

**Cabinet Office – Office of the Third Sector
Social Investment Wholesale Bank: A consultation on the functions and design**

cdfa response

The Community Development Finance Association (**cdfa**) welcomes the opportunity to respond to the Office of the Third Sector's (OTS) *Social Investment Wholesale Bank* consultation.

The **cdfa** is responding on behalf of its 71 members comprised of Community Development Finance Institutions (CDFIs) [see Appendix for list of Members and Supporters]. CDFIs are non-commercial social enterprises which deliver fair and responsible financial service to those in greatest need. CDFIs serve three markets: third sector/social enterprise; small- and micro-business; and personal/consumer, providing credit where access the finance has been denied by mainstream financial institutions. Our response has been instructed via direct consultation with the membership.

Community Development Finance Institutions (CDFIs) are one of only a few social investment retailers working in the space as proposed by SIWB consultation able to deliver capital to the third sector front lines, in particular to underserved markets. As such, the **cdfa**, as the CDFI sector's representative body, is best placed to provide expert evidence and recommendations.

The most recent figures available, for the (as yet unpublished*) period ending 31 March 2009 show that **cdfa** members have made £472 million worth of loans since 2003, thereby financing nearly 35,000 businesses and households, creating 21,000 jobs and sustaining 76,000 more in those six years. CDFIs have also levered an extra £492 million into the businesses and households they serve, creating a total contributory impact of nearly one billion pounds (£964 million).

* **cdfa** annual survey, *Inside Out 2009*

1. Do you agree with the vision for a Social Investment Wholesale Bank (SIWB) set out in this consultation?

The time is right to realise the vision of “a financial institution which would work in the interests of society as a whole”. We fully endorse an institution which would help increase investment in society, the environment and the economy, delivering against a ‘triple bottom line’ of greater economic growth, social cohesion and sustainable development. It is important that OFT recognise the so-called “third sector front line” as comprising financially excluded individuals, businesses in deprived communities and social enterprises – as well as charities and voluntary organisations – and that this defines how we use the term “front line” herein.

CDFIs are ideally positioned to deploy capital to businesses in deprived communities, financially excluded individuals, social enterprises and charities in the form of responsibly-managed affordable credit. CDFIs have demonstrated their efficacy in reaching these underserved markets, yet recognize an inability in being able to meet demand for affordable credit.

It is important to recognise the conditions under which SIWB could work successfully. Mediation of risk associated with provision of wholesale capital to social investors which are, by definition, serving high risk markets, must be addressed in order for SIWB to function efficiently and provide affordable credit to retailers. As an important part in a multi-faceted policy and investment framework, a Social Investment Wholesale Bank would play an important role in addressing the need for increasing CDFI scope and reach. Structured correctly, SIWB could play a valuable role in providing much needed affordable finance to CDFIs, thereby building their capacity and reach to help ensure adequate and appropriate financial support of business in deprived communities and underserved markets. As experienced social investors, CDFIs are supremely positioned to deliver this goal.

2. Do you agree with the economic case as it is set out, and do you have further evidence, case studies or detail in its favour or evidence to the contrary? To what extent does the evidence suggest problems are short term (for example, linked to the immaturity of the market or perceptions) or intractable?

Market failure exists at both the wholesale-retail interface level as well as the retail-front line. These are interlinked, as adequate provision is not in place to ensure that social investor retailers are in a position to meet the demands of the third sector front line, including businesses and consumers in disadvantaged communities.

The market between the wholesale and the retail levels must be developed in order to ensure that adequate retail infrastructures are in place to handle incoming wholesale capital for on-lending to the third sector and disadvantaged communities. Inadequate capitalisation stems from the lack of a systemic, sustained strategy of support. This function could be borne by SIWB.

Latent and unmet demand requires the capacity building of the CDFI sector. The sector would benefit from market-making activities as there is a lack of appropriate capitalisation products. The CDFI sector is mature enough to expand to meet this demand provided there is adequate resourcing. In addition, a CDFI Fund running parallel to SIWB would mitigate risk allow for utmost flexibility in developing the sector's reach and scale.

