Financing the Big Society

Why social investment matters

A CAF Venturesome working paper: September 2010

CAF Charities Aid Foundation

Charities Aid Foundation (CAF) offers a range of efficient giving, financing services and solutions for companies, individuals and charities that support and work in the non-profit sector. CAF believes that access to capital is vital for a healthy and thriving charitable sector. Over the years CAF has been instrumental in pioneering and incubating funding solutions; including CAF Venturesome, a high-risk investment fund, and Charity Bank, which became independent in 2002.

CAF Venturesome provides capital to charities, social enterprises and community groups, operating in the space between providers of charitable grants and providers of bank loans at market rates. Since its launch by CAF in 2002, £18 million has been offered to 250 organisations. Venturesome operates the pioneering Community Land Trust Fund, working with community groups to develop affordable housing in rural areas.

In addition to accumulating practical deal experience, Venturesome has endeavoured to have a central role in building a responsible social investment market, adopting an open-book approach to share knowledge and build experience, but also ready to operate in competition so as to raise standards.

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This working paper is a contribution to the discussion invited by the coalition government. The paper has been written by Paul Cheng, Emilie Goodall, Rob Hodgkinson and John Kingston, members of the executive team at CAF Venturesome.

Introduction

Over the past twenty years, civil society has moved from being fuelled solely by grants and goodwill to a more sophisticated funding ecology. There are a growing number of funders and investors, using a variety of financial products to support community groups, charities and social enterprises – referred to here as civil society organisations (CSOs).

In 2010, there is an emerging social investment market with a track record, a number of independent players and a body of expertise. The coalition is building on this and has big ambitions to grow civil society further in the UK, fuelled in part by social investment.

Social investment has a key role to play in each of the three fundamental issues identified by government:

1 Making it easier to run a charity, social enterprise or voluntary organisation

Funding is often cited as a major barrier to charities delivering on their mission. Providing access to capital, and choice in doing so, can free up organisations to focus on the things that matter, ie, delivering effective services to beneficiaries. Critical issues like strategic direction and impact too often take a back seat to the incessant drive to secure funds.

2 Getting more resources into the sector: strengthening its independence and resilience

Access to capital provides civil society organisations with greater flexibility, freedom and independence, providing financial room for manoeuvre.

3 Making it easier for sector organisations to work with the state

Contracting with local or central government often requires access to capital, to provide the freedom to engage in the tendering process and bridge between receipts of income.

The government has committed itself to the creation of a Big Society Bank, which will use unclaimed assets to leverage additional, private capital with which to capitalise retail social investors. We welcome this as a big step towards the shaping and expansion of this fragile space.

As well as development of infrastructure to support the sector, the critical task is to stimulate long-term private investment into the space from individuals, companies and charitable foundations alike. By channelling this investment through retail funds, civil society organisations will be provided with the access to capital needed to deliver tangible social impact.

Social investment can play a central role in transforming the UK into a Big Society, empowering more local communities, enabling more social enterprises to deliver public services and establishing more financially resilient charities.

But there are a series of challenges, particularly in this age of austerity. This paper outlines the key opportunities and challenges.

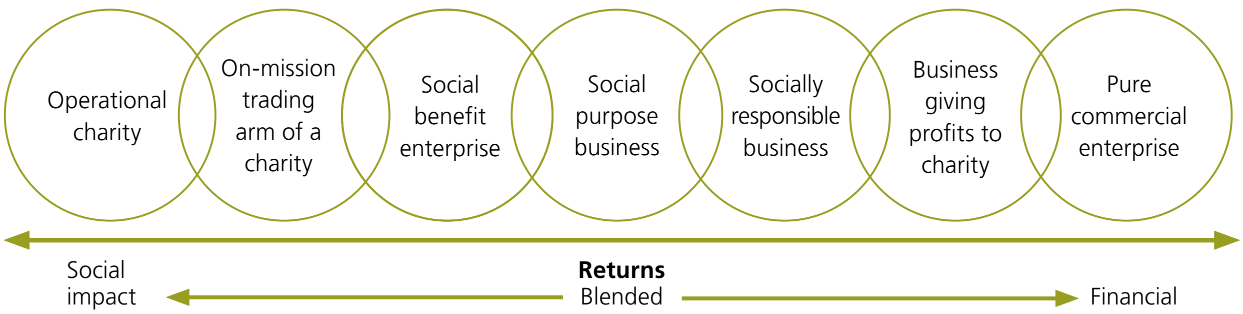
Who benefits from social investment?

