Responsible Finance: Autumn Budget 2024 Representation

Responsible Finance is responding to this consultation as the industry body for Community Development Finance Institutions (CDFIs).

CDFIs are not-for-profit mission-driven lenders which support underserved businesses and low-income consumers with access to finance. There are 40 CDFIs across the UK that lend £287 million each year to 90,000 customers.

Our response

Responsible Finance welcomes the new Labour Government's plan for financial services and looks forward to working together to unlock the untapped potential in our communities, increase financial resilience and give access to opportunity; for which CDFIs are recognised as key actors. CDFIs which lend to small businesses are expert at driving investment in jobs and growth within more deprived communities, thereby acting as a vehicle for growth from the bottom up. And CDFIs which lend to households harness innovation and fintech to boost financial resilience for low-income households across the whole of the UK.

Responsible Finance welcomes the Government's pledge to develop a national financial inclusion strategy. CDFIs are central to ensuring all people have access to affordable products and services to support their financial wellbeing. Responsible Finance would welcome representation on the committee overseeing this work given the scope for CDFIs to be instrumental in putting policy into practice.

The following four recommendations to the 2024 Autumn Budget are made with the aim of supporting the Government's missions to support economic growth, financial inclusion and break down barriers to opportunity. All the recommendations contained in this submission are of no immediate cost to the Government.

Recommendations:

1. **Launch an innovative investment vehicle for CDFIs through the British Business Bank. (page 5)**
2. **Remove the credit broking barrier to unlock referrals to community finance providers. (page 7)**
3. **Amend Community Investment Tax Relief to facilitate its future use. (page 12)**
4. **Make a minim 5-year commitment to the Growth Guarantee Scheme. (page 15)**

About CDFIs which lend to SMEs

Access to finance for small businesses remains a constraint on economic growth. SMEs face a record low success rate when applying to the UK's seven largest banks of just 45%[1], and overall bank lending was down 9% compared to 2022[2]. This stifles their ability to invest, grow and innovate. Based on data from the BEIS Longitudinal Surveys and the SME Finance Monitor, Responsible Finance estimates that the annual unmet need for small business loans is £5 billion. Other sources, however, estimate that the total unmet demand for all small businesses could reach up to £22 billion.

Across the UK access to affordable finance is patchy, particularly in more deprived areas. This is a significant contributor to regional inequalities.

CDFIs lend to underserved yet viable businesses whose impact would otherwise be lost without the opportunity to access finance from a CDFI. They address information gaps by offering a relationship-based approach, coupled with a deep understanding of the local community. This distinguishes them from mainstream commercial lenders. 99% of the SMEs they lend to have previously been rejected by a bank. On average, around 90% of borrowers go on to successfully repay their loans and grow their businesses. Lending by CDFIs creates additional economic growth in areas where it is most needed.

Through this lending to unlock entrepreneurs' potential, in 2023 alone CDFIs lent £60 million to over 800 SMEs and £42 million to 3,700 start-ups. This supported 11,800 jobs.

<u>CDFIs are experts at channelling investment to revitalise deprived areas:</u>

- In 2023 75% of CDFI loans met the criteria for Community Investment Tax Relief (CITR), meaning that the business was in an area of disadvantage, or that it was owned and operated by individuals recognised as disadvantaged according to their ethnicity, gender, age, religious beliefs or disability.
- 98% of CDFI loans to SMEs are made outside London.

<u>CDFIs have a strong track record in lending to women and ethnic minority founders:</u>

- CDFIs were early signatories of the Investing in Women Code and have long been exemplary.
- They report on the numbers of women and ethnic minority-led businesses they lend to each year and run various initiatives to increase lending to these groups.
- 30% of CDFI SME loans are made to women, despite women-led businesses only making up around 16% - 21% of SMEs[3].
- 17% of CDFI SME loans are made to Black, Asian or Other ethnic minority entrepreneurs which make up around 6% of SMEs[4].

<u>CDFIs create economic growth and wealth in communities by:</u>

- Filling financing gaps: CDFIs lend to businesses that cannot access bank loans due to a lack of credit history, collateral or risk.

[1] Small Business Finance Markets 2023/24 (british-business-bank.co.uk) Page 125
[2] Small Business Finance Markets 2023/24 (british-business-bank.co.uk) Page 16 – lending in 2023 £59.2bn compared to £65.1bn in 2022.
[3] Hutton, G., Ward, M. (2021) Business Statistics. Research Briefing. House of Commons Library.
[4] House of Commons Library (2021) Business Statistics.

