

# Access to Finance and Community Economic Development Solutions

**Pat Conaty**

**Localise West Midlands – Community Economic Development  
Project Discussion Paper**

**October 2012**



The double-dip recession in the UK has highlighted the access to finance issue. John Stuart Mill observed in 1844 that business slumps are characterised by credit rationing problems by banks and that stimulating new investment is crucial.<sup>i</sup> The credit crunch problem is currently deep and apparently structural. Diverse methods by the Coalition government over the past year have thus far failed to turn the problem round. Bank lending to all businesses according to Bank of England data has declined by 17% over the past four years and collapsed by £4 billion in the three months to May 2012.<sup>ii</sup>

This paper examines the access to finance issue both in relation to the current crisis but also more broadly in relation to enterprises and organisations that even in good times find it very hard to secure investment from the banks. This is particularly a major issue in the UK because of the intensive centralisation and concentration of banking.

The paper also looks at a broader range of solutions that have been developed by community economic development methodologies, the co-operative sector and by government intervention. Finally the policy context will be examined and ways proposed for developing a new more socially and financially inclusive approach to local economic development.

## **1. Bankability and access to finance – the barriers in the UK**

Banking and high street lending has changed beyond recognition since the regulatory changes introduced in the 1980s in the lead up to the Big Bang. The number of building societies has declined from hundreds to under 50 today. Before 1980 regional building societies dominated the mortgage lending industry, now the big banks are the major lenders.

Trustee Savings Banks were local and regional financial institutions and they were some of the earliest mutual savings banks to be set up in Europe with the first one going back to 1810 The Birmingham Municipal Bank established in 1916 had 66 local branches in the 1950s. Forced with many other local savings banks to merge to form one highly amalgamated TSB corporation for England in 1976, the TSB was a decade later privatised and then taken over in 1995 by Lloyds Bank.

Thirty years ago there was a clear-cut separation between merchant and investment banking and high street commercial banking. This is no longer the case. Additionally insurance and banking were separate. The 1990s saw the emergence of banc assurance that led to the mergers of the big banks with the insurance industry to create along with investment banking the truly global banks of today. As a result of widespread privatisation and demutualisation, the UK has become one of most centralised and concentrated banking markets in the world.

Today a handful of banks dominate commercial, mortgage and other investment in the UK, whereas in the USA, Germany, Switzerland and Austria there continue to be many more local and regional banks with a healthy share of the market. The benefits of this greater competition and banking diversity (between private, co-operative, mutual, municipal, postal and public forms of banking) have been found in a number of studies.

In Germany and Austria, municipal savings banks and co-operative banks are widespread and have strong local and regional roots. Indeed the municipal savings banks service the local economy as their mission and do this practically by providing both mortgages and small business loans. Indeed the local banking sector in Germany and Austria are by far the largest lenders to small and medium size enterprises and in Germany the volume of lending to the enterprise sector has grown since 2008, not shrunk like in the UK.

Germany has its large international banks like Deutsche Bank and Commerzbank but their focus is heavily on meeting the needs of large international businesses and in foreign investment and mergers and acquisitions. In this way the German global banks are highly similar to Barclays and HSBC. What is missing here though is the local and regional utility banking system that in Germany remains strong.

Before the deregulation of the 1980s there was still in the UK a strong focus on enterprise lending using relationship-banking methods. Branch managers were trained and bred in this culture and local knowledge and building trust was key. This though disappeared as credit scoring and automated systems for making lending decisions replaced the local banker's expertise. In commenting on this bygone past, Simon Thompson of the Chartered Institute of Bankers has said:

*'During the "golden age" banks were originally focused on local clients, and bank managers had a strong bond with their borrowers.'*

There are other issues though that impact upon access to investment on affordable terms. Banks make small business lending decision based on a set of criteria known as CAMPARI. These include an appraisal of:

**Character:** does the bank know the business owners as customers? If not, what do they know about them and how reliable they are? What evidence is there about this on credit registers and other payment tracking systems?

**Ability:** what skills do the managers and senior staff has and what is their track record in their business area?

**Means:** what assets are in place and what capital do the business owners have? What are their plans for future investment?

**Purpose:** what will any bank funding be used for and what assurances are there available that the money will be used for business purposes and not leak out otherwise?

**Amount:** what sum is being asked for and is this sufficient to meet the purpose? What other matching investments are being put up by the owners or others and will any loan be less than the assets or other risk forms of investment?

**Repayment:** how will the bank be repaid and by when? Is this feasible from the financial projections and available evidence supporting the business plan?

**Insurance:** what collateral or security are the owners willing to put up for the loan? Is this enough to protect the bank investment?

This is a pretty demanding list and banks are cautious lenders to small businesses – especially ones that they have little or no previous links with. Also they like to see strong security and commonly this means more than just personal guarantees for loans and access to business assets. As a result, many small business owners need to put their homes up as security.

Those businesses that struggle to meet the CAMPARI criteria include:

- Start up businesses
- The self-employed and sole traders
- Service sector businesses with few business assets

- Co-operatives and social enterprises where personal guarantees are not available
- Charitable organisations seeking to trade where loan security is restricted

As a result of this access to bank lending problem and the gap, Community Development Loan Funds have been established in the USA and the UK since the late 1970s and other micro-finance loan funds have developed across North America and Europe.

