Responsible Finance

Autumn Statement representation

21st September 2018

About Responsible Finance

Responsible Finance is the trade body for responsible finance providers (also known as community development finance institutions (CDFIs)). Responsible finance providers promote prosperity and address inequality by empowering people to take control of their financial futures. They offer 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. Responsible finance providers play an essential role in ensuring people can access useful and affordable financial services. Access to finance is access to opportunity, and consumers who struggle to borrow from mainstream lenders will also struggle to climb out of disadvantage.

Personal and homeowner lending sector

The Money Advice Service (MAS) has estimated that 8.3 million people are over-indebted in the UK, and 22% of UK adults have less than £100 in savings, making them highly vulnerable to a financial shock such as job loss or unexpected bills[i]. 8 million people (12% of the population) rely on high cost credit to pay essential household bills[ii]. They will frequently turn to alternative forms of finance to make ends meet, such as high cost payday lenders or illegal loan sharks[iii]. The median amount of outstanding consumer debt on rent-to-own, home-collected credit and catalogue credit all more than doubled between 2014 and 2016. In addition, cuts to welfare, stagnant wages and economic instability over the past decade have exacerbated the precarious position of many in the UK. Personal lending responsible finance providers can help to fill this gap and save individuals from falling in to the hands of exploitative payday loan and rent-to-own firms.

The National Audit Office has estimated that the minimum annual cost to the public purse of problem debt (due to its direct impact on a person's likelihood to experience anxiety or depression or be in state-subsidised housing) is £248million. The cost to the economy as a whole is estimated to be around £900 million a year (for example due to lost productivity or increased crime).[iv]

British households continue to need access to finance as tough economic conditions force people to continue borrowing to make ends meet. In addition, traditional lenders in this area, such as Provident, are moving to higher income and less risky groups and not catering for the non-prime personal market. While the demise of Wonga is welcome, its many customers now face a bleak choice about where else they can access credit.

The responsible finance industry is committed to supporting this segment of the market, often providing wraparound services to promote financial wellbeing and literacy and encourage saving. At a time when lending decisions are increasingly made by algorithms, responsible finance providers offer a personalised service; they reach those who feel left behind and give them the opportunity to achieve their goals. Access to affordable credit and financial capability support has a positive impact on reducing poverty, it improves economic growth as well as health and well-being and ultimately has a positive impact on building wealth in low income communities to tackle inequality.

One of the main aims of the Financial Conduct Authority (FCA) is to oversee a sustainable credit market that gives consumers access to the services they need while protecting them from harmful practices. The FCA recognises responsible finance providers as an alternative to the harmful lending practices prevalent in the high-cost short term credit market. However these organisations need investment and support if they are to scale to meet market needs.

Business and Social Enterprise lending sector

Access to finance is a key component for businesses across industrial sectors when making strategic decisions, and restricted access to finance is a key limiting factor for businesses seeking to expand in the UK. 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[v].

The recent British Business Bank report 'Small Business Finance Markets 2017/18' noted that although traditional banks are still the predominant source of finance, demand for bank finance is stagnating. In fact, bank lending to SMEs as a proportion of all bank lending has decreased by a third in the past thirty years[vi]. The BDRC Continental SME Finance Monitor from Q4 2017 found that only 41% of applicants applying for finance were confident their bank would lend to them if they applied. This figure is down from 55% in Q2. Almost half of SMEs met the definition of a permanent non-borrower in 2017[vii], whereas the percentage of non-borrowers was 34% of all SMEs in 2012[viii]. This increase is a concerning development for the outlook of growth and productivity in the SME sector as permanent non-borrowers are less likely to grow, innovate, and make a profit than those who use external finance[ix]. Actual success rates for first time loan or overdraft applicants has also declined to 50%; down from 60% for applications in the 18 months to Q4 2015[x]. There is anecdotal evidence from businesses across the UK that banks are retreating and client relationship managers disappearing from their areas. UK Finance data shows that the outstanding balance of loans and overdrafts to small businesses by major lenders fell by 6.9% to £87.2bn across the country between the final quarters of 2015 and 2017. It found specifically that small business lending in Huddersfield, for example, has fallen by 27.5% in just two years.[xi].

