The Financial Inclusion Centre

Financial markets that work for society

Personal Lending in the CDFI Sector: Evolution of the sector and the challenges to growth

Financial Inclusion Centre Discussion Paper

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Summary

CDFIs have a proud legacy and have made a useful contribution to promoting financial and social inclusion in the UK. But, it has to be said that, up to now, the contribution has been fairly marginal. Can CDFIs make a bigger contribution? We have identified a number of major economic, technological, and regulatory trends which will create opportunities *and* challenges for CDFIs.

We think that financial exclusion in the UK will grow as a result of economic, technological, and commercial trends and the continued squeeze on household finances – unless the effects are mitigated and social lenders step in to fill the gap in lending markets.

This should present opportunities for CDFIs - if they are able to respond. However, those same external economic, technological, and regulatory trends create real challenges for CDFIs which, when combined with a number of operational and organisational barriers, could severely limit the ability of the sector to thrive and take advantage of those opportunities.

In this discussion paper, we describe those challenges, the implications for CDFIs (and other social lenders such as credit unions), and what needs to be done if CDFIs are to thrive and fulfil their potential.

Introduction

We thought it might be useful to share some of the scoping work we recently undertook for research proposal into how to double the scale of personal lending within the Community Development Financial Institutions (CDFI) sector. We have adapted it to hopefully be of interest to those in the wider sector or simply provided some background for those with little or no knowledge of these social lenders.

Overview

Over the last decade, CDFIs involved in personal lending have distributed £156 million to 253,000 people. Collectively, CDFIs have saved some of the poorest households £23 million in repayments compared to using high cost lenders.

At the moment, there are just 10 CDFIs across the country that specialise in providing affordable credit and financial capability support to individuals. During 2016-17, these collectively lent £25.8 million[1] to nearly 56,000 individuals[2]. A total of £17.44 billion was lent to UK households (in the form of credit cards and other personal loans) in the year to November 2017[3]. This means CDFI lending represented just 0.15% of all consumer credit advanced over the year. Moreover, personal lending within the CDFI sector has stagnated over the last five years – having hovered around the £20-25 million pound mark since 2013.

Yet, to put this into some kind of context, a large community-based credit union such as London Mutual Credit Union or Leeds Credit Union each have lending portfolios of between £12 -13 million to approximately 15,000 households with an average loan size of just over £1,100.

To help determine and shape the future direction of the CDFI sector, to ensure it flourishes over the next decade in an ever evolving and challenging credit market place and an uncertain socio-economic climate, it is important to both reflect on its historical development as well as understand the challenges the sector faces going forward.

Historical context

CDFIs in the UK have gone through a two decade long evolution split into three broad phases.

The initial **Fledgling Phase (1999 – 2005)** saw the very first personal lending CDFI's established in Portsmouth, Salford, and Blackburn mainly through engagement with Local Authorities and grant funding (ERDF, SRB and Phoenix Fund). This largely 'trial and error' period, with these operations seen more as 'projects' rather than 'businesses', acted as templates for many of today's leading CDFIs.

The **Growth Fund Phase (2006-2012)** was hugely influential in shaping the next phase of CDFI evaluation to meet the Government's financial inclusion strategy. It provided both the lending capital and an effective operating subsidy and led to the creation of new personal lending CDFI's (such as My Home Finance) and the significant expansion of others (for example, Moneyline opened twelve new outlets in this period). The period saw operating models geared towards new customers. The lending capital available meant that bad debt was not a limitation and subsidised interest rates drew in wide ranging stakeholder support.

The end of the DWP Growth Fund, which coincided with greater FCA regulatory scrutiny, has mandated a **Commercial Adaptation Phase (2012 and beyond)**, where personal lending CDFI's have been forced to completely reconsider their business model. Over the last five years, CDFIs have found it necessary to operate more commercially, increase the interest rates charged (in some cases the rate is now around three quarters of the commercial equivalent) and move towards greater online / remote delivery with more efficient application processes. The growth of the sector has also been hampered by a lack of lending capital and it has had to work extremely hard to both secure and then satisfy this new debt finance.

[1] £22million to 55,348 individuals, and a further £3.8million to 379 homeowners for home repairs

[2] See Responsible Finance: The industry in 2017, Responsible Finance December 2017

[3] FIC calculations based on data from Bank of England, Household Credit Visual Summary, Consumer Credit Flows https://www.bankofengland.co.uk/statistics/visual-summaries/household-credit

Challenges to, and opportunities for, sustainable growth

CDFIs have a proud legacy. We should recognise the sector's successes and celebrate the financial and social benefits CDFIs have produced in some of the most disadvantaged communities across the country.

