Big Society Capital: Vision, mission and activities

BIG SOCIETY CAPITAL
Transforming social investment

Contents

Big Society Capital: Introduction

Big Society Capital (BSC) is an independent financial institution established to develop and shape a sustainable social investment market in which social sector organisations can access the capital they need to increase their positive impact on society. We are governed by our social mission and reinvest the majority of surplus generated in pursuit of that mission.

Big Society Capital is a 'social investment wholesaler' which provides finance to social investment finance intermediaries (SIFIs). These are organisations that provide appropriate and affordable finance and support to frontline charities, social enterprises and voluntary organisations (the social sector). In doing this we aim to grow the market for social investment and ultimately increase the amount of money available to the social sector. BSC will also seek to achieve financial sustainability over the long term.

Vision, mission and objectives

Our vision is for:

> A strong, diverse, well-capitalised and sustainable social investment market in the UK, through which social sector organisations can access appropriate and affordable finance and support to grow their impact on society.

Our mission is:

1. To have a transformative impact on the social investment market in the UK by supporting social investment finance intermediaries to become financially robust and able to:
    - Attract greater and more diverse sources of investment;
    - Effectively and efficiently channel appropriate and affordable capital to the social sector; and
    - Provide effective financial and business support services to the social sector.
2. To increase awareness of and confidence in social investment by:
    - Promoting best practice and sharing information;
    - Improving links between the social investment and mainstream financial markets; and
    - Working with other investors to embed social impact performance and assessment into the investment decision-making process.

Our objectives are:

- To enable SIFIs to become financially robust, able to attract investment, and able to provide effective financial and investment-focussed business support to frontline social sector organisations. We will do this through direct investment in SIFIs, co-investing in social-purpose funds, or providing SIFIs with subordinated capital;
- To enable new financial products and market infrastructure to be developed and brought to market. We will do this by providing appropriate support, including investment, to SIFIs that are developing viable, innovative products and mechanisms that can attract investment and meet a financing need in the social sector;
- To increase the flow of capital into the social investment market and, in particular, attract greater and more diverse sources of

finance into the sector. We will do this by helping to develop an effective and efficient market infrastructure which will channel greater sums of appropriate finance alongside our capital.

- To increase awareness of and confidence in social investing. We will do this by promoting best practice, disseminating information, and by creating and supporting forums for networking and facilitation; and
- To work with other investors to drive best practice in the embedding of social impact performance, assessment and measurement into the investment decision making process.

Activities

Big Society Capital will achieve its objectives by addressing key market failures in the social investment market, ultimately increasing the social impact achieved by frontline social sector organisations. In particular, BSC will focus on five key areas of activity:

- *Capitalisation and balance sheet growth*: injecting of core equity capital to build stronger, larger SIFIs who are able to provide a reliable and predictable flow of capital to frontline social sector organisations;
- *Risk and working capital*: acting as lead or cornerstone investor in the developing and piloting of financial products and funds that provide risk and working capital to the social sector;
- *Sustainability and organisational growth*: providing medium to long term capital to SIFIs to enable them to achieve sustainability and scale and so increase the volume of affordable finance that they can offer to the social sector;
- *Market mechanisms and infrastructure:* acting as lead or cornerstone investor and/or providing underwriting support for the development of the market infrastructure;
- *Advice, skills and information:* providing direct equity and loan investments in SIFIs developing and providing financial advisory and corporate finance services to help social sector organisations build the skills and capacity required to take on investment.

Structure and governance

Big Society Capital Group comprises three entities: the holding company which is called 'The Big Society Trust' and is a company limited by guarantee with the sole object of protecting the social mission of its operating subsidiary company 'Big Society Capital Ltd', a private company limited by shares; and a separate entity, the 'Big Society Foundation', which will be constituted to receive charitable donations and develop complementary grant programmes to support the Group's mission.

Financing

Big Society Capital will be financed with equity investments by the Big Society Trust and the four major UK high street banks.

Dormant accounts

The equity investment by the Big Society Trust will be funded with the English share of dormant accounts released for social spending through the Dormant Accounts Scheme. This will involve a series of capital transfers over time, which could total up to £400m, although the profile and quantum of dormant account releases are still uncertain as these will depend on the observed rate of reclaim.

The UK Parliament passed the Dormant Bank and Building Society Accounts Act in November 2008 to provide a legal framework for money from dormant accounts to be released for the benefit of society, while protecting the rights of account holders.

Following the 2008 Act, banks and building societies can voluntarily transfer account balances that have been dormant for 15 years or more to a reclaim fund. The reclaim fund is then responsible for meeting claims from customers who always maintain their rights to their accounts. It is the reclaim fund's responsibility to analyse how much money it needs to keep in order to repay customers who can establish claims on transferred accounts. Any surplus money will, in accordance with the Dormant Accounts Act, be transferred from the reclaim fund to the Big Lottery Fund to distribute for social purposes as directed by government.

Cooperative Financial Services has established a reclaim fund ('Reclaim Fund Ltd'), which was authorised by the Financial Services Authority in March 2011 and has started receiving dormant account balances from banks and building societies. Reclaim Fund Ltd has an independent board which will decide how much money should be transferred to the Big Lottery Fund and when. These plans will be subject to FSA scrutiny and approval given the potential impact on account holders if Reclaim Fund Ltd cannot meet its liabilities.

The money that is transferred to the Big Lottery Fund will be apportioned between England, Wales, Scotland and Northern Ireland according to an agreed formula. Once Reclaim Fund Ltd has transferred money to the Big Lottery Fund to be distributed for social spending it will have no right to claim that money back. The English portion of Dormant Accounts money will be released to Big Society Trust to invest as equity in Big Society Capital.

'Merlin' investment

Barclays, HSBC, Lloyds Banking Group and RBS have agreed to invest £50m each in Big Society Capital in the context of wider discussions (known as the 'Merlin' agreement) with the Government on improving their positive contribution to society and economic recovery.

The 'Merlin' Banks are investing permanent equity in BSC. They will collectively own a maximum of 40% of the shares of BSC but will always remain a minority shareholder with their collective voting rights capped at 20%. They will have equal information rights and a say in any material changes to the BSC strategy, including BSC's mission and the rights attached to their shares. If BSC makes and decides to distribute a dividend, the Merlin banks will have a right to a share proportionate to their equity contribution to BSC. The Merlin Banks' shares also carry a right of preference in the event of BSC winding up.

Background

In July 2010, the Government committed to using all dormant accounts money available for spending in England to establish a social investment wholesale institution, or 'Big Society Bank', to develop and grow a sustainable market for social investment in the UK.

The 'Big Society Bank' builds on work to develop the concept of a 'social investment wholesaler' that began independently from government. The independent *Commission on Unclaimed Assets*[1] was established in 2005 and in its final report (2007) argued that the social sector was in urgent need of greater investment and professional support. The Commission recommended the creation of an independent 'Social Investment Bank' using the money from dormant accounts which would act as a wholesaler of capital, investing in new and existing social investment finance intermediaries and ultimately increasing the amount of finance available to the social sector.

The Government consulted on a UK unclaimed assets scheme in March 2007 and, following responses to the consultation, made

[1] The independent Commission on Unclaimed Assets was established in October 2005 to consider how unclaimed assets (money sitting untouched for 15 years in dormant bank and building society accounts) could be best used to benefit society.

clear that it saw merit in the model of a new social investment institution and recognised a gap at the wholesale level. The Dormant Bank and Building Society Accounts Act was passed in 2008 and set up a framework under which money in dormant bank and building society accounts can be distributed for the benefit of the community. The Act set the conditions that money from dormant accounts available for spending in England must be used for one or more of: provision of services for young people; financial capability and inclusion; or a ‘social investment wholesaler’. The previous administration prioritised spending on the provision of services for young people but, in July 2010, the current Government committed to use all dormant accounts money available for spending in England to capitalise a ‘Big Society Bank’, which would have among its high level objectives a mandate to support the development of community-led social enterprise initiatives to improve opportunities for young people.

Given the nature of the prospective ‘Big Society Bank’, the Government sought the engagement and advice of senior people from the financial sector who also had some experience of the social sector. In February 2011, Sir Ronald Cohen, former chair of the Social Investment Taskforce[2] and of the Commission on Unclaimed Assets, offered to advise the Government in an independent capacity and develop a proposal for the ‘Big Society Bank’ with Nick O’Donohoe, formerly Global Head of Research at J.P. Morgan, and head of their social finance unit.

The Government announced Sir Ronald’s offer at an event on 14 February 2011, and subsequently wrote to all the key stakeholders and organisations in the social sector on 21 March inviting views on the process. Key stakeholders within the sector publicly welcomed Sir Ronald’s involvement.

Sir Ronald Cohen and Nick O’Donohoe submitted an outline proposal for a ‘Big Society Bank’ to Government in May 2011. Ministers endorsed the proposal as meeting the Government’s requirements for a ‘Big Society Bank’ and indicated that, under the terms of the Dormant Bank and Building Society Accounts Act 2008, in due course the Government would expect to capitalise the proposed organisation with money from dormant accounts subject to four main conditions:

- Further development work on organisational design, investment strategy, financial model and management arrangements;
- Satisfactory conclusion of discussions with the ‘Merlin’ banks about the terms on which they would make a capital injection of £200m;
- Approval from the Financial Services Authority (or successor organisation); and
- State aid approval from the European Commission.

Given the impact of the economic situation on the social sector there was a strong imperative to use dormant accounts money for social spending as soon as it became available (summer 2011). To do this the Big Lottery Fund, the nominated distributor of dormant accounts as set out in the Dormant Accounts Act, established an interim Investment Committee in May 2011. The Investment Committee announced its first ‘in-principle’ investment in July 2011 and a further four investments in December 2011. The Investment Committee is wound up and its investment portfolio is being transferred to BSC.

[2] The Social Investment Taskforce was established at the request of HM Treasury in 2000 to assess the ways in which the UK could achieve a radical improvement in its capacity to create wealth, economic growth, and an improved social fabric in deprived communities. It made five recommendations: the introduction of Community Interest Tax Relief; establish community development venture funds; disclosure by banks of their lending in under-invested areas; greater latitude for charitable trusts to invest in community development; support for Community Development Finance Institutions.

Market context: The social sector

Introduction

The social sector in the UK plays an important role in driving positive social and environmental change. It has grown and evolved substantially over the last ten years and includes a diverse range of organisations that exist to deliver social and environmental benefits. These include voluntary and community organisations, charities, social enterprises, cooperatives and mutuals. The social sector is central to the UK Government's plans for the delivery of their Big Society agenda.

Growing and strengthening social sector organisations to drive positive social and environmental change is the fundamental objective of Big Society Capital. It will do this by providing support to social investment finance intermediaries that offer specialist finance and services to social sector organisations. A supportive and effective financing environment will increase the ability of these organisations to tackle difficult social problems, strengthen communities, empower disadvantaged groups, and provide responsive and innovative public services.

Defining the social sector in the UK

The social sector is defined by its social purpose

The social sector includes a wide spectrum of organisations operating across all sectors of society and the economy. Organisations within the sector are not limited to specific legal forms or particular types of activity, but can be distinguished by certain key organisational principles that differentiate them from other market actors:

1. They exist to deliver social and/or environmental impact;
2. They principally reinvest surpluses to further their social or environmental objectives;
3. They are independent of government.

There is no specific legal form for social sector organisations

There are a number of labels that are commonly used to describe social sector organisations. Some of these correspond to the values of the organisation or the way in which it works. 'Voluntary organisation', for example, describes organisations which share common values around voluntary association: they may have paid staff but a defining characteristic will be their voluntary nature, whether in governance through the board of trustees, in their financing through donations and grants, or in the mobilisation of volunteers. 'Social enterprise' describes an organisation that uses business to achieve specific social and/or environmental aims. While 'community organisation' describes an organisation that is based in, and provides benefits to a particular local neighbourhood or community of identity. Other commonly used labels, such as charity, community interest company (CIC) and co-operative describe an organisation's legal form and have associated regulatory arrangements.

Social sector organisations may use a combination of these 'labels,' may use them interchangeably, or may not use any of them at all. A voluntary organisation is quite likely to be a charity, but may be a CIC; a social enterprise may well be a registered charity that achieves its charitable objects through business; while a community organisation may be a charity, a CIC or an IPS. Ultimately, it is an organisation's overall purpose, how it makes decisions, and how it uses its resources in support of that purpose that defines it as a social sector organisation.

The importance of the social sector to UK society and economy

The social sector drives positive social and economic change.......

It helps to:

- Strengthen and empower communities by supporting people to come together to take control and address the social and environmental challenges that they face. Social sector organisations are often rooted in communities which enables them to develop appropriate and sustainable community-led solutions to intractable social problems;
- Provide a strong conduit for social action, bringing individuals and communities from different backgrounds together and enabling people to give their time and expertise to achieving social outcomes, and to develop their skills and networks;
- Design and deliver innovative and responsive public services, often reaching people and communities that the public sector struggles to reach. Social sector organisations often have a greater understanding of service users and involve those users in defining their needs and designing services, enabling them to provide flexible and joined-up services that meet complex personal needs and tackle difficult social issues;
- Build new markets by pioneering the provision of new ethical and socially or environmentally responsible products such as Fairtrade, as well as setting new standards for socially responsible business practices;
- Encourage entrepreneurship, particularly in deprived areas, by attracting those who may not be interested in conventional business into social enterprise, including women, young people, and people from black and minority ethnic communities.

....and is a growing part of the economy

The social sector also makes an important contribution to the economy. According to data from the Department for Business Innovation and Skills, social enterprises contribute about £24billion to the economy and employ about 800,000 people[3]. The National Council for Voluntary Organisations estimates that the total expenditure of charities in 2007/8 was £32.8bn and that they employed about 680,000 people in the UK[4].

The size, shape and changing nature of the social sector in the UK

Most social sector organisations are small and local......

There are 600,000 informal community organisations, 171,000 charities[5] and 62,000 social enterprises in the UK[6]. Informal community organisations are large in number but small in financial weight and are generally below the radar in terms of legal or registration status, funding, policy and influence. The boundaries between the activities of very small informal organisations and volunteering are blurred. These types of organisations have very limited, if any, income and do not employ staff.