- Stimulating job creation: SMEs are critical engines of employment. By supporting SMEs, CDFIs directly stimulate job creation which helps to reduce unemployment and create economic opportunity in local communities. CDFI loans are often made to small businesses that provide essential services in communities, which in turn creates more local jobs. In 2023 CDFIs helped to create 6,411 new jobs.
- Promoting inclusive economic growth: By focusing on underserved and under-represented groups, CDFIs bridge racial, gender and economic wealth gaps. This fosters broader and fuller participation in the economy.
- Supporting entrepreneurial success: Many CDFIs offer advice and support in addition to lending, which increases the likelihood of success and growth for small businesses. In 2023 CDFIs provided 9,500 hours of support.
- Building wealth in communities: CDFIs help businesses to grow and establish themselves in their communities. As businesses grow, they often use local supply chains and hire local employees to create a ripple effect of economic activity that benefits the whole community.
- Leveraging private investment: CDFIs demonstrate the viability of investing in underserved businesses, so attract in further investment from private finance, multiplying the economic growth potential. Current CDFI funding programmes match £1 of public sector investment with £4 of private sector investment.

About CDFIs which lend to households

There has been an 80% surge in enquiries to personal lending CDFIs since 2022. As one quarter of UK adults have less than £100 in savings[5], the need for short-term, affordable loans to cover unexpected costs will continue to be high. Credit is not right for everyone, but fair and affordable access is often crucial to enable households to smooth expenditure.

Despite this there is shrinking provision in consumer credit for low-income borrowers as many lenders have exited the market. Those who are left have shifted to serving prime and near prime borrowers. An estimated 16 to 17 million adults in the UK are financially underserved. The unmet credit need among this population is estimated to be around £2 billion[6].

CDFIs offer access to affordable credit and are scaling to fill this gap. Their lending is targeted to those who are often hardest to reach, yet they get good outcomes with the majority of customers repaying loans in full. Last year 66% of loans were made to women and 11% to those belonging to a minority ethnic group. CDFIs' customer characteristics closely mirror those found to be using illegal lenders, therefore in some cases they may be a safe alternative.

Giving people affordable options from lenders like CDFIs supports better financial decision making. It enables people to get back on their feet quickly and avoid getting into spiralling debt, putting their ability to work and their health at risk. In the absence of access to affordable credit, many households face a poor choice of high cost or illegal lenders, or being pushed into unacceptable hardship when presented with an unexpected or high expense. Access to credit allows an individual to replace a broken washing machine, or repair a car, without needing to cut back on their food or fuel budgets. A lack of access to affordable credit exacerbates the poverty premium; for example, the high long-term cost of using a laundrette compared to purchasing a new washing machine.

[5] Money and Pensions Service (2022) One in six UK adults have no savings
[6] Fair4All Finance (2024) Access to credit and illegal lending

Through their lending to support the financial resilience of low-income households, in 2023 CDFIs lent £66 million to over 85,000 households.

CDFIs embrace innovation and fintech, harnessing it to produce better outcomes for consumers:

- CDFI Moneyline recently won the FCA's 'Eureka' prize for the most original tech adaptation at the Financial Inclusion Tech sprint for its Money Toolkit. The Toolkit uses loan application data to refer those it declines directly to emergency support.
- CDFIs use Open Banking to make a thorough assessment of their applicant's financial situations; a level of detail not possible with traditional credit reference bureaus. For example, recent research by CDFI Salad Money has found that credit scores are ineffective at identifying a person's gambling propensity, and it declines the same proportion of applications for gambling with sub-prime (low) credit ratings as super prime (high) credit ratings[7].

CDFIs are exemplary in putting the FCA's outcomes-based Consumer Duty into practice:

- CDFIs aren't just lenders; they provide wrap-around support to improve outcomes for their applicants. They have embraced the FCA's Consumer Duty with ongoing extensive analysis, monitoring and improvements to consumer outcomes.
- The educational role of CDFIs includes supporting people to maximise their income (for example, benefits they are eligible for), to make appropriate decisions about accessing credit, to negotiate longer payment periods with suppliers, and to access debt advice.
- In 2023 they identified an average of £4,200 in unclaimed benefits for over 660,000 people totalling £600 million. This translates as £350 per person per month, helping people build up their wealth and in some cases not need to take out credit.
- They signposted 660,000 applicants to additional support.

CDFIs increase growth and wealth building in communities by:

- Enabling more participation in the economy: Through investing in skills/education. For example, a customer who used a CDFI loan to get a driving license was able to secure a higher-paid job.
- Helping people rebuild their finances: CDFI loans save an average of £340 per loan compared to a high-cost lender (CDFI customers saved £29m in total last year) and the wrap-around support from CDFIs identifies unclaimed benefits to boost monthly incomes.
- Increasing opportunities for the next generation: when family finances are better, kids' school attendance can improve e.g. the family can afford to buy a washing machine and wash clothes more often.
- Improving financial resilience: People can manage life shocks better without resorting to loan sharks or high-cost lenders, and can benefit from budgeting and other support that helps build resilience.
- Saving government and the NHS money: fewer emergency situations including the health and mental health impacts of financial problems.

