Responsible Finance

European funding and the responsible finance sector

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Responsible finance providers are expert stakeholders poised to deliver the Government's ambition to 'level-up' the regions and reduce inequalities between communities.

The Government's central aim to 'level-up' the UK can be realised by deploying funds through expert organisations already stationed in the most deprived regions of the UK.

Responsible Finance is writing on behalf of its Community Development Finance Institution (CDFI) members. CDFIs are mission driven organisations which deliver finance to those unable to access it from mainstream sources, such as banks. CDFIs serve three markets: start-ups, small and medium sized enterprises; social enterprises and charities; and financially excluded individuals. They are currently the only entities solely focused on investing into disadvantaged communities through loans to enterprises unable to access finance from mainstream sources. They foster inclusive economic growth; they create good jobs, build businesses and revitalise communities.

The Government can make best use of its post-Brexit funding by utilising the vehicles already in place which encourage enterprise in typically underserved areas; a consortium of national CDFIs would ensure full coverage of the UK's regions. With over twenty years of experience and success lending in deprived communities, including delivering good value for money on government programmes such as the Regional Growth Fund, CDFIs offer the Government an 'oven-ready' tried-and-tested vehicle for revitalising the UKs most deprived communities. By partnering with and investing into CDFIs, the Government will catalyse a complementary reaction by the private sector; CDFIs are experienced in leveraging in capital from UK banks to match Government funding programmes and utilising the Community Investment Tax Relief.

Successful rebalancing of the economy will require long-term thinking. If CDFIs can access long-term patient capital to scale their lending, the knock-on effect on communities across the UK will be tangible.

This briefing has been instructed via direct consultation with our membership on the extent to which they currently benefit from EU funding and guarantee mechanisms, and the otherwise unmet finance gap they fill across the regions of the UK.

Key statistics – the responsible finance industry in 2019

- £171 million lent to 4,600 businesses and social enterprises
- 94% of loans were made outside London and the South East
- 3,400 new businesses and social enterprises created
- 13,800 jobs created and safeguarded
- 93% of businesses lent to previously turned down by a mainstream bank
- Businesses reported an average £320,000 increase in turnover
- 46% of loans were located in the UK's 35% most disadvantaged areas
- 75% of CDFIs offer business mentoring and advice

CDFIs and European Union funding

The EU's European Regional Development Fund (ERDF) has been critical to the successful regeneration of regions across the UK. Its coherence and longevity have been key to its success. EU funding and instruments have been instrumental for CDFIs in enabling them to grow their Small and Medium Enterprise (SME) lending and increase their offering of advice and support services to entrepreneurs.

Since 1999, our member CDFIs have received a total of almost £77 million in EU funding. This is broken down as:

- European Regional Development Fund: £63,030,851 (82 %)
- European Social Fund: £1,265,000 (2 %)
- EaSI Guarantee Instrument: £5,000,000 (7 %)
- EaSI Capacity Building: £3,000,000 (4 %)
- EIF European Progress Microfinance Facility: £4,383,763 (6 %)

These funding and guarantee mechanisms have enabled members to leverage in over £11 million from private sources, further increasing the positive impact on communities.

Since the 2016 referendum, some CDFIs have already seen a reduction in funding and support received from the EU. In particular, EaSI guarantee facilities were lost, with the EU being unwilling to explore extensions. For those who continue to be in receipt of EU funding, this is set to cease in the coming years now that the UK has withdrawn from the European Union.

The majority of organisations we surveyed stated that once EU funding ends, they will need to scale back their lending services and make staff redundancies. Some organisations have already had to dramatically reduce their activity levels and headcount.

The gap filled by CDFIs

The UK has a landscape of deep-rooted inequality built up over many decades, and is now one of the most regionally unbalanced countries in the industrialised world. Because of the regional and local differences in prosperity, we are not harnessing the economic potential that lies in the regions, and if no action is taken the gap is expected to grow with 50 % of future job growth going to London and the South-East[1].

Despite relatively low unemployment figures since the aftermath of the recession in Britain's older industrial towns, when economic trends are looked at closely this drop in unemployment can largely be attributed to the rise in out-commuting jobs in other places and a local population with an excess of retirements over young entrants to the workforce[2]. It is questionable as to whether employment growth in this way is sustainable or beneficial. It also has negative environmental implications by increasing dependence on the UK's road and rail networks.

Rewarding employment opportunities should be available in towns and cities up and down the UK, as a city-centric model of growth does not necessarily work for every region. One way of creating more and better jobs is to increase investment in SMEs.

