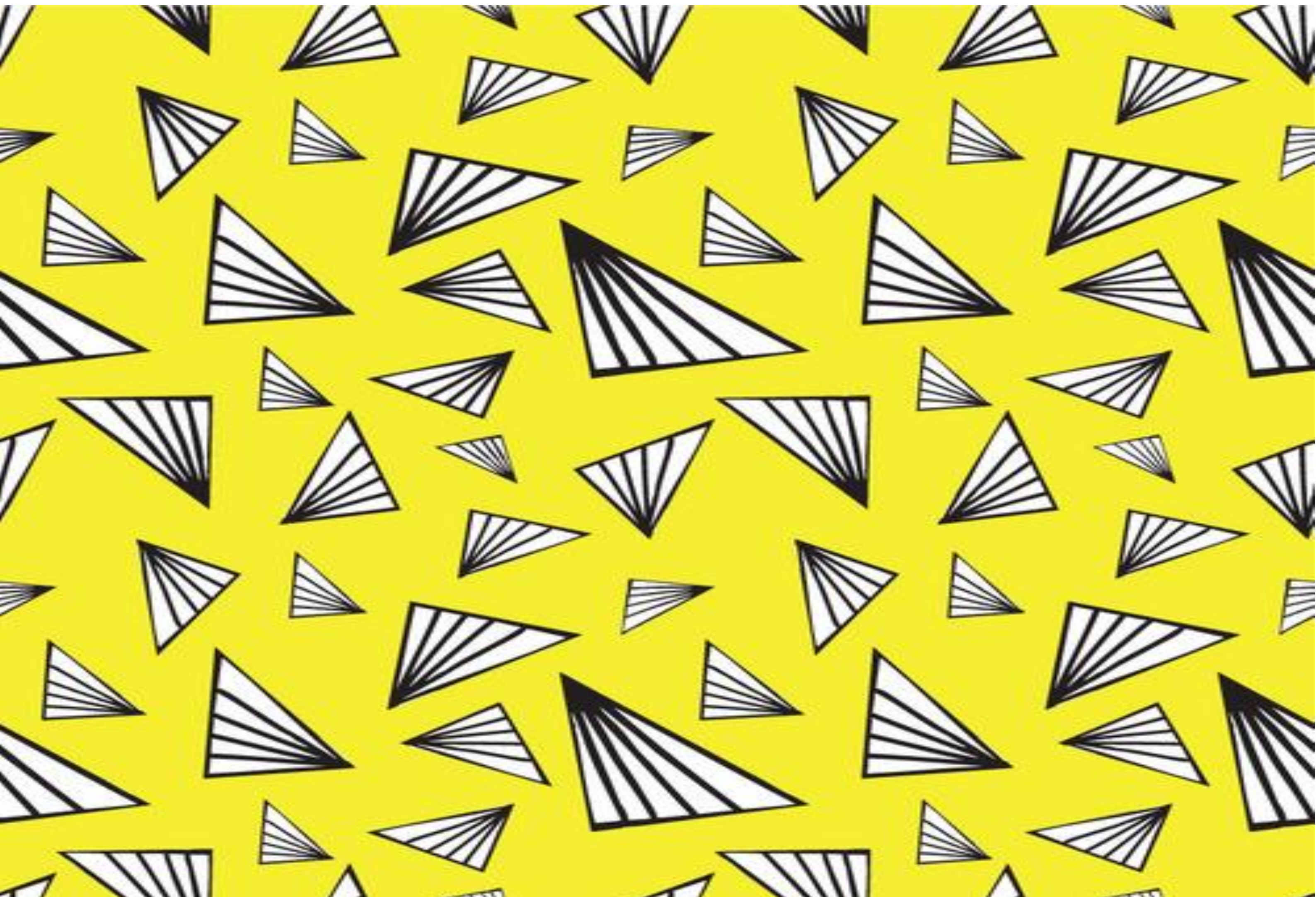
ANGELS IN THE ARCHITECTURE

Building the infrastructure of social investment

Dan Gregory, Common Capital

September 2013



ABOUT

In early 2013, the Big Lottery Fund and Big Society Capital came together, encouraged by John Kingston, to commission this research into the future of social investment, with particular regard to the infrastructure that supports the market. Big Society Capital has a mandate to support the development of market infrastructure and has already made commitments to invest in four initiatives aiming to link social investors to social entrepreneurs and social sector organisations. Similarly, the Big Lottery Fund has a mandate to play a catalytic role in developing the social investment market.

This report was written by Dan Gregory with guidance and support from John Kingston in a personal capacity. Dan works as an independent advisor under the banner of Common Capital (for more information, please see www.commoncapital.org.uk). He has worked for the Treasury and the Cabinet Office and has recently been working as Head of Policy for Social Enterprise UK. John has a portfolio of responsibilities, including a non-executive directorship of Big Society Capital. He was previously Founder Director of CAF Venturesome, after senior roles at Save the Children UK and the 3i Group.

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1. SUMMARY

The aim of this research has been to outline a vision for the social investment market and the 'infrastructure' required to deliver it, to take stock of the current state of the market and to make recommendations for the future.

This research draws on conventional economic theories. But it also recognises the limitations of our economic textbooks and how actors in the social sector operate beyond narrow self-interest. It has been informed by two roundtable meetings, extensive desk-based research and a number of interviews with experts, practitioners and observers who have provided a range of perspectives from within and beyond the market. (For a list of contributors, please see Annex A.)

This report explores the evolution, characteristics and infrastructure of other markets. It draws lessons which may be instructive for the development of social investment, acknowledging the time it takes for an emerging market to reach maturity, the infrastructure which supports market development and the role of subsidy, the significance of governance, ownership and business models, tensions between social and financial value, the role of tax incentives, the need for honesty about return expectations and the importance of cultural and political factors.

This report then explores the landscape of what is meant by social investment and how the market might be segmented. It subsequently explores the characteristics of the current market, with uncertain demand, concentrated supply, difficult intermediation, imperfect information, troubling cultural factors and a significant role for government.

It subsequently attempts to sketch out a number of tensions in the marketplace, including diverse perspectives, ideology and politics, views on the pace of change, the nature of investors and the underlying business models of the social sector. It then goes beyond these towards describing more common ground and what a more effective market or 'better place' might look like.

A first table sets out the characteristics of a better market, and suggests potential supporting infrastructure, including brokers and advisors, product developers, data and information providers, research houses, product reviewers, mechanisms for collaboration, a trade body, education, skills and training providers, rating agencies, platforms and exchanges.

A second table takes stock of the current market infrastructure, which is relatively limited compared to mature markets, sometimes perceived as murky in terms of ownership and not yet sustainable. Priorities for market development are identified as data and information provision, product development, some brokerage and advisory services and mechanisms for collaborating. This leads to a number of targeted recommendations. In particular, that:

- advocates of social investment should ensure that the rhetoric around the market more adequately reflects the stage of development of the market;
- the Big Lottery Fund and Big Society Capital should consider how they support priorities for market infrastructure through 'concessionary' capital or a voucher model, while staying mindful of directing resources away from the frontlines;
- potential funders' conditions encourage the most appropriate ownership, governance, transparency and accountability standards; support a diversity of organisations, leverage other resources; and encourage collaboration;
- emerging infrastructure bodies should carefully consider governance, ownership, transparency and accountability standards, and provide greater clarity on whether they seek to support access to finance for the social sector, on one hand, or social or impact investment on the other.

2. CHARACTERISTICS AND INFRASTRUCTURE OF OTHER MARKETS

MARKET INFRASTRUCTURE

What is meant by market infrastructure? Describing the support structures for the voluntary sector, Justin Davis Smith of NCVO points out how "the rather drab word 'infrastructure' conjures up images of motorways and pylons"[1] but how he believes that "infrastructure is the difference between a good sector and a great one."

In the economy more widely, infrastructure provides "the foundations on which the economy is built, encompassing long-term fixed capital assets that enable and support economic activity in fields such as energy, transport, water, waste and communications, infrastructure has undeniable importance in driving growth, output and economic and social capital[2]".

In financial markets more specifically, "infrastructure has often been compared to the plumbing… vital, but unglamorous and forgotten until something goes wrong.[3]" The Oxford Finance Group suggest that infrastructure can be defined as institutions which "provide the basic framework that supports or underlies a system… is essential to support commerce, economic activity and development… operates a network which facilitates the delivery of goods and services.[4]" Financial Market Infrastructure (FMI) has a very specific meaning for a "multilateral system among participating institutions, which facilitate the clearing, settlement, and recording of monetary and other financial transactions.[5]"

In this report then, infrastructure is interpreted as the architecture and actors which support a financial market's operation but which do not include demand for, or supply of, capital in themselves.

EXAMPLES OF MARKET INFRASTRUCTURE

Infrastructure in financial markets can include, for example:

- data and information providers;
- brokers and advisors;
- trade bodies;
- product developers and reviewers;
- research houses;
- education, skills and training providers; and
- platforms and exchanges.

This chapter explores some of the characteristics and infrastructure of a number of financial markets. It does not pretend to be a rigorous or systematic analysis of each of these markets but simply highlights particular features of each which may offer lessons for the evolution of social investment.

MAINSTREAM FINANCIAL MARKETS

Financial markets are of course, huge, diverse and stretch across the globe, with the derivatives market alone, for example, worth at least 500 trillion dollars, or more than a dozen times global GDP. Those demanding and supplying financial products are diverse and numerous, many products are highly liquid, with secondary markets, real time or daily pricing and highly sophisticated systems and processes of exchange.

[1] http://blogs.ncvo.org.uk/2013/07/03/six-challenges-for-infrastructure-organisations/
[2] http://www.respublica.org.uk/documents/utl_Financing%20for%20Growth_A%20new%20model%20to%20unlock%20infrastructure%20investment.pdf
[3] http://ec.europa.eu/internal_market/financial-markets/index_en.htm
[4] http://www.oxfordfinancegroup.com/media/10347/gfmi%20ofg.pdf
[5] http://www.bis.org/publ/cpss101a.pdf

Yet the financial system has come under increasing scrutiny, particularly since 2008. Critics across the political spectrum question its transparency, its ability to identify and absorb systemic risk, its narrow short-termism and its often baffling complexity. Others question the implications of automated electronic trading and the consequences of remote and unengaged investors.

