

Response to BIS' Improving Access to Non-Bank Debt: Call for Evidence

From Community Development Finance Association (CDFA)

Chief Executive, Ben Hughes

13 January 2012

The Community Development Finance Association (CDFA) is the trade body representing Community Development Finance Institutions (CDFIs), social enterprises that provide loans at non-exploitative rates accessible by underserved markets unable to secure mainstream finance, delivering both economic and social returns.

This response is on behalf of the 52 CDFIs that provide loans and support to businesses and social enterprises, in particular to microenterprises and SMEs, both start-ups and existing.

Our evidence is only on those topic items to which we are able to provide authoritative evidence and is not meant to supplant, but rather augment, any evidence provided by any of our members directly.

The evidence provided by the CDFA highlights the following:

- The rationale behind CDFI service delivery in access to finance for enterprise
- The need for an incentivised referral system from mainstream banks to community providers
- The need for greater government support, including a CDFI-specific government guarantee scheme.
- The need for banks to disclose where they lend

Enterprise-lending CDFIs data collected for the period Mar 2010 – Apr 2011 showed:

SME-lending CDFIs:

- reported 11,000 enquiries for finance totalling £190m
- provided 1,500 loans to business totalling £23m
- created and protected 1,350 UK businesses and 5,700 jobs
- leveraged £2 for every £1 lent through additional mainstream bank lending

Civil Society-lending CDFIs:

- reported 2,100 enquiries totalling £276m
- provided 400 loans to social enterprises totalling £146m
- financed 75 new social enterprises, and supported 325 existing ones
- leveraged £1.20 for every £1 lent through additional mainstream bank lending

Non-bank Finance Providers

a. Are there any business sectors which you currently cannot access and would like to?

CDFIs lend to the following markets which banks often struggle to serve:

- Micro-enterprises with less than ten employees
- SMEs, primarily those employing 11-50 staff
- Social enterprises
- Start-ups
- Businesses unable to provide security
- Businesses in or from disadvantaged communities (geographically or demographically)

CDFIs are highly innovative and dynamic, endeavouring to serve all who, for whatever reason, are unable to secure debt finance from mainstream banks.

Therefore some CDFIs operate in more specialist markets, perhaps with a more particular focus on deprived wards or to demographics who traditionally find it harder to access finance, for example disabled, older, or younger entrepreneurs. Micro-enterprise start-ups in these categories are often higher risk than the norm and, as such, unless the business case is particularly stronger than the norm, lending will not be forthcoming through mainstream sources. Therefore, when CDFIs lend into these markets they must accept higher levels of risk and therefore of default rates.

We have seen that for these CDFIs their ability to be sustainable or to draw funds for onward lending is significantly compromised unless greater latitude is shown to provide for lower levels of capital return to the primary lender alongside lower recycling levels of funds. Whilst the initial cost is greater,

the lifetime rewards to the Exchequer through any intervention supporting these communities is greater, and the length of time to achieve payback of the investment shorter because of the greater financial savings.

b. What are the key issues preventing you from lending to mid-sized businesses and or SMEs?

The following three areas severely restrict CDFIs in providing finance to SMEs which have already failed at securing finance from mainstream sources:

Lack of capital, revenue and structural policy supports

At a time when mainstream bank lending is ever harder to come by CDFIs can, with the right kind of sustained and strategic support, play a pivotal role in supporting less-well-off communities and the economic recovery of the nation. But at the moment, the CDFI sector is too small and has incomplete geographic scope to meet the gap between demand for finance and credit availability.

CDFIs have been quietly providing community finance to some of the most disadvantaged communities in the UK for more than ten years. CDFIs are themselves social enterprises that invest in markets underserved by mainstream financial institutions.

By and large, CDFIs are run by and for the local community, aligning capital with social justice, providing affordable credit to businesses, social enterprises and households unable to access credit from high street banks. Where others see risk, CDFIs see opportunity. But CDFIs lend responsibly, investing only in those customers whom they believe can repay the loan.

CDFIs take an holistic approach to their customers. They not only invest in their communities by providing money but also by providing advice and support to help budding entrepreneurs prepare business plans, by mentoring exciting businesses and social enterprises to develop their skills, and by supporting households to increase financial capabilities. Most CDFIs report that much time and effort is required to help potential borrowers to become investment ready.

