10th July 2020

BEIS Committee Post-Pandemic Economic Growth Super Inquiry

About Responsible Finance

Responsible Finance is the trade body for Community Development Finance Institutions (CDFIs). CDFIs offer loans and support to viable micro, small and medium sized enterprises (SMEs) in deprived and underserved communities across the whole of the UK which are unable to access bank loans or other sources of finance. Without CDFIs, these businesses would be unable to access finance and would likely fail or be unable to grow and create jobs.

CDFIs protect and create jobs in communities and businesses which have fallen through the cracks, boost productivity, foster inclusive growth and inspire and facilitate enterprise creation. They are key strategic partners for the Government and the British Business Bank, delivering both the essential Start Up Loan scheme, as well as the Northern Powerhouse, Midlands Engine and Cornwall and Isles of Scilly Investment Funds, which each address structural regional imbalances through their expertise and specialised nature.

Responsible Finance's mission is to support the development of a thriving and sustainable responsible finance sector that provides finance for underserved communities and, as a result, contributes to their increasing economic growth and prosperity.

About our submission

Seventeen CDFIs are accredited to deliver the Government's Coronavirus Business Interruption Loan Scheme (CBILS), therefore our submission will focus on the CBILS and the role that CDFIs can play in the UK's economic recovery.

As of the 6th July 2020, CDFIs had lent over £24 million through CBILS to almost 400 SMEs, protecting over 3,000 jobs. Because CBILS is a guarantee scheme, CDFIs require access to low-cost capital in order to continue to lend through the scheme to SMEs which have fallen between the cracks. Their specialist knowledge and triaging support will be critical as small businesses will likely face several waves of economic hardship over the coming months (such as the end of the furlough scheme and resuming VAT payments), and the sector is preparing for how to support businesses during these crunches so that furloughed workers remain employed.

There is a persistent issue with the messaging around CBILS. Given its name as a loan scheme, it has been difficult to communicate to small businesses that it is a Government-backed guarantee, rather than direct Government money. As such, CDFIs and other non-bank lenders are not able to lend at their full potential due to restricted access to capital.

We have developed a policy proposal that would allow the Government, through Community Development Finance Institutions, to: protect and create jobs in communities and businesses which have fallen through the cracks; boost productivity; foster inclusive growth and inspire and facilitate enterprise creation. This will put the UK securely on a path to recovery whilst at the same time 'levelling up' the communities and regions of the UK:

- **£100 million CDFI fund to allow CDFIs to continue to step-up their lending to support small businesses on the route to recovery.**
  CDFIs and non-bank lenders are not on a level playing field with banks as they do not have access to the same low-cost capital. If left uncorrected, this unlevel playing field risks damaging the long-term sustainability of the non-bank finance sector, and creating a less

diverse financial services ecosystem. By unlocking £100 million in funding for the CDFI sector, the Government could protect 13,000 UK jobs[1]. Because the businesses CDFIs lend to are located in the more deprived areas of the country, these jobs retained have a multiplier effect on sustaining the local economy.

Mainstream banks find it difficult and costly to adequately assess the risk of small businesses that have a thin credit history or a limited trading track record. Many therefore do not have the risk appetite to lend unsecured on flexible terms to businesses which lack sufficient collateral. A long-term solution for channelling funding into the CDFI sector is through partnering with the mainstream banks. However, at this stage an incentive from government is the most effective way of compelling the banks to partner with CDFIs.

Consultation response

1. **What core/guiding principles should the Government adopt/prioritise in its recovery package, and why?**

   The Government must prioritise a fundamental change in our economy which focuses on:

   - The environment and creating a just transition
   - Supporting businesses, preventing unemployment and stimulating the creation of new jobs
   - Fostering inclusive growth and 'levelling up' pockets of deprivation across the UK
   - Boosting productivity
   - Facilitating and inspiring enterprise creation

2. **How can the Government borrow and/or invest to help the UK deliver on these principles?**
   Addressed in a later question below.

3. **What measures and support will businesses need to rebuild consumer confidence and stimulate growth that is sustainable, both economically and environmentally?**

   We believe a campaign highlighting the incredible resilience of the UK's entrepreneurs and the importance of SMEs as a force for social good would be beneficial, alongside encouraging people to buy British and local, whilst thinking globally.

