Cabinet Office
Office of the Third Sector

SOCIAL INVESTMENT WHOLESALE BANK

A consultation on the functions and design

Office of the Third Sector, July 2009

Building Britain's Future

Topic of this consultation	This document sets out the vision and economic case for the Social Investment Wholesale Bank (SIWB). It then consults on the design and functions of a potential SIWB.
Scope of this consultation	This consultation will be used to determine the design and function of an SIWB and inform the substantive proposals which the Office of the Third Sector will produce.
Geographical scope	Some of the ground covered here applies across the UK, in those policy areas where government's responsibilities extend across England, Northern Ireland, Scotland and Wales. However, most aspects of policy highlighted in the document are devolved, in differing settlements, to the administrations in Northern Ireland, Scotland and Wales.
Impact assessment	There is no impact assessment at this stage because this consultation does not yet impose or reduce costs on businesses or the third sector. An impact assessment will be made before any imposition or reduction of costs on businesses and the third sector.
To	We would particularly like to hear from the third sector, financial sector and social investment intermediaries, but anyone is free to respond and their views will be taken seriously.
From	Office of the Third Sector in the Cabinet Office Social Enterprise and Finance Team, together with other departments including the Department for Business, Innovation and Skills, HM Treasury, Department for Work and Pensions, Department of Health, Communities and Local Government, Department for Children, Schools and Families, Department for Environment, Food and Rural Affairs, and Department of Energy and Climate Change.
Duration	**The consultation will start on 15 July 2009 and end on 7 October 2009.**
Enquiries	Any enquiries about the content or scope of the consultation, requests for hard copies, information about consultation events etc. should be made through: General enquiries number: 020 7276 6400 Email: siwbconsultation@cabinet-office.x.gsi.gov.uk
How to respond	We are happy to receive replies by post or by email. Please send responses to: SIWB Consultation Social Enterprise and Finance Team Office of the Third Sector 2nd Floor, Admiralty Arch The Mall London SW1A 2WH Email: siwbconsultation@cabinet-office.x.gsi.gov.uk **Please respond by 7 October 2009.** This document is available on the website of the Office of the Third Sector at www.cabinetoffice.gov.uk/third_sector.aspx

Additional ways to become involved	This publication can be made available in alternative formats and languages on request.
After the consultation	Responses will be analysed and the Office of the Third Sector will then report with substantive proposals.
Code of Practice on Consultation	This consultation complies with the Code of Practice on Consultation.

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Ministerial foreword

It is a pleasure to launch this consultation on the design and functions of a Social Investment 'Wholesale' Bank. Despite the complicated name, the idea is really quite straightforward. It's a vision we can all believe in.

In short, this is a vision of a financial institution which would work in the interests of society as a whole. A bank which would help increase investment in society, the environment and the economy at the same time, delivering against a 'triple bottom line' of greater economic growth, social cohesion and sustainable development.

Following the upheaval in the financial markets, we have seen considerable and increasing interest in cooperative, ethical and mutual financial institutions. This consultation is therefore set in a wider debate which asks how we can help harness the power of finance for the common good.

Although the idea is simple, we know that building such an institution will not be easy. Above all, because it has never been done before. A Social Investment Wholesale Bank as outlined in this consultation would be the first of its kind in the world. Globally, the UK Government is a pioneer in the field of social investment. So we need your input to help ensure that we get it right. This is a new concept, an evolving field and one that raises complex questions. The success of this idea will rely on your contributions.

It is worth making a few further observations about the consultation itself.

First, we are seeking to establish the case for, and consider the design and functions of, the Bank. We are not, through this document, aiming to identify the resources required to make it happen, which would be the next step. Before knowing what the Bank would do and how it would work, it is impossible to set out the appropriate financial resources.

Secondly, while the third sector is at the heart of social investment, this consultation goes wider than the third sector. Of course, credit unions and Community Development Finance Institutions are themselves social enterprises, for example, but their beneficiaries are often people and businesses in deprived areas, not third sector bodies. The Government is focused on making a difference to communities and our efforts should be directed not by legal status or corporate form but, above all, by social impact and on the basis of need. This is not, therefore, a consultation on a 'Third Sector Investment Bank' but on a Social Investment Bank with the third sector at its heart.

Thirdly, we want to make clear that just as social enterprises work to deliver social and environmental benefits, so a social investment bank would generate social and environmental returns. It is worth noting, however, that environmental projects already attract billions of pounds of investment globally, so we may find that as the Bank worked to meet gaps in the market, it would focus mainly on social rather than environmental outcomes. But of course it is still important that the Bank would report against a 'triple bottom line' and would be transparent about the environmental impact that it generates.

Fourthly, we want to acknowledge that the language in this consultation might not always be easily accessible. This is to some extent unavoidable, as consideration of any financial institution will bring with it technical questions and the need for appropriate expertise. So again, the Government needs help from a range of different partners and stakeholders – from financial experts to front-line charities, and from citizens who care about how money is invested to those already helping to develop the social investment market. Please contribute where you can, and pick and choose the sections and the questions most relevant to you. Of course, you are free to answer all the questions!

Finally, this is a consultation on a Social Investment Wholesale Bank, which would invest in those who, in turn, invest in social impact. However, this is not just another layer of funding or financing, as the Bank could have other functions. Raising capital, for example, where the Bank could seek to bring in additional resources and benefits. The extent to which the Bank would act not only as a wholesaler but would also undertake other wider work will depend on your views and your evidence.

The Government needs your help and we must continue to work together. Then perhaps we can help build social investment into a part of our lives that is as familiar to us as the other ways we use our money – like investing in a pension fund or an ISA, or like sponsoring a friend or payroll giving. We hope that this consultation will take us a significant step closer towards a culture of social investment and, in the current financial climate, help develop a fairer, more responsible and sustainable model of financing social change.

Angela Smith

Angela Smith MP
Minister for the Third Sector

Stephen Timms

Rt. Hon Stephen Timms MP,
Financial Secretary to the Treasury

15 July 2009

1. Background

Social investment

1. **Social investment** is the provision of finance with the primary aim of generating social returns. But, in the same way that social enterprises may also make a profit as they deliver their social objectives, social investment may also generate financial returns. For example, the Charity Commission describes how "social investments may generate a financial return, but the [charity's] main objective in making them is to help its beneficiaries".[1]

2. The Social Investment Task Force, chaired by Sir Ronald Cohen, represented a significant step in raising the profile of social investment. The task force reported in October 2000 and made five specific proposals to encourage social investment, focused on tax incentives, new funds, disclosure of banking activity, investment by trusts and foundations, and support for Community Development Finance Institutions (CDFIs).[2]

Social investment and the third sector

3. The task force report and subsequent progress in this area has focused on helping enterprising communities, deprived areas and the financially excluded, as well as the role of **the third sector**. The third sector is at the heart of social investment. For example, CDFIs and credit unions are themselves part of the third sector and as they work towards supporting individuals and business excluded from mainstream finance, this can often include many third sector organisations.

4. The **third sector** is a diverse, active and passionate sector. The term encompasses voluntary and community organisations, charities, social enterprises, cooperatives and mutuals both large and small. Organisations in the sector share common characteristics – they:
   - are non-governmental;
   - are value-driven; and
   - principally reinvest any financial surpluses to further social, environmental or cultural objectives.

5. The third sector attracts **funding** – or income or revenue – from a range of sources, including grants, donations, contracts, fees and other sources. Yet **finance** – investment or capital – is also important in enabling third sector organisations deliver their social and environmental objectives. Community groups, charities and social enterprises can benefit from a wide range of investment, including grants, loans and equity.

6. So third sector organisations need to be able to access the finance that is appropriate for them. Yet **access to appropriate funding and finance often remains the single biggest concern** facing organisations driven by social or environmental purpose.[3]

The Commission on Unclaimed Assets and the Social Investment Bank

7. The independent **Commission on Unclaimed Assets** was established in October 2005. Its final report,[4] published in March 2007, argued that the ability of the third sector to combat disadvantage and build a more cohesive society, respond to need and pioneer new approaches is undermined by its financial fragility. The Commission argued that the third sector is fragmented, under-capitalised and, in aggregate, unable to invest in sustainable growth and development. The report concluded that:

1 *Investment of Charitable Funds: Basic Principles,* Charity Commission Guidance CC14, December 2004
2 *Enterprising Communities: Wealth Beyond Welfare*, Social Investment Task Force, 2000
3 *The future role of the third sector in social and economic regeneration*, HM Treasury and Cabinet Office, December 2006
4 *The Social Investment Bank*, The Commission on Unclaimed Assets, March 2007

- the third sector urgently needs greater investment and professional support and suitable capital should be available for organisations at all stages of development;
- an independent Social Investment Bank should be created using the capital from dormant accounts with founding capital of at least £250 million, and an annual income stream of £20 million for a minimum of four years;
- the Social Investment Bank should be small, adaptable, innovative and able to take risks. It should act as a 'wholesaler of capital' working through existing and new financial intermediaries;
- the Social Investment Bank would capitalise present financial intermediaries and fill gaps in the marketplace; develop the provision of advice, support and higher-risk investment; develop programmes of sustained investment in specific markets; and support existing and new intermediaries in their efforts to raise private capital;
- tax incentives should be used to encourage the flow of capital; and
- the Social Investment Bank should be an independent institution answerable to the third sector.

