nef

economics as if people and the planet mattered

Social investment for community development:

Completing the half-built house

nef is an independent think-and-do tank that inspires and demonstrates real economic well-being.

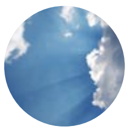
We aim to improve quality of life by promoting innovative solutions that challenge mainstream thinking on economic, environmental and social issues. We work in partnership and put people and the planet first.

nef centres for:

global interdependence

thriving communities

well-being



future economy

nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

Contents

Executive summary **2**

Introduction **4**

Making the case: the potential of finance for community development **6**
- The reality of disadvantaged communities 6
- Policy response 7
- Finance for community development 10

What now? **13**

Social investment for communities: interview findings **15**
- Demand-side 16
- Supply-side 17
- Enhance market efficiency 18

Role of banks and financial institutions **20**
- Legislation to require universal service provision 21
- Incentives to invest in disadvantaged communities 22

Development of a Social Investment Bank **24**
- Political slowdown 24
- Mixed views from the sector 25
- Chicken and egg 26

Recommendations **27**

Appendix 1: List of interviews **29**

Appendix 2: Further reading **30**

Endnotes **31**

Executive summary

Community finance has had a significant impact on some of the most disadvantaged communities, leveraging in millions of pounds of investment.

The community finance sector – including credit unions, community development finance institutions (CDFIs), social enterprise finance funds, and community development venture capital funds (CDVC) – has a key role to play to revitalise local communities in partnership with other entities, such as financial institutions, housing associations, development trust associations, local authorities and Regional Development Agencies (RDAs).

Community finance organisations are key components of the network of institutions that, if designed well and with supportive policies, can work together to form an effective social investment market. Increasingly private finance is seeking opportunities to invest in enterprises or projects with social objectives to redress economic exclusion and poverty or support community regeneration.[1] This social investment marketplace has potential to channel substantial funds to social and community enterprises. It requires a supportive policy environment that recognises the value of long-term funding for third sector organisations and puts in place the requisite tax and legislative mechanisms to build and sustain social investment institutions. Currently this architecture is half-built.

The recommendations of the Social Investment Task Force (SITF) in 2000 were successful to put in place the basic foundations for a social investment marketplace. SITF brought about a gradual shift in thinking and awareness of the role of private finance to achieve social outcomes and positive change for underinvested communities. But while some of the initial SITF recommendations have been fully adopted, there is still a long way to go.

Following the original SITF recommendations, we have identified five clear steps required to complete the infrastructure for a thriving social investment market in the UK.

1. Implement a simple and well-designed tax mechanism to attract private investors, including financial institutions, to social enterprises, including community development finance organisations.

2. Legislate compulsory disclosure by financial institutions of lending and investment in disadvantaged areas, as a means of tracking performance and stimulating the flow of finance to communities in need of redevelopment.

3. Establish a grant fund for long-term public support of third sector finance institutions to maximise their ability to leverage private finance, improve lending practices and enhance technical capability. Many third sector institutions will require ongoing grant funding to carry out the activities that have the most social benefit.

4. Design a matched funding scheme to incentivise charitable foundations to invest in social enterprises and encourage use of endowments for social investment purposes.

5. Support development of a new social finance institution that can act as a wholesale organisation to co-ordinate and channel investment to existing third sector intermediaries, to link the social and financial sectors.

This report finds that the architecture for a social investment market that will channel finance to community development is incomplete.

- Too few community finance organisations have been able to attract sufficient private investment to reach a scale that allows them to fulfil their potential for disadvantaged communities.
- Public funding for the community finance sector has been short-term, patchy and increasingly scarce.
- Community investment tax relief (CITR) is widely viewed as too complex and narrow to attract sufficient investment capital, and is in need of revision.
- Incentives for charitable trusts and foundations to invest their substantial endowments in community finance and other social enterprises have not been forthcoming.
- Banks have largely avoided transparency and disclosure of their lending and investment in disadvantaged communities.
- A voluntary agreement with banks to invest in disadvantaged neighbourhoods has resulted in a mediocre response. Bank partnerships with community finance organisations are the exception rather than the rule.
- Political support appears to be waning to capitalise a social investment bank to act as a wholesale institution providing much-needed capital to the sector.
- Much more could be done at a policy level to support social enterprises and community finance organisations that are vital outposts in some of the most disadvantaged communities.
- A new form of funding for the third sector is required. Third sector institutions require a long-term, dedicated source of investment capital that is tailored to the needs of each organisation.

The main aim of this report is to encourage policy-makers to address shortcomings in policies to support social investment for community development. Appropriate and enabling legislation, financial and tax mechanisms are required to support a thriving community finance sector. It is disgraceful to abandon a half-built house.

Further steps are required to build a strong community finance sector that is part of a thriving social investment marketplace, where private financial flows can be channelled to well-managed social and community enterprises that create real and lasting change for disadvantaged neighbourhoods.

We address three key issues facing community finance and the social investment marketplace:

1. The need for continuing support to the community finance sector in the form of policy reform and continuous, appropriate funding.
2. The appropriate role of banks and the wider financial sector to combat financial exclusion and invest in disadvantaged communities. This includes banks' obligation to lending disclosure and the potential for legislation to enable a more active role for banks.
3. The future form of a wholesale institution for social finance, such as the proposed Social Investment Bank, which would be capitalised by unclaimed assets held by financial institutions.

Introduction

As the full extent of the credit crunch has begun to emerge, access to credit has become increasingly difficult for disadvantaged communities and individuals. The blight of financial exclusion and debt problems brought on by lack of access to appropriate credit will affect many more people.

Excluded groups could now find that banks' lending criteria make access to affordable credit difficult, if not impossible. The need for community finance organisations is even more acute.

Despite the increasing wealth of British society – which has made many better off – there remains a persistent group of socially excluded individuals who are living in poverty. With increasing wealth has come greater inequality. Poverty is concentrated in specific geographic areas, where disadvantage is intensified by low skills, joblessness, and underemployment. These 'neglected neighbourhoods' are characterised by financial deprivation, poor public services, low-quality housing and limited infrastructure. In disadvantaged communities, lack of access to opportunity is the norm.

Among the many factors contributing to the decline of disadvantaged neighbourhoods are limited access to finance and lack of appropriate training and business support. Financial services institutions often withdraw from low-income communities. Bank branches and post offices close down. Issues of personal financial exclusion, such as low financial literacy, language barriers, poor credit history and lack of collateral, further contribute to limit access to finance. Private investors are often reluctant to invest in disadvantaged neighbourhoods, creating a spiral of underinvestment, stagnation, and decline for the local economy. As **nef**'s *Small is Bankable* report put it in 1998 'the neighbourhoods that have the most telling need for capital… have least access to it'.[2] Enterprise and entrepreneurial activity are stifled in this context.

The Social Investment Task Force (SITF) was announced by the Chancellor of the Exchequer in 2000 to consider the potential for new sources of private and institutional investment to bring about economic regeneration of disadvantaged communities.[3] Chaired by Sir Ronald Cohen, SITF recommended a five-point programme of action to increase investment, enterprise and wealth creation. The business and the financial sector was expected to work in close partnership with social and community entrepreneurs, supported by Government playing an active and enabling role.

The SITF recommendations laid the foundations for development of the community finance sector. Credit unions, community development finance institutions (CDFIs), social enterprise finance funds, and community development venture capital (CDVC) funds have the potential to widen the access of disadvantaged communities to investment capital and financial services, training and business support. These community finance organisations have a range of objectives, but share a common function to address financial exclusion and problems of underinvestment for disadvantaged communities, along with other third sector institutions, such as social enterprises. Community finance organisations are social enterprises in their own right. They provide finance to a varied client group including excluded individuals, small businesses, micro-enterprises, community and social enterprises and charities.

The community finance sector was designed to create a positive cycle of investment, redevelopment and opportunity. This, in turn, facilitates the development of local enterprise, employment and wealth creation. The community finance sector demonstrates that the unbanked and marginalised can be financially included, and that social investment can be a basis for community redevelopment.

Uncertainty in the funding and policy environment has presented challenges for the success of this sector. Like many third sector institutions, community finance organisations have had to struggle and adapt in order to survive. Some have done this better than others. Credit unions are redefining their ‘common bond’ to tap into new sources of membership and investment. Many CDFIs have shifted away from enterprise lending to personal financial exclusion because of Government funding priorities. A few organisations are innovating in order to develop new products and sources of private finance.

The community finance sector is now at a critical juncture. The proposed release of unclaimed assets from UK financial institutions for funding of third sector institutions could create a significant shift in the resources available to invest in disadvantaged communities.[4] With the right support from government, local agencies and the financial services sector, community finance organisations could play a major role to address financial exclusion and underinvestment in disadvantaged communities throughout the UK.

