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Helping SMEs Access Finance: The importance of responsible finance providers

Briefing note: January 2017

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Small and medium-sized enterprises' (SMEs) access to finance took a dramatic hit during the financial crisis and subsequent recession. The small business lending environment has improved since then, however. The rate of decline in the stock of SME lending slowed from 2012 onwards,[1] evolving into positive annual growth from 2015. It achieved 2.1 per cent in September 2016.[2] In fact, 2015 saw growth in a variety of types of finance for SMEs, including flows of both equity and debt finance, asset finance volumes and new equity deals.[3] Between 2015 and 2016, 81 per cent of all SMEs that applied for a loan or overdraft were successful, increasing from 69 per cent between 2011 and 2012.[4]

In addition, a lower proportion SMEs view access to finance as a barrier to running their business, declining from 11 per cent of SMEs in 2012 to 5 per cent in the first two quarters of 2016.[5] In a list of potential barriers, access to finance was ranked sixth in importance by SMEs respondents, behind the economic climate, regulation and political uncertainty. It was ranked fourth in 2012.[6] Access to finance has clearly become less of an issue for SMEs.

However, many small businesses applying for finance are still being rejected. According to survey evidence, almost 100,000 SMEs and approximately £4 billion worth of applications for debt are rejected each year.[7] There is clearly a funding gap (the difference between the funding required by SMEs and the funding available). In 2013 the National Audit Office suggested that there was a funding gap of between £10 billion and £11 billion.[8] According to the British Bankers' Association, estimates of the gap range from a few hundred million to over £30 billion.[9] Finding an exact value for the gap is very problematic because it is difficult

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[1] Department for Business, Innovation and Skills, *Written Evidence from the Department for Business, Innovation and Skills*, 12 February 2016, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-innovation-and-skills-committee/access-to-finance/written/29245.html.
[2] Bank of England, 'Bankstats (Monetary and Financial Statistics)', September 2016, http://www.bankofengland.co.uk/statistics/Pages/bankstats/2016/sep.aspx
[3] British Business Bank, *Small Business Finance markets 2015/16,* 2016, p.12, http://british-business-bank.co.uk/wp-content/uploads/2016/02/british-business-bank-small-business-finance-markets-report-2015-16.pdf.
[4] BDRC Continental, *SME Finance Monitor, Q2 2016*, September 2016, p. 134, http://bdrc-continental.com/products/sme-finance-monitor/.
[5] Ibid, p. 253.
[6] Ibid, p. 253.
[7] Ibid, p. 16.
[8] National Audit Office, *Improving Access to Finance for Small and Medium-sized Enterprises,* 1 November 2013, p. 7, https://www.nao.org.uk/wp-content/uploads/2013/10/10274-001-SMEs-access-to-finance.pdf.
[9] British Bankers' Association, 11 February 2016, p. 7.

to measure some of its aspects, including discouraged demand for finance amongst SMEs. However, the evidence overwhelmingly points to the existence of a large funding gap.

There are three types of SMEs that have found it particularly difficult to access the finance they desire: very small businesses, those with a worse than average risk rating and start-ups[10]. For example, 66 per cent of businesses with zero employees, 52 per cent of those with a worse than average risk rating, and 45 per cent of start-ups were successful in their loan application between 2015 and 2016. This differs drastically with the number of large SMEs (97%), those with a minimal risk rating (98%), and those seeking a renewal (100%) that were successful.[11] Overdraft applications follow the same pattern.[12]

According to the British Business Bank, a fair proportion of SMEs that do not obtain external finance are actually viable businesses, turned down due to failures in the access to finance market. A variety of market failures exist, but one is especially poignant. SMEs, especially riskier SMEs that are usually small and young, are less likely than bigger businesses to have the information required by lenders to make an informed investment decision, including a lack of credit history or trading record. This lack of information makes it difficult and costly for the lender to assess the SME and subsequently extend finance, even if the SME is a viable business. It can also lead lenders to ask for large levels of collateral that the SME simply does not have. As a result, the lender's funds are usually driven towards larger and less risky firms that are easier to asses and away from viable SMEs.

Since the financial crisis, banks have become particularly risk averse. Riskier but viable SMEs have therefore found it particularly difficult to attain finance from banks. It does not help that SMEs are overly dependent on bank finance. Between 2010 and 2015, bank lending accounted for approximately two-thirds of the post-crisis increase in gross funding to SMEs.[13] In 2015, 29 per cent of SMEs used a bank overdraft, bank loan and/or credit card, overshadowing any other type of finance, including non-bank loans (6 per cent) and equity finance (2 per cent).[14] The lack of alternative finance options mixed with the risk-averse nature of banks has made it difficult for some types of viable SME, especially small start-ups and those with an inadequate credit history, to get the finance they need.

This is a huge problem because SMEs are vital to the UK economy, making up 99.9 per cent of all private sector businesses, 60 per cent of private sector employment and 47 per cent of private sector turnover. The types of SMEs being rejected make up a significant proportion of the SME sector: 49 per cent of SMEs have a worse than average credit rating[15] and 96 per cent of businesses in the UK are small, employing between zero and nine people.[16] Their lack of finance is resulting in lost output, employment and economic growth.

The funding gap needs to plugged. This cannot be achieved by bank lending alone. Requiring banks to extend finance to the risky SMEs would not be sensible, and the variety

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[10] Businesses under two years of age.
[11] BDRC Continental, September 2016, p. 162. Data regarding start-ups is on p. 166.
[12] Ibid, 145.
[13] British Bankers' Association, *Written Evidence from the British Bankers' Association,* 11 February 2016, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-innovation-and-skills-committee/access-to-finance/written/28852.html.
[14] BDRC Continental, September 2016, p. 58.
[15] BDRC Continental, September 2016, p. 36.
[16] C. Rhodes, *Business Statistics,* House of Commons Library Research Paper, Number 06152, 23 November 2016, p. 3, http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06152.

of products required by the smallest SMEs could not be delivered efficiently by one type of provider. According to the Federation for Small Businesses, 'banks cannot be expected to design and provide products and services to meet the needs of all types of smaller businesses.'[17] Instead, other finance providers are required to help plug the funding gap. Responsible finance providers (RFPs) are one such provider.

Responsible finance providers

There are 34 RFPs across the UK that lend and offer services to SMEs[18] and microenterprises[19] who struggle to get finance from the mainstream banking sector.[20] These businesses are deemed financially viable by the RFP but, for one reason or another, can't gain external finance. Most RFPs therefore require proof that an applicant has been turned down by a bank, building society or loans company.

RFPs are social enterprises and profits made via their lending activity are recycled back into the market in the form of more loans whilst also attempting to cover the cost of operation. The nature of the RFPs' target market means that many loan applicants are hard to assess, especially small and young businesses, as they usually have either an inadequate credit or trading history. As a result, assessing the business is usually costly, and involves both pre- and post-application support.

Whilst lending is their core purpose, RFPs offer a variety of business support services. This is partly because many businesses targeted by RFPs are not investment ready. Some RFPs require these services be undertaken as part of a loan application, whilst others offer them at the customer's discretion. This support enhances the ability of a business to repay its loan. In addition, RFP loans and services enable an enterprise to demonstrate to future lenders a track record in borrowing and repayment. RFP loans therefore help enterprises attain mainstream bank finance in the future.

In 2014 business mentoring was the most common service offered with 50 per cent of all RFPs offering this service.[21] This can help firms that are not investment ready and need support with the preparation of proposals or business plans. In the same year, 20 per cent of RFPs offered money management services, almost 20 per cent let business space and approximately 10 per cent offered training.[22] These services usually increase the firm's likelihood of success, thereby improving portfolio performance.

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[17] Federation of Small Businesses, *Written Evidence from the Federation of Small Business,* 9 February 2016, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-innovation-and-skills-committee/access-to-finance/written/28592.html.

