Autumn Statement representation

7th October 2016

About Responsible Finance

Responsible Finance is the trade body for responsible finance providers (also known as community development finance institutions (CDFIs)). Responsible finance providers provide loans and support to businesses and individuals who find it difficult to access finance from commercial banks. Responsible Finance's mission is to support the development of a thriving and sustainable sector that provides finance for underserved communities and, as a result, contributes to the increasing economic growth and prosperity of these communities.

About the Responsible Finance sector

Access to Finance

Access to finance and financial exclusion continue to be significant barriers to growth and long-term prosperity in local economies across the UK, at the individual, household, and business levels. Despite the economic recovery and a wave of new entrants such as challenger banks and alternative lenders, there is still a large minority of businesses and people that cannot access the finance they need to achieve their goals. **Since 2011, high street banks have withdrawn £26 billion from the SME sector and nearly half of all SMEs are now choosing not to borrow at all. For consumers, 2 million people, or 3% of the population, do not have a bank account and a further 4 million people incur regular charges on their accounts.** These indicators point to a persistently significant gap in access to appropriate finance, and the fragile nature of improvements in financial inclusion to date.

This gap has been driven by a lack of competition and transparency in the financial services sector, along with credit tightening policies, low levels of financial literacy and awareness of alternatives to bank finance. The inability to access appropriate financial services creates a drag on the economy and has led to financial instability, problem debt, and decreased productivity. This not only erodes society but also limits people and firms' participation in the economy.

The impact of the responsible finance sector

Our monitoring of the responsible finance sector indicates that, in the decade from 2005-2015, responsible finance providers:

- Lent £1.6 billion to 280,000 people, businesses, and social enterprises;
- Financed 50,000 businesses and 4,100 social enterprises;
- Enabled the creation of 68,000 jobs and protected another 41,000 that were at risk. This constitutes up to 5% of the UK's total job growth each year;
- Helped 40,000 new businesses and social enterprises start up, fuelling the economy with £0.6 billion annually (2% of last year's growth in GDP);
- Helped 216,000 people save £20 million in repayments to high cost lenders, and tackled 2% of the UK's problem debt;
- For every £1 responsible finance providers lend, they generate £7 in economic value.

As demonstrated by the impacts above, the responsible finance sector made strides in the last decade in both tackling the root causes of financial inclusion and its negative consequences on the economy and society. For this successful and effective growth trajectory to continue, we recommend the Government to consider the following good value for money proposals in the Autumn Statement:

- Enable the use of the Enterprise Finance Guarantee (EFG) on Community Investment Tax Relief (CITR) investments;
- Guarantee the continuation of EU facilities for access to finance (EaSI, COSME, ERDF);
- Launch a responsible finance fund.

Recommendations

1. Enable the use of Enterprise Finance Guarantee (EFG) on Community Investment Tax Relief (CITR) investments

About CITR

1.1 The Community Investment Tax Relief (CITR)[1] is a tax relief launched in 2002 to encourage corporate and institutional investment into responsible finance providers for the purpose of on-lending to SMEs and social enterprises that are located in disadvantaged communities and are unable to access mainstream finance.

1.2 CITR is an important tool for responsible finance providers to attract new private investment for onward lending. To date over £100 million has been raised through CITR, which has facilitated more than £100 million of onward lending.

About EFG

1.3 The Enterprise Finance Guarantee Scheme (EFG)[2] is a policy guarantee programme that incentivises investment into small and micro businesses that would otherwise likely find it difficult to access finance due to lack of security. It is a useful tool for the responsible finance sector to extend reach into underserved SME markets.

1.4 To date EFG has stimulated an additional £42 million in responsible finance lending to SMEs, and £2.7 billion in total lending to businesses that may otherwise be viewed as higher risk.

Using CITR and EFG together

1.5 A body accredited by the Department for Business, Energy and Industrial Strategy (BEIS) for CITR is able to raise 'qualifying investment' from companies and individuals. Investors are granted a tax relief of 25% on these investments (spread over 5 years) on income or corporation tax for individual and companies respectively. The tax relief is only payable to the investors whilst the body remains accredited under the programme.

1.6 In order to maintain accreditation any accredited body needs to onward lend a proportion of the money raised using CITR in relevant investments (an average of 75% from the end of year three onwards) into 'qualifying enterprises'.[3] This means in practice that they must onward lend the money raised to enterprises based in or serving disadvantaged communities.

1.7 If an accredited body fails to maintain the required onward lending levels then BEIS withdraws the accreditation and from that point investors cannot claim further tax relief. In reality an investor is likely to require repayment of the investment if a responsible finance provider loses accreditation.