[7] Salad Money (2024) Credit Fuelled Harmful Gambling

Recommendation 1: Launch an innovative investment vehicle for CDFIs through the British Business Bank.

200,000 small businesses each year have unmet financing needs, and research estimates that 50,000 of these have good, viable business plans but are underserved by mainstream finance[8]. This market failure results in lower growth, higher inequality and lost opportunity. CDFIs are key in filling these gaps, and their reach could be scaled up through long-term access to investment.

In the Labour party's 'Start-Up, Scale Up' report it recommends that the British Business Bank:

- Unlocks more finance for small businesses by examining its ENABLE funding programme
- Targets the deployment of finance to women and ethnic minorities
- Deploys finance in every region of the UK to encourage more investment outside of London

CDFIs are recognised for their reach and effectiveness as delivery partners for the British Business Bank's (BBB) Start-Up Loans Scheme, its regional funds including the Northern Powerhouse and Midlands Engine Investment Funds and the Growth Guarantee Scheme. The BBB acknowledges the increased role that CDFIs can play in channelling investment to address the UK's SME finance market failure. **Responsible Finance recommends that the Government launches an investment vehicle specifically for CDFIs through the British Business Bank. The programme will sit within the BBB's existing schemes so will not require any new money from the Government.**

<u>Proposal</u>

- Responsible Finance recommends the Government launches a new funding vehicle for CDFIs to enable the sector to fill market gaps in SME access to finance through the British Business Bank's ENABLE programme.
- The new vehicle has undergone detailed planning over the past 12 months. It is in its final stages and requires sign off from Government to launch.
- As CDFIs use CITR, all funding would be invested in SMEs which meet the criteria for Community Investment Tax Relief (CITR), therefore investment would be channelled into areas of disadvantage and to businesses led by those facing disadvantage, such as on the grounds of ethnicity or gender.
- The programme would crowd in private investors to invest in CDFIs, multiplying its impact.
- The funding structure will be scalable to unlock long-term growth opportunities.

<u>Rationale</u>

- Raising capital to on-lend has been a longstanding issue for the CDFI sector.
- CDFIs are relatively small (lending on average £3mn to £10mn each year), therefore investors such as banks and pension funds find it difficult to provide finance directly – even though many would like to do so.
- The British Business Bank has been working closely with CDFIs and Responsible Finance for 10 years. It has conducted operational audits and has detailed historical performance data for the sector.
- A new funding vehicle would be a pioneering, evidence-based solution to the long-standing issue of CDFI investment raising and SME access to finance.

[8] Responsible Finance researched based on the Department for Business and Trade's annual survey

- It directly responds to the Labour party's recommendations for the British Business Bank in its 'Start-Up, Scale Up' report by:
    - Using the ENABLE programme to unlock more finance for small businesses
    - Targeting the deployment of finance to women and ethnic minorities
    - Deploying finance in every region of the UK outside of London

Impact

- The funding vehicle would aim to invest an additional £1 billion in underserved businesses over the next five years.
- **It promotes economic growth:** It addresses market failures with a tangible and widely accepted mechanism to unlock economic growth which is frustrated through market failure.
- **It reduces inequalities and creates opportunities:** The fund specifically channels investment into more economically deprived areas and for more disadvantaged entrepreneurs.
- **It will crowd in private sector finance:** Once the structure is established, Responsible Finance projects that as a minimum every £1 of public sector investment will be matched by £4 of private sector investment. This is currently achieved in other CDFI funding structures.
- **It is a strong example of a public/private partnership:** CDFIs are exemplary in bringing the public and private sectors together.
- **It sends a powerful signal to small businesses:** It will send a positive signal from the new Government to the UK's small businesses about the importance of their role in firing up the economy.
- **It supports the green economy:** CDFIs are impact organisations therefore support lending to businesses which deliver climate gains.
- **It is evidence based:** CDFIs have been in existence in the UK for over 20 years. They have strong and evidenced track record on delivering funding programmes and surpassing targets set by Government[9].

Cost

- The funding vehicle will not require any new money as it will sit within the British Business Bank's existing programmes.

[9] For example, the Regional Growth Fund – impact report: https://responsiblefinance.org.uk/download/responsible-finance-rgf-impact-report/?tmstv=1725620332

Recommendation 2: Remove the credit broking barrier for referrals to community finance providers.

