SOCIAL INVESTMENT INSIGHTS SERIES

December 2014

Financial Inclusion and Social Investment

In recent years the increasing exclusion of individuals from mainstream financial services in the UK has been a cause for concern for a number of public, private and philanthropic stakeholders. In this, the third of Big Society Capital's Social Investment Insights Series to focus on a social issue, we look at how social investors can support the financial inclusion sector. The paper includes evidence about the social need, provides an overview of the current market actors, outlines current challenges in the sector and highlights opportunities for social investors and Big Society Capital.

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The Social Investment Insights Series are occasional papers drafted by members of Big Society Capital's team on areas of interest to the social investment market.

Big Society Capital is a financial institution with a social mission, set up to build the social investment market in the UK, so that charities and social enterprises can access appropriate repayable finance to enable them to grow, become more sustainable and increase their impact on society. It is doing this by building a diverse social investment market: encouraging investors to lend or invest money to achieve a social as well as a financial return. Since it was set up as an independent organisation in 2012, Big Society Capital has committed over £165 million in investments to specialist organisations who lend to charities and social enterprises. Over five years Big Society Capital will be capitalised with approximately £600 million, from a combination of English dormant bank accounts and the four main UK high street banks.

EXECUTIVE SUMMARY

In its broadest sense, financial exclusion is an individual's inability, difficulty or reluctance to access appropriate mainstream financial services. Over the past few years, rising exclusion of individuals from mainstream financial services in the UK has become a cause for concern for a number of public, private and philanthropic stakeholders.

While cause and effect is hard to establish with financial exclusion, there are broadly four main drivers of financial exclusion for low income individuals:

1. An individual's inability or reluctance to exercise their full **financial capability**
2. Lack of access to **adequate banking services**
3. Lack of access to **affordable credit**
4. Lack of access to **other suitable financial, savings and insurance products**

Low income individuals are considered to be those with household incomes in the lowest 10% bracket of the population, the majority of whom are benefit claimants and are deemed to suffer the most from the effects of financial exclusion. In addition, low income individuals are prone to falling into a vicious cycle that exacerbates the effects of financial exclusion. The earlier that an individual's financial needs are satisfied, the lower the chance of them falling into, or continuing on, the vicious cycle of financial exclusion.

Given that most financial services are not inherently designed to increase an individuals' level of income (rather, they are tools that help an individual manage their disposable income) reducing unnecessary costs and increasing financial capability are the two main levers that can be used to mitigate the effects of financial exclusion for low income individuals.

There are several types of organisations who are active in this diverse and complex market including: Credit Unions; Community Development Finance Institutions; debt advice providers; new ventures piloting innovative business models; mainstream finance providers; and government agencies and regulators.

Knowing where to focus investment to 'solve' financial exclusion is not obvious and finding financially sustainable ways to tackle this issue is challenging. While there are some social investment opportunities, the financial inclusion sector remains fragmented and is transitioning from a history of subsidies. Beyond the provision of capital, social investors can also support the sector through advocacy, research, and collaboration.

In the short term, Big Society Capital will continue working closely with relevant stakeholders and social investors, including intermediaries funded by Big Society Capital, to:

- **Signpost organisations looking for investment to suitable sources of capital**
- **Commission research, advocate for policy and regulation, and encourage collaboration that will support the case for social investment in the financial inclusion sector**

In the medium to long term we expect to see the emergence of, and intend to **support, dedicated social investment capital pools** which are tailored to the needs of the financial inclusion sector.

In addition, we intend to **monitor the development of other innovative business models** that are potentially suited to social investment, including micro-entrepreneur lending, peer-to-peer lending platforms, home improvement and equity release lending.

SOCIAL NEED

Big Society Capital Outcomes Matrix: Income and Financial Inclusion	
Big Society Capital's outcomes matrix represents a map of need in the UK. It has been designed from a beneficiary perspective and includes nine outcome areas which reflect what a person needs to have a full and happy life. The income and financial inclusion outcomes are shown opposite.	**Individual:** The person has sufficient income to meet their essential needs and access to suitable financial products and services **Community, sector and society:** Everyone reaches an optimum level of income for health and well-being, and income differentials support social cohesion

In its broadest sense, financial exclusion is an individual's inability, difficulty or reluctance to access appropriate mainstream financial services[1]. It is estimated that up to seven million people use sources of high cost credit and up to four million low income households have poor access to mainstream financial services[2]. However, financial exclusion is caused by a complex set of factors (ranging from an individual's behaviour and level of income, to changes in policy, regulation, and the overall dynamics of the UK's financial system) which have an impact on a broad spectrum of the population in a number of different ways. As such, this paper will focus on the needs of low income individuals, who are deemed to suffer the most from the effects of financial exclusion.

