

Extending a Community Investment Tax Relief scheme

Consultation document

June 2005



HM TREASURY



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PREFACE

This consultation document seeks views on the case for, and practicalities of, extending a Community Investment Tax Relief (CITR) scheme to investments in community development finance institutions' (CDFIs') personal lending activities.

The Treasury would be grateful for responses to the questions outlined in this consultation document, to be sent by 26 September 2005 to:

CITR consultation

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Respondents are requested to give details of any organisation whose views they represent.

Unless respondents indicate to the contrary, it will be assumed that they have no objection to their response being made public. General statements of confidentiality of the type commonly found at the end of emails from corporate systems will be ignored. If you are replying by email, please make it clear in the body of your response whether or not you wish your comments to be treated as confidential.

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SUMMARY

1.1 In December 2004, the Government published *Promoting financial inclusion*¹ which set out a range of measures to tackle financial exclusion in three priority areas:

- access to banking;
- access to affordable credit; and
- access to free face-to-face money advice.

1.2 As part of promoting access to affordable credit the Government set out its plans to boost the coverage, capacity and sustainability of ‘third’ sector lenders – credit unions and community development finance institutions (CDFIs). One of the key elements of the Government’s package of measures is a growth fund to provide revenue and capital support to credit unions and CDFIs to encourage further growth and sustainability in the sector. In addition to this, the Government announced that it would consult stakeholders within the CDFI sector and the investment community on the case for, and practicalities of, extending a Community Investment Tax Relief (CITR) type scheme to investments in CDFIs’ personal lending activities.

1.3 The Government wants to promote the sustainability of third sector lenders so they are better able to serve the credit needs of low-income groups. The purpose of this consultation is to gather evidence on whether there is a case for extending a CITR type scheme, and specifically to gauge whether a CITR type scheme would contribute to increased investment in personal lending CDFIs and subsequently to improved sustainability of the sector. The Government is also seeking views on the practical issues that would need to be considered were such a scheme to be developed.

¹ Promoting financial inclusion, HM Treasury. December 2004.

TACKLING FINANCIAL EXCLUSION

2.1 Financial exclusion is defined broadly as where individuals lack access to certain financial products and services or where individuals are forced to pay more for those services than those who are able to access a broad range of financial products and services. Despite progress made on the issues identified in the 1999 PAT 14 report,² financial exclusion remains a key challenge. An indication of the size of the problem is given in the 2003-04 Family Resources Survey.³ This survey identified that there were around 1.5 million households in the UK without a bank account, any other types of savings account or a Post Office Card Account (POCA), equating to around 2.3 million adults. Many more households are unable to access mainstream sources of credit and must pay rates many times that of a standard personal loan in order to access credit.

2.2 The reasons for remaining outside the mainstream financial services system are complex and interrelated, however two broad themes can be identified:

- people see few advantages to opening bank accounts and entering the financial mainstream; and
- mainstream providers have concerns about profitability and risk.

Reasons for remaining outside the financial mainstream

2.3 On the demand side, for example, financially excluded groups may have concerns about understanding complex mainstream financial products, or there may be mistrust of mainstream financial institutions. Research also indicates that many people think that mainstream financial products are not for them and are instead for wealthier people in employment. One study concluded that non-users of financial services have a very similar profile to existing users drawn from the same social groups.⁴ The main difference between the two groups was the extent to which their friends and family members were users of financial services, implying that one of the determinants of accessing mainstream financial services is social norms and networks.

Incentives for the financial services industry

2.4 On the supply side, the mainstream financial services industry faces disincentives to attract the excluded population largely because low-income groups are likely to be less profitable and more risky customers. This is true both in terms of providing basic banking services and credit. Looking at the provision of credit, providing loans for under £1,000 to any borrower is unlikely to be profitable for a mainstream bank and few would consider offering loans of that size. In addition, the basic transaction costs for low-income consumers are often higher – as they are heavier users of the bank branch network and are likely to want to make smaller repayments than better off customers. Low-income groups are therefore less likely to generate profits than higher-income customers for the same size of loan. Low-income groups are also more likely to default on their loans than higher-income consumers, making it more risky for the bank to provide credit to them.

² Access to Financial Services. Policy Action Team 14 report. HM Treasury 1999.

³ www.dwp.gov.uk.

⁴ Social networks: their role in access to financial services in Britain, Pamela Meadows, National Institute of Economic and Social Research, Paul Omerod and William Cook, Volterra Consulting Ltd, National Institute Economic Review no.189, July 2004.

2.5 The lack of availability of mainstream financial services for financially excluded groups has resulted in the growth of an alternative credit market, established to meet the specific credit needs of these people but charging high prices in comparison to mainstream institutions to do so. These higher prices reflect the fact that loans tend to be smaller and so the fixed costs of provision are proportionately higher and that there is a higher risk of default among low-income groups. However, while it is clear that lending to low-income consumers will be more costly for providers, it is also true that it is often those on the lowest incomes – and thus those least able to pay – who face these higher charges.

Costs of financial exclusion

2.6 Financial exclusion can impose significant social and financial costs on individuals, on their wider neighbourhood, and on society as a whole. For the individual some of the most important problems associated with financial exclusion include higher charges for basic transactions and services such as cashing cheques and accessing credit, a lack of security in holding and storing money and difficulty in gaining or retaining employment. As well as impacting negatively on individuals, financial exclusion also contributes to problems of child poverty, social exclusion and neighbourhood decline. Moreover, the economic consequences of these effects are exacerbated in areas of social deprivation and for groups on the lowest incomes.

‘Promoting financial inclusion’

2.7 The Government is committed to tackling financial exclusion and believes that there are strong grounds for intervening in order to counteract the negative impact of financial exclusion on individuals and communities, and to contribute to the delivery of both social and economic objectives. *Promoting financial inclusion* and the 2004 Pre-Budget Report set out a range of Government measures to tackle financial exclusion in three priority areas:

- access to banking;
- access to affordable credit; and
- access to free face-to-face money advice.

2.8 The announcement of this consultation formed part of a package of measures aimed at improving access to affordable credit.

ACCESS TO CREDIT

Credit needs of low-income groups

2.9 Low-income groups often use credit to buy essentials, such as household appliances, furniture or clothing, to pay bills and to meet the cost of smaller discretionary items. These groups have particular credit needs⁵ and value credit agreements that offer:⁶

- small cash loans, typically under £1000, repayable over short periods;
- easy access to credit, without having to engage in lengthy application procedures;
- affordable weekly repayments;
- a method of repayment that fits with a household’s method of financial management;

⁵ Life on a low income: An overview of research on budgeting, credit and debt among the ‘financially excluded’, Elaine Kempson, 1996 in *How People on Low Incomes Manage Their Finances*, Economic and Social Research Council, 2002.

⁶ Affordable credit – The Way Forward, Elaine Kempson and Sharon Collard, Joseph Rowntree Foundation. 2005.

- a flexible approach to repayments and rescheduling; and
- credit from a reputable and trusted provider.

Options for the financially excluded

The alternative credit market

2.10 With no access to mainstream credit the financially excluded often have to turn to the alternative credit market which, unlike the mainstream market, exists to meet the needs of low-income groups requiring access to small, short-term loans. Research data⁷ suggests that clients of the alternative credit market are likely to be on low-incomes, single or the head of a single parent family, not in paid work and living in accommodation provided by a local authority or housing association. The alternative credit market includes:

- home credit companies;
- pawnbrokers;
- sale and buyback shops;
- payday loans;
- some mail order catalogues;
- rental purchase outlets; and
- illegal moneylenders.

2.11 Reliance on the alternative credit market means that the most vulnerable consumers can end up paying much more for credit than consumers accessing mainstream sources. Typical products in this market have Annual Percentage Rates (APRs) of over 100 per cent. For example, a loan from a home credit company for £200 might attract a charge of £94, which is repaid over 30 weeks at £10 a week. This equates to an APR of 309 per cent.⁸ In addition to the high costs, the specific lending practices of some of the key providers in this market are often criticised as intentionally leading clients into taking out more credit and then creating and perpetuating a cycle of borrowing and indebtedness.⁹

The Social Fund

2.12 More affordable options are however, available for low-income groups and one important source of credit for financially excluded groups¹⁰ is the Social Fund. This provides a safety net of Government grants and interest-free loans (with repayments deducted directly from benefits) for the most vulnerable in times of crisis. As the next step in the reform of the Social Fund, the Government announced in the 2004 Spending Review its intention to abolish the 'double debt' rule¹¹ for Budgeting Loans eligibility and to lower the highest loan repayment rates. These measures, which will be

⁷ See for example, *In Too Deep*, CAB Clients' Experience of Debt, Sue Edwards, Citizens Advice Bureau, May 2003.