Based on our experience, demand from the front line varies according to category:

- Demand for affordable credit from financially excluded individuals outstrips supply. This is partly evidenced by the success of high-cost creditors and illegal moneylenders (loan sharks). CDFIs operate in the space between this overpriced credit and mainstream credit, but at the moment have the capacity to meet only a very small proportion of demand.
- Businesses operating in deprived communities often struggle to access affordable finance; this has intensified greatly under the recession. CDFIs are one of only a few social investors operating in this area, and the gap in the capacity of CDFIs to provide appropriate business finance has been exacerbated by the credit crunch.
- Social enterprises are a very diverse group with an array of funding sensibilities and requirements. Grants will continue to play an important role, but access to affordable finance is also recognised as an area that requires further development.
- Charities and community groups have limited capacity to incur debt. However, regardless of the degree of demand, this is a sector where specialist retailers are best placed and require the right kind of support. Without access to suitable financial products, the third sector remains dependent on short term grant funding, which

stifles the sector's ability to grow and invest in new ways of working and delivering services.

There are market gaps in the provision of financial products to front line communities and third sector organisations. CDFIs have demonstrated their efficacy in serving these markets, and a combination of community reinvestment measures – SIWB and a CDFI Fund – will reduce market failure. The SIWB should support retailers in capacity building the front lines.

3. There are five potential functions for the Bank outlined in this consultation: • a champion for sustainable social investment; • raising capital; • investing and providing capital; • market-making; and • advisory services. Are these an appropriate response to best address the problems identified? If so, why? If not, why not and what are the alternatives?

Broadly speaking, CDFIs and other social investors require advocates at top governmental levels in order to ensure the success of a social investment paradigm which includes SIWB. It is only at this level of influence that a truly robust social investment culture can be created and sustained. Although SIWB should act as a social investment champion, it can do so within the more narrow contexts of the banks functions as set out in the consultation document.

In terms of the appropriateness of the proposed functions:

- Raising capital will, of course, be a necessary function. Committing unclaimed asset resources would serve to launch the Bank, with a range of investment-attraction strategies in place to build the bank and diversify its assets.
- A range of adequately-scoped structures must be in place in order to efficiently invest and provide capital to CDFIs and other social investors, as set out in the document. Intermediary lenders, in particular CDFIs, require both revenue support for operations as well as capital for on-lending.

A Social Investment Bank would need to develop delivery vehicles and capacity in the sector, as well as drive financial engineering. Some of the products for consideration could include the following, as well as more commercially orientated loans and investments:

- Capacity-building and technical support grants
- Investment readiness and market support programme
- Grants to mitigate risk and reach the chronically underserved
- Products to develop balance sheets, including product diversification and asset acquisition
- Guarantee funds
- Long term, subordinated and/or unsecured lending
- Equity and equity-like products

Developing both the wholesale-retail and the retail-front line markets would address the undercapitalisation faced by CDFIs and other social investors, as well as the investment-readiness of the third sector and disadvantaged communities. At the retail level, commitments to expand the sector to deliver a national programme of social investment delivered locally, must be coupled with a commitment to financial sustainability structures which include SIWB as well as direct government support in the form of a grant fund. Working in tandem, a grant fund will ameliorate the risk inherent in capitalising CDFIs.

Although it would be prudent to offer advisory services to CDFIs and other retail intermediaries, such services should not be delivered by SIWB directly to the front lines.

Retail intermediaries are better placed to provide such services, and could be contracted by SIWB to provide them. By doing so, CDFIs would assist in delivering the market-making function.

4. Each potential function will have costs and benefits over time (both direct and indirect, social and financial). What is your view about these costs and benefits, and what evidence is there to back this up?

The business plan of SIWB will need to focus on the scale and range of services offered and the cost to deliver those services.

Providing capital should be the core function of SIWB, without which the other functions have little or no use. Where this lies on the social–financial return continuum is dependent upon the types of capital raised and the way in which capital provision is structured. It must be recognised that working in this space, by definition, might require a certain degree of philanthropic underwriting to ensure that retailers can actually take-up SIWB products in a sustainable way.