Unclaimed Assets and a Social Investment Wholesaler

8. The Government consulted on a UK unclaimed assets scheme in March 2007. In England, the focus of these resources will be on funding youth services that are responsive to the needs of young people, followed by financial capability and inclusion. Following responses to the consultation, the Government made it clear[5] that it saw merit in the model of a new social investment institution and recognised a gap in the market at the **wholesale** level. The Government stated that, resources permitting, it would like to see a proportion of unclaimed assets in England used to support social investment in third sector organisations, by strengthening existing finance providers.

9. The Government therefore made it a priority to examine how a new social investment wholesale institution and other new approaches to social investment might help to ensure that third sector organisations can access more secure and sustainable funding and finance. The findings reinforced the importance of any investment being open to a wide range of third sector organisations and able to meet the diverse needs of the third sector. In the report, the Government also:

   - noted the importance placed on developing diverse sources of funding for the third sector, such as debt finance, quasi-equity and equity, and that grants remain crucial for many organisations, particularly small, grassroots bodies;
   - recognised that the case for the creation of a new institution is not universally accepted;
   - supported the view that a social investment wholesaler should be independent;
   - supported the view that a new vehicle should not be given any unfair advantage within the existing market and recognised the need to adequately address risks and concerns, particularly around a wholesaler competing with existing 'retailers'; and

[5] *A UK unclaimed assets scheme: summary of responses to consultation,* HM Treasury, November 2007

- agreed that developing the social investment market would also have the effect of helping to free up limited grant funding for organisations that need it most.

10. Responses to the consultation also suggested that the financial products which a social investment wholesaler should offer could include guarantees, financial advice and business support, capacity-building grants, long-term risk-taking investments, equity and so-called quasi-equity investments, long-term subordinated or unsecured lending, and so-called patient capital.

11. Responses also suggested that activities to generate further demand in the social investment market could include gathering evidence of the impact of social investment, design and innovation of new products and services, provision of business advice and support, leveraging private capital and brokering co-investments, and syndication and collaboration. The Government made it clear in its response that it understood the importance of innovation and the provision of professional and targeted capacity building and business support to the third sector, alongside financial support.

12. In the Budget 2009, the Government announced that, to support the long-term growth of a thriving third sector, it would **consult on the design and function of a Social Investment Wholesale Bank (SIWB)** and that the Office of the Third Sector (OTS) would report back with substantive proposals. HM Treasury's *Reforming financial markets*[6] reinforced the Government's ambition to create an SIWB.

Government policy

13. The Government has done a great deal to support third sector access to finance and encourage social investment. First, in **strengthening the supply of investment**, through programmes such as OTS's Futurebuilders Fund, the Risk Capital Fund, the Grassroots Grants endowment programme and the Adventure Capital Fund. Other government departments also invest in the sector through the Department of Health's Social Enterprise Investment Fund and through the Department for Children, Schools and Families' Youth Sector Development Fund. Communities and Local Government also plays a role in enabling third sector organisations to develop effective and sustainable approaches to supporting public services and communities, for example through the Communitybuilders Fund. The Department for Environment, Food and Rural Affairs has recently published a third sector strategy which provides a framework for 'greening' the sector.

14. The Department for Business, Innovation and Skills, HM Treasury and the Department for Work and Pensions share an interest in improving access to finance for businesses in deprived areas and in addressing financial exclusion. Investment to support this has been provided through the Growth Fund and Social Fund, the Phoenix Fund, Community Investment Tax Relief and investment in Bridges Community Ventures, for example.

15. The Government has also worked to **support demand for finance** through programmes such as Capacitybuilders, through investment readiness support, and through work on financial capability and financial inclusion.

16. The Government has also sought to **improve the way the market works**, through two social investment pilots, through support for the Community Development Finance Association and through a range of other work.

[6] *Reforming financial markets*, HM Treasury, July 2009

2. The vision

Social investment

17. Social investment can be explained as investment made for a primarily social purpose in organisations that deliver **benefits for society and the environment**.[7] It aims to create a combination of social, financial and environmental value and deliver against a so-called 'triple bottom line' of more effective mutual interaction between greater economic growth, social cohesion and sustainable development.

18. We are familiar with **public investment** – to improve the effectiveness of public services – through the building of new schools and hospitals. We also recognise private investment – to deliver returns from enterprise – when venture capitalists invest in small businesses and banks lend.

19. **Social investment**, however, is about investing in society, the environment and the economy, in a way that sustains and benefits each area, rather than pursuing one objective to the potential detriment of another.

20. But social investment is in shorter supply, not least because the private benefit that an investor receives as a result of their investment can differ from the benefits to society as a whole. This is an example of 'market failure', which leads to under-investment.

Examples of social investment programmes

- The $20 million Eye Fund (Deutsche Bank, International Association for the Prevention of Blindness and Ashoka) provides low-cost loans in India, China, Nigeria, Paraguay and South Africa, to increase the scale of programmes to help the poor. The Fund has a range of investors, with a $2 million grant from development agencies, $14 million of senior debt at 6% and $4 million of subordinated debt at 1%.
- Impetus Trust is a venture philanthropy initiative whose portfolio charities have on average grown their turnover by 23% per annum (six times the sector average) and their social impact (number of people benefiting from their programmes) by 66% per annum.

21. In an uncertain financial and economic environment, ethical and mutual institutions have been performing remarkably well so far. Triodos Bank, for example, reported record levels of lending over 2008[8] and the Co-operative Bank paid a record dividend to the Co-operative Group, thanks in part to a 70% increase in banking business profits in 2008.[9] Public opinion also reveals an increasing interest in ethical finance and an increased desire among people to make finance work for the common good and not solely for private benefit.

[7] For the purposes of this document, 'social' represents shorthand for social and environmental. While this may be potentially confusing, it has parallels with the term 'social enterprise'
[8] Triodos Bank press release, March 2009
[9] Co-operative Financial Services financial results for year end January 2009, published April 2009

