THE BIG SOCIETY TRUST

Big Society Capital Quadrennial Review

Report

30 July 2020

Contents

This document was commissioned by The Big Society Trust (BST) and should be read alongside BST's announcement in response to this report and the response to the Review authored by BSC. These documents are available on BST and BSC websites.

Summary

Key achievements and successes

All interviewees agree, and the data demonstrates, that Big Society Capital (BSC) has made substantial progress towards its ambitious and challenging objectives as a result of its activities as a social investment wholesaler, as a market-builder and through initiatives such as supporting the establishment of Access – the Foundation for Social Investment (Access) and Good Finance:

- Expanding the social investment market and the number of participants.
- Increasing the amount of capital invested in social investment and scaling social investment opportunities.
- Making progress towards self-sustainability with a forecast portfolio IRR in low single digits.
- Changing the narrative and improving understanding of social investment.
- Achieving considerable social impact through the charities and social enterprises that have received funding.
- Initial feedback has been positive about its role during COVID19.

The overwhelming majority of interviewees believe that social investment in the UK would not have grown to the same extent without the catalytic impact of BSC's focus, its funding resources and its highly-skilled people. A common comment from investors and investees (even among those who were more sceptical) is that "it is a privilege to work with members of the team at BSC".

Strategic issues for further consideration

It is inevitable in reviews of this type that greater space is accorded to issues (the term used in our terms of reference – see appendix) than to documenting success, because such matters typically require more specificity and explanation. The Panel's suggestions for further consideration should be seen against the background of the challenges BSC has faced and its overall substantial success. The issues identified herein all emerged with a high degree of consensus in interviews internally with BSC leaders and externally with investors and investees as well as other stakeholders. Given BSC's overall success and consensus as to the issues, it is the Panel's view that BSC is in a strong position to take stock and consider how it might build on successes and address issues. This report considers the following strategic issues:

1. **System change**
   Building a robust social investment market – what more needs to be done to realise this ambition over the coming years? The social investment market is still maturing and there are ongoing tensions between elements of BSC's mandate to sustain its capital base and to invest in building the market.

2. **Relationships**
   Where does BSC need to improve aspects of its relationships with investors and investees? BSC is challenged by operating at every level – as wholesaler, as developer of potential co-investors and intermediaries, and as originator with charities and social enterprises.

3. **Strategy and innovation**
   What does maintaining success look like for BSC? BSC should continue its strategy to invest in innovative social investments and consider broadening its social impact focus areas.

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4. **Influencing Government**
   How can BSC have greater voice in the ‘levelling-up’ agenda? BSC has potential to play a bigger role, influencing Government across the UK for potential policy benefits from increased social investment.

5. **Culture**
   How can BSC build on its powerful internal culture to be more open to learning? BSC has an enviable talent pool but organisationally it comes across to many investors and investees as insufficiently attuned to stakeholders.

6. **Operating cost-effectively**
   Is BSC cost effective in delivering its objectives - balancing investment in market development vs self-sustainability? BSC’s cost base compares favourably to mainstream fund managers but there is a disparity when compared to some of those it funds.

7. **Governance**
   How can BSC improve decision-making and challenge? BSC operates to appropriate governance standards but could be more transparent in decision-making and challenge to its strategic thinking.

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Big Society Capital quadrennial review

Review process – consensus across the spectrum of interviews

The independent review panel (the 'Panel') of Keith Leslie, Neil Sherlock and Claire Brown (supported by Yemi Kuteyi of Moorhouse Consulting) were tasked with assessing whether BSC has met its objectives and whether it is effective in its operations. The Panel worked to a Big Society Trust (BST) Board team of Nicola Pollock, Stephen Howard and Alastair Ballantyne. BSC made their senior staff available for interview and established a comprehensive data room of material, meeting records, analyses and other documents. We are grateful to Tessa Godley of BSC for her support with documents, meetings and dealing with many and various questions from the Panel. Terms of Reference are appended as are brief biographical notes on the reviewers.