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[1] https://www.gov.uk/government/publications/community-investment-tax-relief-citr/community-investment-tax-relief-citr

[2] http://british-business-bank.co.uk/ourpartners/enterprise-finance-guarantee/

[3] SI2003/96 Regulation 8 states that within one year of the date that an accredited body raises CITR investment, at least 25% of the CDFI's 'investment fund' must have been invested in 'relevant investments' in 'qualifying enterprises'. Within two years at least 50% of the investment fund must have been so invested. Within three years at least 75% of the investment fund must have been so invested. For Year 4 and subsequent years the CDFI must ensure that an average of at least 75% of its investment fund must be invested in relevant investments in qualifying enterprises.

1.8 Responsible finance providers have long looked at the possibility of using EFG and CITR together. **CITR provides the investor a return (thus making capital available more cheaply to the CDFI) but it does little to cover the risk of the investment. Using CITR in conjunction with a guarantee mechanism would provide some protection against risk and may encourage greater investment in the sector.**

1.9 There is a clause in the regulations which Government has previously interpreted as not allowing EFG and CITR to work together. The clause in the regulations which determines that guaranteed investment are not relevant investments is set out below.

> *"Any investment which benefits directly or indirectly from the security offered by a Phoenix Fund Guarantee or by any similar publicly-funded underwriting or guarantee arrangement' is not classed as a relevant investment"*[4]

1.10 It is worth noting that guidance relating to the EFG programme has suggested that accredited bodies could use EFG for 25% of the investment raised using CITR and still meet the 75% onward lending requirement. However, this is unlikely to work in practice as the accredited body will have repayments being made against many of their portfolio of 'relevant investments'. If they had guaranteed (using EFG) 25% of the loans made from their CITR fund, they would need to maintain a 100% average of onward lending against the remainder. This would not be practical.

1.11 However, if it were recognised that EFG is not similar to the Phoenix Fund, it would follow that a responsible finance provider is able to use EFG on loans and still count these as 'relevant investments'. In practice this would remove the barrier to EFG and CITR being used together. There is a strong argument that EFG is sufficiently different to the Phoenix Fund Guarantee for it not to be captured by the above clause. This is on the basis of the objectives and structure of the different guarantees.

1.12 The Phoenix Fund Guarantee was designed to cover a responsible finance provider's whole loan portfolio. There was no cap on claims across the portfolio (although the performance of a responsible finance provider was assessed if its default rate exceeded 40%). This guarantee was specifically designed to cover only the responsible finance sector.

1.13 On the other hand, EFG has been used by a much wider variety of SME lenders (not just responsible finance providers) and is also used by banks. It is materially different to the Phoenix Fund Guarantee in that there is a cap on the liabilities for Government. As such it only covers a proportion of the portfolio. Also lenders do not use it across all of their SME lending.

1.14 It is worth noting that, elsewhere in the regulations, there are clauses prohibiting the use of mechanisms which provide protection against the risk of an investment in relation to 'qualifying investments' (investments into a responsible finance provider which attract CITR). There is an exception in where these mechanisms are used in everyday banking. EFG has historically been allowed in this circumstance as it is used by the banking sector.

1.15 Any State aid issues would also need to be addressed were EFG and CITR were used together. Both EFG and CITR come under the de minimis block exemption. As such it would be the responsibility of the CDFI to ensure that the recipient of any aid was informed as such. If both programmes were working together then the accumulated aid would need to be calculated and communicated to the beneficiary business.

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[4] *The Community Investment Tax Relief (Accreditation of Community Development Finance Institutions) Regulations 2003 (SI2003/96)* as amended by *The Community Investment Tax Relief (Accreditation of Community Development Finance Institutions) (Amendment) Regulations 2008 (SI2008/383)*

1.16 Therefore, **we recommend that the Government recognises that EFG is not similar to the Phoenix Fund, and changes the regulation to reflect this**. This would enable EFG to be used on CITR investments, therefore providing a suite of tools that both provide a return and cover risk, which would incentivise greater investment into the responsible finance sector. At a time when the availability of first loss funding is diminishing, this would be catalytic in continuing to grow the sector and its social and economic impacts.

1.17 The table below outlines the costs and benefits to the Exchequer of using CITR and EFG together. As can be seen there is a net benefit to the Government, and the cost per job for the Government is good value for money.

1.18 Table 1: Cost benefit analysis of using CITR and EFG together

Assumptions	
Investment raised through CITR annually	£10 million
Average loan size	£27,600
Average cost for job created	£11,185
Average cost for job safeguarded	£10,100
Costs	
Overall cost to the Exchequer for CITR	£2.5 million
Overall cost to the Exchequer for using EFG on CITR portfolio (20% portfolio cap)	Maximum of £2 million (£1.52 million after fee is repaid)
Total Cost to the Exchequer	**£4.02 million**
Cost to Government per job supported	£2,116
Benefits	
Total jobs supported	1,900
Businesses supported	360
Economic impact of jobs and businesses supported	**£70.3 million**
Net benefit to Exchequer	**£66.27 million**

2. Guarantee EU facilities (such as Easi, Cosme, ERDF funding)

Current EU funding

2.1 The Chancellor of the Exchequer guaranteed that key projects supporting economic development across the United Kingdom which are dependent on European Union funding would continue to receive funding after the UK exits the EU.

