Responsible Finance response: BEIS Commons Select Committee Inquiry into regional investment and growth

17th May 2019

The Business, Energy and Industrial Strategy Committee has launched an inquiry into business investment and growth in all parts of the UK, beyond areas of heavy investment such as London and the South East. It will be examining the Government support available for businesses and how best to attract inward investment to parts of the country with lower productivity.

The BEIS Committee has published correspondence from the Department for Business, Energy and Industrial Strategy, showing a breakdown of regional funding from the British Business Bank, which aims to increase the supply of finance to smaller businesses. Figures show how in the year to October 2018, companies in London received 54% more finance than those in the North West region, despite the capital's population being just 15% higher.

The UK has a long-standing productivity problem, exacerbated by wide disparities in productivity between regions in the UK. While labour productivity is above the national average in London and the South East, the regions of the North of England and the Midlands have productivity levels between 7% to 15% below the UK average.

The inquiry will be examining the barriers to establishing new businesses, the role of regional bodies in promoting growth and how areas are prioritised for Local Industrial Strategies.

About Responsible Finance

Responsible Finance is the trade body for responsible finance providers (also known as community development finance institutions (CDFIs)). Responsible finance providers offer loans and support to SMEs and consumers who find it difficult to access finance from commercial banks.

Responsible Finance's mission is to support the development of a thriving and sustainable responsible finance industry that provides finance for underserved communities and, as a result, contributes to their increasing economic growth and prosperity. Responsible finance providers are a critical source of finance that helps businesses contribute to employment and job creation, including in some of the most deprived parts of the UK. In 2018, responsible finance providers lent £85 million to 5,310 small business, creating 4,490 new businesses and creating and saving 10,370 jobs. 84% of viable SMEs lent to by a responsible finance provider had previously been turned down by a mainstream bank.

About our submission

Given Responsible Finance's area of expertise, our submission will focus on the funding needs of small businesses across the UK. There must be a focus on improving access to alternative forms of finance at the local level, such as through responsible finance providers, so that businesses in all regions of the UK, at all sizes and stages can access the finance they need to grow and enhance their productivity.

Recommendations

1) **To design effective solutions to meet the needs of businesses across the country, we recommend the creation of a £150 million responsible finance fund.**

A responsible finance fund is needed to properly address under-capitalisation of the responsible finance sector, which is a significant constraint on growth. The creation of a dedicated responsible finance fund of £150 million would unlock significant private sector investment and scale the responsible finance sector's impact on excluded and underserved communities. The United States Government invests $200 million annually into its CDFI Fund. The Fund is essential to allowing US CDFIs to operate sustainably by providing them with equity and first loss capital.

Ensuring finance markets work well is vital to the success and growth of small businesses. Government interventions aiming to address the barriers of access to finance should recognise and promote the responsible finance sector as an important part of a diverse and locally based supply side. This will help ensure that all segments of the SME market are able to access the finance they need.

Regional Growth Fund as a precedent for a wider responsible finance fund

The Regional Growth Fund (RGF) programme aims to increase access to finance for small businesses after the financial crisis. £30 million was allocated to the responsible finance sector, matched by £30 million from Unity Trust and the Co-operative banks. By 31st December 2018, this fund of £60 million, delivered through responsible finance providers, had supported over 2,450 businesses and created or saved over 10,500 jobs, easily meeting the targets set by the Government. 91% of the fund was 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 £2,837, compared to the programme average of £37,400. The Government cost per job will continue to fall as responsible finance providers recycle repaid capital into new loans, representing good value for the Government.

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 do not feel confident or are unable to engage in mainstream finance.

RGF has demonstrated success in scaling the sector to meet the gap in finance that still persists nearly a decade after the financial crisis, and is a blueprint for a wider sector fund that is expanded to include more responsible finance delivery partners throughout England, Wales, Northern Ireland and Scotland. This will catalyse higher levels of commercial investment and allow responsible lenders to scale their impact. At the end of this submission we have included a case study on the organisational benefits that the RGF fund has brought to one of our members, The Key Fund.

2) **We recommend that the Shared Prosperity Fund channels funding through a diverse range of innovative, local third sector and private organisations in addition to larger players.**

The new fund should not be biased to favour delivery partners based on their capacity to deal with large administrative burdens. Accessible, grass-roots organisations such as responsible finance providers are most suited to deliver interventions on the ground.