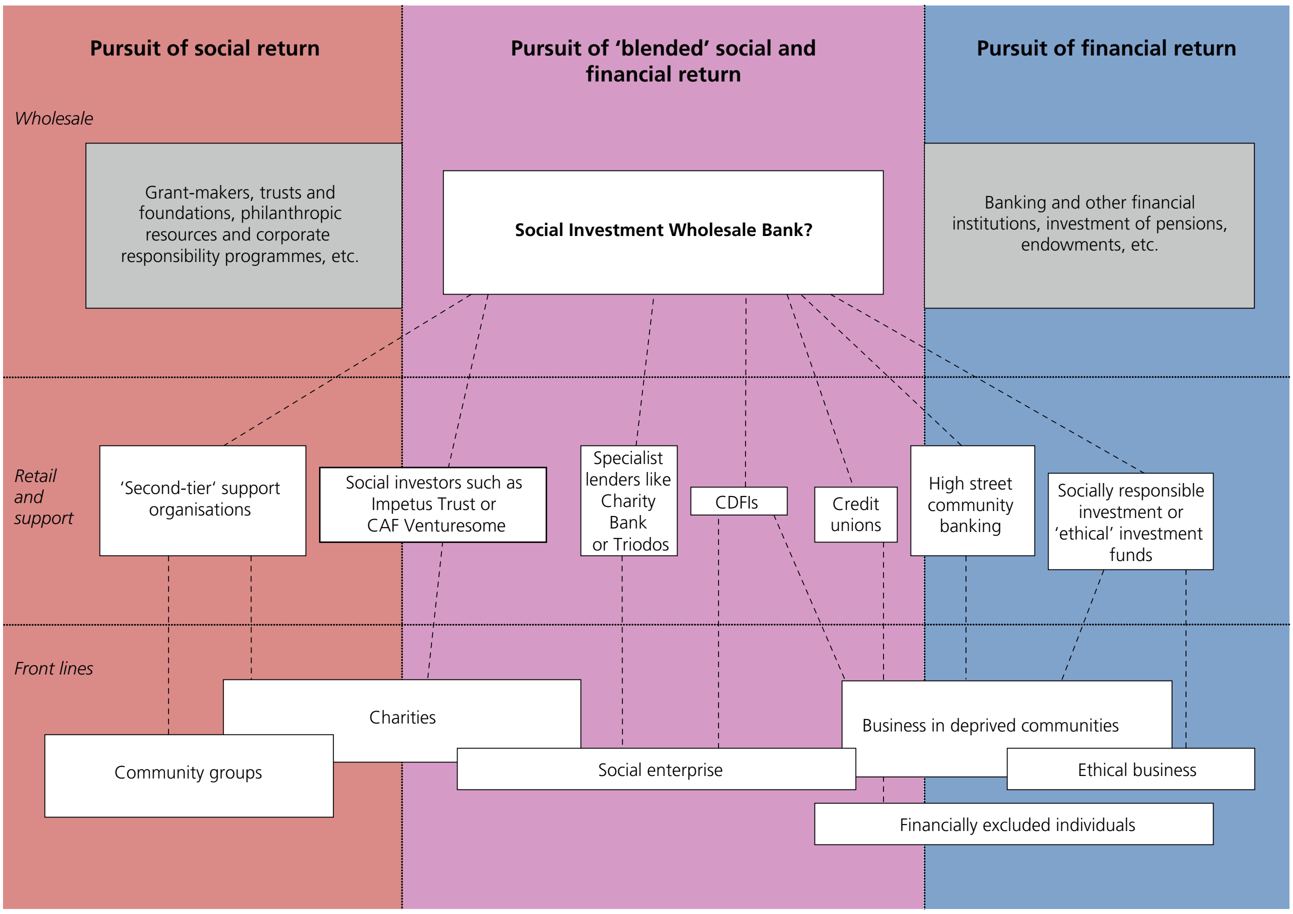
A Social Investment Wholesale Bank

22. Drawing lessons from investment banks in the mainstream markets, an SIWB could support those who invest for a social purpose, for example in charities, social enterprises and third sector organisations, strengthening and developing their reach and capacity.

23. An SIWB would be a **mission-driven investment bank** supporting investors and lenders with a social purpose – like Charity Bank, Triodos and CDFIs. As a **wholesaler** of social investment, it would support the long-term growth of a thriving third sector by working with investors and lenders at the 'retail' level. For example, it could:

- finance Charity Bank's expansion into new areas which mainstream markets do not reach;
- support a grant-making trust interested in investing in social enterprises; or
- provide financial backing to a social enterprise lender (i.e. a credit union) offering fair finance to people unable to access affordable credit.

Figure 1



24. But the Bank **could do more** than just invest in existing intermediaries. It could seek to address a range of market failures in the social investment market which mean that the third sector cannot currently access adequate and appropriate finance. It would aim to increase the supply of investment, support demand for finance and develop the social investment market.

25. The Bank could fill the gap between banks on one hand and charitable trusts and foundations on the other, helping investment in charities and social enterprises towards becoming a recognised 'asset class' – like property, cash or government bonds – where investors choose to place some of their capital or individuals choose to put a certain percentage of their pensions.

26. The Bank could also improve the Government's support for the market over the long term. By entrusting the Bank to provide the financial support for existing and new programmes and providing it with the means to do so, the Government could effectively enable the Bank to take a more joined-up and long-term approach. This could also provide a vehicle through which government investment could be more effectively managed.

Impact

27. The Bank could ultimately help deliver sustainable and economic ways of providing services to disadvantaged communities. It could encourage banks and other financial institutions to work better in the interests of society as a whole and go some way towards shaping global markets to meet the needs of communities. As a pioneering institution which provided the driving force behind the sustainable businesses of the future, the SIWB could offer a new model for an investment bank – one built on the principles of fairness, trust and responsibility.

In practice

- For a **citizen** who participated in the Cafédirect share issue and wonders why there are not more opportunities to buy into companies in which she believes will do good – and maybe also make money – the Bank could help create a social ISA or a social investment fund in which people could buy shares.
- For a small **community bank** which is struggling to put the finance together it needs to cope with the people coming through the door, the Bank could help it put together a package of finance from a range of sources, including banks, trusts and government bodies.
- For a **social entrepreneur** with an unproven idea that needs investment, the Bank could help create a fund for investing in such ideas by bringing together different investors and pooling their money.
- For a **county council** with an idea to create a fund for post offices or village shops which could be run as social enterprises in their area, the Bank could help the council use its money to attract more investment from other partners and advise on how the fund could be set up most effectively.
- For a **grant-maker** who is not sure how to deal with high-quality applications from social enterprises which it has to turn down as they are not registered as charities, the Bank could facilitate for cross-referring applications with a funder that could invest and has some applications of its own it wants to pass on.
- For a **pension fund manager** who wants to offer his clients the chance to put some of their money into a pot where it works only for the good of society and may also generate financial return, the Bank could help create a recognisable product for the fund manager to invest in alongside others and get the money flowing.

1. Do you agree with the vision for a Social Investment Wholesale Bank set out in this consultation?

3. The economic case

28. The idea of an SIWB has been proposed for several years.[10] But while there are some isolated examples of organisations already undertaking activities akin to those of an SIWB, such an institution does not yet exist. If government is required to help create a new institution, any intervention would need to be based on a strong rationale that establishes the case for government support.

Economic rationale

29. The Government believes that proposals for policy, programmes or spending need to be underpinned by sound **economic analysis**. This includes consideration of:

    - the achievement of economic objectives by addressing inefficiencies in the operation of markets and institutions; and
    - the achievement of an equity objective, such as local or regional regeneration.[11]

30. In other words, any reason to act should be based on evidence of market failure or inequality. Market failure is a description of a situation where, for one reason or other, the market mechanism alone cannot achieve economic efficiency. Economic efficiency is achieved when nobody can be made better off without someone else being made worse off. One potential cause of inefficiency is where circumstances mean that the private returns which an individual or firm receives from carrying out a particular action differ from the returns to society as a whole. Market failures might include:

    - coordination problems, imperfect and asymmetric information – for example, where investors and investees do not know the financial risk of investment in an area, which makes it almost impossible to measure the value of what is being 'traded' and therefore to judge the value of deals, restricting their quality and number;
    - transaction costs – for example, where enterprises do not understand what it means to be or are not investment ready; or
    - positive externalities – for example, where social and environmental benefits spill over to society as a whole but are not valued by the market and are not taken into account in investment decisions.

31. Another important consideration for government intervention is the achievement of **equity objectives or 'distributional impacts'** – which concerns the distribution of the costs or benefits of interventions across different groups in society. Proposals might have differential impacts on individuals, among other aspects, according to their income, gender, ethnic group, age, geographical location or disability.

32. Finally, an economic analysis that looks at market failures and equity considerations may not tell the whole story. This consultation will also raise **wider issues**, such as the way in which government has intervened in the market so far, which can also be important.

A market analysis

33. This chapter considers the **market for social investment**. On the demand side, we can look at how the third sector accesses finance. On the supply side, there is a range and number of financial institutions that invest for a combination of social and environmental outcomes, from grant-making trusts and foundations on one hand to banks and commercial institutions on the other.

[10] For example, see *The other invisible hand: remaking charity for the 21st century*, Geoff Mulgan and Charles Landry, 1995
[11] *The Green Book: Appraisal and Evaluation in Central Government*, HM Treasury, 2003

34. There is a range of evidence around market failures in this area. Some problems in the market are perhaps symptomatic of its youth and immaturity. Others may be potentially more intractable. The following analysis looks at, in turn, **demand** for finance in the third sector, **supply** of investment and whether the **market works effectively**. The Government acknowledges that the evidence varies significantly in quality and age, and would therefore welcome any more robust or more recent evidence, where it is available.

Demand

35. The third sector is incredibly diverse, ranging from informal community groups to multimillion-pound international social enterprises. Charities alone turned over at least £31 billion in 2005/06.[12] These organisations have traditionally funded activities from grants and donations. However, these have tended to be directed towards the provision of certain outcomes, thereby limiting their potential for generating surpluses.

36. Increasingly, the third sector has moved towards contracts and earned income[13] as a proportion of their revenue. This is perhaps a symptom of the opening of markets for contestability in public services, a relative trend to contracts from grants, the increasing emergence of social enterprise as a viable business model and a growing market for ethical products and services.[14] So the third sector – and not just social enterprises – is increasingly operating in markets and facing business imperatives such as robust financial management and planning for sustainability.

37. So, in this context, third sector organisations need adequate access to finance to enable them to continue to carry out their social and environmental objectives. **Access to appropriate finance is vital** to improving the sector's growth and sustainability, and to enabling it to fulfil its role in social and economic regeneration.

