Mind the Finance Gap: Evidencing demand for community finance

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INSPIRING SOCIAL ENTERPRISE

INSPIRING ENTERPRISE

We're committed to promoting economic growth and to fostering the right conditions for people to turn their ideas into business success.

RBS Inspiring Enterprise

is how we encourage more people in more communities to explore enterprise, build their skills and start up in business.

Foreword

The RBS Group supports businesses of all shapes and sizes, in every sector of the economy. We're committed to promoting economic growth and to fostering the right conditions for people's business ideas to flourish. In addition, we focus efforts on three groups that we believe, with further support, could play a stronger role in the entrepreneurial economy: young people, women and social entrepreneurs. We call this Inspiring Enterprise.

For each focus area, we have set ourselves a goal for what we want to achieve by the end of 2015. For the social enterprise sector, we want to support 2,500 social enterprises, working in partnership with the sector to improve access to enterprise, markets and finance by the end of 2015.

Supporting social enterprise is nothing new to RBS. We have worked with the sector for over 10 years, including as a Founding Partner of Social Enterprise UK and the annual RBS SE100 index, which tracks the sector and celebrates success. In addition, the RBS Group Microfinance Funds – an independent charity closely connected to the Group that lends directly to the social enterprise sector – approved over £3m of loans in 2012.

Our support for Community Development Finance goes right to the heart of this agenda. Community Development Finance Institutions (CDFIs) are social enterprises themselves, performing an important role at the heart of the communities in which they operate. But they also lend money to social enterprises, filling the gap between the big banks and high-cost, sub-prime lenders.

We have invested heavily in community finance over a number of years. Most recently we funded the development of the sector's 'Change Matters 2' performance framework, which is designed to benchmark the sector, build capability and make CDFIs more investment ready. We are delighted that the framework is working, and new funding is now being made available to the sector from sources such as the Regional Growth Fund and Big Society Capital.

But there is more to do. Access to fair and affordable finance is vital for social enterprises and also for individuals, small businesses and homeowners. Yet, the gap between the availability of affordable finance and demand from viable, credit-worthy customers is increasing. Although this market gap is well recognised, it has never been effectively quantified.

This is why we have partnered with the Community Development Finance Association (CDFA) to commission this report from ICF GHK. Understanding this gap in access to finance, why it happens and what can be done about it is an important step to finding potential solutions, and is the basis for this new research.

The report shows that, in 2012, community finance organisations delivered an estimated £0.7 billion of community finance – against an estimated current annual potential demand of between £5.45 and £6.75 billion. The report suggests that this scale of unmet demand can only be met through a partnership of public, private and social investors – through a viable and sustainable community finance system as an established and embedded feature of the UK's financial landscape.

We hope you find this report useful.

Chris Sullivan
Chief Executive Officer
Corporate Banking Division
RBS Group

Foreword

The past decade has seen huge strides in building the UK's community finance sector to better meet the needs of financially underserved households, businesses and social enterprises. That we are where we are is a tribute to the many that have shown vision, courage and commitment to establishing a new type of financial service – the community finance provider. Banks – and the RBS Group in particular – have played a vital role in this journey through offering the capital and development support necessary to kick start the whole venture.

Yet we've known for some time that, whilst the services our CDFI members offer is a lifeline to the 33,000 customers they serve annually, it remains the tip of the iceberg in meeting the full need of the UK's financially underserved. We've known that there's a gap – a gap in capacity, skills, understanding and of course availability of capital. But we've not known the extent of this gap, particularly in terms of the capital shortfall – until now.

With the welcome support offered by the RBS Group, Mind the Finance Gap pioneers a whole new approach to developing the sector, through providing precisely the evidence we need to engage key partners in the banking, public and independent sectors, in scaling the sector as a corner stone to the financial services industry. Then and only then can we begin to replicate the genuinely collaborative approach we've developed with the RBS Group, to better meet the needs of those eight million underserved clients and ensure a fully inclusive financial services industry.

Ben Hughes
Chief Executive
CDFA

Community Development Finance Association
The Community Development Finance Association (CDFA) is the membership body for community finance providers. The CDFA exists to create a thriving community finance industry, which brings social and financial benefits to communities across the UK.

Executive summary

Community Finance — What is it?

Access to finance, credit and financial services is a key requisite for full participation in today's economy and society.

Community finance describes the provision of affordable financial services and other support to businesses, civil society organisations, individuals and homeowners unable to secure mainstream finance.

The Community Development Finance Association (CDFA), with the support of the Royal Bank of Scotland Group, commissioned ICF GHK to undertake a review of the state-of-play in community finance.

Community Development Finance Institutions (CDFIs) sit at the heart of community finance and provide loans and credit to:

- **Businesses and entrepreneurs** (especially in disadvantaged communities) unable to secure finance from mainstream commercial institutions such as banks;
- **Civil society organisations** (CSOs) such as social enterprises, charities, and voluntary organisations that place a strong emphasis on social, environmental and stakeholder as well as financial objectives;
- **Individuals** unable to access short-term, low value credit and other financial services who must deal with sometimes abrupt fluctuations in income; and,
- **Homeowners** who are unable to access a loan from a commercial lender (or a grant) to carry out essential repairs, adaptations and improvements to their property.

Community Finance — Supply, demand and meeting the finance gap

In 2011, the big banks made £75 billion of loans to small and medium enterprises. Between September 2011 and August 2012 banks and building societies combined provided £7 billion of overdrafts and loans and £137 billion of credit card lending to individuals[1]. For those businesses, organisations, individuals and homeowners that cannot access mainstream finance such as that described above, Community Finance is an alternative option.

This report estimates current potential annual demand for community finance in the UK (excluding the Green Deal) is at some £5.45 – 6.75 billion. In contrast, in 2012, community finance organisations delivered an estimated £0.7 billion of community finance to UK businesses, civil society organisations, individuals and homeowners. Community finance investments generate a wide range of economic and social benefits (especially within the most disadvantaged and excluded communities of the UK) – and which meet a wide range of Government policy objectives.

Community finance organisations, if capitalised to do so, have the potential to generate sustainable economic development and social well being at the heart of UK communities. Currently, the majority of potential economic and social benefits are being lost to UK economy and society.

The scale of unmet demand can only be met through a partnership of public, private and social investors – through a viable and sustainable community finance system as an established and embedded feature of the UK's financial landscape.

This sets challenges for all the partners concerned, especially the community finance sector.

1 See **http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx** *accessed January 8 2013*

Conclusion 1 The large scale potential demand for community finance in the UK

This report suggests current potential annual demand for community finance in the UK of some £5.45 to £6.75 billion (excluding the Green Deal).

