

UNDERSTANDING THE DEMAND FOR AND SUPPLY OF SOCIAL FINANCE

Research to inform the Big Society Bank

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ABOUT NESTA

NESTA is the UK's foremost independent expert on how innovation can solve some of the country's major economic and social challenges. Its work is enabled by an endowment, funded by the National Lottery, and it operates at no cost to the government or taxpayer.

NESTA is a world leader in its field and carries out its work through a blend of experimental programmes, analytical research and investment in early-stage companies. www.nesta.org.uk

ABOUT NEW PHILANTHROPY CAPITAL

New Philanthropy Capital (NPC) is a charity that advises all types of donors on how to give more effectively. Our aim is to increase the quantity and quality of resources available to the charitable sector.

We do this through a combination of published research and tailored advice. Our research identifies charities, large or small, that are tackling problems in communities, education and health in the UK, and achieving excellent results. Our advice for donors guides them on how to ensure their money has high impact. In all of this, we focus on the long-term benefits for the people that charities serve.

ABOUT THE SERIES

This publication is one in a series of three that sets out what we have learned about the social investment market through the Big Society Finance Fund – its current nature and its potential for growth.

Also in the series:

Twenty catalytic investments to grow the social investment market, UnLtd, Panahpur and NESTA.

Investing for the Good of Society – Why and How Wealthy Individuals Respond, Fairbanking Foundation with Ipsos MORI and NESTA.

FOREWORD

One of the most pressing questions facing a developed country like the UK is how to put our considerable resources to work in innovative ways to address major social challenges.

These challenges, from social exclusion to long-term ill-health, and from demographic change to climate change, are growing. But the ability of our public services and civic society to respond is too often constrained by straitened public finances or by institutional inertia.

There is widespread agreement that innovative approaches hold the key: shifting our efforts from treatment to prevention, and replacing central control with the energy of empowered citizens and communities.

Social investment can help us achieve this. By financing new approaches, increasing the diversity of provision, and allowing money to be diverted from the symptoms of social problems to their causes, it helps innovation take root.

The Government's enthusiasm for social investment, exemplified by their establishment of the Big Society Bank, is to be welcomed. We are excited to see the realisation of a project envisaged 11 years ago when the Social Investment Task Force began its ground-breaking work.

The Big Society Finance Fund is a practical contribution to this project. Working with Panahpur and UnLtd, two of the UK's leading social investment charities, we have constructed a portfolio of pilot investments to demonstrate the kind of products and services that a thriving social finance sector could enable. Alongside the portfolio, we are publishing two substantial pieces of research, looking at UK investors' interest in social investment, and the demand for finance among social enterprises and the organisations that serve them.

We hope that the Big Society Finance Fund, through its portfolio of projects and research base, offers a helpful practical contribution to the development of the UK's social investment market.

As always, we welcome your thoughts.

Stian Westlake
Executive Director of Policy and Research, NESTA

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PART 1: INTRODUCTION

Overview of research

The Big Society Bank (BSB) should start making investments in the third quarter of 2011. This piece of research was commissioned by NESTA as part of its role researching and piloting elements of the Big Society Bank.

The aim of this research is to: *“set out the nature of current and future demand for capital from social finance intermediaries and to develop an understanding of the mix of financing the Big Society Bank will need to support.”* This report presents the findings of research delivered by New Philanthropy Capital (NPC).

NPC was asked to consider the demand for capital in three target markets: social finance, financial inclusion, and social housing. In our report, the first of these, social finance, covers the demand from social finance intermediaries to supply capital to charities, social enterprises and businesses with a social purpose. The second, financial inclusion, explores demand for capital from non-profit providers of affordable loans in the UK. The third, social housing, looks at demand for capital from housing associations.

This report considers the UK market only. It does not deal with the international market.

Approach

These three markets are very different, but we used the same research approach for each, and focused on the needs of each market overall, rather than of individual organisations:

- *Work through intermediaries:* our approach was to interview intermediaries and umbrella bodies about the target markets. This was the most efficient way of getting a market-level picture of the supply of, and demand for, capital.
- *Interviews to provide insights:* we interviewed

a mixture of intermediaries, umbrella bodies and experts to build up a nuanced understanding of each market.

- *Quantify the scale of demand:* we used published accounts to build up a high-level picture of the size of demand for social finance in each market. We drew on the findings from our interviews to help us analyse these figures.

We are grateful to all those we interviewed, who gave their time and inputted their knowledge and experience. A list of interviewees can be found in Appendix C.

Structure of the report

Our research produced a large quantity of information about the different markets: how they have developed, what the problems are, and what needs to happen in the future. In the body of the report we have focused on the findings directly relevant to the research question, i.e. about demand for capital and mix of financing, and the BSB's potential role in the market. The appendices provide a wealth of additional background information which will help elucidate these findings and provide further food for thought.

The report is structured as follows:

- *Summary of findings:* a very high-level view of the findings across the markets.
- *Social finance findings.*
- *Financial exclusion findings.*
- *Financing social housing:* lessons for the BSB.
- *Recommendations:* NPC's recommendations for the BSB based on our research findings.
- *Appendices:* further information and findings on social finance and financial inclusion.

PART 2:

SUMMARY OF FINDINGS

In both the social finance and financial exclusion markets in the UK there is a role that the BSB could play, and make a difference. In both markets we found a demand for capital and organisations capable of using that capital effectively. There is appetite from intermediaries for money for:

- Onward investment in or lending to investees and financially excluded individuals.
- Capitalising intermediaries.
- Overhead contributions to intermediaries where the customer base is expensive to service but the service plays an important social role.
- Developing new products.
- Building the sector's capacity and catalysing the market.

The findings for the social housing market are very different, and NPC believes they may fall outside the scope of the BSB. Housing associations need a vast amount of capital – approximately £3 billion – in the next four years to finance new developments. Our view, and the view of our interviewees, is that the BSB will not be able to meet these capital needs, and that any role it could play would have limited impact. However, over the past 20 years, housing associations have increased the amount of commercial capital they use to build social housing. Their experience provides useful lessons about the risks and opportunities of greater commercial investment in the non-profit sector, which are summarised in Part 5. Occasionally social housing organisations offering additional services will apply to social finance intermediaries for funding, which is fine, but outside the already established and vast capital market for housing finance.

Focusing on the social finance and financial exclusion markets, six key findings jump out:

1. **The absolute amounts needed from a funder like the BSB total hundreds of millions rather than billions of pounds.**
2. **By far the majority of demand for capital is for soft capital** – patient, semi-commercial capital and grants. The BSB should not expect to achieve commercial returns on many of its investments (although there are opportunities for this, set out below). By patient, we mean capital which takes many years to return the principal.
3. **Soft capital does not mean being undisciplined.** The money needs to be spent wisely and realistically in order to achieve social impact. Careful consideration of what may have a genuinely sustainable future, and what is in reality a perpetual subsidy, will be important in making funding decisions.
4. **Building the market is essential**, which requires grants or very patient capital. Both markets are ‘underdeveloped’ in many respects; both require investments to help them become more efficient and sustainable.
5. **The BSB may have to make a trade-off between building the market and maintaining its capital.** Market-building activity largely requires investments that make low or no financial investments. This in turn will reduce the BSB's funding pot, which goes against the concept of a ‘disciplined investor’. However, if market-building activity increases the amount of social investment and improves the way investments are made, we feel a case can be made for prioritising it over maintaining levels of capital.
6. **There seems little appetite for a new intermediary entrant** offering direct products and services competing with existing intermediaries. However, some intermediaries indicated that they would like access to capital/liquidity for their investees if this were in short supply and existing investors wanted to share risk.

These findings are challenging for the BSB, and mean that it must be absolutely clear about its role: is it to help social enterprises and charities to access capital, in order to enable them to deliver greater social impact? Or to invest for financial returns? If the former, the consequence of this role is that a significant investment providing non-commercial capital will be needed. If the BSB does not allow for this, and prioritises commercial returns, it will fail to support those that it is set up to support and displace capital in investments that would otherwise have been provided by a commercial investor. Another question is whether the BSB wants to catalyse market provision, or be a player in perpetuity? Again, the preference will affect how it plays in this market now.

NPC's recommendations are summarised in Part 6 and include commentary on market issues emerging from our research.

2.1 The social finance market

Demand for social finance is growing. But the market is still in its early stages of development. This growth has, in many areas, been fuelled by subsidised finance. Subsidy will continue to be needed in the future: many market segments need seed capital or soft capital to provide to investees, and investment is needed overall to develop the market.

Opportunities to earn attractive financial returns will be limited, without crowding out private investors – although there are exceptions (see below). The following areas will need support from somewhere in the next few years:

- **Hard or commercial capital to lend on to/invest in investees:** where a market is still not functioning as it should, because it is illiquid, or investors do not yet understand the market, or investor appetite remains low for other reasons. This would provide an opportunity for the BSB to recoup financial returns by taking advantage of failures or illiquidity in commercial markets, of the sort we are currently seeing in the venture capital market. BSB could contribute upwards of £50 million to this market over the next few years.
- **Soft, semi-commercial capital to lend on to/invest in investees:** to a large extent stepping into a gap in the market left by Social Investment Business (SIB) funds – but applied with discipline to achieve maximum impact. Some charities/social enterprises are not

able to offer commercial returns. BSB could contribute upwards of £50 million a year to this market.

- **Capital to fund intermediary capitalisation:** continued patient capital investment to allow intermediaries to develop and attract more capital/liquidity from other markets. Important because without sound and growing intermediaries, the development of the market will falter. NPC believes there could be more than £20 million of opportunities suitable for BSB.
- **Capital to fund intermediary overheads:** in reality these are subsidies in the form of grants (sometimes masquerading as patient capital) in circumstances where the costs of servicing a nascent and complicated investee/investor base are very high. There needs to be justification for this in terms of social impact, or potential for sustainability: propping up a failing organisation or market long-term is unlikely to fit the BSB's objectives. There is a general gap of around £15 million to £20 million over the next three years, some of which might be appropriate.
- **Capital to build capacity of the sector – investees:** i.e. improving financial literacy, understanding of alternative financial mechanisms, and business planning of charities and social enterprises. Most intermediaries report that a lot of time and effort is required to help investees to become investment ready: and this carries costs which have been borne through some kind of subsidy. The BSB should be careful about how it invests, and learn from the Capacitybuilders experience: be clear on objectives, measure impact and avoid waste. NPC has not quantified this market.
- **Capital to build capacity of the sector – investor market:** more is needed to catalyse the investor market. For instance, investors are seeking more co-investors to share risk. There are currently few available as there is a very limited investor base. If the BSB acted as a co-investor to deals developed by intermediaries, via intermediaries, this could liberate additional capital from investors such as trusts and foundations; many of whom are willing to invest but cautious about the risks and do not want to shoulder the majority of risk in any one deal. Some deals will have commercial returns, others will be sub-market. However, the BSB should not become a retail investor as such, but provide capital to intermediaries

for syndication. NPC has not quantified this market.

- **Development of new products:** there is demand and potential for social impact, but commercial investors won't be the ones to develop the market, as the development of new products rarely yields a financial return first time. It's hard to quantify this market, but NPC could readily identify at least £20 million of opportunities as of now – more may follow.

In addition, NPC sees a role for the BSB in **influencing the legal, regulatory and tax environment for the market**. Investors are seeking better corporate structures than are currently available and the tax breaks available favour some areas more than others. Helping to resolve these issues with expert advice would be welcome. The bank could also press for **greater transparency in the market**, in terms of funds managed, costs of management, returns and losses.

Further detail on our findings can be found in Part 3.

2.2 The financial exclusion market

Third sector lenders of affordable credit were the focus of our analysis. We considered the likely demand for different types of capital from these lenders in the next three years. For the capacity-building aspect, we focused on credit unions as they have a greater potential to become sustainable long-term. Our analysis suggests that third sector lenders require three types of capital over the next three years:

- **Soft, semi-commercial capital to lend on:** up to £36 million of patient capital for third sector lenders to make loans to financially excluded individuals.
- **Capital to fund intermediary overheads:** £7 million to £16 million of grants to cover the high costs to third sector lenders of making small loans to people on low incomes.
- **Capital to build capacity of the sector:** £22 million to £25 million (some as patient capital), to move all unsustainable credit unions to sustainability (i.e. not reliant on grants). £7 million to £10 million (as a mix of grants and patient capital) would pay for mergers of local credit unions and £15 million (mainly as patient capital) would fund the creation of a Central Service Organisation for

credit unions.

Some third sector lenders will need external subsidy for the next three years, in the form of grant and subsidised capital, if they are to continue to make loans. This is because a large proportion are not able to cover the cost of lending through interest on loans (see 4.1.1).

Sustainability is probably the main challenge facing third sector lenders over the next few years. Our research suggests that a one-off investment of £22 million to £25 million, coupled with integration with the Post Office network should make credit union more efficient, more available, and more attractive, and therefore better able to grow deposits and loans. This would in turn mean they could become self-funding in the next ten years – a number should achieve this in the next five years. Credit union sectors in other countries have shown that this is possible. If this happens, then the sector will require no external funding.

Therefore, from an investor perspective, the first two opportunities are very different from the third. **The first two opportunities could be seen as a short-term way of ensuring lenders continue to make loans**. They are about funding organisations to address financial exclusion in the next three years. The third, on the other hand, could be seen as an **investment in the long-term sustainability of the sector**. It is about funding activity that will ensure lenders carry on making loans to financially excluded individuals years into the future, without external funding.

2.3 Summary of demand for the two sectors

Table 1 defines the need for different types of capital in the two sectors.

Table 1: Need for different types of finance by social finance intermediaries and financial exclusion market

| Benefits | Social finance | Financial exclusion |
|--|--|--|
| <p>Hard, or commercial, capital to lend on to/invest in investees</p> <p>Capital not used to support the intermediary, but to invest in the investee. It can be loans, stand-by facilities, equity.</p> <p>This capital can earn commercial returns commensurate with risk (or nearly).</p> | <p>Gap: £50 million to £100 million potentially in illiquid market.</p> <p>Gross need: c. £300 million to £400 million over next three years.</p> | <p>Not required.</p> |
| <p>Soft, semi-commercial capital to lend on to/invest in investees</p> <p>Again, this is not used to support the intermediary. It can be loans, stand-by facilities, equity.</p> <p>But this capital may not earn commercial returns.</p> | <p>Gap: £50 million to £100 million.</p> <p>Gross need: c. £200 million to £300 million over next three years.</p> | <p>Gap: Up to £36 million over the next three years.</p> |
| <p>Capital to fund intermediary capitalisation</p> <p>This is capital which stays with the intermediary to allow it access to other finance. It rarely yields commercial returns.</p> | <p>Gap: £20 million, if BSB can share burden; £50 million if not.</p> <p>Gross need: c. £50 million over next three years.</p> | <p>Only required under certain circumstances.</p> |
| <p>Capital to fund intermediary overheads</p> <p>The data on these requirements is weak, but NPC believes that the objective here should be to achieve sustainability. NPC would not like to see demand for this type of funding perpetually repeated, unless the social impact arguments are extremely persuasive.</p> | <p>Gap: £15 million to £20 million over the next three years, which is also the gross need.</p> | <p>Gap: £7 million to £16 million over next three years.</p> |
| <p>Capital to build capacity of the sector</p> <p>In the case of credit unions, this may be to pay for mergers and the creation of a Central Service Organisation.</p> | <p>Unquantified.</p> | <p>Gap: £22 million to £25 million over next three to five years.</p> |
| <p>Capital to develop new products</p> | <p>Gap: £20 million if the BSB can share burden.</p> <p>Gross need: c. £50 million upwards over next three years.</p> | <p>Not required.</p> |

PART 3: SOCIAL FINANCE FINDINGS

This research set out to investigate the demand for capital from social finance intermediaries, and to draw findings about the likely balance of demand for commercial and softer, or philanthropic capital, from the Big Society Bank (BSB). The research focused on quantifying demand from the existing intermediary market and did not directly research demand from investee markets.