Serving as social investment champion would require dedicated funding which would be appropriately resourced from the Bank's own revenue streams or direct third-party funding.

Although offering advisory services to retail intermediaries is prudent, it is important that the cost to provide such a service does not deter take-up by CDFIs and other retailers. The provision of such services to front line organisations is better delivered by retailers who already possess expertise in areas critical to the success of the front line. In our experience, the knowledge and insight CDFIs have from delivering finance 'on the ground' means that they are also able to offer the most appropriate types of advisory services. This combination of providing finance and advice in tandem has shown to deliver better results in terms of performance (lower write-off rates).

5. Should advisory services for front-line third sector organisations and social investment intermediaries accompany the provision of capital or be provided separately?

Advisory services to CDFIs and retail intermediaries should be offered by SIWB, but should not be an option rather than a required condition of the provision of capital. Care must be taken to resource such a service so as not to make terms and conditions of SIWB capital too costly to accept.

Although a need has been identified to build the knowledge and capacity of the front line to understand investment products and services, supportive advisory services should be provided by retailers or others expert in this area – such as CDFIs – rather than by SIWB directly. Nearly 60 percent of CDFIs already offer advisory services and are best placed to continue to do as well as extend such services under the auspices of SIWB funding.

6. When raising capital, what combination of social and financial risks and returns would be attractive to investors? What evidence is there that the Bank could attract investment on these terms, from whom and through which investment products?

We support the use of unclaimed assets to capitalise SIWB initially. At such a time if and when additional capital is required, care must be taken to access sources of capital which do not compete with other wholesalers already in place.

Should additional investment be required, diverse investment products should be designed to attract philanthropically-minded investors to capture as wide a range of potential investors as possible, based on the likelihood of product success. Products such as investment certificates, guaranteed for some period of time, could provide capital as well as a share of principal interest and social investment ISAs, whereby earnings are shared between investors and SIWB could be considered.

The experience of CDFIs attracting investment using Community Investment Tax Relief points to the need for a risk mitigation mechanism, quantification of social return of investment, delivery on financial return at any rate, and some flexibility in fund management. To date, CITR has raised ca £55 million for CDFIs, proving that it can be a useful tool but one that requires further refinements to realise its potential.

Market research in these areas should be undertaken prior to raising capital in order to design the best possible products.

7. When providing capital, what combination of social and financial risks and returns would the Bank offer? What evidence is there that the Bank could make investments on these terms, to whom and through which investment products?

The pricing of capital made available by SIWB must be devised so as to attract CDFIs and other intermediaries – after all, this is the primary function of the Bank.

Accept higher social versus financial returns must direct the Bank's mission. Once an acceptable combination of social and financial returns is decided, the form and structure of the Bank's operating systems and financial solvency standards can be established.

A range of funding products should be made available to retailers tailored to the range of retailer types as well as retailer scale and capacities, with varying degrees of social/financial return. SIWB could make investments that carry a higher level of risk than other institutions are able to make.

8. Which combination of functions would be most effective and deliver best value for money?

The success of providing capital – the core function of SIWB – is dependent upon having investment-ready retailers like CDFIs and front line recipients in place. Ensuring that the retail level has the scale and reach required to take-up finance from a SIWB is required. More clarity on the proposed market-making function is required before additional comments are possible. Advisory services should be provided only to SIWB funded retailers.

9. Do you agree that eligibility should be based on potential social and environmental impact, rather than defined by legal or organisational form? If so, would it be necessary to ensure that the Bank ultimately supported a diverse range of enterprises, for example small, black and minority ethnic-led and rural projects?

Social investment retailers should be trusted to utilise SIWB financing appropriately and make lending decisions based on their own guidelines and mission without interference from SIWB. CDFIs by definition ensure that social impact is maximised and need not be unduly burdened with proscriptive rules as to eligible front line recipients.

