

The Big Society Bank ("BSB") Outline Proposal

May 2011

Introduction

The BSB 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 sources of finance to help increase their social impact. The BSB will also act as social investment champion with the public, stakeholders and investors.

The policy framework for the BSB is set out in HM Government's February 2011 document "Growing the Social Investment Market: A vision and strategy" and this proposal is presented in accordance with that document.

We have consulted with leading organisations from the social sector and have also discussed responses that the Cabinet Office received following the Ministerial announcement of 21 March which invited comments on the development of the proposal.

We recommend that the parent company of the Group be named "The Big Society Trust", with an operating company as its subsidiary and a separate entity capable of receiving charitable donations to support the Group's mission. The BSB Group is described in this document as the "BSB".

Section 1 below sets out the proposed Mission, Objectives and Operating Principles of the BSB. Section 2 sets out how it would fulfil its twin objectives of acting as a wholesale investor as well as a driver for development of the sector. Section 3 outlines its proposed legal structure, governance, regulatory framework and accounting policies. Section 4 summarises its proposed management team, organisation structure and the policies and procedures it will adopt. Section 5 summarises its assumptions regarding capital structure, commentary on financial outcomes and proposed interim arrangements prior to State Aid clearance from the EU.

Section 1: Mission, Objectives and Operating Principles

The social sector, through its charitable investors and social organisations, already plays a significant role in tackling social issues. Its capacity to achieve maximum social impact is, however, severely constrained by a number of factors and in particular by its inability to access investment capital and its heavy dependence on donor finance. Removal of these constraints will enhance its capacity to deal effectively with important social issues such as:

- Achieving better attendance at schools;
- Supporting disabled people and other disadvantaged groups into the workplace;
- Reducing homelessness and boosting affordable housing;
- Reducing re-offending and promoting better alternatives to custody, particularly for younger people;
- Delivering better outcomes for vulnerable children;
- Delivering better prospects for chaotic families;
- Providing better access to drug and alcohol rehabilitation programmes;
- Improving healthcare in the community and reducing the need for hospital admissions;
- Boosting preventative action in order to reduce the strain on the health system from chronic diseases;
- Improving access to and control over finance for individuals excluded from mainstream banking;
- Achieving effective mixed use of community assets, thereby enhancing community cohesion; and
- Encouraging entrepreneurship to stimulate employment in under-invested areas.

The BSB Mission and Objectives

The BSB's mission will be to boost significantly the ability of the social sector to deal with social issues. It will do this by supporting the development of a social investment market which is more effective in attracting capital to achieve social impact.

The BSB's objectives will be to help:

- Develop intermediaries to operate effectively between sources of capital and those in need, be they social ventures or individuals, and so to augment the flow of investment and skills to the social sector;
- Connect social entrepreneurs to the capital markets so that they can access growth capital;
- Support financial innovation so that social organisations can be rewarded for their performance in delivering valued social outcomes;
- Develop the investor market through the creation of social investment vehicles that support high growth ventures, as well as smaller local organisations; and
- Support the development of community-led, social enterprise initiatives to improve opportunities for young people.

Through its capacity to invest debt and equity, to co-invest with other investors and occasionally to protect investors against the risk of loss, the BSB will have the ability to accelerate the establishment of diversified social purpose funds, such as venture funds, property funds, community asset funds, microfinance funds and funds that invest in social impact bonds. Such funds will provide social and management expertise as well as investment capital to social ventures capable of expanding to deliver significant social impact as well as a financial return.

The BSB will spur development of the market infrastructure necessary to boost social entrepreneurship and investment by supporting the growth of existing and new intermediaries that can:

- Develop robust investment propositions with clearly articulated social and financial risks and returns;
- Provide reliable independent research on social investment opportunities and organisations; and
- Create effective financial markets to trade and issue securities.

An effective social investment market is crucial for social entrepreneurs whether they seek to scale existing organisations, to create new social ventures or to migrate social activities out of the public sector. Making capital, expertise and management skills available to social entrepreneurs, as they have become available to business entrepreneurs, is crucial to sustaining a powerful wave of social entrepreneurship.