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. This means they are not filling the finance gap for the businesses that cannot or are discouraged from seeking bank finance. There is a distinct lack of competition at the higher risk segment of the business finance market. A new market of online lenders can potentially lend to these underserved businesses, but as the market is unregulated there is little transparency on pricing and terms.

This is contributing to the UK having “one of the lowest proportions of micro enterprises that grow to more than 10 employees in three years” in OECD countries[xii]. The British Business Bank report highlighted strong evidence that scale-ups in the UK need more long-term patient capital throughout all stages of development. Whilst many businesses start small, they may have ambition and potential to grow.

All this suggests that the process of navigating finance options, applying, and facing rejection is a major barrier to businesses that could make investment to scale up and grow. The Federation of Small Businesses (FSB) has recognised this problem and is lobbying the regional governments of the UK for measures to be taken to improve the lending environment for small businesses[xiii].

There needs to be a focus on both improving access to alternative forms of finance such as responsible finance providers and creating a thriving supply and advice side. This will enable businesses at all sizes, risk profiles and stages of growth to access the finance they need. As a viable alternative to mainstream banks for credit, responsible finance providers are the only lenders that are actively targeting the gap in access to finance with fair and affordable products.

The impact of the responsible finance sector

Our monitoring of the responsible finance sector indicates that in 2017 responsible finance providers:

- Lent £235 million to 60,000 people, businesses, and social enterprises;
- Financed 5,000 businesses and 350 social enterprises;
- Enabled the creation of 6,000 jobs and protected another 2,000 that were at risk.
- Helped 4,000 new businesses and social enterprises start up, adding £0.25 billion back to the economy.
- For every £1 responsible finance providers lend, they generate £7 in economic value.

10 years on from the financial crisis, responsible finance providers are more critical than ever in supporting local economic growth and financial resilience. The UK is still feeling the effects of banks withdrawing investment and physical presence from large parts of the market, and trust in the system remains at a low. Our financial services system underpins the economy, so a flawed system prevents businesses from starting up and growing, and households from accessing credit and other banking services to effectively manage their money. This has real implications for economic growth, especially in those communities that face long-term underinvestment and deprivation.

Responsible Finance calls on the Government to support a financial services system that allows everyone access to the services and products they need for economic inclusion and prosperity. This includes supporting responsible finance providers focused on serving ‘underserved’ markets by providing resources and incentives to encourage investment, appropriate regulation and the replacement of EU funding and facilities.

As the UK prepares to leave the EU, it must plan for the financial services of the future: a system that is competitive, diverse, inclusive, and underpins a fairer society.

The responsible finance sector has made strides 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 that the Government considers the following good value for money proposals in the Autumn Statement:

1. Funding

i. Launch a sector fund

ii. Launch a fund for personal lenders

iii. Replace EU funding and instruments

2. Fit for purpose tax reliefs and guarantees

i. Launch a tax relief or guarantee for personal lenders

3. Proportionate regulation

i. FCA Regulatory Fees

ii. Greater transparency and regulation around affordability in the business lending sector

Recommendations

1. Funding

i. Launch a fund for the sector

1.1 A Responsible Finance Fund is needed to properly address under-capitalisation of the responsible finance sector that 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 sector's impact on excluded and underserved communities. The United States Government invests $200 million annually into its CDFI Fund[xiv]. The Fund has been an important force in allowing US CDFIs to operate sustainably by providing them with equity and first loss capital; itis cited as one of the major milestones in achieving their $45 billion loan book.

1.2 In 2017, the US CDFI fund was given $248 million funding from the U.S. congress. It awarded organizations more than $472 million in financial assistance, loans, and bond guarantees, and $7 billion in New Markets Tax Credits (NMTCs). The funding has leveraged billions of dollars in private sector investment, enhancing the impact that community-based development organisations are having across the nation by expanding access to credit and capital. It's 2017 year in review impact report showed that in 1997 there were 196 certified CDFIs. This increased to 1,095 by the end of 2017[xv].

1.3 The Government launched a series of programmes targeted at underserved areas of the market following the financial crisis including the Regional Growth Fund (RGF), Start Up Loans Company and Big Society Capital. These programmes targeted businesses unable to access mainstream or alternative finance – such as start-ups microbusinesses, businesses outside of London and social enterprises – through locally-based financial intermediaries such as responsible finance providers. These programmes have increased access and availability of finance, however they have not gone far enough to bridge the gap which persists in certain industrial sectors and market segments.