Small or medium sized businesses account for 99.9% of all private sector businesses and 60% of all private sector employment[3]; they are the engines of the UK economy. The Government has a leading role to play in addressing regional disparities for businesses by ensuring more small businesses can access appropriate, affordable finance when they need it.

Regional imbalances in business finance hampers the ability of businesses to grow, recruit and innovate. In the UK, access to finance at the local level varies considerably, and the British Business Bank's 'Benefits of Diverse Smaller Business Finance Markets' report showed that for seemingly identical companies, where they are based significantly impacts the type of finance and finance providers they can access. For debt financing, bank lending volumes broadly match the regional distribution of the small business population, however local level data shows considerable variation in lending[4].

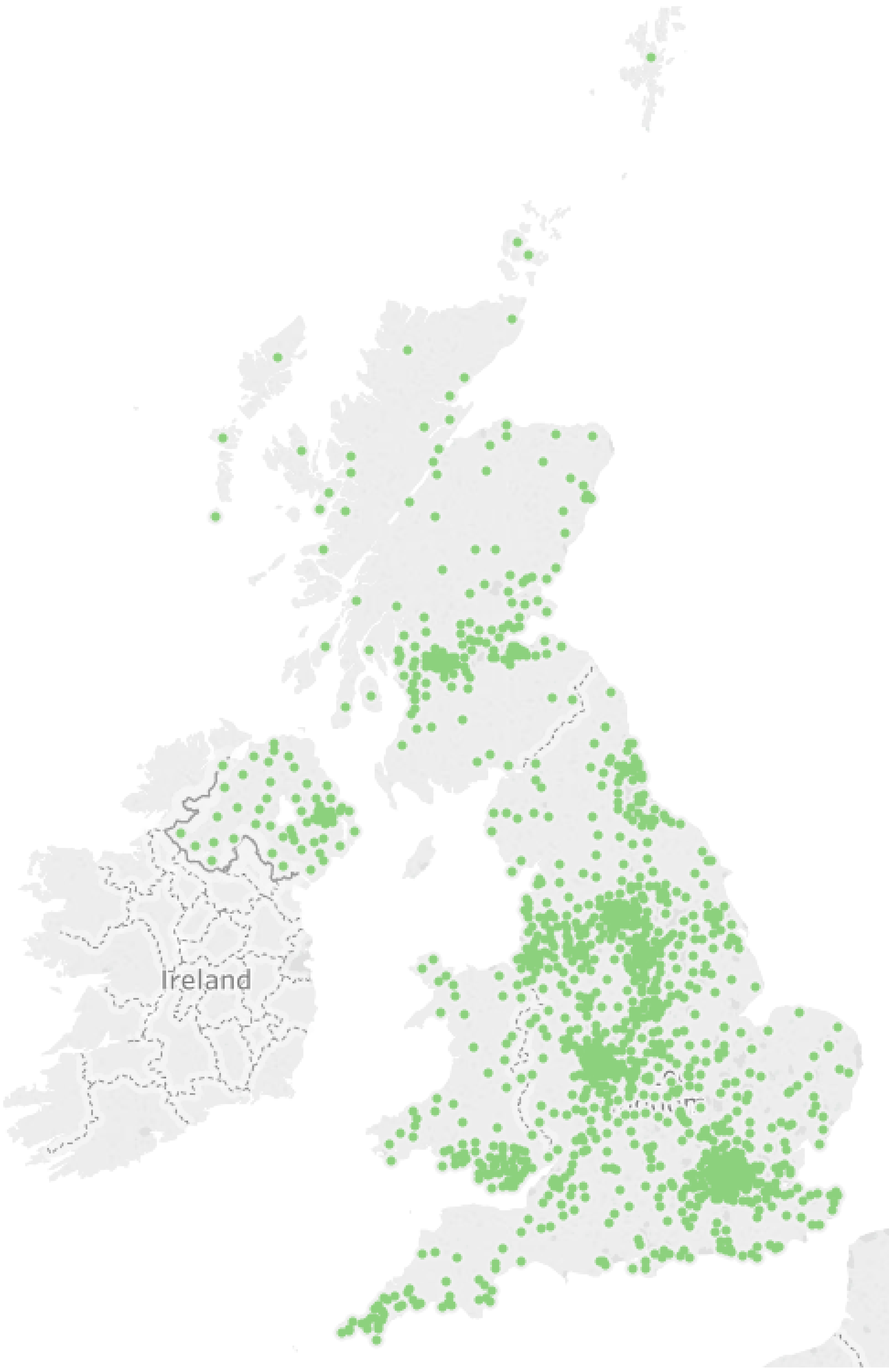
Businesses often struggle to access finance from mainstream banks if they are deemed high-risk due to a lack of trading history or insufficient assets for security. The latest SME Finance Monitor found that the success rate for bank loans in the UK has continued to decline and is now at just 63%. Among those declined, a third were not able to expand as they had planned, and a similar proportion found running their business more difficult[5].

