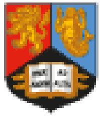

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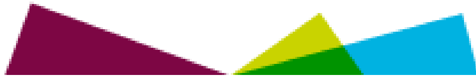

The Future of CDFI Business Lending

Richard Roberts &
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CREME
Centre for Research in Ethnic Minority Entrepreneurship

A note from the Authors

This report has been written at the end of our two year collaboration as research fellows facilitated by the Centre for Ethnic Minority Business Research (CREME) at the University of Birmingham. We are both grateful for the support from the University and especially Professor Monder Ram for his encouragement.

This work formed part of a number of activities within the University of Birmingham Business School Entrepreneurship Cluster. We are very grateful for the input from a large number of academic, industry colleagues and other stakeholders who have discussed all or part of the comments in this paper. We have presented earlier work in progress at ESRC funded seminars on Access to Finance and received useful advice as well.

However, of course, we are fully responsible for the views contained within. In particular, they do not represent the views of the University or ART. We are also responsible for any remaining errors and omissions.

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<u>THE FUTURE OF CDFI BUSINESS FUNDING</u>

<u>The Funding Challenges for Enterprise Lending in the UK over the Medium to Longer Term</u>

Summary

- ***Enterprise Lending CDFIs (ELCDFIs) played a small but important part in the SME funding landscape in 2017 – new loans advanced still exceeded £60 million to about 5,000 viable firms unable to access commercial funds. However, activity has fallen since 2014;***
- ***Since 2015, a number of new developments have emerged to help build a sustainable funding environment to support the ELCDFIs despite the Government decision to end the Regional Growth Fund scheme. These include recent announcements by BSC and the work of the new BBB managed sub-national funds and changes to rules on Community Investment Tax Relief;***
- ***However, it is taking time for this new funding ecosystem to be secured. Fee based schemes alone are insufficient to underpin this new environment and a further decline in gross lending from ELCDFIs looks likely in the short term;***
- ***To help speed up a sustainable future for ELCDFIs we propose greater use of public loan guarantees – perhaps through a variation to the existing Enterprise Finance Guarantee –in order to promote raising investment capital at lower risk for investors;***
- ***A stronger ELCDFI sector will help secure and create jobs – especially amongst underserved communities -in the UK SME sector through the years of economic uncertainty ahead.***

Background

Amongst firms with a viable business plan, external finance is often a key requirement for enterprise creation, survival and growth, particularly where personal and family-based resources are insufficient and a venture cannot generate sufficient surplus cash flow to provide internal funds. Commercial sources often fund this requirement. This is often regarded as primarily a problem for new business ventures. However, despite having a credible business

plan, established firms can also have problems accessing commercial funding from debt or equity sources. [1]

This report is primarily concerned with a group of Community Development Finance Institutions (CDFIs) which have been providing funding solutions to businesses for many years. These Enterprise Lending CDFIs (ELCDFIs) work with a range of businesses that have been unable to obtain appropriate finance from the market. These ELCDFIs have had particular funding challenges over the last few years-especially outside of the start-up sector- despite their lending activity playing a small but important part in the UK SME funding environment. Without change, the outlook for ELCDFIs also looks challenging.

The report starts with a brief review of the overall SME funding market and the role of ELCDFIs within it. The next section outlines how the ELCDFI sector has faced a funding problem over the last few years. The final part of the report considers some proposals to address this problem over the next few years.

The External Funding Environment for SMEs since the Global Financial Crisis to 2017

(a) Overall Market Trends

The data on the flow of gross new loans from the main external sources of funds to SMEs in the UK since 2008 is summarised in Table 1.[2] Following the most recent low point in 2011/12 in the aftermath of the financial crisis, the annual gross flow of new funds - excluding primarily working capital facilities - has increased by about 64% to exceed £83 bn a year. Within this total, all the main originators of new funds have reported improvement. Indeed, banks still provided two-thirds of all the increase in origination to SMEs between 2011 and 2016. Provisional data for 2017 suggests lending growth has been sustained, although the rate has slowed. Overall, compared to the annual level reported at the last low point in 2011, gross new funds to UK SMEs have increased by a cumulative total of £120 bn.

[1] For a summary of the main themes of SME funding see Richard Roberts, *Finance for Small and Entrepreneurial Businesses,* Routledge (2015)
[2] For more detail see British Business Bank, *Small Business Finance Markets, 2017/18* (February 2018). However the authors have added data to the table from other sources and estimated 2017 numbers in some cases. RF data has been estimated from a FY to CY basis

TABLE 1: Gross New Funding for UK SME's, 2008-2016 and 2017 Estimates (£bn)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 est	Growth since 2011 (%)	Growth since 2011 £m Baseline
- bank loans	44.5	41.2	40.4	38.9	38.0	42.9	53.4	57.8	59.0	57.0	47	74.9
- private equity	1	0.5	0.5	1	1.5	1.5	2.3	3.6	3.4	5	400	11.3
-asset finance	14.3	9.95	10.2	10.6	12.2	12.9	14.4	15.9	16.7	18.6	75	27.1
-P2P business lending	0.001	0.001	0.001	0.02	0.06	0.25	0.59	0.8	1.2	1.8	8900	4.6
-P2P Invoice funding	0.001	0.001	0.001	0.003	0.04	0.1	0.27	0.3	0.35	0.5	16567	1.5
-CDFIs	0.03	0.03	0.02	0.03	0.05	0.07	0.09	0.10	0.08	0.06	112	0.3
Total	59.8	51.7	51.2	50.5	51.8	57.7	71.0	78.5	80.7	83.0	64	119.7

