Responsible Finance

Responsible Finance: Spring Budget 2023 Representation

Responsible Finance is grateful for the opportunity to feed into HM Treasury in advance of the 2023 Spring Budget. It does so as the industry body for Community Development Finance Institutions (CDFIs).

Summary of Responsible Finance's Spring Budget 2023 Representation

CDFIs are not-for-profit lenders whose goal is to improve access to finance for underserved businesses and individuals. There are approximately 50 CDFIs serving areas across the UK, with over 95% of lending taking place outside London.

During the last five years CDFIs have lent over £1bn to small businesses turned down by mainstream banks. Lending has been focussed on deprived areas and disproportionately to demographics which face high barriers when trying to access finance. Around 90% of CDFI enterprise borrowers go on to successfully repay their loans and grow their businesses.

Personal lending CDFIs provide a vital alternative to high-cost credit and illegal loan sharks for individuals needing short-term loans to cover essential items. Their purpose is to reduce the poverty premium and potential debt spiral faced by millions in the current cost-of living crisis. Personal lending CDFIs have lent £167mn during the last five years.

CDFIs' objectives are closely aligned with those of Government: unlocking economic growth, delivering on levelling up and facilitating financial inclusion. Governments have long recognised the value of CDFIs who lend where banks are increasingly unable to. To encourage CDFI lending, successive governments have provided support for CDFIs in a variety of ways: provision of investment capital (e.g. Regional Growth Funds), targeted tax reliefs (e.g. Community Investment Tax Relief) and loan guarantees (e.g. The Enterprise Finance Guarantee, now the Recovery Loan Scheme). Program reviews have consistently demonstrated the high economic additionality and excellent benefit-cost ratios generated by these schemes.

This representation aims to support Government objectives by building on existing programs which have already established an excellent record of value-for-money. Our recommendations will create additional lending capacity for CDFIs, keep down their funding costs and increase customer awareness. In turn, the ultimate goal of our recommendations is to:

- Unlock economic growth in deprived areas and among more disadvantaged groups.
- Mitigate the impact of high-cost credit on personal borrowers affected by the rising cost-of-living.

Responsible Finance's Recommendations:

1. **Increase the scheme limits on Community Investment Tax Relief (CITR) and expand its use to personal lending CDFIs.** Over the past decade the banking sector has raised the threshold for loans to be considered outside of data-driven credit models. As a result more small businesses are likely to find themselves unable to get the credit they need. The proposed uplift in CITR limits would represent a real increase over inflation since the relief's introduction over 20 years ago. The new limits would be better aligned with more recent CDFI funding programs designed to support small business lending in deprived areas or run by disadvantaged groups. These include the Community Investment Enterprise Facility (CIEF) which is administered by Big Society Capital and has become a key source of funding for the sector.

   CITR is an important mechanism for improving the supply and reducing the cost of capital to CDFIs. By offering investors a higher rate of return, CITR provides an important incentive to investors, delivering around £25mn p.a. of funding to CDFIs. Our members believe that without CITR, a high percentage of this funding would simply not be available to CDFIs[1].

   Some social investors choose to share the benefits of CITR between investors and CDFIs where they believe the risk and return warrants this. This can help CDFIs reduce their lending costs and increase the provision of business support, creating a virtuous circle.

   According to RF estimates, raising the for-profit loan limit from £100k to £250k, and for non-profit loans from £250k to £375k, could add a further £20mn of annual lending capacity to small businesses in deprived areas and enterprises led by individuals who face high barriers to finance.

   The rules for CITR ensure that taxpayer support will continue to be applied where it is needed most: underserved businesses in deprived areas and those run by more disadvantaged demographics. The expansion of CITR to personal lending CDFIs would be within similar parameters to precisely target funding.

2. **Endow the remaining assets of the £30mn Regional Growth Fund grant made in 2012 to the CDFI sector.** Over the 10 years since its inception, the £30mn Scheme has significantly exceeded its original lending target (actual: £100mn vs £70mn target) and job support target (11,770 vs 8,500). It has also been very successful in attracting match-funding from the private sector.

   The development of new funding structures indicate that more effective use can be made of the remaining grant assets (c.£15mn) if they are released from the Scheme. RF believes that the remaining grant assets could unlock a further £50mn of lending capacity over the next 10 years if the grants are endowed to the sector as provided for in the Scheme Letter[2].

   If the RGF CIC vehicle is unlocked from the Scheme, RF believes it has the potential to create the basis for a national CDFI funding vehicle, building on its track record to attract new sources of capital.

3. **Extend the credit broking exemption for registered social landlords to all organisations to reroute more people away from high-cost and illegal lenders.**

[1] RF Member Survey data, 2023, suggesting an average 4.8% increase in funding costs in the absence of CITR
[2] Revised Scheme Letter dated 8th February 2017, paragraph 4(b)ii

Summary of Recommendations

Recommendation	Projected Impact	Gross cost to the taxpayer
1. **Uplifting CITR limits and expanding to personal lending CDFIs**	Est. +£20mn lending to underserved small businesses each year, adding ~£80mn to local economies focused on deprived areas. +£100mn in lending over 5 years. Primarily unlocks sources of funding that otherwise may not exist. In addition, reduces CDFI costs, enabling lower borrower rates and more business support. Enabling personal lending CDFIs to raise funding and reduce the cost of funding – impact uncertain at this stage.	+£1mn p.a. for 5 years for each additional £20mn of lending
2. Endowment of remaining RGF Grants to the CDFI enterprise lending sector	Est. +£10mn lending each year to underserved small businesses, estimated to add ~£40mn to local economies focused on deprived areas each year +£50mn in lending over 5 years with £40mn of private sector match funding. Providing a structure to attract further private sector finance through existing infrastructure and track record. Potential vehicle to leverage new dormant asset allocations on a £1:£4 basis	Potentially no cost, depending on how Government accounts for RGF grants
3. Extend credit broking exemption for referrals to community lenders	Encourage partnerships which increase the effectiveness of CDFIs and reroute individuals away from high-cost and illegal lenders	No cost to the taxpayer

Background – About SME lending CDFIs

Community Development Finance Institutions (CDFIs) are not-for-profit financial institutions, driven by a desire to achieve both social and economic impact. They lend to small businesses, social enterprises and individual consumers who have been turned down or are unable to access finance from mainstream sources. They have a particular focus on deprived areas and disadvantaged groups, providing not only affordable finance but also valuable support.