The ecology of civil society has become increasingly diverse in recent years, with a range of approaches being developed to deliver social impact. In particular, social enterprise, whereby an organisation generates income to create social impact, has become more commonplace. This innovation and diversity is welcome, as a range of organisations are required to successfully tackle the social challenges facing the UK.

Nevertheless, it should be noted that social enterprise has become a catch-all term that does not distinguish between organisational models. To disentangle financial risk from expected levels of social impact, there is a need to specify the different organisational models that exist under the umbrella 'social enterprise' term. The spectrum of models is illustrated in figure 1.

The past few years have seen a resurgence of community-based models (such as Community Land Trusts) alongside developments in community-funded initiatives (such as community investment[1] and crowdfunding[2]).

Figure 1 Spectrum of organisational models



1 Defined by Community Shares as 'a way of raising money from communities through the sale of shares or bonds in order to finance enterprises serving a community purpose.' See www.communityshares.org.uk

2 The pooling of funds, usually via the internet, in order to support efforts initiated by other people or organisations.

We have also seen the emergence of community development finance institutions (CDFIs), some of which provide finance to individuals (personal lending/microfinance), others loans to businesses in deprived areas, and others finance to charities and social enterprises.
All provide capital to individuals or organisations that have historically struggled to access mainstream finance, but the models and approaches for the various audiences are very different.

So we see that social investment is not and should not be limited to institutions; rather, it is an approach, using different financial mechanisms and tools to achieve social goals[3]. It is an approach that has many different audiences, potentially, reflecting the breadth of civil society and the social needs it meets. This paper's focus, reflecting our experience, is charities and social enterprises.

Access to capital is a fundamental need – and remains misunderstood

Although social enterprises may have a different income model to community groups and charities, the capital requirements are strikingly similar. CSOs (just like businesses) require capital for a number of critical functions:

- as reserves or insurance to give financial resilience, protecting the organisation and its activities against the unexpected happening;
- to acquire the fixed assets necessary to deliver ongoing services, projects, and activities;
- as working capital to manage timing differences between spending money and receiving it (cash flow) thereby enabling ongoing activity;
- as development capital to fund the costs of:
    - growing existing services and projects
    - developing the infrastructure of the organisation, eg, through IT, or financial systems, or marketing
    - innovation in new products, processes and services

We have seen growing recognition of the distinction between capital and revenue/income in recent years. The NCVO Funding Commission (2010) argues that 'there is an urgent need to ensure the focus of funding is more evenly balanced between addressing revenue income needs and the strengthening of balance sheets.'

3 *It is important to note that no organisational model or approach is inherently more (or less) profitable than any other. Nor is any inherently more (or less) socially impactful than any other. Each model is a means to an end, and not an end in itself. As such, every civil society organisation should ultimately be judged on its actual social impact.*

Capital is no substitute for income; it is the flipside of the same coin. Civil society cannot fully function without both.

Few charities have been able to create a surplus on the income and expenditure side, with which to build reserves and strengthen the balance sheet. Indeed, the donor community can be sceptical of reserves, in the same vein as they are sceptical about administrative costs. These views influence charities, and can be counterproductive, as a lack of reserves leaves charities vulnerable which in turn can jeopardise the efficiency and effectiveness of donations. As such, the government's commitment to ensuring civil society organisations can compete on price rather than cost is welcome. Without a fair (economic) price for the services they deliver, organisations can become trapped in an inefficient and unsustainable income fundraising cycle, which can result in mission drift and insufficient focus on impact.