The findings in this section relate most directly to the capital and development needs of social finance intermediaries, and the role that the BSB could play in meeting these. Our interviews also

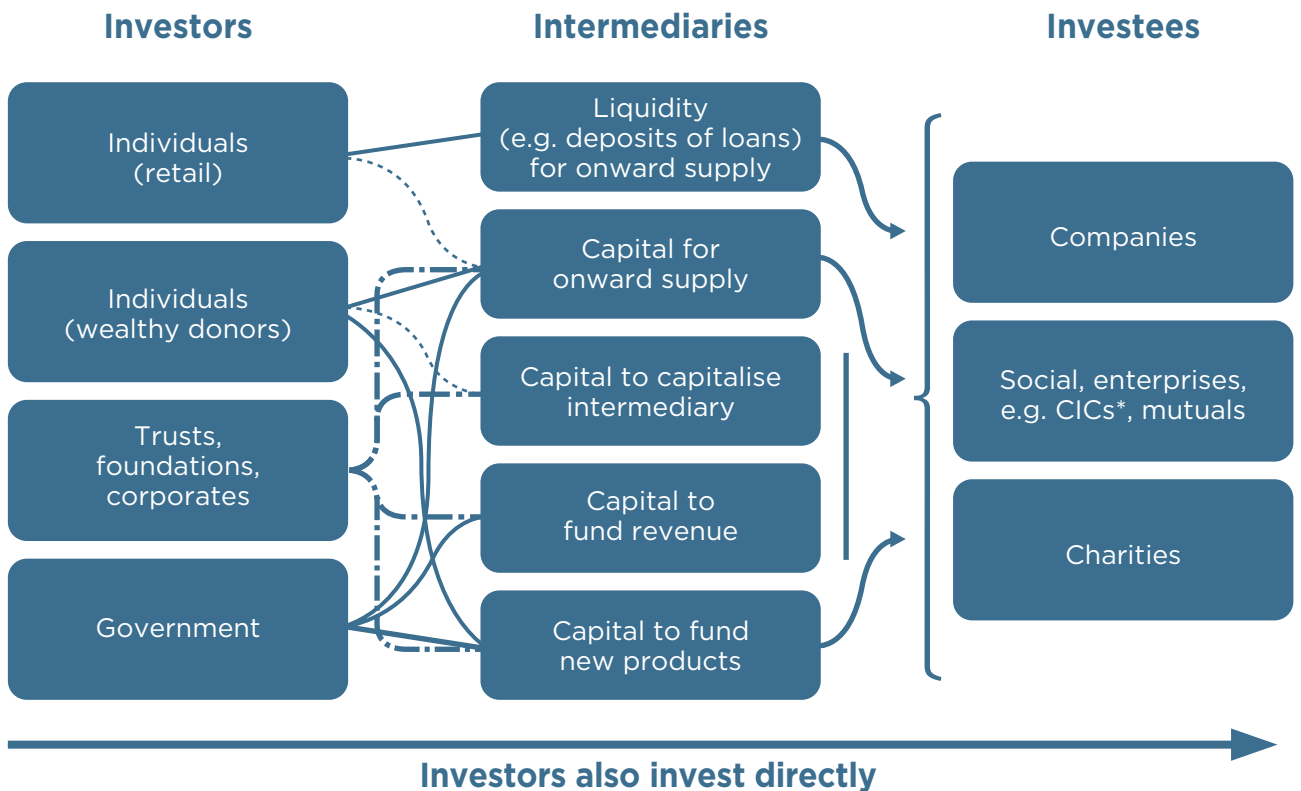
highlighted a lot of useful information about the structure and workings of the market, which should inform the development of the BSB’s strategy. These are documented in Appendix A and cross-referenced throughout this section.

3.1 Background: explaining the market

3.1.1 Market structure and an overview of investment options

An overview of the structure of the market is necessary for understanding demand, financial

Figure 1: Supply and use of capital in the social finance market



*A CIC is a community interest company, designed for social enterprises seeking to use their profits for social good.

returns, and investment options.

Figure 1 illustrates how the market works. Investors supply capital and liquidity to the market, usually via intermediaries, but sometimes directly. The form of investment required will depend on the intermediary – the products it offers and the target markets it serves. Differentiating the capital and liquidity requirements of intermediaries is important in developing a strategy for investment.

From an investment point of view, financial returns, social returns and risk are the three drivers of the market, which can be divided as follows:

- **Financial returns commensurate with risk while achieving social returns.** Investees are usually companies, and investors commercial, e.g. Bridges Ventures, Triodos Bank. In some circles this type of finance is known as ‘Finance First’.
- **Financial returns approaching commercial rates, but tending to ignore risk** while pursuing social returns. Investees are companies, charities and social enterprises. Investors would demand higher returns if they wanted the risks to be fully rewarded. NPC would put Rathbones’ social enterprise strand, Bridges Ventures’ Social Entrepreneurs’ Fund, Charity Bank and CAF Venturesome in this bracket.
- **Social returns more important than financial returns.** This often involves patient capital yielding 0 per cent or very low rates, and at high risk of non-repayment. Investees are charities or social enterprises. Investors in intermediaries such as CAF Venturesome may fall into this category. This is often termed ‘Impact First’ investment.
- **Social returns but financial loss – e.g. grants.** Or repayable grants not repaid!

Ten years ago the market for social finance barely existed. Charity Bank (not yet called that, and not yet a bank) was experimenting with lending to charities. The Social Investment Task Force was formed in 2000. But many of the institutions familiar today did not exist until 2002 and later.¹ The market is still ‘early-stage’, but today a wide array of products for investors and investees has developed – with a number of social finance organisations acting as intermediaries. These players are often active across more than one area or product type.

Appendix A carries a more detailed explanation of:

- Financial products.
- Investor and investee perspectives.
- Availability of capital.
- Obstacles to growth in the future.
- Segmentation of the market according to deal size.

Some readers may want to refer to this for more background and understanding.

A list of many of the organisations operating in the space can be found in our list of interviewees, Appendix C.

3.1.2 Overview of the market

This market only started in the late 1990s/early 2000s, so has only been growing for a decade: a short time for a new market to develop.

There are huge variations in scale between different organisations/sectors – Triodos and the Social Investment Business (SIB) dwarf providers such as Venturesome and Big Issue Invest. Commercial areas of the market now hold sizeable players such as Bridges Ventures (£145 million) and Triodos UK (£450 million). Areas which can offer near-commercial opportunities also hold bigish players, for instance Charity Bank has a total asset portfolio of nearly £60 million, as it can offer attractive rates to depositors. Some of these big players are considered to be Community Development Finance Institutions (CDFIs) and are members of the Community Development Finance Association (CDFA). When NPC talks about CDFIs generally, however, we usually refer to smaller regional organisations (see below).

The non-commercial space is dominated by SIB, with small players such as Venturesome and regional CDFIs also present. In the absence of SIB, this part of the market looks thin and fragmented. Big Issue Invest has intimated that its expansion plans would be into the commercial arena, where it is easier to reach scale: making investments is easier in the more commercial space, and capital potentially easier to access. Triodos’ exit from its Social Enterprise Fund arose because it was unable to generate sufficient deal flow on acceptable terms for its investors. So a gap is emerging.

We have used the term ‘esoteric’ to describe products which defy categorisation. Esoteric and

new products may look small now, but each new product could develop its own sizeable market. An example of an esoteric product would be the Allia (formerly CityLife) Bond, a complex mechanism whereby investors buy social housing bonds, but waive the financial return on the bonds, which charities then benefit from instead. The Social Impact Bond is also new and esoteric, in that a similar mechanism to reward investors financially for savings generated for government has not been tried and tested before. The Social Impact Bond is also quite complex. Commercial investors are unlikely to develop new markets and products as developing new products rarely yields

a financial return first time. Nor does the market development process carry an immediate financial reward. But the potential social rewards are high. CDFIs may be willing to pilot new products (their own or others) and could offer regional penetration.

3.2 Investment opportunities for the BSB

3.2.1 Options for all investors

Based on the market structure above, Table 2 presents the different options for investors.

Table 2: Options for investors

| Option for investors | Investment type needed and likely return |
|--|--|
| Invest in an intermediary so that the capital or liquidity is onwardly distributed to investees. Hard or soft capital an option: see Table 3. | Can result in good financial returns , depending on the risk/reward profile of the investees. Some intermediaries aim to make commercial returns for investors. Examples would be Bridges Ventures, Triodos – even Charity Bank offers very respectable rates for depositors. But others specialise in making investments with high social impact but low financial returns in comparison to the risk: Venturesome, and the funds run by Social Investment Business (SIB), would be examples of this. |
| Invest in an intermediary so that the intermediary has the necessary capital base to support investment from other investors (e.g. depositors). | Likely to require patient capital , unless the intermediary is well-established, and generating commercial returns commensurate with risk on its onward investments. Triodos successfully generates a return on its core capital because its banking operations are profitable. Charity Bank is not yet profitable, so its capital has not yet generated financial returns. |
| Invest in an intermediary so that it can develop. Typically the investor would be helping to pay operating costs (if the intermediary incurs deficits rather than surpluses); pay for capital expenditure (e.g. IT). | Likely to require grants , even if this is dressed as patient capital, as it is hard to see how to recover operating losses through future financial returns. Start-ups will experience several years of operating losses before reaching a sustainable level. Charity Bank's core investors will be familiar with this scenario. Local Community Development Finance Institutions (CDFIs) may have revenue funded by local authorities. |
| Invest in an intermediary to cover the cost of developing and piloting new products. | Likely to require grants, or very patient capital with a very high tolerance of risk. Examples would include the first Bridges Ventures fund, which was funded by government (grants and patient capital), although this ultimately spawned a commercial product. The development of Social Impact Bonds would be another example, although once developed, these can yield commercial returns. |
| Provide grants to develop the market, e.g. capacity-building grants to investees or more general capacity-building initiatives. | Grants will generate no direct financial returns but can generate good social ones. Social Investment Business estimated that £1 granted to an investee to help it develop to become 'investment ready' generated £27 of future financing. |

3.2.2 Capital gaps: potential for the BSB

Table 3 shows an estimate of the demand for capital and potential returns available against each of the options outlined above. This is based on NPC's modelling of the needs for investment of social finance intermediaries, explained in more detail in Appendix A.

Table 3: Demand for capital and potential returns

| Type of capital | | |
|--|-----------------------------------|--|
| Hard, or commercial, capital to lend on to/invest in investees via intermediaries | Amount required* | c. £300 million to £400 million over next three years Mainly comes from depositors |
| | Potential gap for the BSB to fill | £50 million to £100 million where markets illiquid, e.g. Bridges Ventures |
| | Form | Loans; stand-by facilities; equity (listed and unlisted) |
| | Term | Range: short-term (<12 months) to long-term (>15yrs mortgage) equity 5-7 years |
| | Returns | Full commercial returns commensurate with risk |
| Soft, or semi-commercial, capital to lend on to/invest in investees via intermediaries | Amount required* | c. £200 million to £300 million over next three years In past mainly come from government (via SIB and regional CDFIs) Involvement of commercial investors or philanthropy limited, although there is potential to grow this |
| | Potential gap for the BSB to fill | £50 million to £100 million if government funds dry up |
| | Form | Recyclable loans biggest component; stand-by facilities; some quasi-equity etc. |
| | Term | Short and long-term |
| | Returns | Interest rates vary between 0 per cent and 6 per cent, not commensurate with risk – losses possible |
| Capital to fund intermediary capitalisation | Amount required* | c. £50 million over next three years, e.g. Charity Bank £20 million |
| | Potential gap for the BSB to fill | £20 million assuming the BSB takes 40 per cent of the market |
| | Form | Patient capital |
| | Term | Very long-term |
| | Return | May not get capital back; poor financial returns; risky Good potential to leverage social impact |
| Capital to fund intermediary overheads | Amount required* | c. £15 million to £20 million over next three years |
| | Potential gap for the BSB to fill | £10 million |
| | Form | Grants/patient capital with high risk of non-repayment |
| | Term | Very long-term/perpetual |
| | Returns | Financial loss, but good potential to leverage social impact |
| Capital to build capacity of the sector | Amount required* | Unquantified – worth quantifying based on Capacitybuilders' experience? Also NCVO Funding Commission recommendations |

| Type of capital | | |
|---|-----------------------------------|--|
| Capital to build capacity of the sector | Potential gap for the BSB to fill | Unquantified: a full analysis of what is needed is required, together with potential impact |
| | | Important to distinguish between grants needed to build capacity, and grants needed to make a financial structure viable |
| | Form | Grants |
| | Term | Perpetual |
| | Return | Financial loss, but good potential to leverage social impact |
| | Amount required* | c. £50 million upwards over next three years |
| Capital to develop new products | Potential gap for the BSB to fill | £20 million if BSB takes 40 per cent |
| | Form | Patient capital |
| | Term | Long-term |
| | Return | Development costs tend to outweigh financial returns in first stage |

*Gross need for capital to make deals or increase portfolio size

3.2.3 Explanation of opportunities in Table 3

NPC modelled a view of the range of financial products offered by social finance intermediaries to investees, the size and characteristics of the different markets, and the likely future demand for capital for each of these. These are summarised in Table 9 in Appendix A, page 41.

The opportunities can be summarised as follows:

Hard or commercial capital to lend on to/invest in investees

- Commercial loans: opportunities here are very limited, as genuine commercial lending can be handled by Triodos and Charity Bank. However pressure on high street banks to join this market more actively would help it to expand.
- Listed commercial equity: opportunities limited for BSB, as ordinary investors can and should participate.
- Unlisted commercial equity: a few opportunities where there are funding gaps. For instance, there are liquidity problems in the venture capital markets, leaving Bridges Ventures short of investment for a £50 million fund. Financial returns might be attractive.

Soft, semi-commercial capital to lend on to/invest in investees

- Semi-commercial loans: Charity Bank and other intermediaries would like to expand, but the best way to achieve this would be to invest capital in the intermediary itself (see below).
- Government-subsidised loans: much will depend on what will happen to funds currently managed by SIB. This is a very large market potentially, with an uncertain future. The BSB could bring greater investment discipline to this area. The funding gap could be £50 million, if SIB closed its doors.
- Complex semi-commercial loans, quasi-equity etc: this is a difficult and costly area, with many intermediaries finding it hard to please both investor and investee. An added burden is the poor investment readiness of many investees. But there may be opportunities to grow some sectors to scale where the products genuinely work. The BSB would not be welcome as a direct retail funder, but would be welcome in supporting promising areas of the market as a wholesale funder. This might include adding to investor syndicates via intermediaries. More analysis of the activities and contribution of regional CDFIs is needed (this is beyond the scope of this report).

Capital to fund intermediary capitalisation

- A range of intermediaries, between them offering a wide spectrum of financial products, have capital needs to underpin balance sheets and attract additional investment. Up to £10 million (more perhaps for regional CDFIs) might be required for complex semi-commercial products, while capital funding for banks such as Charity Bank for semi-commercial loans may need £20 million.

Capital to fund intermediary overheads

- NPC suspects (although data was hard to find to confirm this) that many intermediaries are using capital to subsidise running costs, and that this would continue to be a requirement for some until they have reached sustainability.