Banks are generally cautious when it comes to small business lending. SME loan applicants may be more likely to be unsuccessful in seeking mainstream finance if: it is a new business venture; they are first time borrowers; they have unique and unproven business plans; their application is presented poorly; or if they have a difficult credit history. The estimated debt funding gap is £1.4 billion[6]. Whilst this number is not high by international standards, it still means missed economic and social benefits for the UK.

CDFIs adopt a flexible approach to determining the viability of a business, and can often provide support when mainstream lenders can't. 93% of the viable businesses CDFIs lent to in 2019 had been previously turned down by a mainstream bank.

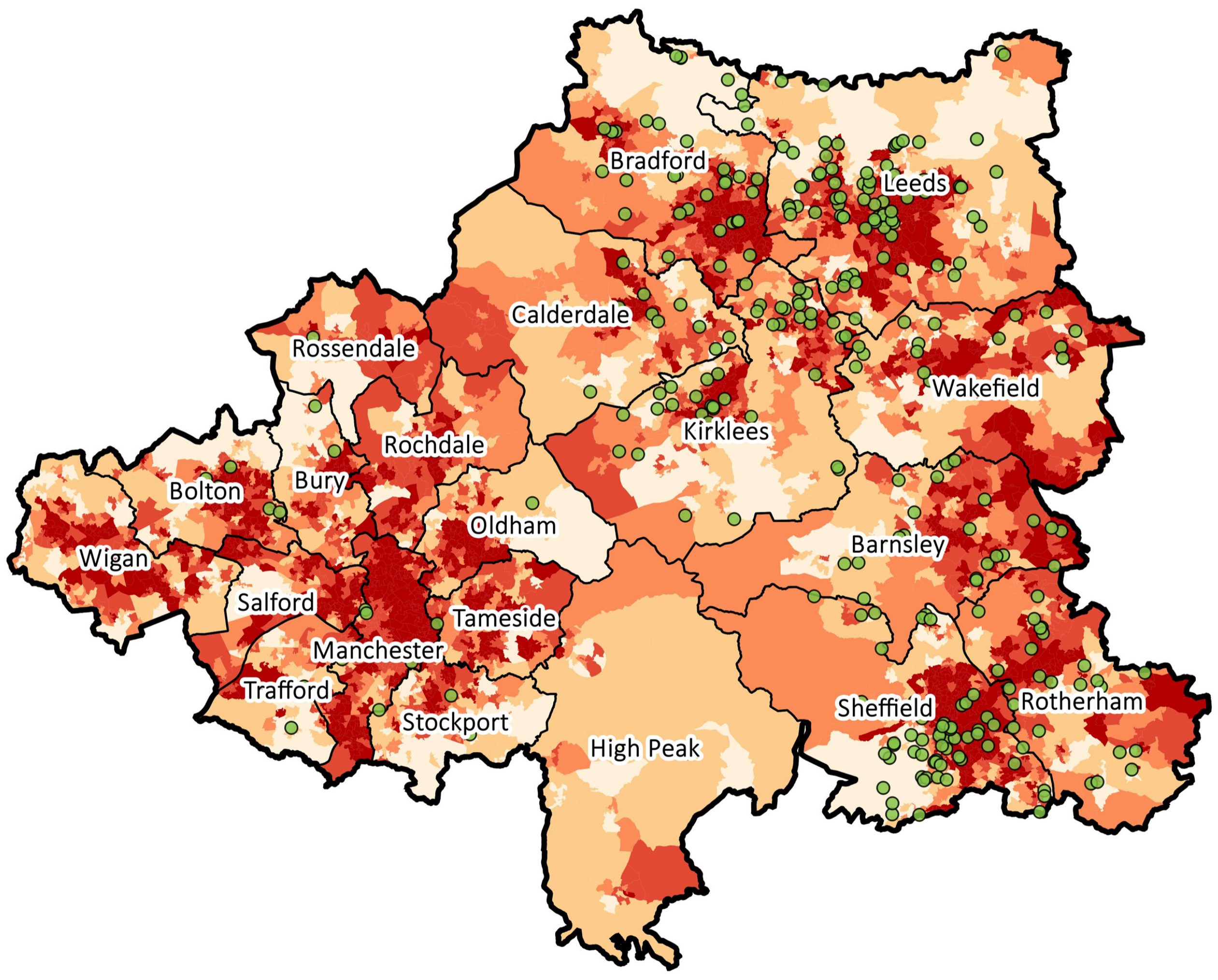
CDFIs lend the length and breadth of the UK. The map below shows the distribution of CDFI loans to businesses and social enterprises in 2017 and 2018.

