BUILDING THE CASE FOR SOCIAL INVESTMENT IN CREDIT UNIONS

September 2016

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WE MUST HELP CREDIT UNIONS TO BECOME BIGGER, BETTER KNOWN AND EASIER TO ACCESS IF WE WANT THEM TO COMPETE EFFECTIVELY WITH HIGH INTEREST LENDERS.

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Executive Summary

In 2015, Big Society Capital and the Association of Credit Unions Limited (ABCUL), asked Social Finance to review the credit union landscape in order to understand the potential for social investment to help grow the sector and make it more sustainable.

Following an analysis of 25 credit unions, along with conversations with investors, Social Finance has concluded that there is an opportunity for social investment. At present, in the form of impact first debt investment, with potential to include patient equity in the future.

To broaden their appeal to social investors, credit unions need to better articulate their social impact and develop more financially sustainable growth plans. In addition, regulation allowing equity investment opportunities which are more attractive to investors should be developed.

Social investment covers a wide spectrum of activity in which capital is provided with the specific intention of generating a social and financial return. At one end of the spectrum, investors seek commercial investment opportunities with clear social purpose, while at the other end the investment is closer to philanthropy (albeit with the expectation that at least the principal amount would be returned). For all social investors, there is a distinct interest in the social impact that their money is able to achieve, and the understanding that the potential for this affects the relationship between risk and return. Social investment sits in a unique space within the financial landscape, with recent reports suggesting that there may be up to £1.5bn social investment in the UK, of which we estimate that approximately a third is still waiting to be deployed.[1]

Financial inclusion itself underpins a range of subsequent social benefits. Recent randomized control trials indicate that formal financial services such as microcredit, savings, insurance and mobile payments can have a positive impact on a variety of microeconomic indicators, including self-employment, business activities, household consumption and well-being.[2] Yet, historical investment in credit unions has been uncommon and limited to a small pool of investors who place a high value on social impact.

A partnership between credit unions and social investment should be natural: credit unions play an important role in providing a community finance alternative to mainstream banks and building societies, and in the process offer inclusive and affordable financial services to lower income individuals.

The majority of credit unions do not presently have funding issues, but they may experience challenges with capital reserve levels. What they are grappling with, is how to continue to lend as their asset base grows. Although this implies that there is no urgent need for extra

1 Big Society Capital report - https://www.bigsocietycapital.com/latest/type/research/size-and-composition-social-investment-uk

2 The Consultative Group to Assist the Poor, Impact Evidence Confirms the Benefits of Financial Inclusion http://www.cgap.org/news/impact-evidence-confirms-benefits-financial-inclusion

cash, it must be recognised that the challenge faced by credit unions is a lack of long term investment to help them address entrenched operational issues restricting growth, such as outdated IT infrastructure or marketing strategies. Investors should be willing to provide patient investments that allow credit unions to develop but that do not necessarily generate an immediate return.

Subordinated loans of 5–10 years in tenure have been approved to credit unions on a handful of occasions. These long term loans are a useful way of providing a credit union with access to sustainable capital for growth, as these loans must remain outstanding a minimum of five years to count towards regulatory capital. The investments we encountered in our research were made by investors who valued the (implied, if not explicitly reported) social impact of the credit union, known as impact first investors. Our research suggests that if credit unions could achieve a significant increase in member loan volume, without eroding the interest rate paid by borrowing members, there could be an opportunity for these types of instruments to be used by many more to support capital ratios during growth spurts.

Deferred shares are another means by which credit unions can raise cash outside the traditional deposits of their members. Our research did not uncover any examples of deferred share investments. We know that a few credit unions outside the 25 analysed have issued deferred shares. A deferred share is currently considerably less attractive to an investor than a subordinated loan.[3] While deferred shares are transferable, a shareholder would only be able to monetise them in very limited circumstances. But deferred shares should be viewed as the patient equity investment that credit unions need: an investment that enables the conservation of cash in the near term and allows the credit union to focus on growth. This highlights the case for regulatory shifts, which could create a more favourable landscape for investment in credit unions. The current requirement of a deferred share investor to become a member of a credit union prohibits investment funds from buying deferred shares. This would ideally be made more flexible (e.g. member of any credit union can invest in another credit union), with the lack of exits addressed by encouraging over-the-counter trading on secondary platforms.

Similarly, we believe that other incentives could be developed to attract investment into credit unions. These could include tax reliefs to individual investors (e.g. community credit union deferred shares qualifying for the existing Social Investment Tax Relief) and other investor groups. Additionally, sector regulatory changes could also increase the attractiveness of investment in credit unions. Our research suggests that total assets should be the main driver of capital adequacy regulation, which would allow the majority of credit unions to achieve a better capital adequacy position, and a better level of surplus generation year on year. The number of retail deposit holders in a bank is not the driver of its reserve requirements, and so it is not clear why the number of members is a driver for a credit union.

If these adjustments are made, capital flow could be stimulated. However, if credit unions are to engage with a wider spectrum of social investors—both more of the impact first investors and others—they will need to articulate, measure and report the long term social impact generated from their activities and expected by this type of investor. This should

3 A deferred share is akin to a repayable grant. It ranks most junior in the capital structure; the potential return is uncertain and it is in practice illiquid as it can only be sold to other credit union members or redeemed by the credit union itself.

incorporate a narrative explaining the need to focus on both higher and lower income loan members to safeguard surplus generation and sustainability. Reporting on impact would ideally be integrated into the IT infrastructure to reduce any additional work. It is hoped that the DWP's Credit Union Expansion Project (CUEP) and the related Transformation Project, explained in more detail in the following pages, could go some way to improving this infrastructure.

This report illustrates the circumstances in which a credit union could make use of social investment to further growth. This will require a combination of efforts from the credit union sector and from social investors. Credit unions must implement growth plans that include better loan penetration and credible business plans to support them, probably including a better use of technology, along with a robust demonstration of social impact. To appeal to a larger universe of investors and unlock further pools of money, credit unions and important stakeholders (e.g. the Association of British Credit Unions Limited (ABCUL) and Cornerstone, Big Society Capital, Prudential Regulation Authority, Big Lottery Fund, the wider social investment intermediary community and trading platforms) should work together to address both strategic and investment readiness questions, as well as improve the features of existing investment instruments (particularly deferred shares) to enable more patient capital for ambitious credit unions.

PRINCIPAL RECOMMENDATIONS:

- **Focus on sustainable growth and reported social impact:** credit unions seeking investment must develop clear, ambitious and viable growth plans (e.g. double-digit annual growth) with a sustainable mix of member demographic. Alongside this, clear social impact measures are needed on the clear social impact that credit unions have.
- **Investor understanding:** investors should recognise the long-term sustainability challenges faced by credit unions, their subsequent need for patient capital, and the key business areas in need of improvement (e.g. upgraded infrastructure, digital delivery channels, increased automation and improved local marketing strategies).
- **Policy-maker support:** policy makers and regulators should look to improve the attractiveness of existing investment instruments. This could include increasing the flexibility and financial attractiveness of deferred shares, and the creation of a tax relief suitable for credit unions.

1 Background

Credit unions are self-sustaining savings and lending businesses that create social impact through their provision of inclusive and affordable financial services. Yet despite this, there is limited evidence of external investment playing a significant role in scaling up individual credit unions or in increasing the sustainability of the credit union sector. In fact, our research shows that in the past five years, substantial external repayable investment has been brought to bear in only a handful of cases. Credit unions were set up, like deposit-taking retail banks, to be self-funding through their members' deposits. It can therefore prove challenging to find an attractive way for external investment to boost credit union expansion.

The obvious time for an external party to commit investment into any enterprise is at the point of growth. Historically, however, the timing of engagement with investors by credit unions has not been driven by a clear growth plan but a variety of reasons: adverse events, mergers, regulatory uncertainty and rapid balance sheet growth. The engagement with social investors might be made easier if it is planned and executed from a point of relative strength.

The DWP's Credit Union Expansion Project (CUEP) is currently working to deliver a sustainable, scalable and shared back office business model and banking technology solution for credit unions through Cornerstone, a subsidiary of ABCUL. This project is reaching several important milestones during 2016 and 2017. It will enable a growing number of credit unions to access a common online platform and automated credit referencing when processing applications. The shared platform affords interested borrowers the ability to immediately sign up to become a member in the local credit union and to apply for an unsecured loan. Credit unions that have implemented Cornerstone's previous Automated Lending Decisions (ALD) product have benefited from faster credit approvals or rejections, along with improved quality of the credit decisions and instant automatic loan disbursal. Additionally, the new online banking platform will also provide members with online access to their financial data in real-time, allowing them to make and receive payments online. The Transformation Project should enable every credit union to acquire and retain members in a way that has been difficult up to this point.

It is therefore important to ask if the coming of age of the Transformation Project, along with other projects focussed on improving online services, constitute an inflection point at which the use of external investment could support ambitious credit unions in scaling up and becoming increasingly sustainable.