[18] Businesses with 10-250 employees.

[19] Businesses with 0-9 employees.

[20] RFPs also provide loans to individuals, homeowners and social enterprises. In 2015 there were a total of 50 RFPs that either lent to one of these four groups or a combination of all four. This review only looks at RFPs that lend to businesses, of which there are approximately 34.

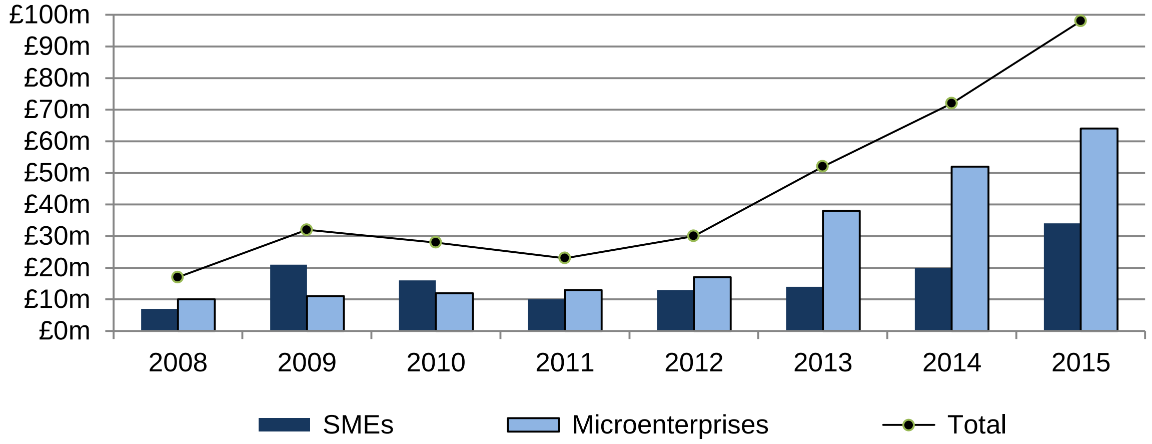
[21] PwC, *The Sustainability of the Community Development Finance Institutions: Final Report,* December 2015, p. 14, http://www.pwc.co.uk/assets/pdf/the-sustainability-of-community-development.pdf.

[22] Ibid, p.14.

Business lending activity

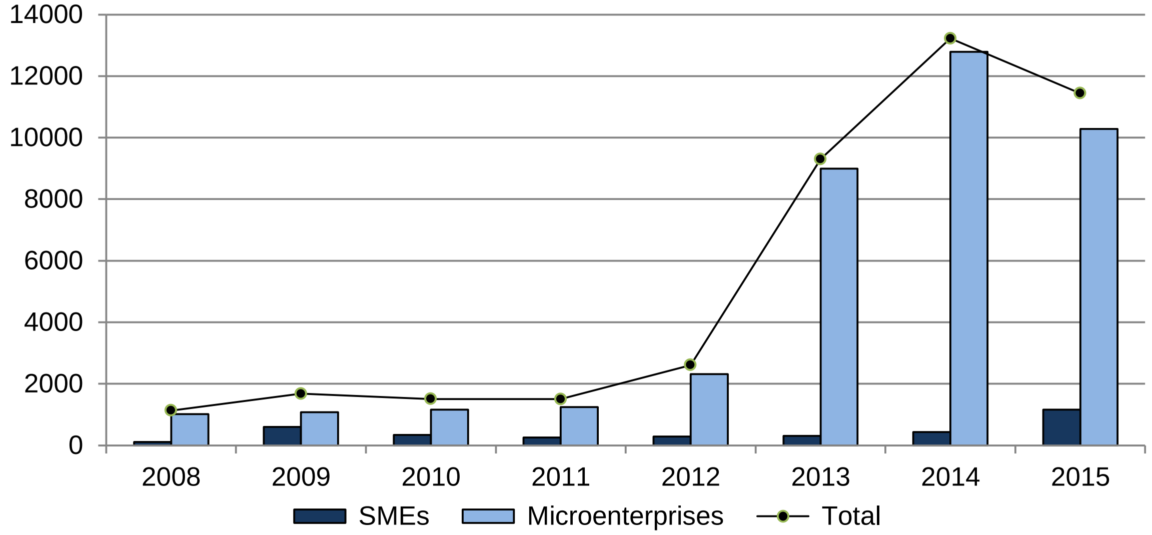
Between 1 April 2014 and 31 March 2015, RFPs lent £98 million to 11,440 businesses. According to Figures 1 and 2, the number and total value of loans disbursed has grown impressively. Between 2008 and 2015, the number of enterprise loans disbursed by RFPs increased ten-fold and the total value of loans increased six-fold.

Figure 1: Business loans disbursed by value in £ millions, 2008-2015



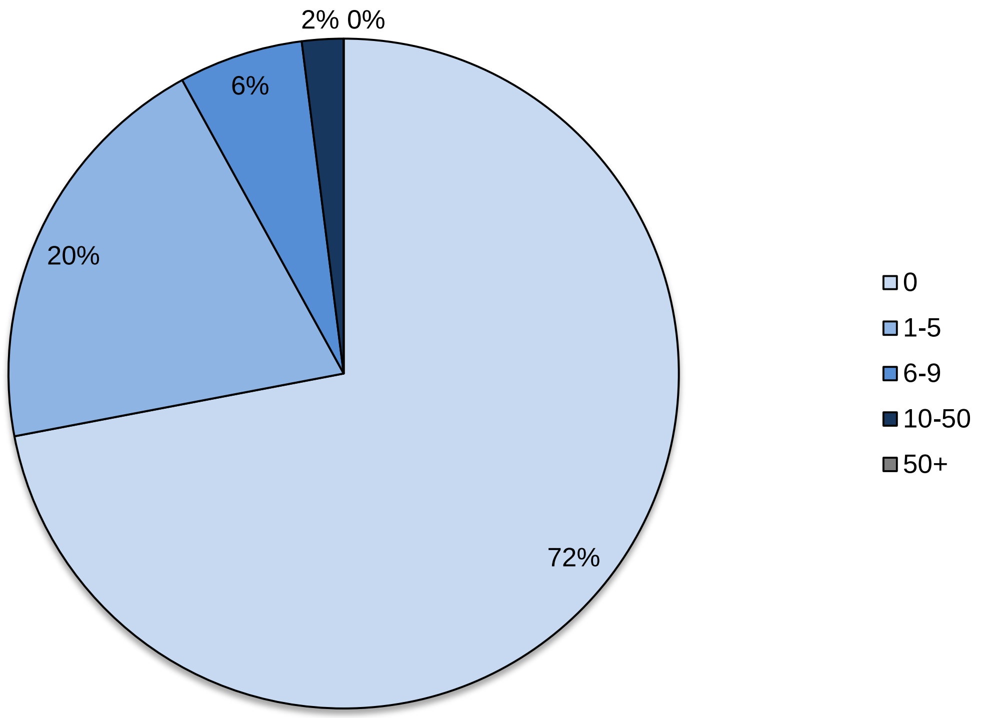
Source: Responsible Finance, *Responsible Finance: The Industry in 2015,* December 2015, p. 36. Responsible Finance, *Inside Community Finance 2013*, February 2014, p. 19.

