

SOCIAL INVESTMENT WHOLESALE BANKING

Providing capital and liquidity to market intermediaries

A briefing paper

Venturesome

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Preface

This paper discusses the meaning and practical implications of wholesale banking in the context of the UK social investment market, prompted by the Office of the Third Sector's consultation regarding a Social Investment Wholesale Bank.

We publish this paper as a contribution to the current thinking on social investment, and the role that a Social Investment Wholesale Bank might play in supporting the existing ecology of this emerging and still fragile market.

Introduction

Financial intermediaries, such as Venturesome, exist to provide investment into charities and social enterprises. Such intermediaries perform a “retail” funding function because they invest directly into frontline, social-purpose organisations through repayable financial instruments such as loans, quasi-equity and equity.

Generally speaking, non-governmental funders rely for their own balance sheets either on grants which are hard to raise (e.g. Venturesome, Fair Finance etc) or depositors who must be repaid (e.g. Charity Bank, Triodos Bank etc). The consequence of this is that the supply side of the market consists of relatively few social investments funds (because of the difficulty of attracting gift capital), small funds that are unable to scale up, and funds that are risk averse.

One solution to this market failure is a **social investment wholesale banking service** which aims to strengthen the financial capacity of these financial intermediaries. Such a service does not necessarily need to be performed by any one institution (and this paper will argue that it is preferable for a variety of players to deliver this function for the market).

We outline some practical ways in which such an investment banking service might transact on a day-to-day basis with retail intermediaries – with a view to providing both capital and liquidity to this nascent market. In the Appendices, we provide a step-by-step case study¹ of how a social investment wholesale bank might actually deploy its funds in a deal, in addition to exploring some fundamental market concepts (such as the nature of capital, risk and return)².

The purpose of this paper is to provide a framework for discussion, debate and reflection. It is by no means exhaustive. We hope that these ideas trigger constructive debate.

¹ See Appendix A

² See Appendices B and C

Banking for bankers

In this paper, we use the phrase “Social Investment Wholesale Bank” (‘**SIWB**’) to denote a generic institution which performs social investment wholesale banking functions.

However, it is important to note that the SIWB need **not** be a single institution – but perhaps should more accurately be seen as a banking *function* which could be performed by a number of players. Indeed, in the future, every major grant-making trust may have their own SIWB departments.

The SIWB function can be effectively performed by any organisation which:

- Has a large balance sheet (£50m or more)
- Is willing to invest over long time horizons (5 to 10 years)
- Is motivated to act in the wider interests of the market.

In the same way that specialist lenders and intermediaries (such as Venturesome, Triodos, Charity Bank etc) provide working capital and development capital to charities and social enterprises, a SIWB could in turn provide similar investments directly into those same intermediaries (e.g. gearing lenders’ balance sheets so that they can do more and reach more customers).

US Calvert Foundation – a wholesaler and the market leader

In technology circles, there is a saying “the future has arrived – it’s just not evenly distributed”. In the world of social investment, the future vision of a brave new world in which an institution performs market-level SIWB functions already exists. In the United States, the Calvert Foundation has been successfully performing such a role for over 12 years.

Through its Calvert Community Investment Notes³ product, Calvert has succeeded in creating a social investment platform which connects the retail investor with a range of social investment funds. The Calvert Notes product (essentially a bond with a coupon of between 0% and 3%) is available to individuals in 49 states (financial regulations in Pennsylvania preclude the sale of the Notes there) through brokerage accounts and an online platform. Calvert has a historical loss rate of less than 0.25%, and as a result, retail investors in Calvert Notes have never lost principal or interest. To date, over \$350m has been raised from over 5,000 investors.

With the money raised, the Calvert Foundation then acts as a *wholesaler of capital*. It allocates capital (mainly through low interest debt) to 250 market intermediaries in the United States such as Acumen Fund⁴ and RSF Social Finance⁵ (who in turn invest directly into frontline beneficiaries around the world).

