

Financing a Private Sector Recovery Response by the Community Development Finance Association 20 September 2010

The Community Development Finance Association (**cdfa**) is pleased to respond to the government's consultation on Financing a Private Sector Recovery.

The **cdfa** is responding on behalf of its 70 members comprised of Community Development Finance Institutions (CDFIs). CDFIs are social enterprises which deliver credit and financial services to the following key markets which are underserved by banks:

- 1) Micro, small and medium enterprises
- 2) Social enterprises, community groups and charities
- 3) Financially excluded individuals

In all cases CDFIs provide credit and support where access to finance has been denied by mainstream financial institutions.

Overview

It is promising to see the government recognising the CDFI sector as playing a role in the private sector recovery. CDFIs are unique. They are currently the only entities delivering and recycling capital and providing support to the underserved markets described above. As each CDFI is set up to address a specific local need for finance (with local business experts on their lending panels), no two CDFIs are the same. What they share is a mission to recycle finance again and again into the communities they serve, creating ongoing impact over many years.

They are local, flexible businesses able to respond to market trends and support emerging needs as they arise. They are ideally poised to deliver the government's Big Society agenda.

The **cdfa** and its members would like to see a holistic approach by the government in tackling this market failure through:

- A CDFI guarantee fund administered through the **cdfa** via the Regional Growth Fund
- Big Society Bank capitalising CDFIs on favourable terms with technical assistance grants
- Re working of the Community Investment Tax Relief scheme increasing private investment
- Banking legislation to ensure engagement and capitalisation with community finance entities
- Re working the Enterprise Finance Guarantee to adequately cover the risk profile of CDFIs

BOX 1 CDFI enterprise lending since 2004*

**CDFIs disbursed circa
14,000 loans totalling
£190m**

Outcomes:

- 7900 businesses created
- 6100 businesses safeguarded

- 13,300 jobs created
- 18,600 jobs safeguarded

- £210 million of additional finance leveraged

From Inside Out 2010, as yet unpublished

*excluding deposit taking CDFIs and one large equity lender

Introduction

Whilst the consultation does “recognise the importance of community finance” within the final section on Future Challenges, the **cdfa** believes the consultation focuses too broadly on mainstream bank lending with too little attention on underserved markets. It is businesses and individuals within vulnerable communities who have been the hardest hit by the recession. The consultation states in conclusion 3.51 that the majority of SMEs can raise the finance they need. The picture emerging from our members is that market failure by the banks has increased since the advent of the ‘credit crunch’, with many CDFIs reporting soaring demand which is still far above pre-recession levels. One South East-based CDFI strongly contested the view that ‘the majority of SMEs can raise the finance they need’.

To ensure a private sector recovery across all parts of the UK the government must work with a broader range of entities to deliver finance equitably and efficiently. Through supporting and capacity building within the CDFI sector, the government will have guaranteed direct results through business and job generation in the UK’s most underserved communities. This, in turn, will make the best use of public funds by recycling them time and time again and will help individuals to stop using the benefit system as they move into working for themselves or other local businesses financed by CDFIs.

Enterprise lending CDFIs

- Enterprise lending CDFIs offer valuable financial support to microenterprises, SMEs and social enterprises where the banks have refused to lend. Unlike high street banks, CDFIs don’t operate to maximise commercial returns, instead recycling finance again and again back into the communities they serve. Wealth created by CDFIs stays in the community as is the vision of the Big Society.
- For over a decade CDFIs have been quietly injecting finance into underserved markets of the UK, and are proven vehicles for delivering results against government targets. (see Box 1)
- Although the majority of CDFIs (60%) operate at the local or sub-regional level¹, even those that operate across larger geographic realms (regionally or nationally) adopt a community-focused approach. Many CDFIs also employ local expert volunteers to act as members of loan panels, enabling lending decisions for each CDFI to be focussed to the needs of the particular community.
- Whilst CDFIs primarily provide loans to enterprises and individuals to set up businesses, many also provide business support. 80% of CDFIs offer support during the loan process and almost half (45%) offer formal mentoring schemes². Working closely with the customer is an essential part of CDFI operations.
- CDFIs work to move their customers to mainstream finance so are not in competition with banks but provide a complementary service which creates new markets for them.

¹ Inside Out “Weathering the Storm” **cdfa** 2009

² Inside Out 2010 **cdfa** (unpublished)

Access to Finance for SMEs

It is generally recognised that banks have retreated from the market sector served by CDFIs and will be unlikely to return for many years, something which this consultation in itself demonstrates. 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. Additionally, CDFIs received 11,500 enquiries for private sector finance last year with only 25% of these tuning into a loan agreement³. CDFIs have seen the number of enquires and formal applications rise dramatically in the recession and are receiving higher demand from more established businesses who cannot obtain mainstream support.