Figure 2: Business loans disbursed by number, 2008-2015



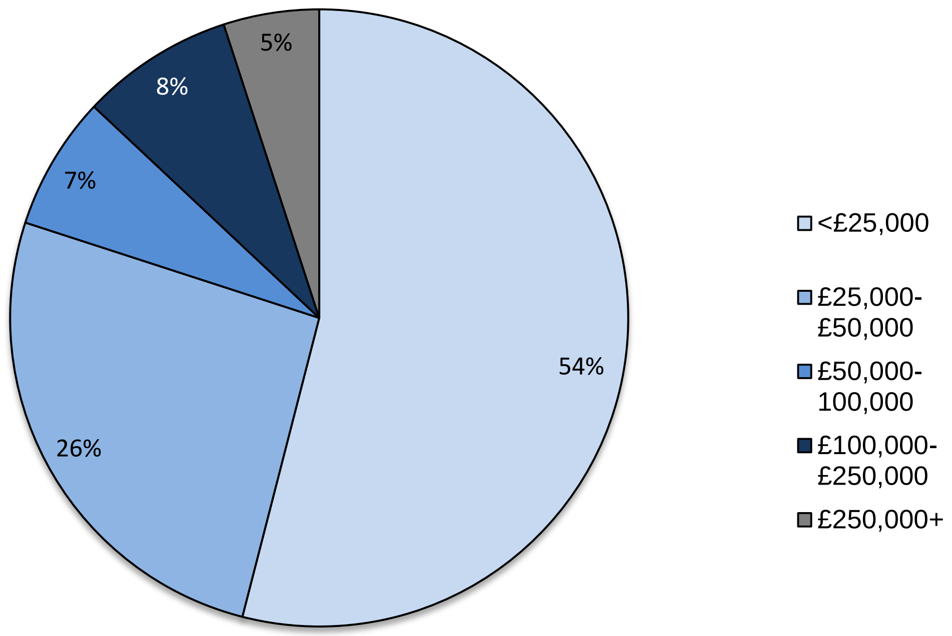
Source: Responsible Finance, *Responsible Finance: The Industry in 2015,* December 2015, p. 36. Responsible Finance, *Inside Community Finance 2013*, February 2014, p. 19.

Figure 3: Employment level of loan recipients, 2015



Source: PwC, *The Sustainability of the Community Development Finance Institutions: Final Report,* December 2015, p. 20

Figure 4: Turnover of loan recipients, 2015



Source: PwC, *The Sustainability of the Community Development Finance Institutions: Final Report,* December 2015, p. 20, http://www.pwc.co.uk/assets/pdf/the-sustainability-of-community-development.pdf

The two figures show that RFPs lend heavily to microenterprises. In 2015, RFPs lent £64 million to 10,280 microenterprises and £34 million to 1,160 SMEs. In addition, Figures 3 and 4 show that 98 per cent of businesses supported by RFPs have less than 10 employees and the majority have an annual turnover of less than £25,000.

In 2015, 87 per cent of businesses supported by RFPs were less than two years old.[23] Bearing in mind that only 20 per cent of SMEs in the UK were less than two years old in 2014,[24] RFP lending is heavily skewed towards young, start-up businesses.

RFPs also extend finance to businesses that have an inadequate credit history. In 2015 86 per cent of enterprises that gained finance had been turned down by a high street bank. According to Responsible Finance, the trade body for RFPs, these enterprises are usually turned down due to an adverse credit history, no trading record, being small in size or lacking adequate security.

Whilst RFPs lend to a variety of businesses, ranging from older well-established SMEs to small start-ups and sole traders, RFPs seem to focus their lending on the three types of businesses that are currently struggling to attain finance: microenterprises, start-ups and those with an inadequate credit history. RFPs are therefore well placed to help tackle the current funding gap that is hindering these kinds of businesses.

Breakdown of microenterprise support

The rise in lending shown in Figures 1 and 2 occurred during the aftermath of the financial crisis, especially from 2012. This was partly facilitated by a rise in public sector funding to expand RFPs' ability to extend finance to SMEs and microenterprises after the financial crisis. This was met in differing degrees by rises in capital from individual investors, the EU and the private sector (including banks). Much of the recent growth has occurred via many RFPs becoming partners in the government schemes such as the Start-Up Loans Scheme (SUL) and the Regional Growth Fund.[25]

As shown in Table 1, two government schemes accounted for a large proportion of RFP microenterprise lending in 2014, one being the Start-Up Loans Scheme and the other being the New Enterprise Allowance (NEA). 'Existing' corresponds to existing microenterprises that are receiving loans from sources other than the NEA and SUL.

Start-Up Loans are government-backed personal loans available to individuals looking to start or grow a business in the UK. They offer the ability to borrow between £500 and £25,000 with a fixed interest rate of 6 per cent per annum. Recipients receive free support in completing their business plan and are also offered up to 12 months of mentoring support. These loans are accessed through delivery partners, many of which are RFPs.

Since its inception, Start-Up Loans has lent almost £261 million to approximately 43,000 businesses. According to the British Business Bank, between 2012 and 2016 the SUL

[23] PwC, 2015, p. 12.
[24] BDRC Continental, September 2016.
[25] R. Roberts, *Banks, CDFIs and SME Funding,* 2015, p. 1.

helped create more than 45,100 jobs and for every £1 spent on providing the loans £3 has been returned to the economy overall.[26]

Table 1: Characteristics of microenterprise lending, 2014			
Type	Volume	Value	Average Loan Size
SUL	3,038	£17,200,000	£5,666
NEA	8,978	£10,600,000	£1,178
Existing	1,141	£26,200,000	£22,970
Total	**13,157**	**£54,000,000**	**£4,104**

Source: PwC, *The Sustainability of the Community Development Finance Institutions: Final Report,* December 2015, p. 16, http://www.pwc.co.uk/assets/pdf/the-sustainability-of-community-development.pdf

The NEA is a scheme designed to help unemployed people who want to start their own business. It is available to individuals aged 18 and over in Great Britain who are claiming Jobseeker's Allowance, Employment and Support Allowance or lone parents claiming Income Support.

Participants receive support from a business mentor who helps them create a business plan. If this plan is deemed successful, they can access financial support once they start their business and stop claiming benefit. This includes a weekly allowance of £65 a week for 13 weeks followed by £33 for the following 13 weeks, totalling £1,274 over 26 weeks. In addition, participants can get help with start-up costs by accessing a loan of up to £2,500 which is supplied by the SUL. Between April 2011 and December 2015, 80,830 people have started to claim the NEA weekly allowance having ended their claim for benefit and commenced training.[27]

According to Table 1, in 2014 NEA and SUL loans accounted for approximately half of all microenterprise loans and 38 per cent of total business loans. Government funding via schemes like the SUL and NEA clearly plays an important role in enabling RFPs to extend finance to underfinanced microenterprises looking to start or grow.

Portfolio performance

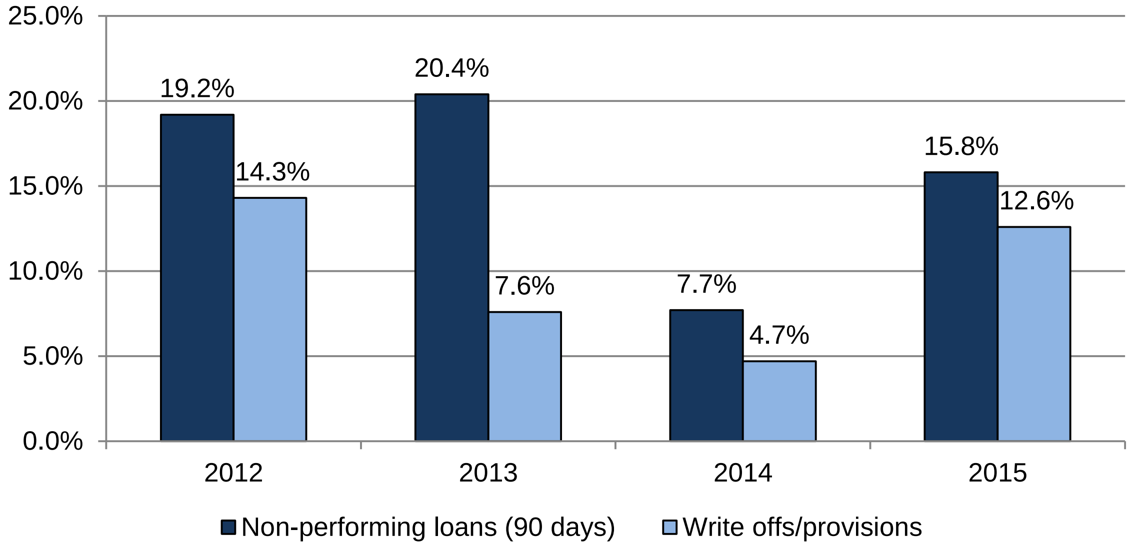
RFPs are targeting market segments that are underserved by mainstream lenders, especially small businesses, young businesses and those with a riskier credit profile. These markets are usually underserved because they are considered relatively high risk. Because these markets are riskier than those serviced by mainstream lenders, it is expected that annual write offs and portfolios in arrears will be higher.