    "Access to appropriate sources and levels of external finance and the development of sound financial skills are often critical in determining the… performance of small businesses, and the extent to which they realise their full growth potential." (Department for Business, Enterprise and Regulatory Reform[15])

    "Access to appropriate sources of finance is a key factor in an enterprise's development." (Bank of England[16])

38. Community groups, charities and social enterprises can benefit from a wide range of investment, including grants, loans and equity. Finance can help third sector organisations deliver their social and environmental aims by enabling them to develop ambitious new plans, purchase buildings, start new activities, manage cashflow or invest in their own capacity to generate more income in the future. Finance can reduce grant dependence.[17] Consequently, in recent years, we have started to see greater consideration of debt and even equity.

39. Yet **access to appropriate funding and finance often remains the single biggest concern** facing organisations driven by social or environmental purpose.

[12] *The Green Book: Appraisal and Evaluation in Central Government*, HM Treasury, 2003
[13] *The UK Voluntary Sector Almanac 2008*, National Council for Voluntary Organisations, 2008
[14] *Ethical Consumerism Report*, Co-operative Bank, 2008
[15] *Enterprise: Unlocking the UK's talent*, Department for Business, Enterprise and Regulatory Reform, March 2008
[16] *The financing of social enterprises: A special report by the Bank of England*, Bank of England, May 2003
[17] *Finance for Small and Medium-Sized Enterprises: Comparisons of Social Enterprises and Mainstream Businesses*, Dr Stuart Fraser, Centre for Small and Medium-Sized Enterprises, Warwick Business School, University of Warwick, 2007

40. Problems in the market include so-called information asymmetries, coordination problems, transaction costs and equity considerations (see Glossary), which can all lead to under-investment. First, as entrepreneurs driven by social or environmental rather than financial motives often have limited financial skills.[18] Second, there is also a perception that they will be unsuccessful when seeking finance.[19] Third, third sector organisations can be averse to debt because of the perceived risks[20] and an unwillingness to provide personal security among volunteer trustees. Fourth, there can be a lack of awareness of the benefits of finance and the options available. Fifth, organisations are often focused on programmes and not development.[21] Finally, organisations are also often unable (due to their legal forms) or unwilling (as a sector often defined by the principal reinvestment of surpluses) to pay dividends which clearly restricts the possibilities for equity investment.[22] These can all lead to under-investment in the third sector.

41. Business models in the third sector can also be, or appear to be, more fragile, as a significant proportion of income can be made up of voluntary contributions. Third sector organisations tend to pick up those who have fallen through gaps in state provision and, as the benefits they deliver can be 'soft', intangible and often realised over the longer term, neither the state nor the market will pay. So as well as influencing the investees' appetite for investment, such business models can appear more risky to investors.

42. So, in summary, whether due to willingness, understanding, skills or perceptions, the **demand for finance in the sector is currently underdeveloped**. This limits the sector's ability to grow and develop sustainability.

Supply

43. There is a range of market failures in the supply of investment, which include so-called transaction costs, information asymmetries (like uncertain price of risk or unknown shared interests), coordination problems and positive externalities as well as equity considerations. These can all lead to under-investment and gaps in supply of finance.

44. High street banks and other **mainstream financial institutions** will lend or invest at a market rate of return. But mainstream financial markets can lack an understanding of third sector investment opportunities and the associated risks. While sometimes there will be an element of 'social screening', institutional investors, pension funds and company directors are bound to seek greatest financial return for the shareholders, with maximum security and maximising profits.

45. So investors tend to seek risk-adjusted financial returns. Indeed, charitable trusts will seek primarily **financial** return in investing their assets – as legislation limits the extent to which trusts can sacrifice financial return for social purpose.[23] Additional social benefits (positive externalities) are not taken into account in investment decisions seeking financial return. Yet third sector organisations exist wholly or mainly to deliver social and environmental benefits. So, through their work, they can generate added positive externalities which spill over to society as a whole. This added value is not valued by investors and, as a consequence, society as a whole invests too little in this area.

18 *Social Investment Pilots: Action research final report,* OTS, 2008
19 Ibid.
20 Ibid.
21 *The Financing of Social Enterprises: A Special Report by the Bank of England*, Bank of England, May 2003
22 *Research on Third Sector Access to Finance: Report to the Office of the Third Sector*, SQW Consulting, May 2007
23 *Investment of Charitable Funds: Basic Principles*, Charity Commission Guidance CC14, December 2004

46. There can also be potential barriers as the prospect of foreclosing on a charity can mean that lenders are reluctant to lend in the first place (reputational transaction costs). On the other hand, there is increasing interest in this area. Evidence based on data from 2004[24] suggests that many social enterprises could be as capable of accessing commercial finance as mainstream businesses, and found little evidence that social enterprises are either riskier or less well understood by finance providers than conventional small and medium-sized businesses. The research found no significant difference between social enterprises and mainstream businesses in the number that had been rejected by finance providers. So the evidence is not entirely clear.

47. **Some providers of capital seek no financial return**. But so-called information asymmetries, the uncertain price of risk, unknown shared interests and coordination problems, as well as poor mechanisms for signalling social returns and higher transaction costs, also lead to under-investment in enterprises that generate social impact. For example, grant-makers and donors often avoid seeking financial return, even when it might be available, as they are wary of working with social enterprises that operate in private markets and/or are wary of being seen to subsidise public services.

48. But a few players are emerging here, such as Charities Aid Foundation (CAF) Venturesome and Big Issue Invest. Charity Bank and CDFIs focus on organisations that find it difficult to obtain finance from mainstream providers, and might take greater financial risks or accept less financial return, due to the additional social return generated. These investors seek some **combination of financial and social return** on investment, whether through loans, patient capital, equity-like investments or some combination. This can also include grants under certain conditions. OTS's social investment pilots reported that: "Social investors understand the concept of social investing, will undertake greater risks and are prepared to take less than market rates in exchange for a social return."[25] Although the report also recognised that this was in "stark contrast to the regulated financial institutions that advise on, control and manage assets on behalf of private investors, institutional funds and charities".

49. But specialist investors in the market are relatively small and new and not yet sustainable, and their need to generate returns to cover costs means that they can be relatively conservative in their investments. They may be too small to generate additional revenue from other services and products through ancillary business other than that generated from lending money – funds management, insurance etc. Social investors are not yet at a scale to be sustainable and flexible enough to meet demand and exploit gaps in the market. Reportedly, so-called quasi-equity (see Glossary), patient finance or venture capital investment equates to less than 1% of the income of the third sector. In summary, the capacity of the supply side is limited[26] and social investment is far from being a recognised asset class, like property, cash or government bonds.

The marketplace

50. Even when demand and supply are in place, the market for social investment is fragile and immature and does not operate either efficiently or at scale. There is a range of market failures, such as so-called higher transaction

[24] Finance for Small and Medium-Sized Enterprises: Comparisons of Social Enterprises and Mainstream Businesses, Dr Stuart Fraser, Centre for Small and Medium-Sized Enterprises Warwick Business School University of Warwick, 2007

[25] *Social Investment Pilots: Action research final report*, OTS, 2008

[26] For example, Triodos Bank lent £33 million to charities and social enterprises in 2007, compared with over £13 billion of voluntary sector earned income in 2004/05

costs in immature market, coordination problems, information asymmetries and positive externalities.

51. In particular, transaction costs can be high as a result of a lack of appropriate investment products and vehicles that build in social returns, which are not yet widely available or understood,[27] or because legal forms can be complex and misunderstood.[28] Second, there is virtually no secondary market (or securitisation) for specialist investments in the third sector. Third, demand can be skewed towards fundraising and seeking grants – or the availability of 'free' capital[29] – which make the market less efficient than it could be. Fourth, referrals, syndication and co-financing between investors are limited, ad hoc, slow and cumbersome. Fifth, the market itself represents an unusual hybrid of commercial and cooperative motivations and does not yet have an established track record. Finally, there remains a lack of support for investment readiness and financial skills.[30]

52. On the other hand, some advisory services are already available both for third sector organisations and for those lending and investing in the third sector, although the coverage and quality is patchy and limited and the financing models uncertain. Furthermore, the costs and benefits to markets of securitisation have been brought sharply into question over the past few years.

Equity considerations

53. The Government believes it is also important to consider the distribution of the costs or benefits of interventions across different groups in society. This means thinking about the different impacts on different individuals, for example according to their income, gender, ethnic group, age, geographical location or disability.

