

Bootstraps or Braces? The regulation of community development finance institutions

by

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“There needs to be different levels of regulation for different institutions. At the bottom end of the market, if you cover yourself belt and braces with the same sort of regulatory impositions as are appropriate to NatWest, these things will die. They need a bit more space.”

Andrew Hilton, Centre for the Study of Financial Innovation

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Introduction

Individuals and enterprises in disadvantaged areas can find it hard to access finance and consequently their economic opportunities are severely limited. The 'financially excluded' include: members of low-income households who have less access to personal financial services; micro-enterprises; small housing associations; housing repairs as well as regeneration activities undertaken by housing associations; many voluntary organisations as well as social and community enterprises. This exclusion can accentuate underlying patterns of social disadvantage including low income and inadequate services and amenities.

Community Development Financial Institutions (CDFIs) promote social benefit by enabling 'excluded' people and enterprises to access capital. There is a long history in the UK of mutual financial institutions, such as building societies and mutual assurers mutuals, which dates back to the late eighteenth century. The origins of recent CDFIs date back to the 1960s and 1970s, when pioneers in the co-operative sector established the first credit union and the first community loan fund in the UK. The focus of this research is on the following:

- Community loan funds, which serve community regeneration initiatives by making capital available. Loans are often co-ordinated with or used to lever other sources of capital as well as subsidy.
- Micro-finance funds, which make very small loans to micro-entrepreneurs, typically working as sole traders, or in business with family and friends.
- Social banks, which are for-profit financial service providers or subsidiaries dedicated, typically in their constitution, to social or environmental objectives.

CDFIs work because they utilise specialist knowledge and commonly also flexible and non-conventional ways of delivering financial services which reduce operational costs and relative risk. Often, they are partnerships with voluntary, private and public sectors coming together, each with a distinct role. There is not a long track record of lending by community loan funds and micro-finance funds, but they have been creative in finding ways to achieve or approach financial sustainability. Some rely on grants, for example, to cover part of the operating costs.

CDFIs are a world-wide phenomenon. European 'social banking' and mutual guarantee schemes are well developed. Progressive legislation in the USA has encouraged retail banks to commit around \$1 trillion to low / moderate income neighbourhoods on a profitable basis. Micro-finance reaches around eight million people in developing countries (Mayo & Guene, 2000). Credit unions, although not the focus of this research, are also mutual savings and loan organisations. There are over 34,000 credit unions world-wide serving around 96 million members (World Council of Credit Unions, 1997).

The aim of our research has been to answer the question "what regulatory framework will be most appropriate for CDFIs in the UK over the next ten to fifteen years?" To answer this, we first assess the overall regulatory framework for financial services and what the key trends are likely to be. We then focus on the current legal and regulatory status of Community Development Financial Institutions, including perceived problems and future needs and conclude by assessing options for future regulation, including the case for and against any new policy action.

A. The Regulatory Framework for Financial Services

Reasons to Regulate Financial Institutions

Financial services are regulated in diverse ways. The UK regulation of investment business, for example, focuses on appropriate prudential procedures and the balance of protection for investors. A range of legal forms can be used, each with an appropriate framework of rules. Commercial banks, however, have traditionally been regarded as special.

This is for two reasons. They are the dominant financial institutions in terms of being repositories for savings, providers of debt finance and providers of payments services. And they alone have liabilities that are money they create and are therefore important in terms of their potential to generate inflation. There are therefore good reasons to prevent failures of large banks or large numbers of banks (systemic failures). These include the need to prevent disruption to the payments system, which is part of the infrastructure of modern economies; the need to prevent shrinkage in the money supply (bank lending) and a consequent credit crunch.

There is also a direct need to protect the interests of depositors. There is likely to be a conflict of interest between depositors in a non-mutual bank and its shareholders. Depositors seek low risk repositories for their savings, and hence accept relatively low returns. Shareholders, instead, eschew the safe option of placing money in a bank and seek a higher return, and hence exposure to risk of loss of wealth, by investing in shares.

The managers of banks are hired by the owners (shareholders) to run the bank on their behalf. There is thus a separation of ownership and control, which creates a 'corporate governance' or 'principal (owner) – agent (manager)' problem. How can the owners ensure that the managers run the (banking) firm in their best interests, rather than pursuing their own goals (high salaries, large expense accounts etc.). This is a major concern to all publicly owned (non-private, state-owned or 'not for profit') companies.

But managers of banks also have an implicit duty to a group of stakeholders other than the shareholders, namely their depositors. It is not clear that the managers should run banks solely in the interests of shareholders, as shareholders would like the managers to invest their funds, and those of the depositors, in a more risky portfolio of assets (loans etc) than the more risk averse depositors would like. The corporate governance problem is thus more complex for a banking firm and government intervention, in the form of regulation limiting the freedom of bank managers, is needed to protect depositors.

Trends and Issues in Banking

Globalisation in banking and wider financial markets is well underway. It started in earnest in the 1970s. Connected with this is a process often dubbed 'securitisation'. This involves both disintermediation, the growth of non-bank-intermediated or direct (from the capital markets) finance, and a process of 'making loans tradable' on securities markets, or using asset-backed securities. This process continued in the 1990s, and was accelerated by the growth in the use of financial derivatives. Also, in the 1990s, there was a progressive relaxation of capital controls. The conclusion of the General Agreement of Trade in Services (GATS) in the mid-1990s encouraged the opening of financial sectors to foreign competition among member countries of the World Trade Organisation. Perhaps the biggest single factor in globalisation of European markets was the coming into force of the European Second Banking Coordination Directive on 1 January 1993, which created the EU banking passport. Meanwhile, progress with European financial integration, which has culminated in Economic and Monetary Union (EMU) and the creation of 'Euroland', is encouraging more cross border activity in the financial service sector, including bank branching and cross border alliances and mergers.

This suggests an evolution of global banks competing on a global stage. This is most advanced in the investment-banking sphere, but is likely to become increasingly evident in the retail-banking sphere as a result of the internet revolution. Banks can now offer services across borders without a branch network.

Retail banks, engaged primarily in deposit banking, the provision of payments services and lending, face competition on both sides of the balance sheet and in service provision. Competition in the provision of loans (home, car etc), including that from credit card companies is clearly increasing. Financial mutuals, such as the UK's building societies, have diversified to cover a wider range of financial services and many have also converted to become private sector banks. The financial mutual sector in the UK is under threat and the trend is for mutuals to convert to company status, either being publicly held or (as in the case of Cheltenham & Gloucester) becoming subsidiaries of other banks. There is also growing competition in the savings market from internet based 'banks', from mutual funds (including unit and investment trusts etc.), and from the providers of longer-term savings investments, especially pension providers. The big banks have also seen their share of the supply of debt finance to the larger firms decline as these clients switch increasingly to direct finance from the capital (bonds) and money (commercial paper) markets. Increasingly banks are left supplying commercial loans to small and medium sized enterprises.

Banks have thus been forced to refocus their businesses. They have done this in two ways. First, many retail based banks have diversified into investment banking in order to help their large corporate clients access the money and capital markets. In so doing they have boosted their fee income (from broking, market making and fund management) to compensate for the lost interest-based earnings from the loans they used to make. The combination of investment and retail banking is sometimes called 'universal banking'.

