

Chelwood Capital

Social Investment Wholesale Bank: A Consultation on the Functions and Design

Response to the Office of the Third Sector

October 7th 2009

INTRODUCTION

Chelwood Capital is pleased to submit this response to the UK's Office of the Third Sector ('OTS') as part of its consultation on proposals to establish a Social Investment Wholesale Bank ('SIWB'). We warmly welcome the proposal, and believe that the creation of a Social Investment Wholesale Bank offers a rare opportunity to establish an institution that could play a genuinely catalytic role in the development of the social investment market in the UK.

However we share the caution of many in the sector that the SIWB needs to be set up in a way that does not distort or suppress competition in the market, and offer below some thoughts on how this might be achieved.

BACKGROUND

- 1.0 This paper focuses predominantly on the role that the SIWB could play in social *investment*, as opposed to grant funding. We define social investment as the provision of capital to organisations whose primary purpose is a social mission rather than maximisation of profits, but which are nevertheless able to at least return the capital back to the investor with a modest financial return. The natural recipients of social investment are *social enterprises*, which we define as socially mission-orientated enterprises that derive at least a significant portion of their income from selling goods and services, rather than from grants and donations.
- 2.0 We recognise that social investment is only a sub-set of the type of funding needed by the social sector, but this is the area where we believe a social investment bank has the greatest value to add, and on which it should therefore focus its activities. This is not to downplay the importance of charitable and other organisations that will only ever be grant or donation funded, and there is a huge amount that needs to be done to improve the grant-making process, but we believe that a bank is not the best institution for facilitating grant-making and therefore restrict our comments to social investment.
- 3.0 While there is a virtually unlimited need for capital in the social sector, the UK social investment marketplace remains in its infancy. The provision of capital to the sector is highly fragmented, with high transaction costs and a laborious and time-consuming process for raising capital. Few social sector institutions take on capital in ways other than donations, grants and local authority payments. In truth, few are ready or able to receive any other form of funding. As such, both the supply and demand for social investment capital are currently severely constrained.

- 4.0 The proposal to establish the SIWB is a unique chance to improve this situation. We believe that it would be a wasted opportunity if the SIWB were to be set up simply as another funder or grant-making institution, and indeed would be counterproductive. **The purpose of the SIWB should be to help build a vibrant social investment marketplace**, by providing capital on an equitable and transparent basis to Community Development Finance Institutions ('CDFIs') and other financial intermediaries such as Bridges, Venturesome and Triodos Bank. It should not seek to replicate or compete with those funders, but rather to grow the market overall to maximise the total amount of capital available to the sector.

HOW SHOULD THE PERFORMANCE OF THE SIWB BE MEASURED?

- 5.0 We believe the success of the SIWB should be measured against two main criteria: (i) how much capital has it helped bring in, directly and indirectly, to the funding of social projects and (ii) what has been the social impact of that funding?
- 6.0 Although there is currently no market standard methodology for measuring social impact, investees should report back on a range of pre-established and standardised metrics in a number of social areas defined to be important to the SIWB's social mission. These might include benchmarking projects against criteria such as: net jobs created, number of NEETs moved back into employment or training, carbon footprint reduction, savings to the welfare budget, improvements in literacy and education standards, and other pre-defined metrics that are appropriate for the project being invested in.

FUNCTIONS

- 7.0 We believe that the SIWB could best serve the sector in the following ways:
- 7.1 Firstly, by **providing wholesale capital to financial intermediaries**. This could significantly grow the capacity of the market and to ensure a diversity of capital providers at different points along the risk spectrum. Capital should be provided on an equitable and transparent basis. The intermediaries supported should meet minimum guidelines established by the SIWB, including experience of management, quality of systems, corporate governance, lending criteria and capital adequacy. Their loan books should be subject to regular monitoring. A greater proportion of capital (i.e. higher leverage) should be afforded to those institutions with more proven track record, more seasoned loan portfolios and/or more conservative lending criteria (e.g. a venture capital fund might only obtain 1:1 matched funding from the SIWB, whereas a conservative CDFI

with an excellent track record lending on a secured basis to proven, long-standing borrowers might obtain 5:1 leverage relative to its own capital).