Sources: UK Finance, BoE, BBB, RF and author estimates Note growth since baseline is the cumulative funding achieved from each source above the 2011 baseline number

Although banks and mainstream asset finance providers have provided the bulk of the growth in gross new facilities for SMEs since 2011, a key trend over this period has been the rapid growth of alternative sources of finance.[3] As these have grown from a low base they have reported spectacular rates of growth so they now account for nearly 31% of the market for new funds providing a real challenge to mainstream established providers such as high street banks as well as being at the forefront of new technology in both lending techniques and relationship management. Moreover, the growing range of finance providers suggests many UK SMEs have greater choice than ever before in the supply of external funding.

(b) Role of CDFIs

Despite these overall positive developments in SME finance, some types of funding propositions are less easy to support, notably start-ups, early stage and first time borrowers, even though the business plan appears to be financially viable. This is because of the enhanced risk in lending to such firms which is difficult to reconcile with the regulatory requirement of a deposit taking commercial bank or even an alternative lender. The risk-reward dilemma also exists for an equity backer. The SME Finance Monitor, for example, confirms that start-up, early stage and first time borrower applications to credit providers do

[3] NESTA, *Pushing Boundaries – the 2015 Alternative Finance Report* (https://www.nesta.org.uk/publications/pushing-boundaries-2015-uk-alternative-finance-industry-report); for a summary of resulting competitive developments see Ross Brown, *The future Funding of SMEs in the UK* (University of St Andrews Centre for Responsible Banking and Finance, 2017 https://www.fca.org.uk/publication/research/future-funding-sme-uk.pdf

face more difficulty in securing funding with these business owners reporting success rates sometimes only half that of established firms with a track record and a record of repayment.[4]

TABLE 2: Loan and Overdraft Application Success Rate (%)
(Average % Acceptance rates for successive 18 month cohorts 2011 to 2017)

Overdrafts				Loans		
All SMEs		82.6		All SMEs		69.1
-Minimal risk		97.1		-Minimal risk		92.0
-Worse than avg risk		73.6		-Worse than avg risk		54.6
-First Time applicants		57.0		-First Time applicants		51.6
-Other new facilities		76.6		-Other new facilities		75.6
-Renewals		99.1		-Renewals		88.6

Source: UKSME Finance Monitor tables

For these reasons, despite the improvements in the overall SME funding environment since 2010/2011, businesses which have been declined for commercial finance but still have a viable[5] business plan have continued to be very evident in the SME debt funding market. In some cases, a formal credit application is made and declined (sometimes in error). Alternatively, informal advice – from a good or bad source – puts off a formal application (direct "discouraged borrowers"). Other business owners may take no advice but decide not to apply for fear of failure (indirect "discouraged borrowers"). The scale of this debt funding gap is difficult to judge but most estimates suggest in 2014/16 it could have been in the range of between £3bn to £9bn a year; a mid-point in this range is equal to about 7% of new SME credit supply. The most comprehensive study recent suggested the number of creditworthy firms declined or discouraged was in the region of 70,000 (or about £2 bn of debt).[6] Other estimates are much higher – up to £30bn - although this is not a figure this report would endorse. The big difference is created primarily by the treatment of firms that have insufficient core capital/founder equity and seek to borrow too much against revenue (or too early in a project with no immediate revenue at all) regardless of how good the underlying business idea as this is mainly evidence of an equity gap.

[4] BDRC SME Finance Monitor Q2 2017

[5] Viable indicates the business has a credible plan to fund debt repayments - e.g. an agreed order- or reserves to cover any shortfall until this funding stream is secured, subject to normal risk considerations.

[6] See S Fraser, *Back to Borrowing – A Study of the Arc of Discouragement* (ERC Working paper, 2014; a wide range of possible causes and market sizes was discussed in the British Business Bank, *Small Business Finance Markets* 2015 (November 2015).

It should be stressed that this is not entirely a *bank* debt funding gap either. This group of commercially viable credit applications have not proved to be attractive lending propositions for the new emerging *alternative finance* providers either. An issue considered in more detail later is that this conclusion is largely contrary to widely-held expectations in 2015 when the ELCDFI sector last came under a UK government policy review. Indeed, with growing regulatory oversight of traditional and emerging lenders, the number of firms potentially within the scope of support from ELCDFIs has increased over the last decade.