Additionally Government policy across OECD countries has developed different forms of small firms loan guarantee schemes to seek to address problem areas where the business proposition is sound, the purpose is clear, the business capacity and track record is good but there is insufficient collateral to cover the lending risk. The UK Government has operated such schemes since 1981. A brief review of these highlights the different approaches being made.

**Small firms loan guarantee (SFLG) scheme:** this operated between 1981 and 2009 and was widely supported by the banks. In its final years it provided a 75% loan guarantee to help cover collateral gaps for companies established less than five years and with annual turnover under £5.6 million. Loans covered could be up to £250,000. At times of recession and over the length of the scheme, the guarantee level was changed from 70% to 85% and this tended to be at the higher end for specific regeneration areas (e.g. under City Challenge). A number of businesses were excluded – largely those in the retail or services sector. In practice the scheme was not accessible to the smaller end of the business sector and not to micro-businesses because most are not incorporated and the paperwork to process the guarantees favoured larger loans to bigger size SMES. Additionally the total number of approved loans each year was low - only 2619 in 2007-2008 and during the peak years of the mid-1990s the level only reach just over 7000. A review of the scheme by the Graham report in 2004 revealed very high levels of default, averaging 30 to 35%, and bad debt claims of around 20%.<sup>iii</sup>

**Enterprise Loan Guarantee:** this replaced the SFLG in January 2009. Like with the former scheme, the focus is on helping banks to lend to SMEs when the barrier to lending is a market failure related specifically to insufficient collateral to secure a loan. Updated in March 2012, the main features for this scheme are as follows:

- To help viable businesses that meet conventional bank lending criteria but where the business has insufficient collateral and other security to be granted a loan.
- Lending can be from £1000 to £1 million to businesses with annual turnover up to £41 million.
- Like SFLGS, the guarantee is 75% with the bank covering a 25% exposure to loss. The cost of the guarantee to the business is 2% a year and repayable quarterly to the Government through its Capital for Enterprise arm.
- A wide diversity of businesses can apply including start-ups but they must provide a sound business plan, satisfy normal bank lending criteria and demonstrate that they do not have adequate security to pledge.
- Business owners must pledge personal assets for loans as security apart from their primary residential property.
- Some service businesses are excluded (health, social services, the arts and education) and there are other restrictions in relation to Coal and Steel, fishing, agriculture, shipping and forestry.

- A major change from SFLG allows qualifying Community Development Finance Institutions (CDFIs) to access the scheme to manage their risk.
- To reduce bad debt levels, there is a cap on what lenders can claim back from Government in any one lending period. This is up to 9.75% of what they have lent. The level for CDFIs is to be increased to 15%.

It appears that lending levels have been operating at the higher end of SFLG performance annually with 6000 or so loans approved in 2011.<sup>iv</sup> The policy goal is to hit at least £500 million of SME lending a year.

**National Loan Guarantee Scheme:** this was launched in March 2012 as a key component of the Government's 'credit easing' programme. The policy focus is a lowering of the cost of capital for enterprises. The scheme aim is to reduce the bank borrowing costs of unsecured lending by 1% for SMEs. The government guarantee is not to the business but to the banks (and also for their investors) for any money they secure from the capital markets to on-lend to SMEs. In return for a fee for the guarantee, the Government will provide guarantees for up to £20 billion from the capital markets. Funding of £200 million has been set aside by Government to leverage this target of new funds for lower cost lending.<sup>v</sup>

HSBC and Co-operative Bank have not signed up as they regard the Government charge as too high. Phil Orford of the Forum of Private Business has stressed 'concerns it is more relevant to larger companies and medium size companies.' John Longworth of the British Chambers of Commerce has echoed this view and added that the scheme 'will make some loans more affordable. But it will not help the smaller, younger, and high-growth firms that have trouble getting credit in the first place.'<sup>vi</sup>

These were the views in last spring when the scheme was launched. The scheme was initially available for lending to firms with a turnover of less than £50 million annually. Then in June 2012 the Government suddenly raised the turnover level to £250 million annually. This sudden shift raised a number of eyebrows among financial journalists.

A few weeks later, Izabella Kaminiska in a review article in the Financial Times revealed that the banks were in fact unable to make the Government scheme work and it appeared unviable. Quoting stockbrokers Rathbones:<sup>vii</sup>

*'This has been a spectacular failure to date as initially the banks made very little effort to promote it and now, having been in receipt of some gentle prodding, seem incapable of knowing how it works.'*

The Government disagree and the HM Treasury website claims on the one hand that the scheme has already been taken up by 16,000 businesses with over £2.5 billion in cheaper loans, while on the other hand it does concede there is a problem:<sup>viii</sup>

*'Changes in market conditions since the introduction of NLGS mean that it is now less economical for banks to raise unsecured funding. In practice this means that banks that are offering NLGS loans are likely to opt to deliver credit easing to the whole economy through the FLS. It is expected that banks currently offering loans through NLGS will, over time, cease to offer NLGS branded products.'*

According to Kaminiska, the problem has been that banks have not been able to work out how to deliver the 1% interest rate cut to businesses against the scheme design. Lloyds TSB has finished its involvement and closed down its application system.<sup>ix</sup> Hence after just four months of NLGS, a rapid transition to the Funding for Lending Scheme (FLS) occurred on 1 August 2012.