Operating Principles

We support the adoption of the four operating principles for the BSB set out in HM Government's February 2011 document "Growing the Social Investment Market: A vision and strategy". These are: Independence from government, Acting as a wholesaler, Transparency and Self-sufficiency.

Independence

We have proposed a legal and governance structure (Section 3) which we believe meets the needs of the BSB. The parent company limited by guarantee (the "CLG") would be responsible for maintaining over time adherence to the founding mission of the BSB. A private subsidiary company limited by shares (the "CLS") would be the operating vehicle of the BSB. The CLS would be independent of government but accountable to the CLG Board which would include a government representative.

Transparency

The CLS would be managed according to the principles of corporate governance set out in the Financial Reporting Council Code. The BSB would publish detailed annual accounts including details of the financial and social impact of its investments and would act as a focal point for the sharing of information and expertise across the social investment sector.

Wholesaler

Our proposed investment policy assumes that the CLS would invest across a spectrum of equity, quasi equity and debt in intermediaries. Under the legislation, which will require clarification in due course, it cannot invest directly in individual social service providers. In its capacity building role, the CLS can invest directly if need be in new social organisations that add to the social investment market's infrastructure, such as impact measurement organisations, securities exchange platforms and investment portals. We propose that the BSB should initially be managed as an unlevered institution which would not seek a banking licence.

Self Sufficiency

The BSB would, in time, cover its operating costs from the return on its investments. Our financial modelling suggests that this self-sufficiency could be achieved after an initial period of five years or so during which there would be some attrition of the BSB's capital.

Section 2: The BSB as wholesale investor and social investment champion

The BSB will have two key roles, as a wholesale investor and as a social investment champion.

Wholesale investor

The success of the BSB in achieving its mission will be driven largely by the deployment of its investment assets. It will provide long-term capital to support the growth of intermediaries and the infrastructure of an effective social investment market. Much of its investment portfolio will comprise assets whose returns are uncertain and whose liquidity is poor. In many respects, the closest parallel is a venture capital fund. The BSB will need to set an appropriate level of investment risk to achieve its social mission, while making sufficient financial returns to cover its operating costs and investment losses.

In estimating the financial returns of the BSB, we have drawn on the experience of the small number of financial intermediaries currently active in the sector. We have also taken into account investment proposals made to NESTA's Big Society Finance Fund.

The BSB will not be a grant-making organisation. Funds deployed will therefore seek both financial and social returns. It is expected, however, that it will often partner with grant-making institutions such as the Big Lottery Fund (BLF), NESTA and foundations that share the BSB's objectives.

We are mindful of the need for a wide regional spread of investments across the UK and this will be a factor in decision-making.

In modelling the financial performance of the BSB, we have split the demand for capital into five categories:

1. Co-investment of equity or debt in social-purpose funds managed by intermediaries;
2. Provision of subordinated capital to social investment intermediaries and funds;
3. Investment in existing intermediaries;

4. Investment in infrastructure organisations; and
5. Investment and underwriting for innovative financial products.

1. Co-investments in funds

The BSB will help fund-raising by acting, where appropriate, as a cornerstone investor in funds. Returns will vary widely from double digit to low single digit or even negative returns. Some venture capital-oriented funds may take five years or more to start returning capital and some socially-oriented funds may have little chance of third party exit and may achieve a pay-back only over a long time through participating securities entitled to receive a share of revenues or profits.

2. Subordinated capital

As part of the financing support it provides, the BSB will extend affordable loan finance, often in conjunction with equity or quasi-equity investment.

3. Investment in existing intermediaries

The BSB will strengthen the balance sheets of intermediaries and help to accelerate the growth of social organisations. Equity investments are likely to be held for the long term with limited running yield.

4. Investment in infrastructure organisations

It is critical if the BSB is to achieve its mission that it invests in the infrastructure of the sector. This requires the investment of long term capital. Given the risks and long holding periods associated with such investments, they are likely to be structured as redeemable equity whose returns are dependent on revenues or profits.

5. Investment and underwriting for innovative financial products.

This category includes innovative financing products as well as commitments that the BSB might make by way of guarantees or underwriting.

