APPG for Financial Markets and Services: Levelling up and the role of financial services

Responsible Finance Response

About Responsible Finance

Responsible Finance is the industry body for the UK's Community Development Finance Institutions (CDFIs). CDFIs are community lenders which offer affordable finance on fair terms to businesses, social enterprises and people unable to access it elsewhere. They lent nearly £230m in 2021, a 32% increase on the year before.

"By providing finance for underserved customer groups, CDFIs increase the number of viable borrowers who access finance, facilitate enterprise creation, contribute to levelling up and remedy underrepresentation in SME finance. CDFIs also address the gap identified in evidence for this inquiry of a lack of support for small businesses, as the majority of CDFIs provide mentoring and support to improve SME outcomes and aid their growth; CDFIs provided nearly 40,000 hours of support to SMEs in 2020."

- "Scale-up to Level-up", APPG on Fair Business Banking, September 2021.

Consultation questions

1. **Which of the Levelling Up White Paper's focus areas and missions do you feel are of most relevance for your organisation or financial services organisations you work with in particular, and the financial services sector in general?**

Living Standards: Small and Medium Sized Enterprise (SME) Finance

A key mission identified by the Levelling Up White Paper is to:

"Boost productivity, pay, jobs and living standards by growing the private sector, especially in those places where they are lagging." Page 159

A significant part of the report explains the role that finance, and in particular access to business finance, plays in supporting investment. However, it goes on to state that access to finance is not uniform across the country:

"There are sharp differences in access to financial capital across different parts of the UK, with financial activity concentrated in relatively few areas." Page 66

The report concludes that improving access to finance for small and medium sized businesses is key to boosting economic activity in areas where it is lagging:

"Finance is crucial to private sector growth, but is a constraint for some companies, especially SMEs. Many promising SMEs fail or do not grow because they cannot access finance. As Chapter 1 discussed, these challenges are felt disproportionately by firms outside the Greater South East." Page 160

The report notes that the British Business Bank believes that there is an annual regional funding gap for SMEs of around £4bn (page 66). The report notes that policy interventions recently announced by the Government (such as the next generation of Regional Funds and the additional funding for the Regional Angels fund) are a step in the right direction, but are relatively modest compared to the scale of the problem. The report therefore recommends that more needs to be done to improve access to finance for small businesses:

"Notwithstanding this progress, COVID-19 and structural trends will continue to pose a challenge to SME finance outside London and the South East. HM Treasury (HMT), the Department of Business, Energy and Industrial Strategy (BEIS) and the Department for Levelling Up, Housing and Communities (DLUHC) will work with the Levelling Up Advisory Council to further explore options for unlocking capital for SMEs." Page 161

Responsible Finance's own analysis suggests that between £1bn and £2bn of the gap identified by the British Business Bank is theoretically bankable, but goes unfunded each year.

It is the mission statement of Community Development Finance Institutions (CDFIs) to improve SME access to finance in areas where it is more difficult to obtain.

Responsible Finance, as the industry body for CDFIs, encourages HMT, BEIS, DLUHC and the Levelling-Up Advisory Council to follow the report's recommendation to explore how institutions, such as CDFIs, can do more to reduce regional disparities in access to finance, and improve borrowing outcomes. We stand ready to help.

2. Are there any other areas of focus where you feel financial services can support levelling up?

In addition to the regional disparities in access to finance which were noted in the Levelling Up White Paper, there are also a number of demographic inequalities which contribute to unfairness and a significant loss of economic output. These include access to finance for:

- **Women-led businesses:** as the Alison Rose Review has highlighted there are up to 1 million missing women-led businesses, and that unequal access to finance is the principal reason for this gap[1]. This deprives the country of up to 10% of GDP (around £250bn per year). Women-led businesses are twice as likely to be declined for bank finance (due to many factors) compared to those run by men.
- **BAME-led businesses**: as recent reports by Aston University[2] and the British Business Bank[3] have pointed out, BAME entrepreneurs are significantly underrepresented in the SME community. Approximately 13% of the population has a BAME ethnicity, but only 6% of businesses are led by BAME entrepreneurs. This suggests a missing 400,000 BAME-led businesses with an economic cost of up to £75bn each year. Discouragement from applying for finance and over twice the rate of rejection for bank finance are cited as major reasons for the shortfall in BAME entrepreneurs.

