Responsible Finance

The Labour Party’s proposed Industrial Strategy – Responsible Finance response

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How does the current financial system help or hinder industrial goals?

Given our position and expertise, we can mainly comment on lessons learnt in terms of the access to finance element of industrial strategy, and the subsequent impact it has had on industrial development.

Following the financial crisis, a significant gap was identified in access to finance for businesses, particularly small and micro businesses. These businesses are often viewed as too risky or unprofitable by mainstream banks, as the transaction and risk costs associated with making a small scale loan outweigh the revenue derived from it. The same perception is true of certain industrial sectors, such as agriculture, tourism, retail, and creative. The Government response to this market failure was to launch a series of programmes targeted at underserved areas of the market, including the Regional Growth Fund (RGF), Start Up Loans Company, and Big Society Capital. These programmes targeted excluded businesses – such as start-ups, micro businesses, businesses outside of London, and social enterprises – through locally based financial intermediaries (such as responsible finance providers – also known as CDFIs).

The impact of these programmes on industry is illustrated by the thousands of jobs created and saved and businesses supported. The £60 million RGF fund delivered (£30 million RGF matched by £30 million commercial investment) through responsible finance providers has supported over 2,000 businesses and created and saved 8,000 jobs. 95% of the fund has been lent outside of London, and into sectors that provide goods and services to the local economy or that support local supply chains. Responsible finance providers have supported 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.

This type of finance was effective because it was delivered through responsible finance providers who are locally-based social enterprises, with understanding of local market condition and business needs. This makes them a vital fair alternative to banks which are reluctant to provide credit where there are low profit margins or in times of uncertainty. Our recently released annual report summarises the activities, focus and achievements of the responsible finance sector in 2016 (http://responsiblefinance.org.uk/policy-research/annual-industry-report/).

How could it be improved?

The financial services system in the UK does not fully support the development of diverse and resilient industries, because the system is viewed as fragmented, complex, and risk averse. There is an alternative market through the responsible finance sector, but it is small and currently restricted by access to capital to on-lend. Recent research by the British Business Bank confirms an emerging trend; that many small businesses are willing to accept lower growth because of they are discouraged from accessing finance. This has negative implications for the UK achieving its industrial goals.

The United States provides an example of a more mature responsible finance system than currently exists in the UK. In the US, the sector was established in the 1970s to combat the exclusion of low income and minority communities from bank lending. This intervention debunked the assumption that low communities have little purchasing power and therefore cannot support a business sector. In tandem with the launch of the CDFI sector a range of support mechanisms were also enacted:

1. The Community Reinvestment Act: Legislation that required banks to reinvest into communities they take deposits from. The legislation enabled them to invest through CDFIs, given they had the reach and market knowledge. This created a more integrated ecosystem for providing access to opportunity to people and businesses previously excluded from mainstream finance.
2. The CDFI Fund, an annual c$200 million fund within the Treasury Department that provides grants and loans to CDFIs for on-lending, core capacity, and for leveraging commercial finance.
3. Financial instruments such as guarantee products and tax reliefs that enabled more communities and businesses to access finance through community-focused financial institutions such as CDFIs.

An ecosystem like this that enables the sustainability and scale of the responsible finance sector would help to develop a strong alternative finance market which in turn would support the growth ambitions of more small businesses. Our Chief Executive, Jennifer Tankard, recently authored an article for the Co-operative Party's 'In Our Interests' policy pamphlet which goes into more depth on the drawbacks of the current financial system and policy solutions focused around the responsible finance industry (page 29 - https://party.coop/publication/in-our-interests-building-an-economy-for-all/).

How can we address the South-East bias and create a financial sector that serves the whole country?

Given that localities now have more influence over their own industrial development, particularly for the devolved nations, it is important to ensure that an industrial strategy is adaptable and supportive rather than prescriptive. Any national industrial strategy should have broad priorities, providing the tools and support to complement local and regional approaches. This includes competitive tools such as guarantee schemes (such as EFG), tax reliefs (such as the Community Investment Tax Relief), and national funds (such as the Regional Growth Fund) that local institutions like responsible finance providers can access and deploy in a more targeted way.

The responsible finance industry is a network of lenders that covers the UK, and operates in traditionally undeserved markets. Investing in the responsible finance sector ensures that businesses and economies outside of London and the South-East are targeted. For example, 90% of the responsible finance £60 million RGF programme was lent outside of London and the South-East, with 35% concentrated in the West Midlands, and 35% in the

North of England. Responsible finance providers have been able to use that funding and flexible capital to scale up their coverage and become more sustainable. Importantly, each has been able to do so in a way that responds to the particular needs of their locality.

Making tools like this available and competitive at the national level can complement local efforts and enable those with local market expertise, like responsible finance providers, to drive local growth through industrial development. This will enable devolved administrations, local authorities and LEPS to make local strategies and access centrally available funds such as Growth Funds in line with the local strategy. The central government having appropriate tools available at high level will enable strong local economies.

The United States example of the thriving CDFI sector also speaks to the question of regional advantages/disadvantages in the financial sector, particularly the credit market. Whilst the US does not have a centralised industrial strategy (it is often delegated to the individual states), the established CDFI sector means the central government has a support system in place around access to finance for underserved and excluded populations. This sector is versatile and can support any industrial development, even in areas that have historically experienced underinvestment. Although specific industrial sectors are not targeted, the support infrastructure enables access to finance and affordable business support for the range of actors – large employers, small firms in the supply chain, new start-ups, retail and services firms, and residents themselves.

What is the impact of the instability of the finance sector on the rest of the economy and how can it be overcome?

The longstanding nature of the finance gap for businesses is indicative of a structural problem in the finance market. Responsible finance providers are working to fill that gap, as addressed previously. The issue is partly due to a lack of trust in financial providers on the part of small businesses as a result of recent scandals in which they have been mistreated by high street banks. These problems demonstrate that market instability is not the only factor, but it does exacerbate problems, widening the finance gap and stifling the knock-on benefits that occur when demand is met. As has been seen in recent years, banks can dampen the supply of credit for reasons other than the market's capacity to responsibly borrow, such as heightened requirements for capital reserve minimums following the financial crash, and the devastating effect on the supply of finance brought about by the crash itself.

Responsible finance providers endeavour during these periods to meet as much demand as possible as a crucial alternative. As an example, a software developer and serial entrepreneur in the West Midlands was declined by a bank loan when he tried to start his new business, Synapse, in 2014 because his business was viewed as high risk and the finance sought was too low to be profitable. He was able to secure a £26,000 loan from ART Business Loans, a responsible finance provider, through the RGF programme and since has grown his business from 3 employees to 28, and is generating a £1.5 million turnover (http://reinvest.co.uk/casestudy/synapse-2/). SMEs like Synapse demonstrate this persistent gap in access to finance that businesses still face, the drag to the economy that a lack of access to appropriate finance creates, and the economic boost that emerges simply by meeting the need that is there.