Capital to build capacity in the sector

- The investee market, especially investment readiness, needs investment, although NPC has not quantified this as it was beyond the scope of the research. SIB and UnLtd have been very active here, as was Capacitybuilders. A review of their results would be important in determining strategy for this. Realistically the capital would be needed in the form of grants.

- Investor market also needs stimulation. NPC is not clear how, as interviewing investors was beyond the scope of this research. However NESTA's other research into investors will shed light on this.

Capital to fund new and esoteric products

- Products like the Social Impact Bond have potential. Development of the products can be arduous and costly, but once developed, and as the market for them grows, they can become commercially attractive. For example, the social housing finance market took time to develop; Bridges Ventures needed patient capital to test its product (now commercial); and parts of the microfinance market have become commercialised (not always successfully). This could be a very interesting area for the BSB as there are many ideas being developed even as we write. Demand is hard to quantify: NPC can think of £10 million in the pipeline, but there may be more.
- NPC has not investigated the potential to exploit intellectual property in these markets. This needs further investigation, as it may be source of financial return although this could compromise social impact.

NPC has some observations on the difficulties of modelling these requirements which are worth highlighting here:

Notes on the model

As might be expected, modelling the capital requirements of social finance intermediaries was a challenge. To do this we identified different markets for investment, and looked at the activity of the various social finance intermediaries in each. Some of the difficulties in developing the model include:

- **Fuzzy boundaries to the sector.** At each end of the market the edges are very blurred: where do grants to support social investment stop and grants generally begin? Impetus is not included, but UnLtd is. When does commercial equity to companies become mainstream, even if there are social benefits to the investment? Rathbones' commercial fund management activities are excluded. And Unity Bank is not included in our calculation of loans.
- **Poor historic and current data.** Accounts do not always exist; accounts are confusing/non-transparent – for instance managed funds are not in the accounts of those managing them, e.g. SIB and Bridges Ventures. At time of writing NPC is still waiting for SIB's latest accounts with full explanations.

- **Sketchy public data contradicts conversations.** It is difficult to correlate what people say about overhead ratios or growth with the data that is publicly available.
- **Projected data reliant on hearsay.** No-one interviewed shared a business plan!
- **CDFI data not analysed in detail.** We think that more detailed analysis of CDFI data would highlight opportunities at regional and local level.
- **Loans revolve, so modelling availability of credit to organisations is difficult.** This is a nice problem to have: in reality capital is more available to investees than the model shows. The model cannot adequately account for or predict the revolving element of loans, it just shows increases in portfolio size.

For further explanations of the different markets see Appendix A, A.1.

We have also included explanation of the different deal sizes on offer in Appendix A, A.5.

3.3 Opportunities for building the market

Social finance is still an underdeveloped market. Some have begun talking about social investment as an ‘asset class’ recently.² However, most commentators admit, at least privately, that if we are talking about social-purpose organisations like community interest companies (CICs), charities and social enterprises, achieving an asset class which is recognised by mainstream investors is still some way off.

The social finance market is still at an early stage, and so building a social finance market is much more than just providing a certain type of capital. The elements highlighted below need development. They all take time and money, but may not offer financial returns. A more detailed discussion of the elements is in Appendix A .

Below are some specific actions required:

- Stimulating demand for finance – particularly regionally and in sectors that have not been targeted by SIB or another fund.
 - Capacity-building to help investees become investment ready – financial/investment literacy and ability to operationally scale-up or replicate.
 - Processing demand and supply – finding good
- staff able simultaneously to understand social impact and structure financeable investments is a challenge. If the market is stimulated too much, there may be a shortage of processing capacity among existing intermediaries. Supporting intermediaries so that they can expand processing capacity should remove this potential bottleneck.
 - Development of financial products which appeal to investors as well as investees, i.e. are simple and have risk/reward properly allocated. There needs to be clear identification of where the product lies on the risk spectrum.
 - Improving the environment for investment: legal structures; tax incentives; regulatory issues. There also seems to be considerable debate about the fiduciary responsibilities of institutional investors and trusts and foundations, and whether a looser interpretation of such responsibilities would free up more capital for social investment.
 - Investor stimulation, including:
 - development of vehicles to make retail investment easier;
 - encouragement and education of retail investors;
 - development of market to spread risk;
 - encouragement of trusts and foundations to participate more willingly; and
 - persuasion of high street banks to participate in bankable deals.

- Impact measurement needs to become more sophisticated. Looking at the impact of the interventions being supported and the impact of using social investment, is leverage increased? Is funding recycled?

3.4 Overall findings

Demand for social finance is growing. Experience from the BSB pilot indicates demand, as do the latest figures from Community Development Finance Association (CDFA) and almost any other intermediary. But the market is still in its early stages, and so this growth has, in many areas, been fuelled by subsidised finance. It is not clear to NPC that subsidy can be avoided in future: there are still too many market segments in need of seed capital and capacity-building.

Opportunities for the BSB to earn attractive financial returns will be limited, without crowding out private investors – although there are exceptions (see bullets below). The following areas will need support from somewhere in the next few years:

- **Hard or commercial capital to lend on to/invest in investees.** This could be an opportunity for the BSB to recoup financial returns by taking advantage of failures or illiquidity in commercial markets, for instance in the venture capital market at the moment. Where this happens, options are attractive – although in the venture capital instance, the BSB would have to wait five to ten years to reap the returns. Being an investor itself (through intermediaries) would help to share investment risks where other investors are looking for scarce investment partners. But the BSB should avoid crowding out commercial investors. There may currently be opportunities of over £50 million in this type of activity, more spread over several years.
- **Semi-commercial, high-risk capital for onward investment.** The reduction in SIB's funds under management will leave a substantial gap in the market, and could stall momentum. The BSB has the potential to step into this market, but improve on SIB: free from the tyranny of spending all funds annually ('annuality') it could operate as a more disciplined investor. The BSB could also offer this type of financing to sectors not previously covered by SIB funds. This could be a fruitful line to pursue, and could absorb upwards of £50 million per annum. But the BSB should take care to respond to genuine demand, rather than top-down distortion.
- **Capital investment in intermediaries.** Capital will be needed to support other capital or liquidity (e.g. deposits) coming into the intermediary. Returns would be uncertain and extremely slow in coming. There could be £20 million to £50 million needed by intermediaries for these types of support. NPC believes this is important, despite the poor returns, because without sound and growing intermediaries, the development of the market will falter.
- **Capital investment in intermediaries to reach sustainability.** Intermediaries in the arena where investments offer insufficient returns to cover the full costs of developing and running a portfolio will need continued patient capital investment and/or subsidy in the form of grants to allow them to develop. In some cases this will be, bluntly, to subsidise revenue as the cost of processing deals with investees with low investment readiness is high. NPC has not been able to get to the bottom of the sector's aggregate operating deficit, but it would be measured in millions, or even tens of millions of pounds. BSB could contribute about £10 million. No financial returns can be expected on this support but it could achieve social impact. For each investment, the BSB must satisfy itself on the genuine costs of running the intermediary – it should be careful not to subsidise failing business models.
- **Capacity-building of investees.** Most intermediaries report that a lot of time and effort is required to help investees to become investment ready, and this carries costs which have been borne through some kind of subsidy. Given SIB's experience in making grants to support its lending activity, the need here could be upwards of £50 million, although NPC has not investigated the demand in detail. Without this investment, it will take longer for the investee market to broaden and take on investments. The BSB will need to distinguish between grants needed to build capacity of the investee, and grants needed to make a loan or other investment work. On the latter, this should be provided by other funders. The BSB cannot expect a return from this capacity-building exercise unless a business model is developed to pay for it. Would investees be willing to pay for this, when the alternative is traditional fundraising? Will investors be willing to pay, if they cannot recoup the cost in financial returns? NPC has yet to see a

convincing model for covering the costs.

- **Capacity-building (2): broadening of investor market.** Investors are seeking more co-investors to share risk than are currently available among the very limited investor base. So if the BSB were to be available as a co-investor to deals developed by intermediaries, this could liberate more willing but cautious capital from investors such as trusts and foundations. Some deals will have commercial returns, others will be sub-market. The amount required to liberate capital is hard to quantify, but a first guesstimate might be £50 million for starters. This funding is needed to encourage more investors into the market, so would be quite a high priority. More generally, NPC believes more work needs to be undertaken to stimulate the investor market, but this would require technical input in terms of tax, legal, regulatory and investment expertise and NPC has not quantified the cost of such work.
- **Development of new products.** There is demand for investment in the development of new products, such as the Social Impact Bond. The BSB's participation in this would be very welcome. For instance Bridges Ventures emphasised the enormous value of seed funding by government in its first fund in establishing the social venture capital market, and believes it could be useful again. These activities are best suited to grants; at best the capital is likely to be patient and risky – development, piloting and getting a new product to market can take several years. However, with time, the product itself may yield attractive returns. BSB may find opportunities amounting to £20 million or more in the pipeline. The potential social returns on this type of investment may be exciting: not only are the deals themselves attractive, but it may spark a new market attracting new players.

The BSB should avoid:

- Investing at levels where there is plenty of capital available (e.g. bank deposits).
- Crowding out the market for other investors, mainly commercial, by offering subsidy where it is not required or setting up new entities where they are already in existence and ready to help.
- Falling into the annuality trap SIB fell into (having to spend its annual allocation of

funding in this financial year).

- Sticking with products that do not work, or backing poorly-performing institutions.

The BSB could invest via intermediaries. NPC does not believe it should set up a new entity to process deals, as this could cannibalise existing intermediaries' processing capability and deal flow.

Other key points

Structural issues

Complicated products such as hybrid quasi-equity instruments for CICs and charities are not always successful. They seem to be neither fish nor fowl: in the absence of a commercial exit, investors are not achieving good commercial returns. And at the same time, investees have to give investors too much cash, which squeezes growth. But these are early days still for this market. Some deals have been successful, so it may be worth pursuing further to test what genuinely works and what does not.

More generally a review of structural impediments – tax, regulations, legal structures – would be very beneficial.

Transparency

NPC would encourage the BSB to be clear and transparent about its funds, how they are invested, what they achieve, and what they cost to run. NPC found this information exceedingly difficult to obtain for the government funds managed by SIB. SIB was open verbally, and tried to answer queries, but there were no published audited figures that clearly showed portfolio outstanding, arrears or loss rates, costs of managing the funds, and so forth. NPC believes such information should be audited and available for public record, and not reliant on personal conversations. Nor should it be necessary to run a Freedom of Information request to obtain such information.

Product and market development

There is more work to be done to develop the market, and developing new products is a long and financially unrewarding process. But once a new product is established, its market can offer commercial returns in some cases.

Appendix A, A.5 discusses what is required of both market and product development in more detail.

PART 4:

FINANCIAL EXCLUSION FINDINGS

4.1 Background: explaining the market, and an overview of investment options

4.1.1 Market structure

A state in which all people have access to appropriate, desired financial products and services in order to manage their money effectively. It is achieved by financial literacy and financial capability on the part of the consumer and access on the part of financial product, services and advice suppliers.

Definition of financial inclusion, TRANSACT.

The main players

A wide range of players have worked to address financial exclusion in the past ten years and more. The players fall into two groups: those dealing with the 'supply side' and those addressing the 'demand side'. The supply side is about financial products available to financially excluded people, e.g. basic bank accounts; insurance. The demand side relates to the skills and knowledge of financially excluded people, and their ability to make sensible financial choices. Our focus is on the availability of finance to financially excluded people, so we focus on the supply side.

The two main problems on the supply side of financial exclusion are a shortage of appropriate banking products and a shortage of affordable short-term loans. Retail banks are the main providers of banking products – such as bank accounts and savings products – and third sector lenders are the main providers of affordable credit. We are concerned mainly with the availability of credit to financially excluded people via third sector lenders. Credit unions and personal finance Community Development Finance Institutions (CDFIs) are the principal third sector lenders – they have very different models (see Figure 2).

The UK credit union movement dates back to the 1970s. It grew substantially from the late 1980s and, with local authority help, credit unions

expanded throughout the country. By 1987 there were only 108, this number ballooned to about 600 by 1997. Most of these were in low-income neighbourhoods. Since then, a combination of credit merger and failures means the number of credit unions has fallen to 444. Many rely on government grants to cover revenue costs, but most of their capital to on-lend is provided by deposits.

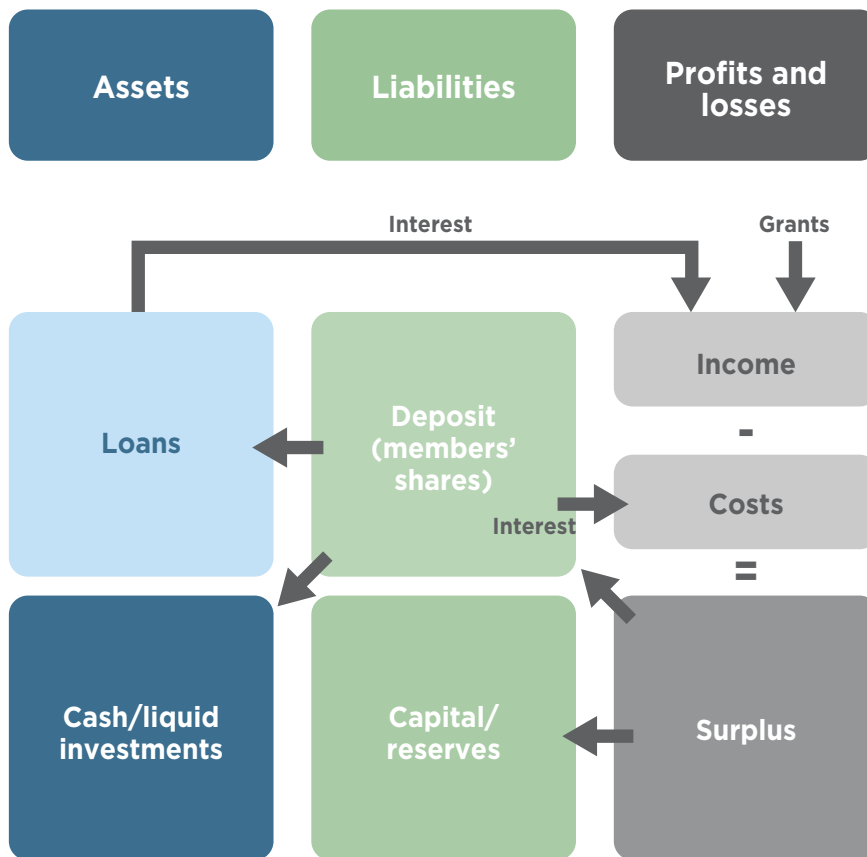
Figure 2 illustrates how credit unions work.

Personal finance CDFIs have mostly been set up in the past ten to 15 years in the UK. They form part of the CDFI movement that benefited from start-up investment from the government – the £42 million Phoenix Fund – since then receiving funding from various government agencies, including Regional Development Agencies. They have seen a steep growth in their loan portfolio since 2005, supported by the £10 million received from the Department for Work and Pensions' Growth Fund. Their growth has therefore been largely reliant on government funding, much of which now looks at risk.

Personal finance CDFIs, unlike credit unions, operate as 'wholesale banks'. This means that they take capital provided by an institutional investor and then lend it on. The people to whom CDFIs lend pay interest on the loans, so covering some of the costs to the CDFI (of lending) and the interest back to the lender. Historically, CDFIs have relied almost exclusively on 'soft capital' (on sub-commercial rates) or grants to lend on – money which has largely been provided by government and charitable funders. In short, the model is reliant upon subsidised capital from institutional investors.