Community Finance Market	Total potential value of annual demand (£b)	Total potential annual number of clients
Businesses	£1.3b	103,000
Civil society organisations	£0.9b – £1.7b	57,000
Individuals	£3 - £3.5b	8,000,000
Homeowners (excluding the Green Deal)	£0.25b	21,000
TOTAL	**£5.45b – 6.75b**	**8,181,000**

Conclusion 2 The substantial funding gap for community finance in the UK

In 2011, the big banks made £75 billion of loans to small and medium enterprises. Between September 2011 and August 2012 banks and building societies combined provided £7 billion of overdrafts and loans and £137 billion of credit card lending to individuals. For those businesses, organisations, individuals and homeowners that cannot access mainstream finance such as that described above, Community Finance is an alternative option.

In 2012, community finance organisations delivered an estimated £0.7 billion of community finance – against an estimated current annual potential demand of between £5.45 and £6.75 billion.

They did so in finance gaps where continuing market failures are well-documented and, most especially, where investment markets fail to reflect the economic and social returns generated for the UK economy and society.

Conclusion 3 The challenge to policy makers: to support provision for unmet demand and realise the extent and range of foregone economic and social benefits

Community finance investments overcome market failures to generate a wide range of economic and social benefits – such as growing businesses, social enterprises and other civil society organisations, enabling financially stable individuals and decent homes (especially within the UK's most disadvantaged and excluded communities).

Conclusion 4 — The challenge to a partnership for community finance: a viable and established community finance system within the UK's financial landscape

The scale of unmet demand can only be met through a partnership between public, private and social investors – and who do share common economic and social objectives.

Conclusion 5 — The challenge to community finance providers – a sustainable community banking system?

Meeting potential existing demand implies developing better-capitalised, more productive, more scaleable providers and stimulating growth of new innovative, lower cost models - ultimately, providing appropriate and integrated financial services that deliver to clients a 'no wrong door' and 'one stop shop' approach.

Conclusion 6 — The challenge of promotion of community finance as a concept

Any Community Finance Partnership should not underestimate the potential complexity of such an 'umbrella' concept. Nor, however, should the power of a simple message of seeking to support the financial needs of those in economy & society excluded from mainstream finance be underestimated.

INSPIRING ENTERPRISE

Community finance describes the provision of affordable financial services and other support to businesses, civil society organisations, individuals and homeowners unable to secure mainstream finance.

Contents

1. Introducing Community Finance

Access by businesses, civil society organisations, individuals and homeowners to finance, credit and financial services remains a key requisite for their full participation in today's economy and society.

Community finance describes the provision of affordable financial services and other support to businesses, civil society organisations, individuals and homeowners unable to secure mainstream finance.

In Autumn 2012, the Community Development Finance Association (CDFA) with the support of the Royal Bank of Scotland Group, commissioned ICF GHK to undertake a review of the state-of-play in community finance.

This evidence review defines the scope of the community finance sector, estimates current market size and potential demand, and reviews the current landscape of service provision.

1.1 What is community finance?

Community finance describes the provision of affordable financial services and other support to businesses, civil society organisations, individuals and homeowners. In the publication Just Finance the CDFA defines community finance as[2]:

Loans and credit charged at a non-exploitative rate accessible by underserved markets unable to secure mainstream finance, delivering both social and economic benefits.

The CDFA has an organisational membership – Community Development Finance Institutions (CDFIs) – that sit at the heart of community finance and provide loans and credit to:

- **Businesses and entrepreneurs** (especially in disadvantaged communities) unable to secure finance from mainstream commercial institutions such as banks;
- **Civil society organisations** (CSOs) such as not for profit businesses (social enterprises), charities, community and voluntary organisations, and mutuals that place a strong emphasis on social, environmental and stakeholder as well as financial objectives;
- **Individuals** unable to access short-term, low value credit and other financial services who must deal with sometimes abrupt fluctuations in income; and,
- **Homeowners** who are unable to access a loan from a commercial lender (or a grant) to carry out essential repairs, adaptations and improvements to their property.

Through provision of their services, CDFIs and other community finance intermediaries deliver both economic and social benefits in the form of new and growing businesses, employment, community and environmental services and financial services. These benefits would otherwise be lost to society.

1.2 The community finance ecosystem

Figure 1.1 below provides an overview of the community finance sector and a simple illustration of how finance is deployed. In summary, the machinery of the sector includes:

- **(A) Investors:** An expanding range of public and private investors exist who are seeking to use their capital to meet economic, social and environmental objectives. The investor landscape is characterised

2 *CDFA (2012), Just Finance: Capitalising Communities, Strengthening Local Economies, page 3.*

by great variety in motivation, the target sector (business, community, individuals and households), the desired 'blend' of return (social, economic and financial) and investment type. Key investors have been Government, institutions, foundations, trusts, individuals and a range of corporate social responsibility and market development activities by banks.

A major development in recent years is the emergence and growth of 'social investment' – a financial transaction intended to both achieve social objectives and deliver financial returns – and whose core principle is the application of market mechanisms (not grant) to fund and incentivise the delivery of social value[3].

- **(B) Intermediaries:** An increasing number and range of intermediaries have emerged to connect investors and their investment with investees, target businesses and communities. Examples include CDFIs, credit unions, charities, social banks, etc. Intermediaries bring together the resources (finance, skills, spaces, systems, market engagement, etc.) to 'do deals and provide services'. A key challenge has been building the capability and capacity of intermediaries in the face of expanding demand and market complexity[4].

- **(C1) Businesses:** Start-ups, micro businesses and small and medium sized businesses that cover all sectors of the economy and are unable to access mainstream finance at certain points in their life stage. Alongside traditional profit-based businesses, this business demographic includes a growing number of 'social ventures' (for example, social enterprises, mutuals, charities, Community Interest Companies, etc). Such businesses are expected to be viable but can often lack investment readiness.

- **(C2) Civil Society Organisations:** Civil society organisations operate in a space not occupied by government or for-profit business and includes two traditions – 'one of mutual self interest, where people come together to meet their own needs, and another of charity where individuals and organisations are directly responding to social needs[5]. Its organisational form includes formal and informal associations such as voluntary and community organisations, charities, social enterprises and social firms. Many of these organisations also fall within the definition of a business and face many of the same barriers accessing mainstream finance.

- **(C3) Individuals:** A small but significant minority of the population cannot access even the simplest financial services, meaning that they pay more to manage their money, find it harder to plan for the future and cope with financial pressures, and are more vulnerable to financial distress and over-indebtedness. Unexpected financial pressures mean they have to borrow, are treated as high-risk borrowers, and pay a very high price for credit. Many also lack access to suitable financial products and tend to make expensive decisions to go with home credit or payday lending; or fall in with illegal lenders.