In 2015 RFPs reported annual provisions and write offs of 12.6 per cent. In addition, 15.9 per cent of loans were in arrears for 90 days or more. Across the Responsible Finance sector

[26] The British Business Bank, 'British Business Bank-Supported Start Up Loans Reach £250M Milestone', http://british-business-bank.co.uk/7287-2/, 31 August 2016.
[27] A. Dar, *New Enterprise Allowance,* House of Commons Library Research Paper, Number 05878, 14 April 2016, p. 6, http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN05878.

levels of bad debt have increased on an aggregate level, but still represent a small proportion of total outstanding lending.

Figure 5: Portfolio performance, 2012-2015



Source: Responsible Finance, Responsible Finance: The Industry in 2015, December 2015, p. 40.

Whilst these figures are high compared to some commercial lenders, they are low compared to other organisations and schemes that provide finance to high-risk SMEs and microenterprises. The Enterprise Finance Guarantee scheme had a default rate of 28 per cent in its first three years of operation,[28] and 35 per cent of loans issued under the Start Up Loans scheme are either in default or have been written off by the British Business Bank since the scheme's inception in 2012.[29]

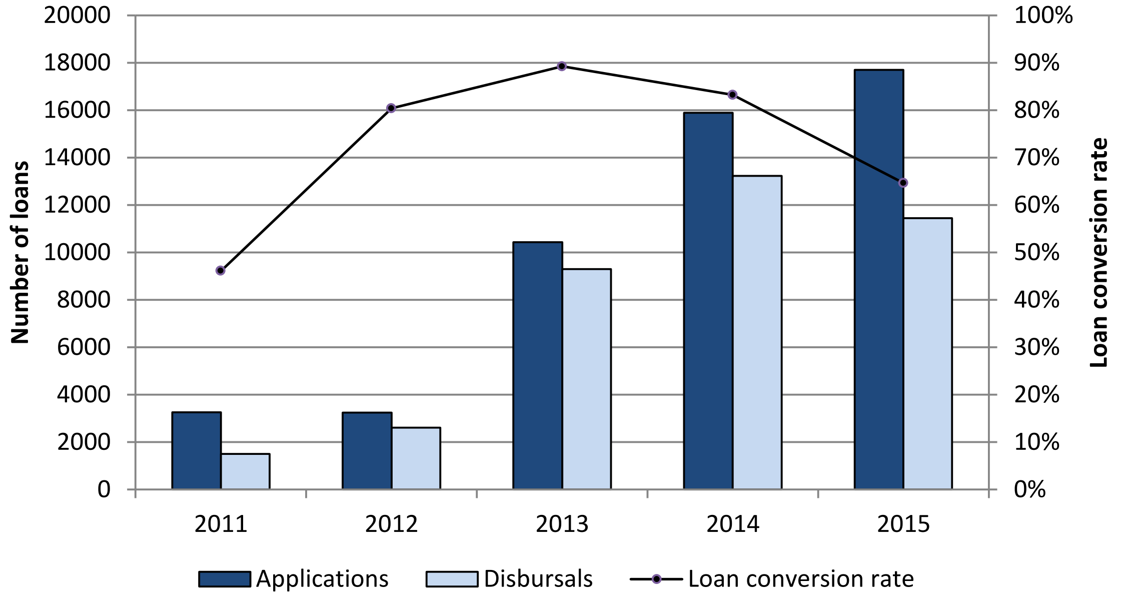
Whilst the average portfolio at risk (PAR) measure hovers between seven per cent and 20 per cent, this covers a wide range of RFPs that have had very different experiences. The level of losses appears to depend both on an RFP's fund size and the sources of funding. In 2014, the percentage of loans written off varied between 0 per cent and 100 per cent.[30]

Demand for RFP finance

Figures 6 and 7 below show a gradual increase in the number and total value of enterprise loans being applied for between 2012 and 2015. During this period the number of loan applications rose from 3,244 to 17,695 (Figure 6), and the total value of loan applications rose from £51 million to £165 million (Figure 7). This shows a rise in demand from businesses for RFP finance.

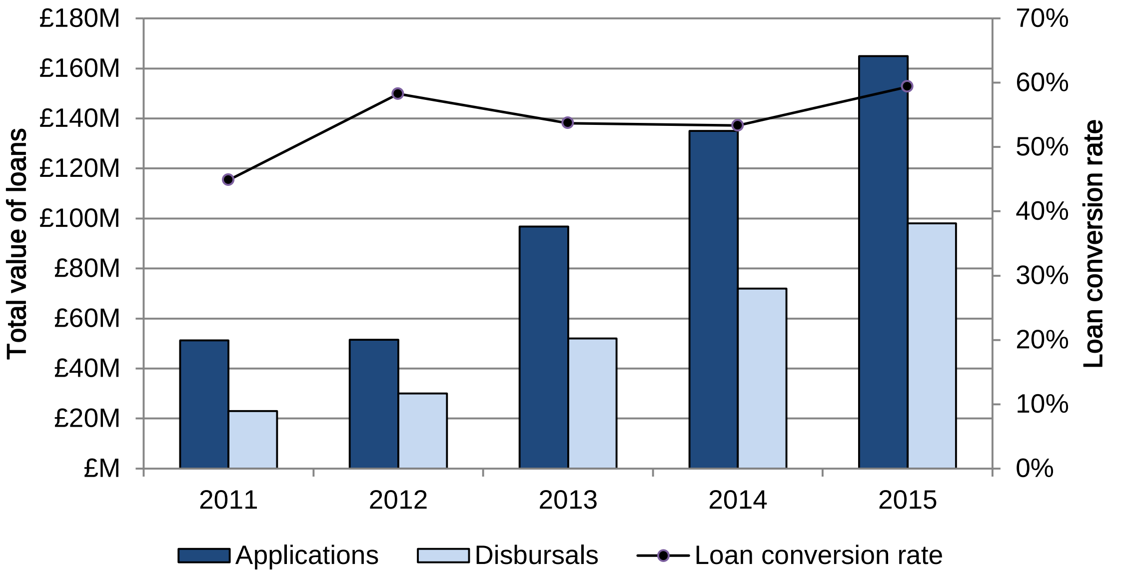
[28] https://www.ft.com/content/ee465a20-88f6-11e3-bb5f-00144feab7de
[29] AOL, 'Start Up Loans scheme sees almost third of money lent turn into bad debt' http://money.aol.co.uk/2016/09/06/start-up-loans-scheme-sees-almost-third-of-money-lent-turn-into-bad-debt/, 6 September 2016.
[30] PWC, 2015, p. 31.

Figure 6: Lending pipeline for enterprise in number of loans, 2011-2015



Source: Responsible Finance, 2016.

