



Aspire – Microloans for Business:
Operational and Funding Lessons for the
Future of Microfinance in the UK

Sarah Forster
Ellen Lederman
John Mayshak
Tanya Mercer

April 2006

Table of contents

Foreword	1
Executive summary.....	1
1. Introduction	6
2. Aspire’s plan to performance	8
Features of Aspire’s business model	10
Aspire’s performance	15
3. Achievements and best practice	21
Governance	22
Marketing and outreach	22
Organisation and structure	22
Human resources	23
MIS and information technology	23
Credit process and risk management	23
Audit and accounting	24
Internal control and risk management	24
4. Scale and sustainability	25
Scale	25
Sustainability	26
Performance of micropersonal lenders	28
Modelling Aspire’s sustainability	29
5. Lessons and recommendations	32
Lessons learned	32
Recommendations for CDFIs	33
Recommendations for cdfa	37
Recommendations for funders	38
Appendix 2 – trend and ratio reporting basic format	42
Appendix 3 – Merging CDFIs	43

Foreword

This study was jointly sponsored by the Community Development Finance Association (cdfa) and Esmée Fairbairn Foundation. The cdfa is the trade organisation for community development finance institutions (CDFIs) with a mission to grow, strengthen and promote the community finance sector in the UK. The Esmée Fairbairn Foundation is one of the UK's largest grantmaking foundations and one of the most important and engaged funders of CDFIs. The Foundation also funded Aspire. The study has been backed by several community development finance stakeholders, interested in and committed to capturing lessons for the broader sector. These supporters include the DTI's Small Business Service, Barclays Bank, RBS/Nat West and Ulster Community Investment Trust.

All these organisations are committed to the advancement of community development finance as a means of improving the quality of life of people and communities. They consider transparency and shared learning to be essential for encouraging innovation and strengthening the sector and its future scale, sustainability and impact. The study was conducted by ShoreBank Advisory Services and Sarah Forster, an independent microfinance specialist and a senior associate of **nef** (new economics foundation).

Acknowledgement

The review was supported by a consortium of CDFI stakeholders including the Small Business Service's Phoenix Fund, Barclays, NatWest RBS, Ulster Community Investment Trust (UCIT), the **cdfa** and Shorebank Advisory Services UK Limited. The review was carried out by ShoreBank Advisory Services UK Limited and Sarah Forster.

Executive summary

About this briefing

This briefing shares the achievements, challenges and lessons learned by Aspire Microloans for Business, a pioneer of community development finance in the UK. It includes a comparison of Aspire's performance with its original plans, describes the strengths and weaknesses of its business model, its best practices, and comes to some initial conclusions about what's achievable in terms of microfinance scale and sustainability in a developed economy context. It concludes with lessons and recommendations for UK CDFIs and funders.

Aspire was a microfinance institution that lent to the self-employed and microbusinesses in order to encourage entrepreneurship and self-employment in Northern Ireland and to tackle financial exclusion and underinvestment. It was a pioneer of microfinance in the UK and demonstrated tremendous success in its underwriting approach, outreach in the community and impact on clients. However, Aspire faced considerable challenges in maintaining a reliable base of funding.

An analysis of its experience revealed a variety of areas from which CDFIs and stakeholders can learn. Like Aspire, most CDFIs in the UK, irrespective of client focus, are not self-sufficient and are facing an uncertain future in terms of securing revenue grants to continue operations. Funders too are still learning about the role that CDFIs play in tackling financial exclusion and the level of subsidy needed to achieve this goal.

Aspire's plan to performance

A comparison of Aspire's original business plan and actual performance revealed some key achievements, as well as some major variances which had an impact on Aspire's ability to generate projected levels of generated income from its portfolio. Aspire was successful at reaching its target market, self-employed people or owners of microbusinesses in disadvantaged areas who have difficulties accessing bank loans. During its five years of operations, Aspire disbursed over £1.5 million in loans to more than 400 clients. These loans had a measurable impact on many of the clients' businesses, including increases in turnover, profitability and employment.

However, Aspire found that several of its original predictions, particularly in relation to market size, marketing methods, loan products and staff costs were not realistic. There was also a high cost associated with testing the original business model and being a 'first mover' in the sector. These factors meant that Aspire did not reach as many clients as originally planned. A combination of a smaller portfolio and higher costs meant that Aspire was only able to generate sufficient income from its lending to cover ten percent of its expenses, compared to full cost recovery as originally planned.

Achievements and best practice

Further analysis showed that aspects of Aspire's operations and systems reflect best practice in the UK. Aspire's achievements provide advice and experience for other CDFIs operating in the same or similar markets including:

- management information systems
- systems and procedures
- risk management
- staff training and development
- outreach and appraisal techniques.

Reaching scale and sustainability

A comparative analysis of Aspire's performance with other microenterprise lenders in the US and Europe shows that the majority of microenterprise lending programmes in the UK, US and other European countries are small scale (serving 100 to 200 clients on average) and require external funding to pay for their services. A few leading organisations have proved that it is possible to reach large scale - thousands of clients rather than hundreds - but even these organisations only achieve operational self-sufficiency levels of 70-80 percent at most. Even though it may not be possible for microlending to be fully self-sufficient, it may still result in social and economic benefits that are a more efficient use of subsidy than alternatives. These findings suggest that focus needs to shift from measuring the financial self-sufficiency of microfinance organisations towards measuring the cost-effectiveness of microenterprise lending as a strategy for alleviating poverty and building strong local economies.

With experience, projections based on applying key metrics, such as average loan size, loan officer efficiency, and loan losses provide an insight into the highest level of generated income Aspire could have achieved. This suggests that Aspire could have grown its portfolio to £1.87 million and at this level it would have been able to cover 56 percent of its operating costs from income earned on its portfolio. This analysis suggests that at most, Aspire could have generated sufficient income from microlending to cover the cost of its loan officers, but would have needed ongoing grant support to cover its back office and other management and administrative costs.

Learning the lessons

A number of findings and lessons emerge from Aspire's experience. The findings focus on what is achievable when serving micro-entrepreneurs, providing small amounts of credit. Lessons for CDFIs, funders and the Community Development Finance Association are also clear.

The findings highlight that:

- the microlending methodology works
- low-income entrepreneurs do repay loans

- microloans have an impact on business development
- the market size for microenterprise lending is smaller than anticipated
- self-sufficiency is not achievable for stand alone microenterprise lending
- there was a mis-match of expectations about self-sufficiency by both funders and practitioners in the early stages of Aspire's development
- interruptions in funding can have a major impact on a CDFI's growth and performance.

For CDFIs, three main lessons emerge to help CDFIs better track their performance and position themselves for long-term growth and sustainability:

1. *Develop realistic targets in business planning, focusing on effective market analysis and achievable business modelling.* Investment in effective market analysis and an awareness of how performance can vary under a range of assumptions in the initial stages can help CDFIs develop more effective and responsive business models, in turn enabling them to develop realistic expectations of performance with stakeholders, including funders.
2. *Take a proactive and realistic approach to tracking performance and progress towards sustainability.* The establishment of goals, critical analysis of trends and ratios, and monitoring performance to plan is crucial for the CDFI sector at this stage of development. Management and boards of CDFIs should undertake to calculate the extent to which earnings from its business model currently cover costs and whether its market, products, pricing, staff efficiency and arrears are likely to lead to self-sufficiency.
3. *Justify subsidy by recognising that even if the business model is not sustainable, it can demonstrate that the social and economic benefits of microlending outweigh the costs.* Aspire's experience highlights that not all CDFIs will be self-sufficient, yet their outreach and impact are significant and worthy of support. Methods for timely, transparent and inexpensive social and economic impact evaluations need to be developed.
4. *Recognise if the CDFI's business model is not sustainable and assess other options, such as developing new products for the same market, entering new markets or merging with another organisation.* The report highlights that such diversification or restructuring requires proper planning, including a careful analysis of demand, risks, increased expenses, required training, ability to assess risk, and the contribution to the bottom line.

The community development finance trade body, the **cdfa**, can take a key role in educating and advocating among funders, as well as improving and enhancing CDFI performance:

1. *Improving understanding of the markets that CDFIs are working in.* Microfinance organisations have demonstrated that they can reach entrepreneurs that banks and other enterprise support programmes do not

reach. But these are small markets and difficult to access. The **cdfa** can help funders understand what a CDFI is aiming to achieve and so develop a shared sense of purpose and understanding of the market.

2. *Establish realistic performance targets that focus on long-term organisational development and achievable levels of scale and sustainability.* The most meaningful reporting for CDFI managers and funders is on the performance of the institution as a whole, rather than how specific funds are used, eg how many loans were made with specific funds. The **cdfa**'s performance framework of indicators and development of benchmarks for the CDFI sector is a useful framework for funders and managers alike.
3. *Provide information for funders about the relationship between microfinance, self-employment, poverty alleviation and local economic regeneration.* Many funders and local and regional authorities know little about community development finance and its role in poverty alleviation and local economic development through encouraging entrepreneurship and self-employment. Hence the importance of increasing funders' understanding of community development finance itself and how much time and money is needed to build a successful CDFI. The **cdfa** can also establish the role and efficacy of community development finance more broadly in the policy arena at national and regional level.

The also findings highlight the influential role that funders play in building CDFIs and suggests some lessons on how funders can best support a CDFI to develop a track record of providing quality financial services to significant numbers of financially excluded people in a cost-effective way:

1. *Form a business-like relationship with the CDFI, based on mutual accountability, institutional performance and shared risks.* CDFIs need engaged funders which see themselves as 'investors' and who have a commitment to building the CDFI over the long term, with overall organisational growth and development as a return on investment (sometimes called institutional performance) rather than a traditional return on investment such as dividends.
2. *Take a patient, long-term approach to funding that rewards institutional performance and with criteria that change as the organisation grows.* Ideally, funding should be performance-based with funding agreements that outline agreed performance targets, including funders' exit strategies. There is also potential for developing funder 'specialisms', perhaps focusing on particular types of financial exclusion or supporting particular lending approaches.
3. *Structure funding around realistic performance targets and monitor organisational performance.* In particular, funders can assist CDFIs to grow by basing performance targets on agreed minimum institutional targets, rather than business plan projections, being realistic about the levels of financial self-

sufficiency microlending operations can achieve and monitoring performance in terms of financial as well as impact indicators, but separating the two.

Community development finance is at an early stage of development in the UK. Aspire was one of its first pioneers. Its experience suggests that the sector is entering a second phase of development – a new era of product and organisational innovation and development of new business models. Practitioners and funders need to engage as partners in this process seeking ways of building on the achievements and best practices of organisations such as Aspire. CDFIs have already made important progress in tackling financial exclusion. However, only with the continued engagement and commitment of public, private and charitable sectors will CDFIs be able to thrive and effectively contribute to ensuring access to financial services for all.

1. Introduction

This report has been written to share the achievements, challenges and lessons learned during its first five years by Aspire Microloans for Business, a pioneer of community development finance in the UK. The report compares Aspire's performance against its business plan, describes the strengths and weaknesses of its business model and the best practices it developed that are relevant for the UK community development finance market. The report also examines Aspire's experience in the context of other West European and US microfinance providers and comes to some initial conclusions as to what is achievable in terms of microfinance scale and sustainability in a developed economy context. It concludes with observations and recommendations for UK CDFIs and funders.