⁸ Access to credit on a low income: a study into how people on low incomes in Liverpool access and use consumer credit, Paul A Jones, Co-operative Bank, 2001.

⁹ See for example *Home credit – an investigation into the UK home credit market*, Claire Whyley and Steve Brooker National Consumer Council, June 2004. This report highlights the practices of step up and rollover loans in the home credit market, which can lead people into taking on more debt. Rolling over loans is also common in the payday lending market.

¹⁰ *The Use of the Social Fund by Families with Children*, N. Finch and P. Kemp, University of York, July 2004 found that Social Fund customers were more likely to be lone parents, younger people or tenants, and were more likely to have a young child, a longstanding illness, health problem or disability, as well as caring responsibilities. They were also more likely to have debts and less likely to have a bank account.

¹¹ The 'double debt' rule takes an applicant's outstanding Budgeting Loan debt into account twice in calculating the maximum amount he or she can borrow.

implemented in April 2006, amount to an increase in funding for the Social Fund loans scheme of £210m over the three years to 2008-09.

Third sector lenders **2.13** ‘Third’ sector lenders – credit unions and community development finance institutions (CDFIs) – also play an important role in the provision of affordable credit and these community-based organisations are already active in providing lower-cost loans and money advice to those on the lowest incomes. The rates of interest offered by these third sector lenders (typically between 12 and 30 per cent APR), while higher than those offered by mainstream sources of credit, are significantly below those in the alternative credit market and in areas where these organisations exist they can offer substantial savings for customers.

COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS AND PERSONAL LENDING

What are CDFIs? **2.14** CDFIs are financial institutions providing for social, economic and physical renewal in under-invested communities. They lend and invest in deprived areas and markets that cannot access mainstream finance. They provide financial services with the aim of generating both financial returns and beneficial social outcomes. CDFIs offer two primary products – equity and debt – and most specialise in one of these. They can serve four types of enterprise market – micro-enterprise, small, medium and social enterprises.¹² Some CDFIs also provide finance for individuals. This tends to be divided between lending for consumption and lending for home improvements.

Personal lending CDFIs **2.15** Personal lending CDFIs are therefore organisations that provide lending and investment facilities at competitive rates to individuals in disadvantaged communities. They lend to people who are unable to access credit in the mainstream sector and therefore provide a viable alternative to high cost options, such as home collected credit.

The CDFI market **2.16** The Community Development Finance Association (CDFA)¹³ 2004 report,¹⁴ shows that 61 per cent of their member CDFIs mainly invest in micro-enterprises, 3 per cent in small businesses, 23 per cent in social enterprises, while 10 per cent of CDFIs provide personal finance. These figures are represented in Chart 2.1. There are currently 6 personal lending CDFIs, who are actively making loans to low-income consumers, unable to access credit in the mainstream sector. These organisations are: East Lancashire Moneyline, based in Blackburn, South Coast Moneyline in Portsmouth, Salford Moneyline, Moneyline Yorkshire, based in Sheffield, Derbyloans and Sandwell Advice and Moneylink, in the West Midlands.

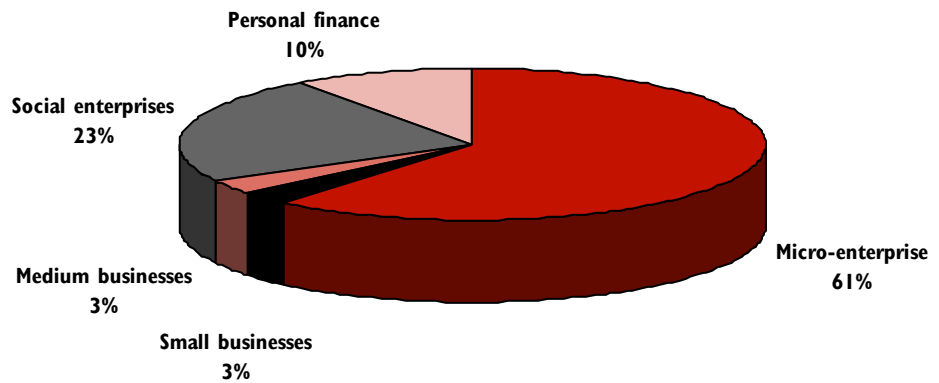
2.17 In terms of value, investing in social enterprises is the strongest sector comprising 54.7 per cent of the £147 million CDFI investment and lending portfolio, while loans for personal consumption represent just 2.5 per cent of the total CDFI investment and lending portfolio by value but almost 50 per cent by number amounting to around 2668 loans. Chart 2.2 demonstrates the total CDFI portfolio by value.

¹² The Small Business Service defines micro-enterprises as enterprises with less than 10 employees, small – enterprises with 10-49 employees and medium – enterprises with 50-249 employees. The Social Enterprise Unit defines a social enterprise as a business that trades with a social purpose.

¹³ The Community Development Finance Association is the UK trade association for CDFIs.

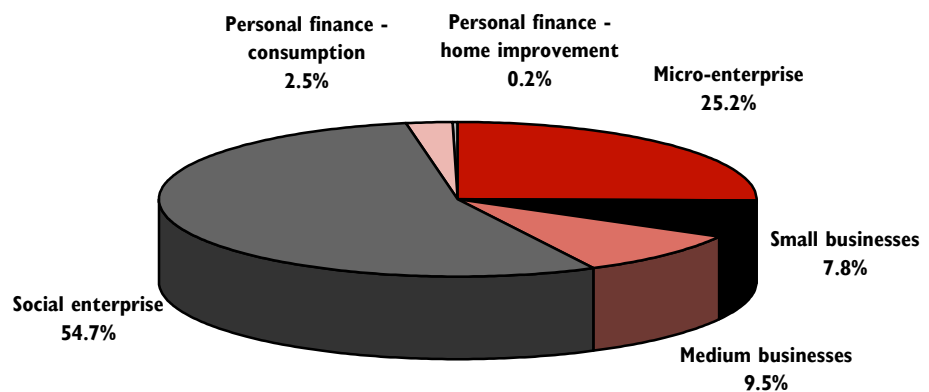
¹⁴ Inside Out. The State of Community Development Finance 2004, Community Development Finance Association April 2005.

Chart 2.1: The CDFI Market in 2004: the proportion of CDFIs involved in each sector



Source: CDFA

Chart 2.2: CDFI Portfolios by value in 2004



Source: CDFA

Growth of personal lending CDFIs

2.18 While currently a small part of total CDFI activity by value, it is clear that the personal lending aspects of CDFI activities are expanding. Although the proportion of lending to individuals for consumption has remained similar from 2003 to 2004, the overall amount lent has grown from just over £1 million in 2003 to over £1.1 million in 2004. The number of loans made has grown by over 750. Looking at individual personal lending, from CDFIs’ own annual return information it is clear that this trend is continuing. For example, East Lancashire Moneyline, one of the leading providers in this market, made 993 loans in 2004 – the majority of them personal loans, and hopes to

achieve 1200 loans in 2005. Salford Moneyline began its operations in a small area of Salford but now covers the whole of the city and by the end of 2004 had over 800 personal customers. Derbyloans achieved over twice as much lending in the 12 months of 2004, as in the 8 months they were operational in 2003 and hopes in 2005 to expand its personal lending beyond the city of Derby.

Typical loans 2.19 CDFIs offering personal loans typically offer annual interest rates of between 15 and 30 per cent,¹⁵ with many operating a risk-based approach, charging the higher rates for riskier clients. East Lancashire Moneyline for example will typically charge 31.1 percent APR for a personal loan for new customers, but 24.3 per cent APR for existing clients who have been able to build up a credit record with them. Evidence suggests that this flexibility allows CDFIs to reach some of the most financially excluded groups.¹⁶ Typically, loans will be provided for emergencies, home improvements, debt consolidation, meeting the costs of going back to work and the purchase of domestic equipment. The average loan size for a personal loan across the personal lending CDFI sector is just over £500 with an average loan term of 15 months.

Clients of personal lending CDFIs 2.20 The clients of personal lending CDFIs are typically on low incomes, excluded from mainstream sources of credit. For example, 71 per cent of South Coast Moneyline's client base, and approximately 90 per cent of East Lancashire Moneyline's customers are reliant on welfare benefits as part of their income. More than half of East Lancashire Moneyline's customers have a weekly income of less than £150 and many have up to 40 per cent of their household income already committed to paying off cash loans that typically charge interest of £160 on each £250 borrowed. About a fifth of loans go to people needing help to pay off loans taken out with home credit companies.

2.21 *Promoting financial inclusion* estimates that there may be around 3 million regular users of the alternative credit market. A proportion of those users could benefit from the low-cost loans provided by personal lending CDFIs. There is currently growth in personal lending by CDFIs, and there is clear demand for low cost lending services from financially excluded groups. The Government wants to enable increased provision in areas of need.