CDFIs are not widely known about. This hampers their ability to increase access to affordable credit for people on low incomes. A straight-forward and zero cost way to improve this is to unlock referrals from organisations who are already in contact with those who could benefit.

Responsible Finance recommends that the Government extends its existing exemption for registered social landlords (RSLs) to enable businesses, charities and community organisations to provide information and make referrals to community finance providers. This amendment will have no material cost to the Government and will have a strong positive impact on financial inclusion.

Increasing the number of organisations which can make introductions to CDFIs and credit unions will help to reroute more people away from high-cost credit providers illegal loan sharks, or from going without and being forced into unacceptable hardship. And it will unlock innovative new partnerships such as those outlined below.

CDFIs have a strong network of charity and other stakeholders that they could better harness through formal referral partnerships unlocked through this change in legislation.

The current regulatory framework

Credit broking is a regulated activity defined in legislation which requires authorisation from the Financial Conduct Authority (FCA). This involves an extensive authorisation process (c. 6 – 12 months[10]). Once authorised for full consumer credit permissions, firms must then pay an annual fee to the FCA of c. £1,000[11] depending on income. This process is off putting for most organisations looking to make fee free introductions to community finance providers.

In 2019 the Government introduced an amendment to the Financial Services and Markets Act[12] to exclude registered social landlords from the scope of credit broking, where:

- the activity concerned is effecting an introduction of an individual who wishes to enter into a credit agreement
- the introduction is to a credit union, community benefit society, registered charity (or subsidiary of a registered charity), community interest company limited by guarantee or subsidiary of an RSL, and
- the introduction is provided fee free, ie the RSL receives no fee (which includes money or any other financial consideration)

Responsible Finance proposes that this is further amended to include all businesses in addition to RSLs. The strict parameters on the type of legal entity of community finance provider that can be referred to, the fact that introductions are fee free, and the rigorous affordability assessments that CDFIs carry out on loan applicants, mitigates any risk of consumer detriment from the proposed change.

[10] https://www.fca.org.uk/firms/authorisation
[11] https://www.fca.org.uk/firms/calculate-your-annual-fee/fee-calculator
[12] https://www.legislation.gov.uk/uksi/2019/1067/article/2/made

The FCA acknowledges that:

"Where there are no charges to consumers and no remuneration paid by the provider to the broker, credit broking is likely to be a relatively low risk activity. This is because there is very little risk of people being driven to unaffordable or inappropriate sources of finance in order to make the broker more money[13]."

This is particularly pertinent considering the proposed Buy Now Pay Later (BNPL) legislation which intends to exempt merchants referring to BNPL providers from credit broking on the basis of proportionality:

"The government considers that bringing merchants which offer newly regulated agreements as a payment option into the scope of credit broking regulation would be disproportionate. The government has concerns that regulating these merchants would impose significant costs on retailers and possibly lead them to cease offering interest-free credit options[14]."

Responsible Finance is proposing the same proportionate approach apply to community lenders to level the playing field so that new impactful partnerships can launch.

Impact: Partnerships waiting to be unlocked

There are several partnerships that Responsible Finance is aware of that would be ready to increase their impact or launch with a change in the legislation. Three of these are highlighted below, and would mean that millions more people will be aware of safe and fair credit options when they need to borrow.

1. Existing project: Fair for You and Iceland's 'The Food Club'

   The proposed amendment to the credit broking regulations could result in 'The Food Club' being raised awareness amongst Iceland's 5 million customers per week, halting food bank usage, reliance on illegal lenders, and saving an estimated £142.86 in interest for the average Food Club customer compared to if they had gone to a high-cost lender.

   CDFI Fair for You (a Community Interest Company wholly owned by a charity) helps the most financially vulnerable people to buy essential items for their homes, such as appliances, through tailored and flexible lending. Since it started in 2015 it has generated an estimated half a billion pounds of social value for over 100,000 customers.

   In 2022 it recognised the fact that more families were going hungry than ever before. In response it partnered with Iceland; a supermarket which uniquely serves the poorest communities in the UK.

   Aim: to support struggling families to avoid food banks, keep their dignity and independence, and keep food on the table during school holidays, without being driven to high interest lenders and loan sharks.

   How it works: the product is a revolving credit facility up to £100, where individuals are given a Mastercard to spend in store and online. Top up windows are in line with school holidays, and repayments are set at £10 per week with 0% interest.