Community development finance institutions (CDFIs) are specialist enterprises that contribute to wider community development by providing financial services to excluded groups. They are financial organisations which are driven by a mission to achieve positive social change by bringing wealth to disadvantaged communities. They provide finance in a range of ways including:

- loans to small businesses that create jobs and offer much-needed services and amenities
- loans to social enterprises that have both a social and commercial purpose
- equity finance to organisations in deprived communities which have the capacity to grow
- loans to individuals whose only other source of finance are high-cost lenders and loan sharks.

The sector has seen significant growth since 2000. CDFIs now have total loan and investment portfolios of £180 million, up 27% from £147 million in 2004 and £106 million in 2003. CDFIs are also controlling more capital than ever before and now have more than £450 million available to lend and invest.

Learning from experience is valuable for such a new sector. Community development finance includes a variety of providers of finance to disadvantaged or underserved markets that have difficulty accessing appropriate mainstream sources of financing. Most CDFIs are less than five years old and few have reached high levels of scale or sustainability.

Aspire was a pioneer of microfinance in the UK, specialising in the provision of small loans of up to £15,000 to the self-employed and micro-enterprises, with an average loan size of around £2,000. It was established in Belfast, Northern Ireland in 1999 with an aim of encouraging entrepreneurship and self-employment in Northern Ireland and of tackling financial exclusion and underinvestment, particularly in communities emerging from conflict and economic decline. Aspire was formed by a partnership between private, public, and community sector organisations.

The microfinance approach adopted by Aspire is one that was born and matured in developing countries and then adapted to industrial countries. Microfinance is regarded as an innovative policy instrument that promotes economic and social justice. Providing access to financial services, such as credit, is thought to improve the economic well-being of clients by increasing incomes, creating jobs, and building assets. Although the UK has one of the most developed financial systems in the world, an estimated 1.9 million households¹ are unbanked and have no access to even the most basic financial services. The unbanked tend to be concentrated among low-income communities. Providing financial services to individuals in these communities is regarded as part of a broader strategy of transforming them into thriving local economies.

Despite proving successful as a provider of microfinance services, Aspire faced considerable challenges in maintaining a reliable base of funding. In 2005, Aspire was faced with a long-term funding gap. Aspire's directors and management were forced to look at other courses of action, including closure, merging with other organisations or acquisition. After analysing several options, in August 2005, Aspire's directors decided to accept a proposal from Enterprise Northern Ireland (ENI) to take over Aspire, with the commitment to continue its microenterprise lending for at least the next two years. Providing microloans to small businesses complements ENI's provision of loans to start-ups and larger loans to existing businesses.

This study was commissioned in recognition of the fact that, for the past five years, Aspire has been a leader in the community development finance sector. The aim is to capture Aspire's experiences and challenges as a stand-alone microfinance organisation and to synthesise the lessons learned that are of relevance to the community development finance sector as a whole.

¹HM Treasury (2004), *Promoting Financial Inclusion*. London: HMK Treasury.

2. Aspire’s plan to performance

Aspire’s mission was ‘to provide permanent access to finance for the self-employed and microentrepreneurs who are excluded from access to financial services’. Over the past five years, it successfully achieved this mission, providing finance to businesses which could not access commercial bank funding with positive impacts on these businesses’ turnover, profitability and employment. The majority of borrowers were located in Belfast’s poorest and most socially and economically disadvantaged communities.

Aspire tested out and developed its business model over the last five years. This section compares Aspire’s original business plan to its actual performance. What worked and what didn’t work? Were the underlying business planning assumptions realistic or not? What are the implications for other CDFIs? The table below provides a summary of Aspire’s expected and actual achievements. Selected aspects of its business performance are then examined in more depth.

Table 1: Comparison of plan to performance

Business model features	Expected / original business plan (2001 - 2006)	Reality
Target market size	13,400 potential customers.	3,900 to 4,600 potential customers; more limited market.
Clients	Sole proprietors; <10 employees; retail, construction, no start-ups.	More retail than expected (56%); with hindsight lack of start-ups considered to narrow the market too much.
Marketing	Aspire to have no formal marketing function. Rely on other organisations (e.g. enterprise agencies, community organisations) to refer clients.	Few clients generated through referral network. Aspire developed internal marketing capacity. Tested different marketing approaches (mail shots, local advertising, cold calling). Customer word of mouth led to strong acceptance in target communities
Loan products	Loans of up to £15,000, with an average loan balance of £1,900 in year 1, increasing to £4,000 in year 3 and £5,000 in year 5. Average loan term to increase from 6 months in year 1 to 12 months by year 3. Stepped lending expected to lead	Average loan balance of £2,350 in year 5 was much smaller than planned. Loan terms were also shorter (most between 3 and 9 months). Larger loans were too short-

	to less risky larger loans.	term and too high interest for more established, growing businesses. These large loans that were made proved to be to fragile businesses. These had high default levels.
Lending methodology	<ul style="list-style-type: none"> • Peer lending with group guarantee. • Individual loans. • Trader loans. • Introduce larger loans for small businesses with >5 employees. 	<ul style="list-style-type: none"> • Individual lending only. • Never had sufficient staff stability to train up loan officers with confidence to promote these larger loans.
Loan portfolio	Demonstrate demand for microloans, client ability to repay and loan impact.	Successfully demonstrated small loans would be repaid and make a difference.
Arrears	Tough on repayment; restructure only for unavoidable events.	Tough procedures were adopted and followed, but during times of staff turnover or dips in morale, delinquency control softened and arrears increased. Higher costs resulted from chasing smaller loan sizes for repayment.
Interest rates	14% APR to be self-sufficient.	19% APR proved not high enough to reach self-sufficiency.
Transparency	Full disclosure.	Data available, but board and funders did not require trend and ratio analysis.
Scale of operations	Portfolio of £1.67 million and 593 clients after 5 years.	Portfolio of £316,819 (19% of expected portfolio) and 135 clients (23% of expected) after 5 years.
Systems and procedures	Off the shelf adaptation of systems found in international best practice.	Pioneered back office systems, policies and procedures, often to the benefit of the wider UK market.
Funding	<ul style="list-style-type: none"> • Initially, American led. • Enough funding secured to cover the cost of start-up and operations until Aspire expected to be self-sufficient. 	<ul style="list-style-type: none"> • Funding was not sufficient or secure. Funding interruptions caused staff losses and decreases in productivity and loan volume.
Portfolio quality	<ul style="list-style-type: none"> • PAR > 30 days less than 5%. 	<ul style="list-style-type: none"> • Fluctuated depending on staffing and morale. • Ranged from 5% to as high as 27.4%.

Productivity	<ul style="list-style-type: none"> • 5 loan officers hired in 2001. • Total lending of 300 loans (or 60 loans per loan officer) predicted by year 5. 	<ul style="list-style-type: none"> • 4.5 loan officers in 2004. • Clients per loan officer fluctuated from 39 in 2001 to 67 in 2005.
Cost Structure	<ul style="list-style-type: none"> • Annual expenses of £100,000 - £133,000. 	<ul style="list-style-type: none"> • Annual expenses ranged from £178,000 to £333,000.
Sustainability / profitability	<ul style="list-style-type: none"> • Interest income expected to reach £129,000 by end of year 3. • Operational self-sufficiency of 96% expected by end of year 3. • Original target to become 100% self-sufficient revised from 3 years and 7 months to 5 years. 	<ul style="list-style-type: none"> • Interest income as a % of expenses fluctuated from 5% in 2001 to 10% in 2005. • Operational self-sufficiency fluctuated from 5% in 2001 to 32% in 2004 and 14% in 2005.

Features of Aspire's business model

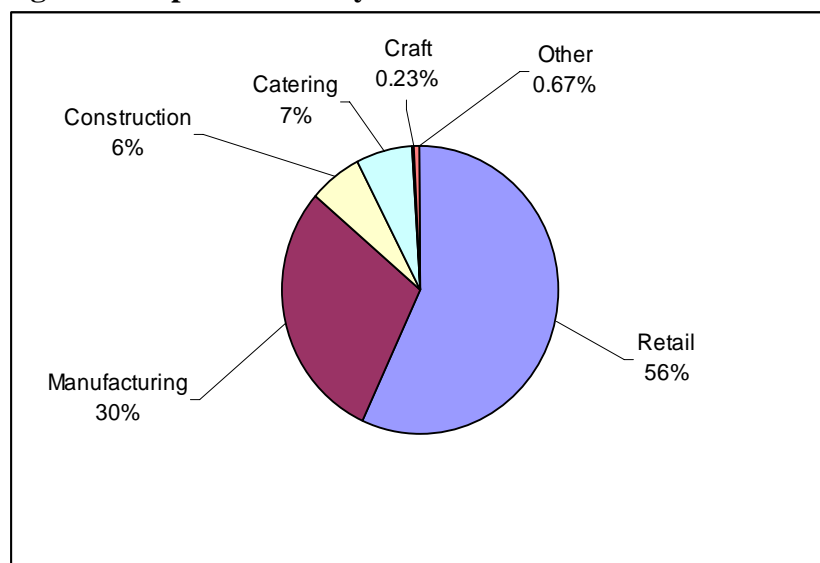
This section describes some of the key features of Aspire's business model and compares the assumptions of the original business plan with Aspire's actual performance.

Target market

Aspire's target market consisted of individuals who were self-employed or owners of micro-businesses with fewer than ten employees who had difficulties accessing bank loans. This may be because they have insufficient collateral, operating history or they deal only in cash.

Aspire successfully reached this target market. Its clients were for the most part typical neighbourhood businesses, such as hairdressers, taxi drivers, green grocers, and window cleaners. They work in a variety of different sectors, from retail, manufacturing and construction, to catering and crafts (see Figure 1). However, the majority of clients (nearly 60 percent) are retail businesses. Most of Aspire's clients lived in disadvantaged areas and were either unwilling or unable to access mainstream bank finance.

Figure 1: Aspire's loans by business sector



One of the main challenges for Aspire was improving deal flow. When Aspire was established, it did not expect to have a formal marketing function and was to rely on a referral network. However, in common with many UK CDFIs, Aspire's initial expectation of referrals from enterprise agencies and traditional business advisors did not lead to the anticipated deal flow. As a result, Aspire had to develop its own marketing materials and carry out direct marketing campaigns. Aspire successfully penetrated its market through approaches such as advertisements in local papers, community meetings, door-to-door mailings and cold calling. Aspire tracked the success of different marketing initiatives and adapted its marketing based on results.

Despite a very active marketing strategy, Aspire typically got at best 40 enquiries a month of which, on average, five were converted into loans. This lower than expected level of demand in part, reflects the small size of Aspire's target market. In contrast to developing countries where microfinance has reached considerable scale, the microenterprise market in Northern Ireland and the rest of the UK is small. In many developing countries, a vast majority of people work in the microenterprise sector (in economies where access to adequate employment is low and micro-enterprise opportunities are more common) creating a larger overall market. In addition, the safety nets of alternative employment and access to welfare benefits are low or non-existent, creating an even readier demand for finance. These demand factors are compounded by lesser (often negligible) supplies of small amounts of finance by the formal financial sector. In Northern Ireland, the levels of entrepreneurship are very low compared to other parts of the UK; the Household Entrepreneurship Survey estimates that only 13 percent of the 16-64 population are self-employed or own or part-own a business.