Low income individuals are considered to be those with household incomes in the lowest 10% bracket of the population[3], the majority of which are benefit claimants. Therefore, groups particularly prone to suffer from financial exclusion are: unemployed people; those unable to work through sickness or disability; single pensioners; and single parents. Geographical areas of high deprivation are also likely to have a higher concentration of financially excluded individuals.

It is hard to quantify the cost of financial exclusion. However, it is considered to be a major contributor to the approximate £1,000 per annum 'Poverty Premium' that low income individuals pay due to higher pricing for basic goods and services[4]. For example, low income individuals are often deemed to represent a high lending risk and are thus limited to higher costs of credit. It is also difficult for low income individuals to benefit from discounts offered by setting up Direct Debits to pay for services given that free-to-use bank accounts have not traditionally been designed with the needs of low income individuals in mind and often result in incurring fines when there are insufficient funds to make a Direct Debit payment.

While cause and effect is hard to establish with financial exclusion, there are broadly four main drivers of financial exclusion for low income individuals:

1. An individual's inability or reluctance to exercise their full **financial capability**
2. Lack of access to **adequate banking services**
3. Lack of access to **affordable credit**
4. Lack of access to **other suitable financial, savings & insurance products**

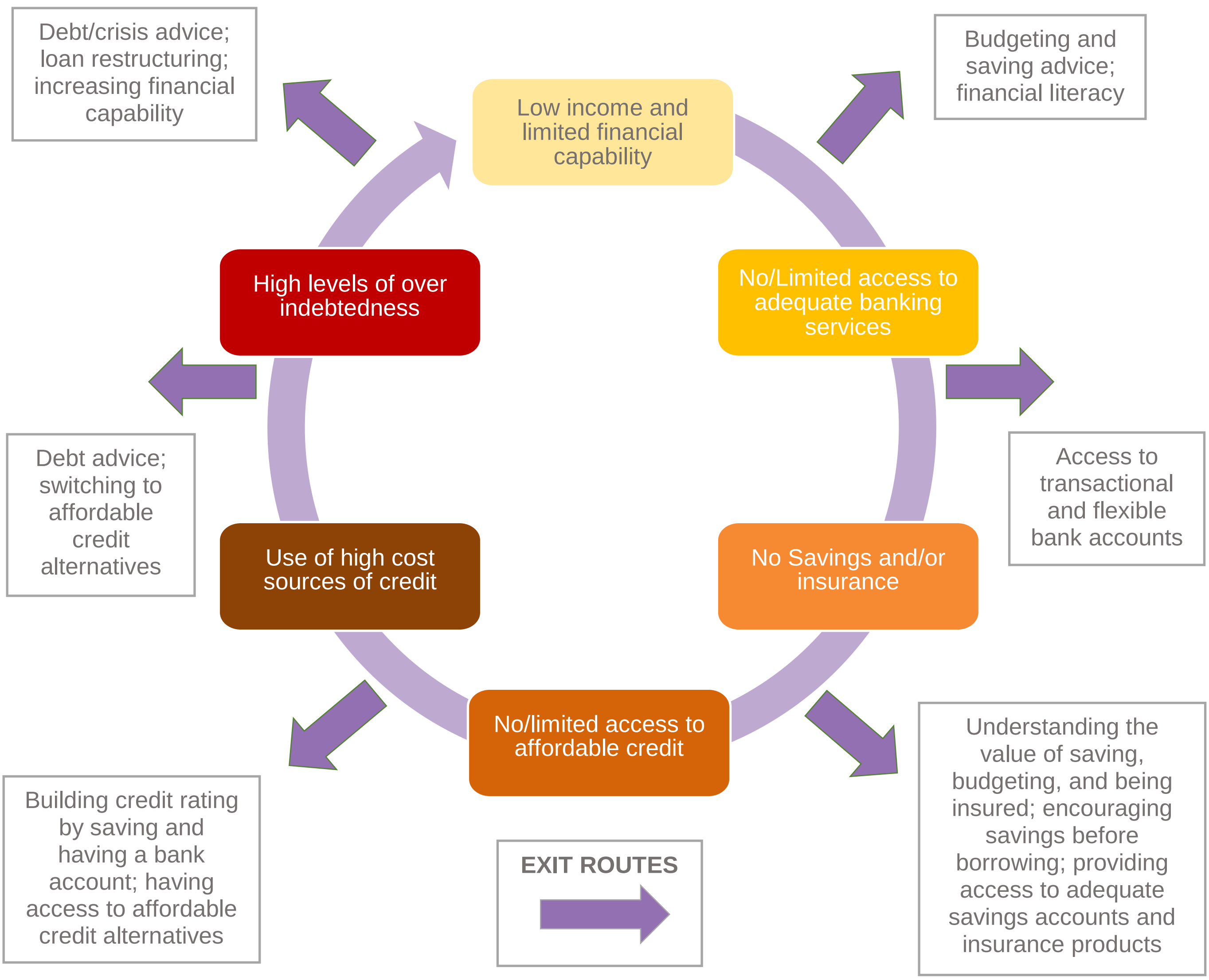
Given that most financial services are not inherently designed to increase an individuals' level of income (rather, they are tools that help an individual manage their disposable income) reducing unnecessary costs and increasing financial capability are the two main levers that can be used to mitigate the effects of financial exclusion for low income individuals[5].