From an investor perspective, the four most significant **differences between credit unions and personal finance Community Development Finance Institutions (CDFIs) are scale, services, customers and sustainability.**

- **Scale:** the credit union sector is much larger

Figure 2: How credit unions work

Credit unions operate, in one sense, like community banks. They take deposits from individuals and then use that capital to make loans to other individuals. The interest on loans is used to pay for their running costs, though most require some charitable grants to cover the high costs of making loans. After costs, some credit unions are able to pay dividends to depositors, in the same way as a high street bank pays interest to depositors. Credit unions have to keep capital as reserves to support loans to members, while protecting depositors' interests. The diagram illustrates how credit unions work.

than the personal lending CDFI sector. Credit unions are by far the biggest provider of affordable loans in the UK; there are 444 credit unions operating here at the time of writing,³ between them making £460 million of loans in 2009. Some CDFIs also do personal lending to financially excluded people, however there are only 13 of these, making about £7.6 million of loans in 2010.⁴ Credit unions not only provide more loans, but they also cover more of the country – they are well-represented in every English region, in Wales, Scotland and Northern Ireland. Personal lending CDFIs are found in five English regions – the North West, North East, West Midlands, South East and London – and in Wales, but only in small numbers.

- **Services:** Credit unions are vehicles for savings as well as loans, whilst CDFIs only provide loans. In addition to making loans, CDFIs provide advisory services to support financially excluded clients both to manage their money better and to access appropriate financial products.

- **Customers:** Unlike CDFIs, community credit unions serving low-income people (86 per cent of credit unions) look to attract people with middle incomes as savers. In addition, employee-based credit unions (14 per cent of credit unions) provide loans and savings. Employees in these credit unions are not, for the most part, financially excluded. CDFIs, on the other hand, serve only low-income, financially excluded people.⁵
- **Sustainability:** credit unions have the potential to become *entirely self-funding* in the long term. They take deposits from savers and lend these on to borrowers, and are therefore able to source their capital primarily from the public. In addition, credit unions have a route-map to sustainability, which includes integrating with the Post Office network.⁶ CDFIs, on the other hand, have always relied on government grants. Key people in the sector feel that government grants will be reduced in the coming years, and it is likely that CDFIs will struggle to secure capital to make loans.

When calculating demand for capital in the short term, we have included both credit unions and personal finance CDFIs, as our research suggests that both have a role to play here. However, **when calculating how much capacity-building investment is required, we focus on credit unions** because they have the potential to achieve sustainability, and are more likely to be able to grow to meet unmet demand for affordable credit.

Progress over the past ten years

Here we provide a high-level story of the past ten years in financial inclusion; more detailed accounts have been written elsewhere.⁷ It shows that, with the right investment, significant reductions in financial exclusion can be achieved, but that more still needs to be done.

Substantial progress has been made towards addressing financial exclusion over the past decade. In 2004, the Financial Inclusion Task Force was set up to help address the problem of financial exclusion. With a budget of £250 million and support from government, the banking industry and the consumer sector, it has helped bring about a huge reduction in the number of people excluded from mainstream banking. It set out with the target of reducing the number of people without access to a transactional bank account by half. This target was achieved in just five years – reducing this number from 3.75 million people in 2002 to 1.75 million by 2007.⁸

The commentators we spoke with felt that, **with regard to exclusion from banking, most of the main ‘supply side’ issues had been addressed**, due mainly to the introduction of basic bank accounts (though there is still work to be done, in particular on improving the functionality of accounts). They saw the main challenge now as addressing ‘demand side’ issues, such as a lack of knowledge of which banking products to use, and how. The Task Force has begun to improve the ‘financial capability’ of financially excluded people by funding 500 financial advisors nationwide for this group. However, its funding ends in March, and more still needs to be done.

The amount of loans to financially excluded people has grown thanks to the £100 million Growth Fund provided by the Financial Inclusion Task Force. This funding allowed credit unions and CDFIs to make 317,798 loans by providing both capital to on-lend and revenue funding to cover the costs of making loans. The majority (over four-fifths) of these loans were made by credit unions.⁹ The current Growth Fund comes to an end in March 2011, and its future beyond then is uncertain.

The progress made in increasing loans to financially excluded people is short-term.

Growth Fund funding brought about an impressive increase in the number of loans made to financially excluded people. The money should continue to be recycled by credit unions and CDFIs (as it is returned from one borrower and lent out to another) for the next few years at least. However, the Growth Fund provided capital to on-lend, and has done little to build the capacity of the sector so that it can continue to grow its loan book beyond the end of the Fund (March 2011), or to make lenders more sustainable.

The sustainability conundrum

The best way to sustain lending is to make third sector lenders self-financing. This means covering operating costs through the margin made between the interest taken in from loans and the interest paid out on deposits. However, it is incredibly difficult to make a small loan cover its costs – a leading academic in the field conservatively calculated that credit unions make a loss of £30 on a loan of £400.¹⁰ He calculated that credit unions would need to charge 50 per cent APR to break even, but the actual return on capital in the sector is around 10 per cent. The other way to make interest cover the cost of lending is by reducing costs by making efficiencies. Why do they struggle to break even? Small loans cost the same as a large loan to make, but generate less interest. It is therefore difficult to make enough interest to cover the overhead cost.

Some progress has been made towards making the credit union sector self-financing, but a lot remains to be done. Sector bodies agree that credit unions need to be of a certain size to cover the costs of lending (‘self-financing’). Birmingham Credit Union Development Agency (BCUDA) says that credit unions need, on the one hand, assets of £400,000, and on the other, £240,000 lent out to members to be sustainable (see Appendix B for details).¹¹ Mark Lyonette, chief executive of the Association of British Credit Unions (ABCUL), also emphasises that scale is the crucial ingredient for sustainability. However, he estimates that a credit union needs closer to £2.4 million on their loan book (rather than £240,000) to achieve sustainability, assuming the credit union is making only small loans.

The proportion of credit unions which are self-financing has increased from around one in ten to four in ten between 1997 and 2008. Alongside this, the overall number of credit unions has fallen from 596 in 1997 to 444 today.¹² Improved efficiency has been achieved largely by growth

and merger. This has made larger, more efficient, credit unions, whilst 40-50 non-viable credit unions have folded. This increase in efficiency has been achieved alongside rapid growth in members (from 262,000 in 2002 to 524,000 in 2008), and in the number and value of loans.¹³ This shows that credit unions are able to grow whilst simultaneously becoming more efficient, given sufficient external funding.

The challenges for the affordable credit sector in the next ten years

What is the scale of the affordable credit challenge in the next ten years? Private sector 'doorstep' lenders provide short-term loans at interest rates in excess of 100 per cent APR, compared with around 25 per cent APR for third sector lenders. There are **three million households using high-cost doorstep lenders**. The Financial Inclusion Task Force estimates that these households borrow £3 billion each year¹⁴ so that there is still much to do to meet this remaining demand for affordable credit.

What needs to be done to meet this need? The banking target – halving the number of people without access to a transactional bank account – has been reached. Commentators we spoke to agreed that there are two main challenges for financial inclusion – **educating financially excluded people to make good choices** and **increasing (or at least maintaining) the supply of affordable credit** in the absence of the Growth Fund. We focus on the latter.

4.1.2 Overview of investment options

Our analysis suggests that third sector lenders require **between £29 million and £77 million** over the next three years to keep lending and move towards sustainability. They need capital in three main forms:

- **Soft, semi-commercial capital to lend on:** up to £36 million of patient capital for third sector lenders to make loans to financially excluded individuals. Credit unions may be able to meet some of their need for soft capital themselves.
- **Capital to fund intermediary overheads:** £7 million to £16 million of grants to cover the high costs to third sector lenders of making small loans to people on low incomes.
- **Capital to build capacity of the sector:** £22 million to £25 million, as a mixture of grants and patient capital, to move all unsustainable credit unions to sustainability (i.e. not reliant on grants). £7 million to £10

million would pay for mergers of local credit unions, and around £15 million would fund the creation of a Central Service Organisation for credit unions.

These are all order of magnitude calculations, and further testing of the assumptions would be required to come up with precise figures.

Table 4 shows the amounts required, and what sorts of returns may be available to the Big Society Bank (BSB). As shown, credit unions need soft capital (grant or patient capital) which will provide no or low returns. Our projections suggest that there is no need to provide hard capital to lend on to investees, this is provided by deposits (or more precisely shareholders – credit unions are mutuals). Nor is it clear to us that credit unions will need additional capital reserves to support deposits, although in some downside scenarios there may be some capital hunger.

After three to five years we expect the demand for grant funding to cover revenue costs to taper, as the capacity building investment mentioned increases the number which are able to cover their costs. However, there will probably still be some credit unions that will take longer, maybe four to seven years, to become fully self-financing. We therefore think that a smaller amount of funding should be provided beyond 2013, tapering down to zero by 2016/2017.

4.2 Modelling demand for capital

Third sector lenders in general

Where our calculations relate to third sector lenders in general, we use trend data from the Growth Fund. We use this data to estimate the needs of lenders for two things: soft capital to on-lend and capital to cover overhead costs.

Credit unions

For credit unions, we had access to FSA statistics on their balance sheets. We used this data to make projections for the funding needs of credit unions to 2013, but to do so we had to make assumptions. We assumed the following:

- **Deposits grow at trend:** The value of credit union deposits grew at a rate of 8.5 per cent per annum from 2005 to 2009. We used this rate to project the growth rate of deposits out to 2013. This may in fact be an underestimate – the recession has already increased the rate of growth of deposits. Also legislative changes will make it possible for organisations to make

Table 4: Demand for capital and returns

| Type of capital | | |
|---|-----------------------------------|---|
| Soft, semi-commercial capital to lend on to/invest in investees | Amount required* | Up to £36 million over the next three years to support third sector lenders to make loans to financially excluded individuals |
| | Potential gap for the BSB to fill | Up to £36 million |
| | Form | Grant/patient capital/mix |
| | Term | Non-repayable/repayable over 10-15 years |
| | Returns | Low/no interest, though money would be recycled to make numerous loans Social returns (reduced financial exclusion), potential savings to the state |
| Capital to fund intermediary overheads | Amount required* | c. £7 million to £16 million over next three years to cover costs not covered by interest on loans |
| | Potential gap for the BSB to fill | c. £7 million to £16 million |
| | Form | Grant |
| | Term | Non-repayable |
| | Returns | No interest, though would help leverage deposits (credit unions) Social returns (reduced financial exclusion), potential savings to the state |
| Capital to build capacity of the sector | Amount required* | c. £22 million to £25 million over next three to five-years to pay for credit union mergers (£7 million to £10 million) and the creation of a Central Service Organisation (£15 million) |
| | Potential gap for the BSB to fill | c. £22 million to £25 million |
| | Form | Mix of grant/patient capital |
| | Term | Mix of non-repayable/repayable over 5-10 years |
| | Return | Mix of low/no interest (mergers) and market or slightly sub-market interest (CSO). Social returns long-term of significantly increasing access to affordable credit (therefore reducing financial exclusion) |

*Gross need for capital to make deals or increase portfolio size

deposits with credit unions from next year.¹⁵ This means that deposits may grow faster than the historic trend.

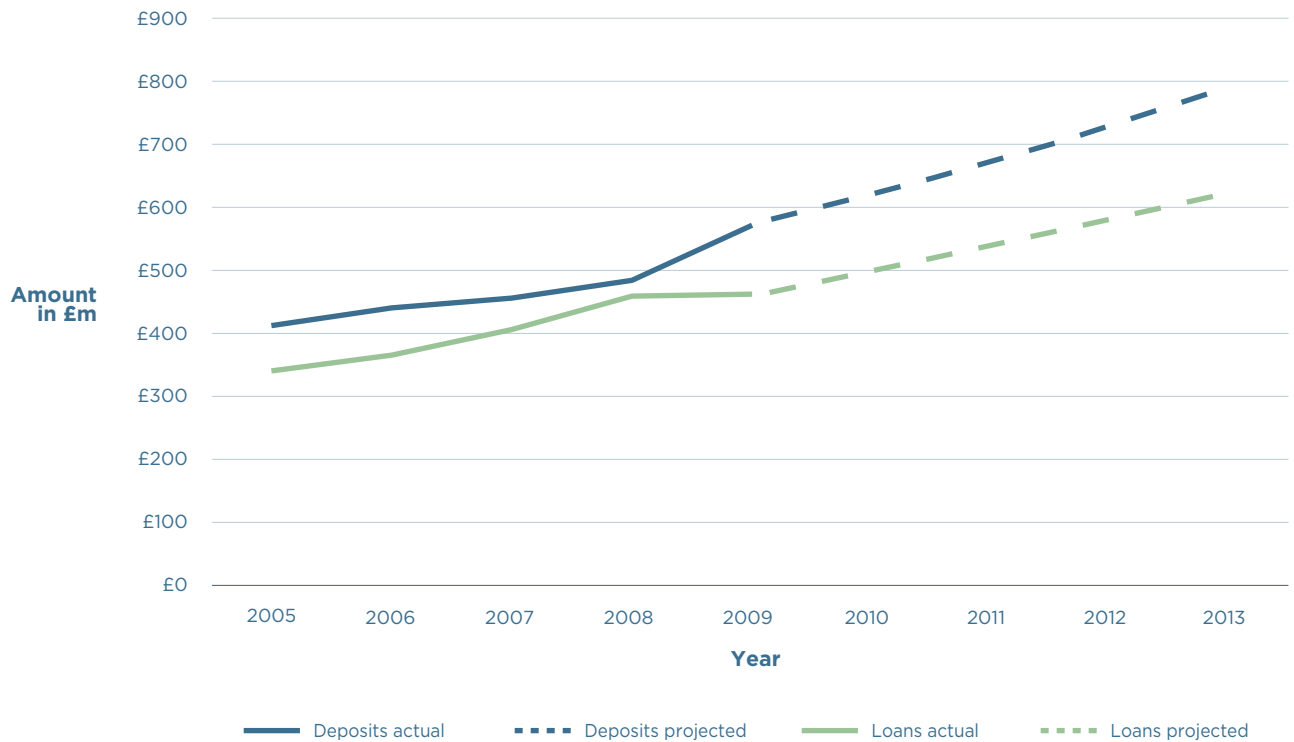
- **Loans grow at trend:** The value of credit union loans grew at a rate of 7.8 per cent per annum from 2005 to 2009. We used this rate to project the growth rate of loans out to 2013. Many factors influence the growth in loans, making it very difficult to predict. We therefore felt it was best to use historic trend data only.

From the trend in deposits and loans from the last four years, we produced a projection for the next three years (see Figure 3).

We then projected forward what would happen on other parts of the credit union balance sheet. We made the following assumptions for specific items in the balance sheet:

- **Liabilities:** We assumed that capital reserves are calculated by adding any surpluses to the previous year's capital reserves.

Figure 3. Trends and projections in credit union loans and deposits



- Assets:** In most cases these were a percentage of the loan book, based on trend – provision for bad debt at 3.5 per cent, liquid assets at 36 per cent and fixed assets at 3.7 per cent of the loan book. The main exception is ‘cash’, which was our ‘balancing item’, in other words where it made up the difference between assets and liabilities. In our model, deposits are greater than loans; meaning credit unions built up cash (see Table 6).
- Income:** We assumed that there would be no grant funding from 2011. Sector experts feel the Growth Fund is unlikely to be continued. Given the challenging funding climate we have assumed that all grant funding was cut. This is a worst-case scenario, but is probably not far from what will take place. We assumed that income on loans followed the trend between 2005 and 2009 (9.7 per cent of the loan book). We also projected a fall in interest rates on liquid assets from 3.7 per cent in 2008 to 1.5 per cent from 2009 to 2013 (given the drop in the Bank of England base rate).
- Costs:** All were set according to the trend between 2005 and 2009, including overhead costs (6 per cent of loan book), dividends (2.4 per cent of deposits), bad debt provisions and write-offs (1.7 per cent of loan book).