During the past 5 years CDFIs have lent over £1bn to small businesses and social enterprises which otherwise would have been excluded from finance. Around 90% of CDFI borrowers successfully repay their loans and grow their businesses. Academic research suggests this has added between £3bn and £4bn of economic activity to local economies[3]. Industry data indicates that CDFI enterprise lending has supported over 50,000 jobs – again with many located in deprived areas. CDFIs lend disproportionately to groups which are twice as likely to be declined for bank finance such as women or BAME-led businesses[4]:

[3] The CDFI Economic Impact Calculator, Coventry University, 2014
[4] https://responsiblefinance.org.uk/policy-research/

- 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.

By lending to businesses who have been previously declined by banks, CDFIs create a high level of economic additionality, unlocking economic growth in areas of high deprivation and among demographics who face high barriers when trying to access finance. CDFIs are also countercyclical lenders and can lend more in challenging and uncertain economic times because they have experience in assessing and managing risk. They carefully consider the social impact of making the loan.

The Small Business Finance Gap

Access to finance for small businesses remains a constraint on economic growth. The British Business Bank has reported that access to affordable business credit varies considerably across the country[5]. They also report that businesses led by certain demographic groups suffer much higher rejection rates when they make loan applications to banks.

The 2022 Levelling Up White paper noted that Government should aim to identify policies which 'boost productivity, pay, jobs and living standards by growing the economy, especially in those places where they are lagging'[6]. The same White Paper also noted that 'many SMEs currently suffer from the "liability of distance" – a lack of access resulting from investors not being close enough to form the relationships and collect the information necessary to make investment decisions.'

Unlike traditional banks, over 90% of CDFI lending is outside London and over half in areas of high deprivation. CDFIs seek to overcome information opacity by providing a relationship-based approach to lending, combined with a knowledge of place. In this way they are recognisably different from mainstream commercial lenders. In 2021 they provided more than 30,000 hours of pre- and post-application support to help their borrowers succeed.

This stands in contrast to high street banks which have little or no human intervention for most small business loans, relying heavily on credit-scoring systems. CDFIs are especially useful when bank credit gets tight: CDFIs have a 20-year track record of being there to support enterprises and communities during economically uncertain times[7]. At the same time, costs have risen in an unprecedented way for businesses[8] making it harder for them to accurately plan for their future investment. It also makes it more difficult for lenders to understand the viability of a business plan when businesses apply for credit.

Using data from the BEIS Longitudinal Surveys and SME Finance Monitor, Responsible Finance estimates the annual unmet need for small business loans at £5bn[9]. Other sources put the figure for all small businesses as high as £22bn[10].

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[5] https://www.british-business-bank.co.uk/research/small-business-finance-markets-report-2022/
[6] Levelling Up the United Kingdom White Paper, UK Government, February 2022
[7] An important goal of the British Business Bank as noted in the NAO review
[8] Roger, S. (2022) The cost of doing businesses 2022q2. Data from the Small Business Price Index.
[9] Analysis available from Responsible Finance
[10] https://www.bankofengland.co.uk/-/media/boe/files/research/an-open-platform-for-sme-finance

The SME Lending CDFI Funding Problem

Despite their impressive record of delivering both economic and social impact, CDFIs can satisfy only a modest fraction of the unmet demand for small business loans.

The capacity of CDFIs to narrow this funding gap hinges on their ability to access their own capital at affordable rates. Sources of capital range from social banks, dormant assets (through Big Society Capital), foundations and other socially oriented investors. Capital raising is also supported through Government measures such as access to loan guarantee schemes administered by the British Business Bank and investor tax reliefs such as the Community Investment Tax Relief (CITR).

The key challenge for CDFIs when raising capital is convincing investors that the returns on lending to businesses previously turned down by banks are proportionate to the risk. It is true that CDFIs are relatively small institutions lending to customers who often have little collateral to offer or have mixed trading records. To consider providing finance to CDFIs, potential investors need to become comfortable with the risks and have a genuine desire to deliver social impact.

Given the apparent credit quality of their borrowers, the loan loss records of CDFIs are surprisingly good. Member surveys show that loan loss rates across the sector average around 12%, varying over time depending on individual CDFI lending policies and the state of the economy. Academic research indicates that CDFIs actually perform better in terms of loan losses than large institutions with comparable loans[11]. With an average loan rate of around 12% and typical loan term of 5 years, most CDFIs aim to make a slight profit which is then reinvested into their organisation[12].

Despite relatively good performance both in terms of loan losses and in delivering social impact, CDFIs find it hard to raise capital – and in particular the junior or first-loss element. Work is ongoing with the Impact Investing Institute to develop CDFI funding structures which are attractive to investors[13]. There are several interesting examples of funding mechanisms from the US which provide case studies of how investors can become comfortable with CDFI risk[14]. However despite the size, sophistication and relative maturity of the US market, raising junior/first-loss capital remains a major hurdle even for US CDFIs.

"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

[11] "The Hazards of SME Loan Schemes", Cowling 2021
[12] Loan losses tend to be spread over the term of the loan, allowing CDFIs to make a profit in the early years.
[13] Supported by DCMS
[14] https://www.lisc.org/our-stories/story/quantum-leap-cdfi-funding-potential-securitization/

Recommendation 1: Update the limits on Community Investment Tax Relief to increase the supply of finance to deprived areas and disadvantaged groups

The following adjustments to CITR will increase its reach to more small businesses and individual consumers underserved by the mainstream financial system:

1. **Relevant Investments: Increase amount that may be borrowed by an end recipient to £250,000 (for-profit) and £375,000 (non-profit). These amounts have not been adjusted since 2002.**
2. **Amounts an accredited body can raise: Increase the limits on accredited bodies of £10 million (retail) and £20 million (wholesale) to £50 million (retail) and £200 million (wholesale).**
3. **Personal lending: open CITR tax-relief to personal lending CDFIs to support more individual consumers who struggle to access affordable credit.**

- Community Investment Tax Relief (CITR) is a highly targeted intervention which delivers on the Government's levelling up objectives by increasing access to finance for SMEs, social enterprises and charities. Its 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's impact is increasing. In the last 3 years CITR has facilitated an average of over £20mn of loans each year. Lending through the scheme increased by 40% between 2016/17 and 2020/21. Investment raised almost doubled in the same period, from £13mn to £25mn[15].
- CITR is a good value intervention with a benefit-cost ration of 6:1[16]. It has created an additional £318 million Gross Value Added in the last 5 years compared with a total cost of £49 million. This is before taking into account the considerable social impact of benefits derived from greater employment in deprived areas and the financial inclusion of excluded groups such as women and ethnic minority entrepreneurs.
- Costs arising from the recommendations will increase gradually as the use of CITR increases and the CDFI sector scales up.

