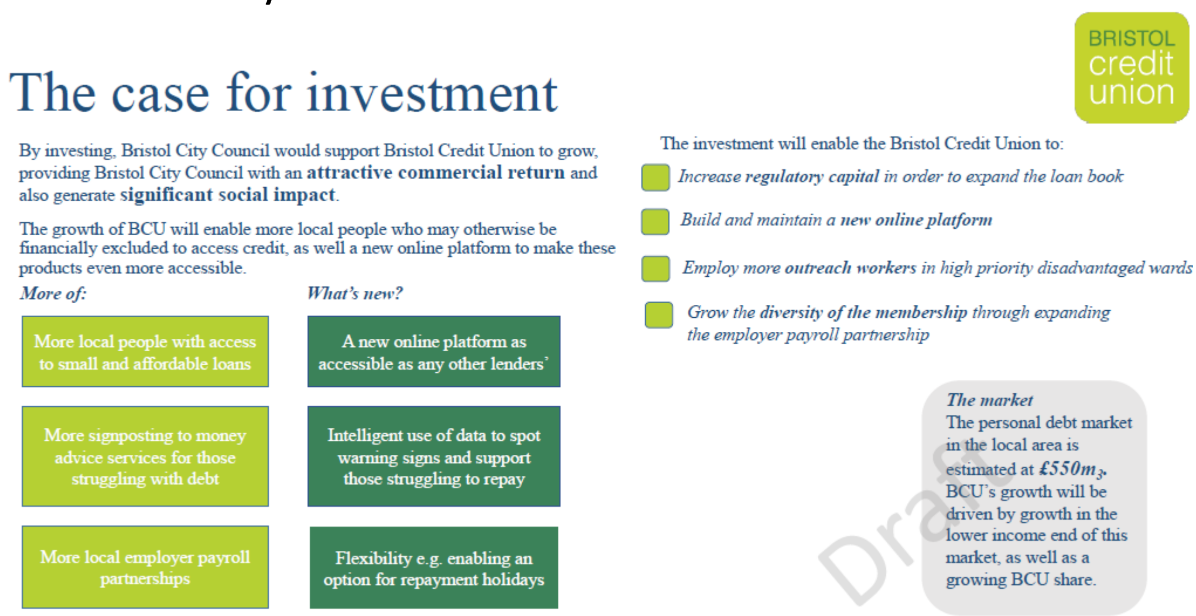
1. Background

Bristol Credit Union (BCU) is a member-owned, not-for-profit financial cooperative. A key tenet of the Credit Union movement is to enable people who are otherwise financially excluded to gain access to financial products, including bank accounts, savings accounts and affordable credit. Thereby it proactively works to create a more inclusive economy, specifically within financial services. BCU has grown significantly over the past 12 years since formation in 2006 from 1,200 members and £0.5m in assets to 11,000 members and £8m in assets in 2017. BCU ambition is to grow threefold over the next five years, to do so BCU requires investment into new infrastructure and in particular investment in an online platform, expand outreach workers, increase regulatory capital and diversify the BCU membership. The investment required deliver these changes is a minimum of £0.85m with an aspiration to raise in excess of £1.00m. Advanced discussions have taken place with Joseph Rowntree Foundation who are willing to invest £0.35m into BCU as long as BCC invests £0.5m. Potentially beyond the £0.85m initially funding a number of other smaller funders will come on board and consideration has been given to raising a public bond to local individual investors.

2. The case made by BCU



Social impact

BRISTOL credit union

Your investment would help to create social impact in Bristol across the short, medium and long term.

Immediate

- *Creating jobs in the local ethical finance sector*
- *Enabling outreach workers who are active in disadvantaged wards*
- *Encouraging follow-on investment, including a local democratised investment offer (a Bristol Bond)*
- *Supports BCU's ability to provide rent accounts to assist Universal Credit recipients to manage better*

Short term

- *An affordable form of credit which puts hundreds of thousands of pounds back into the local economy*
- *Loans to prevent financial problems from worsening*
- *Continued ability to support access to private rental sector to combat homelessness*

Medium term

- *Boosts the local economy via loans to social enterprises and local business*
- *Reduced unemployment**

Long term

- *Members gain improved financial literacy and savings rates and reduced reliance on loans*

A route to financial independence for local people

Draft

**(Schemes such as the HGV Driver Training scheme provide the necessary credit to allow unemployed individuals to access training and materials needed to access employment opportunities)*

Who does the Credit Union support?

BRISTOL credit union

Bristol Credit Union exists to support those who might otherwise not be able to access affordable credit. This is part of tackling the **poverty premium**. That's the injustice that those on the lowest incomes in the UK have to pay proportionately more for many services. BCU's impact is greatest in the most deprived areas in Bristol and Bath. Here we explore the numbers and the people the Bristol Credit Union supports[1].

Roughly 2/3 of BCU members…

2/3

…have a household income below £30,000

…live in the 26% most deprived districts of the BCU membership area

52%

Of outstanding loan balances are with members in the 10 most deprived areas of Bristol[2].

Of the loan interest BCU receive, over **90%** is spent in Bristol, keeping funds re-circulating.

Bristol University's Personal Finance Research Centre estimates that ***borrowers save*** between ***£377*** and ***£425*** in interest by using credit unions and other third sector lenders.