The approach adopted by the Panel, in agreement with BST and BSC, was to engage the people and stakeholders of BSC in conversation, exploring the successes, challenges and opportunities for the organisation. The Panel did not conduct an audit of BSC data nor develop alternative analyses, the review was conducted on the basis of data and analyses provided by BSC. The priority was to have open conversations with a wide range of stakeholders on the topics they wished to discuss and to do so in a constructive and confidential atmosphere. The Panel believes this priority has been realised.

The Panel worked with BST and BSC to identify 50-plus stakeholders and organisations including: past BSC leadership, BSC Advisory Board members, BST Directors, shareholder banks, policy makers and mainstream market investors, co-investors/partners, intermediaries (including those who were not successful in gaining funding) and ultimate investees in the voluntary, charitable and social enterprise sector. The appendix lists the stakeholder organisations who were represented during the interview process. Interviewees also suggested further organisations and individuals who could provide valuable insight. Alongside the internal and external interviews, an open invitation was shared on the BSC and BST websites and social media channels (from 6th April to 15th May) to encourage input from the social sector. Respondents were encouraged to either share free form responses to a dedicated mailbox or complete a short online survey. All responses were managed by, and confidential to, the Panel.

We found a high degree of consensus across all our interviews. Typically, an interview discussion split between 15-20 minutes of appreciation of BSC's work and 20-30 minutes of discussion around issues and options facing BSC – all addressed constructively. Another beneficial (although surprising) aspect of our interviews was that there was a high degree of commonality and consensus in points raised by both investors (commercial and social banks, foundations, fund managers and intermediaries) and by investees (charities and social enterprises). We believe this gives BSC an opportunity to take advantage of future debate and decisions around this review's findings.

The review took place during the COVID19 shutdown but, in line with the new normal, the interviews took place via video technology, the Panel worked from home and we believe that we obtained full and open input from interviewees and full and open feedback from BSC on our report and thinking as they developed. Our thanks are due to all whom we 'met' during the review period 16th March to 2nd June. All data cited was correct as of 19th June 2020, but some may be subject to later change as reports are updated in the normal course of events.

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Overview of Big Society Capital

BSC is a social investment wholesaler, established in 2012 to improve the lives of people in the UK through investment with a sustainable financial return – i.e. to achieve both a financial return and a social impact return. Using its knowledge and capital, BSC collaborates and invests with entities such as fund managers and specialist banks who also want to create a better, sustainable future. These entities then invest in charities and social enterprises, and together they create the social impact. BSC's aim is to play a central role in making connections and driving change; to bring together experts from their networks to generate ideas and connect capital to where it is most needed.

As a wholesaler, BSC cannot invest directly in charities and social enterprises; BSC only invests dormant account money in intermediaries, such as fund managers and social banks, who provide finance to social sector organisations. BSC was established to make repayable investments, and cannot make grants. Whilst recognising that social investment is not enough on its own, and is not the solution to many pressing social problems, BSC believes that as a tool in the right circumstances, it can be transformational.

BSC is funded from two streams; the English portion of dormant bank accounts and the four main UK high street banks. BSC has received an investment of £426m (as of 2nd June 2020) by BST with funds coming from the National Lottery Community Fund (NLCF) representing the English allocation of monies collected by the Reclaim Fund Ltd under the Dormant Bank and Building Society Accounts Act Account. Over time, Barclays, HSBC, Lloyds Banking Group and RBS each contributed £50m in capital as an equity investment. BSC can only invest dormant account money in entities providing finance to "Social Sector Organisations". Social sector (or third sector) organisations are defined by the Dormant Accounts Act as those that "exist wholly or mainly to provide benefits for society or the environment". BSC has interpreted this to include regulated organisations such as charities, Community Interest Companies or Community Benefit Societies and, in addition, has invested in organisations that are not regulated but adopt BSC governance principles. BSC interprets this requirement to include some profit-making entities that meet clear high standards of commitment to social purpose.

As of the time of writing (June 2020), BSC and its partners working with Government had put in place a range of measures to alleviate the financial consequences of COVID19 for investees. Interviewees have welcomed these measures which preserve the sector's resilience, BSC's achievements and opportunities for future growth.

