has to be matched by an increase in capital to cover the demand.

Because of the nature of microfinance as a promoter of social and financial inclusion, commercial investment was always an unlikely source of capital for MFIs. MFIs need social investment that blends financial and social returns – and this will become more important than ever before. Aligning the sector with microfinance can help organisations do just that: the term has kudos and is a unifying 'brand' that most investors will recognise as a successful model for social investment.

The popularity of microfinance has increased greatly since Muhammad Yunus won the Nobel Peace Prize in 2006. Many philanthropists and social investors will have heard of microfinance and its potential for poverty reduction.

The term CDFI, on the other hand, is hardly known outside the sector. This makes it difficult for organisations bidding for investment to present their case. As this paper has sought to demonstrate, return on investment for microfinance in Europe will be below market rates. Hence, MFIs cannot present a mainstream financial investment opportunity.

Financial investment needs to be tailored to the organisations. Quasi-equity, patient capital, programme-related investment, or soft loans may all be useful, as may be models that fund the outreach activities of an organisation separately, allowing straight lending activities to achieve operational sustainability through increases in efficiency and scale. Using the term 'microfinance' may increase the chances of organisations attracting this kind of long-term, social investment.

Two organisations, WEETU in Norwich and Community Finance CIC in London, both call themselves microfinance institutions, as they know the term to be more recognisable. They not only hope to attract more investment in this way, but deliberately use it as a beacon to market themselves to clients at the very low end of the scale (up to £2,500). Puck Markham from Community Finance CIC said that he gained the support of two social investors by using the term 'microfinance'. He strongly believes that it would have been much more difficult if he had used the term 'CDFI'.

The current financial situation will make it even more important for CDFIs to secure alternative funding streams. Competition will be stiff, and using a combination of good evidence (impact measurement), innovative products and lending practices, and strategic use of branding can give organisations an edge when applying for patient capital.

Conclusion

The holistic character of the community finance sector in the UK is a laudable ambition. As public funding and commitment for the sector is waning, however, there is an urgent need to develop a typology of the different credit lines, distinguishing between the different impacts they have and their differing finance needs.

Without such a typology and a differentiation, microfinance may cease to exist in the UK in the next five years.

Many UK CDFIs engage in microfinance, and the failure to use the term and to align this market segment to the European microfinance movement is to the detriment of the sector as a whole. It may appear counterintuitive, but in order to preserve the holistic structure of the sector, the sector needs to be differentiated.

EU recognition that microfinance is unlikely to be fully sustainable should be a wake-up call for all stakeholders in the sector, especially governments and funders insisting on fully commercially viable CDFIs. The CDFA should actively campaign in this area to achieve a stable funding environment for outreach and support activities. It could also offer a more interactive platform on its website to increase information exchange.

By calling microfinance in the UK by its name, and accepting that it is unlikely to be financially sustainable, many microfinance CDFIs would be relieved of a burden. Funders should focus on maximising the social returns of investment that these CDFIs create in the most efficient way possible, which in turn should lead to increased funding for holistic impact measurement. CDFIs operating in the microfinance sector should look to demonstrate their social impact and go beyond just reporting on the number of loans given and enterprises created. The CDFA should assist organisations in developing these mechanisms, and tailor them to their specific market segment: microfinance.

Recommendations

The CDFA

- The CDFA should join EMN. This would facilitate knowledge dissemination as well as increase the UK sector's political influence in the EU. It would also send a powerful signal to those CDFIs engaging in microfinance that currently feel overlooked by the CDFA.

- It should also push for the development of a typology separating the differing needs of community finance lenders and the differing impacts. Not only will this reduce pressure on MFIs to become financially sustainable, it will also help stakeholders focus on the ultimate beneficiary – the client.

- It should put out a call among UK CDFIs to publicise any impact measurement assessments they have undertaken, and provide a list of tools available in the UK and in Europe. The social benefits of microfinance should be emphasised in this development to ensure its impact is correctly measured.

The Government

- The Government should recognise the social benefits of microfinance and desist on focusing solely on financial sustainability for CDFIs. Evidence, such as that generated by WEETU, on the financial benefits created for government by CDFIs must be taken into account. Specific funds should be made available to allow these kinds of exercises to be carried out across the sector.

- Microfinance should be championed by one government department. As microfinance serves the goals of the Government to promote social inclusion, it should task the DCLG with incorporating the concept into the national action plan on social inclusion. The DWP could also assist the promotion of the sector by acknowledging its potential to reduce unemployment and increasing the tax base.

- Especially in light of the current credit crunch, the Government should, jointly with the CDFA, launch an inquiry into demand for microfinance and enterprise finance, similar to the one carried out by the Financial Inclusion Taskforce for personal finance.[40]

CDFIs

- CDFIs lending below £10,000 should increase their co-operation and share more information, especially with regard to innovative lending methodologies. Client retention and matching products to the requirements of the clients will not only serve to fulfil their social mission. The more clients are served, and the better they fare, the more revenue CDFIs can generate, reducing funding pressure and recycling the loan capital.

- CDFIs should also actively seek to market their social impact to social investors. Only by taking a proactive approach to this challenge of measuring social impact will they be able to do so. Recognising that this is an essential part of their mission will also help in ensuring that they fulfil their purpose.

Endnotes

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6 The EU 15 consists of the Western European member states: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

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11 In 2004/05, 25 CDFIs from the UK took part in this survey, some of which do not exist anymore or have dropped microfinance from their product portfolio. In 2006/07, only 13 UK organisations took part.

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38 For further information, contact Michael Weatherhead at Michael.weatherhead@neweconomics.org

39 It s interesting to note that two organisations that have aligned themselves with microfinance, and are members of EMN, appear to be pioneering impact measurement in the UK:WEETU has completed the SROI, and StreetCred is a member of the Social Performance Task Force http://www.microfinancegateway.com/resource_centers/socialperformance/article/28257/

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