As social impact bonds and other forms of outcomes-linked finance establish a track record of correlated social and financial returns, these types of investment are likely to enjoy strong growth.

To the extent that the BSB insures against first loss or takes underwriting risk, these exposures will be limited to a small proportion of its assets.

Social investment champion

The BSB will aim to create a market environment in which mainstream investors can find easy access to social investment vehicles and social organisations can attract capital from varied sources. Achieving

these objectives will necessitate accelerated product innovation, process standardisation and a common understanding of best practice.

The long term success of the BSB will be measured by its multiplier effect, both financially and in terms of social impact. Financially, this will be measured by the amount of capital it succeeds in attracting to social investment as well as the growth and sustainability of the social investment market. In terms of social impact, it will be measured by the growth of significant intermediaries as well as growth in the number and scale of social organisations. Over the next two decades, its success will be reflected in the establishment of social investment as an accepted asset class.

The BSB will focus its efforts on the following areas:

Information sharing and networking

The BSB will seek to become a hub, connecting social enterprises with capital and support. It will do this by:

- Providing web site access to industry data and market research;
- Arranging events to promote social investment and best practice;
- Connecting, via its web platform, enquiries from front-line organisations seeking capital to a range of intermediaries; and
- Providing relevant information to the sector on government incentives and policies.

Research

The BSB will communicate research on such areas as:

- Best practice and replicable models;
- Developments in the social investment marketplace;
- Guides to new products and initiatives;
- Analysis of financial risks and returns across social investments;
- Social impact measurement; and
- Policy initiatives outside the UK and their relevance for the domestic market.

Capacity Building

The BSB will boost market capacity. It will do this by:

- Encouraging the development of robust intermediaries able to promote best practice among front-line organisations;
- Working with grant-makers to support initiatives directed at investment readiness;
- Facilitating access by social ventures to sources of investment capital; and
- Supporting the creation of a secondary market in social investment securities.

Promoting best practice

The BSB's investment policies will typically require provision of finance to be linked with measurable social impact. It will also seek to ensure that best practice in areas such as governance, finance, risk control, social performance metrics and the use of innovative financial instruments is disseminated across the social sector. Specifically the BSB will:

- Promote transparency of intermediaries in the utilisation of funds provided by the BSB;
- Publish in its Annual Report details of the social and financial performance of its investments;
- Promote innovative products such as Social Impact Bonds that link investment returns to social outcomes; and
- Promote initiatives that help communities to raise local capital for local provision of services.

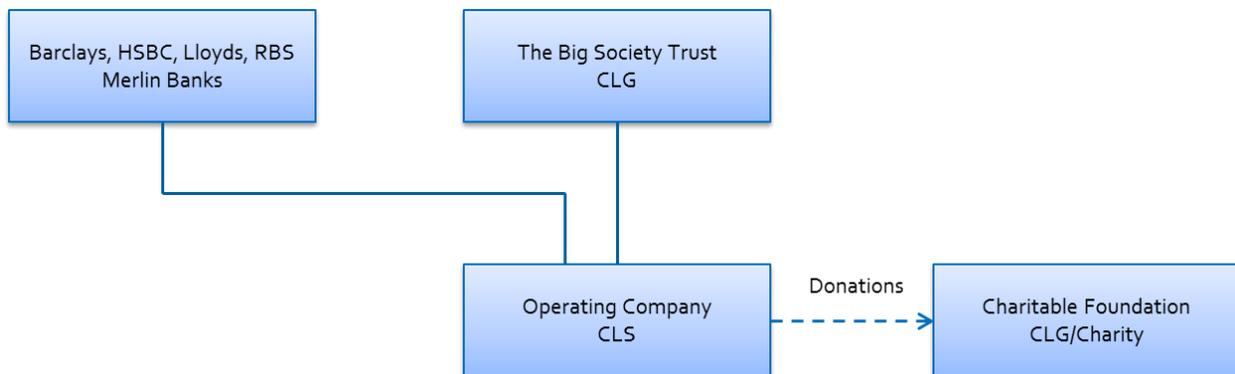
Market development

The BSB will provide advice, in partnership with others where appropriate, on the social sector and on incentives to stimulate market development. It will do this through:

- Advice to government on the needs of the social investment market, on relevant incentives and on opportunities to open public services to social ventures;
- Appropriate support and advice to regulators such as the FSA and Charity Commission on measures to develop the social investment market, reduce the cost of raising finance and increase broader participation by the investment community; and
- Partnership with banks to promote increased commitment to the social investment market in new product development, distribution, research, lending and investment.