In addition, the fund must replace EU facilities which incentivise commercial investment into the responsible finance sector and facilitate business support activities, namely EaSI, COSME and ERDF.

Evidence

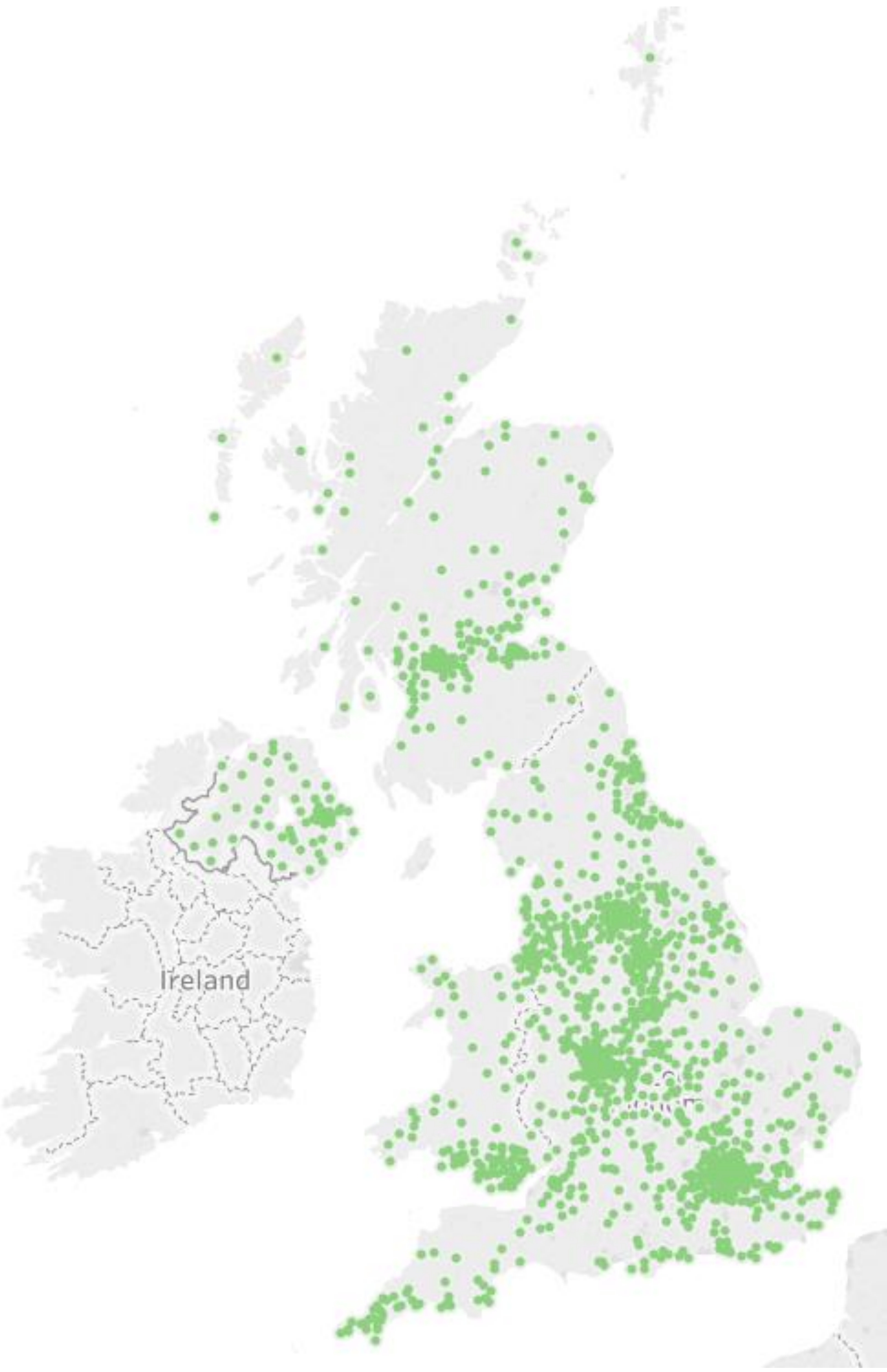
Diversity in the provision of small business finance at the local level is key to increasing access and improving the appropriateness of the finance[1]. The current economic uncertainty highlights the need to ensure that small businesses in all regions have access to appropriate finance to enable them to contribute to economic growth. Responsible finance providers are a key part of this.