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Key achievements and successes

The objectives of BSC as set out in its Articles are to:

> *"act as an investment wholesaler and generally to promote and develop the Social investment market place in the United Kingdom. In carrying out its objectives BSC shall: ensure that all dormant account monies received by it directly or indirectly under the Act shall be used by it in a manner that is consistent with being a social investment wholesaler under the Act; and seek to achieve and sustain financial self-sufficiency."*

The legal objectives of BSC explicitly focus on market development but the underlying purpose is equally clear: social impact. In the Panel's assessment – supported by the overwhelming majority of interviewees – it is clear that:

- BSC has made substantial progress towards its objectives in terms of quantum of social investment of repayable capital, of expanding the market and the number of participants as a result of BSC activities as a financially self-sustaining wholesaler, as a market-builder and through initiatives such as supporting the establishment of Access and Good Finance – detailed in 1. below.
- BSC-funded investments in charities and social enterprises have delivered considerable social impact – detailed in 2. below.
- Feedback during the review suggests a number of strategic issues for further consideration by BSC leadership – issues that we address in later sections of this report.

1. BSC catalysed development of the UK social investment market place

BSC reports[1] a number of significant market-building accomplishments that their capital has contributed towards, including:

- 28 Venture Impact funds in 2018 compared to 3 in 2012
- More than 70 outcomes contracts in the UK compared to 13 in 2012
- 4 funds specialising in financing outcomes contracts compared to 0 in 2012
- Over 67,400 community share investors compared to 33,200 in 2012
- Over 85 Social Investment Tax Relief deals since its inception in 2014
- The social property fund market size was £2.0bn+ in 2018 compared to £0 in 2012
- UK charity bond market has grown from £30m in 2014 to £369m in 2019
- 18 UK retail impact funds compared to 0 in 2012

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Participants with BSC are positive about market development

The overwhelming majority of interviewees believe that social investment in the UK would not have grown to the same extent without the catalytic impact of BSC's focus, its funding resources and its highly-skilled people. Many comment that having an entity entirely dedicated to developing social investment has been "truly game-changing". Intermediaries have said that they would not exist at the same scale – "or even at all" – without BSC's influence, support and capital. There is wide-spread high regard for the calibre and expertise of the BSC team.

BSC has had the capital to enable it to be a cornerstone investor in a number of funds, giving confidence to other investors. It is on track to become a self-sustaining wholesaler, preserving its capital endowment with a forecast portfolio IRR in low single digits, and thereby adding to the stock of total funding available for social investment. Since its inception, BSC has made a total of over 93 investments, totalling £600m. Alongside other investors, over £1.9bn[2] has been made available to charities and social enterprises. It is a vital part of the social investment landscape, recognised by all, and interacts with all of the key stakeholders.

The profile and understanding of social investment has increased, with more social sector organisations now utilising this form of capital. In 2010/11 a Cabinet Office report estimated the size of the social investment market in England as £165m of annual transactions, by the end of 2018 BSC estimated that the UK's social investment market was delivering £1.1bn of annual transactions or a total value of over £3.5bn.[3] The amount of capital that BSC has managed to deploy is impressive given where the sector was in 2012. Unsurprisingly, it took time for BSC to gain traction initially and the sums invested by BSC have accelerated during recent years. Currently BSC has a strong pipeline of nearly £250m of investment propositions in development. As a wholesale provider BSC has played a key role in making the sector more attractive for others, including mainstream investors. BSC has made significant progress towards self-sustainability, which enables it to not only recycle its capital into social investment but also 'prove the model' to other investors looking to invest. As with any start up, this has been challenging and BSC has incurred losses in the early years – however it currently forecasts a net portfolio IRR on current investments in low single digits.

A number of respondents reported that BSC had been a great partner to work with, described as having a collaborative approach. BSC people are able to bring their investment knowledge, while allowing partners to take the lead on areas where they have a deeper expertise. This approach appears to be driven by staff who have a good understanding of finance, as well as a genuine desire for impact. BSC have been described by some as being "generous with their time" and supportive of others who are interested in growing their organisations. An example was shared of a senior BSC leader who took the time to provide valuable advice and feedback that led to real change within the investee organisation.