The majority of charities (53%) are micro in size, with income of less than £10,000. Another third (32%) are small, with income of less than £100,000. Together micro and small charities account for 6% of charity income, they are unlikely to employ staff and rely mainly on donations from individuals. A further 12.5% of charities are medium in size, with income of between £100,000 and £1m; 2.4% are large, with income of between £1m and

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[3] Department for Business Innovation and Skills (2008) *Annual Small Business Survey*, 2005-7 average
[4] NCVO (2010) *The UK Civil Society Almanac 2010*.
[5] NCVO (2010) *ibid*
[6] Department for Business, Innovation and Skills (2008) *op cit*

£10m; and 0.25% are major, with income above £10m. The 453 major charities with income above £10m account for 44% of all charitable income. They are more likely to operate nationally or internationally and have paid employees[7].

....but a growing number are trading to pursue social objectives

Social enterprises are businesses trading for social and environmental purposes. Many commercial businesses would consider themselves to have social objectives, but social enterprises are distinctive because their social purpose is absolutely central to what they do and their profits are principally reinvested in their mission. The median turnover for social enterprises is £240,000; 20% of social enterprises have a turnover over £1m; 39% have a turnover of between £100,000 and £1m; and 33% have a turnover of less than £100,000[8].

Income

The total income of charities in 2007/8 was £35.5bn (or £52bn if independent schools, non-departmental public bodies, NHS charities, faith groups, and housing associations are included). The sector's two most important sources of income are individuals (£13bn) and statutory funders (£12.8bn), which together constitute two thirds of all income. Income from individuals includes fees for goods and services as well as donations, while statutory income includes both payments for contracted services and grants. Other sources of income are internally generated funds (£4.1bn), including income from trading, dividends, interest payments and rent from investment property; contracts and grants from trusts and foundations (£2.9bn); sponsorship and grants from the private sector (£2.9bn); and lottery grants (£0.5bn)[9].

[7] NCVO *ibid*(2010) *op cit*
[8] Social Enterprise UK (2011) *Fightback Britain: a report on the State of Social Enterprise Survey 2001*.
[9] NCVO (2010) *op cit*

The income picture for social enterprises reflects the fact that they are businesses. Seventy percent of social enterprises earn at least 76% of income through trading (with the public sector, private sector, social sector and the general public) and 85% earn at least 51% of income through trading. Fifty-eight percent of social enterprises earn the majority of their income from trading with the general public, the private sector or the general public, while only 18% earn the majority of income from trading with the public sector. Nine percent of social enterprises rely on grants from the public sector for the majority of their income and 0.5% rely on individual donations as their main source of income[10].

Business models

Earned income is an increasingly important funding stream for the social sector

As the sources of sector income show, there is a growing trend for social sector organisations to operate in markets and generate income from trading and contracts. Since 2003/4 earned income has been the sector's most important type of funding and in 2007/8 it accounted for £17.4bn (49%) of the sector's income, an increase of 76% since 2001. This is partly a reflection of government policies that have created the conditions for the sector to increase its involvement in the delivery of public services: earned (contracting) income from statutory sources has increased by 128% since 2000/1 and now stands at £9.1bn. Although it is important to note that while the sector's statutory income has grown faster than total public spending, only 2% of total public spending is spent on the sector[11].

There is also an increasing desire in the sector to become more sustainable by diversifying income streams. In many cases, this has meant social sector organisations becoming more market oriented and earning more of their income through trading in both

[10] Social Enterprise UK (2011) *op cit*
[11] NCVO (2010) *op cit*

public sector markets and in consumer markets. Earned income from individuals paying fees for goods and services has increased by 36% since 2000/1 to £5.3bn, and earned income from other sources including trading, dividends, interest and rent increased by 50% to £2bn between 2000/1 and 2007/812. Increasing numbers of social sector organisations are considering themselves to be social enterprises.

This trend is also reflected in the steady growth of the social enterprise sector over the last decade or so. As well as new social enterprises being established directly, traditional charities are increasingly trading in markets and/or setting up social enterprise subsidiary companies, organisations are beginning to ‘spin-out’ of the public sector to become independent, often employee-owned social enterprises, and private sector businesses are beginning to bring social enterprises into their supply chains to maximise their own positive social impact. Just under 5,000 community interest companies have registered with the independent regulator since the bespoke legal form for social enterprise was created in 2005 and 14% of all social enterprises are start-ups less than two-years old, which is more than three times the proportion of start-ups among mainstream SMEs. Social enterprises are also outperforming SMEs in terms of growth, with 58% of social enterprises growing in 2010 compared to 28% of SMEs[13].

With earned income now representing a substantial proportion of the social sector’s income and more and more social sector organisations operating to a greater or lesser extent as social enterprises, the sector is moving away from a model based on grants and donations towards models that focus on developing more sustainable ways to finance core costs, to grow, and to invest in capacity to generate future income. Consequently the demand for finance in the social sector is ever increasing.

[12] NCVO (2010) *op cit*
[13] Social Enterprise UK *op cit*

But operating in markets requires capital and opportunities to generate resources are limited

Examples of key (and non-exclusive) social sector business models include:

Trading for social purposes - characteristic of social enterprise approach, but many charities that rely in the main on fundraising and grants have trading arms to earn supplementary income	
Income	Earned income from sales to customers.
Potential for surpluses	If net income is positive. Many organisations operate in a way that costs more (e.g. by employing long-term unemployed), but the need to sell goods at competitive price can affect potential margins.
Capital needs	• Product/service development. • Development capital to fund people, stock, marketing, running costs ahead of sales reaching volume necessary to break even. • Production of stock before sales are achieved. • Working capital to fund variability in sales and sales paid in arrears.
Social impact	Achieved through way of doing business, and/ or by using profits/ surplus for specific social purposes

Delivering public services - social sector organisations of all sizes and types are entering into contracts/grant agreements with the public sector for outputs or outcomes	
Income	Earned income from contract payments.
Potential for surpluses	Contract price should include a ‘profit’ margin, but this is constrained in practice, and social sector organisations cross-subsidise contracted activities. This is because contracts often do not capture/pay for the full value that is being delivered because social sector organisations are looking to secure a revenue stream that will enable them to deliver a service they want to provide anyway and so are reluctant to walk away from a contract even if commissioners are not paying enough. There have been moves towards full cost recovery, but there is still limited scope for generating enough surplus to reinvest in organisational capacity.
Capital needs	• Product/ service development. • Working capital to cover costs

	before contract payment. • Capital to manage delivery risk (not winning a contract, or not delivering a social outcome). • Fixed assets.
Social impact	Additional social impact (compared to public sector delivering service itself or for-profit contractor delivering a service) from greater access and knowledge of excluded groups, more flexibility to shape service around need and greater credibility with service users.

Providing support and services to vulnerable and excluded groups - characteristic of much of the social sector where beneficiaries of the support or service cannot pay for them themselves. Public spending and trading may fund some of this activity, philanthropic funding is still vital to the majority of social sector organisations in this category.	
Income	Grants, donations and fundraising.
Potential for surpluses	Limited - grant funding is usually tied to the cost of providing a service, and sometimes for capital acquisitions, with little scope for generating surpluses. Fundraising is also generally tied to a particular theme or project, and there is a reputational risk around spending donations on 'admin' costs.
Capital needs	• Product/ service development. • Working capital to smooth fluctuations in income and allow retention of staff and continued provision of services. • Fixed assets.
Social impact	Social impact derives from the activity that the organisation is carrying out

Providing financial services - some social sector organisations exist to provide affordable financial services to individuals, groups and organisations excluded from mainstream finance.	
Income	Earned income from interest payments and fees.
Potential for surpluses	If capital and interest payments cover the cost of capital, including default risk and the cost of doing business. This is generally not the case, and the difference is made up through sustained losses and grants.
Capital needs	• Organisational capacity building • On-lending. • Core capital (to protect against default risk). • Equity to strengthen and grow balance sheet.
Social impact	Social impact derives from the activity the organisation is carrying out. Additional social impact is delivered through the growth and development of the organisations that are financed that would otherwise fail to grow.

Opportunities and challenges for the social sector

The last decade or so has seen a number of cultural shifts in which people have begun to think more carefully about the social, ethical and environmental impact of the choices they make as consumers and investors. These moves towards ethical consumerism, ethical finance and community enterprise, which do not seem to have been significantly slowed by the current economic climate, present important opportunities for the social sector. Equally, recent trends and changes in government policy in the UK such as the focus on localism, the opening up of public services to a wider range of providers and the move to a regime of payment by results in the delivery of public services also create opportunities for social sector organisations. To take advantage of the opportunities that these changes offer the social sector it will need to overcome some key challenges.

There is growing demand for ethical goods and services

Public attitudes are shifting, with consumers increasingly expecting the companies that they buy from to show a high degree of social and environmental responsibility in their operations. Between 2007 and 2009 'ethical consumption' grew by 18% and, overall, the ethical market in the UK was worth £43.2bn in 2009 compared to £36.5bn two years earlier. Between 1999 and 2007 the percentage of people who said that they chose a product or service on the basis of a company's responsible reputation increased from 51% to 55%. In 2009, the average spend per household on ethical products and services (excluding charitable donations and ethical finance) was £764, a three-fold increase from 1999[14].

...and growing awareness of the social and environmental consequences of investment decisions

Within the mainstream investment market, Sustainable and Responsible Investment (SRI) is growing rapidly and is estimated to account for over £900bn or 28% of all assets under management in the UK[15]. SRI covers three types of investment philosophies:

- *Screening* (or negative screening) – probably the best known among consumers, where companies may be excluded from investment portfolios because of their involvement in certain activities such as nuclear power, the fur trade, tobacco or arms dealing;
- *Preference* (or passive investing) – where companies may be included in investment portfolios for positive contributions to society or the environment. A preference or best in class approach would apply social, environmental and ethical guidelines to give a preferred selection when all other factors are equal such as sector type and financial performance; for example the oil company with the best environmental management;
- *Engagement* (proxy voting or advocacy) – where investor pressure is used to actively encourage companies to adopt social best practices. It assumes a certain size of shareholding as well as certain resource/time commitment to follow through a lobby-style campaign.

While clearly distinct from social investment, the size and growth of SRI suggests that investors are increasingly interested in the social consequences of their investment decisions.

Individual savers are also increasingly opting to save with ethical banks and green and ethical retail funds. Monies in ethical finance, including ethical banking and investments, credit unions and ethical share holdings grew by 23% from 2007 to 2009 to stand at £19.3bn, and at the end of 2009 there was £9.5bn in UK green and ethical retail funds, held in about 750,000 accounts invested across nearly 100 funds[16].

There is also growing interest in community enterprise

There has been a resurgence of communities taking over and running local services and buildings such as shops, community centres and pubs and in using community investment to finance these activities. This not only enables community groups to raise important capital but also to engage the community in the enterprise by creating a sense of shared ownership and community reinvestment of profits. Forty-one community enterprises have used a form of community investment to raise finance over the last ten years, which is just over half of all of those organisations identified by the Community Shares Programme[17]. The combined investment in these organisations is £44million, with combined membership of almost 32,000 people. Most of these organisations are involved in community-owned shops; community-owned renewable energy; community finance; community farms, land and buildings; and community telecommunications services. The Community Shares Programmes identifies a number of areas where community enterprise and community investment could play an important role in the future including waste recycling, community land trusts, community supported agriculture, low carbon projects, community facilities such as GP and dental services, community transport, and community pubs.

But social sector organisations face challenges in meeting the demand for ethical products and ethical investment approaches

[14] Co-operative Bank (2010) *Ethical Consumerism Report 2010*
[15] Eurosif (2010) *European SRI Study*

[16] *ibid*
[17] www.communityshares.org.uk

Social sector organisations should be ideally placed to take advantage of the increase in ethical consumerism, ethical finance and community finance to attract new customers and investors, but they face challenges in doing so. In particular, social sector organisations struggle to access the capital that they need to enable them to grow and meet consumer demand and to market themselves effectively to prospective customers.

As highlighted in the social sector business models above, it is often very difficult for social sector organisations to generate capital internally to invest in organisational capacity and resilience as they have limited opportunity to generate surpluses from contracts and trading. Generating capital externally in the form of non-repayable finance is also problematic for the sector as grants tend to be project or programme based so generally will not provide social sector organisations with long-term unrestricted funding. More broadly, philanthropic money is also becoming increasingly scarce with the top 500 UK charities witnessing a 1.1% or £104m drop in voluntary income in 2008-9 and the major trusts and foundations reducing their support for the sector by 7% as their own investment income fell by 13.6%[18].

At the same time, the social sector faces difficulties in generating capital externally in the form of repayable finance (debt, equity or quasi-equity). In part this is because social sector organisations are often perceived by mainstream investors to be a higher financial risk and mainstream investors can fear reputation damage if they are seen to be closing down a 'charity' in the event of default which means that their risk appetite is low.

Social sector organisations need higher risk finance to fund working, development and reserve capital to build capacity and resilience and ultimately deliver greater social impact. The majority of them simply cannot, however, deliver commercial returns on higher risk finance because their activities and business models cannot afford it. This is either because their social purpose makes the cost of doing business higher than for other businesses, or because they are structured to use the majority of surpluses to achieve social objectives. Equally the legal structure of many social sector organisations precludes them from raising equity capital in the way a for-profit business seeking higher risk finance for business start-up or growth would do.

There is a strong aspiration for the social sector to participate in public service delivery...

... in the diversification of providers of health and social care services

The Government's proposed reforms to the provision of health and social care services include an explicit aspiration for a greater role for the social sector, including as a provider of services. The reforms aim to create a more diverse provider market for health and social care where the NHS, private sector and social sector all compete for contracts and money is designed to follow patients around the system to enable stronger competition between providers.

The social sector already plays a significant role in delivering health and social care services, with around £3.39bn per year spent by the statutory sector on health services delivered by the social sector and just less than one quarter of charities involved in the provision of adult health or social care and support services[19]. The sector often plays a key role in providing preventative, advocacy and signposting services and has considerable expertise in developing innovative ways to integrate and coordinate care and support, particularly for people with multiple and complex conditions. It also often offers an alternative to statutory services that many people who are wary of the state prefer to access.

[18] CGAP at Cass Business School (2010) *Charity Market Monitor 2010*

[19] Kings Fund and NCVO (2011) *The voluntary and community sector in health: implications of the proposed NHS reforms*

The opening up of health and social care markets to different providers offers the social sector the opportunity to expand existing service provision as well as to enter markets it hasn't previously had access to. Given the ability of the sector to reach people that the state struggles to reach and to develop services that fill gaps in statutory provision, it should be in a strong position to extend its role further. The sector could also develop its role providing advocacy and signposting support to help people understand and find their way around the new system, as well as building on the role it currently plays in coordinating care and integrating services.