An increase in the use of CITR will catalyse economic growth within disadvantaged communities as CDFIs use it to lend to enterprises in the 35% most deprived communities and to excluded demographic groups.

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[15] Community Investment Tax Relief (CITR): Aggregate Investment for Accredited Community Development Finance Institutions. From: Department for Business, Energy & Industrial Strategy and HM Revenue & Customs
[16] Cost benefit analysis in Appendix 2

Proposed amendments to Community Investment Tax Relief

Community Investment Tax Relief is an important tool to help CDFIs raise funding for social impact lending. The terms of CITR have not been changed since 2002 so there are some refreshments that would make the scheme even more effective.

With the following changes CITR's impact on supporting a thriving community development finance sector and thereby stimulating private investment into disadvantaged communities can be increased as a tool to support the Government's levelling up priorities:

1. **Relevant Investments: Increase amount that may be borrowed by an end recipient to £250,000 (for-profit) and £375,000 (non-profit). Regular future review points should be provided for to enable limits to keep pace with inflation.**

   The intention of this recommendation is to acknowledge the impact of inflation on original borrowing limits and bring the scheme more into line with the major industry lending schemes.

   Currently, enterprises are limited to borrowing £100,000 (for-profit) and £250,000 (non-profit) based on the legislation of 2002. That amount has fallen in real terms over the past twenty years, and the corresponding amounts to 2021 would be approximately £150,000 and £375,000.

   At the same time, many CDFIs lend up to £250,000 to for-profit enterprises under the Government's Recovery Loan Scheme and through programmes such as Big Society Capital's Community Investment Enterprise Facility (CIEF). Without a change to loan amounts, CDFIs will have to attract an increasing proportion of their funding outside of CITR, despite borrowers otherwise qualifying to receive funding through it. This increases the cost of capital for SMEs which have a social impact and is a missed opportunity for supporting enterprises unable to access funding above £100,000. With an increase in CITR limits, more small businesses could benefit from this type of affordable credit. We therefore recommend raising the amounts that may be borrowed by the end recipient to £250,000 (for profit).

   It is also important to note that as relationship-based, supportive lenders, CDFIs often have long term relationships with their borrower SMEs. This means that they often provide follow-on funding to SMEs (where that SME still is not able to meet a mainstream bank funder's requirements). However once the maximum amount has been borrowed through CITR, they are not able to access funding through CITR again despite fitting all the other scheme requirements.

   Impact of the amendment

- CITR unlocks capital for CDFIs to borrow for on-lending. Without CITR, this capital may not be available and CDFIs would not be able to support SMEs with access to finance.
- As a secondary impact, CITR can lower the cost of capital that CDFIs borrow to on-lend where investors are able to pass on some of the cost savings, allowing CDFIs to reduce their loan costs. CDFIs pass on this cost saving because they are not-for-profit organisations, with no shareholders to make returns for.
- Evidence from brokers working with the CDFI sector consistently indicates that other commercial for-profit lenders serving a similar market to CDFIs are routinely charging over 20% interest to SMEs, despite CDFI historical loan losses averaging around 12%.

- One real life example was given to a CDFI by one of its SME customers, who received this quote from a well-known, commercial SME lender, but subsequently borrowed from the CDFI instead. The almost £40,000 saving through going to a CDFI illustrates the importance of creating the right conditions to scale up the CDFI sector to increase its reach:

Commercial lender quote

Amount borrowed	£150,000
Term	60 months
Arrangement fee	*£10,350 (6.9% - added to loan so interest is payable on fee)*
Interest	*£94,012.62 (19.9%)*
Total fees and interest	**£104,362.62**

Subsequent CDFI quote (note this specific client borrowed £250,000 from the CDFI so this quote is illustrative for comparison)

Amount borrowed	£150,000
Term	60 months
Arrangement fee	*£4,500 (3% - fee deducted from the £150,000 loan advance)*
Interest	*£61,238.42 (14.39%)*
Total fees and interest	**£65,738.42**

- From a sample of CDFIs, we estimate that currently 55% of overall lending (value) to for-profit SMEs is above £100,000 and below £250,000, where funding must be found outside of CITR. If the CITR lending limits were raised Responsible Finance estimates it could lead to an annual increase in lending of up to £20m.

<u>Impact of not making the amendment</u>

- It will increasingly limit CDFIs' ability to serve the underserved market. An increasing number of otherwise eligible businesses and social enterprises will remain unfunded, reducing investment in deprived areas and among excluded groups.
- SMEs and social enterprises may need to pay more for the capital they are borrowing, particularly at a time when their costs are already rising.
- A rising proportion of small enterprises will fall short of their potential economic potential creating an increasing drag on the growth of productivity and the social impact that small businesses can deliver.

2. **Amounts an accredited body can raise: Increase the limits on accredited bodies of £10 million (retail) and £20 million (wholesale) to £50 million (retail) and £200 million (wholesale).**

   The aim of this recommendation is to reduce the complexity of raising larger amounts of capital. The capital raised will still need to meet the requirements of the CITR scheme and therefore deliver on the intended impact. Overall more capital will flow into deprived areas and to groups which face higher barriers when trying to access capital.

   At present there is a limit of £20 million and £10 million for wholesale and retail CDFIs respectively on the CITR investment that can be raised during a three-year period. Whilst a CDFI can request the opportunity to raise more than this from BEIS there is a lack of clarity on this and the process which sits behind it, which leads to greater administrative costs and acts as a potential barrier to new investment.

   The current limits were established in negotiations with the European Union to comply with restrictions on State Aid. Following the UK's exit from the EU these limits could be removed in order to support a scale-up of the CDFI sector and future proof the scheme.

   At the moment institutions providing capital may need to know the amount of the total fund raise in order to assess the level of their participation, and the need for CDFIs to request multiple accreditations needlessly complicates institutional fundraising.

   It was widely regarded in feedback from CDFIs and investors that a wholesale fund is unlikely to work capped at a £20 million limit. The current Big Society Capital CIEF 1 structure requires each CDFI to set up a Special Purpose Vehicle as a wholly owned subsidiary to which funding is provided from Triodos Bank and Unity Trust Bank with the benefit of CITR. Each is therefore classed as a retail CDFI.

   The structure for the next iteration of this fund (CIEF 2) is yet to be agreed but it is likely that the initial fundraising target will be up to £100 million, with a maximum allocation of approximately £25 million to an individual CDFI.

   <u>Impact on existing funds: The Community Investment Enterprise Facility (CIEF)</u>

   Many small businesses across the UK are unable to access mainstream finance. While they can access finance from socially motivated lenders such as Community Development Finance Institutions (CDFIs), the CDFIs themselves face barriers to achieving long-term sustainability and securing significant capital at scale to meet the demand of viable small businesses.