54. The evidence suggests that third sector organisations tend to support some of the **most marginalised groups in society**, often addressing multiple and complex user needs and working with those who do not trust or want to engage with the state.[31] Charities, for example, must demonstrate that their purpose includes prevention or relief of poverty, advancement of education, health or the saving of lives, citizenship or community development, advancement of environmental protection or improvement, and relief of those in need, by reason of youth, age, ill health, disability, financial hardship or other disadvantage. Equally, social firms[32] are defined by their aim of creating opportunities for disadvantaged people, and Community Interest Companies (CICs) must pass a community interest test to ensure that they have been established for community purposes.

27 *Research on Third Sector Access to Finance: Report to the Office of the Third Sector*, SQW Consulting, May 2007

28 According to *Social Investment Pilots* (2008): "the marketplace for such investments is imperfect and there can be significant transaction costs and co-ordination problems in bringing investors to market"

29 *Social Investment Pilots: Action research final report*, OTS, 2008

30 According to *Social Investment Pilots* (2008), support to social enterprises provided by various intermediaries can be patchy. Intermediaries do not have the combination of: i) sufficient expertise in corporate finance; ii) a strong understanding of social enterprise; and iii) the ability to provide the required service for a cost commensurate with the size and value of the deals to structure equity-based deals

31 *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*, HM Treasury, September 2002

32 A Social Firm is a type of social enterprise whose specific social purpose is to employ people disadvantaged in the labour market (Social Firms UK)

55. On the other hand, some evidence may suggest that charities, for example, are disproportionately located in more affluent areas.[34] However, this does not, in itself, indicate the level of disadvantage of their beneficiaries.

Wider considerations and government investment

56. First, the third sector can often operate outside effective public markets as they seek to generate income. Third sector organisations often pick up those who have fallen through gaps in state provision and can work as a social innovator. The introduction of Local Area Agreements and emerging ideas such as personalised budgets for example, along with developments in commissioner practice which go beyond a focus on relatively narrow, short-term and easily quantifiable benefits towards joining up resources around citizens, may offer significant opportunities for the third sector.

57. The Government is keen to develop its support for the market on the capital side and ensure an environment in which the third sector can thrive. However, understanding and applying relevant tax incentives can be complex and the Charity Commission rules around social investment are not always widely understood. The experience of government programmes to support the third sector and social investment has also reinforced the challenges in addressing the demand-side issues identified above such as the sector's capacity and willingness to access finance.[34]

58. So, **government must consider how the available resources should be most effectively managed** to ensure a coherent approach, build on existing interventions, and 'crowd in' – and not 'crowd out' – further investment in order to maximise value for money. This implies a broad approach, taking in the landscape for social investment as a whole.

2. Do you agree with the economic case as it is set out, and do you have further evidence, case studies or detail in its favour, or evidence to the contrary? To what extent does the evidence suggest problems are short term (for example, linked to the immaturity of the market or perceptions) or intractable?

[33] *The UK Voluntary Sector Almanac 2007*, National Council for Voluntary Organisations, 2007
[34] For example, see *Investing in Thriving Communities: The final evaluation report on the Adventure Capital Fund*, Stephen Thake and Sanjiv Lingayah, London Metropolitan University, June 2009

4. Functions

Options

59. There are a number of functions that could potentially address the market failures that exist in the social investment market. This chapter sets out these potential functions. An SIWB could pursue none, several or all of these functions, or more besides. Each function may require a certain level of capital initially and would then subsequently generate a combination of social and financial returns over time. Alternatively, the Government could consider a legislative, fiscal or regulatory intervention to address the problems in the market identified above.

A champion for sustainable social investment

60. This function would seek to address the reported lack of understanding of third sector investment opportunities and risks, the reluctance of grant-makers and donors to engage in this area and the third sector's limited awareness of the benefits of finance options, and would aim to improve access to knowledge and networks.

61. Acting as a champion and emerging market analyst could take the form of research, awareness raising and spotting gaps in the market, tracking, analysing and publishing research on credit risks and other market data – perhaps with alternative approaches that consider social ratings – and making this information available to all.

Examples

- It has been suggested that social enterprises may offer, on the whole, more limited potential for generating spectacular financial returns to equity investors – due to a limited ability to distribute profits or due to their business models. It has also been suggested that, in the long term, the risks of investment are also lower due to their ability to attract grant funding and support from the communities they serve. Whether this is true is unclear. **Publication of robust evidence** would help clarify the potential risks and returns available to potential investors in social enterprise.
- **Social Return on Investment (SROI)** is a framework to help understand the value of social change, which provides a financial proxy for the value of this change. By quantifying the social return of an organisation's activities, SROI can be used by social investors to enable more informed and intelligent investment decisions. Information from investors on SROI reports could be collected, analysed and published to improve understanding of investment opportunities and social returns.

Raising capital

62. This function would seek to address the issue of mainstream financial markets lacking an understanding of third sector investment opportunities and the associated risks, social benefits not being taken into account in investment decisions that seek financial return, and other information asymmetries and transaction costs. This function would help social investment move towards a recognisable asset class (see Glossary), helping to attract investment and unlock private and independent capital.

63. Such a function would take the form of marketing to investors in order to raise capital. This could include taking deposits, share or bond issues, borrowing, attracting payments contingent upon delivery of outcomes, equity investment (for example, in a fund of funds) and attracting philanthropic resources.

64. Products that could be used to attract investors would have to be clear about what they offer in terms of both their financial and social risk/return profiles. They must highlight the liquidity, transparency, duration and security of any investment and the associated risks. Investors could be found among banks, traditional asset managers (such as pension funds or insurance companies), alternative asset managers, local or central government, trusts, endowments and foundations, and individuals. Investors could exploit appropriate tax incentives, such as Gift Aid, Community Investment Tax Relief, Enterprise Investment Scheme and Venture Capital Trusts, where available.

Examples

- **Investing for Good** worked with OTS on a social investment pilot and suggested products for raising capital structured through so-called 'vanilla'-style products – which are simple and easily understood by investors – delivered through a regulated body, designed and structured so that they are easily approved by product panels, able to deal with all post-trade processing issues and the idiosyncrasies of the social investment sector, available through existing reporting platforms and easy to sell, with excellent marketing material. The research suggested that, to attract institutional asset managers, the size would need to be in the region of £50 million.

- **The US Calvert Foundation's** 'Investment Notes' provide a way for organisations to invest funds in causes that support their mission. Notes can be custom targeted to support specific organisations or causes. Investments are pooled and placed in a managed portfolio, and backed by guarantees and other measures to make the 'Note' a safe investment option for investees. The Calvert Foundation has raised over $125 million since 1995.

Investing and providing capital

65. This function would seek to address the problem of social benefits not being taken into account in investment decisions, the reputational transaction costs of investment in this area and aversion from grant-makers and donors. It would also seek to address the limited and immature supply-side capacity, the issue of reinvestment of profits hindering equity investment and where business models rely on voluntary contributions and appear risky. It would also seek to address equity considerations by getting more investment into disadvantaged areas, pick up those who have fallen through gaps in state provision and reflect the role of the third sector as a social innovator.

66. Such a wholesale function would take the form of financial and other support to strengthen existing and new social investors (retailers). This could include financing the incubation of ideas emerging in the market.

67. To do so, the Bank could employ a range of innovative instruments, in combination or structured and packaged into tranches. These could include debt, grants, guarantees or underwriting, acting as a 'cornerstone investor',

equity, patient capital, equity-like risk capital, securitising investments and offering incentives to attract co-investors under certain conditions.

68. Whatever form investment takes, the Government believes that investment should pursue, be contingent upon, and demonstrate a combination of social and financial return. Of course, any investment also brings risks, so the Bank would need to consider the combination of financial and social risk and return, as well as questions of liquidity, security and simplicity.

69. The Bank also must seek to bring in maximum possible leverage from other sources, whenever it can. Through a transparent approach and offering the chance for others to take on part of the investment and co-invest, the Bank would 'crowd in' rather than 'crowd out'. The Bank would offer deals to the market, secure maximum leverage, seek to refinance and act to drive broader investment, rather than principally invest its own capital.

Examples

- As a promotional bank under the ownership of the German Federal Government, the **KfW Bankengruppe** offers support to encourage sustainable improvement in economic, social, ecological living and business conditions, in the areas of small and medium-sized enterprises (SMEs), environmental protection, housing, education finance and development cooperation. Roles include offering expertise to the German Federal Government; loans to partner banks throughout Europe, enabling them to extend investment to SMEs and to finance private, environment-friendly, residential building projects; and raising €60–70 billion annually to fund reduced-interest promotional loans.
- **Norfund** is a Norwegian development financial institution which invests risk capital in profitable private enterprises in developing countries. Norfund contributes to viable projects which balance economic, social and environmental considerations. It provides equity, quasi-equity and loan financing for business expansion, corporate restructuring, management buy-ins and buy-outs and new business ventures. Norfund will contribute or generate something in addition to that which would otherwise have taken place through the market. It aims to be on an equal footing with its partners by sharing risks and profits.