- 7.2 Secondly, **by using its capital to leverage in additional capital from the commercial sector**, thereby expanding the total amount of capital available in the same and reducing competition for the limited supply of grant funding. It can do this via credit guarantees, providing 'first loss' insurance and a wide range of other mechanisms (please see Case Study 4 in the appendix for an example).
- 7.3 Thirdly, the SIWB can act as an **aggregator of deal flow**. The social enterprise sector is characterised by small organisations (i.e. fewer than 20 employees, typically annual budget less than £1m) with important but small-scale capital needs (we estimate typically less than £0.5m per annum). For these organisations to raise capital individually is inefficient and expensive. The SIWB could help reduce these costs by pooling together transactions and raising capital on a larger basis. For example, the SIWB could use its balance sheet to underwrite a single £50m bond that could then be channelled through its financial intermediary partners to service the funding needs of 20-30 social enterprises. At £50m, the bond would have a size and liquidity, backed up by the stronger credit rating of the SIWB, that would make it investable by mainstream investors such as pension funds, who can rarely invest in issuances smaller than this for liquidity reasons. This could significantly lower transaction and funding costs.
- 7.4 Fourthly, the SIWB could help **create a secondary buy-out and refinancing market** for both equity and debt. Many early stage social investment funds struggle to raise capital because they do not have any way to exit their investments, and hence get capital back for their investors. A long-term institution such as the SIWB with a strong balance sheet could remedy this by offering to buy-out successful equity and debt investments made by such early stage funds once they achieve breakeven profitability. The presence of an institution that could offer this exit option, which currently does not exist, could facilitate the creation of many more such early stage funds, in size much greater than current achievable, and could greatly increase the flow of capital into the sector.
- 7.5 Fifthly, the SIWB could create a **syndication market** for social investment. Over time, the SIWB will be accumulating a significant number of social investments onto its balance sheet, through the mechanisms of co-investment, aggregation, secondary buy-out and refinancing discussed above. The SIWB should actively seek to syndicate this risk onto a wider variety of market participants, such as pension funds, insurance

companies, and Socially Responsible Investment (SRI) Funds, thereby freeing up its own balance sheet for further lending.

- 7.6 We believe that aggregation and syndication of deals should be the SIWB's immediate priority. Ultimately we envisage that the SIWB could also evolve to take on a **market-making role**, offering regularly updated pricing and running an actively traded book, thereby creating a liquid secondary market for social investments. But this presupposes a wide universe of institutional social investors, which does not exist as yet and we believe will not exist until an active syndication market has been developed.
- 7.7 Sixthly, the **SIWB should support the establishment of new institutions that play important roles in the financial eco-system**. These institutions include corporate finance advisors such as Social Finance Ltd, social rating agencies and research institutions such as New Philanthropy Capital, as well as organisations that can help reduce the costs of search, due diligence and subsequent investment monitoring for investors. The SIWB could foster these players by acting as a key client, funding critical services that many social sector organisations need but do not have the budget for. This would be preferable to replicating these functions in-house as that would stifle rather than foster the development of such organisations.
- 7.8 Finally, **the SIWB should help direct capital towards capacity building for social sector organisations**. In our experience, a major funding gap for social sector organisations is funding for capacity building; i.e. capital that is needed to grow or manage an organisation, but not directly used for delivery of services. Donors typically restrict the proportion of funds donated that can be spent on 'overhead' or 'central costs' for fear that their funds will otherwise be wasted on expenses that are not directly related to delivery of the mission. This means that social sector organisations are frequently starved of the funds that they need for critical expenditures such as central administration, IT, Treasury management, marketing, and fund-raising. This situation is pandemic across the sector¹. The SIWB could greatly assist by creating a pool of capital specifically targeted at capacity building expenditure, that might be provided in conjunction with funding from partner foundations who can then direct their own capital towards paying for the direct 'programme delivery' elements of the social organisation.

¹ See "The Non-Profit Starvation Cycle" (2009) Stanford Social Innovation Review

- 7.9 The SIWB could also provide capital to support social sector organisations in getting **‘investment ready’**. This could include funds to prepare business plans, create financial models, or to upgrade the IT, Treasury and cash management systems to be able to handle the greater administrative responsibilities of larger scale. Again, in our experience, lack of funding for such necessary expenditures is often a reason why many enterprises fail before they can even reach the attention of social investors.
- 7.10 Strictly speaking, the activities described in 7.8 - 7.10 above are not the traditional function of a bank, but all in our experience are critically important unmet needs in the marketplace.

