Review of grant subsidy for blended finance to support civil society

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Executive summary

This is the executive summary of the independent review into the future of grant subsidy for blended finance, to support the growth of charities and social enterprises, commissioned by the Department for Digital, Culture, Media, and Sport (DCMS).

The report provides a backward-looking review of the use and impact of blending grant funding with investment capital as a subsidy to support lending to civil society in England; and a forward-looking review of potential options for how best to structure this type of funding in the future. Government has been a key supplier of grant funding for this purpose and this report examines the likely effect of withdrawing this supply of funding and the evidence for a continuing need for these interventions to support such social investment in charities and social enterprises.

This review is based on analysing data from blended finance funds; interviews and roundtables with social investment intermediaries, social investors, foundations, and social enterprises; and a literature review. It focuses on England since the primary sources of grant subsidy have been England-only funds, such as through dormant assets, the National Lottery Community Fund and Futurebuilders England.

Key findings

This review finds that there is an ongoing need for future public policy interventions by government to support the social investment market through the provision of grant subsidy into blended finance for voluntary or community organisations and social enterprises (VCSEs).[1]

The persistent inability or failure of the market to price the benefits of social value means that the market is unable to adequately serve and grow the social sector without subsidy. This is particularly true for smaller or start-up VCSEs or those with untested thematic or place-based approaches in socially disadvantaged areas, where the need to cover losses and high transaction costs exacerbate the underlying market failure.

[1] For the purpose of this report, a 'VCSE organisation' is defined as: an organisation with a social or environmental purpose, including charities and social enterprises. For an organisation to qualify, it must satisfy the following criteria: have charitable, social, or environmental objectives; have an asset lock (i.e. its assets can't be used for private gain); and have restrictions on the redistribution of its profits.

The government's mandate to intervene in the market to remedy market failures and optimise public or social welfare values provides a sufficient rationale for the continued provision of grant subsidy and aligns with government policy objectives to level up left behind communities.[2]

The impact that grant subsidy into blended finance for VCSEs has had is evident in the effect it has had on:

1. The **social investment market**, particularly on the number and strength of social investors offering blended products.
2. The **social enterprises and charities** who have received investment, particularly in their improved resilience and growth and their ability to reach more people (particularly in disadvantaged communities).
3. The **beneficiaries** themselves, through an increase in the impact on beneficiaries and number of beneficiaries reached through VCSE services.[3]

This impact justifies ongoing interventions to support the social investment market and the VCSE sector through the provision of grant subsidy into blended finance for VCSEs. If government was not to provide this subsidy, it is unlikely that other actors, such as trusts and foundations, would replace it within the next five to ten years, if at all.

Furthermore, grant subsidy into blended finance for VCSEs has the potential to be an important delivery mechanism for the government's wider policy objective to 'level up' disadvantaged communities. The scale of ambition for these policy objectives should determine the scale of subsidy allocated to deliver them. The added benefit of scaling up the amount of subsidy allocated to achieve these policy objectives is that it will also scale up the sources of non-governmental funding for the 'levelling up' agenda, while bringing the public, private and civil society sectors into partnership to deliver those public policy objectives.

We have examined five options for how government might proceed—from not providing any further subsidy through to capitalising a wholesale provider of subsidy and investment capital. We have tried to assess which option would be best at delivering policy objectives and value for money, and which is the most feasible. On the basis of this options appraisal, **we recommend establishing a**

[2] *HMG Subsidy Control Principles: Schedule 1.* *https://bills.parliament.uk/publications/45935/documents/1668* p.53: 'Common interest: A. Subsidies should pursue a specific policy objective in order to—

(a) remedy an identified market failure, or

(b) address an equity rationale (such as local or regional disadvantage, social difficulties or distributional concerns).'

[3] There is a lack of concrete beneficiary level data, therefore this has been inferred from proxy data.

specialist blended finance wholesaler for the UK social investment market by re-endowing the current wholesaler of grant subsidy into the social investment market as a permanent actor in the market—capitalising it as a wholesale provider of **both grant subsidy and investment capital** into blended finance for VCSEs, and giving it a mandate to build the social investment market and enable VSCEs to access suitable capital through the provision of tailored solutions to fill funding gaps.