The key market gap traditionally targeted by ELCDFIs covers these firms which are financially viable but are either declined -or discouraged from applying – for mainstream funds. In reality, this market gap is not a homogenous group of firms. Rather, the inability to obtain commercial funding covers a range of circumstances. At one end of the range, novice entrepreneurs, often with a poor or non-existent credit profile may have a good business proposal but it is poorly developed and may be badly articulated to a funder not able to give adequate time to nurture the idea. These entrepreneurs are also more evident amongst the UK's financially underserved communities, although far from exclusively so. At the other end of the funding gap, established and experienced entrepreneurs may also face credit access issues for more specific reasons. For brevity, we can call these access problems more directly policy-related for a number of sectoral or credit issues covering the business or its owners, or even issues over the credit worthiness of commercial counterparty or a lease covenant. Efforts have been made by the financial services sector to reduce some of these problems over recent years, notably through an SME Lending Appeals process and related work on a referral programme but credit issues of this type still exist.[7]

The niche role played by ELCDFIs in the SME funding market has been reviewed on many occasions [8] and the sector's contribution is evident by the estimated 340% increase in the gross flow in the value of new loans between 2008 and 2015 (see table 1). While the volume market share (< 1%) held by the sector remains very small, this growth has still helped over 50,000 of small firms obtain funding and advice with wider economic and social benefits (see table 3). ELCDFIs are well placed to do this work, especially in nurturing business development ideas amongst microenterprises where they have specialist expertise which other

[7] British Bankers Association, *Business Finance Taskforce Report, 2010* (November 2010); see also UK Finance, *Unsuccessful Lending Applications and Lending Declines* (Accessed February 2018)

[8] For a recent summary see: Civitas, *Helping SMEs Access Finance – The Importance of CDFIs* (January 2017). Also, Responsible Finance, *RF - Annual Review*, (December 2017). Note data is Table 1 in this report has been recast by the authors from a FY to CY basis to match other data. The RF report is FY basis, see

funders have often lost. This work is aided by not for profit status which permits greater flexibility on lending criteria and pricing. In 2015/16 nearly 95% of all ELCDFI applicants had already been declined by a bank for funding yet around 60% of them still managed to obtain funding, confirming they had a viable lending proposition for ELCDFIs. Overall, the CDFI trade body Responsible Finance estimate in 2016/17 alone its ELCDFI members supported just over 5,000 firms and this combined activity added £250m to UK economic activity.[9] In addition for many firms, ELCDFI funding has enabled leverage to access commercial further mainstream finance and avoid the use of high cost personal (or business) credit.

Much of the historical growth in lending activity can be linked back to the success of the sector in being awarded a Regional Growth Fund (RGF) programme in 2011/12 for £30 million of new capital on a first loss basis (then matched by two banks to create a £60 million fund). The RGF was an emergency programme in response to the recession to create and protect jobs in England & Wales (although most of the funds were allocated outside London). The RGF programme for ELCDFIs proved very successful in terms of delivery outcomes and cost per job. As discussed below, ELCDFIs have also benefited from being delivery partners for government backed and funded start-up loans through The Start Up Loans Company (SULCO). [10]

The RGF scheme continues to give benefits to participating ELCDFIs with the recycling of capital now underway but the volume boost it provided to the market has passed its peak as a further round of new funding was declined in 2015. The current government funding for SULCO is not committed in its current form beyond 2020.[11] Much of the remainder of this report looks at the future funding outlook for ELCDFIs now the RGF is running down and dedicated government funding for start-up loans is under review. Without access to capital to lend ELCDFIs will find it increasingly difficult to contribute to filling the SME debt funding gap even to the modest degree seen in the last few years. The fall back in the gross flow of new lending already seen from about £100m in 2015 to £60m last year could become even more severe.

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[9] See Responsible Finance 2017 report, chpt 2 for more detail.

[10] https://www.startuploans.co.uk/

[11] The Conservative Party made a manifesto commitment to fund 75,000 loans by 2020 – about 55,000 had been made by late 2017-

The Outlook for SME Funding and Enterprise Lending CDFIs

SME external funding trends are linked to economic activity and especially investment. This review of ELCDFI funding is not the place to look in detail at the outlook for the overall SME finance market. However, it is likely that as the rate of expansion of the UK economy slows down the rate of growth in SME funding will moderate as well in 2018/19. Over the longer term, much depends on the impact of Brexit on investment confidence, although this will have a range of impact on different business sectors with both winners and losers. In such circumstances it is realistic to expect the number of viable SMEs unable to access commercial debt funds to at least stay the same; indeed, they are more likely to increase. What is much more certain though is that – regardless of the fortunes of the overall SME finance market – because of a lack of long term funding mechanism for ELCDFIs they will face a difficult period in even sustaining recent levels of activity in the next few years let alone achieve growth to meet demand. This will have a negative economic impact on the UK economy, as well as a social impact (particularly in underserved communities).

At the time of the last review of CDFI funding in 2014/15, very little new information was presented on the positive economic benefits of investment in ELCDFIs. For many years, the positive economic return on investment in the sector had been reported – albeit in a number of different ways – in a succession of studies. [12] More recent data has continued to support this optimism, although data quality remains an issue in building the evidence base. Overall ELCDFIs reported an economic return of £3.7 per £1 invested in 2016/17, we estimate rising to a figure closer to £4.5 per £1 for SME loans.

TABLE 3: Implied Economic Return on ELCDFI investment, 2016/17

2016/17 Data		Value £m	Volume No	Return £m	Avg loan £ th	Return/£
Total ELCDFI loans		67.2	5072	250	13.25	3.7
SULCO partners		33.0	3796	99	8.69	3.0
Other Micro and SME		34.2	1276	151	26.80	4.4

Note the table are author estimates as an illustration only based on combining the data in the latest Responsible Finance Annual review and the BBB review of the Start-up Loans programme. We are grateful to Responsible Finance in providing additional data to help compile these estimates

[12] The most detailed review was in *GHK, Evaluation of Community Finance Institutions – A Report to the Cabinet Office and BIS (2010)*; this reported an economic return for business lending of £3.57 for every £1 invested in 2008/9. It is the basis of the current RF methodology of reporting.