[1] Joseph Rowntree Charitable Trust; Financial Inclusion: policy and practice, 2008
[2] CDFA/RBS Group; Mind the Finance Gap: Evidencing demand for community finance, 2013
[3] Classified as "Tier 3" consumers by Experian; Credit Union Expansion Project: Demographic Profiling, 2012
[4] Toynbee Hall; The Poverty Premium in Tower Hamlets, 2014
[5] While this paper does not focus on interventions that aim to increase an individual's level of income, readers may find useful information on this subject on our Social Investment Insight Series on Long Term Unemployment

THE CYCLE OF FINANCIAL EXCLUSION

We have developed the diagram below in an effort to explain how low income individuals are prone to falling into or continuing in a vicious cycle that exacerbates the effects of financial exclusion.

Diagram 1: Cycle of Financial Exclusion



The earlier that an individual's financial needs are satisfied, the lower the chances of an individual falling into, or continuing in, the vicious cycle of financial exclusion.

CURRENT MARKET

There are several types of organisations who are active in this diverse and complex market:

Credit Unions (CUs) are the largest providers of credit and financial services to financially excluded individuals with 400 CUs serving around one million customers. They are allowed to take deposits from customers and enjoy certain tax benefits, but face the challenge of covering the cost of lending and default risk with interest rates capped at 3% per month, while also adhering to capital-to-total assets requirements of 3/5/8%, depending on their scale. The Department for Work and Pensions (DWP) established the Credit Union Expansion Project (CUEP) in 2013 to help the Credit Union sector transition from a history of heavy government subsidies (DWP Growth Fund) and has the dual goal of attracting up to a million new CU members whilst supporting CUs to become financially sustainable.

Community Development Finance Institutions (CDFIs) are not constrained by the interest rate cap imposed on CUs, and some enjoy certain tax benefits, but they are not allowed to take customer deposits. While personal lending CDFIs also have a history of government subsidy (DWP Growth Fund), they appear to be transitioning to a sustainable model quicker than their CU counterparts. This can be attributed to the interest rate flexibility they enjoy, but also due to their need to raise external funding given their lack of access to funding from customer deposits. Personal lending CDFIs remain a small subset of the market with ten CDFIs serving around 40,000 individuals. *Refer to East Lancs Moneyline case study below for an example of a personal lending CDFI.*

Debt advice providers, most of which are charities, are the largest subset of institutions offering financial capability training and debt counselling to those who find themselves in financial difficulty. Most CUs and CDFIs partner with debt advice providers to signpost or directly offer debt advice to their customers.

