

Submission of written evidence to:

**All Party Parliamentary Small Business Group  
Entrepreneurship Inquiry**

From: **Community Development Finance Association (CDFA)**

Chief Executive, Ben Hughes

CDFA would like to be considered to give oral evidence; our response is *not* confidential.

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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 evidence 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 extant.

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.

## **1. The effectiveness of Government policies in place to support entrepreneurs**

### **b) Enterprise Finance Guarantee**

The Enterprise Finance Guarantee scheme (EFG) is a targeted measure intended to facilitate additional commercial lending to viable SMEs unable to obtain normal commercial loans due to having no or insufficient security.

Thirteen of 52 CDFIs serving SMEs are authorised to use EFG; the number being so low due to an assessment by many that the scheme is inappropriate for them as community lenders.

Community lenders such as the CDFIs (community development finance institutions) provide loans to viable businesses unable to access finance from mainstream providers (banks); the majority of these businesses have offer little or no collateral/security.

The concepts and principles behind a loan guarantee scheme are sound and right, especially within the context of community finance as provided by CDFIs. However, EFG was designed primarily by and for banks, and therefore the provision, terms and condition of EFG are, at times, ill-suited to the business model and target markets to which CDFIs lend.

#### EFG guarantee level

The Government's total liability is currently limited to 9.75% (75% of each loan not exceeding 13% of the value of the lender's annual EFG portfolio). For many community (CDFI) lenders

- Recovery of a maximum of 9.75% is insufficient given the target markets served
- 9.75% recovery does not warrant the difficulty and resources needed to administer
- Recovery provides scant reassurance and comfort to CDFIs serving customers that banks cannot or will not serve.

For CDFIs, the plans to raise the liability to 15%, although welcome, are not adequate for specialist community lenders.

#### **→ What could be done differently?**

Any uplifting claim limit on CDFI small lending limits would further encourage investment in SME's and potential job creation and other social outputs. A guarantee scheme remains an absolute key element in risk management/SME lending as provided by CDFIs.

CDFIs require a bespoke guarantee scheme to adequately cover their business model and risk profiles. With such a scheme in place, CDFIs would be better enabled to more readily secure

additional capital from banks and alternative social investment markets in order to serve more business unable to access credit from banks.

A community lender guarantee scheme, devised specifically with and for CDFIs, would adequately cover the risk profile within their specific market. In addition to any direct financial remuneration of such a scheme, government recognition of the value received in savings and returns – direct and indirect – to the public purse in the form of creation and sustaining businesses and employment that might otherwise fail, keeping people off benefits and so forth.

#### EFG premium

For CDFI customers, paying a premium of 2 percent a year on the outstanding balance of the loan on top of risk-adjusted cost of credit (CDFIs charge an average interest rate of 13% to micro- and SMEs) simply increases risk by making the credit that much more expensive and therefore potentially more difficult to repay, especially by fiscally-challenged businesses.

Many borrowers - actual or potential - interpret this 2% premium as 'insurance cover,' erroneously believing that this covers their individual loan defaults of up to 75% (see below) – perhaps not surprising, given that the premium is to “partially covers the cost of providing the guarantee” [BIS].

#### → *What could be done differently?*

A bespoke CDFIs guarantee scheme, proposed above, would address this issue.

Within the current context, such a charge levied on such a relatively small liability is inordinate and should be adjusted downwards accordingly.

#### EFG promotion

A significant problem exists with the way EFG has been misleadingly publicised directly to potential borrowers. Public promotion has routinely and consistently been along the lines of “EFG covers up to 75% of each qualifying loan”, which is an inaccurate oversimplification, is misleading to potential borrowers, and creates unnecessary burdens for community lenders.

Dissemination of inaccuracies means that many businesses (esp social enterprises and those unsuccessful at securing grants) turn to EFG out of a misperception that avoiding repayment of 75% of their loan is acceptable. Our understanding from CDFIs is that virtually all prospective EFG loan applicants neither realise that they are responsible for debt taken nor that EFG does not afford coverage of 75% of their partial loan.