From the perspectives of some of the ultimate buyers and sellers in the market, the market is failing, in the UK at least. For UK SMEs, for example, financial markets do not appear to be delivering, evidenced not least by the scale and scope of government interventions to support access to finance. Meanwhile, some parts of the financial system, such as hedge funds, are accused of not only having limited social usefulness, but not delivering for investors. Furthermore, two of the UK's largest banks remain in an embarrassing position of quasi-public ownership, not yet attractive enough for the Government to entice a buyer. Investors and investees alike have some cause for complaint.

Financial market infrastructure may be owned and governed along various lines. The Oxford Finance Group describe five governance models for FMI: the non-profit, co-operative, for-profit, public, and hybrid models, reporting that "no one governance model is globally optimal"[6]. They report that 40% of exchanges are privately owned (some for profit, some not), 27.8% of exchanges were mutual not-for-profits, 16.7% were listed, and 15.6% were government controlled not-for-profits. Clearing institutions are mainly controlled by exchanges (36.7%) or, often not-for-profit user-controlled (38.9%). Settlement entities were mainly owned by users on a not-for-profit basis.

The Bank of England assert that "if FMIs are operated only in the private interests of their managers, owners, or even their members, they may under-invest in the mitigation of risks to the wider system.[7]" The Oxford Finance Group report questions "whether the pursuit of private interests at market infrastructure institutions is leading to anti-competitive behaviour, and conversely about whether the pursuit of public interests at such institutions is adversely affecting efficiency." They go on to acknowledge that co-operative and non-profit models can "allow users to stop themselves being exploited by a market infrastructure institution with market power". Even when FMI is privately controlled, regulators may exert influence over their governance. For example, the Bank of England requires notification, prior to appointment, of some appointments to an FMI's board and to some senior executive positions. The CPSS-IOSCO suggest that FMIs should have a well-founded, clear, transparent, and enforceable legal basis and governance arrangements which promote safety and efficiency of the FMI itself, and support the stability of the broader financial system, the public interest and objectives of relevant stakeholders.

Beyond the tightly defined FMI, key elements of the wider infrastructure which supports these markets includes data agencies and indices, platforms which centralise data and standardise procedures, corporate finance and brokerage functions, secondary markets and ratings agencies. While this infrastructure has itself stood up relatively well through the financial crisis, elements of this architecture have not been immune from criticism.

Data is essential to the operation of established financial markets, although infrastructure varies across particular markets. Bloomberg is perhaps one example which is known even to those outside the industry. There is some hedge fund wide data, for example, but this is not as developed as private equity data or as transparent as publicly listed securities. Emerging equity markets developed the infrastructure which collected, analysed and assured data in the 1980s, leading to indices and published data.

Brokers and advisers play a huge significant role in the allocation of capital but have also come under fire. A European Commission report on Consumer Decision-Making in Retail Investment Services[8] in

[6] http://www.oxfordfinancegroup.com/media/10347/gfmi%20ofg.pdf

[7] http://www.bankofengland.co.uk/financialstability/Documents/fmi/fmisupervision.pdf

[8] http://ec.europa.eu/consumers/strategy/docs/final_report_en.pdf

2010 argues that "Features of the retail investment market may make consumer decisions particularly prone to biases and errors…. consumers are often confused about the true nature of their investment… consumers are often unaware of potential conflicts of interest. Consequently, people struggle to make optimal investment choices." Since the 1980s, capital markets have moved from more relationship based advice models towards transactional fees. More recently - as the potential for bias and perverse invectives which a transactional model allows - the pendulum has perhaps swung back. The new retail distribution review (RDR) rules mean that financial advisors (for pensions, ISAs and unit trusts) can no longer take commission from companies supplying financial products. Instead the investor pays a fee up front, a move designed to increase transparency and avoid incentives that may distort the market.

Platforms and exchanges are a crucial feature of the financial architecture, not least the London Stock Exchange. In the funds market, risk-rated collective investment schemes are traded on recognised platforms which allow asset managers, private banks and others to exchange investments with relatively low transaction costs. The UK small companies funds market, for example, includes about 40 or 50 funds, each worth between £50 and 200 million. These funds - created by 'product manufacturers' - sit on platforms like Hargreaves Lansdown[9], which offers a comprehensive range of web-based services to a huge number and diverse range of investors.

Credit rating agencies are an element of the infrastructure of financial markets which have a crucial role in the credit-worthiness and tradability of financial products. But recently, observers have increasingly questioned rating agencies in particular for their market power, lack of accountability and their business and ownership models (not to mention their mistakes, for example, in rating Icelandic Banks at AAA shortly before they collapsed).

[9] www.hl.co.uk

VENTURE CAPITAL

Venture Capital is now an established market in the UK with a track record over several decades, many funds and an established infrastructure. However, the industry evolved gradually at first, taking several decades to develop "from being little more than a cottage industry into part of the mainstream economy". In the early years of venture capital, deal flow was a significant problem. The celebrated Apax Partners was founded in 1972 but still had only £10m under management in 1984.

What is perhaps less frequently reported is, while there are some very successful funds, the average return for VC funds from 1998 to 2007 in the UK is negative[10]. Other criticisms of VC may limit the extent to which it may be desirable to replicate certain features of the market. Information disclosure and incentives for fund managers appear to be significantly flawed. And for one half of the market – the demand side – a successful deal is no indicator of long-term success, with the VC model relying on one or two winners in ten to compensate for the vast majority which never reach scale or sustainability[11].

Nevertheless, it is instructive to observe how the infrastructure of the VC market has developed over several decades. Models of intermediation include networks, events and brokers. "Real Deals" magazine, for example, and other periodicals provide regular data on deals. While there is no clearing house where funds are obliged to report activity, business information providers have databases of deals compiled through information in the public domain, press reports and other sources.

The trade body – the British Private Equity & Venture Capital Association (BVCA) is the "industry body and

[10] www.nesta.org.uk/library/documents/Unchaining_investment_report.pdf

[11] For social investment risk capital funds, the likes of Mitie and Baxendale which seek relatively modest returns but fewer failures in a portfolio are arguably more appropriate parallels than the vast majority of VC funds.

public policy advocate for the private equity and venture capital industry in the UK" – was founded in 1983. The BVCA provides an annual 'Directory of Members' as well as an annual Performance Measurement Survey and a Report on Investment Activity.

Tax incentives have played a significant role in the development of venture capital and private equity models, with the creation of EIS and VCT schemes designed specifically to support this type of investment.

PHILANTHROPY

Observers of philanthropic giving have long bemoaned the characteristics of the 'market', which include weak data, massive transaction costs for both sides, unstructured models of exchange and significant information asymmetries.

There have been a number of responses to these perceived weaknesses over several decades on both sides of the Atlantic, including significant state support. Guidestar, Givewell and the National Centre for Charitable Statistics in the US have sought to provide data and information on the demand side while New Philanthropy Capital and Guidestar UK were set up to develop the market in the UK.

The Directory of Social Change provides information on the supply side, particularly on institutional investors, seeking to empower the demand side and provide more transparent and symmetrical information. Despite these efforts, Jay Kennedy from DSC reflects how "philanthropic markets are extremely undeveloped, weak and lack data and information sharing."

CROWDFUNDING AND THE UKCFA

The UK Crowdfunding Association, or UKCFA[12], was formed in 2012 by 14 crowdfunding businesses who initially started to meet informally to talk about regulation of the sector.

The UKCFA has since become a trade body for the sector, particularly helping participants engage more effectively with regulators. It has a business model where members pay a subscription in return for PR, marketing and policy support.

The aims of the UKCFA are to promote crowdfunding; to be the voice of all crowdfunding businesses in the UK; and to publish a code of practice that is adopted by UK crowdfunding businesses.

SRI AND ESG FUNDS

Socially Responsible Investment has developed over several decades to a point where ESG funds (which place some emphasis on the significance of Environmental, Social and Governance factors) now trade in liquid, publicly traded markets across the globe. Social Responsible Investment funds blossomed from the late 80s. John Elkington's work on the 'Triple Bottom Line' paved the way for a number of financial institutions to develop their interest in the market.

Investors' return expectations have fluctuated over time and diversified with some investors maintaining the assumption that more socially-oriented investments are likely to supress financial returns, while others, particularly since the turn of the 21st Century, take an opposing view. Perhaps relevant here is the struggle over time to define the market and the confusion between different terms, such as SRI, ESG, Eco, Green, Responsible Investment, Ethical Investment, Sustainable Investment and more.

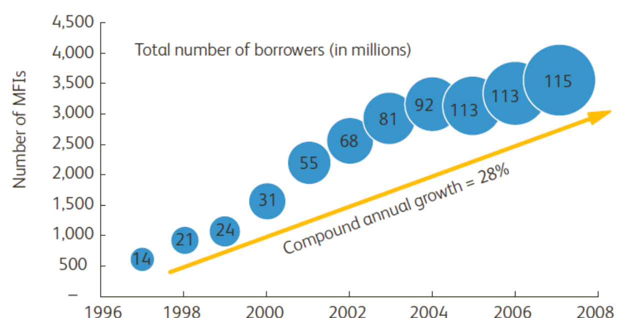
12 www.ukcfa.org.uk

The capture, analysis and disclosure of data has supported the development of the market. Data providers offer standardised and assured data on thousands of companies, investment criteria and performance. EIRIS "is one of the largest independent SRI research organisations worldwide" which undertakes "research into corporate environmental, social and governance (ESG) management and performance… [and] data on more than 80 research areas for some 2,800 companies". Nearly 100 EIRIS clients (which include retail funds, pension funds, asset managers and charities) access research through bespoke software (EPM) as well as accessing country ratings, research on corporate adherence to international norms and climate change data, among others. EIRIS is an independent not-for-profit organisation with a mission to "empower responsible investors with independent assessments of companies and advice on integrating them with investment decisions"[13]. Other providers include Maplecroft which provides research on ESG performance, risks and opportunities with a "comprehensive portfolio of company risk ratings, country and sub-sovereign risk indices, interactive GIS maps and in-depth reports."[14]

Trade bodies like the UK Sustainable Investment Forum (UKSIF) and Eurosif have also played a role with UKSIF launching in 1991 (NB: at the time UKSIF was called the UK Social Investment Forum!). Eurosif was founded in 2001. UKSIF report that the first UK retail ethical fund was launched in 1981 and by 1996, over £1 billion was held in UK retail ethical funds. By 2012, UKSIF estimate that over £1 trillion was under management in UK across different responsible investment strategies. There is however, a significant ongoing role for public capital in these markets, evidenced by the creation of the Green Investment Bank, for example.