Market-making

70. This function would seek to address the lack of products, the fragility and immaturity of the market and higher transaction costs. It would also seek to address the limited referrals, syndication, co-financing and secondary market and fundraising inefficiencies where demand is skewed towards the availability of 'free' capital. It would also seek to support investment readiness and financial skills.

71. Such a function would help build the market – or 'intermediate' – between retailers and investees, as well as at the wholesale level between retailers and providers of capital. This could include: creating platforms and mechanisms to link buyers and sellers; creating a marketplace where social investors can trade in and out of investments, providing liquidity; covering the costs of knowledge sharing, co-financing, refinancing and syndication; providing brokerage services; and product development and innovation.

Examples

- A **mortgage broker** is an intermediary who brings together and facilitates transactions between borrowers and lenders – so neither originates nor provides funds themselves. The broker might sometimes negotiate with the lender to find the best financing deal possible for the borrower. Typical tasks include marketing to attract clients, assessment of the borrower's circumstances, assessing the market to find a mortgage product that fits the borrower's needs, applying for a lender's agreement in principle, providing paperwork and streamlining the process. This function could be translated into the social investment market.
- **Zopa** is an online marketplace where people borrow and lend money to and from each other. Individuals or businesses looking to borrow are categorised according to their credit scores and matched with appropriate lenders. Zopa earns its money by charging borrowers a transaction fee and lenders a 1% annual fee. **Kiva** is a person-to-person micro-lending website, enabling individuals to lend directly to entrepreneurs around the globe. Kiva partners with existing institutions and provides a transparent lending platform.

Advisory services

72. This function would seek to address the problems of reluctance to take on debt in the third sector, limited financial skills, perceptions of success when seeking finance, unwillingness to provide personal security among volunteer trustees, lack of awareness of the benefits of finance options, and the focus on programmes over development.

73. Such a function could be provided alongside capital or separately. This could include improving investment readiness, financial management, capacity building and technical support.

74. It would also seek to address the problems at retail level – that specialist investors are often relatively small and new, not yet sustainable, relatively conservative in their investments, too small to generate additional revenue from other services and products, and not yet flexible enough to meet demand and exploit gaps in the market. Such a function could again be provided at the wholesale level alongside capital or separately to help increase the capacity of the supply side. It could include advising social investors on how to manage their portfolios and exploit their assets, financial restructuring and asset management.

Examples

- The **Local Initiatives Support Corporation** (LISC) is a US organisation which attracts corporate, government and philanthropic support to provide local community development organisations with loans, grants and equity investments, policy support, and technical and management assistance (including information resources, workshops and conferences).
- Many of the **investment-readiness** models currently available in the private sector have yet to be adequately tested for social enterprises and have potential to varying degrees. Evidence shows that a lack of availability of funds to cover the costs of professional fees may be one of the things preventing social enterprises accessing the investment support they need. An SIWB could explore how investment-readiness providers may be sustainably financed in the long term and hence encourage professional, able providers with business experience into the sector.

3. There are five potential functions for the Bank outlined in this consultation:

- **a champion for sustainable social investment;**
- **raising capital;**
- **investing and providing capital;**
- **market-making; and**
- **advisory services.**

Are these an appropriate response to best address the problems identified above? If not, why not and what are the alternatives? If so, is an SIWB an appropriate vehicle to carry these out? Would it add greater value than existing government programmes to date?

4. Each potential function will have costs and benefits over time (both direct and indirect, social and financial). What is your view about these costs and benefits, and what evidence is there to back this up?

5. Should advisory services for front-line third sector organisations and social investment intermediaries accompany the provision of capital or be provided separately?

6. When raising capital, what combination of social and financial risks and returns would be attractive to investors? What evidence is there that the Bank could attract investment on these terms, from whom and through which investment products?

7. When providing capital, what combination of social and financial risks and returns would the Bank offer? What evidence is there that the Bank could make investments on these terms, to whom and through which investment products?

8. Which combination of functions would be most effective and deliver best value for money?

5. Design

75. An SIWB could be designed around the functions outlined in the previous chapter. In considering the design of such a bank, principles of good design have been variously described as robustness/durability, usefulness/efficiency, and beauty or the ability to delight. So, the Government is keen to seek views on how the design of an SIWB could ensure that it delivers **sustainable impact and social and environmental value, and that it captures imaginations**. This chapter considers the following areas before concluding with potential principles drawn from the arguments in each section:

- scope and eligibility;
- mission and strategic objectives;
- adaptability;
- structure, governance and ownership;
- wholesale approach;
- regulation, reporting and accountability;
- distorting competition; and
- financial requirements.

Scope and eligibility

76. The evidence explored in the economic case is particularly focused on the third sector. The third sector is often at the heart of social investment. But the Government recognises that the role of an SIWB **may not be limited to financing and supporting only the third sector**.

77. While third sector organisations often embody common characteristics and values which are cherished by society and by government, the third sector exists only to help its beneficiaries and to deliver social change. It is not an end in itself. The Government is interested in better outcomes rather than processes and ends, not means. For example, while credit unions and CDFIs are themselves third sector organisations, they are valued by government and society because they work to reduce financial exclusion for people and provide investment for businesses in deprived areas.

78. So, the Government is attracted by the scope of the work of the Bank being **defined by social and environmental outcomes and not by eligibility on the basis of form**. It would be a Social Investment Wholesale Bank and not a Third Sector Investment Bank. The Government is wary of discriminating on the basis of legal form and excluding activities from the scope of the Bank's remit, regardless of the potential impact.

79. For example, in seeking to make the market work and raising capital, the Bank would merely be acting to improve 'intermediation' (see Glossary). So the ultimate impact of the Bank would be determined by the interests of its investors, not by a tightly defined historical mandate. By way of illustration, a foundation investing in the Bank may be focused on one region of England only while other investors may have other interests, perhaps even outside the UK.

9. Do you agree that eligibility should be based on potential social and environmental impact, rather than defined by legal or organisational form? If so, would it be necessary to ensure that the Bank ultimately supported a diverse range of enterprises, for example small, black and minority ethnic-led and rural projects?

Mission and strategic objectives

80. The Government believes that an SIWB should have a clearly defined mission and objectives. Taking inspiration from the private and third sectors, this mission could be alternatively described as the Bank's mandate or purpose.

81. The mission could be limited to enabling the third sector to deliver more and better outcomes, perhaps over the long term. Or, defined more widely in order to reflect the issues of scope discussed above, its mission could be to **create social and environmental value by increasing investment for a social or environmental purpose**.

82. The mission could be underpinned by strategic objectives. Reflecting the analysis above, these objectives could be built around its role in addressing market failure in the provision of social investment. Or defined in more detail: to support demand for finance in the third sector, strengthen supply of investment for a social purpose and work towards a better functioning marketplace.

10. This consultation suggests that the mission of the Bank could be to create social and environmental value through increasing investment for a social or environmental purpose. How do you think the mission of the Bank should be defined?

Adaptability

83. In time, the financial success of the Bank's investments and its ability to attract further investment will determine its long-term future. It may be that other institutions are able to enter the market or that the need for a specialist bank is reduced as the market develops.

84. Furthermore, the economic analysis above is based on the available evidence at this point in time. So, the Bank will need to be flexible and adaptable to changes in the market, perhaps growing, shrinking or changing as the need evolves. The Government believes that the Bank could have an evolving remit based on the evidence of problems in the market, and therefore innovate and evolve as the market develops.

11. Do you agree that an SIWB would need to be flexible and adaptable to address evolving issues as the market develops? How could it be ensured that the Bank would respond appropriately to the evolving market?

Structure, governance and ownership

85. The structure of the Bank would need to be tailored to its functions. For example, if the Bank had a mission defined by social purpose but also sought to attract equity investment, then it would need to be able to issue shares and potentially pay dividends, while protecting its social mission. The extent to which it could distribute surpluses may be limited, or not. This would need to be reflected in the Bank's legal form and governing documents. So it is possible, for example, that financial ownership and control over investment activity could be held separately, as with many investment funds.

86. The Government believes that an SIWB should be **independent of government** and that its social mission would need to be protected in its governing documents. Financial ownership should be held, in the main, outside government. However, this should not preclude the possibility for government to act as a minority investor in the Bank as it seeks to raise capital.