The small business finance market across the UK is varied, and in many parts there are considerable challenges. Access to finance at the local level varies considerably, and the British Business Bank's 'Benefits of Diverse Smaller Business Finance Markets' report shows 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[2].

Regional imbalances in business finance hamper the ability of businesses to grow, recruit and innovate. Latest figures from the BDRC's SME Finance Monitor showed that half of SMEs met the definition of a permanent non-borrower, meaning they are also less likely to be innovative or have growth plans. This is reflected in the declining proportion of SMEs that have innovated; 40% in 2012 to 33% in 2018[3].

In its most recent annual report, the BDRC's SME Finance Monitor found that SMEs in London had the most above average indicators for current and future performance, whilst the North East had the most below average indicators[4]. Similarly, the British Business Bank's latest small business finance report found that almost half of equity deals are in London, despite it only accounting for around 20% of high-growth firms[5].

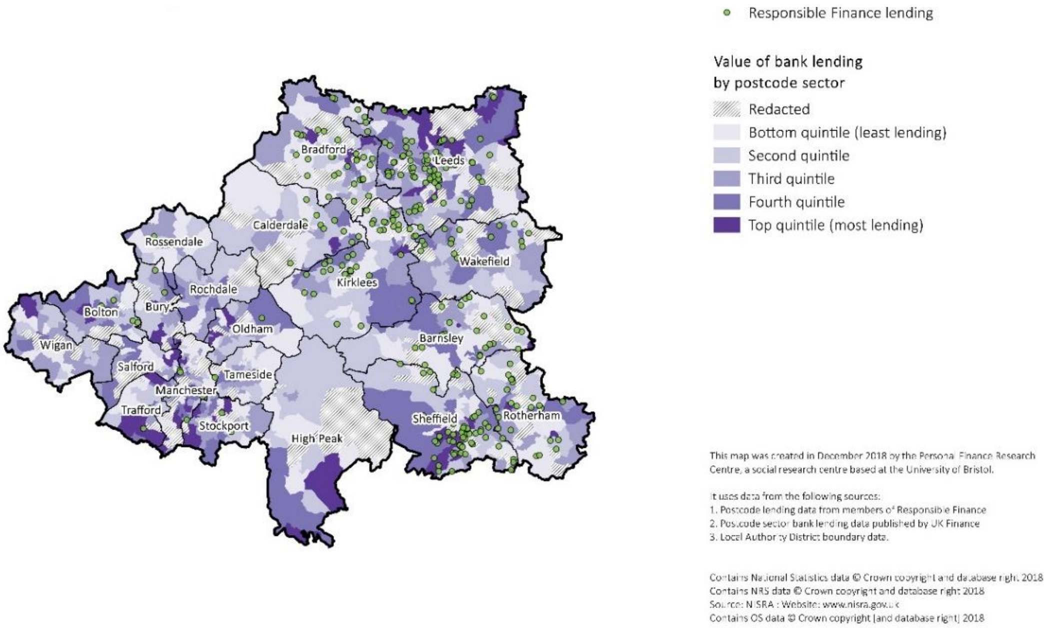
The map below shows the location of business and social enterprise loans made by responsible finance providers throughout 2017 and 2018. As you can see, their local knowledge and spread allows them to target businesses the length and breadth of the UK.