Making the case: the potential of finance for community development

The reality of disadvantaged communities

With increasing wealth has come greater inequality. In 2005/2006, 13 million people in Great Britain lived in households that were below the low-income threshold; this is roughly one-fifth of the population.[5] Poverty is now concentrated in specific geographic areas, where disadvantage is intensified by low skills, joblessness, and underemployment. In 2007, there were 3.6 million people who wanted to be in paid work but were not. These 'neglected neighbourhoods' are characterised by financial deprivation, poor public services, low-quality housing and limited infrastructure. Lack of access to opportunity creates disengagement and apathy.

Social exclusion in the UK results from multiple factors. Unemployment, poor skills, economic inactivity, low income, family breakdown, crime, weak institutions, poor infrastructure, and limited services together restrict options and isolate residents of disadvantaged communities.

Among the many factors contributing to the decline of disadvantaged neighbourhoods are limited access to finance and lack of appropriate financial training and business support. Financial services institutions often withdraw from low-income communities. Bank branches and post offices close down. Issues of personal financial exclusion, such as low financial literacy, language barriers, poor credit history and lack of collateral, further contribute to limit access to finance. Enterprise and entrepreneurial activity are stifled in this context.

Disadvantaged communities face the significant challenge of underinvestment. Both existing and start-up enterprises in low-income neighbourhoods face multiple problems to access finance. These problems are compounded by banks' reluctance to lend in the wake of the credit crunch.

Individuals are negatively affected by financial exclusion. People without access to financial services are exposed to higher cost credit, lack of insurance and more expensive bill payment. Without a bank account, individuals are hindered in their efforts to participate in the mainstream economy, which has knock-on implications for the community as a whole.

There is a clear need for alternative sources of finance to combat the failure of the market to meet the needs of disadvantaged communities. As banks increasingly withdraw from disadvantaged communities, there is aversion to financing start-ups and enterprises in these areas, which are viewed as unprofitable and more risky. In addition, financial exclusion affects many low-income individuals. Those who are outside of the mainstream financial services sector suffer disadvantages such as higher interest credit, lack of insurance, and no bank account.[6] Lack of access to financial services can reinforce and magnify the problems associated with poverty, resulting in social exclusion. Financial exclusion results from a variety of factors including bank branch closures, poor credit history, lack of required documents, or cultural and psychological barriers linked to financial illiteracy.

Changes within the banking sector have made it more difficult for disadvantaged communities to access banking services. The use of online banking, direct debits and telephone banking make financial services less accessible to low-income and other vulnerable individuals. The drive to maximise profits has meant that relatively low-margin activities, such as small loans or basic bank accounts, are de-emphasised. Banks are reluctant to finance very small businesses given the high transaction costs of appraising and securing such loans. Banks increasingly use credit-scoring techniques. Customers thought to be risky, such as those based in deprived areas, are more likely to be denied credit. Banks charge more to lend in deprived areas. The margin on small business lending in deprived areas is higher than that of lending to small business generally across Britain.[7] Individuals without capital or credit history or with limited financial literacy – the reality for many in deprived communities – find it almost impossible to access appropriate financial services.

Banks have distanced themselves from disadvantaged communities. Consolidation in the UK banking sector has reduced the number of regional and local branches. Many banks no longer have a physical presence in low-income areas, making loan application and assessment increasingly difficult for local entrepreneurs. Branch networks of both banks and building societies have been in continuous decline since the 1980s. Britain's least affluent inner cities and traditional manufacturing areas have lost more local high street branches than any other area since 1995.[8] Lack of bank branches has clear negative consequences for low-income customers and local businesses. Britain's poorest communities have been the hardest hit.

Informal micro-enterprises provide income for some of the poorest families in the UK. Small enterprises and start-ups in deprived communities are most likely to have financing needs that can be best met through community finance organisations. Small lifestyle or self-employed businesses may lack detailed accounts and knowledge of mainstream banking practices. Ethnic-minority-owned businesses and women-owned businesses face particular difficulties when it comes to raising bank finance. These micro-enterprises may require intensive support and training prior to being investment-ready. These could be bankable through the more risk-tolerant approach to business lending adopted by community finance organisations.

Policy response

The Government's commitment to reduce social exclusion has resulted in a variety of policies to promote enterprise and financial inclusion in disadvantaged communities across the UK. A series of policy steps outlined in Table 1 helped to build the community finance sector.

Policy-makers have focused on enterprise development as a way of securing full employment and narrowing the gap in economic wealth between different regions. The Labour Government views enterprise as a means of achieving sustainable economic development, growth and regeneration in deprived areas. Regional Development Agencies (RDAs) were created in 1999 to reinvigorate the task of economic development and social and physical regeneration through a business-led approach. A range of finance initiatives, such as the Small Firms Loan Guarantee (SFLG), regional venture capital funds, and enterprise capital funds were intended to improve access to finance for small to medium-sized growth businesses. Other measures such as the Neighbourhood Renewal Strategy sought to stimulate economic regeneration at a local level.

Enterprise policy also focused on expanding economic opportunity for disadvantaged individuals and under-represented groups. Policies such as the Local Enterprise Growth Initiatives (LEGI), the establishment of Women's Enterprise Units, and the Ethnic Minority Business Forum reflect concern to ensure equality of opportunity and to address market failures in enterprise start-up, particularly in disadvantaged communities.

To address financial exclusion, a variety of policy initiatives have been implemented at a local and national level. The Government set out its strategy to tackle financial exclusion in *Promoting financial inclusion*, published alongside the 2004 Pre-Budget Report. The report sets out a range of measures in three priority areas of access to banking, access to affordable credit, and access to free face to-face money advice. A Financial Inclusion Fund (FIF) of £120 million was established in 2005 be overseen by the Financial Inclusion Task Force (FITF) chaired by Brian Pomeroy. A follow up report *Financial Inclusion: the way forward* was released in 2007 to set out the future policy framework, including extension of the FIF for the 2008–2011 period.

Support for community finance emerged from the Government's objective to reduce social exclusion. The Government has promoted community finance as a means of delivering financial inclusion, enterprise-building, and regeneration since 2000. This was largely the result of Policy Action Team reports which highlighted underinvestment in low income neighbourhoods coupled with problems of personal financial exclusion. To address this, Gordon Brown launched SITFin February 2000 to encourage private investment in enterprises in deprived communities. The specific remit of SITF was: 'To set out how entrepreneurial practices can be applied to obtain higher social and financial returns from social investment, to harness new talents and skills to address economic regeneration and to unleash new sources of private and institutional investment.'[9]

Chaired by Sir Ronald Cohen, SITF recommended a five-point programme of action to increase investment, enterprise and wealth creation for low income neighbourhoods. This framework for investment in disadvantaged communities successfully resulted in establishment of the cdfa, creation of the CITR, and the launch of the Bridges Community Development Venture Capital Fund. SITF contributed significantly to development of the basic mechanisms and institutions of the social investment marketplace, so that private finance can be directed to community finance organisations and other social enterprises working to improve local communities.

The initial five points for action recommended by SITF were:

1. Introduction of the CITR as a credit to private investors in enterprise lending schemes targeting disadvantaged areas.

2. Development of Bridges Community Venture Capital Fund, the UK's first venture capital fund to generate both social and financial returns through investment in businesses located in disadvantaged communities.

3. Enhanced disclosure and accountability by commercial banks of their enterprise lending activities in disadvantaged communities.

4. Greater latitude and encouragement for charitable trusts and foundations to invest in community development initiatives.

5. Establishment of the cdfa as a trade body to represent the interests of diverse CDFIs.

Community finance has regularly been divided into the personal and enterprise finance activities of CDFIs, credit unions and other loan funds. Increasingly this distinction has broken down as community finance organisations respond to local priorities and adapt to funding constraints. Credit unions have typically been associated with personal finance, whereas CDFIs were initially designed to focus on enterprise lending. As the sector evolves, these distinctions are blurring. It is often difficult to establish whether a small loan to an individual is used for enterprise or personal reasons. However, the policy context has continues to focus on these distinctions.

Policy support for the sector resulted in the provision of funding to enterprise-lending CDFIs through the Phoenix Fund, the establishment of the cdfa and the CITR credit for investment. The Phoenix Fund represented one of the most important sources of funding for community finance organisations involved in enterprise lending. The Phoenix Fund closed in 2006, with Department of Trade and Industry (DTI) oversight transferred to individual RDAs.[10] In February 2006, HM Treasury agreed an additional £11 million of interim support for the sector. Since then, however, no new sources of government funding for enterprise lending have been

Table 1: Policy steps that helped to build the community finance sector.