³ See: http://www.calvertfoundation.org/invest/community_investment_notes/index.html

⁴ See: <http://www.acumenfund.org/>

⁵ See: <http://rsfsocialfinance.org/>

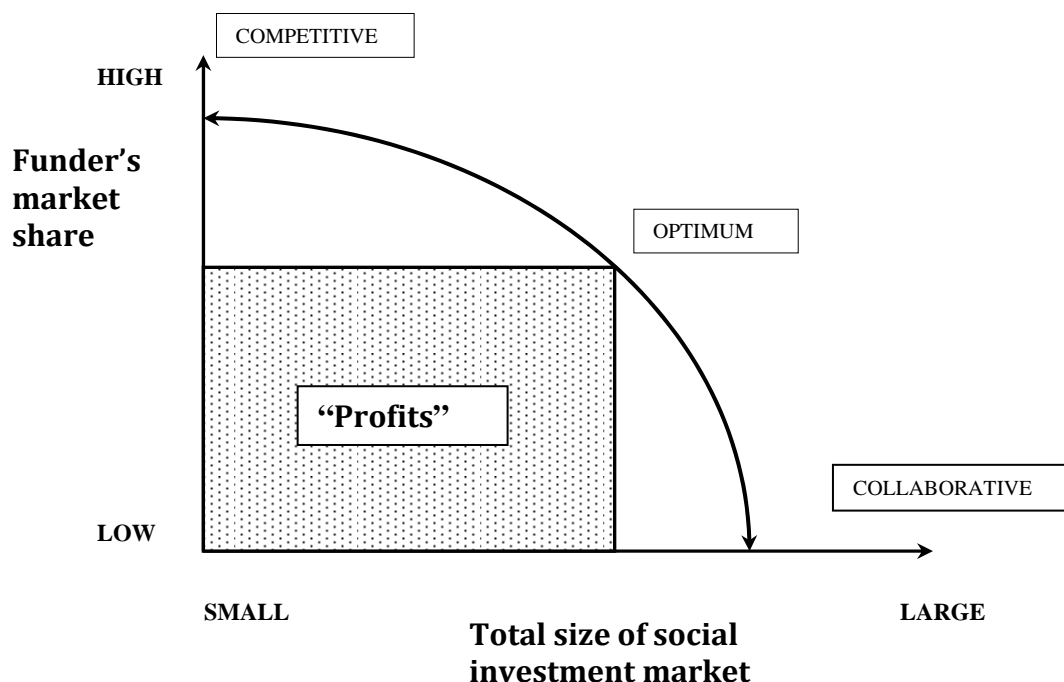
As a measure of how robust this product is, Calvert reported that since the financial crisis of 2007 investor appetite for their Notes product has significantly increased. Calvert closed 2008 with \$207m in assets, up 22% from 2007, and with more than \$42m deposited into the Calvert Notes (up 33% from the previous year).

How are new markets created?

In order to achieve optimal market effectiveness in which SIWB functions thrive, we need a variety of market players who are both able and willing to strike a balance between being competitive and being collaborative. Being too competitive too early will stunt the overall development of the market. On the other hand, being ‘too collaborative’ later on might perhaps reduce individual market players to below their true potential.

Retail funders must collectively focus on both their own ‘slice of the pie’ and the overall ‘size of the pie’. Single-minded focus on either one or the other consideration will lead either to unhelpful market behaviour or the bankruptcy of the funder.

Wholesale funders, however, should be primarily concerned with the overall ‘size of the pie’. A SIWB should see its public interest role as enabling flows of capital to support specific market infrastructure. The diagram below illustrates this tension:



A wholesaler of capital

“The [Social Investment Wholesale Bank] would support the long-term growth of a thriving third sector by working with investors and lenders at the ‘retail’ level”⁶

It is important that a social investment banking function carried out by a government entity operates at the **wholesale** level because this:

1. Minimises the danger that public money ‘crowds out’ private investment;
2. Builds on the expertise and hard-won experience of existing retail intermediaries, thereby reducing (i) the risk to the public purse of repeating the mistakes of previous social investors and (ii) the search costs of identifying and assessing social investment opportunities;
3. Avoids the risk of opportunistic behaviour by a government-backed entity which might be tempted to compete unfairly for the ‘best’ social investment deals.