Rather than any suggestion of poor value for money, a major factor in the decision by the Government not to extend or replace the RGF financing facility in 2015 appears to have been an expectation that the ELCDFI sector and its target market would benefit from a number of linked market developments then underway. [13] As discussed earlier, the RGF programme started a significant growth in lending activity amongst ELCDFIs in 2012 onwards. However, it was only intended as a short term programme while these wider initiatives were underway in the SME finance market, including a competition review and schemes to develop a lending appeal and referral service and the creation of a start-up loans programme following the Young Review. [14]

In part this optimism amongst policy makers at the time was justified, especially for start-ups. However, some of the market developments that looked so promising have not developed further or have had only a limited impact; others have been more positive. The main developments since 2014/15 can be reviewed in turn:

- *Commercial bank loans to CDFIs* – In 2012/13, Unicredit and the European Investment Bank (EIB) supported the capital raising work of Fair Finance to start business lending, the first commercial fund raising by a CDFI post the financial crisis.[15] By the time of the 2014/15 CDFI funding review, some high street banks were considering entering or returning the market of providing loans to CDFIs. Mainly this was a consequence of the RGF programme agreed after the global financial crisis. This provided over £30 million of first loss guarantee funding giving confidence for two banks (Co Op and Unity trust Bank) to match the funds, also supported in some cases by Community Investment Tax Relief (CITR). This provided an important demonstration of how to develop scale in ELCDFI lending capacity. Over the last two years, several further schemes have been developed to provide commercial funding without the RGF backing but most have not reached fruition, despite the efforts of many interested parties. Most of these proposals remain commercially sensitive so cannot be outlined in detail. Some proposals have looked at using access to EIB funds to support micro finance, other have relied on the tax relief alone. The only major example to reach fruition is the Lloyds London Fund backed by an EIB guarantee and

[13] PWC Report for BBB Sustainability of CDFIs, November 2015
[14] CMA Review papers; BEIS Research paper - SME lending and Competition: An international Comparison, May 2016; Lord Young; Make Business Your Business - May 2012
[15] https://www.fairfinance.org.uk/about-us/history/

using tax relief as well – similar to the RGF programme with a first loss facility. [16] All the others outside of the RGF have stalled as being too complex or risky without a first loss guarantee. It is puzzling why less progress has been made on using EU funds but since the Brexit vote discussion of this option seems to have faded away.

- *Local Authority and regional legacy funds* – During the years of the financial crisis interest emerged again about the use of local authority financial resources to fund new local lending institutions, sometimes in partnership with a commercial bank. Indeed, some small scale examples did get set up but most appear to have been quietly run down and closed by 2016 as lending defaults emerged.[17] Rather during 2014/5 more ambitious ideas were discussed about the investment of some local authority pension funds into local commercial funding ventures. Several larger cities looked at the idea but again these appear to have fallen by the wayside when the pension trustees looked at the risks and potential liabilities of such schemes (other than by way of larger equity investment funds or more recently social housing).[18] A number of local authorities provide financial resources for local CDFIs, in some cases legacy funds from previous programmes but, for example in Birmingham, this also includes commercial bank and P2P investment. [19] However, no discernible growth in funding to SMEs has been apparent at a national or broad regional level from this direction, despite encouragement from national government ministers in response to questions from CDFIs to seek such funding in 2105 when the initial RGF funds were exhausted.

- *The Start-up Loans Company (SULCO)* – In 2012, as part of a wide ranging review enterprise policy Lord Young suggested the idea of a government funded start-up loan programme with a central holding company providing the capital but support and advice provided through local delivery partners. The Government accepted this idea and set up the SULCO. The programme increased activity sharply in 2013 and has now made more than 50,000 loans totalling over £360 million. [20] The creation of this programme was a key factor in discussions regarding the changing shape of the SME funding market in 2014 and – unlike some of the other ideas at the time – this has

[16] EIB announcement
[17] Bank of Essex, Bank of Bournemouth closure
[18] EIB -BNP announcement 2016, see also Web article Social Housing article
[19] Birmingham Small Business Loan Fund
[20] More information can be found on the SULCO website. See History . Note SULCO originally had a separate existence but is now part of the BBB although the funds are provided by BEIS.

proved to be partly correct. A number of ELCDFIs now work with the SULCO. Responsible Finance reports that in the year to March 2017, its members' were linked to over 3,796 loans to microenterprises worth £33.5 million (over half of all ELCDFI lending by value and providing 80% of all loans to microenterprises by number). [21] The funds are provided by the Government through the British Business Bank and any losses are written off in full. ELCDFIs receive a fee for the work. They do not have to provide loan capital. Since 2016/17, the SULCO has changed its operational activity and appears to have reduced its risk appetite with most partner ELCDFIs seeing a reduction in volume. This appears to be linked to the move of the scheme to management by the British Business Bank in advance of decisions on the future of the programme after the current phase of activity in 2020. Nevertheless, the funding environment for new entrepreneurs seeking small loans[22] but denied commercial funding is different now from 2012 although speculation is increasing on post 2020 plans.