2.2 Regional funds through the British Business Bank (such as the Northern Powerhouse and the Midlands Engine Investment Funds) plan to utilise future LEP JEREMIE 2 allocations, and a loan from the European Investment Bank. In the Northern Powerhouse Investment Fund at least £300 million was expected to be funded by JEREMIE 2 allocations, and £50 million as a loan from the European Investment Bank. Given their local reach, consortia of responsible finance providers are bidding to deliver the microfinance allocation of these funds to businesses that cannot otherwise access finance.

2.3 ERDF and ESF allocations to access to finance. Responsible finance providers access these funds both directly and through their LEPs and on-lend it to viable micro businesses and SMEs that otherwise cannot access finance. ERDF and ESF funding allocated to access to finance accounts for over 10% of new funding secured by responsible finance providers each year. Over the past 5 years responsible finance providers have secured over £30 million of ERDF and ESF funding to on-lend to new and growing businesses in their local economies.

2.4 Responsible finance providers access EU instruments that incentivise commercial investment into the sector. Loan guarantee facilities available through the European Investment Fund such as EaSI and COSME guarantee a portion of responsible finance providers' portfolios against potential losses, giving commercial funders the security to invest. Currently these guarantees are being used to structure a 3-year £75 million fund with a commercial UK bank. At least 3 responsible finance providers are currently applying for accreditation for these guarantees.

2.5 **Responsible Finance proposes that EU funding support for the responsible finance sector be replaced following the UK's exit from the EU. This includes:**

- **the microfinance allocation of JEREMIE2 funding**
- **ERDF and ESF allocations to access to finance**
- **EaSI and COSME guarantee structures**

2.6 The funding and guarantees play a critical role supporting innovative growth in the responsible finance sector, which by extension supports businesses, social enterprises and individuals who will otherwise become financially excluded once the UK exits from the EU and loses access to European schemes.

3. Responsible finance fund

3.1 Under-capitalisation of the responsible finance sector in the UK has long been identified as a significant constraint to growth. **The creation of a dedicated responsible finance fund of £150 million –** would complement the measures in recommendations 1 and 2, and unlock significant private sector investment (typical leverage is 1:3, which would equal a total of £600m). In the United States, the government invests $200 million annually into the CDFI Fund. The CDFI Fund has been an important force in allowing CDFIs to operate sustainably by providing them with equity and is cited as one of the major milestones in achieving their $45 billion loan book. In 2015, CDFIs benefitting from the programme financed over 12,300 businesses and provided more than 35,000 individuals with financial literacy training.[5] The CDFI Fund also manages guarantee programmes, technical assistance to CDFIs, capacity building trainings, and tax relief programmes.

3.2 The Regional Growth Fund (RGF)[6], launched in 2010, distributed £60 million through responsible finance providers. A £30 million fund from the Department for Business, Innovation and Skills was combined with £30 million in private investment from banks (Unity Trust Bank and the Co-operative Bank), targeted at the micro and small segment of the market that struggles the most to access finance, and for which this finance has a disproportionate impact, not to mention the benefit to the local economy.

[5] CDFI Fund, https://www.cdfifund.gov/Documents/CDFI_Brochure%20Updated%20Jan2016.pdf
[6] Regional Growth Fund, https://www.gov.uk/guidance/understanding-the-regional-growth-fund

3.3 To date, the programme has surpassed its own targets on a number of KPIs. As of the end of 2015, £57 million had been disbursed to 1,850 microbusinesses and SMEs. This has created 1,191 full time jobs, and saved a further 7,060. The resulting cost per job to the government is £3,459, which is 7% of the total cost per job across the entire RGF programme.[7] The businesses and jobs created and saved through this programme have added £400 million to the local economies in which they are located. 90% of the fund has been disbursed to businesses outside of London: nearly 40% has been distributed to the West Midlands, and a further 35% to the Northern Powerhouse region (North East, North West, Yorkshire and the Humber), driving business investment to rebalance the economy. 100% of the nearly 2,000 businesses supported had been previously declined by a bank, and a large proportion have been high growth, as evidenced by the number of new jobs created.

3.4 As evidenced by the KPIs, this was a very effective intervention by the government that was also good value for money, that and improved the landscape for access to finance for those businesses that experience the greatest difficulties. However, no new rounds of RGF were announced in the 2015 Spending Review. A dedicated £150 million responsible finance fund could replace and build on the success of RGF. Together with CITR, EFG, and European instruments, this package of support could foster a healthy and sustainable responsible finance sector that bridges the gap in access to finance.

[7] House of Commons Library Regional Growth Fund, 2015, http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN05874#fullreport