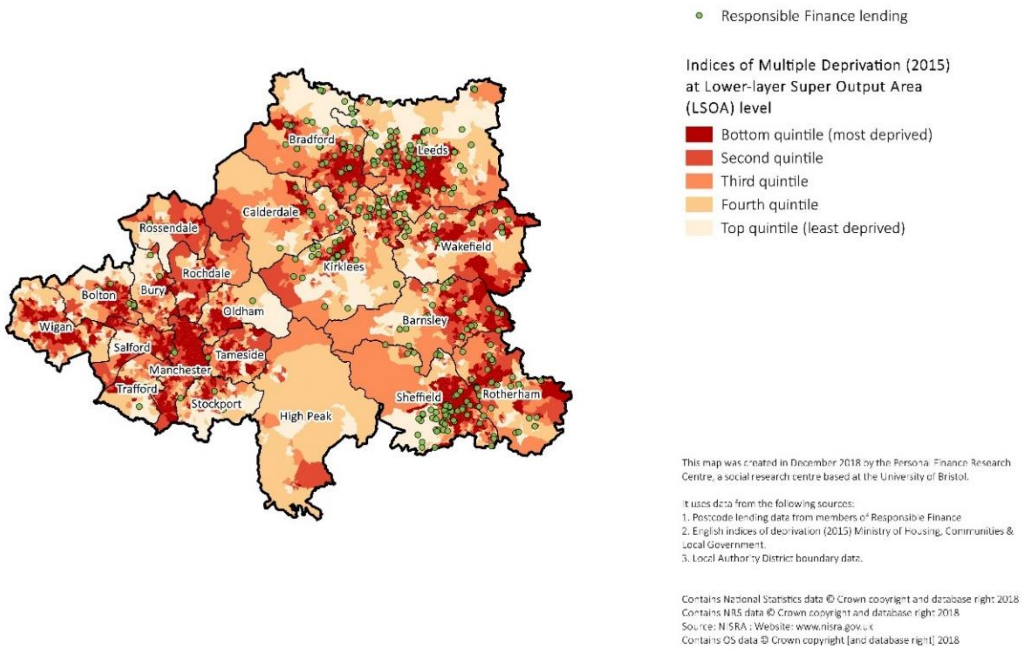
Over time, the debate around SMEs and external finance has moved from issues around access to finance to demand, and the extent to which appropriate forms of funding are available to businesses looking to grow and invest. Despite this, last year 84% of the viable businesses lent to by responsible finance providers had previously been turned down by a mainstream bank[6], highlighting the fact that access is still an issue for a large minority of small business owners.

Responsible finance providers have a flexible approach in determining the viability of a business and a different risk appetite to banks which allows them to lend to businesses who are otherwise excluded. In 2018, responsible finance business lending data was mapped by the Personal Finance Research Centre at the University of Bristol alongside bank SME lending data and geographies of deprivation in the Northern Powerhouse region[7]. These maps demonstrate that responsible finance loans are made in areas where there is less bank lending and higher levels of deprivation.

Business lending by responsible finance providers in the Northern Powerhouse in 2018 compared with bank SME lending.



Business lending by responsible finance providers in the Northern Powerhouse in 2018 mapped by local area deprivation.



Consultation questions

1. What is the role of the Government in addressing regional disparities for businesses across the UK? Does the devolution of powers, including City and Region Deals, the Northern Powerhouse, and Midlands Engine, provide LEPs and other bodies with the tools they need to deal with the issue?

Small or medium sized businesses account for 99.9% of all private sector businesses, and 60% of all private sector employment in the UK is in SMEs[8]; they are the engine of the UK economy. The Government has a leading role to play in addressing regional disparities for businesses across the UK by ensuring more small businesses can access appropriate, affordable finance when they need it.

The Northern Powerhouse Investment Fund and the Midlands Engine Investment Fund are both important components of regional devolution. Six responsible finance providers deliver the microfinance portion of both funds, demonstrating the effectiveness of the industry in reaching underserved and hard to reach businesses and unlocking local economic growth.

We believe that the focus for funding delivery should be local rather than purely regional or national, therefore the devolution of powers should include a wider range of smaller organisations, which can deliver funding on the ground to SMEs across the UK.

There is an inequality of opportunity in Wales compared to England in terms of the funding options that are available to CDFIs. In Wales, the Welsh Government created the Development Bank for Wales in 2017 as a national financial institution that would give businesses the support they need. This has left little room for smaller, independent organisations to lead at the community level, and has therefore stifled innovation and competition. No funding opportunities or access to wholesale finance for growth are available for responsible finance providers in Wales so they have to rely on their own capital and liquidity resources. Despite this, in 2018 responsible finance providers in Wales invested £1.7 million in 250 businesses, creating 224 new businesses and 226 new jobs. The UK and Welsh Governments must work together to address this issue.

2. Are there barriers to new businesses being established in less-productive areas? How does clustering affect other businesses in that region, for example: are Catapult Centres widening or limiting investment in their local areas?

Access to finance is a key component for businesses across industrial sectors when starting-up, and restricted access to finance is a key limiting factor for businesses being established in less-productive areas. The Start-Up Loans Company is essential for this, and it should extend its reach so an increasing number of small, local delivery partners can deliver start-up funding.

3. Are businesses outside of cities able to access finance and attract investment? How has existing support from EU structural funds supported regional growth? Will new Government measures, such as the Stronger Towns Fund and Shared Prosperity Fund, provide effective support for growth in these areas?