4.3 Investment opportunities

4.3.1 Soft capital to lend on

We estimate that third sector lenders could use up to £36 million of soft capital to make loans to financially excluded individuals in the next three years. This is based on the amount of soft capital provided by the Financial Inclusion Task Force’s Growth Fund – £59 million over five years. We have little doubt that third sector lenders will have enough demand for loans to lend similar amounts in the next three years (see Table 5).

The £59 million of capital provided by the Growth Fund has all been lent out, and in some instances lent numerous times. Together, third sector lenders took in an average of £12 million of soft capital per annum and lent it on. The majority (£10.4 million per annum) was lent by credit unions, with the remainder lent by CDFIs (£1.1 million) and housing associations (£0.3 million).

Looking forward, we therefore estimate that third sector lenders could use £12 million of soft capital per annum, which is £36 million in total over the next three years. The Growth Fund provided revenue funding for the cost of lending; this demand is likely to remain (see 4.3.2).

Table 5: Soft capital provided by the Growth Fund and estimated demand over three years

| | Average annual capital on-lent | Amount required over three years |
|----------------------|--------------------------------|----------------------------------|
| Credit unions | £10.4m | £31.2m |
| CDFIs | £1.1m | £3.4m |
| Housing associations | £0.3m | £0.9m |
| Total | £11.8m | £35.5m |

It may be that credit unions can meet a substantial amount of this need for capital themselves. Our modelling suggests that the credit union sector has no requirements for soft capital to on-lend or for their reserves to 2013 (see Table 6). This is because we project that the sector as a whole will receive enough deposits to cover loans, and will make enough surplus to build up their capital reserves to a healthy level (10-12 per cent of assets).

However, there are likely to be at least some credit unions that require soft capital. We looked at the sector on aggregate, and so our calculations do not pick up on the financial situations of individual credit unions. Experience from the Growth Fund suggests that some credit unions serving financially excluded individuals can struggle to attract enough deposits to meet demand for loans. There may therefore be a role for the Big Society Bank in providing soft capital to keep credit unions lending.

Form that capital should take

The capital could either take the form of a grant or patient capital (e.g. a loan over 10-15 years with very low interest and high appetite for risk). Providing some funding as patient capital could be a driver for sustainability. To pay back the loan, they will need to generate operating surpluses. To generate surpluses, they will need to increase income from loans so that it more

than covered costs. This would mean they are funding themselves, and so would be financially sustainable. Providing soft capital does not mean being an undisciplined investor. Soft capital gets very low levels of financial return; the BSB should therefore be disciplined about achieving other types of return with this investment:

- Priority should be given to lenders making loans to financially excluded groups in areas with insufficient affordable credit providers (along the lines of the Growth Fund).
- Funded organisations should be asked to demonstrate impact on financially excluded people.
- Need for soft capital should be assessed on a case-by-case basis to avoid creating unnecessary dependence on state funding.
- Funding should be designed to make lenders sustainable, rather than creating long-term dependence on public or charitable funding.

4.3.2 Capital to fund intermediary overheads

Demand for revenue funding to keep third sector lenders lending

Third sector lenders will probably face a revenue funding gap of between £7 million and £16 million over the next three years. This would

Table 6: Future credit union capital needs

| | 2011 | 2012 | 2013 |
|------------------|-------|-------|-------|
| Capital reserves | £107m | £105m | £105m |
| Capital ratio | 12% | 11% | 10% |
| Cash | £46m | £44m | £45m |

Please note: Cash was the 'balancing item' in our model; it shows how much money is left over in credit unions' bank accounts after deposits have been lent out to borrowers.

Table 7: Growth Fund spending on overhead costs

| | Average annual cost of loans | Amount required over three years |
|----------------------|------------------------------|----------------------------------|
| Credit unions | £4.6m | £13.7m |
| CDFIs | £0.5m | £1.5m |
| Housing associations | £0.1m | £0.4m |
| Total | £5.2m | £15.6m |

have to be provided in the form of grant funding. The demand will depend on how many are able to make themselves self-financing. The Central Service Organisation, if implemented, should also reduce this gap in funding.

The maximum revenue funding needs of lenders is £16 million; this is based on Growth Fund figures. In the past five years, the Fund has provided a total of £26 million to cover third sector lender costs, which is just over £5 million per annum: £23 million revenue funding for running costs (e.g. salary costs), and £3 million for capital expenditure (e.g. premises or IT). As not all lenders will become sustainable in the next three years (see 4.1.1), and cuts to grants are likely, lenders may still need this level of subsidy over the next three years.

Credit unions alone (removing other third sector lenders) will face a revenue funding gap of between £5 million and £14 million. Our modelling suggests that credit unions will have losses of £5 million over the next three years, which means that they would require funding of that level to maintain lending. However, if the need for revenue funding remains the same as during the Growth Fund period, the revenue funding gap for credit unions could be up to £14 million.

Big Society Bank funding would have to take the form of a grant. The funding could not be provided as a loan as it is there to make up the

shortfall in operating surpluses made by lenders. The fact that lenders struggle to cover their costs means that they are very unlikely to generate surpluses to repay loans in the short term. The aim of the grant would be to help lenders continue lending to financially excluded people in the next three years. To gain maximum social return on its investment, the BSB should target this funding in the following ways:

- Priority should be given to lenders making loans to financially excluded groups in areas with insufficient affordable credit providers (along the lines of the Growth Fund).
- Of these, it should be targeted on those not generating enough income to cover the costs of making loans.
- Funded organisations should be asked to demonstrate impact on financially excluded people.
- Funding should be designed to make lenders sustainable, rather than creating long-term dependence on public or charitable funding.

4.3.3 Capital to build capacity of the sector

There is now consensus in the credit union sector that there are two big steps required for credit unions to reach sustainability and continue to grow rapidly. First, individual credit unions need to become self-financing (cover their own costs

Table 8: Future credit union revenue needs (all figures rounded to nearest £0.1 million)

| | 2011 | 2012 | 2013 | Total |
|-----------------|------------------|------------------|-----------------|-------------------------|
| Income | £66.3m | £73.2m | £81.1m | |
| Costs | £69.4m | £75.0m | £80.9m | |
| Surplus/deficit | -£3.1m (deficit) | -£1.8m (deficit) | £0.1m (surplus) | -£4.8m (deficit) |

without external funding). Secondly, they need to integrate 'back office' functions nationally, to make the sector more efficient and to allow credit unions to significantly increase loans and deposits.

Making local credit unions self-financing

We estimate that the total cost of making most local credit unions self-financing is between £7 million and £10 million. This would pay for 90 mergers, over either one year (£7 million) or two (£10 million). We recognise that mergers won't be the only way to reduce costs and achieve sustainability for local credit unions. In some cases, other types of collaboration or integration of services between credit unions will also achieve this outcome. However, we still feel the costs we set out below provide a useful proxy (indicator) of the amount of investment required in local credit unions to move them towards sustainability.

We estimate that a single merger will cost between £73,000 (one year) and £108,000 (two years). If the 271 unsustainable credit unions merged, and they did so by groups of three, there would be 90 mergers. The amount of individual mergers could be more or fewer depending on the way mergers are undertaken. Because of the various assumptions in our calculation, we emphasise that this is an order of magnitude figure rather than a calculation of precisely how much is required.

We estimate that around 271 credit unions are not self-financing, of the total of 444 credit unions operating in the UK today. This estimate is based on a 2008 survey that found that 61 per cent of credit unions were not self-financing.¹⁶ We have then estimated how much it would cost to make them self-financing in the long term. In making our calculation we have made these assumptions:

- Merger or closer integration of back office services is the only way to achieve the scale credit unions need to be self-financing.
- On average, three credit unions would need to merge to create a sustainable operation.
- A merger would take between one and two years, based on evidence from a merger that took place in the West Midlands.¹⁷
- The cost of a merger would include revenue items such as staff salaries, but not capital items like new office space.

The full calculation of merger costs is set out in Appendix B.

A Central Service Organisation for credit unions nationwide

Association of British Credit Unions (ABCUL) estimates that creating a Central Service Organisation for credit unions would take a one-off investment of around £15 million. We feel ABCUL is well placed to make this estimate, but this figure should be scrutinised by experts, including specialists in banking technology.

This organisation would provide credit unions with a single platform that could be linked to the Post Office network of 11,500 branches, giving credit unions access to millions of new clients. This, along with the phone line and online services provided by the Central Service Organisation, should help credit unions to grow their deposits and their loan books at a scale not seen before in the sector. The organisation would enable credit unions to provide a totally new level of service to both depositors and borrowers, as ABCUL explains:

"...if a number of credit unions in Britain shared one banking platform it would enable them to offer shared branching through the Post Office network and each other's branches. It would also allow for a telephone helpline giving credit unions much longer opening hours and easy internet access to accounts for those who were able to use this."¹⁸

Why is a Central Service Organisation needed? Credit unions in the UK have grown substantially in the past ten years. However, they make a lot of small loans to people on low incomes. To achieve sustainability, they need to increase income from loans and reduce costs. To increase income from loans without punishing financially excluded people, they need to provide more large loans to more affluent people. These large loans provide much better returns, and can therefore be used to cross-subsidise small, costly loans to financially excluded groups. To reduce costs they need to make their back office functions more efficient.

Evidence from around the world shows that the best way to both grow their loan book and become more efficient, credit unions need to centralise their 'behind the scenes' services at a national level. By this we mean all the systems (for instance IT systems) and processes (e.g. due diligence) that credit unions have for making loans and taking deposits. In 1999, the Credit Unions of the Future Taskforce suggested that the only way to integrate these services would be to create a Central Service Organisation. An organisation of this sort has been essential to creating thriving credit union sectors in other countries.¹⁹

Form that capital should take

Funding for mergers could be provided as a mixture of grant and patient capital (soft loans). The local merger investment is unlikely to generate significant surpluses for lenders. The majority of third sector lenders are not self-financing. If the Growth Fund is not extended beyond March 2011 (which is likely), lenders' financial situations in the next couple of years will be even more challenging. In addition, even when they are sustainable, lenders that serve financially excluded people are unlikely ever to be able to generate surpluses on a par with the private sector, for two reasons. First, because it is costly to make small loans to low-income clients. Secondly, because even if third sector lenders' surpluses grew, much of this would go to depositors in the form of dividends (basically interest payments on their deposits).

Funding for the Central Service Organisation (CSO), on the other hand, could be provided as patient capital. The Central Service Organisation should help create significant surpluses over the next five to ten years. Therefore the loan could be provided at either market or slightly sub-market rates and be repaid over five to ten years (the precise terms of the loan should be set in consultation with the Association of British Credit Unions). Providing funding as a loan would be part of BSB's 'disciplined investor' approach – to ensure that credit unions generate surpluses so that they become sustainable.

4.3.4 Who else could help meet the capital needs of the sector?

From our interviews and desk research, we have not identified another source of funding that is big enough to fill the gap in third sector lending (between £29 million and £77 million over the next three years). Central government, local authorities and banks all potentially have a role to play. However, given the current funding situation the public sector is more likely to be reducing than increasing funding. Our view is that banks are the most likely other source of support to credit unions, both financial and non-financial (see 4.4). However, banks are unlikely to make an investment of this scale. We therefore feel that the BSB should play a key role in plugging the funding gap we have identified.

4.4 Building the wider financial inclusion market

This section has so far focused exclusively on what funding third sector lenders need to increase

loans to financially excluded people in the short and over the long term. Here we take a step back and provide a short (and certainly not exhaustive) list of what else would help to build a healthier affordable credit sector:

- **Ensure that Post Office plans come to fruition:** First, more detailed work is needed to estimate the precise costs of integrating the credit union Central Service Organisation into the Post Office network. Secondly, this investment needs to be made. Alongside this, government and the Post Office need to remain committed to making the necessary changes to Post Office processes and marketing to make these plans a success.
- **Explore potential of 'intermediate' loan products:** Government could look at the potential of CDFIs (e.g. My Home Finance) providing 'intermediate' interest rates to grow. Their interest rates, at 50 per cent or 60 per cent APR, are higher than other third sector lenders, but lower than doorstep lenders. Higher rates give these lenders a good chance of covering the costs of loans. Some in the sector feel their role should grow. Others feel interest rates of over 50 per cent APR aren't affordable. Some people on both sides of the debate agree that loans at these interest rates could be termed 'responsible', as they are a less risky alternative to doorstep lenders. More research is needed into whether such interest rates are affordable for financially excluded people. Funding an impact evaluation of My Home Finance would be a good start.
- **Make banks long-term partners:** Government should consider how to secure commitments from banks to support the affordable credit sector over the long term. In discussions with the Financial Inclusion Task Force, a number of high street banks committed themselves to supporting the affordable credit sector – most have not fulfilled this pledge. Banks could fund third sector lenders directly or provide expertise free of charge (e.g. advising them on how to improve the efficiency of their systems). Most banks could also be doing more to ensure that local branches signpost financially excluded people to local third sector lenders.
- **Building 'financial capability':** A lack of financial skills and knowledge is one key reason that people become financially excluded. The funding for 500 financial advisors for low-income people runs out in

March 2011. Government should consider either funding these advisors in future or finding other ways of supporting third sector organisations that offer these services (such as the Citizens Advice Bureau).

4.5 What might the Big Society Bank achieve?

4.5.1 Impact

Providing soft capital (£36 million) and revenue funding (£7 million to £16 million) would help third sector lenders to keep lending. The benefits of this would be that levels of lending to financially excluded people would remain the same or grow slightly. Financially excluded people would, as a result, have an alternative to doorstep lenders and in turn avoid getting into serious financial problems. The precise numbers of people the money would help would depend on the amount of funding provided. The Financial Inclusion Task Force's Growth Fund gives some indication. It was used to make 317,798 loans; if each loan was to a different person, it will have reached over 300,000 financially excluded individuals.²⁰ This is around 10 per cent of the estimated number of people using doorstep lenders (three million people). The benefit of the Growth Fund was that it was lent out more than once. By late 2010, government had provided £59 million of funding to make loans over five years, but lenders had made loans worth £137 million.²¹ So for each £1 of government money given to lenders, £2.32 was lent to financially excluded people. It will continue to be recycled to make further loans in future.

The capacity-building investments of £22 million to £25 million could realistically take the credit union sector to sustainability in the next ten years, with substantial progress towards this target in the next five years. Providing an accessible service through the Central Service Organisation and the Post Office network would open credit unions up to millions of new savers and borrowers. As a result the sector should vastly expand loans to financially excluded groups, in turn attracting tens or even hundreds of thousands of people away from high-interest doorstep lenders (who currently serve an estimated three million people).

4.5.2 Return on investment

Financial inclusion interventions have a range of potential benefits. By providing affordable alternatives to doorstep lending, individuals have more disposable income, which they

spend. This means that more money is kept in local economies. A recent evaluation found that financial inclusion interventions in Leeds (including affordable loans and advice services) that cost £3.3 million increased the disposable income of clients by £26 million.²² **For every £1 invested in financial inclusion interventions, £8 was spent in the city economy.**

Though the evaluation did not cover this, increases in disposable income should increase income to the state, in the form of VAT. In addition, addressing financial inclusion could create a range of savings to the state. By preventing financial crisis, it could reduce the costs associated with bankruptcy and homelessness, amongst other things. We would welcome further research into whether affordable loans create savings for the state.