Aspire initially estimated its target market to be in excess of 13,400 customers. However, a later study by the new economics foundation (nef)² estimated that the market was in fact smaller than this; between 3,900 to 4,600 potential customers. Aspire's on-the-ground experience reflects this. It found the target market smaller and

² Thomas W, Goggin N (2004). *Attracting clients: The challenge of marketing for CDFIs in the UK*. London:nef.

harder to reach than originally envisaged. This made reaching a sustainable scale far more challenging. Only with scale can organisations reduce costs per transaction and achieve financial self-sufficiency.

Loan product

Aspire provided one core product, a short-term, small-scale capital investment loan (for example for vehicles, machinery and equipment, refurbishment). The loan size ranged from £100 to £5,000 for first-time borrowers, with repeat clients able to borrow up to £15,000 (the average first loan was £2,000). Initial loans were repaid over a term of three to nine months and subsequent loans may be for a period of up to eighteen months. The interest rate was 1.5% per month or 19.5% APR, decreasing to 16.6% APR for repeat loans.

Such short-term working capital loans dominate the microfinance industry. It is the type of product that is most useful to those in the services and retail sectors, e.g. to build up stock. Unlike some microfinance institutions, Aspire took a flexible approach, tailoring loan terms to the clients' business needs. However, tailored solutions require well trained staff and take time to analyse. This affects costs and efficiency, although it can lead to high levels of client satisfaction, as well as heightened staff morale, as was the case with Aspire.

Aspire's loan term and interest rate proved not to be well-suited to more established, growing microbusinesses which had difficulties getting bank finance. Such businesses need longer-term, low-interest loans (more like equity investment) and were not attracted by the short-term loans Aspire could offer. Although Aspire introduced more in-depth analysis for larger businesses, they did not complement this with a new loan product.

With hindsight, Aspire's management recognised that staff members were caught up with everyday operations and did not make the time to thoroughly investigate the market and design new products; rather the focus was on increasing demand for Aspire's existing product. This highlights the importance of market research and product diversification. It also underlines the need to have sufficient funding to have staff dedicated to these functions.

Today, many microfinance institutions have found that other products are highly valued by their customers. Some microfinance institutions have ventured into longer-term loans for investment purposes, as well as loans for consumer purposes, home maintenance and repairs, and savings products. Serving other financial needs of customers is one way of better serving customers, as well as contributing to organisational growth, impact and cost recovery.

By 2004, Aspire was planning to diversify its services to increase its scale and sustainability. It planned to expand the existing microenterprise lending services through a partnership with the Irish League of Credit Unions, as well as to provide larger loans to small businesses and social enterprises³. Forming partnerships with credit unions would have allowed greater distribution of loans and the provision of

³ Though the consumer lending market has proved to be successful for CDFIs in the UK (see next chapter), Aspire did not consider entering this market as it is well served by credit unions which are more developed in Ireland.

larger loans which would have generated more income to cover overheads and back-office costs. However, these diversification plans never came about as Aspire could not secure additional funding.

Lending methods

In the original business plan, it was expected that Aspire would offer three products: a Peer Group (mutually guaranteed) loan, a Self-Enterprise (individual loan) and a Trader Credit (for retail and wholesale sectors). The peer group loans were expected to account for 70% of all Aspire's loans. However, in practice Aspire found that people were not interested in the group loans. In fact, most people were opposed to guaranteeing other people's loans on a mutual basis. This reflects similar findings from other CDFIs that have tried to implement peer-lending models in the west (Street UK also dropped its group lending model early on). While organisations such as WEETU (Women's Employment, Enterprise and Training Unit) have found peer groups very successful as a training and personal support tool for women entrepreneurs in Norfolk, the model has generated very few loans.

The wholesaler and retailer loans were also not developed as this client group was found to be largely bankable. There was the potential to develop niche investment products for these types of businesses in more deprived areas where banks were not operating. But, as mentioned above, Aspire did not have the product development capacity to do this.

Character-based lending. A core principle of microfinance (and much CDFI lending), which Aspire adopted, is to make lending decisions based on the 'client's character, cashflow and commitment to repay, rather than collateral (formal banking) or poverty (charity)'. No collateral was taken for loans other than the occasional personal guarantee. Generally Aspire found that the legality and cost of taking security, whether through a personal guarantee or other means, was unacceptable or even prohibitive. The risk of non-repayment was mitigated by a combination of loan structuring, informal business advice, close monitoring and determined pursuit of bad payers.

This lending approach worked very well. The trust-based approach was appreciated by clients and allowed Aspire to reach out to people who would never have approached a bank. Aspire created a user-friendly application process and a streamlined loan appraisal methodology which meant that on average loans were approved within three weeks. This made them relatively fast compared to other CDFIs in the UK and again was appreciated by clients.

Western European CDFIs are somewhat unique in the 'commercial' microfinance world. In developing countries and the US, collateral is taken whether in the form of group guarantees, cash collateral (forced savings), personal guarantees or personal assets. For these institutions, experience suggests that having some form of collateral commits the borrower to the business and the loan contract. In the UK, the expense of perfecting small amounts of collateral and the ability to collect on collateral have been prohibitive relative to the size of loans. It is still too early to say whether arrears would be significantly better if UK CDFIs routinely took collateral.

Stepped lending. Aspire also adopted the so-called 'stepped lending' approach. The principle behind this is that a client is given a first loan as a way of testing out their

creditworthiness. If the client repays in-full and on-time, he or she is automatically eligible for another, larger loan. The premise is that this provides an incentive to clients to repay their loans as it secures their future access to credit. The CDFI can make more income from these larger loans.

Aspire found that reality isn't as simple as recommended practice suggests. Those businesses that needed repeat loans often needed them just to survive. Many were fragile and subsequent loans were as or more risky than Aspire's first loans. Even businesses that needed repeat loans to grow were often encountering problems, such as having inadequate management capacity to handle growth. This resulted in Aspire having more repayment problems with its repeat loans than with its first loans. Delinquency problems with its repeat clients led Aspire to develop other strategies for increasing the overall loan size and as a result it established a new loan category, the Developing Enterprise Loan (DEL). These loans, which averaged about £5,000, were made to businesses with more than five employees and more sophisticated operations than smaller businesses. Such businesses were required to provide three years of accounts and were subjected to a more robust level of business and credit analysis. While larger loan sizes may have helped Aspire with self-sufficiency targets, the organisation never had the stability of staff to properly train up loan officers to manage these loans and hence they were never marketed systematically. Few DEL loans were made and they were never a significant part of Aspire's portfolio.

Reporting and analysis

In international microfinance, standards for reporting and analysis have been developed. Leading microfinance institutions routinely disclose financial and social performance data complementing the pictures and stories of clients which used to dominate their annual reports. Internationally, funders have required such reporting. Boards and management have learned how to utilise this information to improve operations. In the UK, such standards have not yet been developed and adopted as best practice. An important exercise in developing reporting standards is the **cdfa**'s annual benchmarking report on the state of the CDFI industry in the UK. Aspire was one of the lead contributors to this report, providing complete data on all aspects of its operations.

From the start, Aspire's management did a thorough job in tracking and reporting information, despite systems that made this cumbersome. Aspire tracked outreach, portfolio quality, financial and marketing data. Un-integrated systems meant this tracking was relatively costly, as data often had to be taken from various sources and re-entered for reporting.

As with most UK CDFIs, Aspire did not regularly produce trend reports, budget to actuals and risk matrices which are standard in more developed microfinance institutions and CDFIs. Aspire's funders did not require such information and were often not attuned to the issues that these would have raised.

Aspire's performance

This section describes Aspire's performance based on standard microfinance performance measures highlighting its key achievements and challenges.

Scale of operations

During its five years of operations, Aspire disbursed over £1.5 million in loans to more than 400 clients. This is equivalent to a market penetration rate of 8-10%, based on nef's estimate of Aspire's market size. As of end February 2005, Aspire had 135 active borrowers with a gross loan portfolio of £316,809 (see Table 2).

Table 2: Aspire's outreach indicators

Outreach indicators	31- Mar- 01	31- Mar- 02	30-Sep- 03	31- Mar- 04	30-Sep- 04	28-Feb- 05
Total no. of active clients	78	145	92	96	110	135
Gross loan portfolio	£159,674	£190,814	£265,287	£279,518	£302,398	£316,809
Average loan balance	£2,047	£1,316	£2,884	£2,912	£2,749	£2,347
Cumulative no. of loans disbursed			285		393	
Cumulative value of loans disbursed			£1,066,151		£1,353,069	£1,572,220

This is considerably less than predicted in Aspire's 2001 business plan, which projected a portfolio of £1.67 million and 593 active clients after five years. In fact, Aspire's portfolio is only 19 percent of what was projected and its client base 23 percent.

It is important to understand why Aspire did not achieve its key lending targets. Several factors were at play:

- The original projections were over-ambitious. Aspire's experience has shown that this market is both smaller and harder to reach than originally envisaged, with a lot of marketing effort needed to stimulate demand.
- The product itself restricts the market that Aspire operated in. Aspire was targeting vulnerable businesses in disadvantaged areas which were resource intensive in terms of loan assessment and follow-up. With hindsight, Aspire considered it was focusing on too narrow a niche, and could have broadened its market appeal by including larger loans for more developed small businesses, start-ups and over time diversifying into other products, such as longer-term investment loans. However, each product line carries its own issues in terms of staffing, skills and systems. Start-ups are particularly risky as survival rates of business starts are typically below 50 percent, often leading to relatively high levels of arrears for CDFIs.
- A lack of funding undermined Aspire's organisational developing and lending growth. During their first year, Aspire's loan officers comfortably met their lending targets (see Table 3). In its second year, Aspire required additional

funding to expand its operations. A new business plan was written and submitted to Aspire's existing funders. Unfortunately, despite Aspire's excellent performance, one funder declined further funding and two others took nine months to make a decision and release funds. This funding crisis damaged Aspire's operations during 2002/03, resulting in a loss of staff. At one point, the organisation had no loan officers and the Chief Executive and Administrator had to manage all aspects of Aspire's operations. This resulted in both a decline in lending volumes and an increase in late payments, as the organisation was severely understaffed. These challenges, not to mention the specialised microlending knowledge that was lost during this transition and the costs of losing, recruiting and training new staff, had a negative impact on the organisation as a whole and resulted in a step backwards in terms of its portfolio and organisational development. The role of funders in building effective CDFIs is further discussed in Section 3.