**Funding for Lending Scheme:** Government has worked closely in partnership with the Bank of England on this new approach to overcome the apparent design flaws of NLGS. The NLGS will still operate for some time but is widely predicted to be superseded by the Funding for Lending Scheme (FLS) that has attracted far more support from both banks and small business trade bodies. The new scheme is much broader than SME lending as it covers other forms of household lending as well. FLS operates by allowing both banks and building societies to borrow cheaply from the Bank of England over the next 18 months and to secure these low rates for up to four years. The hope is that this will lead to lower interest rates to borrowers across the economy. Banks and building societies are allowed to borrow up to 5% of the stock of their existing lending plus a top up for any net expansion in lending between June 2012 and December 2013.<sup>x</sup> There is a strong interest rate saving to borrow more and lend more. The charge for capital as a fee is just 0.25% per annum but if you lend less over the target period, this charge goes up to 1.5% by increments where lending decreases by 5% or more. At present, Community Development Finance Institutions do not have access to this low cost capital.

With all these schemes, the overriding focus is on the banks and on getting them to return to an earlier level of lending before 2009. From a much lower base level of provision, other small business lenders are showing how lending access can be increased. It is important to examine these efforts and how more localized and relationship-lending approaches can reach down to the local economy and apparently more effectively. Why might this be the case?

## **2. Community Economic Development and Access to Finance**

The Centre for Responsible Credit has provided a helpful definition of community economic development or CED.<sup>xi</sup>

*“Community Economic Development” is a broad term which incorporates a number of local, community led, approaches to stimulating economic growth and developing social cohesion. It includes activities designed to ensure that money re-circulates within the local economy; that assets are community owned, and that profits from social enterprises are re-invested for community benefit.’*

CED developed in the USA in the 1970s and grew out of the campaigning work of the American civil rights movement from 1965, then spread to Canada and has been slowly gaining recognition in the UK. CED has some similarities to the movement in countries in Europe and Latin America influenced by Catholic social action and co-operative economic development thinking. This movement is known in France, Belgium, Spain, Italy and Portugal as the Social Solidarity Economy. Because of its bi-lingual governance system, Canada has developed both approaches for local economic development - CED in Anglophone western Canada and Social Solidarity Economy in Francophone Quebec.<sup>xii</sup> There are key lessons to be learned from both approaches and both forms of local economic thinking have influenced the development of the Fair Trade movement.

What CED and Social Solidarity Economy recognise is that the real economy in urban and rural localities is highly dependent upon the health and well-being of local businesses – especially the self-employed, family businesses, small partnerships, small and medium size enterprises of diverse sorts and the growing number of social enterprises. The closure of bank branches over decades in low-income communities and the loss of the relationship lending methods by the banks has made it increasingly difficult for such businesses to secure working capital and other forms of investment on low-cost terms.

Despite the new small business schemes from Government, the Federation of Small Business (with 200,000 members) report that 41% of small firms were refused finance from the banking sector in the second quarter of 2012.<sup>xiii</sup> Summing up the crisis in relation to these findings, FSB chairman Jon Walker commented.

*'There needs to be more competition in the finance and banking sector because only when there are more options to choose from will small firms get a fairer deal. There also needs to be more alternative sources of finance that small firms can tap into. This ongoing credit squeeze is becoming critical. Government is relying on small business growth to drag the UK out of recession. The will of small businesses to grow is there but the money to enable them to do so is not. Unless this situation is addressed effectively and rapidly, that confidence might evaporate altogether, with dire consequences for the economy.'*

The present situation is tragic because it is sole traders and micro-businesses (with under 10 employees) that are the backbone of both the local and the national economy. They are at the heart of the 500,000 new start-ups every year and they currently provide more than one in three private sector jobs and most new jobs. Research by new economics foundation in 2008 revealed that sole traders and the micro-business sector employ 6.4 million people – more than 20% of the UK workforce.<sup>xiv</sup> By contrast, Tesco, one of the largest corporations has 280,000 employees. Self-employment has more than doubled since 1979 nationally from 6.6% of the workforce to 14.1% (the highest level ever) in 2011.<sup>xv</sup> Self-employment also has both regional and rural variations. Rates of self-employment are for example double the national average among many immigrant communities and in rural areas of England the rate is 37% higher and 56% higher in Wales.<sup>xvi</sup>

Of the 4.5 million of businesses in the UK, 96% are micro-businesses. The BIS report in 2010 on *SME Access to External Finance* does recognise that it is these businesses that have the hardest time accessing credit because of a variety of factors including lack of collateral, lack of a track record or credit history and because they carry a higher level of risk.<sup>xvii</sup> Beginning in the 1970s work on addressing this market failure and financing gap has been developing. In India and Bangladesh, micro-credit was developed by pioneers like Muhammad Yunus at the Grameen Bank (village bank) and in by Ella Bhatt at SEWA (Self-employed Women's Association) in Gujarat. This work was paralleled by CED work in the USA in the mid-1970s.

Initially work in the USA focused on access to mortgage finance for African Americans discriminated by US banks. Research led by Gale Cincotta of National People's Action (NPA) showed a clear pattern of so-called 'red-lining' where both banks and insurance companies were not providing credit in self-evidently discriminatory ways. For example, in the case of South Shore Bank in Chicago, the research showed that African Americans had provided the bulk of savings in this local bank, but all the lending was going out of the low-income community for investment and diverted into higher income areas. A successful funding drive was raised and the bank was bought by a range of social investors and then redesigned to become first Community Development Bank in the USA.