In this report, we attempt tounderstand how these situtations might occur, and to understand: "**Does the need, instruments and investment case exist today for social investment in credit unions? Is it likely to exist in future? If not, what is missing?"** There are particular conditions where a credit union would be able to make use of social investment although we do not anticipate access to investment as a primary challenge for credit unions. The investors most likely to engage with credit unions at this juncture are local authorities and/or charitable trusts for whom social impact is a high priority.

2 Analysis: Financial Health of 25 Credit Unions

To assess the financial position of the credit unions within the CUEP, Social Finance analysed the business plans of 25 credit unions submitted to Cornerstone.

Membership of a credit union is based on a common bond. The bond can be working for a particular employer or in a particular industry, belonging to a certain association, living, working or studying in a specified geographical area or a combination of these. Of the 25 credit unions in our group, only one had a common bond based on a common employer. All others had a common bond based on common geography. All 25 had financial forecasts inclusive of financial year 2015/16 and 19 of financial year 2016/17.

The CUEP credit unions represent different sizes, and therefore must conform to different, escalating regulatory capital requirements.[4] For the purposes of this report, we have divided the credit unions into three groups or types:

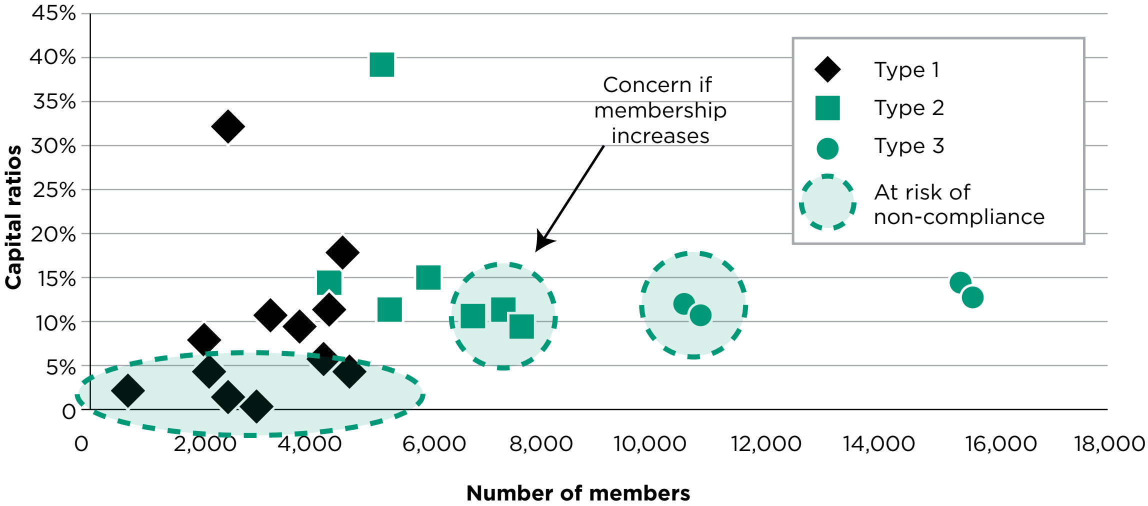
TYPE	ASSETS	MEMBERS	CAPITAL RATIO REQUIREMENT	NO. OF CREDIT UNIONS ANALYSED IN COHORT (N=25)
	Either/Or			
1	< £5m	< 5,000	3%	13
2	Between £5m and £10m	Between 5,000 and 10,000	5%	7
3	> £10m	> 10,000	8%	5

Our assessment focuses on five measures to assess the financial health of the credit union group: capital adequacy; cost to income performance; asset efficiency; bad debt performance and focus by customer group.

CAPITAL ADEQUACY

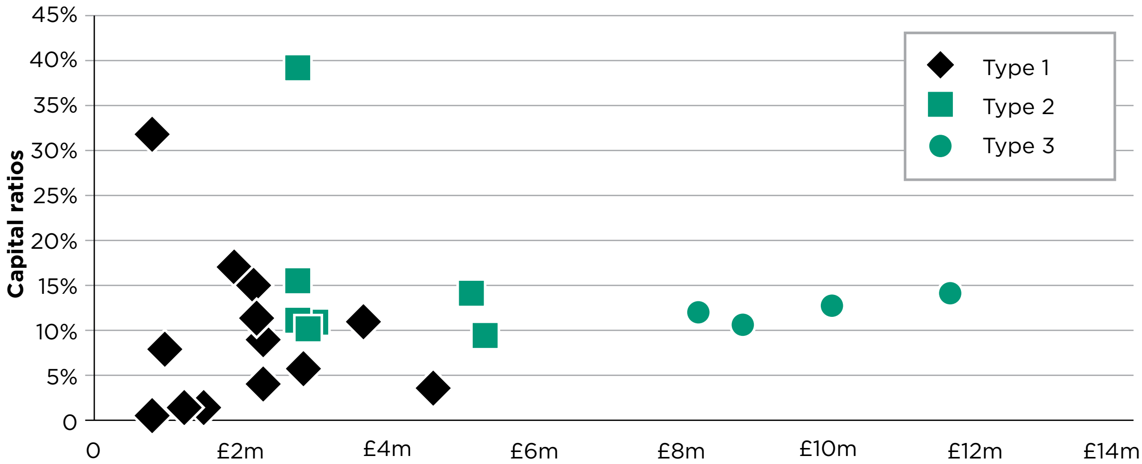
Based on the capital ratios of the 25 credit unions' reported business plans, 32% of credit unions are below, at or only just above their capital adequacy thresholds. 12% of the credit unions forecast financial projections that put them below the regulatory capital requirement and 20% close or below the requirement. This lack of financial headroom suggests that a third of the 25 credit unions find it difficult to generate surpluses consistently year-on-year.

4 On 3 February 2016, capital adequacy regulations changed for the third category of credit union (Type 3). As of this date, credit unions with more than £10 million in assets or 15,000 members, the minimum capital requirement is 8% plus a 2% capital buffer.



If capital adequacy were to be calculated on assets only,[5] most of the larger credit unions would be in a better capital adequacy position, as per the chart below.

2015/16 (f) Capital adequacy ratios vs assets



Historically, there has been a link between the number of members within a credit union and its total assets. Credit unions provided loans only on the basis of a member having saved with the credit union for a certain period of time, generally 26 or 13 weeks. Today, the link between the number of members and prospective borrowers and total assets may no longer be strong as credit unions are not enforcing prior savings as a precondition for a loan. The average loan amount may also vary considerably between credit unions. In effect, there is a case to argue that total assets should be the main driver of capital adequacy regulation. The number of retail deposit holders in a bank is not the driver of its reserve requirements, and so it is not clear why the number of members is a driver for a credit union. The data

5 There are only 24 CUS as the employer based credit union is an outlier

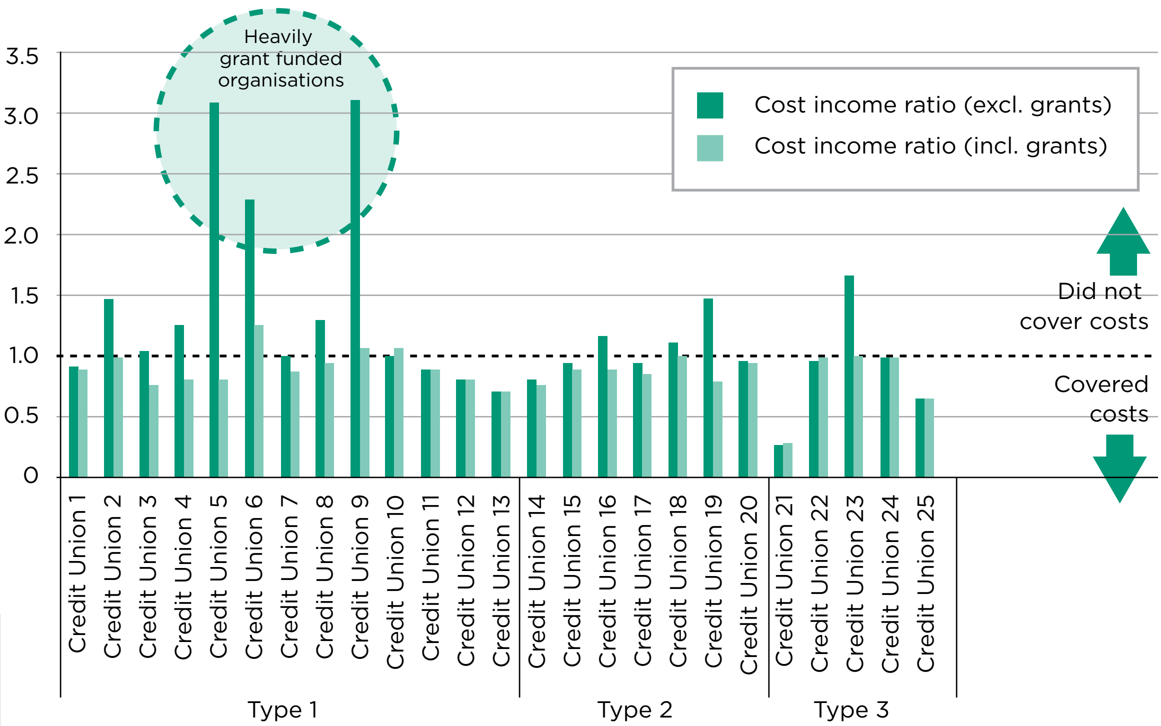
analysis also suggests that the reason why a credit union graduates into a higher capital ratio category is the expanding membership number, not the total assets threshold.