And overall, the DWP Growth Fund evaluation[4] found that **32%** of borrowers from third sector lending organisations considered that they had borrowed less from any other source since first taking out a loan with a DWP Growth Fund Lender.

All but one of BCU's High Priority Wards are in the ***top 14*** most deprived wards in Bristol[3].

91% Of the loan book are the ***highest risk*** loans that BCU provides.

3. BCU Financial Performance

	2013/14	2014/15	2015/16	2016/17	2017/18
Loan book size (£k)	2,572	3,172	3,748	3,950	4,581
Total interest income (£k)	501	709	780	771	782
Member deposits (£k)	4,950	6,402	5,756	6,350	6,675
EBT (£k)	(88)	(11)	(95)	5	(110)
Capital ratio %	11.5	12.1	11.5	10.8	11.3
Bad debt %	9.4	6.7	8.0	8.8	7.8

Lending has grown at double-digit rates, and at a faster rate than the growth in deposits. Lending quality has been maintained with a reduction in bad debt rate. Book churn has reduced as a greater proportion of new lending has been larger loans over longer terms, as per plan. Total interest income has not grown as quickly due to a mix of lower interest rates on fixed term and other cash deposits over the last couple of years, and a greater proportion of loan

balance growth coming from higher value/lower margin/lower risk loans than in previous years. Deficit for the year was primarily due to investment in resource and capability to be ready to deliver the investment programme. We've also continued to invest in marketing which has delivered further confidence that future growth is very achievable. Growth in marketing budgets has been focussed towards targeted online marketing, whilst maintaining the level of more traditional area-based focus.
Capital has increased at year-end September 2018 despite the deficit for the financial year. We have been able to increase our regulatory reserves due to Deferred Shares issue as well as a re-classification of certain funds we manage.

4. Investment Benefits

In return for the investment into BCU by BCC and JRF of £0.85m each will receive a return of 6% percent over a ten year period. At that point it is anticipated that the principal investment will be repaid. There is a risk that due to regulatory set minimum capital ratios that the principal may not be repaid without BCU refinancing the initial investment.

	Yr 0	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Cost of borrowing & MRP	-500,000	62,500	62,375	61,000	59,625	58,250	56,875	55,500	54,125	52,750	51,375
Return @ 6.00%	500,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000	-30,000
Repayment of principal investment											-500,000
IRR	5.59%								Net Cash		-225,625

Borrowing at 2.5% based on a 10 year term and on lending at 6% would generate a cash surplus of £226k at the end of the 10 year term assuming the principal is repaid at year ten. The investment has a positive IRR of 5.59%.

The JRF investment is on the basis of 10 years with a notice period at 10 years which may result in the term of the investment being extended for a further 5 years.

5. Due Diligence

To ensure that the risks associated the investment proposition as set out by BCU are fully understood a piece of due diligence was carried out. Numbers For Good, an organisation who specialises in the social and environmental projects to connect investors with opportunities for sustainable financial and social returns, was engaged to undertake the due diligence.

The report produced by Numbers For Good is contained in appendix A. Numbers For Good gained access to BCU's senior staff and detailed financial statements from that they concluded that the key financial drivers affecting the investment are as follows:

1. Loan Growth – loan growth is a critical driver of success as despite the consolidation to date the organization is sub scale;
2. Bad Debt Rates – the financial model developed by BCU is highly sensitive to the proportion of loans which are not repaid;
3. Operational Efficiency – this will be driven by scale and investment in IT

Lenders to businesses typically make their lending decision on a downside analysis given that ideally there is for example, a 90% chance that this will be outperformed and the lender gets their money back and say a 50:50 chance which might reflect a base case set of projections. Usually two of the three of these scenarios would be combined to determine the most realistic worst case scenario.

The analysis has been done on an annual – there may be further volatility on a monthly basis which could make, for example the worst-case capital ratio, reserves position or cash position slightly lower than set out below.

- Of the downside scenarios tested:
  - None generate enough surplus over 10 years to repay the loans
  - All generate peak cash losses of more than £700k during the period before becoming profitable
  - All require future capital injections during the period to maintain the 10% capital ratio
  - None generate sufficient surplus to repay the interest due in the first 5 years

In conclusion there are therefore a number of weaknesses to this investment proposition:

- The financial model is extremely sensitive to downside tests and a small bad debt decline, limited reduction in growth or failure to implement efficiencies would all prevent BCU from repaying the loans
- In each of the downside cases BCU would not be capable of generating enough surplus in the major part of the loan to pay the interest due

6. Mitigation of Risks

JRF have also undertaken their own due diligence on the investment proposition and not surprisingly have identified similar risks as set out above. Discussions between BCC, JRF and BCU have agreed that there needs to be open and regular performance reports across the period of the investment. It is proposed that during the life of the investment that BCC and JRF receive regular reports from BCU on a range of to be agreed indicators. These have yet to be developed and agreed. Should any of these indicators fall out of an agreed set of tolerances either BCC or JRF can trigger a change to the terms of the investment. BCC, JRF and BCU have agreed that a 6% coupon is a fair rate of return for the investment made but if a trigger is activated then BCC & JRF will work with BCU to mitigate any risks to BCU. That may mean a reduced coupon rate for the remainder of the term of the investment, extending the term of the investment or accepting that the initial investment is not repaid. The key outcome is that the payment of the interest on the investment does not adversely affect the financial position of BCU. The details of this have yet to be worked through.