MICROFINANCE

The microfinance industry has grown over a number of decades to a mature market which stretches across the globe.



Venturesome graph on the annual growth of MFIs since 1996[15].

CAF Venturesome's report[16] on lessons from microfinance provides a valuable insight into the market, in particular around the role of subsidy; the risk of mission drift; the important role of information brokers, transparency and initiatives to provide standardised language and metrics for the industry; the significance of proof of concept; and the important role of movement-building, cultural factors and popular support, among others.

The ongoing role of subsidy should not be forgotten - in 2009, still almost a third of investment in the market was state-backed, following billions of 'concessionary capital' provided by the World Bank across a number of continents (£20 billion in Eastern Europe alone, helping create a number of intermediary institutions).

Venturesome describe how that has reduced over time, albeit slowly: "In 1985, with 172,000 beneficiaries, the average subsidy as a fraction of the loan portfolio was over 20%; in 1994, with client numbers over 2 million, this had reduced to 7%."[17] In short, however, "For more than two decades, microfinance was completely dependent on subsidies.[18]"

As well as subsidy, public bodies have also played a significant role in market development, through policy and regulation, which vary across geographies. Professor Habib Ahmed, Sharjah Chair in Islamic Law

[13] www.eiris.org
[14] www.maplecroft.com

[15] From http://www.cafonline.org/pdf/impact_investor_report_2011.pdf
[16] http://www.cafonline.org/pdf/impact_investor_report_2011.pdf
[17] http://www.cafonline.org/pdf/impact_investor_report_2011.pdf
[18] http://www.cafonline.org/pdf/impact_investor_report_2011.pdf

and Finance at Durham University, argues that Malaysia saw a relatively strong development of bespoke Islamic finance models as a result of political will. Ahmed argues that a tension between historic legal and regulatory frameworks and values based investment can create additional barriers to the evolution of markets.

More recently, as the market reached some sort of maturity, the influence of conventional financial institutions has been brought into question. James Perry from Panahpur, for instance, argues that "as recent experience in the microfinance industry has shown, social finance products need a socially motivated investor base if they are to retain their social mission."[19] As one investor argues "Microfinance started well and it went wrong when those with overriding financial incentives took over." One observer concludes, perhaps rather gloomily, the "lesson from microfinance is that you throw money at it for ages then eventually it will be able to meet up with global capital. Then it's sold out."

The microfinance market now includes a range of infrastructure bodies from ratings agencies to information brokers providing benchmark data, some powered by bespoke IT solutions. The Consultative Group to Assist the Poor (CGAP) provide "innovative solutions for financial inclusion through practical research and active engagement with financial service providers, policy makers, and funders."[20] It was established in 1995, is hosted by the World Bank and has a network of over 30 development agencies, private foundations, and national governments as members. CGAP has focused on "building the financial market infrastructure - standards and a body of transparent, high-quality financial information about MFIs"[21] (microfinance institutions). Most recently, CGAP has focused on transparency, for example, through "clarification and plain-language disclosure of the total costs and other terms and conditions of loans and other products to clients", and "disclosure around the poverty levels of clients and the outcomes they experience. What clients are we reaching? How poor are they? Are their levels of incomes, assets, and security increasing? How can we reach - and more important, benefit - poorer clients?"[22]

MIX[23] (Microfinance Information eXchange) is a global web-based microfinance data and information source. As CGAP explain "The MIX has become the number one source for data… with data on 940 MFIs and 93 funds." Meanwhile a 'Rating Fund' has enabled 320 MFI ratings and a transparency award now has over 200 participating MFIs. MicroRate[24] – a private company - was the first microfinance rating agency founded in 1997. MicroRate has conducted over 750 MFI ratings.

MicroPlace[25] was founded in 2006 as a platform that provides online retail brokerage for microfinance investments intended to give retail investors the chance to invest in the market. Also a for-profit business with a social mission, it is funded by those seeking investment who pay fees for providing the platform.

[19] www.panahpur.org
[20] www.cgap.org
[21] http://ec.europa.eu/europeaid/where/acp/regional-cooperation/microfinance/documents/cgap_iv_strategy_en.pdf
[22] www.cgap.org
[23] www.themix.org
[24] www.microrate.com
[25] www.microplace.com

3. LESSONS FROM OTHER MARKETS

These other markets explored above can offer us a number of potential lessons to be applied to the development of the social investment market, with two caveats.

First, we should not simply translate lessons from different contexts unquestioned. It is unlikely that the social investment market requires exactly the same infrastructure as the hedge fund industry, for example, or that it is appropriate or desirable to mimic other markets in any case, with their flaws and peculiarities. The VC market, for example, exhibits a different appetite or risk than may be appropriate in this sector. As one interviewee reflected, "these are not the same as conventional financial markets and we shouldn't just ape them. They are different."

Second, infrastructure in each of the above markets varies hugely in terms of purpose, governance, evolution and effectiveness, not least as a result of the vastly different economic contexts, policy environments and the influence of social factors. Nevertheless, it may be worth acknowledging:

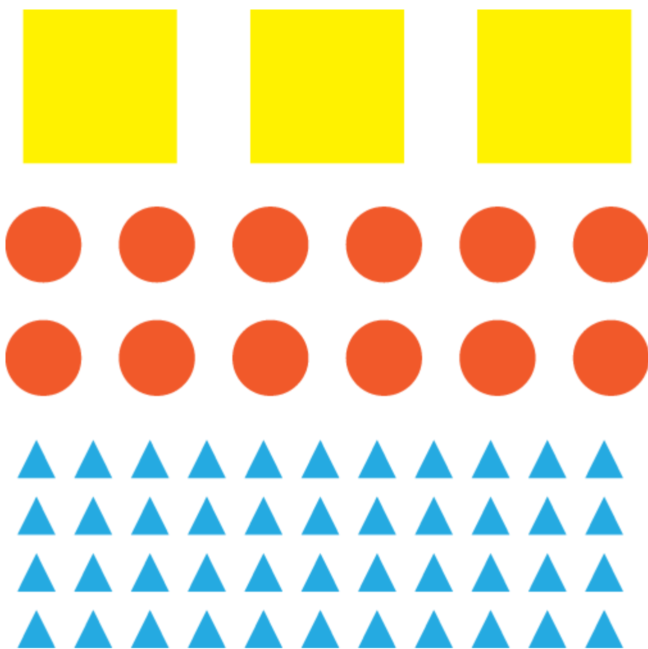
- the time it takes for an emerging market to reach maturity and the significant scale that is required before it can be recognised as an established market in its own right;
- the infrastructure which is necessary to support the development of the market over time and the role of subsidy in the development of this infrastructure. The Oxford Finance Group suggest that infrastructure requires "large, long-term, and sunk investments… some form of government or public sector involvement";
- the suitability and effectiveness of a range of governance and ownership structures; (including the merits of mutual and not-for-profit models) and business models (e.g. transactional models vs. payment for advice) at various stages in a market's development;
- a tension between social and financial value, particularly if a market founded on social need makes the connection to conventional sources of capital;
- the significance of appropriate tax incentives in accelerating market development;
- the need for honesty about return expectations, particularly in the early years of a market's development and for decades at a time; and
- the importance of "movement building" and the role of cultural factors, appropriate skills sets and the risks of exaggerating achievements and potential.

4. THE LANDSCAPE OF SOCIAL INVESTMENT

TWO MARKETS?

Is there a common conception of what is meant by the social investment market? Who are the customers? Who are the buyers and sellers? Interviews undertaken as part of this research paint a picture of a landscape of social investment which features two sets of buyers and sellers operating in two distinct areas – or layers - of the market.

This is evidenced by the presence of social investment intermediaries sitting between the demand for, and supply of finance. These intermediaries are themselves selling finance to the frontlines while also buying finance from the ultimate suppliers of capital.



This distinction between these layers in the market may be obvious to some. But is worth reiterating – not least as it corresponds to some degree to another distinction in the market. On one hand, those who interpret the focus of social investment to be about how social sector organisations can access finance. On the other hand, others interpret social investment to be about how finance can deliver social impact. These are not necessarily the same thing.

DEFINING THE SOCIAL SECTOR

For those who are concerned with the social sector, interpretations range across a spectrum where the defining feature of the sector (along with its independence from the state) is that it:

- is non-profit distributing;
- is principally non-profit distributing;
- has an enshrined social purpose; or
- delivers social impact.

Social investment has meant different things to different people at different times. For the Government and Big Society Capital, for example, social investment means "the provision and use of capital to generate social as well as financial return". For others the focus is often on encouraging investment in under-invested communities, personal lending to people that traditional banks would not lend to, small loans for self-employed people and very small businesses, loans to help local businesses, and loans to charities, community organisations and social enterprises. For others, it is about investing capital for social return but does not necessitate financial return. (Some Housing Associations such as Trident[26] use it even more widely, simply to describe how they seek to maximise their impact on local communities.)