GOVERNMENT ACTION TO SUPPORT THIRD SECTOR LENDERS

2.22 The Government wants to ensure that those on low incomes, excluded from mainstream sources of credit are able to access affordable loans. The Government believes that a key way to meet the credit needs of low-income groups is to provide support to the third sector. The Government recognises the valuable role already played by the third sector in providing low-cost lending services to financially excluded customers, however the coverage of these institutions is at present limited. Therefore, at the same time as making commitments to improve access to the financial mainstream particularly through increasing access to banking facilities, the Government announced a series of measures to boost the coverage, capacity and sustainability of the third sector.

¹⁵ Credit unions currently lend up to a capped interest rate of 12.68 per cent APR, although the Government has consulted on whether to raise this cap. CDFIs tend to lend at slightly higher rates – starting at around 15 per cent APR and going up to around 30 per cent APR.

¹⁶ Research produced by Community Finance Solutions at the University of Salford suggests that customers of personal lending CDFIs tend to be younger, less well off and in less stable relationships than credit unions' customers.

Boosting coverage 2.23 To boost the coverage of credit unions and CDFIs the Government has committed, subject to obtaining State Aids approval from the European Commission, to establish a growth fund for third sector lenders – credit unions and CDFIs. The support available to CDFIs will comprise both revenue and capital funding, and will help establish new CDFIs, support existing enterprise lending CDFIs to expand into the personal lending market and provide ongoing support for existing personal lending organisations.

2.24 The Government has also consulted¹⁷ on the costs and benefits of raising the interest rate limit that credit unions can charge on loans, in particular to ascertain the likely impact this may have on existing credit union members and the communities they serve. The Government is aware that some in the credit union sector consider that the current limit of 1 per cent a month, restricts their ability to make loans available to those on the lowest incomes and disadvantages credit unions in comparison with other lenders. The current cap may also make it harder for credit unions to become financially self-sufficient. On the other hand, legislative reform to increase the interest rate limit could have the effect of making loans more expensive for existing credit union members or undermine credit unions' social role.

Increasing capacity 2.25 *Promoting financial inclusion* highlighted the role of volunteers and staff in delivering an increase in the capacity of the sector and invited the Financial Inclusion Taskforce to consider ways in which the capacity and skills of volunteers and staff within third sector lenders could be enhanced. The membership of the Financial Inclusion Taskforce was announced in January 2005 and the Taskforce was formally launched on 21st February 2005.

Promoting sustainability 2.26 All CDFIs rely to varying extents on external sources of both capital for on-lending and revenue funding to meet the costs of their operations. The long-term sustainability of the CDFI sector therefore depends on CDFIs' ability to attract investors and grant providers. The CDFA identifies three types of sustainability in the context of CDFI activity.¹⁸ Financial sustainability means that the organisation covers all its cost from earned income on its lending activities including paying a 'market' rate for its capital. Operational sustainability means that the organisation covers all its revenue costs from earned income. This can include fee and consultancy income as well as income from lending charges. However, in this case elements of capital raised are typically below market rates. Market place sustainability is what most CDFIs are aiming to achieve in the short to medium-term. Here, operational costs are not covered by earned income in full, but the organisation is working towards some form of operational sustainability.

2.27 CDFIs currently attract funds from a variety of sources including the banking sector, individual investors, Government and charities. The Community Investment Tax Relief (CITR) scheme, introduced in 2002 for those CDFIs that invest in enterprises, is designed to encourage the raising of capital from new and existing sources of investment and has been warmly received within the sector. Building on the success of the CITR scheme to date, the Government is now interested in the views of stakeholders on the case for, and practicalities of, extending a CITR type scheme to investments in CDFIs' personal lending activities. Further details of the current CITR scheme can be found in paragraphs 3.16 to 3.22 in Chapter 3.

¹⁷ Credit union interest rate cap; consultation document, HM Treasury March 2005

¹⁸ <http://www.cdfa.org.uk/cmframe.php?prmid=6400> Glossary of CDFI terms

2.28 The objective of achieving sustainability in the sector is to ensure that CDFIs are able to extend their lending to more of the financially excluded groups they currently serve. The Government would not expect that achieving sustainability would alter the characteristics of the CDFIs' client base or the interest rates they offer to their customers currently.

Aims of the consultation

2.29 This consultation seeks views from interested parties on the case for extending a CITR type scheme to investments in personal lending CDFIs as one of the series of measures the Government is taking forward to promote sustainability in the sector. The Government believes that attracting external investment is a way in which CDFIs can work towards sustainability and the Government wants to establish whether an extended CITR scheme would encourage new investment in personal lending CDFIs. The Government also wants to be able to assess whether any new investment would promote sustainability and contribute to the work CDFIs already undertake in providing low-cost loans to low-income groups.

2.30 Chapter 3 looks at the case for extending a CITR type scheme to investments in personal lending CDFIs. The consultation does not ask questions about the CITR scheme for enterprise investment as it currently stands, except where the current scheme is used as the basis on which a future CITR type scheme for personal lending might be structured. If the Government were to go ahead with extending a CITR type scheme to personal lending CDFIs, there would be a number of practical issues to address. Chapter 4 looks at these practical questions and asks for views on the possible nature of an extended CITR type scheme.

3

PROMOTING SUSTAINABILITY

SUSTAINABILITY IN THE CDFI SECTOR

3.1 Despite the recent growth in personal lending activities of CDFIs, the sector has not yet been able to demonstrate sustainability and is still reliant on external subsidy in order to fund its activities. The sector is still young and developing and, as such, there is little information in the UK on which to assess when and how the sector might reach sustainability.

Learning from US experience

3.2 Some comparisons can be drawn from the United States however, where there is a strong, mature sector of Community Development Credit Unions (CDCUs). While these are not identical to CDFIs as we recognise them in the UK, they are organisations that provide finance to individuals unable to access mainstream sources. The comparison with UK CDFIs can be further drawn by the fact that many CDCUs provide enterprise finance as well as loans for personal consumption.

3.3 The National Federation of Community Development Credit Unions (NFCDCU) published a survey of its members' operations up to the end of the fiscal year 2000.¹⁹ The survey shows that:

- the median year for beginning loan financing was 1969;
- CDCUs are serving some of the poorest sections of society;
- CDCUs control more than \$1.82 billion in assets;
- CDCUs carry out more numerous and smaller transactions than other CDFI-type institutions;
- 60 per cent of CDCUs are totally self-sufficient in their operations, receiving no grants or subsidies;
- donations and grants are an especially critical component of profit and sustainability for new and smaller CDCUs; and
- as CDCUs increase in size and age, financial performance improves and services expand while reliance on external funding decreases.

3.4 The NFCDCU report does not state the age at which a CDCU might become sustainable, however it is clear that younger institutions, which the report defines as being less than 10 years old, are more reliant on external support than more established CDCUs. In the United States, a wide range of investment and financial support for the full spectrum of CDFIs has been provided. Research suggests that, for example, around one in three CDCUs have received public investment packages from the CDFI Fund, managed by the US Treasury. In addition, the banking sector has assisted by providing grants for operating expenses and staff salaries and has also contributed non-member deposits.²⁰

¹⁹ Community Development Finance from the Grassroots Up. A Study of Community Development Credit Unions. National Federation of Community Development Credit Unions, 2000.

²⁰ Life Saving Community Development Credit Unions, Mick Brown, Pat Conaty and Ed Mayo, The New Economics Foundation, the National Association of Credit Union Workers and the National Consumer Council. July 2003

3.5 In the UK, the longest established personal lending CDFI is South Coast Moneyline, which has been operating since 2000. Working from the United States' CDCU model, this suggests that UK personal lending CDFIs are likely to be in need of external support for some time before sustainability can be achieved. Indeed research evidence from Community Finance Solutions²¹ indicates that currently personal lending CDFIs are struggling to match their income, largely because average loan sizes are lower and staff costs are higher than expected.

BARRIERS TO SUSTAINABILITY

3.6 Three key barriers to achieving sustainability faced by personal lending CDFIs have been identified:

- small loan sizes mean the fixed costs of provision are proportionately higher;
- lending to vulnerable groups means that repayments can be erratic; and
- often extensive money advice and support needs to be offered when dealing with clients resulting in staff costs that are high in relation to the size and number of loans granted.

3.7 Due to the nature of lending to low-income groups, particularly their need for small, low-value loans and often for money advice it is likely that these barriers to sustainability will continue. However, CDFIs may be able to offset some of the increased costs of lending in this market by attracting additional investment from external sources. This investment may then be used to increase lending volumes and to reduce costs proportionately, leading to improved sustainability in the longer-term. The Government would like to establish if there is unmet demand for personal loans from CDFIs along with the extent to which any lack of provision is the result of a lack of investment in personal lending CDFIs.