1997	The Government's **Social Exclusion Unit** (SEU) is established to address poverty issues.
1999	**Policy Action Teams** (PATs) on enterprise finance and financial exclusion issue make recommendations leading to development of the sector.
2000	The **Phoenix Fund** bidding rounds is initiated to channel finance to enterprise-lending CDFIs.
	The **Social Investment Task Force** (SITF) is established.
2002	The **Community Development Finance Association** (cdfa) is established.
	Bridges Community Development Venture Capital Fund is launched.
	Community Investment Tax Relief (CITR) is enacted to channel investment to CDFIs.
	Legislation introduced to change operating conditions for credit unions, including a new regulatory framework overseen by the Financial Services Authority (FSA).
2003	Over £42 million is awarded to 63 CDFIs in **Phoenix Fund** bidding rounds.
	Launch of universal banking with the introduction of the basic bank account by high street banks
2004	Treasury report *Promoting Financial Inclusion* lays out a strategy to address financial exclusion. **Financial Inclusion Task Force** is established.
	A **£120 million Financial Inclusion Fund** is announced, including the Growth Fund administered by the DWP, which is allocated £36 million to disburse as low cost personal loans through credit unions and CDFIs.
2005	17 CDFIs are accredited for **CITR**; £38 million is raised by 11 CDFIs.
2006	The **Phoenix Fund is discontinued**; £11 million is made available for transition.
	The responsibility for oversight and provision of funding to **CDFIs. transferred to Regional Development Authorities (RDAs).**
	Treasury Select Committee hearings on financial exclusion, publishing a series of three reports to highlight the issue.
2007	Treasury report *Financial Inclusion: the way forward* sets out actions to be taken to address financial exclusion through to 2011.
	The Pre-Budget report announced **£130 million funding for the Financial Inclusion Fund** over the 2008-11 period.
2008	**Liberalisation of the credit union 'common bond'** is proposed by HM Treasury to increase membership and available capital for these institutions.

committed and the future of support for enterprise lending remains uncertain.

Increasingly credit unions have been promoted to address personal financial exclusion. Funding to tackle personal financial exclusion of £36 million was made available to community finance organisations through the Growth Fund, which will run until 2011. Regulated by the Financial Services Authority (FSA), these institutions can be a positive alternative to mainstream banks for disadvantaged communities. Guided by their membership base, many credit unions have developed products and services that are targeted to low-income or disadvantaged individuals. Based on a 'common bond' of membership, credit union members receive higher returns on their regular savings and pay lower interest on loans. Credit unions often provide additional education and money advice to members, and can facilitate debt management and bill payment. The Treasury's planned expansion of the 'common bond' for credit unions announced in June 2008 is a positive step that would to allow for a broader range of members and investors.

Finance for community development

A wide range of community finance organisations have emerged in the past ten years. The community finance sector includes credit unions, CDFIs, social enterprise finance funds, and CDVC funds. These organisations have the potential to widen the access of disadvantaged individuals and communities to investment and financial services, training and business support. They may also provide finance to third sector organisations, such as charities or social enterprises, that have a social or environmental purpose.

The community finance sector has had a significant impact on some of the most disadvantaged communities, attracting millions of pounds of investment.[11] Community finance organisations are part of a network of institutions that can form an effective social investment market. Unlike traditional finance, this form of investment creates significant social benefits alongside financial return. Community finance organisations can be key players in the effort to regenerate disadvantaged areas by seeding capital to local individuals and micro-enterprises.

Since the SITF recommendations in 2000 put in place the basic architecture of social investment for community development, a variety of third sector lending institutions have emerged:

Community Development Finance Institutions (CDFIs)

- Approximately 80 CDFIs have been established across the UK. The sector has achieved a high degree of diversity, ranging from the provision of small personal loans of £50 to enterprise loans of £750,000.[12]

- CDFIs have financed over 15,000 businesses and households. CDFIs have sustained or created 33,000 jobs, while the finance provided has levered £330 million of funds.

- The sector is maturing with nearly half of CDFIs between two- and five-years-old, while nearly a quarter have more than ten years lending experience.

- As of March 2007, CDFI loan portfolios had grown to £287 million, a 59 per cent increase year on year. The coverage of CDFIs in the UK is by no means complete, and community finance is not yet of a scale to lend to all those who could benefit.

Credit unions

- As of 2007, there were over 500 credit unions operating in the UK with just over 600,000 members, representing a 1.5 per cent penetration rate.[13]

- Credit unions hold member deposits of £410 million and have loans outstanding of approximately £340 million, as at June 2005.

- Membership in credit unions affiliated to ABCUL (the Association of British Credit Unions) has trebled since 1995, while money saved by members has increased by over 600 per cent.

- Since July 2002, credit unions have been regulated by the FSA, as are banks and building societies.

- Membership of the Financial Services Compensation Scheme means that in the event of a credit union failing, savers will be compensated.

Community development venture capital (CDVC)

- Bridges Ventures was founded in May 2002 by Apax Partners, 3i and entrepreneur Tom Singh to invest in businesses in the most disadvantaged areas of England to create entrepreneurship, jobs and economic dynamism.

- Bridges CDVC Fund I is a ten-year fund of £40 million: £20 million of private sector investment primarily from banks and pension funds and £20 million in matching investment from the DTI (now BERR – the Department for Business, Enterprise and Regulatory Reform).

- Bridges CDVC Fund I invested in businesses ranging from start-ups through to small management buy-outs and property-backed ventures, and has made equity investments in 24 businesses employing 700 people, almost 200 of whom came out of unemployment. The fund has had three successful exits to date.

- Launched in 2007, Bridges CDVC Fund II is a second £75 million fund, raised entirely from private sector investors. Its core focus is investment in the most deprived parts of the UK, but also invests in businesses bringing strong social benefits in sectors such as healthcare, education and the environment.

Social enterprise finance funds

- Triodos Bank provides loans to social enterprises and charities in amounts ranging from £20,000 to £10 million for up to 25 years. Triodos Bank lent £33 million to charities and social enterprises in 2007, more than doubling the previous year's amount.

- Triodos has recently launched the Triodos Opportunities Fund, a venture capital fund to invest between £200,000 and £750,000 in social enterprises looking to scale up operations. The Fund has raised almost £3 million in its first fundraising round, which closed in June 2008.

- Big Issue Invest currently provides loan finance to social enterprises, and is launching a Social Enterprise Venture Fund to provide risk capital for social enterprises that have the capacity for scale and significant social impact. These investments will range from £50,000 to £500,000 and will involve additional strategic development support.

- Charity Bank is a regulated bank and registered general charity that has provided over £72 million in loans to charities and social enterprises since its launch in 2002. Social enterprises and community organisations may be allocated loans of up to £1 million to help with anything from working capital to building purchase and refurbishment. Charity Bank agreed over £15 million in loans in 2007.

- Venturesome has raised £7.5 million for its social enterprise investment fund from charitable trusts, companies and private individuals. At October 2007, Venturesome had provided £10 million of financing to over 140 social organisations.

- Futurebuilders England is a government-backed fund that has made £138 million investments in 271 community and social enterprises since its launch in 2004. Loans and guarantees make up 84 per cent of total investments: nearly half the loans are unsecured.

- Adventure Capital Fund (ACF) will manage the second phase of a £215 million government Futurebuilders Fund to develop third sector delivery of public services by social and community enterprises. As well as managing existing investments, ACF will invest an additional £65 million on top of the £150 million already available to the fund.

- Set up in 1995, the Local Investment Fund has allocated £7 million of loans to 150 community enterprises. The fund re-launched in April 2008 as the Social Enterprise Loan Fund and plans to double the size of its loan portfolio over the next three years.

- A £10 million fund for risk capital investment in social enterprises proposed by the Office of the Third Sector (OTS). The proposed fund has been subject to Government consultation, and will likely be an equity and equity-like investment scheme, to be matched by private investment.

Supporting mechanisms

- The CITR scheme encourages investment in disadvantaged communities by giving tax relief to investors who back businesses and other enterprises in less advantaged areas by investing in accredited CDFIs.

What now?

Uncertainty in the funding and policy environment presents a challenge for the community finance sector. The future of community finance organisations is under threat because of a changing policy context and shifting funding priorities.

- CITR has raised investment of £40 million for CDFIs since its inception, with an additional £10-15 million expected to be raised in the next two years.
- Charitable foundations and trusts are not eligible for CITR. In addition, the Government has applied restrictions to property investment through the CITR such that community finance organisations have been limited in the extent to which they can expand to finance housing and property.
- SFLG provides a guarantee to the lender covering 75 per cent of the loan amount, for which the borrower pays a two per cent premium on the outstanding balance of the loan. This is available for loans of up to £250,000 for small businesses with an annual turnover of less than £5.6 million.
- Three CDFIs (South West Investment Group, Foundation East and Bradford Enterprise Agency) have recently been approved for the SFLG scheme.

The short-term nature of Government funding means that many institutions will struggle to carry on with the activities that have the most social benefit, such as training, money advice and business support. Providing small loans in disadvantaged areas is a costly activity that banks avoid because of limited profitability. Yet funding for community finance institutions has all but dried up. Likewise, there is limited funding to support the more advanced systems, training and reporting requirements that community finance organisations need to expand.