Eligibility of retail intermediaries should be based on demonstration of serving the third sector and frontline service providers in disadvantaged communities.

10. This consultation suggests that the mission of the Bank could be to create social and environmental value through increasing investment for a social or environmental purpose. How do you think the mission of the Bank should be defined?

The detail for the mission should be defined by a Board of Directors populated with representative stakeholders.

11. Do you agree that SIWB would need to be flexible and adaptable to address evolving issues as the market develops? How could it be ensured that the Bank would respond appropriately to the evolving market?

Given the iterative nature of the social investment market, it is difficult to predict developments. However, an appreciation of this situation points to a need to embed a system into SIWB whereby stakeholders are engaged on a regular basis to respond accordingly. In addition, a structure must be developed to allow for adequate and timely recalibrations based on changing conditions. A well-connected and representative Board directed by an appropriate mission statement should suffice. Effective governance arrangements and clear leadership would be needed in order for SIWB to remain true to its values whilst adapting to market developments.

SIWB would need to be flexible and adaptable to allow its knowledge and approach to inform its ability to react to priorities and to address evolving issues as the market develops. This would, however, need to be placed within a clear context so that aims and objectives are not diluted and the Bank does not suffer from mission-drift.

Benefits of an SIWB would be diminished if it were overburdened with targets and constraints. The institution must be able to make informed decisions based on current market conditions and not over-capitalise emerging markets.

12. How best could the Bank be structured and owned in order to deliver its functions and meet its mission?

A significant government stake is going to be essential - at least for the first few years – utilising unclaimed assets, as originally envisioned for SIWB.

The Board must represent key stakeholders -- social and ethical investors, CDFIs, credit unions, ethical investors – as well as the finance sector to ensure fiduciary acumen, and grant providers for charity/community representation. Appointing an independent, impartial Chair may be of use to suppress undue bias.

13. Under what circumstances could an SIWB carry out activities itself, rather than being limited to financing and offering support to others?

Wholesale and retail functions should be kept separate by principle. Front line investment readiness activities should be funded by SIWB and performed by retailers.

Conducting research and analysis on the Banks functions as well as mission will help ensure mission clarity and commitment.

14. Do you agree that the Bank should seek to report transparently against a 'triple bottom line' of social, environmental and financial value? What ideas do you have for how this could be achieved?

A methodology for disclosure and transparency must be part of the fabric of such an institution. Such disclosure is particularly relevant under current financial circumstances and will also help to ensure appropriate responsive to changes in the social market. Such a system would put SIWB in the vanguard and lead the way, serving as a model for other financial institutions to provide details on their business activities as well.

15. Do you agree that the Bank would not distort competition to an extent contrary to the common interest if it followed the guidelines set out in this consultation? What mechanisms or safeguards could be put in place to ensure this, while still enabling the Bank to effectively carry out its mission and functions?

CDFIs have the capacity to accept a much greater degree of capitalisation, demand from the front lines, and a mission to expand nationally in scope and reach. Therefore, no undue benefit or market distortion is identified. Provided the retail / wholesale split is well defined, most distortion can be avoided

16. How would you make a robust assessment of the necessary financial requirements over time of an SIWB, and what evidence is there to back this up?

As stated previously, without knowing the specific terms and conditions of products offered by SIWB it is really difficult to predict the take-up of Bank credit by retailers. A business plan would need to be adopted which accounts for this situation as well as iterative financial modelling. Flexibility, operational review and external audits must be established to ensure robust assessment.

17. The Government recognises uncertainties around the capacity and willingness of the third sector's demand for finance. How could the risk of this undermining the success of the Bank be mitigated?

Our experience shows that unmet demand exists with groups CDFIs serve – social enterprises, businesses in deprived communities and financially excluded individuals. Much of this demand is investment-ready, and market-making activities would increase this demand further, providing a large pool of front line recipients.

CDFIs cannot meet the demand by consumers, micro, small and social enterprises. There must also be a proportionate level of support to the CDFI sector, with an up-scaling to position CDFIs in their rightful place as retailers with full national reach.

