Responsible Finance

# How to ensure start-ups can thrive and grow in Britain to boost jobs, investment and economic growth across the country

## A submission to Labour's Start-Up Review by Responsible Finance on behalf of Community Development Finance Institutions (CDFIs)

**12 August 2022**

***"We need all parts of the financial system firing on all cylinders and I believe CDFIs have a really important part to play."***

**– Pat McFadden MP, Shadow Chief Secretary to the Treasury.**

***"The important role CDFIs play in the UK's finance system – helping businesses survive, stabilise and prosper – has been witnessed first-hand by Unity Trust Bank.***

***"Driven by a strong mission and place-based lending, their ultimate goal is to build stronger, more inclusive economies and to create employment opportunities and wider socio-economic benefits.***

***"Our values and interests are closely aligned to CDFIs as we are both committed to making a positive difference to the economy, local communities and the environment."***

**– Unity Trust Bank**

### Background:

Labour has called for evidence to its review which will *explore "how to ensure start-ups can thrive and grow in Britain, to boost jobs, investment and economic growth across the country."*

It is examining a number of issues. Three are of particular relevance to the UK's CDFIs.

For more than 20 years they have improved **access to patient capital**, supported what the review terms **"geographical distribution"** and enabled **women and people from ethnic minorities to access the finance, support, and networks needed to start and grow businesses**. They are ready to and could do even more with appropriate policy leverage.

This submission includes evidence about the finance gap which must be addressed, the work CDFIs do in supporting otherwise excluded and disadvantaged businesses (including social enterprises) and jobs, and recommendations about how to accelerate and develop their impact.

**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.

## 1. Access to finance is not equal and many viable businesses are excluded or discouraged:

- Access to finance plays a significant role in supporting business investment and is key to boosting economic activity in places where it is lagging[1].
- 1 million SMEs (1 in 5) cite access to finance as a major constraint to their growth[2]. Many promising SMEs fail or do not grow because they cannot access finance[3].
- The British Business Bank estimates an annual regional funding gap for SMEs of £4 billion[4]. Responsible Finance's analysis suggests that between £1bn and £2bn of this gap is theoretically bankable but goes unfunded each year.
- The All Party Parliamentary Group on Fair Business Banking recently described a critical shortage of finance for small businesses (amounting to a £22 billion funding gap), and a lack of trust between businesses and banks[5]. It found the acute lack of finance restricts business growth and is a barrier to addressing regional inequalities in opportunity; and concentration, centralisation and the lack of relationship-based banking within traditional SME banking cause problems for all small and micro businesses (99% of the UK's businesses), but these are especially acute for women-led and ethnic minority-led businesses.
- Other research shows women and ethnic minority-led enterprises are disproportionately affected by gaps in finance leading to higher decline rates[6]. They are also more likely to be discouraged from applying for finance[7].
- Areas of high relative deprivation attract £10bn less bank finance (due to lower collateral and variable credit records) than more prosperous areas.

## 2. What are CDFIs and how do they improve access to finance?

- Community Development Finance Institutions (CDFIs) are social impact lenders which are locally and regionally based and use a relationship approach to assessing loan applications. They provide start-up and growth finance to micro, small and medium sized enterprises (MSMEs), social enterprises and charities in the more deprived areas of the UK which cannot access finance from other sources.
- In each of the past five years CDFIs have lent on average around £170m to 3,500 businesses, social enterprises and charities, supporting close to 10,000 jobs (in addition to their personal lending).
- CDFIs' lending is additional. It creates economic value which would have otherwise been lost. Over 90% of CDFI SME lending is to SMEs previously declined by another lender. Around 90% of CDFI borrowers successfully go on to grow their business.
- CDFIs provide both start-up and growth finance. Many are successful delivery partners for the British Business Bank's regional and start-up programmes.
- CDFI lending helps businesses become more profitable and productive, creating future customers for mainstream lenders.

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[1] The Levelling Up White Paper
[2] Longitudinal Small Business Surveys 2015 and 2019, Employers and Non-employers, Question G2.
[3] The Levelling Up White Paper
[4] The Levelling Up White Paper
[5] Scale Up to Level Up – Reforming SME Finance (a report for the All-Party Parliamentary Group (APPG) on Fair Business Banking
[6] BVA BDRC (2020) Women-Led Businesses
[7] British Business Bank: Small Business Finance Markets 2021/22, Brown, R. et al (2018) An empirical Examination of discouraged borrowers in the UK. Enterprise Research Centre

**Geographical distribution**

- CDFIs focus on deprived regions and areas, with around 50% of lending going to the 35% most deprived areas; it is complementary to bank lending, where approximately 25% of lending goes to the 35% most deprived areas.
- As well as tackling pockets of deprivation all over the UK, 93% of CDFI SME loans and 79% of CDFI social enterprise loans are made outside of London and the South-east.
- CDFIs are active participants in their communities throughout the UK. They support enterprise activity and job creation in disadvantaged communities.
- CDFI lending is a very cost-effective mechanism to create jobs. CDFIs have previously delivered a place-based investment fund addressing inequalities in access to finance, the Regional Growth Fund. Under this programme the cost per job created by a CDFI was £2,549, compared to the overall expected programme cost per job of £37,400. The programme's evaluation demonstrated that a £30m grant levered £45m in bank investment and £120m in other funds; CDFIs exceeded targets for businesses created, and for jobs created in SMEs by a third[8].
- CDFIs improve access to finance by adding diversity to the market for SME finance, giving options to businesses which otherwise have no or limited choices available.