- **12% of credit unions are below their capital adequacy thresholds.**
- **The main driver of level of regulatory capital ought to be total assets.**

COST TO INCOME

The cost to income ratio looks at the proportion of costs that are covered through earned income. A ratio higher than one demonstrates that a credit union does not completely cover its costs through income generation. Social investment would not be suitable for those with cost ratios above one or close to one, as there would be limited surplus to service debt and repay the external investment – unless of course the cost to income ratio investment itself could contribute to revenue growth and/or cost reduction through improved operational efficiency.

Some of the smaller credit unions in the cohort are heavily grant dependent. Not surprisingly, due to the fixed nature of a proportion of operating costs, larger credit unions are more likely to cover costs before grants are taken into account: The average cost to income ratio for larger (Type 3) credit unions (excluding grants) is 0.9 whereas the same ratio for smaller (Type 1) is 1.5 (although this ratio is skewed due to the effect of three specific, explicitly grant-dependent credit unions). For Type 1 credit unions the cost to income ratio



	Type 1	Type 2	Type 3
AVERAGES	Excl. grants: 1.5 Incl. grants: 0.9	Excl. grants: 1.0 Incl. grants: 0.9	Excl. grants: 0.9 Incl. grants: 0.8
	31% covered costs before grants	**43% covered costs before grants**	**60% covered costs before grants**

falls below 1 only when grants are added. Based on this evidence it is likely that larger credit unions would be better placed to use social investment to boost growth. Again, an impact first investor's contribution could be instrumental in providing the confidence to pursue more mergers and thereby improve cost: income ratios.

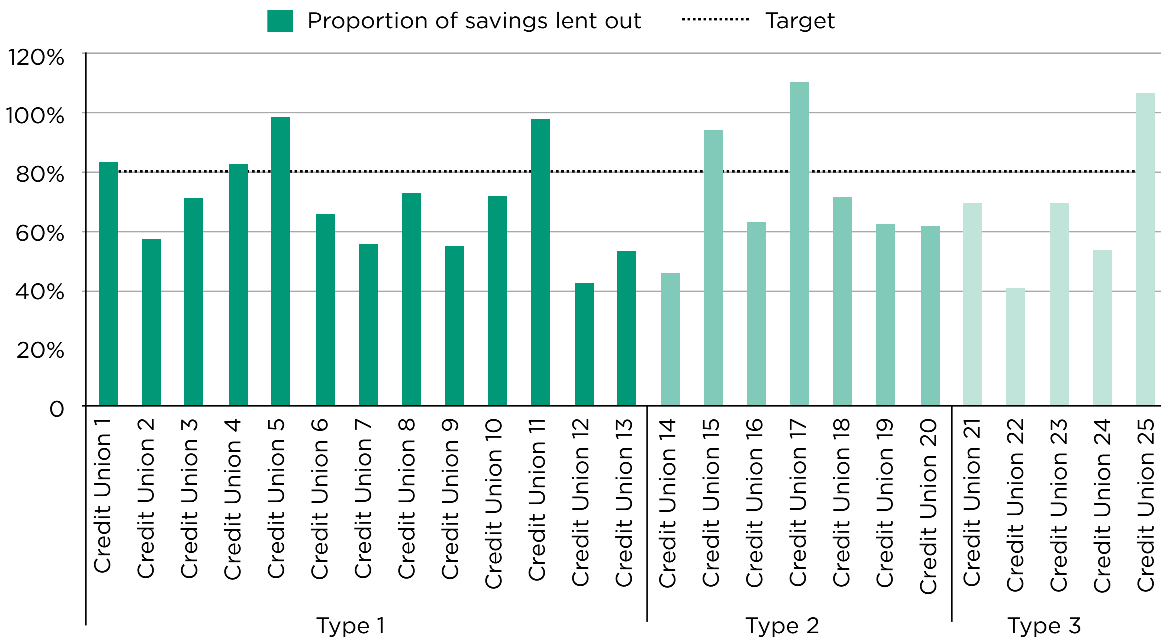
INVESTMENT COULD BE INAPPROPRIATE FOR THOSE WITH COST RATIOS ABOVE OR CLOSE TO ONE, AS THERE WOULD BE LIMITED SURPLUS TO SERVICE AND REPAY THE EXTERNAL INVESTMENT.

ASSET EFFICIENCY (LOANS TO ASSETS)

The loans to assets ratio depicts loans outstanding as a proportion of total assets. 70-80% is a target set by the World Council of Credit Unions. Additional income can be generated by increasing this ratio, and given the low interest rate level currently, creating close to no income from deposits results in a very low return on cash assets and overall low absolute earned income.

Only 7 of the 25 credit unions reviewed were expecting to hit the industry target of 80% loans to assets ratio, and 11 of the 25 reviewed were achieving 70%. The credit union interviews we conducted also confirmed that the ability to lend more in order to generate earned income was a concern for almost every management team we spoke to.

For many credit unions, it is critical to increase their loans to assets ratio to generate more income whilst avoiding a significant deterioration of credit quality. As such, credit unions believe it necessary to access more Tier 2 borrowers and see payroll deduction through local employers as a key channel for their financial products. Payroll deduction is also a means to monitoring and maintaining credit quality whilst saving back office processing costs.



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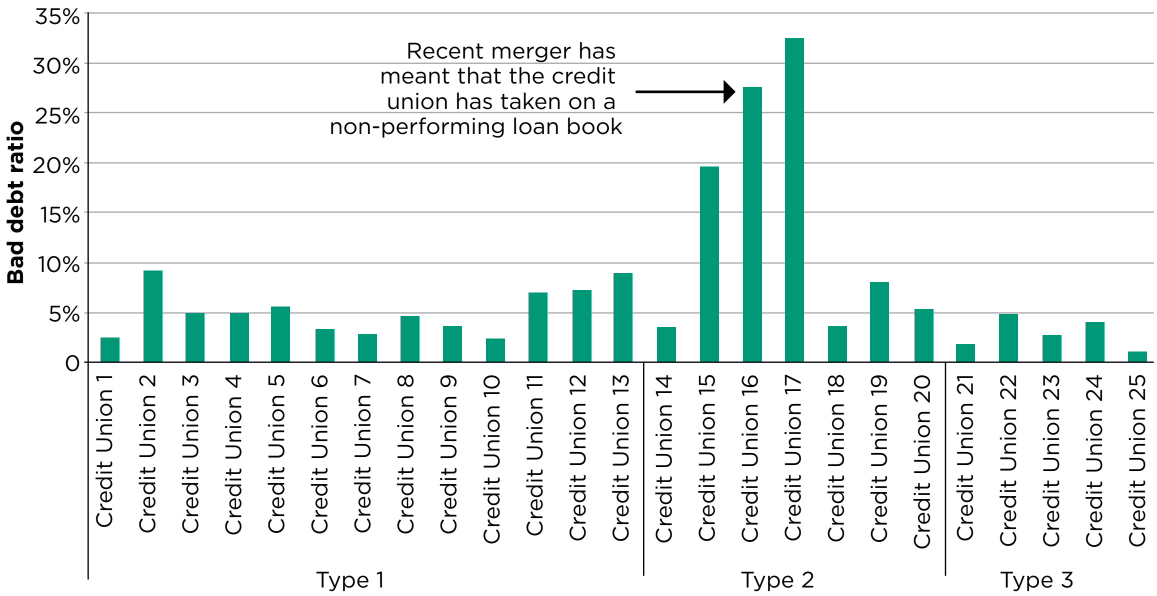
WRITTEN OFF DEBT

Bad debt across the data set stands at around 5% for the 2015/16 forecasts, with 88% of credit unions experiencing bad debt levels below 10%.[6] Forecasts for 2016/17 show similar levels of bad debt across the sector.

In comparison to the wider market, a bad debt level of 5% is comparatively low. The write-off/provisions rate experienced by the personal lending Community Development Financial Institutions would be considerably higher at 13.6%.[7] When expanding the loan book there is a risk that write off rates will go up: as such, credit unions may need to be prepared to take on more risk in their lending. However, this may still be acceptable, provided overall profitability grows.