These changes do, however, also present a number of challenges to the sector. The social sector has limited reserves and, as noted above, can already face difficulties covering the full cost of the services it provides, with many organisations using grant and donation income to cross-subsidise services. The sector is also already affected by cuts in statutory budgets and has had to decrease services and reduce staffing numbers. With limited reserves and difficulties accessing external finance the social sector may struggle to compete for and win contracts, particularly where those contracts pay by results and social sector organisations will need to fund the delivery of services upfront before being paid for outcomes much later down the line. Social sector organisations may also face difficulties in entering new markets as their limited reserves, small balance sheets and problems accessing finance make it harder for them to innovate, to take risks, to invest in marketing and to bear financial loss for any period of time.

... through payment by results

The move towards payment by results (PBR) in the delivery of public services, including in the delivering of welfare to work services through the Department for Work and Pensions' Work Programme, could provide key opportunities for the social sector to grow its role in delivering public services. The focus on outcomes rather than process in the context of PBR contracts should work in favour of social sector organisations which focus on delivering social impact but often achieve that impact in a variety of different and innovative ways that don't always fit traditional contracting models. The Work Programme also includes financial incentives to work with the hardest to help which should also work in the favour of social sector organisations, as working with the hardest to help is often what they do best and what the larger private sector providers struggle with the most.

As noted above, however, social sector organisations are small and do not generally have large reserves and so cannot wait 12 months or more to be paid. This may restrict their ability to deliver services in advance of being paid for them under a PBR contract. The difficulties that social sector organisations face in generating capital, whether internally or externally, are noted above, and may represent an additional barrier to their ability to win and deliver payment by results contracts. There is also an ongoing tendency for large government programmes to award fewer and bigger contracts which social sector organisations simply do not have the scale to compete for. This means that social sector organisations generally find themselves as sub-contractors to large private sector prime contractors who can force lower margins on them, further limiting the ability of social sector organisations to generate capital to invest in building capacity and growth.

... and as part of the localism agenda

The focus of the current Government on devolving power away from Whitehall to the local level is potentially an important opportunity for the social sector. In particular, the 'Community Right to Bid' provides community organisations with the opportunity to take buildings and land into community ownership to run essential local services and businesses, supporting community regeneration. The 400 community organisations in the UK who are members of

Locality[20] currently have assets of about £750m, many of which were previously disused buildings and empty wasteland. These assets are now used to train unemployed people; provide workspace and business support for business start-ups; offer childcare facilities, meeting spaces and sports facilities; and to provide cafes, affordable housing, community shops and community gardens, often in communities where access to such facilities and services is severely limited.

The 'Community Right to Challenge' could also open up important opportunities for the social sector to take over the delivery of local services. The Community Right to Challenge will enable communities (a voluntary or community body or other body established for charitable purposes) to submit an expression of interest to provide a local service if they believe that the service is failing them. This could trigger the local authority to open up procurement for the service, allowing any organisation to submit a proposal to take over the running of the service. While this could of course mean that social sector organisations already running services could be challenged, it opens up the possibility for an increased role for social sector organisations in delivering local services.

To capitalise on the opportunities presented by the localism agenda such as the Community Right to Bid and the Community Right to Challenge, social sector organisations will need access to affordable and appropriate finance, whether to take over and run community assets or to deliver local services. As noted above, such finance is not sufficiently available to the sector. Social sector organisations will also need the skills and capacity to develop strong business plans with reliable revenue streams to make assets viable over the long term.

[20] Locality is the leading nationwide network of settlements, development trusts, social action centres and community enterprises – www.locality.org.uk

Market context: The social investment market

Social Investment

What is social investment?
Social investment describes the provision and use of capital to generate social impact as well as financial returns.

Social investors weigh the social and financial returns they expect from an investment in different ways. They will often accept lower financial returns in order to generate greater social impact.

Some interpretations of social investment include the provision of capital without *any* expectation of financial return. When we refer to social investment however, we mean investment mainly to generate social impact, but with the expectation of *some* financial return.

Social investment provides *capital* which gives social sector organisations the *capacity* to deliver returns. These may be social, financial or both. Capital investment is distinct from, but related to, revenue funding.

Revenue funding allows an organisation to deliver defined outputs or outcomes. It covers day-to-day activities, regular service provision and ongoing projects. It often takes the form of payments for contracted services, grants and donations.

Capital investment provides finance to build an organisation's long term capacity to achieve its social mission. It is used in different ways:

- To invest in asset acquisition;
- As working capital - to manage time differences between spending money and receiving it and so continue ongoing activities;
- As development capital - to invest in growth and expansion;
- As reserve capital - as insurance to protect against the unexpected.

Social investment is repayable, often with interest. It provides capital to enable social sector organisations to develop new and/or existing activities that generate income. These activities generate a surplus which is used to repay investors. Social sector organisations may generate a surplus through trading activities, contracts for delivering public services, grants and donations, or a combination of some or all of these.

The UK social investment market has grown in response to the need for capital
Over the last decade there has been greater focus on the issue of the social sector's access to appropriate and affordable capital and the implications that not having access might have on the sector's ability to achieve positive social change.[21]

Some of the focus has been on increasing the effectiveness of philanthropic giving and grant making. 'Venture philanthropy' has been one such approach. While still generally involving the venture philanthropy organisation raising philanthropic funds and dispersing this as grants to charities, the focus is on providing resources, skills and expertise to enable the beneficiary to increase its impact and sustainability rather than on funding its operations or a particular programme.

[21] Goodall E and Kingston J (2009) *Access to Capital: A briefing paper*; Commission on Unclaimed Assets (2007) *The Social Investment Bank: Its organisation and role in driving development of the third sector.*

At the same time, recognising that the availability of philanthropic funds will always be constrained, a number of organisations have looked for ways to make ‘repayable’ finance work more effectively and efficiently for the social sector. They have aimed to either ‘recycle’ money (i.e. invest financial returns generated by social investment in other social sector organisations) and thereby generate more impact than if the money had been given to a single organisation, or generate a financial return for the investor which makes it possible to raise more capital to go to the sector.

Government policy has influenced the way that social investment has developed in the past 10-15 years, particularly in terms of increasing the supply of capital

The Futurebuilders programme was set up following HM Treasury’s 2002 review of the role of the voluntary and community sector in public service delivery. This review highlighted the social benefits that could be derived from the involvement of the voluntary and community sector in public service delivery, but also the difficulties for small, social-purpose organisations in competing for contracts. The Futurebuilders fund was set up as a £215m fund to offer loans and capacity building grants to social sector organisations to enable them to compete for public service contracts. When it was launched in 2003, there was scepticism about the demand for loans from the social sector (who were traditionally reluctant to use loans even for the purchase of major assets) and demand took time to grow. The Department of Health’s £100m Social Enterprise Investment Fund was set up in 2007 and has also offered a mixture of loans and grants, again at highly sub-commercial rates.

The supply of capital has also been significantly increased by the growth of banks specialising in lending to the social sector

There has also been a growth in specialist bank lending to the social sector, predominantly secured lending against property. Triodos, a Dutch bank that lends to organisations that have a positive social or environmental impact, opened a UK branch in 1995. In 2010, Triodos’ UK branch had a balance sheet value of €549m, including lending to environmental businesses as well as social enterprises and charities, and made a profit of €1.67m. In 1992, the Charities Aid Foundation (CAF) started exploring the concept of a bank for charities. Charity Bank was launched as an authorised bank and a charity, the only one of its kind, in 2002. Charity Bank’s focus is on lending to charities and organisations with a charitable purpose that are not able to access appropriate and affordable finance elsewhere. By 2010, the size of Charity Bank’s balance sheet was £68m and it had started to break even.

There has also been a focus on social lending in deprived communities

The Government has also had a strong interest in improving access to finance for businesses in deprived areas and addressing financial exclusion. As a result, a lot of public funding has been made available to community development finance institutions (CDFIs) lending to businesses, social sector organisations and individuals in deprived areas to provide both capital for on-lending and operational costs. Community Investment Tax Relief (CITR) was introduced in 2000 to help CDFIs raise private investment.

Between 1984 and 2010, the number of CDFIs has increased from 3 to 66 (with a drop over recent years from a peak of 80 organisations in 2006-7). Lending activity has continued to increase, even over the last three years. Between 2007 and 2010, the aggregated value of the CDFI portfolio (excluding lending by social banks) grew from £104m to £228m.

Social Investment Finance Intermediaries

Social Investment Finance Intermediaries (SIFIs) develop channels between those interested in investing for social impact, and *the organisations that need investment to achieve positive change*

We have defined social investment finance intermediaries (SIFIs) as organisations that:

- Provide, facilitate or structure financial investments for organisations that have a primary objective of achieving a positive social impact; and/or
- Provide investment-focussed business support to organisations which have a primary social objective.

SIFIs share the characteristics of the social sector

The key characteristics of SIFIs are[22]:

- They are *social-purpose organisations*. Of the 30 organisations surveyed by BCG, two-thirds described themselves as 'not-for-profit', eight as 'for profit, but prioritising social impact' and two organisations identified themselves as 'for profit';
- They are *dominated by a few large players*. Six organisations account for 90% of the social investments made in 2010. Social Banks account for two thirds of the total market for social investment (~£105m).Twelve SIFIs account for most of the remainder (~£60m). SIFIs are small, with the majority employing ten full time employees or fewer, and only five employing more than 50 people;
- Their *activity is not commercial* and therefore their funding is not either. The most developed and well established business area within the market is secured lending (69%) offered at rates that are comparable to mainstream banks but where the terms, conditions and levels of risk taken are not comparable. Over 80% of the money provided for investment to funds expects a sub-commercial but still positive return, while over 60 % of capital for on-lending is grant based (primarily from government);
- They receive the *vast majority (66%) of funds for investment from central government.* Smaller proportions originate from charitable trusts and foundations (11%), individuals (8%), and banks and commercial institutions (7%). Balance sheet funding is also dominated by funds originating from central government, although social banks' deposits account for 44% of the sector's balance sheet funding;
- They are *diverse and have a variety of legal forms* ranging from trusts to companies limited by guarantee, industrial and provident societies, companies limited by shares, community interest companies, trusts and limited liability partnerships;

SIFIs carry out a variety of functions, but they all have difficulty financing themselves

The SIFI population in the UK can be divided into three main categories: social banks, (non-bank) social investors, and support providers.

Social banks are organisations that hold a banking licence, take retail deposits and use that money, alongside their core Tier 1 equity capital, to lend to social sector organisations. Social banks are regulated and operate in the same way as mainstream banks but their lending is limited to organisations delivering mainly social and environmental benefit. Much of the lending provided by the social banks is secured against property, average loan sizes are between £50,000 and £400,000 and default rates are under 1%. Social banks tend to compete for depositors alongside mainstream banks but the transaction costs for loans are much higher since transactions are complicated, due diligence needs to be highly robust, and a financing will often involve more than one capital provider. As the primary purpose of social banks is to help their borrowers achieve social objectives, they offer very flexible terms and often renegotiate terms in order to avoid defaults and endangering the social and environmental impact that their borrowers deliver. Security is also almost impossible to call-in since assets are often specialist buildings or residences

[22] Statistics in this section are drawn from BCG and Young Foundation survey of Social Investment Finance Intermediaries, 2011

serving those that need them most (i.e. disabled, homeless, rehabilitation etc) and so are difficult to sell. Social banks do not generally provide any grant funding.

(Non-bank) Social investors include a variety of organisations whose functions include: lending (on a revolving basis), developing and structuring finite funds and financial instruments, and fund management. To date the largest funds in the market have been government-sponsored funds that combine loans with grants and are managed by independent socially-focused fund managers appointed through competitive tender. There are also smaller funds offering a variety of debt and equity-like investment products where the organisation managing them has also structured the fund and raised capital from a variety of sources.

All funds face the problem of attracting investors since they have little or no track record, there is no liquidity in the market and no standardised pricing mechanisms. Given the complicated legal structures of many social sector organisations, structuring funds and financial instruments can be complex and require potentially expensive advisory support before it is even certain whether the fund can be launched. Lead times to raise investment capital are also long and there is a need to comply with Financial Services & Markets Act (FSMA) regulation. As a result, most social investors require funding in the form of grants, soft loans or donations in order to sustain themselves.

Support providers to social sector organisations offer services including: general business support and advice; investment readiness support; investment structuring and brokering; investment and fund advisory services; networks and events; crowd sourcing and online exchange platforms; and incubator space. These services are often also provided by social banks and social investors.

Given the difficulty of generating fee income from social sector organisations for these services, the operating costs of service providers often exceed their revenue. The operating gap (approximately 35% across the spectrum of SIFIs) is filled primarily through donations, grants, and endowment income.

Government is the biggest source of capital for the social investment market, but trusts and foundations and individuals play an important role

- *Government: c67% of all SIFI funding*

Central and local government, alongside other public sector institutions, have played a critical part in the development of new financing options within the social sector. This has largely been through grant funding, but also through repayable grant/loan funds. A key consideration for government in the provision of finance in this way has been the link between finance and the delivery of public services and policy initiatives such as payment by results.

- *Trusts and Foundations: c12% of all SIFI funding*

Trusts and foundations will invest amounts of between £200k and £5m on a long term, patient basis where social impact and transformational change are the key returns alongside some financial return. These foundations are increasingly looking for standardised ways of assessing their investment against the social impact they return and are also increasingly concerned about the cost of transactions and the lack of ‘vanilla’ style investment products in the market.

- *Individual retail investors: c45% of balance sheet funding for social banks*

Individual retail investors will invest small amounts of money (£10 to £50,000) into FSA regulated and authorised social banks. In making such investments, individual investors are looking for security of capital through the Financial Services Compensation Scheme, competitive rates, easy access to funds and a clearly articulated and reported social impact. They are also generally happy with a nondirect link between their money and the social impact that is created with it.

- *Wealthy Individuals: c7% of all SIFI funding*

Wealthy individuals will invest amounts of between £50,000 and £2m in a portfolio that mixes a diversified approach to investment in SIFIs with direct investments into specific social sector organisations. Key requirements for such investors are financial returns linked to investment/social impact risk, some access to funds, engagement and a direct, personal link with the social impact being delivered.

- *Commercial Finance: c7% of all SIFI funding*

Mainstream banks and commercial institutions are beginning to enter the field of social investment. However, while this funding may come from mainstream institutions, the bulk of it is either CSR funding or on concessionary terms. In the case of the UK high street banks, tentative entry into the UK social enterprise market is generally through signposting services for high net worth individuals or secured lending alongside other social banks. This activity is dwarfed by their mainstream and commercial activities. The £200m investment by the 'Merlin' banks into Big Society Capital will be the largest investment by the high street banks into the social investment market.