Second, the banks have sought to diversify their retail financial activities, often hoping to cross-sell products, e.g. house insurance on the back of home loans, or simply to exploit the information contained in enlarged data bases for marketing and product development purposes. They have thus diversified their loan portfolios, often offering home loans which were traditionally the preserve of specialist savings banks in many countries (savings and loans companies in the US and building societies in the UK, for example). In addition, they have engaged in offering long-term savings products, insurance and pensions, leading to the development of what are called 'bancassurance' companies.

International Banking Regulation

Banks have traditionally been regulated separately from other financial institutions in most countries. But as banks have diversified and other financial institutions have entered into banking, so the continuing need to regulate banks separately has been questioned. The UK, Sweden and Japan have already introduced FSAs. The letters stand for different words in each country, Financial Services Authority in the UK, Financial Supervisory Agency in Japan, and Financial Supervisory Authority in Sweden, but the approach is similar. All providers of financial services have the same regulator and the regulator is a semi-autonomous government agency, which is not the central bank. The US, with its complex array of bank and other regulators, each with their own vested interests, has yet to move in this direction, however.

A general trend in regulation over the last three decades has been away from proscriptive regulation of financial activities, quantitative control of bank lending (whether in total, in pursuit of monetary control, and to sectors, in pursuit of development policy), and qualitative controls and guidance. The old regulation has in many cases been replaced by a set of rules that encourage banks and other financial institutions to manage their asset and liability portfolio risks effectively. What this means is that banks are allowed to engage in whatever investment risks they wish to, provided they hold sufficient capital to cover the losses that could result from exposure to those risks. Since such capital is expensive, the system essentially imposes a tax on risk taking. The

second line of defence for depositors is commonly a deposit insurance scheme (now required in the EU and long established, since the 1930s, in the US).

Box 1: Three trends in bank regulation

1. Quantitative and qualitative controls and guidance have been largely replaced in many countries with a price (interest rate) oriented monetary policy and general regulations. The latter include: risk related capital adequacy requirements; deposit insurance schemes (also risk-related in the US); rules prohibiting over exposure (to individuals, sectors of the economy, or foreign exchange risk); and rules requiring the holding of adequate reserves to assure liquidity and to make provisions against bad or doubtful debts.
2. To enhance supervision by the authorities, confidential disclosure rules are enforced; and to facilitate monitoring by shareholders, public disclosure and auditing requirements are imposed.
3. Finally, to aid comparison in the increasingly global environment, accounting and disclosure rules are in the process of being harmonised and country based supervisors are increasingly sharing information about banks and other financial firms.

As we move to the global stage, we see that the Basle Committee of international bank regulators and supervisors has driven international bank regulatory and supervisory harmonisation, whilst the International Organisation of Securities Commissions (IOSCO) has led harmonisation of regulation in the sphere of securities firms. There are numerous gaps in global co-operation, however, and there is no global regulatory and supervisory organisation.

EU Banking Regulation

The EU members of the G10 countries that have participated in the Basle Committee led harmonisation of basic bank regulations and this is reflected in the accumulating EU wide legislation, which has (mostly) been ratified by national legislatures. A core principle is the concept of the banking passport, set out in the Second Banking Co-ordination Directive. Banks that are duly licensed and regulated in one country, according to a common set of baseline standards, such as minimum (initial and continuing) capital base requirement of five million EURO, are able to do business in any EU country.

But despite making progress towards a single European financial market and EMU, crowned by the introduction of the Euro in January 1999, financial sector supervision remains a national responsibility and local variation in regulation continues. In some countries the central bank is responsible for bank supervision, in others there is a dedicated institution. The regulatory and supervisory arrangements in other parts of the financial sector are even more varied. There is no EU wide banking or wider financial services regulator. It is also worrying that 'Euroland' has no 'lender of last resort' at present – the European Central Bank does not (yet) issue euros and is anyway not directly responsible for financial stability.

UK Banking Regulation

The UK is, of course, subject to EU banking and financial directives, but still retains its own esoteric institutional arrangements within this framework. Traditionally the UK financial system was organised around 'clubs' of specialists, with government keeping an eye on proceedings. Since 1979 there has been substantial re-regulation. Despite the raft of legislation, the emphasis has been one of liberalisation. The removal in 1980 of the Supplementary Special Deposit Scheme or 'Corset' followed the abandonment of the banks' interest rate cartel in 1971, which

had marked a watershed, following which the Bank of England had progressively withdrawn from 'advising' banks on lending priorities.

As a consequence, banks entered into mortgage lending and building societies entered into the provision of payments and wider money transmission services. The removal of exchange controls in 1979 exposed the financial system to foreign competition. From 1980 the banks (and other financiers, including building societies) were increasingly allowed to choose their own asset and liability portfolios and manage the inherent risks therein. Rather than curb risk exposure, liberalisation has been backed by legislation designed to protect depositors (banking) and investors (wider investment services) against fraud, mismanagement and excessive risk taking.

The emergence of the Financial Services Authority has been in response to perceptions that the supervisory structure in place by the beginning of the 1990s was too complex. There was considerable regulatory overlap and it was not clear that, as larger banks diversified, the various bodies involved were co-ordinating activities adequately.

Box 2. The Cruickshank Report

The Cruickshank report, released in March 2000, set out concerns about weak competition in the UK banking sector. One issue was around money transmission systems (cash, cheques, cards, electronic payments). The second was a potential complex monopoly in financial services for small and medium sized enterprises that the report argued should be referred to the Competition Commission.

The report concluded "banks are treated differently from the rest of the economy in many respects. Regulatory barriers to entry are high, producers are represented on the board of the industry's regulator, their exposure to competition is diluted, and in many areas banks are allowed to write their own rules." (Cruickshank, 2000)

The report did, however, conclude that in other spheres of retail banking, competition had increased or was likely to increase with new entrants, such as supermarkets and internet banks.

The Government has accepted many but not all of the reports' recommendations and an investigation into a possible complex monopoly over small business banking by the Competition Commission is underway

A wide range of range of financial services providers operate outside of the Banking Act and have now come under the regulatory supervision of the Financial Services Authority. These include building societies, friendly societies offering facilities for small savings and life assurance, insurance, investment management, retail investment business, credit unions, industrial and provident societies, securities and derivatives business, investment business (including responsibility for supervising exchanges and clearing houses). In addition, consumer credit institutions continue to be licensed by the Office of Fair Trading under the Consumer Credit Act 1974¹ with the exception of credit unions, that are exempt.

¹ While the Financial Service and Markets Act has now passed through Parliament, none of the subordinate legislation or FSA rule books and guides needed to bring it into effect have yet been finalised. Accordingly, regulation in the UK is still technically on the basis of the pre-Financial Services and Markets Act legislation. Regulation in the UK is therefore currently on a functional basis, with the FSA having taken over from the Bank of England as the regulator of banks, but with the old self-regulating organisations (SFA, IMRO and PIA) regulating different investment activities. In practice these have effectively delegated their functions to the FSA, which currently carries out their functions as agent on their behalf.

Conclusion

Global financial conglomerates now exist which provide retail banking, insurance, and asset management (pensions and mutual funds etc), as well as investment banking services worldwide. These will of course continue to compete with narrower specialist and domestically based institutions, some of which will be 'national champions', formed by domestic mergers.

But while there is increasing cross-over between different forms of financial services, deposit-taking will continue to attract the tightest regulation. Regulation is tending to shift away from proscriptive guidelines in favour of enabling banks to manage risk appropriately. At the same time, a 're-regulation' has occurred in many countries, for example setting out new requirements on financial disclosure.

