

**Date:** 31 October 2002  
**Time:** 09:00 to 12:30  
**Venue:** Committee Room 1, National Assembly, Cardiff Bay  
**Title :** THE CREATION OF A COMMUNITY DEVELOPMENT FINANCIAL INSTITUTION FOR WALES – SECOND REPORT OF THE SOCIAL ECONOMY SUPPORT TASK & FINISH GROUP

## **Introduction**

1 On 28 November, the First Minister announced that a Task & Finish Group would be set up to consider whether setting up an Community Development Financial Institution (CDFI) to take advantage of the forthcoming Community Investment Tax Credit (CITC) could also have a role in providing business as well as financial support for enterprises in the social economy. The Group's full terms of reference and membership are set out in Annex 1.

2 The Group's approach to its terms of reference has been to consider the questions of:

- whether an all-Wales CDFI should be set up; and
- how the business support needs of social economy enterprises may be met; as two separate issues. The Group is therefore presenting two reports, of which this is the second. The first dealt with the need for research into the business support needs of social economy enterprises.

## **Summary**

3 This report recommends that:

- the Assembly Government takes a decision **in principle** to set up an all-Wales CDFI to take advantage of the future availability of CITC (pending the finalisation of the CITC scheme);
- the proposed CDFI should have responsibility for providing financial assistance to social economy and other SME enterprises both directly and indirectly, through other CDFIs that may be set up in Wales with local or other focuses, for which it should also function as a network facilitator in order to promote and disseminate best practice for CDFIs;
- the proposed CDFI should encourage the creation of local and other CDFIs in Wales and undertake market research into the potential size of the market for financial support in deprived areas and the potential of the investment market to supply tax-incentivised investments;
- the proposed CDFI should be located in Finance Wales, who will liaise closely with ICOF and other CDFIs active in Wales;
- there should be no presumption, pending the outcome of the proposed research, that the proposed CDFI should also be responsible for providing business support to social economy enterprises.

## Background

### Community Investment Tax Credit

4 The CITC is a tax incentive scheme at present being worked up by DTI, HM Treasury and Inland Revenue. It is a State Aid and is in the course of being cleared with DG Comp by the UK Government. In consequence, the final details of the scheme have not yet been fixed and the Group's recommendations can, at this stage, be no more than provisional, since it is possible that changes to the way the scheme works could impact on the relationships between the organisations concerned in Wales.

5 Draft clauses for the 2002 Finance Bill can be found at

[http://www.hm-treasury.gov.uk/mediastore/otherfiles/financebill02\\_draftclause.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/financebill02_draftclause.pdf).

A Treasury commentary on the proposed legislation can be found at

[http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/finance\\_bill\\_2002/consult\\_finance\\_02draftclause.cfm-draft](http://www.hm-treasury.gov.uk/consultations_and_legislation/finance_bill_2002/consult_finance_02draftclause.cfm-draft)

The general principle underlying the CITC scheme is that individuals or businesses investing in accredited CDFIs for a period of five years will obtain a certificate from the CDFI which they can use to reduce their tax bill by 5% of the amount of the investment per year. The aim of the scheme is to increase the volume of private sector funds supporting the regeneration of deprived areas in the UK. CDFIs can be sponsored by public sector organisations, such as the Assembly Government or Local Authorities, or by economic regeneration partnerships. They can be focused on geographical areas or on non-geographic communities, such as the disabled. Accreditation will be undertaken by the Small Business Service (SBS) and the Small Business Investment Taskforce (SBIT), advising the Secretary of State (for Trade and Industry). Assembly Government officials will be a part of the accreditation team in respect of CDFIs in Wales. The CITC scheme allows for the creation of both wholesale and retail CDFIs. The job of a wholesale CDFI would be to raise large sums through the CITC, thereby being able to negotiate better deals with investors, and pass the funds so raised on to local (retail) CDFIs, which would make the loans to SMEs in their areas of operation.

6 CDFIs will work under a number of constraints. They will be required to:

- invest the majority of the funds raised through CITC in defined deprived areas – in Wales, these areas are intended to be the 504 worst electoral divisions in the Welsh Index of Multiple Deprivation, covering approximately 60% of the population of Wales;
- ensure that 55% of the tax-incentivised funds are invested by way of loans in SMEs within one year of receiving them, and 75% within two years (there are informal signs that this constraint may be eased a little but no commitment to do so as yet); and
- apply for re-accreditation every three years – failure to meet either of the first two constraints will be justification for refusing re-accreditation.

