OVERCOMING FINANCIAL EXCLUSION:

COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS (CDFIS) AND THE BALANCING OF FINANCIAL AND SOCIAL OBJECTIVES

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Abstract

This thesis explores Community Development Finance Institutions (CDFI) as an alternative vehicle for the supply of debt finance to financially excluded enterprises. CDFIs are part of a broader approach to addressing financial exclusion that is experienced by commercial and social enterprises in the US and UK. The thesis explores US and UK CDFI lending processes to develop an understanding of how financial and social objectives are balanced in the lending process and the ways in which CDFIs become embedded in local financial and business support networks. The analysis is based upon detailed comparative research of CDFIs located in the US and the UK; interviews were undertaken with CDFIs, their clients and a quantitative analysis of a CDFIs loan portfolio was undertaken. The research concludes that CDFIs are complex dynamic organizations as they have to balance a double or triple bottom line which has the potential to undermine the firm's long term survival or mission. The danger is that over time a CDFI will reduce its exposure to risk and become more like a mainstream bank. The tensions with the CDFI business model implies that they will only ever provide a partial solution to the enterprise finance gap.

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CONTENTS

FIGURES

TABLES

GLOSSARY OF TERMS

ART- Aston Reinvestment Trust

ASLP- Advantage Small Loan Programme

AWM- Advantage West Midlands

BCEF- Black Country Enterprise Fund

BCRS- Black Country Reinvestment Society

BEA- Bank Enterprise Award

BERR- Department for Enterprise, Business and Regulatory Reform (UK)

BOE- Bank of England

BBV- Bolton Business Ventures

CARS- CDFI Assessment and Rating System

CASE- Collaborative Awards in Science and Engineering

CDFA- Community Development Finance Association

CDFI- Community Development Finance Institution

CDP- Community Data Project

CITR- Community Investment Tax Relief

CDLF- Community Development Loan Funds

CRA- Community Reinvestment Act (1977)

CSR- Corporate Social Responsibility

CWRT- Coventry and Warwickshire Reinvestment Trust

DCLG- Department for Communities and Local Government (UK)

DTI- Department of Trade and Industry (UK)

EC- European Commission

ELSBC- East London Small Business Centre

ERDF- European Regional Development Fund

ESRC- Economic and Social Research Council

FDIC- Federal Deposit Insurance Corporation (US)

FSA- Financial Services Authority (UK)

HBOS- Halifax/Bank of Scotland

ICOF- Industrial Common Ownership Finance

INAISE- International Association of Investors in the Social Economy

IPS- Industrial and Provident Society

LETS- Local Exchange Trading Systems

NACDLF- National Association of CDLF

NCCA- National Community Capital Association

NEF- New Economics Foundation

NGO- Non-Governmental Organization

NMTC- New Markets Tax Credit

NSFNR- National Strategy for Neighbourhood Renewal (UK)

NSRCF- North Staffordshire Risk Capital Fund

OCC- Office of the Controller of the Currency (US)

ODPM- Office of the Deputy Prime Minister (UK)

OECD- Organization for Economic Cooperation and Development Group

OFN- Opportunity Finance Network

PAT- Policy Action Team (UK)

RDA- Regional Development Agency (UK)

SBA- Small Business Administration (US)

SBS- Small Business Service (UK)

SETF- Social Exclusion Task Force (UK)

SEU- Social Exclusion Unit (UK)

SFLGS- Small Firms Loan Guarantee Scheme (UK)

SITF- Social Investment Task Force (UK)

SME- Small-and-Medium-sized Enterprises

UKSIF- UK Social Investment Forum

CHAPTER 1 FINANCIAL EXCLUSION: SMALL FIRMS

Introduction

The purpose of this thesis is to explore the supply of funds available to support the activities of entrepreneurs[1], as well as commercial and social enterprises that are deemed by mainstream lenders to be unbankable. Enterprises that are unable to access finance are considered financially excluded[2], defined simply as 'those who lack financial products' (Marshall, 2004:241) or more correctly, those who are unable to access financial products including loan finance. Conversely, financial inclusion is where individuals and businesses can open a bank account and have access to credit facilities such as a an overdraft or credit card. Start-up enterprises may be unable to access finance as their founders may not have a track record, lack experience, have a poor credit history and limited wealth. The same also applies if enterprises seek finance to grow who cannot, for example, provide security to guarantee a loan that operate in high risk markets and declining markets.