"Impact investment" has also become increasingly popular in recent times, not least as a result of influence form across the Atlantic. So – as with the social sector itself - there is a spectrum of terms and definitions that can describe the blend of financial and social return expectations, from commercial investment

[26] www.trident-ha.org.uk

through ethical investment, social investment, mixed motive investment and programme related investment through to capital grants. There are overlaps, where two investors may interpret the financial and social risk and return of one investment differently - what may be an entirely commercial decision for one investor may be a more blended approach for another. As with any other type of investment, risk and return are in the eye of the beholder. [27]

SEGMENTING THE MARKET?

While some are concerned that fragmenting the market into even smaller silos could compromise the integrity of the market and how it is understood by observers, others suggest the need for a clearer distinction and market segmentation between, for example:

- mortgages and other secured lending for charities;
- bonds for Housing Associations and big charities (e.g. Scope, Golden Lane, Places for People, etc.);
- risk and working capital for public service delivery organisations (e.g. Social Impact Bonds and Payment by Results models);
- small loans to financially excluded, entrepreneurs in disadvantaged areas (e.g. credit unions and CDFIs);
- risk capital for consumer facing social enterprise; and
- share issues for community enterprises (e.g. post offices, pubs, shops

[27] For more on the spectrum of investment motivation and for an annotated diagram see Social Finance's forthcoming *Introduction to Social Investment for Charitable Trusts and Foundations*

5. THE CHARACTERISTICS OF THE SOCIAL INVESTMENT MARKET

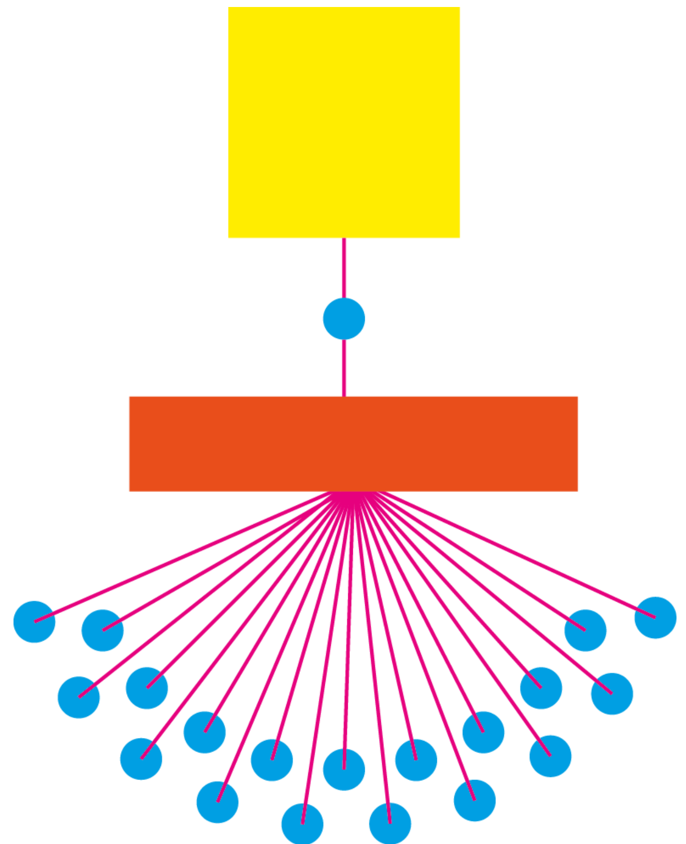
There is a huge diversity of opinion, approaches, understanding and sentiment about the state of the market (however it is defined or understood). Some common themes emerged, however, in the course of this research with regard to the characteristics of the market as it stands.

DEMAND

Access to finance remains the top barrier to growth for social enterprises[28]. There is, however, perhaps a need to clarify the extent to which access to finance is a greater barrier for the social sector than for 'conventional' businesses, which are of course also struggling in this regard. Furthermore, we should distinguish between the demand for finance from social sector organisations with different business models e.g. those which predominantly trade with the public, those which deliver public services and those which rely on grants and donations.

But tangible demand for social investment is slower than many would hope or had foreseen, and there is increasing recognition of a broad spectrum of investment needs on the demand side. From the perspective of the frontlines, many social sector organisations are uncertain about what (social) investment means, if they really want it and indeed, seem increasingly sceptical.

Some sector representatives suggest that the market is being driven by government or investors rather than the ultimate customer - as they see it - and, for example, relay how the "supply of capital is simply too expensive and is not applicable to the vast majority of the sector". Social sector organisations often feel, rightly or wrongly, that they are being rather pushed into something which they haven't fully understood or themselves taken a conscious decision to pursue.



SUPPLY

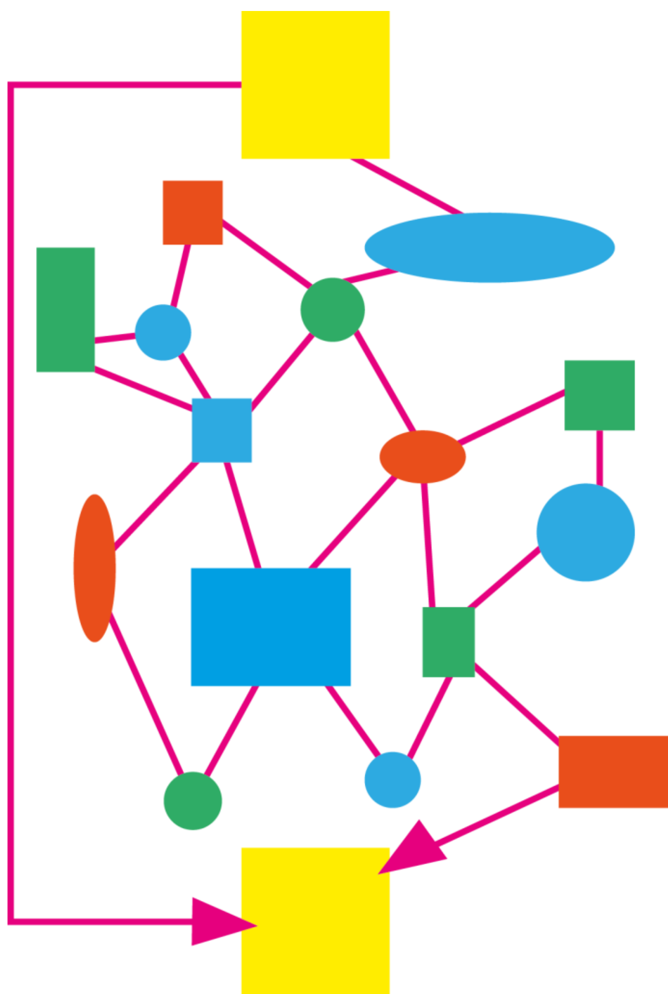
The supply of social investment has increased substantially over the past few years. Supply is currently dominated by the presence of Big Society Capital, which wields considerable market power, facilitating infrastructure development as well as investing in intermediaries. As one senior funder admitted: "At the moment all the capital is residing in one institution – which is not a good thing for the market." This market power is also soft as well as hard, as one investor describes it, "it's difficult for voices in the market to disagree with BSC."

Elsewhere, as Cabinet Office point out, "the market remains concentrated in terms of funding. In 2011-12, the three largest SIFIs accounted for just over 80% of

[28] http://www.socialenterprise.org.uk/uploads/files/2013/07/the_peoples_business.pdf

total investment."[29] Social banks who undertake secured lending represent the vast majority of the market at the intermediary level.

Beyond the intermediary funds, Big Society Capital and the social banks, there are a small number of specialist foundation investors (such as the Esmée Fairbairn Foundation, the Barrow Cadbury Trust, the Lankelly Chase Foundation and City Bridge Trust) who can invest up to around £1 million at a time. Interviewees suggested an absence of funds worth between £50 million and £100 million able to make investments of between £1m and 10m.



A number of interviewees suggested that there has been rather too much focus on institutional investors. As one observer noted "good investment bankers are just not going to do this stuff yet". Others are nervous about the focus on trusts and foundations as the first port of call, putting their endowments at risk in the early stages of market development.

Rather, many suggested that so-called "Low Net Worth Individuals" (LNWIs) investing through more disintermediated retail models may be worthy of greater focus and may align better with the *social* ethos of the market. This includes local, community share and bond models which echo the mutual tradition, internet-based investment platforms, crowdfunding and peer-to-peer models which bypass conventional financial institutions. The Café Direct share issue is perhaps the most well-known example here. Many argue that this would enable a social reconnection and more appropriate alignment between investees and the non-financial motivations of investors.

INTERMEDIATION

The social investment market, as generally understood, is currently a small and immature market with a limited track record. There has been much progress in the growth of specialist banks, the development of community shares, the rise of retail bonds, the creation of new funds and experimental models reaching proof-of-concept stage.

But while the process of intermediation between demand and supply works well on occasions, it is too often still flawed, expensive and missing. Supply and demand are still often worlds apart, particularly between intermediaries and the frontlines where expectations have outpaced reality. As one sector representative suggests "Despite the rhetoric, there are not many market-aware intermediaries that can make this money work." As another observer comments, the market is "Right in theory, wrong in practice."