The above functions do not need to be performed solely by the SIWB (and it is probably preferable for market development overall that these functions are delivered by a range of organisations). But the SIWB could play a key co-ordinating role with a variety of socially engaged partners with substantial balance sheets. Foundations such as Esmée Fairbairn, Tudor Trust, and City Parochial might be the natural partners to help perform the above functions, as might some of the Housing Associations. CityLife, for example, have successfully utilised the balance sheets of such institutions with great creativity to help underwrite over £10m of charitable bonds to date².

There are a number of other roles that the SIWB could play that this paper has not addressed. These include: corporate finance advisory, underwriting of new debt and equity, research, being an industry forum and advising on public policy. While all of these are important, we believe that these functions could be equally well performed by other parties, and may be better out-sourced to encourage the development of the market.

CHARACTERISTICS OF THE SIWB

In order to best fulfil the role outlined above, we believe that the SIWB should have the following characteristics:

- It should be designed from the outset as an institution that is intended to be **permanent**, rather than with a limited life or with the intention of running down its capital over a period of years. Only then will it be able to provide the patient long-term capital that the sector needs. The SIWB should be able to invest in intermediaries with a time-frame of up to 40 years if necessary (many commercial companies already issue corporate debt with maturities longer than this).

² See www.citylifeltd.org

- It should aim to be **self-sustaining but not profit-maximising**. We believe that a profit-maximising institution, or an institution targeting a financial return in excess of single digits, will be too conservative in its lending policy and not be able to direct its capital to those areas where it is most needed. Where necessary, this means providing subsidised capital at below market rates.
- It should be **willing and indeed actively seek to bring in private sector capital**, and be prepared where necessary to deploy its capital in a way that helps best leverage in commercial capital, for example by taking a higher portion of the risk through first-loss insurance or helping gear up the lower financial returns offered by a social project through subsidised funding. While counter-intuitive to the instincts of many in the social sector, this could bring a wide number of social projects out of the grant-funded universe and into mainstream finance, and significantly grow the amount of capital available for the sector.
- The SIWB should be **separately incorporated and independently governed**. In order to plan and invest over the long term, it should ideally have a budget that is insulated from the annual government budgeting cycle. To avoid a conflict of interest, it should also be independent of the financial intermediaries to whom it provides capital to. However it should have an advisory board that comprises key representatives from across the sector, including Government as well as both non-profit and for-profit social sector organisations.

CAPITAL

- **We agree with the Consultations Paper's indicated level of initial capital for the SIWB of not less than £250 million, together with annual income of £20m a year for four years.** An amount significantly less than this is unlikely to permit the SIWB to carry out the functions described above.
- We believe that it may be optimal for the SIWB to have **several ring-fenced pools of capital**. The main pool would be used for the provision of wholesale capital to financial intermediaries and is intended to be permanent. This portion of the balance sheet could be further leveraged by the SIWB itself raising capital from the debt capital markets.
- There should probably also be a portion of capital that will inevitably run down over time, and which will need to be periodically replenished, either from profits generated by the SIWB or by further capital contributions. This portion of capital would be used for all activities that do not generate a financial return – such as the making of capacity building grants and procurement of investment-related services such as research and social impact analysis.

ABOUT THE AUTHOR / CHELWOOD CAPITAL

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Appendices

Case Study 1: Providing wholesale capital to financial intermediaries

This paper supports the view that the key role for the SIWB should be to provide wholesale capital to retail funders. By ‘retail funders’ are meant lending and investing institutions such as CDFIs, credit unions, social retail banks such as Charity Bank and Triodos, as well as higher risk capital funds such as Bridges, Venturesome, and Big Issue Invest. All of these are institutions that provide capital to social sector organisations for the primary purpose of achieving a social mission, with varying levels of risk appetite but at least some financial return or at least return of capital to investors.

At present, there are only a handful of players making social investments in this marketplace, and the amounts that they make are typically small relative to the commercial markets (investments typically ranging from £20k - £250k per institution).