CDFIs authorised to use EFG have been inundated with applicants armed with this misinformation; for CDFIs – especially the smaller ones, many of which are micro-social-enterprises themselves – this creates an unwelcome and uncompensated drain on limited resources.

#### → *What could be done differently?*

The relationship would work best at the government guarantor- lender interface, pointedly excluding the public as potential end customers. Borrowers have little concern with who is underwriting, but instead with the fact that there is such provision. EFG lenders are best suited to promote a guarantee themselves directly.

#### EFG borrower eligibility

The wider eligibility criteria relative to EFG's predecessor, SFLG, has supported loan deal flow and enabled consideration of more client activity than previously.

Lastly, many businesses coming to CDIs report that they cannot access EFG loans from the banks; Most CDFIs report no evidence that EFG has had any impact in mainstream lending; Banks seem reluctant to use EFG, which has been borne out by recent data.

## **d) New Enterprise Allowance**

### NEA performance

Our understanding of scheme performance to date (no less than five of our CDFI members are contracted Loan Providers), indicates that it is developing more slowly than the DWP Activity Forecast, often running at between 10% and 25% of loans disbursed to DWP target.

With demand driven from Job Centre Plus through DWP contracted Lead Mentor Organisations, the loan providers are unable to affect deal flow despite forming good relationships with both and have attended awareness workshops for the latter to promote the accessibility of the loan plus its features and benefits.

Recent feedback from lead mentor organisations is that the level of demand for those wanting to go on the scheme was circa 75% of the anticipated figures, and additionally the percentage of those on the scheme wishing to go on and apply for the loan was circa 15% as opposed to their expectations of somewhere in the region of 75%. Possible reasons for this included:

- A greater number of individuals than expected were using their own funds / funds from family to help with start up costs.
- Given their current credit status after several months of employment, they thought that they may not qualify for the loan.
- There has also been an indication that the 26 week period of unemployment prior to eligibility may be having a detrimental effect, in that if entry to the Scheme was allowed after 13 weeks for example, individuals would still be relatively 'keen' to look at self-employment options and not have fallen into the 'long term unemployed' mindset.
- Seasonality – individuals less likely to sign off JSA in December - February as these are the most expensive months in relation to Christmas expenses and higher utility bills.
- External factors – what incentive is there for the JCP advisors to promote the NEA Scheme – if other alternatives involve less administration i.e. programmes to assist getting back into 'employed' work. Similarly, if the mentors are not promoting the advantage/benefits of the loan.
- A high level of JCP staff turnover could mean lack of continuity re awareness of the scheme/loan.
- The amount – £1,000 – is insufficient

### NEA promotion

Some of the challenges inherent in the way NEA is administered relate to the way it is promoted to potential customer beneficiaries. The success of the scheme depends amongst other things on 'first impressions' that those on JSA are presented with when they visit a Jobcentre Plus.

#### **→ *What could be done differently?***

- The level of 'encouragement' to go onto the scheme provided by JCP advisors to potential individuals is appropriate – that the bar is not being set 'too high'.
- That the potential accessibility and benefit of the scheme and loan funding is relayed positively to the individual.
- Confirming to individuals that the loan application is not credit scored and will not be based solely on credit history.
- Individuals being able to access the mentoring scheme after a shorter period of unemployment.
- Increase the amount £3,000 i.e. up to the minimal loan available under BFS core product.
- DWP to ensure Single Points of Contact from Jobcentre Plus meet with Loan Provider on a regular basis to ensure the details and benefits of the loan are cascaded as per point 2 above,
- JCP to provide formal response to DWP for reasons individuals not wishing to take up the scheme /loan – i.e. we can only address the shortfall situation when we find out the main reasons – this is one question that must be asked.