- *British Business Bank programmes* – even before the creation of the SULCO the British Business Bank (BBB) was set up by the Coalition government to use public investment to develop competition and choice in the market for SME funding, as well as manage some long standing government debt and equity programmes.[23] The emergence of the economic devolution agenda with the creation of the Northern Powerhouse (NP) initiative and later the Midlands Engine (ME) also created the opportunity to develop funding programmes for businesses to help deliver these projects.[24] In some cases, these programmes have effectively merged with longstanding infrastructure projects using ERDF budgets to pool resources along with EIB and LEP local funds. The model adopted differs from the SULCO in that a separate fund of funds has been created from a variety of sources with the BBB - being accountable for the objectives - appointing a fund manager covering equity and loan provision as local delivery partners. Both the NP and the ME have provided a specific micro loans scheme element which is welcome and these programmes are clearly regarded as the natural successor to the RGF programme based on public funds. The micro loan schemes have all been awarded to a handful of ELCDFIs via a competitive bidding process. However, although both regional programmes are still

[21] RF Annual Report, 2017, see ; the authors acknowledge the support of RF in providing additional data from their research to support this analysis.
[22] Start up loans are personal loans up to £25,000 – although more than one loan can be agreed per start-up
[23] The proposal for a single central government SME fund management/investment agency was originally raised as a recommendation in the Breedon Report on SME funding in May 2012
[24] Fund websites: NPIF and MEIF. Note a fund is also under development for Cornwall and the Is of Scilly

very new, early criticism has been two fold. First, the size of the micro lending funds allocated often appears too small compared to the expected geographical coverage and –in some locations - the market analysis undertaken. For example, the NP fund has an initial plan to provide £20 million of microloan funding over 5 years, below recent delivery rates in the same areas (although the figure can be reviewed in the future).[25] Second, early indications are that SME loan schemes are targeting high growth/high impact firms rather than the general business population with viable lending plans having difficulty obtaining commercial funding.[26] However, despite these initial concerns in the geographical areas concerned these are undoubtedly a positive development for SME's seeking finance.

- *Alternative Funds* – In 2014/15 in particular, much of the discussion on SME funding trends concerned the rapid growth of a range of alternative funders to SMEs, some with investment from the BBB. Using innovative crowdfunding techniques P2P business loans, for example, grew rapidly after 2008/9 in a low interest rate environment. In 2014/15, it was suggested that this strong growth would continue but also that by increasing the volume of lending supply all lenders including the established banks would seek to retain lending volumes by looking again at some applicants that had traditionally been excluded.[27] The alternative lending sector has indeed grown rapidly over the last couple of years – P2P business lending alone increased more than three-fold between 2014 and 2017 - but the subsequent realignment of the lending market has not occurred. [28] Contrary to the expectations in 2014/15, alternative funders have limited interest in the ELCDFI target market but they are competing strongly with commercial banks especially for secured business lending. Commercial banks – especially in a period dominated by structural reform – have no inclination or much regulatory leeway to change lending appetite. Some positive developments have been evident, for example the work of Newable and Liberis to set up a Fair Finance Business Loan fund in early 2017.[29] However, as the P2P market matures it has become more formalised in operation and subject to regulatory scrutiny. A recent survey of P2P business loan investor risk attitudes as well indicates that platform investors desire their funds to have roughly the same level of investor risk

[25] NPIF Spotlight . The equivalent MEIF funds are initially £30 over 5 years split East and West. see article
[26] For example, see press announcements on MEIF objectives and the earlier fund manager announcement
[27] See PWC Report for BBB Sustainability of CDFIs, November 2015 .
[28] See Table 1. Also Cambridge Centre for Alternative Finance 4th UK Report (December 2017).
[29] Newable Business Loan Fund (this is a national fund, not London based)

as the UK buy to let housing market, suggesting it would be unwise to expect too much interest in typical ELCDFI customers in the near future. [30]

- *Social Investment* – For several years many of those working in the CDFI sector have suggested a greater role for Big Society Capital (BSC) in supporting wholesale fund raising for CDFIs of all types. Again this was a potential new funding source for CDFIs discussed in 2014/15 as part of the PWC review. BSC has a wide remit to support charities, social enterprises and less advantaged local communities and does work already with some ELCDFIs. For example, BSC is a significant supporter of Key Fund's charity and social enterprise lending. [31] As part of a strategic review in 2016/17 BSC has recently committed to a new £30 million five year Community Investment Enterprise facility targeted at small business creating positive impact in local disadvantaged communities. While BSC recognises that this will not meet all the funding needs of the ELCDFI sector, it is hoped the facility can test and develop a range of social investment models to provide a further £30 million of private capital. Much of the detail of this new facility has yet to be announced but in principle it does have the potential to make a fundamental difference to the ELCDFI sector over the medium to longer term.[32]

Taking all these developments together, the current situation in early 2018 is mixed. The recent announcement by BSC is an interesting and positive development, as is the work of the BBB in its sub national funds, although both are still in their infancy. The ELCDFI sector received a further boost late in 2017 when the Government agreed to a reinterpretation of the rules regarding the use of Community Investment Tax Relief (CITR) to raise funds which could subsequently be lent onwards by a CDFI using the Enterprise Finance Guarantee (EFG).[33]