Box 3.1

Question 1 – Do you consider that there are factors that inhibit CDFIs from being able to raise funds to on lend for personal loan purposes? If so, what are they?

Question 2 - What is your estimate of the likely level of demand for loans from personal lending CDFIs? How do you think this will change over time? (The Government is interested in views on a national scale, but also at a local level).

Question 3 – Would an increase in the level of investment in CDFIs help to offset some of the high costs of lending in this market? To what extent?

Question 4 – Would an increase in the level of investment in CDFIs help them extend their services to more customers?

²¹ Community Finance Initiatives – A Policy Success Story. Karl Dayson, Community Finance Solutions and the University of Salford.

OPTIONS FOR PROMOTING SUSTAINABILITY

3.8 The Government believes that support to the third sector, as set out in Chapter 2, will help to extend sources of affordable credit to low-income groups. The Government considered a number of options in deciding what kind of support should be provided to achieve this goal.

3.9 The Government has already committed to providing support to personal lending CDFIs through the growth fund, which will be focused on establishing brand new CDFIs, supporting enterprise investing CDFIs expanding into the personal lending market and providing ongoing support for existing organisations to boost their coverage. As set out in *Promoting financial inclusion* the Government is also committed to mapping the coverage of third sector lenders, to ensure that support is targeted in areas of need and this work is ongoing.

3.10 A different form of grant funding is the provision of a payment awarded to personal lending CDFIs to reflect the additional costs arising from advising and supporting clients above an agreed norm. This is something that the University of Salford has termed a 'Community Finance Initiative Service Delivery Payment' and would reflect the fact that the amount of time taken to support clients can have an impact on the sustainability of personal lending CDFIs.²² The Government has focused on growth funding at this time reflecting the need to boost the coverage of these organisations and to provide support to establish new personal lending CDFIs in areas where there are no alternatives to high cost lenders.

Attracting external investment

3.11 In addition to the growth fund, attracting another tier of capital in the form of private sector investment could further promote the sustainability of personal lending CDFIs.

3.12 To incentivise this private sector investment, one option could be to provide matched funding of investments in personal lending CDFIs. Investments into personal lending CDFIs could be matched at a certain rate with the CDFI able to keep any returns on the matched contribution to support further investment activity. This measure would incentivise CDFIs to look for investment and allow them to benefit from the returns on loans financed by matched funding and from the match itself. However, without a significant additional reward to investors, it is not clear whether this measure would be effective in attracting additional investment.

3.13 The incentive could also be offered directly to the investor, for example by match funding the investor's money but allowing any returns on that matched funding to flow to the investor rather than the CDFI. This would incentivise investors to contribute, boosting the funding available to the CDFI. Alternatively, similar incentives may be achieved using a tax-based scheme.

3.14 The Government has chosen to consult on a tax-based scheme because it reflects a scheme already in place for enterprise financing, so may have the advantage of being more readily understood by investors already in the market and by CDFIs that are involved in both enterprise financing and personal lending. The Government will consider the case for a CITR type scheme, following responses to this consultation.

²² Community Finance Initiatives – A Policy Success Story, Karl Dayson, Community Finance Solutions and the University of Salford

Box 3.2

Question 5 – Do you agree with the analysis of the potential options set out above and the approach adopted by the Government?

3.15 The following section describes the current CITR scheme before asking about the case for extending a CITR type scheme to investments in CDFIs' personal lending activities. In particular, the Government is interested in whether such an extension would help to promote sustainability in the sector, and whether there would be any detrimental effects, for example, on current enterprise financing CDFIs' investment levels.

THE COMMUNITY INVESTMENT TAX RELIEF SCHEME

What is the CITR scheme?

3.16 The introduction of a Community Investment Tax Credit (as it was then described) was one of the recommendations made by the Social Investment Task Force to the Chancellor of the Exchequer in 2000.²³ After clearance as a State Aid by the European Commission, the necessary legislation was enacted within Finance Act 2002 and the first CDFIs were accredited for the Community Investment Tax Relief (CITR) scheme in March 2003.

3.17 The key defining features of a CDFI for the purposes of being accredited for CITR are as follows:

- it must be set up with the intention of carrying on its activities for at least 5 years, and demonstrate this by explaining its chosen structure and by submitting a detailed business plan including details of its lending practices, revenue funding arrangements and plans for use of CITR to facilitate the raising of capital;
- it must intend throughout the period for which it seeks accreditation, that not less than 75 per cent of its activities are directed at the provision of finance, or the provision of finance and business advice for small or medium-sized enterprises (SMEs), for disadvantaged communities (see below);
- it must only provide finance to enterprises that have been unable to obtain funding from other sources, primarily mainstream providers of finance, and must offer a range of products applicable to the needs of its customer base; and
- it will only provide finance to SMEs that are located in specific geographic areas of disadvantage or are operated by, or for the benefit of, certain disadvantaged groups.

3.18 Accreditation is granted for a three-year period after which it must be renewed if existing investors are to continue to receive tax relief or if the CDFI wishes to raise further funds under the scheme. In order to successfully comply with the terms of accreditation CDFIs must also onward-invest within a certain time. By the end of the first year of their accreditation 25 per cent of the capital raised by the CDFI must be

²³ Enterprising Communities: Wealth Beyond Welfare, Social Investment Task Force, London, October 2000 (www.enterprising-communities.org.uk).

invested, 50 per cent by the end of the second year and 75 per cent by the end of the third year, with the 75 per cent limit maintained subsequently.

3.19 CITR is available to any individual or company with a UK tax liability investing in an accredited CDFI where the investment is held for at least five years. The taxpayer, who can either be an individual or a company receives a relief to offset against their Income Tax or Corporation Tax liability of 5 per cent of the amount invested in the year the investment is made and a further 5 per cent in each of the four subsequent years. The total relief is worth up to 25 per cent of the value of the investment. This tax relief is in addition to any interest or dividend paid by the CDFI. It should be noted that those without a UK tax liability such as overseas investors and pensions funds would not be able to receive support from the Government for any investment in a CDFI.

Benefits of CITR **3.20** At present 21 CDFIs are accredited, representing around 25 per cent of all the organisations in the UK that, by virtue of their primary activities, fall within the generally understood definition of a CDFI. By being CITR accredited, these organisations have at their disposal an additional means of attracting capital for on-lending that is not available to non-accredited CDFIs. Furthermore, the availability of tax relief has the potential to act as a lever for negotiating a reduction in the interest rate paid to the investor. Non-accredited CDFIs can potentially benefit indirectly from CITR if they access capital from a wholesale CDFI that is itself accredited.

3.21 As of June 2004, a total of 136 individuals and corporations have made qualifying investments in accredited CDFIs with a total value of over £8 million. Individuals represent 93 per cent of the investors and have provided 53 per cent of the capital raised. The most popular type of investment has been through depositing in savings products offered by the two accredited CDFIs that are banks (Charity Bank and Triodos). To date this route has accounted for 72 per cent of the investors participating and 90 per cent of capital raised.

Requirements of CITR **3.22** The current scheme has a number of requirements at each of the three operational levels, i.e. the investor, the intermediary CDFI and the enterprise borrowing from the CDFI:

- for investors there is a requirement to maintain their investment in the CDFI for at least five years in order to obtain the tax relief. The relief is not available for shorter investment periods and nor does it continue to be available after the fifth year. The relief is only available against income and corporation taxes and not against other forms of taxation such as capital gains or inheritance taxes;
- for the CDFI there is the requirement to manage its CITR capital separate from other resources in order to ensure that the rules on onward deployment and other requirements in the CITR rules are being met. Additionally, because of the public incentive that has been provided to attract CITR capital into the CDFI, there may also be constraints on its use to “match” resources from other public sources, thus potentially restricting the CDFI’s overall fundraising strategy; and
- for the clients of the CDFI, especially those that are profit-distributing businesses, there are CITR-specified constraints that limit the value and form of the products that the CDFI can provide.

INCENTIVISING NEW INVESTMENT AND PROMOTING SUSTAINABILITY – ASSESSING THE CASE FOR EXTENSION OF A CITR TYPE SCHEME

Extension of a CITR type scheme? **3.23** The Government wants to ensure that those on the lowest incomes have access to forms of affordable credit, and personal lending CDFIs are an important source for many low-income groups. The Government has put in place a package of measures designed to support personal lending CDFIs to do this and to grow, recognising that:

- the sector is currently young and small;
- there is potential for growth in this sector;
- a number of barriers to sustainability exist; and
- personal lending CDFIs need to attract external investment to operate and to achieve sustainability in the longer-term.