When community finance organisations were launched, a key expectation was that they could achieve independence from grant funding through the revenue their activities generated. It is now evident, however, that all but the largest enterprise loan funds will struggle to reach financial sustainability. CDFIs and credit unions are in a continual struggle to make ends meet. This is particularly true of organisations that have smaller loan portfolios, provide microloans, focus on personal financial exclusion or offer training, budgeting and business support. Low-income or disadvantaged individuals – many suffering from multiple issues such as financial illiteracy, substance abuse, or disability – are a challenging client group that is costly to serve.

Many third sector organisations are chronically undercapitalised. Funding for community finance is cobbled together from a variety of regional, local and private sources. Funders have conflicting and overlapping objectives and reporting requirements. It is costly and time-consuming to meet the needs of each funder, particularly when grants are short-term and project-driven. A number of third sector organisations, including some community finance institutions, limp along from one grant to another, despite the key role they are expected to play to rehabilitate disadvantaged communities. This patchy approach to funding is ultimately bad for individuals, as projects start up and disappear with alarming regularity, leading to confusion and mistrust.

On the investment side, it is clear that CITR has not attracted as much private finance to CDFIs as had been hoped.[14] CITR is widely viewed as too complex and narrow to attract sufficient investment capital. It is in need of further revision, particularly with respect to its effectiveness and its limited flexibility.[15] The operation of CITR was under review in 2007 by HM Treasury and OTS. As a result of this consultation some technical changes were made.[16] There is continuing evidence that inefficiencies in CITR need to be addressed.

The sector needs additional capital in order to reach the scale required to make a lasting impact on community development. A positive step has been discussions about how to use unclaimed assets lying dormant in financial institutions. In December 2005, the Treasury agreed with the UK banking sector that funds left unclaimed for 15 years or longer could be put to other social purposes. The Commission on Unclaimed Assets recommended that these assets could be put to use as a lump sum payment to capitalise a wholesale finance institution, called the Social Investment Bank.[17] This institution would inject additional capital, along with the needed financial expertise, to push forward community finance organisations and other social enterprises in the third sector.

It is clear that a new form of funding for the third sector is required. Community development finance organisations have come a long way, but they are still limited by patchy funding and insufficient mechanisms to drive investment to the sector. Third sector institutions, such as community finance organisations and social enterprises, require a long-term, dedicated source of investment capital that is tailored to the needs of each organisation. A new form of social investment for communities is possible if the right mechanisms and supporting legislation is in place.

Social investment for communities: interview findings

Great strides have been made to develop the infrastructure of finance for community development. Eight years on from the SITF recommendations, selected policy measures and mechanisms have been created to support third sector finance institutions.

The UK now hosts a range of innovative social enterprises, community finance organisations and social investment funds seeking to create social change alongside financial return. These organisations are remarkable for the millions of pounds that they have brought to disadvantaged communities, despite the fact that many struggle with an adverse and uncertain funding environment.

But this architecture is half-built. There is still a long way to go to achieve a thriving and robust social investment market linked to the mainstream financial sector. To achieve the scale of social change required, community finance organisations and other social enterprises must be able to tap into private sources of finance. For many organisations, this means that they require targeted grant support now to help them reach a point where private finance is a possibility in the future. Well-designed tax mechanisms and supporting legislation is required to encourage supply of capital from private and institutional investors.

nef carried out a series of 24 interviews with leaders from the sector to determine the key issues facing the future of social investment. The objective of this research was to determine the missing pieces required to complete the infrastructure of the UK social investment market. Given the challenges and opportunities the sector faces, the key questions we sought to answer include:

1. What form of funding and legislative support is required by third sector finance organisations to enable them to expand and improve?

2. What are the obligations of commercial banks as stakeholders in the effort to combat financial exclusion?

3. What role should the proposed Social Investment Bank perform if it is to meet the needs of third sector financing and the goals of the Social Investment Taskforce?

We consider each of these questions in the three sections below.

Like any market, discussion of social investment for community development can be considered from the perspective of the demand and supply of capital. Typically discussion of demand has focused on the ultimate recipients of finance – the individuals, businesses and social enterprises operating in disadvantaged communities. Our analysis of demand focused primarily on third sector finance intermediaries – credit unions, CDFIs, social enterprise finance funds, and CDVC funds.

In some cases the issues on the demand side overlap, affecting both third sector finance intermediaries and the social enterprises they serve. Supply of capital to these institutions comes from both government and private sources of finance, ranging from individuals to large institutional investors. Given the objectives of the sector, there are additional measures required to improve the efficiency of the market and accelerate its development. We have segmented our interview findings into these three categories in order to focus the analysis.

Demand-side

There is consensus among those interviewed that the social investment market is at a turning point. Having reached its current state of development, community finance organisations need additional support and funding if they are to scale up. While a few credit unions and CDFIs have begun to tap into private finance, on the whole these organisations remain dependent on grant funding. Social enterprise funds and CDVC funds have been the most proactive third sector finance organisations to attract investment. These funds have received both private and public sources of finance, with some tapping into a blend of both.

The demand for capital is there, but for the most part, expertise and know-how is lacking. This varies across organisations, which have different remits and spheres of operation. Social enterprise finance funds typically have key staff with significant experience in the finance sector. But social enterprises, such as community finance organisations, may struggle with concepts of social investment and raising private finance.

One funder commented that, 'There is a need to have innovation in the community finance space in general. The third sector is highly entrepreneurial, but an additional push is required. How can the sector be catapulted to the next stage of growth? On the demand side, what is required to build a more robust social investment marketplace?

Build expertise and investment-readiness

Many of those interviewed emphasised the need to increase the financial competence of third sector organisations. As one social investor noted, 'The key issue is still quality of investment opportunities on the demand side.' Capacity building is required to encourage social enterprises, such as community finance organisations, to use non-grant finance and educate them to the opportunities to raise debt and other instruments. Social investment is relatively new as a concept. An interviewee commented, 'There is little awareness of how appropriate finance is catalytic and this hurdle is very big.' Those who are aware of new forms of investment may not know where to start.

The demand side needs the tools and education to access the right type of finance. A growing range of finance is now available to social enterprises. As one individual commented, 'What would make the biggest difference quickly would be the understanding of where to access the right type of finance.' This, of course, depends on the stage and type of organisation. As the social investment marketplace matures, a spectrum of organisations requiring different types of finance will emerge. This will range from start-ups and small community organisations requiring grants to maturing social enterprises that need equity capital.

Support organisations to move beyond grants

To a certain extent, the way the funding system has operated has created grant dependency. As one interviewee noted, 'To change that psychology is difficult.' People have become grant reliant and are frightened of equity and loan products. Social enterprises should understand the advantages and risks of alternative forms of finance in order to increase investment readiness. There is continuing need for support, as very few social entrepreneurs have had experience with raising finance. As in the private sector, there will be a role for advisory expertise targeted to the individual needs of organisations. One individual suggested, 'Grant money should be used to foster and build capacity, to bring organisations up to the point where they enable private money to come in.'

Long-term grant funding still required

Innovation is happening, but not on a sufficient scale. One commentator noted, 'We are at the stage of moving from the embryonic to the infant.' As in any new market, innovation and growth needs to be supported and encouraged. This requires additional, ongoing grant funding. As one individual noted, 'Community finance organisations need to grow and develop. They need to invest in themselves but they can't do it because don't have the reserves. This illustrates all too graphically the classic conditions of organisations whose lack of capital resources stifles their ability grow. Most funders will not fund the core operational requirements or will not do so long enough, and yet they want them to tackle complex social problems.'

More funding resources are needed to make it happen. Ultimately, where good things are being developed, they need to be replicated. Existing finance could be used better and new finance is required to enable community finance organisations to undertake the task they are being asked to complete.

Supply-side

The critical issue for the social investment marketplace is how to best supply finance to the third sector. While hotly debated, the consensus is that 'if you build it, they will come.' This was clearly stated by several interviewees, 'Unless you get the supply side making the offers and developing new products, then the possibility of different ways of using money [for third sector organisations] will not emerge.' Big advances have been made, but the supply of finance to third sector organisations is still modest relative to the financial services sector as a whole.

Implement appropriate tax mechanisms

A variety of different supply-side actors have started to emerge. But there is agreement that the sector needs supporting mechanisms to further its efforts. Additional and improved tax breaks are required. The current CITR credit is very narrowly focused on CDFIs, and has been proven to be too complex and inflexible to attract significant private funds. The Enterprise Investment Scheme (EIS) has been used selectively by a few social enterprises to attract investment.[18] However, the rules governing EIS are not well adapted to social enterprises. SFLG functions to support the activities of qualified community finance organisations by providing a government guarantee against default, but does not attract additional investment capital for on-lending.