It would be virtually impossible to quantify what has previously been called 'the near infinite need' for risk capital from the social sector[4]. Lack of access to capital is preventing social purpose organisations, charities, community organisations and social enterprises alike, from delivering the social impact necessary to transform Britain into a Big Society.

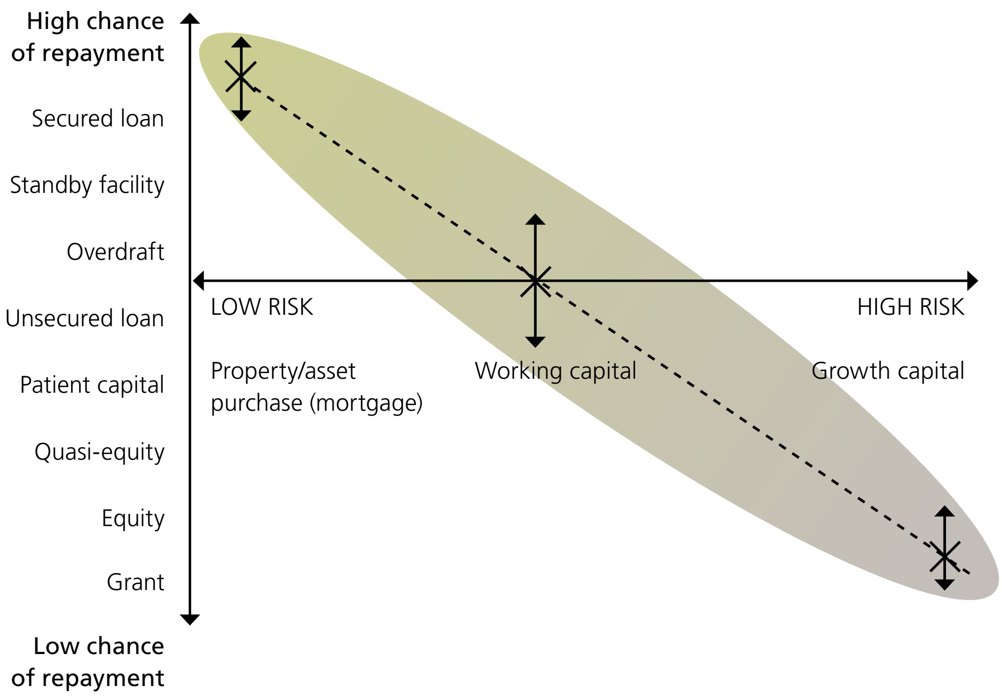
4 *N Wilkie for Civicus (2006) Sustainable funding: a basic theoretical introduction*

The role of social investment

1 Types of investment mechanisms

The social investment market has emerged in response to the need for civil society organisations to access appropriate capital. As well as increasing the total amount of capital available in the sector, the role of social investors has been to match appropriate funding mechanisms with funding needs. Appropriate mechanisms successfully balance risk, social return, financial return, and price for the underlying investee. Figure 2 below demonstrates how different investment mechanisms are available to provide capital appropriate to its use and risk profile (the shaded area represents the zone of appropriate funding).

Figure 2 Matching appropriate funding mechanisms with funding needs



2 Current providers

Lower risk capital, in the form of property and asset purchases (the left-hand side of figure 2), is increasingly being met by Charity Bank, Triodos Bank and other mainstream lenders. Secured lending is their primary tool.

However, the supply of higher risk capital for development and early-stage capital (the right-hand side of figure 2) remains limited. This is in part because the financial risks remain high. Civil society organisations need access to risk capital but more often than not their business models cannot afford the risk-adjusted cost of capital a commercial supplier would demand (or not without significant trade-offs which would significantly dilute or negate the social benefits). Suppliers of such capital have to add the social impact/return to any financial return to make sense of the risks they run.