7 These constraints give rise to some risks in sponsoring a CDFI. If the target of making investments within the required timescale is not met, the CDFI will fail to get re-accreditation; as a result, it is predictable that the investor would require the repayment of the investment, so that it could be re-invested with an accredited

CDFI. There are political and financial risks inherent in this situation. On the other hand, it is possible that, in order to meet the timescale constraint, a CDFI might make risky investments in SMEs and therefore lose money. When the five year period for the tax-induced investment is ended, the CDFI would be unable to repay the investment. This is a risk that the investor would have to bear. However, the credit rating of the CDFI would be bound to suffer and it may, as a result, be unable to continue in business. There are, however, ways of minimising and managing these risks.

8 While CITC funds may only be used to provide loans to SMEs, there are no further constraints on the type of SME supported. Many are likely to be firms operating in the social economy, but many mainstream firms will seek support. No sectoral restrictions (other than the usual State Aid restrictions such as shipbuilding) will be imposed and retailers and other firms providing local services may be expected to be very interested in the scheme, since these sectors are excluded from most other sources of public sector support on the grounds of displacement. However, the existence or development of local services is an important factor in the regeneration of deprived areas and some displacement is likely to be beneficial, particularly activity that is displaced from outside to inside the priority areas. Precisely what displacement is likely to be beneficial is best judged at local level, by people and institutions with roots in the locality.

9 Part of Treasury's agenda for this scheme is to use it to create more of a market for regeneration funds. At present, the major banks retain centrally the discretion to make investments of the type envisaged by the scheme. Treasury have been encouraged by the banks' reaction to hope that the CITC will influence the banks to devolve these decisions to local branches. Contributing to the formation of a market, the decision announced in the Chancellor's pre-Budget Report to remove the overall cap on the amount of tax credit available is likely to be a powerful incentive for the creation of a large number of new CDFIs, many with a local base.

### **Current and proposed CDFIs in Wales**

10 Few CDFIs are operating in Wales at present. These include:

- Finance Wales, and in particular its Community Loans Fund (CLF);
- ICOF; and
- The Pembrokeshire Lottery Fund.

11 The CLF is a joint venture between Finance Wales and HSBC. It is being funded by the Assembly Government through the WDA. Over the period 2001-02 to 2004-05, nearly £2 million has been allocated or planned for by the Assembly Government. This is being matched pound for pound by HSBC. CLF makes loans to social economy enterprises, mainly focused on Communities First areas. It has been found to be a good method of securing private sector leverage; a ratio of 6:1 leverage on CLF loans has been achieved.

12 ICOF is a UK wide organisation that exists to help more people take control of their economic lives by the provision of loan finance and business support - to

enable people to own and control the businesses in which they work or which operate in their own communities. It specialises in financing co-operatives.

13 The Pembrokeshire Lottery Fund was set up in the wake of the military closures in Pembrokeshire in the early 1990s. It is a mainly voluntary effort; the only public sector support, after some pump priming for publicity, is accommodation provided by the local authority. Individuals enter for a weekly lottery prize, generally paying by deduction from their earnings, and the profits are invested by providing loans to businesses in the area. An independent investment panel decides on whether to make the loan. The Fund is said to be successful in achieving minimal losses due to the local and community nature of the source of funds – only one loan, out of about 100, has had to be written off.

14 In recent weeks, the Group has heard that a new CDFI is being proposed for the Newport area by Newport and Gwent Enterprise. A bid for support under the element of the Phoenix Fund that offers guarantees to bank loans to CDFIs (the only UK wide element of the Fund) has been given approval in principle by SBS, subject to working up a detailed proposal.

15 It is likely that further local CDFIs will be formed. Some of them are likely to be more successful than others in attracting investments and making sustainable investments in the areas on which they are focused. Some of them may fail.

### **Managing risk**

16 There are two categories of risk that need to be considered;

- the potential failure of CDFIs, (this has been examined in paragraph 7); and
- the risk of displacing investment activity away from the mainstream market system.

17 It is possible that the banks' reported reaction to the advent of CDFI – moving decisions on investments from HQ to local branches – may simply be an attempt to claim the tax credit in respect of investments that they would have made anyway. To an extent, this is going to be allowed for in the scheme; there will be a method by which banks will be able to convert existing investments with CDFIs into CITC investments, assuming the CDFI concerned is accredited. Treasury clearly hope that the scheme will generate more investment funds for deprived areas however, and this possibility can be enhanced by the actions of CDFIs in managing their own investment policies in such a way as to avoid making investments that could be made through the market system. Whether or not CDFIs in the rest of the UK take this investment stance, the Group believes that CDFIs in Wales should.