The change to the rules regarding these schemes creates a new funding solution – as outlined in our previous paper - as it would allow ELCDFIs to use the EFG on viable loans in order to get a 75% government first loss guarantee to protect against capital loss at the same time as using the CITR to raise retail deposits with a tax break for investors. [34] Both schemes already exist and ELCDFIs often have

[30] Cambridge Centre for Alternative Finance 4th UK Report (see figure 37)
[31] BSC Investment data
[32] BSC announcement, 7th February 2017
[33] See Aslan, Robinson & Henry, *Community Investment Tax Relief and the Responsible Finance Sector (2018)* - forthcoming
[34] Walker & Roberts, Paper Presented to the ESRC Access to Finance for SMEs Seminar, Birmingham (November 2016)

experience of using them for parts of their operations. [35] Rather up to now it had been assumed that using both at the same time would breach accounting rules relating to the use of public money for guarantees. Social investors will have a first loss guarantee on funds invested with the benefit of tax relief. As well as potentially supporting the efforts of BSC to develop new methods of social investment to support ELCDFI activity, it may also encourage some commercial banks to increase involvement in the sector. Overall, this suggests we are beginning to see the building blocks put in place to help build a new ecosystem for funding ELCDFIs as a whole, although it is not in place yet.

The less encouraging news concerns the shorter term fortunes of many ELCDFIs which are trying to cope with the fallout from the end of the RGF programme with no immediate replacement. Supply side developments expected in 2014/15 are underway but do not seem to directly impact on the ELCDFI customer base too much. In 2016 and 2017, overall lending volumes by ELCDFIs have fallen by c30% without a growth in replacement sources of funding and no evidence of falling demand. The RGF programme is running down although recycling of repayments will allow some new lending for several years to come. A number of ELCDFI providers have been increasingly reliant in the short to medium term on funds provided through the SULCO although this programme is reaching maturity and subject to review. The fee income from this work has helped cover operational costs but does not provide any surplus to support other lending activities.

TABLE 4: Active Enterprise Lending CDFIs 2014-2017

Financial Year data	**2013**	**2014**	**2015**	**2016**	**2017**
No of ELCDFIs	36	34	34	30	27
New Loans (£m)	52	72	98	104	67
New Loans (no)	9,303	13,230	11,400	9,600	5,072
Avg Loan Size (£)	,5,580	5,442	8,596	10,833	13,209

Source: RF Annual Reports

Hence, despite a number of positive developments the future of ELCDFIs and the viable SME businesses they support still remains subject to a high degree of uncertainty at the present time. While we have seen some of the building blocks emerge to support a longer term funding mechanism for the responsible finance

[35] For more details on the specific rules on both schemes see EFG and CITR – note in the case of the EFG the borrower pays a premium on loans to cover losses and the 75% government guarantee is subject to a portfolio cap (20% for ELCDFIs)

sector as a whole, it could be that some existing ELCDFIs will struggle to stay active in the market while this actually happens. Unless new ideas emerge to speed up this process ELDFI business lending flow will continue to fall (or at best level off at about £40 million a year). In such a scenario some ELCDFIs will merge, others will close and, taken together, this will be a significant loss to the overall SME finance landscape (especially as the ELCDFI business model is based normally on the use of local market knowledge, relationships and credit skills).

TABLE 5: ELCDFIs Key Statistics

Financial Year Basis

	2013	2014	2015	2016	2017
Total number of startup/micro loans disbursed	8,992	12,791	10,280	9,150	4,720
Total number of SME loans disbursed	311	430	1,160	433	352
Total number of loans disbursed	9,303	13,230	11,440	9,583	5,072
Total value of startup/micro loans disbursed	£38m	£52m	£64m	£85m	£52m
Total value of SME loans disbursed	£14m	£20m	£34m	£18m	£15m
Total value of loans disbursed	£52m	£72m	£98m	£103m	£67m

Source RF, Annual Report 2017 Appendix

What else?

As discussed earlier, several of the key elements for developing a more sustainable funding environment for ELCDFIs have emerged over the last year. Moreover, it is likely that calls for further grant aid based proposals – such as the recent £150 million fund request from Responsible Finance and the Banking Futures study[36] - will face difficulty in getting support in the current austerity environment. Rather, as illustrated by the EFG/CITR initiative now underway, it would seem more sensible to look towards existing programmes and interventions to see if we can accelerate the pace of change in the ELCDFI funding environment to increase the survival chances of the current supply network to deliver over the medium term. Also, the ELCDFI sector needs to better promote its case for investment and support given the less sharp focus on this issue by public authorities than in years gone by. Both these ideas can be discussed in turn:

[36] Banking on trust, 2016

(a) Move from an Enterprise Finance Guarantee to a more general guarantee scheme for ELCDFIs?

If we go back to the basic operational activity of an ELCDFI – working with customers with a viable proposal that have been declined for lending from a commercial debt provider – funds to do this work are limited by the unwillingness of community finance investors to provide the underlying capital to on lend. Traditionally public resources have stepped in and filled the gap and underwritten – if needed – the majority of this lending activity.[37] In more recent years, this first loss arrangement has been used under the RGF programme to lever in matched commercial bank money which is only at risk once the government funds have been written off. The SULCO programme is effectively a 100% first loss guarantee although local providers never actually lend the money in the first place. The same guarantee approach has been used on European backed schemes and so on.