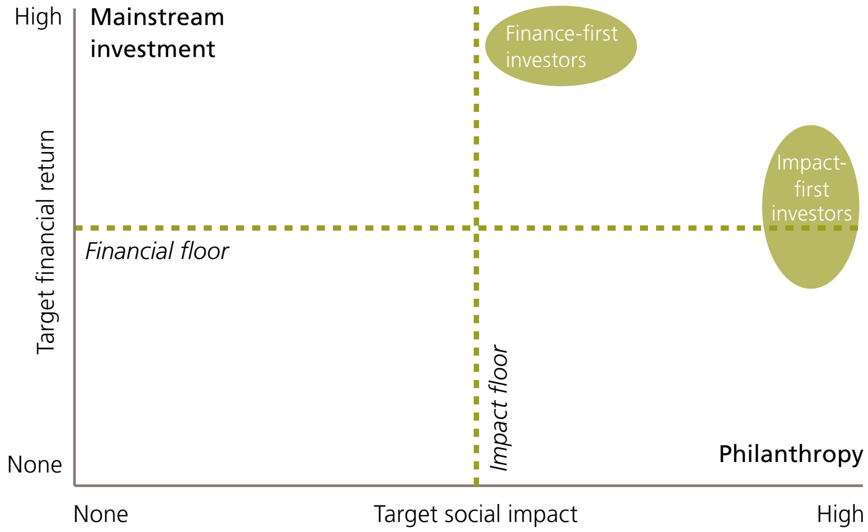
3 'Finance-first' versus 'impact-first' investments

It is this area, financial return versus impact return, that requires most attention if the social investment market is to move beyond its infancy. Venturesome itself was set up to provide charities with access to this higher risk capital, particularly in the form of working capital and growth capital. A number of other funds have been established, including Bridges Ventures and Big Issue Invest. These funds reflect the varying mixes of financial return and social return (or impact), which can be divided into 'finance-first' impact investments and 'impact-first' impact investments.

The right-hand side of figure 3 overleaf shows the area in which social investment operates. 'Finance-first' investment in particular has recently caught investors' attention, with its prospect of reasonable financial returns as well as social returns. A handful of 'finance-first' investors have emerged across the risk/reward spectrum in the UK and US, including Bridges Ventures and Generation Investment Management. Investor demand for 'finance-first' products is growing; pioneering venture capitalist Sir Ronald Cohen anticipates that Bridges Ventures (currently £100m) "will grow over the next several years to £1 billion under management." It is as yet unclear if there are sufficient investment opportunities for such 'finance-first' investors: Triodos Opportunities Fund recently closed, having made one £320,000 investment from a £3m fund over two years, citing lack of investment readiness and appetite for equity among social enterprises.

'Impact-first' investment has social impact as its core focus, recognising the trade-off required between social impact and pricing for financial risk. As a leading UK 'impact-first' investor Venturesome seeks to demonstrate to private investors the credibility of a model that places social impact ahead of financial returns.

Figure 3 The Social Investment Market



Adapted from Monitor Institute (2009) Investing for Social and Environmental Impact

Building a responsible and intelligent market

A Big Society Bank alone will not catalyse the social investment market. Although out of the starting gates and with an increasing track record, we are far from a 'robust' social investment market, ie, one in which informed civil society organisations have access to appropriate capital, from resilient and diverse sources of capital, distributed using a variety of financial mechanisms.

Venturesome has identified four pillars that it believes are critical to the creation of such a market[5]:

1 Confident and informed demand from the civil society sector

At present, there remains a cultural aversion to taking on non-grant investment. The distinction between income/revenue and capital is not widely understood. In a robust market, civil society organisations need to be confident in identifying their own financial needs, be aware of different financial mechanisms available to support those needs and aware of different providers. The bulk of financial intelligence in the sector sits in income generation and cost management; more is required on asset management and capital investment.

5 *CAF Venturesome (2009) Access to capital*

2 Efficient matching of supply and demand

With a lack of clarity in the language used and new concepts arising, demand for social investment is often poorly communicated and therefore not being successfully exploited at present. Likewise, supply is minimal and very patchy, with few signs of operating as a connected market. In a robust market, demand is efficiently matched with supply, supported by informed intermediaries and quality business advice.

