THE SOCIAL ECONOMY ALLIANCE

CONSULTATION PAPER – INVESTMENT

How social investment, co-operative and community finance and peer-to-peer models can address the challenge of restoring credibility, transparency, stability, sustainability and trust to our financial system.

THE FINANCIAL CRISIS

The shadow of the financial crisis still hangs over us. While catastrophe was averted by massive government intervention, we now need to turn to addressing the problems that caused the crisis. Following the public outrage since 2008, we need to build new models of greater competition, effectiveness and transparency in our financial services.

Our financial institutions are still too big to fail, with the banking industry in the UK dominated by an oligopoly of four or five institutions. Conventional retail banking is still fatally intertwined with short-term, high stakes investment banking and less than half of the total assets held by British banks are actually loaned to customers. We need to move on from complexity, opacity and over-intermediation and put scandals, LIBOR rigging and miss-selling behind us.

So capital adequacy standards have been raised and tests have been strengthened, placing banks under greater constraints. Yet this makes it harder for them to lend, take calculated risks and turn a profit. It is not even clear that bank lending to UK SMEs, particularly small and micro-enterprises, can be a profitable business model in future. The Government's review into non-bank finance reported that the expected constraints on banks as they deleverage could create a finance gap for businesses of £84 billion to £191 billion over the next five years.

Beyond the banks the picture isn't much healthier - returns in the UK venture capital industry average around zero since the dot com bubble[1]. While hedge fund management fees dwarf returns to investors, themselves even lower than returns on government bonds or stock market averages, highlighting problems with transaction costs. With the global value of - often complex and opaque - derivatives now estimated at over a quadrillion[2] dollars, it is far from clear that we are any more able to identify and absorb systemic risk today than we were five years ago. We've lost touch with where our money is being invested and our financial institutions are no longer serving savers or the financial needs of most of the population.

Neither do they seem to be serving those seeking to attract investment - loan rejection rates have risen from 5% in 2004 to over 20% in 2012. 55% of SMEs use credit cards[3] with almost 50% of users unaware of the interest rate[4]. Early stage finance gaps and equity gaps still remain, and particularly in the social sector, unmet demand for cash flow finance and genuine risk capital.

To keep this system 'working', the state provides an unprecedented array of subsidies and support. The major banks are still supported and implicitly guaranteed by the state, we have billions of pounds of quantitative easing and interest rates held at historically low levels. One state intervention after another has been developed to support the flow of finance - Funding for Lending, the Enterprise Finance Guarantee Scheme, the bond support scheme, the

[1] http://www.nesta.org.uk/sites/default/files/unchaining_investment.pdf
[2] 1,000,000,000,000,000
[3] http://www2.warwick.ac.uk/fac/soc/wbs/research/ei/latest/small_firms_in_the_credit_crisis_v3test.pdf
[4] http://www.moneywise.co.uk/news/2013-05-02/half-all-credit-card-holders-have-no-idea-what-interest-rate-they-pay

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export working capital scheme, the letter of credit guarantee scheme, a Business Bank, Regional Venture Capital Funds, numerous tax breaks and more. In Mark Carney's words, this is "wartime spending on peacetime calamity".

Yet even worse, while there are alternatives which are starting to prove themselves, this state subsidy, regulation and fiscal incentives hold them back. Billions of pounds are directed at the established models, blue chip firms and financial services for the 1%. Regulators are overly suspicious of social lenders and new models - barriers to entry are high. 'Challenger banks' look set to emerge but may be mini-Metros, all located within the M25. The tax regime directs investors to where money is already flowing, to the FTSE or the bond markets rather than SMEs. EIS and VCT are targeted at 'sophisticated investors' and High Net Worth Individuals rather than ordinary investors. Peer-to-peer models are disadvantaged as they are unable to net out losses like institutional models. Mutual and social sector models don't always fit the rules as they stand. Consequently, we are missing a *Mittelstand* layer of financial services and are stuck in what the Bank of England's Andy Haldane calls a "doom loop", with the state propping up and beholden to old models which are too big to fail.