While we have global banking, as well as a diversity of national banking systems, there are major gaps in global regulatory co-operation. It seems likely that the present, largely nationally based, regulation system will need to adapt to provide for adequate regulation supervision of the emerging global bancassurance companies, increasingly interlinked capital markets and internet based financial markets and transactions. The need for co-operation, or at least greater consistency between national regulatory regimes, will grow. At a European level, the shift from national to European-wide regulation is far from straightforward, but further coordination and harmonisation is likely to be required as the financial services sector starts to consolidate across borders.

This is the emerging and increasingly global landscape within which the future regulation of CDFIs needs to be understood.

B. The Regulatory Framework for Community Development Financial Institutions

Perhaps as significant as any event in the life of an organisation is the choice of legal and regulatory status. The nature of that choice determines whether they can start, how they operate and whether they succeed. CDFIs in Europe have tended to develop in three stages (Table 1, Guene 2000). Their needs in terms of regulation and legal form may change as they grow. Where an appropriate framework is not available, new CDFIs are restricted or they can get stuck in an earlier phase with a framework that does not support appropriate growth or achievement of a social mission. Most CDFIs operate at small scale. At such a point, the key need is for permissive regulation, which offers an established model or choice of models for doing business, with the maximum flexibility of operations.

In reality, there is considerable diversity in the rules that govern the activities of CDFIs, in almost every case for the principal reason that the rules were not designed with CDFIs in mind. A non-profit or charitable status, for example, is often appropriate for early stage development of CDFIs. However in some countries, they face limitations such as on making loans (prohibited in Spain and Portugal, limited in Germany). There are also issues of eligibility (limiting micro-credit in Germany and arguably in the UK). In response to this diversity, CDFIs have evolved in different forms and with different models. In Portugal the National Association for the Right to Credit operates as an intermediary, using a credit line from a commercial bank to lend to poor people who could not otherwise borrow. Portuguese banking law prohibits it from extending credit itself.

Table 1. What kind of legal form and regulatory structure do CDFIs in Europe require?

| | | |
|---|--|--|
| <ul style="list-style-type: none"> • Is simple and cost-effective • Has credibility for early backers wanting to pursue a social purpose • Allows for experimentation, such as attracting a mix of funding on different terms • Enables independent lending or investing to start immediately | <ul style="list-style-type: none"> • Promotes financial credibility, by enabling the development of internal quality controls and procedures • Allows eligibility for public funding and / or tax exempt donations | <ul style="list-style-type: none"> • Promotes internal control and accounting systems through prudential supervision • Allows risk taking that is appropriate to its activities • Allows for the separation of the business and non-business elements of operations • Allows eligibility by the social component for public funding and / or tax exempt donations • Encourages appropriate disclosure of performance information for investors • Safeguards any depositors |
| Phase 1 Experimentation and Innovation | Phase 2 Development & discovery | Phase 3 Stabilisation & mainstreaming |

(adapted from Guene, 2000)

In the UK, the regulation status of an organisation is determined on a functional basis, i.e. by reference to the activities which the organisation proposes to conduct. There is no single status or recognition of CDFIs. Social banks are licensed banks. The majority of community loan funds and micro-finance funds are constituted as companies limited by guarantee or as industrial and provident societies. They often operate multiple legal structures in order to capture the benefits of

different regulatory or tax treatment, such as for registered charities or accredited enterprise agencies (Table 2).

Table 2. Legal Structures

| | Registration | Supervision | Consumer credit | Tax relief |
|---|---|-----------------------------------|------------------------|-------------------|
| CDFIs organised as: | | | | |
| - Industrial & Provident Societies, for the benefit of the community | FSA | unclear | Office of Fair Trading | Inland Revenue |
| - Registered charity | Charity Commission (England and Wales) | Charity Commission | Office of Fair Trading | Inland Revenue |
| - Social Banks | FSA | FSA | | |
| - Companies | Companies House | Companies House, but minimal | Office of Fair Trading | - |
| - Credit unions | FSA (exempt from banking licence) | FSA | Exempted | - |
| - CDFIs with enterprise agency status | Federation of Enterprise Agencies, Department of Trade and Industry | Federation of Enterprise Agencies | Office of Fair Trading | Inland Revenue |

Financial Co-operatives

The law most closely designed for the mix of social and financial purpose of CDFIs is co-operative law (such as Industrial and Provident Societies). Malcolm Lynch, a solicitor who has advised many CDFIs, argues that “There is presently only one vehicle which is really suitable for investment, which is an Industrial and Provident Society. It is interesting to note that it is performing its historical function.”

The Industrial and Provident Societies Act (1965) governs co-operatives and societies for the benefit of the community. The Act is a consolidation of 19th century legislation, pioneered by John Stuart Mill. It permits registration of two types of industrial and provident society: co-operatives and societies for the benefit of the community. The Chief Registrar of Friendly Societies (now part of the Financial Services Authority) acts as a registrar, focussing on legal rather than financial regulation, although the extent to which it is or should be a regulator beyond registration is unclear.

The Act sets out a range of limits on raising capital. These include a maximum limit on any one shareholding of £20,000, shares that may only be held by members and limitations on the return on capital (although there is no limit on investment by other industrial and provident societies). The Housing Finance Corporation demonstrates the scale at which this can, however, operate. It is an industrial and provident society and has raised over £8.5 billion of finance for housing (1995 figures, Lynch & Haidar, 1998). It raises finance through public bond issues, or from institutional sources on terms equivalent to a bond issue and from bank and building society loans.

In 1998, the UK Government issued a consultation paper on revisions to the Industrial and Provident Societies Act (although without committing itself to enact any changes). The reason

stated was that “this legislation has not kept pace with the framework applying to companies, which has been the subject of frequent amendment, in particular in the areas of capital structure, corporate governance, accountancy and audit provisions, and insolvency.” (HM Treasury, 1998b)

A number of significant scale financial co-operatives operate across Europe (although typically without the strong social objectives of CDFIs). In countries such as Belgium and Italy, co-operative law provides an excellent basis for early start and development – having low capital requirements, the ability to attract investment in the form of share capital, the right to serve non-members and no restrictions on geographical coverage. However in other countries, such as Germany and Spain, restrictions on financial co-operatives have been steadily tightened, to a point that new financial co-operatives face significant start-up barriers (Guene, 2000).

Credit Unions

Credit unions are a separate co-operative legal model, limited to personal finance but operating with an exemption from the Banking Act. In the UK, credit union law draws on common international regulatory practice in defining credit unions and the ‘common bond’ that is required between members. This concept sets out that there needs to be a link or ‘bond’ which connects all members of a credit union together, such as living in the same neighbourhood or working for the same employer.

The Credit Unions Act (1979) was revised in 1996, which, among other changes, created a greater degree of flexibility in the kind of common bond that would be permitted, in particular allowing a mix of members living *or* working in a particular locality. However the constraints of regulation has been a common complaint among credit unions (National Consumer Council, 1994; Conaty & Mayo, 1997). The Government announced a consultation in 1998 on options for further regulatory change for credit unions (HM Treasury, 1998a). The thrust of these changes is to permit a wider range of activities for credit unions, particularly those with the capacity to manage them prudently.