- **(C4) Homeowners:** Homeowners on low incomes with limited savings who are unable to meet the cost of remedial action or maintaining, repairing and adapting their home to changing circumstances (including energy efficiency) as they are unable to obtain a loan from a mortgage lender, bank, building society and do not qualify for a grant.

- **(D) Market Infrastructure:** A well-functioning market relies on appropriate infrastructure (for example, specialist investment / risk management skills, industry organisations, associations and education, standard metrics / benchmarks / ratings, trading mechanisms, routes to market, etc). As social returns do not attract capital in the same way as financial returns, Government has recognised the necessity to create a system to support community investment[6].

3 *Cabinet Office (2011), Growing the Social Investment Market, p.21-29. On a global scale the term 'impact investment' is often used to describe this form of investment activity.*
4 *NESTA (2011), Understanding the demand for and supply of social finance, p.6-8*
5 *Buonfino, A and Mulgan, G. (2009) Civility Lost and Found, p.16*
6 *Sir Ronald Cohen (2012), Speech at the Bridges Ventures: Ten Years On event*

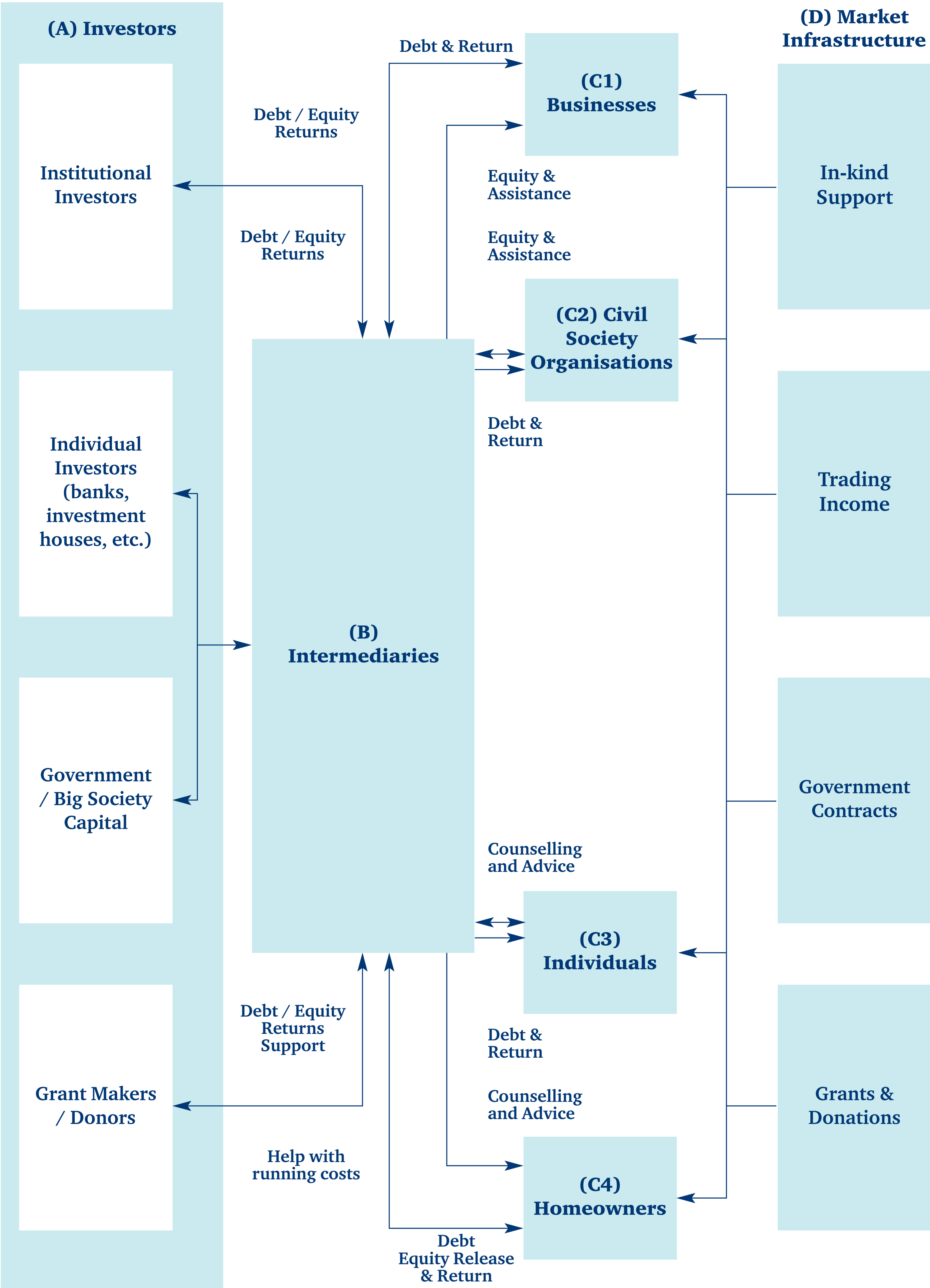
The community finance ecosystem

1.3 The aim of this evidence review

In this report we draw on the limited evidence base available to establish the current state and scale of the community finance sector, its impact and the sector's potential over the medium term future. The findings are based on published literature in books and journals, grey literature from non-governmental organisations, national government, think tanks and projects about the community finance sector from the United Kingdom and more widely.

The report considers each of the four finance gaps in turn – lending to business; social ventures and wider civil society organisations; individuals; and homeowners. In the process we identify the different approaches and new business models being established to raise investment for community finance and the barriers to current provision and future growth.

We conclude by drawing together indicative implications for policy makers and stakeholders seeking to strengthen and expand community finance.



Source: *ICF GHK*

2. Businesses, the finance gap and community finance

There is an estimated potential finance gap, which is not currently covered by mainstream finance, of £1.3 billion and 103,000 clients per annum – against mainstream small and medium business (SME) lending of some £75 billion in 2011.

Community finance currently provides £100 million per annum (particularly through Community Development Finance institutions) into this finance gap.

New market developments to meet growing demand – principally by non community finance providers – include crowdfunding, expanding asset-based finance and other short-term loan provision.

2.1 The finance gap

There are 4.5 million small and medium-sized businesses (SMEs) in the UK, 95% of which employ fewer than ten people (micro-businesses)[7]. In 2011-12 alone, there were 450,000 newly registered companies in Great Britain[8].