Figure 7: Lending pipeline for enterprise loans in value, 2011-2015



Source: Responsible Finance, 2016

In general access to finance is becoming less of a problem for SMEs. This is partly down to a decline in demand for external finance. The percentage of SMEs and microenterprises in the UK using external finance has declined from 44 per cent in 2012 to 34 per cent in 2016.[31] Between 2012 and 2015, the proportion of SMEs and microenterprises that classified

[31] BDRC Continental, September 2016, p. 52.

themselves as 'happy non-seekers of external finance' rose from 63 per cent to 76 per cent.[32]

However, the number of applications for RFP finance have grown rapidly during this period (Figure 6), and RFPs have managed to partially satisfy this rise in demand via increased lending. Between 2012 and 2015, the total value of loans disbursed rose from £30 million to £98 million (Figure 7). The growth of RFP lending has also outstripped other types of lenders, including banks. Between 2012 and 2015, RFP business lending increased by 227 per cent whilst gross bank lending increased by 53 per cent.[33] Demand for RFP finance was therefore growing impressively at a time when the proportion of SMEs and microenterprises in the UK seeking external finance was declining.[34]

Outcome

By offering capital and advice to businesses that cannot get it from elsewhere, value is created that would otherwise not have been possible. This is generated via the employment created by new and growing businesses, and the wealth and savings generated compared to high cost alternatives, such as high cost lenders for businesses. In the financial year 2014 to 2015, RFPs helped create 9,584 businesses and safeguarded 1,225. They also helped to create 14,433 new jobs and safeguarded 5,431. According to Responsible Finance, RFPs' business lending activity added £595 million to the UK economy during this period.[35] The wider economic benefits created by addressing market failure is the rationale for such large levels of public funding that we see in the following section.

Funding

Looking at the total number of providers, including those that lend to business, RFPs received £116 million in total capital funding in 2015, rising from £91 million in 2014.[36] This figure is the funding received by RFPs for all their services, including but not restricted to capital for on-lending.

Capital to on-lend

Because RFPs do not take deposits, they must raise capital for on-lending to sustain and grow their lending activities. This is raised via a mixture of loans, investments and grants. Capital raised for on-lending makes up the biggest proportion of RFP funds. In 2015 all RFPs, including but not restricted to those that lent to enterprise, secured £84 million in new funding, a 42 per cent increase over the £59 million raised in 2014.

This comes from eight primary sources shown in Table 2 below: central government, local government, commercial banks, trusts and foundations, housing associations, individual

[32] British Bankers' Association, 11 February 2016.
[33] Ibid.
[34] BDRC Continental, September 2016, P. 212.
[35] Responsible Finance, *Responsible Finance: The Industry in 2015,* December 2015, p. 17.
[36] Data for RFPs that lend to enterprise was not available so this section looks at all RFPs. This is still relevant because business lending RFPs make up approximately 68 per cent of RFPs.

investors, social investors and the EU (especially via the European Regional Development Fund).[37]

According to Table 2, a large proportion of RFP funding came from central government in 2015, reaching 48 per cent. This reliance has grown since 2012. Looking specifically at RFPs that lend to enterprise, in 2015 these RFPs raised £69 million in new capital to on-lend, a 30 per cent increase over the amount raised in 2014.[38] Most of this increase was from the Regional Growth Fund and the European Regional Development Fund, both public-private investment models, and the government Start-Up Loans Scheme.[39] It seems that central government funding, especially from the SUL and Regional Growth Fund, makes up a large proportion of the capital secured to on-lend by RFPs that lend to enterprise.

The rise in central government support was partly caused by the financial crisis and the subsequent recession. The severity of both created a short-term increase in the numbers of underfinanced SMEs that needed RFP assistance. This was met with a subsequent increase in public support and schemes, especially from 2012, and these schemes, such as Start-Up Loans and the New Enterprise Allowance, now make up a large proportion of RFP activity.

Table 2: Sources of funding for on-lending, 2011-2015

Source of Funding	2011	2012	2013	2014	2015
Central Government	18%	7%	26%	44%	48%
Banks	22%	10%	10%	20%	26%
Other (including individual investors)	10%	16%	20%	14%	2%
European Union	8%	38%	11%	13%	11%
Local Government	33%	24%	14%	7%	8%
Trusts/Foundations	10%	6%	1%	1%	<1%
Social Investors	0%	0%	11%	1%	4%
Housing Associations	0%	0%	7%	0%	<1%
Total Received in the year	**£28.3m**	**£15.8m**	**£42.3m**	**£59.4m**	**£83.8m**

Source: Responsible Finance, *Responsible Finance: The Industry in 2015,* December 2015, p. 40.

Bank support

Whilst a variety of private sector actors provided capital to on-lend in 2015, banks contributed the lion's share. Bank funding has risen to make up almost a quarter of the total capital sourced by all RFPs to on-lend. The UK banking industry has a long history of supporting the RFP sector. In the early to mid-1990s, support was usually linked to a bank's Corporate Social Responsibility. As a result, support usually took the form of subsidised loan support or grant aid to help set up many RFPs. The early to mid-2000s saw a move away from grant funding towards support services that sought to help develop the professionalism in the RFP sector. Bank staff were encouraged to work for a RFP and banks started to assist RFP staff training and professional development initiatives.

[37] PwC, 2015, p. 25.
[38] Responsible Finance, December 2015, p. 18.
[39] Responsible Finance, December 2015, p. 18.

Whilst many aspects of this kind of support continue, providing the bulk of activity between banks and RFPs, more commercial practices have risen in prominence between some banks and selected RFPs. In most cases, this kind of commercial activity is made possible via a type of tax relief or first loss guarantee/funding.[40] These lower the risk a bank faces when it lends to or invests in an RFP, especially because most RFP lending is unsecured, thereby making the activity more commercially viable for the bank.

Most tax reliefs are provided by the UK government. For example, the Community Investment Tax Relief (CITR) offers investors a tax relief when investing in RFPs. Investors receive a relief of 25 per cent of their total investment over five years or 5 per cent per annum. This makes RFPs a more profitable investment for investors. RFPs have secured over £100 million in new funding since 2002 via the CITR, primarily via bank loans.[41] This has facilitated more than £100 million of onward lending.

First loss guarantees are also predominantly provided via government schemes, such as the Regional Growth Fund or the Enterprise Finance Guarantee (EFG). However, EU-backed loan guarantees also exist. The EFG can be used as a wholesale guarantee, covering 15 per cent of a bank's investment into an RFP. This is a useful tool in minimising risk the bank faces when investing in an RFP that on-lends to riskier SMEs, thereby making the investment more attractive. In 2014 RFPs raised over £7.5 million using this scheme.

Tax reliefs and first loss guarantee schemes have been used concurrently by banks to increase commercial viability. In 2014, Lloyds Bank partnered with the European Investment Fund and the RFP GLE OneLondon to provide a £5 million loan fund which the RFP would on-lend to over 270 microbusinesses.[42] This fund uses both the CITR and an EU guarantee facility issued under the European Progress Microfinance initiative established by the European Union.

The Regional Growth Fund has been particularly adept at leveraging in funding from banks. Between 2012 and 2015, RFPs received £36 million from the Regional Growth Fund which leveraged in a further £36 million of commercial bank funding. In 2015 approximately 60 per cent of the commercial funding secured by the RFP sector is obtained by matching it with the Regional Growth Fund.[43]

Short-term funding

Last year PwC surveyed a variety of RFPs, the majority of which lent to business, to understand how short-term their funding was.[44] According to respondents, 57 per cent of the capital funding streams the sector received in the financial year 2015 are due to run out by the end of 2017. This includes funding from the Regional Growth Fund, European Regional Development Fund and Local Enterprise Partnership loan funds.