This is a market a million miles away from functioning effectively in its own right, let alone one fit to finance the economy of the future. We believe there is a huge opportunity here.

THE SOCIAL ECONOMY SOLUTION

We believe that social investment, co-operative and community finance and peer-to-peer models can help address the challenge of restoring credibility, transparency, stability, sustainability and trust to our financial system.

We need proper competition for a market that works. As Andy Haldane says, we need diversity. More banks and regional banks would help but are not a simple answer – the failed Cajas of Spain are just as relevant here as the successful Sparkassen in Germany. But new players and business models have emerged, are already developing a track record and starting to prove themselves.

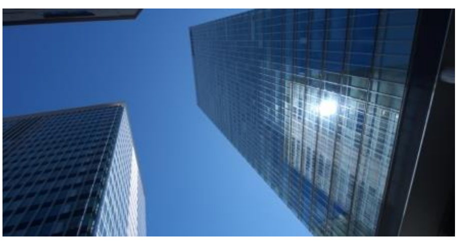
These include mutuals, community development finance institutions (CDFIs) like East Lancs Moneyline, credit unions, crowdfunding platforms, peer-to-peer models, Charity Bank, Unity Trust Bank, Triodos Bank, Ecology Building Society, Abundance Generation, Quidcycle, Buzzbnk, community shares, Ethex, and more. The Church of England are planning to create a 'Good Bank' out of the ruins of RBS.

These 'alternative finance' models are, with a human perspective, not really so alternative. They are often built around principles of making genuine connections to communities and real investment in the economy, disintermediation, democratic participation, long-term investment (rather than with a preoccupation with speculation, exits and liquidity), responsibility, regard for social and environmental impact, transparency, accessibility and simplicity. By giving ordinary savers a say in what happens to their money, we can help to ensure that financial markets promote sustainable growth and deliver long-term value.

Despite the odds, with state support largely bypassing them, these models are successful and growing. The Global Alliance for Banking Values reports that alternative banks are delivering better returns and greater stability[5]. The FT reports how the mutual sector "weathered the recent crisis better than its commercial counterparts". Crowdfunding activity has almost doubled in just twelve months[6]. CDFI lending is growing year on year[7]. Research shows that more diverse banking systems perform better on SME lending, regional economic development, branch coverage, access to banking to the financially marginalised and support for social enterprises[8]. They even improve the stability of financial system by adopting more prudent approaches to funding and risk, and produce a more stable, long-term and consistent flow of profits.

The financial services industry is of vital importance to the UK economy. The social, alternative and pioneering innovations which are emerging here can re-popularise financial services and help bring about - as the Governor of the Banks of England describes it - the "transition from its self-appointed role as the apex of economic activity to once again be the servant of the real economy."

[5] http://www.gabv.org/wp-content/uploads/New-13-5923_GABV_report_Washington_07mvd1.pdf
[6] http://www.nesta.org.uk/sites/default/files/the_rise_of_future_finance.pdf
[7] http://www.cdfa.org.uk/wp-content/uploads/2010/02/ICF-full-report-web1.pdf
[8] http://www.neweconomics.org/publications/entry/stakeholder-banks



WHAT CAN GOVERNMENT DO?

1. Transparency is vital. Effective and efficient markets rely on high quality information. The financial market regulators should ensure that:

   - banks and other finance providers are obliged to properly disclose and publish the amount of lending to, and deposits from, small businesses and civil society, the provision of basic bank accounts, current accounts, branch location and free to use ATMs, fees and charges, the quantity and cost of lending on an area basis; and support for credit unions and CDFIs. Following the US model, and the critically important role of the independent arbiter and scrutinizer role played by the Federal Reserve, the FCA or Bank of England should have responsibility for independent oversight of this obligation and powers to act in response. This could be the cornerstone of a Community Reinvestment Act for the UK.