1.4 The Regional Growth Fund (RGF)[xvi] aimed to increase access to finance for small businesses after the financial crisis and allocated £30 million to the responsible finance sector. Matched by £30 million from Unity Trust and the Co-operative Banks, the £60 million of RGF delivered through responsible finance providers supported over 2,000 businesses and created or saved 8,000 jobs, easily meeting the targets set by the fund. 95% of the fund was lent outside of London into sectors that provide goods and services to local economies or support local supply chains. The cost per job supported was £3,500, compared to the programme average of £37,400. However, RGF was a one-off fund, as no new rounds have been announced since 2015.

1.5 The Regional Growth Fund (RGF) has demonstrated success in scaling the sector to meet the gap in finance that persists nearly a decade after the financial crisis. It is a precedent for a responsible finance fund. The RGF model is a blueprint for a wider sector fund that can catalyse higher levels of commercial investment and scale the sector's impact.

1.6 Responsible finance providers supported firms across a range of industries through the RGF programme – including manufacturing, clean energy, engineering, software and retail – all of which would otherwise not have had access to the finance they needed to succeed. The fund was successful because it was delivered through responsible finance providers – a sector specifically focused on underserved markets.

1.7 This type of targeted, good value for money and high-impact initiative is necessary to drive growth in small-scale ventures that feel unconfident or unwilling to engage in mainstream finance. Government interventions aiming to address the barriers of access to finance to drive business growth should recognise and promote the responsible finance sector. This will help ensure that all segments of the SME market are able to access the finance they need.

ii. Invest in access to affordable credit

1.8 Responsible Finance is calling for a dedicated strand of funding from the Dormant Accounts Fund to be allocated to affordable lenders, including personal lending responsible finance providers. This will ensure the sector has the capacity and capital to expand its reach and impact. Like international models, a critical role of the fund will be to catalyse commercial investment into the sector, creating a public-private partnership. A strong affordable alternative market to high cost credit will build wealth, help move people out of poverty and reduce inequality of opportunity. The cost to the government of achieving these outcomes would be a fraction of the cost for other programmes. See Appendix 1 for the positive impact of other centralised funds.

1.9 The supply of capital to the personal lending responsible finance sector has been start-stop, hindering continuous scale up. The only capital currently available to the sector is social investment which does not enable scale. Social investment is a debt, therefore there is a limit to how much responsible finance providers can borrow, it is short term, the cost of capital is high, and it takes a long time to secure.

1.10 Personal lending responsible finance providers have small marketing budgets compared to commercial lenders therefore often struggle to compete in attracting customers. Responsible finance provider Five Lamps spent £41,000 on marketing in 2017; in 2012 the five largest payday lenders collectively spent £36.3 million in the year on marketing. In addition to this, and to competing on the cost of borrowing, responsible finance providers must also compete with commercial lenders on the customer experience including high speed lending decisions, online and mobile friendly interfaces and back office systems that can handle high volumes of applications. This infrastructure requires significant investment.

1.11 An injection of capital to strengthen the balance sheets of responsible finance providers would enable them to access commercial finance. This is larger scale, longer term and more appropriately priced than social investment. Responsible finance providers could use this capital to raise investment individually or collectively for wholesale funding. A stronger balance sheet also has impact in terms of providing more free cash to invest into systems, infrastructure, marketing campaigns and personnel, which tackles the route to market challenge. Given the sector's track record, we estimate that a £50 million fund allocated in this way could stimulate approximately £1 billion in lending over 10 years to support the financial capability of low income and vulnerable consumers. This capital could take the following forms:

- *Equity*: Equity would increase the value of the assets on a responsible finance provider's balance sheet. Investors look at a responsible finance provider's debt to equity ratio which indicates whether the organisation can repay any new debt they take on. Many responsible finance providers are operating at their maximum debt to equity ratios, so an injection of equity into the sector would unlock access to additional investment.

- *Grant*: Depending on their legal structure some responsible finance providers cannot use equity. For them certain grants can help to build their balance sheet in the same way. However, grants often come with restrictions around how they can be used (e.g. restrictions on eligible activities, leverage ratios, timeframe, specific measurable outcomes). If the grant is unrestricted then it would enable the same flexibility as equity and be used towards strengthening the balance sheet and leveraging in capital to on-lend.

iii. Replace EU funding and instruments

1.12 The Chancellor guaranteed that key projects supporting economic development across the country which are dependent upon European Union funding would continue to receive funding. It is important that EU facilities which incentivise commercial investment into the responsible finance sector, namely EaSI, COSME and ERDF, are replaced. Since the EU referendum in 2016 applications from UK responsible finance providers to use these guarantees have been declined.