Table 3: Disbursements – performance to plan

Year	2000/01		2001/02		2002/03		2003/04	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual
Loans disbursed	57	72	124	67	264	88	428	105
Amount disbursed £	142,500	289,000	419,900	300,633	1,044,700	313,839	1,794,600	307,239
Average £	2,500	4,013	3,386	4,487	3,957	3,566	4,192	2,926

Depth of outreach and client satisfaction⁴

Funders are interested in microfinance as a tool for reaching clients on low-incomes, improving their economic situation and its impact on regenerating deprived communities. While Aspire's absolute numbers were below projections, at least in part due to the low level of referral from partners, its outreach met the intended. Seventy-five percent of all loans disbursed have been for businesses located in disadvantaged areas. Significant improvements in turnover (up 25 percent or £2,500 on average), profitability (up 57 percent or £615 on average) and employment (up 24 percent or 0.35 employees on average) have been recorded for the 104 businesses that have completed returns, demonstrating clear economic benefits as a result of accessing finance through Aspire.

Clients were extremely satisfied with Aspire, with over 90 percent of clients who responded to a client satisfaction survey rated Aspire's service as excellent in terms of the clarity of the application process, the speed of decision-making, the quality of service, the reliability of service and the relationship with the loan officer. Seventy-

⁴ In international microfinance, the term 'depth of outreach' refers to the extent to which an MFI is reaching the poor.

seven percent of survey respondents felt that the way Aspire met their business finance need was excellent, while ten percent considered it good and three percent satisfactory. Typical comments include:

'Aspire provides a personal, one-to-one service which, I'm very happy with. No need to fill in forms.'

'Aspire's staff are very understanding and appreciate businesses concerns.'

'Aspire bridges the gap between LEDU and the loan sharks.'

'I appreciate the speed of lending decision. I had a loan in 6 days.'

'My business would have had to grow itself without the help of Aspire.'

Portfolio quality

A core best practice in microfinance is to control arrears. Agreement has evolved in the international microfinance community that a portfolio with more than ten percent of its loans overdue say for 30 days or more, would tend to spiral downwards as the microfinance institution gets a reputation for being a soft lender. Most aim to have no more than five percent of loans in arrears past 30 days overdue.⁵ However, it is less clear (as the sector is yet to mature and grow large enough to provide a cohort of comparable organisations) what best portfolio performance amongst micro-lenders in the UK might be.

Table 4: Portfolio quality

Portfolio quality indicators	31-Mar-01	31-Mar-02	30-Sep-03	31-Mar-04	30-Sep-04	28-Feb-05
Portfolio at risk (past 30 days)	0.5%	26.2%	5.3%	7.0%	10.0%	27.40%
Portfolio at risk (past 90 days)	0.5%	14.1%	1.6%	1.0%	8.2%	25%
No. of clients in arrears (% total)			28%		19%	
Write-offs/average portfolio	2%	9%	24%	7%	10%	4%

In line with microfinance best practice, Aspire took a very strict approach to late payments and aimed to have no more than 5 percent of loans in arrears. All late payers were subject to Aspire's very determined set of follow-up measures, starting with a phone call when they were one day overdue and ending with court prosecution if necessary.

⁵ See discussion of microfinance best practices in Chapter 3 - J.D. Von Pishke (2002). Current Foundations of Microfinance Best Practices in Developing Countries. *Replicating Microfinance in the United States*

However, Aspire has experienced very variable levels of arrears. During its first 18 months, Aspire experienced very good loan repayment and wrote-off only two percent of its portfolio as losses. However, loss of staff made it difficult for Aspire to follow-up with borrowers in arrears that peaked in early 2002. Staffing shortages were triggered by funding discontinuity and subsequent morale issues related to concerns over job security. Aspire also ran into delinquency problems with repeat borrowers who had taken out larger loans. By March 2002, over a quarter of Aspire's portfolio was in arrears (see Table 4). The organisation was forced to write-off 24 percent of the value of its portfolio in 2002/2003. Aspire was able to reverse this cycle of declining portfolio quality. Stricter delinquency management measures combined with the new loan appraisal methods, brought delinquency back down to satisfactory levels with portfolio at risk past 30 days of five to seven percent and losses of around seven to ten percent. Unfortunately, the last funding crisis resulted in another downturn in arrears control due to turnover in staff, staff morale and Aspire's softening its stance to rescheduling.

High levels of arrears were partly due to the small potential market size and lower than predicted demand which led to a smaller pool of clients to choose from. Loan officers were therefore including and approving a higher percentage of higher risk clients (when compared to developing countries where organisations can be more selective and in the end have a relatively lower risk portfolio of clients). High risk clients started to cause problems and defaults which led to the loan officers spending a lot of time chasing defaulters and not getting new clients - productivity (case-loads) fell dramatically. Chasing bad clients is the hardest and most unpleasant part of the job, leading to low morale and high staff turnover. Low productivity also led to low portfolio outstanding and less interest income to cover expenses.

Cost efficiency

Because microenterprise lending needs subsidy, it is important to understand whether those funds are being used effectively. This requires a comparison of costs and outputs. In the case of Aspire, it was costing between £1.00 and £1.40 to lend £1. This is equivalent to a cost of around £3,500 per borrower. This is relatively cost-efficient compared to other microlending programmes (see next section). However, if Aspire had been able to achieve greater scale, its unit costs would have decreased.

Table 5: Cost efficiency indicators

Productivity indicators	31-Mar-01	31-Mar-02	30-Sep-03	31-Mar-04	30-Sep-04	28-Feb-05
No. of full-time employees	4	2	7.7	7	7.8	6
No. of loan officers	2	1	5.2	4	4.5	2.5
No. of clients per credit officer	39	145	18	24	24	56
Operating expense/gross portfolio	139%	93%	133%	134%	131%	119%
Operating expense/no. of active borrowers	£2,844	£1,229	£3,837		£3,589	

Financial sustainability

In Aspire's original business plan, it was assumed that it was feasible to create Aspire as a sustainable microfinance organisation with break-even achieved after three years and seven months. This was later extended to five years. However, based on experience a number of working assumptions in the business plan no longer seemed realistic, namely:

- The size of the loan portfolio – the business plan assumed a greater level of lending and a larger average loan size than the actual experience of Aspire. These targets were over-ambitious. The market proved harder to reach than Aspire anticipated with more effort required to find qualifying clients through marketing than planned. Aspire found it less risky to focus on those clients demanding smaller loan amounts, hence the lower than anticipated average loan size. It also proved difficult to find and retain suitable staff as loan officers. This also reduced the capacity of the organisation to build up a large deal flow.
- The level of income generation – based on the original business plan assumptions, interest and fee income was expected to reach £129,000 by end of year three, equivalent to 96 percent operational self-sufficiency with 100 percent operational self-sufficiency achieved seven months later. Given its much smaller portfolio and higher costs than planned, Aspire only generated a fraction of planned income, around £30,000 interest income a year, and achieved a correspondingly lower level of operational self-sufficiency (10 percent based on lending income alone).
- The cost structure – the business plan assumed annual expenses of between £100,000 and £133,000 a year. However, actual expenses were significantly higher than this; £178,000 in 2002 and £333,000 in 2003, mainly due to higher than projected labour costs. High initial costs are partly linked to the costs of being a 'first mover'. Aspire faced significant costs as an early CDFIs trying to adapt international microfinance practice to the UK market. Back office, management systems, product features, marketing techniques, training modules, policies and procedures all had to be developed without the benefit of demonstrated experience or lessons learned from other microfinance providers. This cost was not reflected in the business plan or donor expectations.
- Charge sufficient interest rates – most sustainable MFIs overseas have a 'sustainable interest rate' pricing policy. This means that they price their loans at interest rates which will generate sufficient income over a reasonable time period (three to five years) to cover their operating costs, including inflation, administration costs, and loan losses. Typically, an MFI's interest rate, though it may reach up to 60 percent APR, is still below the very high interest rates (eg ten percent a month) charged by informal or so-called predatory money lenders. If Aspire was to succeed in serving the financially excluded, it would have to price its loans higher than banks or credit unions and lower than predatory sources. This was the approach taken in Aspire's original business

plan. The plan envisaged break-even occurring assuming an effective annual interest rate of 14 percent. However, as discussed above, the level of lending was far lower and costs higher than originally projected, which meant it was not possible to reach operational self-sufficiency in this time frame with this interest rate. Although credit card companies charge mid-20s percent and doorstep lenders average around 150 percent, Aspire felt it could only charge a maximum of APR 19 percent for business loans as it was cautious of appearing usurious. A sustainable interest rate for Aspire, based on an Aspire loan officer having 70 active loan clients p.a. each with an average loan balance of £2,000, and a loan officer cost of £25,000 p.a. would have been 56 percent. This was considered unacceptably high in the local context. Hence, setting a sustainable interest rate was not a realistic practice for Aspire. Aspire was therefore dependent on grant funding. It was not in a position to increase interest income substantially with the average loan size and market volumes experienced.

These factors combined mean that it was not possible for Aspire to reach financial sustainability within the five years which they operated. By its fifth year, Aspire was only covering ten percent of its costs from interest and fee income. Another four percent was covered by income earned on cash balances at the bank – mainly donated capital that had yet to be lent out. This source of income made an important contribution to Aspire’s sustainability and underlines the role that endowments of capital can play in supporting CDFIs to become sustainable. However, clearly such earnings should not mask other performance targets in terms of outreach, portfolio quality and efficiency. Aspire also earned income from training, but was in somewhat of a unique position relative to other CDFIs as Aspire’s Chief Executive was asked to lead many of the sector’s training drawing on Aspire’s experience, which was considered best practice, and Aspire’s Chief Executive was the **cdfa**’s Board Chair for a time, which included resources to cover her time away from Aspire’s core business. This income exceeded interest income in 2003/04.

Table 6: Financial sustainability

Sustainability/profitability indicators	31-Mar-01	31-Mar-02	30-Sep-03	31-Mar-04	30-Sep-04	28-Feb-05
Interest earned on portfolio/total expenses	5%	13%	7%	8%	9%	10%
Interest on cash and other assets/total expenses	0%	0%	8%	2%	9%	4%
Income from training and consultancy/total expenses	0%	0%	3%		14%	
Total operational self-sufficiency	5%	13%	18%	10%	32%	14%

Note: March figures are taken from Aspire’s accounts which do not include training income as earned income. Hence, this income is only reflected in the September figures which derive from Aspire’s **cdfa** performance report.

3. Achievements and best practice

This section looks at key institutional areas of Aspire and provides a brief performance analysis, highlighting areas of best practice. The best MFIs and CDFIs set out to establish themselves as permanent sustainable institutions and draw from operating practices of regulated financial institutions. Aspire followed this approach on a number of levels, summarised in Table 7.