However, this is an option that would work best with an investment over £300m from government, as it requires sufficient subsidy alongside sufficient investment capital. This is significantly higher than investments into blended finance to date. If only a smaller amount was available, we believe that it would be preferable to **re-endow a wholesaler provider of grant subsidy into blended finance for VCSEs**, with a mandate to build the social investment market and enable VSCEs to access suitable capital. This preference is because the evidence suggests that subsidy is a key element in building the social investment market.

Summary

What is blended finance?

At its simplest, blended finance combines grants and loans to make borrowing more affordable for VCSEs and to make more money available to invest in in civil society. It is a mechanism available to government for making grant subsidy go further by combining it with private capital and investing it to achieve public policy objectives.

Blended finance is an approach used within social investment. Social investment is investing in social sector organisations, that is, in organisations that have charitable, social, or environmental objectives; have an asset lock that restricts the use of their assets to social purposes; and have restrictions on the redistribution of their profits. This could include equity investment, loan investment, or social impact bonds.

Blended finance bridges the gap between investors who make the investment and the investees who receive it. The structure of these financial products balances and serves the interests of both, supporting both the availability of investment capital and its affordability. It helps to meet and stimulate both the supply of investment capital from investors and the demand for it by VCSEs.

How has blended finance been used in England?

Prior to 2015, blended finance was primarily delivered by grant funds that offered a ‘blended product’ of grant and loan to VCSEs. The establishment of Big Society Capital expanded the reach of social investment, but Big Society Capital and others recognised that there was a need for subsidy in the market to get social investment to 'growth stage' VCSEs. This led to the creation of Access: The Foundation for Social Investment ('Access') in 2015 which has been the primary mechanism for delivering blended finance to VCSEs in England ever since. For the first time in the UK social investment market, funds were created at scale in a way that employed a 'blended structure', combining both investment capital and grant money within the fund. Access has five key blended funds (each with a differing focus): Growth Fund, Local Access, Covid Emergency Lending, Flexible Finance for the Recovery and Enterprise Growth for Communities.

Sources of subsidy to date

Grant subsidy into blended finance for VCSEs has primarily come from central government via dormant assets, HM Treasury, and the National Lottery Community Fund's England-only funds. Philanthropic funding is also a source of subsidy in England, although at a much smaller magnitude. Local councils and authorities are an even smaller source of subsidy.

Blended finance has a broader definition internationally and is widely used in a development context—primarily because, within the British context, social investment is determined by legal structures that are not internationally comparable. Partly because of this wider definition, there are more sources of subsidy into blended finance internationally.

Why is subsidy needed

Without subsidy, the cost of a loan would be too expensive for smaller and growth stage VCSEs to take up the finance. This is because the tight profit margins of social enterprise business models, which prioritise social rather than financial value (compared to Small and Medium Enterprises (SMEs)), mean that repayments need to be cheap, long-term, and flexible to enable social enterprises to grow. Mainstream lenders do not provide this, and social investment is therefore required.

To provide this type of finance, however, social investment finance intermediaries need to be subsidised with grant money so that they can at least cover their losses. The subsidy in blended finance has been needed to cover the costs of investing in growth stage VCSEs—including the transaction costs of doing small deals; sourcing and attracting deals; and providing additional support. Growth stage social enterprises often need encouraging to take on loan financing, help to put together the business information needed, and often help with issues like cashflow management.

The subsidy also helps provide investment capital, through de-risking the deals; it supports scale by attracting in investors; and improves affordability through lowering the interest rate or allowing payment holidays. This allows more investors to come in, who would otherwise think that they would have too high a level of defaults to make it attractive. It can also help give the financial products on offer more flexibility and longer, or more 'patient' terms for repayment. Originally it was thought by government that these would be temporary issues, and therefore subsidy would not be needed permanently. Most people we interviewed in the sector now feel that these market failures are not temporary, or if they are, they will take a longer time frame to unwind.