Any organisation performing SIWB functions should respect the emerging ecology of the existing market. The guiding principle should be *“coordinate and cultivate”* (not *“command and control”*). In this way, the SIWB could provide helpful signals to the market which then gently influences how others decide to allocate capital (both philanthropic and commercial).

Above all, a government-backed SIWB should not behave as either a regulator or an all-powerful ‘central bank’.

Resilient supply of capital

In the Venturesome “Access to Capital” paper⁷, a ‘resilient supply of capital’ was identified as one of the four critical pillars to a robust social investment market. A number of key barriers to progress were also drawn attention to.

A SIWB function could help to alleviate two of those barriers identified:

- (1) *“Dominance of government funding”* – the SIWB could identify, select and invest in the best, private sector specialist lenders (especially those that can demonstrate resilient (sustainable) income/expenditure models).
- (2) *“Specialist lenders have struggled to articulate their role and its value to the sector”* – the SIWB could enable those specialist lenders with a proven track record to do more and act with greater flexibility in the market. The SIWB could play a supporting role in coordinating the patchwork of private funders.

⁶ Social Investment Wholesale Bank (July 2009), *A consultation on the functions and design* (Office of the Third Sector)

⁷ Venturesome (2009) *Access to Capital* (E Goodall and J Kingston)

How a SIWB function could help

Social investment wholesale banking could help resolve the following situations which currently trouble social investors and specialist lenders:

(1) Leveraging up funds

See *Appendix A* for a detailed case study of how a SIWB could help a retail funder attract mainstream banking facilities to gear up its fund with commercial debt. Of course, the SIWB would need to have the skills to work closely with such funders/borrowers to ensure that they have the necessary capital to achieve their missions without the burden of an inappropriate amount of debt.

(2) Leveraging up deals

Problem: A specialist lender wants to make a £500k loan into a charity – but the size of the lender’s overall fund precludes single deals of that amount because it would increase the fund’s idiosyncratic risk to an unacceptable level.

Solution: The SIWB could co-invest with the specialist lender on a *pari passu* basis (say, an even split 50:50 or perhaps 75:25 in those cases where the SIWB feels that the specialist lender should shoulder more risk). This solution does not violate the principle that the SIWB should only act as a wholesaler of capital provided that the SIWB only acts in this supporting role at the behest of the specialist lender. The SIWB should refrain as far as possible from imposing its own terms on the deal (but, of course, may reserve the right to refuse to participate in the deal in the first place). Again, the guiding principle is “coordinate and cultivate”, thereby respecting the ecology of the market.

(3) Refinancing loan portfolios

Problem: A specialist lender has £3m of low risk loans to charities in its portfolio. It now wishes to refocus its portfolio on a new customer segment, but does not have sufficient capital.

Solution: The SIWB could refinance the portfolio by purchasing the low risk loan book.

In the United States, the Community Reinvestment Fund⁸ (‘CRF’) has purchased more than 2,100 loans worth almost \$1 billion from community development corporations and other community development leaders whose portfolios are not large enough to attract institutional investors directly. Since its inception, CRF has provided liquidity for loans that have generated or retained more than 35,000 jobs, financed almost 600 women or minority-owned businesses, and built more than 16,000 housing units.

⁸ See: <http://www.crfusa.com/Pages/Default.aspx>

(4) Providing exit strategies for social investors

Problem: Potential social investors are frequently deterred from making equity investments into social enterprises because there is no prospect of an ‘exit’.

Solution: The SIWB could offer to buy out equity investments in key sectors (e.g. social enterprises engaged with environmental issues or delivering services to old people) in order to provide such an exit – thereby encouraging more investors to enter those markets.

(5) Creating liquidity through secondary markets

There is a role for the SIWB to create liquidity through setting up secondary markets in:

- Revenue Participation Agreements (“quasi-equity”)⁹
- Social Impact Bonds¹⁰
- Community shares¹¹
- Community bonds¹²

A secondary market for these financial instruments would encourage their greater use and proliferation. Currently, there are either no secondary markets for such instruments or there are matched bargain mechanisms which offer very little liquidity.