Section 3: Legal Structure, Governance, Regulation and Accounting

We propose the structure set out below which, in our view, responds best to the legal and governance requirements pertaining to the BSB.



The BSB’s operating entity would be a private UK company limited by shares (the “CLS”). The principal advantage of a company limited by shares versus a company limited by guarantee is that it permits new equity investment and retains maximum flexibility to respond to possible needs for future capital. The mission and objectives of the CLS would be enshrined in its Memorandum and Articles of Association (“constitutional documents”).

There is no advantage in seeking PLC status as there is no present intention to offer shares in the CLS to the public at large.

The ordinary shares of the CLS would be held by a private company limited by guarantee (the “CLG”).

The BSB’s structure includes a charitable foundation whose purpose would be to receive charitable donations aimed at supporting the BSB’s mission, for example, by way of grants to venture philanthropy organisations whose purpose is to increase the investment readiness of strategic social organisations.

The £200m investment to be made by the Merlin banks (Barclays, HSBC, Lloyds and RBS) remains to be finalised. We commend the principle that the Merlin banks should supply long term permanent capital. We recommend that the Merlin banks’ capital is senior to the unclaimed assets in the event of liquidation.

CLG Structure

The CLG structure would comprise a Board of eight Directors including the Chair of the CLS. The CEO of the CLS would have the right of attendance at CLG Board meetings in an observer capacity . The CLS Chair and CEO would be excused from CLG Board discussions where a conflict of interest occurs. The CLG Board’s overall responsibility is to ensure that the CLS remains true to its social mission and it would have specific powers in this regard to remove the CLS Board if it felt this to be necessary.

The CLG Board would have the following composition:

Two leaders of leading social sector organisations
Two leaders of leading national organisations
Two social sector nominees
One representative selected by Government
The Chair of the CLS

The CLG Board would select as Chair the most suitable candidate for the position. However, neither the Government representative nor the CLS representative would be eligible.

The CLG would meet once or twice a year. It would have access to CLS Board papers and reports. It would have specific powers:

- To remove the Directors of the CLS if it ceases to be managed in line with its constitutional documents;
- To approve any proposed changes to the CLS’s stated Mission and Objectives or to its constitutional documents; and
- To approve any changes to the stated remuneration policy or appointments policy of the CLS.

The CLS would provide funding as well as secretarial and ancillary support to the CLG. The Directors of the CLG would be unpaid.

CLS Structure

The Board

The role of the Board would be to support the efforts of the executive team and to hold it accountable for its performance according to the remit set by the constitutional documents of the CLS and CLG.

The Board would comprise a balance of skills and experience. Roughly half of the Board's members would have financial or business backgrounds and half would bring deep knowledge of the social sector. Several Board members would have overlapping skills in both social issues and finance.

The Board would initially comprise 9 - 10 people of whom 7 - 8 would be non-executive including a Chair with a financial background. The Chair would be elected by the Board. The roles of Chair and CEO would be separate and the CEO and either the COO or the CFO of the CLS would be members of the Board.

The CLS would have regard to the Main Principles laid down by the FRC Code, and amended from time-to-time, as if the CLS were a public limited company.

The Articles would give the Directors the power to make donations to the BSB's Foundation. Such donations could become appropriate if regular profits were made by the CLS.

The Board will initially meet monthly. Once the CLS has become fully operational, the Board would probably meet four to six times a year.

Directors would generally serve for terms of three years and would be submitted for re-election on a staggered basis. No non-executive director including the Chair could serve for a period greater than nine years. The CLS would need to inform the CLG before co-opting an individual to its Board if an appointment is contemplated prior to formal nomination.