   Big Society Capital (BSC) established the Community Investment Enterprise Facility (the "CIEF") to provide CDFIs with the capital they need to meet demand, to help increase understanding of the financial and social impact of CDFI lending, and to attract other investors to help achieve long-term stability. This Facility is managed by Social Investment Scotland and has so far provided capital to four CDFIs – Finance for Enterprise, BCRS Business Loans, Business Enterprise Fund and First Enterprise – Enterprise Loans – to help them lend to small businesses operating in disadvantaged areas. The facility combines private debt (in junior - £30 million capital from BSC, and senior tranche - £30 million from Triodos and Unity Trust Bank).

CDFI loans are covered by a partial government backed guarantee, the Recovery Loan Scheme, to mitigate the risk posed from lending to small businesses with little collateral or a variable track record. All loans are made to small businesses that qualify under CITR and investors benefit from CITR. To build impact evidence and track record, a long-term financial, social and economic evaluation of the facility is carried out on an annual basis by the Centre for Regional Economic and Social Research at Sheffield Hallam.

To ensure CDFIs continue to access to capital at scale, the CIEF structure is evolving to a larger Fund, CIEF 2, which will include new investors in the sector as well as additional CDFIs able to access the Fund to reach more businesses in underserved areas. The ambition is for 100% of CIEF 2 to qualify for CITR investors, to encourage a wider group of investors to support the sector who might not be able to otherwise.

One constraint to further utilising CITR is that CDFIs can lend a maximum of £100,000 to small businesses under CITR rules. In the current CIEF fund CDFIs have made loans of up to £200,000 (made possible because not all CIEF Facility attracts CITR). Businesses that CDFIs fund are unable to attract funding from other sources, which means c.16% of the number of businesses supported in CIEF may not have been reached if restricted by CITR.

Impact of the amendment

- It has the potential to unlock negotiations with larger investors, including sector-wide funding opportunities. If limits are raised and CITR funding applies to larger loans, Responsible Finance estimates there is scope to double the volume of annual funding under the CITR scheme. This would add an additional £20mn of funding to the sector each year.
- Enhance planning for future growth through greater certainty of capital.
- Enable CDFIs to scale up and become more cost efficient, therefore supporting more businesses.
- Remove added complications of needing to attain multiple accreditations.
- Pass on cost savings of scaling to more small business borrowers through lower interest rates.

Impact of not making the amendment

- Growth of wholesale funding at scale using CITR will be diminished.
- Alternative sources of funds, including from new ESG investors, will be restricted.
- Potential funders are put off due to current limits and administrative concerns.
- CDFI sector scale-up negatively impacted.
- Enterprises are unable to access lower cost loans from CDFIs at scale.
- CDFIs will be less able to provide business support services.

3. **Personal lending: open CITR to consumer lending CDFIs to support more vulnerable individuals with access to affordable credit.**

   The cost-of-living crisis is exacerbating the negative impacts of financial exclusion. Consumer lending CDFIs help to restore their customers' financial stability and reroute them away from exploitative and illegal money lenders. Since the characteristics of customers served by CDFIs tend to mirror those found to be using illegal loan sharks, measures which create the right conditions to support the sector's scale up are both timely and important:

CDFI Customer Demographics in 2021	**Victims of Illegal Moneylenders according to the Centre for Social Justice[17]**
52% social housing tenants	48% social housing tenants
65% with an income below £21,300	62% with an income below £20,000
41% unemployed	49% unemployed
67% benefits recipients	75% benefits recipients

   CDFIs help to protect people's incomes and wellbeing against exorbitant interest rates and exploitation. This saves the Government money by reducing the knock-on impacts to the economy of poor emotional and physical wellbeing, leading to improved productivity of the workforce. Extending CITR for use by personal lending CDFIs will support the sector to scale-up and provide more households with vital, fair and affordable access to credit.

   <u>Responsible Finance is proposing to extend CITR tax-relief to consumer lending CDFIs. This can be done through:</u>

- Amending the requirements (Part 7, Chapter 2 of the 2007 Income Tax Act 7) for an organisation to qualify for CITR accreditation to include organisations that have the principal objective to provide finance (or finance and access to financial advice) to (a) enterprises (b) individuals or (c) enterprises and individuals.
- The requirement to onward lend a proportion (currently 75%) of funds raised in 'Relevant Investments' would remain.
- Definitions of 'Relevant Investments' and 'Qualifying Enterprises' as set out in The Community Investment Tax Relief (Accreditation of Community Development Financial Institutions) Regulations 2003, Part 3, Regulation 11 would need to be expanded/modified to encompass individuals in disadvantaged postcodes that meet certain measures of disadvantage.

Personal lending by CDFIs does not currently qualify for access to CITR, as the 2002 legislation targeted "qualifying enterprises". This is primarily because the legislation was sponsored by the (then) Department of Trade and Industry and focused on business lending.

Personal lending by non-profit and asset locked responsible lenders in 2020/21 was £34 million through 67,000 personal loans. The average personal loan approved by CDFI personal lenders in 2021 was £374.

[17] Centre for Social Justice (2022) Swimming with Sharks: Tackling Illegal Moneylending in England

One of the key barriers to the expansion personal lending by the CDFI sector is a lack of capital to on-lend. Access to CITR would enable the personal lending CDFI sector to explore increasing partnerships with social and mainstream banks to raise investment. Investors in consumer lending CDFIs estimate they may be able to reduce interest rates by as much as 4%. This may reduce CDFI interest rates by as much as 10% alone, alongside further reductions created through economies of scale which will be unlocked through greater access to capital.

Current UK government policy supports the need to increase the availability of affordable and appropriate credit products for people on low incomes. The autumn 2018 budget statement included a number of initiatives designed to support the expansion of responsible credit.

By setting the parameters for the program so that they are aligned with policy objectives, Government can achieve policy goals with the private sector making the investment. The extension of CITR to personal lending CDFIs would support financial inclusion by generating investment for onward lending to improve access to credit for those on lower incomes.

Responsibility for due diligence would reside with investors as would the risk of the investment. This private sector investment would complement any government investment made, for example, through the dormant assets financial inclusion funds delivered by Fair4All Finance.

Mitigating the risks of expanding CITR to consumer lenders

- Any changes to CITR would need to be robust to ensure that CITR encourages investment into responsible finance providers rather than subsidising investment into the high-cost short term credit (HCSTC) market.
- The accreditation parameters would be straightforward to design using the expertise of Responsible Finance and other specialist organisations, such as Fair4All Finance.