Gale Cincotta and NPA, whose office was in Chicago, set up Neighborhood Housing Services (NHS) in 1975 to provide low-income communities with a package of home repair surveys and access to a diverse range of loans for home improvement. This was a path finding national project and as a sister company to NHS, they set up with the support of the City of Chicago, a Community Development Loan Fund, Neighborhood Lending Services (NLS). Over the past forty years this local revolving fund has invested over £1 billion in a wide range of home improvement and renovation programmes in the city's low-income neighbourhoods.

The campaigning work of Cincotta and the NPA led to the national Community Reinvestment Act (CRA) in 1977. The CRA requires banks to supply information on the lending they provide in specific local neighbourhoods and additionally disclose the accessibility of their other financial services. The CRA fact-findings and other available data is analysed and banks are given scorecards and ratings on their performance. With this transparency of capital flows, the successful advocacy work of Cincotta led in the 1980s to the signing of CRA agreements with mainstream banks to earmark specific pools of capital to lend in neighbourhoods over agreed periods – often 3 to 5 years with a review of lending

performance. These CRA agreements have continued to be developed through the work of the National Community Reinvestment Coalition – both to widen access to capital for small businesses and for housing.

A key finding from the CRA work was that the investment in housing and infrastructure could be fed into local supply chain benefits to support new jobs in construction, energy conservation, community buildings and to secure a local economic multiplier. This work led to the development of Community Development Corporations that are based in different urban and rural areas to specifically work on CED programmes across a range of practical fields including: labour force development, job training in specific sectors, enterprise support, home owner advice on repairs, the green economy, mortgage rescue and community facilities investment. Without CRA, the success of CED and the development of community development financial services would have not been as successful as it has been.

In the 1990s under President Clinton, the demonstrable success in Chicago and in other cities of CED led to legislation that defines Community Development Finance Institutions. The Reigle Community Development and Regulatory Improvement Act of 1994 defines a CDFI as a financial institution that has a primary development of community development, serves a target market, provides development services, is accountable to its community and is a non-government body. Today four types of CDFI in the USA are recognised and each with a different lending and investment mission. The four CDFI forms are and comprise approximately:

- 500 community development loan funds
- 350 community development banks
- 290 community development credit unions
- 80 community development venture capital funds

This growing social finance sector has expanded fast over the past decade and is united both through separate trade bodies and under the national CDFI Coalition. A 2010 review of CDFIs by the US Social Investment Forum (SIF) tracked growth. This found that from 1999 to 2009 community investment capital assets across the movement grew in these ways:

- Community development loan funds from \$1.7 billion to \$11.9 billion
- Community development credit unions from \$610 million to \$11.1 billion
- Community development venture capital funds from \$150 million to \$2 billion
- Community development banks from \$2.9 billion to \$17.3 billion.

As a result of this expansion, community development investment in the USA has been shifted from the margins to a new more strategic role as a new mutual banking sector for the country. The united organisations have a good opportunity of achieving this bigger vision over the next ten years due to the growing numbers of social investors, households, businesses and institutions fed up with the global banks who are voting with their feet and moving either their cheque accounts or funds to CDFIs under the growing Move Your Money Campaign kicked off by the Huffington Post in 2009.<sup>xviii</sup> In February 2012 a Move Your Money Campaign was launched in the UK.

Critical to the scaling up of community investment success in the USA has been the development of effective methods for providing patient capital and quasi-equity finance for CDFIs. Secondly, collaborative work with Government under President Clinton established the CDFI Fund operated by



the US Treasury and additionally opened up CDFI access to public sector loan guarantee funds for small business financing. A third key factor for success was the unity created through the CDFI Coalition, a broad-based consortium that has brought together five national CDFI trade bodies; this has secured joint advocacy that speaks politically today with one powerful, 'community investment' voice to campaign for change and to raise resources for the expansion of a growing community banking movement.

The success of the CDFI movement inspired action research twenty years ago to develop a similar movement here. Aston Reinvestment Trust (ART) in Birmingham was established in 1997 as the first local CDFI in the UK. There are now 60 active CDFI lenders spread nationally, including five in the West Midlands: Street UK, Black Country Reinvestment Society, Coventry and Warwickshire Reinvestment Trust, Impact in Shropshire and ART. In 2011-12, ART had its most successful year lending £1.37 million.<sup>xix</sup>

CDFIs are united under their UK trade body, the Community Development Finance Association and they have experienced a three hundred percent growth in lending since 2006. In 2010-11 CDFIs disbursed £190 million in loans to 23,000 borrowers and created or preserved 5700 jobs.<sup>xx</sup> In addition they attracted £47 million in bank finance for CDFI borrowers.<sup>xxi</sup>

It is important to view the CDFI achievement against the lending gap in the market for SME finance. ACCA has done an appraisal of this gap in March 2012.<sup>xxii</sup> It is important to understand the lending market as both a stock of existing loans and a positive or negative flow of new loans. Thus it is comparable to a bathtub with a water level either going up or dropping down. ACCA point out that most bank lending is established with ongoing and shifting levels of agreed overdraft limits for businesses and existing term loans. This is the stock of loans and it has been going down in recent years with more old loans being repaid to the banking sector by comparison to new loans being advanced.