New ventures including so called “challenger banks”, specialised credit providers (e.g. responsible rent-to-own schemes) and innovative transactional platforms are emerging – although most are still at an early stage of development and some are not specifically focused on serving financially excluded individuals. *Refer to Frees Family Finance case study below for an example of an innovative transactional platform.*

Mainstream finance providers include high street banks, high-cost short-term lenders and providers of wider financial products including insurance and asset leasing – most of which aim to maximise profits and often marginalise or charge a premium to financially excluded individuals. In addition, the UK’s high street banks and the Co-op continue to be the main providers of agency banking services for CDFIs and CUs, which they require in order to access the clearing and payments system (e.g. to offer Direct Debits), resulting in rigid agency banking fees for CDFIs and CUs.

Government agencies and regulators (e.g. Financial Conduct Authority and Prudential Regulation Authority), which are increasingly tightening regulation for institutions providing credit and financial services to the financially excluded. Government policy is also increasing the emphasis on individual responsibility, particularly with regard to pensions and universal credit. This increases the risk that those with low financial capability will become further financially excluded, but also poses a significant market opportunity for services tackling financial exclusion.

CHALLENGES FOR SOCIAL INVESTMENT

Cause and effect is hard to establish with financial exclusion, so knowing where to focus investment to ‘solve’ the issue is not obvious. Furthermore finding financially sustainable ways to tackle this issue is challenging.

Financial capability

Financial capability training is mostly provided free-of-charge to individuals and is often offered in conjunction with debt counselling services to those in crisis. There is potential for generating a margin when managing debt recovery (e.g. if costs of bad debts are reduced, savings can be shared). However, financial capability currently looks best suited for grant funding or to be financed on a contract basis.

Banking services

Providing profitable transactional banking services for those on lower incomes faces the dual challenge of competing with free-to-use current accounts provided by mainstream banks, which are considered inappropriate for the financially excluded, as well as the need to pay rigid agency banking fees. Macro level changes in the banking sector are likely to be necessary, alongside early-stage funding, to foster innovative new banking products that are emerging (e.g. budgeting/flexible bank accounts, including Jam Jar accounts).

Affordable credit

Providing credit in a morally responsible and financially sustainable way is a very fine balance to strike. The social impact is still to be understood, including evidencing that offering loans is a pathway to increase financial capability of low income families. It also remains to be seen if recent changes in regulation of pay day lending will drive the financially excluded to black market high cost lenders due to lack of supply of adequate financial services. From an infrastructure point of view, there is a need for CUs and CDFIs to invest in their operations, realise efficiencies, and aspire to grow their loan portfolios in a financially sustainable way.

Other financial products

Provision of other financial products, particularly insurance and pension schemes, are underdeveloped and difficult to implement in a financially sustainable way, mainly due to the lack of financial capability and low disposable incomes of financially excluded individuals.

OPPORTUNITIES FOR SOCIAL INVESTMENT

While there are some social investment opportunities, the financial inclusion sector remains fragmented and is transitioning from a history of subsidies. Beyond the provision of capital, social investors can also support the sector through advocacy, research, and collaboration.

Financial capability

Investment is unlikely to be used to improve financial capability. However, there is significant potential in enhancing collaboration between providers of affordable credit and stakeholders offering and/or funding financial capability.

Banking services

A number of investment opportunities exist in new ventures which need early stage funding. Advocacy could be focussed on liberalisation of the payments system. Research is necessary to evidence needs and behaviour of beneficiaries in relation to banking services. Collaboration should be encouraged amongst CUs, CDFIs, mainstream banks, the Post Office, housing associations and utility companies.

Provision of credit

Both CUs and CDFIs are in need of development/patient capital and CDFIs also require access to lending capital, albeit only a few operate on a sustainable basis and are "investment ready". Specialised credit providers are emerging and require early stage funding. Collaboration, in particular with housing associations, is seen as an area where a reduction in tenant arrears can subsidize the provision of credit. Advocacy for further disclosure of lending data from credit providers and increased access to financial data from CU's and CDFIs, coupled with comprehensive research, will help identify areas of need and the institutions best placed to serve them on a financially sustainable basis.

Other financial products

Few investment opportunities exist in institutions offering other financial products like insurance and pension schemes. Collaboration with mainstream finance providers, who have an expertise and potential to cross-subsidize, should be encouraged.

PRIORITIES FOR BIG SOCIETY CAPITAL

Current Portfolio of Investments

Big Society Capital has made a number of investments which aim to provide finance for a wide range of outcome areas, including financial inclusion. Examples of such investments are shown opposite.