Anecdotal evidence from an enterprise lending CDFI Capitalise Business Support (based in Hastings) demonstrates shifting customer demographics in light of the recession:

“CBS statistics historically show a clear 70/30 split in favour of enquiry rates from start up businesses. From October 2008 i.e. when the recession officially commenced we have seen a marked shift to a more consistent 55/45 split in favour of start up business. As such we continue to receive higher numbers of established businesses who cannot obtain mainstream support than before the recession”

CDFIs have the potential to play a much greater role in increasing access to finance for micro enterprises and SMEs in the UK. Through increased government support and a ‘fit for purpose’ policy framework CDFIs would be able to step up and meet the demand where credit is currently being restricted.

Government support required

We are pleased that the consultation has acknowledged the work of CDFIs and the role they can play in financing enterprise. However, the sector, whilst maturing, is in danger of being unable to fulfil its mission, and indeed the Government’s objectives for business finance, without immediate support from the government in the upcoming Comprehensive Spending Review. CDFIs should be supported through the mechanisms highlighted in this section. Immediate action by the government would allow CDFIs to scale up to sustainability or otherwise risk the curtailment of business finance and support to viable UK private sector entities.

1) Capitalising CDFIs in a Big Society

As locally-based social enterprises with a mission to increase prosperity in their communities, to boost enterprise, reduce welfare dependency and facilitate job creation, CDFIs should be seen as big players in the Big Society agenda. The GHK report on CDFIs clearly shows that bank market failure in our target markets is endemic of the private for profit structure of mainstream banking. Through the Big Society Bank CDFIs can help serve these markets. However, the terms of credit need to be low enough for the propositions to be viable, with technical assistance grants built in to allow CDFIs to deploy the capital funding as quickly and efficiently as possible, whilst also enabling new CDFIs to be established in areas of the country with less coverage.

³ Inside Out 2010 **cdfa** (unpublished)

There is also a requirement for a grant based guarantee fund in order for CDFIs to leverage private finance for their operations from a diverse range of sources. A useful tool to help fund this is through re directing a portion of the £1bn Regional Growth fund, into a 'guarantee fund' to help CDFIs cover their first losses. With the Phoenix Legacy Fund drying up for many CDFIs, and a general fall in grant funding, there is a need for a pot of grant funds to ensure CDFIs can attract the necessary private funding, be it from the Big Society bank, mainstream banks or individual investments through CITR.

Directing a portion of the Regional Growth Fund through the **cdfa**'s trading arm would ensure the grants are targeted towards the 'fit for purpose' CDFIs who adhere to the industries code of practice and undertake the sectors performance framework 'Change Matters'.

Investment in the CDFI sector through this form of a guarantee fund is an efficient and targeted way to ensure greater private sector investment in CDFI activities. For every £1 invested in enterprise lending CDFIs this will create or safeguard £8.57 at the local community level⁴. This does not take into account the recycling of money and the private leverage brought into CDFIs through government grant based support, which historically has been on a 50/50 basis; public to private match funding. The true benefits of a CDFI guarantee fund will outweigh the already very competitive figures quoted in the evaluation.

2) Renew and Strengthen the Community Investment Tax Relief scheme

The Department for Business Innovation and Skills is currently undertaking a review of Community Investment Tax Relief as a method for bringing in private finance into underserved markets. The **cdfa** and its members are strongly advocating for the continuation of this scheme. It is essential for the existence of many CDFIs. Since its inception, members have raised £62.5m of private finance⁵. To enable CDFIs to bolster this amount of investment the tax relief needs to be tied to the base rate to ensure more favourable returns for the investor when interest rates begin to rise.

An overhaul of the scheme after its state aid renewal in 2012 should see the on lending and administration requirements under the scheme relaxed, the 5% return per annum increased significantly or tied to the base rate. CITR should also be able to be used alongside the guarantee fund proposed to cover first losses and EFG. The banks should also be encouraged to invest in CITR accredited CDFIs through a reworked version of the Community Reinvestment Act in the UK (see below).

3) Action Community Reinvestment Legislation

Public funding is crucial but it is also limited, as such we also believe the government needs to place more pressure on the corporate sector, especially banks to provide its fair share of support. Disclosure of where and who banks lend to will help CDFIs in targeting their markets and addressing market failure where it is most prominent. Where CDFIs have coverage the mainstream banks should be compelled to work with them, both in a referral capacity and capitalisation through the CITR scheme. Under the appropriate legislation banks should be compelled to capitalise CDFIs though CITR credits bringing commitment to the communities in which they are based, helping restore much needed trust in mainstream banking.