Business and Social Enterprise lending by responsible finance providers 2017-18



Dividing the UK up into 'north' and 'south' doesn't take account of the nuances in location, overlooking the reality of many places. CDFIs target pockets of deprivation that exist all over the UK. The maps below show CDFI lending data mapped by local area deprivation in the Northern Powerhouse and Birmingham regions. They show that CDFIs lend in the most deprived communities. These are the communities which need support and investment to enable them to level-up with the rest of the UK.

Business lending by Responsible Finance providers in the 'Northern Powerhouse', 2017-18, by deprivation



Responsible Finance lending

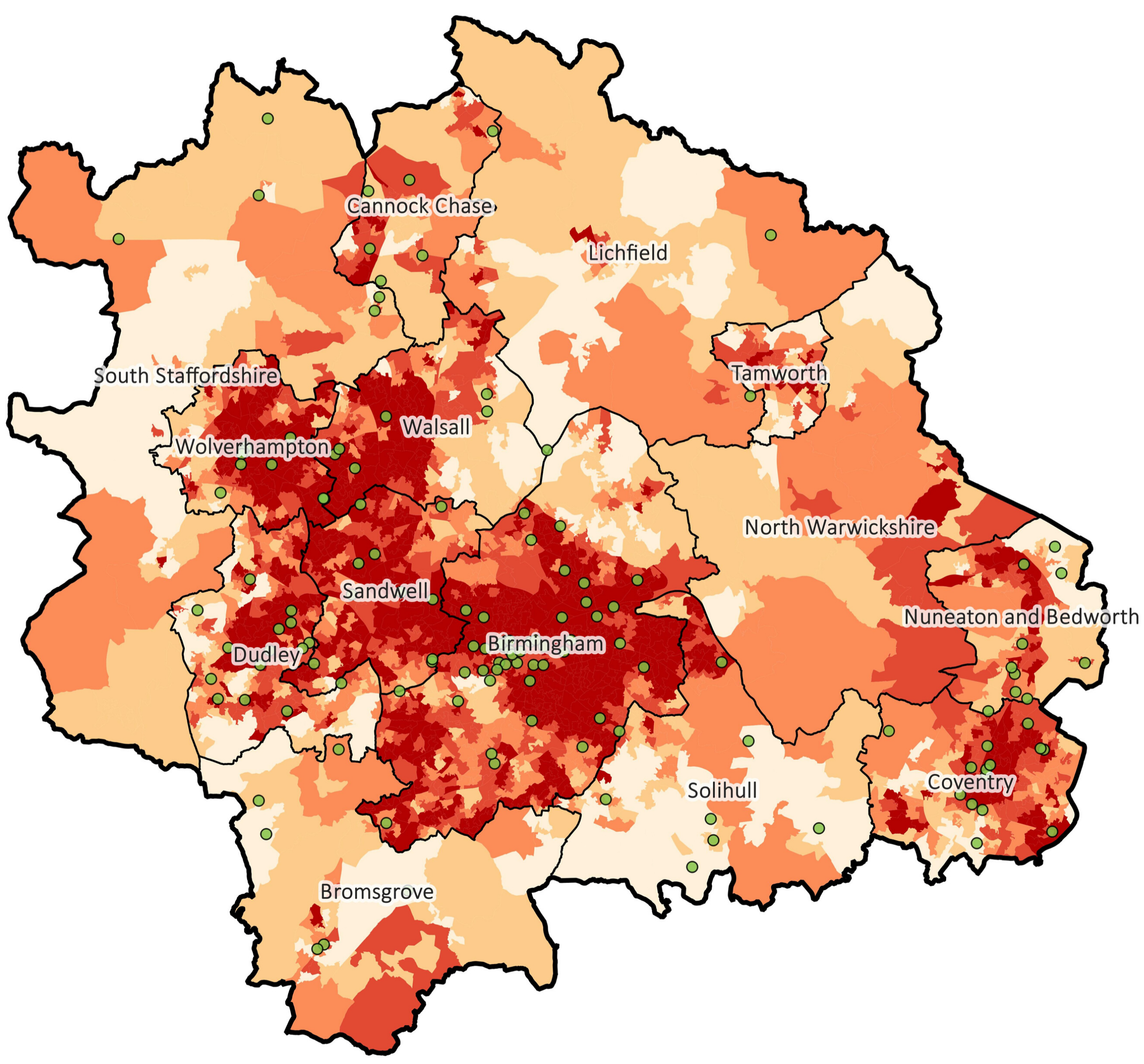
Indices of Multiple Deprivation (2015) at Lower-layer Super Output Area (LSOA) level