On the theme of thought leadership and acting as role model, global players stated in interviews that the UK experience has been a model for social investment, illustrated both by the work with the G7/8 and the countries that have introduced variations on the BSC model, including Japan, Portugal, South Korea, Canada and Italy.

This world-leading success in boosting social investment is in the view of the Panel a considerable credit to the BSC team who developed the strategy, investment model and organisation through several iterations and despite significant challenges.

As of the time of writing (early June 2020), BSC and its partners working with Government had put in place a range of measures to alleviate the financial consequences of COVID19 for investees. These

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measures included sharing information, adjusting existing funding and exploring new funding, notably through the redesigned Community Investment Enterprise Facility and, with Social Investment Business, the new Resilience & Recovery Loan Fund. Interviewees have welcomed these measures which preserve the sector's resilience, BSC's achievements and opportunities for future growth.

BSC relies on collaboration with other players, some of whom it played a key role in creating

Although BSC is the principal actor in social investment, it is part of a wider eco-system including Access, NLCF, Good Finance and the British Business Bank. BSC plays a critical role in many of these other entities and shares credit for their impact and symbiosis:

- Access is "tasked with developing programmes to stimulate both the demand for social investment from the sector, funded through a £60m endowment from Government, and the supply of the right sort of finance to meet the sector's needs, blending grant funding from NLCF and debt from BSC into the Growth Fund. Across both of these strands of work, Access seeks to use grant subsidy to help build the market – a wholesaler of subsidy to sit alongside the wholesaler of capital; ultimately to make social investment more charity-shaped."[4]

- BSC played a major role in creating Access in 2015, which came into being because at the time "The social investment that is taking place is ill-fitted to the needs of the vast majority of charities and social enterprises; designed instead around large deals, assets, and government contracts. It does not reflect the realities of their various enterprising activities and, instead, feels like it is driven by the demands of investors: seeking market returns, transferring risk, and emphasising competition rather than collaboration between organisations". A NLCF-commissioned report in 2012 highlighted this mismatch, concluding: "Organisations that are looking to raise finance are primarily interested in longer term finance of less than £100,000 to help them scale up their existing activities. This does not match the dominant type of capital on offer to this sector".[5] Closely allied to BSC, Access has a distinct but complementary role. It is seeking to define the most effective role of subsidy in the social investment market through providing grant to blend into loan funds, to support smaller charities and social enterprises, and provide grant to support enterprise development and investment readiness programmes.

- Good Finance is a collaborative project to help improve access to information on social investment for charities and social enterprises. In 2016, key representatives from social enterprises, charity and social investment sectors came together to launch an initiative to help tackle information barriers for social sector organisations. Good Finance is jointly funded by Access, BSC and DCMS, with in-kind support provided by members of the steering group.[6]

- NLCF have provided grant funds which Access use to blend with BSC debt in the Growth Fund, and been part of BSC's Advisory Board in the past – and provide grants to many charities and social enterprises that either could or do also deal with BSC.[7]

- British Business Bank is a government-owned business development bank dedicated to making finance markets work better for smaller businesses, working through a large number of finance partners, some of whom are also BSC-funded intermediaries.[8]

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2. BSC-funded investments delivered considerable social impact

BSC reports[9] a number of social impact accomplishments that their capital has contributed towards since inception, including:

BSC Social Impact	
Impact by product area[1]	**Impact by outcome area**[1]
Charity Bonds BSC has worked to seed new funds, and the market has now grown from £30m in 2014 to over £369m in 2020.	*Housing and Local Facilities* Over £610m committed to social enterprises and charities through 228 investments. 26,000 people living in suitable housing.
Property BSC invested and brought in other investors alongside, to create the scale needed to achieve impact in affordable housing, which has a disproportionate effect on vulnerable groups like people at risk of homelessness or survivors of domestic abuse. As a result, 2,147 affordable homes have provided housing for 3,256 people.	*Citizenship and Community* Over £78m committed to social enterprises and charities through 109 investments. £22.7m in projected and actual funds generated for local communities.
Outcome Contracts In 2013, BSC issued a call to fund managers to provide social enterprises and charities with the capital and support they needed to deliver outcomes-based contracts. There are now over 70 outcomes contracts in the UK commissioned by central and local government, and CCGs, compared to 14 in 2012, and 4 funds specialising in financing outcomes contracts compared to 0 in 2012.	*Physical Health* Over £24m committed to social enterprises and charities through 81 investments. 729,000 people taking part in physical activity.
Venture BSC is seeking to tackle social problems by nurturing and scaling ventures that are developing innovative solutions. There have been 9.9m beneficiaries across 92 active ventures. There were 28 Venture Impact funds in 2018 compared to 3 in 2012.	*Employment, Training and Education* £34m committed to social enterprises and charities through 203 investments. 50,000 people supported into employment.
Bank lending BSC's bank lending investments seek to provide adequate access to lending to more charities and social enterprises. As a result of BSC's investments, 3,500 people have been housed and 10,800 people receiving training.	*Arts, Heritage, Sport and Faith* £12m committed to social enterprises and charities through 48 investments. 420,000 people taking part in arts and cultural events.
Non-bank lending There have been 600,000 beneficiaries. BSCs non-bank lending investments often serve as the last resort for many investible impact projects, addressing specific market gaps for social organisations to raise small loans to enable growth or asset acquisition.	*Mental Health and Wellbeing* Over £38m committed to social enterprises and charities through 128 investments. 255,000 people receiving online support for mental health.
Renewable BSC has supported 43 community energy projects. £22m in projected community benefit funds.	*Income and Financial Inclusion* £37m committed to social enterprises and charities through 34 investments. 35,000 affordable loans provided.
	Families, Friends and Relationships £22m committed to social enterprises and charities through 51 investments. 6,700 children accessing nurseries or childcare.
	Conservation of the Natural Environment £12m committed to social enterprises and charities through 10 investments. 1,473 MW of renewable energy capacity.

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Overall this is a catalogue of considerable social impact over the last five years. While our quadrennial review was neither tasked nor resourced to audit BSC's social impact, the Panel did invite comment during our interviews. Points raised included:

- The validity of specific claims of the scale of the social impact – examples include the slow growth of outcome-based contracting (although this is arguably due to the caution of Whitehall, local authority and NHS commissioners, not a BSC failure) or the emphasis on asset-backed projects (addressed in Issue 3 below).

- The BSC model of investable capital – examples include questions such as 'what greater social impact could have been delivered in a different model?' which cannot be conclusively answered because we cannot conduct laboratory tests under controlled settings on complex social issues. It is clear that BSC's model cannot tackle all social issues and, again, we address the strategy issue in Issue 3 below.

- The relative impact of BSC compared with related entities in the social enterprise eco-system such as Access, NLCF and the British Business Bank. It is correct to say that all these entities overlap somewhat in social impact, they are inter-related (Access manage grant funding on behalf of NLCF which is blended with debt from BSC in the Growth Fund) – and conceivably may double-count some of their social impact.

However, Access, NLCF and the British Business Bank are operating with different objectives and mandates than BSC, making comparisons difficult:

British Business Bank has a mandate to support SMEs while earning a return equivalent to long-term UK Government bonds – there is no basis for comparing the relative social impacts of BSC with the British Business Bank.

NLCF disbursed £511.1m in 12,143 grants in the UK during 2018-19, with much smaller grants (86% were £10,000 or less) through a much larger organisation (831 FTEs). Their 26,988 active projects covered many similar areas of impact to BSC[10] – as illustrated opposite in NLCF's published analysis. However, the many small transactions and the grant-giving status of NLCF makes comparing the relative social impacts of BSC and NLCF highly problematic.