1.13 Up until 2017, funding from EU instruments represented 10% of new capital secured each year for responsible finance providers to on-lend to small businesses. In 2016, this was £7.1 million. In 2017 this dropped to £550,000, or 1% of total funding secured by responsible finance providers.

1.14 The loan guarantee facilities that were available through the European Investment Fund, such as EaSI and COSME, guaranteed a portion of responsible finance providers' portfolios against potential losses. This gave commercial funders the security to invest. Responsible finance providers who have had their applications for the EaSI guarantee declined are unable to use the instrument to cover risk when leveraging in private investment.

1.15 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

1.16 The funding and guarantees played a critical role supporting innovative growth in the responsible finance sector, which by extension supported businesses, social enterprises and individuals who will otherwise become financially excluded.

2. Fit for purpose tax reliefs and guarantees

Launch a guarantee and/or a tax relief for the personal lending sector

2.1 Launching a guarantee scheme or tax relief for the personal lending sector would enable greater investment into responsible finance providers that are competing head on with high cost credit providers.

2.2 A **guarantee mechanism** is a sustainable way to cover the risk of bad debt in the long term for the sector. Given that responsible finance providers serve a higher risk market, the potential losses prevent commercial investors from investing. Using their assets to cover losses from bad debt erodes responsible finance providers' reserves and weakens their balance sheets over time (which then impacts on the scale of investment they can leverage in). It would also preserve any capital injection from the Government, so this could continue being used for lending and leveraging. Guarantees cover a pre-defined proportion of potential losses and therefore de-risk an investment. Appendix 2 contains an overview of the guarantee mechanisms that have been used by the responsible finance sector lending to businesses. These guarantees are currently not available to personal lenders to use.

2.3 A **tax relief** is another part of a suite of policy tools that can improve an investment proposition for investors. As with the guarantee it can be used on an ongoing basis, thus enabling sustainable fundraising for the sector over the long-term. When used together with a guarantee it improves the risk-return for the investor. As tax reliefs improve the return an investor gets, it can also be used to offset the cost of capital for the investee. Appendix 3 contains an overview of the Community Investment Tax Relief (CITR), available only to the responsible finance sector lending to businesses. Using guarantees and tax reliefs not only improves the proposition for commercial investors, but also opens up a new market for high net worth individuals and savers wishing to generate both a social and financial return.

2.4 Table 1: Cost benefit analysis of introducing a personal lenders tax relief

Assumptions	
Investment raised annually through a personal lenders tax relief	£5 million
Average loan size	£569
Average cost per number given financial capability support/advice	£1,188
Average amount saved compared to a high cost lender per loan	£263.97
Costs	
Total cost to the Exchequer (25% over 5 years)	£1.25 million
Benefits	
Total number of individuals supported	**8,786**
Amount deposited in savings accounts	**£680,272**
Amount saved compared to a high cost lender	**£2.3 million**

2.5 Using tax reliefs not only improves the proposition for commercial investors, but also opens up a new market for high net worth individuals and savers wishing to generate both a social and financial return.

3. Proportionate regulation

i. FCA Fees

3.1 The responsible finance industry is regulated by the Financial Conduct Authority (FCA) and therefore is compliant with the FCA's rules and regulations that protect consumers and promote competition. However, the FCA's rules and fees are designed for large scale financial institutions and hamper the type of diversity in the system that would lead to greater access; and small firms like responsible finance providers have increased regulatory and reporting requirements. Proportionate and fit-for-purpose regulation would enable responsible small providers to grow and innovate.

ii. Greater transparency and regulation in the business lending sector

3.2 Currently the business finance sector is unregulated and there is a wide range of different practices amongst lenders, therefore there are very few protections in place for businesses. The precedent for these conditions is the consumer credit market prior to 2013. With only light touch regulation by the Office of Fair Trading (OFT) there was an influx of new entrants into the market and many, like Wonga, were viewed as innovative 'Fintech' firms. Without enforced regulation, consumer credit firms developed practices and pricing that maximised profit for lenders at the cost of the consumer. From debt management firms to brokers to lenders, firms were opaque within their terms and conditions so that hidden fees and charges could not be challenged. There was poor practice around affordability checks so consumers were extended loans they could not repay and would ultimately need to roll over, and debt collection verged on predatory. Significant consumer detriment was caused by this 'wild west' market. The government and the FCA intervened in 2013 and are still establishing policies six years on to create a fairer and more transparent market.