The impact that Brexit will have on small business finance is unclear at the current time, so the Government must equip local organisations to be ready to respond to economic developments.

A recent report on Brexit's impact on British industry found that Brexit will widen the UK's North South divide. The 10 slowest growing locations in Q4 2020 will be dominated by locations outside the South East, with the bottom five comprising of Sunderland, Wolverhampton, Hull, Middlesbrough, and Derby[9].

Responsible finance providers utilise EU facilities which incentivise commercial investment into the sector and facilitate business support activities, namely EaSI, COSME and ERDF. In addition, both the Northern Powerhouse Investment Fund and Midlands Engine Investment fund use funding from European sources.

In Wales, the delivery of EU Structural Funding was moved away from a multiplicity of funded interventions towards larger and more strategic models of delivery. This meant that many third sector organisations were consigned to delivery roles, or no role at all, as opposed to being project leads or partners. This inaccessibility has deprived communities across Wales the use of the funding in more diverse and innovative ways. Despite Wales receiving a large amount of EU money, this has done little to address the regional disparities and it has been the only UK nation to see an increase in child poverty[10].

The Shared Prosperity Fund must be designed to be flexible and accessible to ensure funding is channelled through the organisations that are most suited to deliver tailored, front-line interventions. It should involve a diversity of third sector and private organisations in order to create a thriving supply side, rather than simply continuing to channel funding through the organisations who have the best resources to deal with large amounts of administration.

Brexit is an opportunity for this support to be streamlined and for the Government to remove the excessive bureaucracy, which can stifle innovation and assumes a 'one-size-fits-all' approach. Instead, interventions should be targeted through those best suited to grass-roots delivery. It must emphasise co-production of activities that build resilience and foster growth in the most deprived communities in the UK.

4. How does the mobility of businesses to relocate within the UK and overseas affect their investment in local areas? Should local and national Government be seeking to reduce business relocation?

No comment.

5. Is the Government prioritising the right areas for early Local Industrial Strategies? Will the Strategies enable areas to tackle productivity and growth disparities within regions?

The Government's Local Industrial Strategies are welcome and it is vital that they foster greater local collaboration and co-production in order to boost UK productivity in all areas, especially when guiding the use of local funding streams.

Productivity is the main driver of earnings differences over time and between places, and its weak growth has been the key factor in stagnating earnings since the financial crisis[11]. Many parts of the UK are locked out of opportunities to access good jobs. Inclusive growth is about reducing poverty through the creation of better jobs and better access to those jobs for people in or at risk of poverty.

Of the three trailblazer areas - Greater Manchester, the Oxford-Milton Keynes-Cambridge Corridor, and the West Midlands – PwC's 'Good Growth for Cities 2018' reported Oxford, Milton Keynes, Manchester, Birmingham and Coventry as some of the highest ranking and most improved cities in the Demos-PwC Good Growth Index, 2015-2017[12].

There is a danger that the early focus on these already flourishing areas could increase regional inequality. Therefore, the Government must realise its ambition for every place in England to have a local industrial strategy in place to ensure that slower growth areas do not drift further behind due to lack of economic investment and opportunity.

Case study

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.

The Key Fund has 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 has 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 recurred significant (over £10 million) of new capital to support its 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.

[1] British Business Bank (2019) Small business finance report 2018/19, https://www.british-business-bank.co.uk/wp-content/uploads/2019/02/British_Business_Bank_Small-Business-Finance-Report-2019_v3.pdf
[2] British Business Bank (2019) Small business finance report 2018/19, https://www.british-business-bank.co.uk/wp-content/uploads/2019/02/British_Business_Bank_Small-Business-Finance-Report-2019_v3.pdf
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[6] Responsible Finance, The Industry in 2018, https://responsiblefinance.org.uk/policy-research/annual-industry-report/
[7] Using Responsible Finance lending data, UK Finance bank lending data, and the 2015 English Indices of Multiple Deprivation.
[8] The Federation of Small Businesses, 2018, UK Small Business Statistics, https://www.fsb.org.uk/media-centre/small-business-statistics
[9] Centre for Economics and Business (2019) Brexit and the impact on British Industry, commissioned by Irwin Mitchell, https://www.irwinmitchell.com/medialibrary/Files/uk-powerhouse/uk-powerhouse-q4-2018/uk-powerhouse-report-may-2019.pdf?la=en
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