18 There are a number of aspects to managing the risk of CDFI failure. A sound knowledge of the local market in which a CDFI is operating can be a factor which helps CDFIs avoid making investments that are not repaid (this is the experience in Pembrokeshire). Contributing to reducing the default rate will be the ability to offer loans at interest rates that the businesses themselves can afford to repay. An understanding of the market for the investment funds that CDFIs will be seeking, whether from banks or other sources, including individuals will help in

this, enabling CDFIs to get a better deal, which they can pass on to the businesses in which they invest. Economies of scale can help in this.

19 In addition, experience with Finance Wales suggests that giving the individuals who are managing the funds financial incentives related to the performance of those funds can be crucial in ensuring the quality of investment decisions and thus the funds' sustainability.

20 In order to ensure that the timescale targets for investing CITC funds are met, a managed approach to drawing down those funds will be crucial. However, investors may not want to place investments with CDFIs in dribs and drabs. Economies of scale can help in this area.

## **Options**

21 The CITC scheme contains powerful pulls in opposite directions. Local knowledge is a key factor for success in handling some aspects of the scheme; understanding the local market, the regeneration needs of the area, the relationship with banks' local branches. The need for local knowledge implies that locally based CDFIs are likely to be more successful than a national CDFI.

22 However, economies of scale, that could only be provided by a national CDFI, are also important factors for success. So too are strategic issues such as developing and disseminating good practice.

23 There are, therefore three broad options available to the Assembly Government:

- leaning towards the local pull;
- leaning towards the centralising pull; or
- reconciling the two.

## **Do nothing**

24 This is the option that leans towards the local pull. Local CDFIs will almost certainly be created whether or not the Assembly Government wishes it. This option delivers the advantages of local knowledge, both in deciding how much CITC-incentivised investment to raise and in deciding on which local investments to make. However, it will not deliver the benefits of economies of scale, or provide a means of developing and disseminating good practice. As a result, some local CDFIs will undoubtedly fail. It could give rise to confusion in the market. This option is also likely to result in only patchy coverage of the deprived areas the scheme is designed to help.

## **A central CDFI**

25 The centralising option would produce economies of scale and the benefits flowing from that. It could be based on the CLF, although Finance Wales would certainly seek to work in partnership with ICOF. However, it would lack local knowledge and thus be subject both to the risk of failure because of unsustainable default rates and to levels of displacement that would secure no increase in the

investments made in deprived areas. If it took too restrictive a view of the risk it could tolerate in making loans to businesses, it could also risk de-accreditation because it could fail to meet its financial targets under the scheme.

26 The existence of a CDFI planned to fulfil a central function would not prevent the formation of local CDFIs. Duplication and overlap, with the resulting confusion would be the almost inevitable results. Although Assembly Government officials will be involved in the CDFI accreditation process, this will be carried out against an agreed set of criteria and it would be wrong for this process to be used to impose a particular strategic direction.

### **Reconciling the two pulls**

27 The innate contradictions of the scheme can be reconciled by the creation of a wholesale CDFI, which would be able to get the best deal raising investment funds, and pass the benefits on to retail CDFIs, which would make the loans to SMEs. Its position in the chain would enable it:

- to drip feed funds to local CDFIs, thus ensuring that they did not fail to meet the financial target;
- to undertake market research into the potential size of the market for this type of financial support in the designated areas, and the potential of the investment market to supply tax incentivised funds to the required extent;
- to develop and disseminate best practice among CDFIs;
- to act temporarily in a retail capacity, covering areas in which local CDFIs had not yet developed, and withdrawing from these areas as new CDFIs came on stream;
- to encourage the development and spread of local and other CDFIs.

This option has the potential to realise both the local and central benefits of the scheme, and the Group **recommends the creation of a wholesale CDFI for Wales**. Annex 2 sets out a possible structure for the CDFI, based around Finance Wales. As presently envisaged, the scheme will limit the funds that a wholesale CDFI can raise through the scheme to £20 million over a three year period. In the light of the market research to be carried out, this may turn out to be insufficient for an all-Wales CDFI. In such a case, the structure proposed would enable the creation of more than one investment vehicle within the Finance Wales framework.