(6) Creating new financing mechanisms

An advanced function for a future SIWB would be its ability to create new financing structures that unlock new capital from the private to the social sector. The SIWB could act as a financial architect which can design new instruments which convert something that is socially valuable into a format which will attract new investors who need such instruments for a potential investment.

For example, in the United States, Wall Street Without Walls¹³ (a corporate finance advisory working with nonprofits) assisted the Community Reinvestment Fund (a large community development loan fund in Minneapolis) with the structure and process of getting a AAA/AA rating from S&P on a \$52m pool of economic development loans. This then allowed six new insurance companies to enter the social investment market.

⁹ See: Venturesome (2008) *A Venturesome case study in using Revenue Participation Agreements* (P Cheng)

¹⁰ See: Social Finance (2009) *Social Impact Bonds – Rethinking finance for social outcomes*

¹¹ See: <http://www.communityshares.org.uk/>

¹² See: <http://www.citylifeltd.org/>

¹³ See: <http://www.wallstreetwithoutwalls.com/>

(7) Extending investment time horizons – (very) patient capital

Many innovative areas of social finance are currently being incubated in pilot projects which have yet to prove a sustainable revenue model. A common problem is that it may take five, ten or more years to prove these models. Unfortunately, the vast majority of investors simply cannot afford to extend their time horizons to such lengths. As a consequence, these projects may end up being starved of capital.

An innovative SIWB could explore using its large balance sheet to hold assets for ten years or more in order to give a sufficiently long ‘runway’ for the most promising areas of social finance.

For example, these might include:

- Community Land Trusts
- Social Impact Bonds
- New ways of seed funding ‘next generation’ public services
- New financial instruments for purchasing and managing conservation areas.

Appendix A

SIWB case study¹⁴

An example of how a Social Investment Wholesale Bank might work with a retail funder to leverage in private capital¹⁵

1.0 Introduction

Acme Microcredit¹⁶ ('AM') is a micro-credit lender managing a portfolio of personal and business loans to low income individuals and small businesses in run-down communities. Over the last few years, the portfolio has demonstrated a healthy average return of around 12% per annum, but with a total portfolio size of £4m this return is still too small to cover all of AM's operating costs. AM is, therefore, dependent on a permanent amount of annual grant funding.

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

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

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

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

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

¹⁴ This case study is for illustrative purposes only, and makes no reference (either express or implied) to any actual organisation or investment.

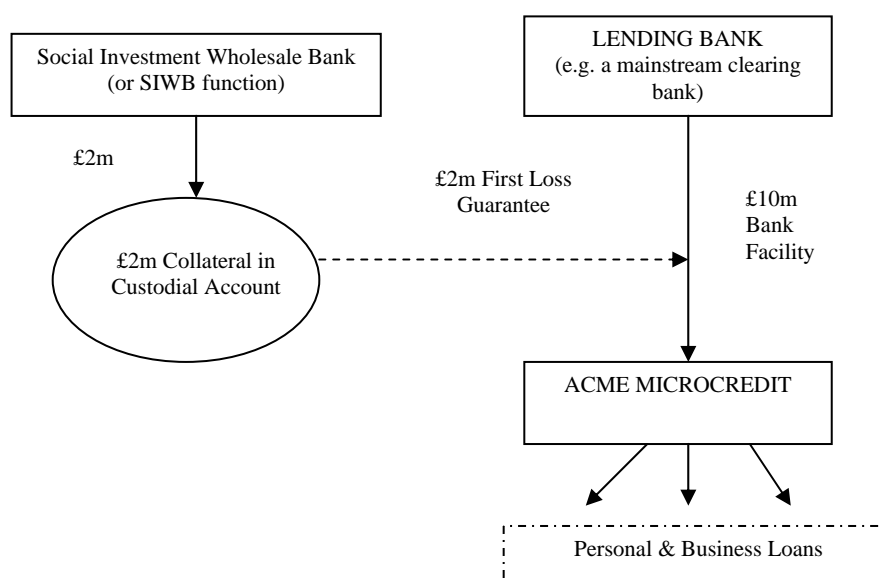
¹⁵ We are grateful to Mark Cheng of Chelwood Capital LLP for his advice in the preparation of this case study.