3.3 There is a risk that without regulation, similar trends could occur in the business lending market, and there are indications that some already are. There is evidence of little transparency around pricing and a lack of affordability checks. This can ultimately have a catastrophic effect on the small business market which is the engine of the UK economy.

3.4 Looking at business lenders' websites, very few have representative examples. The table below demonstrates the variation in information presented.

3.5 Table 2: Example of the variation in information presented on business lender's websites

	iwoca	**Capital On Tap (business credit card)**	**Funding Circle**
Representative example on website?	Yes	No	Yes
Monthly Advertised Rate	2%-6% per month	0.79%-4.94% per month	N/A
Current Annual Rate Range	40% per annum (fixed)	N/A	1.9%- 21.9% per annum
Maximum Term	12 months	N/A	60 months
Maximum amount	£200,000	£50,000	£1,000,000
Fees?	No fees	No upfront, monthly or annual fees.	1.5%-6% arrangement fee, up to 15% missed payment fees, up to 15% default fees

Table correct according to company websites as at 18/09/2018.

3.6 Although it is difficult to make a judgement on what is 'high cost' for businesses given the range of products, business' working capital needs and risk profiles, what is certain is that critical information is not presented consistently and therefore businesses cannot make informed borrowing decisions.

3.7 There is also evidence that affordability checks are not regularly conducted, and businesses are sold products with repayment terms that are not feasible for them. This means that a business may be offered a loan with a repayment schedule that is not compatible with its cash flow and therefore it would not be able to afford repayments.

3.8 Together these issues mean that businesses are not choosing the right product and are entering into unaffordable contracts. Then there is the additional risk that in an unregulated market, lenders can get away with extortionate interest rates and hidden fees as well as not exercising fair practice when a business encounters difficulty repaying; these are all trends occurred in the consumer lending market that could be latent in the business lending market. As business loans are term loans, the extent of detriment to businesses may not be realised until several years from now.

3.9 For responsible finance providers transparency and affordability are central tenants to responsible lending. Part of treating customers fairly is ensuring that before taking out a loan the customer understands the cost and terms and how that will impact on their personal and/or business' finances. Responsible finance providers will not lend to a customer if debt and its associated costs will make the customer worse off or not improve their business' trajectory. Responsible finance providers such as ART Business Loans and Let's Do Business Group display the full cost of borrowing to their customers upfront.

3.10 The current conditions in the business lending market creates a strong case for investigating transparency and affordability, and introducing regulation that mirrors the FCA's regulation of consumer credit. While industry codes and standards can have a positive impact, there are so many segments of the business lending market that there is not a single industry body that encompasses them all and enforces such standards. The implementation of the CMA's Retail Banking Order has already proven ineffective by exempting peer-to-peer lenders and not monitoring compliance in a systematic way. To rectify existing detriment caused and prevent future poor practice Responsible Finance calls for the FCA to regulate the business lending market alongside the consumer credit market.

3.11 Although it is critical to ensuring a fair and customer-centric market, regulation will have an effect on the supply of finance; not only will regulation restrict certain lending, there is evidence that firms become more risk averse. For example, when the FCA introduced the payday lending cap 800,000 consumers immediately lost access to credit. Now as it is looking to further intervene in other high cost markets the FCA is working with the responsible finance sector to understand how it can fill the gap. Any regulation in the business lending sector should take into account how to support ethical lenders such as responsible finance providers to fill the supply side gap that will emerge from regulation. For this reason, Responsible Finance calls for a £150 million responsible finance fund that will enable the responsible finance sector to scale up and mitigate a further gap in access to finance. As small businesses are the backbone of the UK economy it is crucial that they have access to responsible products and support that will enable them to grow and prosper.