Because CDFIs move the customers into bank finance, it is appropriate that banks support them as a market development activity.

⁴ *Evaluation of Community Development Finance Institutions (CDFIs)*, BIS and Cabinet Office, GHK, March 2010

⁵ Inside Out 2010 **cdfa**

4) Rework the Enterprise Finance Guarantee

Although on paper the EFG looks to have helped the flow of credit to businesses lacking security anecdotal evidence from our membership suggests that most major banks used the scheme last year to merely restructure existing debt rather than deliver new funding to businesses in need. An extension or more permanent successor to the EFG scheme would be welcomed and is required. We do not believe tying the Guarantee rate is the best option as this will merely serve to over complicate processes leading to higher transactional costs for assessing propositions which will either result in higher pricing or great pressure on margins. The latter will not help lenders' appetite to use the scheme.

As the successor to the Small Firm Loans Guarantee, scheme EFG has not provided a suitable guarantee for CDFIs operating in riskier markets. The claim cap of 9.75% (no such cap applied under the SFLG scheme) does not provide adequate coverage to the risk profile of CDFI lending versus bank lending given the markets they serve. CDFIs do not operate under the same risk models as banks therefore a scheme designed with mainstream banks in mind does not transfer well to the CDFI sector.

Government changes to the scheme to allow banks to lend to CDFIs under EFG have seen poor results. Banks have not taken on the onus to lend to CDFIs. Poor advertisement of the scheme and the incompatibility and complex interactions between CTR and EFG has discouraged its use by the mainstream banks. Unless the cap on EFG can be raised to a level around 40% for CDFIs there is an urgent need for a CDFI specific guarantee fund (delivered through the Regional Growth Fund- mentioned above) to adequately cover the risk profiles of enterprise lending CDFIs.

Evidence and Efficiency of Enterprise Lending CDFIs

CDFIs are proven efficient delivery mechanisms for generating jobs and enterprise in the UKs poorest communities where the mainstream banks refuse to lend.

Independent research commissioned by BIS and OTS in March 2010 demonstrated that "...CDFIs are generally efficient vehicles for the delivery of capital to businesses..."⁶ and that for each £1 of public expenditure CDFIs create or safeguard £8.57 at the local community level. However, this does not take into account the role of capital recycling, that capital is repaid and re-lent. Extrapolating from this, over the average three year enterprise loan term, it is likely that for each £1 invested into CDFIs an estimated £15 gross value added would be delivered.

The report also states that:

- CDFIs continue to address the consistent market failure to reflect the economic and social benefits of lending in underserved markets⁷.

BOX 2: 09/10 Lending Activity

Markets Served: Micro enterprise
SMEs
Social enterprises

Data based on 42* UK CDFIs
conducting enterprise lending

OUTPUTS

- 2,964 loans disbursed totalling £34.3m

OUTCOMES

- 2,004 businesses created
- 960 businesses supported
- 2,805 jobs created
- 4,354 jobs safeguarded

Additional £25m leveraged through
commercial banks

From Inside Out 2010

**active enterprise lenders responding to
Inside Out 2010*

⁶ Evaluation of Community Development Finance Institutions (CDFIs), BIS and Cabinet Office, GHK, March 2010 p79

⁷ Evaluation of Community Development Finance Institutions (CDFIs), BIS and Cabinet Office, GHK, March 2010 i

- By servicing demand from target markets, the sector meets a range of enterprise related public policy rationales and goals⁸.
- The sector is now able to evidence in a robust and comprehensive manner the scale and extent of its positive economic impacts⁹.

Data collected from the membership in consultation with GHK consultancy for 09/10 from enterprise lending CDFIs is provided in Box 2 and demonstrates that CDFIs are continuing to generate returns on investment not only through job and enterprise generation, but also through the leveraging of additional private finance for their clients through the mainstream financial system.

Conclusion

The **cdfa** would like to see the government deliver on its commitments outlined in this consultation to support micro and SMEs in the UK, thus addressing the banks market failure. This response has outlined the need, proposed solutions and demonstrated an evidence base for the scaling up and support of the CDFI sector in the UK. Access to finance for Micro and SMEs is still limited, profoundly so in disadvantaged communities. With adequate support from the government CDFIs have the local frameworks and expertise in place to deliver finance in these areas, contributing to a private sector recovery. We would urge the government to follow the steps outlined by the **cdfa** to help create a strong and sustainable community finance sector stimulating the flow of credit to businesses that need it most in challenging financial times.

September 2010

⁸ *Evaluation of Community Development Finance Institutions (CDFIs)*, BIS and Cabinet Office, GHK, March 2010 ii

⁹ *Evaluation of Community Development Finance Institutions (CDFIs)*, BIS and Cabinet Office, GHK, March 2010 ii