[13] https://www.fca.org.uk/publication/finalised-guidance/fg18-06.pdf
[14] https://www.gov.uk/government/consultations/regulation-of-buy-now-pay-later-consultation-on-draft-legislation

Credit broking: Iceland is not authorised for credit broking therefore it cannot raise awareness of the partnership. By extending the credit broking exemption to all organisations, Iceland could raise awareness about this vital resource and scale the Food Club's positive impact.

Impact: the pilot reached c. 4,500 families in limited geographical areas. An independent report on the impact found that before joining food club, 92% were struggling to pay for food or other essentials, 65% were borrowing money from friends or family, 38% obtained help from a food bank, and 8% were borrowing from a loan shark. After joining:

- 92% have stopped or reduced their use of Food Banks;
- 80% reported their use of loan sharks has dropped;
- 57% feel less stressed, anxious or depressed about their financial situation;
- 71% reported a reduction in falling behind with rent, council tax or other bills.

Since launching in 2022 the Food Club has now served over 25,000 customers.

The Food Club has the added impact of enabling customers to build their credit record. It was awarded the "ONE TO WATCH" award in the Global Good Awards 2022, and a bronze award in the Global Good Awards 2023.

"The Food Club has been a saviour ever since I was accepted, the panic and fear up to pay day and feeling like I'll struggle to feed my children or myself has completely lifted!"

2. <u>Existing project: Fair4All Finance's No Interest Loan Scheme Pilot</u>

The proposed amendment to the credit broking regulations would mean that partners can refer some of the most financially vulnerable and excluded groups to the No Interest Loan Scheme, diversifying the NILS customer base and increasing its impact.

The No Interest Loan Scheme (NILS) Pilot deploys funding from HM Treasury, JP Morgan Chase, and the Scottish and Welsh Governments in the form of small, short-term interest free loans to people for whom borrowing is an appropriate solution but who can't access or afford existing forms of credit. The loans are deployed through community finance providers. So far over £10 million has been issued to more than 13,000 individuals.

Aim: The NILS pilot aims to help people in financially vulnerable circumstances to spread essential or emergency costs. It provides a vital financial cushion for people unable to access or afford existing forms of credit, but who can afford to repay small sums. The average loan value is £752.

How it works: Customers can be eligible for a NILS loan where they are declined for an interest-bearing loan by a community lender, but where removing the interest makes the loan affordable, or where the lender is able to accept a higher level of risk due to the bad debt guarantee under the pilot.

Credit broking: Currently the only entry point into the scheme is through community lenders' declined customers. It could reach more people, including those who are particularly vulnerable and excluded, if referrals from charity, community and other partners were made possible.

PWC's most recent evaluation of the pilot said that it has been described by beneficiaries as a 'lifeline', however states that:

"The current credit broking exemptions for housing associations and local authorities are opaque, and there appears to be a lack of confidence among social landlords in their interpretation of the scheme. In addition, the exemption does not cover charities, restricting what could be an additional referral route into NILS."[15]

Potential impact: Currently, 80% of NILS loans are reaching customers in financially vulnerable circumstances, according to Fair4All Finance's segmentation model. Since these customers are spread across all six of Fair4All's segments of financial vulnerability, there is evidence that a NILS loan has the potential to help a wide range of people and circumstances. Further widening the referral routes for accessing NILS could help to reach more of those who could benefit, for example those who are receiving support from a charity or community partner.

3. Prospective Partnership: Fair for You and Clarion Housing Group

The proposed amendment would enable the UK's largest housing association to raise awareness of CDFIs amongst its tenants in case they need to purchase essential household items, thus rerouting them away from high-cost and illegal lenders.

Clarion Housing Group is the largest housing association in the United Kingdom. Its charity arm, Clarion Futures, has been working with Fair for You with the aim of increasing access to affordable credit for its tenants.

Aim of partnership: Low-income people, such as housing association tenants, are more likely to use high-cost credit. The partnership aims to increase access to affordable credit for tenants so they can meet their essential needs, rerouting them away from high-cost and illegal lenders.

How it would work: Clarion would provide information and referrals to CDFI Fair for You for its tenants in need of access to credit for essential household items.

Credit broking: Clarion Futures, the customer support arm of Clarion Housing Group, is a registered charity. Therefore it is not exempt from the requirement to have credit broking authorisation from the FCA to give its tenants information about, and make referrals to, Fair for You. This means at this stage the partnership cannot progress.

Potential impact: Clarion Housing Group provides a home to over 350,000 people. If a proportion of these people were made aware of an alternative source of credit it could improve the financial inclusion of thousands of individuals. Clarion Futures provided money guidance to more than 6,000 households in 2023-24.