### NEA contract

Loan Providers must look to address the potential variance for not only revenue, but also how the contract activity may be affected by future DWP intervention and possibilities regarding changes in the delivery of the overall project.

#### Experience of one Loan Provider in one particular region

Although the status and performance of the scheme may vary from region to region, detailed report for one particular region should, we believe, provide greater insight and detailed opportunities.

##### *What has worked well in this region?*

- Most LABs understand what is required in preparing business plans and financials that meet the Loan Provider's needs
- Most LABs have made existence of the NEA loan known to their mentors and mentees
- Most LABs have co-operated in supplying the Loan Provider with the supporting info required to consider loan applications
- Those who have taken advantage of the NEA loan are most grateful and feedback without exception has been positive to date
- All NEA interest-only and interest and capital repayments are up to date
- Loan Provider has a good working relationship with Jobcentre Plus District Offices across the region (as they confirm eligibility in each case) and with DWP's central representative.
- Mentoring programme is successful in that that all providers in region are oversubscribed (this is of course a problem as well).
- The majority of volunteers involved have been excellent and are very positive about the scheme and the people they are supporting

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##### *What has not worked so well in this region?*

- Take-up has been slower than expected. This may be because
  - The interest rate (9.52% APR 10.00%) is perceived to be expensive
  - There is a disconnect between LABs and Loan Providers made worse because there is no incentive to LABs to promote the loans
  - Those on benefits are often those with poor credit histories and they may believe that, as a result, they won't get the loan if they apply, and so they do not
  - There may not be sufficient understanding amongst customer-facing Jobcentre Plus staff of the features and benefits of the full NEA programme which means people joining the scheme may not have a good understanding of what is available
  - The advice and information provided by Job Centre staff leaves a lot to be desired and that there may be a reluctance to discuss as 'starting a business' is seen as taboo.
- Some LABs have not had a good understanding of what makes a new business work and what areas should be covered in the business mentoring process
- Mentors in some LABs appear to have minimal contact with their mentees which is often evident in the quality of the business plans submitted in support of a loan application
- Some LABs have not promoted the existence of the NEA loan to their mentees
- Some LABs have been reluctant to provide information in support of loan applications on behalf of their clients or get involved in any way in the loan application process because it is not a requirement of their contract
- Some clients are under impression that it is a grant rather than a loan or that they can access grants as well as the loan
- Some clients are under the impression that they automatically get the loan and have not been told about the business plan requirement
- there is a disconnect between the mentoring and loan contracts, resulting in no financial incentive for LABS to support loan applications and no recourse if a LAB is underperforming (refers to Keir's comments over quality of business plans)
- There are too many other 'volunteer mentor' schemes being promoted by the government which
  - causes massive confusion

- puts off entrepreneurs' who may want to volunteer as they are concerned it will result in requests from various other schemes

*Why have these not worked so well in this region?*

- One or two LABs do not appear to have much experience of working with entrepreneurs and new start-up businesses – or with understanding the process of obtaining business loans
- Some Jobcentre Plus customer-facing staff do not have a good understanding of the NEA scheme as a whole or of the NEA loan
- There appears to have been little promotion of the availability of the NEA scheme as a whole in Jobcentre Plus offices generally
- The level of general advice given by Job Centre has been extremely poor or nonexistent, perceivably down to lack of or poor training to the advisors combined with an unwillingness to learn on behalf of the advisors. Direct experience of overhearing some appalling advice/information given to individuals at a Job Centre who were thinking of starting a business.
- There is a lack of knowledge with advisors or, more concerning, there is limited knowledge of self-employment which can result in erroneous information and signposting (ie: assuming people would not be eligible unless they were going to employ others).