3.24 The Government wants to understand more about whether extending a CITR type scheme would encourage additional investment in personal lending CDFIs, and the extent to which this would further promote sustainability and growth in the sector. The Government is keen to gather evidence on whether an extension would encourage new external investment sources and if it would result in displacement away from current investment in enterprise investing CDFIs.

Box 3.3

Question 6 – Would an extension of a CITR type scheme to personal lending attract new CDFIs into the market? Would an extension encourage enterprise investing CDFIs to develop personal lending activities?

Question 7 – Would an extension of a CITR type scheme to personal lending CDFIs help to promote sustainability and growth in the CDFI sector?

Question 8 - Who might be prepared to invest in order to attract such a tax relief? Would it be companies, individuals or both? If both, what might the balance of investment be between these two sources? What might be the likely level of demand for an extended CITR type scheme?

Question 9 – In addition to the external investment already provided to personal lending CDFIs, how much extra investment could be expected to be generated as a result of a CITR type scheme being introduced?

Question 10 - Would investors use an extended CITR type scheme to obtain tax relief on funding they would have provided to personal lending CDFIs anyway or would this lever in additional investment?

Question 11 - Would any extension of a CITR type scheme to personal lending activities divert investment from enterprise financing by CDFIs?

Question 12 - Are the potential investors for personal lending and enterprise financing different?

Question 13 - Could the extension of a CITR type scheme divert investment away from other tax-incentivised investment?

3.25 The Government will assess the case for extending a CITR type scheme based on the potential for the option to meet the Government's objectives in this area, on whether it presents value for money for Government, and having regard to whether the scheme would impact negatively on other Government objectives or produce distortionary outcomes. For example, the Government would wish to understand the potential impact of any scheme on the current CITR scheme for enterprise financing. If an extension of the CITR scheme to investments in the activities of personal lending CDFIs would result in additional investment in the sector and would meet the Government's objectives in promoting sustainability the Government would need to consider a range of practical issues around the nature of an extended CITR type scheme. Chapter 4 considers some of these practical issues.

4

PRACTICALITIES OF ANY EXTENSION

4.1 The key features of the current CITR scheme are outlined in Chapter 3. Extending a CITR type scheme to provide tax relief for investors in organisations engaged in personal lending would require significant adaptations of the rules of the current scheme to take account of differences between enterprise financing and personal lending. This Chapter outlines, and seeks views on, some of the practical issues likely to arise if such an extension were to be considered.

TAX RELIEF FOR INVESTORS

4.2 Under the current scheme, CITR reduces the investors' Income Tax or Corporation Tax liability by 5 per cent of the value of the investment for each of the five years over which the investor is required to maintain the investment in the CDFI. The total relief is worth up to 25 per cent.

4.3 The design of the existing scheme in part reflects the requirement for enterprise lending CDFIs to have a source of capital funding whose likely duration roughly corresponds to the terms of their onward investment in client enterprises. Onward-investment by personal lending CDFIs generally involves loans of shorter durations, which might imply a shorter lock-in period. However, the Government is also aware that personal lending CDFIs, like enterprise financing CDFIs, require stability in their funding levels, which would imply that a longer lock-in period might still be appropriate. The Government is seeking views on what would be the appropriate tax relief rate and timescale over which tax relief would be received for investments in personal lending CDFIs. The Government is also keen to understand how designing an appropriate CITR type scheme, with potentially different incentive structures to the current CITR scheme for enterprise financing CDFIs might impact on current investment in those enterprise financing CDFIs.

Box 4.1

Question 14 – Taking into account the different risk profiles of enterprise financing and personal lending, what would be the appropriate rate of tax relief and lock-in period for the relief to attract and sustain additional investment in personal lending CDFIs? Why?

Question 15 - Which taxes should fall into the scheme? Currently relief is available under the CITR scheme for enterprise financing CDFIs against Income Tax and Corporation Tax only – are these appropriate for investors in personal lending CDFIs?

Question 16 - Based on your answer to Questions 14 and 15, what impact would this CITR type scheme have on investments in enterprise financing CDFIs?

THE ACCREDITATION PROCESS

4.4 The existing CITR scheme involves a process of accreditation for CDFIs engaged in appropriate investment activities. It is expected that bodies engaged in personal lending would need to be accredited for the purposes of any extended CITR type scheme. The process by which CDFIs have to seek accreditation to be able to receive tax-incentivised investment reduces the likelihood of abuses of the tax relief and also keeps the burden on potential investors to a minimum. This accreditation would be in addition to any regulatory framework set out by the Financial Services Authority (FSA).

4.5 The accreditation process for personal lending CDFIs might be modelled fairly closely on that of the current scheme, with an accrediting body assessing applications for a three-year period of accreditation by reference to published criteria based on the aims and activities of the CDFI.

4.6 The Government is interested in establishing what an appropriate accreditation process for any extended CITR type scheme would be and notes that a body seeking accreditation under any extended scheme may be engaged in enterprise financing of a type that meets the current accreditation criteria of the existing scheme, personal lending within the scope of an extended scheme, or both. In terms of minimising the costs to CDFIs there may be advantages for CDFIs of having one accreditation process for all of these types of finance provision. However given the likely need for some significant differences in the accreditation criteria for personal lending CDFIs, it may in fact be simpler to keep the accreditation processes separate.

Box 4.2

Question 17 – Would it be practicable for accreditation under any extended scheme to involve a single process modelled on the existing scheme and dealing with applications from both enterprise financing and personal lending organisations? Or would it be preferable to have distinct processes for organisations involved in each activity? If so, would the benefits of a separate accreditation process outweigh any additional complexity and costs?

Question 18 - Would the existing three-year period of accreditation be appropriate for bodies accredited for personal lending?

Question 19 – Would it be appropriate to extend the existing CITR ‘brand’ to organisations involved in personal lending or would a different branding be more appropriate?

ACCREDITATION CRITERIA

4.7 Any accrediting body would need criteria against which to judge applications for accreditation from organisations engaged in personal lending. The criteria that would be used to determine eligibility for the scheme would be likely to be based around:

- What constitutes a qualifying investing organisation/CDFI;
- What constitutes a qualifying investor; and
- What constitutes a qualifying loan by the CDFI.

Qualifying organisation

4.8 Any process put in place by which an organisation could be judged for accreditation would need to take account of the proposed activities of that organisation: the organisation would need to provide low cost credit to individuals unable to access mainstream sources of credit, offer suitable financial advice to borrowers, and provide annual reports of its activities.

4.9 The lending organisation would also need to provide evidence that it has the skills required to deliver on a sustainable basis appropriate types of lending activities. This would include submitting a business plan detailing how the organisation will find suitable lending opportunities, endeavour to re-coup its loans on behalf of investors and how it will lend in sufficient volumes to ensure a viable spread of its risk.

4.10 It may also be necessary to include some restrictions on the types of organisations, that could be accredited, in order to avoid bringing the scheme into disrepute. For example, accreditation criteria may need to exclude organisations which set up a 'CDFI style' subsidiary or branch but whose other activities could be considered to run counter to the Government objectives for the scheme.

Box 4.3

Question 20- What aims should be held, and what activities undertaken, by an organisation to merit accreditation as a personal lending CDFI?

Question 21 - Are there any professional or regulatory qualifications, institutional memberships or existing approval processes that could usefully be incorporated into the accreditation criteria for bodies engaged in personal lending?

Question 22 - Are there any activities that, if undertaken, should disqualify a body from accreditation as a personal lending CDFI?

Question 23 – Should the accreditation of personal lending CDFIs be based solely on the proposed activities of the applicant organisation or should other factors (such as whether or not the applicant's primary purpose is to lend to the financially excluded) be taken into account?

4.11 Under the current CITR scheme, the CDFI must ensure that a set proportion of its investment activity (75 per cent) is qualifying in order that the CDFI's investors qualify for tax relief. It is thought that a similar requirement would be needed in any extended CITR type scheme in order to ensure that the tax relief was given in support of the activities which the Government would wish to encourage. It is likely that the accreditation agency would want to understand the nature of the non-qualifying as well as the qualifying activity, in order to ensure that organisations whose non-qualifying activities run counter to the Government objectives for the scheme could be excluded. This could be monitored by means of the CDFI's business plan and annual reports.

Qualifying investor

4.12 It is likely that, in order to ensure that the tax relief available under any CITR type scheme for personal lending was not abused, legislation would be required to prevent investors who are connected with either the lending organisation or any existing customer of the lending organisation from receiving tax relief under the scheme.

Box 4.4

Question 24 – Would a restriction on investors of the type described in paragraph 4.12 create difficulties for the lending organisation in attracting investors to use the scheme?

Qualifying loan

4.13 As stated previously, the Government believes that it would be important to ensure that to be accredited under any extended CITR type scheme the majority of the CDFI's activity would need to be qualifying. Under the current CITR scheme, qualifying is defined by reference to the type of enterprise which is receiving investment. For example, the enterprise must not have been able to access funding from other sources, and must be located in specific disadvantaged areas or serving certain disadvantaged groups.