As government investment becomes more limited, developing other sources of finance is crucial

- *Using charitable assets to further social change*

At the end of 2010, charitable foundations in the UK had a total of £77.7bn of assets under management, none of which were invested primarily for social and environmental benefit. Charitable foundations have a potentially unique position amongst mainstream investors as they can have up to four separate financial strategies which could all work together to deliver more towards their mission: (1) the 'traditional' strategy of maximising returns from endowment investments which provide the income for (2) grant making and (3) providing non-market rate loans and investment (Programme Related Investments - PRI). Mission Connected Investment (MCI) is the fourth strategy and allows a portion from the endowment portfolio to be invested in activities that support the social mission. By investing, rather than granting, in this way foundations can recycle a small proportion of funds for further use and tailor their grant strategy to focus on supporting those organisations that cannot take on investment.

These options create a unique set of possibilities for trusts and foundations to drive social investment as well as for enhancing their mission. There is clearly overlap between the different funding strategies adopted by trusts and foundations, and PRI and MCI are sometimes blended to provide one investment package to an organisation. There are important legal duties and principles that apply to charity investments and the risks that trustees must address which are covered by the Charity Commission 14 (CC 14) guidelines. These have recently been revised to ensure that they reflect the emergence of social investment.

- *Providing individuals with ethical finance choices*

There is growing demand from investors for investments that link to positive social outcomes and supporting communities, which is derived not least from mistrust and disillusionment with existing financial services. Linked to the growth in ethical consumerism is a greater awareness of the positive use of money as a whole. Just as people realised that their consumption decisions could have a positive or negative impact on society, there is a growing realisation that decisions about the way that money is invested can also have a direct positive or negative impact. As a result, a variety of options have been emerging offering different ways for people to invest their money in a positive way, ranging from philanthropy to Socially Responsible Investment.

Although Socially Responsible Investment (SRI) is generally about screening out investments that have a negative impact rather than investing in order to achieve a positive social impact, it is expected to grow at a rate of 25% a year and there is significant potential for social investment to grow on its coat-tails. Investing for blended social and financial returns in many ways bridges the gap between philanthropic giving and conventional or even socially responsible investment. Eurosif, which has been collecting data on the ethical investment market since 2007, predicts that the share of impact investing in high net worth individuals' portfolios will grow from 11% to 15% by 2013.

Failure in financing the social sector

Frontline social sector organisations are similar to mainstream businesses in that they need to manage their income and expenditure and cash flow; they need to carry out financial and business planning for the future; they need to build organisational resilience; and they frequently need investment to expand. Building the resilience of a social sector organisation to manage irregular income patterns and deal with unexpected events has an added social dimension when there are vulnerable people depending on its services.

In particular, social sector organisations need financial capital for the following reasons:

1. As working capital to help with cash flow management and timing;
2. As development capital to grow and expand;
3. To acquire the fixed assets necessary to deliver ongoing services; and/or
4. As reserves or insurance to protect against the unexpected.

An inadequately capitalised social sector

In 2010-11 the frontline social sector obtained £0.9-1.7bn[23] less private finance than equivalent private sector organisations. This £0.9-1.7bn annual finance 'gap' held the frontline social sector back from operating as efficiently as comparable mainstream businesses as it was less likely to obtain working capital to smooth business cycles or growth capital to expand. Nearly half of all social enterprises see access to finance as a key obstacle to their success[24] compared to only a third of small and medium sized enterprises[25].

Capital investment is also not keeping pace with the growth in turnover of the sector[26]. The income of the sector grew at 5%p.a. between 2003 and 2007, but its asset base did not grow to the same extent: fixed asset growth was 3%p.a. and current asset growth -1%p.a. over the same period. This reflects in part the fact that, over the sector as a whole, income broadly matches expenditure: in 2007/8 sector expenditure was 93% of total income[27]. The Social Enterprise UK survey shows that 45% of start-up and new frontline social enterprises cited lack of and/or poor access to affordable finance as their top barrier in setting up, while 44% of established frontline social enterprises cited it as their top barrier to sustainability and growth. These quantitative insights are also supported by strong anecdotal evidence that the sector is undercapitalised[28].

The finance 'gap' is also caused in part by lack of demand as frontline social sector organisations without government funding also demand 9% less private repayable finance than mainstream SMEs. This lack of demand is partly a reflection of lack of supply of capital, but it also reflects the lack of investment readiness in the social sector as well as the lack of relevant services available to help frontline social sector organisations become investment ready.

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[23] Based on Cabinet Office regression analysis of the Small Business Survey (2010)
[24] Department for Business, Innovation and Skills (2010*) Social Enterprise Barometer, February 2010*

[25] SME benchmark is a conservative one as SME lending in the UK is in itself constrained- http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery.pdf
[26] NVCO (2010) *op cit*
[27] NCVO (2010) *op cit*
[28] Goodall E and Kingston J (2009) *Access to Capital: A briefing paper.* London: CAF Venturesome; Commission on Unclaimed Assets (2007) *The Social Investment Bank: Its organisation and role in driving development of the third sector.* London: Commission on Unclaimed Assets; NCVO Funding Commission (2010) *Funding the Future: A 10-year framework for civil society*. London: NCVO.

The provision of capital to the social sector

SIFIs are only able to partly offset the £0.9-1.7bn finance gap, providing the frontline social sector with only £0.2bn in 2010/11. This is because the social investment finance intermediary market is relatively immature and underdeveloped and is consequently not able to respond adequately to the financing needs of the social sector, in particular those that require risk and working capital.

Market research and analysis of both the social sector[29] and the social investment finance intermediary sector[30] highlights five key areas where the social investment market is not operating efficiently:

- *Capitalisation and balance sheet growth*

SIFIs lack sufficient capital to on-lend to frontline social sector organisation resulting in a finance gap at the frontline. This is partly because SIFIs themselves are undercapitalised and lack scale, and there are currently no sources of the equity capital that is required to strengthen and grow SIFI balance sheets in order to address the issue. Injections of core equity capital would result in stronger, larger SIFIs able to provide a reliable flow of capital to frontline organisations.

- *Risk and working capital*

SIFIs operate a particularly high risk business model due to their complex structures, low security and the bespoke, lengthy and expensive transaction process necessary to adequately meet the needs of the frontline social sector. Investments are generally small in number and in size and often only offer longer term returns. This means that SIFIs have a particularly significant need for risk and working capital to sustain them through funding and payment cycles which are often choppy, long and lacking security.

- *Sustainability and operational growth*

While many SIFIs provide affordable, specialist lending to the frontline social sector, they often do so with an operating deficit which is invariably financed by grants. This operating deficit limits the ability of SIFIs to lend to social sector organisations at affordable rates and limits growth at both the SIFI and the frontline level

- *Market mechanisms and infrastructure*

The social investment market will only function effectively if it has an infrastructure which encourages investment readiness; facilitates access to comparative data, pricing and information through investment and market data platforms; provides transparency on measurement of social impact; assists industry participants to network and share learning; and provides for liquidity through secondary markets. The lack of this infrastructure in the social investment market is a key manifestation of the immature nature of the market.

- *Advice, skills and information*

There is a lack of skills and understanding in the social sector of the obligations, processes and expectations involved in taking on investment. While SIFIs do provide some investment readiness and other support to the social sector the market for such professional advisory services is not well developed and not currently sustainable.

Evidence of market failure

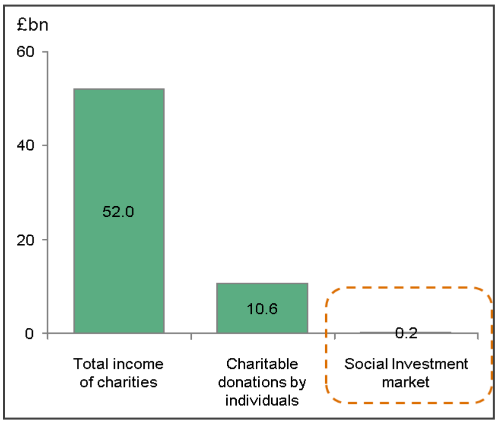
Capitalisation and balance sheet growth

1) The social investment market does not have sufficient capital to fully offset the finance gap

There is not sufficient appropriate and affordable capital available in the market, nor are there appropriate market institutions able to distribute capital efficiently. In total SIFIs were only able to invest £0.2bn into the frontline social sector in 2010 when the funding gap for frontline businesses was £0.9bn-1.7bn.

[29] Social Enterprise UK (2011) *Fightback Britain: A report on the State of Social Enterprise Survey 2011*
[30] The Young Foundation and Boston Consulting Group; Surveying England's emerging social investment market; August 2011

Chart: Social sector income



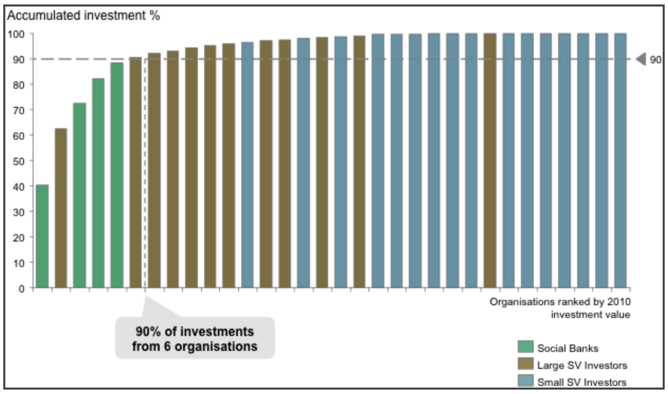
Source: BCG and Young Foundation (2011)

2) SIFIs do not have sufficient scale to underwrite frontline social sector risks

Frontline social sector organisations receive less investment than comparable SMEs partly because they are more likely to be rejected for certain types of private finance (supply is constrained), particularly risk capital and unsecured finance which present difficulties in terms of analysis to private investors. For example, social sector organisations are a third more likely to be rejected for private overdraft finance than SMEs[31]. This is because frontline social sector organisations have different cash-flow issues (the funding cycle is inevitable choppier[32]) and, because this is an emerging and highly specialised market, banks do not fully understand this risk and so reject more applications than they should.

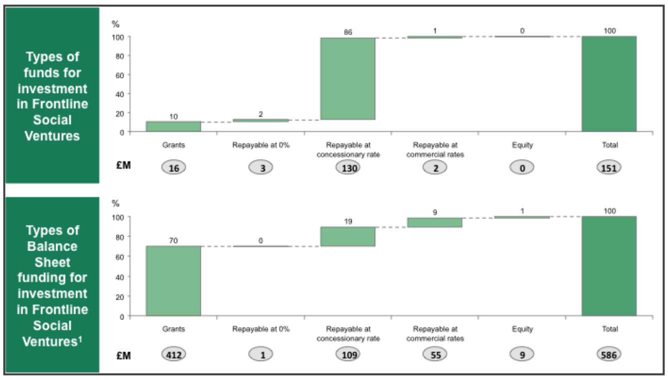
In order to provide the higher risk investment that the social sector needs and so offset this market failure, SIFIs themselves need to be sufficiently capitalised to allow them to underwrite risks which other investors are unwilling to take. The SIFI sector is small and immature and there are few, if any, market players of sufficient size to underwrite these risks: in 2010, 90% of all social investments were undertaken by only six organisations. This is a reflection of a nascent market but also an illustration of the specialist nature of the market, where the cost of setting up and growing a SIFI with the relevant expertise, resources and capital is difficult.

Chart: Accumulated investment in the SIFI sector (%)



3) SIFIs do not have sufficient capital to expand their lending

Less than 1% of SIFIs capitalisation is equity which restricts their ability to increase lending to the frontline.



Source: BCG and Young Foundation (2011)

4) SIFIs are unable to obtain capital from the private sector

To date SIFIs have been capitalised through a mixture of grants and soft loans. Recent research by BCG found that there are no wholesale funds available to SIFIs on commercial terms. Only 6% of SIFIs said that they had successfully applied for commercial funding during their last financial year. However, on closer inspection, this finance was not strictly 'commercial' as it was provided as part of a package with matched grant funding and claimed against CITR.

[31] Based on Cabinet Office regression analysis of the Small Business Survey (2010) found that when all relevant factors available are controlled for social frontline organisation (without grants) are more likely to be rejected.

[32] Department for Business, Innovation and Skills (2010) *Social Enterprise Barometer 2010*

Risk and working capital

1) SIFIs operate a particularly high risk business model with longer time horizons for investment sustainability.

This is due to the complex structure of funds and other investment vehicles, low security and the bespoke, lengthy and expensive transaction process necessary to adequately meet the needs of the social sector.

2) SIFI investments are small in number and size and provide returns only over the longer-term.

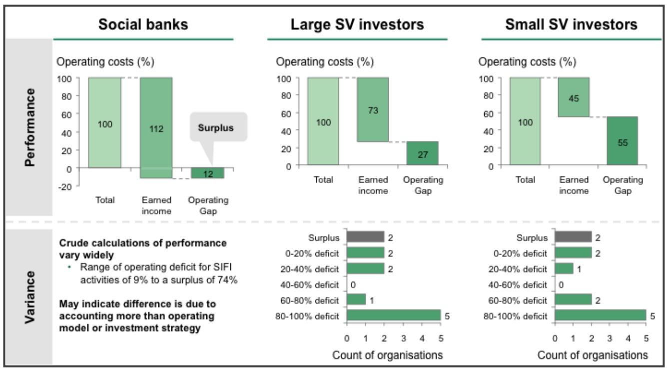
Deals in the social investment market also take longer to put together and are consequently more costly. Anecdotal evidence shows that the cost of developing and establishing new investment vehicles is prohibitive and has only been achieved through the use of ad hoc pro bono work from law firms. It takes SIFIs, on average, two years to raise a fund and not every fund that has been launched has succeeded in reaching first close without subsidy.

Operating sustainability and growth

1) Some SIFIs are not able to cover their operating costs

Most SIFIs carry an operating gap resulting from the fact that the cost of capital and of doing business (including providing essential investment readiness support to the social sector) is not covered by returns on investments. This is partly due to the lack of scale and the associated efficiencies as well as the length of time required for social investments to begin delivering financially. This operating gap has been filled to date through government grants and philanthropy. As the availability of finance from government in particular reduces, SIFIs will need access to long term, patient finance in order to grow to the required scale necessary to offset the operating gap.