Alongside this is an emphasis on enhanced powers of regulatory scrutiny and enforcement. The Taskforce established by the Government under the leadership of Fred Goodwin of Royal Bank of Scotland, for example comments that “there is considerable scepticism as to the effectiveness of the current system, not least because non-compliance seems in many instances to go unchallenged.” Under a system of stricter enforcement, it argues “those credit unions that could not achieve the standards might be allowed to continue as some form of local savings club.” (HM Treasury, 1999b)

This mix of deregulation, such as more permissive interpretations of the common bond, and re-regulation, such as calls for tighter enforcement, is in line with regulatory trends for mature credit union sectors internationally. An example is the proposed development in the UK of a share protection scheme (Financial Services Authority, 2000). As the common bond widens, the effectiveness of peer review weakens. More information may be required for risk assessment or default rates may rise. In a number of countries, therefore, deregulation has been associated with improved share protection schemes, in order to protect members’ savings, if for example repayment rates fall and the credit union fails.

Charities

An alternative model, suited to Phase 1, is a non-profit or charitable model. As Helen Barber of ICOM, points to the importance of “recognisability by the rest of the market. One thing crops up with industrial and provident societies is that people have never heard of them. We have arguments with bank managers, lawyers and others who don’t believe that industrial and provident societies even exist. People recognise the class of charities.” UK charities are also, to a degree, exempt from the Banking Act 1987, so that charitable CDFIs can take deposits from another charity or receive deposits on which it pays no interest or premium.

However, Steve Walker of Aston Reinvestment Trust comments that, “while being a charity opens up the door for grants, it can be detrimental to the CDFI’s chance of being taken seriously for investments and loans, especially with the corporate sector, who perceive charity as a gift or hand out.”

CDFIs find themselves on the boundaries of what is currently understood to be charitable status. The guidelines do not necessarily fit well with what they aim to achieve. Richard Cordon of the Charity Commission for England and Wales points out that “you have issues of whether the activity itself is charitable, both in terms of fundraising and how the money is spent. So you have to stress both arms of that, which brings in public benefit issues in particular. If you do cross that hurdle, then you will be treated like any other charity, which means that we will be interested in ensuring that the money is spent appropriately and in accordance with the charitable trust.” The Commission carried out a consultation in 1999 / 2000 on the boundary between public and private benefit for charities (Charity Commission, 1999).

So, the benefit of tax preference and eligibility for grants comes with a cost of restrictions and regulatory supervision which can seriously distort the operational model being pursued. For example, Street, a micro-finance fund, was informed by the Charity Commission that it could lend to reduce unemployment, but not lend to reduce the risk of unemployment. PART, a new CDFI in Portsmouth, has been able to use precedents established by charitable housing associations to claim charitable status. However, it is only able to do this because it restricts lending to individuals, rather than corporate bodies.

Achieving charitable status when the guidelines are not yet clear is also expensive – tying up time and money from the pioneers who have least of both. As Pat Conaty of the New Economics Foundation says “Shared Interest spent years and a lot of legal money trying to go a straight-forward route to obtain charitable status direct from the Inland Revenue, avoiding the considerable red-tape that the Charity Commission are increasingly imposing on charities. This has to be the way for CDFIs to fight for.” Indeed, the Ulster Community Investment Trust in Northern Ireland achieved this in 2000, suggesting that this could now be a realistic option.

As Richard Cordon says “what is important is to work out what is going to be the right model to support this sector over the next ten or twenty years. We would be delighted to work with people, if the charity model is the right one, to make sure it works as well as possible. Equally, if the conclusion is that the Industrial and Provident Society is the better model than I think we are more concerned that people take the right decision rather than anything else.”

C. If it ain't broke, should we fix it?

At present, CDFIs in the UK appear to have developed in the context of a regulatory 'benign neglect'. There has been little or no regulatory scrutiny of their operations as CDFIs (as opposed to generalised regulation, such as conforming, where appropriate to charitable status). This has offered considerable advantages, in terms of low barriers to entry and good scope for experimentation. As Malcolm Lynch puts it, "one of the strengths in the United Kingdom regulatory environment has been to leave space for non-Banking Act credit institutions to develop." (Lynch & Haidar, 1998) However, there are four possible constraints to this approach.

a. the downside of neglect

If regulators do not understand the business model, this can lead to bureaucratic or ill-informed implementation when they come into contact with CDFIs. CDFIs can find it hard to get permission where it is needed, such as at point of registration. For example:

- The founders of PART, a new CDFI in Portsmouth, argue that they faced considerable delays in registering as an industrial and provident society.
- Investors in Society is a loan fund with £5 million in capital, investments and deposits. It made its 100th loan in June 2000. It is an entity within Charities Aid Foundation, a registered charity, and does not have its own legal form. Charities Aid Foundation has applied to set up this loan fund as a Charitybank but has faced considerable delay in this process.

b. restricted powers

There is a more restricted range of services that CDFIs can offer, in particular if they do not have banking status. They also do not have access to deposit protection insurance. CDFIs in developing countries, such as SEWA in India, have developed over time from micro-credit into a wider range of affordable micro-financial services, including savings and insurance, for the poor. The same options are not open to CDFIs in industrialised countries unless they comply with the same regulation as mainstream providers. There is no 'intermediate' banking status. An exception is the credit union, which operate in the UK and Ireland with special exemptions from banking laws in terms of taking savings. But they are not permitted in countries like Germany (where credit unions were invented in the nineteenth century) and they cannot lend to non-members or typically to businesses.

c. barriers to entry

It can be a long and problematic process for CDFIs when they do wish to apply for regulatory approval, such as banking status. A major issue is the capital adequacy requirements. This acts as a barrier to entry, given the small size of CDFIs and the difficulty they frequently have in raising capital. Minimum capital requirements have proved a stumbling block for a range of proposed CDFIs across Europe, including Greece, Portugal, Spain, Italy, Austria, Finland, Sweden and Germany. This is discussed below.

In a number of cases, CDFIs applying for banking status and unable to meet minimum capital requirements have proceeded by taking on a non-banking form. In Finland, Ecobank has become an investment company. In the UK, Aston Reinvestment Trust stepped back from initial plans for an application for a banking licence and became an Industrial and Provident Society.

d. the cost of uncertainty

A consultation issued by the Government in 1999 on Industrial and Provident Societies made proposals that would have closed a number of CDFIs, including Shared Interest, ICOF Community Capital, Aston Reinvestment Trust and Citylife (HM Treasury, 1999a). This case is discussed below.

A related case is the regulatory treatment of mutual guarantee schemes. These were launched in the UK in the late 1990s with the enthusiastic support of the Department of Trade and Industry,

seen as a mutual approach which could improve small firm access to finance. Mutual guarantee societies are formal associations of small and medium-sized enterprises who pool their savings in banks to offer collective guarantees so that they can borrow more and achieve better lending and deposit rates. However, the schemes up and running have been halted by a Treasury ruling that these may in effect be carrying on insurance business and therefore unauthorised.

Similar examples have occurred across Europe. Grether Ost in Germany was told by regulators to close down, and later that everything was fine provided one phrase was changed in their prospectus. Network Vlaanderen in Belgium had to give back € 375,000 EURO of savings as the banking authority had decided that the savings more than 49 savers would henceforth be considered as 'deposits', which only banks are allowed to take (Guene, 2000).

The cost of uncertainty is to put a high price on innovation. Radical Routes has halted some of its earlier public calls for funds, out of legal uncertainty. Similarly, Pivot in Belgium sees the views of the banking authorities as so changeable that it refrains from making too public its calls for savings.

Is it a bank?