Table 7: Performance analysis of aspire

I.	<i>Ownership and governance</i>	<ul style="list-style-type: none"> • Set up as a legal entity. • Good quality, engagement, little turnover, and community representation of Board of Directors. • Good communication flow with Executive Director.
II.	<i>Strategic and operational planning</i>	<ul style="list-style-type: none"> • Well developed business plans. • Very good and professional marketing material .
III.	<i>Organisation and structure</i>	<ul style="list-style-type: none"> • Lean organisational structure. • Well defined job responsibilities.
IV.	<i>Human resources</i>	<ul style="list-style-type: none"> • Excellent personnel policies. • Very good staff training. • Very good staff reporting.
V.	<i>MIS and information technology</i>	<ul style="list-style-type: none"> • Excellent front end tracking of clients in process (initial enquiry through loan approval to disbursal). • Helped drive the development of MIS which is used by other organisations today. • Market for integrated systems in the UK not yet developed leading to cost of development and cost of dealing with multiple systems.
VI.	<i>Credit process and credit risk management</i>	<ul style="list-style-type: none"> • politically conscientious and neutral approach. • Responsive and non-bureaucratic. • Strong methodology based on experience.
VII.	<i>Administrative and accounting management</i>	<ul style="list-style-type: none"> • External audits. • Systematic monthly processing.
VIII.	<i>Financial management</i>	<ul style="list-style-type: none"> • Low-cost funds secured. • Good policies in place.
IX.	<i>Internal control and risk management</i>	<ul style="list-style-type: none"> • Maintained thorough underwriting. • Good internal controls to prevent fraud, direct payment online. • Follow-up of delinquent borrowers. • Creative and effective use of part time

		help to assist with chasing delinquent clients.
--	--	---

Governance

Aspire attracted a volunteer board with the right skill mix for overseeing Aspire. The board was made up of experts from finance, banking, business, and the community and voluntary sector. The board was engaged and clearly understood the goals, strategy and mission of Aspire. There was strong communication with the Chief Executive, Niamh Goggin. There was little turnover in the make up of the board, allowing continuity and consistency. The board met regularly and received financial and management information that allowed the board to monitor the performance of Aspire. While some additional monitoring tools would be considered desirable for best practice in terms of risk management and oversight, Aspire was still quite a small, young and dynamic organisation and had developed a sufficient base in terms of governance.

Aspire had two credit committees with an appropriate mix of skills and experience to approve loans. The focus of the credit committee was to ensure loan underwriting standards were maintained which led to relatively strong loan performance as previously noted.

Marketing and outreach

Many UK CDFIs were set up with the expectation that referrals would happen through enterprise agencies, Business Links and various community and voluntary sector agencies associated with the CDFIs. Aspire quickly realised that referrals were not coming from these expected sources. Aspire then did an impressive job of developing a marketing plan and tested various systems of marketing, tracking the outcomes to inform future marketing campaigns. Marketing materials were very professional, supporting the development of Aspire as a brand and permanent organisation in the community. Targets were set for loan officers and incorporated into their daily plans. Marketing included mailings to businesses and residents, follow-up phone calls, advertising in selected local papers that reached both Protestant and Catholic communities, development of relationships with local media to publish stories of clients, cold-calling on businesses, door to door leaflets in targeted areas, developing relationships with referral agencies and networks, and holding seminars at local community centres.

Organisation and structure

Aspire had a well defined organisational structure, with clear reporting lines, information and process flows and job descriptions. Aspire maintained a lean staffing, allowing it to try and achieve maximum efficiency and productivity, characteristic of best practices internationally. While lean, Aspire was able to maintain its emphasis on outreach, in-depth analysis of clients, underwriting standards, monitoring, and tracking. Loan committees were staffed with the requisite

skills to make effective decisions on borrowers and develop a high quality credit culture.

Human resources

Aspire developed a body of manuals covering policies including lending, administration, cash handling, money laundering, accounting and finance and human resources. Job descriptions were developed for each position with plans, targets and performance reviews. Aspire also invested in training. For lending officers, Aspire focused on developing skills in business assessment, cash flow analysis, character analysis, brokering loan terms and conditions, supporting clients, managing repayments, and recovering defaults. A strong set of policies and procedures allows for independent audits and risk management as well as the development of the organisation. Investment in staff, training and policies is crucial in a sector characterised by a high degree of interpersonal interaction, teamwork and small teams working on multiple levels. Aspire excelled in the policies, procedures, training and practices for personnel.

MIS and information technology

Aspire found that there were no systems that could be bought and utilised. Traditional banking or credit union systems were much too big and costly for a start-up loan fund. While CDFIs and microfinance organisations in other countries have systems, the UK accounting, credit and banking systems were sufficiently different to require a new system. Aspire worked with LoanMan to adapt its system. The system tracks client information, including enquiries, client data and repayment history. It generates loan applications and data can be utilised for tracking, reporting on clients, loan quality and other performance measurements. LoanMan is now used by other UK CDFIs and has been further developed to provide better information tailored to the sector.

Aspire tracked data on clients, marketing, loan quality, accounting and finance. Aspire's level of information gathering and tracking represents best practice. Unfortunately for CDFIs of Aspire's size and stage of development, an integrated loan, payment and accounting system is not readily available. Aspire also used excel, BACS and SAGE accounting systems requiring numerous inputs by staff into the various databases. This caused inefficiencies in terms of staff timing, the potential for human error and difficulties in not having all information in one database for easy reporting and monitoring.

Credit process and risk management

Aspire represented best practice in terms of its credit process, underwriting procedures, client relationships, monitoring and handling loans in arrears. Aspire used a sound credit analysis system that utilised both financial and non-financial information to determine the creditworthiness of a loan application. Loan write-ups were clear and consistent, allowing credit committees to get a good understanding of a borrower's potential and ability to repay, utilising debt service coverage ratios and other tools. Loans in arrears were followed up quickly and Aspire followed best

practice by not relaxing payment discipline or lapsing into a soft loan fund. Rescheduling borrowers was rare.

Aspire used its information technology to analyse its borrowers and refine its marketing and products accordingly. For instance, Aspire noticed that young male borrowers experienced higher level of defaults and Aspire tried to limit lending to this higher-risk pool.

Audit and accounting

Aspire had annual external audits and presented its information in a way that is transparent and clear. Many small organisations feel they must follow auditor's guidelines that may not be based on best practice for the microfinance and CDFI sector. Presenting information on interest income, earned income, provisions for loan losses and other standards developed for the sector are important for creating a true picture of the sector.

Internal control and risk management

Aspire fosters a culture of accountability and learning. Team members are encouraged to review systems and make recommendations for improvements. An emphasis on maintaining high standards of underwriting and tracking client interactions has greatly assisted in the development of solid internal controls and managing the risk of fraud. External audits and systems to minimise the risk of fraud were put in place, including requirements on signing authority and utilising electronic banking for loan payments.

4. Scale and sustainability

This section provides a comparative analysis of Aspire's performance with other microenterprise lenders in the US and Europe, as well as with CDFIs which provide microconsumer loans to low-income people. It also provides some basic reworking of Aspire's business model to test out whether it could have ever achieved sustainability using key metrics based on actual experience. The purpose of the analysis is to draw some conclusions as to what is achievable in terms of the scale and sustainability of microfinance in the UK context.

Scale

Many microenterprise lenders aim to reach large numbers of clients. This contributes to an organisation's mission of having an impact on financial exclusion and is also a means to an end - achieving financial sustainability. So what's been achievable in terms of scale in a developed country context?

In the US and Europe, most microlending programmes serve a maximum of a few hundred clients. A survey of US microlenders found that organisations served an average of 424 clients in 2003 (and a median of 265). Most of these organisations have seen steady growth over the last few years, an average of 34 percent during the last two-year period.⁶ In Western Europe, most microenterprise lenders are younger and smaller in scale than their US counterparts. The majority of microlenders (72 percent) have less than 100 clients, according to a survey by the new economics foundation (nef) on behalf of the European Microfinance Network.⁷ However, growth is relatively robust, with a 29 percent increase in the number of loans disbursed in 2003 compared to 2002. The majority of clients are marginalised and disadvantaged individuals that the programmes were designed to assist. In Europe, Aspire's total client base of 135 is above average.

Several organisations in the US and Europe have demonstrated that it is possible to serve significantly larger numbers of clients, thousands rather than hundreds. These high-volume lenders tend to dominate the sector. The Aspen Institute found that out of a total of 230 microenterprise lenders, 16 account for 45 percent of all microloans (5,899 loans valued at \$37.1 million). The largest microlenders assisted as many as 6,000 people with over 1,000 loans outstanding. In Europe there is a similar picture of a concentrated industry. Eighteen microlenders supplied information on their number of active borrowers as at December 2003. The total number of active borrowers was 26,223; however, 25,000 of these were clients of just two microlenders. The largest microlender in Europe is ADIE in France which was

⁶ Edgcomb E and Klein J (2005). *Opening Opportunities, Building Ownership: Fulfilling the Promise of Microenterprise in the United States*, Aspen Institute by which presents data and findings from the Microtest survey.

⁷ nef (2004). *The Microfinance Sector in Western Europe: An Overview*. European Microfinance Network: London: nef

founded in 1989 and now has 300 employees all over the country. In 2003, ADIE had 10,000 active borrowers.

Several factors appear to influence the ability of microenterprise lenders to achieve greater levels of scale in both the US and Europe:

- First, microlenders which reach scale typically have large markets, operating either state-wide or in large urban centres. This is not the case for Aspire, which operates in a small urban centre (Belfast has a population of less than 300,000).
- Second, in the US many of the largest microenterprise lenders are not specialised microenterprise CDFIs, but rather CDFIs which lend to a range of markets. The National Community Capital Association (NCCA) found that those CDFIs with more than a \$1 million portfolio of microenterprise loans were large lenders with an average total portfolio of \$59 million.⁸ On average, microenterprise loans made up only 3.7 percent of their loan portfolios. This is an interesting finding, and suggests that unlike in developing countries, multisectoral community finance institutions, rather than specialist microfinance organisations, are best placed to achieve large-scale microlending.
- Third, the age of the organisation is a significant factor. It takes time to become established and known in the marketplace. Each of the large-scale programmes in the US is at least nine years old. For ADIE, it took eight years to reach significant scale (1,000 loans a year) but then ADIE's operations reached 'take-off' point and it is now disbursing more than 5,000 loans a year.
- Fourth, the organisation's degree of focus and commitment to increasing its scale is considered critical. Most large-scale microlenders were explicitly designed with scale and sustainability as their goals. They engage in substantial market research, and generally offer multiple products or services that clients demand and are feasible to deliver with some volume.
- Finally, market knowledge is critical. Successful microenterprise lenders carry out market research and understand the characteristics and preferences of their target clients. They design products and services that will attract microentrepreneurs in large numbers.

Sustainability

Like many CDFIs, Aspire's goal was to become sustainable by achieving a level of cost recovery from its lending operations that would have enabled it to cover all of its costs. However, like other microenterprise lenders in the US and Europe, Aspire found this goal difficult to achieve.

⁸ NCCA (2004), *CDFIs: Providing Capital, Building Communities, Creating Impact*, an NCCA publication analyzing fiscal year 2003 data collected through the CDFI Data Project (CDP). Washington: NCCA.