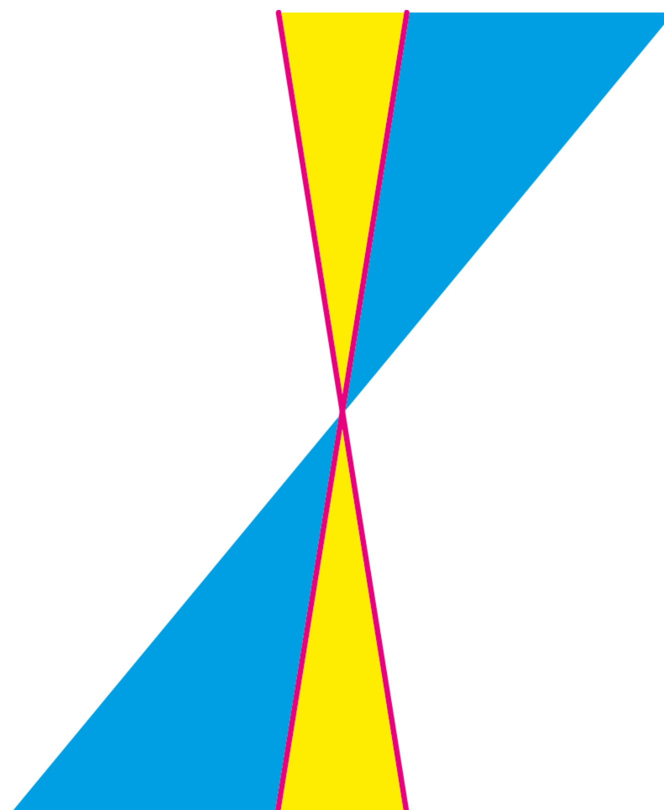
So the market is characterised by a number of small and complex deals with high transaction cost for both sides, an absence of standardised products and indeed, despite progress, products still missing at both levels (e.g. small amounts of equity-like risk capital and unsecured debt). As one intermediary puts it "we need to accept that Intermediation on a transaction

29 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205295/Social_Investment_Strategy_Update_2013.pdf

basis is currently uneconomic – there are significant problems with basic deal making". The City of London report[30] that in 2011/12 high transaction costs were reported as the top developmental constraint for SIFIs. One large funder estimates that "they are 15-20% of deal value" for investors. Equally, a significant burden falls on the demand side, with prospective investees sometimes reporting a process of almost two years of due diligence ultimately leading to no investment.

Deal-sourcing is also problematic, with one representative body describing "a real barrier around navigability of the social investment market – people don't know where to go to identify appropriate products and services." As ClearlySo and New Philanthropy Capital reported from a survey of over 1200 VCSE organisations, one in three potential investees reported that identifying who to go to for social investment was 'very difficult'[31]. Sign-posting is frequently identified as a major barrier.

This research suggest that significant question marks remain over whether intermediaries will be able to reconcile diverse risk and return expectations on the demand and supply side over the long run. Some are bullish – arguing that information asymmetries with regard to pricing risk can be overcome as perceptions of risk are currently dislocated from real risk. They point to evidence of Charity Bank write-offs being very low or how data suggests social enterprises are outperforming conventional businesses. Some paint a picture of prospective returns that compare well to historic VC performance or argue that "there should be expectation of market rate returns in the sector and no reason why that should not be the case".



Others argue that this sector will never be able to deliver commercial returns and doubt that terms of investors and investees can be reconciled[32] (as long as the social investment market is limited to the a defined social sector). One investor suggests that, with the cost of capital from Big Society Capital and others, along with intermediaries' management fees and defaults, investors "are not offering finance on terms which the majority of existing social sector organisation can tolerate. So they are either saying 'you have to change your business model or we're not interested in you.'"

This is linked to a suspicion in many quarters that some players in the market are too focused on replicating the intermediation models of other markets, pursuing the creation of structures which create significant transaction cost, unnecessary layers and money lost to the system through regulation, lawyers and accountants. This is seen not only as costly but, as one investor says, it is "a process of intermediation

[30] http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Growing-social-investment-market.pdf
[31] www.biglotteryfund.org.uk/er_invest_ready.pdf

[32] The image above is intended to represent how the interests of demand and supply may only meet within a narrow band amid a wider spectrum of financial return.

that removes the non-financial motivations in the way that money gets invested".

INFORMATION AND CULTURE

There is some consensus that the social investment market is characterised by partial (biased), partial (incomplete) and asymmetric information. As one market observer notes, "All markets need data and information to allow people to make good decisions" but at the moment "the production of data is not managed very well". Venturesome describe how "extensive debate surrounds definitions, terms, impact measurement, and all other aspects of this market." and how "the lack of information on the successes or failures of social investments inhibits the flow of capital into the sector.[33]"

Many observe that market power is stronger with intermediaries (soft power, language and understanding how investment works) while others suggest that knowledge (of social sector business models, income streams, prospects, etc.) is stronger on the demand side. It seems information is both lacking and, where it exists, asymmetrical. As Rupert Evenett argues "Information symmetry is key - and not just symmetry but data at all. Symmetry is no good if neither side has adequate data."

Research activity in the market is disorganised and overlapping research exercises sometimes represent a burden for intermediaries and social enterprises. Some interviewees suggested that research is too often provided by those with expertise lying outside the market, or sponsored by those with a vested interest. There is relatively little research emerging from the social sector itself and few reports are truly independent. Several important gaps in market information still exist.

Finally, there is some linguistic, political and cultural confusion between many of the players in the market. Several interviewees independently talked of the 'Wild West' – an exciting, dangerous confusing and almost lawless place. Some of this is perhaps inevitable and may be overcome with time. For instance, when some intermediaries talk of 'retail', they are referring to retail investors, whereas to social sector organisations, this is more likely to refer to selling coffee in a community café. Politics can also play a role in dividing opinion, particularly when several players in the market are often, rightly or wrongly, perceived to be associated with one political party.

But some cultural factors are perhaps more troubling in the long term. One interviewee talked about "patronising and condescending behaviour" from the investor community. Another asked with frustration, "Why are we putting so much trust is these financial people who have bought the City to its knees?" Perspectives like these may continue to pose problems for the smooth development of the market. More hopefully, Venturesome offer a way forward, suggesting that "a unified voice, perhaps in the form of industry bodies or associations, to lobby for regulation and build public recognition" could help overcome differences of opinion and confusion in the market.

SOCIAL RETURN

What makes social investment *social*? The answer is not entirely clear and there are a range of issues with the whole concept of social value which may not be resolved in our lifetimes, both at a practical and philosophical level.

For example, one leading market participant has suggested a three-dimensional investment model, featuring financial risk, financial return and social return. On the other hand, one of the leading academics in this field introduces four dimensions, highlighting both social risk and return. Other market actors argue that social aspects are sub-categories of long-term financial risks and revert to two dimensions.

Yet even if there was consensus here, incorporating social return in social investors' approach to investment appears to be highly problematic, given the complexity of issues like attribution and deadweight, predicting the prospects for social impact in the future, and unpredictable

[33] www.cafonline.org/pdf/impact_investor_report_2011.pd

commissioner and customer behaviour. Furthermore, even if investors could accurately factor in prospective social return, it is unclear how this impacts upon the financial terms of an investment and the cost of capital to the investee, if at all.

Some have argued that instead, investors should be seeking to appraise the capacity and potential of investees to deliver social value rather than evaluating the social value itself, putting emphasis on values, transparency, capability and governance, for example, rather than complex social impact metrics. This echoes how a financially-motivated investor may take a judgement on the prospects of an entrepreneur to deliver value, beyond the financial projections in the business plan.

THE MARKET AND THE ROLE OF GOVERNMENT

A number of interviewees questioned the extent to which the social investment market was truly a market. David Floyd puts this perspective perhaps most succinctly, "the social investment market in the UK is currently around 80% distortion, 20% market"[34]. One sector representative asks "How many pilots and pathfinder and boosters and funds and government support and interventions does a market need? If you really want it to grow as a market you should just respond to demand..."

In any case, government intervention in this area is considerable and sometimes unpredictable. While from the perspective of one observer, successive governments have now "almost entirely done what has been asked of them" and Cabinet Office itself suggests that "a sustainable market is one which isn't dependent on Government investment"[35], public bodies show little sign of 'getting out of the way'. From a spending perspective, it is unrealistic to imagine that numerous interventions to support the market by the Cabinet Office, the Big Lottery Fund, local authorities, European institutions, devolved administrations, Local Economic Partnerships, the Treasury, the Department for Work and Pensions, the Department of Business and the Department for Communities could be perfectly aligned and would never undermine each other.[36]

For some, the forthcoming revisions to the tax code are arguably the final piece in the jigsaw. Yet some actors in the market fall between the cracks in regulation, sometimes to their advantage and sometimes otherwise.

[34] http://beanbagsandbullsh1t.com/tag/big-society-capital/
[35] http://iipcollaborative.org/wp-content/uploads/media/Social_Investment_Strategy_Update_20131.pdf
[36] For full list see www.commoncapital.org.uk

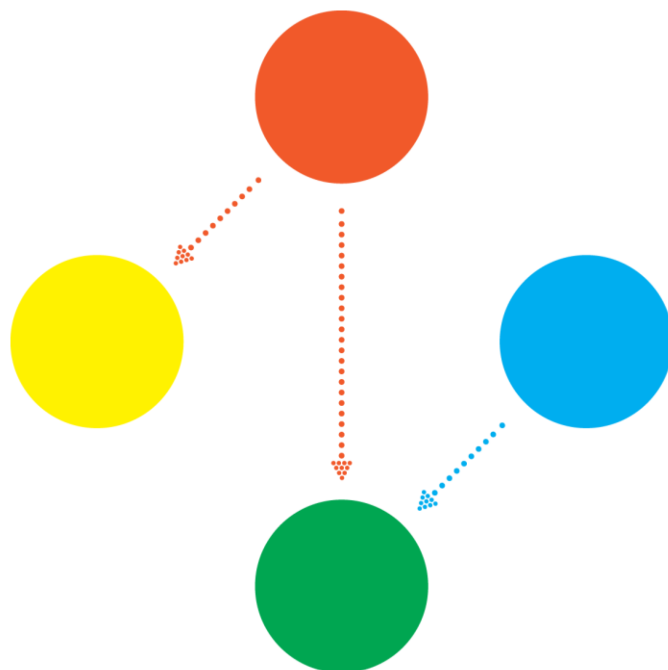
6. A BETTER PLACE?

This research has uncovered a range of diverse views on the future of the market. Tensions in terms of politics, perspective, culture, language and ideology are already causing some confusion and frustration in a market which is not straightforward to define. The principal areas of tension are explored below.

ACCESS TO FINANCE VS. SOCIAL INVESTMENT?