PART 5:

FINANCING SOCIAL HOUSING: LESSONS FOR THE BIG SOCIETY BANK

5.1 The context

Since 1988 the way social housing has been financed, built and run has been transformed. Since then the majority of council housing stock has been transferred to housing associations (HAs) in the UK. The amount of public subsidy per home built has shrunk and the role of commercial finance has grown. Many in the sector see this as a great success story in the transfer of mainstream public services to the voluntary sector. However, it has also brought tensions and risks. The Big Society Bank (BSB) has ambitions to leverage-in private sector finance to social purpose organisations, and may well have a role in financing voluntary sector providers to deliver mainstream public services. Based on interviews and desk research, we summarise what seem to be the key lessons from the housing association story that should be taken into account when designing the Bank.

5.2 A success story

The growth and development of HAs over the past 30 years or so is, in some ways, a great success story. The transfer of council housing stock to HAs in the UK from 1988 on is the largest transfer of state assets to the voluntary sector ever in the whole of Europe. The 1988 Housing Act encouraged big growth in the sector, making HAs government's preferred deliverer of new social housing and manager of housing stock. Today HAs in the UK own and manage 2.5 million homes that house around five million people.

The combination of massive fixed assets (the buildings that they own), a reliable income stream (in the form of rent) and strict government regulation has allowed HAs to leverage in private sector funding. Using its property as security, the sector has borrowed around £60 billion from commercial sources over the past 30 years. This has more than matched the £40 billion of

public funding to the sector. HAs' operating surplus of £15 billion over this period has also been reinvested in new homes or neighbourhood services. This surplus comes in large part from rents, but also from the profits from the sale of new homes, which are used to subsidise socially rented housing. The expanded role of commercial loans and operational surpluses allowed HAs to reduce the amount of government grant required to fund social housing – from around 80 per cent per unit in 1989 to around 40 per cent in the last couple of years. In effect, HAs have been able to deliver more or less the same social housing for less government capital funding.

Freed from restrictions on public borrowing that constrain councils, HAs have been able to lever in commercial borrowing to make substantial improvements to housing stock. Generally, social tenants are more satisfied with their housing.

5.3 Dependence on the state

The increased role of commercial funding has not meant a wholesale shift away from dependence on the state. The HAs' new financing model is heavily (in practice wholly) reliant on government. David Montague of London and Quadrant (L&Q) describes HAs as resting on a three-legged stool supplied by government: regulation, capital grants, and housing benefit.²³ The capital grants provide an essential subsidy for the delivery of new housing. Housing benefit represents two-thirds of housing associations' income, and provides them with a consistent, predictable source of revenue. Grants and rents combined with tight government regulation have underpinned their high credit ratings and the favourable rates they get from commercial lenders. Heavy government involvement mean banks and bond markets see investing in the HA sector as a safe way of achieving reliable returns with low risk, not least because of the implicit (and unwritten) rule that government will step in if a housing association is unable to fulfil its obligations.

5.4 Vulnerability of the model

The new model of financing social housing makes HAs vulnerable to changes both in government policy and in the private sector.

HAs are **vulnerable to changes in government policy**. HAs borrow money against the value that their properties will have over the next 30 or so years. This value is determined by the level of housing benefit, which represents on average two-thirds of rental income. Changes in housing benefit therefore impact on HAs' capacity to borrow. Housing benefit looks set to change when it becomes part of the Universal Credit proposed by the coalition government. It is as yet unclear whether the housing cost element of this Credit will match actual individual rents.²⁴ If it does not, welfare reforms could make it much harder for HAs to borrow money from commercial lenders. Such a change would probably make it more difficult for housing associations to service existing loans, which are based on previous housing benefit levels. It may also make it more costly to take out new loans, as reduced revenue would probably prolong repayment and increase interest rates. So despite increasing their commercial borrowing, housing associations are as sensitive as ever to changes in government policy.

The new model also makes the developer HAs more **vulnerable to fluctuations in the housing market**. Over the past few years, some of the larger HAs have developed large numbers of homes for sale, generating surpluses to reinvest in other activities. When the credit crunch hit housing markets in late 2007, some found themselves exposed. As one industry source put it: *“Over the next few years a lot of housing associations will be working through the consequences of having had too much development risk at the wrong point in the cycle.”*

The model also makes HAs **vulnerable to the terms of borrowing offered by banks**. Though a growing number of large HAs are issuing bonds as an additional source of finance, commercial loans still make up the majority of commercial finance in the sector. HAs have benefited from borrowing on incredibly good terms in the last few years. If the terms on which credit is lent were to change, this would fundamentally alter their ability to finance social housing in future. An industry source said that over the past two years some banks have done their best to increase the interest rates given to HAs, both for existing and new loans. There are only a handful of banks – around five – that provide the majority of the commercial loans to

the sector. If just one or two of them hardened the terms of lending (e.g. increased interest rates), this could cause a ‘credit crisis’ in the HA sector.

In summary, HAs have had huge success in using assets and rents to lever in commercial finance to deliver new social housing and improvements to existing stock. The model has worked through a combination of government backing, cheap commercial lending and high demand for market-rate homes. Today, this model looks vulnerable to changes in government policy, the terms of lending, and the downturn in housing markets.

5.5 Lessons for the Big Society Bank

The politicians, civil servants and advisors charged with designing the BSB might do well to consider the following lessons:

- Housing associations have been able to reduce dependence on government capital grants and increase the role of commercial finance, this has in turn helped them improve housing stock and tenant satisfaction.
- Housing associations' borrowing relied heavily on substantial assets and stable rents, both of which are unusual in the voluntary sector. Other voluntary sector organisations will struggle to lever in similar amounts of commercial finance without these two elements.
- Also, more commercial funding has not meant total independence from the state – HAs' financing model remains almost entirely dependent on government capital grants, regulation and revenue funding (in the form of housing benefit).
- There can be risks for HAs of blending a reliance on government funding/policy and commercial loans in the social sector. Political cycles are shorter than commercial cycles, and policy changes can place commercial deals and loans at risk.

PART 6: RECOMMENDATIONS

The Big Society Bank (BSB) has a huge range of options to deliver social impact, and prioritising the options will be difficult, especially if it is under pressure to generate financial as well as social returns. The Bank will have to be clear about what it is trying to achieve. And it has to ask itself does it want to solve problems in the market? Or do something useful with its money without endangering its long-term future? The two are not the same.

6.1 Investment options

6.1.1 Social Finance

A mix of investment may be the solution. If the BSB can take advantage of market failures to earn returns on part of its portfolio, then this may help to spread the returns and risk. It could split its investments into three categories:

- **Making investments with commercial or close to commercial returns.** This would support deals where there are insufficient investors either to share risk, or where there are liquidity problems in a commercial sector.
- **Investing patient capital for minimal or zero returns.** This is likely to include capitalising intermediaries, or investing in new product development.
- **Provide grants/other support.** This would be to develop the market, e.g. capacity-building grants for investees, or activities to support investors.

The BSB should avoid crowding out other sources of capital, be they commercial or philanthropic, even though this might compromise its ability to participate in markets with attractive returns. Start-up risk capital was identified as a shortage area, which, although highly risky, can provide returns.

There is a trade-off between the sustainability of

the BSB, which would rely on achieving financial returns, and its impact in terms of building the market, which does not promise much in the way of financial returns. Similarly there is a trade-off between perpetuity and short-term gains. Options for the BSB lie anywhere along these continuums.

What might the BSB achieve?

The BSB could help to fill gaps in capital provision which currently frustrate intermediaries. By adding some disciplined investment to the market, it might encourage other entrants.

However, as some of the bigger existing funding streams may be drying up, NPC cannot say with any certainty that the BSB's participation in the market would result in growth. The BSB's capital may just replace this with something more flexible and disciplined. But it will help to maintain the momentum of the market, and also target particular areas needing investment.

6.2 Financial exclusion

Our analysis suggests that third sector lenders require **between £29 million and £77 million** over the next three years to keep lending and move towards sustainability. They need capital in three main forms:

- **Soft, semi-commercial capital to lend on: up to £36 million of patient capital** for third sector lenders to make loans to financially excluded individuals.
- **Capital to fund intermediary overheads: £7 million to £16 million of grant** to cover the high costs to third sector lenders of making small loans to people on low incomes.
- **Capital to build capacity of the sector: £22 million to £25 million, as a mixture of grant and patient capital**, to move all unsustainable credit unions to sustainability (i.e. not reliant on grants). £7 million to £10 million would

pay for mergers of local credit unions and £15 million could fund the creation of a Central Service Organisation for credit unions.

These are all order of magnitude calculations, and further testing of the assumptions would be required to come up with precise figures.

What might the BSB achieve?

The first two opportunities (£36 million and £7 million to £16 million) would help third sector lenders to keep lending. The benefits of this would be that levels of lending to financially excluded people would remain the same or grow slightly. The government's Growth Fund was used to make over 300,000 loans to financially excluded individuals, about 10 per cent of the estimated number of people using doorstep lenders (three million people). The Growth Fund showed that over a number of years, government money can be lent out multiple times, benefitting hundreds of thousands of people.

The capacity-building investments of £22 million to £25 million could realistically take the credit union sector to sustainability in the next ten years, with substantial progress to this target in five years. If this investment was combined with a link to the Post Office network, the sector would vastly expand deposits and loans to financially excluded groups.

6.3 Important considerations for strategy and operations

Key findings from the research to factor into decisions

1. **The absolute amounts needed from a funder like BSB total hundreds of millions rather than billions of pounds.**
2. **Patient and soft capital is in greater demand than purely commercial capital.**
3. **But soft capital does not necessarily mean undisciplined.** All funds should be spent wisely with a clear understanding of impact and objectives.
4. **Building the market is essential, but financially unrewarding.**
5. **So BSB will have to think about the trade-off between its own sustainability and market strength.**

6. **There seems to be little appetite for a new intermediary entrant.** Intermediaries exist to process deals and indeed the greatest shortage is in staff equipped to process demand.

Other considerations

Market building:

- Both the social finance and affordable credit markets are still early-stage and not financially sustainable. They need further subsidy and investment to reach sustainability. The housing finance market on the other hand is more mature. Lessons can be learnt from this market, as they can from the microfinance arena.
- Developing new products is a slow and expensive process, but ultimately rewarding.

Making investments:

- The BSB must avoid incurring government funding restrictions which cause annuality to be an issue. Annuity has made the SIB funds' investment and disbursement processes very difficult, and in the case of the BSB would certainly lead to reduced financial returns and reduced social impact.
- The BSB should adopt a 'disciplined investor' approach, even if its investments contain subsidy. Subsidy should not mean sloppiness.
- The BSB must be transparent about its investments, funding, and costs, and present clear accounts on its website. NPC found the paucity of clear public information on the SIB managed funds a hindrance to understanding and assessing the market.

The impact of investments:

- NPC did not comprehensively examine the social impact of the markets and segments in which the BSB might operate. This is well worth exploring, as there are likely to be difficult choices – sacrificing financial returns for social benefit. Going forward, the BSB should have systems to measure its social impact as well as financial returns, and develop measurement tools/platforms to share with other social finance intermediaries.
- The BSB should regularly 'take the temperature' with commercial providers to ensure that it is not crowding out their space

unnecessarily.

The regulatory environment:

- The BSB/government should review tax, legal, regulatory issues to see whether improvements might help to make the market more attractive to investors.
- The BSB could be a champion for policy improvements to the whole sector to improve the environment for investment. It could take an active role in market development, identifying needs, forming strategy, helping to coordinate efforts and funding development within the sector.

6.4 Suggestions for further research or investigation

NPC could not cover everything and saw interesting avenues worth exploring further.

6.4.1 Social finance

- Investigating the role and potential of CDFIs in serving local and regional markets in more detail. NPC only looked at CDFIs at quite a high level, but has the impression that there could be some valuable lessons from closer examination, including mining their 2010 data, which is not yet available. In particular the social return on the current operational subsidy on CDFIs should be assessed. Also, could the CDFI network expand from its core geographical areas? The Community Development Finance Association (CDFA) would be ideal for this.
- Investigating ways to improve the legal, regulatory and tax environment for investment products and investors.
- Examine the impact of past social investment funds and activities more closely, especially SIB. (Views on SIB's contribution are mixed – only formal evaluations will demonstrate the case either way). NPC believes that examining the evidence of impact of previous funds should be an essential part of the process going forward.
- NPC has not quantified the costs associated with capacity-building in the sector. This could be guesstimated by an analysis of other capacity-building efforts in the past.

- The market is still 'early-stage'. Lessons could be learnt from other sectors, such as microfinance, environmental technology and social housing.

6.4.2 Financial exclusion

- More detailed work to estimate the precise costs of integrating the credit union Central Service Organisation into the Post Office network.
- Explore the potential for banks to provide support to third sector lenders, either through funding or by providing expertise (e.g. *pro bono* support to help them improve their systems and processes).
- More research is needed into whether 'intermediate' interest rates (e.g. My Home Finance) are affordable for financially excluded people. Funding an impact evaluation of My Home Finance would be a good start.

6.4.3 Further reading

Social finance

Inside Out 2010

Community Development Finance Association, November 2010.

Evaluation of Community Development Finance Institutions

GHK, March 2010.

Financing the big society

CAF Venturesome, September 2010.

Response to the Office of the Third Sector's consultation on Social Investment Wholesale Bank: A consultation on the functions and design

CAF, October 2009.

Access to Capital, a briefing paper

CAF Venturesome, September 2009.

Financial exclusion

Mainstreaming Financial Inclusion: Planning for the future and coping with financial pressure: access to affordable credit

Financial Inclusion Taskforce, March 2010.

Breaking through to the future: The strategic development of credit unions in Britain, 1998–2008

Paul Jones for ABCUL, December 2008.

Short Changed: Financial Exclusion - a guide for donors
NPC, July 2008.

Credit Unions of the Future
Taskforce Report HM Treasury, November 1999.

Towards Sustainable Credit Union Development
Paul Jones for ABCUL, January 1999.