6,656	Projects supporting health & wellbeing
1,298	Projects improving education & life skills
850	Employment & entrepreneur projects
1,586	More active communities
6,853	Projects that bring communities together
979	Environmental projects

Access is BSC's sister organisation and the wholesaler of subsidy into the social investment market. The Growth Fund, which Access manages, combines £22.5m of NLCF grant with c.£26m of debt from BSC which is currently invested in 14 intermediaries. The programme has made 434 investments, analysed below, totalling £27.3m in England to date.[11]

£63,000	Average investment
5 FTEs	Median employment by investee organisation
£241,000	Median turnover of investee organisation
48 months	Average loan term
7.28%	Average interest rate
59%	Investees receiving grant
12%	Total investment received as grant

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Strategic issues for further consideration

It is inevitable in reviews of this type that greater space is accorded to issues than to documenting success, because issues typically require more specificity and explanation. The term 'issue' was used by the Panel, given that it is in our terms of reference – see appendix. The Panel's suggestions for further consideration should be seen against the background of the challenges BSC has faced and its substantial overall success. The issues identified herein all emerged with a high degree of consensus in interviews internally with BSC leaders and externally with investors (commercial and social banks, foundations, fund managers) and investees, as well as other stakeholders. Given overall success and consensus as to the issues, it is the Panel's view that BSC is in a strong position to take stock and consider how it might build on successes and address the strategic issues.

As a Panel, we had anticipated the normal pattern of responses – different views from internal and external interviews, and different views from major segments of external stakeholders i.e. investors, investees and policy-makers. During this review of BSC, there was a high degree of consensus across all interviews and the issues for further consideration emerged early and clearly. We have not reported comments that came from only a few interviews, in order not to dilute the impact of the consensus. In this report, we have sought to distinguish where we report the views of others as "interviewees comment that" from our conclusions as "the Panel's view is".

1. Achieving sustainable systems change and building the social investment market

The majority of interviewees believe that BSC has significantly catalysed growth in social investment. This catalytic role is recognised even by sceptics who question BSC's role or strategy. There is strong consensus however that the social investment market and BSC is still maturing and needs further time and investment to change the system, attract further capital and build a robust and sustainable social investment market at scale in the UK. Whilst some cited various concerns and reservations about BSC's approach, the vast majority believe the past and continued existence of a single organisation whose primary focus is to wholesale and develop the social investment market is game-changing. Add to that the quality of the BSC team and their knowledge, energy and drive and BSC is widely believed to be a vital part of building a long-term sustainable social investment market over time.

Pool of potential social investors

The relatively small pool of potential investors for social investment, compared to mainstream and impact investment, was often commented on by interviewees as still a challenge to building the market and achieving sustainability through scale.

BSC has done much via networks and initiatives including working with the Social Impact Investors Group for Foundations interested in social investment and establishing the Good Finance brand to bring intermediaries and investees together. BSC has also had significant success in attracting investment from, and persuading organisations to make allocations to social investment, including from universities, local authority pension funds, donor advised funds and the Church Commissioners. Interviewees were keen that BSC continues to invest in this vital aspect of growing the market and to promote, develop and share further its successes.

BSC usually requires a matching investment for its funding which has been a useful mechanism for growing the investor community. In some circumstances BSC has provided unmatched funding where the development or impact case justifies it – interviewees are

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supportive of this flexibility and would like to see it continued or indeed potentially expanded as the market grows.

A key element of BSC's objectives is to be self-sustaining – in part to recycle its capital into future social investments – but also such that it 'proves the model', both financially and for social impact, to more mainstream investors and thereby attracts more investors and capital into social investment. This of course has pricing and cost implications for BSC which we address below and in Issue 6. For the purpose of this section it is worth highlighting that BSC needs to exit its existing investments in order to 'prove the model' – and a proportion of exits will need to be to more mainstream commercial and impact investors. The first cycle of exits is in its infancy with the bulk of early investments maturing 2022-24 and thus this key element of proving and growing the market is – as yet – unproven. There is a significant opportunity identified by some for BSC to grow a network of 'secondary' investors to facilitate its own and other social investor exits in the medium term. The Panel's view is that BSC will need to devote significant resource to building further networks and expertise to ensure a range of successful exits over the coming years.