28 The proposed CDFI will be responsible for providing finance, either directly or through other CDFIs, to firms operating in both the social and the mainstream economies. Its role will relate directly to the financial matters affecting CDFIs or the firms in which they invest, and not to general business support issues. These issues are being addressed by the research proposal that is the subject of the Group's first report. The Group believes that providing business support and guidance to social economy enterprises should be the responsibility of organisations with specialist expertise in that field and recommends that there should be no automatic presumption that the proposed CDFI should have a role in providing business support to social economy enterprises.

### **Costs**

29 Since the CDFI would be raising funds from the private sector, there appears to be no need for the Assembly Government to provide it with funds for loan purposes. However, there would be initial one-off costs for setting up the new CDFI and for market research.

### **The way forward**

31 The scheme is still subject to State Aids clearance. The UK Government plans to include the necessary legislation in the Finance Bill, if necessary with a Commencement Order, the date of which will probably be determined by the outcome of the State Aids consideration. DTI's tentative timetable is to accept CDFIs' bids for accreditation during the summer, with a view to accreditation following about three to four months later. This timetable may slip, if there are difficulties in obtaining State Aids clearance, particularly if this meant significant changes in the scheme.

32 Although the scheme is not finalised, and points of detail may alter, the Group believes that there is scope for Ministers to take a decision in principle to take forward the recommendation. Such a decision would allow preliminary work to be carried out. This would ensure that, when the details of the scheme are finally settled, no time is lost by having to start from scratch at that time. At that stage, Ministers could consider whether the decision should be confirmed.

### **Social Economy Task & Finish Group**

April 2002

**Community Investment Authority / Community Development Financial Institution**

**Background**

The Liberal Democrat / Labour partnership agreement includes a pledge that the administration will create a Community Investment Authority.

Many of the original reasons for the creation of such an authority have been fulfilled, though the specific need to provide greater co-ordination and support to the Social Economy/ Community Enterprise sector, remains an issue which the administration is keen to explore.

The re-assessment of the need for a CIA coincides with the need for Wales to develop a vehicle through which social enterprises can benefit from the proposed Community Investment Tax Credit, probably through the formation of a Community Development Financial Institution.

**Terms of reference**

The First Minister has agreed to the formation of a task and finish group which could look at these issues. It will be necessary for the task and finish group to:

- Examine options for establishing a Community Development Financial Institution (including legal structure) in order to exploit Community Investment Tax Credits; and
- Explore the potential relationship between the proposed CDFI and with Finance Wales' Community Loan Fund;
- Consider existing mechanisms for supporting the growth and development of social enterprise and make recommendations for improving these
- To consider the most appropriate organisational arrangements for delivering support to the social economy and maintaining relationship between the proposed CDFI and the National Assembly

The Task and Finish Group will be expected to report to the First Minister with specific recommendations by February.

## Membership

Ian Hargreaves	Member of Social Investment Taskforce
Simon Gibson	Venture Capitalist, Member of WDA board
Ian Taylor	Industrial Common Ownership Fund
Simon Jones	Chief Executive of Wales Co-op Centre
Sue Price	Groundwork Trust
Meurig Royles	North Wales Economic Forum
Colin Mitten	Finance Wales
Mike Davies	Finance Wales
Norma Barry	Communities Directorate, National Assembly
Allan Moss	Economic Development Department, National Assembly
Nick Bennett	Special Adviser

**FINANCE WALES PLC**

**Community Development Financial Institution for Wales**

**Summary Proposal**

It is proposed that Finance Wales plc establish a Community Investment Vehicle (CIV), as a subsidiary company, which will act as the Community Development Financial Institution for Wales. The proposed model is the result of discussions between Finance Wales, the National Assembly for Wales, and the Assembly Task and Finish group. It aims to create a partnership approach that will deliver benefits to local communities.

Key elements are as follows:

- An initial injection of grant in aid is given to the CIV by the Assembly as a 'pump priming' activity and is non-recurring.
- The new vehicle will have an unpaid Advisory Panel with a rotating chair (starting in year 1 with Finance Wales). The panel will organise market research into the potential size of the market for this type of funding, attract investment, and determine staffing requirements. This panel will be composed of representatives from the social economy.
- The CIV will act as a wholesaler, obtaining economies of scale, and will be able to lend money to National and Local funds, which in turn will on-lend to SMEs in disadvantaged communities.
- The CIV will obtain economies of scale in raising finance and will be able to identify gaps in the provision of finance for community enterprises in Wales.
- The CIV will seek accreditation from the UK Small Business Service for CITC purposes.
- Finance Wales will assist with management resources.

Diagram



# Cyllid Cymru Finance Wales

## Community Development Financial Institution for Wales

### Proposed Structure