The SIWB could have a powerful effect by increasing the capacity of primary funders through co-investment. For example, consider the fictional example of Social Loans Ltd (**‘SL’**), a social loan fund that makes loans of £10k - £150k to social enterprises. SL frequently receives request from high quality borrowers for a higher amount of lending, but is constrained by the limited amount of capital that it has available.

One such borrower is SpringBoard³ Ltd, a social enterprise that provides work placements and job training for marginalised young people who would typically be classified as NEETs (Not in Employment, Education or Training). SpringBoard has an outstandingly successful programme for young people, with over 70% of those coming through the programme going on to full-time jobs or education, and more than 2/3 of those still in employment or education one year later. SpringBoard needs £500k of development capital to grow the business. It is already a client of SL, but is only able to raise a maximum of £150k from SL before SL reaches its single borrower limit.

SpringBoard is therefore forced to go out to another five funders to raise the remaining funds, which it is ultimately able to do through a combination of commercial loans, donations and grant funding, as well as contributions from some socially conscious high net worths. The process takes two years and is extremely laborious, consuming most of the CEO’s time. Moreover each of the Lenders has different lending requirements (interest rates, repayment schedules, covenants, security requirements, use of cash restrictions) and reporting standards, leading to a mountain of paperwork for the beleaguered SpringBoard Treasurer.

³ This is a fictional company used as an example. Any resemblance to actual companies is coincidental.

A Social Investment Wholesaler could make a huge difference. The SIWB could provide additional capital to SL to enable SL to front the entire £500k of loans to SpringBoard.

SL would continue to be the lender to SpringBoard, and would be responsible for all of the due diligence, as well as the negotiation of the Lending terms and monitoring of the loan on an ongoing basis.

The additional capital from the SIWB could be contributed either pro rata along-side SL's loans on a *pari passu* or even senior basis (i.e. any losses incurred under the loans would be borne by SL first, and written off against its £150k, before the SIWB would suffer any losses under its capital). By having SL write down its own capital first in any co-investment arrangement, the SIWB ensures that SL is adequately incentivised as if it was taking all of the risk, and reduces moral hazard.

The advantage to SpringBoard is that now only has to deal with a single lender – SL – that now has the capacity to meet all of its funding requirements, greatly simplifying the fundraising process and hence reducing transaction costs.

Case Study 2: Providing a refinancing option for debt providers

Community Finance⁴ ('CF') is a Community Development Finance Institution (CDFI) that provides loans to charities, social enterprises and other social sector organisations. It has been operating for many years and demonstrated a good track record.

CF raises money from donors, high net worths, and foundations. Raising such money is hard work and CF is struggling to raise enough capital to meet the needs of its borrowers.

CF discusses the situation with the SIWB, which notes that about one quarter of the loans in CF's portfolio (about £5m in total) are high quality, performing loans from good borrowers that have been steadily paying back for more than two years. These loans have an average another 3 years to run.

The SIWB offers to refinance these low-risk loans and take them off CF's book, paying CF £5m and taking those low-risk loans directly onto the SIWB's balance sheet.

CF is delighted to have £5m of capital freed up which can immediately be put to use in new lending. It enters into an ongoing arrangement with the SIWB whereby future loans that have matured and demonstrated good performance can be similarly refinanced by the SIWB on a regular basis, dramatically increasing CF's capital efficiency.

⁴ This is a fictional CDFI and is not intended to refer to any actual institution

Case Study 3: Providing an Exit for Social Venture Capital Funds

The market has a number of funders (for example Venturesome, Triodos Bank, Charity Bank) that are able to provide debt finance to social sector organisations, but these are typically only once they have achieved a certain scale, track record and demonstrable cashflow.

Many fledgling social enterprises fail before they reach this stage. To expand, they need more capital than is available from the traditional donor and grant funding universe, but they have not yet reached the maturity necessary for taking on debt financing. They therefore fall in the gap between these two sources of finance.

Social Venture Capital Fund LLP ('SVC Fund')⁵ is a new equity fund that seeks to fill this gap. It offers to provide venture capital that is prepared to take a higher risk on early stage ventures. But the SVC Fund finds itself struggling to raise funds itself, for a simple but fundamental reason: it has no ability to exit the investments that it makes, and therefore to return capital back to its own investors within a reasonable time-frame.