Appendix 1 – The positive impact of other centralized funds

The personal lending responsible finance sector has largely been excluded from government initiatives since the DWP Growth Fund. This is reflected by the relative flatline in lending, roughly £20 million per year. Despite this, the personal lending sector has still reached significant milestones including:

1. Accessing commercial investment;
2. Being at the forefront of securing social investment;
3. Investing in back office loan decision systems to enable online lending and national coverage;
4. Participating in innovative partnership projects to benefit from economies of scale.

Dedicated funding for the personal lending responsible finance sector through the Dormant Account Funds would provide a pathway to scale for personal lending responsible finance providers. Dedicated sector funds in other markets and countries have demonstrated success in achieving good value for money. The summaries below examine the structure and impact of a sample of dedicated funds.

- **DWP Growth Fund**: The DWP Growth Fund drove early growth in the personal lending responsible finance sector. In addition to the positive impact on access to affordable credit for consumers, it helped credit unions and responsible finance providers to increase their lending by 200% during the programme. The revenue element of the fund also acknowledged that lending to the financially vulnerable segment of the market is more expensive, and the cost of risk is a contributor to the overall cost of credit for consumers. The impact of the DWP Growth Fund continues today as many responsible finance providers continue to recycle their Growth Fund capital into new loans for consumers.

- **RGF:** the RGF programme was an effective mechanism for enterprise lending responsible finance providers delivering funds and economic opportunity to businesses across England that could not access mainstream finance. The grant element served multiple purposes: it covered risk and therefore leveraged in a commercial match, and it lowered the overall cost of capital for the bank finance. As a result, the sector increased its lending and impact by over 340% in three years.

- Outside of the UK, **the CDFI Fund in the United States** was launched in 1994 and offers a number of financial and technical assistance programmes to CDFIs. The CDFI Fund has an annual budget of $200 million which it distributes through a range of grants, loans, equity, tax reliefs, and technical assistance programmes. The Fund has been an important force in enabling US CDFIs to operate sustainably by providing them with equity and first loss capital; it is cited as one of the major drivers in achieving their $45 billion loan book. On a per capita basis the fund is a relatively small public sector commitment, but has a catalytic effect in helping the sector raise commercial finance and scale.

- In **Australia**, the government committed 63.4 million AUD (£40 million) over five years to the microfinance sector[xvii]. This commitment includes an allocation to micro loan programmes, support for programmes aimed at building financial literacy, and to a broader financial inclusion strategy. This budget commitment has garnered private sector investment and participation in the country's financial inclusion plans.

Appendix 2 – Guarantee mechanisms

The following guarantee mechanisms provided by the UK government have been used by responsible finance providers lending to small businesses. Because of the rules around eligible activities they are/were not available to responsible finance providers lending to consumers. Currently only EFG is active. 15 of the 37 EFG accredited lenders are responsible finance providers. In total responsible finance providers have guaranteed over £100 million of loans since 2008. This represents 3% of total EFG usage.

- **Enterprise Finance Guarantee** *(EFG)*: SFLG (below) adapted into EFG in 2009. Managed by the British Business Bank (BBB), it guarantees loans from banks and other lenders to small viable businesses that are struggling to secure finance because they do not have adequate security. Eligible loans are between £1,000 and £1.2 million, with a term of 3 months to 10 years. EFG guarantees 75% of individual loans, across 20% of a lender's total EFG portfolio (leading to a net overall liability to Government of 15%). The business pays a premium of 2% to BBB for the lender to guarantee their loan using EFG.

- **Enterprise Finance Guarantee – Wholesale**: Until the EFG review in 2016, there was a wholesale EFG option. This guaranteed up to 15% of an investor's investment into a lender. It was only used on two occasions while it was available (both times by responsible finance providers). This option has been suspended since the 2016 review.

- **Small Firms Loan Guarantee** (SFLG): In operation from 1981 until 2009. Guaranteed loans from banks and other financial institutions for small firms that tried and failed to secure a conventional loan because of lack of security. Eligible loans were £5,000 - £100,000 (£250,000 if the business had been trading for 2+ years) on 2 to 10 year terms. SFLG guaranteed 75% of the loan, with no portfolio cap[xviii].

- **Phoenix Fund Guarantee**: Part of the Phoenix Fund, which was announced in 1999, designed to encourage entrepreneurship in disadvantaged areas. The Phoenix Fund Guarantee was only available to responsible finance providers and covered 100% of the loan capital and interest due[xix].