Among the 4.5 million SMEs in the UK, 3% applied in 2011 for either new loans or existing loan renewals. According to ACCA and figures from the SME Finance Monitor, about 50,000 were declined. ACCA estimate that the implementation of a more effective system of loan guarantees could have financed at least half of those declined. However this ACCA appraisal is only analysing the SMEs that meet banking lending criteria except, say, in one area where a guarantee could solve the problem.

Many small businesses simply don't apply for bank loans as either they have been declined often repeatedly in the past or they know they will not meet the loan criteria. The CDFA tracking of the success of CDFIs in financing these so-called 'viable but non-bankable' micro-businesses and small businesses with more generous lending criteria indicates that the level of unmet demand is much higher. The CDFA that there at least 370,000 financially excluded businesses in the UK.<sup>xxiii</sup>

Ben Hughes, the chief executive of the CDFA has highlighted the potential for CDFIs to develop rapidly over the next five years with fair access to Government's new low-cost capital programmes like Funding for Lending, which is forecast to provide up to £80 billion over the next 18 months.<sup>xxiv</sup> He indicates the tangible CED potential that even a small percentage of capital from Government or the Bank of England for on lending could secure.<sup>xxv</sup>

*'Previous initiatives like Project Merlin and the Enterprise Finance Guarantee clearly aren't getting finance to the local struggling businesses that need it most. If the Treasury really wants to support the struggling small businesses that are the lifeblood of our economy, they must channel some of the Funding for Lending money through the locally based community lenders who can reach them. Our research suggests that £100 million – just a fraction of the funding for lending money – could create about 20,000 jobs overnight if it was delivered to businesses through our tried and tested members.'*

CDFIs also have developed a number of other sectors and target markets for lending and investing. For example, there are 62,000 social enterprises operating nationally, employing over 800,000 and with an annual turnover of £24 billion.<sup>xxvi</sup> 44% report that they are hampered from achieving their potential because of a lack of affordable finance. CDFIs over the past ten years have become specialists in the provision of community finance to social enterprises.

Some CDFIs have also developed a specialism in the provision of community finance to households for consumer needs and housing repairs. There are an estimated 8 million people who are either unbanked or under banked nationally. These mainly low-income people are financially excluded and forced to pay credit charges from 200% with a doorstep lender and up to 4500% from a payday lender. CDFI lending in 2010-2011 saved these households £4.3 million in exorbitant credit charges through the provision of affordable finance.<sup>xxvii</sup>

As in the USA, there clearly is scope in the UK to develop CED methods to support urban and rural revitalization. It is important to consider potential ways for CED and CDFI development to link up with sources of public investment and broader social investment. The CDFI are increasing their lending at a healthy rate and need new sources of capital. This is proving to be problematic for them to access. After a considerable delay, £60 million of new funding has just been approved under the Regional Growth Fund for CDFIs, with half the capital being provided by BIS and the other half by The Co-operative Bank and Unity Trust Bank.<sup>xxviii</sup> ART has been awarded the first investment package under this scheme.

The Government's proposed Big Society Bank became operational in April 2012. It is called Big Society Capital and has secured an initial £600 million of capital from two main sources – dormant account money and capital investment funds from Barclays, HSBC, Lloyds and RBS.<sup>xxix</sup> It operates as a social investment wholesale bank with lending placed with intermediaries. The organisational mission is the provision of finance for organisations that can achieve a social impact. So far among CDFA members, only two CDFIs have secured capital and these are two specialist community development venture capital funds, Big Issue Invest and Bridges Ventures.

There are other sources of community investment that are growing steadily and where community and social investors can put funds directly into the shares of co-operative and mutual enterprises. Since 2009 more than 15,000 people have invested in over 100 community share issues and more than £15 million has been raised in this way.<sup>xxx</sup> Projects backed include mutually owned football clubs, community shops, village pubs and a wide range of community energy schemes. With government support, Co-operatives UK and Locality have expanded their Community Shares Unit to provide specialist advice and support to establish an increasing range and number of community share issues over the next three years. A number of CDFI are working out ways to complement the services of the Community Shares Unit by partially underwriting a share issue or by providing additional loan finance to help the social enterprise funded to develop. The Key Fund in Yorkshire has been pioneering these methods for community energy schemes.

In addition to the start up support that the CDFA and the Community Shares Unit can provide to new ventures, there are credit union trade bodies in England/Wales, Scotland and Northern Ireland that that can help community finance initiatives get going. Credit unions are savings and lending co-operatives regulated by the Financial Services Authority (FSA). Generally speaking, credit unions provide personal loans to meet household's needs, though they can and sometimes do lend to the self-employed.

Both credit unions and CDFIs take considerable time, training and expertise to set up. The CDFA and credit union trade bodies can help with the provision of model legal rules, CDFIs are not regulated financial institutions because they do and cannot take savings deposits. The main hurdle legally they need to set up and operate is a lending system compliant with the Consumer Services legislation and a

lending license from the Office of Fair Trading. Credit unions are much harder to establish as they need to organise a group of prospective saver members, train operational officers, prepare a credible business plan and be approved for registration by the FSA. Once set up, they also have to provide quarterly and annual returns to the FSA.