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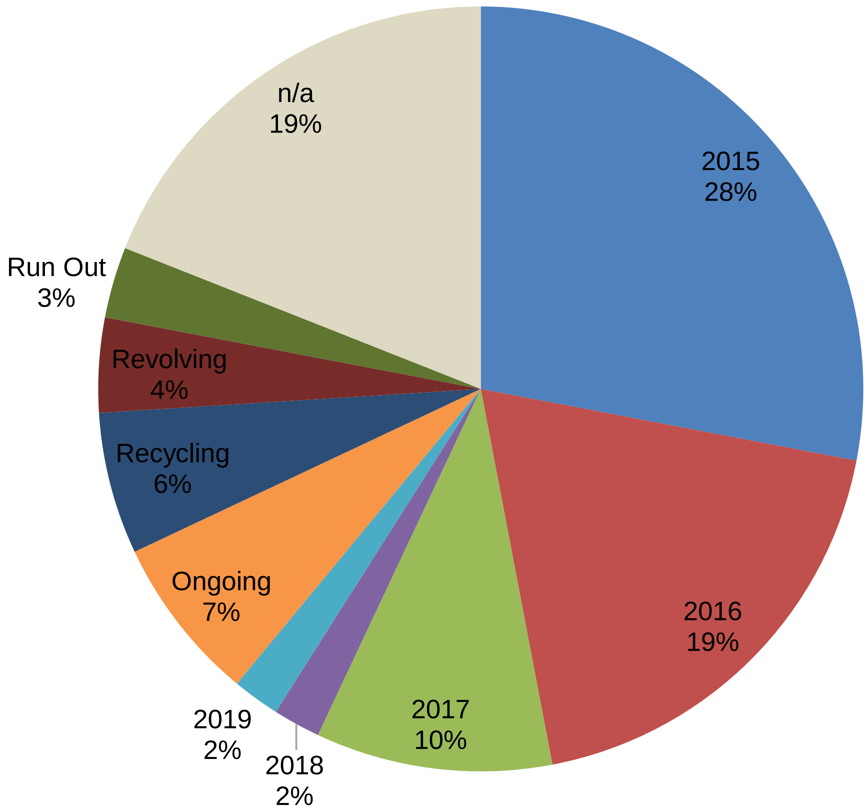
[40] R. Roberts, 2015, p. 19.
[41] Responsible Finance, 2015, p. 26.
[42] GLE OneLondon, 'GLE OneLondon teams up with Lloyds Bank and the European Investment Fund (EIF) to lend £5m to London SMEs', http://www.gleonelondon.co.uk/news-article.php?id=117, 30 April 2014.
[43] PwC, 2015, p. 3.
[44] Ibid, p. 26.

How much of this funding will be replaced is uncertain. However, it is highly likely that grant aid from central and local government will not remain at such high levels. In 2014 three government schemes accounted for £58 million of grant funding (the Regional Growth Fund, Start-Up Loans and the New Enterprise Allowance).[45] One of these, the Regional Growth Fund, will not supply further rounds of funding to RFPs. Also, many government schemes that are linked to RFPs were created during the recession to stimulate the economy by assisting SMEs and microenterprises. As the UK economy has moved from recession to recovery and subsequent growth, the next phase of RFP funding seems uncertain.

Because government funding accounts for a high proportion of total RFP funding, any significant drop in it will have large ramifications for RFPs' entire funding structure. According to PwC, a 50 per cent drop in central government funding in 2014 would have caused a 38 per cent drop in total funding to the sector, declining from £91 million to £56 million.[46]

Figure 8: Run out rates of 68 capital funding streams received in FY 2015



Source: PwC, *The Sustainability of the Community Development Finance Institutions: Final Report*, December 2015, p. 26, http://www.pwc.co.uk/assets/pdf/the-sustainability-of-community-development.pdf

This drop in funding would have caused some RFPs to close operations. Others, in an attempt to operate more sustainably and reduce risk, would most likely have lent fewer, larger loans to more secure businesses, thereby alienating many viable but riskier SMEs in need of finance, including smaller SMEs, start-ups and those with an inadequate credit

45 Ibid, p. 3.
46 PwC, 2015, p. 35.

history. On an aggregate level, the proportion of viable SMEs attaining RFP finance would have subsequently decreased.

Part of this drop would have been caused by a fall in private funding that had been matched with government funding. As we've already seen, some government schemes, such as the Regional Growth Fund, have been particularly adept at leveraging in private capital, especially from banks. Lower levels of government assistance and funding via schemes like the Regional Growth Fund will therefore have a double impact, directly lowering government grant funding and indirectly lowering funding from private sources.

Sources of income

The uncertainty of continued public sector funding has forced many RFPs to attempt to become more sustainable. The RFP sector uses two definitions of sustainability: operating sustainability and financial sustainability.[47] The former describes the extent to which an RFP can cover its operational costs, for example staff and overhead costs, via income generated through its core activities, including interest earned on loans and fees charged. Financial stability concerns the ability of an RFP to cover its operational costs and meet its capital requirements, primarily by replacing lending capital lost through bad debt, via earned income.

RFPs generate income in two ways, either through earned income or other income. The former includes what an RFP can generate via its own activities, including managing funds, lending, and providing business support services and mentoring. Other income is not generated from these activities and includes grants and donations, for example, from local government.

According to Figure 9 below, the majority of RFP income is earned income, accounting for 84 per cent of total income in 2015. Income from lending activities made up the largest portion of earned income in 2015, increasing to £19 million. It has also accounted for a growing proportion of earned income, rising from 45 per cent in 2011 to 50 per cent in 2015.

Data for the breakdown of other income does not exist for 2015, but it does for 2014. Shown in green in Figure 9, other income made up 17 per cent of total income in 2014. 42 per cent of this was from revenue grant funding to support RFPs with their operations, 19 percent was from capital grants to help RFPs raise capital, and 39 per cent was from other unlisted income, including donations.[48]

Whilst no expenditure data exists for 2014, in 2013 total RFP income was £34 million whilst total expenditure was £36 million.[49] However, £7 million of this income was not 'earned income' but was 'other income' – income predominantly from grants or other unlisted income, such as donations. £18 million of total expenditure was incurred via the provision of lending, including bad debts, and the rest was incurred via non-financial costs of operation,

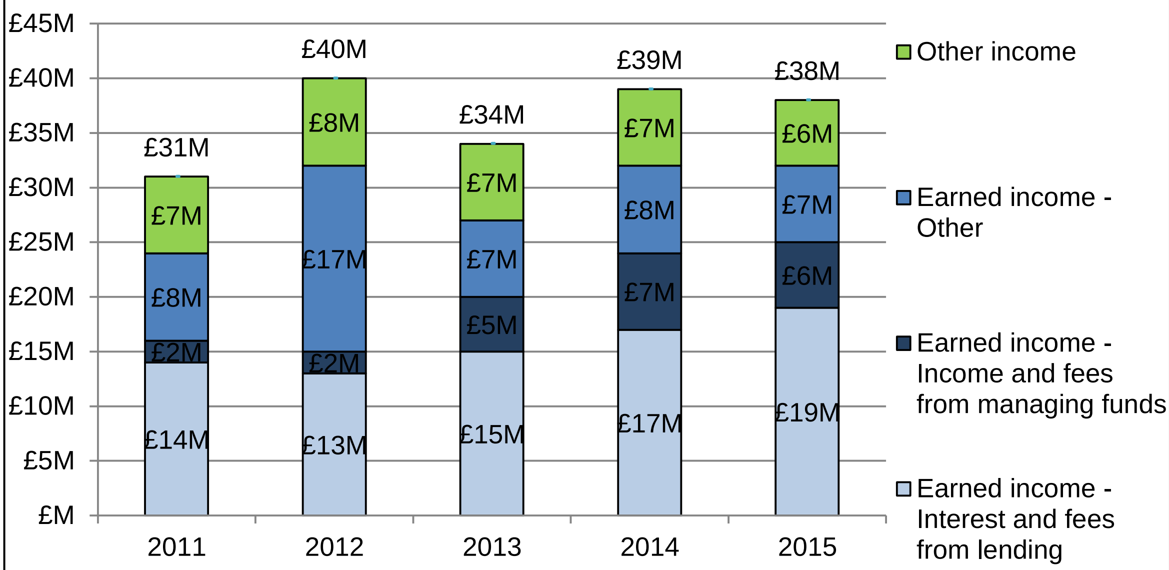
[47] GHK, *Evaluation of Community Finance Institutions (CDFIs): A report for the Cabinet Office and BIS*, 2010, p. 24.
[48] PwC, 2015, p. 24.
[49] Ibid, p. 2.

including staffing and utilities. These losses are generally absorbed by central government funding, grant funding, or funds drawn from other sources.