According to Ian Snaith, Professor of Co-operative Law, compliance with the Banking Act is unrealistic for smaller CDFIs. In addition, the way that risk is assessed (including minimum levels of capital and guidelines from the Basle Committee of international bank regulators) may be inappropriate for CDFIs, distorting their activities. However "once you are free of the banking act, then really you have a lot of freedom...the contractual arrangements you can make are very wide."

Where they do take deposits, CDFIs in the UK and EU, are treated as banks. The critical distinction for CDFIs that operate outside Banking Laws is often the distinction between deposits versus risk capital. Deposit taking involves taking credit from third parties that do not share the risk of lending this money out again. They expect their funds to be repaid in full at some future date. Risk capital, on the other hand, involves attracting equity or equivalent capital and sharing the risk of on-lending, with its upsides and downsides.

National law across the European Union, particularly in continental countries, can cover both taking deposits and extending credit. There are exceptions to lending restrictions – such as moneylenders in the UK, credit unions in the UK and Ireland, financial co-operatives in Belgium and some financial non-profit voluntary associations in France. The '1st EU Banking Directive', however, covers lending only where the institution is *also* taking deposits.

This is a fine line. In the case of CDFIs, where they are industrial and provident societies, risk capital can come in the form of withdrawable shares. Withdrawable share capital looks like risk capital as you are able to lose your money. But to the extent that there is a perceived obligation to repay, it looks like a deposit (see Box 3). Indeed credit union shares are in effect treated as deposits but given an exemption from the Banking Act.

Box 3. Withdrawable Share Capital

Ian Snaith comments that CDFIs “have succeeded in using withdrawable share capital ingeniously.” These are “withdrawable, which means that the society can buy back the shares at the original price paid (or less, if there have been losses, but not more, even if there are profits). They do not offer the prospect of a capital gain, but may pay a dividend in the form of ‘share interest’.” (Shared Interest et al, 1999).

An exemption exists from the current Banking Act for withdrawable shares issued by industrial and provident societies. However, the government proposed to remove this, replacing it with a power for societies to raise deposits in line with a code of practice, but not to engage in lending (HM Treasury, 1999a). This was challenged by a consortium of CDFIs, who pointed to the 1999 European Court of Justice case, concerning the activities of Romanelli, who was issuing repayable bonds. They argued that the opinion indicated that the EU First Banking Directive implies that a body which issues share capital for the purposes of lending is not considered as a credit institution, provided that the share capital does not imply an obligation to repay. (Shared Interest et al, 1999)

The consortium of CDFIs argued that, as long as their terms did not lead investors to believe that an obligation to repay existed, they were accepting risk capital rather than deposits, and as such were not covered by banking regulations. Indeed, on this interpretation, even the existing exemption from the Banking Act was not required. However, they also argued that this was a confused field and that a clarification was required, which would protect them from the challenge that they are operating as unauthorised banks. They argued for:

- A new exemption from the Banking Act clarifying that withdrawable shares which do not create an obligation to repay represent risk capital rather than deposits.
- Failing this clarification, no exemption at all for withdrawable shares should be made in relation to the Banking Act, so as not to perpetuate confusion about their status.
- A public guidance note from the Financial Services Authority, setting out that “they will not prima facie regard withdrawable shares as deposits provided societies give a clear ‘risk warning’ to investors in standard form. (Shared Interest et al, 1999)

The UK Government accepted the underlying argument. It set out that “for the avoidance of doubt, HMT [The Treasury], having consulted with the FSA, wishes to make it clear that withdrawable shares will represent deposits only if the sums involved are paid on terms which provide for their repayment in full.” (HM Treasury, 1999c). In short, if CDFIs attract finance in this form, then it is not regulated as a credit institution under EU banking directives. However, it should be pointed out that the Romanelli case does not represent a clear test of this interpretation. The European Court of Justice has the scope to interpret EU banking law in a wider sense. The UK is bound to uphold such an interpretation, unless it was able to make and justify specific exemptions. Until the direct position of non-bank CDFIs is tested, a degree of uncertainty will therefore remain.

As Helen Barber of ICOM comments, withdrawable share capital is “like most of industrial and provident society regulation: quirky and eccentric.” The precarious line between bank and non-bank is, however, not limited to the neglected state of co-operative law. The issue of bonds, whether by industrial and provident societies or charities, can be caught by the Banking Act 1987. Most bond issues have an agreed time or condition for repayment which means that they can be considered as deposits. What is important, however, is whether the organisation issuing the bond is seen as carrying on a ‘deposit-taking business.’ The regulatory interpretation in this area has tightened over recent years, so that even a single bond issue may be considered as a deposit-taking business if there is an extensive period for acceptance (Lynch 1997a).

Below the Radar

The lack of a clear regulatory framework for CDFIs has therefore allowed greater experimentation and diversity that would otherwise have been the case. Conversely, from the perspective of a regulator, Nigel Fawcett of the Financial Services Authority implies that there is a clear fiduciary gap: “the Industrial and Provident Society legislation is a consolidation of 19th century legislation. No way was any of this ever envisaged in 1876 when the first act went through. Nor indeed in 1965 when the legislation was consolidated... The law isn’t adequate. Something is happening that wasn’t designed within the law. And if people’s monies are at risk, the government, if it is personal funding, should have some sort of supervision. I think therefore it is up to people to draw their own conclusions.” In contrast, Mark Hayes of Shared Interest argues that there are historical precedents for the way CDFIs operate under Industrial and Provident Society legislation.

At the same time, the lack of a clear framework can limit growth. As Malcolm Lynch explains, “where organisations try and seek more than grant based funding, i.e. some form of returnable capital, then they get caught by the regulatory system in one form or another, whatever their structure is. Some regulatory provision provides for exemption, but as soon as you start that process of trying to get some form of evolving capital, then you start to impinge on the regulatory systems.”

This way of operating, below the radar of regulatory policy, is unlikely to be appropriate for long to a growing sector, concerned to win support and demonstrate sustainable performance. The next phase of activity for CDFIs is likely to be one of growth. Their role has been explicitly commended by Government (HM Treasury, 1999c). A £30 million Phoenix Fund has been established by government, in part to help capitalise CDFIs, in order that they can become more effective partners for commercial banks in promoting regeneration. A range of new CDFIs are emerging, from Wales to East London. The Social Investment Taskforce, chaired by Ronald Cohen, has explored a proposal made by the Chancellor for a £20 million Community Development Venture Fund (Social Investment Task Force, 2000).

And yet pressure to rein CDFIs into existing UK and EU financial services regulation is not appropriate either. The case of mutual guarantee societies is a case in point (see Box 4). As Andrew Hilton, of the Centre for the Study of Financial Innovation, comments “like internet regulation, the longer you leave it the better, at least that way the plant can take root. Don’t regulate it until you know it is robust enough to survive regulation or don’t regulate it formally, you are certainly going to kill it. The last thing you need is micro-regulation of micro-finance. Yes, there are going to be losses, yes there are going to be scandals, and I realise that regulation is usually driven by the fear of the scandal. But broadly the Friendly and Provident Societies have been astonishingly scandal free. And look at Building Societies, their regulatory touch has been substantially lighter than banks and there has never been a pound of building society deposits ever lost.”

Box 4. Mutual Guarantee Societies²

The National Association of Mutual Guarantee Societies was established in the UK in 1993, but its eight pilot schemes have not yet been able to begin issuing guarantees to their members. Despite financial support from the Co-operative Bank and Unity Trust Bank and encouragement from the Bank of England and Department of Trade and Industry, regulatory obstacles have prevented the operation of the schemes.