Impact of the amendment

- Unlock negotiations with investors and potentially reduce funding costs.
- Enable consumer lending CDFIs to scale up to reach more financially excluded individuals, rerouting them away from high-cost and illegal lenders.
- Customers will benefit from economies of scale through a lower cost of credit.

Impact of not making the amendment

- The ability of personal lending CDFIs to raise private investment will continue to be suppressed.
- CDFI sector scale-up negatively impacted.
- Individuals are unable to access affordable credit from a scaled-up CDFI sector so continue to access credit from high-cost and illegal lenders, resulting in:
    - The poverty premium remaining high, compounding impacts from the rising cost of living.
    - The wellbeing and productivity of the workforce continuing to be suppressed through the negative impact of financial difficulty on staff productivity.

Recommendation 2: Endowment of Historic Regional Growth Fund Grant

Our Proposal

In 2012 a grant of £30mn was made via the Government's Regional Growth Fund to the CDFI sector with the aim of improving access to finance for small businesses and particular focus on deprived regions and underserved groups. Targets for the grant have been comfortably exceeded by CDFIs: the scheme has delivered over £100mn of small business loans (original target £70.4mn) supported by match funding from the private sector and recycling of grants; it has supported 11,700 jobs (target 8,746) with a focus on deprived areas and disadvantaged groups[18].

Economic additionality of the lending has been very high with loans being made to businesses previously turned down by mainstream financial institutions.

Approximately £15mn of the original grant continues to be recycled, matched by private sector funding. While the remaining grant is still supporting high impact loans for underserved small businesses, our proposal aims to double its future impact over the next 10 years.

Our proposal is that BEIS exercises its right under paragraph 4(b)ii of the Regional Growth Fund Scheme Offer Letter dated 8th February 2017[19] to endow the Scheme's assets to the CDFI sector so that:

> *"the Scheme should continue to be run by you (RF) without any involvement of Us"*

This proposal explains how and why our recommendation will:

- Add up to £50mn of small business lending capacity over the next 10 years, unlocking economic growth focused on deprived areas and among disadvantaged groups.
- Enable the remaining grant funds to be used more efficiently by CDFIs.
- Achieve this without any new taxpayer support or legislation.
- Reduce administrative burden on both Government, the Scheme manager and CDFIs.
- Provide an operational platform and track record to develop a national CDFI funding vehicle which can be used to attract additional capital into the sector from both private and public sector sources[20].

We believe our proposal is consistent with endowment of similar funds[21] and is the best choice of the four termination options provided for in the Scheme Letter.

An announcement of endowment in the Spring Budget would provide a very welcome boost to small businesses across the UK.

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[18] Responsible Finance RGF Impact Report, August 2020
[19] Regional Growth Fund Scheme Offer Letter – Revised, Case Ref: 01.09.02/1319C, dated 8th February 2017
[20] For example funds allocated to the sector following the current round of Dormant Assets consultations.
[21] For example endowment of the Future Builders Fund

The Regional Growth Fund Investment

In recognition of the important role that CDFIs play, and the difficulties SMEs faced in raising finance after the 2008 Great Financial Crash, the UK Government decided in 2012 to provide the sector with a £30mn grant as part of the Regional Growth Fund (RGF). This grant provided first-loss capital as a tool to leverage in third party capital. Responsible Finance (RF), the industry body for CDFIs, established a subsidiary to distribute and administer the grant. An independent investment committee allocated capital to CDFIs and monitored performance. The Scheme Impact Report sets out detailed evidence of the significant support and inward investment that it provided to deprived areas and disadvantaged groups[22].

The operation of the vehicle has been effective and has more than delivered on the Scheme's targets. The grant was initially matched with £30mn of external private funding. As the underlying loans were repaid, the repaid grant element was re-lent, again matched by third party capital. Since the Scheme was established in 2014 it has delivered over £100mn of small business lending and supported in excess of 11,700 jobs focussed on deprived areas and disadvantaged groups. After 10 years of operation, around £15mn of the original £30mn grant is still being recycled as first-loss capital by CDFIs. Under the current structure this has the capacity to support up to £30mn of loans when fully invested.

What are the drawbacks of the existing Scheme terms?

The fund vehicle continues to operate as originally anticipated, but with a reduced level of grant. The terms of the Scheme itself create a number of drawbacks, the impact of which have grown over time.

Firstly, leverage of grant to private sector funding was fixed by the Scheme at 1:1. Over time senior investors have become comfortable with the structure and guarantees have become more supportive. New investors are now prepared to offer leverage at up to 1:4.

Secondly CDFIs have developed new structures to attract funding which involve special purpose vehicles. Matched funding can be more effectively leveraged if CDFIs have flexibility to lend capital to subsidiaries or other vehicles. This is difficult under the current Scheme.

Thirdly re-cycling of grant capital can sometimes be delayed due to the way lenders interact with CDFIs. Releasing RGF from the constraints of the Scheme is likely to facilitate faster turnaround[23].

Fourthly the Scheme contains a considerable body of rules to account for EU subsidy and state aid regulations which add to paperwork and restrict grant usage. We believe there is considerable scope to simplify these requirements.

Fifthly although the Scheme has a long track record which could in theory be used to attract new junior/first-loss investors, in practice the Scheme is not open to other investors. Initial work with the Impact Investing Institute suggests that the Scheme, if released from the current structural constraints, could potentially form the basis for an industry-wide funding vehicle.

[22] https://responsiblefinance.org.uk/download/responsible-finance-rgf-impact-report/?tmstv=1675218199
[23] Responsible Finance member email

How can the remaining grants be used more effectively?

As discussed above the remaining grant funds could be used more effectively if they were released from the constraints of the Scheme. This could be achieved by changing the Scheme as envisioned in 4(b) of the Scheme Offer letter[24].

Changing the terms of the Scheme to allow greater leverage would increase private sector funding leverage, but it would not increase flexibility to structure lending within CDFIs or open up the Scheme vehicle to outside investors.

The original Scheme letter provided for four options following July 2018:

i. The Scheme could be extended;
ii. The Scheme could be handed over to the Scheme manager to run for the benefit of the sector;
iii. Remaining grant could be returned or;
iv. Some other course of action.

Our recommendation is that BEIS exercise their right under paragraph 4(b)ii of the Regional Growth Fund Scheme Offer Letter dated 8th February 2017 to permit that:

"the Scheme should continue to be run by you (RF) without any involvement of Us"

It is anticipated that the remaining grant would continue to be used as first-loss financing for CDFIs wishing to lend to underserved groups and in deprived areas. The terms of the Scheme would be amended to add flexibility to CDFI loans and reduce delays to reinvestment. An independent investment committee would continue to allocate the assets and monitor their performance.