Chart: Income, operating costs and operating deficit of SIFIs by type



Source: BCG and Young Foundation (2011)

Market mechanisms

1) Lack of infrastructure

Mainstream financial markets operate efficiently partly due to the functioning of market mechanisms that link investors to the investments that they want to make or have made. These market mechanisms include a capital raising infrastructure with Nomads (Nominated Advisors), a variety of exchanges for different types of investments, the ability to price an investment and the ability to distribute that price to potential investors. There is also a wealth of sectoral research and historical data that allows investors to accurately assess the risks associated with new investments. There are also diverse mechanisms that enable investors to buy and sell investments, alongside clearing and settlement processes and established market data platforms for pricing and risk management purposes.

None of this infrastructure currently exists in the social investment market. While there are organisations that are beginning to try to create this type of market infrastructure, they are constrained by lack of capital. This is illustrated by the BCG research which found that the biggest constraint to SIFIs obtaining capital is not knowing who to approach which implies a severe lack of standardised market infrastructure.

Advice, information and skills

There is clear evidence that, whilst frontline organisations may be commercially adept, the understanding and knowledge associated with taking on investment capital is at a fledging stage. SIFIs struggle with the costs and overheads associated with working with frontline organisations that are not investment ready, at the same time as frontline organisations identify the following three top priorities for non-investment services:

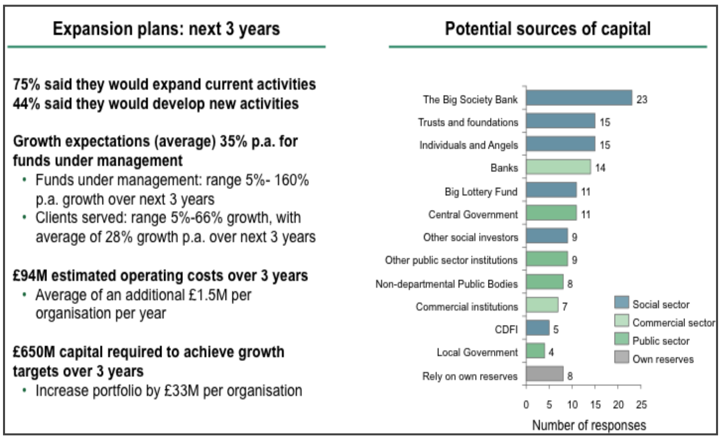
1. Investment Readiness Support
2. General advice and knowledge sharing
3. General business support and capacity building.

The potential of the social investment market

Although the social investment market faces considerable challenges, the injection of appropriate and affordable capital would allow the social investment market to increase in scale and sustainability. This will allow the market in turn, to provide the appropriate and affordable finance that the social sector needs in order to grow and become more sustainable itself, and ultimately deliver greater impacts for society and the environment.

SIFIs themselves are optimistic about the future, and their growth plans for the next three years show the extent to which they anticipate the market growing:

Source: BCG and Young Foundation (2011)



The role of Big Society Capital

Big Society Capital has a critical role to play in developing and shaping a sustainable market for social investment in the UK, giving social sector organisations access to new, appropriate and affordable sources of finance to increase their social impact.

Scope

BSC is a ‘social investment wholesaler’ which provides finance to social investment finance intermediaries (SIFIs) in the UK. These are defined as organisations that**:**

- Provide, facilitate or structure financial investments for organisations which have a primary objective of achieving a positive social impact; and/or
- Provide investment-focussed business support to organisations which have a primary social objective.

BSC will increase the quantity, diversity and sustainability of capital available to social investment finance intermediaries to invest into the frontline social sector; and it will provide support and help to build the infrastructure necessary to facilitate the creation of an efficient social investment market which can fully support the frontline social sector.

BSC will provide investment and support to SIFIs so that they are better able to provide the social sector with appropriate and affordable finance. We will only invest in SIFIs. We won’t invest directly in frontline social sector organisations. This is because, by supporting SIFIs to grow we can help them to make more connections between socially motivated investors and social sector organisations. This will leverage more capital into the social sector than BSC can provide alone and will increase long term impact. As far as is compatible with our mission, BSC will seek to achieve financial sustainability over the long-term.

Vision, mission and objectives

Our vision is for:

> A strong, diverse, well-capitalised and sustainable social investment market in the UK through which social sector organisations can access appropriate and affordable finance and support to grow their impact on society.

Our mission is:

1. To have a transformative impact on the social investment market in the UK by supporting social investment finance intermediaries to become financially robust and able to:
   - Attract greater and more diverse sources of investment;
   - Effectively and efficiently channel appropriate and affordable capital to the social sector; and
   - Provide effective financial and business support services to the social sector.
2. To increase awareness of and confidence in social investment by:
   - Promoting best practice and sharing information;
   - Improving links between the social investment and mainstream financial markets; and

- Working with other investors to embed social impact assessment into the investment decision-making process.

Our objectives are:

- To enable SIFIs to become financially robust, able to attract investment, and able to provide effective financial and investment-focussed business support services to frontline social sector organisations. We will do this through direct investment in SIFIs, co-investing in social-purpose funds, or providing SIFIs with subordinated capital;
- To enable new financial products and market infrastructure to be developed and brought to market. We will do this by providing appropriate support, including investment, to SIFIs that are developing viable, innovative products and mechanisms that can attract investment and meet a financing need in the social sector;
- To increase the flow of capital into the social investment market and, in particular, attract greater and more diverse sources of finance into the sector. We will do this by helping to develop an effective and efficient market infrastructure which will channel greater sums of appropriate finance alongside our capital.
- To increase awareness of and confidence in social investing. We will do this by promoting best practice, disseminating information, and by creating and supporting forums for networking and facilitation; and
- To work with other investors to drive best practice in the embedding of social impact performance, assessment and measurement into the investment decision making process.

Activities: investment

Big Society Capital will achieve its objectives by addressing key market failures in the social investment market, ultimately increasing the social impact achieved by frontline social sector organisations. In particular, BSC will focus on five key areas of investment activity:

- *Capitalisation and balance sheet growth*: injecting of core equity capital to build stronger, larger SIFIs who are able to provide a reliable and predictable flow of capital to frontline social sector organisations;
- *Risk and working capital*: acting as lead or cornerstone investor in the developing and piloting of financial products and funds that provide risk and working capital to the social sector;
- *Sustainability and organisational growth*: providing medium to long term capital to SIFIs to enable them to achieve sustainability and scale and so increase the volume of affordable finance that they can offer to the social sector;
- *Market mechanisms and infrastructure:* acting as lead or cornerstone investor and/or providing underwriting support for the development of the market infrastructure;
- *Advice, skills and information:* providing direct equity and loan investments in SIFIs developing and providing financial advisory and corporate finance services to help social sector organisations build the skills and capacity required to take on investment.

BSC activity in each of these five areas is set out in more detail in Annex A.

Activities: impact

The overarching aim of BSC is to help frontline social sector organisations increase their social impact by improving their access to appropriate and affordable finance. BSC will do this by investing into the development of an efficient and effective social investment market. An intrinsic part of this role will be to ensure that the provision of finance is clearly linked with measurable social impact.

As a significant investor in the social investment market, BSC has the opportunity to ensure that best practice in social impact performance assessment and evaluation lies at the core of social investment. Key to achieving this will be in maximising the flow of capital into the social investment market and ultimately to the frontline social sector on the basis of social outcomes that are clearly articulated, understand and consistently evaluated.

To do this BSC will work collaboratively with the sector to develop a principles and performance based taxonomy and standardised metrics that will measure social impact for social investment portfolios. BSC will adopt this taxonomy as part of its role as investor.

The key principles that underpin BSC's approach are:

- *Collaborative*
BSC will work with stakeholders across the sector in the development of an agreed investor focused taxonomy and associated guidelines;

- *Investor driven*
BSC will focus its approach to social impact performance on the effect that the integration of social impact has on the performance of the investment overall, in particular the correlation of risk, return and social impact within a very diversified portfolio;

- *Beneficiary based*
The purpose of any investment should be expressed in terms of the beneficiary targeted and the intended outcomes associated with the use of invested capital. The core dependencies for coordinating and aggregating these outcomes are: agreed sectors; common definitions for each sector; and standard outcome themes within each sector;

- *Principles based*
BSC's approach to social impact performance will be based on the principles of accountability, proportionality, transparency; standardisation; and comparability; and

- *Open-source*
Data, guidelines, research and tools developed as a result of BSC's activity in this area will be made freely accessible through its website.

Investment strategy

The overarching aim of BSC is to help front line social sector organisations increase their social impact by improving their access to appropriate and affordable finance. BSC will do this by supporting the development of an efficient and effective social investment market that is able to fully support the finance needs of the frontline social sector. The financial support BSC provides may take the form of: capitalising SIFIs; co-investing in social purpose funds; providing subordinated capital to SIFI funds; and investing in SIFIs developing new products or market infrastructure.

The landscape in which social sector organisations and SIFIs are operating is in a state of considerable change and uncertainty. In particular:

- The general financial environment for businesses is difficult. Banks are lending less, with implications for both social sector organisations seeking commercial finance and also SIFIs that both need finance for their activities and supply financial services it to those who cannot access it elsewhere. Indications are that the demand for capital from SIFIs is rising but it is unclear what the long term trends are or the implications of a changing pattern of demand;
- There have been significant cuts in public spending in the UK which are now starting to have an impact. It is too early to know what the impact will be on social sector organisations dependent on public service contracts, or on general economic activity and consumption which also impacts the social sector;
- There are major changes being made to public service markets, but it is too early to know clearly what the implications will be for social sector organisations as policies are still being developed or are in the early stages of implementation. In general, the government is seeking to open up markets, which should provide more business opportunities to social sector organisations. However, it is not yet completely clear what basis they will be competing on, where the most viable opportunities will be, and therefore what support they will need from SIFIs and other finance providers to the social sector.

In the light of these big and unquantifiable uncertainties which affect what SIFIs need to do to support the social sector and therefore how BSC needs to support SIFIs to grow an effective social investment market, BSC's investment strategy needs to be flexible and responsive to developments in the emerging social investment market, economic climate and government policy. BSC's investment strategy has therefore been developed to provide a framework for decision-making and avoids predictions that cannot currently be anchored.

BSC will focus, initially, on making investments and providing support to the social investment market in response to demands for capital from SIFIs, who in turn will be driven by the needs and demands of frontline social sector organisations.

As the market develops and as BSC, through its initial investment activity and through its research, builds a more detailed picture of both the social investment market and the finance needs of the frontline social sector, BSC will begin to take a more proactive approach to its investments. This includes potentially identifying a need for capital or greater intermediation activity where there is neither articulated demand nor supply, and facilitating flows of capital and support to those areas.

BSC will review and refine its investment strategy regularly to ensure that it is able to respond effectively to changes in the market and remains focused on addressing identified market failures.

Asset allocation

BSC will aim to have a portfolio diversified across:

- *Asset type*

The medium to long-term aim is for a portfolio diversified across all assets. However, in the initial stages of investment, the portfolio will be heavily weighted towards investments into funds and into equity in order to address the key market failures of lack of capitalisation and balance sheet growth, and lack of risk and working capital. Loan investments are expected to grow over time as the market develops and becomes more robust.

- *Geography*

BSC is committed to achieving broad geographic diversification within its portfolio. Given that SIFIs are often based in key metropolitan cities, particularly London, the geographic diversification of BSC's portfolio will take into account the location of frontline social sector organisations benefitting from investment through SIFIs, as well as the location of the SIFIs themselves.

- *Sector*

BSC aims to achieve broad sectoral diversification across its portfolio. BSC will look to invest in SIFIs, funds and vehicles that invest across a range of sectors as well as sector specific SIFIs and vehicles.

- *Market failure*

BSC will aim to have as diversified a portfolio across the five identified market failures as possible.

Governance

The directors of BSC will establish an Investment Committee to provide oversight of the Investment Strategy, Policies and Activities of BSC. The Investment Strategy and investment approval is owned by the Investment Committee and is reviewed annually by the BSC Board and the BST Board against the requirements of the Governance Agreement between them, the Risk Management Policy and BSC's Business Plan.

The Investment Committee is an executive committee and will be chaired by the chief executive of BSC. It includes the Chief Investment Officer, Chief Operating Officer, Chief Financial Officer, Director of Strategy and Market Development and Senior Investment Analyst. The quorum for meetings of the Investment Committee shall not be less than three persons.

A detailed investment memorandum for each proposed investment will be submitted to the Investment Committee. The Investment Committee will maintain comprehensive written records of all decisions and the decision-making process.

Investment criteria

Every investment will be assessed and rated against the following criteria:

1. Qualified intermediaries

The beneficiaries of BSC investments must be UK based SIFIs (of any nationality) who finance positive social impact by providing, facilitating or structuring financial investments for/to organisations that have the primary objective of achieving social impact, and/or by providing investment-focussed business support to organisations that have a primary social objective in order to make them capable of receiving financial investment. BSC cannot invest directly in frontline social sector organisations but will ensure that investments are targeted at organisations and/or financial products working in one or more of areas detailed below. As the social investment market changes, this list will change to reflect the current market need.

- *Children and families*

Early intervention for improving the quality of life for at-risk children, young people and vulnerable families.

- *Community regeneration*

Construction, renovation and purchase of community facilities and assets (arts, sports, libraries, shops, community centres), including the engagement of the community in using, running and owning those assets.

- *Disability*

Support services for those with disabilities to ensure that they have the same opportunities and ambitions as everybody else.

- *Education*

Creating opportunities to improve aspirations, attitudes and behaviour of children and adults through education

- *Employment*

Creation of long-term and stable employment opportunities through the provision of training, skills, living skills, jobs and mentoring.

- *Financial exclusion*

Provision of credit, debt advice, savings, insurance and financial literacy in a way that is appropriate, affordable and supportive for those who cannot access mainstream financial services.

- *Health and social care*

Services and support in the medical and health sector seeking to provide access to improved health services for the underserved.

- *Housing and shelter*

Immediate shelter needs as well as long term shelter and housing needs and any specialist support and services related to social housing and tenancy issues.

- *Infrastructure*

Provision of specialist finance, support, advisory services and market infrastructure specifically to social sector organisations across a diversified range of sectors and local areas.

- *Mental health*

Services and support to help people survive, manage and recover from mental health problems.

- *Young people and children*

Youth services and early intervention in terms of youth offending and rehabilitation.