This chapter first considers why enterprise, entrepreneurship and social enterprises are important in today's economy. The second part explores why enterprises require access to finance and the types of funding available and the sources of funding. The third part explores the enterprise finance gap and one solution, CDFIs. The final part outlines the structure of the thesis.

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[1] Entrepreneurs are individuals who have established and currently manage a business.

[2] Social inclusion, on the other hand 'is about having the personal capacity, self confidence and aspiration to make the most of the opportunities, choices and options in life that the majority of people take for granted' (SETF, 2007:4).

Consequences of Financial Exclusion

The neoliberal strategies of successive US and UK governments have aimed to create jobs and to reduce the reliance on welfare support. One of these strategies aimed to stimulate and support enterprises in disadvantaged areas[3] through providing loans and business support as deprived areas have least access to finance. This thesis explores the role and relations of *Community Development Finance Institutions* (CDFIs) as an alternative vehicle for the supply of debt finance to enterprise. CDFIs serve the financially excluded by providing access to credit and in doing so, contribute to overcoming financial exclusion in which individuals and firms are denied access to various forms of financial products and loans for business start-ups and firms wanting to invest in developing their business activities. CDFIs work to a double bottom line by realizing social as well as financial objectives and can be defined as independent finance institutions that provide capital and support to empower individuals or organizations at the edge of commercial margins to develop opportunity and wealth in disadvantaged areas.

The UK New Labour Government's promotion of the Third Way's social and financial inclusion agenda, implies that it is advocating a retreat of the state as the UK system is shifting towards alternative forms of loan finance for both individuals and businesses rather then the provision of grants (Giddens, 1998). The UK is following the US model of making citizens responsible for their own welfare using public finance to support businesses that create jobs rather than directly supporting the unemployed. In spite of

[3] Deprived or disadvantaged areas are characterised by multiple indices such as poverty, high unemployment, low skills, poor health and housing, and a lack of geographical access to goods and services (Troni & Kornblatt, 2006).

dramatic economic change over the 20th Century, community finance has become instrumental in providing financial products and services to individuals and firms. For community finance institutions to remain viable in the long term they have to be innovative and diversify to adapt to changing policy market and economic conditions.

One solution to the enterprise finance gap in the US and UK has been developed and provided by Community Development Finance Institutions (CDFIs). CDFIs are an alternative vehicle for the supply of debt finance to financially excluded enterprises in deprived areas (Bryson and Buttle, 2005; Leyshon & Thrift, 1994; Mayo *et al*. 1998; Marshall, 2004; NEF and Nicholson, 2003). These institutions are involved in relatively high risk lending and consequently have to manage relatively high default rates. In many respects, CDFIs are an alternative to providing firms with grants. They use criteria developed in the mainstream financial institutions but modify them to target financially excluded enterprises and to include social criteria. Loans sanctioned by CDFIs are re-lent on repayment which multiplies economic wealth in the local community. In this way, CDFIs minimize risk and maximize social impact by operating revolving loan funds. This means that grant finance can be targeted at CDFIs as they will try to ensure that the funding they receive is re-circulated around the local economy. In this way, CDFIs could be largely responding to a set of policy objectives regarding financial exclusion and enterprise. This research aims to explore the different ways in which CDFIs operate to understand how effective they are in addressing financially excluded enterprises.

There is an unequal geography of CDFI provision as many CDFIs have been established by local volunteers rather than being the product of an organized movement to ensure equal access to CDFI services throughout the US and UK. High default rates and a gap in the provision of financial resources implies that CDFIs only contribute to overcoming financial exclusion in some parts of the US and UK. Due to their double bottom line, CDFIs are highly complex and so tensions within their operations will always exist. CDFIs must be financially viable and as such they do not finance extremely high risk business propositions. This means that financially excluded firms that operate below the lending threshold set by CDFIs will remain financially excluded. As such, one does not know the true size and scale of the finance gap. There is also self exclusion due to cultural norms such as firms that follow Islam and comply with Sharia law and the restrictions it places on interest payment.

The aims of the research are to:

1. Understand how ART provides access to finance and how it bridges the gap between fulfilling social objectives and economic purposes.
2. Define how CDFIs in the UK and US identify and measure effectiveness of socio-economic criteria that drive the business.
3. To compare ART with other UK and US CDFIs through benchmarking.
4. Consider the processes in which CDFIs become embedded in local financial and business support networks.
    - How effective are CDFI networks?
    - How do the networks operate and under what conditions?