The proposal does not require any additional taxpayer financing but seeks to make better use of existing Regional Growth Fund grants made to the CDFI sector. It will achieve this goal by increasing private sector leverage, streamlining reporting requirements, updating re-lending rules and allowing lenders to structure their operations more flexibly[25].

It is our understanding that this proposal does not require any additional legislation and can be implemented using the existing agreement between BEIS and Responsible Finance[26].

Impact of this proposal

If adopted this proposal will generate a number of significant benefits. Specifically it will:

1. Add nearly £50mn of small business lending capacity to deprived areas and disadvantaged groups over the next 10 years.
2. Allow CDFIs to increase private match funding by structuring their balance sheets in the way that is most efficient for them. For example CDFIs will be able to lend RGF legacy funds to special purpose vehicles which are sometimes preferred by lenders, thereby increasing private sector matched funding.
3. Speed up recycling of the Scheme's assets.
4. Reduce administrative overhead – for example eliminating the need to continuously report and monitor elements of state subsidy.

[24] Regional Growth Fund Scheme Offer Letter – Revised, Case Ref: 01.09.02/1319C, dated 8th February 2017
[25] Such as the creation of special purpose vehicles financed in part by legacy RGF grants.
[26] Program Letter to Responsible Finance on July 2017 – copied attached to this proposal.

5. By removing the UK Government's oversight role in the Scheme, it will create the potential for the Scheme manager to develop the CIC as an industry vehicle for third party first-loss capital – a key goal of the sector.

Why is the proposed option better than simply removing the leverage constraint?

A Scheme variation request from Responsible Finance to remove the constraint on leverage was submitted in 2022 and we believe is still under consideration. However Responsible Finance believes that by handing the Scheme to the manager rather than simply changing or removing the existing leverage constraint, a number of additional benefits will accrue:

- Additional lending capacity will be created due to increased flexibility (benefits 2 and 3 listed above)
- Operating costs will be reduced (benefit 4)
- Potential for opening up the vehicle to wider investment for first-loss capital, unlocking a key constraint to the growth of CDFI the sector[27] (benefit 5)

Are there other examples of grants being "endowed" to the CDFI sector?

Responsible Finance does not have access to comprehensive information about other grant schemes, but this Scheme documentation clearly envisioned endowment as a possibility.

There are examples of other CDFI grants being endowed once they have achieved their initial objectives. For example CDFIs have received grants from local authorities with ERDF[28] elements which, after their initial term, have been endowed. Wording taken from one agreement is as follows:

> *"Once all collections have been received, the loan operator will retain the ERDF element in a legacy fund. The legacy fund must be reinvested in the form of new loans to small businesses with the […….] area, following the eligibility principles upon which this project is based."*

In our opinion the original document provided for endowment as an option, there is other precedent for this action and it will make the best use of the remaining assets.

Conclusion

In summary we believe this proposal offers the opportunity to:

- increase the impact of the remaining grants on economic growth;
- deliver greater impact on regional and demographic inequalities and;
- create potential for a national vehicle for CDFI funding.

[27] Potentially creating a mechanism to distribute dormant asset allocations.
[28] European Regional Development Fund

Recommendation 3: Extend the credit broking exemption for registered social landlords to all organisations to reroute more people away from high-cost and illegal lenders

Responsible Finance recommends extending the Government's existing exemption for registered social landlords (RSLs) to all organisations when making fee free referrals to individuals who wish to enter into a credit agreement with community finance providers.

This will expand the exemption the Government introduced in 2019 when it amended the Financial Services and Markets Act[29] 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)

Encouraging referrals to providers of alternatives when consumers need credit can be key in supporting people to be rerouted from high-cost and illegal lenders when they need credit, providing consumers with a cheaper, lower-risk source of finance.

Credit broking is a regulated activity defined in legislation. If a firm or person is engaged in regulated activity they must have authorisation from the Financial Conduct Authority (FCA). This involves an extensive authorisation process (c. 6 – 12 months according to the FCA's website[30]). Once authorised for full consumer credit permissions, firms must then pay an annual fee to the FCA of c. £1,000[31] (depending on their income). This process is off putting for most organisations looking to make fee free introductions to community finance providers.

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.[32]'

Therefore expanding the credit broking exclusion for fee free referrals from all organisations, and further specifying that referrals can only be made to community finance providers, should give the Government confidence that the change cannot be abused or be detrimental to consumers.

As well as RSLs, local authorities are already excluded from the legal requirement to be authorised for most credit-related regulated activities, including credit broking.

[29] https://www.legislation.gov.uk/uksi/2019/1067/article/2/made
[30] https://www.fca.org.uk/firms/authorisation
[31] https://www.fca.org.uk/firms/calculate-your-annual-fee/fee-calculator
[32] https://www.fca.org.uk/publication/finalised-guidance/fg18-06.pdf

Rationale

Community Development Finance Institutions (CDFIs) are not well known so rely on word of mouth and costly marketing to reach their customers. This hampers their ability to scale up to increase access to affordable credit and build economies of scale to further bring down the cost of credit they charge their customers. Increasing the number of organisations which can make introductions to CDFIs will help to build greater awareness of the sector, and therefore reroute more people away from high-cost credit providers, illegal loan sharks, or from going without the credit they need and being forced into unacceptable hardship. It will also unlock innovative new partnerships, such as those outlined below.

Responsible Finance and its member CDFIs have a strong network of charity and other stakeholders that it could better harness through formal referral partnerships unlocked through this change in legislation. This could help to set a precedent for other partnerships, including with registered social landlords.

Example use cases for this extended amendment are below:

Existing Partnership: Fair For You and Iceland's 'The Food Club'

CDFI Fair For You (a Community Interest Company wholly owned by a charity) helps the most financially vulnerable people in society 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 £60 million of social value for 40,000 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 of partnership: 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 at 0% interest.

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:

- 95% of members found the food club helpful;
- 65% said their diet had improved;
- 71% said they are better able to pay for food and other essentials;
- 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.

"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!"

"We are able to eat food when we are supposed to, I am not having to wait until late evening to feed my children or skip breakfasts due to lack of food."

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.

Credit broking: Iceland is not authorised for credit broking therefore it cannot raise awareness of the partnership to its customers. 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 to more consumers across the UK.

Prospective Partnership: Fair For You and the National Benevolent Charity

CDFI Fair For You and the National Benevolent Charity (NatBen) have been exploring ways of working together to enable the charity's grant pot support more individuals. This is not currently possible without NatBen gaining FCA approval for credit broking.