Many potential and existing commercial partners still view social investment as part of their corporate social responsibility (CSR) rather than their mainstream investment activity – that is, they look to achieve social impact and get their capital back rather than earning a 'market' return. In Issues 2 and 3 the Panel picks up the implications of this behaviour for relationships with investors and for BSC strategy and at this point asks what this behaviour means for the evolution of social investment:

- There is a risk that social investment is subsumed within 'impact investing' and the social sector loses capital to 'for profit with purpose' rather than becoming a distinct and recognisable part of the spectrum of capital and benefiting from the recent growth in interest in impact investing.

- BSC is seen as being well placed to promote social investment within the spectrum of responsible, ESG and impact investment and to help 'defend the integrity of impact' across markets. There was caution however that any role around the 'defending of integrity' should be about judgement and experience and not purely metrics-driven.

- There is a question here also as to the appropriate return or pricing of social investment and the 'value' of social impact in the model which we address under 'Proving the model' below.

BSC has a robust and rigorous investment philosophy and process, which is widely recognised as appropriate, especially in light of the dormant account monies. Some interviewees commented that the process of investment had made them interrogate their organisation and finances in a different and constructive way. However, co-investors across the board did point to what they viewed as being an impediment to past and future co-investment with BSC in the perceived inflexibility and lengthy nature of BSC's investment approach and process – we discuss this further in Issue 2. There was a strong consensus that BSC often went beyond normal commercial levels and could afford to be lighter touch, more collaborative and flexible without losing its validity or effectiveness. The Panel's view is that BSC could helpfully revisit its approach by comparison to mainstream investors by testing the relative level of rigour to ensure BSC is not unnecessarily deterring co-investment.

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‘Proving the model’ – pricing, risk and return

As we discuss above, growing the social investment market includes attracting a sustainable pool of investors at scale. Investors need to have confidence in and understand the likely risk and returns of their investments – ideally evidenced by a strong track record. BSC’s objective of being self-sustaining and delivering a positive net return for their shareholders – building their own investment track record – remains a core part of its strategy to build the market by ‘proving the model’ and giving confidence to other investors to invest.

The risk/return profile, including social return element, and thus the pricing of social investment is still seen by most as evolving, needing further debate, track record and data. BSC’s catalytic and influential role and breadth of investment experience mean it is seen as well placed to contribute to, or indeed drive, this debate. It is important for this debate to go beyond ‘proving the model for mainstream commercial investors’ and recognise that financial returns do not necessarily need to compete in all sectors, or for all investors, with ‘market’ or commercial norms. There is, and will continue to be, capital available with mixed motives from philanthropic sources, CSR money as mentioned above, and blended finance models – none of which are driven primarily by financial return. This full spectrum of capital can successfully be invested in the social investment market. The Panel suggests that BSC’s dialogue should support and encourage the broader discussion of the spectrum of capital available and investment opportunities. BSC should also share its thinking and experiences where it has invested its own capital in specific individual ‘below market’ investments.

Whilst BSC’s objectives and operating restrictions are widely understood, the impact these have on BSC’s portfolio and sector level investment activities and particularly pricing and risk appetite is less well understood. We heard some interviewees assert that BSC has crowded-out commercial money by offering a cheaper alternative, whereas others believe BSC’s money is expensive and comes with too many restrictions and oversight. BSC’s approach is in fact to price its capital to investees at a rate that balances what it believes the business model can support with the ability to attract co-investors at that level of return. BSC then overlays its portfolio allocation (how much is invested in what) as the way to address its shareholders target return objective. BSC prices differently in different areas to attract co-investors or indeed prices at preservation of capital only or expected partial loss of capital in order to develop a part of the market.

In the Panel’s view, greater transparency and open debate and analysis is required from BSC on returns, pricing of capital, investor motivations / sources of capital, the potential need for subsidy and risk. In the Panel’s view, this would assist the growth of what is now widely recognised as, not a single market, but a diverse robust social investment market. This diverse market offers a spectrum of investment opportunities, with a variety of investors confidently engaging.