12. How best could the Bank be structured and owned in order to deliver its functions and meet its mission?

Wholesale approach

87. A key function of an SIWB could be to act as a provider of finance to existing or new retailers. The Government believes that it should act as a wholesaler of finance and support, investing in those who invest in the third sector. Yet in order to carry out some of the potential functions outlined in the previous chapter, such as advisory services, the Bank may be able to carry out activities itself rather than finance others.

13. Under what circumstances could an SIWB carry out activities itself, rather than being limited to financing and offering support to others?

Regulation, reporting and accountability

88. The functions outlined in the previous chapter, which potentially include deposit-taking and providing investment advice for example, suggest that the Bank would need to be regulated by the Financial Services Authority (FSA), perhaps under a range of areas. It may also have a duty to report to the CIC regulator, Companies House or the FSA, depending upon the legal forms it adopts.

89. Furthermore, the Government believes that, in order to demonstrate to mainstream investors the risks and rewards of investment in this area and to carry out one of its potential functions, the Bank would want to proactively disclose its financial activities, risks and returns. The Government is attracted by the idea that the Bank should be as transparent as possible.

90. The Government further believes that the Bank should embody robust reporting mechanisms, reporting **not only its financial activities and returns but also its social and environmental impact against a 'triple bottom line'**. This may require reporting – formally or informally – to a range of stakeholders. These could potentially include Parliament, the BIG Lottery Fund, government and the European Commission.

91. The Government is attracted by the idea that, to best reflect its mission, the Bank must report its social and environmental return on a regular basis. SROI is a tool which can be used to help measure the social value of investment and which could be used by the Bank across its range of functions to help measure and improve its impact.

14. Do you agree that the Bank should seek to report transparently against a 'triple bottom line' of social, environmental and financial value? What ideas do you have for how this could be achieved?

Distorting competition

92. Potential government support for an SIWB introduces the risk of distorting competition. However, the presence of state aid is not necessarily incompatible with European Commission rules, but rather any aid must be designed to clearly address the market failure or equity objective in question in a proportionate way – in this case, ensuring that the Bank does not distort competition to an extent contrary to the common interest. The Government believes that this could be achieved through the design of the bank, which at its heart could have a mission to act in the common interest.

93. First, with respect to supporting the wholesaler itself, any resources directed from government towards the Bank would be determined on the basis of **fair and open competition**. A new vehicle entrusted with a primarily social purpose could ensure that government was not favouring any existing players in the market.[35] Such a competition would also allow for further development of ideas set out in this document and could take the form of one or more of a grant, grant-in-aid, procurement, government investment, mandate or public appointment.

94. Second, the Bank should not unfairly benefit 'retail' investors, such as CDFIs or specialist banks, through the provision of finance. Third, the risk of 'retailers' passing on any aid to enterprises in which they invest[36] and, finally, the risk of the Bank favouring co-investors also need to be mitigated. This could be achieved if the Bank was entrusted to:

- invest or raise money on commercial terms (which represents no form of subsidy or aid);
- match co-investors on the same terms (which means the Bank demonstrating that the market was also willing to invest and therefore there was no distortion);
- ensure that any aid was contingent on demonstrating social return or through entrusting duties in the general interest (which means there is no aid as the Bank is 'buying' defined outcomes that benefit society as a whole);
- offer or raise finance transparently on terms that are open and available to whoever comes forward without prejudice (therefore not favouring particular undertakings); or
- use public money only to go where the market would not otherwise go and, in doing so, seek to 'crowd in' rather than 'crowd out' (therefore not unduly distorting the market against the common interest).

These principles would be enshrined in the working methods of the Bank; for example, through a visible platform for communicating and offering deals to the market before and after investments were made.

15. Do you agree that the Bank would not distort competition to an extent contrary to the common interest if it followed the guidelines set out in this consultation? What mechanisms could be put in place to ensure this, while still enabling the Bank to effectively carry out its mission and functions?

Financial requirements

95. The level of resources required to enable the functions set out above are uncertain. First, some of the functions could potentially be made possible without any capital, or with very little. On the other hand, others could potentially employ hundreds of millions of pounds, or more.

[35] If this vehicle were then prevented through its mission from diversifying into other activities than those intended (unless it could demonstrate it would do so in a way that did not distort competition), this would prevent undue distortion of the market. For example, the Bridges Community Ventures Fund followed a similar approach.

[36] This risk already exists with existing government-backed programmes in this area. On the whole, this risk is managed as the programmes limit their activities to offering support below a certain level, to enterprises where there is no danger of distorting the market; where any aid is linked to support for disadvantaged or disabled workers or to pursue employment training outcomes; and where the investee is not seeking to engage in gainful activity, but fulfilling a social function or duty to work for the benefit of society as a whole rather than be governed by private special interests, based on the principles of solidarity and non-profit-making. This could include investing in charities (where to a large extent the legal framework that exists for charities in the UK restricts their economic activities to those which the market does not provide to the extent or quality that the state requires and that is in the general interest) or investing in CICs (where CICs must demonstrate that they operate for the benefit of the community) investing in small enterprises engaged in local services or local employment initiatives, cooperative, mutual and non-profit associations, and enterprises involved in reintegration work.

96. Second, the scale and nature of demand is particularly hard to quantify. Some argue that by introducing supply into the market then demand will follow. The Government believes that the scale and type of demand depend on the nature of supply. In other words, without considerable capacity building and investment readiness on the demand side, it may be impossible to increase the supply of capital in this area.

97. Third, the financial requirements depend upon the functions of the Bank over time. While an initial capitalisation could enable an institution to get up and running, the balance sheet of the Bank would evolve, depending on the financial success of investments and the ability of the Bank to attract more capital on various terms.

98. It is not clear the extent to which there will be a continuing cost of addressing market failure and where ongoing support will be required on one hand or, on the other, where an intervention is necessary only because of perceived problems in the market or because of its youth and immaturity, and no 'subsidy' is required. Some investments could generate commercially comparable rates of return, others would secure a 'blended' social and financial return and others may not generate any financial return.

99. So, clarifying the financial requirements for an SIWB will mean giving consideration to initial capital requirements, the terms on which further capital can be raised and the ongoing sustainability of its activities. In order to generate a more rounded and long-term picture of the potential balance sheet of the Bank over time, the Government will take forward more detailed financial modelling over the coming weeks.

100. To this end, the Government is seeking input into establishing a robust methodology to calculate the necessary financial requirements for an SIWB. Potential approaches could include:

- To what extent is the third sector undercapitalised?
- What is the scale of need under each issue and function outlined above?
- What is the current scale of demand at the retail level? And what is the projected scale?
- What is the necessary scale of a viable and practical institution?[37]
- What are the nearest comparable benchmarks internationally?[38]

101. The Government is wary of the risk of an SIWB being unable to identify sufficient demand and effectively deploy its capital, or to counter this, taking too many inappropriate risks and compromising value for money and social impact. The Government believes that the Bank should be demand led but should also apply necessary safeguards. The Government is also interested in the possibility and viability of testing a prototype bank in the first instance which, if successful, could lead to further capitalisation thereafter.

102. If the Bank were unable to identify sufficient demand, and in order to manage liquidity, it would need to invest its resources in the short term. The Government is interested how it might invest in a socially responsible manner.[39]

[37] For example, the Social Investment Pilots suggested that, in order to attract capital from institutional investors, a minimum fund size of £50 million was required

[38] For example, the Local Initiatives Support Corporation (LISC) in the US or the KfW Bankengruppe in Germany

[39] Socially responsible investment (SRI) is an investment strategy which combines investors' financial objectives with their concerns about social, ethical and environmental issues. In economic terms, this is investment that focuses not on the creation of positive externalities but rather seeks to limit negative externalities

16. How would you make a robust assessment of the necessary financial requirements over time of an SIWB, and what evidence is there to back this up?

17. The Government recognises uncertainties around the capacity and willingness of the third sector demand for finance. How could the risk of this undermining the success of the Bank be mitigated?

Principles

103. Bringing together the ideas outlined above, the Government believes that the design of an SIWB could embody the following principles:

- **outcomes focused** – working primarily to realise social or environmental returns;
- **additionality** – working only where there are gaps in the market to avoid distortion, through existing partners where possible, and seeking maximum leverage;
- **sustainability** – both of the market and its investments, which consider whole-life considerations and 'triple-bottom-line' returns, and apply necessary safeguards;
- **independence** – structured to reflect its unique hybrid approach;
- **ambition** – encouraging replicability and scalability;
- **transparency and accountability** – adopting a visible, ethical and simple approach; and
- **flexibility** – with an innovative and adaptable evidence-based approach.