NatBen already provides a number of vouchers towards a purchase (eg a £100 voucher towards a washing machine), but they are not able to do this very often as the recipient rarely has the funds to cover the remaining cost of a new item. This means more high value grants with grant pots running out sooner and less people being supported.

By working with Fair for You, NatBen are looking to provide a voucher towards a purchase, with Fair for You providing its affordable credit for the remaining balance. There is also the potential for NatBen to indemnify the loans, which would seek to reduce the risk to Fair For You and enable them to serve more customers – provided they pass strict affordability checks. This approach would make NatBen's grant funds go further, helping more people, as well as many other expected benefits.

Prospective Partnership: Referrals Between Community Lenders

Whilst CDFIs serve a similar market of customers to one another, they each have distinct lending criteria meaning that one CDFI may be able to support a customer where another one isn't able to. If CDFIs were able to refer these customers to one another, it would keep the potential customer in the 'affordable credit ecosystem' and prevent them from potentially falling into the hands of other exploitative or illegal lenders. The network already has a strong ethic of collaboration through Responsible Finance.

Appendix 1: List of Responsible Finance members accredited for CITR

- ART Business Loans (Artshare (Social Help Association for Reinvesting in Enterprise) Ltd)
- AskIf
- BCRS Business Loans (Black Country Reinvestment Society)
- Big Issue Invest Limited (& Big Issue Invest Trust)
- Business and Enterprise Finance
- Capitalise Business Support
- Charity Bank 1 (& Charity Bank 2)
- Cooperative and Community Finance (Industrial Common Ownership Finance Ltd)
- Coventry and Warwickshire Reinvestment Trust
- Cumbria Community Asset & Reinvestment Trust
- DSL Business Finance
- Enterprise Loans East Midlands (formerly First Enterprise Business Agency)
- Finance for Enterprise
- Key Fund Investments
- Purple Shoots
- Saltend Community Development Company Ltd (Sirius)
- Social Investment Scotland
- South West Investment Group Services T/A Swig Finance
- The Enterprise Fund T/A GC Business Finance

Appendix 2: 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[33], 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[34].
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:

[33] An Economic Impact Tool for the Community Finance Industry, Centre for Business in Society, Coventry University 2014 (Henry and Jarvis)
[34] 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[35]. When lending to smaller businesses with limited collateral CDFIs are assessed to perform significantly better than larger lenders.

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

Appendix 3: CITR Background

Why is CITR important for unlocking and reducing the cost of lending to SMEs?

- **CITR increases investment into CDFIs for on-lending to SMEs by providing a return enhancement:** CITR is highly effective at attracting investment into enterprise lending CDFIs and in making fund structures work. In the last 5 years accredited CDFIs have raised a total of £86 million in investment using CITR, and lent £97 million into qualifying enterprises in disadvantaged communities.
- **It enables CDFIs to pass on a cost saving to their customers:** It provides CDFIs with a lower cost of commercial capital, therefore reducing interest rates for borrowers by upwards of 2.5%.
- **CITR is flexible and easy to administer:** It encourages a wide range of investors such as banks, individual investors and corporations to provide capital to CDFIs to on-lend for social impact. It is relatively straightforward to administer, and reporting requirements are proportionate.
- **Investors in CDFIs use the tax relief to demonstrate their commitment to ESG:** CITR is a way for banks and other investors to demonstrate their commitment to their Environmental, Social and Governance goals. We believe it could also be harnessed to support disadvantaged communities to meet net-zero commitments.
- **CITR is increasingly integral to CDFIs' capital raising strategies, unlocking further lending for SMEs:** The majority of CDFIs and members of Responsible Finance specialising in MSME, social enterprise and charity lending are accredited for CITR. In the last 3 years, through feedback from CITR accredited CDFIs actively using the scheme to raise funding, we estimate that at least approximately 30% of their funding was raised using CITR. We expect this to increase to 40% in the next 3 years.

How do CDFIs use CITR?

- **How investment is raised:** The most common use of CITR is through investors making loans to a CDFI.
- **Bank investment:** The most common CITR-backed investors in CDFIs are social banks. The social banks Unity Trust Bank and Triodos Bank are core to CITR's success, but conversations are progressing with other mainstream banks.
- **Individual investors:** Some CDFIs raise loan and share investment from individuals using CITR. One lender presents to local 'Business Angel' networks to procure CITR investors. Another CDFI uses an investment platform. Ethical banks like Charity Bank can raise investment using CITR from individual investors through customer deposits and loans. These are very low cost to the bank and offer investors a good pre-tax equivalent yield.
- **Compatibility with other policy tools:** In 2017 the Government permitted the use of CITR in combination with loan guarantee schemes (the Enterprise Finance Guarantee scheme at the time). In the proceeding years this has been a significant factor in the growth of CITR and its increasing impact.

How and why do investors use CITR?

- **Investors use CITR to generate social impact and to earn a return:** CITR bridges the gap between what investors expect to earn as an interest rate on a loan to a below-investment grade CDFI, and the amount that the CDFI can afford to pay for capital. Therefore CITR enables CDFIs to attract investors despite paying returns below what an investor would normally require. This enables them to keep loan interest rates for borrowers reasonable and still provide a good return to investors through the tax relief.

- **Administration of tax relief for the CITR lender is uncomplicated**: Because it is structured as an enhancement to the annual yield received for the term of the loan, it is straightforward to assess whether the effective interest rate is comparable to a similar below-investment grade loan or bond.

Does CITR make economic sense for taxpayers?

- An independent economic impact tool created for the CDFI sector by Coventry University[36], estimates that additional lending over the past 5 years supported by CITR has added £400mn in economic value compared to a cost to the taxpayer of £22mn.
- A benefit cost ratio analysis based on historical portfolio performance indicates that CDFI lending supported by CITR delivers a benefit cost ratio of over 6:1. Details of this estimate are provided in Appendix 2.
- Independent assessment of borrower outcomes compared to larger lenders suggests that CDFIs are at least as effective as larger lenders, and significantly more effective when considering borrowers with limited collateral[37].

How do consumer lending CDFIs alleviate pressures on households from the increased cost of living?

- 22% of adults have less than £100 in savings and over half of all households would not be able to cover a large, unexpected expense[38]. This leaves millions of people highly vulnerable to a financial shock.
- People with poor credit scores, on low and/or unpredictable incomes and without savings are viewed as "high-risk" by mainstream lenders and excluded from access to credit.
- The number of regulated credit options open to the lowest income and most vulnerable customers in society has shrunk. There has been an 86% drop in high-cost short-term credit and home credit loan values since 2013[39].
- 11 million people are unable to access affordable credit[40]. Instead, people are forced to borrow either from the remaining very high-cost lenders, or at even higher rates from informal sources such as loan sharks. The use of loan sharks has exploded in the last decade and 1 million people are now estimated to be borrowing from one[41].
- Or, people have go without household essentials, like a washing machine or fridge. 4.8 million people are living without these essential household items. This has a negative impact on financial, physical and emotional wellbeing[42].