Candidates for Board membership would be appointed following a formal process led by a Nomination Committee of the Board to which the Board would appoint a combination of internal and external members. Candidates short-listed by the Nomination Committee would be interviewed and the final decision would rest with the Board, with due regard to the 50/50 balance of Board member expertise in social and financial matters and to the expertise required for a sophisticated financial institution operating in the social sector.

The company would arrange appropriate legal indemnity cover for its Directors.

The Advisory Board

The object of this group is to bring prominent practitioners from the social, financial and business sectors to advise the CEO and help drive speedier implementation of the BSB's programme. It would comprise up to 15 people. Members would be appointed by the Board on the recommendation of the CEO to serve for a period of two years at a time on a staggered basis. The Advisory Board would meet twice a year.

The Investment Committee

This group would comprise executives of the CLS. Directors of the CLS could serve on the Investment Committee subject to exclusion from decisions where conflicts might arise.

The Remuneration Committee

The Remuneration Committee would be composed of non-executive directors of the CLS. It would set remuneration policy for CLS's senior management team. The committee would receive evidence on internal and external trends in remuneration and benefits, including commissioned reports and surveys where necessary.

The CLS Articles would enshrine the principles of its remuneration policy, with changes subject to the approval of the CLG Board.

The remuneration policy for the senior management of the CLS would be designed to attract talented individuals who are highly motivated by the BSB's social mission.

The remuneration policy would:

1. Adhere to the principle of benchmarking remuneration by reference to other significant social sector organisations;
2. Provide fair remuneration commensurate with individual responsibility and contribution, including the potential to reward junior and middle ranking staff for outstanding performance during a year; and
3. Have due regard to any relevant legal requirements, the provisions and recommendations in the UK Corporate Governance code and associated guidance.

Details of remuneration levels paid to the Directors and to the highest paid staff would be disclosed in the Annual Report as would any remuneration paid to non-executive directors.

Other committees of the CLS Board would include audit and risk committees.

Charitable Foundation

This entity would be incorporated by guarantee with charitable status. Its purpose is to receive donations and put charitable funds to work in direct support of the CLS's mission to develop powerful intermediaries and a thriving social sector, with a particular focus on investment readiness. It would not provide grants alongside CLS investments.

The foundation would receive philanthropic donations from third parties as well as such monies as the Board of the CLS decided to donate if profits were regularly generated in the CLS.

The Trustees would include some members of the CLS Board as well as external figures with relevant experience who share a strong commitment to the BSB's mission.

Regulation and Accounting Policies

The CLS will be regulated by the FSA. There is no current intention to become a bank or to seek a banking licence though this may become appropriate in the longer term.

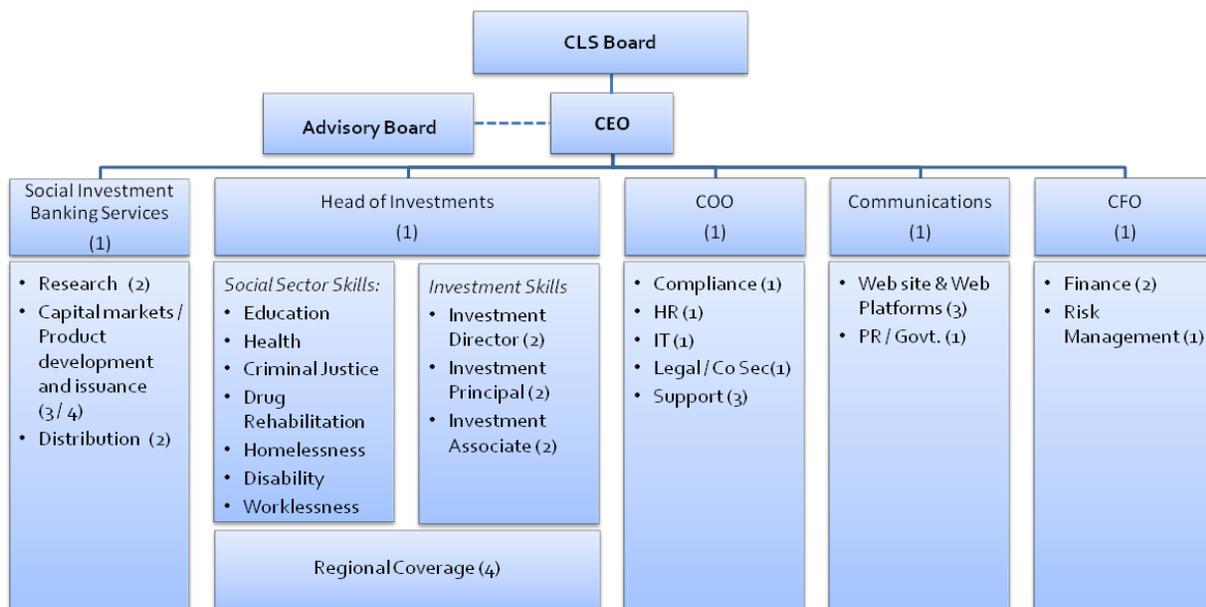
The CLS has a choice between adopting UK GAAP and IFRS.