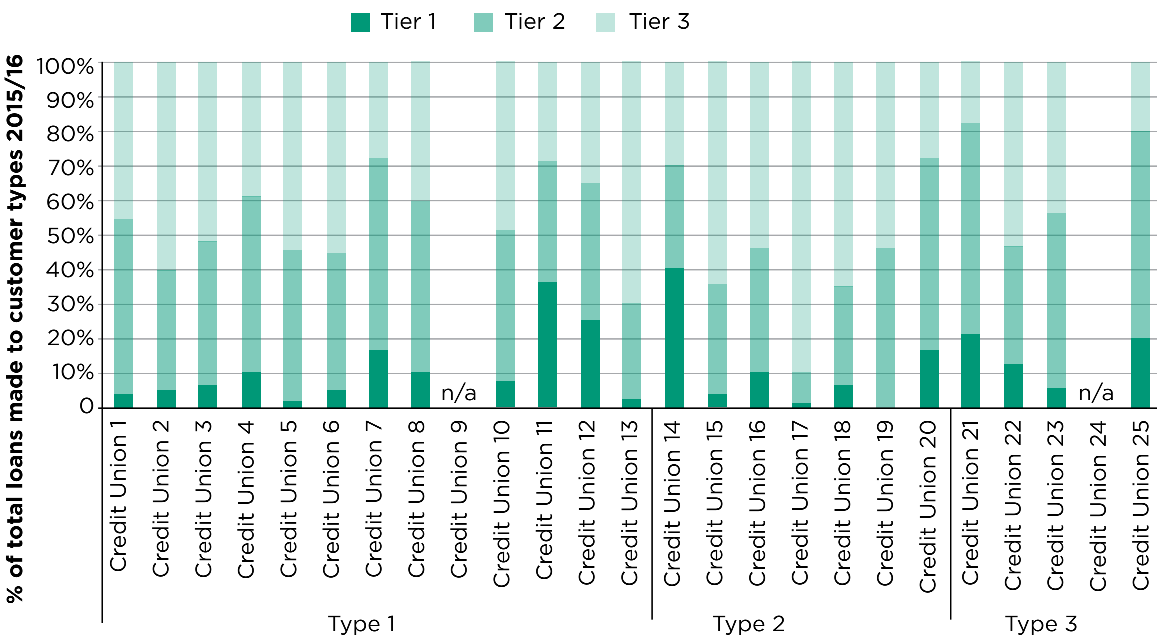
BAD DEBT LEVEL OF 5% IS LOW COMPARED TO OTHER LENDERS SERVING SIMILAR DEMOGRAPHIC GROUPS.

6 One of the credit unions with high bad debt rates had recently taken on another credit union via a merger and so had had to make significant provisions for bad debt in its loan book.

7 Responsible Finance report of December 2015.

LOANS BY CUSTOMER GROUP

The credit unions in the sample disburse loans (by value) almost exclusively to Tier 2 and Tier 3 customers, demonstrating a focus on the less wealthy member segment.[8] 19 out of 23 credit unions for which data was available disburse more than 80% of their loans (by £) to Tier 2 and 3 customers.[9] If the same data were available for number of loans, the proportion of loans disbursed to the Tier 2 and 3 customers would be even higher. The data indicates that even larger credit unions remain clearly wedded to the Tier 2 and 3 customer groups.



19 OF THE 23 CREDIT UNIONS IN THE SAMPLE LEND MORE THAN 80% BY VALUE TO TIER 2 AND 3 MEMBERS.

8 See Appendix for classification details

9 One of the four not included in this group is an employer based credit union where it is natural to have more Tier 1 loan members.

KEY MESSAGES

Credit unions have fallen in number from c.450 to c.350 (primarily as a result of mergers but also due to liquidation) in the last five years. Credit unions play a critical role in increasing financial inclusion, serving some of the most financially excluded groups in society. This is evident from the strong focus on lending to Tier 2 and Tier 3 members (households with an annual income of below £15,000 and between £15,000 and £30,000, respectively). Credit unions are also an alternative to bank savings for more mainstream customer groups, their not-for-profit status allowing them to offer attractive rates and fewer fees.

Despite their relevance, credit unions are struggling to lend, with only 7 of the 25 reviewed hitting the industry target of 80% loans to assets ratio. Their wealthiest segment (Tier 1 members) rarely borrow from their credit union and therefore rarely contribute to earned income. To add to this conundrum, credit union bad debt rates are low, at 5% on average. This suggests that credit unions are very prudent compared to other lenders at this end of the market. Despite this prudence, 32% of credit unions are below, at or only just hitting the capital adequacy thresholds on current business plans. This seems to be because many are running costs that are higher than income levels (excluding grants), reflecting the failure to disburse enough revenue generating loans. Insufficient revenues relative to the cost base may be eroding core capital but many credit unions have been, and some are still, topping up the shortfall with grants. However, grants are increasingly drying up, demonstrating the need for alternative sources of capital.

Social investment from impact first sources could help remove some of the pressures experienced by credit union management teams and give them greater confidence to "go for growth" by acquiring more loan members. In the sections of the report which follow, we explore the challenges faced by credit unions in further detail, and draw out some opportunities for social investment to intervene.

3 Operating Challenges

The assessment of 25 business plans indicates that the majority of credit unions are struggling to disburse the funding provided through their membership and savings accounts. This is backed up through conversations between Social Finance and ten credit unions, of which nine had surplus loan capital and did not sense that they could push lending up to the recommended 80% loans to assets ratio without considerable effort or risk to their write-off statistics.

WHY DO CREDIT UNIONS FIND IT CHALLENGING TO DISBURSE LOANS AND INCREASE EARNED INCOME?

There are several factors that make it difficult for credit unions to achieve the recommended ratio. On the funding side, the interviewed credit unions confirmed that they had benefitted from a higher public profile after the media attention surrounding the Archbishop of Canterbury's comments regarding Wonga.com and his general criticism of payday lenders in 2013. Some of the credit unions we spoke to indicated that they had seen a heightened membership take-up from wealthier Tier 1 and 2 customers during this period of media focus.

> "WE MUST HELP CREDIT UNIONS TO BECOME BIGGER, BETTER KNOWN AND EASIER TO ACCESS IF WE WANT THEM TO COMPETE EFFECTIVELY WITH HIGH INTEREST LENDERS… WE CAN BEGIN SIMPLY BY SAVING SOME MONEY WITH OUR LOCAL CREDIT UNION, USING THEIR SERVICES AND ENCOURAGING OTHERS TO DO THE SAME."
>
> Archbishop of Canterbury Justin Welby, 2013

On the lending side, credit unions have found that wealthier saver members tend not to take out loans from the credit union and thus do not contribute to earned income. Conversely, a business model relying predominantly on loans to Tier 3 households is unsustainable. As such, there has therefore been a focus on Tier 2 households in recent years. To attract Tier 2 households as loan members – individuals who are used to online or mobile access to financial data and quick, comparatively impersonal decisions and service – credit unions find that their current product offering and distribution channels are not always appropriate. To access Tier 2 members more generally, online access is vital.

Digitalising current services is also critical for credit unions to access another valuable group of prospective savers (and borrowers) through payroll deduction partnerships with local employers. The roll out of the Transformation Project along with other similar projects aimed at increasing the digital offering of credit unions during 2016 has the potential for a hugely positive impact on business models. Yet, to utilise the Transformation Project to its fullest, and make use of the cost per member that is charged to the credit union, it will be necessary for management teams to invest in business development by, for instance, acquiring payroll deduction partners among local employers.

There are at least three levels of payroll partner engagement that credit unions must aim for:

1. achieving the buy-in of top management of the local employer;
2. ironing out any issues with the employer's payroll department or any company providing outsourced payroll services; and
3. persuading individual employees of the merits of credit union membership and savings and loan products.

Each of these levels is complex and time consuming, and all require marketing and influencing skills. Several credit unions, potentially co-ordinated by Cornerstone, could pool resources in order to invest in Customer Relationship Management (CRM) tools and systems.

Some credit unions within the Transformation Project are biding their time and not yet making significant resource investment into business development. It is only when the project platform has become operational in 2016, and tested for robustness for a while, that these credit unions will start re-focusing on employer partners in their geography.

For a credit union to be able to offer interest on membership accounts, it can often be considerably less expensive to increase the attractiveness of existing savings products rather than consider external investment. Currently, London Mutual Credit Union is experiencing its lowest levels of loans to assets, with just over half of its total savings lent out. Earlier in 2016, it stopped accepting new ISA applications from its members. For London Mutual, increasing the interest rate on its ISAs, Junior ISAs or potentially some other savings accounts by a mere 1%, could increase funding significantly. Whilst such funding is likely to cause initial deterioration in London Mutual's capital ratios, it is considerably more affordable than external funding.

"WE HAVE TOO MUCH MONEY AT THE MOMENT. OUR STARTING INTEREST RATE ON OUR CASH ISA WAS 3% AND WE HAVE ATTRACTED A LOT OF MONEY... WE MAY LOWER THE INTEREST RATE ON OUR CASH ISA TO 0.75% AER"

Lucky Chandrasekera, CEO, London Mutual Credit Union, December 2016

EXAMPLES OF CREDIT UNIONS MAKING USE OF INVESTMENT

There are a handful of examples of credit unions which have thus far made use of external funding: Bristol Credit Union, Eastern Savings & Loans, London Capital and Riverside (attempted). In the case of Bristol Credit Union and Eastern Savings & Loans, the investments were priced at advantageous interest rates and probably not wholly on a commercial risk-return basis.