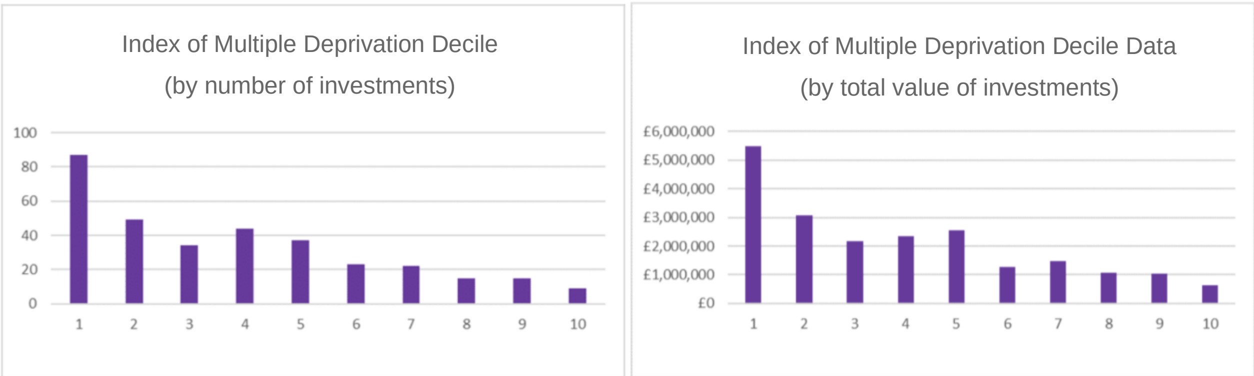
What has been the impact of blended finance?

Our review has found that blended finance has had an impact on the social investment ecosystem; the VCSEs and, by extension, the people those VCSEs are working with.

Blended finance has gone to more disadvantaged communities

Blended finance has gone to organisations working in lower socio-economic areas of England. Nearly half (46%) of blended finance funds have been given to organisations working in the 30% most deprived places in the UK.[4] The Growth Fund, Access's largest blended fund to date, is more successful at targeting disadvantaged communities than both blended finance or social investment more generally.[5]

Figure 1: Growth fund distribution by deprivation decile (2016-22).[6]



This shows that blended finance can be targeted towards social objectives, as the Growth Fund has been targeted in this way. This knowledge of how to engage deprived local communities is currently embedded in institutions such as Access and other social investment intermediaries.

[4] Data from blended finance funds. Geographical information was available for only 30% of the 2,353 VCSEs across all approved and deployed funds. Note that deprivation has been calculated using VCSE postcode—beneficiaries may live in a different postcode.

[5] Gregory, D., *Levelling the Land: Social investment and 'left behind' places* (2021), Local Trust.

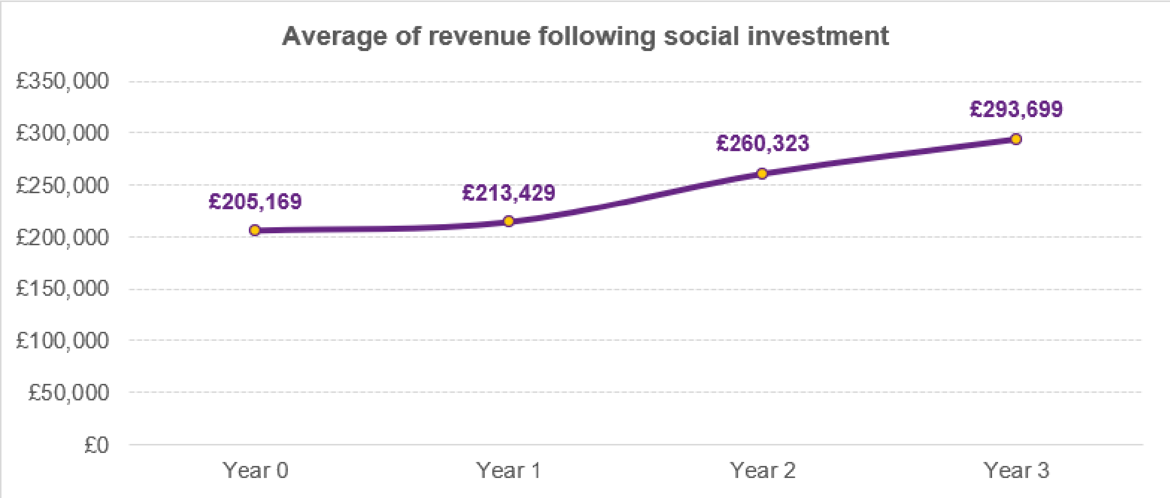
[6] Graphs sourced from: https://access-socialinvestment.org.uk/blog/targeting-the-most-deprived-regions/