For the most part, these businesses can access external finance from commercial investors, principally banks, to sustain themselves and support growth. In 2011, for example, gross lending by the five major UK banks to SMEs (0-£25m turnover) totalled £75 billion[9]. A small minority (around 1-2%) of SMEs also access equity finance (venture capital, business angels, etc)[10].

There remains, however, a continued and long run debt funding gap in the SME business lending market[11]. Ultimately, at any one time in the economy, there exist a set of 'commercially viable but unbankable' businesses unable to access the finance they require and a set of what is known as 'nascent and / or discouraged entrepreneurs' who cannot raise external finance for their start-up plans.

Such constraints have been shown to mean a range of economic and social benefits foregone by the UK economy and society. For example, a conservative calculation has shown that for every £1 of public sector expenditure invested in this finance gap, £3.57 of Gross value added (GVA) is created and £5.00 of GVA safeguarded locally[12].

2.2 Current market size and potential demand

It is estimated that the current total investment inflows into the UK market are around £100 million[13] per annum.

In contrast, it is estimated that current UK potential demand (including latent) for access to finance by entrepreneurs and businesses unable to access mainstream finance is in the order of £1.3 billion per annum from around 103,000 clients[14].

7 *BIS Business Population Estimates for the UK and the Regions 2011*
8 *Companies House data quoted in Lord Young (2012) Make Business Your Business*
9 *See* **http://www.bankofengland.co.uk/publications/Pages/other/monetary/additionaldata.aspx**; *accessed January 4 2013-01-07*
10 *"The Breedon Report" Boosting Finance Options for Business (2012)*
11 *BIS (2012) SME Access to External Finance, BIS Economics Paper, No 16*
12 *GHK/BIS/OTS (2010) National Evaluation of Community Development Finance Institutions*
13 *ICF GHK estimation, 2012, as aggregate of reported supply*
14 *ICF GHK estimation, 2012, utilising nationally published statistics (mostly for 2011). Key assumptions are that all UK nascent entrepreneurs and enterprises bar those funding themselves or funded by mainstream finance and seeking external finance would apply to CDFIs with current sector enquiries-to-loans conversion ratio applying (13% micro-enterprise and 31% SME) at current average loan rates (microenterprise, £11,300 and SME £37,000).*

2.3 Current provision and market developments

Historically, provision to the finance gap has been dominated by Community Development Finance Institutions (CDFIs). In 2012, 2,600 loans totalling £30 million were made to micro-businesses and SMEs. Actual level of enquiries equalled almost 13,000 businesses seeking £231 million. In 2012, around half of CDFIs lending to businesses covered their costs through earned income. The remainder were unable to cover their costs using income streams and had to rely on grants, reserves and other assets[15].

Very recent developments have seen alternative providers to mainstream finance – who are not viewed as part of the community finance sector – entering the (underserved) market. These are;

- Crowdfunding – the use of online platforms to enable 'a crowd' of investors to invest small amounts into new and early stage businesses – is a recent entrant to the market. In the UK, the peer-to-peer market was estimated to be in the order of £50 million in 2012, driven by a handful of companies.
- Equity based crowdfunding involves the same principle – but in this case the crowd becomes a shareholder in the business and each investor holds a stake. There exist a handful of such platforms in the UK potentially equalling around £5 million of loan capital in 2012[16].
- Whilst short-term loan based provision has been a longstanding element within SME finance markets, very recent developments include: the asset based finance industry seeing advances to companies with an annual turnover below £1 million grow by 9% to £1.33 billion in 2011[17]; major companies (such as Amazon and Google) using large balance sheets to support business consumption of their products[18]; and new pay day lenders entering into the business loans market (for example, Wonga).
- Finally, to varying degrees and dependent upon prevailing corporate social responsibility policies at any one point in time, mainstream providers such as banks may also have initiatives which contribute to filling the finance gap for entrepreneurs and SMEs.

2.4 Market assessment

Overall, the current finance gap is characterised by the following dynamics:

- Evidence suggests that the long run funding gap for micro-businesses and SMEs remains, has become harder to negotiate, and continues to be served by a set of undercapitalised CDFIs many of whom remain some distance from financial sustainability.
- Reduced lending by mainstream banks has seen the finance gap expand 'upwards' (i.e. previous 'bankable' entrepreneurs and SMEs are now facing access to finance difficulties). Arguably it is some of these businesses that are the recipients of expanded and new short-term loan 'market provision' such as asset based finance and pay day business lending.
- Crowdfunding, angel investors and so forth (utilising new investment and new delivery methods) remain an emergent and potentially substantial source of provision to a broader spectrum of SMEs than those who have recently become underserved – but barriers to development remain.

15 CDFA, Unpublished data
16 ICF GHK estimate, 2012
17 See ***http://www.abfa.org.uk/members/newsletter/EconomicReportQ42011.pdf*** *(accessed 9 October 2012)*
18 See ***http://www.ft.com/cms/s/0/55be35f2-1093-11e2-a5f7-00144feabdc0.html*** *(accessed 8 October 2012)*

2.5 Future growth scenario

If it is assumed that latent and existing demand is brought forward – and then funded at double the current conversion rate that applies (circa 50%, and see footnote 14 above) – it is estimated that the future potential annual demand for finance from the finance gap would equal in the order of £4.7 billion and 395,000 businesses[19].

19 *For example, if UK entrepreneurship rates matched those of the USA, it has been estimated that the UK economy would have an additional 900,000 businesses (Lord Young, 2012, Make Business Your Business). The growth scenario above includes key assumptions: for example, the process of bringing forward demand (especially latent) would not see at least some other finance provision or demand determinant intercede in certain cases, business support interventions bring forward higher quality applications, community finance providers are not undercapitalised and no account is taken of the operational (and even business model) impact of such expanded conversion ratios.*

3. Civil society organisations, the finance gap and community finance

An estimated potential finance gap not covered by mainstream finance of £0.9 – 1.7 billion per annum.

Current provision in to finance gap of £286 million per annum (especially Community Development Finance Institutions and other Social Investment Finance Intermediaries).

Rapidly growing emergent market including Big Society Capital, nascent diversity of providers, products and financial instruments, and mainstream bank corporate social responsibility activity.

3.1 The finance gap

The UK's almost 900,000 Civil Society Organisations (CSOs) vary in size from informal community organisations which are generally very small with very limited, if any, income and no paid staff, to the 453 largest charities with income above £10 million.

Social enterprises are an important subset of the sector. They are businesses with primarily social objectives that reinvest their surplus in the business or community. There are approximately 68,000 social enterprises in the UK that are estimated to employ 800,000 people[20].