3 Variety of investment mechanisms

Income funding via grants remains the pre-eminent funding mechanism in the sector. It remains critical, and will be under much pressure in coming months as cuts fall across the sector. Grants are also required as capital investment. At the same time, other instruments such as unsecured loans, underwriting and equity-like investment have a role to play in a robust social investment market.

4 Resilient supply of finance

In a robust market, there is diversity of supply from private, public and individual sources at both the retail and wholesale levels.

The Big Society Bank as currently discussed supports pillar 4, a resilient supply of finance. There is a risk that without attention to pillars 1-3 the ambitions of the Big Society Bank go unfulfilled. At the same time, there are a number of additional issues that need to be confronted if we are to seize the promise of social investment.

From the perspective of charities, these include:

1 Lack of income funding

In the coming months, charities' reserves will be under extreme pressure, more so than usual. Without reserves or access to external capital, there is no room for manoeuvre. And charities need room for manoeuvre in times of uncertainty, such as now. Social investors like Venturesome use their capital funds to bolster or even stand in place of charities' reserves, but can only do so where there is a clear plan of action and a viable route forward, whether that be grants, donations, contracts or income generated from activities.

As indicated previously, capital is no substitute for income; it is the flipside of the same coin. Capital investment does not work in a vacuum; how relevant and successful it is depends on the ecology that exists around it.

2 Risk aversion

In a time of crisis, organisations may be less willing to take on something that is perceived to be new and risky. Greater understanding of how non-grant finance can reduce financial risk is required, as part of an organisation's approach to planning and risk management.

From the investors' perspective, the risks include:

1 Economic turmoil

Social investment could become collateral damage in the global economic slowdown that took hold during 2008[6]. The crisis is likely to be long and deep, and may lead to changes in industry structure and regulation that constrain investors' appetite for this new style of investing. Alternatively, the turmoil could simply delay the emergence of the industry until the next economic cycle. The positive flipside is that a severe crisis could change the regulatory environment to such an extent that social investment is in fact fuelled.

2 Unrealistic expectations around financial returns

Investors are keen to make money and do good, yet the opportunities for a genuine social and financial return are limited. There is a risk that the definition of social impact becomes so loose as to be virtually meaningless. Indeed, it could actually divert capital away from philanthropy, decreasing the resources dedicated to confronting serious societal challenges. It also risks leaving behind the very organisations that need access to capital. As indicated previously, the majority of existing vehicles for social change are simply not able to deliver commercial returns, as their activities and business model cannot afford it.

This does not mean that these organisations are ineffective or inefficient, nor that they should be denied access to appropriate and affordable capital so that they may become more resilient. It does, however, have implications for the financial expectations attached to investors' capital, and the type of capital that the sector can afford. A similar shift has already been observed in the microfinance world, to the consternation of those who believe that the primary purpose of microfinance (lifting the poor out of poverty) has been forgotten.

Successfully confronting these risks to deliver the social investment market will require direct confrontation of these potential pitfalls with an eye on the potential prize.

6 *Monitor Institute (2009) Investing for Social and Environmental Impact*

The role of the Big Society Bank

So far, the main government announcement on the topic of social investment has been the Big Society Bank. Something of a tension is already apparent, as to how a wholesale bank (supplying capital to retail investors) will meet the needs of a 'microscopically granular'[7], volunteer-led Big Society.

Broad principles emerged from last year's consultation responses[8] on a social investment wholesale bank. We believe these still stand:

- The Big Society Bank ('BSB') should operate as a wholesale funder providing capital and liquidity to retail intermediaries. Previous government retail funds were criticised for distorting rather than leveraging private capital, and have proven short-lived.

- The BSB should play a market-building role, recognising that the financial needs of charities and social enterprises are various, ranging from routine working capital needs to high-risk growth capital. A range of supply sources are required, therefore, from different financial providers.

- The business model of the BSB must have both clear social and financial objectives. If the BSB is to meet the needs of civil society, it cannot be a purely profit-maximising entity. Social investment is not a mere adjunct to commercial markets.