4.14 For personal lending, the Government believes that it would be both difficult and inappropriate to apply the same criteria. For example, a rule requiring that a borrower must not have been able to access finance from any other source would be inappropriate since people who use personal lending CDFIs do generally have other sources of finance available, such as the alternative credit market, albeit at higher prices.

4.15 However, the Government is still concerned that loans are targeted appropriately, so that those for whom the scheme is intended are able to benefit without leaving the scheme open to abuse. It may therefore be necessary to restrict the types of loan that qualify, for example, by:

- Placing an upper limit on the allowable APR of the loan, in order to ensure that those providing loans at higher costs are excluded;
- Placing a lower limit on the allowable APR of the loan, in order to prevent lending organisations being set up to make use of the available tax relief and lending to those who would be able to access other sources of affordable credit;
- Enforcing a maximum loan length, so that money can be recycled to other customers within a reasonable time. This would help to promote the sustainability of the lending organisation; and
- Placing an upper limit on the size of the loan which can be offered to any one individual per year across all CDFIs, in order to protect the scheme from misuse and encourage responsible lending.

Box 4.5

Question 25 - Do you think the restrictions on qualifying loans, set out in paragraph 4.15, would help to limit abuse of a CITR type scheme for personal lending CDFIs?

Question 26 – Are there any other restrictions on qualifying loans which would be useful to include, in order to target the loan appropriately?

Question 27 – If you agree that the restrictions set out in paragraph 4.15 would be necessary, at what levels would it be appropriate to set the limits?

Reporting obligations

4.16 The Government recognises that it may be necessary to limit the way in which a qualifying loan can be used. For example, without some restrictions on the way in which money is applied it would be possible for the owner of a business that was not a qualifying enterprise under the existing scheme to obtain funding for the same purpose through the personal lending scheme. This would frustrate the purpose of the existing scheme.

4.17 It is important to note that this may place some monitoring and reporting requirements on the CDFI. For example, under the existing CITR scheme CDFIs are required to provide to the Small Business Service on an annual basis a narrative report of the CDFI's activities over the past year along with detailed financial data relating to the investments raised, repaid, made and written off during the reporting period. This financial data provides the names of both investors and investee enterprises and the purpose of the investments made. This data is needed by Government to monitor the CITR scheme and to check that the money raised through the scheme is being properly targeted, as well as to comply with State Aid rules.

Box 4.6

Question 28 – Do you think it likely that the owner of a business that was not a qualifying enterprise under the existing scheme would wish to seek financing for the same purpose through a personal loan from a CDFI, if such a loan were available?

Question 29 – Are there any cases, other than that outlined in paragraph 4.16, where a personal loan should not be regarded as a relevant investment for the purposes of an extended CITR scheme?

Question 30 – To what extent would CDFIs be able to monitor the ways in which personal loans enabled by a CITR type scheme have been used?

Question 31 – Would a requirement to routinely return details of borrowers to Government deter a significant proportion of the target population from applying for loans? If so, would there be a way of monitoring an extended scheme, that wouldn't deter borrowers, but would provide assurance that funds are being lent and applied appropriately?

Box 5.1 - Questions in Chapter 3

Question 1 – Do you consider that there are factors that inhibit CDFIs from being able to raise funds to on lend for personal loan purposes? If so, what are they?

Question 2 - What is your estimate of the likely level of demand for loans from personal lending CDFIs? How do you think this will change over time? (The Government is interested in views on a national scale, but also at a local level).

Question 3 – Would an increase in the level of investment in CDFIs help to offset some of the high costs of lending in this market? To what extent?

Question 4 – Would an increase in the level of investment in CDFIs help them extend their services to more customers?

Question 5 – Do you agree with the analysis of the potential options set out in paragraphs 3.8 – 3.14 and the approach adopted by the Government?

Question 6 – Would an extension of a CITR type scheme to personal lending attract new CDFIs into the market? Would an extension encourage enterprise investing CDFIs to develop personal lending activities?

Question 7 – Would an extension of a CITR type scheme to personal lending CDFIs help to promote sustainability and growth in the CDFI sector?

Question 8 - Who might be prepared to invest in order to attract such a tax relief? Would it be companies, individuals or both? If both, what might the balance of investment be between these two sources? What might be the likely level of demand for an extended CITR type scheme?

Question 9 – In addition to the external investment already provided to personal lending CDFIs, how much extra investment could be expected to be generated as a result of a CITR type scheme being introduced?

Question 10 - Would investors use an extended CITR type scheme to obtain tax relief on funding they would have provided to personal lending CDFIs anyway or would this lever in additional investment?

Question 11 - Would any extension of a CITR type scheme to personal lending activities divert investment from enterprise financing by CDFIs?

Question 12 - Are the potential investors for personal lending and enterprise financing different?

Question 13 - Could the extension of a CITR type scheme divert investment away from other tax-incentivised investment?

Box 5.2 - Questions in Chapter 4 and Annex A

Question 14 – Taking into account the different risk profiles of enterprise financing and personal lending, what would be the appropriate rate of tax relief and lock-in period for the relief to attract and sustain additional investment in personal lending CDFIs? Why?

Question 15 - Which taxes should fall into the scheme? Currently relief is available under the CITR scheme for enterprise financing CDFIs against Income Tax and Corporation Tax only – are these appropriate for investors in personal lending CDFIs?

Question 16 - Based on your answer to Questions 14 and 15, what impact would this CITR type scheme have on investments in enterprise financing CDFIs?

Question 17 – Would it be practicable for accreditation under any extended scheme to involve a single process modelled on the existing scheme and dealing with applications from both enterprise financing and personal lending organisations? Or would it be preferable to have distinct processes for organisations involved in each activity? If so would the benefits of a separate accreditation process outweigh any additional complexity and costs?

Question 18 - Would the existing three-year period of accreditation be appropriate for bodies accredited for personal lending?

Question 19 – Would it be appropriate to extend the existing CITR 'brand' to organisations involved in personal lending or would a different branding be more appropriate?

Question 20- What aims should be held, and what activities undertaken, by an organisation to merit accreditation as a personal lending CDFI?

Question 21 - Are there any professional or regulatory qualifications, institutional memberships or existing approval processes that could usefully be incorporated into the accreditation criteria for bodies engaged in personal lending?

Question 22 - Are there any activities that, if undertaken, should disqualify a body from accreditation as a personal lending CDFI?

Question 23 – Should the accreditation of personal lending CDFIs be based solely on the proposed activities of the applicant organisation or should other factors (such as whether or not the applicant's primary purpose is to lend to the financially excluded) be taken into account?

Question 24 – Would a restriction on investors of the type described in paragraph 4.12 create difficulties for the lending organisation in attracting investors to use the scheme?

Question 25 - Do you think the restrictions on qualifying loans, set out in paragraph 4.15, would help to limit abuse of a CITR type scheme for personal lending CDFIs?

Question 26 – Are there any other restrictions on qualifying loans which would be useful to include, in order to target the loan appropriately?

Question 27 – If you agree that the restrictions set out in paragraph 4.15 would be necessary, at what levels would it be appropriate to set the limits?

Question 28 – Do you think it likely that the owner of a business that was not a qualifying enterprise under the existing scheme would wish to seek funding for the same purpose through a personal loan from a CDFI, if such a loan were available?

Question 29 – Are there any cases, other than outlined in paragraph 4.16, where a personal loan should not be regarded as a relevant investment for the purposes of an extended CITR scheme?

Question 30 – To what extent would CDFIs be able to monitor the ways in which personal loans enabled by a CITR type scheme have been used?

Question 31 – Would a requirement to routinely return details of borrowers to Government deter a significant proportion of the target population from applying for loans? If so, would there be a way of monitoring an extended scheme, that wouldn't deter borrowers, but would provide assurance that funds are being lent and applied appropriately?

Question 32 – Do you agree with the analysis of the costs and benefits of the options described in the partial Regulatory Impact Assessment? Is there further information you can provide that would enable a better understanding of these costs and benefits?

A

PARTIAL REGULATORY IMPACT ASSESSMENT

I. PURPOSE AND INTENDED EFFECT OF MEASURE

Objective A.1 This partial Regulatory Impact Assessment considers the potential costs and benefits of measures to incentivise external investment in the personal lending activities of community development finance institutions (CDFIs). One of the options considered and being consulted on is the possibility of extending a Community Investment Tax Relief (CITR) type scheme to CDFIs' personal lending activities. The consultation document seeks views on a wide range of practical aspects of extending a CITR type scheme and final decisions on whether and how to proceed will be taken following the consultation. The partial Regulatory Impact Assessment therefore only considers the general costs and benefits of extending a CITR type scheme to personal lending CDFIs.