Blended finance has been targeted at smaller and medium sized organisations, helping them to grow and therefore employ and reach more people

Blended finance has enabled VCSEs to grow. The majority of deals (78%) have been with organisations under £1m of turnover, with over a quarter (28%) going to organisations under £100,000.

Two thirds of VCSEs that received funding from the Growth Fund increased their income, and most of them attributed that to the Growth Fund. Analysing average revenue of a sub-sample of Growth Fund investees, shows that average revenue has grown by 43% in the three years following investment.[7]

Figure 2: Average of revenue following social investment.



The same sample also shows that there was a nearly 50% increase in the number of staff employed. Most interviewees said that blended finance allowed VCSEs to grow faster than they otherwise would have. 41% of organisations said that they intended to increase their number of beneficiaries with the funding, and 33% said it would allow them to produce a better quality intervention for the existing beneficiaries.[8]

[7] The sample size for this data was small, drawing from 48 out of a total portfolio of 148 organisations within two funds from the Growth Fund. Organisations were excluded if they did not have more than three years of published accounts post-investment or if they did not report any of the core metrics. Beyond the small sample size, several additional caveats accompany this data, including the potential for selection bias (borrowers that went insolvent wouldn't be included in the sample), and exclusion of the smallest of borrowers through a lack of reporting requirements to Companies House. While there remain questions about how reliable and useful financial data is as a predicter of performance, this gives an indication of the relationship between social investment and organisational resilience.

[8] This is based on a sub-sample of the Growth Fund dataset, and it concerns 298 VCSEs for a total of 374 approved transactions deployed between 2016 and 2022.

Taking this data together with the geographical data—we can infer that blended finance is allowing organisations in some of the poorest areas to grow and increase their impact through reaching more people. Many interviewees therefore thought that blended finance was a good mechanism for delivering the levelling up goals and for increasing outcomes for people in the poorest areas.

Blended finance has helped organisations become more stable and reduce grant reliance
Blended finance has helped organisations to become more financially stable. Looking again at a sub-sample of Growth Fund investees, average total assets increased from £180,012 to £267,582 three years later (a 49% increase). Interviewees thought that blended finance had allowed organisations to be less reliant on grants. This has enabled some VCSE sectors to transition from being primarily grant-funded to being able to diversify their income and therefore become more sustainable, so providing a better service to the people in their community. This also represents better value for money for traditional grant funders of this sector, including central and local government.

Blended finance has helped organisations work with a wide range of people
There is more limited evidence for the impact on social goals because there has been limited data collected about the impact on beneficiaries. Blended finance recipients have worked in a wide range of sectors, with a wide range of beneficiaries. The most popular intended areas of activity or outcome for the Growth Fund recipients were education, training, and employment, and mental health and well-being. Self-reported data from organisations said that they feel that blended finance has contributed to them increasing outcomes in a wide range of areas. Nearly three-quarters (73%) said that it had improved outcomes for beneficiaries in mental health and well-being; and 68% of organisations said it had increased the number of people in employment.[9]

What would be the impact of withdrawing the grant subsidy for blended finance?

Interviewees and the literature review showed that withdrawing the subsidy would be very harmful for the social investment ecosystem. This would reduce the number of organisations offering social investment to smaller, growth stage VCSEs, particularly in more deprived areas, as they would not be able to cover their transaction costs. Without these social intermediaries, small and medium sized VCSEs would be more reliant on grants, rather than using investment to become more sustainable.