An appropriate tax mechanism to attract investors to social enterprises is required. As one interviewee noted, 'Look at the tax breaks that RBS, Tesco, Barclays and others access in the private sector, yet the social sector has none.' Nigel Kershaw, Chief Executive of *BIG Invest* stated in a recent article, 'The Government doesn't reward investors for taking risks in investing in social enterprises. Offering the same tax incentives to investors in social enterprises is the single most important issue for government… if it truly wants to support and grow social enterprises.'[19]

Any interventions developed must be clear, consistent and simple. One interviewee suggested that gift aid tax relief could be extended to investment in community shares, thus providing automatic government top-up to organisations raising finance locally. For example, investment could be capped at £20,000 for attracting gift aid on Industrial and Provident Society (IPS) shares. As one individual we spoke with noted, 'The idea that they could get tax relief and be doing something with their money is very attractive to many people. But [the tax credit] has to be well promoted and well designed, marketed effectively.' Another participant concurred, 'There would be a lot of leverage from public awareness campaigns that would highlight different opportunities to invest in social enterprises.'

Attract mainstream sources of finance

The next big step is to encourage charitable trusts and institutional investors to invest in social enterprises. An SITF recommendation was to facilitate greater latitude for charitable trusts and foundations to invest in community development initiatives. Increasingly, charitable foundations are seeking ways to invest their endowments in line with their mission.[20] Foundations should be included in any new tax credit to increase the amount of funds available. Ultimately the sector needs to look outside of itself to mainstream capital markets for finance. Appropriate tax credits would allow large institutional investors, such as insurance and pension funds, to invest a small portion of their enormous funds for community benefit. One social investor commented, 'There is a lot of money that institutional investors have which they have nominally earmarked for social investment. However, there is still a big disconnect. The barriers are scale: investors typically need very high minimum stake sizes. The other barrier is a lack of track record and understanding of social entities.'

Develop new products

There is also an onus on suppliers to continue to develop better products and attract new talent and financial expertise. New product development is important.

The sector needs equity investment for a long-term approach to financing social enterprises. Social investors should focus on high risk, unsecured lending and equity investment in social enterprises to avoid overlapping with traditional bank finance. Taxpayers' money should not be used to support less-risky secured lending. The pressure to be sustainable causes some social investment funds to drift to doing larger deals closer to market, which are already well-serviced. That said, suppliers have not yet cracked the nut of how best to manage risk, by packaging investments with varying risk levels into one fund.[21] This would make investment by a range of institutions in the sector much more attractive.

Inject rigor into the market

Suppliers of social finance must be rigorous. They need to stick to the terms of loans in order to enforce these contracts. If social investors are not willing to allow bad debts to fail, it will result in a culture of moral hazard that undermines the social investment space. Investors need to encourage the same level of reporting and transparency from social enterprises as would be expected of their mainstream counterparts. This may involve working with and incentivising investee organisations to develop more advanced reporting processes. Finally, because of the shared social objective of suppliers, a degree of collaboration, rather than competition might make sense.

Enhance market efficiency

Additional steps could be taken to improve the functioning of the social investment market.

Develop positive procurement strategies

The Government could support the sector by implementing more positive procurement strategies. Increasingly there is a trend to outsource public services to social enterprises or community organisations. Organisations providing public services need to be allowed to make a profit. If not, they are condemned to the same struggle for survival facing under-resourced charities. As one individual noted, procurement could be designed to better link to social enterprises. For example, the winning bid of Hackney and Ealing Community Transport to provide bus services to workers at the London Olympic games underlined the importance of local participation, but also required them to join together in order to meet the minimum turnover requirement. Entry points for social enterprises could be built into local or Government contracts being required to include local and social delivery agents. One individual added, 'We need to work to establish mechanisms to break down sub-contracting to manage at local neighbourhood level. We need 5–10-year inflation-related contracts – that would make the risk of using loan finance or the costs of going out looking for equity more reasonable.'

Improve marketing and awareness

There is still limited awareness of third sector finance organisations. Very little poor and patchy marketing takes place. This challenges the effectiveness of the sector to attract new clients and to raise finance from external sources. Like any business, these social enterprises need to develop brand recognition and establish a track record. This is particularly true of community finance organisations operating directly in local communities. Lack of awareness limits the possibility of innovation and expansion of the sector. As one interviewee observed, 'They can't even copy each other like in the commercial market because they don't know enough about what each other is doing.'

Standardise social return

It is important to demonstrate the social outcomes that third sector finance organisations achieve. Finding a clear and simple way to communicate social return is the Holy Grail. This would help to improve transparency and drive investment to the sector. Many organisations, including **nef**, have worked on how best to measure social return on investment (SROI).[22] The lack of a standard in the industry is a challenge. Funding for social enterprises to carry out social reporting is scarce. As one individual commented, 'Financial return is often an unknown [for social investments], and social return is often entirely unquantifiable. The latter in particular needs to be simpler and clearer.' The OTS initiative to develop a standard SROI tool is very welcome.[23]

Improve transparency and reporting

A key challenge of social reporting is that organisations rarely record the necessary information, and to do so is costly and time-consuming. In addition, there is still a need to improve financial reporting and transparency in general. There are very few standard key performance indicators. The little information available is often held by trade associations, which may not make it readily available. A basic method of comparing performance across organisations will become necessary. This is particularly true as more social enterprises seek to attract outside investment. Regular systems and information management processes are required, so that, at a minimum, expertise and knowledge is not lost once a key individual moves on.

Simplify policy

Policy needs to be simple. One individual noted, 'Government is rearranging the deck chairs, it isn't helpful for building up [third sector] institutions. Government is constantly coming up with new structures.' For example, recently the DTI became BERR and the Office of the Deputy Prime Minister (ODPM) became the Department for Communities and Local Government (DCLG). The short-termism of Government policy and funding is difficult for young third sector organisations to cope with. With each policy cycle, the priority moves on from social exclusion and enterprise development to child poverty, multiple deprivation and financial exclusion. Funding and oversight is shifted or closed when one department supersedes another. Key relationships and knowledge are lost. Enterprise-development focused CDFIs have been transferred from the DTI to RDAs, which are now also under threat). Personal financial exclusion has been split between the Department of Works and Pension (DWP), the Legal Services Commission (LSC) and FSA. Organisations struggle to swim in this alphabet soup.

Role of banks and financial institutions

A key question for the development of the social investment marketplace is the role of banks. Financial institutions are a key component of the effort to combat financial exclusion and to provide sufficient investment capital to local areas.

Banking institutions have the resources, infrastructure and capital required to achieve substantial change in disadvantaged communities. Banks are given a license to operate which allows them to make vast profits by investing and lending funds to savers and borrowers. They provide a service of intermediation that is fundamental to a modern economy. As part of this function, banks have an obligation to serve all members of society, regardless of their potential for profit.

When banking institutions become too large they no longer have a vested interest in the well-being of any community. Banking conglomerates operate across multiple international areas. Retail banking in the UK may be only a tiny fraction of the business of many financial institutions. This limits the extent to which a bank engages with and invests in local communities. For the most part, management, training and staff incentives are not structured to create local outcomes. Despite the best advertising efforts of some banks, a global bank cannot be local.

Banks make decisions purely on the basis of profit. Local branch banking based on personal relationships is dead. Many bank branches in low-income areas have been closed. Banks have promoted internet or telephone banking as an alternative to personal service provision. This reality makes access to finance more challenging for the financially excluded.

Banks have no incentive to engage in unprofitable activities for social benefit. Banks are not designed to maximise social outcomes. Financially excluded and disadvantaged individuals do not make attractive customers. The long-term benefit of revitalising communities and attracting new customers has not motivated banks to act. A philanthropic approach by banks to financial exclusion and community redevelopment, while positive, is often ad hoc and not of sufficient scale to achieve the necessary social change. As one of our interviewees commented, 'One of the ironies of the way banks approach these areas, is that one of the reasons they got engaged in this area was because the Chancellor was very interested. Once they are no longer the flavour of the month, the interest wanes, because banks have been quite opportunistic rather than strategically coordinated in their involvement.'

A carrot-and-stick method would be effective to persuade banks to serve disadvantaged communities. Currently both of these mechanisms are missing. Banks must be compelled to meet the needs of disadvantaged communities through appropriate government regulation, while being incentivised through appropriate tax mechanisms. This would ensure a continued and strategic approach to investment in disadvantaged areas by banks.

Our discussion of the appropriate role for banks focuses on several key issues:

- Compulsory disclosure by banks of lending and investment in disadvantaged areas, as a means of tracking performance.
- Legislation to require universal service provision by banks for financially-excluded individuals and disadvantaged communities.
- Incentives for banks to invest in disadvantaged communities.