[1] https://www.natwestgroup.com/news/2022/02/nwg-rose-review-reports-third-year-of-progress.html
[2] https://www.natwestgroup.com/news/2022/05/advancing-the-growth-potential-of-uks-ethnic-minority-businesses.html
[3] https://www.british-business-bank.co.uk/research/small-business-finance-markets-report-2022/

CDFIs play a small but growing role in helping to level up these groups. In an average year:

- 35% of CDFI lending goes to women-led businesses which make up around 16% of SMEs
- 13% of CDFI lending goes to BAME led businesses which make up around 6% of SMEs
- CDFIs provide extensive business support both in the application process and during the life of the loan (over 30,000 hours per year).

Many reports have noted the role that CDFIs, as relationship focussed lenders, play in helping to reduce these inequalities. Most suggest that CDFIs should be supported to play a bigger role. A report on BAME-led businesses recently produced by Aston University and supported by the NatWest Group made the following suggestion:

> *"We propose UK high street banks seek to address this access gap by working with the UK's community finance network, especially community development finance institutions (CDFIs), to capitalise locally focused loan funds, targeting areas highly populated by EMBs, especially those already reporting high start-up rates."*[4]

CDFIs already play a role supporting minority and excluded groups to obtain the finance they need. However CDFIs are limited by their lending resources. With more support from Government and the private sector they can do much more to reduce these inequalities.

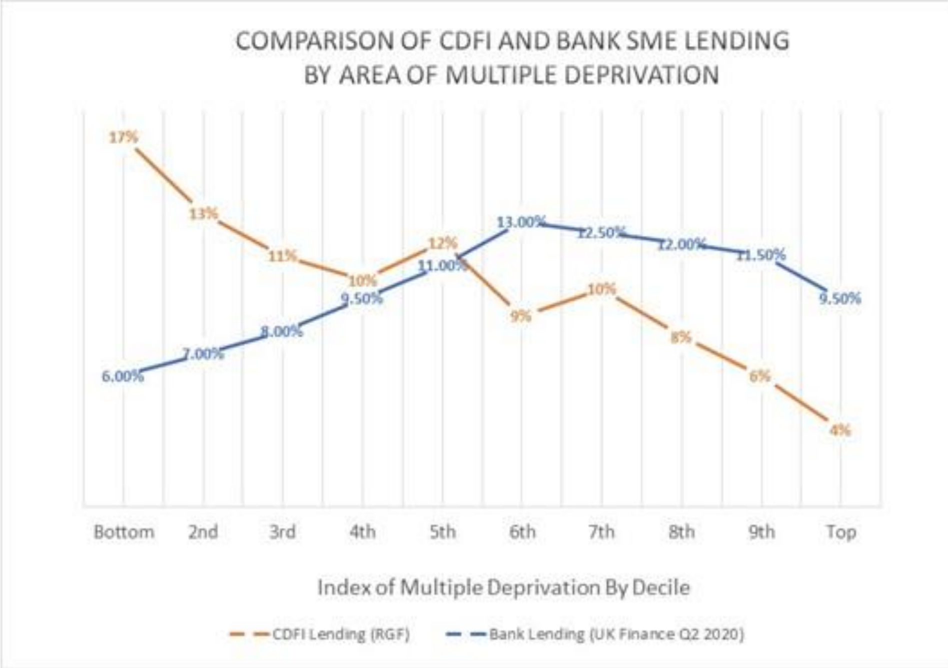
3. With reference to the focus areas and missions referenced in the Levelling Up White paper, what activities does your organisation, or financial services organisations you work with, already undertake in support of the levelling up agenda, and what is their impact? We are particularly interested to understand activity related to the following areas:

a) Regional growth and productivity

As noted in our response to Question 1, the principal mission of CDFIs is to supply finance to viable SMEs where access is restricted. Between 90% and 95% of CDFI borrowers have previously been declined by a mainstream lender. In economic terms CDFI lending has a very high level of additionality, creating economic value which would have otherwise been lost.

CDFI lending does not crowd out or compete with bank lending, but it does help businesses become more profitable and productive, creating future customers for mainstream lenders. CDFIs focus on deprived regions with around 50% of lending going to the 35% most deprived areas. CDFI lending is complementary to bank lending, where approximately 25% of lending goes to the 35% most deprived areas.