² This box draws directly on the work of David Boyd and Malcolm Lynch at Wrigleys Solicitors (Wrigleys 2000)

A number of regulatory obstacles have made it impossible to develop a viable legal structure for the operation of mutual guarantee schemes in the UK. The hurdle which the aspirant mutual guarantee societies have found impossible to clear has been the need for authorisation under the Insurance Companies Act 1982. Under the Act, the Treasury's Insurance Directorate is responsible for the authorisation and supervision of companies who carry on insurance business in the UK. Since 1 January 1999, the Treasury has delegated this role to the Financial Services Authority.

To achieve authorisation as an insurance company, it is necessary to satisfy a number of requirements which are set out in a series of regulations made under the 1982 Act. These requirements include adequate financial resources, a minimum guarantee fund and a required margin of solvency. The cost of achieving these requirements is prohibitive for the UK's pilot mutual guarantee schemes. However, the efforts of the National Association of Mutual Guarantee Societies to convince the regulator that it did not intend to conduct insurance business and its attempts to redesign the guarantee process to fall outside the Act have not yet proved successful.

Were it possible to obtain an exemption, mutual guarantee societies would be given the chance to develop in the UK. According to the National Association of Mutual Guarantee Societies' estimates, there is the potential for the establishment of at least 50 societies over the next eight years, serving more than 15,000 businesses who could borrow £375 million (625 million EURO) and create 400 jobs³.

There are other reasons to avoid bringing CDFIs into line with mainstream regulation. There is no danger of systemic risk from a collapse of CDFIs. Where CDFIs do not attract deposits, the classic requirement for regulation, to protect the savings and assets of depositors, does not apply. The costs of supervising such small institutions would at any rate be disproportionate to the size of their current portfolios. It could be argued that a number of CDFIs have developed strong working relationships with banks, so that some level of supervision will be exercised anyway. Where CDFIs do attract deposits, they register as banks, so that regulation is already in operation. With lending, the risk of failure needs to lie with the borrower, so that there is limited need to protect borrowers through regulation.

Investment Societies

There are essentially two models of CDFI – the banking model, taking deposits, and the investment society model, taking risk capital. With the investment society model, the price for escaping more onerous banking regulation is carried by the investors. Their investment represents risk capital without the financial benefits of classical venture capital in that their financial return is restricted. The downside risk is that the activities of CDFIs, particularly at an early stage, do carry significant risk. If CDFIs are to grow, they will need to grow their equity capital base. In turn, that means more social investors, whether individuals or institutions.

Yet the experience of the USA is that, if the ranks of social investors are to grow, it is likely to be among those willing to see a positive financial return on their capital but still concerned to invest at low risk. It may be possible to develop investor protection or insurance schemes, such as guarantee funds, without stepping back over the line towards the legal definition of deposits. Even so, this points to a clear future need for a regulatory framework capable of minimising risk and developing investor confidence. The UK comes closer to this than many other EU countries, but does not achieve it and may take steps backwards if EU banking law evolves in ways that, most likely accidentally, outlaws non-bank CDFIs.

³ National Association of Mutual Guarantee Societies, submission to the Cruickshank review of banking services in the UK, 22 February 1999

Banks

The banking model offers a route to a clear and accepted status. Banking status also allows greater access to resources at lower cost, including savings deposits and wider scope for shareholder investment, bond issues. Banking status may also enable CDFIs to achieve greater leverage by borrowing from commercial sources or raising funds from capital markets. A number of European CDFIs have chosen this option for that reason. However, questions remain, in particular in relation to the entry barriers of banking status, which makes it difficult for many CDFIs to graduate.

For CDFIs that wish to become banks, the main obstacle is the entry requirements. In particular, as John Milne of the Financial Services Authority, puts it “the fundamental principle that is embedded in the legislation is that all regulated forms will be required to have adequate resources.” Yet, while EU banking directives talk in nominal terms of the freedom of establishment and freedom to provide financial services, in reality, as Christophe Guene concludes, “it is difficult to start small, be small and to serve small.” (Guene, 2000) A major part of this is the minimum capital requirement. These, as Andrew Hilton argues, “are too high. You want mini-banks to come in. I have no problem with banking consolidation, banking convergence, the emergence of mega banks at the top end provided there are lots of little banks coming in at the bottom. But at the moment, the price of getting in is higher and higher.” In the words of Rosalind Gilmore, of Zurich Financial Services, “it should not be a regulatory objective to stop these things happening.”

Why have a minimum capital threshold? “Some theorists of financial regulation downplay the importance of minimum capital requirements as a safety factor, viewing them rather as a rationing device to prevent the supervisory authority from being overwhelmed with more institutions than it can handle.” (CGAP, 1996). Indeed it can be argued that they play an unnecessary and restrictive role in terms of competition, shielding existing banks against new entrants, particularly in the markets in which CDFIs operate.

There is no guarantee that a minimum capital base in itself delivers more effective systems, a more diversified portfolio or indeed a more appropriate allocation of reserves against losses. After all, many CDFIs operating below the 5 million Euro threshold are 100% capital-backed. In terms of capital reserves, a 500,000 euro social finance organisation is less likely to fail than a 10 million euro bank that works with a 12.5 time leverage on its capital (Guene, 2000). However, it should also be recognised that most CDFIs “do not have private owners with deep pockets who can be expected to provide rapid infusions of fresh capital in emergencies.” (CGAP, 1996)

There is therefore a case on grounds of competition for a lower minimum capital threshold for deposit-taking institutions such as CDFIs if the backing percentage is set higher – up to 100%. This could mean restoring at EU level the one million Euro initial capital threshold which is being phased out. Whereas in the UK, under the Second Banking Coordination Directive the minimum capital requirement went up from £1 million to 5 million EURO. This would imply a new potential approach, allowing CDFIs, on grounds of social benefit, to graduate towards banking status over time. A regulatory approach that adapts as CDFIs grow is successfully used in UK credit union legislation. Prudential rules are variable, enabling credit unions of sufficient size and capital to take on additional powers with a Section 11C certificate but then be subject to additional regulatory scrutiny.

Against this, Pat Conaty argues, “I do not think that the banking route is sensible. For those who are successful as CDFIs, this route will open up to them in due course after say 10 years or so. Banking status anywhere in the world has a high cost liability in regulatory obligations and this inevitably pushes CDFIs away from the socially excluded. I can think of few exceptions to this. Grameen Bank and SEWA Bank yes, but look at their size and in the former case, ability to secure gift capital over a considerable period.”

Similarly, Mark Hayes argues that there are two issues of regulation, “supervision (of the lending business) and protection (of the investor). It should be possible to protect the risk investor (shareholder) against fraud etc., without supervising the business. On the other hand, depositor protection probably does need supervision, why should CDFIs be any different? What is required is that the regulator has the specialist knowledge of the sector to avoid stifling it – easier said than done. For the risk investors, I am not convinced there is an economic alternative to self-regulation at the individual fund level. Investors have to look after their own interests, and societies have to put a premium on effective corporate governance. Ownership has to be real.”

This suggests that there is over time a need for greater clarification and greater flexibility, and that this should come in the form of flexible and enabling regulation rather than the blanket extension of existing law designed for and only appropriate to large-scale financial service providers.