Like other businesses, a social enterprise needs access to finance if they are to invest and grow – and a variety of market and policy drivers (for example, ever broadening concepts of 'socially responsible consumption' and the Government's Open Public Services agenda and mechanisms such as the Social Value Act) are encouraging an expanding array of CSOs to begin the journey towards sustainable business models.

Historically, demand for finance by CSOs has been met by a variety of provision[21]. Government has played a long term and key role (through predominantly grants, but increasingly unsecured loans, quasi equity and equity products) alongside commercial lenders providing predominantly secured lending[22].

Market failure exists, however, because mainstream banks can only fund based on financial return – not the social returns to society also generated by CSOs. The nascent social investment market seeks to address these market failures by providing finance to CSOs based upon their blend of social and financial return.

Constraints on finance imply that a range of social and economic benefits are lost to UK society and a range of costs incurred due to social innovations and interventions not brought forward.

3.2 Current market size and potential demand

It is estimated that the current total investment inflows into the UK social investment market are around £286 million[23].

The State Aid case prepared by Government on difficulties in accessing finance encountered by CSOs concluded that the market fails to supply CSOs (the potential demand) with between £0.9 and £1.7 billion per year[24].

20 BIS (2010), *Annual Survey of Small Businesses*
21 Boston Consulting Group (2012), *The First Billion, see especially Driver 4*
22 For example, Boston Consulting Group (2012) estimates annual commercial lending of £1 billion to charities
23 Boston Consulting Group (2012), *The First Billion, p.1*
24 European Commission (2011), *Notification of State Aid Approval – Big Society Capital*

3.3 Current provision and market developments

As this market has emerged – and remained underserved – CDFIs have become the dominant providers of finance to the sector. In 2012, 28 CDFIs received enquiries from over 1,800 CSOs and lent £145m – two CDFIs alone accounted for almost 93% of loan value[25].

A small number but wide variety of other Social Investment Finance Intermediaries (SIFIs) than just CDFIs also exist who lend, develop and structure funds and financial instruments – the largest of which to date have been government-sponsored funds. Currently, most SIFIs are not financially sustainable.

An example of a relatively new financial instrument is the Social Impact Bond – which is designed to encourage innovation in provision and tackle challenging social issues. Essentially, a civil society service provider contracts with the public sector in which a commitment is made to pay for improved social outcomes that result in public sector savings.

Community investors play a small but growing role in the supply of social investment, offering for sale shares or bonds in enterprises serving a community purpose. There are known to be at least 177 local community enterprises that have or plan to have investment[26], the vast majority are co-operative or community benefit / industrial provident societies.

Crowdfunding is a recent entrant to the market using donation and reward based platforms to raise relatively small sums for a large number of projects. Crowdfunding in the US has seen extremely rapid growth over the last few years and such growth is beginning in the UK.

Finally, to varying degrees and dependent upon prevailing corporate social responsibility policies at any one point in time, mainstream providers such as banks may also have initiatives which contribute to filling the finance gap for CSOs. For example, in 2011, RBS launched a Community Business Loan Fund of £5 million, Santander launched its Social Enterprise Development Awards and HSBC invested £4m in the Big Issue Invest Social Enterprise Investment Fund.

3.4 Market assessment

Overall, the current finance gap is characterised by the following dynamics:

- A strong set of market and policy drivers are bringing forward expanding demands for finance from a substantial array of organisations and enterprises who deliver a blend of social and financial returns.
- In response, the current social investment market remains nascent and complex – Big Society Capital has been created as a wholesale social investment institution with up to £600 million of funds to accelerate the creation of a robust and sustainable social investment market[27].
- Whilst the social investment market remains immature – and its market infrastructure in development through a range of funded activities – it is unlikely that SIFIs will be able to meet the funding demand, and do so sustainably.

25 CDFA, 2012, unpublished data
26 Presentation to Cabinet Office by Locality and Cooperatives UK, March 2012
27 Big Society Capital (2012), Vision, Mission and Activities

3.5 Future growth scenario

Building on the 2011 estimate of £0.9 - £1.7 billion per year funding gap for CSOs (see footnote 24), further allowance needs to be made for new entrants to the finance gap – principally CSO experiencing a, say 10%, cut in grant (and therefore an access to finance requirement) and new social enterprises seeking finance (say 4% sector growth per annum).

This equates to an additional annual funding gap of some £0.4 billion from around 14,000 organisations and enterprises, suggesting a total funding gap per annum of between £1.3 and £2.1 billion per year.

4. Individuals, the finance gap and community finance

A growing market exists beyond mainstream bank provision of lending to individuals– and is estimated to comprise £3-3.5 billion loan value per annum. Most of this provision is deemed 'exploitative' by community finance providers due to the high cost of credit offered.

Current provision by credit unions and community development finance institutions of personal loans to individuals comprises some £0.5 billion per annum.

Department for Work and Pensions is investing in a modernisation agenda for credit unions to substantially expand provision to 2 million members – against the current estimate of 8 million UK individuals who are either underbanked and / or paying high charges for access to financial services.

4.1 The finance gap

The vast majority of people rely on a bank account to pay their bills, receive their salaries and access other financial products such as pensions (alternatively, for example, recent years have also seen the introduction of the basic bank account and the Post Office card account). In 2011, there still remained a significant finance gap for financial services, largely consisting of the following groups[28].

- 1.4 million adults in the UK without even a basic bank account (down from 3.75 million adults in 2003);
- Up to 4 million low income households that are 'under banked' as they have poor access to mainstream financial services;
- Up to 7 million people who use sources of high cost credit; and,
- Up to 1 million adults that are in need of money management advice to avoid high levels of regular bank charges.

There is no single explanation for individuals being underserved[29] but there exists an unmet need for day-to-day money management, including savings or consumer credit products, insurance and pensions. Unexpected financial pressures mean clients have to borrow small amounts for short periods, are treated as high-risk borrowers, and pay a very high price for credit. Mainstream banks have little capability to serve this market effectively as the cost of delivery would necessitate charging interest of a level that could bring reputational risk.

It should be noted that market mechanisms do exist in this market – there are a very large number of providers but at very high cost to borrowers[30]. The community finance movement views such costs as 'exploitative' and, therefore, it is these exploited individuals (by force of their degree of financial exclusion from the mainstream) who are seen to comprise the finance gap[31].

Meeting such individual financing needs reduces the personal and societal costs incurred by financial exclusion and captures a range of social benefits.