"We want to support and encourage referrals to providers of alternatives when consumers need credit. We consider that in this area social landlords can play a key role in assisting tenants find alternatives to high-cost credit when looking to get essential household goods. This can create better options for consumers and could provide them with a cheaper, lower-risk source of finance."[16] *The FCA*

[15] https://fair4allfinance.org.uk/resources/pwc-no-interest-loan-scheme-pilot-interim-report/
[16] https://www.fca.org.uk/publication/finalised-guidance/fg18-06.pdf

Potential risks and mitigations

Responsible Finance consulted with StepChange Debt Charity and England's Illegal Moneylending Team about potential risks of this change in legislation and how these would be mitigated.

Potential Risk	Mitigation
A CDFI might not be the best option for the borrower – a high street bank or a credit union might be more appropriate and cheaper.	CDFIs will work closely with partners to educate them on the different credit options and when a more appropriate solution might be available.
An over-indebted person may apply for a loan rather than seeking debt advice.	CDFIs conduct rigorous affordability checks and never lend to over-indebted individuals. All CDFIs signpost to debt advice and income maximisation services when this is appropriate and many now go further, with innovative solutions like "nudge behaviours" to increase uptake of support.
How can we ensure the relationships develop once the credit broking exemption is made?	As illustrated above, there are a number of partnerships ready to go once the amendment is made. Responsible Finance will work with CDFIs and other close stakeholders to create effective referral partnerships and raise awareness of the change.

Cost of making the amendment

This amendment will have no material cost to the Government aside from the administration of making the change.

Recommendation 3: Amend Community Investment Tax Relief to facilitate its future use.

In the 2023 Spring Budget the Government raised the limits on Community Investment Tax Relief to update it and increase its usability. This has already facilitated a new £62 million funding vehicle, the Community Investment Enterprise Fund (CIEF), which has brought in high-street bank Lloyds as the lead investor. It aims to invest in 800 small businesses and support 10,500 jobs and investments are made directly through accredited retail CDFIs.

The CITR amendment also enabled Responsible Finance and its stakeholders, including the Impact Investing Institute, to undertake detailed planning to put in place a wholesale fund. The new fund model will capitalise on the increased £100 million wholesale CITR limit by bringing institutional investment into a newly created wholesale CDFI funding vehicle. This will be on-lent to the existing individual retail CDFIs, who will then on-lend the funding to SMEs in disadvantaged communities.

As part of this planning, a further necessary amendment has been identified to the detailed wording of the 2003 regulations. The amendment will enable the usability of the original policy intention to enable £100 million of CITR funding to be raised and distributed via wholesale accredited CDFIs.

Responsible Finance therefore recommends amending the detailed wording of the 2003 Community Investment Tax Relief (CITR) regulations to enable the original policy intention of a £100 million wholesale funding vehicle to be created. This amendment will have no additional cost to the Government as it was already costed in the Spring 2023 Budget and will have a strong positive impact on supporting disadvantaged businesses.

Specifically, Responsible Finance recommends raising the £2.5 million limit for a wholesale CDFI to on-lend to a single retail CDFI to the lesser of £25 million or 25%:

Current regulation

"SI2003/96 Schedule 1(11)

An investment by a wholesale CDFI (see CITM2050) is not a relevant investment for the purposes of SI2003/96 (see CITM3030) while (if and for so long as), as a consequence of that investment -

- the investment exceeds the lesser of
- 20% of the amount of the investment fund at the immediately preceding anniversary of the accreditation date, and
- £2,500,000[17]"

Proposed amendment

An investment by a wholesale CDFI (see CITM2050) is not a relevant investment for the purposes of SI2003/96 (see CITM3030) while (if and for so long as), as a consequence of that investment -

- the investment exceeds the lesser of
- 25% of the amount of the investment fund at the immediately preceding anniversary of the accreditation date, and
- £25,000,000

[17] https://www.gov.uk/hmrc-internal-manuals/community-investment-tax-relief-manual/citm3110

Rationale

- Currently the detailed wording of the 2003 CITR regulations mean that a single retail CDFI could only receive the lesser of £2.5 million or 20% of the amount invested in the wholesale CDFI without losing CITR eligibility for investors in the wholesale vehicle. This means that a £100 million wholesale fund would need to invest in at least 30 retail CDFIs.
- There are currently only c. 20 CITR-accredited CDFIs and 35 CDFIs in total. CDFIs are of varying sizes and the sector is currently scaling.
- Therefore, whilst the long-term aim is that any funds will deploy investment across the whole CDFI sector, it is helpful to test the viability of new funding models with a smaller group of investment ready CDFIs to create a proof of concept. For example, the new £62 million CIEF fund invests through a total of three retail CDFIs. In addition, the larger CDFIs who have the capacity to take on large scale investment would have their impact heavily restricted by the £2.5 million limit.
- The proposed amendment would mean that any new wholesale fund could invest in a minimum of 3 CDFIs. This enables the new funding model to be tested with a smaller cohort of lenders. CDFIs are stable, have long track records and undergo extensive due diligence to ensure they are creditworthy and can afford to take on larger wholesale investment.
- It unlocks the clear intention behind the Government's 2023 increase to the wholesale CDFI fundraising limit.