Alongside the economic benefits generated by CDFIs, they also generate positive social impacts. By taking the social as well as financial returns into account. CDFIs create prosperity where it is needed most, strengthening the social and economic cohesion of neighbourhoods and communities.

Through their work, CDFIs help to regenerate communities, creating and recycling wealth in households and high streets across the UK.

A major challenge is the need to modernise and achieve sufficient scale in order to offer affordable financial services to underserved markets. There are measures that can be adopted immediately to provide finance where it is needed now, as well as strategies to institutionalise solutions to access to finance for the future.

Immediate, stop-gap recommendations

CDFIs are here and want to lend to more businesses. However, many of the 52 CDFIs specialising in serving SMEs are coping with an increase in demand for credit whilst simultaneously managing dwindling loan funds and few sources of adequate and appropriate sources of capital to enable sustaining or expanding lending activities. Many of our member CDFIs has reported a surge in demand for business loans directly as a result of curtailed credit provision by banks. In our 2009 annual survey of our members we found that 70% of CDFIs said they had seen increased demand from previously bankable businesses. Compared with 2007, demand (in the form of applications) from micro-enterprises increased by 130% and SMEs by 90%.

The current capacity of the CDFI sector would need to be 123 times larger in order to serve only half of those 370,000 SMEs identified as seeking yet unable to access credit presently. Of course not all those seeking credit may be investment-ready, even by community finance standards; after all,

CDFIs lend responsibly, only to those able to repay loans. However the current CDFI capacity means reaching only one four-thousandth (0.004) of the expressed demand.

CDFIs need immediate support not only to maintain current service levels but also to expand a tried and tested service model that is simply grossly undercapitalised. Government, banks and the private sector could be implored to provide capital and revenue support to CDFIs.

Strategic, permanent recommendations

Firstly, bank disclosure is required in order to understand the nature of the gaps in the market and to identify which communities (geographically and demographically) in particular are underserved.

Secondly, integration of community finance into the larger financial system. With disclosure, banks will be encouraged to serve underserved markets directly or in partnership with the community finance specialists, i.e. CDFIs. The community finance sector requires capacity building to ensure that it can reach all communities across the UK.

Specifically, Government support of the sector should include providing a significant amount of funding from the £1bn Business Finance Partnership. This could be used to fund a new 'CDFI debt guarantee' scheme to adequately cover the risk profile within the market CDFIs serve. This cover would be easily recuperated in government returns and savings by the jobs and businesses CDFIs secure and create, often in the communities most hit by the recession. The guarantee cover currently available, which 13 CDFIs are registered to use, the Enterprise Finance Guarantee, is inappropriate for CDFIs, with the overall level of security covered by the government only at 9.75%. CDFIs need a specific scheme to adequately cover their business model and risk profiles. If in place this would allow CDFIs to more readily secure capital from banks and alternative social investment markets.

In addition, a CDFI specific guarantee would help cover the risk to investors looking to invest in the sector through tax incentive schemes such as Community Investment Tax Relief.

Lack of appropriate business support and mentoring services

Access to appropriate business support services to enable CDFI customers to become investment-ready is essential for ensuring CDFIs can serve all viable businesses.

Although around half of CDFIs lending to businesses offer formal mentoring to help clients become investment ready, many are having to curtail their support to clients due to a lack of funding support for these activities. Those members who have to rely on third party support mechanisms are seeing funds being cut and those support schemes remaining are disparate and often not the face-to-face advice clients need.

The CDFA would like to see Government undertake a comprehensive review to identify gaps in provision of support services necessary to creating investment-ready and credit-worthy customers and also identify organisations, such as CDFIs, which already provide support services, and enhance their capacity to deliver. Government must, of course, also ensure delivery of the BBA's Better Business Finance mentoring scheme with CDFIs acting as key partners with those institutions involved.

Lack of a bank to CDFI referral system

Although CDFIs in many cases have ad hoc referral mechanisms in place, a steady stream of appropriate clients is essential for CDFIs to efficiently meet the client base of those unable to secure mainstream credit. Project Merlin stated that the big four banks would "signpost alternative sources of finance"¹ where applicants were rejected.