**Patient capital**

- CDFIs provide appropriate and patient capital to SMEs and social enterprises. They don't place unfair limits on lending in certain sectors and can be flexible when algorithm-driven organisations can't or won't. Some social enterprises deliver vital frontline services but are only paid after incurring delivery costs. They can struggle to access patient finance. CDFIs, social enterprises themselves, understand their business models and consider the 'triple bottom line' when lending. They don't just invest in social enterprises but support them to launch, grow and increase resilience.
- CDFIs provide borrowers with business support: CDFIs are recognisably different from mainstream lenders by focussing as much on soft information such as management strength as upon financial and credit data. In 2021 they provided more than 30,000 hours of pre- and post-application support to help their borrowers succeed.

**Removing barriers and enabling women and people from ethnic minorities to access the finance, support, and networks needed to start and grow businesses**

- **CDFIs break down barriers to finance**: they target and lend disproportionately more to ethnic minority led and women-led businesses:
    - 35% of CDFI SME lending goes to women-led businesses (which make up around 16% of SMEs).
    - 60% of CDFI social enterprise lending goes to women-led social enterprises (which make up around 50% of social enterprises).
    - 13% of CDFI SME lending goes to ethnic minority-led businesses (which make up around 6% of SMEs).

[8] Wynne, R. (2020) Responsible Finance Economic Growth Co-Investment Wholesale Fund Regional Growth Fund: Final Review

    - 50% of all overall CDFI SME lending is made in the UK's 35% most deprived areas, compared to bank lending, where approximately 25% of lending goes to the 35% most deprived areas.

- **CDFIs are especially useful when banks restrict credit:** CDFIs are there to support enterprises and communities during economically uncertain times[9]. The sector has a 20-year track record, with a strong performance after the 2008 Global Financial Crisis when mainstream lenders became more risk averse.

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

*"CDFIs are really the only financial institutions capable of putting money into SMEs in deprived communities. Investing in CDFIs puts capital into the heart of communities that need capital, whilst getting a return."* **Jamie Broderick, Board member, Impact Investing Institute, 2021.**

*"I appeal to those with the most insight into the dire state of consumers' finances — the heads of our retail banks. Why wait for the government to force your support? Show us that your corporate social responsibility programmes really count for something and get behind the community lenders today."* **Claer Barrett, The Financial Times' consumer editor, May 2022.**

*"Treasury should use the coming dormant assets windfall to stimulate growth of the ethical lending sector."* **Lord McNicol, February 2022.**

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

**Lack of capital to lend** – first-loss and commercial capital. Historically EU/UK Government has provided capital. Commercial banks have been reluctant to lend to small CDFIs. CDFIs are limited by their lending resources. With more support they can do much more to reduce inequalities.

**Lack of grant and development capital**, which has been key to growth in the US CDFI market (where not only banks but corporates have woken up to the impact that investing in CDFIs can unlock for them). Companies such as Starbucks, Netflix, Twitter, PayPal and Square have invested in CDFIs as a way of combating racial injustice and poverty.

**Awareness of CDFIs** among central and local Government, commercial banks, SMEs, some local enterprise partnerships and the general public.

[9] An important goal of the British Business Bank as noted in the NAO review

**Gold Crown Bakeries: Rapidly Expanding Bakery**

Hull-based Gold Crown Bakeries works exclusively within the wholesale market and counts luxury hamper producers among its client base. Funding from CDFI Finance for Enterprise, supported by CITR (community investment tax relief), enabled the firm to relocate to a new 20,000 sqft facility, create three new production lines and double its workforce from 14 to 28 employees.

Gold Crown Bakeries secured a £150,000 loan which included £75,000 from NPIF – BEF & FFE Microfinance, part of the Northern Powerhouse Investment Fund, and £75,000 invested directly by Finance For Enterprise, which was backed by the Coronavirus Business Interruption Loan Scheme and included a portion of capital raised through CITR from a social bank.