- The BSB should encourage both a diversity of retail funders (eg, Triodos, Bridges, Big Issue Invest, CAF Venturesome, CDFIs and high-street retailers such as Barclays, RBS etc) and wholesale funders (eg, the Esmée Fairbairn Finance Fund) in order to help build a more resilient social investment market. The market should not be dominated by any one player, either at the retail or the wholesale level. Nor should it prop up failing institutions by subsidising the operating costs of models that are not viable.

7 *Minister for the Cabinet Office Francis Maude, in a speech entitled 'Leading your charity through a time of change' given at an Action Planning conference 9 June 2010.*
8 *CAF's Response : Social Investment Wholesale Bank Consultation (October 2009).*

Challenges

- There is a big difference between working with individuals and working with organisations. Existing social investors and community development finance institutions have experience of working with organisations and of personal lending. Providing investment to groups of socially-motivated individuals brings with it its own challenges, regarding governance and legals, timescales and the level of support required. Our experience of managing the Community Land Trust Fund reflects this (see below).

- There is a role for financial packages (which include grant, patient capital, loan) to allow communities to take a project from concept to realisation: eg, from the discussion in the pub, to the architect's blue print, to new affordable homes being built in the village. Our work with community groups, and especially through our Community Land Trust fund, indicates that local groups need access to:

  - technical expertise and skills, probably paid for by starter grants
  - contingent capital, to finance detailed planning and costing work
  - patient capital (at less than commercial rates) to underpin long-term borrowing from mainstream banks

Recommendations

In order to address the challenges identified in this paper and fully realise the potential of social investment to support the Big Society, Government should work with the sector to:

- Set up the Big Society Bank with a clear mission, relating to the creation of a robust social investment market in which a range of civil society organisations have access to appropriate capital[9]. This requires the encouragement of long-term sources of capital. The Bank should have transparent objectives linked to this mission, and a clear business model. It should not have short-term targets which can lead to unintended and negative outcomes, such as targets for funds dispersed.

- Support individuals and civil society organisations to make sense of the funding environment and the variety of finance opportunities available to them. Focus on the supply of capital alone is unlikely to build a sustainable market. The Big Society Network could play a role in coordinating more personalised existing support and advisory functions, and signposting enquirers at a local level.

- Identify incentives to encourage grant-making trusts and private investors to engage in programme-related investment, ie, impact-first investment, to meet the higher-risk end of the social investment spectrum (figure 2). The government has committed to introducing measures to promote philanthropy and giving. This should include consideration of tax incentives to encourage social investment.

- Engage the Charity Commission in clarifying the rules and guidance around the investment of charitable funds in programme-related investments (eg, CC14 guidelines).

- Create an easier, simpler way for charities and private investors to set up FSA-compliant social investment funds. For example, the current collective investment scheme principles set out under the Financial Services and Markets Act (FSMA) 2000 restrict charities from accepting monies from organisations and private investors on anything other than a donation basis[10]. The Government should consider granting exemption for monies raised and held solely for charitable purposes from the collective investment scheme definitions under the FSMA 2000.

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9 *For a more detailed discussion of how a wholesale bank might operate, see CAF Venturesome (2009) 'Social investment wholesale banking – Providing capital and liquidity to market intermediaries'; available for download on the Venturesome website.*

10 *As any such funds provided will be pooled with the funds of other individuals/organisations – whereas donations pass the charitable threshold and become the funds of the charity itself. The costs of establishing and running a collective investment scheme to handle these monies are prohibitive for charities, and would operate against the intent of the supporter in question. We do not believe that it was the intent of the legislation to restrict the access of charities to funds for the restricted use as programme related investment.*

- Promote financial instruments that share risk and return (eg, quasi-equity, patient capital and social impact bonds).
- Encourage foundations and private investors to set up a clearing house to facilitate co-investments, pooled funds and syndications.

Final word

We welcome the government's commitment to building a robust and responsible social investment market. Providing access to appropriate capital for CSOs is a vital component of building resilient organisations that can achieve real, positive and lasting change to civil society.

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