The present trend though is witnessing fewer numbers of CDFIs and credit unions. There has been a distinct shift of late towards consolidation in the CDFI sector with the number of CDFIs declining in number in recent years but becoming somewhat larger. Similarly this has been happening in the credit union sector from well over 500 to a steadily reducing number in England, Wales and Scotland.

Another social lender with some similarities to a CDFI is the Prince's Trust. A well-established charity, the Prince's Trust has provided a package of finance for new enterprises set up by those from 18-30 years. The enterprise programme includes four days of training, access to mentoring and a potential loan. The service has operated for several decades now and can provide low-interest loans up to £5000 from their enterprise programme. Loans up to £1000 can be provided to young unemployed people seeking to create their own work through self-employment. The goal for the current year is to support 600 new enterprises to start up under the programme.<sup>xxxix</sup>

The Prince's Trust also operates a business support and advice service for people over 50 seeking to go into business. The services include workshops, networking and mentoring.

### **Relationship banking, Peer-to-Peer Lending and Crowd funding**

The UK is unique in having such a large banking market dominated by just a handful of global banks. CDFIs are striving to provide an alternative but there is a long way for them to go. Handelsbanken, a Swedish bank that has been operating under the radar screen since 1982 in the UK and now expanding fast, has demonstrated the latent power of old-fashioned relationship banking.<sup>xxxix</sup>

Handelsbanken was near to bankruptcy in 1973 and rescued by an entrepreneur, Jan Wallander. He restructured the bank completely and turned it back to a traditional small business lending system. But he did much more than this. First he cut the marketing budget and forced branch managers and staff to market the bank locally themselves and develop word of mouth marketing by meeting the needs of local business and other customers. Another innovation was to change the incentive structure from bank bonuses to a system of profit sharing that builds up asset accounts for each member of staff that is not paid out until the staff member reached 60. This long-term asset savings system is called Oktonogonen. The system is based on a fair share concept as every employee receives the same profit allocation from the most junior to the most senior manager.

The other innovation of Handelsbanken is the use of the 'church spire' principle for lending. Each branch's defined market area should not be larger than the geography you can view from the top of the local church tower. So the focus of the lending is very local indeed and the lending staff are encouraged to get out of the branch and get to know their local businesses and customers and how to meet their needs. Unlike conventional banks, all Handelsbanken loans are decided at the branch level with no interference from head office.

Since the banking collapse of 2008 Handelsbanken has been expanding fast and has advanced £9 billion of finance. They are opening three new branches a month and have a national network of 137 branches and intend to continue to expand as they take business from the big banks.

Zopa, an Internet intermediary, has developed the innovation of peer-to-peer lending in the UK. Zopa acts as the intermediary between individuals willing to lend and individual creditworthy borrowers. For lenders for a fee it carries out credit checks and will also collect debts. Finance is available up to £15,000 and credit charges are decided by the lenders and negotiated with the borrowers based on the

expectation of the lender. Zopa acts to manage the risk by helping lenders spread their investment across a number of borrowers.

Set up in 2005, Zopa in the UK has brokered £238 million in loans in the seven years to October 2012.<sup>xxxiii</sup> By comparison CDFIs have increased their lending portfolio over this same period by £567 million. Zopa borrowers though are near to the conventional risk profile for bank loans whereas this is not the case for CDFI borrowers.

Zopa provides a broad range of peer-to-peer lending for individual borrowers. Funding Circle operates in a somewhat similar way peer-to-peer way but for small business lending only. Set up in 2010, it has facilitated £53 million in small business loans in its first two years of operations.<sup>xxxiv</sup> Loans are available range from £5000 to £250,000 with an average loan reported of £39,000.<sup>xxxv</sup> The average return to lenders is 8.3% before tax and fees.<sup>xxxvi</sup>

Funding Circle is a focused small business financing service with similarities to a bank in practice. The lending criteria are precisely the same as those used by conventional bankers. They require both personal guarantees and security over the business assets being financed or over the wider business itself. They also only finance businesses that are well established. The main difference of Funding Circle from the banks is the peer-to-peer methodology and the speed of delivery and lending decisions are made within two weeks.

A more recent investment innovation for small businesses is 'crowd funding.' Crowdcube is developing this market in the UK. The difference here from Funding Circle is that the investments are not loan finance but equity investment for small companies. Equity stakes sought can be anywhere from £10,000 to higher levels. Businesses fill in an application and Crowdcube posts the funding pitches on its website along with the target amount to be raised. As a guiding rule, to attract such risk capital investments, enterprises need to indicate with evidence a profitable and attractive return over three to four years. Crowdcube essentially is an Internet service with some similarities to the network of business angels.

Business angels support business development by providing risk capital in the early years of a promising new business. Banks are aware of these networks and will make referrals where appropriate. Sometimes they act alone but more commonly business angels operate through a syndicate of business angel investors. Sums can be large and up to £1 million in an unquoted company. This is a high-risk form of investment and investors buy significant shares in the business that they are willing to hold for a number of years. They want to see clear proof of high level profitability and through their expertise business angels can assist in this goal by becoming actively involved in the business through board membership and/or an operational management role. Business angels also need to see a clear-cut exit route. The opportunity in successful cases is to sell their shares at a significant capital gain through bank or private equity refinancing, a merger or acquisition or when a company can secure a listing and their shares become tradable on the AIM or other stock market.