CREDIT UNION	TYPE OF INSTRUMENT	AMOUNT AND TERMS	PURPOSE	COMPLETED
Bristol	Subordinated loan	£75,000 for 10 years	Capital ratio support in growth phase	Yes
Eastern Savings & Loans	Subordinated loan (term and evergreen)	Total of £65,000 combination of 10 years and evergreen	Capital ratios in a merger	Yes
Riverside	Bullet loan, would have qualified for regulatory capital	£250,000 matched by £250,000, both over ten years	Shortage of loan capital	No

BRISTOL CREDIT UNION: SUPPORT TO CAPITAL RATIOS DURING A GROWTH PHASE

In September 2009, ahead of the drastic reduction in the base rate in late 2009, Co-op and Community Finance (a CDFI) extended a £75,000 10-year subordinated loan to Bristol Credit Union (BCU) at 0.5% above the base rate. This loan is still outstanding though it is now being written down from capital as required by the PRA. The loan supported the capital ratio when BCU developed into a larger credit union.

BCU is considering further opportunities to secure similar capital support in order to maintain asset growth, albeit the same interest level is not likely. BCU's experience of the subordinated loan has been entirely positive, and BCU would consider using such external investment again should (a) the regulatory capital ratio requirement be further raised or (b) if BCU decided to pursue significant expansion.

EASTERN SAVINGS & LOAN: SUPPORT TO CAPITAL RATIOS IN CONNECTION WITH SEVERAL MERGERS

Following a merger with Norfolk Credit Union and subsequently Cambridge City Credit Union, Eastern Savings and Loans sought support from Big Local and a local authority to ensure adequate capital ratios following the merger. Two subordinated loans were agreed: a 10-year term loan and an evergreen. The interest level was set at the greater of 1% or 1% above the dividend rate.

RIVERSIDE CREDIT UNION (ATTEMPTED)

Riverside Credit Union in Liverpool was seeking loan capital to be able to expand its lending. Whilst initially successful in securing a commitment from an impact first lender, finding the required match funding proved much harder. Other potential co-investors were seeking security or created complicated structures that the management of Riverside did not feel were suitable for a community credit union. In the end, Riverside has accepted that its catchment area is not affluent and that finding savings for onward lending is challenging. Credit rationing remains necessary on an annual basis.

OPERATING CHALLENGES: KEY CONCLUSIONS

It is clear from our analysis that credit unions are still experiencing challenges with capital adequacy during periods of growth. With a surfeit of deposits, seeking external investment may seem unnecessary. However, an injection of capital could soon be turned into revenue generating loans, if it were to be used to tackle operational challenges head on.

Subordinated loans, or similar, may give management teams the comfort to meet the challenges without worrying about capital adequacy or write-off levels too much. There are opportunities for growth, the mobilisation of which could be supported by investment from social investors. We have outlined below some potential avenues to growth in which external capital could be used:

- **Boosting loan membership growth:** Among those credit unions that have signed up to it, the Transformation Project is an important mechanism for enabling credit unions to generate more revenue through online access for customers.
- **Payroll deduction partnerships:** Credit unions with a geographic common bond could seek to emulate an employer credit union by signing up one or several local employer partners.
- **Product offering:** Credit unions can aspire to disburse larger loans to Tier 1 customers, e.g. 1st and 2nd charge mortgages, secured car lending, credit cards and revolving credit.
- **Consolidation:** Merging is the obvious way of addressing a high fixed cost base relative to revenue potential.
- **Cost base:** Collaboration on marketing spend, treasury functions and investment management activities can generate further operational savings.

4 Social Investor Perspectives

INVESTOR UNIVERSE

We interviewed 13 social investors in order to better understand their perspectives on the credit union sector. We segmented them into two categories: seven impact first charitable trusts and foundations and six financially-minded social banks and social impact funds.

IMPACT FIRST INVESTORS: CHARITABLE TRUSTS AND FOUNDATIONS

In the past, charitable trusts and foundations have been strong supporters of credit unions through grants. However, only a few of them have had either applications from, or conversations with, credit unions about repayable capital. For example, Tudor Trust provided 40 grants to 32 separate credit unions during 2002-12, with a total disbursement of £1.9 million. Tudor Trust has made no investment into a credit union.

If credit unions are to engage with charitable trusts and foundations in order to achieve investment as opposed to grants, the key to success will be the credit union's ability to demonstrate that the prospective investor's social mission is successfully addressed by the credit union. Any investing activity by the charitable trust or foundation must ultimately serve the mission of that organisation (through so-called Mixed Motive or Programme Related Investment). All seven charitable trusts and foundations we spoke to are currently focussing, or have in the recent past focussed, on financial inclusion, but seek to use their investment funds in slightly different ways:

	Charitable trust and foundation	Min interest/ annualised return	Impact goals
1	Barrow Cadbury	Variable	Criminal justice, migration, resources and resilience (includes financial inclusion).
2	Esmée Fairbairn	Lower single digit	Invests in its grant funding priorities (arts, children and young people, environment, social change, food).
3	Friends Provident	Lower single digit	Current funding programme entitled "Building Resilient Economies". It aims to contribute to a more resilient, fairer and sustainable economic system.
4	Joseph Rowntree	Variable	Social change through research, policy and practice.
5	Local Trust (Big Local)	Nominal (e.g. 1%)	To enable residents to make their communities and their areas even better places in which to live.
6	Panahpur	Variable	Making positive change through impact investment. Panahpur's portfolio contains investments in clean energy, social housing, microfinance, the Social Stock Exchange, Social Impact Bonds and sustainable manufacturing.
7	Tudor Trust	Variable	Wants to help smaller, community-led groups which are supporting people at the margins of society.

Source: Websites or annual reports

Given the comparatively broad range of social focus, and the specific impacts that need to be achieved and reported on, it may prove difficult for a credit union to satisfy all charitable trusts and foundations' social impact ambitions. Their motivations and expectations vary. For some of the above investors, the social impact metrics based on cross-subsidisation of the delivery of financial products to lower income (Tier 3) members through an increased number of wealthier (Tier 2) members would be acceptable. After all, Tier 2 members with a household income of between £15,000 and £30,000 can in many geographies in the UK be viewed as vulnerable.

However, a handful of charitable trusts and foundations will require further persuasion to make an investment. For instance, an investee credit union would need to develop a a cogent narrative as to how the credit union investment is "disruptive"; addresses poverty and strengthens "community-led groups"; or builds "resilient economies".

FINANCIALLY MINDED: SOCIAL BANKS AND IMPACT FUNDS

Traditionally, voluntary and charitable sector organisations will have been able to access debt financing predominantly through secured loans. Over the past decade and a half, more providers of unsecured debt to voluntary and charitable sector organisations have emerged. The two social banks mentioned below do limited unsecured lending, whereas unsecured lending is the main business of the other four investors. While these investors deploy their capital in social sector organisations and report on the social impact of their funds/ investments, they apply a risk-return lens as well.

The majority of the organisations below are funding or have invested in one or more Community Development Finance Institutions (CDFIs) (e.g. Big Issue Invest, CAF Venturesome, the FSE Group and Unity Trust Bank) and are therefore familiar with the cost of delivering unsecured loans and other financial products to a less affluent client base.

	Social bank / social impact fund	Assets Under Management (£m)	Impact goals
1	Big Issue Invest (BII)	30	
2	CAF Venturesome	50	
3	Charity Bank	114	Agreed up-front at the time of investment; regular reporting on impact achieved
4	FSE Group (Social Impact Accelerator)	11	
5	Social and Sustainable Capital (SASC)	50	
6	Unity Trust Bank	831	

Source: Company annual report or website

Whilst the above investors have funded CDFIs, they are unfamiliar with credit unions. At first glance, the interest rate cap of 3% per month was perceived as low and potentially not enabling the credit union to price a member loan according to risk or to generate surpluses.

BII, the FSE Group and SASC are all active investors. For them, subordinated debt which must remain outstanding for five years in order to fulfil a regulatory purpose is unattractive in case the credit union experiences adverse trading conditions. These investors would prefer to be able to accelerate the repayment of debt in such a situation. For the credit union, on the other hand, the acceleration of repayment would disqualify the investment from regulatory capital: the subordinated debt would no longer support the capital ratio.

For credit unions, the ideal investor would find the social issue of financial exclusion compelling and therefore be prepared to accept a return that is not necessarily calibrated against financial risk. An ideal investor would also not require acceleration in the recovery of its capital if the credit union's trading environment deteriorates. Both of these traits point to charitable trusts and foundations as the most natural choice.

MEASURING AND REPORTING IMPACT: WHAT IS NEEDED?

Credit unions have so far not collected information on or reported much by way of social impact. In our conversations with credit unions, it was clear that all had information on household income of loan members, but not all had collected such information for their saver members. Where data had been collected, it was sparse and varied from credit union to credit union.

With online automation increasing through the Transformation Project and other tools, collecting and reporting social impact statistics should be more easily achievable and not cause management or staff significant additional work. Community credit unions already have one route into reporting, their common geographic bond, which allows for reasonably easy data against which to make comparisons. For some credit unions, post code information could act as a proxy for information as to whether members/borrowers were from affluent or vulnerable communities.

It is clear that for social investors, systematic collection and reporting of social impact is critical as the achievement of social goals goes to the core of their motivation. Social impact funds, social banks and charitable trusts and foundations would most likely request an investee credit union to supply all or a proportion of the below information annually, as well as request that the credit union make a prediction of the total impact to be achieved during the term of the investment.