D. An Agenda for Future Regulation

A new regulatory framework would enable CDFIs to emerge, experiment and grow to serve groups in need, while retaining consistency with appropriate protection for depositors, investors and borrowers and with wider core regulatory objectives and principles. Such regulation could come in different forms ranging from statutory supervision through to self-regulation. Examples of international practice are set out in Table 3. What we set out is a framework of potential regulation, which draws on all of these levels.

**Table 3. Different Models of CDFI Regulation:
International practice**

| Model | Example |
|---|--|
| 1. Existing Law approach | CDFIs such as Triodos that are registered as banks. |
| 2. Special Law approach | Co-operative legislation, India |
| 3. Industry self regulation (with or without supervision) | USA: National Community Capital Alliance Canada: La Caisse Central Desjardins du Quebec |

What is important to note is the special status that mutuals can have in this framework. Mutual financial institutions and co-operative banks have played a key historical role in Europe in extending access to finance. Yet, with diverse rights or exclusions in different EU countries and no common framework, no effective framework exists for the emergence of new financial mutuals to serve groups excluded from financial services in contemporary society.

There is a good basis for allowing greater self-regulation in the case of mutuals. In terms of corporate governance side, taking deposits from only members (the mutual / co-operative approach) would enhance peer review and greater self-regulation might be allowed than in cases where deposits (and investments) are collected from non-members. But size also matters as does the existence of a common bond between members. Small clubs (depositor and investor) could within limits reasonably be left to self-regulate (as at present with largely middle class investment clubs). As size increases then the need to assure that fiduciary responsibility for handling the money of remote participants increases (as the risk of fraud etc. rises).

The framework we explore therefore includes:

Existing Law

- Recommending the use of existing banking law for deposit-taking CDFIs with a capital base of over 5 million EURO.
- Liberalising existing UK law in relation to 'deposit-taking' charities and credit unions and 'risk capital' industrial and provident societies.

Special Law

- Recognising exempt deposit takers at EU level.
- Creating a new UK investment society model, drawing on the model of oeics, which would be a pooled, unauthorised investment company appropriate for larger-scale CDFIs and new 'high-impact' social investment funds.

Industry Self-Regulation

- Promoting the building blocks for effective self-regulation in terms of prudential management and benchmarking.

Existing Law and liberalisation

The 'existing law' approach of UK and EU bank regulation should be used for deposit-taking CDFIs that hold more than 5 million EURO in capital. Below this, UK CDFIs that wish to take deposits have two options. They can operate as credit unions or as charities. Both have explicit exemptions under certain conditions from the UK Banking Act. There is a case for certain liberalisation, for example, charities should be allowed to pay a limited, below-market rate of interest on deposits.

For 'risk capital' industrial and provident societies, there is also a case for selective liberalisation, such as expanding the maximum investment allowed from £20,000 to £40,000. The FSA should also issue explicit guidance on the appropriate use of withdrawable share capital by CDFIs.

The cost of registration for industrial and provident societies is significantly higher than costs for companies. This could be addressed by demerging the Registrar of Friendly Societies from the FSA and attaching it to Companies House and, as Malcolm Lynch suggests, moving it out London to reduce costs. This could come as part of a wider rationalisation of co-operative law, such as the new Mutuality Act proposed by Rosalind Gilmore, which would create a new overarching framework for mutuals.

However, a long-term approach is needed which complements these changes with the development of a new recognised status in EU Banking Directives and a new model for large-scale social investment societies.

Special Law

a. Exempt deposit takers

As part of a new EU directive, a recognised status could be established for exempt deposit takers. This would offer the opportunity for the EU to harmonise a number of existing exemptions operating at national level. Member states would have the right to apply this within their own banking rules. Eligibility could be determined through an accreditation process, most likely handled at a national level.

This would require an appropriate and robust definition. Initially, such a definition would:

- specify distinct initiatives such as credit unions;
- ensure that initiatives were mutuals or non-profits.

EU member states could nominate CDFIs for accreditation by the EU Commission. Eligible CDFIs would be able to take deposits from members and could operate with less than the existing 5 million EURO capital requirement, as long as they were sufficiently backed with share capital. They would be regulated by peer (depositor) review. They would have access to deposit insurance, on a tiered basis, but if they took this up, would then accept increased costs and scrutiny in line with this privilege.

Such an exemption would help address two potential future concerns. First, there is an issue of whether CDFIs regulated in one member state is permitted to operate in another. Could workplace credit unions for staff in international companies like News International operate in countries where, so far, credit unions have been illegal? This has already happened in the UK, in the case of US credit unions with branches in air bases for US service personnel. Second, it would assist in the accession of Eastern European countries such as Poland, which have a significant credit union sector.

b. A new model of high-impact social investment fund

Investment funds come in a variety of forms. What is notable is that there is a clear gap between mainstream investment funds, including ethical funds screened against social or environmental criteria, and non-bank CDFIs. Two constraints explain this. First, there are regulatory restrictions

on ethical investment funds placing monies into unquoted social investment. A number of funds, such as Hendersons, have started to place money with Triodos Bank, but even this has been limited for reasons of perceived risk. Secondly, where a fund operates as a unit trust, it is subject to trust law. A disadvantage of trust law for ethical investment is also that trust law demands that financial return be given primacy in the management of funds. The complexity of trust law was one reason for the introduction of oeics (open-ended funds), authorised funds but operating under contract law and therefore with less rigid constraints (subject to the way in which the oeic is incorporated).

Both constraints could be addressed by developing a new unauthorised variant of the oeic. There is therefore a gap in the market that, given an appropriate legal and regulatory form, could be filled. This could operate as a mutual investment fund that was open-ended, unauthorised and operating under contract law, and therefore able to set social return above financial returns. It would be a pooled unauthorised company.

A 'high impact' social investment fund model such as this would be a logical extension of the operations of ethical funds and CDFIs. It would take savings from mainstream sources but accept a savings strategy agreed by the participants without being required (in pursuit of 'due diligence' and 'fiduciary duty') to maximise (over a relevant period subject to risk exposure levels) financial returns. The strategies agreed by member participants might for example 'trade' social or environmental ('green') returns for financial returns. This would require enabling legislation. However, once established, it could also then allow existing CDFIs and ethical investment funds to 'convert' if there is sufficient support amongst the membership. Otherwise, the membership attracted by the new funds could simply 'migrate' to them.

The government now requires pension fund trustees to state their social objectives, if any and the Department of Social Security is to conduct a survey of pension funds to establish how they are implementing a socially responsible strategy. A logical next step is to allow pension, and other, fund trustees to agree objectives (social and financial) with investors. A new high-impact social investment fund model would enable this to take place.

Industry Self-Regulation

Self-regulation by an association of CDFIs could be an effective and responsive way to meet many additional needs that CDFIs may have beyond statutory regulation. In the USA, the National Community Capital Association operates a model of self-regulation for members, including financial performance requirements for entry and benchmarking against peer groups. In Quebec, the confederation of credit unions, Caisses Desjardins, is licensed effectively to regulate its members.

As Malcolm Bush explains, "the caisses from the 1930s on cemented their financial success with regional and then provincial collaboration and support that resulted in very tightly knit industry-based regulation. The result of the collaboration was the sharing of human and capital resources that gave the caisses key advantages over the more loosely knit, locally controlled, but more publicly supervised credit unions in the rest of Canada. The industry collaboration could in theory have occurred or indeed be sustained in a system where the day-to-day regulation was public. In practice, however, the industry control permitted the federations and the confederation to develop their supportive networks as they saw fit rather than as the regulators permitted." (Woodstock Institute, 2000)

In the UK, Roger Brocklehurst of the Local Investment Fund argues that, "a new financial intermediary for the CDFI sector could take on the mantle of regulator, in the sense that funds are only released that have passed an accreditation process, or can meet certain pre-determined covenants/ratios etc." There could be a central association to develop IT-based monitoring for members, which would report to the FSA.