### **Community Economic Development and development banking**

On another front, Government has made some moves towards forms of development banking over the past four years. What might the opportunities here be? Prior to the banking collapse in September 2008 the view of mainstream economists was that the deregulation of markets was working exceptionally well in OECD countries. Ideas about development banking were regarded as inapplicable to countries in the EU and North America. Year by year since 2009 this view has steadily receded and there is now an open policy discussion about areas of market failure. This has now begun to move forward in a new direction with announcement by Vince Cable and George Osborne on 2 September 2012 of their plans

to set up a state bank for small businesses. Development banking for the UK is now firmly on the agenda.<sup>xxxvii</sup>

One of the earliest development banks was the Reconstruction Finance Corporation (RFC) set up in the US Depression in 1932. The problem faced then of lack of access by small businesses and farmers to investment and working capital from the banking sector was identical to the crisis of today. Compass and the Labour Party called for action in late 2011 to set up a national development bank. The RFC was wound up some years after World War II but other development banks in a handful of OECD countries highlight the potential.

For example, the German public bank, KfW was established after World War II to act as a development bank for reconstruction. It continues to operate today and has been playing a strategic role in the implementation of German's carbon reduction and green economy transformation. After Fukushima in 2011, the German government decided to phase out nuclear power completely. This decision has concentrated the national policy mind and investment action on energy conservation and renewable energy. Germany has been a global leader on forms of green energy since the 1990s and they pioneered the feed-in tariff. Over the past ten years KfW has been at the forefront of carbon reduction implementation both for small businesses and for households. How does the social financing work?

KfW plays a strategic lead role by providing very low-cost capital to the German retail banks for on lending. The German municipal savings banks and the co-operative banks cover the majority of this market. Loans at 2.65% are provided through this system to both homeowners and small businesses for retrofitting housing and commercial premises with tailored packages of energy conservation and renewable energy measures to achieve rigorous carbon reduction savings.<sup>xxxviii</sup> Borrowers are provided incentives to achieve the targeted savings by a bonus that reduces the capital sum advanced if the carbon reduction levels are met. KfW provided finance to provide green retrofit measures for 282,000 homes in 2011. This programme created and sustained 247,000 jobs last year. Capital that KfW provides for on lending is charged at about 1.5%.

A small number of CDFIs in England have developed housing retrofit work for homeowners. This work has been modelled on the work of Neighborhood Lending Services in Chicago. Leading CDFIs include London Rebuilding Society, Wessex Home Improvement Loans in the South West, Street UK in the West Midlands and the North West and Parity Trust in the South East. Bad debts have been marginal and the finance has been tailored to meet the financial circumstances of low-income homeowners.

Loans include interest only, interest roll-up for those over 70, equity share loans and normal repayment loans. Key to success has been a low-interest rate of between 3% and 5%. This has been achieved by recycling local authority grant funds as low-cost loans. The CDFIs have also piloted with the Energy Savings Trust 'green loans' for a mixture of energy savings and renewable energy measures. Although West Midlands Kick Start partnership for home improvement lending through Street UK has been discontinued, the Wessex Home Improvement Partnership among 19 local authorities in the South West is ongoing and developing new methods. In a handful of sub-regions of England, £100 million has been advanced thus far with marginal loan arrears and no bad debt problems.<sup>xxxix</sup>

The Government plans for a new development bank could replicate the success here of the German schemes. German success over many years now has shown that the cost of capital to SME and household borrowers needs to be kept low and rates in the region of 3% work well. The fully commercial plans for the Green Deal Lending Company at 7.5% are unaffordable to low-income households and the plan for a Green Deal for SMEs has been postponed.

The use of Funding for Lending capital at 0.25% and CDFI proven methods would work exceptionally well for providing financially inclusive solutions to tackle fuel poverty, reduce carbon and lower the costs of energy services for small businesses.

In summary there are several key lessons to be drawn for how access to finance can be opened up with community economic development methodologies and supportive change in national policy. This review indicates that key action areas include:

- (i) the introduction of a Community Reinvestment Act for the UK that enables transparency to be created to reveal where banks are lending or not lending locally right down to the neighbourhood level.
- (ii) the development of a Community Investment Coalition so that CDFIs, credit unions and social banks in the UK can speak with one voice to Government and jointly advocate for policy changes to tackle underinvestment in local areas and offer creative solutions for tackling these issues in partnership with local authorities, Chambers of Commerce, small business trade bodies, banks, building societies and other stakeholders.
- (iii) The introduction of development banking methods like those proven by KfW to reduce the cost of capital and to provide more effective guarantees for widening access to finance and for developing strong, sustainable and inclusive local economies.