The following guarantee mechanisms were available through the European Investment Fund (EIF) to responsible finance providers lending to small businesses. Since the EU referendum in 2016 applications from UK responsible finance providers to use these guarantees have been declined.

- **EPMF – Progress Microfinance**: Ran from 2010-2013. Loan and guarantee products for eligible intermediaries to enhance their capacity of providing microcredit. Guarantee solely available for microenterprises, with a maximum loan size of 25,000 euros. The guarantee covered up to 75% of an individual loan with a portfolio cap of up to 20%[xx].

- **EaSI**: Launched in 2015, this guarantee is targeted at eligible intermediaries for providing microcredit to microenterprises and social enterprises. Eligible loans are 25,000 euros for microenterprises and 500,000 euros for social enterprises. The guarantee covers 80% of an individual loan, up to a maximum of 30% of the total portfolio[xxi].

- **COSME**: Launched in 2015, this guarantee is targeted at eligible intermediaries lending to SMEs. The guarantee covers 50% of individual loans, up to a net 10% portfolio cover[xxii]

Other guarantee examples for personal lenders:

- **Eligible Loan Deductions Scheme** (ELDS)[xxiii]: the only active form of a guarantee for personal lenders in the UK. Lenders can apply to DWP to recover the balance of a defaulting loan from clients receiving benefit payments. The payment to the lender is withdrawn from a consumer's benefit payments. This scheme is not widely used by the responsible finance sector given the affordability challenges it would create for consumers already facing financial difficulty to reduce benefit income.

Appendix 3 – Community Investment Tax Relief

About CITR

The **Community Investment Tax Relief** (CITR) scheme encourages investment in disadvantaged communities by giving tax relief to investors who back businesses and other enterprises in less advantaged areas by investing in accredited responsible finance provider. Because of the rules on eligible investments, it cannot be used by personal lending responsible finance providers.

The tax relief is available to individuals and companies and is worth up to 25% of the value of the investment. The relief is spread over 5 years (5% claimable each year).

The objectives of CITR are:

- To stimulate private investment into disadvantaged communities
- To support a thriving responsible finance sector

The CITR scheme is jointly run by HMRC and the Department for Business, Energy & Industrial Strategy (BEIS). BEIS is responsible for accreditation of new responsible finance providers and the ongoing management of the scheme. HMRC oversees the relief and can advise the investor where CITR is claimable and, if necessary, where no relief is due.

There are currently 33 accredited responsible finance providers that can take on CITR investment.

To date it is estimated that £145 million in private investment has been raised by the sector using CITR.

Who can invest

Unlike other tax reliefs, CITR is a versatile scheme, enabling a range of different kinds of investment from various investor groups:

- Individuals
- Banks
- Other corporations

Responsible finance providers can raise CITR investment for on-lending through:

- Loans which can be investments from banks, corporations and individuals.
- Equity investment raised through the sale of shares. Accredited responsible finance providers that have a community benefit legal structure (formerly called IPS) have raised money through the issue of shares. Individuals and corporations can purchase shares and benefit from CITR.
- Deposit accounts Accredited responsible finance providers that offer bank accounts can offer CITR.
- Securities Investors can purchase securities offered by accredited responsible finance providers. The rules around securities are similar to those which govern the issue of shares.

Return

The tax relief provides the equivalent of up to 5% of their total investment off of their annual tax bill. For individual investors the effective annual return ranges from 6.2% to 9.1% based on the individual's tax rate. For corporates the effective annual return is 6.2%.

Some accredited responsible finance providers provide an additional return on top of the tax relief; others do not. Some investors will be motivated by the additional return that the 5% relief provides on their investment. For some investors this additional return will be the tipping point for making the investment and compensate them for the risk they are taking with the investment. Other investors will claim partial relief and reduce the cost of capital charged to the responsible finance provider. For example if the investor normally expects a 7% rate of return, given that 5% is returned through CITR they may choose to rebate 3% of the relief to the responsible finance provider. This means the responsible finance provider effectively pays 2%.

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[i] Money Advice Service (2018) Mapping the unmet demand for debt advice in the UK, https://masassets.blob.core.windows.net/cms/files/000/001/064/original/Mapping_the_unmet_demand_for_debt_advice_in_the_UK.pdf
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