Building banking back better

The role of Community Development Finance Institutions

SMEs account for 99.9% of businesses in the UK and employ 60% of the workforce. The importance of the SME sector is growing as communities rely more heavily on their local businesses during COVID-19 and national chains cut jobs and reduce their high street presence. SMEs need the right support now so they can invest in growth and innovation to lead the UK's economic and employment recovery.

The issue

- Financial services in the UK is dominated by a few high-street banks. Due to commercial and regulatory constraints they cannot provide all SMEs with adequate funding.
- The reasons SMEs cannot access funding from banks and lenders who predominately operate using algorithms is because many SMEs do not fit within these lenders' policies. It does not mean the SME is not viable.
- Difficulties in accessing finance severely impacts SMEs' ability to invest and grow, hampering opportunities for local economic growth and job creation.
- After the 2008 financial crisis banks retreated from lending to SMEs; between 2008 and 2011 bank lending reduced by £151 billion. This may happen in the aftermath of the COVID-19 crisis.

Action in other countries

The United States has a thriving community finance sector. In 2018 there were over 1,000 certified CDFIs operating across all 50 states. The sector's growth is propelled by Government initiatives.

The Community Reinvestment Act (CRA) compels banks to provide community development, and rates them on their commitment to it. Banks comply with the CRA by engaging and investing in CDFIs, giving the sector access to long-term sustainable capital.

The US Department of The Treasury also administers a CDFI Fund to provide capital grants, equity and revenue grants for technical assistance and capacity building. It allocated $12 billion to CDFIs in December 2020 as part of its emergency stimulus funding package.

The solution: Community Development Finance Institutions

- The UK does not just need more banks; it needs an increased diversity of financial services providers.
- Community Development Finance Institutions (CDFIs) exist because they believe that communities can build wealth, create good jobs, and thrive if they can access finance.
- There are 50 CDFIs in the UK.
- They are not-for-profit lenders who lend to people, SMEs and social enterprises. They specialise in lending in areas of deprivation – including post-industrial and seaside communities - and traditionally excluded groups such as women and BAME entrepreneurs.
- CDFIs are pioneers; they turn a bank's 'no' into a 'yes' for businesses that would otherwise fail, and support them to thrive.
- They have been around for twenty years and have supported SMEs to weather many storms. Their relationship-based approach, delivered sustainably at an affordable cost, is unique. SMEs need this human touch, support and mentoring to steer them through rough seas in the coming years.
- They serve the function of the mainstream financial services sector by ensuring investment and opportunity reaches all corners of the UK, helping to level up left behind areas.
- They work in partnership with the Government and the British Business Bank to deliver funding programmes including the Northern Powerhouse Investment Fund and Start Up Loans Scheme.

CDFIs take a different view by understanding what lies behind an SME's...

Limited cash

If a business has limited capital on its balance sheet CDFIs can look past this. If its balance sheet is diluted by trading losses and it is trying to trade out of the situation to fund a growth in turnover to break even and eventually move into profit, a CDFI can take this into account and make a realistic assessment of the SMEs chance of success. Other lenders may not be able to do so.

Lumpy credit history

CDFIs look into the business's situation to uncover the reasons why it has County Court Judgements (CCJs) or delinquent debts. It uses this insight and qualitative analysis to determine whether the business has learnt from past problems and is on a stronger trajectory.

Sector

CDFIs do not have blanket policies not to lend to certain sectors. They take a business on its merits, regardless of the sector it falls into.

Low credit score

Banks use a score-based system to assess SMEs which essentially says 'yes', 'no', or 'maybe' (where further assessment is needed). These score systems are not perfect but they are effective at assessing the large volume of customer applications banks receive. Even though there will be cases that they lend to that default, and cases that are declined that would have repaid satisfactorily, the scoring system is effective overall at producing a limited level of exposure. CDFIs do not take this approach and are more flexible in their analysis.

Current account conduct

SMEs who are under financial pressure may have excesses over agreed credit facilities, dishonoured payments, or falling account turnover. This impacts the analysis undertaken by bank lenders, but CDFIs can take time to understand the reasons behind the financial pressure and make an informed decision based on the additional facts learned from talking to the business owners.

Constructive decline

Where a bank has advised an SME not to apply, or offered it a facility with conditions or covenants that the business is not able to meet, CDFIs can take a different view and make an offer with less strings attached.

By taking a different view CDFIs give SMEs a chance; in the past five years they have sustained and created over 86,000 jobs.

CDFIs and the COVID-19 pandemic

CDFIs lent a total £96 million to 900 SMEs across the UK through the Government's Coronavirus Business Interruption Loan Scheme (CBILS), enabling businesses to keep trading, innovate and pivot to survive the disruption. CDFIs continue to lend under the Government successor Recovery Loan Scheme.

CDFIs' personalised service and non-financial support builds the resilience and confidence of SMEs at this crucial time.

"They had a refreshingly different approach to the methods used typically by High Street banks. They gave consideration to exactly how we had been affected by the coronavirus crisis and focused on understanding our business and its potential. The loan provided by them will help us to navigate this extremely challenging period, and support innovation." – customer quote

What Does the Sector Need to Grow in the UK?

CDFIs cannot access the same funding that is open to banks. They have to raise capital elsewhere, often at high rates of interest.

This lack of long-term, low-cost capital has hampered the UK CDFI sector's growth ambitions, but it can be remedied.

By giving mainstream banks a duty to promote the economic health of the areas in which they take customer deposits, banks will be compelled to invest in CDFIs to fulfil this duty at the local level.

What can you do to help build banking back better?

A strong network of CDFIs already exists in the UK. To help it to reach scale - so the UK has a competitive, balanced, and purpose driven financial services sector - we ask that you support CDFIs by:

- **championing the sector;**
- **raising awareness of the need for sustainable capital.**

This will support the growth of community finance in the UK and help to build banking back better for a more resilient future.