2. Market failure

The aim of BSC is to address market failure in the social investment market and help fill the £0.9bn-£1.7bn finance gap faced by the social sector. BSC will therefore look at the extent to which each application effectively addresses one or more of the failures in the social investment market identified in this document. A key consideration of any investment BSC makes will be the existence (or lack) of other providers of capital willing to invest. This could mean that raising capital for a fund could not have been started or completed to desired scale without BSC. Or it could mean that an equity investment allows a company to operate as a sustainable entity and as such attract other sources of investment capital.

The failures in the social investment market that investments by BSC will aim to address are set out at page 23 above.

For all investment decisions BSC will need to be able to confirm to its Investment Committee that each and every investment made generates an outcome that would not have been possible had BSC not committed its capital. This applies to both financial and social outcomes.

3. Robust investment proposition

Any equity, quasi equity, risk/working capital or debt investment by BSC must be shown under rigorous stress testing to generate over time a financial and social return commensurate with the underlying risk assumed. This means that BSC will need to balance the overall levels of financial risk it takes in pursuit of social impact with the need to generate sufficient financial returns to remain operationally viable. Key elements for an initial common sense screen are:

- *Quality of business plan and financials*

A robust plan for investment that articulates how much money is required, in what form, and for what purpose.

- *Management strength*

The strength and experience of the management team and governance structures, as well as the quality of the Board.

- *Capital raising history*

Any previous experience, either within the organisation or the management team, in successfully raising and repaying investment capital.

- *Scale ratio*

The amount being raised defined as the size of the investment fund divided by the size of the underlying organisation.

- *Operational strength*

The operational strength, efficiency and operational self-sufficiency of the organisation.

4. Impact

BSC will look for best practice in the way in which SIFIs looking for investment will implement impact assessment and reporting. This will include:

- *Mission statement*

A clear and relevant mission statement that encapsulates the organisation’s vision. How quickly the mission will be achieved and how it is demonstrated.

- *Management of change*

Evidence that the organisation has the competence and capability to deliver on its mission statement and that its corporate structure and governance is congruent with its mission.

- *Multiplier effect*

The extent to which the organisation is delivering outcomes that are additional to its key mission and to which invested capital will have a multiplier effect (local economy, investment leverage, knowledge).

- *Extent of change*

The impact that the organisation has on people’s lives and the organisation’s efficacy in delivering and measuring its performance.

- *Beneficiary involvement*

How well beneficiaries are consulted and involved in the development and delivery of projects and programmes.

- *Reporting*

How results are reviewed, assembled, reviewed and used to develop future plans.

- *Communication*

Transparency and quality of impact reporting.

- *Attitude to profit and remuneration*

How the organisation uses its profits, how staff are remunerated and how this affects profits.

5. Game changing

BSC will look to see if the SIFIs themselves and/or the frontline organisations that they are targeting represent new and highly innovative approaches to business practice and/or tackling social problems and therefore their potential to bring about a game change in thinking and behaviour within the social investment sector and/or the social sector. This will include:

- *Innovation of operations*

An assessment of an organisation's core business for innovation in new products and services.

- *Innovation of application*

The extension of existing practices or products into new areas either geographical or targeted at a market failure.

- *Access to capital*

The extent to which the organisation's activities mean that it cannot access commercial private capital.

6. Mechanism/process for assessing and monitoring aid to the frontline under existing state aid exemptions[33]:

SIFIs will be required to ensure, as a condition of receiving support from BSC, that the investments they make in frontline social sector organisations fall into one of the following three categories with regard to state aid. In each case the SIFI will be required to ensure that all requirements laid out below are abided by.

De minimis

It is expected that the majority of aid to the frontline will be delivered under the EU *de minimis* rule[34]. SIFIs delivering BSC funding under this condition will be required to:

1. Ask all frontline social sector organisations applying for investments to identify the value of all other *de minimis* aid they are receiving over a rolling three year period;
2. Assess the aid intensity of the proposed investment by finding the difference between the State Aid reference rate and the interest rate charged to the frontline social sector organisation then multiplying this by the value of the loan(s) over three years;
3. Total a) and b) to ensure that the value does not exceed €200,000;
4. Write to the recipient outlining explicitly that they are receiving *de minimis* aid and the value of the award in Euros.

General Block Exemption Regulation (GBER)[35]

SIFIs investing in activities covered by the GBER will be permitted to invest under the relevant exemption.

SIFIs seeking to invest through GBER will be required to assess the aid intensity of the proposed investment to ensure that it falls under the relevant threshold. They will be further required to confer with investees to confirm the eligibility of the recipient frontline social sector organisation.

[33] State Aid is aid from a Member State (of the European Union) to organisations which the Treaty of Rome (which established the European Union) declares generally incompatible with the common market – with certain possible exceptions. Broadly it means financial aid provided by Member States which favours certain organisations and has the potential to distort competition and affect trade between EU Member States. The Treaty of Rome contains exemptions that allow State Aid to be granted legally in instances where the market alone won't produce the optimum outcome. These are set out in frameworks, guidelines and block exemptions.

[34] Small amounts of financial support granted through or by state resources (less than €200,000 to any organisation over a rolling three year period) are considered *de minimis* amounts. This aid can be given without the need for notification and approval by the European Commission but the provider of the aid must first ascertain that the amount of aid will not exceed €200,000 over a three-year period when added to any other de minimis aid the intended recipient has already received from all sources during that period.

[35] The General Block Exemption Regulation (GBER) provides a simple method of providing aid measures which are considered less problematic (less distortive). These enable notified aid to be granted without the need for approval in each case. This involves completing, within 20 days of the grant of aid, a short form describing the form and level of aid and confirming that the conditions of the Regulation will be respected. The GBER covers 26 areas including regional aid, SME aid, risk capital aid, environmental aid, and training aid.

SIFIs will further be required to notify the Commission within 20 working days of the grant of aid and to publish details of the aid on their website.

Investments on the same terms as commercial investors (pari passu)

SIFIs may co-invest under Market Economy Investor Principles (MEIP)[36] where they are able to provide assurances that:

- The co-investor is investing on purely commercial terms;
- The co-investor is investing on identical terms;
- The co-investor would have invested without the support of the SIFI.

Because investments in the social investment market are rarely made on commercial terms, it is unlikely that SIFIs will invest under the Market Economy Investor Principle a great deal, if at all.

[36] The essence of the MEIP is that when a public authority invests in an enterprise on terms and in conditions which would be acceptable to a private investor operating under normal market economy conditions, the investment is not a state aid.

Investment process

The following sets out the high level process that BSC will follow in inviting and assessing investment proposals.

Enquiries

Investment criteria and eligibility will be clearly articulated and signposted in all externally facing documentation.

Expression of interest

An online Expression of Interest form will be available on BSC's website. This short form will ask SIFIs for information about their organisation, the type of investment sought, how much and for what.

Expressions of interest will be assessed by the internal investment team who will decide whether to take proposals forward.

Expressions of interest can be submitted at any time and can be submitted for more than one proposal.

Application

SIFIs whose proposals pass the initial screening following an expression of interest will be sent a standard application form. This will include the following sections:

- The details of the organisation (name, address, legal status) together with a summary of the organisation's relevant experience and expertise, as well as its social mission or purpose;
- A summary of current capitalisation and portfolio of assets (if applicable), together with past financial performance (up to 3 years if available);
- Brief details of the proposed investment: how much money, and in what form (equity, debt, investment into a fund etc). This should include suggested investment terms and details of co-investors if applicable;
- A business plan which articulates the case for investment and includes a description of the intended use of the money. This will provide the substantive detail of the proposed investment. It should include a qualitative and quantitative description of why money is needed and how financial and social and environmental (if applicable) returns will be generated. The business plan should detail both expected financial return and social impact metrics that will demonstrate positive social impact. Additional information required will include identified risks and challenges; potential sources of upside; and details of other co-investors and/or links to other funds or investments that are managed by the applicant;
- A three-year prospective financial model that shows projected cash flows, balance sheet, profit and loss statement, assumptions underpinning growth, operational costs, and repayment.
- Evidence that investment cannot be sourced from elsewhere, both at the level of the SIFI and the frontline social sector organisations. See Annex B for further details on how BSC will look to establish that potential investees cannot access investment from elsewhere;
- Details of progress made to date: evidence of a track record, and details of due diligence completed;
- Evidence of process/mechanism to assess, quantify, report and monitor any aid to frontline social sector organisations in line with existing state aid exemptions

(*de minimis*, GBER, MEIP); a repayment plan in the case of debt; a plan detailing the sustainability and creation of equity value in the case of equity/quasi equity applications; target fund IRR together with details of how returns will be realised in the case of fund investments.

Eligibility

Applicants will be screened and scored against the eligibility criteria listed in this document. Acceptable applications will be considered from qualified intermediaries that show evidence of existing market failure together with a robust investment proposition. This must include sufficient evidence to prove money cannot be sourced elsewhere**.** All such applications will be discussed and reviewed by the investment team at BSC on a weekly basis, and a decision will be made whether to proceed to due diligence or not, potentially after having sourced additional information if an application is not clear or well-articulated.

Due diligence

This will involve meeting the management team who submitted the proposal on site, visits to key site(s) if in a different location to the proposing team, as well as a review of the business model and financial plan and impact assessment. BSC analysts will include an overview of the specific sector and a context for the proposed investment, as well as a comparative analysis of existing or similar projects (if applicable). In addition, legal and regulatory due diligence will be completed.

Key to the investment process will be due diligence into a SIFIs approach to profit distribution. BSC will look closely at operating profit margin (where it exists) and the stated objectives to the disbursement of company profits, and importantly how these are protected within the governance structure of the company. If these protections are not strong enough BSC will require that they are strengthened before it considers making an investment. NB this includes the concept of profit allocation across all stakeholders of which investors are only one element, and also the distribution of assets and proceeds from potential sales.

Risk assessment

Internal risk assessment is fundamental to the investment process: BSC will stress-test underlying assumptions to see the impact on financial and social key performance indicators. If initial due diligence is compelling, BSC will complete a process of internal re-modelling of the business plan as a robustness check, complete stress-testing on key risk areas and finally explore areas for potential outperformance. This process will help to establish the correct key performance indicators, both financial and social, which will form the basis for on-going monitoring and management of the investment. In addition this will help BSC understand what the correct terms of the proposed investment should be.

Pricing investments

BSC will make investments in response to demands for capital from SIFIs, who in turn are driven by the needs and demands of the front line. Central to every investment application must be a clear presentation of the ultimate use of BSC's capital: how the money will be invested into the frontline. As a result, the pricing of each investment will be driven by the underlying risk at the front line and the capabilities of these organisations to take on investment obligations (what they can afford to commit to repay). BSC will apply its investment criteria to all SIFIs without prejudice, considering the SIFI's costs of administration and derive the financial and social return in can deliver to BSC. The return will therefore reflect first and foremost the investment opportunity presented by the frontline: the investment must be suitable to meet front line needs. All investments will be subject to a 1% arrangement fee.
Details of BSC's equity valuation policy are included at Annex C).

Portfolio management

If the proposed investment meets the basic requirements it will be discussed at the monthly portfolio review. It is critical that BSC retains a view of its own progress, targets, and mission performance. The portfolio review will consolidate information from each and every investment strategy. The investment strategy will be defined in terms of both addressing market failures as well as delivering frontline social impact, and as such these discussions will involve looking at the data in relation the disbursement of capital (in what form, terms, liquidity, underlying risk assumed), the success in driving innovative social enterprise models and practices, and the ultimate frontline social impact. BSC will consider each new potential investment against existing and target portfolio in terms of risk profile, sector allocations, liquidity and size metrics. This will ensure BSC clearly understands and can articulate what each and every investment brings to the portfolio as well as to the market as a whole in terms of a solution to existing market failure and delivery of social impact.

Diversification / risk management
BSC is committed to the following guideline caps on investment size as part of responsible portfolio management at launch:

- At launch, the maximum investment size will be £15m;
- Once BSC has invested £150m, the maximum investment will rise to 10% of the total BSC portfolio;
- The maximum percentage of the portfolio invested into any one asset will fall by approximately 0.5% for every £25m added to the portfolio to a level of 5% when £400m has been invested.

BSC's aim is to build a sustainable and diverse social investment market in the UK which will require BSC to make several investments and to encourage co-investors to invest alongside. It is imperative to BSC's financial management strategy that it manages the risks in its portfolio of largely illiquid and high risk investments which will necessitate diversification. If, however, BSC is successful in growing the market so that it is bigger and less risky, it may be appropriate for BSC to make larger investments than these initial guidelines suggest.

BSC currently forecasts an average investment range of between £1-8 m, although these investments may be phased over time (once certain milestones have been hit). BSC is more likely to make investments at the lower end of this range initially as the current size of the social investment market in the UK will limit the size of investments that BSC can make.

Negotiation / approvals
This is the process by which each investment is negotiated and finally approved by the investment committee. This may be a lengthy process and will require much attention to detail. The process will help to refine the metrics by which BSC will continually assess each investment. Final negotiations of investment terms and a monitoring/reporting plan will be signed off by the Investment Committee.

Profiling
The profiling process will include the categorisation of each investment and an assessment of proper portfolio allocation. It will be completed by the investment team to ensure that BSC's investment portfolio accurately reflects the risk and return profile of underlying investments, and that it clearly addresses market failures and identifies the ultimate social impact.

Monitoring and reporting
The final investment documentation will include a plan for the on-going monitoring of each investment against stated financial and social impact targets. A full report on each investment will be submitted to the Investment Committee every quarter, to be discussed at the portfolio review. The report will detail key financial and social Key Performance Indicators, as well as areas of outperformance and underperformance. There will be annual valuation of each investment, verified by an external third party for audited accounts.

Consistent with widely recognised social accounting best practice, the reporting will be underpinned by the measurement, monitoring, and regular reporting of specific financial metrics and social indicators. The true extent of an organisation's impact can rarely be reliably reported by use of a single indicator, and rather a group of indicators is required, which captures both raw volumes and how these translate into meaningful benefits. The specific collection of indicators that best track the impact of individual organisations is by no means standard.

Governance

Big Society Capital Group comprises three entities:

- The Big Society Trust[37] (BST), a company limited by guarantee and holding company that owns the majority of shares in its operating subsidiary, Big Society Capital Ltd and exists to protect the social mission of BSC;
- Big Society Capital Limited (BSC), a private company limited by shares[38] and the operating company which functions as a 'social investment wholesaler; and
- The Big Society Foundation which will be constituted to receive charitable donations and develop complementary grant programmes to support BSC's mission.