Compulsory disclosure of lending and investment in disadvantaged areas
Bank disclosure is an important tool to tackle financial exclusion. A key SITF recommendation was that UK banks should publish details of their lending and investment in disadvantaged areas. Information on the lending patterns of individual banks makes it possible to compare the performance of these institutions, as well as to understand patterns of financial exclusion more broadly. SITF recommended that banks should disclose this information on a voluntary basis. To date, limited success has resulted from a voluntary approach.

Compulsory bank disclosure follows from the positive example of legislation enacted in the USA. The USA passed the Community Reinvestment Act (CRA) in 1977 requiring banks to disclose their lending and investing in underinvested areas.[24] Implementation of the CRA has resulted in more than $4.5 trillion (£2.5 trillion) of loans and investment committed to redevelopment of disadvantaged communities for individuals, businesses and affordable housing.[25] This law requires banks to offer credit throughout their entire market area and prohibits them from 'cherry-picking' higher-income communities and individuals. The level of credit provision and investment by banks in disadvantaged areas is publically available to allow monitoring, analysis of performance and local decision-making on this basis.

Information on area-based lending and investment is used to evaluate whether each banking institution has met its obligation to local communities. This CRA record is taken into account when the federal government considers a bank institution's application for specific activities. For example, if a bank has a poor record, the Government can turn down its applications to expand, merge or take over another financial institution. In response to this heightened transparency, many US banks have established separate business units or community development corporations to facilitate lending that will be given positive consideration during CRA reviews.

The success of bank disclosure is dependent on it being compulsory. Only consistent and regular reporting to a central database will provide a sufficient level of transparency. Without a legislative mandate, banks have no 'first-mover' incentive to disclose. Banks must take steps to restructure reporting systems, which they are unlikely to do without external pressure.

Disclosure matters because government, local authorities and community groups can take action according to the performance level of a bank. This could be as simple as local authorities choosing to bank with top-rated banks that re-invest in their community. Banks that take deposits from a local area should be held to account to reinvest a proportion of these assets for the benefit of that community.

Legislation to require universal service provision
The imperative for banks to develop solutions to financial exclusion can only result from a universal service obligation. Such a legislative obligation would mandate the provision of basic banking services to all individuals, making this inherent in the receipt and continued operation of a banking licence. Similar to utilities, telecommunications, and the postal service, access to a bank account is a basic requirement to function effectively in society. Unlike these basic services, banking remains exempt from the obligation to provide access to everyone.

To address financial exclusion, the UK Government urged retail banks to introduce a new product, the basic bank account, in 2003. The basic account offers a simple transaction account to facilitate use of ATMs, direct debit, and electronic income transfer but is without an overdraft facility. In theory, the basic account is available to everyone, with proof of identity and credit checks designed to be more flexibly implemented. Basic bank accounts are also accessible free of charge over the counter at most post offices. The basic bank account, combined with the introduction of electronic payment of benefits and pensions, was designed to establish universal banking services. Basic bank accounts are now offered by all major high street banks.

Introduction of basic accounts was agreed with UK retail banks as part of their social responsibility and voluntary commitment to the UK Banking Code. Retail banking remains one of the last bastions of UK financial services industry to be self-regulating. As part of this voluntary agreement, the banking industry signed up in December 2004 to work with the Government to halve the number of unbanked households in the UK.[26]

Some limited progress has been made to address financial exclusion. In response to Government pressure, most notably from the House of Commons Treasury Select Committee, banks have worked closely with FITF. According to the most recent data, two million adults are without access to a bank account as of 2005/2006, suggesting that a moderate decline in financial exclusion has occurred.[27]

Nevertheless, it is clear that there are still many obstacles. Banks' performance in providing and operating the basic bank accounts has been lacklustre. Some banks continue to treat basic bank account holders as second class citizens by denying branch counter access and hiding behind onerous identity requirements and administrative delay.

Banks have no incentive to innovate and develop new product alternatives for low-income individuals, rather than simply hitting a numerical target. There is a significant gap between tacit agreement at a senior level and compliance and implementation throughout the branch network. The Treasury Select Committee acknowledged a host of banking practices that continue to disadvantage the financially excluded people.[28]

UK retail banks have no imperative to comply with the Government's financial exclusion targets, beyond the threat of further regulatory action. A universal service obligation would transfer the onus of guaranteeing financial access to the banking institutions, ensuring their ongoing commitment to address financial exclusion.

Incentives to invest in disadvantaged communities

Under the current system, financial institutions have little or no incentive to invest in disadvantaged communities. With very few exceptions, funds allocated by banks to achieve social outcomes are philanthropic grants rather than investments seeking a return. Banks make grants to improve their public image as part of a strategy of corporate social responsibility. Investment by banks in third sector lenders has fallen short of expectations. As the Treasury Select Committee has noted, support from the banks for third sector lenders through the provision of capital is far lower than that provided in the USA, where combined regulatory and incentive mechanisms are in place.[29]

An appropriate tax mechanism could spur investment to disadvantaged communities, encouraging banks to channel substantial funds to redevelopment alongside other private investors. Combined with a regulatory requirement to disclose these community investments, a tax credit would attract a wave of new funding to those communities most in need. Viable business and development opportunities exist in disadvantaged neighbourhoods, but are often overlooked because of higher risk and a perceived returns gap. This gap can be effectively bridged through the use of tax credits.

A successful example of this model is the New Markets Tax Credit (NMTC) and Low Income Housing Tax Credit (LIHTC) in operation in the USA. LIHTC is the most important resource for creating affordable housing in the USA. Created in 1986, the tax credit incentivises the use of private investment in the development of affordable housing for low-income individuals. This is achieved through a 'dollar-for-dollar' reduction in federal income tax based on a large percentage of the cost incurred for housing development. Similarly NMTC permits taxpayers to receive a credit against federal income taxes for making qualified equity investments in designated community development corporations that invest in low-income communities.[30] Established in 2000, the NMTC programme has awarded tax credits totalling $16 billion in its first five rounds, indicating the scale of investment channelled to community redevelopment through this mechanism.

It is clear that a well-designed tax mechanism is required to attract private investment to disadvantaged communities. To achieve this, a substantial redesign of CITR is necessary. A more far-reaching and flexible tax mechanism is required to drive private investment to third sector lenders and other social enterprises. This should allow tax credit for investment in social enterprises that provide services to disadvantaged communities. Investors would welcome a simple and flexible means to channel funds to projects and enterprises that generate both social and financial returns.

Development of a Social Investment Bank

The idea for a new social finance institution emerged from discussions about how best to provide long-term funding for third sector organisations. The proposed disbursement of unclaimed assets held by financial institutions presented an opportunity to review the needs of community organisations, social enterprises and other charities.[31]

The Commission on Unclaimed Assets, chaired by Sir Ronald Cohen, was formed in October 2005 to consider how funds released from dormant bank accounts could be used to generate the maximum public benefit.

Based on a consultation carried out in 2006, the Commission recommended the creation of a Social Investment Bank (SIB).[32,33] This new entity would support third sector institutions with financial and technical expertise to develop a long term source of investment capital for the sector. A key objective of the proposed SIB is to develop a robust and thriving social investment marketplace, so that private investment can be directed to third sector institutions, including social enterprises and community development organisations. A final report in March 2007 defined the activities proposed for the SIB:

- To capitalise financial intermediaries, such as third sector lenders, and fill gaps in the marketplace where lack of capital is limiting social impact.
- To provide advice, support and higher-risk investment in order to accelerate demand for repayable finance, as opposed to grant funding, for third sector organisations.
- To develop programmes of investment in community regeneration and financial exclusion.
- To support existing third sector organisations to raise private capital and attract significant additional finance to the sector.

To carry out these activities on a sustainable basis, it was proposed that the SIB should be initially capitalised with a minimum of £250 million, with an annual income stream of £20 million for a minimum of four years. The SIB is designed to be an independent institution that is innovative and flexible, allowing it to bridge both the financial and social sectors. The SIB would function as a wholesale fund to provide finance to existing and new financial intermediaries. A key function of the SIB will be to use financial innovation to meet the needs of each of these sectors, allowing third sector organisations to tap into capital markets.

Following these recommendations, Sir Ronald Cohen founded Social Finance, a new limited company focused on financial product development, market intelligence, capital raising and management to lay down the cornerstone of the social investment bank. As of April 2008, Social Finance had raised £500,000 in seed capital to launch its operations, primarily from high net worth individuals and foundations.[34]

Political slowdown

The disbursement of the unclaimed assets has been slowed by the legislative process. It appears that political willpower may be waning to capitalise a new SIB, with various other proposals competing for the funds. Information from the OTS suggests that the bulk of the funds in England will go to youth services, with financial capability and inclusion a second priority. As its website states, 'If resources permit, and subject to clarifying and addressing any state aid implications, the Government would also like to see a proportion of unclaimed assets in England used to develop the social investment market.'