18. Do you agree with the principles for the design of an SIWB outlined in this consultation?

SIWB would play a significant part in providing the support required to ratchet up social investment in the UK. Such an institution would work well alongside other mechanisms for CDFIs, including a CDFI fund.

Conclusion

Then **cdfa** supports the mission of a Social Investment Wholesale Bank which assists CDFIs and other retailers in supporting enterprising communities, deprived areas and the financially excluded. In order for such an institution to succeed, the CDFI – which already possess the requisite skills, knowledge and expertise – must be supported in expanding its capacity to reach the demands of the front lines by securing a marketplace across the whole of the UK. SIWB would play an important part in an interlinked system of mechanisms built to deliver the vision of a robust, adaptable and responsive social investment culture.

We appreciate your consideration, and are at your disposal for further consultation on these issues.

7 October 2009

Appendix – cdfa members and supporters

Members

ABI Associates - Faith in Business
 Acorn Fund - Hull Business Development Fund
 Aspire Microfinance
 Aston Reinvestment Trust (ART)
 Bees Knees
 BIGInvest
 Black Country Reinvestment Society (BCRS)
 Blackpool Moneyline
 Bridges Community Ventures
 Bristol Enterprise Development Fund
 Business Enterprise Fund
 Business Finance North West (BFNW)
 Business Finance Solutions
 Capitalise Business Support
 Charity Bank
 Community Money CIC
 Co-operative and Community Finance
 Coventry & Warwickshire Reinvestment Trust
 Croydon Enterprise Fund
 Cumbria Community Asset & Reinvestment Trust
 Donbac
 DSL (Development Strathclyde Ltd)
 East Lancashire Moneyline (ELM)
 East London Small Business Centre (ELSBC)
 Enterprise Loans East Midlands
 FACT 2006
 Finance South Yorkshire
 Five Lamps Organisation
 Foundation East
 Fredericks Foundation
 Fredericks Gloucestershire
 Fredericks Wessex
 Futurebuilders England
 GLE oneLondon
 Goole Development Trust
 HBV Enterprise
 Impetus
 Innovative Finance - Hastings Trust
 Isle of Wight Lottery - Opportunity Society
 Key Fund Yorkshire
 Lancashire Community Finance
 Leicestershire Moneyline
 London Rebuilding Society
 MCF Loans
 Merseyside Special Investment Fund
 Moneyline Greater Manchester
 Moneyline Yorkshire
 Norfolk & Waveney Enterprise Services (NWES)
 North London Enterprise Credit Union
 North Staffordshire Risk Capital Fund
 Plymouth Small Business Fund
 PRIME

Prince's Trust
 Project North East (PNE)
 Robert Owen Community Banking Fund
 Rootstock
 Scotcash
 Shoreline Housing Partnership
 Sirius
 Social Investment Scotland (SIS)
 South Coast Moneyline
 South West Investment Group (SWIG)
 Spirit of Enterprise Loan Fund
 Street UK
 StreetNE
 The Social Enterprise Loan Fund (TSELF)
 Triodos Bank
 UK Steel Enterprise
 Ulster Community Investment Trust (UCIT)
 WEETU - Full Circle Fund
 West Yorkshire Enterprise Agency

Organisational Supporters

Advantage West Midlands
 Andrew Baker Consultancy
 Bank of Scotland Community Banking
 Barclays Bank
 Citylife
 Community Enterprise in Scotland - CEiS
 Community Finance Solutions (U. of Salford)
 Cylch - Wales CRN
 Deutsche Bank
 East Midlands Development Agency (EMDA)
 Esmee Fairbairn Foundation
 Finance Wales
 Global Finance Research Group (U. of Birmingham)
 Harley Reed Consulting
 Head for Business Finance
 HURT
 Inclusive Finance Community Interest Company
 NatWest & The Royal Bank of Scotland (RBS)
 New Economics Foundation (NEF)
 Prowess
 Red Ochre
 Street Cred
 Venturesome
 Wrigleys Solicitors
 YFM Group