TYPE OF DATA	SPECIFIC EXAMPLES	RATIONALE
Minimum reporting statistics	• Membership by household income • Loans by household income • Membership, loans by post code	Evidence of continued service to Tier 3 customers – in absolute and relative numbers
Hypothetical counterfactual	• Cost of credit (in absence of credit union) • Savings that have been made, and potentially spent in local economy	Evidence of the savings/benefits achieved by the credit union
Specific initiatives	• Initiatives for vulnerable groups (e.g. ex-offenders, current offenders, single mothers)	Evidence to charitable trusts and foundations (in particular) of the continued focus on vulnerable groups

INVESTORS: KEY CONCLUSIONS

Social impact reporting will be crucial if investment is to be achieved – first at the point of investment and then periodically thereafter. Investors look to understand what social impact their investment will achieve. Impact first investors (e.g. charitable trusts and foundations, local authorities) want assurances that a specific social issue is being addressed by the investee, while a financially minded investor would like to actively manage its investment, and may therefore find subordinated debt unattractive. Whomever the investor, it is clear that social impact reporting will need to ideally become built into the operating structures of credit unions so as to minimise extra work and provide key statistics.

5 External Investment – How Could It Help?

TWO PRINCIPAL INSTRUMENTS: SUBORDINATED DEBT AND DEFERRED SHARES

Whilst financial support to a credit union could take the form of savings deposits, loans from one credit union to another, asset-backed loans and, in a fashion, even pooled treasury functions across credit unions, our analysis on additional external investment has focussed on debt and equity, or in the credit union context, on subordinated debt and deferred shares, respectively.[10]

Subordinated debt is debt that is junior to members' deposits in their membership accounts. Only those subordinated loans with a minimum original term to maturity of five years can be included in the calculation of regulatory capital. Subordinated debt counts towards regulatory capital according to a decreasing scale of: 5 years outstanding (100% of principal); 4 years outstanding (80%); etc. Subordinated debt may be term or evergreen debt. If the latter, the provider of the capital can enable the subordinated debt to remain outstanding until it "calls" the principal and "breaks" the evergreen feature. When the principal is called, the debt will need to remain outstanding for five more years in order for the evergreen instrument to contribute to regulatory capital.

Evergreen subordinated debt in the hands of a supportive investor provides flexibility in terms of the timing of repayment and therefore some comfort in terms of the ability of the credit union to maintain healthy capital ratios. As long as the evergreen feature remains intact, 100% of the principal will count towards regulatory capital.

Deferred shares are perpetual capital instruments which can only be bought back by the credit union with the authority of the regulator and must not be offered or sold to investors on the basis that this is expected or promised. Deferred shares can pay a discretionary dividend return or a guaranteed interest rate return – in the case of the latter the credit union needs at least 5% capital reserves (i.e. capital excluding subordinated debt) and confirmation from its auditor that it is in a position to pay this. Deferred shares may be transferred between members only and can be redeemed by the credit union.

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10 The first three forms of financial support are comparatively well known already, and the pooled treasury function concept has been the focus of a separate analysis by Barclays.

In summary, seen through a commercial lens, subordinated debt is somewhat risky as it is unsecured and its repayment cannot be accelerated if the credit union is experiencing adverse trading conditions. Deferred shares, again, resemble a donation (unless the credit union is able to pay a financial return on the shares). It is not an "investor friendly" instrument in its current incarnation. During the course of our research, we were not able to identify an example in which an investor agreed to purchasing deferred shares in a credit union.

The table below briefly compares the main features of the two instruments.

	SUBORDINATED DEBT	DEFERRED SHARES
Ranking within asset class	Member shares have preference	Member shares have preference (Pari passu with subordinated debt)
Term	Minimum 5 years to provide regulatory capital benefit	Indefinite
Regulatory capital	Yes, provided term is minimum 5 years	Yes
Interest / Dividend	Negotiated with lender	Discretionary dividend or guaranteed interest return
Other relevant features	The effect on regulatory capital is tapered	Requires PRA approval to be redeemed; can only be transferred between members
Overall assessment	Unsecured; therefore comparatively risky debt for the lender	Akin to a donation with uncertain yield and some potential for redemption

SUBORDINATED LOAN: POTENTIAL SCENARIOS FOR SUCCESSFUL USE

To test the conditions under which credit unions could successfully use a subordinated loan to invest in business development and thereby grow Tier 2 membership and borrower base, we created an illustrative model based on two credit unions (one small, one large) from our sample of 25. Both credit unions are taking on an 8-year, soft-bullet, 5% subordinated loan. Both credit unions are participating in the Transformation Project/CUEP.

Our aim with this model is to understand under what Tier 2 loan volume and loan pricing assumptions such a subordinated loan could be repaid. We stress that the examples are based on one set of assumptions about growing and mining the Tier 2 membership base. In reality, each credit union will have a unique set of pricing and volume assumptions to inform them of their ability to service their subordinated loan.

The fees for participating in the Transformation Project are charged as a per member fee. This means that in order to utilise the Transformation Project to its full effect, a credit union needs to mine its existing Tier 2 customer base better, or significantly grow its loan membership (members who also become borrowers).

An investor deploys repayable capital in order to enable growth and with a view of receiving that investment back, assuming that the capital will enable a credible growth trajectory in the investee. The premise of our scenario analysis is thus that growth in the number of Tier 2 "payroll" borrowers can bring about a more sustainable, stronger credit union. The narrative involves the following steps:

1. As Tier 2 membership grows, the number of Tier 2 members taking loans grows proportionately;
2. A better mix of members can enable credit unions to make less risky, longer term and higher value loans – thus enabling growth in revenues;
3. This growth is not at the expense of enabling access to finance for Tier 3 customers who want to take smaller loans. On the contrary, a larger number of Tier 2 loan customers should strengthen the credit union's ability to serve Tier 3 customers; and
4. Could external investment support the growth of Tier 2 membership by 25% year-on-year growth (during 2017-19), while the rest of the membership grows at 2%? The proceeds of the external investment raised would go towards activity that would generate Tier 2 loan growth, e.g. business development staff working on recruiting payroll partners.

To test this scenario, we looked one small (Type 1) and one large credit union (Type 3). We also wanted to understand the boundaries regarding the ability of the credit union to (a) grow its Tier 2 membership numbers; (b) penetrate its Tier 2 membership base with loans (annually); and (c) price the Tier 2 loans competitively. In other words, what do investors and credit union management need to believe about the credit union's ability to grow the loan book without eroding loan pricing?

Tier 3 customers are comparatively price insensitive customers as they have limited choice. Tier 2 customers, on the other hand, are a more mixed group which is likely to be much more aware of interest rates charged and compare and contrast the cost of credit with other options such as, say, unsecured credit from retailers, credit card providers or even pay-day loan providers.

KEY ASSUMPTIONS

Our starting point for the two credit unions is the key features of their businesses (through data submitted to Cornerstone):

Credit Union	Members	No. of members by Tier 1	Tier 2	Tier 3	Assets	Reserves	Loans to members outstanding	Member shares	Capital ratio
Type 1 (small)	4,000	200	600	3,200	£2.9m	£215k	£1.0m	£2.5m	8%
Type 3 (large)	17,700	400	2,000	15,300	£10.7m	£1.1m	£3.2m	£9.7m	11%

Notes: Cornerstone forecast data as at September 2015 (small credit union) and September 2016 (large credit union).

To model future revenue, we made assumptions regarding the type of loans that the model credit unions will make and how large the membership deposit balances will be. The current business assumptions are rooted in conversations with Cornerstone and the research project steering group:

Customer group	Average loan size [1]	Average term (months) [1]	Interest rate [1]	Write offs (as £ of annual capital disbursed) [1]	Average deposit amount [2]	% of members taking a loan each year [3]
Tier 1 (HH income >£30k)	£5,000	36	1% per month	2%	£2,500	17% / 15%
Tier 2 (HH income £15k–£30k)	£2,500	24	1.5% per month	3%	£1,500	25% / 23%
Tier 3 (HH income <£15k)	£500	12	3% per month (set at cap)	8%	£250	50% / 46%

Notes:

1 Conversations with Cornerstone and the research project steering group;

2 Credit Union deposit information was provided by Cornerstone and weighted according to the number of members a Credit Union had in each Tier; and

3 Extrapolated from 2015 data on the value of loans outstanding per Tier, the average loan size per Tier and the number of members per Tier. The first percentage is for the smaller Type 1 credit union, the second percentage is for the larger Type 3 credit union.

SMALL AND LARGE CREDIT UNION – SIGNIFICANT INCREASE IN TIER 2 MEMBERS AND LOANS

Our 2017–25 forecasts assume that both credit unions can grow their Tier 2 membership significantly and therefore also their Tier 2 loan book, applying our base case assumption of 1.5% monthly interest rate (c.19.6% APR). Clearly, should the credit union be able charge a 2% monthly interest rate (c. 26.8% APR), the financial position of the credit union would be commensurately better.