To date, no stand-alone microenterprise lender in the US or Western Europe has achieved full financial self-sufficiency.⁹ In the US, the highest levels of sustainability are among large and growing credit-led programmes with the best performers achieving operational self-sufficiency ratios of around 60 percent. However, most US microenterprise lenders engage in both lending and business development services and total programme cost recovery remains low at a median rate of 14 percent. Unsurprisingly given their younger age, European microlenders have lower levels of operational self-sufficiency than their US counterparts. Available data suggests that at best microlenders are achieving up to 10 percent operational self-sufficiency, in line with Aspire's performance based on lending revenue only. Improving portfolio risk management and efficiency have helped boost sustainability in both the US and Europe. The best performing microenterprise lenders in the US have a portfolio at risk past 30 days of less than five percent and loan losses below two percent. In terms of efficiency, US microenterprise lenders have made important strides. In 1998, it was costing the MicroTest sample of the best-performing lenders \$2.33 to lend \$1. In 2003, the average operational cost rate was 42 cents to lend \$1. Smaller programmes are less efficient with an average operational cost rate of 90 cents. And for very small programmes, with less than 20 loans outstanding, the costs can run far higher, with some lenders spending as much as \$4,800 per dollar disbursed.

In both the US and other European countries, there is now an acceptance that microenterprise programmes are likely to depend on subsidy from public and private sources for some time. Such public subsidy is considered justifiable as microlenders target the unemployed or other socially excluded groups, and the cost of providing microloans and support as a tool to assist these people become self-employed is less than the cost of welfare payments and other job creation schemes. The benefits of these microenterprise programmes, including increased business turnover, increased incomes and job creation, are also considered to outweigh the cost. However, given the need to make the case for ongoing public funding, greater emphasis is now being put on measuring whether those funds are being used effectively. Most specialists agree that more work is needed on assessing the costs and benefits of microenterprise programmes to fully evaluate the social returns on investment.

The table below provides a summary of the key average performance indicators of US, European and UK microlenders, as well as those for Aspire and the 'top performers'. Top performers include those organisations from across the U.S, U.K and rest of Europe which have achieved the best results for each performance indicator. Good performance on one measure does not necessarily guarantee good performance on another. For example, ADIE rates as a top performer in terms of scale, but has very low levels of operational self-sufficiency.

⁹ Operational self-sufficiency is used to mean when an organisation is earning sufficient own source income to cover all of its administrative and operational expenses, but relies on a partially subsidised capital base. Financial self-sufficiency is achieved when the organisations earns sufficient own income to cover all administrative expenses, as well as inflation, loan loss, the market cost of funds and any subsidies.

Table 8: Key performance indicators for microenterprise lenders in US and Europe

Performance indicators 2003-2004 (averages)	US	Europe	UK	Aspire	Top performers
Scale (no. of current clients)	100 - 200	50 - 100	50-100	110	1,000 – 10,000
Loan portfolio (value of current loans)	£50,000 - £400,000	£300,000 - £500,000	£150,000 - £250,000	£220,000	£1 – 3.5 million
Portfolio at risk (past 30 days)	14%	16%	13%	12%	< 5%
Loan losses (as a % of average loan portfolio)	7%	7%	7%	7%	2%
Operating cost ratio (cost per £1 lent)	0.40 – 0.90	n/a but likely to be > 2	1 - 2	2	< 0.40
Sustainability (operational self-sufficiency)	30 - 40 %	5 - 10 %	5 – 10%	32%	10-70 %

Performance of micropersonal lenders

As part of this analysis, we also compared Aspire’s performance to micropersonal lenders, ie CDFIs that provide small loans for consumer purposes, to see if these operations have better prospects of achieving scale and sustainability. The consumer finance market is far larger than the microenterprise finance market and such CDFIs have experienced higher levels of demand, although the average loan size is smaller. The table below summarises the results:

Table 9: Comparison of Aspire and micropersonal lenders

Performance (as of Sept 2004)	Aspire	Micropersonal
Age in years (since first loan)	4	2.75
No. of active clients	110	1,011
Gross loan portfolio	£197,746	£678,498
Average loan balance	£1,798	£666
Portfolio at risk (past 30 days due)	15%	15%
Total write-offs/total disbursements	8%	8%
Clients per credit officer	55	408
Cost per loan	£3,128	£216
Operating expense/gross portfolio	174%	32%
Operational self-sufficiency:	32%	33%
of which % income earned on portfolio	9%	29%

Note: The data for micropersonal lenders is based on the results of two high performing organisations with 90 percent consumer loans, eight percent microenterprise loans and two percent home improvement loans.

This analysis shows that:

- The strongest consumer lenders have reached scale far more quickly, reaching over 1,000 clients in less than three years.
- These operations are also more efficient than microenterprise lending with a loan officer handling over 400 clients compared to Aspire's 55 and at a cost per loan of just over £200 compared to over £3,000. Such efficiency is largely due to the simpler loan processing methods as consumer loans require less analysis and monitoring than business loans.
- Given the larger scale of operations and greater efficiency, the micropersonal lenders are also able to achieve higher levels of operational self-sufficiency earning sufficient income from interest and fee income to cover 29 percent of their operating expenses compared to only nine percent for Aspire.
- These results suggest that consumer lending has better prospects of reaching large-scale and sustainability.

Modelling Aspire's sustainability

So if Aspire had successfully secured further financing, could it ever have been sustainable, as was the expectation of its main funder? As a final look at what's achievable, we analysed the following scenario:

- average Loan size of £2,500
- efficiency level of 75 clients per credit officer
- loan losses of two percent
- loan portfolio of £1.87 million.

This is depicted in Scenario 1 in the table below. The assumptions were considered aggressive, particularly in terms of loan volume, but achievable. Even with these figures, Aspire would only be able to cover 56 percent of its operating costs from income earned on its portfolio. This suggests, in line with the experience of top performers in the US and Europe, that 60-80 percent operational self-sufficiency may be as much as is achievable for a stand alone, microenterprise lending programme. CDFIs following this model are always likely to need to find other ways of supporting operations, through grants, other income generating activities or income from endowments and other assets.

We also looked at two other scenarios. In Scenario 2, we modelled a smaller scale of operations consistent with steady growth from current levels, and assuming three loan officers, and seven percent loan losses. This is a fairly realistic level of operations for many microlenders. The analysis shows that the resultant portfolio size of £0.5 million only generates sufficient income to cover 30 percent of total operating costs. However, this amount of income (£84,000) is sufficient to cover all three loan officers' salaries. Such levels of operation would either require on-going subsidy to fund the back-office and other administrative costs to survive, or would need to be part of a larger organisation that can fund these costs from other sources. This is effectively what has happened with Aspire. Their microenterprise lending operations have now been taken over by ENI, a larger CDFI that lends to start-ups and small and medium sized enterprises (SMEs), which will fund their overhead costs.

In Scenario 3, we demonstrate how increasing the average loan size (and keeping loan losses at seven percent) would have helped Aspire's sustainability. With an average loan outstanding of £10,000, three loan officers could handle a loan portfolio of £2.25 million pounds, which is enough to make the organisation fully operationally self-sufficient. However, the reality was that Aspire found larger loans to have greater levels of arrears than smaller loans. So achieving this depends on being better able to control the risk of such loans.

Table 10. Key findings of modelling aspire's sustainability

	Scenario 1	Scenario 2	Scenario 3
INCOME			
Interest income	£318,750	£84,375	£384,000
OPERATING EXPENSES			
Salaries and benefits	£420,000	£150,000	£150,000
Admin. expenses, rent etc.	£110,000	£84,000	£84,000
Loan losses	£37,500	£39,375	£150,000
TOTAL OPERATING EXPENSES	£567,500	£273,375	£384,000
NET PROFIT/LOSS	-£248,750	-£189,000	£0
Operational self-sufficiency	56%	31%	100%
Assumptions:			

Portfolio outstanding	£1,875,000	£562,500	£2,258,800
Total no. of staff	14	5	5
No. of loan officers	10	3	3
Total no. of loans	750	225	225
Average loan balance	£2,500	£2,500	£10,000
Loan officer case load	75	75	75
No. of loans disbursed per month	18 - 20	18 - 20	18 - 20
Loan losses	2%	7%	7%
Portfolio yield	17%	15%	17%

Two of the UK's leading microlenders, Aspire and Street (UK) have now concluded that it is not possible for microfinance organisations in the UK to achieve scale and full financial sustainability with a single microcredit loan product only. Both have found the number of microentrepreneurs in need of loan finance and sufficiently creditworthy to receive a loan to be lower than expected and the transaction costs of delivery higher than planned.¹⁰ They, along with other microlenders, are beginning to conclude that solving the twin challenges of scale and sustainability will require changes in the design and delivery of products and services, as well as the organisational structures through which they are offered. Suggestions as to the types of changes needed are made in the final section of this report.

¹⁰ See nef (2005). *Street (UK) A microfinance organisation: Lessons Learned* by Rosalind Copisarow, 2004 and *Street (UK) Learning from Community Finance*. London: Esmée Fairbairn Foundation for a review of Street (UK)'s experience which draws many of the same key findings and conclusions as Aspire.

5. Lessons and recommendations

Lessons learned

Aspire's experience provides some important lessons for the community development finance sector:

The microlending methodology works. Aspire brought a distinctive lending methodology to the UK, requiring competency in business assessment, cash flow analysis, character analysis, brokering loan terms and conditions, supporting clients, managing repayments, and recovering defaults. This methodology enabled the organisation to lend to businesses that are excluded from the mainstream banking sector and was highly appreciated by clients.

Low-income entrepreneurs do repay loans. Aspire has demonstrated that low-income entrepreneurs who may not appear creditworthy from a commercial bank perspective are willing and able to repay loans. However, ensuring repayment requires a close client relationship and regular follow-up, making the quality and capacity of staff a key element. Dips in Aspire's loan collection rate coincided with external funding pressures outside its control, when the organisation lost staff and could not maintain strict delinquency management procedures suggesting recruiting and investing in staff is a key issue.

Microloans have an impact on business development. Aspire has demonstrated that access to very small loans, averaging around £2,000, can have a significant impact on microbusinesses, helping to support business growth, including increases in turnover, profitability and employment, as well as boosting clients' confidence and self-esteem.

The market size is smaller than anticipated. Aspire found that market demand was lower than anticipated. It estimated that the target market was approximately a third the size originally envisaged, with the type of clients more limited than originally expected. This impacted on several aspects of Aspire's operations; loan officer efficiency in terms of number of loans per loan officer, risk profile of deals, and the ability to reach scale.

Self-sufficiency is not achievable for stand alone microenterprise lending. Experience suggests that Aspire's business model could not have become financially sustainable given the size of its market, its average loan size, and the cost of loan officers. Greater realism is required among practitioners and funders to recognise that sustainability (ie full operational self-sufficiency) is not realistic for UK and other developed economy microenterprise lending programmes. US and European experience suggests that rates of 30 percent operational self-sufficiency should be considered good performance for programmes with around 100-200 clients and 60-80 percent considered as a maximum sustainability target for stand alone microenterprise lending.

Beware of a mis-match of expectations between funders and practitioners. Self-sufficiency was established as a goal for Aspire in its original business plan and by its donors. Aspire's market and operating results made self-sufficiency difficult to attain, yet expectations were not tempered to this reality. Aspire's main donor cited the ability to meet self-sufficiency as a pre-requisite for further funding after it became apparent that microlending could not be self-sufficient, and even though Aspire was highly praised for its impact. In turn, Aspire did not anticipate the difficulties in finding subsidy-based resources and other long-term funding required to cover operating deficits.