APPENDIX A:

BACKGROUND ON SOCIAL FINANCE

A.1 Financial products

A.1.1 Products for investors

These are the types of investment through which investors can supply capital and liquidity to the market:

- **Deposits in banks.** Anyone can make a deposit in a licensed bank. Banks can attract depositors from the general public, as well as corporates, trusts and foundations, other charities and so forth. Deposits are immediately accessible.
- **Bonds.** Bonds are becoming fashionable, but are complicated to issue to the public as investments offered to the general public are subject to regulation. But other investors (corporates, trusts and foundations) can invest more easily. Investment in bonds tends to be longer-term – typically investors will get their money back when the bond matures. The market for trading bonds in social investments is illiquid, unless the issuer is sufficiently established (such as big housing associations) to access mainstream capital markets.
- **Loans.** These can be tailor-made to suit borrower and lender. They vary in term to maturity, price, risk versus financial return, and social return.
- **Equity subscription in unlisted companies.** Subscription in unlisted investments is usually via a venture capital fund of the type managed by Bridges Ventures. But capital would only be returned when the fund matures – quite a wait. Most of the return comes from the fund's exit from the underlying investment (e.g. trade sale). Alternatively business 'angels' may take direct investments. These investments are not liquid.
- **Equity subscription in listed companies.** These range from mainstream companies which purport to offer social benefits (contentious), to a very few listed companies where the primary aim is social purpose. It is difficult for a company to maintain a primary social purpose when its shares can be traded and owned by people who may be seeking purely commercial returns.
- **Quasi-equity in organisations which are not companies, e.g. CICs, charities.** Generating financial returns from these structures is difficult, as the entities cannot be sold to realise capital gains from exits – in the commercial world usually a sale of the business or flotation. Instead returns must come from cash generated by the entity – a harder task, particularly if rules or sustainability issues cap what cash can be taken out of the entity and returned to investors. It is difficult to grow entities with this conflict.
- **Direct arrangements with charities, social enterprises etc.** Relationships and engagement are key. Increasingly business entrepreneurs are becoming social entrepreneurs, setting up social enterprises. Business angels are also investing directly in charities and social enterprises.
- **Investments in intermediaries themselves.** The greatest social impact may not be achieved by investing directly in opportunities, but rather supporting the intermediaries ensuring the market exists and grows.
- **New products and esoteric instruments.** A number of products emerging do not fit any of the categories above. CityLife's bonds, first developed in 1999, are an example of a complex structure offering investors a chance to invest funds in housing association bonds but allowing charities to benefit from the financial return on the bonds. These bonds would not be deemed investments for regulatory purposes. The Social Impact Bond is a much newer development, offering financial returns to investors should

interventions to prevent prisoner reoffending succeed. Some products are offered directly by charities, e.g. Scope's zero interest loan/donation package, rather than through intermediaries. **NPC believes that more products will be developed over time.**

Commercial investors will not be the ones to develop the market, as the development of new products rarely yields a financial return first time, and other aspects of the market development process carry no immediate financial reward. But there are high potential social rewards.

A.1.2 Products for investees

Investees need a range of financing:

- Short to medium-term funding for working capital, especially if government pays in arrears for services.
- Stand-by facilities and underwriting so that investees have the confidence to pursue a project or expand, even if they never actually have to draw the funds.
- Long-term funding for assets, e.g. property.
- Medium to long-term funding for organisational development, expansion, start-ups and so forth.

The financing comes in many forms:

- **Commercial loans:** Big brand charities can borrow from high street banks, and do not need specialist lenders. They may also have an asset base against which to borrow.
- **Commercial and semi-commercial loans from specialist lenders:** Other charities and social enterprises can access products from Charity Bank and Triodos. These banks report steady matching of supply of liquidity (deposits) and demand for loans. Stand-by facilities are also popular. But in order for Charity Bank to grow further it will require more capital to meet capital ratios required for banks. Triodos is able to access its own capital commercially.
- **Government finance – subsidised:** The funds managed for government departments by Social Investment Business (SIB) have been huge investors in this market – NPC estimates that over £350 million has been invested by funds managed by SIB since 2008. The funding is by no means commercial – roughly 30 per cent of the funding comes in the form of grants (this varies between funds), around

70 per cent in the form of loans where interest rates also vary. But many of these funds are now closed, which may result in a funding gap (to be described in more detail later).

- **Soft loans outside SIB:** The scale of individual participants in this market are dwarfed by SIB's activities, and very varied. Venturesome and Big Issue say they keep pace with demand, but volume seems quite limited. The regional CDFI market is important in this, but mainly concentrated on the North West of England, West Midlands, Yorkshire and the Humber, and London, so access in many areas is limited. Processing the loans is very labour-intensive and expensive, so it is difficult to avoid subsidy of some sort to cover operating costs. Loan losses may also be incurred. Intermediaries are generally supported by development grants or very patient capital.
- **Quasi-equity in charity/CIC sector:** This market is pretty thin. The current tax and legal structures do not readily lend themselves to successful deal-making, although some investments are being created. It is very difficult to get organisations to investment-readiness, and the structures available deny investors returns commensurate with the risk. And once a charity becomes investment-ready, it can often opt for a straightforward loan instead.
- **Real equity in commercial sector:** Equity investments in companies are a more successful product. It is possible to find companies coupling social good with financial returns, and a normal company structure allows sensible participation on profits and capital growth. Bridges Ventures is happy with performance of funds and is fully commercial/sustainable; Rathbones feels the same about its mainstream asset management.
- **Esoteric instruments:** e.g. Social Impact Bond. New instruments and products are being invented all the time and create new markets. This requires much time and effort – Social Finance worked on the Social Impact Bond for 18 months before launch. Other products are being developed, e.g. financing arrangements for retro-fitting social housing for energy efficiency. Refinancing charity assets is another area being developed. Seed funding/patient capital for these areas is valuable.
- **Grants:** Almost all charities access grants in some shape or form. Specialist grants are available to help charities and social

enterprises develop the social enterprise/ investment side of their work, e.g. UnLtd, which offers grants to help develop business plans and feasibility studies.

A.2 Investee market

NPC did not analyse the investee market directly, but this is what we learnt from interviews about the characteristics of charities and social enterprises seeking funding:

- **Small organisations need grants to get to first base** if they are to develop social enterprise activities with potential to scale. But grants for developing early-stage plans are scarce. UnLtd is therefore a key player here, but only goes up to £20,000 grants. SIB also makes grants and has found the leverage to be excellent – £1 invested in investment-readiness capacity-building is claimed to yield £27 of future investment.
- **Small to medium-sized charity/social enterprise trying to get beyond first base** to an investable proposition on a bigger scale, or seeking to diversify income. We are told that there is a gap in the market for £20,000-£250,000 high-risk investments to get charities to the next level. Impetus provides grants but only works with charities and is not necessarily about supporting social enterprise. Many of the SIB funds kick in at £50,000 and upwards, but not all of them are still open, they are generally sector specific, and their futures are uncertain. Venturesome also covers this market. Loans are available from £50,000 upwards from specialist lenders, but these tend not to be high-risk. Local CDFIs may have an important role here.
- **Traditional charities and social enterprises of medium-large size needing working capital for government contracts.** This market will grow as commissioning structures move to payment by results. Risk profiles will also change. Specialist lenders (Triodos, Charity Bank, Venturesome) are already active in this space. These claim they are keeping up with demand at the moment, but NPC is not sure whether they are marketing aggressively enough to stimulate demand.
- **Charities and social enterprises needing working capital to bridge private income.** A charity may have reasonably assured future income from donations or trusts, but it is not arriving soon enough to meet a specific cost. Specialist lenders which understand these dynamics are prepared to lend against such future income.
- **Traditional charity/social enterprise needing financing to develop assets.** Asset development can be good business for banks as the assets can be secured, and often development brings income streams. NPC believes that high street banks could complement specialist lenders more. The market for bond issues could grow, although the investor base is still somewhat thin.
- **Social enterprises trying to scale-up with a quasi-commercial proposition.** This often needs patient capital in the absence of immediate cash flow or assets for security. It may take time before implementation becomes fully commercial. SIB, Venturesome and Big Issue are players here, albeit on different terms. It takes time to generate investable deals and get charities and social enterprises to investment-readiness. However, a new breed of social entrepreneurs with business backgrounds is entering the market, although these do not displace the need for some charities with little business experience to develop commercial strands. It is also very difficult to structure deals offering financial rewards to investors.
- **Established social enterprises growing.** Low-risk propositions can be funded by loans. Higher-risk propositions are still hard to structure in order to reward investors, unless they are companies. Companies are much easier to invest in.
- **New ideas, new vehicles, consortia etc.** Social Finance is the current best-known example of this – fixing social problems through engineering financial products. However, Social Finance stresses that it takes a huge amount of work to put packages such as the Social Impact Bond together.

A.3 Availability of capital

NPC has not spoken to investors directly, so we are reporting what we have heard from intermediaries, as well as our own knowledge of the sector.

What happens with the SIB funds and other government funding will have consequences for

the market. There are a number of issues with SIB funds:

- They are sector-specific (e.g. Social Enterprise Investment Fund (SEIF) focuses on health and social care; Communitybuilders on local communities). So charities and social enterprises not in the particular sectors are denied access to this sort of funding.
- Their futures are uncertain. We only partially know what will happen in 2011, let alone 2012, and without certainty it is hard to determine the demand left unserved.
- If the funds go, will there be a gap? When Futurebuilders closed, some intermediaries reported a surge in demand until this current period where organisations have become risk averse in the face of cuts. But once this period has settled, there may be a rise in demand once more.
- The funds are 'sub-market'. Some fellow intermediaries have been frustrated by SIB funds undercutting them. However SIB would argue that there is a tranche of organisations needing sub-market funding which is unserved by other intermediaries.
- SIB's **annuity** requirement has been an enemy to disciplined investment. Deals are struck and disbursements made in undue haste in order to spend the year's allocation, and furthermore the investee then has arduous requirements to spend within time. So this inhibits organisations' ability to prepare well for the investment. **The heinousness of annuity is one of NPC's key findings for the Big Society Bank. It must avoid being tied to Treasury annuity requirements at all costs.**
- SIB may have helped stimulate demand for loan products, but it has done little to stimulate the investor market, and may even have stifled part of it through 'crowding out'. One large charity known to NPC remarked that its loan from Futurebuilders was helpful for one project, but that Futurebuilders could not help it on the scale required and that it is having to create its own market for philanthropic lending. A full evaluation of impact of funds so far not evaluated would be enormously helpful in determining the market impact of SIB funds.
- But evaluations of SIB-managed funds (if all completed) may reveal the benefits of SIB's somewhat generous grants offerings. For

instance, grants to help achieve investment-readiness may result in considerable additional investment, both immediately and in the future.

Government has heavily funded the development of the CDFI market. The £35 million pumped into the CDFI market via the likes of the Phoenix Fund needs examination to determine to what extent it has developed market, and what social returns have been achieved. Will CDFIs ever become sustainable? Earned income was only sufficient to cover 74 per cent of operating costs for the average CDFI.²⁵ There seems to be some rationalisation in the sector with the number of CDFIs dropping from 80 in 2006 to 66 in 2010.

The appetite for CDFI funding is growing fast – up 77 per cent in the year to March 2010, although much of this may be due to new joiners to the CDFA. But it may be that the operating losses of CDFIs are worth the social returns on getting the funding out there. Not all of the funding went to charities and non-profits. Small local businesses make up about 20 per cent of the portfolio.

Trusts and foundations are dipping their toes in the market. But the sums are relatively modest. Esmee Fairbairn is most notable in setting up a £20 million Finance Fund in 2007. By 2010 £14 million was spent, partly via intermediaries such as Venturesome. The Tudor Trust is also active (not quantifiably), while the Henry Smith Charity has been very cautiously looking at deals on a case-by-case basis. Some of the Sainsbury's Trusts relating to the younger members of the family are considering participating in developing social finance products, e.g. retro-fitting social housing to improve energy efficiency. There may be other trusts in this market, but NESTA's other research into investors will answer this question more fully.

Trusts and foundations control £30 billion of financial assets. If just 5 per cent of the collective portfolio were invested in social finance, £1.5 billion would be available to the market. But many trustees are cautious about using what they see as the endowment to make risky social finance investments or even straight loans. And in addition they may apply their own grant criteria – not always appropriate to good social investment – to the social investment in question. Some intermediaries felt their approaches were being subjected to the wrong criteria even though the social mission should have matched that of the trust. Some trusts and foundations are too small to risk capital, but the bulk of assets are held by the large foundations. Trusts and foundations

worried about their own expertise could fund intermediaries. In reality the due diligence issues around pure grants and social investments will be different, with a small degree of overlap. So different skills will be required.

Ideally, NPC would like to see tranches of recycling capital lying between the grants portfolio and the investment portfolio becoming the norm.

Deepening of the risk capital market might help to coax more players onto the field. If a trust is looking at a deal but would only like to commit 15 per cent of the amount, how can this be achieved with only two to three other players present? If there were 10-20 regularly active players, then risk-sharing and syndication would be much easier.

Commercial investors are just that – commercial. They will only invest if they obtain a return commensurate with the risk. So they will not generally provide patient capital to develop intermediaries or markets. But they may provide intermediaries with capital or liquidity to invest onwards for commercial returns. Most prefer tested products and organisations with track records, unless returns are stellar – hence commercial investors backed Bridges Ventures once the proposition was proved using government capital.

Commercial markets have their own wobbles. The venture capital market is extremely illiquid at the moment. It has offered good returns, so institutional investors such as pension funds and insurance companies are already invested as far as their own asset allocation policies allow, leaving not much room for additional investment. This is affecting players such as Bridges Ventures.

Ups and downs in the banking industry also affect the banking players – sometimes positively, if they are viewed as ‘safe havens’.

Private investors prepared to offer risk capital are still quite thin on the ground. Some intermediaries say they are able to match demand with supply, but admit that it is often ‘the usual suspects’ providing the investment. NPC wonders if there is a ceiling to the current supply of private capital in this area, and that if greater demand were stimulated it might be hard to meet.

Tax, legal and regulatory issues may be inhibiting appetite, but even if these were solved the ‘retail’ market still looks extremely young. It does not help that currently liquidity in the venture capital market is a problem.

The direct market (i.e. retail investors having direct relationships with investees) is too fragmented to quantify in the time allowed, but would include products such as the combined loan and donation package put to philanthropists by Scope; the bond issue by the Mencap subsidiary Golden Lanes Housing; or the complex bond issue by CityLife (now Allia) to generate income for local charities. Some of these types of products are described in NPC’s report *New facilities, new funding* published in May 2010. NPC would say that many of these products have enjoyed a somewhat slow start, and they have required enormous effort to develop. But they are generating some interest.

Private individuals are showing appetite to invest in mainstream products with a social purpose. Banks can attract deposits; fund managers of listed equities are increasingly attracting investors looking for combined social and financial returns.

Charities themselves have deposits which are starting to look for low-risk combined social and financial returns, such as those offered by the specialist banks. Ditto **corporates**.

A.4 Investment options

Table 9 provides an overall picture of all the key players we interviewed and used to develop our model. It’s structured differently from our high-level findings, around the organisations and their market area rather than the type of capital. This means that the rows below sometimes include more than one type of capital. We have done this because this is another way of looking at what is needed. For example, if you are to offer a loan product, what is required to achieve this? Deposits *and* capital.

NB Social Finance is not a fund manager, but as a significant player we have included it within the table below.