The CLS would produce an Annual Report to the standards of a major listed UK public company incorporating its social and financial performance. Its accounts will be audited by a leading firm of auditors.

Section 4: Management and Organisation Structure, Policies and Procedures

Organisational structure

Set out below is an organisation chart for the CLS.



Management

The senior executive team would comprise the CEO, COO, CFO, Head of Investments, Head of Social Investment Banking Services and Head of Communications. Of this group, the CEO and another

executive director would be members of the Board. Other senior executives would include compliance and risk officers.

Once funding is available, the core team would be recruited to establish the CLS and to set in place a recruitment process to enlarge the team.

The CLS will wish to build up expertise within its team but it will use existing intermediaries where possible as a cost-effective alternative to employment. The CLS will also seek to attract talented individuals on secondment from institutions in the social, government, financial and business sectors as a way of retaining flexibility, reducing costs and spreading understanding of the social sector and social issues. Its recruitment policy will conform to best practice standards.

We have assumed an initial team of about 10 largely senior executives and that the team would grow to some 20-25 people reasonably shortly after the launch of the BSB, though with a cautious approach focused on recruiting team members with the appropriate skills.

Operating Costs

The CLS will in general use a combination of full time employees, part-time employees, secondees and consultants to maintain a lean management and organisational structure. The principal elements of operating cost will be people and premises, with significant spend likely to be incurred in areas such as product development, market research, communication and championing activities focused on the public, stakeholders and investors.

Policies and Procedures

The BSB will adopt standard policies and procedures for risk management.

The Investment Committee will be appointed by the Board on the recommendation of the CEO. The CLS will require regular reporting about the performance of its investments in funds and will share with the public on an annual basis information about the social impact and financial returns achieved.

The Investment Committee will undertake a portfolio review at least on a semi-annual basis and will adjust the values of each investment. The annual independent audit review would require a full discussion of fair value and impairment.

Compliance and risk management policies would include approvals of new investments and conflicts of interest.

Section 5: Capital Structure, Operating Costs, Financial Modelling, Interim Arrangements

Capital Structure

It is our understanding that the Minister for the Cabinet Office will instruct the BLF to transfer unclaimed assets to the CLS for no consideration.

We assume that monies from the Merlin banks will be paid to the CLS in exchange for non-assignable securities.

For purposes of modelling, we have assumed that the CLS would receive over a period of five years all of the English portion of the dormant accounts money (which has been estimated at around £400m for the whole of the UK) and that the Merlin banks' investment of £200m is received in stages over the first two years.

Operating costs

It is expected that the CLS will number about 40 people in total when fully operational. Staff costs are modelled as salaries plus social charges with no allowance for performance-based pay. Consultant costs assume that the CLS would receive advice on a range of issues.

Premises costs assume a location in London's outer West End.

Financial modelling and possible outcomes

We have modelled a range of allocations to the categories of investment outlined in Section 2 above. There is limited data on which to place reliance. Modelling assumptions are based on a balance between social investments which are likely to yield positive returns and social investments where returns are likely to be uncertain.