Traditional VC funds operating in the commercial sector raise funds with the promise to repay them within 5-7 years plus a target financial return typically in excess of 15%. They can do this because the market affords them several different ways to exit their investment: for example, they can list successful companies on a stock exchange through an Initial Public Offering (IPO), or sell the investment to a trade buyer (trade sale) or financial buyer (secondary buy-out), or sell the company to Management through a Management Buy-Out (MBO).

These options do not currently exist in the Social Enterprise Sector. There is no IPO market except for the most exceptional social enterprises. Nor is there a secondary buy-out sector (i.e. funds that are prepared to buy out successful investments from social venture capitalists, and support them on the next phase of their growth).

Early stage social enterprises typically require a much longer time horizon to achieve cashflow break-even and then profitability. The few that do rarely offer financial returns in the range of 15%+ that are required by commercial venture capitalists.

As a result, anyone seeking to raise a Venture Capital Fund for the social sector is forced into an unpalatable choice – either:

(i) to require any investee to pay back all of the capital plus an adequate return within a 3-5 year time-frame; or

⁵ This is a fictional fund. Any resemblance to actual funds is entirely coincidental.

(ii) to extend the investment horizon of the Fund to a time-frame (say 15-20 years) that is unfeasibly long, so that investors can get their money back through dividends paid from operating cashflow over time, rather than through sale of the enterprise.

Option (i) is an almost impossible requirement for any business, let alone a social enterprise. Option (ii) is unacceptable to the vast majority of potential investors.

It should be no surprise, then, that the Social VC market in the UK is practically non-existent. The SIWB could help this situation by providing potential Social VCs with a genuine exit possibility for their investment within a time-frame that is acceptable to investors.

In this fictional example, the SIWB works closely with SVC Fund and makes the following agreement: SVC Fund will raise capital from private investors, and make investments in up to 30 early stage social enterprises. Prior to year 7, the SIWB agrees to buy out at an agreed premium any investments in SVC's portfolio that have:

- (i) achieved positive cashflow and self-sustainability;
- (ii) have continuing good growth prospects;
- (iii) have demonstrated delivery of social impact in line with metrics agreed by both SIWB and SVC at inception of the investment.

SVC (and its investors) will take the risk that its investments do not achieve these benchmarks.

Underpinned by the 'buy-out' agreement from the SIWB, SVC Fund is finally able to go out and raise a significant amount of money from private investors. By using its balance sheet and its longevity to buy successful and profitable enterprises, the SIWB has provided what early stage investors need: a genuine and credible prospect of exiting successful investments within a reasonable time-frame.

Case Study 4: Helping leverage private sector capital⁶

Acme Microcredit⁷ ('AM') is a micro-credit lender managing a portfolio of personal and business loans to low income individuals and small businesses in run-down communities. Over the last few years, the portfolio has demonstrated a healthy average return of around 12% per annum, but with a total portfolio size of £4m this return is still too small to cover all of AM's operating costs. AM is, therefore, dependent on a permanent amount of annual grant funding.

AM does, however, have a good operating track record – over the last 5 years, bad debts have successfully been kept at less than 5% of the portfolio.

Up to now, AM has been funded entirely through local authority support, together with individual donations and grants from charitable foundations. It needs to refresh these every year, which can be burdensome and makes long-term planning difficult.

Given the relative stability of its loan book and its track record, AM discusses with the SIWB the potentially transformative idea of scaling up its operations by using SIWB funding as a catalyst to bring in extra funding from private sector banks. This would enable AM to expand beyond its traditional donor base, accessing commercial funding, which would put it on a more sustainable long-term basis.

AM agrees with the SIWB a proposal whereby AM seeks a £10m loan from a group of commercial banks, which will help it more than triple the scale of its lending. At this size, the return on the portfolio would be sufficient to cover all of AM's operating costs plus generate a surplus that could be used to build reserves. AM could, therefore, become self-sustaining.

In exchange for a fee, the SIWB agrees to provide a credit guarantee to the private sector banks, putting up cash collateral to cover the first 20% of any losses incurred in the portfolio. Since historic bad debts have only been running at 5% of the portfolio, the SIWB has effectively offered to cover 4x any expected losses. This ought to make providing the remaining unguaranteed portion of the loan a relatively safer proposition for a commercial bank, enabling a significantly greater amount of funding to be available for AM. Based on this guarantee from the SIWB, the commercial banks are prepared to fund the £10m.