   The Government should also devise more focused business networks with advisers that are sector specific, to build and share knowledge and experience between businesses and entrepreneurs on how to recover and stimulate sustainable business growth. They should also encourage SMEs to invest in themselves, particularly in digitisation.

4. **Whether the government should give a higher priority to environmental goals in future support?**

   We strongly believe that the Government should prioritise environmental goals in future support.

   CDFIs are well placed to support the Government in reducing carbon emissions. The phase out of high-carbon sectors must not leave workers and communities behind. It should promote local regeneration in affected communities and invest in reskilling for workers, and ensure that the transition delivers positive effects for communities. CDFIs help this by creating decent

[1] Figure based on job outcomes from previous CDFI funding programmes.

jobs and thriving businesses in deprived areas. This stimulates local economic activity, tackles inequality, and promotes inclusive growth.

A recent example of this was Pure Haus, a Leeds-based ecological housebuilder which needed a funding lifeline to continue building one of the few UK developments in which all the homes will meet the strict 'Passivhaus' standard. When a larger funding facility vital to the work was delayed because of the Coronavirus crisis, the entire project was put at risk. CDFI Business Enterprise Fund was able to step-in to provide the company with a Coronavirus Business Interruption loan.

There are hundreds of community projects, sustainable businesses and social enterprises across the UK making a positive environmental impact which would not exist without community development finance institutions. Some CDFIs also have dedicated funds for community energy projects which enable communities to build successful renewable energy schemes.

CDFIs have a track record of measuring the impacts of their lending, including environmental impacts, for example in the delivery of the Midlands Engine Investment Fund. Because of this they are well placed to deliver Government funding to SMEs to support and track environmental goals.

CDFIs are also well-placed to transfer knowledge on reducing organisational environmental impact to their investees because of their person-centred approach to lending. Some CDFIs already offer impact discounting on loan interest for SMEs which agree to adopt measures to reduce their carbon footprint, or for SMEs who are borrowing for environmental initiatives.

5. **Whether the Government should prioritise certain sectors within its recovery package, and if so, what criteria should it use when making such decisions? What conditions, if any, should it attach to future support? n/a**

6. **How can the Government best retain key skills and reskill and upskill the UK workforce to support the recovery and sustainable growth? n/a**

7. **Is the Industrial Strategy still a relevant and appropriate vehicle through which to deliver post pandemic growth? n/a**

8. **How should regional and local government in England, (including the role of powerhouses, LEPs and growth hubs, mayoralties, and councils) be reformed and better equipped to deliver growth locally?**

It is crucial that regional and local Governments, including LEPs, growth hubs, mayoralties and councils, are given sufficient devolved spending to deliver growth locally. As institutions set up to respond to local ecosystems, they are best placed to assess where to invest and must be given the spending power to be able to do so.

A viable business idea may fail because the entrepreneur has a lack of business experience and does not have the right advice and support in place to compensate for this. This means that businesses often do not have the resilience to survive the first two critical years. In addition, a perception that loan funding support is hard to obtain, poor signposting to sources of support, and a perception that an entrepreneur could 'lose everything' if a venture fails also act as barriers to starting and growing a business in the UK.

It is estimated that around one in ten SMEs (9.3%) across the UK can be classified as a 'discouraged' borrower, which amounts to half a million SMEs[2]. The British Business Bank also reported that the share of SMEs willing to use finance to grow and develop fell sharply from 45% to less than 30% in 2019[3].

Discouragement varies according to a range of factors: it is highest amongst micro businesses compared to larger SMEs; it is found across England but was highest in London (12.9%) and geographical areas on the periphery – the North West (13.2%) and the South West (9.5%); and is substantially higher among growth oriented SMEs (12.4%) than non-growth oriented SMEs (5.2%); and differs between different ownership groups[4].

To help offset this discouragement, in addition to being sufficiently resourced, we believe Growth Hubs should have grants available to be delivered alongside a panel of businesses advisers, mentors and coaching support. These mentors should be former business owners and entrepreneurs.

It is crucial that local business networks and ecosystems work in synergy with one another towards a common goal, with a combined plan for their area focusing on each of their strengths. The ecosystem is currently a little siloed therefore work to address this will strengthen ecosystems and equip areas better to deliver growth locally. As standard, CDFIs provide business mentoring and support to their investees.