According to a PwC survey, most RFPs seem to typically operate at a loss. 50 per cent of surveyed RFPs said they could not cover their expenditure with the income they generated in 2015.[50] In 2015 Responsible Finance showed that 64 per cent of RFPs were able to cover their operating costs via earned income whilst 43 per cent could cover their financial costs, including bad debt and the cost of capital.[51]

According to a 2010 GHK report,[52] RFPs that lend to microenterprises are much less sustainable than those that lend to SMEs. Small RFPs that lent to microenterprises were on average 25 per cent operationally sustainable and 18 per cent financially sustainable, whilst small RFPs that lent to SMEs were on average 63 per cent operationally sustainable and 44 per cent financially sustainable.[53] The report concluded that considerable amounts of external funding would be required to cover the formers' operating and financial costs.

Figure 9: Earned and other income, 2011 - 2015



Source: Responsible Finance, *Responsible Finance: The Industry in 2015,* December 2015, p. 27.

This position is not sustainable, especially when it is based on uncertain and short-term funding streams. There must be a change in RFP's funding structure, with a move to secure, medium-term funding, if they are to continue satisfying the growing demand for finance from alienated SMEs and microenterprises.

50 Ibid, p. 25.
51 Responsible Finance, December 2015, p. 29.
52 GHK, 2010.
53 Ibid, p. 28.

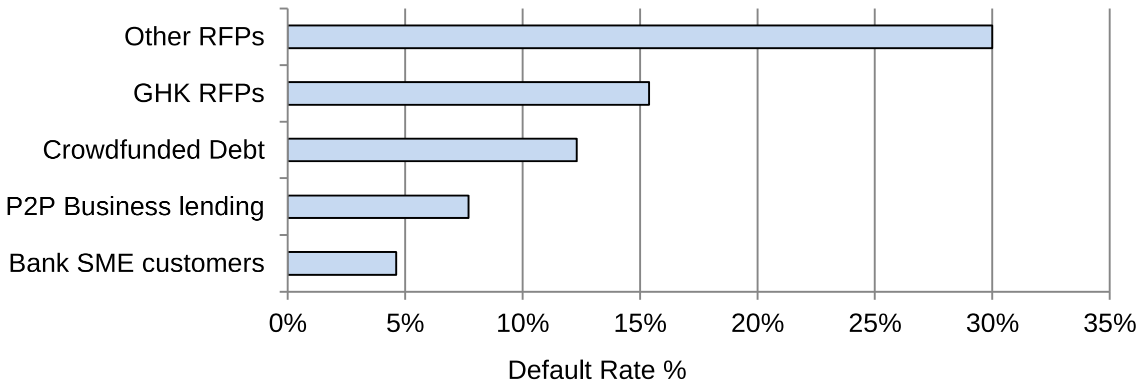
Sustainability

Between the mid-2000s and 2010, RFPs gained the bulk of their new funding for enterprise lending from RDA grants. After the closure of RDAs in 2010, it was recognized in a GHK report that RFPs needed to develop a source of sustainable funding.[54]

The report had many recommendations for RFPs to move to operational and financial sustainability. These included generating greater portfolio income, partly via higher rates of interest and minimal business support; facilitating larger loans; maximising income via loan fees, interest and reducing bad debt; and reducing the number of very small loans. The cost of delivering the latter and collecting interest and principal often exceeds the amount earned.

A small proportion of RFPs have managed to increase their sustainability via these recommendations, including reducing their levels of bad debt. The estimated portfolio default rates for these RFPs reached 15 per cent in 2015. As shown in Figure 10 below, this rate (labelled 'GHK RFPs') is closer to the rates of two alternative finance providers and even banks than the majority of RFPs (labelled 'Other RFPs'). In addition, these RFPs have a lower risk profile compared to 'Other RFPs', which makes them more attractive to private investors, and banks will favour these RFPs when looking for RFPs to build partnerships with. As a result, many of these RFPs have the ability to diversify their funding away from an over reliance on government grant funding.

Figure 10: Estimated portfolio default rates for selected business lending activities, 2015



Source: R. Roberts, *Banks, CDFIs and SME Funding,* 2015, p. 11.

Whilst GHK's recommendations have helped a small proportion of RFPs attain higher levels of sustainability, the sector has not been able to make significant steps toward a long-term sustainable funding environment or operational and financial sustainability.

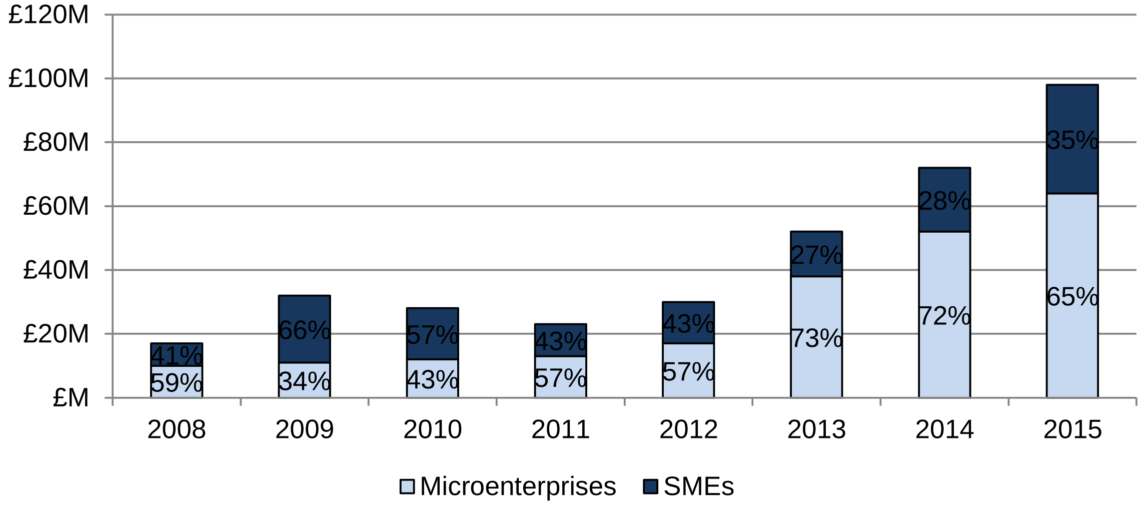
This is for a variety of reasons, but two are especially poignant. Firstly, many RFPs are very small in scale with out-dated delivery process and labour-intensive activities, thereby increasing the costs of operation. This is exacerbated by the costly nature of lending to risker SMEs, including comprehensive business services and support.

[54] GHK, 2010.