A.2 The objective of incentivising private sector investment in personal lending CDFIs would be to attract additional investment as a means of promoting further sustainability in the sector. The objective of achieving sustainability is to ensure that CDFIs are able to extend the coverage of their lending to more financially excluded people. The objective would not be to encourage CDFIs to lend to different groups, nor to alter the interest rates that they offer to their customers.

Background A.3 This partial Regulatory Impact Assessment and related consultation document follows *Promoting financial inclusion*, which was published alongside the Pre-Budget Report in December 2004. This announced a number of measures to tackle financial exclusion in three priority areas: access to banking, access to affordable credit and access to free face-to-face money advice. Lacking access to mainstream sources of credit means that the financially excluded have to turn to the alternative credit market, which, unlike the mainstream market, exists to meet the needs of low-income groups requiring access to small, short-term loans. Reliance on this alternative credit market means that the most vulnerable groups can end up paying much more for credit than consumers accessing mainstream sources. Typical products in this market have Annual Percentage Rates (APRs) of over 100 per cent. *Promoting financial inclusion* therefore set out a range of measures to increase access to affordable credit, including plans to boost the coverage, capacity and sustainability of the third sector in providing a source of affordable credit to low-income consumers. The third sector includes credit unions and personal lending CDFIs.

A.4 CDFIs are financial institutions providing for social, economic and physical renewal in disadvantaged communities. They lend and invest in deprived areas and markets that cannot access mainstream finance. They provide financial services with the aim of generating both financial returns and beneficial social outcomes. CDFIs offer two primary products, – equity and debt. and most specialise in one of these. They can serve four types of enterprise market – micro-enterprise, small, medium and social enterprises.²⁴ Some CDFIs also provide finance for individuals and this tends to be divided between lending for consumption and lending for home improvements.

²⁴ The Small Business Service defines micro-enterprises as enterprises with less than 10 employees, small – enterprises with 10-49 employees and medium – enterprises with 50-249 employees. The Social Enterprise Unit defines a social enterprise as a business that trades with a social purpose.

A.5 Personal lending CDFIs are organisations providing lending and investment facilities at competitive rates in disadvantaged communities. They lend to individuals who are unable to access credit in the mainstream sector. The rates of interest offered by CDFIs vary between around 15 and 30 per cent and are significantly below those found in the alternative credit market.

A.6 Community Investment Tax Relief provides relief to investors to offset against their Income Tax or Corporation Tax liability of 5 per cent of the amount invested in the year the investment is made and in each of the four subsequent years. This relief is only currently available for investments in accredited CDFIs engaged in enterprise investment; investing in small businesses including social enterprises that have been unable to obtain funding from other sources.

**Rationale for
Government
intervention**

A.7 Low-income groups, excluded from mainstream sources of credit often have to turn to the alternative credit market, which includes home credit companies, pawnbrokers and sale and buyback shops. *Promoting financial inclusion* estimated that there may be around 3 million regular users of the alternative credit market, who are likely to be paying higher rates of interest than found in the mainstream market. Affordable options, such as the Social Fund, credit unions and CDFIs are available, however at present their coverage is limited.

A.8 The Government wants to ensure that those on low incomes, excluded from mainstream sources of credit are able to access affordable loans. The Government believes that a key way to meet the credit needs of low-income groups is to provide support to organisations such as credit unions and personal lending CDFIs. The Government recognises the valuable role already played by CDFIs in providing low-cost loans to financially excluded customers, however is aware that the sector is currently young and small. The Government believes that the recent growth in the sector and the numbers of consumers accessing the alternative credit market means that there is potential for further growth. However, without some Government support there is a danger that the personal lending CDFI market will not reach its potential.

A.9 The risks and costs associated with offering loans to low-income consumers can be higher than with other consumers. This is due to the fact that loans tend to be smaller and so the fixed costs of provision are proportionately higher and that there is a higher risk of default among low-income groups. In order for CDFIs to be able to provide low-cost loans they rely on attracting external sources of capital for on-lending and revenue to meet the costs of their operations. CDFIs currently attract funds from a variety of sources, however to promote the long-term sustainability of the personal lending CDFI sector, it may be necessary to introduce measures to assist the sector in attracting investment. Without this additional support, the CDFI sector may find it difficult to continue to extend its services to low-income groups.

2. OPTIONS

A.10 This partial Regulatory Impact Assessment looks at three options: do nothing, extend a CITR type scheme to CDFIs' personal lending activities and match funding of investments in personal lending CDFIs.

Option A: Do nothing

A.11 This option would mean that the current status quo is maintained. The Community Investment Tax Relief scheme would remain applicable to enterprise financing CDFIs only, and investments in CDFIs' personal lending activities would not receive tax relief.

Option B: Extend a CITR type scheme to CDFIs' personal lending activities

A.12 This option would mean that investments made to accredited personal lending CDFIs, under certain conditions, would be able to take advantage of tax relief.

Option C: Match funding of investments in CDFIs' personal lending activities

A.13 This option would mean that any investments made in personal lending CDFIs would be matched, at a certain rate. Any returns from the matched contribution to the CDFI could either be kept by the CDFI for re-investment, or could be returned to the investor.

3. COSTS AND BENEFITS

Business sectors affected

A.14 There are currently 6 UK CDFIs that are actively providing personal loans to consumers unable to access mainstream sources of credit. The sector is very young, although lending volumes are increasing each year. Measures to incentivise investment in these institutions could potentially lead to increased investment in these CDFIs as well as new CDFIs that are currently being established or which may be established through the Government's growth funding provision.

A.15 Measures to incentivise investment in personal lending CDFIs would also impact on the investment community. As of June 2004, a total of 136 individuals and corporations have made qualifying investments in enterprise investing CDFIs and have therefore benefited from the CITR scheme. These investments have a total value of £8 million.

A.16 Measures to promote the sustainability of the CDFI sector in providing loans to low-income individuals may also have an impact on the credit market that these individuals are currently accessing. The alternative credit market including providers such as home credit companies, pawnbrokers and payday lenders is highly developed and serves a large number of customers. Government support to lenders that provide an alternative to this high cost provision may have an effect on the numbers of clients of these lenders.

Benefits - Option A: Do nothing

A.17 The benefit of doing nothing is that personal lending CDFIs would avoid any increased costs of an extended CITR scheme or match funding scheme and could continue to develop and grow at their current rate. Under option A there is also no risk that the current market for investment in enterprise investing CDFIs will be distorted.

Option B: Extending a CITR type scheme

Impact on the CDFIs **A.18** Extending a CITR type scheme to CDFIs' personal lending activities may have the effect of attracting increased investment in these CDFIs. CDFIs attracting this additional investment will have more funds for on-lending to vulnerable groups. Increased lending volumes could in turn have the effect of reducing the fixed costs of providing these loans proportionately, although it is likely that CDFIs will continue to offer extensive money advice and support to clients, which is costly to provide. Over time, the sustainability of personal lending CDFIs could be enhanced, allowing them to expand into new areas and to increase their coverage and serve more clients.

A.19 Evidence from the current CITR scheme suggests that the relief available to potential investors puts the CDFI in a stronger position than if they are simply seeking a grant, loan or investment. By being CITR accredited these organisations have at their disposal an additional means of attracting capital for on-lending that is not available to non-accredited CDFIs. Furthermore, the availability of tax relief has the potential to act as a lever for negotiating a reduction in the interest rate paid to the investor. A further benefit of becoming an accredited CDFI for the purposes of the CITR scheme is that this process in itself provides the CDFI with a badge of credibility, having been subject to independent scrutiny.

Impact on Investors **A.20** Investors in personal lending CDFIs under an extended CITR type scheme would benefit from the tax relief on their Income Tax and Corporation Tax Liabilities. Under the current CITR scheme for investments in enterprise financing CDFIs, investors are able to benefit from relief of 5 per cent of the amount invested in the year the investment is made and in each of the four subsequent years. The total relief available is up to 25 per cent of the value of the investment. Up to June 2004, 136 individuals have made qualifying investments in or loans to accredited CDFIs with a total value of £8 million.

Impact on the individuals **A.21** Extending the CITR scheme may have the effect of promoting new personal lending CDFIs to emerge and may boost the coverage and capacity of existing CDFIs. The effect of this may be to increase the availability of affordable sources of credit, for low-income groups who may otherwise be reliant on higher cost alternatives. The average Annual Percentage Rate for the home credit industry is for example, around 170 per cent. The table below uses an example of a typical £400 loan from a home credit company²⁵ set against a typical £400 loan from a personal lending CDFI. As CDFIs often use different rates to reflect the risk base of their client group the table highlights loans at 15 per cent APR and 30 per cent APR – which largely reflect the range of rates CDFIs offer.