The first of these perspectives places greater emphasis on the relationship between intermediaries and investees working on the frontlines and whether they can access finance that works for them. Many here argue that "a walled garden" is important - they are attached to particular models of ownership, governance, control and profit distribution - and often want to protect the defined social sector against its 'colonisation' by commercial capital. One market observer suggests that the "possibility of investors making profit out of vulnerable people is sick." Massimo De Angelis describes the wall in the walled garden as a frontline in a battle and an "opportunity to mobilize against the capitalist logic, or to capitulate to it"[37]

Others take a rather less ideological perspective and are merely concerned about the dynamics of power and that those within the 'walled garden' should decide for themselves whether to venture out, and on what terms, rather than being led by "reformed fugitives from the financial sector who have never ever been in the garden". Many are concerned about a dilution of social purpose, if and when a connection to conventional capital is made, describing how "because the amount of money that might flow in is so large, the bar for what is social is being pressed down upon."



The second perspective – of social or impact investment - takes a different view and is more interested in the relationship between intermediaries and pools of capital at a wholesale or retail level. Here, the "game is shifting investment flows from areas which create less social value to those which create more". Advocates here are focused on the trillions of pounds under management by pension funds, private banks and other asset managers, on collective investment funds and vehicles such as SIPs, OEICs and ISAs.

This interest is often driven by an analysis of the scale of social issues, the pressure on public finances, the unaffordability of exiting models of public service delivery and addressing social need, rather than a specific set of organisations, defined by what they do with their profits. From this angle, a 'walled garden' can look too narrow or provincial, given the scale of the challenges facing society. As one investor states, "we are fundamentally stuffed if we think social investment means financing of charities and CICs." Investors, intermediaries and infrastructure bodies tend increasingly to be more concerned with impact above

[37] http://wealthofthecommons.org/essay/crises-capital-and-co-optation-does-capital-need-commons-fix

ownership (unless under direction from government otherwise) arguing that we need "other ways to think about social mission and social impact beyond social ownership and limits to profit distribution". There is perhaps a growing frustration among some investors that social enterprises are, literally by their very nature, precluding opportunities for capital to be invested for social ends. As one intermediary puts it, "A social enterprise is a business that restricts itself from accessing equity." Here, this is meant as a criticism, whereas many social entrepreneurs might say almost the same thing, except with pride.

EVANGELISTS, SCEPTICS, RHETORIC AND REALITY

Some market advocates appear to believe in an internal logic of social investment which will inevitably grow in size and strength, whereas others are entirely dismissive of the market's prospects for a brighter future. Most, of course, fall somewhere in between.

There are also mixed views on the value of the hype around social investment, peaking perhaps at the fringes of 2013 G8 summit. As one social entrepreneur puts, "the rhetoric bears no relation to the reality of social enterprise." But most observers would agree with one funder who suggests that "We need to be clear on expectations and greater clarity on what we are selling."

Many would also agree with the participant who observed that the destination for social investment is a "market that is recognised as a professional capital market. It has clear presentation in one direction to mainstream financial markets which can understand it as a capital market. But also needs to be well functioning which means investees need to be able to access capital." One observer suggests we need to move from a "village fête to a well-signposted shopping centre". A clearer distinction between social investment on one hand and access to finance for a defined social sector on the other is perhaps slowly emerging.

INVESTORS - INSTITUTIONS OR PEOPLE?

There is some sentiment, although no consensus, that the market should put less emphasis on pursuing institutional investors and more 'sophisticated' intermediation and towards more retail models, simplicity and some disintermediation, as discussed above. Again, there is some ideology here which cannot be ignored. While one interviewee observes the "danger of starting from scratch is that you isolate beneficiaries from potential sources of capital", others would see this as an aim rather than a danger - nervous about making the connection to powerful pools of capital and fundamentally preferring perhaps new models or slower growth and greater self-reliance.

FAST OR SLOW?

In terms of the time horizons for market development, some are conscious of the political cycle, believe the market has around 5 years to prove itself, are conscious of pressing social need, and are focused on the immediate next steps for the likes of Big Society Capital and the Big Lottery Fund. Others suggest that socially motivated investment was here long before modern politics, or suggest that the market is roughly at year 10 of a 25 year journey. From this perspective, then, the market has rather more time on its side.

THE FUTURE IS NOW?

Oddly, the irony here is that the 'walled garden' appears to be already much better connected to conventional pools of capital than many of those with ambitions to connect the two may have realised. Cabinet Office remind us of NCVO figures, suggesting that 82% of £3.5bn charity debt is provided by commercial lenders[38]. Intriguingly, Robert Yetman form the University of California reported in 2008 that "non-profits in the US use debt in about the same proportion, and at roughly the same level of sophistication, as for-profit

38 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205295/Social_Investment_Strategy_Update_2013.pdf

companies"[39].

For example, the University of Manchester – a charity - recently issued a £300 million pound bond which, alone, puts the social investment market rather in context, estimated at a value of around £200 million per year[40]. It seems that billions of pounds of commercial capital are already being applied to make a difference in the social sector, yet largely unreported relative to the 'noise' around the nascent specialist social investment market.

So while social investors are starting to look beyond the social sector for social return, social enterprises are already going beyond social investors to access the capital they need.[41] While this is principally in the form of secured, senior debt, recent figures on the state of the social investment market suggest that over 90% of market activity is also in this form.

CAPITAL OR REVENUE?

Many observers suggested that a range of building blocks need to be in place in order for a better functioning capital market to be realised. Policy has focused on each of these in turn over the last decade, ranging from the need to assemble specialist pools of capital, to the supposed investment readiness challenge and increasingly, to a need for better and more accurate market data as the final magic ingredient.

But some observers are concerned that the focus on capital is rather a distraction from what they see as the real challenge for social sector organisations – the viability and sustainability of their revenue streams, commissioning and procurement behaviour, the ongoing role for grants and the need to develop commercially successful models of social enterprise.

One sector representative observes that, "If we sorted out the revenue side, we wouldn't need to worry too much about capital". One interviewee suggested that investors who think this sector can work as a smoothly functioning market are "either naïve or arrogant or both".

MATCHING CHALLENGES TO SOLUTIONS

But regardless of diverse perspectives, ideology and politics, the pace of change, the nature of investors and the underlying business models of the social sector, it is nevertheless possible to analyse the weaknesses in the characteristics of the social investment market as it stands, and describe a better place. Most of those interviewed in this research could agree on some common ground for a better functioning market e.g. lower transaction costs are better than higher transaction costs. The table below therefore sets out a number of characteristics which improve upon the current state of the market, and suggests potential supporting infrastructure to help deliver these.

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[39] http://nonprofitfinancefund.org/files/docs/2010/ssir_summer_2008_equity_capital_gap.pdf

[40] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210408/Social-Investment-Report1.pdf

[41] The image on page 19 is intended to reflect this situation.

Characteristics of a well-functioning market (or better place)	Potential supporting infrastructure
Large number of buyers (e.g. more confident demand) and sellers (e.g. more diverse supply), no barriers to entry.	Authorised brokers and advisors with local, regional and national reach, signposting, pitch events, filters, referrals, etc. NB: distinction between advisers and arrangers.
Standardised and more complete range of products appropriate to diverse needs of demand and supply.	Product developers, at both levels
Better quality, more balanced information, benchmarking, research and market intelligence	Data capture, IM&T, assurance and indices, standard setters
	Research houses
	Product reviewers and media
Lower transaction costs (both for those applying for investment and those undertaking due diligence and at both levels)	Sharing services and collaboration mechanism, providers of standardised legal documentation, etc.
Language and culture shared and proportionate to market activity	Representative trade body
	Education, skills and training providers
Better risk pricing and understanding of social return	Rating agencies
Some liquidity (opportunity for exit) and better risk management	Platforms and exchanges

7. STOCK-TAKE OF EXISTING INFRASTRUCTURE

EXISTING INFRASTRUCTURE

The following table sets out the extent to which infrastructure may already exist in the social investment market. It is not intended to be exhaustive but provides an approximate overview of the current state of market development.

Infrastructure	State of play
Brokers and advisors	There are few brokers on the frontlines and little filtering between investees and intermediaries. The Investment and Contract Readiness Fund plays this role to a certain degree, as well as the Big Lottery Fund's emerging work in this area. ClearlySo are focused on brokering angel investors to social businesses but there are otherwise few referrals or 'pitch' events. There is a very limited corporate finance-type capability in the market. However, GHK report[42] that SIFIs themselves do provide some of these functions with 16% offering brokerage and 42% offering investment structuring. There is almost no authorised capacity to give impact investing advice to investors, including trusts and foundations, other than some testing of the market by Social Finance in particular. The City of London report that no SIFIs offer investor advisory services[43].
Product developers	This is limited (at both levels) and relies on intermediaries not yet operating at sufficient scale. Between intermediaries and investors, standard off the shelf products should be adoptable (see Social Finance's VCT fund) but there is a gap between intermediaries and the demand side, problematic as a result of the transaction costs at a relatively small deal size. Emerging products (SIBs, quasi-equity) are far from standardised. The Big Lottery Fund's *Next Steps* programme has invested several million in supporting product development in the market.
Data capture, IM&T, assurance and indices, standard setters	Engaged X is emerging but there is little assurance, few benchmarks nor reporting standards. There are no bespoke IM&T solutions for social investment portfolio management.
Research houses	ClearlySo, GHK, Social Finance, New Philanthropy Capital and a few others provide some research capacity while NCVO and SEUK, for example, have the potential to deliver more. Individual consultants e.g. this author, David Floyd and Mark Richardson are arguably more sensitive to the demand side whereas conventional private consultancies like Boston Consulting are more trusted by the institutional investor community.