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

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

[38] Evans, J., Collard, S. (2022) Findings from the 6th Coronavirus Financial Impact Tracker Survey.

[39] Fair4All Finance

[40] Fai4All Finance

[41] In 2020 200,000 people were estimated to be borrowing from a loan shark annually (The Financial Inclusion Centre: The Real Cost of Christmas). In 2022 £1.08 million people were estimated to be using one (The Centre for Social Justice: Swimming With Sharks)

[42] Turn2Us (2020) Living Without: The Scale and Impact of Appliance Poverty.

- It is therefore vital to scale up the personal lending CDFI sector, so that people can access fit-for-purpose affordable credit options when they need and can afford to borrow. CITR can support this objective.

How do consumer lending CDFIs help to improve workforce productivity?

- Money worries are the biggest cause of stress for UK employees. Almost 8 in 10 UK employees take their money worries to work which had a detrimental effect on their performance, and a high proportion of employers believe that staff performance is negatively affected when employees are struggling financially[43].
- This often results in absenteeism; 4.2 million worker days are lost every year in the UK because of a lack of financial wellbeing, equating to £625 million in lost output[44].
- Research has shown that having a reliable and trustworthy credit provider has positive long-term impacts on health and wellbeing, and leads to the benefits of improved sleep, improved mood and reduced anxiety and depression[45].
- 55% of CDFI customers are employed either full or part-time.
- One CDFI lends specifically to NHS and public sector workers. Independent research of its loan applicants found that over 90% are using one or more types of credit from different lenders, including high-cost lenders who charge APRs over 1,000%[46].
- Extending CITR for use by the personal lending CDFI sector could therefore have a positive impact on the wellbeing and productivity of the UK's workforce, by supporting the sector to scale up.

How do consumer lending CDFIs Increase prosperity across the UK?

- High interest costs contribute to the "poverty premium" in the UK; recent estimates put the additional costs for low-income consumers for a subprime personal loan at £557[47].
- This dampens local economic growth and prosperity, and adds to the squeeze being felt by households now, by draining money from lower income communities and diverting money from being spent locally.
- Other indirect costs such as increased crime, relationship breakdown, poorer health outcomes and reduced educational achievement have been linked to the impact of high-cost debt on poverty.
- CDFIs save their customers £190 per average loan compared to commercial lenders serving the same market. 84% of CDFI personal loans are made outside of London and the South East.

[43] Money and Pensions Service: Financial wellbeing in the workplace
[44] Ibid.
[45] Gibbons, D. (2020) The Social Impact of Fair For You
[46] Harrison, T., Andreeva, G. (2021) The Financial Health of NHS Workers.
[47] Davies, S., Trend, L. (2020) The Poverty Premium: A Customer Perspective

Appendix 4: CDFI Case Studies

CDFI SME Lending Case Study: Doncaster Manufacturer secure six-figure backing to deliver ground-breaking research and employ new staff

A Doncaster-based engineer and entrepreneur, who secured a significant contract to deliver ground-breaking research into laser technology in the energy industry, secured a six-figure cash injection from CDFI Finance For Enterprise to help realise his plans and employ new staff.

Laser Additive Solutions specialises in delivering a wide range of projects on behalf of the aerospace, energy and transport sectors. It was appointed as the lead member of a research and development consortium to investigate how innovative laser technology could be harnessed during the construction of nuclear power stations. The new project required significant investment in raw materials including the need to build a special facility within the company's headquarters.

The sector is a relatively new one so this presented challenges for fundraising, and the firm struggled to secure finance from traditional high street lenders before turning to CDFI Finance For Enterprise for help. Since securing the loan, Laser Additive Solutions has successfully built a new laser process cell and welcomed two new staff members. It is confident the support from Finance For Enterprise will not only help to continue delivering its unique research but lay the foundations to explore new market possibilities for the technology.

Today the company employs five full-time members of staff and counts Siemens, Rolls Royce and Strathclyde University amongst its growing client base. The SonicSMR project is a 12-month collaborative R&D project funded by the Department for Business Energy and Industrial Strategy and aims to address the challenges posed by using metal additive manufacturing in the nuclear industry. Consortium partners include the University of Sheffield's Nuclear AMRC, Brunel Innovation Centre, IVY-TECH and Taraz Metrology.

"Our business is built around helping businesses to embrace 3D metal additive manufacturing, which allows components to be built using lasers to shape metals by building in layers. We're working at the cutting edge in an emerging industry that presents some very exciting opportunities.

"However, as the sector we're working in is a relatively new one, historically, this presented its own challenges when it came to raising the vital funds we needed to purchase the necessary equipment.

"When I launched the business, like many new business owners, I struggled to secure finance from traditional high street lenders, but Finance For Enterprise listened to my plans and were able to help. When the business needed additional financial support, due to the combined impact of Covid-19 and the need to purchase vital raw materials, I approached them again, and they helped us to secure the funds our business needed.

"As a result of the investment we've received, we've been able to install a new facility in our workshop to support the demands of our research project as well as recruit additional members of staff to help us manage our workload more effectively."

Peter Brown, Managing Director, Laser Additive Solutions

CDFI Consumer Lending Case Study: Maggie

CDFI Scotcash is a Community Interest Company. The not-for-profit firm launched in 2007, firstly serving Glasgow only, then the rest of Scotland and now the whole of the UK. Actor and activist Michael Sheen has visited several times and met customers and staff. Last year he wrote "Every pound Scotcash saves for people helps their money go further: for food, clothes, household essentials or savings."

Maggie, 52, is one. The cost of her food shop shot up immediately when her fridge-freezer broke down, but a recent loan from Scotcash meant she could replace it and stop worrying about whether she could afford to feed her 15-year-old son. "Without a fridge-freezer you spend so much more on food. Buying small jugs of milk, not large ones. Lugging tins about. Popping to the shops every day. It's so much cheaper when you can buy fresh ingredients in bulk and cook proper meals. He's about to go to college and he's got to eat properly," she says.

"It was a real discovery to find Scotcash," she says, "for the same loan with other people you were paying back nearly double." Alongside COPD, which means daily trips to the shops can be damaging to her health, Maggie lives with impaired mobility, "which makes it a good thing I didn't have to go to the Scotcash office. Plus with Scotcash there's no-one coming out to your house, I like the way I can do everything digitally and it's so quick."