Unclaimed asset funds could be allocated directly to third sector organisations as grants, rather than in one lump sum to capitalise a new entity. The funds are to be distributed by the BIG Lottery Fund. The principles underpinning disbursement outlined by HM Treasury further emphasise that funds will be disbursed across all four countries of the United Kingdom and, in England, will encompass a range of communities. As such, there may be limited remaining funds to meet the minimum founding capital required by the SIB. There is a clear danger that the total amount of money available may not be enough to create an institution that is robust enough and which itself is struggling.

Mixed views from the sector

Representatives from the sector also have mixed views about the SIB. A key concern is that the SIB should not duplicate or crowd out existing financial intermediaries that have struggled for many years to develop. Others point out that the sector may be too young and fragile to cope with the flood of capital it would bring. Interviewees point to the fact that most social enterprises are not yet investment-ready and require further technical development before they can absorb private investment. Currently the financial expertise of the SIB could only benefit a very narrow range within the social investment sector.

Some representatives were concerned about the structure of a new social finance entity as a bank. They felt that the same objectives could be achieved through a smaller fund without the expense and unwieldy infrastructure of an investment bank. There was a concern that the focus should remain on the community and grassroots level, rather than establishing a monolithic bank that controls financial flows to the sector.

Most interviewees from the social investment sector were cautiously supportive, provided that the SIB focused on specific activities. A strong view is that it should function as a wholesale fund, as has been proposed, to finance other third sector intermediaries. The introduction of financial and technical expertise 'people with top notch talent and an understanding of finance' to the social sector is welcomed, as is the opportunity for further innovation.

New financial products and methods for packaging risk could be developed to improve the attractiveness of third sector organisations to investors. One interviewee noted, 'Syndication or pooling across the spectrum [of investments] could be a useful approach, to package up people's engagement (e.g. with different philanthropic or financial goals) in complex single structures.'

A critical function for the SIB would be to facilitate investment in very high-risk social ventures, where currently there is little alternative to grant funding. As one person observed, 'It should go where people are currently not willing to go… [and]… could be a guarantee provider to high risk or very small propositions that aim to be hugely impactful organisations – which normally really struggle to source funding.'

There is an important role for the SIB to play to develop the financial expertise and capacity of the social sector. One interviewee noted, 'I think what they're doing in the "getting people investment-ready" is a great, fantastic thing.' Others have suggested that there is a need for a 'demand-side handholding' through a form of social investment broker service that could point the way to investment for different organisations, such as a mortgage broker does. There is an education role for the SIB to help institutions to refine and understand social investments.

Interviewees also suggested that the SIB should operate according to certain principles. These should be consistent with most forms of Government guidance, namely the bank: (i) must not distort competition; (ii) must be limited to investments the market would not otherwise meet; (iii) must encourage mainstream markets to participate; and (iv) must report the social and financial return which it generates. Representatives from the sector clearly emphasised the need to maximise social as well as financial return, a driving principle behind the creation of the SIB. Another individual added, ‘In everything it does, it should encourage leverage and seek to involve a wider pool of funders and stakeholders, to promote liquidity and encourage other investors to continue to act in the social investment market.’ It is clear that there is a role for the SIB to continue to build the necessary infrastructure of a social investment market.

The SIB can act to champion and focus social investment:

- Co-ordinate existing social investment to enhance efficiency and knowledge of the market.

- Develop new forms of funding and finance for the third sector.

- Act as a bridge between the social and financial sectors to mediate and package investment opportunities for the private investor community.

- Capitalise and support existing third sector lending institutions, such as CDFIs and credit unions, as a wholesale finance fund.

To make this happen, sufficient capital is required. It would be a shame if the unclaimed assets funds were disbursed as one-off grants, rather than investing them in a new institution with long-term sustainability. A new social finance institution, if well designed, could have the capability to transform the endemic short-termism of current grant funding for third sector institutions by linking them to a social investment marketplace that taps into mainstream sources of finance.

Chicken and egg

The concept of a social finance institution is positive, and may be ahead of its time. It will take time to build an organisation with sufficient expertise, capital and credibility in both the financial and social sectors. The approach taken by Social Finance Ltd is effective, as it can help to develop the social investment market while it is still in its infancy. Ideally demand-side intermediaries will grow in partnership with a new social finance institution to enhance the financial and technical capabilities of the social sector. Like the chicken and egg, one could argue endlessly about which steps should come first: Do we need a social investment bank to drive improvements in the third sector, or do we need improvements in the third sector to justify a social investment bank?

The reality is that both the demand-side and the supply-side need to evolve to realise the vision of a thriving social investment marketplace that taps into mainstream sources of financial capital. To achieve the objective of a thriving social investment marketplace, various steps must be taken. The requisite measures include implementation of the tax mechanisms and legislation that we have outlined above. Without appropriate supporting infrastructure, the proposed social finance institution will not be able to operate effectively to bring private investment to the third sector.

Recommendations

A range of new organisations have evolved to direct finance to third sector institutions. CDFIs, credit unions, social enterprise finance funds, and CDVC funds have struggled against the odds to build an emerging social investment marketplace that can bridge the worlds of charity and finance.

Social investment has the potential to link mainstream finance to social enterprises that are a force for good. To maximise social outcomes, third sector organisations are increasingly moving beyond short term grant funding to adopt new forms of investment finance. By tapping into the power of private finance, social enterprises can reach the scale to make a sizeable difference to disadvantaged communities.

Following the original SITF recommendations, we have identified five clear steps required to complete the infrastructure for a thriving social investment market in the UK.

1. Implement a simple and well-designed tax mechanism to attract private investors, including financial institutions, to social enterprises, including community development finance organisations.

2. Legislate compulsory disclosure by financial institutions of lending and investment in disadvantaged areas, as a means of tracking performance and stimulating the flow of finance to communities in need of redevelopment.

3. Establish a grant fund for long-term public support of third sector finance institutions to maximise their ability to leverage private finance, improve lending practices and enhance technical capability. Many third sector institutions will require ongoing grant funding to carry out the activities that have the most social benefit.

4. Design a matched funding scheme to incentivise charitable foundations to invest in social enterprises and encourage use of endowments for social investment purposes.

5. Support development of a new social finance institution that can act as a wholesale organisation to co-ordinate and channel investment to existing third sector intermediaries, to link the social and financial sectors.

The implementation of these recommendations would complete the architecture of social investment, allowing a thriving and robust marketplace to develop. While there will always be the need for grant funding of third sector organisations, they also require new methods to access private finance in order to reach a scale to create significant social change. These recommendations would significantly increase the flow of private funds to redevelop communities, creating new opportunities for disadvantaged individuals.

Table 2: Next steps to build the social investment marketplace.

What we have	What we need
Supporting mechanisms	
CITR • Narrow and inflexible tax credit focused on enterprise CDFIs	Implement a simple and well-designed tax mechanism to attract private investors to social enterprises
SFLG • Government guarantee scheme to expand access to finance for SMEs	
EIS • Tax relief for investors in qualifying companies, not targeted at social enterprises	
Public grant funding	
Growth Fund • £36 million to increase the availability of affordable personal loans via third sector lenders	Establish a grant fund for long-term public support of third sector finance institutions
Phoenix Fund • £42 million awarded enterprise-lending CDFIs that closed in 2006	
Private grant funding	
Various charitable trusts • Short-term revenue grants made on a project basis • Decisions to provide capital to third sector organisations and social enterprises on an ad hoc basis	Design a matched funding scheme to incentivise charitable foundations to invest in social enterprises
Public investment finance	
Selected social enterprise funds • £215 million directed to the second round Futurebuilders fund for retail disbursement	Capitalise a new social finance institution that can act as a wholesale organisation to co-ordinate and channel investment, with long-term sustainability
Bridges CDV I Fund (blended) • One-off matched investment by Government	
Private investment finance	
• Trickle of private investors investing for social returns on an uncoordinated basis	• Implement a simple and well-designed tax mechanism • Develop a new social finance institution to co-ordinate social investment
Supporting legislation	
Expansion of ‘common bond’ for credit unions	Legislate compulsory disclosure by financial institutions of lending and investment in disadvantaged areas
Release of unclaimed assets from financial institutions	

Appendix 1: List of interviews

Abbie Maxwell, Senior Policy Advisor, HM Treasury

Bruce Wood, Head of Enterprise Investment, London Rebuilding Society

Caroline Mason, Operations Director, Investing for Good

Dan Gregory, Finance Policy, Office of the Third Sector

Danielle Walker-Palmour, Director, Friends Provident Foundation

David Carrington, Independent Consultant

David Orr, Chief Executive, National Housing Federation

Hugh Rolo, Investment Manager, Development Trusts Association

Joan Shapiro, Founder-member of Social Investment Task Force

John Kingston, Director, Venturesome

Karl Dayson, Executive Director, Community Finance Solutions, University of Salford

Malcolm Hayday, Chief Executive, Charity Bank

Mike Barbier, Enterprise Directorate, BERR

Mike Watts, Business Finance Executive, Advantage West Midlands

Naomi Kingsley, Founder & Chief Executive, London Rebuilding Society

Niamh Goggin, Independent Consultant, Former Director of Aspire

Peter Thackwray, Director for Enterprise, Greater London Enterprise

Puck Markham, Founder & Chief Executive, Community Money CIC

Robin Edwards, Head of Business Team, SWERDA

Sarah Forster, Director of Development, BIG Invest

Sarah McGeehan, Deputy Chief Executive, cdfa

Tim Pope, Head of Liveability Policy, DCLG

Toby Eccles, Development Director, Social Finance Ltd.