28 *DWP (2011), Credit Union Expansion Project - Feasibility Study Report*
29 *JRF (2008), Financial Inclusion in the UK – Review of Policy and Practice*
30 *In fact, given the potential likelihood of abnormal or supranormal profits, the nature and extent of the market and associated market failures is subject to substantial popular and regulatory debate*
31 *In November 2012, HMG agreed that new powers should be introduced under the Financial Services Bill to cap interest rates in the personal lending market.*

4.2 Current market size and potential demand

It is estimated that the current total investment inflows into the UK based on value of loans made is around £3-3.5 billion. It should be noted that, on average, clients take out 3.4 loans. Given that loans are short term this suggests a crude estimate of total money needed to service loans of around £1 billion per annum.

The community finance sector views the vast majority of this demand as exploited due to the very high cost of credit supplied – and would therefore seek to replace existing supply with more affordable provision. This would imply potential demand to be in the same order of current market size[32].

4.3 Current provision and market developments

Almost 450 member-owned credit unions are the major community finance provider in the individual personal loan market – making over 600,000 loans and with current member loans totalling some £0.5 billion. There is a 2% per calendar month interest cap on credit union loans (average 27% APR) which equates to a total charge for credit of about £13 for every £100 borrowed[33]. Additionally, credit unions are an important source of access to other financial products.

Nine CDFIs provided personal loans to individuals in 2012 also – equating to around £11.4 million of loans to almost 29,000 clients. Average APR (which is not capped) was 40%, representing £22 for every £100 borrowed[34].

Much of the provision by credit unions and CDFIs has been driven by the Department for Work and Pensions (DWP) Growth Fund.

Community finance providers such as credit unions and CDFIs view a substantial number of other providers as 'exploitative' (and therefore not part of the sector) and are seeking to substantially replace their market position, including:

- The credit gap in the 'sub-prime' market filled by a range of high cost credit lenders. These organisations operate lawfully within the terms of credit licenses from the Office of Fair Trading (OFT) and other financial regulation. This traditional high cost product, with typical APR of 272%, is used by 2.4 million individuals. A total £1.4 billion is lent annually – the lowest cost from commercial home credit providers is about £82 for every £100 borrowed.
- 'Payday loans' are the latest market innovation charging interest in excess of 2,000% APR. It is estimated that, in 2009, 1.2 million individuals took out 4.1 million loans totalling £1.2 billion, and the total for 2010 was £1.9 billion[35]. Research by Consumer Focus suggests that some borrowers like payday loans, despite the high interest rates, because they are quick, convenient and it is easy to understand how much it will cost them to repay the loan[36]. A recent interim report from the OFT (2012) has highlighted a number of concerns with this type of provision[37].

32 *Notwithstanding that, on the one hand, demand for repeat loans may reduce with more affordable provision and/or, on the other hand, latent demand may be brought forward due to previously unmet need.*
33 *Recently, DWP have suggested an increase in the interest that credit unions may charge from 2% pcm to 3% pcm; this would put rates in line with the average charged by CDFIs.*
34 *CDFA, 2012, unpublished data*
35 *House of Lords Oral Question - PQ/12/00241 on 13/06/2012*
36 *Consumer Focus (2010), Keeping the Plates Spinning*
37 *OFT (2012), Payday Lending Compliance Review*

4.4 Market assessment

Overall, the current finance gap is characterised by the following dynamics:

- Credit unions and CDFIs are currently serving about 4% of the lower income population. A consumer survey commissioned by DWP showed that 60% of low income consumers wanted the type of local, trusted service that credit unions provide; only 13% were aware of the services they provided[38]. Meanwhile, usage of high cost and payday lenders continues to grow.
- DWP wishes to see the expansion of local trusted financial services to serve a million more people with the financial products they need (including potentially 'jam jar' accounts) and will invest up to £38m between 2012 to 2015 to achieve this objective.
- Evaluation of the Growth Fund and the DWP feasibility study both demonstrate that the current credit union model is not financially sustainable; cost structures are high, interest on loans is significantly lower than charged by other similar lenders (such as CDFIs), and that the gap between cost and income needs to be bridged.

4.5 Future growth scenario

The growth expected through the DWP modernisation agenda would see credit unions serving no more than 8% of the lower income population (2 million members). Those individuals who are either underbanked or paying high charges for access to financial services currently number 8 million in the UK[39].

38 DWP Credit Union Expansion Project (2012)
39 The Economist (2011) Shark Bait

5. Homeowners, the finance gap and community finance

The finance gap is defined as when homeowners are unable to access the grant or the incremental credit they require and lack the income or savings required to tackle repairs or adapt their homes over the longer term. The market is undergoing transformational change.

It is estimated that current UK potential demand for home improvement finance to meet the Decent Homes standard is in the order of £250m and 21,000 households per annum[40]. Minor provision by community development finance institutions – funded by Local Authorities - may comprise around a tenth of this potential demand.

A very substantial – but as yet to be fully determined – potential demand will be generated by the 'Green Deal' and Electricity Company Obligation to be introduced in 2013 which will see a national loan-based home improvements scheme, including explicit targeting of low income and disadvantaged communities.

It is expected that community development finance institutions may provide a key 'route to market' for energy companies and other providers of the Green Deal – and open up other potential service provision such as that concerned with fuel poverty.

5.1 The finance gap

The cheapest way to borrow money for a home improvement is to take out a further advance on a mortgage. Government and local councils offer assistance also to vulnerable residents living in unsafe and cold private homes through grants and low interest loans. These are typically made available to improve energy efficiency and adapt homes to meet the needs of older or disabled occupiers. Practical help is often made available, through Home Improvement Agencies, to choose reliable builders and fill in application forms. Alternatively, an older and asset rich homeowner, who wants to live in their home and fund improvements, may choose to make use of a home equity release scheme or other such products.

A finance gap occurs when homeowners are unable to access the grant or the incremental credit they require and lack the income or savings required to tackle repairs or adapt their homes over the longer term. Mainstream banks are unable to offer suitable loan products due to the significant transaction costs of raising relatively small amounts of money. They may also perceive these customers to be high risk or express concerns about the potential reputational risks of loan default. A further alternative may be sub-prime lenders.

Meeting the needs of the finance gap provides social benefits (for example, reduced carbon emissions and improved health and well-being) and reduces future costs (on society).

5.2 Current market size and potential demand

Assessment of the current market size and potential demand remains extremely difficult due to current transformational market developments; for ease, two finance gaps focused principally on differing social benefits are delineated – decent housing standards / well-being and energy efficiency / carbon reduction.

Decent Homes

The National Housing Condition Survey provides information on the number of households experiencing poor conditions or requiring home improvements ('non-decent'). In 2010-11, there were 5.1 million homes

40 *ICF GHK estimate, assuming 500,000 homes per year brought up to decent standard, the average enquiry to loan conversion ratio for CDFIs (27%) and the average CDFI loan of £12,000.*

that were owner occupied and failed to meet the decent homes standard (i.e. one that meets statutory minimum standards for housing, is in a reasonable state of repair and has reasonably modern facilities and services)[41].