The key element in all this is the use of a guarantee or first loss arrangement to allow ELCDFIs to operate at scale. Hence we believe that some form of general guarantee scheme for ELCDFIs should be at the centre of building a sustainable funding environment for the sector working alongside the current developments discussed in the first half of this report. This guarantee could be used to raise private investment to fund the core capital to on lend rather than use scare public resources. Moreover, the mechanism to largely achieve this outcome is already with us. As we have seen, the combination of the CITR and the EFG is already being developed to support the growth of social investment.

The additional policy innovation we propose to cement the future of the ELCDFI sector concerns the EFG. The UK government has had a small firm loan guarantee scheme in a variety of forms since 1981/2 but it has always been based on the lender making a decision to lend on their own normal commercial terms using its own funds with the guarantee being used if the only reason for a decline is a lack of security (or enough security). The borrower pays a premium on the loan interest to fund a reserve pool to cover pay-outs on the guarantee to the lender in cases of default. If this reserve pool is too small, the government pays any additional amounts from public funds.

However, innovation in SME credit appraisal has been very evident over the last decade and for loans under £50k the issue of security no longer forms such a vital part of the lending decision (it may impact more on the price offered). More

[37] Currently 75% on each loan subject to a portfolio cap

often firms with viable lending proposals are declined from commercial debt sources for a variety of reasons concerned with business or industry specific constraints with security availability playing little or no part in the decisions. This is especially the case for smaller loans with little face to face contact between the borrower and the lender. For simplicity we can call this development the growth of policy-related declines. The EFG is not always applicable to commercial or ELCDFI lenders in such circumstances. However, as these SME customers have a commercial provider bank decline they form an increasing part of the client base of ELCDFIs.

TABLE 6 – Reasons for Credit Decline by Commercial Providers

"Not Viable"	**"Weak Finances"**	**"Due Diligence"**	**"No Security"**
			Covered by EFG
Affordability	Weak balance sheet	Licence/patent ownership	
Serviceability	Insufficient stake/equity	Outstanding legal issues on firm/key staff	
	High gearing	CCJs	
	High short term debts		
	----------------------- "Other Reasons" -----------------------------		
	Weak management	Main client credit score	
	Past account issues	Worries over premises/lease/tenancy	
	Business credit score	Over reliant on one contract	
	Personal credit score	Crown debts	
	Directors' debts	Sector or location specific worries	

If the eligibility to issue a government guarantee to a financially viable proposition– paid for by an interest premium – was extended for ELCDFI applicants to cover a wider range of circumstances than just lack of security this would allow greater coverage of the SME debt funding gap than at the present time. ELCDFis – with or without the use of the CITR – would be more attractive to investors such as mainstream banks as the capital would be less at risk and the enterprise lender would have the benefit of a closer, supportive face-to-face relationship. This would cover many of the decline reasons in the middle two columns of Table 6 rather than just lack of security. Such a scheme could be introduced on a loan by loan basis. It would be down to the ELCDFI with the close customer relationship to decide which customer applications to recommend for a government guarantee having investigated the circumstances. Alternatively, building on the RGF experience, ELCDFIs could bid for a pool of guaranteed money with proposals to use is for a range of local business circumstances.

Over the longer term, it would be possible to consider a further extension of this proposal to cover other acknowledged funding gaps. For example, post 2020 the existing SULCO model could be replaced by a guarantee based approach which would reduce the need for public resources to provide the lending capital in exchange for an insurance based guarantee scheme.

Quite deliberately at the present time we do not have a fully developed proposal along the lines discussed above. It should be acknowledged that the current guarantee rate, premium and portfolio cap arrangements for the EFG may be altered substantially for any such change. [38] Also, work would be needed on developing investor interest in providing capital funds to support ELCDFI activity using this new guarantee (we acknowledge the work already underway on the EFG/CITR funding arrangement as being very important in this regard as it will cover similar ground in some respects, plus the recent announcement by BSC to rekindle interest in social investment activity). Rather, this report seeks to raise as a key proposal for discussion the principle of using public guarantees in the way outlined to support the work of ELCDFIs going forward, alongside the existing developments.

In terms of detail the US Small Business Administration (SBA) may well provide some guidance.[39] Under the SBA's main loan guarantee scheme (the 7(a) scheme), the rules are already less definitive than under the EFG. In particular the SBA has fixed published minimum criteria for acceptance notably around credit-worthiness which are less stringent than for a bank, encouraging the lender to bring the marginal/border line loan application to the SBA for endorsement. In contrast, in the UK the EFG assumes a commercial provider will only ask for a guarantee where an applicant meets its own normal loan criteria except for those linked to security. The key difference is that the US scheme in effect targets viable propositions that "just miss" a banks normal take on criteria as well as reducing discouragement through lowering applicant uncertainty.

Indeed, the SBA can also issue a guarantee to a lender even if the loan has sufficient collateral already, as well as to fund lines of credit (overdrafts). The SBA Express scheme for loans under 350k USD offers incentives for underserved groups and notably covers wholly unsecured loan products if under 25k USD. On top of this, the SBA operates a microloan guarantee programme specifically for

[38] A working assumption is the current EFG could be modified to form the basis of the scheme. This may have legal issues and it could be easier to run both the EFG and a new scheme alongside each other. However, commercial and ELCDFI operators have knowledge of the EFG procedures and requirements so it would be best to stay as close as this model as possible.