Whitni Thomas, Investment Manager (Venture Capital), Triodos Bank

Appendix 2: Further reading

Brown J (2006) *Developing a social equity capital market* (London: **nef** © Charities Aid Foundation).

Brown J and Nissan S (2007) *Reconsidering UK community finance* (London: **nef**).

Brown J and Thomas W (2005) *Basic bank accounts: the case for a universal service obligation* (London: **nef**).

Nissan S and Bolton M (2008) *Mission possible: emerging opportunities for mission connected investment* (London: **nef).**

Thiel V and Nissan S (2008) *UK CDFIs: From surviving to thriving* (London: **nef**).

Thomas W and Brown J (2006) *Full disclosure: why bank transparency matters* (London: **nef**).

Endnotes

1 Nicholls A and Pharoah C (2007) *The landscape of social investment* (Oxford: Skoll Centre for Social Entrepreneurship).

2 Mayo E, Fisher T, Conaty P, Doling J and Mullineaux A (1998) Small is bankable (York: Joseph Rowntree Foundation).

3 The Task Force was initiated at the request of the UK Social Investment Forum in partnership with **nef** (the new economics foundation) and the Development Trusts Association, all of which have continued to work with it. The UK Social Investment Forum's role has been taken over by the Community Development Finance Association (cdfa), which is the trade association established on the recommendation of the Task Force.

4 Unclaimed assets are monies in financial institutions that have been untouched by their owners for a considerable period of time. The Unclaimed Assets Commission was set up at the initiative of the Scarman Trust in 2005, drawing together a group of experts from the banking, finance, consumer protection and third sectors to examine a proposed plan to release unclaimed funds to engage young people, and promote financial education and inclusion and community regeneration.

5 Figures on UK poverty based on the New Policy Institute/Joseph Rowntree Poverty Site: www.poverty.org.uk [7 August 2008].

6 Mitton L (2008) *Financial Inclusion in the UK: Review of policy and practices* (York: Joseph Rowntree Foundation).

7 Bank of England (2002) *Finance for small businesses in deprived communities* (London: Bank of England).

8 Leyshon A (2006) *The changing geography of British bank and building society branch networks* (Nottingham: University of Nottingham).

9 *Enterprising communities: wealth beyond welfare,* A Report from the Social Investment Task Force.

10 RDAs play an increasing role in the funding and strategic management of CDFIs. RDAs have been tasked with funding CDFIs and promoting a region-wide strategic framework for community finance. The level of engagement of RDAs with CDFIs varies across each region, resulting in inconsistent commitment to funding, technical assistance and long-term development. With the future role of the RDAs increasingly in doubt, long term support for community finance as agents of community development is unclear.

11 According to the cdfa's 2007 *Inside Out* report, CDFIs alone have leveraged £330 million into disadvantaged communities.

12 Based on data from cdfa's *Inside Out* report 2007.

13 World Council of Credit Unions (WOCCU) 2007.

14 'Deprived areas tax break yield stalls' *Regeneration & Renewal* 14 March 2008.

15 In **nef'**s June 2007 report, *Reconsidering community finance*, only four per cent of CDFIs said that Community Investment Tax Relief provides effective finance for them

16 Previously, CDFIs were required to invest at least 75 per cent of funds raised through the scheme each financial year from their fourth year after accreditation onwards. If they invested less, they would lose their accreditation and investors would lose their tax relief. But now CDFIs will be allowed to invest an average of 75 per cent in firms in poor areas from their fourth year on.

17 Commission on Unclaimed Assets (2007)*The Social Investment Bank – its organisation and role in driving development of the third sector* (London: CUA).

18 For example, Triodos Bank's offer on behalf of the organic pub chain The Real Food Pub Company.

19 'Social enterprise investors need tax breaks too' *Real Business* 31 July 2008.

20 Nissan S and Bolton M (2008) *Mission possible: emerging opportunities for mission connected investment* (London: **nef).**

21 An example of such product innovation is the Community Investment Note developed by Calvert Foundation. Investment in these notes is pooled and placed in a managed portfolio of loans to social enterprises. These notes can be packaged with a variety of mainstream Calvert Investment Funds by allocating one to three per cent of assets to the notes.

22 Lawlor E, Neitzert E and Nicholls J (2008) *Measuring real value: a guide to Social Return on Investment* (London: **nef**).

23 The project to develop a standard tool to measure SROI is currently out to tender and the OTS, who will manage the project, predicts that the programme will be operating towards the end of 2008. There will be a three-year development and testing period, analysing the tool in different circumstances so that it will be ready to roll out in 2011.

24 The Community Reinvestment Act (CRA) is one of the great success stories of grassroots organising. People in local communities came together in the 1970s, first to painstakingly gather the data necessary to analyse the lending patterns of their local financial institutions, then to organise politically to persuade Congress to require banks and savings and loan associations to compile and make public this data, and finally, to convince federal regulatory agencies to consider the level of local lending by financial institutions when reviewing their applications for operational changes. Since the CRA's enactment, the regulations have been substantially amended three times in 1989, 1995, and 2005. Changes to the regulations reflected both experience gained in the implementation of the law as well as ongoing developments in financial markets and the economy.

25 Based on data from the National Community Reinvestment Coalition as of September 2007 www.ncrc.org

26 Data from the Family Resources Survey 2002/3 indicated that 2.8 million adults lacked access to an account of any kind. For the goal to be met, the number of adults in households with no account of any kind would need to reach 1.4 million. No threshold was set by the Government for what it considers to be 'significant progress' which the Government and the banks wished to be achieved by the end of 2006.

27 HM Treasury (2007) *Financial inclusion: the way forward* (London: The Stationery Office).

28 House of Commons Treasury Select Committee (2006) *Banking the unbanked: banking services, the Post Office Card Account, and financial inclusion* (London: The Stationery Office, Thirteenth Report of Session 2005-2006).

29 House of Commons Treasury Select Committee (2006) *Financial inclusion: credit, savings, advice and insurance.* (London: The Stationery Office).

30 The credit provided to the investor totals 39 per cent of the cost of the investment and is claimed over a seven year credit allowance period. In each of the first three years, the investor receives a credit equal to five per cent of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is six per cent annually. Investors may not redeem their investments prior to the conclusion of the seven-year period.

31 A dormant bank account was defined as one where there has been no customer-initiated activity for 15 years.

32 Commission on Unclaimed Assets (2006) *A Social Investment Bank – consultation paper* (London: CUA).

33 Commission on Unclaimed Assets (2007) *The Social Investment Bank: its organisation and role in driving development of the third sector* (London: CUA).

34 Cohen launches first UK social investment bank. www.efinancialnews.com, 21 April 2008.

One of the other centres at **nef**

Centre for Well-being

Measuring what Matters is an innovative programme of research to value what matters most to people, communities, the environment and local economies, and to ensure that these inform policy. The research uses social return on investment (SROI) to determine the full costs and benefits of government decisions in three areas: women and criminal justice, economic development and children in care.

Measuring what Matters starts from premise that we have a tendency to measure the wrong things and therefore to pursue the wrong priorities. Immediate financial savings often drive policy decisions, meaning that hidden costs and benefits are not taken into consideration. Measuring what really matters means shifting the focus to how we as a society can pursue real economic, social and environmental well-being.

Through the use of SROI, **Measuring What Matters** advocates a long-term, transparent approach to measurement which takes a holistic view of impacts and effects. Capturing and valuing what matters most is crucial to ensuring maximum public benefit from public spending. The reports are being published throughout 2008 and are available to download on the **nef** website.

For more information please call 020 7820 6300

economics
real wealth
means well-being

Written by: Jessica Brown

Edited by: Mary Murphy

Design by: the Argument by Design – www.tabd.co.uk

This report was written with support from:

THE HADLEY TRUST

new economics foundation
3 Jonathan Street
London SE11 5NH
United Kingdom

Telephone: +44 (0)20 7820 6300

Facsimile: +44 (0)20 7820 6301

E-mail: info@neweconomics.org

Website: www.neweconomics.org

ISBN 1 904882 39 8