Yet, if the CDFI sector is to achieve the step change required to expand and meet the needs of households and communities, it must learn the lessons of the past. We also need an honest appraisal of the capacity of the sector to adapt to the challenges *and* take advantage of the opportunities it will face. It is worth noting that many of these points will also be relevant for the credit union sector.

Describing the numerous challenges facing the sector would take an entire report to cover. But, to summarise, we group these into two broad categories - external and sectoral/ operational.

External threats and opportunities:

The main external challenges we identify include:

- Economic and financial conditions;
- Regulation;
- Technological change - fintech/ big data; and
- Competition threats.

The UK is facing some very difficult economic conditions. Economic growth remains subdued. Critically, from the perspective of community lenders such as CDFIs, household earnings have been stagnating. There has been a huge growth in the number of people with 'precarious' jobs (such as zero hours contracts and self-employment) and unpredictable earnings. Similarly, welfare reform and the implementation of Universal Credit has hurt the finances of financially vulnerable households.

The household savings ratio is falling, while consumer credit is rising again. Although it may not seem like it, the UK's major banks are not making much money on their core business and are having to cut costs.

The overall effect of this will be that more households will be less commercially attractive for mainstream lenders who will increasingly focus on more profitable households. This should create new markets for non-profit lenders *if* they can develop the capacity and capability to meet these needs on terms which make economic sense for CDFIs and borrowers. CDFIs are not charities and if they want to serve excluded households with uncertain incomes improved risk management techniques will be needed.

Secondly, regulation is increasingly influencing the conditions for non-profit lenders. Following campaigns by the Financial Inclusion Centre and others, the government decided to transfer consumer credit regulation to the FCA and cap the charges levied by payday lenders. Tougher regulation by the FCA and the payday charge cap has driven many payday lenders from the market.

This is a welcome development. We had argued for tougher regulation and a charge cap for two reasons – to protect consumers and create space for non-profit lenders to grow (non-profit lenders stood little chance against payday lenders with huge marketing budgets to deploy to acquire new business).

Now the FCA is also taking a tougher stance against high cost credit card providers and door step lenders. This should also create opportunities for non-profit lenders to fill the gaps. But, again, this will only happen if non-profit lenders are able to step up to the plate and grasp the opportunities.

However, regulation could also create challenges for CDFIs. The FCA already emphasises affordability and credit worthiness. But, as interest rates on CDFI loans rise to the level of rates in the market, this could attract further attention from the FCA who may start to apply conduct of business rules covering fair treatment of borrowers even more robustly.

The third major external factor is the growth in the use of fintech/big data/ artificial intelligence. This could be given a significant boost now that the Open Banking Initiative has gone live and the 2nd Payment Services Directive (PSD2) took effect in January 2018. Fintech is an opportunity and a threat for CDFIs. Some fintech evangelists believe that financial innovation will improve efficiency in financial services and so allow more borrowers to be served on economically viable terms.

But, we take the view that fintech could actually lead to greater financial exclusion[4]. The combination of fintech and big data means that commercial lenders will be able to identify with even greater precision more profitable/ less risky borrowers and less profitable/ higher risk borrowers – who will be excluded and/ or be exploited. This should create new opportunities for non-profit lenders if they are able to respond and offer good value, fair, affordable and economically sustainable loans.

However, fintech also represents a threat to non-profit lenders in the form of even fiercer competition. Less scrupulous lenders are not going to sit back and miss out on the opportunities created by fintech. We are already seeing payday lenders 'evolve' new ways of providing credit to consumers. Many commercial lenders have the backing of funders with deep pockets to develop new fintech products. We are concerned that CDFIs and other non-profit lenders may struggle unless they develop capacity to take on the competition.

<u>Sectoral/ operational challenges:</u>
From our experience, we think CDFIs face four major sectoral or operational challenges if they are to respond well to the external threats and opportunities identified above:

- Developing the right organisational capacity and culture to develop innovative, attractive products and services and raise awareness of CDFIs;
- Knowing more about potential customers to allow them to take managed risks and expand operations
- Establishing distribution and generating economies of scale; and
- Obtaining the funding to fend off threats, expand operations, and make more loans.

Over the last decade, the profile of the CDFI customer has shifted to some degree from the 'typical' young mother with dependent children, living in rented accommodation and reliant on income from benefits and/or part time wage. But, as the attitudes and expectations of all consumers have grown,

[4] Fintech – beware of 'geeks' bearing gifts?, Financial Inclusion Centre, January 2018, http://inclusioncentre.co.uk/wordpress29/our-work/publications/fintech-beware-of-geeks-bearing-gifts

has the CDFI movement been able to meet these demands through greater product ranges and efficient modern service delivery and attract a new diverse profile of customers? Research has shown the success of CDFI's in retaining existing customer with high overall satisfaction levels. However, there is little understanding of those who do not engage with CDFI's, their reasons for not using CDFIs, and how to overcome the barriers to acquiring new customers at the scale needed to grow in a cost effective, sustainable way.