[9] Data taken from Key Fund customer surveys 2017 to 2020. 210 responses in the sample size.

In particular, the newer social investment markets, such as community businesses,[10] were likely to be worse hit by a reduced amount of subsidy. Organisations interested in blended finance are unlikely to get other forms of social investment, because the subsidy is either needed to make the deal attractive enough for the investor to make, or is needed to make the deal affordable for the VCSE themselves. Customer survey data reveals that organisations only see a grant as a possible alternative to blended finance. Grants are increasingly scarcer to access and represent worse value for money for government. Other forms of social investment such as loans or equity are much less attractive to VCSEs because they are unaffordable, more risky for the organisation, or not possible due to legal structures.

Therefore, without the subsidy, organisations are not likely to take on social investment, and therefore the impacts of growth that we have seen above are not likely to happen. Interviewees also said that it would likely make social investment become less mission focused—because the market's failure to properly price social value means that they won't be paid for working with the most disadvantaged. This is most likely to mean that organisations in more deprived areas are less likely to take on social investment, and therefore won't grow. This lack of growth will therefore mean that organisations will work with fewer beneficiaries. The other possibility is that organisations may still take on finance, but because it is on less favourable terms, they reduce the amount of social value they provide and work with those people who are easier to help rather than most in need.

What non-governmental sources are there for subsidy?

There are few non-governmental sources for subsidy of this kind in England. Therefore, almost all interviewees and roundtable attendees thought that government subsidy was necessary for blended finance to grow or be maintained. There was some disagreement about whether that was true in the long term as well as in the short term. Some thought that other sources may come into the market in the next five to ten years, if proper attention is paid to attracting them into it. There are some structural reasons that prevent philanthropic organisations, such as trusts and foundations from being involved, but many people thought that the market may be attractive to banks. However, it was felt that little has been done to encourage them, and so a government exit would be 'catastrophic' for the market in the short term, as one interviewee said. There was also some argument about whether government subsidy was preferable to non-governmental subsidy as it has a wider remit than any other funder and can therefore provide more flexibility.

[10] Community businesses can be any type of business that trades products and services such as shops, transport, farms, hubs, pubs, gardens or leisure centres, run by local people for the benefit of the local community.

What need is there for future government funding?

Although everyone agreed that government funding was needed because other sources of subsidy are not yet at the level needed to replace it, there were a number of potential improvements to the offering. This includes making products better suited to the needs of VCSEs, lowering the interest rate further, designing the market in a different way, and keeping hold of current improvements such as diversity initiatives and being more flexible.

The future of subsidy

Many participants thought that there was an opportunity to reframe government funding of social investment, and to align policy objectives in social investment with other key policies. Many participants saw an opportunity for grant subsidy into blended finance to focus on large social challenges that it could help meet through mission-based funds.

Access suggests that the scale of subsidy needed to continue current provision is around £15m per year, and have identified further gaps in the sector's access to finance which could be addressed through the enhanced supply of blended finance that would add an additional £20m per annum, bringing the total annual provision of grant subsidy needed to meet the market's needs to around £35m, reaching a total of some £300m by the end of the decade. However, interviewees also made the point that the scale of subsidy is related to the objectives of blended finance—a more expansive objective linked to levelling up, might warrant more funding.

Interviewees pointed out that government intervention to support the social investment market through the provision of grant subsidy into blended finance for VCSEs could contribute to the four key objectives outline in the government's Levelling Up White Paper:

- Objective 1. Boosting productivity, pay, jobs and living standards
- Objective 2. Spreading opportunity
- Objective 3. Restoring a sense of community, local pride and belonging
- Objective 4. Empowering local leaders and communities

Evidence of where blended finance is concentrated, the types of organisations it goes to, and the outcomes and people that they are working with suggests that blended finance would be a valuable mechanism to deliver these objectives. The report's findings suggest that encouraging social enterprises to thrive through increasing their access to social investment will contribute to a greater number of resilient and growing organisations, offering purposeful employment opportunities in deprived areas. It will also support the organisations that are most experienced and best placed to deliver an improvement in well-being in disadvantaged communities. By doing so, social investment would directly support the achievement of 2 of the 12 missions designed to realise the government's key levelling up objectives:

- Mission 1: By 2030, pay, employment and productivity will have risen in every area of the UK, with each containing a globally competitive city, with the gap between the top performing and other areas closing.
- Mission 8: By 2030, well-being will have improved in every area of the UK, with the gap between top performing and other areas closing.