- Bottom quintile (most deprived)
- Second quintile
- Third quintile
- Fourth quintile
- Top quintile (least deprived)

This map was created in December 2018 by the Personal Finance Research Centre, a social research centre based at the University of Bristol.

It uses data from the following sources:
1. Postcode lending data from members of Responsible Finance
2. English indices of deprivation (2015) Ministry of Housing, Communities & Local Government.
3. Local Authority District boundary data.

Business lending by Responsible Finance providers in Birmingham 2017-18, by local area deprivation



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Business investment is also a key driver of productivity, and the decline of investment as proportion of domestic output in the past three decades has had an impact on the UK's low productivity[7]. The SME finance monitor shows that permanent non-borrowers are less likely to export than those that use external finance, and are less likely to grow, innovate, and make a profit . This contributes to the productivity challenge as businesses are unable to invest in the new equipment and technology which drives up their performance. This ultimately has an impact on the strength and resilience of local economies and the economic opportunities for their residents. Improving productivity is vital for increasing economic growth and raising living standards.

Whilst flows of bank lending have remained relatively flat, the latest British Business Bank Small Business Finance Markets report finds there has been significant growth in the volume of finance outside of traditional bank lending products[9]. The influx of alternative online lenders has not proved to boost productivity. Evidence shows that peer-to-peer lenders are lending to low-risk bankable businesses, and not filling the finance gap for the businesses that cannot or are discouraged from seeking bank finance. Responsible finance providers are the only lenders that are actively targeting the gap in access to finance with fair and affordable products.

The entrance of new providers and products is welcome, however in an unregulated market there are very few protections in place for businesses and there is little transparency on pricing and terms. Responsible finance providers are increasingly receiving loan refinancing applications from businesses who have taken out high-cost business loans from online lenders. There is a risk that without regulation, similar trends could occur to those that appeared in the consumer credit market prior to 2014 when the FCA stepped in. This could ultimately have a catastrophic effect on the small business market and on UK productivity.

Business case study - global growth for Bedford business

Skills4Stem is tackling the STEM (science, technology, engineering and mathematics) skills shortage by focusing on providing relevant and up-to-date skills within the STEM sectors as well as specialist expertise in the construction industry and the built environment.

Launched in 2014 by Sarah Davis, the business now has offices in the UK and Republic of Ireland and employs 20 people. It has created several jobs in the local community that people would otherwise have had to travel for. It was established to fill a gap in the market for delivering a blend of technical, leadership and management training to mature learners, and provides a portfolio of industry ready, accredited qualifications & apprenticeships.

After a successful start, Skills4Stem turbocharged its growth when it secured investment from the Midlands Engine Investment Fund (MEIF), through responsible finance provider First Enterprise, to help Sarah expand the company, improve its digital marketing strategy and create a live web chat to help their customers in real time.

Over the last six years, Skills4Stem has rapidly grown from a simple idea to a global company, offering services up and down the UK as well as in the Republic of Ireland and United Arab Emirates.

Case study – using CITR to attract investment from banks

BCRS Business Loans (BCRS) is a CDFI based in Wolverhampton, lending to small businesses across the West Midlands. This case study focuses on how an investor bank can use Community Investment Tax Relief (CITR) on a loan to a CDFI.

Unity Trust Bank plc (Unity) was involved in the Regional Growth Fund programme (RGF), where a commercial loan matched a government grant. Unity made its match investment using CITR. Since 2012 BCRS has raised over £4 million in loans from Unity using CITR. In the RGF model, the investment risk is covered by the RGF grant match. Outside of RGF, individual CDFIs cover risk in different ways, through obtaining a grant, using assets/reserves, or using a government-backed guarantee, such as the Enterprise Finance Guarantee.