Tier 2 members	2017	2018	2019	2020	until	2025	Difference (2025 – 2017)
Small	777	971	1,214	1,238		1,367	590
Large	2,495	3,119	3,898	3,976		4,390	1,895
Tier 2 loans							
Small	194	243	304	310		342	148
Large	574	717	897	915		1,010	436

Both credit unions are able to maintain a dividend of 1%, repay the external 8-year investment and maintain their capital ratios under the base case assumptions indicated above. The way the instrument is structured it will also assist in boosting the credit unions' capital ratio.

SENSITIVITY ANALYSIS

On our assumptions, repayable capital can be considered an option for the **small credit union** if:

(a) it can grow its Tier 2 membership by 10–25% p.a. for three years; **and**

(b) Tier 2 loan pricing can remain between 1.5% and 2.0% per month (and the loan penetration rate among members remains fixed at 25%); **or**

(c) Tier 2 members taking a loan each year in 2017–19 is 25–30% (and pricing fixed at 1.5%).

For the **large credit union**, the conclusions are the same, although the loan penetration percentage could be somewhat lower at 20–30%.

For further information on the sensitivity analysis, please see Appendix D.

Tier 2 customers are likely to be price sensitive due to the comparatively larger number of options they may have. The assumption that 25–30% of Tier 2 members would take out a loan every year is an important assumption. Other assumptions regarding loan penetration are much higher at 80%. If such high figures are achieved, then interest rates could potentially be set at lower levels.

A few conversations suggested that some segments of the Tier 2 and definitely Tier 1 loan members were price elastic. In these specific examples, single digit APRs were needed to enable loan volume growth among employed members:

- In September 2015, London Mutual started offering two new loan product variants, Gold and Platinum. These were offered from £5,000 to £15,000. Successful applicants could borrow at 5.9% with a gold loan and at 6.9% with a platinum loan over a term lasting 6 to 60 months;
- In December 2015, Bristol Credit Union decided to expand its payroll lending in the New Year. Loans were going to be offered at 4.9% APR, 300 basis points lower than the lowest normal rate. These loans were aimed at Tier 2 individuals and above, and were very successful in raising loan volumes through employer partners by over 1,500% relative to the previous financial reporting period; and
- Eastern Savings and Loans currently offer payroll scheme loans at 6.2% APR. Equally, an Advantage Loan is available at 0.5% interest per month (6.2% APR) to individuals with a good credit history and borrowing £2,000–£5,000. This product is designed to appeal to Tier 1 and Tier 2 customers.

Pricing is an important consideration but not the only one. There are examples of Credit Unions who are choosing to use other elements of their products to maintain higher loan pricing on their loan offerings. Each credit union will know the price sensitivity of its Tier 2 customers and will need to make a judgement as to the level of pricing that can be sustained during a growth phase.

KEY MESSAGES

We have looked at the viability of two well run credit unions (one small, one large) taking on an 8-year, soft-bullet, 5% subordinated loan. We have then tested under what Tier 2 loan volume and loan pricing assumptions such a subordinated loan could be repaid. Our illustrative financial model suggests that for a credit union confident of its ability to maintain Tier 2 volume growth without significant erosion in loan pricing, a subordinated loan would be a helpful way of growing the loan membership base.

6 Regulatory and Legal Framework – Suggestions for Change

HOW CAN REGULATION IMPROVE THE ATTRACTIVENESS OF CREDIT UNIONS TO PROSPECTIVE INVESTORS?

During the course of conversations with both credit unions and social investors, suggestions were made as to how regulatory changes could assist credit unions in attracting supportive external investment. We have detailed these principal recommendations in the table below, along with another more detailed proposal for the inclusion of community credit unions as a fifth group of social enterprises qualifying for Social Investment Tax Relief (SITR). Alternatively, a bespoke new tax relief for community credit unions could be introduced. If these changes were implemented, the attractiveness of credit unions to prospective investors would increase.

PROPOSAL	ACTOR	COMMENTARY
Capital ratios linked to assets only	Credit union	For assessing the adequacy of capital reserves, the number of members is as relevant as, say, the number of retail deposit holders in a bank.
Non-members ability to hold deferred shares	Social investor	Supportive investors (e.g. charitable trusts and foundations) could be prepared to club together in a fund structure to support a portfolio of credit unions through deferred share investment. However, a fund cannot satisfy the membership requirement of a deferred share, nor can any one single investor who does not satisfy the common bond condition.
Capital stacking	Social investor	A supportive investor in a credit union is invariably going to prefer subordinated debt over deferred shares. If the deferred share had a "core tier one" type benefit for the credit union (i.e. enabled capital stacking), a supportive investor might be willing to consider the deferred share.

APPLICABILITY OF SOCIAL INVESTMENT TAX RELIEF (SITR) TO COMMUNITY CREDIT UNIONS

As a credit union cannot grant security over member loans, any loan to a credit union (without a specific asset as security) is effectively unsecured. This is clearly different to other financial institutions which are free to provide security over their loan books.

Credit unions seeking additional regulatory capital would potentially benefit if their wealthier members were not willing to leave all their funds in the membership account, but instead potentially purchase deferred shares of the credit union. A deferred share in a credit union is currently difficult to sell and carries uncertain yield. A SITR tax relief on a deferred share (providing, inter alia, 30% income tax relief in the year of purchase) would considerably increase the attractiveness of such an instrument. The deferred share has the feature required by an SITR qualifying instrument: it is unsecured and the most junior form of equity. Given that it is equity, it should also qualify for loss relief, should the credit union not prosper. Most credit unions would also qualify on the grounds of size as very few would fall foul on the SITR size requirements (gross assets of <£15 million and full time employees <500 prior to investment).

A key consideration for the Treasury and HMRC would be the ability of the Prudential Regulatory Authority to categorically classify a credit union as community credit union (i.e. a social enterprise).

KEY MESSAGES REGARDING DEFERRED SHARES

The characteristics of a deferred share could be improved by: allowing non-members to hold them; accepting community credit unions as SITR qualifying social enterprises (or advocate for a separate tax relief for credit unions).

If the deferred share could be made more investor friendly through implementation of the features listed above, there is a supportive audience in the Tier 1 saver-members currently "parking" some of their savings in the membership account. A proportion of their funds could be invested in deferred shares instead.

7 Concluding Remarks

This report demonstrates that there is indeed a case for social investment in credit unions. The partnership should be natural: providing credit unions with the long term patient capital they require, whilst allowing investors to create impact through investment in financial inclusion. To encourage this alignment, significant shifts would need to occur. Credit unions, regulatory bodies, government and funders should all play a part in creating a conducive environment for social investment to occur, to allow credit unions to grow and ultimately, scale their social impact.

It is clear that the primary problem faced by credit unions is not a lack of funding for onward lending, but the ability to lend more and increase earned income as their asset base grows. To achieve this, they must address the structural problems preventing them from disbursing their funds: outdated marketing or IT infrastructure which continues to decrease their relevance to target customer groups. What credit unions require most is patient capital which allows the time to resolve these operational issues fully.

As we have seen through the case studies, subordinated loans have been used in the past to strengthen credit unions, while deferred shares have proven decidedly less popular. We believe that unless the features of the deferred share are improved, we will continue to see social investment in credit unions primarily via subordinated loans.

HM Treasury, however, does have the potential to change this. Creating a more investor friendly product would widen the sphere of investors interested in this opportunity. In addition, the liquidity of deferred shares could also be increased through players in the social investment market (e.g. Ethex), who could facilitate or intermediate the sale or transfer of deferred shares. This would provide prospective investors with a route to selling the deferred share, making them more attractive.

Other bodies, such as Big Society Capital (BSC), are also key to the development of an investment-friendly landscape. One suggestion would be for them to match capital from impact first investors investing in deferred shares or subordinated loans. Additionally, in their role as market catalyst for social investment, BSC might also advocate for credit unions to become eligible for the existing Social Investment Tax Relief, or indeed for a new tax relief specifically for credit unions. HM Treasury would also need to play a role in achieving a more constructive landscape.

Broadening the appeal of credit unions is somewhat circular: change must occur within the credit unions themselves to create a more attractive investment opportunity, but this change will be facilitated by investment. The Transformation Project and others working to a similar end are already going some way to achieving this. In enabling increasing numbers of credit unions to access a common online platform, the project gives interested borrowers the ability to immediately sign up to become a member of a local credit union and to apply for an unsecured loan.

ABCUL could play a further part in closing this gap. ABCUL could assist in bringing credit unions together to jointly develop their Client Relationship Management and marketing tool kits, potentially through capacity building support from approved social investment intermediaries through the capacity building funds.

Finally, to appeal to a wider range of investors, the obvious social impact of credit unions needs to be more clearly articulated, measured and reported.

The below table details the suggestions described above, noting the areas where stakeholders and credit unions could collaborate.