[42] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210408/Social-Investment-Report1.pdf
[43] http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Growing-social-investment-market.pdf

Product reviewers and media	There is little critical independent and robust analysis or product reviews. Worthstone have produced some pilot product reviews for the UK wealth management and advisor community while Investing for Good / The Good Analyst have provided impact analysis, which has received a mixed reaction.
Mechanisms for sharing services and collaborating	Such mechanisms for reducing transaction costs are currently ad-hoc and limited. There is little, if any, standard deal documentation or boiler plates which can provide the basis for deals.
Trade body	Currently none, although some overlap with the cdfa and UKCFA. SEUK's social investment forum is an emerging but as yet relatively informal platform.
Education, skills and training providers	There is no 'sector skills council' and currently limited solutions for addressing the human capacity gap in emerging social finance institutions. There are no methodologies for "inoculating finance people with social value". There is an Institute for Social Banking based in Germany while the Finance Innovation Lab, the CDFA and the Skoll Centre for Social Entrepreneurship, for example, could develop their offer to the market. There are some programmes for helping social sector staff develop their financial and investment literacy e.g. the investment readiness course at the University of Ulster[44].
Rating agencies	None.
Platforms and exchanges	Secondary markets may be emerging with the development of the Social Stock Exchange and Ethex (nascent exchanges for equity and other investments). Abundance and Microgenius demonstrate how the market may develop in future. ImpactBase is an international platform for investors to find funds.

[44] http://www.business.ulster.ac.uk/businst/courses/SITS/endorsements.html

THE INFRASTRUCTURE CHALLENGE

This table confirms the Cabinet Office's assessment that "the social investment still lacks several essential elements of a functioning financial market". Current market infrastructure is:

- limited compared to mature markets but arguably well developed with respect to the level of market activity;
- sometimes perceived as murky in terms of ownership e.g. some interviewees question the extent to which infrastructure is accountable to those it is intending to serve; and
- generally not yet at a point where business models are sustainable.

Market infrastructure is likely to develop over time and some pieces of the architecture may be more essential at certain stages in the market's development. One market observer, for example, argues that "we do need social investment brokers but not yet", as this would follow further product development. From interviews, it seems that more immediate priorities include:

- data and information provision;
- product developers;
- some brokerage and advisory service; and
- mechanisms for sharing services and collaborating.

While some research gaps exist and independent product reviews are also important, there is little call for a greater level of research per se, rather for greater co-ordination, transparent funding and more critical and independent models. A trade body would be helpful, as long as overlaps with other trade bodies was considered. Education, skills and training providers appear to be less of a priority for most market observers, along with rating agencies. Platforms and exchanges are already under development.

Considering infrastructure in a slightly different context - in terms of VCS support - Justin Davis Smith describes the challenges for infrastructure bodies as including:

- communicating the symbiotic relationship between front-line activity and infrastructure ;
- how to capture, share and demonstrate value;
- openness to markets, vouchers and other models of competition
- the role as a champion or advocate;
- new models of sustainability; and
- tension between collaboration and competition.

Each of these challenge apply equally to the developing social investment market infrastructure[45].

LIQUIDITY

Liquidity describes the degree to which an investment can be easily bought or sold. Research has thrown up contrasting perspectives on the important of liquidity in the social investment market, which echo similar debates around securitisation witnessed prior to 2008.

Some argue that platforms, funds and/or market makers are essential for delivering liquidity which will enable investors to enter the market with greater confidence. Others are less concerned, suggesting that we should be less occupied with investor's preference for an 'exit' or describing how some investors are exhibiting a shift to "buy and hold rather than the need for liquidity".

There is perhaps an important distinction between securitisation and liquidity as a liquid investment does not necessarily break the link between the investor and the underlying investment which is arguably a dangerous feature of securitisation. Securitisation has also been more of an issue for institutional investors where liquidity is perhaps more of a concern for retail investors.

[45] http://blogs.ncvo.org.uk/2013/07/03/six-challenges-for-infrastructure-organisations/

BUSINESS MODELS

Many observers – and perhaps more predictably, some nascent infrastructure bodies themselves – argue for the need to subsidise emerging market infrastructure at this stage in the market's development. As one nascent infrastructure body suggested "The industry itself is operating subscale and at this level of capitalisation the economics don't stack up." Another funder was even gloomier, suggesting that "this stuff needs subsidising as it is never going to wash its own face."

A nascent infrastructure body describes a similar challenge with advice and research, "Non-transaction related advice and research gets harder and harder to finance. Once you then link it to a transaction you have other problems." And deal size is so small in the current market that even fees linked to transactions, where they are appropriate, may not be sufficient. A feasibility study undertaken by a nascent infrastructure body on the case for an advisory service for foundations and trusts received little interest and very few potential paying customers. One global microfinance expert agrees, describes the importance of subsidy to build intermediaries and their capacity, suggesting that "if it was straightforward the market would do it."

But many also identify a trajectory towards more sustainable business models over the longer term. The prospective long-term paying customers of market infrastructure are diverse, potentially including, for example:

- retail investors – for brokerage and advisory services, product reviewers and research, credit scoring, platforms and exchanges;
- SIFIs – for the trade body and education, skills and training providers and research, data assurance, IM&T, standard setters and mechanisms for sharing services;
- SIFI staff and other jobseekers - education, skills and training providers;
- institutional investors – for brokerage and advice, product reviewers, new product development, data capture, assurance, credit scoring and research, platforms and exchanges;
- public bodies – for research and new product development; and
- social sector organisations – for brokers and advisors, product reviews, developers and research.

The risk here appears to be that that emerging infrastructure bodies will either fail completely or, alternatively, will aggressively pursue short-term commercial viability to the detriment of the wider market's development. One large funder suggested that "I hope there will be a point where we don't need that subsidy but for the next ten years, yes, we need it." (Indeed, the sentiment from the emerging infrastructure community echoes noises which have been emerging from the frontlines for rather longer, as if they too are slowly learning the challenge of developing sustainable business models in areas of market and government failure!) But several interviewees acknowledged that a grant funding model may also be inappropriate, instead describing a role for patient, 'hope' or concessionary capital and a venture philanthropy type model - or what Davison and Heap have termed "builder capital"[46].

DATA – THE MISSING PIECE?

Rupert Evenett describes how, as investment activity in a market grows, portfolios develop and intermediation increase, "investment decisions get further from specialist investors with the time and knowledge for detailed research and due diligence" then data on risk and return characteristics become more significant. Interviews revealed much consensus on the importance of data and information. But what is this data and who is it for? Market observers described a need for information, perhaps at 3 levels:

- on overall market activity – number and size of transactions, intermediaries and funds with some market segmentation.

[46] http://www.tomorrows-people.org.uk/files/blog/can-social-finance-meet-social-need-heap-and-davison-june-20131.pdf

- on investments - risks and returns, security and liquidity, social impact. Above all, information on how social investments are performing in the form of credible, consistent and structured industry wide reporting standards.
- on social sector organisations – market intelligence improving on the datasets held by NCVO, SEUK, BIS and others.

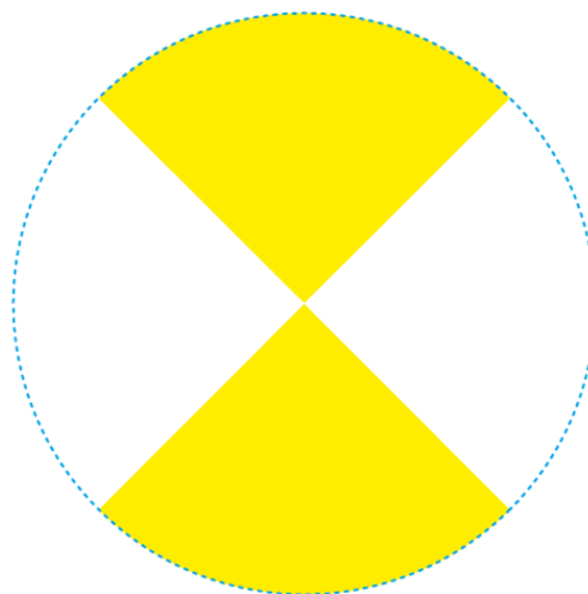
This kind of data is often essential for independent financial advisers and wealth managers to help them determine suitability of investment propositions and better asses risk. Retail investors may have different needs to institutional investors and be rather more interested in information on a social sector organisation's mission, activities, impact or even pay differentials, for example. Ratings agencies provide some of this information in other markets and can support risk pricing and reduce transaction costs but can also introduce other risks. Some market actors are interested in developing alternative models of credit scoring and how to identify a successful and robust social sector organisation.

Information Management and Technology may play an important role here. Investors currently use a mix of software solutions which are not necessarily fit for the purpose of making social investments, or improvise with spreadsheets. Some suggested a need for new, bespoke software which can dovetail with existing financial packages and grant-making software. Many intermediaries have data but this is not in a state where it becomes useful data which can be benchmarked against others.

Of course intermediaries themselves need to be convinced of the benefits of releasing data and while most would rather do so, others have "yet to be philosophically persuaded" that transparency and trust is in their enlightened self-interest. One investor, in particular, has openly described transparency as "wishy-washy aspirational stuff."

GOVERNANCE AND OWNERSHIP MODELS

Infrastructure bodies and intermediaries were perceived by some market actors and observers to sometimes be opaque. One described a "massive accountability gap between investors and intermediaries and the people they are benefiting. The ultimate beneficiaries have no voice and have no way to hold them to account." Some nascent infrastructure bodies recognise this challenge, arguing themselves that emerging structures "have to be collaborative, and collective either legally or in principle… independent of any one investor".



It may be that infrastructure bodies evolve over time from subsidised, collaborative and mutual not-for-profit models towards replicating into more competitive business models as the market develops and the economics begin to stack up. In any case, interviews suggested that infrastructure bodies, not least to develop trust in the market, may need to consider how they embody three qualities:

- social purpose;
- transparency; and
- accountability to those they serve[47].

[47] The image above is intended to reflect this model of top-down mission, bottom-up accountability and transparency.

8. RECOMMENDATIONS

STEPPING STONES

This chapter seeks to make relevant, achievable and concrete recommendations for market actors, supporters and others to help take the market forward. These include, but are not limited to, the Big Lottery Fund, Big Society Capital and HM Government.