Jonathan Battersby, Bakery Director, Gold Crown Bakeries said:

*"In recent years, Gold Crown Bakeries has been on a considerable growth journey. Turnover has risen from £800,000 in 2015 to more than £2.25 million during our last financial year, however we realised our factory was working close to capacity, with members of staff working around the clock in order to meet demand.*

*"We approached Andrew Craggs, a specialist finance broker at ECS Group and during our discussions they referred us to Finance For Enterprise. The support we received from NPIF & Finance For Enterprise was excellent. They kept us updated throughout the application process and with funding in place, we were able to begin production just two months since we began the process.*

*"The additional capacity in our new premises has meant we are able to increase the volumes of products created as well as investing time introducing new product ranges. As a direct result of the support we've received from Finance For Enterprise, I'm confident that we're on course to enjoy a record year of growth, enabling us to double our workforce and create 14 new jobs in the business."*

**Miss Macaroon is a Birmingham-based** producer of bespoke macaroons set up by social entrepreneur and trained pastry chef Rosie Ginday in 2011 (Ginday was awarded an MBE in 2018).

The firm specialises in producing distinctive, luxury macaroons and high-end patisserie for both private and corporate clients, and uses profits to support education and training programmes for young people. Founded by Ginday with £500, in 2016 it needed finance to establish a retail arm.

*"These plans almost didn't materialise when I was unable to secure the necessary funding from a number of traditional and social lenders,"* says Ginday. *"Thankfully BCRS Business Loans [a CDFI in the West Midlands] understood our needs and stepped in to support us with a business loan."*

Miss Macaroon now operates a prosecco and macaroon bar in Birmingham's Great Western Arcade, and a licensed Miss Macaroon store at Resorts World, one of Solihull's major leisure venues. It produces tens of thousands of macaroons each week.

Ginday was presented with a Natwest Everywoman Award in December 2021. The business' online store helped it bounce back after Covid disruption to its corporate, conference and wedding work. HRH Prince Charles chatted with Ginday during his visit to Birmingham's Commonwealth Games opening ceremony.

**Allegro Optical** provides bespoke optical examinations and lenses for musicians, who often experience specialist eye problems due to their craft. The family business – the only opticians accredited by British Association of Performing Arts Medicine – was founded in Meltham by Sheryl Doe and her husband Stephen Tighe, with the help of a £40,000 Start-Up loan from CDFI the Business Enterprise Fund (BEF). Now, with over 6,000 clients and a turnover of £600,000 a year, it is looking to expand again.

Sheryl and her conductor, composer and brass band player husband employ 20 staff, all musicians, and will be recruiting more people over the coming months.

The company works with the Royal Society of Musicians of Great Britain and the Royal College of Music and has been recognised with awards from the Federation of Small Businesses, as well as being named Dispensing Optician of the year 2019 and 2021.

## How to scale-up CDFIs in the UK

In November's **SMEs: Access to Finance** debate, Peter Gibson MP, Vice-Chair of the APPG on Fair Business Banking, said:

*"We must deliver a strong local finance option for businesses in the UK. We cannot continue to deprive hungry and ambitious businesses of access to finance and scaling up, simply because they do not have access to the right financial product.* ***We need to provide capital to community development financial institutions and regional mutual banks, to allow them to increase their offering."***

His call was backed by **Pat McFadden, Shadow Economic Secretary to the Treasury** who agreed CDFIs have a very important role to play in this debate, and have already proved successful in stepping in where main high street banks are unable to help.

Additional first-loss capital, key to growing CDFI lending, can be secured through:

Using **dormant assets** to support CDFIs is an effective way to catalyse community lenders. Commercial banks are showing much greater interest in lending to the sector to leverage up first loss capital. The (newly announced successor) Recovery Loan Scheme could give the sector a significant opportunity to leverage any newly released dormant asset funding by between two and five times. Responsible Finance is submitting a response to the current consultation on the use of new dormant assets.

**Incentivise banks to back community-based lenders**. The Centre for Research in Ethnic Minority Entrepreneurship (CREME) has proposed UK high street banks seek to address the access to finance gap for ethnic-minority led businesses by working with CDFIs to capitalise locally focused loan funds, targeting areas highly populated by EMBs, especially those already reporting high start-up rates.

Some commentators have called for a **Community Reinvestment Act** in the UK. In the US the Act means banks must support community lenders and invest in communities where they take deposits. It also encourages and incentivizes partnerships between commercial organisations and CDFIs.

**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 to help CDFIs raise funding for social impact lending. The terms of CITR have not been changed since 2002.

CITR's impact on supporting a thriving community development finance sector and stimulating investment into disadvantaged communities could be increased through a number of measures. Responsible Finance recently submitted a detailed paper to HM Treasury about how the scheme could be more effective.

**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 local government pension funds:** unlocking local pension funds to support community enterprise. As community-based lenders, CDFIs can enable Local Government Pension Schemes to increase their assets invested in local areas.

**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. Small grant support through will enable the CDFI sector to develop more quickly.

**We thank the panel for considering our evidence and would be happy to consult with you and provide more details of our sector's impact and potential to ensure start-ups can thrive and grow in Britain to boost jobs, investment and economic growth across the country.**

Please contact Theodora Hadjimichael, CEO of Responsible Finance, or Jamie Veitch, Head of Communications, to discuss these proposals via 07904 272 200 or email:

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