The Big Society Trust

The Big Society Trust has been established to act as a shareholder in BSC and to provide oversight to ensure that BSC remains true to its object which is to act as a social investment wholesaler and generally to promote and develop social investment and the social investment market place in the United Kingdom. To enable it to carry out its role, BST has a controlling interest in BSC. This takes the form of a 60% equity stake and 80%b of the voting rights. Any change to BSC's object (and thus its overriding social purpose) requires the consent of 75% of BST Board Members, including the Government representative.

A Governance Agreement between BST and BSC provides the framework within which BST is empowered to carry out its role in ensuring that BSC remains true to and is held accountable for long-term performance against its social mission. The Governance Agreement sets out that BST will not have any day-to-day involvement in the management or decision-making (including investment decisions) of BSC. It also sets out that BSC will operate in line with agreed investment principles, responsible business principles, appointment procedures and principles, and remuneration principles. The Governance Agreement also commits BSC to reporting to each BST Board meeting on its financial performance, new investments (and how they further the aims of BSC), monitoring of existing investments, material breaches of investment principles or responsible business principles, and details of Board or senior management appointments or changes to remuneration. BST also has the power to request additional information from BSC and must approve any changes to BST operating principles.

The Big Society Trust is a company limited by guarantee with nine directors who are also members. To ensure BST has a balance of financial and social sector experience, the directors will comprise:

- A financial sector appointee
- A business sector appointee
- One of either the CEO of NCVO (National Council for Voluntary Organisation) or the Chief Executive of ACEVO (Association of Chief Executives of Voluntary Organisations), ex officio rotated every three years
- The CEO of Social Enterprise UK, ex officio
- Two Third Sector appointees

[37] The use of the term 'Trust' in The Big Society Trust is not used in a legal sense but to signify the role of The Big Society Trust in protecting the social mission of BSC.
[38] Neither The Big Society Trust nor BSC will be licensed as a bank or deposit taker and the term 'Bank' will not be used in promoting their activities.

- The Chair of Big Society Capital, ex officio
- A Government appointee (appointed by the Accounting Officer for the Cabinet Office[39])

Big Society Capital

Big Society Capital Ltd is the operating company of the Big Society Capital Group. It is a company limited by shares with a mission to act as a social investment wholesaler and to promote and develop social investment and the social investment market in the UK.

BSC's purpose is to achieve its social mission rather than to maximise profits for shareholders. BSC shares are owned 60% by the Big Society Trust and 40% by the four 'Merlin' Banks (Barclays, HSBC, Lloyds Banking Group and RBS). The BST will always hold at least 80% of the voting rights in BSC and the Merlin Banks no more than 20%.

The composition of the BSC board reflects the purpose of BSC and includes a balance of financial and social sector expertise. The board is mainly non-executive, with one executive member (the CEO of BSC) [40].

The Board of BSC provides overall leadership and is accountable for BSC's performance. The Board is responsible for overseeing the development of BSC's business plans, investment strategy, and budgets; for BSC's decision-making, monitoring and evaluation, and performance reporting; determining the nature and extent of the risks BSC is willing to take; and overseeing risk management and controls. They are also responsible for BSC's ICAAP (Internal Capital Adequacy Assessment Process) as required by the Financial Services Authority, and for ensuring that BSC follows the relevant principles and Code Provisions of the UK Corporate Governance Code published by the Financial Reporting Council (June 2010 edition).

The Board delegates some decision-making through a formal committee structure, including an investment committee which is set out below.

The corporate structures of BSC comply with the principles set out in the Financial Reporting Council UK Corporate Governance Code and will ensure that BSC operates to high standards in fulfilling its social and financial mission.

Merlin Banks

Barclays, HSBC, Lloyds Banking Group and RBS (the 'Merlin' Banks) will invest 66.7p in Big Society Capital shares for each 100p invested by the Big Society Trust, up to a maximum of £200m[41]. As such, the Merlin Banks will own a maximum of 40% of Big Society Capital shares. Each share drawdown will be divided into equal portions between the Merlin Banks.

Merlin Bank shares will carry equal income rights to the Big Society Trust shares. If BSC makes a surplus and decides to distribute a dividend, the Merlin Banks will have a right to a share proportionate to their equity contribution to BSC. The Merlin Banks' collective voting rights will, however, be capped at 20%. As such, the Merlin Banks will always remain a minority shareholder.

The Merlin Banks will have a veto over the following changes to BSC, in which they have a material interest:

- changes to BSC's mission;
- changes to the rights attached to the Merlin Bank's shares; and

[39] BST Board Members are: Sir Richard Lambert (University of Warwick) (Chair), Ian Davis (formerly McKinsey & Co), Baroness Pitkeathley (House of Lords), David Robinson (Community Links), Sir Stephen Bubb (CEO of ACEVO) [ex officio in rotation every three years with NCVO], Peter Holbrook (CEO of Social Enterprise Coalition) ex officio, Gareth Davies (Cabinet Office) ex officio, Sir Ronald Cohen (Chair of BSC) ex officio.

[40] Board members were announced in July 2011. Sir Ronald Cohen (the Portland Trust and Bridges Ventures) will be temporary Chair until BSC is operational, at which point, the board will look for a permanent appointment. Other board members are Nick O' Donohoe (CEO Big Society Capital, formerly JP Morgan), Dawn Austwick (Esmée Fairbairn Foundation), David Carrington (Independent Consultant), John Kingston (Association of Charitable Foundations), Geoff Mulgan (National Endowment for Science Technology and the Arts), Dai Powell (HCT Group), Lady Susan Rice (Lloyds Banking Group), Danielle Walker Palmour (Friends Provident Foundation).

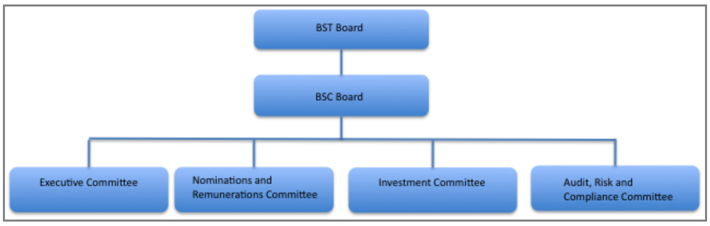
[41] The Merlin Banks retain the right to continue to buy shares in BSC for 66.7p for each 100p invested by BST.

- changes to the business principals which significantly affect the amount of distributable profit available for distribution to the Merlin Banks.

The Merlin Banks will also be entitled to a seat on Big Society Capital's board and will be entitled to certain information rights, including the right to see any information requested by the Big Society Trust that is not commercially sensitive.

Committee Structure

Big Society Capital's Board delegates its authority through a formal Committee Structure:



Executive Management Committee

The Executive Management Committee supports the Chief Executive, who also chairs the Committee, in carrying out the executive management of Big Society Capital. The Executive Management Committee has the delegated authority of the Board for the operational and executive running of Big Society Capital on a day-to-day basis.
The key responsibilities of the Executive Management Committee are:

- The development and implementation of strategy, operational plans, policies, procedures and budgets;
- Monitoring the operating and financial performance of the company;
- Monitoring the quality of the investment portfolio against investment criteria and other income generation processes against objectives;
- Monitoring all changes in Big Society Capital compliance policies or procedures that are subject to recommendation to the Audit Committee of the Board;
- Assessment and control of risk;
- Monitoring market forces in the social investment and frontline social sectors.

In carrying out its role and performing the functions and responsibilities described above, the Executive Management Committee will act in accordance with the direction and requirements that may from time to time be laid down by the Board. Formal responsibilities are described in Executive Committee's Terms of Reference that are reviewed and approved annually by the BSC Board

Nomination and Remuneration Committee

The Nomination and Remuneration committee is responsible for the following:

- Determining and agreeing with the Board of Big Society Capital the framework or broad policy for the remuneration of the company's chairman, chief executive, the executive directors, the company secretary and such members of the executive committee as it is designated to consider;
- In determining such a policy, the Committee will take into account all factors which it deems necessary including relevant legal and regulatory requirements, the provisions and recommendations of the UK Corporate Governance Code and the Governance Agreement between BST and BSC. The objective of such policy shall be to ensure that members of the executive of the company are provided with appropriate policies to encourage performance and are, in a fair and responsible manner, rewarded for their individual contributions to the success of the company. In particular, the committee will ensure that executive directors and senior staff are paid a comparable remuneration package to persons engaged in like positions in the public, not for profit and charity sector and adhere to its no bonus policy. It will do so

through an independent survey once every five years to establish the benchmark for such salaries;

- Regularly review the structure, size and composition (including the skills, knowledge and experience) required of the Board compared to its current position and make recommendations to the Board with regard to any changes:
- Give full consideration to succession planning for non-executive directors and the executive staff in the course of its work, taking into account the challenges and opportunities facing BSC, and what skills and expertise are needed on the Board in the future:
- Keep under review the leadership needs of the organisation, both executive and non-executive, with a view to ensuring the continued ability of the organisation to compete effectively in the marketplace.

In carrying out its role and performing the functions and responsibilities described above, the Nomination and Remuneration Committee shall act in accordance with the direction and requirements that may from time to time be laid down by the Board. Formal responsibilities are described in the Nominations and Remuneration Committee Terms of Reference that are reviewed and approved annually by the BSC Board.

Audit, Risk and Compliance Committee
The Audit, Risk and Compliance Committee will, subject to any applicable regulatory rules, consider all issues related to the audit of BSC accounts and systems and its compliance with all regulatory requirements. In particular the Audit, Risk and Compliance Committee has responsibility for:

- Examining management's process for ensuring the appropriateness and effectiveness of systems and controls;
- Examining and challenging management's process and effectiveness of risk management systems and controls;
- Examining the arrangements made by management to ensure compliance with requirements and standards under the regulatory system;
- Overseeing the internal audit function;
- Maintaining direct contact with the external auditors during the year in relation to the report and accounts.

In carrying out its role and performing the functions and responsibilities described above, the Audit, Risk and Compliance Committee shall act in accordance with the direction and requirements that may from time to time be laid down by the Board. Formal responsibilities are described in the Audit, Risk and Compliance Committee Terms of Reference that are reviewed and approved annually by the BSC Board.

Investment Committee
The BSC Investment Committee is an executive committee, chaired by the chief executive of BSC, with delegated responsibility for the performance of BSC's portfolio of investments. In this regard it:

- Sets a realistic investment policy to define the purpose of BSC's portfolio and the measures by which it monitors its success in fulfilling that purpose;
- Defines and regularly reviews BSC's investment strategy and evaluates investment recommendations against that strategy and its eligibility criteria;
- Monitors the amount of funds invested in any given period;
- Takes full responsibility for investment decisions and monitors the performance of the BSC portfolio against the investment policy and strategy;
- Owns and reviews the investment risk strategy for BSC including asset allocation and impact;

- Reports to the Board on the performance of the portfolio and escalate any issues, where relevant to the Board.

In carrying out its role and performing the functions and responsibilities described above, the Investment Committee shall act in accordance with the direction and requirements that may from time to time be laid down by the Board. Formal responsibilities are described in the Investment Committee Terms of Reference that are reviewed and approved annually by the BSC Board.

Regulated activities

Big Society Capital Limited is an independent financial institution authorised and regulated by the Financial Services Authority (No:568940) with a mission to grow the social investment market and so increase the quantity and diversity of appropriate and affordable capital available to the social sector. BSC will invest in and support social investment finance intermediaries who in turn provide finance and support to frontline social sector organisations. BSC will not invest directly in frontline social sector organisations and will not make grants. It will also not take deposits or offer personal accounts.

Investment business

BSC will make long-term investments as principal, but it may also engage in underwriting activities where this supports the development of the social investment market and so the broader achievement of BSC's social mission. BSC needs flexibility in how it deploys its capital and so it may invest in and use funds or special purpose vehicles from time to time. Consequently BSC is authorised to manage investments and operate unregulated collective investment schemes.

Under its investment management strategy BSC will invest primarily in unlisted shares and unlisted bonds, with the risks associated with potential difficulties in realising unlisted investments, the degree of regulation that unlisted companies are subject to, the lack of infrastructure and the difficulty in valuing investments in smaller companies.

BSC will utilise a full range of financial instruments, not just providing loans, but also taking equity stakes as well as using quasi-equity and bond instruments. It may also act as a co-investor, underwriter or guarantor of deals, taking on varying degrees of risk. As a co-investor BSC may: invest alongside other investors (match funding) to send a signal to the market; act as a cornerstone investor (first in) to draw in other investors; act as a capstone investor (last in) to ensure a deal goes ahead where there are insufficient investors to achieve the level of finance needed; and take a differentiated (e.g. lower interest rates) or subordinated risk (e.g. junior debt, deferred shareholdings) to give other investors more confidence of a financial return should the investment underperform.

Scope of FSA permission

BSC is a full scope investment firm with a based capital requirement of €730,000. Despite being a full scope firm, BSC will invest predominantly for the longer-term and its principal dealing activities will be limited to underwriting and wholesale investment into SIFIs that are generally unlisted organisations. Therefore, as its core business, BSC will be investing in the following types of instruments:

- unlisted shares and occasionally shares listed on AIM, PLUS Markets or other offshore exchanges;
- unlisted private equity funds;
- unlisted bonds;
- cash deposits, structured notes and sub participation loans.

BSC will adopt the standardised approaches to credit and market risk and the basic indicator approach to operational risk.

Under FSA Part IV Permission BSC is authorised to carry out the following regulated activities:

- Advising on investments (excluding pension transfers/opt-outs);
- Dealing in investments as principal;
- Arranging (bringing about) deals in investments;
- Making arrangements with a view to transactions in investments;
- Arranging safeguarding and administration of assets;
- Managing investments; and
- Agreeing to carry on a regulated activity.

BSC will perform its regulatory activities in respect of the following specified instruments:

- Share;
- Debenture;
- Government and public securities;
- Warrant;
- Certificates representing certain securities;
- Unit;
- Rights to or interests in investments (security); and
- Rights to or interests in investments (contractually based investments).

Annex A: Key areas of investment activity

1. Capitalisation and balance sheet growth

Market failure

SIFIs lack sufficient capital to on-lend to the frontline social sector resulting in a finance gap at the frontline. This is partly because SIFIs are undercapitalised and lack scale. Currently there are no sources of the equity capital that is required to strengthen and grow SIFI balance sheets in order to address this issue. Injections of core equity capital will result in stronger, larger SIFIs who are able to provide a reliable predictable flow of capital to frontline organisations.