Interruptions in funding can have a major impact. Aspire faced several instances when funding was not forthcoming which led to reduction in staff, lack of continuity with clients, low staff morale, higher arrears, and lost momentum. As noted in the recommendations for funders, supporters need to realise that interruptions of funding flows can have a major impact on a small organisation, especially during its early years of operation.

Recommendations for CDFIs

So, how can CDFIs learn from Aspire and work to ensure their future? This section sets out three recommendations, or actions that could help microfinance organisations better track their performance and position themselves for long-term growth and sustainability:

Recommendation 1: Develop realistic targets in business planning, focusing on effective market analysis and achievable business modelling. Aspire's experience suggests that for many new start or young CDFIs business planning and modelling can be challenging. In the initial stages of securing funding and beginning operations, CDFIs have to rely on a range of informed assumptions about the size and nature of their market, corresponding product design and the potential portfolio yield. As CDFIs develop and test their market these assumptions are replaced by market knowledge and experience. However, there is no doubt that investment in effective market analysis and an awareness of how performance can vary under a range of assumptions in the initial stages can help CDFIs develop more effective and responsive business models, in turn enabling them to develop realistic expectations of likely performance with stakeholders including funders.

Recommendation 2: Take a proactive and realistic approach to tracking performance and progress towards sustainability. Management and boards of CDFIs should calculate the extent to which earnings from its business model currently cover costs and whether its market, products, pricing, staff efficiency and arrears are likely to lead to self-sufficiency in a defined period of time. CDFIs need to establish goals for outreach, productivity, portfolio quality and other critical elements of its model and track performance against plan. Trends should be tracked as a way to analyse whether the CDFI is moving towards its goals or whether attention needs to be focused on areas that are slipping or not making sufficient progress to meet goals. The establishment of goals, critical analysis of trends and ratios, and monitoring performance to plan is crucial for the CDFI sector at this stage of development. Boards, while committed, are generally volunteers and do not have the time or skills to request management to provide reporting. Boards need to have synopsis reports

that give the critical information to provide strategic oversight. Information that only includes current values without setting them against plans and mutually agreed goals and trends make it difficult for boards to identify risks and provide support before there is a crisis. So far in the sector's development, funders have not required reporting in this manner, but such reporting will assist CDFIs to make their case for continued support. Adjustments to the business model that reflect realistic pricing scale and efficiencies should be made and communicated to boards and funders to align expectations.

UK CDFI industry benchmarks have not yet been established. However, CDFIs can usefully learn from existing performance measurement systems such as the World Council of Credit Union's PEARLS Monitoring System, which provides managers with easy-to-read reports revealing institutional weaknesses and trends (see <http://www.woccu.org/pearls>), Accion's CAMEL evaluation system which is adapted from regulated banking evaluation approaches and measure the capital adequacy, asset quality, management, earnings and liquidity of microfinance institutions (<http://www.accion.org/camel.asp>) and PlaNet Finance's GIRAFFE rating methodology which identifies critical institutional risks of microfinance institutions (see <http://www.planetrating.com/en/index.ph>). All of these systems have been reviewed and the relevant indicators included in the **cdfa's** draft CDFI performance framework that will generate benchmarks for the UK environment.

Recommendation 3: Justify subsidy by recognising the business model is not sustainable, but demonstrating that the social and economic benefits of microlending outweigh the costs. Aspire's experience highlights that not all CDFIs will be self-sufficient, yet their outreach and impact are significant and worthy of support. Methods for timely, transparent and inexpensive social and economic impact evaluations need to be developed. Demonstrating that the CDFI is making effective use of grants to recycle funds on a commercial basis and helping individuals and enterprises in deprived communities out of grant and benefit dependence can be powerful. It is important to couple these arguments with a demonstration that the CDFI is operating efficiently and prudently in terms of staff productivity and portfolio quality. Securing long-term grants is difficult and risky as grant funding can be easily affected by a change in policy, financial circumstances and the interest of funders. Raising grant funds can also be costly, requiring CDFI management and boards to spend a significant amount of time fundraising. Some CDFIs are able to secure endowments, getting capital or funding that can earn interest on deposit before being deployed. Such endowments are to be encouraged as a means of capitalising CDFIs and providing them with a revenue source and greater financial security. However, it is important to ensure endowed CDFIs report transparently on their performance, as endowments can mask inefficiencies or be eroded by bad debts.

Recommendation 4: Recognise if the CDFI's business model is not sustainable and assess other options. If grants are not available or do not cover all costs CDFIs need to consider other strategies to achieve sustainability. These include the following options:

- develop new products
- enter new markets (either client-based or geographic)
- merge / consolidate.

Develop new products. One strategy is to use the same platform to provide complimentary products to the same market, that can help cover core costs and cross-subsidise microenterprise lending. Products, such as more differentiated types of microenterprise loans, consumer loans, savings, insurance, and micro-leasing, can allow CDFIs to increase income per loan officer. Some of the CDFIs that were set up as Community Reinvestment or Regeneration Trusts have followed a model of providing multiple products to the same market. They typically combine microenterprise lending with serving the consumer or personal finance needs of the ‘unbanked’.

Enter new markets. Diversifying into new markets is another way for CDFIs to increase their scale, sustainability and impact. For a microenterprise lender, other markets include small business lending, social enterprise lending and housing finance. Some microenterprise lenders, eg Street UK, provide back office services as a way to increase revenue.

Expand geographically. CDFIs may consider expansion into other areas to attain the volumes that can earn sufficient income to cover operating costs. The average staffing of a UK CDFI is five people, with two loan officers.¹¹ To have two loan officers develop the loan volume to cover the costs of three additional staff is daunting and not likely to result in self-sufficiency, unless the average loan size is quite large. Having additional loan staff in different geographic locations may contribute to covering the base-operational cost. In Aspire’s case, however, earned income was not sufficient to cover even lending staff costs. The CDFI’s business model must be such that adding additional loan officers will contribute to covering base costs. Expansion geographically may not only include adding lending staff, particularly if administrative staff, premises and communication systems add to costs. Many CDFIs have local knowledge with locally oriented boards. Geographic expansion may require a different board, different structure and more specialised staffing. Local knowledge and acceptance also takes time to develop. The CDFI will also probably need to raise financing to support scaling up, requiring a business plan, projections and time for capital raising which can be a drain on existing management and staff while managing current operations. The experience of Street (UK) also suggests that expanding geographically is difficult. Street (UK) aimed to build a national-level microfinance organisation from day one but was unable to achieve the scale of operations to benefit. This suggests that geographic expansion is best undertaken gradually and only once individual branches have reached a reasonable level of operational self-sufficiency.

Such product or market diversification can be good in theory but CDFI management must do a careful analysis of demand, risks, increased expenses, required training, ability to assess risk, and the contribution to the bottom line before making plans to diversify. Often, the knowledge and training required for each product and/or market is different, requiring different staffing, marketing and systems. Aspire found, for instance, that making larger (DEL) loans for small businesses was quite a different proposition to its microloans, requiring training staff in new loan analysis methods and different marketing techniques.

¹¹ McGeehan S (2004). *Inside Out, The State of Community Development Finance 2004*. cdfa: London

If financial self-sufficiency is the goal, new products must contribute to the bottom line. This requires realistic projections and conducting targeted and limited piloting of new products. Setting benchmarks that lead to a decision to launch the product is crucial so that the CDFI and its stakeholders don't slide into a product line, only to have support pulled when it doesn't meet expectations.

In considering which new products to introduce, it is important for the CDFI to examine the following questions:

- **Will the customer base be the same or different?** This will impact marketing and staffing.
- **Do the new products fit with the CDFI's mission or is the CDFI chasing money?** CDFIs may be stretched in terms of capabilities by introducing new products that significantly diverge from their original business strategy. For instance, a CDFI focusing on small businesses in an urban setting may find it difficult to suddenly provide microenterprise loans to rural-based women.
- **Can staff handle the new products?** Often specialised staff or training is required to deal with different products, such as property related products or finance for social enterprises.
- **Will new systems be required to track and serve the products?** The introduction of different products often requires different underwriting policies, loan agreements, security arrangements, collection methods, and monitoring and tracking systems. The systems required for personal lending, for example, may be substantially different from property related financing, enterprise lending or leasing. The costs and management of these systems must be factored in when analysing whether to introduce new products or enter new markets.
- ***Merge with other CDFIs to achieve scale, diversification and efficiencies.*** Another strategy to achieve greater scale and sustainability is to pursue a partnership or merge with another organisation. There are an estimated 85 CDFIs in the UK, the majority of which operate at a very small scale. Consolidation within the sector is anticipated and can be a relatively quick way for a CDFI to reach scale and efficiency. However, merging is never as easy as it seems on paper, as it is about people within the institution and the clients the CDFIs serve. Funder agreement and support for the process is also necessary and not always easy to obtain. When considering merging, it is important to consider various factors including:
 - How compatible are their legal structures?
 - How compatible are their policies, procedures, systems?
 - How complementary are the products and markets of each institution?

- Who will sit on the board and do they have vested interests to one of the organisations in the merger?
- Who will be the management of the combined entity?
- Is this a merger or a takeover?
- What will be the brand that emerges?
- How will client agreements be transferred into the combined, new, or surviving entity?

Appendix 3 provides more detailed guidelines and advice to CDFIs which are considering merging or partnering with another organisation.

Recommendations for cdfa

The role of the community development finance trade body, the **cdfa**, is key in educating and advocating among funders and improving and enhancing CDFI performance.

Recommendation 1: Improving understanding of the markets that CDFIs are working in. Microfinance organisations have demonstrated that they can reach entrepreneurs that banks and other enterprise support programmes do not reach. By targeting the most disadvantaged communities and individuals, microfinance programmes help broaden income and wealth creation opportunities and revitalise local economies. However these are small markets and difficult to reach. The **cdfa** can help funders understand what a CDFI is aiming to achieve and have a shared sense of purpose and understanding of the market.

Recommendation 2: Establish realistic performance targets that focus on long-term organisational development and achievable levels of scale and sustainability which are used by both CDFIs and funders. The most meaningful reporting for CDFI managers and funders is on the performance of the institution as a whole, rather than how specific funds are used e.g. how many loans were made with funds from a particular source. Funders could concentrate on the reporting of a few indicators focused on core areas of a CDFI's institutional performance. It would be useful if the **cdfa** could coordinate agreed reporting standards among funders so as to increase the effectiveness of support for microfinance. One model to look at is Consultative Group to Assist the Poor (CGAP)'s 'Donor Guidelines on Good Practice in Microfinance' which are based on the views of a broad range of donors. The guidelines suggest that, at minimum, funders require reporting in five core areas (see Appendix 2 for more details). Comparing similar CDFIs can help funders (and managers) see how they are doing against industry benchmarks and their peers and provide strong incentives to boost performance and learn from each other. In this regard, the **cdfa**'s performance framework of indicators and development of benchmarks for the CDFI sector is a useful tool for funders and managers alike.