¹ Business Finance Taskforce, October 2010

Anecdotal evidence from our members suggests that this is not yet happening, and indeed such a scheme does come into existence without intervention. We believe that there needs to be incentives in place to ensure that bank staff – from regional bank managers to frontline staff – are aware of alternative providers of finance and that mechanisms are in place to ensure unsuccessful candidates are referred on to a suitable alternative. This could, for example, include a link to the CDFAs sister website (www.findingfinance.org.uk) in loan rejection letters and a ‘referral review’ to be factored into front line staff appraisals.

George Osborne’s Autumn Statement stated, “The Government welcomes the BBA’s intention to work with Community Development Finance Institutions (CDFIs) to put in place a system to refer unsuccessful loan applicants to CDFIs.”²

Government should take heed in ensuring the above statement is delivered on the ground. The CDFAs will continue to provide evidence to the government as to whether CDFIs are seeing a greater number of customers come from the mainstream banks.

Lack of market awareness

Market awareness amongst target customer of non-bank finance providers especially new market based or community focused lenders and investors is very low. If one could increase the profile of what is available, how it operates and why and when it is able to fund propositions that traditional bank operations will not, then it could go some way to solving the challenge of providing ambitious SME’s with the growth capital they require.

Poor channels to markets for non-bank finance providers

Efforts to rectify these problems are likely to be sub-optimal because of the non-bank financier’s relative size, especially in relation to the banks, meaning that they are at present unable to afford the marketing expenditure to successfully reach and serve the SME market place. The major high street banks almost have a stranglehold primarily due to their branch network on the channels to market. It would be good for competition if these banks, especially those owned or part owned by the state, were obliged by government to open up their branch networks to other finance providers or failing that, if all those who were refused finance were automatically referred to a “clearing house” where they would receive information on other sources of funding able to take risks.

Lack of investment-ready business borrowers

Only one-quarter of those who apply for Community Finance loans are successful. This is partly due to an adverse selection problem (those with poor lending, poor growth and poor risk profiles being the most likely to search for loans/ funding from non-banks) caused partly by non-bank finance industry low profile including a lack of understanding on what risk capital will and will not fund. Other factors behind the poor conversion/ funding success rates (which in itself puts off applications) are the high transaction cost incurred by businesses when they are required to provide the non-bank financiers with the quantity and quality of information (such as a business plan) necessary to assess risk and return.

Lack of origination network

The present private and public sector “sales funnel” for non-bank finance is not working. There is a requirement for an origination network that can inform, advice and support particularly companies with potential to grow. The evident “market failure” requires a governmental intervention at either the national or regional level. The lack of origination network also touches upon perhaps the major issue which is the uncertainty that the UK economy will be able to generate and then nurture sufficient

² Autumn Statement 2011, HM Treasury, November 2011, p39

entrepreneurial talent, ambition and capability to capitalise on the present and future supply side initiatives.

f. What international examples are you aware of that facilitate non-bank lending channels?

In the United States, CDFIs have been able to grow and flourish due to the *Community Reinvestment Act*. The Act legally requires US banks to disclose where and to whom they are lending. This level of transparency has allowed the community finance sector to grow into the areas where it is most required. According to the trade body Opportunity Finance Network, in 2009 the 146 CDFIs in the States lent over \$1.6bn into deprived communities³. With UK CDFIs lending around £177m last year (£23m to businesses, £146m to social enterprises and £8.3m to individuals) it is clear the UK sector has not yet achieved the scale seen in the United States, even when taking into account population differential.

Greater transparency is necessary in order to understand which communities face difficulty in accessing mainstream finance. Data disclosed by banks would be used to adequately resource and appropriately locate CDFIs to ensure that those who remain outside the banking system have access to community finance. In addition, where banks are unable to serve their communities CDFIs can fill this gap.

Ensuring that banks disclose where they lend is an essential part of facilitating non-bank lending channels.

3. Government's Role

a. What, if any, are the market failures in the non-bank lending landscape and where would Government's influence have the greatest potential impact?