²⁵ Access to credit on a low income: a study into how people on low incomes in Liverpool access and use consumer credit, Paul A Jones, Co-operative Bank, 2001.

Table A.1 Comparison of cost of £400 loans

Lender	Amount Borrowed	Amount to be repaid	Period (weeks)	APR (per cent)
Home credit	£400	£636.00	53	164.08
CDFI 1	£400	£430.19	53	15
CDFI 2	£400	£465.33	53	30

Option C: Match funding of investments

A.22 There are two match funding options available. For both, any investment in the CDFI would be matched, in proportion to the size of the investor's investment, boosting the size of that investment overall. However, there are two ways in which returns on the investment could be treated. In the first, the CDFI would be allowed to use any returns made on the matched contribution to re-invest. This scheme would incentivise CDFIs to look for investment in the knowledge that if this investment were provided, additional resources would be available from the match funding. This could then lead to the potential benefits described under option B for the individuals and for the CDFIs.

A.23 Under this option, investors capital investment would be boosted however the investors would not receive any additional returns as a result of the additional capital added to their investment. Therefore, it is not clear whether this measure would be effective in attracting additional investment in the sector.

A.24 In the second match funding option the returns generated from the matched contribution to the CDFI would be passed back to the investor. This could have the effect of promoting additional investment into the personal lending CDFI sector and subsequently promoting sustainability in the sector, with the same benefits as described in option B. However, the incentive for the investor is dependent on the returns generated on the match funding by the CDFI that has received the investment. Therefore, the size of the incentive is less certain than for option B where a pre-determined tax relief is available.

Costs – Option A

A.25 There would be no direct financial costs associated with doing nothing to incentivise investments in the activities of personal lending CDFIs. The long-term indirect costs may be regarded as the potential lost investment that may result if no incentives are put in place by Government. This may mean that personal lending CDFIs will find it more difficult to play a long-term sustainable role in providing a source of affordable credit, potentially resulting in low-income groups having to borrow at higher rates from alternative lenders.

Option B

A.26 Extending a CITR type scheme to personal lending CDFIs will bring some increased costs to CDFIs seeking accreditation for involvement in the scheme. These costs include fixed costs such as applying for accreditation and several ongoing costs:

- attracting investors;
- issuing tax relief certificates;
- ensuring that on-lending of funds that are provided through the CITR scheme meets the requirements of the scheme; and,
- monitoring and reporting requirements.

A.27 Under option B, for the investors in CDFIs, costs associated with a CITR type scheme include the time needed to understand the CITR process and to consider how to accommodate it within their own investment strategies. Investors may also need to consider competing offers from different CDFIs.

A.28 There is also the possibility that extending a CITR type scheme to investments in personal lending CDFIs will have the effect of displacing current investment in enterprise investing CDFIs. The Government is interested to understand the extent to which this might happen.

Option C

A.29 Under a match funding scheme, it is envisaged that personal lending CDFIs would have to undertake a similar accreditation process to an extended CITR type scheme. Therefore the costs associated with this process for CDFIs will be similar under both option B and C.

A.30 Where the returns are kept in the CDFI, some of the incentives are placed upon the CDFI to seek out investment in order to gain the returns on the match funding for re-investment, so there may be further costs associated with attracting this investment. Under this option, there will be fewer costs for the investors in personal lending CDFIs as investors will have no need to familiarise themselves with a CITR type process.

A.31 Where the returns on the matched contribution to the CDFI are returned to the investor, the ongoing costs would be similar to option B, except that there would be no need to issue a tax relief certificate.

A.32 A match funding scheme would not have the advantage of reflecting a scheme already in place for enterprise financing, so may not be as readily understood by investors already in the market and by CDFIs that are involved in both enterprise financing and personal lending.

A.33 Following this analysis of the costs and benefits the Government has decided to consult on the case for and practicalities of extending a CITR type scheme to investments in CDFIs' personal lending activities.

Box A.1

Question 32 – Do you agree with the analysis of the costs and benefits of the options described? Is there further information you can provide that would enable a better understanding of these costs and benefits?

4. EQUITY AND FAIRNESS

A.34 Options B and C would apply equally to all CDFIs that could meet any accreditation criteria.

5. CONSULTATION WITH SMALL BUSINESS

A.35 Options B and C would impact the CDFIs themselves as small businesses and potentially lenders in the alternative credit market who are small businesses. As discussed below, as the CDFI sector is small in comparison to the alternative credit market, it is unlikely that growth in this sector supported by Government intervention would impact significantly on these small businesses overall. However, it is possible that rapid growth of a CDFI's lending activities could have an effect on the alternative credit market in the immediate geographical area of the CDFI. The impact on personal lending CDFIs of going ahead with incentivising investment is likely to be positive for this sector of small businesses through better enabling them to attract investment and to become sustainable. The impact on enterprise financing CDFIs that are small businesses may be that investment is drawn away from this sector and the Government is seeking views on whether or not this will be the case in questions 6–13.

A.36 The Small Business Service is content that a Small Firms Impact Test is not needed for this partial Regulatory Impact Assessment. However, the Government would welcome the views of small business and their representative organisations on the points raised in the consultation.

6. COMPETITION ASSESSMENT

A.37 Personal lending CDFIs are a source of credit in a market with a wide range of providers. A competition assessment however, should focus on CDFIs as competing specifically in the alternative credit market, a market that caters for the needs of low-income consumers. Options B and C may have the effect of better enabling personal lending CDFIs to compete with high cost lenders and to provide a source of affordable credit to consumers who may rely on high cost providers.

A.38 To the extent that personal lending CDFIs provide loans to low-income groups that would otherwise have to rely on high cost providers in the alternative credit market, supporting CDFIs may have an impact on these lenders. However, at present, the CDFI sector, particularly in comparison to the alternative credit market, is very small and the impact of measures to support personal lending CDFIs is unlikely to have a significant impact overall. In addition, the different lenders in the market and the loan products they offer have different features, which, despite the high costs, are attractive to low-income groups. Therefore, while promoting sustainability of the CDFI sector may make more low-cost loans available to low-income groups, it is not automatically the case that these groups will choose to use this facility. The Government wants to ensure however, that these choices are available to the most vulnerable groups, and at

present the limited coverage of the third sector means that in many areas, this is not the case.

A.39 Moreover, there are other developments that will potentially have a much larger impact on competition in the alternative credit market. In June 2004, the National Consumer Council lodged a super-complaint with the Office of Fair Trading (OFT), highlighting their concerns about a lack of competition in the home credit market.²⁶ The OFT response to the super-complaint identifies several market features that suggest that there may be limited incentive for lenders to compete on price.²⁷ The OFT concluded that this is likely to lead to significant harm to the interests of consumers and in December 2004 referred the case for investigation by the Competition Commission. This investigation is now underway.

A.40 In light of these considerations, a competition filter test was performed and it was agreed that a more detailed assessment is not necessary given that the competition implications do not appear to be significant. For example, no CDFI occupies more than 10 per cent market share of the alternative lending market. Furthermore it was considered that the proposal would not restrict the ability of firms to choose the price, quality, range or location of their products or lead to higher set up costs of new or potential firms. Any impact should be positive in enabling personal lending CDFIs to compete more effectively in the alternative credit market, to the benefit of low-income consumers.

7. ENFORCEMENT AND SANCTIONS

A.41 The accrediting agency would oversee an extended CITR scheme and would be responsible for judging CDFIs against accreditation criteria, and for ongoing monitoring of the operation of the scheme.

8. MONITORING AND REVIEW

A.42 As part of the overall strategy to tackle financial exclusion, the Government has established a Financial Inclusion Taskforce to monitor progress against the objectives the Government has set in three priority areas: access to banking, affordable credit and free face-to-face money advice. The Financial Inclusion Taskforce will also be making recommendations to Government on what more needs to be done. The Taskforce will therefore have a role in monitoring the provision of affordable credit, looking at the supply of affordable credit providers and the demand and uptake of this provision by low-income groups, and on reporting to Government on progress made in this area.

9. CONSULTATION

Within Government **A.43** In producing this consultation document HM Treasury has consulted with HM Revenue and Customs, the Small Business Service and the Department of Trade and Industry.

Public consultation **A.44** On 24 June 2005, HM Treasury published a consultation document on the case for, and practicalities of, extending a Community Investment Tax Relief scheme to investments in CDFIs' personal lending activities. The consultation document is

²⁶ Home credit – an investigation into the home credit market, Claire Whyley and Steve Brooker, National Consumer Council, June 2004.

²⁷ Response to the super-complaint on home credit made by the National Consumer Council, September 2004. OFT 747a.

available on the HM Treasury website and printed copies are available on request. The deadline for responses is 26 September 2005.