Please refer to the following website for additional details on our investment portfolio: ***www.bigsocietycapital.com/how-we-invest***

- Charity Bank - £14.5 million
- The FSE Group - £10 million
- Social and Sustainable Capital - £15 million
- Impact Ventures UK - £10 million
- NESTA Impact Investment Fund - £8 million
- Social Investment Scotland - £8 million

In the short term, we will continue working closely with relevant stakeholders and social investors, including intermediaries funded by Big Society Capital, to:

- **Signpost organisations looking for investment to suitable sources of capital**

  Of particular relevance, the investment capacity of Social Investment Finance Intermediaries with a remit to support the financial inclusion sector has been significantly increased through recent investments made by Big Society Capita.

- **Commission research, advocate for policy and regulation, and encourage collaboration that will support the case for social investment in the financial inclusion sector**

  We continuously seek to initiate and maintain a dialogue with relevant stakeholders to identify potential opportunities for Big Society Capital to advocate for policy and regulation and to encourage further collaboration in the sector.

  By way of example, we recently published the report "*Tackling Financial Exclusion: Data Disclosure and Area-Based Lending Data",* alongside a diverse group of commissioners spanning the financial services spectrum. Refer to the link below to download a copy of this and other research reports commissioned by Big Society Capital: **www.bigsocietycapital.com/social-investment-research-library**

  We are also working with credit union stakeholders to commission research that will investigate the potential for social investors to support the Credit Union sector.

In the medium to long term we expect to see the emergence of, and intend to **support, dedicated social investment capital pools** which are tailored to the needs of the financial inclusion sector.

In addition, we intend to **monitor the development of other innovative business models** that are potentially suited for social investments, including micro-entrepreneur lending, peer-to-peer lending platforms, home improvement and equity release lending, amongst others

The above list is not exhaustive so if you have an enquiry about whether a proposal is eligible for investment, please contact us through the enquiries form on our website at: **www.bigsocietycapital.com**

Please note that Big Society Capital is a social investment wholesaler, which means we can only invest via Social Investment Finance Intermediaries.

CASE STUDIES

East Lancs Moneyline

Helping people who are financially excluded by providing access to affordable loans

Big Society Capital has invested £950,000 – through Big Issue Invest – into East Lancs Moneyline (Moneyline).

Moneyline is a not-for-profit Industrial & Provident Society established in 2002 with a mission to provide fairly priced credit for low income consumers in and around Blackburn. Over the past decade, they have expanded their business and today are one of the largest personal lending CDFIs in the UK with 20 branches located across the North West, Midlands, East Yorkshire and the Humber and South Wales.

Moneyline offers various products – including loans, money advice, bank accounts and savings accounts – for people who are either financially excluded or under-banked, where their alternatives are limited or substantially more expensive.

Moneyline's typical beneficiary group is female, young, with a low income, with dependent children and renting in the poorest neighbourhoods. Moneyline addresses both the demand and supply sides of financial exclusion by providing customers with financial capability services and access to appropriate low-cost finance products.

For more information please go to: **http://elmline.co.uk/**

Ffrees Family Finance

Unique type of current account that helps families to save as they spend

Big Society Capital has invested – through Nesta Impact Investments – into Ffrees Family Finance (Ffrees).

Ffrees is a digital current account that helps families to save as they spend. Customers receive Ffrees points when they purchase through their account from Ffrees' network of providers. These points are placed into a separate savings account, which customers can then redeem as cash.

Services such as Ffrees Money Manager also help people manage their budget and put money aside that is ring-fenced to pay bills. The basic account is free to join and has no monthly fees, and anyone with a confirmed UK address can get an account regardless of financial or social status.

For more information please go to: **www.ffrees.co.uk/**

The information and opinions in this report were prepared by Pepe Morales, Investment Director, and Nick Benton, Management Accountant, on behalf of Big Society Capital.

Titles available in the Social Investment Insights Series

Growing Social Enterprise Through the Holding Company Model: Groupe SOS (June 2014)

Social Impact Bonds: Lessons Learned (June 2014)

Growing the Market for Charity Bonds (July 2014)

Housing and Social Investment (August 2014)

Heath and Social Care and Social Investment (December 2014)

Financial Inclusion and Social Investment (December 2014)

Long-Term Unemployment and Social Investment (December 2014)

www.bigsocietycapital.com

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