Failure of CDFIs to serve these markets are driven by lack of capacity, capital, policy frameworks, and other ancillary supportive measures, and occur despite rather than because of the CDFI's business model.

To give the Taskforce some idea of the level of unmet demand facing SMEs we can use figures from the Federation for Small Business to calculate the pool of SMEs who were unable to access mainstream sources of credit in the last year.

According to the Federation of Small Business there are currently 4.5m SMEs operating in the UK, with around 25% of applying for bank loans in the last year. Of these, 33% of applicants were unsuccessful in raising all the capital they needed.⁴ This leaves a pool of around 320,000 SMEs in the UK that could benefit from community finance as delivered by CDFIs.

With around 11,000 enquiries for business loans to CDFIs last year (around 3.5% of all businesses in need) there is a clear gap between those that access non bank community lending channels and those that need it. To ensure a larger proportion of those businesses are able to access alternative credit the greatest impact would come from the government and banks supporting the growth of CDFIs. Through providing support, funding and the appropriate infrastructure outlined above, the CDFI sector will lead the way in the non bank lending channel, ensuring all viable credit-worthy businesses refused mainstream credit can be funded efficiently and effectively with the least cost to the public purse. To realise David Cameron's vision of "Making the UK the best place in the world to start and grow a business" CDFIs need to be imbedded within the financial landscape.

Although there are alternative providers of debt finance in the non bank lending landscape, notably crowd sourcing and peer-to-peer websites, none of these utilise the community-based localised business model of CDFIs. CDFIs, by and large, are run by and for the local community, aligning capital with social justice, providing affordable credit to businesses, social enterprises and households

³ Inside the Membership, Opportunity Finance Network 2009

⁴ Federation of Small Businesses, Survey of members, Oct 2011

unable to access credit from high street banks. Where others see risk, CDFIs see opportunity. CDFIs lend responsibly, investing only in those customers whom they believe can repay the loan. CDFIs take a holistic approach to their customers. They not only invest in their communities by providing money but also by providing advice and support to help budding entrepreneurs prepare business plans, by mentoring exciting businesses and social enterprises to develop their skills.

Peer-to-peer and crowd-sourcing lending models do not provide these extra, essential services of support, local knowledge and face-to-face intervention. The real niche of CDFIs is traditional relationship banking, and by placing an emphasis on the social as well as the financial returns CDFIs generate wealth where it is needed most.

b. What is the role for Government in addressing the issues raised above?

Government would have the most impact by devising structures, policies, investment regimes and, above all, capital and revenue support to enable CDFIs to maximise their potential. Specially, Government could influence one supra-oversight department to oversee and coordinate community finance, ideally, HM Treasury, High level remits residing with BIS, DWP and the Cabinet Office would create a triumvirate under HMT covering the major markets CDFIs serve.

Government also has a duty to communicate, publicise and promote community finance. Raising awareness of community finance is essential to ensure the sector is a recognised entity within the financial services of the UK, and will further encourage the banks to work closely with CDFIs beyond their Corporate Social Responsibility remits.

The government also should provide greater support to the CDFA to enable us to:

- Act as the recognisable and credible voice for the widespread adoption of community finance
- Drive growth and lead innovation in financial services for underserved communities
- Maintain an effective infrastructure for the sector
- Ensure that the sector meets professional standards
- Provide cohesive data on CDFI performance

With this collaborative support for both the sector and its trade body, providers of community finance will be robust, responsible, sustainable and ambitious.

c. Are there other initiatives that government should explore e.g. the incentives provided by the current tax or regulatory regime?

The government is currently undertaking a consultation of Community Investments Tax Relief (CITR). CITR is designed to drive private investment into CDFIs. The government must recognise that the scheme to date has not delivered the growth of the sector as promised and that changes need to be adopted to ensure the scheme is for for purpose. Changes should include:

- Raising the level of tax relief for investors commensurate with other schemes
- Providing a deposit guarantee for those CDFIs that use the scheme who are not FSA regulated deposit takers
- Wider promotion of the scheme to ethical investors and social investment vehicles

The CDFA is available for comment on any of the above issues and is available to give oral evidence to the Taskforce if required.

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13 January 2012