[4] Time to change: a blueprint for advancing the UK's ethnic minority businesses – Aston University, May 2022



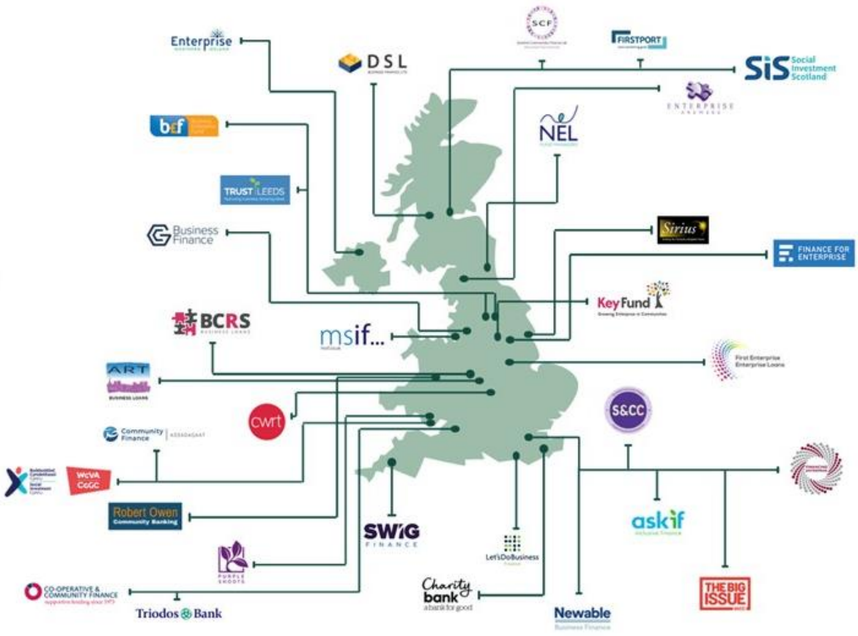
CDFI's have an excellent track of investing taxpayer funds to deliver local growth. For example the £30 million allocated to CDFIs under the Regional Growth Fund (RGF) in 2012:

- has been matched with private sector match funding to create over £100mn in loans.
- created or supported nearly 12,000 jobs, exceeding the Government target by over 35%.
- Nearly £15mn of the original grant is still being recycled after 10 years
- 16% of RGF funds were to BAME-led businesses and
- 24% to Women-led business

CDFIs are building a range of other public-private partnerships to increase their impact. These include the Community Investment Enterprise Facility with Big Society Capital and a number of social banks (£60mn).

b) Regional investment and the provision of capital for businesses outside London and the South-East

In 2021 93% of CDFI lending was to SMEs based outside London, helping to create and sustain around 10,000 jobs. Our members are located around the country:



c) Skills, training and financial education

- Providing over 30,000 hours annually of pre and post application business support to small businesses. Since Help to Grow is only available to businesses with 5 or more employees, CDFIs' provision of expert support is particularly important to enable micro-enterprises to increase headcount, turnover, productivity and profitability.
- Providing budgeting and financial planning assistance, and access to savings accounts, to individual borrowers, over half of whom have at least one dependent child.

d) Support for communities, including services provided directly to customers and activity to support those with particular needs

As social enterprises themselves, CDFIs' focus is very much on the social impact of their lending. They make decisions not just based on financial returns, but on the impact they make.

CDFIs which make personal loans play an important role in supporting individuals who do not have access to affordable finance. Access to credit is essential at the individual level to improving wellbeing. In the UK 22% of adults have less than £100 in savings leaving them highly vulnerable to financial shocks[5], over 1 million people are estimated to be borrowing from loan sharks[6], and 11 million people do not have access to affordable credit[7].

[5] Money and Pensions Service Financial Capability Strategy for the UK (2021) Financial capability of UK adults How well do UK adults manage money?
[6] Centre for Social Justice (2022) Swimming With Sharks: Tackling illegal money lending in England.
[7] Estimate by Fair4All Finance.

10 specialist personal lending CDFIs lend to low-income households all over the UK making small loans to people who are increasingly unable to access other forms of legal credit, saving them on average £190 in interest repayments compared to the nearest alternative lender[8]. Having a reliable and trustworthy credit provider has a positive long-term impact on health and wellbeing[9]. It also saves the NHS millions of pounds due to the positive health benefits of giving people the means to spread the cost of buying essential appliances, improves sleep, and reduces anxiety and depression[10].

CDFIs also provide wraparound services designed to improve their customers' financial health and wellbeing, including access to savings accounts and support to uncover unclaimed benefits. Since October 2021, 2 CDFIs have identified over £7.5 million in benefits each month that individuals can claim on top of their incomes. This works out at £414 per person every month, significantly boosting their financial wellbeing[11].

4. How can the financial services sector work most effectively with national and local government, and other actors, to help deliver the levelling up agenda?

The Levelling Up White Paper says that for levelling up to succeed we need to *create* incentives and institutions to deliver change. In fact the UK has many of the institutions needed to drive the levelling up agenda, but we need to find ways of making them work together more effectively through appropriate incentives.