It is estimated that the current total investment inflows into the UK decent homes finance gap is around £15m per annum[42]. It is estimated that current UK potential demand for home improvement finance is in the order of £250m and 21,000 households per annum[43].

Energy Efficiency, The Green Deal and Fuel Poverty

The Government has a number of programmes to improve the energy efficiency of the existing housing stock and reduce carbon emissions so as to meet domestic and international carbon targets. The primary one has been the Carbon Emissions Reduction Target (CERT), introduced in 2008, which included a statutory obligation on energy suppliers with a customer base in excess of 250,000 customers to make savings in the amount of CO2 emitted by householders. Under CERT energy suppliers were required to spend £2.8 billion on carbon reduction measures between 2008 and 2011 and CERT has subsequently been extended to December 2012 with a new higher target[44].

CERT also requires 40% of its target to be delivered from Priority Group (PG) households. In 2010, CERT targets and duration were extended and a Super Priority Group (SPG), a subset of PG, created. The amended CERT obligation requires 15% of the 'extended target' (or 5.5% of overall target) to be fulfilled through SPG. The Community Energy Saving Programme (CESP), which started in September 2010 until December 2012, is a CERT associate programme with a particular focus on hard-to treat dwellings in low-income areas.

Energy suppliers and contractors have been using a range of delivery channels for CERT including: direct negotiation and partnership with local authorities, social housing groups, social landlords; direct partnership with insulation contractors and lead generation agents; area based initiatives such as Local Community Energy Partnership and Warm Zones; direct marketing such as emails, direct mail, flyers, telemarketing, door-to-door, local magazine / newspapers, etc. and charity organizations such as Age UK and Citizens Advice. Overall, however, many are failing to meet their target obligations, especially amongst SPG households.

The 'replacement' for CERT is the Green Deal and the Energy Company Obligation (ECO).

The Green Deal is an innovative financing mechanism that lets people pay for energy-efficiency improvements through savings on their energy bills. A loan is taken out for a series of energy efficiency improvements to the house and is repaid through the reduction in energy costs and, literally, through the electricity bill (the loan is essentially 'attached' to the meter in the house, not the person). Interest will be charged on the loan but the rate will be fixed.

Funding will be through Providers who can access wholesale funds through the Green Deal Finance Company (comprising the energy suppliers, banks and investment houses and housing infrastructure companies). Government has committed also to financially incentivise early take-up by householders although this is yet to be finalised.

The ECO for the big six energy suppliers comprises an:

- Affordable Warmth Obligation: to provide energy efficiency measures to low-income and vulnerable households (except social housing tenants);

41 *CLG (2011), English Housing Survey headline Findings*
42 *ICF GHK estimate, 2012 based on CDFI activity*
43 *ICF GHK estimate, assuming 500,000 homes per year brought up to decent standard, the average enquiry to loan conversion ratio for CDFIs (27%) and the average CDFI loan of £12,000.*
44 *See* ***http://www.decc.gov.uk/en/content/cms/news/pn10_075/pn10_075.aspx***

- Carbon Saving Obligation: funding for insulation of insulate solid-walled and 'hard-to-treat' properties;
- Carbon Saving Communities Obligation: free insulation and glazing measures to people living in the bottom 15% of the UK's most deprived areas (including the social housing sector).

Investment by suppliers is expected to be £1.3 billion per year with target support to 230,000 low-income households[45].

Energy efficiency is linked also to fuel poverty. Households are considered by the Government to be in 'fuel poverty' if they would have to spend more than 10% of their household income on fuel to keep their home in a 'satisfactory' condition – and the energy efficiency of the home is a key driving factor alongside income and energy costs[46].

Given CDFIs role in providing finance to disadvantaged and financially excluded householders and communities, including through loan activity, they are expected to offer a key 'route to market' for the Green Deal and delivery of the ECO.

5.3 Current provision and market developments

Reduced opportunities to obtain mortgage finance and growing labour market insecurity have made it more difficult to obtain finance for home improvements and adaptations. Similarly there has been a reduction in the provision of resources to support home improvements schemes – previously funnelled through Local Authorities – in the context of a very difficult public expenditure outlook.

Recent years have seen the introduction of a broader portfolio of subsidised loans, now including equity release schemes, individual and community renewable energy schemes and specialised support to homeowners – but coverage is varied and patchy.

Fourteen CDFIs currently serve homeowners and work with local authorities and debt support agencies and others to inform and attract customers and deliver subsidised home improvement loans. In 2012, almost £13m was made available to around 1,400 homeowners; with the average loan made being £13,000, within a range from £3,000 to £58,000.

5.4 Market assessment

Overall, the current finance gap is characterised by the following dynamics:

- Regulatory tightening and affordability criteria have seen a substantial curtailing of mortgage lending. Similarly there has been a reduction in the provision of resources to support home improvements schemes in the context of a very difficult public expenditure outlook.
- Capital to on-lend is in short supply. CDFIs are heavily dependent on public sources and notably funding from local authorities (67% of funding for on-lending). However, local authorities are seeing their government grant cut by 28% over the current funding period.
- The exception remains the very substantial – but as yet to be fully determined – Green Deal which will see a national loan-based home improvements scheme, including explicit targeting of low income and disadvantaged communities.

45 See **http://www.decc.gov.uk/en/content/cms/tackling/green_deal/green_deal.aspx#**
46 See **http://poverty.org.uk/80/index.shtml**

6. Conclusions

Current potential annual demand for community finance in the UK (excluding the Green Deal) is estimated at some £5.45 – 6.75 billion.

In contrast, in 2012, community finance organisations delivered an estimated £0.7 billion of community finance to UK businesses, civil society organisations, individuals and homeowners.

Community finance investments generate a wide range of economic and social benefits (especially within the most disadvantaged and excluded communities of the UK) – and which meet a wide range of Government policy objectives.

Community finance organisations, if capitalised to do so, have the potential to generate sustainable economic development and social well being at the heart of UK communities. Currently, the majority of potential economic and social benefits are being lost to UK economy and society.

The scale of unmet demand can only be met through a partnership of public, private and social investors – through a viable and sustainable community finance system as an established and embedded feature of the UK's financial landscape.

This sets challenges for all the partners concerned, especially the community finance sector.

Conclusion 1: The large scale potential demand for community finance in the UK

This report suggests current potential annual demand (including latent) for community finance in the UK of some £5.45 to £6.75 billion (excluding the Green Deal).