SUGGESTED STAKEHOLDER ENGAGEMENT BY ISSUE AREA

STAKEHOLDER	ISSUE AREA	SUGGESTED REMEDY
HM Treasury	Unattractive deferred shares	More investor friendly instrument, available to a wider universe of social investors
HM Treasury	Social Investment Tax Relief, or creation of other tax relief applicable to community credit unions	For example, community credit unions to be Social Investment Tax Relief qualifying social enterprises
ABCUL, Cornerstone	Business Development tools to grow loan members Mergers	Subsidised dissemination of best-in-class Business Development; Client Relationship Management (CRM) tools and systems; and Training of trustees
Big Lottery, capacity building foundations	Funding for subsidised dissemination of best-in-class Business Development Funding for training of trustees	Support to ABCUL and Cornerstone
Social Investment Business / Big Lottery	Central support for management teams to develop Business Development strategies and/or build capacity	Capacity building grants to Cornerstone/ABCUL or a "themed" group of applications
Big Society Capital	Deferred share investment & subordinated debt	Advocate for Social Investment Tax Relief for community credit unions (or specific relief for credit unions) Matched funding for investing in deferred shares (conditional on regulatory change) and/or subordinated loans
Social investment intermediary community	Liquidity of deferred shares	Ethex and others could facilitate or intermediate sale and purchase of deferred shares Capacity building support from social investment intermediaries to community credit unions (via Big Potential)

APPENDICES

Appendix A: What is a Credit Union?

A credit union is a financial co-operative which provides savings, loans and a range of financial services to its members. Owned and controlled by the members, each member has one vote. Volunteer directors are elected from the membership by the members.

Given that the credit union is owned by its users (and not by external shareholders or investors) the emphasis is on providing the best service to members. Membership of a credit union is based on a common bond. This can be working for a particular employer or in a particular industry, belonging to a certain association, living, working or studying in a specified geographical area or a combination of these.

Around the world, there are 217 million members in 57,000 credit unions in 105 countries with assets in excess of $1.7 trillion. In the USA, Canada, Australia and Ireland, over a quarter of the population are credit union members.

Around 350 credit unions exist in England, Scotland and Wales. At the end of June 2015, there were 1.2 million people using credit unions; £1.3 billion of credit union savings; and £720 million disbursed through loans.

Credit unions are authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Savings are protected up to £85,000 by the Financial Services Compensation Scheme.

Appendix B: Methodology Applied and Classifications

Social Finance's research into the business case for social investment in credit unions has been divided into five work streams:

1 desk-based research and financial statements analysis and diagnostics;

2 legal work reviewing the legal and regulatory constraints on funding applicable to credit unions;

3 interviews with management teams of a representative group of growing credit unions; and the development of case studies of a handful of credit unions which are making use of external capital;

4 development of an illustrative financial model where external investment is used to support the growth of a credit union; and

5 interviews with social investors.

In order to complete the analysis and diagnostics (and the financial model), Social Finance has had access to the confidential business plans (covering financial reporting periods up to and including the financial year ending 9/2016) of 25 credit unions within the CUEP group.

Credit unions tend to categorise their members and borrowers into three separate tiers:

1 Tier 1 customers are individuals with a household income in excess of £30,000 (middle income);

2 Tier 2 with household income of between £15,000 and £30,000 (low to middle income); and

3 Tier 3 with less than £15,000 (low income).

This is an important classification as many credit unions within the Transformation Project are keen to increase lending to the Tier 2 membership group. Whilst many in the Tier 2 group may well be employed, many Tier 2 customers still find that they cannot access inclusive and affordable financial services. Due to the comparative ease of access and speed of decision making, such individuals may be using pay-day lenders or similar high cost credit providers, and could – with the right marketing and awareness raising campaign – be interested in becoming loan members of their local credit union instead.

Appendix C: Subordinated Loan T&Cs

We assumed the following terms for the subordinated loan:

	Small credit union (Type 1)	Large credit union (Type 3)
Size of loan	£100,000	£200,000
Interest	5%	
Term	8 years	
Interest only	5 years	
Principal repayment	Years 6, 7 and 8	
Further assumptions	Assumes further internal funding not available (e.g. additional savings) No delay between new Tier 2 membership and new Tier 2 loans 25% of the loan amount expensed in 2017; the remainder in the next 2 years Sufficient distributable reserves to continue to pay 1% dividend Corporation tax grows with inflation only as tax loss carry forwards are utilised	

Appendix D: Sensitivity Analysis

SMALL CREDIT UNION: NET CASHFLOW POSITION IN 2023 (THE FIRST YEAR OF REPAYMENT OF THE PRINCIPAL)

Tier 2 loan penetration equals 25%

% ANNUAL GROWTH IN TIER 2 MEMBERS 2017–2019	INTEREST RATE			
	0.5%	1.0%	1.5%	2.0%
2%	-£64.367	-£36,371	-£7,379	£22,594
10%	-£63,468	-£28,355	£8,008	£45,601
20%	-£62,146	-£16,559	£30,649	£79,456
25%	-£61,396	-£9,870	£43,488	£98,653

Tier 2 loan pricing is fixed at 1.5% per month

% ANNUAL GROWTH IN TIER 2 MEMBERS 2017–2019	% OF TIER 2s TAKING A LOAN EACH YEAR			
	10%	20%	25%	30%
2%	-£42,350	-£19,036	-£7,379	£4,278
10%	-£35,854	-£6,613	£8,008	£22,628
20%	-£26,296	£11,668	£30,649	£49,631
25%	-£20,875	£22,034	£43,488	£64,943

LARGE CREDIT UNION: NET CASHFLOW POSITION IN 2023 (THE FIRST YEAR OF REPAYMENT OF THE PRINCIPAL)

Tier 2 loan penetration equals 25%

% ANNUAL GROWTH IN TIER 2 MEMBERS 2017–2019	INTEREST RATE			
	0.5%	1.0%	1.5%	2.0%
2%	-£181,304	-£98,614	-£12,982	£75,548
10%	-£180,184	-£76,471	£30,931	£141,968
20%	-£178,536	-£43,888	£95,549	£239,706
25%	-£177,602	-£25,412	£132,191	£295,129

Tier 2 loan pricing is fixed at 1.5% per month

% ANNUAL GROWTH IN TIER 2 MEMBERS 2017–2019	% OF TIER 2s TAKING A LOAN EACH YEAR			
	10%	20%	25%	30%
2%	-£110,287	-£35,437	£1,988	£39,413
10%	-£91,112	£2,767	£49,707	£96,646
20%	-£62,896	£58,985	£119,925	£180,865
25%	-£46,895	£90,864	£159,743	£228,623

Appendix E: Interviewees

CREDIT UNIONS

1	Bristol	10,557
2	Bridgend	4,200
3	London Mutual	23,000
4	Plymouth	2,104
5	Eastern Savings and Loans (Ipswich, Suffolk)	7,356
6	Hull and East Yorkshire	15,580
7	Sheffield	5,228
8	Hoot	4,623
9	London Capital	13,000
10	Riverside	5,230

SOCIAL INVESTORS

1	Barrow Cadbury	Charitable trust
2	Esmée Fairbairn	Charitable trust
3	Friends Provident	Charitable trust
4	Joseph Rowntree	Charitable trust
5	Local Trust (Big Local)	Charitable trust
6	Panahpur	Charitable trust
7	Tudor Trust	Charitable trust
8	Big Issue Invest	Social bank
9	CAF Venturesome	Social bank
10	Charity Bank	Impact fund
11	FSE Group	Impact fund
12	Social and Sustainable Capital (SASC)	Impact fund
13	Unity Trust Bank	Impact fund

Partners

ASSOCIATION OF BRITISH CREDIT UNIONS

The Association of British Credit Unions Limited (ABCUL) is the leading trade association for credit unions in England, Scotland and Wales providing a range of advocacy, training, support and information services and providing thought leadership to the credit union movement. It is the British affiliate to the World Council of Credit Unions and the European Network of Credit Unions. Its subsidiary service company, Cornerstone Mutual Services, is delivering the Credit Union Expansion Project on behalf of the Department for Work & Pensions.

www.abcul.org

BIG SOCIETY CAPITAL

Big Society Capital is a financial institution with a social mission, set up to build the social investment market in the UK, so that charities and social enterprises can access appropriate repayable finance to enable them to grow, become more sustainable and increase their impact on society. It is doing this by building a diverse social investment market: encouraging investors to lend or invest money to achieve a social as well as a financial return. Since it was set up as an independent organisation in 2012, Big Society Capital has invested, along with its co-investors, over £270 million in specialist organisations who lend to charities and social enterprises.

www.bigsocietycapital.com

SOCIAL FINANCE

Social Finance is a not for profit organisation that partners with the government, the social sector and the financial community to find better ways of tackling social problems in the UK and beyond. Since its formation in 2007, Social Finance has mobilised over £100 million of investment and helped to design a series of programmes, including the Social Impact Bond model, to improve outcomes for individuals with complex needs. It has sister organisations in the US and Israel and a network of partners across the world.

In the UK, our work includes support for 2,000 short sentence offenders released from Peterborough Prison, 380 children on the edge of care in Essex, 4,500 young people at risk of dropping out of school, and 1,400 homeless youth and rough sleepers. Internationally, Social Finance is working with the Global Fund, World Bank, Grand Challenges Canada, the Inter-American Development Bank, USAID, DfID and others to address challenges in low and middle income countries.

www.socialfinance.org.uk

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Social Finance is a not-for-profit organisation that partners with government, the social sector and impact investors to find better ways of tackling social problems and improving the lives of people in need.

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