Options for future delivery of subsidy

In looking at the options for future delivery of subsidy, we have examined five options for how government might proceed. We have tried to assess what option would be best at delivering the government's policy objectives, providing value for money, and which is the most feasible. The options we have assessed are:

1. **Do nothing**. No additional provision of grant subsidy or ongoing support of Access beyond the existing funding window.
2. Access is re-endowed as a permanent actor in the market, capitalised as a wholesale provider of **both grant subsidy and investment capital** into blended finance for VCSEs, and given a mandate to build the social investment market and enable VSCEs to access suitable capital through the provision of tailored solutions to fill funding gaps.
3. Access is re-endowed as a permanent actor in the market, capitalised as a wholesale provider of **grant subsidy** into blended finance for VCSEs, and given a mandate to build the social investment market and enable VSCEs to access suitable capital when unavailable elsewhere through the provision of tailored solutions to fill funding gaps.
4. Access closes at the end of its ten-year life and grant subsidy is provided directly by government to established social investment intermediaries to make market-based decisions about the provision of capital to VCSEs.
5. Access closes at the end of its ten-year life and large funds are capitalised by government to lend and blend directly to the sector with a specified mandate.

Recommendation

On the basis of the options appraisal, **we recommend Option 2: establishing a specialist blended finance wholesaler for the UK social investment market**. This would work by re-endowing the current wholesaler of grant subsidy into the social investment market as a permanent actor in the market, and capitalising it as a wholesale provider of both grant subsidy and investment capital into blended finance for VCSEs. We recommend that it is given a mandate to build the social investment market and enable VSCEs to access suitable capital through the provision of tailored solutions to fill funding gaps.

We recommend that this option explore funding possibilities in addition to dormant assets that would provide the scale necessary to take advantage of the opportunity of growing the social economy and delivering the levelling up challenge. We also recommend that consideration of additional funding possibilities, without the dormant asset's England-only restriction, take into account the potential advantages of unlocking a blended finance wholesaler with a UK-wide remit.

We recommend that this option also include a limited version of Option 4, exploring a targeted capitalisation of a small number of social investment intermediaries by the wholesaler, using a proportion of its initial investment capital to support a vibrant mixed economy of wholesaler and intermediaries within the social investment market.

We believe that this option is likely to deliver the greatest social impact. It will support enterprise-centric finance for organisations that need it, and continue to target left behind communities, areas of regional disadvantage, and social difficulties. We believe that having a single specialist blended finance wholesaler, able to structure and deploy both investment capital and grant subsidy, should simplify things for the sector and help to lower transaction costs. It would continue to support the existing social intermediaries so that their learning about what has and hasn't worked, and the strength of their relationships with local organisations in their communities, would continue.

However, we recognise that for this to work, it requires a significant capital outlay of at least £300m, exceeding what has been given to blended finance as grant subsidy to date. **If any future investment is likely to be in the same order of magnitude as in the past, we feel that the best option is Option 3: to re-endow a wholesaler provider of grant subsidy into blended finance for VCSEs**, with a mandate to build the social investment market and enable VSCEs to access suitable capital when unavailable elsewhere through the provision of tailored solutions to fill funding gaps. **This will ensure that limited funds are used as grant subsidy, which our interviewees suggested was key to unlocking demand**. This is essentially the status quo—but it could be improved through design features to ensure that more is done to attract in other funders. We recognise this is the preferred option if the amount of budget is less than £300m over the next decade as the evidence shows that subsidy is important in driving demand from growth stage VCSEs.

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