In our view, there will be some attrition of the initial capital over the first five years or so due to the gradual inflows of funds from unclaimed assets, the need to cover initial operating costs, the elevated weighted average risk of the portfolio and the time lag before returns are achieved. However, our modelling indicates that on the central assumptions adopted, the BSB will earn a return on its investments sufficient to cover its operating costs within five years or so after its launch.

In the longer term, once the CLS reaches self-sufficiency, it may be appropriate to leverage the institution moderately in order to increase the capital that can be deployed to increase social impact.

Interim Arrangements

It is assumed that an interim committee will be established by the Big Lottery Fund to make investments from dormant account monies during the period prior to State Aid approval. It has been assumed that any investments made would be transferred to the CLS at accounting fair value for no consideration once the CLS commences operations.

Glossary of Terms

Bond: normally the term is used to describe a debt security issued for a period of more than one year which pays a fixed or floating rate of interest with the principal repaid at maturity. For example, "gilts" or "gilt edged bonds" are pound sterling denominated UK government bonds.

NB. A "social impact bond" is not a "bond" in the traditional sense of the word.

Co-investment of equity or debt: BSB could make an equity investment in, or lend money to, a project or fund alongside and on the same terms as other private sector investors.

Debt: an obligation to pay money under an agreement. The cost of debt is the interest paid on the loan. In general, companies use debt in their financial structure because they are able to use the money they borrow to generate revenues that are much greater than the cost of the debt.

Equity or quasi-equity investment: equity investment means having ownership rights and sharing in the profits of a business. Some businesses do not have shares but it is possible to structure financial instruments that have similar features to equity in terms of participating in the upside if the business is successful in generating income and being an investment that can lose all its value if the business fails.

First loss: if an investment loses money it is possible to have different tiers of investors so that one set of investors accepts that it will lose the money it invested before any of the other investors lose any money. For example, BSB could take the first 20% loss on a loan portfolio. If the loan portfolio declines in value by 10% BSB would take all this loss and the other investors would be paid in full. If the loan portfolio declined in value by 30% BSB would take 20% of the loss but the other investors would share the remaining 10% loss between them.

Intermediaries: organisations that intermediate or help bring together bodies that need capital, and bodies that have capital and want to invest it. Intermediaries in the social investment market include funds, financial institutions or other organisations that arrange financing for end-user social organisations.

Liquidity: From an investor perspective, the liquidity of an investment or investment portfolio refers to the ability to transform that investment into cash quickly with little or no loss in value.

Redeemable equity: shares issued in a company where the company itself has a right or obligation to repurchase the shares at some time in the future on specific terms.

Social Impact Bond: A financial instrument also known as "pay for success" bond. Investors buy a bond to achieve a particular social outcome (such as helping to reduce reoffending by prisoners). The money raised by the bond issue is used to pay for programmes to help address the problem (such as, in the case of reoffending, mentoring and counselling, providing accommodation, providing help to find work or training on leaving prison, drug rehabilitation etc). The government (or local authority) agrees to pay the bondholders a return on their investment that reflects how successful the intervention has been and the cost savings achieved by government as a result (eg the need for fewer prisons). If the programmes are unsuccessful, the investor receives no payment.

Subordinated capital: a debt or equity investment in a business that, in the event of the business being liquidated, ranks junior to other investors. In other words, all senior or secured liabilities will be paid by the business prior to the subordinated claims.

Underwriting risk: BSB could agree to buy a financial instrument that was intended to be on-sold to end-investors. If the sale to other investors was unsuccessful BSB would have the risk that it owned the instrument.

Venture capital fund: venture capital is an approach to investment that involves making an equity investment in a start-up or small and growing business with the investor also actively providing management and strategic advice. A venture capital fund invests in a number of small businesses to spread its risk to make a more consistent return by having a portfolio of what are normally highly risky investments.

Wholesale investor: an investor which makes larger investments in funds or financial organisations (intermediaries) that will themselves invest smaller amounts in a number of frontline end-user social organisations.