Impact of making the amendment

- Community Investment Tax Relief is an extremely targeted intervention. Its stated aims are:
    - To stimulate private investment in disadvantaged communities; and,
    - To enable this by supporting a thriving community development finance sector.

  Loans made using capital raised through CITR must be to enterprises unable to obtain funding from other sources and those who are:

    - located in areas of disadvantage, or;
    - owned and operated by, or intended to serve, individuals recognised as disadvantaged on account of their ethnicity, gender, age, religious beliefs, disability or other defining characteristics.

- CITR is a good value intervention with a benefit-cost ration of 6:1[18]. It created an additional £318 million Gross Value Added in the 5 years between 2018 and 2023 compared with a total cost of £49 million.
- The Impact Investing Institute believes 'there is a significant opportunity to mobilise institutional capital to increase finance flowing to SMEs through Community Development Finance Institutions (CDFIs).[19]', yet the main barrier to the expansion of the CDFI sector remains the availability of affordable capital.
- The detailed design of a wholesale funding vehicle for CDFIs aims to create a straightforward vehicle for bringing large scale institutional investment into the sector to on-lend to SMEs in disadvantaged areas, and those led by individuals facing disadvantage.

[18] Cost benefit analysis in Appendix 1

[19] https://committees.parliament.uk/writtenevidence/124013/pdf/

- In the absence of the change being made, any alternative large-scale fund structures available are complex and would therefore risk putting off institutional investors.

Cost of making the amendment

- The cost of increasing the wholesale limit to £100 million was already accounted for in the Spring Budget 2023. This further small amendment will therefore not cost anything new, but it will ensure that the original intention can be utilised.
- The use of CITR will likely increase gradually in the coming years as the fund goes through a lengthy planning, design and capital raising process.
- Once a wholesale fund is set up, the cost to the Government – as already accounted for – will be 5% of the fund spread over 5 years.

Recommendation 4: Make a minim 5-year commitment to the Growth Guarantee Scheme.

Loan guarantee schemes have been a critical part of making the CDFI model work well and enabling lending to underserved businesses. Responsible Finance welcomed the introduction of the Growth Guarantee Scheme which launched in July 2024 with a two-year term and supports access to finance for small businesses to invest and grow.

The Growth Guarantee Scheme succeeded the Recovery Loan Scheme, and previous similar loan guarantee schemes dating back 40 years[20]. They are recognised by Governments across the globe as an important policy tool to mitigate widely accepted market failures in financing for small businesses.

Responsible Finance recommends extending the Growth Guarantee Scheme beyond its current two-year commitment to a minimum 5-year commitment to enable CDFIs to undertake long-term planning for future growth to support more disadvantaged small businesses. This amendment will have no immediate cost.

<u>**Rationale**</u>

- The UK's loan guarantee schemes have been extremely effective at unlocking finance for SMEs who lack adequate security, including women, ethnic minorities, and those located in disadvantaged areas.
- They do this by being a crucial part of CDFIs' business models and how they manage the risk of lending to underserved businesses. In 2023 74% of CDFI loans were guaranteed by the Recovery Loan Scheme.
- It enables CDFIs to raise capital as it gives investors in CDFIs greater reassurance that their investment will be re-paid.
- 17 CDFIs are currently accredited for the Growth Guarantee Scheme.

<u>**Impact**</u>

- Extending the term of the Growth Guarantee Scheme will enable longer-term planning for investors, lenders and small businesses.
- It will empower CDFIs to ambitiously invest in the long-term scaling and sustainability of their business models and positively impact the development of future fund structures, such as the detailed planning of the wholesale CITR funding vehicle.
- This will provide investors with reassurance that the CDFI sector can become a mainstream investment product which delivers significant social benefits.
- It will encourage the formation of new CDFIs.
- A scaled up CDFI sector will give an increasing number of disadvantaged SMEs the opportunity to grow.

<u>**Cost**</u>

- There will be no immediate cost to the Government within the next two years.

[20] The Small Firms Loan Guarantee Scheme launched in 1981, it became the Enterprise Finance Guarantee Scheme in 2009 and subsequently the Coronavirus Business Interruption Loan Scheme in 2020

Appendix 1

Does CITR represent good value for taxpayers?