A key benefit for Unity from using CITR was gaining the additional return through the tax relief. The additional return meant that Unity could lower the cost of capital for BCRS by rebating a portion of the relief. Unity Trust Bank charges a commercial rate, so lowering the cost of capital reduced a significant cost for BCRS and helps the CDFI become more sustainable. For Unity this is an additional social benefit in addition to catalysing lending to underserved businesses.

The impact of using CITR is potentially more profound as it requires loans to be concentrated in areas of high deprivation, or on traditionally underserved populations (such as women or black, Asian, and minority ethnic owned businesses). Unity reports on the social impact it generates to its stakeholders. The advantage of investing through CITR is not only claiming the relief, but stimulating greater enterprise activity in underserved communities through CDFIs. Unity reports this indirect impact in its annual report.

Case study – The Regional Growth Fund programme

The Government's Regional Growth Fund (RGF) programme is an example of a good value for money and high impact partnership with the CDFI sector. RGF aimed to increase access to finance for small businesses after the financial crisis. £30 million was allocated to the responsible finance sector, which triggered a complementary reaction by the private sector; the fund was matched by £30 million from Unity Trust and the Co-operative banks. One of its biggest successes was this significant amount of private sector capital which the fund enabled responsible finance providers to leverage.

By 31st December 2019, repaid capital from the original fund of £60 million had been recycled into new loans by responsible finance providers totalling over £88 million. This has supported over 2,700 businesses and created or saved over 11,770 jobs, easily meeting the targets set by the Government. 91% of the fund has been lent outside of London into sectors that provide goods and services to the economy or support local supply chains.

The Government cost per job supported (safeguarded or newly created) was £2,706, compared to the programme average of £37,400. This cost will continue to fall as responsible finance providers recycle repaid capital into new loans. Responsible finance providers have supported businesses across a range of industries through the RGF programme, including manufacturing, clean energy, engineering, software and retail, all of which would otherwise not have accessed the finance they needed to succeed. The fund was successful because it was delivered through responsible finance providers – a sector with local reach that specifically focuses on underserved markets. This type of targeted, good value for money and high-impact initiative is necessary to drive growth in small-scale ventures that are unable to engage in mainstream finance.

The impact of RGF on CDFI organisational capacity – The Key Fund

The Key Fund (KF) is a responsible finance provider dedicated to supporting community and social enterprises. It delivers the Regional Growth Fund in the North of England. The vast majority of its investees either work with disadvantaged groups, or operate in disadvantaged areas, and as not-for-private profit organisations they invest their income to deliver social impacts in their local communities. It reported some key organisational impacts that resulted from acting as an RGF delivery partner:

- Regional coverage – RGF has enabled KF to support a number of enterprises in a broad range of industry sectors across a wide geography, beyond its historic Yorkshire area. The flexibility of the RGF fund enabled this.
- Internal capacity – Funds from RGF have enabled KF to increase its investment activity and subsequently its internal capacity, which has enabled it to provide even more support and mentoring to its community and social enterprise applicants. This has helped to equip them with the necessary skills and experience to evolve in a changing funding environment.
- Additional capital – KF has raised a significant amount of new capital to support wider geographic operation, partly based on the track record of delivering RGF.
- Marketing – KF's use of RGF to increase its work across relatively new areas of operation and the increased internal capacity it has offered prompted KF to expand into online targeted marketing through social media. This has proved particularly effective.
- Additional investee funding – KF investees has been able to secure almost £900,000 of additional funding as a result of its investments using RGF.

About Responsible Finance

We are the voice of the responsible finance industry. We support a strong network of responsible finance providers – primarily Community Development Finance Institutions (CDFIs) – which drive inclusive growth across the UK by lending to those excluded from mainstream sources. We ensure the growth and sustainability of the responsible finance industry through our high-quality member services and our work to advocate for a positive regulatory and policy environment.

Endnotes

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[2] Beatty, C., Fothergill, S. (2020) Recovery or stagnation?: Britain's older industrial towns since the recession, available: https://www.tandfonline.com/doi/full/10.1080/00343404.2019.1699651

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[5] BVA, BDRC (2019) SME Finance Monitor, available: http://www.bva-bdrc.com/wp-content/uploads/2019/09/BVABDRC_SME_Finance_Monitor_Q2_2019_Management_Summary.pdf

[6] Richard Roberts, Aston University (2020)

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[9] British Business Bank (2020) Small Business Finance Markets 2019/20, available: https://www.british-business-bank.co.uk/small-business-finance-markets-update-january-2020/