18. Do you agree with the principles for the design of an SIWB outlined in this consultation?

6. Summary of questions

1. Do you agree with the vision for a Social Investment Wholesale Bank (SIWB) set out in this consultation?

2. Do you agree with the economic case as it is set out, and do you have further evidence, case studies or detail in its favour or evidence to the contrary? To what extent does the evidence suggest problems are short term (for example, linked to the immaturity of the market or perceptions) or intractable?

3. There are five potential functions for the Bank outlined in this consultation:

- **a champion for sustainable social investment;**
- **raising capital;**
- **investing and providing capital;**
- **market-making; and**
- **advisory services.**

Are these an appropriate response to best address the problems identified? If so, why? If not, why not and what are the alternatives?

4. Each potential function will have costs and benefits over time (both direct and indirect, social and financial). What is your view about these costs and benefits, and what evidence is there to back this up?

5. Should advisory services for front-line third sector organisations and social investment intermediaries accompany the provision of capital or be provided separately?

6. When raising capital, what combination of social and financial risks and returns would be attractive to investors? What evidence is there that the Bank could attract investment on these terms, from whom and through which investment products?

7. When providing capital, what combination of social and financial risks and returns would the Bank offer? What evidence is there that the Bank could make investments on these terms, to whom and through which investment products?

8. Which combination of functions would be most effective and deliver best value for money?

9. Do you agree that eligibility should be based on potential social and environmental impact, rather than defined by legal or organisational form? If so, would it be necessary to ensure that the Bank ultimately supported a diverse range of enterprises, for example small, black and minority ethnic-led and rural projects?

10. This consultation suggests that the mission of the Bank could be to create social and environmental value through increasing investment for a social or environmental purpose. How do you think the mission of the Bank should be defined?

11. Do you agree that the SIWB would need to be flexible and adaptable to address evolving issues as the market develops? How could it be ensured that the Bank would respond appropriately to the evolving market?

12. How best could the Bank be structured and owned in order to deliver its functions and meet its mission?

13. Under what circumstances could an SIWB carry out activities itself, rather than being limited to financing and offering support to others?

14. Do you agree that the Bank should seek to report transparently against a 'triple bottom line' of social, environmental and financial value? What ideas do you have for how this could be achieved?

15. Do you agree that the Bank would not distort competition to an extent contrary to the common interest if it followed the guidelines set out in this consultation? What mechanisms or safeguards could be put in place to ensure this, while still enabling the Bank to effectively carry out its mission and functions?

16. How would you make a robust assessment of the necessary financial requirements over time of an SIWB, and what evidence is there to back this up?

17. The Government recognises uncertainties around the capacity and willingness of the third sector's demand for finance. How could the risk of this undermining the success of the Bank be mitigated?

18. Do you agree with the principles for the design of an SIWB outlined in this consultation?

Glossary

Added value This refers to the enhanced usefulness and worth of any product or service as a consequence of a particular process. For example, third sector organisations may be said to add value to the delivery of public services due to their creativeness, innovation or close understanding of the needs of the communities that they serve.

Additionality An impact arising from an intervention is additional if it would not have occurred in the absence of the intervention.

Asset class An asset class refers to a group of investments that exhibit similar characteristics of risk and return. The four main asset classes are shares, bonds, property and cash deposits.

Distributional impacts This is a term used to describe the distribution of the costs or benefits of interventions across different groups in society.

Economic efficiency This is achieved when nobody can be made better off without someone else being made worse off.

Equity finance This is share capital invested in a business for the medium to long term in return for a share of the ownership in – and sometimes an element of control of – the business.

Ethical investment An investment strategy that tries to maintain a balance between the financial returns and the social and environmental impact of the activities of the company in which the investment is made.

Externality An externality exists when the production or consumption of goods directly affects business or consumers not involved in buying and selling those goods and when those effects are not fully reflected in market prices – in other words, it is the non-market impacts of an intervention or activity that are not borne by those who generate them.

Green Book The *Green Book* is the central point of access to guidance on how to make an economic assessment of the social costs and benefits of all new policies, projects and programmes in the public sector in order to ensure the proper use of public resources. This guidance is designed to promote efficient policy development and resource allocation across government.

Information asymmetry Differences in information held by parties to a transaction where this information is relevant to determining an efficient contract or a fair price, or for monitoring or rewarding performance.

Intermediation Intermediation is a brokering activity that involves matching providers and seekers of finance, for example. This is usually required because of information assymetries in the market (see above).

Investment readiness This relates to the degree to which organisations have a good understanding of available financing options, including risk finance, the degree to which they are able to appreciate and meet needs of investors and the quality and level of presentation of business plans. Evidence shows that those factors can impact on organisations' ability to access equity finance from investors.

Leverage Financial leverage is the extent to which investors use loans or other forms of debt to generate a higher rate of return than the cost of interest. Leverage means investors having exposure to the full benefits arising from holding a position in a financial asset, without having to fully fund the position with their own funds.

Market failure An imperfection in the market mechanism that prevents the achievement of economic efficiency.

Market value/rate The price at which a commodity can be bought or sold, determined through the interaction of buyers and sellers in a market.

Mezzanine finance This is often a high-risk form of finance, part way between debt and equity. It has the characteristics of debt but may carry a right to shares.

Mutuals Mutuals are organisations that are owned by, and run for the benefit of, their current and future members. Mutuals take many forms and operate in a wide range of business and social environments. Mutual business structures include cooperatives, building societies and other employee-owned businesses.

Patient capital This refers to capital invested for the medium to long term where the investor does not expect immediate repayments or quick returns on investment. Standard conditions can include repayment holidays, reduced interest rates, etc.

Price of risk This is the compensation that investors require to hold a given amount of risk.

Quasi-equity This is an investment with equity-like characteristics (such as flexible repayment terms and higher risks but potentially higher returns) and where returns are dependent on success, such as an agreed percentage of future income or surpluses. Risks and rewards are shared between investors and investee. The instrument is usually used where debt is inappropriate and traditional equity is not possible due to legal forms or organisation objectives. Examples may include 'mezzanine debt' and 'subordinated debt'.

Secondary market The financial market where investors can purchase and sell existing investments and financial instruments such as stock, bonds and options directly from and to other investors.

Securitisation A securitisation occurs when a portfolio of loans, similar in purpose and usually of high credit quality, are grouped together and transferred either to a special purpose vehicle (SPV) or a non-resident company which funds the purchase through the issue of bonds. SPVs are specifically set up by institutions to purchase their loan portfolios.

Senior debt This refers to debt that has priority for repayment in case of liquidation or bankruptcy of a company.

Social screening Social screening is the process by which investors select firms to invest in on the basis of their social and/or environmental performance in addition to the firm's financial performance.

Subordinated debt This is debt that is issued on terms which stipulate that it will only be repaid once the claims of more senior creditors have been satisfied.

Syndicated loan (syndication) A loan issued to a borrower by a group of lenders, usually banks or financial institutions including pension plans, mutual funds and hedge funds. There is usually a lead agent who will coordinate the transaction.

Social Return On Investment (SROI) A framework to help understand the value of social change from the perspective of those most affected by an activity. Alongside a qualitative account, it provides for a financial proxy value of this change, which can be understood alongside traditional financial costs.

State aid These are transfers of state resources that provide selective support to particular companies. When the state confers even a limited advantage on an undertaking, there is usually a distortion, or risk of distortion, to competition. To protect competition across the EU, the European Commission provides a complex body of treaty-based legislation, frameworks and case law to establish which aid is, and is not, allowable.

Transaction costs These are costs sustained in an exchange of goods or services and through the process of overcoming market failings. Transaction costs can include legal fees, informational costs, negotiating costs, etc.

Triple bottom line This is a framework for measuring and reporting the performance of a firm against economic, social and environmental dimensions.

Unclaimed assets Unclaimed assets or dormant accounts are bank and building society accounts where there has been no customer-initiated activity for 15 years. In 2008, the Government introduced legislation to enable unclaimed money in dormant bank accounts to be used for youth facilities, financial inclusion and social investment.

Unsecured/secured loans Unsecured loans are loans that have been issued without collateral, e.g. assets of the borrower. Secured loans are loans that have been offered with some claim over the assets of the borrower.

Venture capital This is a form of private capital investment usually provided to new or developing companies with high growth potential, often in exchange for shares in the company. This can also be accompanied by board representation and/or management rights in the company.

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Additional information

The seven criteria of the Government's Code of Practice on Consultation are as follows:

- When to consult – Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises – Consultations should normally last for at least 12 weeks, with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact – Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercises – Consultation exercises should be designed to be accessible to, and clearly targeted at, those people that the exercise is intended to reach.
- The burden of consultation – Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises – Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult – Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

The Department's Consultation Coordinator is David Kavanagh.

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

If you want information that you provided to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department. The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

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