Secondly, there has been an increase in the amount of alternative finance providers (AFPs) offering finance to riskier entrepreneurs that cannot attain bank funding. For example, between 2012 and 2014 peer-to-peer business lending grew by approximately 250 per cent whilst the RFP sector grew by 55 per cent.[55] Whilst these AFPs usually lend to SMEs at the less risky end of the market, there is evidence of client overlap. For example, in 2014 33 per cent of enterprises that used peer-to-peer business lending believed they would not get funds elsewhere.[56] The increase in competition has made it more difficult for many RFPs to follow the suggestions in the GHK Report, including lending larger loans, maximising income via loan fees and interest, and reducing the amount of bad debt and small loans. This is because the kinds of loans that would satisfy these criteria are generally sort by less risky SMEs that fit within the lending criteria of many AFPs. RFPs are therefore having to compete with a growing number of AFPs in extending finance to these less risky SMEs.

The GHK report accepts that there is a trade-off between sustainability and helping risker SMEs attain finance. For example, many of GHK's suggestions, including lower risk clients, larger loans, higher rates of interest and minimal business support, are likely to reduce the ability of these RFPs to help viable yet risky businesses that are finding it the most difficult to acquire finance. This is because these kinds of businesses, which are usually small start-ups with an inadequate track record or credit history, usually require facilities at odds with the suggestions in the report. For example, they require high levels of business support, won't be able to afford higher rates of interest and will usually ask for smaller loans.

Figure 11: Total business loans disbursed by value and broken down by allocation to SMEs and microenterprises in %, 2008-2015



Source: My own calculations based on Responsible Finance, *Responsible Finance: The Industry in 2015,* December 2015, p. 36. Responsible Finance, *Inside Community Finance 2013*, February 2014, p. 19.

According to the GHK report, there is evidence of some RFPs becoming more risk averse, targeting less risky enterprises and moving out of the microenterprise sector in a bid to

[55] R. Roberts, 2015, p. 7.
[56] Nesta, *Understanding Alternative Finance,* November 2014, p. 28, https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf.

improve sustainability. According to Figure 6, more applicants are being turned down, increasing from 1,123 in 2013 to 6,255 in 2015. This could be partly explained by a rise in riskier applicants and a lack of capital to on-lend and fulfil demand. However, it could also be partly explained by RFPs lending more to larger SMEs, which are generally safer than microenterprises. Between 2013 and 2015, the average loan size did increase from £5,400 to £8,570, and Figure 11 above shows a higher proportion of lending going to SMEs in 2015. These measures are in line with the GHK report's suggestions and show a move, albeit a very small move, towards SME financing on a sector-wide level in 2015. However, RFPs are extremely diverse in their funding streams and clients. As a result, many RFPs still extend large proportions of their capital towards microenterprises.

It has therefore become clear that commercially funded growth via earned income, mainly through lower default rates, can make an RFP more sustainable. However, the push towards sustainability can hinder an RFP's ability to lend to the kinds of viable SMEs that are struggling for finance. Whilst increased sustainability is important, it should not be pursued to the point where RFPs find it difficult to lend to the most alienated of viable SMEs. Not lending to these kinds of businesses is resulting in lost employment and economic output. If RFPs are to continue lending to these kinds of SMEs, then some middle ground is needed where RFPs sacrifice some proportion of financial and/or operational sustainability to be able to extend this finance.

Where next?

In 2015 the Coalition Government decided that Responsible Finance would not receive further funding from the Regional Growth Fund to support enterprise lending. Such funding accounted for a large proportion of RFP finance, and its cancelation reignited the debate regarding the future funding of the RFP sector.

The British Business Bank subsequently announced a review analysing how to achieve sustainability in the RFP sector.[57] According to the review, published in December 2015, improved sustainability can be achieved via new sources of funding and operational improvements, including those that can increase efficiency.[58] These two goals are interlinked – improvements in operational efficiency are likely to attract new funding and vice versa.

The review asked many RFPs as well as current and potential funders of RFPs what kind of strategy could best improve the sustainability of the RFP sector. There was most interest in a sector-wide approach that could be implemented to improve future sustainability at both an operational level and to make RFPs more attractive to external funding sources.[59]

The question is: what kind of sector-wide approach can both create operational improvements and attract new sources of funding? According to the report, this approach needs to clarify both the level of future anticipated losses and the sources of support that might cover such losses. Funders stated that there is also a need for a first loss position adopted by another party to draw in their own and other suppliers of capital.[60] RFPs

[57] PwC, 2015.
[58] Ibid, p. 34.
[59] Ibid, p. 41.
[60] Ibid, pp. 41-45.

therefore need to engage with sources that can cover at least some losses and provide a first loss position.

It seems then that a sector-wide approach is required that encourages external funders to provide capital to RFPs. However, for this position to become tenable the issue of first loss would have to be resolved.

A new UK RFP Fund

The 2015 review briefly mentions a new fund for the sector but it does not develop a detailed proposal.[61] However, a national RFP Fund, funded by the government, could provide the medium term secure funding required by the RFP sector.

The UK RFP Fund will help RFPs replace potentially large losses of funding over the next few years via grants. All RFPs could apply for grants from the RFP Fund. Criteria could be set so that only those with the highest levels of operational efficiency would be successful. The ensuing competition between RFPs for grant financing could create higher levels of effectiveness, innovation and efficiency across much of the sector.

In addition, it could be stipulated that RFPs must on-lend a proportion of their grant to alienated enterprises, for example, SMEs that are small, young or have an inadequate credit score. Whilst many RFPs lend to these kinds of enterprises at the moment, such a stipulation would stop some RFPs moving their financing towards less risky enterprises in the future.

Such a fund could also leverage in private investment. Like the Regional Growth Fund, applicants would be made to match their grant with private capital. The specific ratio of private to public funding is open to debate. To offer some perspective, in round 6 of the Regional Growth Fund applicants had to demonstrate that they could deliver £1 of private sector funding for every £1 of public funding received. In addition, the Fund would cover a proportion of an RFP's losses incurred via loan defaults (the scale of this protection is up for debate). Offering this guarantee will decrease the risk for private investors, thereby increasing investment and subsequently the amount of capital that can be on-lent to viable small businesses.

A similar fund already exists in the US: The Community Development Financial Institutions Fund. This could provide some inspiration for the UK fund. The amount of public funding allocated is open for discussion. To offer some guidance, the US allocates £27 million a year to its CDFI Fund after being scaled in line with the UK population.[62]

Government assistance is valid because RFPs tackle market failure and create wider economic benefits (RFP lending added £595 million to the UK economy in 2015). Without government funding, the RFP sector would have to become sustainable through commercially funded growth via earned income, mainly through lower default rates. However, we have already seen that this hinders an RFP's ability to lend to the very kinds of

[61] Ibid, p. 34 and 39.
[62] R. Roberts, 2015, p. 15.

SMEs that are currently struggling for finance. Lending to these kinds of SMEs, which are usually at the risker end of the spectrum, can lead to higher default rates and lower levels of sustainability, and the UK RFP Fund may need to cover some of these losses. However, the wider economic benefits created by RFP lending seem to validate such government support.

Conclusion

Many viable SMEs and microenterprises cannot access funds from the mainstream banking sector, especially microenterprises, start-ups and those with an inadequate credit history, due to a variety of market failures. RFPs are playing a crucial, and growing, role in tackling these market failures, but their future existence depends upon finding new and secure sources of funding.

A new, publicly funded UK RFP Fund could help provide this new source of funding. This would not only offer a secure pot of grant funding for RFPs, but allow RFPs to leverage in private capital. It would also alleviate some of the pressures faced by RFPs to become operationally and financially sustainable through commercial means, for example, via lower default rates, which have curtailed some RFP's ability to lend to the very kinds of small businesses that are currently finding it difficult to access the finance they need to grow.

In outlining her ideas for a new industrial strategy, Theresa May stated her desire for an inclusive strategy that makes 'the economy work for everyone' and gets the whole economy firing. A new UK RFP Fund would help achieve both of these aims. It would help many alienated but viable businesses attain the finance they require to grow, resulting in more employment and economic output.

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