A.5 Obstacles to future growth

Demand for finance

NPC has not quantified demand by surveying the wider market. Our information is based on anecdote from intermediaries, which is biased. NPC noted that not all intermediaries are active in stimulating demand, having enough deals to process and consume readily available capital. The experience of Futurebuilders

Table 9: Size and characteristics of different markets for investment

| Market | Players | Size 2010 | Where does funding come from | Potential 2011-2014 | What is needed |
|---|---|--|--|---|---|
| Commercial loans | Triodos mainly and high street banks | £460 million loans and commitments by Triodos | Fully commercial | Past growth of 25 per cent bodes well for future: could go to £600 million to £700 million loans and commitments | Nothing. Can raise own capital on markets |
| Semi-commercial loans | Charity Bank and others | £50 million loans outstanding by Charity Bank | Deposits, but underlying capital also required | Would like to grow to £200 million balance sheet - c. £150 million loan book | Needs £20 million of patient capital to achieve this |
| Government-subsidised loans | Funds managed by Social Investment Business (SIB) NB SIB funds are limited to specific sectors and not available to all-comers | Total funds managed c. £300 million to £350 million c. £60 million loans and grants packages drawn each year (73 per cent loan/27 per cent grant) | Government departments | Unknown: depends on status of individual funds. SIB say current demand for investable loans/grants £55 million to £60 million pa, could rise to >£100 million | Should government continue to fund? Funding gap could be £50 million+ Impact assessment of past funds required to determine future course of action |
| Complex semi-commercial loans, quasi-equity etc. Wide range of finance/risk/impact drivers and level of subsidy/sub-market rates | Venturesome, Big Issue Invest, Rathbones' social enterprise stream; Bridges Ventures' social enterprise fund. NB some players more business oriented than others | c. £25 million portfolio outstanding | Patient capital providers: individuals, angels, trusts and foundations | Growth slow and steady: expansion comes in other areas. Hard to cover operating costs Reach of organisations limited: there may be more demand if stimulated | Continued support and patient capital: this sector helps to develop market £5 million to £6 million pa needed from mix of sources Broadening of investor base would help develop market |
| Semi-commercial loans, quasi-equity etc. from other CDFIs | Regional CDFIs | Estimate c. £70 million to £80 million, but this assumes strong growth from regional CDFI sector which includes investment in local businesses | Government: Phoenix Fund; Regional development authorities; Growth Fund; CITR, ERDF and bank loans Trusts and foundations | Good growth in past (20-30 per cent pa) but operational losses can erode capital. CDFIs could expand regionally | Capital to enable sector to grow to scale NPC recommends more detailed analysis of sector carried out by CDFA |
| Listed commercial equity/fund management | Rathbones, and increasing asset managers e.g. Deutsche Bank | Not quantified: definition of social benefit too open-ended. But large and growing | Fully commercial | Demand increasing although only fully commercial companies can play: on edge of this space | Encouragement, but cash and development should come from players |

| Market | Players | Size 2010 | Where does funding come from | Potential 2011-2014 | What needed |
|--|---|--|--|---|--|
| Unlisted commercial equity | Bridges Ventures | c. £120 million under management, not all invested yet | Fully commercial, but with social objectives | Limited at present because venture capital markets have limited liquidity, so hard to raise funds But commercial returns are offered | Help to raise another £50 million fund Bridges Ventures may be able to manage more |
| Esoteric products /new products | Social Finance; other thinkers e.g. Allia (formerly CityLife); Sainsbury's trusts | Social Finance: £5 million Social Impact Bond; Allia so far raised £11 million since 1999; Sainsbury's trusts developing product | Individuals; trusts and foundations | More products down the pipeline: some £10 million in size. Some markets could be sizeable | Seed funding for products Broadening of investor base |
| Grants (specifically those to develop investee capacity) | Funds managed by SIB; UnLtd | SIB see above UnLtd £3 million to £5 million pa | Big Lottery Fund Millennium endowment | Always demand for grants | N/A |

and Communitybuilders was that it required considerable effort and outreach to stimulate demand. So there may be more demand out there that is not being stimulated.

Some intermediaries were finding that the market was currently a bit sticky while organisations digested the implications of funding cuts and new commissioning arrangements. Twelve to 18 months hence may see a sharp increase in demand.

Not all of the demand is investable. Conversion ratios vary – Venturesome finds it can only invest in 10 per cent of enquiries. So there needs to be considerable effort, often tempered with grant funding, to get organisations to a point where they are investable.

A clue to real demand might be in the pilot project run by NESTA for the Big Society Bank. It received £47 million of enquiries, many very promising. Many of the applications lay in the £500,000 to £1 million bracket – these were for intermediaries who then may do smaller deals with this capital and aim to raise two to three times extra funding. Out of 65 applications, only 18 were for amounts less than £500,000, but this may be to do with how the invitation to apply was couched. NPC was surprised by the demand for equity – over 30 per cent of amounts requested.

Investee-readiness

This is an obstacle. Intermediaries repeatedly talked of the effort to get deals done because investees were unfamiliar with financial concepts such as business planning, borrowing, risk/reward sharing, obligations to investors (covenants etc.), and reporting requirements. Rathbones finds social investees behave differently from commercial ones. For example, a company is unlikely to forget its reporting requirements and would have systems in place to ensure the right information is supplied at the right time. Social investees often simply forget, or do not see reporting as a priority, so working in this area often requires a commitment to investee education.

In any case, many promising ideas need resource to do business plans, feasibility studies, market testing and so forth. Charities in particular may lack funding and expertise for these types of activity, so support for this is essential. There are also cultural issues. An organisation full of social workers used to focusing on family problems will find the transition to becoming a social enterprise quite tough.

Which is why the recent increase in business entrepreneurs becoming social entrepreneurs (observed by Big Issue) is an interesting one.

Processing of demand and supply

This is an issue. Finding good staff able at once to understand social impact and to structure financeable investments. More processing capacity might make stimulation of the market feasible. For instance, Bridges Ventures has no regional network. If it had one, could it grow like 3i did in the 1980s? But could it recruit? Venturesome is happy with its current balance, and finds recruitment and training of the right staff sufficiently challenging that it is cautious about growth.

Part of the challenge is matching deals with investors. What investors want may not be what organisations need, so this process takes resource. This market is not like the commercial market with standard and readily available products understood by both sides. A common characteristic of esoteric products is the very slow process of developing them, piloting them, and then getting them to the commercial market.

Tax, regulations, and legal structures

Generally NPC heard that the **legal, tax, and regulatory environment can inhibit the investment environment**. Sometimes it was because the environment was too complex, or the products permitted too inflexible to cope with a particular circumstance that could generate social impact. Tax breaks only favoured narrow areas, and legal structures often did not work well.

For fully commercial products, this is not an issue. However, for hybrid quasi-equity type instruments, intermediaries such as Rathbones report that investments are falling between stools and are very difficult to structure. As a consequence the market may not be able to grow as it could.

NPC has not investigated this in detail – we are not qualified to give opinions on tax, legal and regulatory matters. But we strongly suggest that this should be looked into, perhaps with a steering group of intermediaries and qualified experts.

Returns

Returns do not always reflect the risk or the efforts to develop deals and manage portfolios. NPC wonders whether the investee market might accept higher charges to compensate for these risks and costs, and therefore become more attractive to investors.

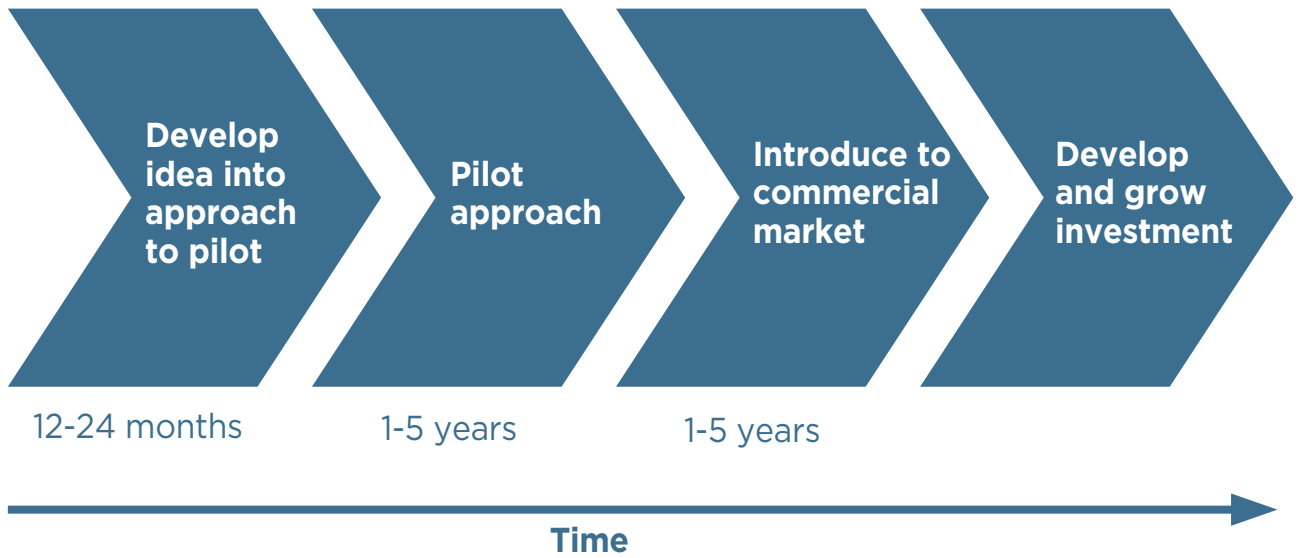
We suspect that interest rate changes could affect returns. Currently intermediaries can attract depositors because returns are lousy in the commercial market. If interest rates went up,

it would be harder to attract depositors unless deposit rates increased. This would either squeeze lending margins or necessitate higher lending rates. Are deals structured to allow higher lending rates if the economic environment changes?

A.6 What else needs to happen to build a social finance market?

Building a social finance market is much more than just providing a certain type of capital. These elements need development, but may not offer financial returns.

- Capacity-building to help investees become investment-ready:
 - Financial/investment literacy.
 - Ability to operationally scale-up or replicate.
- Development of financial products which appeal to investors as well as investees:
 - Simplicity.
 - Risk/reward properly allocated.
- Improving the environment for investment:
 - Legal structures.
 - Tax incentives.
 - Regulatory issues.
- Investor stimulation:
 - Development of vehicles to make retail investment easier.
 - Retail investor encouragement and education.
 - Development of market to spread risk.
 - Encouragement of trusts and foundations to participate more willingly.
 - Persuasion of high street banks to participate in bankable deals.
- Impact measurement needs to become more sophisticated:
 - Impact of interventions being supported.

Figure 4: Social finance product development process

- Impact of using social investment to support/scale-up – is leverage increased? Is funding recycled?

All these elements take time and money, for instance, the development of a **successful financial product** may take five to ten years. Figure 4 shows the time needed.

One example is the Social Impact Bond. First the product was developed (which included a great deal of policy work) and it is now being piloted but results will take five to ten years to come through.

Commercial investors will not be the ones to develop the market, as the development of new products rarely yields a financial return first time, and other aspects of the market development process carry no immediate financial reward. But there are high potential social rewards.

The BSB will need to consider its role in developing the market.

A.7 Deal sizes offered by intermediaries

Intermediaries do not generally specify size of organisation in their investment criteria, but they do specify size of deal. There were wide ranges in some funds, and funds overlapped. This is potentially an issue in the market and needs to be monitored. Table 10 shows the different levels.

Table 11 summarises the theoretical availability of funds by deal size. NB segments overlap, upward limits being considerably above the next bottom limit. So in reality we have overestimated the practical availability of funds, given that resources have to be shared.

Small to medium-sized enterprises do also access bank overdrafts and credit facilities if they can get them.

Table 10: Deal sizes offered by intermediaries

| Organisation Ranked by deal size at bottom of range | Range | | £m | | |
|---|---------|------------|-------------------------|------------------------|---------------------------------|
| | Bottom | Top | Funds available 2010 | Portfolio 2009/2010 | Funds available to draw 2010 |
| Rathbones | 500,000 | 1,500,000 | | 10.0 | 2.0 |
| Bridges Ventures - equity | 500,000 | 10,000,000 | 120.0 | 74.0 | 46.0 |
| Big Issue equity | 100,000 | 500,000 | 3.0 | 1.0 | 2.0 |
| Big Issue loans | 50,000 | 250,000 | 5.0 | 3.2 | 1.8 |
| Triodos | 50,000 | 30,000,000 | | 304.0 | 50.0 |
| Charity Bank | 50,000 | 2,000,000 | | 35.8 | 15.0 |
| Bridges - entrepreneur fund | 500,000 | 1,500,000 | 9.0 | 1.0 | 8.0 |
| Venturesome | 20,000 | 300,000 | 9.0 | 10.0 | 3.0 |
| Social Investment Business (SIB) funds | | | | | |
| Futurebuilders | 50,000 | 2,000,000 | 0.0 | 176.0 | 0.0 |
| Communitybuilders | 50,000 | 2,000,000 | 0.0 | 61.5 | 0.0 |
| Modernisation Fund | 30,000 | 500,000 | 0.0 | 9.5 | 0.0 |
| SEIF | 25,000 | 10,000,000 | 95.0 | 70.0 | 25.0 |
| ACF | 20,000 | 500,000 | | 12.0 | 2.0 |
| CDFIs | | | | | |
| CDFIs - civil society* | 50,000 | 300,000 | | 24.0** | 21.0** |
| CDFIs - small to medium business | 30,000 | 250,000 | | 33.0 | 29.0 |
| CDFIs - micro | 0 | 30,000 | | 54.0 | 47.0 |
| CDFIs - personal | 600 | 600 | | 7.6 | 6.6 |
| UnLtd | 0 | 20,000 | | | 3.0 |

*i.e. social enterprise, charity, voluntary and community groups

**excluding Triodos, Bridges Ventures, Charity Bank, Big Issue Invest and SIB

Table 11: Availability of funds by deal size segment

| Deal size | Available to draw 2010, £m | Serviced by |
|-----------|----------------------------|--|
| Sub £20k | 3.0 | UnLtd grants only |
| £20-50k | [40-45] | Venturesome, local CDFIs, possibly SEIF SEIF appetite for small deals very limited CDFIs are potentially interesting in the small organisation market Capital quite patient, but possibly more grant financing required |
| £50-500k | [150-160] | Triodos, Charity Bank, Big Issue, CDFIs, SEIF, Venturesome, Bridges Ventures Entrepreneur Fund Mainly hard loans offered: risk capital/soft loans availability somewhat limited, depending on SEIF |
| £500k + | [90-100] | Bridges Ventures, Rathbones, SEIF, Social Finance, Triodos, Charity Bank. Healthy mix of loans and risk capital |

APPENDIX B: FINANCIAL EXCLUSION

B.4 Investment opportunities

Merger calculations

For merger costs, based on conversations with ABCUL and reading of a report on credit union merger, we developed the following list of items that would be required for a merger. Then we did some desk research into average costs per item (e.g. average costs for a project manager). We then calculated how much each item would cost for one year and two years, and then totalled these.

Table 12: Checklist: What is required to implement credit union merger?

| Item | Total cost - one year | Total cost - two years |
|--|-----------------------|------------------------|
| Cost of a project manager | £30,000 | £60,000 |
| Expenses of a merger sub-committee | £2,000 | £4,000 |
| Cost of due diligence | £10,000 | £10,000 |
| Travel to meetings | £2,000 | £4,000 |
| HR costs in upgrading staff terms and conditions and communication | £8,500 | £8,500 |
| Members' meetings | £1,000 | £2,000 |
| New marketing materials and branding | £1,000 | £1,000 |
| Staff training | £2,160 | £2,160 |
| Contingency | £16,166 | £16,166 |
| Total cost (one merger) | £72,826 | £107,826 |
| Total cost (90 mergers) | £6,574,731 | £9,734,531 |

APPENDIX C: INTERVIEWEES

| Organisation | Interviewee |
|--|---------------------------------|
| Social Finance | |
| Charity Bank | Roger Ong |
| Social Investment Bank | Sue Peters |
| Social Finance | Ellie Stringer |
| Bridges Ventures | Michele Giddons |
| Venturesome | Emilie Goodall |
| Triodos | Charles Middleton & Bevis Watts |
| Unlimited | Jonathan Jenkins |
| Rathbone Greenbank | Mark Mansley |
| Social Enterprise Coalition | Ceri Jones |
| Big Issue Invest | Sarah Foster & Ed Siegel |
| Community Development Finance Association (CDFA) | Bernie Morgan |
| Financial exclusion | |
| FSA | Brian Pomeroy |
| Association of British Credit Unions (ABCUL) | Mark Lyonette |
| Barclays | Reema Shah |
| Toynbee Hall/TRANSACT | Chris Hobson |
| Social housing | |
| National Housing Federation | Gavin Smart |
| Tenant Services Authority | Gill Rowley |
| Trusts & Foundations | |
| Esmee Fairbairn | Danyal Sattar |
| Sainsbury Family Charitable Trust (SFCT) | Victoria Hornby |

ENDNOTES

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