Growing demand for community finance in the UK is generated by four sets of clients:

- Businesses and entrepreneurs (especially in disadvantaged communities) unable to secure finance from mainstream commercial institutions for a variety of reasons;
- Civil society organisations (CSOs) such as not for profit businesses (social enterprises), charities, community and voluntary organisations, and mutuals that place a strong emphasis on social, environmental and stakeholder as well as financial objectives;
- Individuals unable to access short-term, low value credit and other financial services who must deal with sometimes abrupt fluctuations in income; and,
- Homeowners who are unable to access a loan from a commercial lender to carry out essential repairs and improvements to their property.

Community Finance Market	Total potential value of annual demand (£b)	Total potential annual number of clients
Businesses	£1.3b	103,000
Civil society organisations	£0.9b – £1.7b	57,000
Individuals	£3 – £3.5b	8,000,000
Homeowners (excluding the Green Deal)	£0.25b	21,000
TOTAL	**£5.45b – 6.75b**	**8,181,000**

Conclusion 2: The substantial funding gap for community finance in the UK

In 2012, community finance organisations delivered an estimated £0.7 billion of community finance to UK businesses, civil society organisations, individuals and homeowners – against an estimated current annual potential demand of between £5.45 and £6.75 billion.

They did so in finance gaps where continuing market failures are well-documented and, most especially, where investment markets fail to reflect the economic and social returns generated for the UK economy and society.

Conclusion 3: The challenge to policy makers: to support provision for unmet demand and realise the extent and range of foregone economic and social benefits

Community finance investments generate a wide range of economic and social benefits (especially within the most disadvantaged and excluded communities of the UK) – and across the aims of the Coalition Government to "rebuild the economy, unlock social mobility, mend the political system and give people the power to call the shots over the decisions that affect their lives".

Community finance investment has the potential to generate sustainable economic development and social well being at the heart of UK communities. Examples of delivery of economic and social outcomes across Government policy include:

- Efficient and effective loan delivery to businesses and entrepreneurs (especially in disadvantaged communities) to create new businesses, support growth and generate new jobs;
- The move to financial sustainability by social enterprises and other civil society organisations delivering economic growth and high quality, co-produced innovative services in response to the opportunities of Open Public Services;
- Over 150,000 individuals avoiding using high cost lenders and saving over £0.25 billion in interest charges; and,
- Over 500 homes repaired, adapted and brought up to 'decent' standard (in a reasonable state of repair, and has reasonably modern facilities and services).

Yet the current scale of investment represents less than one-tenth of potential demand for the goods and services of community finance (excluding Green Deal) and, at best, current 'policy pipelines' might be expected to support a doubling of market supply to £1 billion per annum in the short to medium term. There exists, therefore, a consequent on-going substantial loss of economic and social benefits.

Given the contribution of community finance to numerous Government policy objectives, the level and range of economic and social benefits generated, and the substantial funding gap which remains, Government should seek to implement at least some of the range of potential mechanisms available to generate substantially increased investment in to community finance.

Potential mechanisms might range, for example, from fiscal stimulus through better harmonised tax regimes (such as Community Investment Tax Relief), to loan guarantee mechanisms, targeted programmes and funding streams, and trialling of new funding instruments (bonds, wholesale funds, etc.).

Conclusion 4: The challenge to a partnership for community finance: a viable and established community finance system within the UK's financial landscape

Government alone cannot (and does not desire to) meet the demand for community finance – it does, however, share common economic and social objectives with a range of public, private and social investors. The scale of unmet demand can only be met through a partnership between public, private and social investors.

Given current times, the scale of the finance gap, and the range of economic and social outcomes generated by community finance that are of interest to investors, substantial opportunities exist for a tri-partite partnership for community finance. The challenge for such a partnership is to develop a viable community finance system as an established and embedded feature of the UK's financial landscape: with the capacity and products to meet the range of client demands not met by mainstream financial services – and to generate the pipeline of tomorrow's mainstream customers.

Opportunities can be identified throughout the market infrastructure – for example, joint sharing of risk, development of innovative products, referral schemes, investment readiness pipelines, etc. – such that community finance becomes an embedded entity within the UK financial services system.

Conclusion 5: The challenge to community finance providers – a sustainable community banking system?

Despite delivery of substantial finance and services to date, the community finance sector meets a minor fraction of current potential demand, remains under-capitalised and is struggling to achieve financial sustainability (whilst providing viable financial services at a cost affordable to clients).

Much of this reflects immature markets and an immature sector characterised by diverse intermediaries, non-standardised methods and products and often high transaction costs. Meeting potential existing demand implies supporting the development of community finance markets and the sector through developing better-capitalised, more productive, more scaleable providers and stimulating growth of new innovative, lower cost models.

Ultimately, community finance implies the ability to encompass a suite of appropriate and integrated financial services which delivers to clients a combined 'no wrong door' and 'one stop shop' approach (potentially known as community banking).

The challenges of maturity should not be taken lightly – given a substantial range of providers with different traditions, governance frameworks, business models, delivery structures, coverage, capacity and capability – but neither should the substantial opportunities for best practice, learning and cross-fertilisation be underestimated.

Sector associations will need to provide leadership, working together to champion the development of the community finance market with initiatives to improve standardisation, transparency, build management capability, develop and showcase best practice and stimulate greater understanding among stakeholders.

Conclusion 6: The challenge of adoption and promotion of community finance as a recognised concept

Community finance describes the range of finance and affordable financial services provided to businesses, civil society organisations, individuals and homeowners unable to secure access to mainstream financial structures.

Any Community Finance Partnership should not underestimate the potential complexity of such an 'umbrella' concept. Nor, however, should the potential simplicity and power of a message of seeking to support the financial needs of those in economy and society excluded from mainstream finance be underestimated.

Often discussions of any of the four finance gaps is an immediate descent into complexity – especially (as this report has grappled with) where even basic labelling and common understanding of market segments remains limited, diversity of intermediaries is the proudly held norm, substantial market development and associated experimentation continues, and stakeholders and potential partners are numerous and wide ranging.

Whilst complexity is inherent and a necessity for inward facing conversations it must be overcome and smoothed for outward messaging – otherwise, the risk is of a damaging response by investors of 'lack of transparency'. Even those Government Departments with the greatest stake in community finance – Cabinet Office, BIS, HM Treasury, CLG and DWP – have limited understanding of the sector, its current contribution and future potential.

Coordinated advocacy, by representative groups and leading intermediaries, to articulate the full contribution of the sector would improve understanding of the sector and potentially promote alignment of Government policy.

Such co-ordination pre-supposes that the community finance sector sees common and added value in the concept of community finance and its advocacy.

Notes

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