Recommendation 3: Provide information for funders about the relationship between microfinance, self-employment, poverty alleviation and local economic regeneration. Aspire's experience shows how its Board members had a false sense of

security about future funding, given central government backing for community development finance. In fact the knowledge and commitment to community development finance is very limited among funders and policymakers in the UK. Many funders and local and regional authorities know very little about community development finance and the role it can play in poverty alleviation and local economic development through encouraging entrepreneurship and self-employment. Often a lack of understanding about this connection leaves microfinance, and community development finance more broadly, off the policy agendas and funding plans of regional and local policymakers and funders. The **cdfa** has an important role to play in educating regional and local policy makers and funders about community development finance; how it fits with local economic development strategies and how much time and money is needed to build a successful CDFI. The **cdfa** can also establish the role and efficacy of community development finance more broadly in the policy arena at national and regional level.

Recommendations for funders

Aspire's experience demonstrates the vital role which funders play in building microfinance organisations, and CDFIs more generally. External funding is the life blood of a CDFI during its start-up phase and early stages of development. CDFI managers need secure access to ongoing funding so they can concentrate on managing and building their operations. Breaks in funding or delays in the disbursement of funds can have a severe impact on lending operations, as was the case with Aspire. After a successful initial 18 months of operations in which all institutional targets were met, it took Aspire management nine months to secure further funding. This gap in funding contributed to loss of staff, a decline in lending levels and increased loan arrears, and another 18 months was needed to recover from this. Uncertainty about funding remained an ongoing concern and was an important contributory factor to Aspire's mixed performance during its six years existence. An approach where funders share responsibility for a CDFI's performance and provide funding stability could have a major impact.

So how can funders best support a microfinance organisation or CDFI to achieve a track record of providing quality financial services to significant numbers of financially excluded people in a cost-effective way? Several recommendations for funders emerge. These incorporate the lessons learned about microfinance funding by CGAP, a consortium of international donors dedicated to supporting best practice microfinance worldwide.¹²

Recommendation 1: Form a business-like relationship with the CDFI based on mutual accountability, institutional performance and shared risks. CDFIs need engaged funders which see themselves as 'investors' or venture philanthropists and which have a shared commitment to building the CDFI over the long-term. with institutional performance substituting for financial return on their investment.

¹² For more information on CGAP visit their website at www.cgap.org Relevant documents available on the website include *Anatomy of a Microfinance Deal: The New Approach to Investing in Microfinance Institutions*, CGAP Focus Note No. 9, August 1997 and *Microfinance Transparency and Reporting to Donors*, CGAP Donor Brief No. 7, October 2002.

Recommendation 2: Take a patient, long-term approach to funding that rewards institutional performance and with criteria that changes as the organisation grows. In Aspire’s case, there was no link between performance and funding, as Aspire’s initial good performance was not rewarded with ongoing funding. Ideally, funding should be performance-based, with contracts outlining agreed performance targets, including funders’ exit strategies. Funding and performance criteria should be structured according to the specific needs of the different developmental stage of the CDFI, eg start-up, growth, product diversification. Assessment of CDFIs could be accompanied with grant support provided for capacity building so that CDFIs are better able to meet performance targets and have confidence that funders will support them in meeting targets. There is also potential for developing funder ‘specialisms’, perhaps focusing on particular types of financial exclusion or supporting particular lending approaches which can simultaneously encourage the development of clusters, shared learning, sharing the costs of research and innovation.

Recommendation 3: Structure funding around realistic performance targets and monitor organisational performance. In particular funders can assist CDFIs in the following ways:

- Base performance targets on agreed minimum institutional targets, rather than business plan projections. Financial projections contained in business plans often represent more ‘hopeful’ (although considered achievable) goals towards which management plans to strive; institutional targets (usually lower) are concrete minimum targets that management is committed to meet, giving the CDFI some latitude should something go wrong.
- Be realistic about the levels of financial self-sufficiency microlending operations can achieve. The experience of Aspire and other microlending operations in the US and Europe demonstrate that it is unrealistic to deliver microlending services to this target market in a financially self-sufficient manner. For microenterprise lending, the focus should shift from measuring financial sustainability towards cost-effectiveness and maximising the yield on subsidy or social return on investment. Attention should refocus on tackling financial exclusion and supporting approaches and organisations which help achieve this goal. The outcome we are seeking is not profit, but effective CDFIs delivering greater access to financial services which can create wealth among disadvantaged individuals and stimulate local economies.
- Monitor performance in terms of financial as well as impact indicators, but separate the two. Credible ‘impact’ information that quantifies client benefits, attributable to a loan or other financial services is expensive to produce and should not be required as part of normal periodic reporting. Rather, separate funding should be considered to carry out meaningful impact assessments to develop a framework for understanding and assessing social benefits.

Community development finance is at an early stage of development in the UK. Aspire was one of its pioneers. Its experiences suggest that the sector is entering a second phase of development – a new era of product and organisational innovation and development of new business models. Practitioners and funders need to engage as partners in this process, seeking ways of building on the achievements and best practice of organisations such as Aspire. CDFIs have already made important progress in tackling financial exclusion. However, only with the continued engagement and commitment of public, private and charitable sectors will CDFIs be able to thrive and effectively contribute to the overall goal of ensuring access to financial services for all.

Appendix 1

Aspire performance indicators						
Outreach indicators	31-Mar-01	31-Mar-02	30-Sep-03	31-Mar-04	30-Sep-04	28-Feb-05
Total no. of active clients	78	145	92	96	110	135
Gross loan portfolio	£159,674	£190,814	£265,287	£279,518	£302,398	£316,809
Average loan balance	£2,047	£1,316	£2,884	£2,912	£2,749	£2,347
Cumulative no. of loans disbursed			285		393	
Cumulative value of loans disbursed			£1,066,151		£1,353,069	£1,572,220
Portfolio yield ¹			11%		13%	
Portfolio quality indicators						
Portfolio at risk (past 30 days)	0.5%	26.2%	5.3%	7.0%	10.0%	27.40%
Portfolio at risk (past 90 days)	0.5%	14.1%	1.6%	1.0%	8.2%	25%
No. of clients in arrears (% total)			28%		19%	
Write-offs/average portfolio	2%	9%	24%	7%	10%	4%
Productivity indicators						
No. of full-time employees	4	2	7.7	7	7.8	6
No. of loan officers	2	1	5.2	4	4.5	2.5
No. of clients per credit officer	39	145	18	24	24	54
Operating cost/gross portfolio	139%	93%	133%	134%	131%	119%
Operating cost/no. of active borrowers	£2,844	£1,229	£3,837		£3,589	
Sustainability/profitability						
Interest earned on portfolio/total expenses	5%	13%	7%	8%	9%	10%
Interest on cash and other assets/total expenses	0%	0%	8%	2%	9%	4%
Income from training and consultancy/total expenses	0%	0%	3%		14%	
Total operational self-sufficiency	5%	13%	18%	10%	32%	14%

Notes: March figures derive from Aspire's audited accounts. September figures derive from Aspire's performance report to the **cdfa**.

¹ Portfolio yield = interest and fee income/ average portfolio

Appendix 2 – trend and ratio reporting basic format

The Consultative Group to Assist the Poorest (CGAP) outlines five key performance areas that donors should focus on: (1) outreach, (2) depth of outreach, (3) portfolio quality, (4) financial sustainability and (5) efficiency¹³. These are broad categories and represent the minimum areas that should be monitored and measured. These five key areas are outlined in the table below. In addition, the table has been adapted to incorporate more indicators that CDFIs and funders should consider reporting and monitoring.

Category	Indicator
Outreach: number of clients being served	Number of loans disbursed. Number of active clients.
Depth of outreach: level of poverty of clients	Average loan size as a percent of gross national income (GNI) per capita.
Portfolio quality: how well the financial institution is collecting its loans	Portfolio outstanding. Portfolio at risk (>30). Loans written off. Number of clients in arrears. Value of loans disbursed.
Financial sustainability: level of profitability; ability to maintain and grow operations with out subsidy	Interest income or earned revenues as % of total expenses and as % of total revenues. Other income. Operating expenses. Financial self-sufficiency.
Efficiency: provision of services at the lowest possible cost to clients	Cost per client or operating expense ratio. Number of loans disbursed per loan officer. Number of active loans per loan officer (case load).

The indicators listed above cover some of the more important areas that CDFIs should be tracking on a regular basis, but should not be considered a comprehensive list and each CDFI must decide which are the most relevant indicators for its management. Ratios allow for critical analysis, particularly if actuals are reported against plan and trends are shown comparing previous periods (for instance on a monthly, quarterly and year to date basis).

¹³ CGAP/The World Bank (2004). Minimum Performance Indicators for Retail Financial Institutions. in *Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance*. US: CGAP/The World Bank

Appendix 3 – Merging CDFIs

A merger or takeover is never painless and requires quite a bit of preparation and management effort. In order to effect a successful and smooth merger or takeover, a closely managed process should be followed.

This process is especially important from the client perspective. Existing clients should not experience any difficulties or ambiguities regarding how their loan repayments should be made. Moreover, clients should not have any uncertainties if their obligations are being forgiven due to the closure of one entity. Such doubts can create large arrears in the portfolio and damage the lending environment for other organisation.

Internally, the process should also be transparent. Any change or reorganisation creates anxiety among staff. To reduce this tension and keep staff productive, management should communicate on at least a weekly basis and allow for key employees from each organisation to be involved in the process. Enough lead time should be planned to review and modify existing processes, policies, products and procedures. Each side should feel that they are contributing to building a new entity which is based on best practice selected from both organisations.

Below is a brief check list of some of the key areas and tasks which should be considered during transitions:

- review donor agreements for any limitations or exclusions
- obtain board approvals to proceed and lay out plan
- if possible, hire an external consultant to oversee the process
- decide on effective date of merger or takeover (should be at least four to six months in advance)
- decide which legal structure to adopt (one used by either organization or a third new to meet the needs of the larger program) and who will sit on the board.
- draft organisational chart (could be two or three scenarios) with all key positions starting with management; decide which staff will be retained and communicate. (Much of overlap frequently occurs in administrative positions)
- be prepared for unexpected staff departure during the process
- communicate with staff on regular basis to reduce anxiety
- form transition working group with members from each functional area from each organisation (finance, legal, credit, admin, etc.)

- policies, procedures, and systems
 - check loan agreements for any articles regarding assignment of loans to new entity
 - accounting procedures
 - underwriting and Loan Approval procedures
 - back office procedures (especially payment processing and disbursements)
 - client repayment procedures (changes in banks and bank account numbers)
 - front office procedures and client management
 - software/MIS – especially loan tracking system and accounting software (how will customer and loan data be migrated to new system)
 - HR policies

- portfolio and records
 - review portfolio/client data
 - review all client files – all loan agreements in place
 - review archive of repayment receipts particularly for active loans
 - write off any loans which need to be written off prior to transfer
 - agree on plan of action for delinquent clients

- which products will be offered (interest rate and terms)
- which markets will be served
- which clients will be targeted
- how will existing clients from the absorbed program be treated in future (as repeat clients?)
- issue official announcement to clients via direct mail and phone calls
- train all staff on new procedures and products
- update Business Plan
- new marketing campaign and re-branding if necessary.

If the whole process is managed systematically, against a plan, and as a team effort the result will be a strong organisation which can continue to serve clients effectively.