Evidence of market failure

- The SIFI sector is still small with around 89 organisations and investments of only £165m in 2010/11, while the private investment market supplies the frontline social sector with £0.9bn-£1.7bn pa less investment than the it needs to be efficient[42] ;
- Individual SIFIs do not have sufficient scale to provide the higher risk equity finance that the social sector needs. Six SIFIs accounted for 90% of total social investments by value in 2010/11; and
- SIFIs are only 1% capitalised with equity, limiting their ability to expand their balance sheet and take riskier investments.

BSC role

- Equity investments into existing and new SIFIs to grow and strengthen their balance sheets, giving them more capital to on-lend;
- Helping to grow the number and size of equity investments in the social investment market by acting as a lead or cornerstone investor in equity placements to give confidence to other investors;
- Undertaking detailed due diligence on investments on behalf of other investors;
- Offering underwriting support to reduce the uncertainty and perceived risk of investments;
- Making quality social impact reporting a condition of investment to increase transparency of returns and help simulate investor interest; and
- Working jointly with SIFIs and champions in the SRI sector to create investment products that fit SRI and mainstream requirements and contain opportunities for social investment.

Investment services

- Dealing in investments as principal;
- Advising on investments;
- Making arrangements with a view to transactions in investments; and
- Agreeing to carry on a regulated activity.

Impact

BSC will invest into existing and new SIFI balance sheets so that the SIFIs are able to increase the amount of investment they make, as well as types of investment, in the frontline social sector organisations. In the cases of regulated social banks for example, each £1 of additional equity will allow them to raise deposits and leverage their balance sheet by a minimum of £7. For non-regulated lenders, BSC will use its investments to attract greater external capital to the sector by increasing investor confidence and interest. This will enable SIFIS to develop new products to leverage new mainstream investment.

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[42] Based on Cabinet Office regression analysis of the Small Business Survey (2010) which finds that, all things being equal, the private investment market supplies the frontline social sector with £0.9-1.7bn pa less than the private sector. Note that this should be considered a conservative estimate because the social additionality of the frontline social sector implies that a socially optimal level of investment should be greater than the private sector.

2. Risk and working capital

Market failure
SIFIs operate a particularly high risk business model due to their complex structures, limited or no security and the bespoke, lengthy and expensive transaction process necessary to meet the needs of the frontline social sector. Investments are generally small in number and size and often only offer longer terms returns. This means that SIFIs have a particularly significant need for risk and working capital to sustain them through funding and payment cycles which are often choppy, long and lacking security.

Evidence of market failure

- SIFIs need greater risk capital to offset their longer, riskier investment cycle. Recent research (2011) found that the biggest constraint to increasing the amount of money invested in frontline social sector organisations is the time taken to perform due diligence and to provide on-going investment support. This is because SIFIs need to provide bespoke investments tailored to the frontline need and this limits the amount of investment SIFIs are able to offer;
- There are very few SIFIs with the necessary expertise and resources to develop, pilot and market new investment products offering risk capital to the social sector; and
- The bespoke nature of the financing needs of the social sector results in high up-front cost, high transaction costs and high fund-management costs.

BSC role

- Acting as a lead or cornerstone investor in new and innovative products to give confidence to other investors;
- Investing in and providing underwriting facilities to support the development of innovative financial products or funds that target the need for risk and working capital into the social sector;
- Providing underwriting, or subordinated debt facilities to mitigate the risk of social investment and so encourage others to invest;
- Working with other investors to ensure that SIFIs have access to the entire package of capital they require to develop, pilot and market new products; and
- Making quality social impact reporting a condition of investment to develop consistency and credibility and provide investors with information and confidence to invest.

Investment services

- Dealing in investments as principal;
- Arranging (bringing about deals in investments);
- Making arrangements with a view to transactions in investments;
- Advising on investments; and
- Agreeing to carry on a regulated activity.

Impact
With access to appropriate and affordable risk and working capital SIFIs will be able to develop, pilot and market more innovative products leveraging in additional investment and providing the social sector with access to the appropriate and affordable risk and working capital that it needs to grow and develop innovative solutions to social problems.

3. Sustainability and operational growth

Market failure

While many SIFIs provide affordable specialist lending to the frontline social sector, they often do so with an operating deficit which is invariably financed by grants. This operating deficit limits the ability of SIFIs to lend to social sector organisations at affordable rates and limits growth at both the SIFI and the frontline level.

Evidence of market failure

- Research (2011) shows that the majority of SIFIs do not cover their operating costs through revenues alone and primarily fill their operating deficit with grants from the social and public sector;
- 54% of SIFI on-balance sheet funding and 76% of off-balance sheet funding in 2010/11 came from public sector sources. The reduction in public sector finance is likely to leave a funding gap for SIFIs; and
- Although SIFI balance sheets have grown consistently in the last 5 years, this has been from a low base and has been characterised by organic rather than strategic growth. With the growing demand for finance from the social sector and increasing interest in the sector among investors SIFIs need long-term patient capital to scale up and reduce their operating gap.

BSC role

- Provision of subordinated debt and patient loan capital to help bridge the operational funding gap in existing SIFIs as a result of the costs associated with the complexities and non-standard nature of social finance transactions;
- Undertaking detailed due diligence in the investment objectives and structure of proposed funds on behalf of other investors, increasing investor confidence so that they are able to lend to SIFIs at more affordable rates;
- Offering subordinated loan finance to ensure SIFIs achieve the scale necessary to ensure their cost/income ratio remains in balance, to provide diversification of revenue sources and to enable SIFIs to reach the necessary economies of scale to become more sustainable;
- Providing medium to long term capital to SIFIs with the dual aim of enabling them to develop more robust business models, and enabling them to expand the volume of affordable finance they can offer to the social sector; and
- Optional underwriting support to enable a fund to be launched at a sufficient scale to be efficient.

Investment services

- Dealing in investments as principal;
- Making arrangements with a view to transactions in investments;
- Advising on investments; and
- Agreeing to carry on a regulated activity.

Impact

By offering bridging investments BSC will allow SIFIs with an operating deficit to continue to channel funds to the frontline social sector in the short term while helping SIFIs become sustainable in the long run.

4. Market mechanisms and infrastructure

<table>
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Market failure

The social investment market will only function effectively if it has an infrastructure which encourages investment readiness; facilitates access to comparative data, pricing and information through investment and market data platforms; provides transparency on measurement of social impact; assists industry participants to network and share learning through trade associations; and provides for liquidity through secondary markets in social investment. This infrastructure is almost completely missing in the social investment market, a clear manifestation of the immature nature of the market.

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Evidence of market failure

- Research shows that the greatest barrier to SIFIs obtaining more capital is lack of knowledge about who to approach for funding which indicates that there is not yet sufficient or functioning infrastructure through which SIFIs can raise finance. There is currently no long-term risk capital available at scale to develop the necessary infrastructure in the social investment market; and
- Some investors prefer to reserve their limited investment capacity for investment programmes which are perceived to have a more direct social impact rather than invest in infrastructure development.

</td><td>

BSC role

- Conducting independent analysis of the nature and scale of the gaps in the market infrastructure to ensure that investment is targeted at the types of mechanisms that are most likely to support the growth of the market and ultimately the growth of the social sector;
- Convening groups of funders to create funding packages that meet the full spectrum of financing needs to build the infrastructure required;
- Providing underwriting support or all/most of the riskiest tranche of capital to facilitate the whole financing package which an infrastructure development project needs;
- Make the integration of quality social impact reporting an integral part of the infrastructure a condition of investment to ensure best practice; and
- Providing underwriting support to enable a fund/issues to be launched at a sufficient scale to be efficient.

Investment services

- Dealing in investments as principal;
- Arranging (bringing about deals in investments);
- Advising on investments; and
- Agreeing to carry on a regulated activity

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Impact

BSC will support the creation of a social investment market infrastructure by ensuring that there is sufficient long term risk capital available for infrastructure development and creating the confidence among other investors to invest in infrastructure development. This will drive down transaction costs and enable more capital to be provided to the frontline at a lower price.

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</table>

5. Advice, information and skills

<table>
<tr><td colspan="2">Market failure
There is a lack of skills and understanding in the social sector of the obligations, processes and expectations involved in taking on investment. While SIFIs do provide some investment readiness and other support to the social sector, the market for such professional advisory services is not well developed and not currently sustainable.</td></tr>
<tr><td>Evidence of market failure
• Recent research (2011) found that investment readiness is the service most demanded from SIFIs by frontline social sector organisations which indicates social sector specific investment readiness support is not sufficiently catered for by the wider private sector; and
• 19% of social enterprises say that lack of knowledge and expertise in terms of finance and investment is a real barrier to growth.</td><td>BSC role
• Conducting independent analysis of the nature and scale of the frontline social sector’s investment readiness needs;
• Collaborating with business schools and universities on investment readiness and advice programmes;
• Making understanding of best practice in social impact reporting an integral part of investment readiness programmes;
• Investing directly in SIFI providers of investment readiness and other relevant services; and
• Championing best practice in the sector to build capacity in the market to provide investment readiness services, business support, skills development and advice to the social sector.</td></tr>
<tr><td colspan="2">Impact
Social sector organisations have access to appropriate and affordable support and advice to develop their capacity to take on and manage investment.</td></tr>
</table>

Annex B: Displacement policy

To ensure Dormant Accounts money is used in the most effective and efficient way, and to avoid unduly distorting functioning markets, all of BSC investments must be additional and must not displace existing capital. In practice this means that, for every investment it makes, BSC will need to ensure that the SIFI (or fund) BSC is investing in as well as the frontline social sector organisations that the SIFIs/funds are on-lending to are unable to access funding elsewhere.

BSC will require potential investee SIFIs to show clearly that they cannot obtain the investment from elsewhere and that the frontline social sector organisations they invest in (or will be investing in) cannot obtain investment from elsewhere. This might be evidenced in a straightforward manner. In most cases, however, this will not be possible because no market exists for most asset classes. The onus will be placed on the SIFI to justify to BSC why they cannot raise finance elsewhere and demonstrate that they will not be investing in frontline social sector organisations that are able to raise finance elsewhere. Understanding the SIFIs position and their policy and process around this point with regard to frontline organisations will form a key part of BSC's due diligence. Given that BSC does not want to perversely incentivise organisations to be rejected from mainstream finance, each application from a SIFI will be assessed by BSC to determine whether it could obtain capital from elsewhere and whether the frontline organisations it intends to invest in could obtain capital from elsewhere.

In assessing each application, BSC will take into account the extent to which each investment proposition is characterised by the following:

- The likely liquidity of the investment at both the intermediary and frontline level: a key reason for SIFIs and frontline social sector organisations failing to obtain finance is the illiquid nature of their investment proposition and their portfolios;
- Path to investment realisation: given the lack of other investors in this sector and the small scale of the social investment market, it is likely that there will not be a clear idea of how investment capital will likely be realised (refinanced and returned).This presents a significant barrier to most providers of finance;
- Business plan/ business model of the SIFI and the frontline social sector organisations they are investing in: mainstream financial institutions are less likely to fund irregular business models which they are less familiar with;
- Longevity of capital required: to efficiently build the social market in the UK, SIFIs and frontline social sector organisations need access to long term capital. This presents a further risk factor and challenge to mainstream finance;
- Expected risk adjusted returns of the SIFI and the frontline social sector organisations they are investing in: mainstream financial institutions do not lend below their cost of capital and in almost all cases this factors in a generous profit margin. Many social sector organisations (SIFIs and frontline social sector organisations) operate with very thin profit margins and as such mainstream rates are unviable;

- Social impact of the SIFIs and the frontline organisations they are investing in: mainstream financial institutions do not generally take this into consideration and the risk factors listed above combine to represent high financial risk. If the social impact is not taken into consideration, the risk involved appears too great for the financial returns alone;
- Number of comparable projects active in the UK: if there are no comparable projects it is much harder to quantify the underlying risk at the level of both the SIFI and the frontline social sector organisation which makes it hard to price investments accurately;
- Percentage of profit reinvested in social purposes: social sector organisations often reinvest their profits in their social mission or the community rather than distributing it to shareholders or expanding their business. This reduces their expected long term profitability and thus reduces their attractiveness to mainstream investors;
- Operating cost model: social sector organisations often operate business models which sacrifice cost minimisation in favour of social impact, making them less attractive to mainstream investors[43];
- Product model: social sector organisations often sacrifice profit maximisation by bringing products to unprofitable markets for social, rather than financial benefit[44]. This makes them less attractive to mainstream investors;
- Track record of the investment team of the SIFIs, particularly delivering social returns which will not be recognised or understood by mainstream investors.

[43] A social sector organisation could be employing less productive ex-offenders in order to reduce re-offending, for example.
[44] A company may sell used sofas at cost price exclusively to very low income groups rather than targeting the whole market which would drive up their potential demand and increase the price they could sell at, but would not maximise social impact.

Annex C: Equity valuation policy

Given that there is very little equity investment currently taking place in the social investment market, equity valuation can be difficult. BSC has strong investment processes which will ensure that the correct equity valuation methodology is selected, monitored and audited for each investment. In this context, BSC will take broadly three approaches to valuing equity investments (although, given the emerging state of the market, it would be impossible to apply uniform valuation methods across the board and BSC will always need to retain the flexibility to apply the most appropriate valuation tool to the particular situation).

For *SIFIs with a banking licence*, BSC will look at book value to value equity. Book value is a very reliable indicator of current value as banks have market to market accounting. If BSC judges that a bank could grow its book value every year BSC would multiple its book value by a factor reflecting this rate of growth.

Where *SIFIs do not have a banking licence*, book value is a less appropriate methodology for valuing equity because non-banking SIFIs may either use depreciation policies that render asset value an unreliable measure of equity value or SIFIs may be asset-light companies. For non-banking SIFIs forecast cash flows tend to be more predictable because they do not have a licence to leverage and so, in most cases, BSC will use multiples of earnings in order to value them. BSC will use multiples that reflect a fair and appropriate absolute value for each equity investment and will use multiples that reflect the inherent risk in an equity investment over, for example, a debt investment. BSC will think of earnings stream as a potential dividend payment, in a similar way that a debt bearing instrument yields a coupon payment.

For *new start-up SIFIs* or SIFIs that are making a loss but have a clear path to profitability, multiples of cash flow can only be applied to the outer years of a model, and would have to be discounted back in order to give an idea of equity valuation. A more detailed methodology to use in these instances is a Discounted Cash Flow (DCF) model.