This must also apply to Scotland, Wales and Northern Ireland. There must be parity of support in the devolved nations.

9. **What opportunities does this provide to reset the economy to drive forward progress on broader Government priorities, including (but not limited to) Net Zero, the UK outside of the EU and the 'levelling up' agenda? What should the Government do to ensure that delivering on these priorities does not exacerbate the vulnerability of businesses, consumers and communities/workers that have been impacted by COVID-19?**

The COVID-19 pandemic is an opportunity for a fundamental change in attitude to growth and what constitutes a successful economy. Our response to this question will focus on the 'levelling up' agenda as we have addressed the environmental agenda in question four.

SMEs and microbusinesses are instrumental to the UK's recovery from the Covid-19 crisis, therefore they need fit-for-purpose and accessible financial services shaped by positive policies which value CDFIs. CDFIs prevent and reduce unemployment by supporting businesses which have fallen through the cracks, fostering inclusive growth, boosting productivity and facilitating enterprise creation.

- **Supporting businesses, preventing unemployment and creating new jobs:**
  CDFIs are social enterprises which lend to businesses which 'fall between the cracks' and are unable to secure finance from banks and other lenders. In 2019, CDFIs lent £78 million to 4,200 businesses, creating over 3,000 new businesses, 6,000 new jobs and protecting over 2,000. 93% of the viable businesses CDFIs lent to were previously declined by a mainstream

[2] Brown R., Linares-Zegarra J., Wilson J. (2018) An empirical examination of discouraged borrowers in the UK. Enterprise Research Centre.
[3] British Business Bank (2020) Small Business Finance Markets.
[4] Department for Business, Energy & Industrial Strategy (2017) Longitudinal Small Business Survey.

bank[5]. If CDFIs had access to additional appropriate, low-cost capital, they could scale this impact up.

There are very few lenders outside of the CDFI space which would consider supporting the borrower profile that CDFIs serve, and those that do charge prohibitive rates of interest, so if a CDFI doesn't step in then the business will likely fail. In doing so they offer a vital funding lifeline, protecting existing jobs and creating new jobs.

Mainstream banks find it difficult and costly to adequately assess the risk of small businesses that have a thin credit history or a limited trading track record. Many therefore do not have the risk appetite to lend unsecured on flexible terms to businesses which lack sufficient collateral. This is supported by data: 75% of SME applicants for finance were successful but rejection rates were higher for loans (37%), first time applicants (31%) and micro businesses (30%) in the 18 months to Q4 2019, which represented an increase in rejection rates from 18 months to Q2 2018. Most of those declined said that it had some adverse impact on their business (69%), typically not being able to expand or improve the business as they would have wanted[6].

CDFIs are able to lend to these businesses because of their flexible, person-centred approach, and more in-depth rational processes for assessing business loan applications. They can unravel a business's situation to arrive at a 'yes' where a bank's automated credit systems have said no. This is possible because of their highly skilled and committed staff, which mitigates the risk of lending to these businesses but is a higher cost to serve model. Despite this additional analysis, CDFIs are charging less loan interest than a number of alternative SME lenders which are accredited under CBILS. This is because CDFIs are not-for-private-profit organisations, and are therefore motivated by their mission to support local economies, rather than maximising profit from their lending. Any profits they do make are reinvested back into the CDFI to support more businesses.

After the 2008 financial crisis, banks retreated from lending to the SME market; reducing lending by £151 billion between 2008 and 2011[7]. Prior to the COVID-19 pandemic, given both latent and nascent demand for finance from SMEs, several studies have put the scale of the gap in access to finance as over £1 billion. Without incentives such as CBILS and the Bounce Back Loan scheme banks will again retreat from the small business market. When this does happen, the UK's pipeline of investible businesses could be strengthened by making bank-referral platforms fit for purpose. At the moment bank referral platforms generally refer customers to inappropriate and very high cost lending solutions as these pay the platforms the most commission.