The inherently narrow product range, focused primarily on lending, could be a major constraint on growth as it restricts CDFI's sources of income and ability to accumulate their own lending capital. More recently, the sector's 'responsible' lending credentials have been called into question as a result of offering loans in isolation of other products (such as savings, protection and advice). Effective diversification of CDFI's product portfolios is needed to appeal to a new seam of customer as well as retain existing users.

If CDFIs want to compete and become genuine challengers to commercial lenders, they will have to provide innovative loan products at significant scale to more demanding consumers with high expectations of efficiency and responsiveness. But expansion cannot be at the cost of responsible lending. As mentioned, the FCA now places greater emphasis on borrowers' affordability and creditworthiness.

To meet the challenge, some CDFIs have begun to embrace technology and are moving towards greater use of online delivery channels alongside or instead of growing their 'face to face' delivery. The aim is to harness technology and online channels to improve lending processes, speed up decision making and reduce costs through greater efficiencies and lower defaults. This has required more automated functionality with decision making that relies more frequently on external credit reference data, which in turn may increase the risk that more vulnerable, less profitable customers will be 'red lined'.

Expanding operations, improving efficiency *and* maintaining social lending obligations may be a difficult circle to square for CDFIs.

One of the issues which needs further examination is poor 'credit visibility' – that is, the lack of data on the financial profile and behaviours of groups of excluded, underserved, and hard-to-reach potential borrowers. Can CDFIs be expected to cast their net wider into underserved markets without access to data that allows them to manage risk well?

Recently, there have been occasions where obtaining promotional help from previously supportive local authority and housing association champions has become more difficult. This is for two reasons: rates charged by CDFIs have become less 'politically' palatable as the cost differential between CDFIs and the commercial high cost lenders has narrowed; and there is a fear of falling foul of perceived FCA restrictions.

Restricted marketing channels together with a general lack of marketing skills/focus and slow adoption of new delivery and promotional approaches within the CDFI sector also provide significant barriers to raising awareness and achieving the desired levels of growth.

Some CDFIs will want to focus on a niche market. But the socio-economic and commercial trends we identify above will create greater need for CDFI's products. However, if the sector wants to expand to meet that need, and take advantage of the opportunities, establishing distribution channels and platforms to generate economies of scale must be a priority.

The scale of required growth means that CDFIs will need to have the right internal infrastructure (IT and financial systems) and sufficient resources (human and financial). CDFIs will have to recruit and develop staff, senior executives and board members with the required skills and attributes to meet these new challenges as well as motivate and retain committed people with long-standing involvement in the sector.

The other ever-present barrier to the growth of the CDFI sector is obtaining sufficient capital on the right terms to expand operations. Interventions by social investors such as Big Society Capital and to a lesser extent the mainstream banks (for example Santander / RBS) have been hugely important but investments can still be rigidly conventional, relatively costly and onerous in their monitoring. More recently, CDFI's have successfully raised short-term bonds (typically 5-8 year terms) which is an important step. But, these bonds will shortly require re-financing/rolling over and the investors' level of commitment to the sector is not fully clear. If CDFIs are to fulfil their potential and meet ambitious growth targets alternative, innovative sources of sustainable funding must be found. For example, the Financial Inclusion Centre is exploring the potential for Social Lending Bonds to attract long term institutional investment into the social lending sector.

Conclusions

CDFIs have a legacy to be proud of and have made a useful contribution to promoting financial and social inclusion in the UK. But, it has to be said that the contribution has been fairly marginal.

A number of major social, economic, technological and commercial trends present external threats to the CDFI sector (and to other non-profits such as credit unions). However, these same external trends present opportunities for community lenders. The need and demand for their products and services will grow in response to growing levels of financial exclusion.

The challenge now is to support CDFIs in fulfilling their potential in a changing world. To do this, we need an honest appraisal of the capacity of the sector to adapt to the challenges *and* take advantage of the opportunities it will face.

We take the view that there are four main development areas for the sector:

- Developing the right organisational capacity and culture to develop innovative, attractive products and services and raise awareness of CDFIs;
- Knowing more about potential customers to allow them to take managed risks and expand operations
- Establishing distribution and generating economies of scale; and
- Developing alternative, innovative sources of investment funding to fend off threats, and facilitate the expansion of operations, and growth in sustainable loans.

We look forward to working with CDFIs, other social lenders, and wider stakeholders who have an interest in promoting social lending, on meeting the challenges ahead.

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