[39] SBA website -Loans

community finance providers with even less stringent fixed acceptance criteria on loans up to 50k USD as well as guarantee scheme for joint loans where community financiers and commercial banks each issue a loan to a small firm for funding business real estate over 15/20 years.

If adopted, the size of any UK type guarantee scheme of the type we have proposed can only be sensibly estimated after more stakeholder engagement and consideration of any scheme rules and premium. However, based on the recent ERC estimates of discouragement[40] if we assume that about 70,000 creditworthy SME loan applications are declined or discouraged each year, perhaps about 10% or 7,000 firms would be immediately eligible if something close to EFG rules applied. At an average of £30k per loan, this would be about £210m of additional SME borrowing. Based on conservative estimates of payback, this would generate around £0.85 bn of economic benefit. By comparison, the EFG scheme was renewed in November 2017 as it currently stands for a further four years but with a higher annual limit on loans that could be sanctioned of £500 million a year. Actual RFG backed origination is about £200 million a year, with a £300 million facility in reserve in case of higher demand.[41] These 7,000 extended guarantees could if needed be easily met from this reserve without any call for additional public spending commitments.

(b) Articulating The Case for Action

Secondly, we turn to some observations regarding the ELCDFI sector itself. Over the last few years the consensus of support for the community finance as a whole – not just ELCDFIs - has been weaker than in the previous decade. This has occurred at the same time as the shake up in the ELCDFI sector after the decision not to extend the RGF scheme and other market developments outlined above. The CDFI industry as a whole is small and under-resourced and the ELCDFI sub group is comprised of an even smaller number of organisations. The problem may have been compounded by confusion within government of policy responsibilities between HM Treasury, BEIS, the Cabinet Office and the BBB as market agent.

However, we still believe a case for action for targeted policy to develop the ELCDFI sector does exist but needs more research and analysis to become effective. The sector has long standing evidence about economic and social impact from the CDFI sector as a whole. However, some of this research needs to

[40] See footnote 6

[41] EFG data

be updated and enhanced. This is why we welcome the recent announcement from BSC of its commitment to support a research team for this purpose at Sheffield Hallam University. [42] However we believe this research should specifically recognise ELCDFI activities distinct from the CDFI sector as a whole. Moreover, ELCDFI programme evaluations – such as for the RGF -needs to be of a similar robustness to the recent review of the SULCO programme and periodic reviews of the EFG.[43]

In addition, to build a stronger consensus for action, the ELCDFI community needs to complement this evidence with additional business case arguments including:

- Local links – ELCDFIs have a long tradition of working within local markets as a way of gaining the confidence of business communities of all types. This model creates financial fragility as well but experience suggests to a degree it is needed to be truly effective;

- Embedded in the local financial ecosystem and building local skills – ELCDFIs need active engagement with local banks, accountants, business advisers and community groups to work effectively. This form of relationship management – as the banks have realised – is the most costly and difficult to sustain at a local level but it does create trust – amongst local financiers as well as businesses. ELCDFIs also train and encourage local financial skills and risk management which remain local to build capacity;

- Financial accountability and supervision – ELCDFIs are able to manage capital funds for the benefit of the community but also allow local scrutiny and accountability for actions. Local control of the business plan allows a ELCDFI to have true diversity and flexibility in its funding programmes to meet neighbourhood funding requirements. One size does not fit all.

ELCDFIs share many of these attributes with the wider CDFI sector and in many respects they no doubt still have a parallel future. Some organisations will also seek to operate as both an enterprise lender and a more widely based CDFIs. However, enterprise lending should increasingly be regarded as a separate market which needs more targeted attention to ensure viable business proposals from start-ups and established SMEs rejected by commercial providers of all types can obtain debt funding. The SME finance market is very different now

[42] Announcement
[43] EFG; SULCO

than a decade ago. The range of commercial providers is greater than ever before and the supply of debt funding for many mainstream established SMEs is not a major issue. However, ELCDFIs provide an important safety net to help support viable business propositions declined for commercial finance or discouraged from approaching traditional providers.

Concluding Thoughts

Many of the current ideas and developments discussed in this paper have strengths but also issues to overcome. The short term outlook for the ELCDFI sector as a whole looks difficult still as the sector seeks to cope with the end of the mainstream RGF programme. Lower levels of activity in 2018/9 look inevitable and a further fall in the number of active lenders remains a possibility, challenging full national coverage.

Nevertheless, we conclude that the medium term outlook for the sector is brighter now than when we started our joint project in 2015. The emergence of some BBB regional funds, the recent BSC commitments to the ELCDFI sector and the ability to use EFG and CITR together are all positive (albeit in all cases it is still early days with issues to resolve).

Even so, we think one further change is needed concerning the use of more policy related public guarantees to provide the final building block to ensure a sustainable long term ecosystem for capital raising and on lending. As we enter a period of greater economic uncertainty and change through Brexit, this would be a welcome reassurance for the UK SME business community. If not, without a longer term sustainable funding solution many ELCDFIs will struggle to survive in their current form and number. If this happens it will leave a gap in the SME funding landscape that will be hard to fill.