- **Fostering inclusive growth:** CDFIs target businesses located in higher areas of deprivation or in underserved communities across the UK, and those which will make a significant employment impact. 59% of CDFI loans are made to businesses located in the UK's 35% most disadvantaged areas, 42% are made to women-led businesses and 15% are made to Black, Asian and Minority Ethnic-led businesses. CDFIs' commitment to tackling the climate

[5] Responsible Finance, The Industry in 2019
[6] BVA BDRC SME Finance Monitor (2020) Q4 2019.
[7] Henry, N. & Craig, P. (2013) Mind the Finance Gap: Evidencing Demand for Community Finance

emergency and reducing the UK's carbon footprint through investing into innovative and sustainable businesses also helps to revitalise and grow left-behind places.

- **Boosting productivity:** Business investment is 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[8].

  Following the Covid-19 crisis, catalysing productivity growth will be key to the economic recovery. This will be driven by investment, and making sure that investment is put to work. SMEs should be actively encouraged to invest in themselves. Productivity enhancing improvements put forward in McKinsey's report include digitisation, commercial excellence, talent management, planning for the future, leadership and operational efficiency. These improvements require investment in people, business development and organisational capacity.

  Data from prior to the COVID-19 crisis, including the SME finance monitor, shows that permanent nonborrowers 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.

  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]. But the influx of alternative online lenders has not proved to boost productivity. CDFIs are the only lenders which are actively targeting the gap in access to finance with fair and affordable products. They also provide advice, support and confidence building which enables businesses to make decisions that increase their productivity.

- **Facilitating and inspiring enterprise creation:** CDFIs deliver the Government's Start-Up Loan scheme. They have seen an uplift in demand in recent weeks as people begin to think about their aspirations after lockdown. CDFIs provide support alongside finance, helping the unemployed transition into meaningful employment. In the UK there is a poverty issue which stifles innovation and entrepreneurship amongst those who are on benefits or left behind by the economy. The benefits system does not enable people to try out business ideas and withdraw if they do not work and try again. It prevents people saving up to start a business, so that those who do manage to start have no back up funds to cope with set-backs. It perpetuates precarious lifestyles which make it extremely hard for people at the bottom of the pile to start up and succeed, and means most funders except CDFIs will not lend to them.

  The Government must also put more value on microbusinesses, and in particular sole traders. These entrepreneurs create bottom-up economic development which is needed now more than ever. Flexible, local, small businesses which are rooted in their communities, use local

[8] Civitas (2018) Closing the Finance Gap.
[9] British Business Bank (2020) Small Business Finance Markets 2019/20.

suppliers and products, and retain profits for local benefit, are crucial to the UK's economic recovery. They revitalise deprived areas and level up disadvantaged communities.

Enabling CDFIs to access low-cost capital will bolster the sector's growth and enable the UK to recover from the crisis in an inclusive way; by lending to disadvantaged and underserved entrepreneurs which otherwise wouldn't be able to access finance.

Pre-emptive, forward looking and long-term policies will be most effective as we look towards our recovery from the COVID-19 pandemic. The CDFI sector needs access to £100 million of low-cost funding to enable it to continue its CBILS lending and step-up its support for SMEs through the recovery.

10. **What lessons should the Government learn from the pandemic about actions required to improve the UK's resilience to future external shocks (including – but not limited to – health, financial, domestic and global supply chains and climate crises)?**

Our resilience to future problems is tied to addressing the inequalities that exist in society. Data has revealed that the rate of deaths involving Covid-19 is approximately twice as high in the most deprived areas of England and Wales compared to the least deprived.

Whilst 94% of CDFI loans in 2019 were made outside London and the South East, CDFIs target pockets of deprivation that exist all over the UK. Because of their focus on building regional economies, CDFIs particularly target businesses located in higher areas of deprivation, and those which will make significant employment impact. The sector has a strong presence across the regions, including in the Northwest, Yorkshire and the Humber and West Midlands.

Protecting and enhancing the resilience of the UK's businesses is an essential lesson for the future, and access to appropriate and affordable finance is a key factor in SME resilience. The Government must do more to encourage investment in micro and small businesses across the UK which are otherwise unable to access funding. It should act now to strengthen the CDFI sector so it can support more viable businesses to build their resilience for the future.

11. **What opportunities exist for the UK economy post Brexit and the pandemic for export growth? n/a**

12. **What role might Government play as a shareholder or investor in businesses post-pandemic and how this should be governed, actioned and held to account? n/a**