One central need which both self-regulation and effective management should address is the promotion of prudential lending. This is important for CDFIs that aim to operate as sustainable institutions. There are distinct challenges. Lending tends to be unsecured or based on limited collateral, focused on specific sectors or areas, rather than diversified and used by borrowers who are not regarded as creditworthy by commercial banks. Set against this might be an argument that information on borrowers, particularly in limited membership schemes or mutuals such as Aston Reinvestment Trust where borrowers are also investor members, is higher than in conventional institutions, tending to improve repayment rates. The following are important concerns for prudential lending by CDFIs:

a. Adequate capital provisions

The legal form of the CDFIs determines how they are able to hold capital (see Box 5). Capital adequacy is a basic measure of an institution's financial strength and its ability to absorb losses. It refers to the ratio of capital to assets, with assets weighted according to their risk. The 1988 Basle Capital Accord recommends a minimum 8 per cent (risk weighted) capital adequacy ratio (or alternatively viewed, a maximum leverage of 12.5%). Some national authorities specify higher, tailored minimum ratios for the institutions they supervise on a case by case basis (along with minimum liquidity requirements). There are two weaknesses in this approach. The first is that the regulatory definition of capital may not represent an institution's true capacity to absorb unexpected losses – for example there must also be adequate provisioning policy. The second is that way that risk is weighted under the Basle Accord and subsequent amendments may, if not appropriate for the nature of CDFI lending, distort the true level of underlying risk. There may also be a concern about institutions holding adequate capital in liquid form.

Pat Conaty of the New Economics Foundation argues “as a minimum for capital adequacy, a CDFI should have reserves of at least 7 per cent and if it is doing business lending that this should be at least 25 per cent. These reserves though for a CDFI will be its guarantee funds not its withdrawable share capital. This is a key point as these reserves are an initial endowment from typically public sector and charitable grants. Beyond the first few years, the reserves need to be maintained and extended by retaining surpluses from trading (i.e. annual provision policy decisions). Whether the reserves are kept in a separate Guarantee Company in the group or in the main fund itself, they are reserve funds which are the insurance provision against risk to shareholders and give additional security beyond security taken with any deal (e.g. asset charges, land charges, personal guarantees and fixed and floating debenture charges). The 25 per cent level need not be maintained indefinitely as it is steep particularly as the activity widens of the CDFI beyond the first few years, but it depends on the makeup of the underlying portfolio.”

Box 5. Defining Capital

Capital equals Equity + Retained earnings (or unrestricted reserves for charities) + Loan loss reserves not ascribed to particular assets + Limited amounts of subordinated long-term debt.

Adapted from: (Microenterprise Development Review, 1998)

Loan loss provisions are established to build up reserves for loans that fall into arrears. The central idea is that they should correspond to the value at risk in a loan portfolio. At present, non-bank CDFIs do not report in a consistent way in relation to either capital adequacy or loan loss provisions. One reason for this is that it is relatively young as an industry and, in a number of cases, building up a track record. However, if CDFIs aim to be sustainable institutions serving those in need, then they will need to report these in a consistent way, whether as a matter or

regulation or self-regulation. Indeed, their portfolios are potentially volatile and they can only demonstrate a relatively short history, so that more conservative capital adequacy ratios than Basle Standards might be preferable.

b. Quality of the conduct of the business

The key concerns for prudential lending in terms of business conduct will be the quality of accounting, control and reporting systems, and the integrity and competence of management and governance.

c. Benchmarking and best practice

An effective industry association for CDFIs is a prerequisite for building the credibility of self-regulation over time. Progress towards this has been slow, but the need for a consensus approach and an effective caucus can only grow. Even if self-regulation does not develop, as Rosalind Gilmore argues, “some kind of competent interlocutor (such as trade association) is a great help for a regulator.”

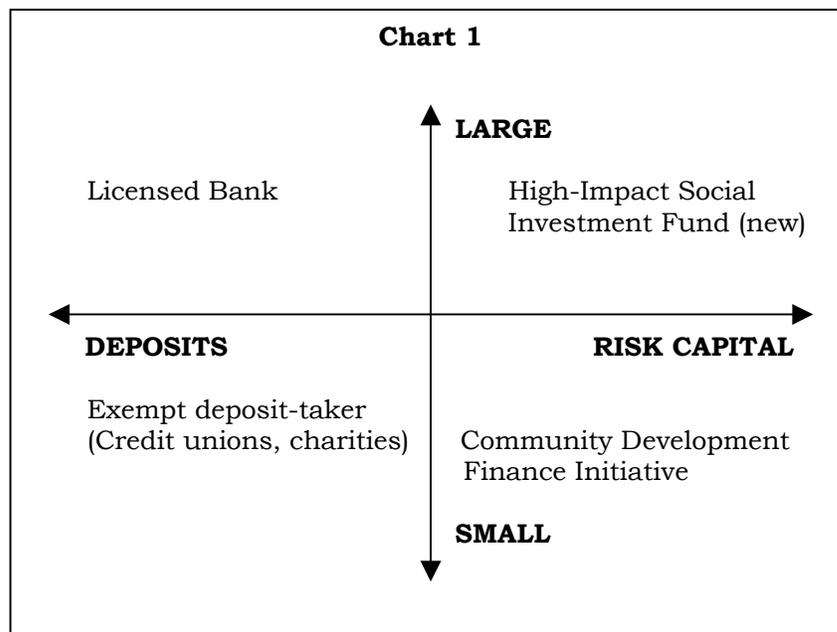
Conclusion

There needs to be life beyond benign neglect for CDFIs. Financial services regulation is changing fast and a new phase of international co-operation and potentially coordination is likely. In this context, CDFIs as a global phenomenon need to find a niche that is recognised both in terms of appropriate regulation for its models of business and in terms of special status for its social purpose.

Ian Snaith comments that “the downside of regulatory uncertainty is when you don’t know if you can do something. The downside of certainty is when you know you can’t.” There are reasons to believe that the next period is likely to require a clearer regulatory policy, and that this brings with it the dangers of a more restrictive interpretation, along with the opportunities for defining new freedoms.

Cruickshank argues against the use of subsidies for tackling financial exclusion on the grounds that this is likely to be anti-competitive (Cruickshank, 2000). But, against this, if there is market failure then careful subsidy can in principle promote competition. However, in relation to regulation, the issue is not one of preference or subsidy. In the context of a regulatory system that could be argued to discriminate against institutions providing financial services to excluded groups, the point is to remove such regulatory barriers and create a fairer basis for competition.

In future, we can envisage different classes of CDFIs (Chart 1); deposit-taking versus non-deposit taking; mutual versus non-mutual; small versus large. Many CDFIs could grow to become a form of investment fund with well defined objectives. If, however, CDFIs take deposits, then the nature of their fiduciary duty is different. But the appropriate regulation may depend on the size of the CDFI and whether CDFIs take deposits in general or just from members (as in the case of credit unions).



There is no logic, no economic sense nor any morality in restricting access to capital for excluded groups. The role of regulation is to achieve the same protection and objectives appropriate to other financial services, but in a clear and enabling way that reduces the possibility of such discrimination.

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