THE ROLE OF SUBSIDY

Conventional economic thinking on the role of state subsidy is summed up by the World Trade Organisation, which argues that "under the condition of a perfectly competitive market, no case can be made for a subsidy. But… situations may arise where a government measure like a subsidy improves welfare. An efficient subsidy would correct a market failure, bringing social and private costs and benefits into alignment."[48] So at one extreme, some would argue that the state should not distort the social investment market at all. At the other extreme, many would point out that the state already plays a hugely significant role. Perhaps more usefully it could be argued that some distortion is appropriate as long as it is in the common interest, well designed (including with regard to other government interventions) and attempts to address market failure in the either the short or long term.

On the basis that this is indeed a nascent market, with some temporary market failures and a set of emerging infrastructure which may become economically sustainable over time, then subsidy should be deployed accordingly. This would mean a combination of either i) risk capital, albeit on patient and concessionary terms. In other words, with the potential for but not *expectation* or *obligation* of financial return to investors, and actively managed with appropriate oversight and governance; and / or b) a voucher-type system allocated to the prospective long-term customers of infrastructure bodies that provides economic rewards for those who deliver value to the market.

One intermediary describes what they are looking for in terms of financial support to develop better information provision in the market, "We have lots of data and we want to share it but we need help to share it in a helpful way which doesn't destroy our USP but helps the market."

However, the Big Lottery Fund in particular, should always consider the opportunity cost of supporting intermediaries and infrastructure bodies who facilitate the flow of capital. In short, would it be more effective to simply support the revenue models of frontline social sector organisations?

KEY RECOMMENDATIONS

1. Government, Big Society Capital, Big Lottery Fund and other advocates of social investment should ensure that the rhetoric around social investment more adequately reflects the stage of development of the market. These bodies should be measured about the potential for social investment and the level of returns possible in the market, not least given historic returns in other markets. Greater recognition should be given to the diverse spectrum of return expectations and the challenge of aligning demand and supply. If pools of capital assigned to investment in the social sector are slow to be committed, an honest and open discussion should consider the alternatives (e.g. greater investor appetite for risk, more 'co-mingling' with softer pools of capital, widening the investee pool beyond the social sector, disintermediation to reduce costs, and/or patience).

2. The Big Lottery Fund and Big Society Capital should consider how they might offer appropriate

[48] The WTO also point out that a number of studies point out that "subsidization is correlated with the political influence of the beneficiaries" (a point which would not be lost on those frontline social sector organisations who have been arguing for more concessionary capital for some time)

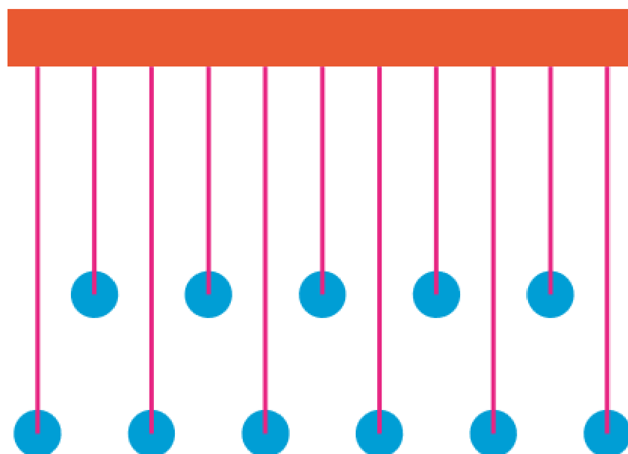
financial support for market infrastructure. (In doing so, the Big Lottery Fund in particular, should consider the opportunity cost and risks of directing resources at intermediaries at a time of financial pressure for those working on the frontlines in the social sector.) Support could take the form of either:

- blending resources through patient and concessionary risk capital (as opposed to either pure grants or commercially priced capital) which reflects the potential - but uncertainty - of infrastructure business models. This should be accompanied by rigorous oversight and investment management. Big Lottery Fund, in particular, would need to think carefully about how it approaches this on a pari-passu', 'risk-reward' or 'but-for' basis[49] and the implications of each. For Big Society Capital, support for infrastructure should be managed either at arms-length or ring-fenced from other activity.

- providing vouchers or credits to the prospective customers of market infrastructure bodies. This would be more appropriate when there is more than one potential provider and the customers of the infrastructure are in the social sector, such as advisory services to the frontlines (funders are likely to be less comfortable giving resources to, say, private wealth managers to commission product reviews, for example).

3. The Big Lottery Fund, Big Society Capital, Government and other potential financiers of market infrastructure should consider how conditions tied to their financial support could:

- encourage the most appropriate ownership, governance, transparency and accountability standards;
- support a diversity of organisations, with a balanced blend of social sector experience and financial expertise;
- leverage other resources; and
- encourage collaboration across the market e.g. if funding IM&T solutions, ensuring bespoke solutions are compatible with a range of stakeholder's systems and processes.



4. The Big Lottery Fund, Big Society Capital, the Cabinet Office and others should consider financial support for, in particular:

- further product development but perhaps more importantly more independent product reviews, for both investors and investees;
- measures to support better data capture and information provision in the market, including, for example, IM&T solutions and a periodic publication that reviews market activity (building on the GHK analysis[50] but reaching out to a wider readership along the lines of the 2009 Good Deals Almanack[51]);
- testing brokerage and advisory services at both levels in the market, including, for example a no-nonsense, jargon-free, engaging and user-friendly social investment navigation tool for social sector organisations;

49 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193697/2900897_HMGCO_Co-mingling_acc.pdf

50 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210408/Social-Investment-Report1.pdf

51 http://www.socialenterpriselive.com/sites/default/files/stories/files/Good_Deals_Almanack_2009_spreads4.1.pdf

- mechanisms for sharing costs such as legal fees and greater collaboration e.g. a referrals process learning from experience such as the Futurebuilders' Funders Forum and an annual prize for the most transparent social investment intermediary;
- a representative trade body, giving due regard to existing networks.

5. Emerging infrastructure bodies and their funders, investors and supporters should carefully consider the governance, ownership, transparency and accountability standards they should embody, not least to ensure they build the trust and support necessary to succeed. They should provide greater clarity on what need they seek to address and who they serve (e.g. access to finance for social sector or social or impact investment.)

FURTHER RECOMMENDATIONS

6. Government, Big Society Capital and other advocates of social investment should place less emphasis on attracting conventional institutional capital. When the market is ready, these institutions will engage and those driven by social purpose need to be prepared for when they do. Rather, there could be more focus on disintermediation, local and web-based community finance models. Equally, a focus on the business models of social enterprises beyond public service delivery.

7. The Big Lottery Fund should develop a clear and transparent strategy to take the lead on co-ordinating research in the market, to avoid duplication and confusion, building on the emerging Market Stewardship Research Group. More research led from the demand side would be welcome. Particular gaps may include greater clarity around the logic of investment and social return; the ability of social enterprises to access finance compared to mainstream SMEs; borrowing across civil society directly from conventional financial institutions; and exploring the characteristics of financially robust social sector organisations. This should include interrogating and clarifying existing and diverse data (e.g. from NCVO, Social Enterprise UK and Department for Business, etc.)

8. The Cabinet Office, Department for Business and HM Treasury should jointly ensure that regulatory responsibilities between the Financial Conduct Authority, Charity Commission and CIC Regulator are consistent, capable, joined-up and sufficiently resourced.

9. SIFIs, Big Society Capital and other social investment market actors should develop their cultural awareness of and responsiveness to market demand across the UK e.g. through field trips, secondments and job swaps. All market actors should be mindful of the following principles in order to win the trust and support of a wider movement;

   - Patience - as Nick O'Donohoe of Big Society Capital points out, "there is no shortcut to a five year track record";
   - Integrity – behaviour, values and culture that are appropriate for the *social* investment market;
   - Humility – in contrast to some of the behaviour which accelerated the financial crisis. Sir Ronald Cohen has suggested "Build it and they will come". If so, this suggest there is no need to hype the social investment market;
   - Empathy – through mutual understanding in order to align the interests of capital and labour rather than set them in opposition; and
   - Utility – making a useful contribution across the UK and more widely by effectively connecting demand and supply.

10. The Big Lottery Fund and other market actors with considerable social sector track record should ensure their wider experience influences the development of the market in a way which supports social sector organisations to operate on a more sustainable footing.

ANNEX B – ACKNOWLEDGEMENTS

Thanks to Jamie Palmer - for interpreting the baffling directions of the author and turning messy words into sharp images – and Eddie Boulton and Frank Winstone for inspiration. Thanks also to John Kingston for his wise direction and Anna Maloney for her support. Further thanks and acknowledgements are also due to those who provided their time and insight into his research:

- Daria Kuznetsova and Matt Robinson, Big Society Capital
- Nat Sloane and Matt Roche, the Big Lottery Fund
- Jamie Hartzell, Ethex
- Tim Hames, BVCA
- Mark Campanale, Social Stock Exchange
- Kostas Zachariadis, London School of Economics
- Karl Wilding, NCVO
- Jonathan Jenkins and Seb Elsworth, the SIB Group
- David Floyd, Social Spider
- Katie Hill, City of London
- Toby Eccles and David Hutchison, Social Finance
- Danyal Sattar, Esmée Fairbairn Foundation
- Jeremy Nicholls, the SROI Network
- Rupert Evenett, Engaged Investment
- Joe Ludlow, NESTA
- Penny Shepherd, UKSIF
- James Perry, Panahpur
- Nick Temple and Charlotte Chung, Social Enterprise UK
- Bruce Davis, Abundance Generation
- Kieron Boyle and Rob Parker, Cabinet Office
- Jay Kennedy, DSC
- Robbie Davison, Can Cook
- Gavin Francis, Worthstone
- Robert Annibale, Citi Community Development and Microfinance
- Professor Habib Ahmed, Durham University
- Meg Brown, GIIN