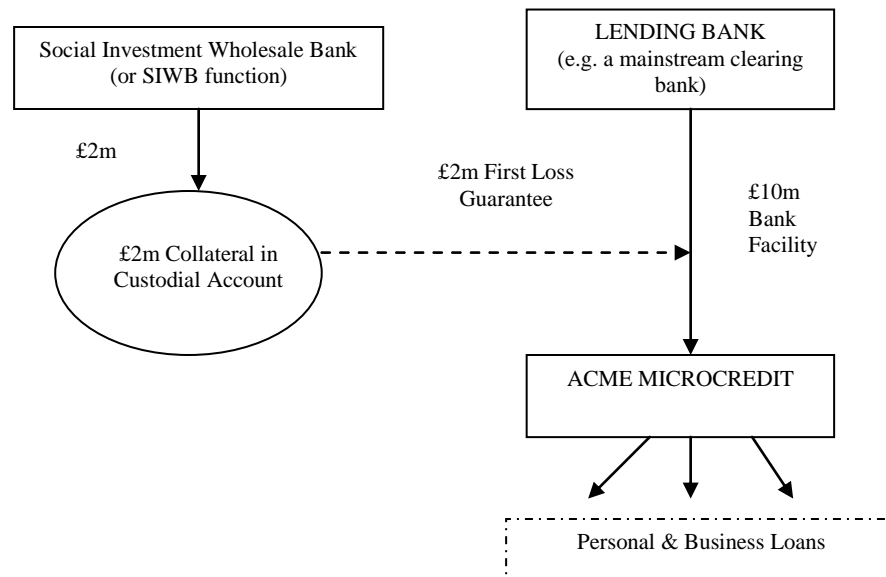
So, in this example, by putting up say £2m of capital to underwrite the first 20% of AM's portfolio, the SIWB has enabled AM to bring in a further £8m of commercial funding

⁶ This case study was originally developed for the Venturesome briefing paper "*Social Investment Wholesale Banking*" (2009) P Cheng, and is reprinted with the kind permission of CAF Venturesome.

⁷ This is a fictional company. Any resemblance to actual companies is entirely coincidental.

from banks on top, leveraging the value of its contribution four times over. Moreover, it has enabled AM to transition from a precarious donor-funded model to a sustainable, long-term commercially-funded model on a much wider scale.

Diagram of structure



The benefits of this structure include:

- Economies of Scale - Acme Microcredit's principal constraint is access to capital. Capital is critical to growing the business in order to achieve a profitable breakeven as quickly as possible. Given that the costs of the business are predominantly fixed (wages, office rent), higher revenues from an increased loan book immediately flows through into higher operating profit.
- Efficient capital management – AM is no longer restricted to only being able to make loans when it has secured the funding from donors, or to be tied to the local authority budgeting schedule. It now has a reliable, long-term source of funding that it can drawdown upon when needed, and only to the extent needed.
- Administrative simplicity - this is administratively an easier system to handle as it reduces the need for AM to be continuously negotiating with the local authorities and/or grant funders for capital and then worrying about having to immediately invest that capital when available. In this system, capital is immediately put to good use as soon as it becomes available. The structure enables the social mission to be delivered with greater independence from the fund-raising activity.

- Facilitate charitable capacity funding – Grant funding can also now be focused more efficiently on *capacity building* of the organisation, rather than programme delivery which can be funded by the private sector. This enables AM to build infrastructure and resources for the long term.
- Ability to grow the business organically – as AM continues to prove its track record and keep losses down, the commercial banks funding AM should become more comfortable to permit a higher ratio of loan size relative to the guarantee support provided by the SIWB. The proposal, therefore, enables AM to fund growth of the loan book (subject to continued solid performance) without needing to seek additional funders.
- Accessing new sources of commercial funding – the proposal brings in private sector involvement and opens up a new source of funding for the organisation. It also introduces traditional pure commercial players into the social investment sector, increasing private sector knowledge and understanding and bringing a much greater flow of private capital into the sector.