Better partnerships might include:

- Partnerships between local government and CDFIs: for example, as community-based lenders CDFIs can enable Local Government Pension Schemes to increase their assets invested in local areas as proposed in the Levelling Up White Paper (page 162). p.
- More joined up approach between social capital wholesalers, such as Big Society Capital, Access and Fair4All Finance, with financial organisations to explore how capital can be distributed more widely and with more impact.
- Assisting commercial organisations, who would like to improve their service to the whole community, to work more closely with organisations such as CDFIs which have a proven track record in filling in those finance gaps. These are beginning to emerge naturally as the effectiveness of CDFIs becomes more apparent. In the US, these partnerships are formally incentivised through the Community Reinvestment Act.
- More support/recognition from Government of the benefit public/private sector partnerships can deliver.

[8] Responsible Finance (2022) Loans That Change Lives.
[9] Moneyline (2021) Social Impact Report.
[10] Gibbons, D. (2020) The Social Impact of Fair For You.
[11] Responsible Finance (2022) Loans That Change Lives.

We recommend the finance sector works together with UK Government to help institutions such as CDFIs which are focussed in improving access to finance and thereby helping to level up. This might include:

- **Incentivising banks to invest in the CDFI sector**
- **Committing to an SME loan guarantee scheme for the long term**
- **Direct support to build capacity and development across the CDFI sector**
- **Updating Community Investment Tax Relief to make it more attractive and effective**

5. What barriers currently exist in enabling your organisation, financial services organisations you work with, or the financial sector generally to help deliver the levelling up agenda?

Key barriers to CDFIs supporting more excluded businesses and demographics are:

- Lack of capital to lend – first-loss and commercial capital. Historically EU/UK Govt has provided capital. Commercial banks have been reluctant to lend to small CDFIs.
- Lack of grant and development capital – has been key to growth in the US CDFI market.
- Short-term nature of guarantees – RLS likely to be extended to June 2024. Commercial lenders and social wholesalers might be more reluctant to invest with under 2 years of risk mitigation.
- Awareness of CDFIs in Government (no direct mention in Levelling Up report), commercial banks, SMEs and the general public.

6. Which advocacy priorities directly linked to supporting levelling up do you think should be a priority for the financial services sector?

The first objective should be to ensure that those who live in deprived areas or are part of an excluded group have fair access to affordable business finance. This requires relationship-focused lenders who:

- Have a business model and expertise which allows them to really understand a business proposition
- Take into account the place-based and social impact of an investment
- Provide pre- and post-application business advice
- Provide appropriate flexibility in lending
- Are comfortable with a reasonable level of credit risk
- Have capital available to lend

The second objective is to support personal borrowers who are caught in a spiral of high-cost debt and who can be helped onto a more financially sustainable and resilient trajectory through access to affordable credit.

7. Do you have any specific policy proposals or recommendations linked to levelling up which you think that the government or the financial services industry should consider?

The Government has a number of policy levers at its disposal which can be used to promote the Levelling Up agenda through CDFIs:

Provision of levelling up funding: funding allocated to the CDFI to promote levelling up through enterprise.

Regional funds: the Government in conjunction with the British Business Bank should earmark a greater proportion of regional funds to small and micro loans than occurred with previous funds, and potentially to relatively deprived areas and excluded groups.

Dormant Assets: additional first-loss capital is key to growing CDFI lending. Using dormant assets to support CDFIs is an effective way to catalyse community-based lenders. Commercial banks are showing much greater interest in lending to the sector to leverage up first loss capital. The Recovery Loan Scheme with 70% guarantee and no portfolio cap presents the sector with a significant opportunity to leverage dormant assets by between 2x and 5x.

Update Community Interest Tax Relief (CITR): CITR is a tax relief specifically targeted at CDFIs. It currently supports around 30% of SME lending capital, and has the potential to do much more with some revisions to its terms. There are a number of public-private initiatives which could support the levelling up agenda through CDFIs:

Establish a national funding vehicle for CDFIs: a national vehicle can be used to simplify the investment process, standardize performance metrics, reduce costs and create a more balanced portfolio of risks. As has been witnessed in the US, a streamlined investment process can accelerate the growth of the sector by bringing in institutional capital.

Review of local government pension funds: unlocking local pension funds to support community enterprise.

Awareness raising about CDFIs: CDFIs are relatively unknown in the UK. With greater support from Government and the financial sector more businesses and individuals will be aware of the support that CDFIs can provide.

Capacity building: CDFIs and the industry body, Responsible Finance, are run on a very tight budget. Grants from the Government and the private sector will enable the CDFI sector to develop more quickly.