¹⁶ This is a fictional company. Any resemblance to actual companies is entirely coincidental.

funding to be available for AM. Based on this guarantee from the SIWB, the commercial banks are prepared to fund the £10m.

So, in this example, by putting up say £2m of capital to underwrite the first 20% of AM's portfolio, the SIWB has enabled AM to bring in a further £8m of commercial funding from banks on top, leveraging the value of its contribution four times over. Moreover, it has enabled AM to transition from a precarious donor-funded model to a sustainable, long-term commercially-funded model on a much wider scale.

Diagram of structure



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

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

2.0 *What are the benefits for the SIWB of providing capital in this way?*

- Enhanced Return on Investment & significantly increased capital available to the sector
- More efficient use of capital – initial capital is continually recycled and leveraged up
- Less administrative burden – no need for repeated drawdown applications during year
- Brings in private sector funding for high social impact projects
- Enables the private sector to become familiar with community development projects and to develop greater knowledge and understanding of the sector, leading to further private sector involvement opportunities and bringing more overall capital to the sector.

Appendix B

What is 'capital' anyway?

The word 'capital' frequently causes confusion (and is generally misunderstood) in the voluntary and community sector. For many charities, 'capital' is synonymous with the purchase of tangible fixed assets such as buildings and equipment (because it is confused with 'capital assets'). However, that is not the meaning used by social investors. Generally speaking, social investment draws a distinction between *project funding* which focuses on income and expenditure patterns ("buying social impact"), and *capital funding* which focuses on an organisation's balance sheet ("investing in the organisation").

However, as the need for access to capital is increasingly recognised by sector commentators, a more philosophical question arises as to what *exactly* is capital?

Firstly, 'capital' is not, and cannot be, just accumulated assets - it refers to the *potential* value that those assets hold to deploy new production or create new value. For example, a house can be seen as a collection of bricks. But, through legal title protected by a legal system, a house can also release money by acting as collateral.

Capital should not be confused with money - which is only one of the forms in which capital travels. Money is just a medium of exchange. Money is not capital itself because value cannot consist of mere metal or paper. In other words, money facilitates transactions, but it is not itself the creator of additional means of production.

Much of the confusion surrounding the abstract notion of 'capital' dissipates as soon as you stop thinking of 'capital' as a synonym for 'money saved and invested'. Capital can be fixed into many forms - money is merely one of them.

Capital is also a dormant value. To unlock capital, we must go beyond just looking at assets as they currently are - to thinking about them as they *could* be. Therefore, unlocking capital requires a conversion process - a way to fix an asset's economic potential into a form that can be used to initiate additional production. A useful analogy is to imagine a lake. What is the lake's potential? You could use the lake for fishing and boating. But if you understood the significance of the lake's elevation, you could also use the water to create hydroelectric energy.

Examples of unlocking economic capital include:

1. Land + legal title = enables the creation of mortgages
2. Cash + collateral account = financial leverage
3. Cash + underwriting agreement = financial leverage
4. Cash + shareholders' agreement = structuring of risk and reward

The key is always to find a way to convert and fix the potential value of an asset into a form that can do additional work.

Not a lot of organizations are asking people to go to that middle space and consider, 'What is the 'right' return on capital for a social investment?' 'What's the 'right' level of impact per dollar spent?'

As a sector I think we could get a lot more sophisticated in explaining that there's a big space between a negative 100 percent financial return (for grants) and double digit returns for private equity. We need to define that middle ground if we expect to see significant influxes of new capital.

The big opportunity we have if we want to see real innovation to tackle global poverty is to get more comfortable making bets on people and organizations, not just programs - the way the venture industry bets heavily on people and networks to bring the best ideas forward."

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