   - institutional investors, pensions funds, asset managers, lenders, mortgage providers and credit card providers make full disclosure of all costs, including actual or estimated transaction costs and performance fees in a way that people can understand.

   - asset managers are subject to the same transparency and accountability as those in whom they invest, with savers having the right to know where their money is being invested, how ownership rights are being exercised on their behalf, their scheme's investment policy and approach to responsible ownership or ethical investment. Savers should have the right to a more participative role, for example, being consulted on investment and voting policies, attending annual meetings where they can question their pension scheme's board, and a place for a member representative on every pension scheme's board.

   - grant-making trusts and foundations, local authorities, their pension funds and other public and social sector organisations disclose their investments and investment approach. Government should also clarify the rules under charity law and around fiduciary duty to put beyond doubt that trusts and others may have regard to a wider range of factors than short-term financial returns.

2. Tax incentives should direct the flow of finance toward economically productive, socially useful and environmentally responsible sectors of the economy. This includes:

   - Adjusting EIS and VCT to reward investment in certain sectors (e.g. renewable energy or healthy living) and exclude others (e.g. tobacco or gambling).

   - Improving SITR and CITR to work more effectively, including indirectly through investment funds and creating incentives which work for ‘ordinary’ investors.

   - Reintroduce the Corporate Venturing Scheme with incentives for larger companies to invest in the social economy

   - Reform the banking levy from a blunt, ad-hoc and unpredictable measure into a longer term consistent incentive for banks to operate with greater social and environmental responsibility.

3. Similarly, public investment and guarantees should be weighted towards more economically productive, socially useful and environmentally responsible sectors of the economy. The range of guarantees, venture schemes, QE, Funding for Lending and the Business Bank, among others, could be more effectively directed to enable stronger growth among social investors, community banking models, mutual, credit unions, co-operative finance and community shares. This would be supported by a more proportionate and appropriate light-touch regime for state aid with regard to the social economy.

4. Regulation should also give greater regard to economic, social and environmental factors, including:

- The PRA and/or the FCA should be given a mandate to support diversity in the market.

- Regulation of social investment, co-operative and community finance, crowdfunding and peer-to-peer models should be better joined-up as well as more proportionate and appropriate. There should also be a more coherent and adequately resourced regulation of social enterprises and co-operatives through the respective regulators of charities, CICs and IPSs.

- The FCA should also take a more active role in addressing unfair and anticompetitive behaviour, such as with regard to loan sharks, lack transparency of fees and charges, indebtedness, etc.

- There should be dedicated resources within HM Treasury, the FCA, PRA and BoE to take responsibility for new and emerging finance models combined with more enthusiasm and less suspicion of new entrants.

- The regulators' approach should create incentives on finance providers to act more responsibly by making regulatory burdens proportionate to size, social mission, behaviour and track record, while ensuring this does not inhibit new entrants.

5. Greater competition can be created through opening the doors to emerging finance models through:

- support better promotion and awareness raising of particularly to 'ordinary' retail investors.

- financial support for those working to develop and strengthen new and responsible models of finance (such as the Social Investment Forum, UKSIF, ABCUL, the Community Shares Unit, the UKCFA and the cdfa).

- Government harnessing the potential of mission driven social investors, credit unions and others across other policy areas, such as, for example, the introduction of Universal Credit, where alternative finance providers can supply pre-paid cards.

- Government allowing both the Big Lottery Fund and Big Society Capital the sufficient independence and flexibility necessary to most effectively support sustainable funding, financing and support of civil society over the long-term.

QUESTIONS FOR CONSULTATION

1. Which of these proposals do you agree with?

2. Which of these proposals don't you agree with?

3. Which of these proposals are the most important?

4. What have we missed? Which proposals would you like to add?

5. Which proposals need further work or refinement?

6. Do you have any evidence to support or refute any claims made in this paper?

7. Is there any evidence or examples from other contexts which can inform the proposals put forward in this paper?