CITR is undoubtedly an important tool to help CDFIs raise finance. Based on industry statistics, the £86 million raised over the past five years using CITR has supported over 1,100 business and around 3,300 jobs overwhelmingly located in deprived areas.

Using an economic impact calculator developed for the CDFI sector by academics at Coventry University[21], lending supported by CITR has added over £400 million to local economies at a cost to the taxpayer of £22 million. The authors of the model point out that their calculator does not fully capture the social benefits of CDFI lending.

An alternative approach to assessing the value for money of CDFI lending supported by CITR is to estimate a benefit-cost ratio. Key assumptions required to make such an estimate include:

Assumption	**Source**
Rate at which jobs are created or sustained for at least 5 years by CDFI lending	Based on independently reviewed Regional Growth Fund data (to 3 years) and annual member returns to Responsible Finance
The level of income from employment created through CITR lending	Based on the 20th centile of income distribution of the Green Book, page 107
The percentage of lending which is "additional" (i.e. would not have been created without CITR)	Member returns show that over 90% of borrowers have previously been declined by mainstream banks. However the model uses a more conservative level of 60% which was also used in an independent evaluation of the Enterprise Finance Guarantee scheme[22].
Enterprise Survival after 5 years	An additional level of conservatism to guard against optimism bias and the fact that RGF job numbers are checked to 3 years, not 5.
Estimated loan losses	Based on industry experience of Regional Growth Fund (15%) and annual RF member returns (generally 10% - 13%)
Cost of capital	Based on Green Book assumption of 3.5%

Based on these and other assumptions our model indicates that CDFI lending supported by CITR created an additional £318mn of Gross Value added over the last 5 years compared to a total cost of £49mn, generating a Benefit Cost Ratio (BCR) of approximately 6:1. This is before taking into account the considerable social impact of benefits derived from greater employment in deprived areas and greater financial inclusion for excluded groups such as women and ethnic minority entrepreneurs. The table below sets out the basis for our estimate:

[21] An Economic Impact Tool for the Community Finance Industry, Centre for Business in Society, Coventry University 2014 (Henry and Jarvis)

[22] Economic impact evaluation of the Enterprise Finance Guarantee (EFG) Scheme, London Economics, 2017

Assumptions			
Estimate of reported jobs supported by CDFI lending			*Notes*
Lending	A	£90mn	*RGF Impact Report*
Reported jobs created/sustained (after 3 year	B	11,771	*RGF Impact Report*
Implied Jobs created/sustained /£10mn lendi	C=B/A*£10mn	1,308	*Calculated jobs supported per £10mn of CDFI lending*
5 yr CDFI Lending Supported By CITR			
CITR Funded lending per annum	D	£86mn	*Average CITR Usage*
Default over term	E	15.0%	*RGF Impact Report*
Enterprise survival after 5 years	F	50.0%	*ONS data*
Job additionality	G	60.0%	*Based on EFG Evaluation Report 2017*
Salary on additional jobs	H	£18,876	*20th centile, Page 107 Green Book*
Wieghted average cost of capital	I	3.5%	*Green Book*
Number of Years	J	5.00	*AverageTerm of Loan*
CITR Rate	K	5.0%	*25% over life of loan*
Model Output			
Gross Value Added			
Loans funded through CITR investments	D	£86mn	CITR funded lending p.a.
Jobs created/sustained	L=D*C/£10mn	11,248	jobs
Enterprise survival	F	50%	
Additionality	G	60%	
Net Jobs created/sustained	M=L*F*G	3,374	Of additional long term jobs supported by the loans
Average salary	H	£18,876	
GVA Created per year	N=M*H	£64mn	
GVA over 5 years	O=N*J	£318mn	
Net Social Benefit			
Gross Value Added	O	£318mn	
Opportunity Capital Cost	P=D*I*J	(£15mn)	
Loan Losses	Q=D*E	(£13mn)	
CITR Cost	R=D*K*J	(£22mn)	
Net Social Benefit	S=O+P+Q+R	£269mn	
Benefit Cost Ratio (BCR)			
Benefit	O	£318mn	
Costs	T=P+Q+R	£49mn	
Benefit Cost Ratio (BCR)	**U=O/T**	**6.44x**	

A further question is whether focussing taxpayer support on CDFIs rather than other lenders makes economic sense. A recent paper on the relative performance of lenders delivering under public guarantees shows that small lenders such as CDFIs perform at least as well as larger lenders[23]. When lending to smaller businesses with limited collateral CDFIs are assessed to perform significantly better than larger lenders.

[23] The hazards of delivering a public loan guarantee scheme: does the size of delivery partner matter? Marc Cowling, University of Derby 2022.