*What could be done differently?*

- JCP offices could place at least as much emphasis on promoting NEA as they do on promoting the Work programme
- The Government could generate more publicity about the positive role entrepreneurs play in the economy whilst promoting the NEA scheme more widely
- JCP LAB contracts could require that all customers accepted on to NEA be informed in writing of all the features and benefits of the scheme
- The LAB selection process could place more emphasis on the level of experience the applicant organisation holds in supporting start-up businesses
- I believe the key is definitely to get 'business/enterprise' champions within the Job Centre and combine this with more promotion of the scheme.
- More promotion would be fantastic, but could the LABs deal with the additional demand as the scheme stands at the moment?
- There should be a referral process from the Work Programme to NEA or closer working links (especially with LABS demonstrating delivery of a quality self-employment product) as there could be duplication of effort and (again) confusion over what is being offered.
- There is a suggestion that the scheme may be opened up to those on IBA – and my concern is that it would be a step too far for volunteers, as this is often an area that needs additional specialist support and time. It isn't impossible, but there needs to be some appreciation that additional support will need to be paid for.

### **3. The help of mentors: Are mentors useful to people who want to set up a business? If so, how can mentoring be better promoted and taken up?**

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

Although around half of CDFIs lending to businesses offer formal mentoring to help clients become investment ready, but 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 left are disparate and often not the face-to-face advice clients need.

The CDFA would like to see the 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, who already provide support services, and enhance their capacity to deliver. The government must also ensure delivery of the BBA's Better Business Finance mentoring scheme with CDFIs acting as key partners with those institutions involved.

Whilst CDFIs primarily provide loans to enterprises and individuals to set up businesses, many also provide business support. 80% of CDFIs offer ad hoc support during the loan process and almost half (45%) offer formal mentoring schemes. Working closely with the customer is an essential part of CDFIs operations. It is through this close mentoring and local expertise that CDFIs can maintain healthy portfolios in more a risky market environment.

However, this is a labour- and cost-intensive activity and one that cannot be delivered without revenue, which can either come from customer charges, thereby driving cost of credit up, or from some other source in the form of subsidy. Over 40,000 CDFI customers have benefited from advice and training.

#### **4. Finance: Is accessing finance difficult to start ups and small businesses? Why?**

It is generally recognised that banks have retreated from the markets served by CDFIs. An evaluation of the CDFI sector report published in March 2010 by GHK consultancy clearly demonstrated a "consistent market failure" in access to finance in disadvantaged areas.

CDFIs serve those businesses which have already applied for mainstream (bank) credit and been unsuccessful either in securing any credit at all or the amount of credit needed.

Many applicants are unsuccessful at securing mainstream credit for the following reasons:

- Identified as not being 'investment-ready', that is not having the businesses skills and acumen required to convince mainstream lenders
- Lack of access to business support services to enable applicants to become investment-ready
- No track record (start ups)
- Seemingly unorthodox business model (social enterprises)
- Lack of collateral / security
- Loan request too small to justify administering
- Located in a community suffering deprivation
- From a traditionally underserved and potentially risky socio-demographic group (e.g., youth, older person, disabled, unemployed, former convict, non-English speaker, ethnic minority, and so forth)

For small businesses access to finance remains one of the greatest challenges<sup>1</sup> despite the Project Merlin agreement banks made with Government. Where traditional funding is available it is increasingly expensive and the terms onerous. Banks are having to juggle the competing demands of lending more to SMEs while increasing the liquidity of their reserves. The result? Demand from small, and in particular, micro-enterprises, cannot be wholly met.

Since the credit crisis, many are no longer able to secure the credit facilities that they have in the past. Micro-enterprises, start-ups and sole traders, usually especially difficult to serve, face increasing obstacles in securing finance.

Using public data, we have determined that there are 4.5m SMEs in the UK. 25 percent of these have applied for a loan last year. Of these 33 percent were unsuccessful<sup>2</sup>, which equates to 370,000 SMEs unable to access finance.

#### **What are your recommendations on financing start ups and small businesses?**

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<sup>1</sup> Federation of Small Businesses, Survey of members, Oct 2011

<sup>2</sup> Small Business Survey: op cit.

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.

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Thank you.

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