---

## References

- <sup>i</sup> John Stuart Mill (1844) *Essays on some unsettled questions in Political Economy* as quoted in Jane Jacobs (1986) *Cities and the Wealth of Nations – Principles of Economic Life*, Pelican Books.
- <sup>ii</sup> <http://www.telegraph.co.uk/finance/yourbusiness/9443389/80bn-lending-scheme-attacked-as-subsidy-for-the-banks.html>
- <sup>iii</sup> [http://www.hm-treasury.gov.uk/graham\\_review\\_loan\\_guarantee.htm](http://www.hm-treasury.gov.uk/graham_review_loan_guarantee.htm)
- <sup>iv</sup> <http://www.cdfa.org.uk/policy/enterprise-finance-guarantee/>
- <sup>v</sup> Nils Pratley '£20bn cheap credit on offer for SMEs – but don't all rush at once', *The Guardian*, 29 November 2011.
- <sup>vi</sup> BBC News Business 'Bank lending scheme targets smaller businesses, 20 March 2012.
- <sup>vii</sup> <http://ftalphaville.ft.com/blog/2012/06/19/1049761/the-strange-case-of-funding-for-lending-confusi>
- <sup>viii</sup> <http://www.hm-treasury.gov.uk/nlgs.htm>
- <sup>ix</sup> <http://www.lloydstsbbusiness.com/finance/nationalloan guaranteesscheme.asp>
- <sup>x</sup> [http://www.hm-treasury.gov.uk/press\\_69\\_12.htm](http://www.hm-treasury.gov.uk/press_69_12.htm)
- <sup>xi</sup> Center for Responsible Credit (2012) 'Responding to the financial crisis in our communities: What we need our banks to do now.' CfRC, London.
- <sup>xii</sup> For examples and case study materials showing the similar but different methods, see Mike Lewis and Pat Conaty (2012) *The Resilience Imperative – Co-operative Transitions to a Steady-state Economy*, New Society Publishers.
- <sup>xiii</sup> Federation of Small Business (2012) 'Voice of Small Business Index' published quarterly.
- <sup>xiv</sup> Pat Conaty, Rosemary Foggitt, Rumbi Tarusenga, Steve Bendle and Mick Brown (2008) *Self-help and Mutual Aid – Re-thinking Microfinance*, new economics foundation
- <sup>xv</sup> <http://www.bbc.co.uk/news/business-15747103>
- <sup>xvi</sup> Conaty, et al, op.cit.
- <sup>xvii</sup> <http://www.bis.gov.uk/assets/biscore/enterprise/docs/s/10-1375-smes-access-to-finance-faqs.pdf>
- <sup>xviii</sup> [http://www.huffingtonpost.com/2009/12/30/move-your-money-tell-us-a\\_n\\_407297.html](http://www.huffingtonpost.com/2009/12/30/move-your-money-tell-us-a_n_407297.html)
- <sup>xix</sup> Aston Reinvestment Trust (2012) *Annual Report 2012*.
- <sup>xx</sup> Community Development Finance Association (2012) *Trends in Lending*, July 2012.
- <sup>xxi</sup> Community Development Finance Association (2012) *Inside Community Finance – Annual Survey of CDFIs in the UK*.
- <sup>xxii</sup> Manos Schizas 'National Loan Guarantee Scheme: An impact assessment Q&A, The ACCA BLOG, 29 March 2012.
- <sup>xxiii</sup> Community Development Finance Association (2012) *Just Finance – Capitalising Communities, Strengthening Local Economies: a New Vision for Community Finance*.
- <sup>xxiv</sup> <http://www.itv.com/news/2012-08-01/80-billion-up-for-grabs-but-how-will-funding-for-lending-make-much-difference/>
- <sup>xxv</sup> <http://www.cdfa.org.uk/2012/07/20/as-banks-lending-collapses-unsung-heroes/>
- <sup>xxvi</sup> BERR (2007) *Annual Survey of Small Businesses UK 2005-2007*.
- <sup>xxvii</sup> Community Development Finance Association (2012) *Just Finance*.

- 
- <sup>xxviii</sup> <http://news.bis.gov.uk/Press-Releases/-60m-small-business-scheme-launched-through-Regional-Growth-Fund-6811e.aspx>
- <sup>xxix</sup> <http://www.bbc.co.uk/news/business-17602323>
- <sup>xxx</sup> Patrick Collinson 'Ethical investment', Money Saturday Guardian, 13 October 2012.
- <sup>xxxi</sup> [http://www.princes-trust.org.uk/about the trust/what we do/programmes/enterprise programme/start up loans.aspx](http://www.princes-trust.org.uk/about_the_trust/what_we_do/programmes/enterprise_programme/start_up_loans.aspx)
- <sup>xxxii</sup> Jill Treanor 'Discreet UK invasion of the Capt Mainwaring-style bank', The Guardian, 15 September 2012.
- <sup>xxxiii</sup> <http://uk.zopa.com/>
- <sup>xxxiv</sup> <http://www.telegraph.co.uk/finance/yourbusiness/8466335/Funding-Circle-expands-its-small-business-lending-reach.html>
- <sup>xxxv</sup> Rebecca O'Connor 'Is there any hope for small businesses?' Moneywise, 17 May 2012.
- <sup>xxxvi</sup> <http://www.telegraph.co.uk/finance/yourbusiness/8815294/Tycoons-back-online-marketplace-offering-funding-to-small-businesses.html>
- <sup>xxxvii</sup> George Parker 'Osborne plans state bank for small businesses', Financial Times, 2 September 2012.
- <sup>xxxviii</sup> Gudrun Gumb (2012) 'Financing Energy Efficiency in Buildings – the German Experience', KfW paper presented at the International Workshop on Financing Energy Efficiency in Buildings, Frankfurt, 16-17 February 2012.
- <sup>xxxix</sup> Pat Conaty (2012) *Community Development Finance and Home Improvement Partnerships – a Social Co-operative Delivery System*, forthcoming report for HACT Fit for Living Task Force on a new model for home improvement delivery for low-income homeowners.