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Missing infrastructure and incentives

Many interviewees applauded BSC's work on addressing the challenge of various missing participants, infrastructure and incentives that impede the growth of the social investment market, such as the work done to address the lack of:

- Brokers and advisers.
- Investment readiness funding.
- Blended funding arrangements.
- Effective tax incentives and the policy work BSC has led on SITR.
- Systematic removal of regulatory and other barriers to wider social investment.

Most interviewees would like to see BSC find a methodology that allows it to continue to pursue and add to these initiatives – recognising that this is a challenge given that it cannot make grants and the tension with the objective of being self-sustaining and meeting its shareholders' return target – we discuss this further in Issue 6. The most quoted was the need for greater availability of blended finance, such as through the Access Growth Fund where grant from NLCF is blended with BSC debt at a wholesale level. Blended finance is widely-perceived as critical for the growth of new social investment opportunities and innovations and consequently for the scaling and sustainability of the market.

The Panel recognises this is a strategic challenge for BSC and may not be realistic, cost effective or indeed BSC may not be the best placed to pursue all areas. Partnership working and shared policy advocacy may continue to prove the most effective methodology.

Sharing of strength with Intermediaries

BSC remains arguably the most influential player and developer of social investment in the UK, even if it is not the largest financially. BSC invests through many small and often still thinly-capitalised intermediaries – many of whom are dependent on BSC. The market is far from its desired long term vision of a mature, deep, broad and competitive marketplace. Many interviewees believe that BSC needs to be more sensitive to this imbalance and look to strengthen the market by greater sharing of its knowledge, resource and capital with others, using its influence to support the ideas and activities of others, and to resist imposing their own view of the world.

Many intermediaries express their frustration in remaining thinly-capitalised with small profit margins which leads to a significant restraint on their ability to innovate, invest in research and development of ideas and products, attract and keep talent, build networks, raise capital and invest in their own growth. In this context, BSC appears to many to be disproportionately well-capitalised and resourced. Interviewees commented that often BSC will imply that intermediaries and their investees in the social sector remain fragile due to poor financial planning and expertise, without due regard for BSC's relatively fortunate history and the confidence and freedom that the 'gifted' Dormant Asset financial strength brings. Intermediaries interviewed, almost without exception, expressed a strong wish that BSC took a more strategic approach to capitalising and working with intermediaries – through more flexible funding models such as:

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- More extensive capitalisation of their Balance Sheets allowing them expansion capital.
- Offering greater up-front funding of development costs during tender processes
- Funding pilot programs that are experimental that prove models or allow intermediaries to build track records.
- Providing fully discretionary funding models rather than narrow funding mandates.
- Funding and working with others to address the underlying drivers in government policy and procurement – e.g., the low take-up and unrealistic bidding processes for outcome-based contracting. Poor public sector procurement processes help perpetuate the poor revenue funding of social sector organisations which, in turn, limits the pool of social sector organisations that can take social investment.
- Funding more research and development by partner organisations and intermediaries and thus sharing expertise and reducing market dominance, rather than continuing to build its in-house expertise – 'BSC has a preference for its own ideas' being a common critique.
- Sharing data that it compels intermediaries and investees to provide, adopting standardised measurement tools and providing common systems platforms – all of which would reduce barriers to entry and encourage a more competitive marketplace.

The Panel understands that BSC has to date capitalised 13 intermediaries to a total of £30m, and these investments are in fact loss making to date, and provides a 'Building Blocks' programme of support to intermediaries including training, networking, recruitment and other support. However, the on-going fragility of intermediaries due to their under capitalisation appears to the Panel to be a legitimate concern and potentially a threat to the sustainability of the social investment market as a whole, the resolution to which requires ongoing strategic consideration by BSC and others.

2. Building relationships with investors and investees

The multiple elements of BSC's mandate (see appendix) of building relationships with co-investors (mainstream investors, impact investors, Foundations, private wealth offices and individuals and others), intermediaries (fund managers, social lending banks and others) and ultimate social sector organisation investees (charities and social enterprises) reflects the broad challenge to BSC to operate at every level of the social investment market in order to build the eco-system largely from scratch:

- Supplying funds to social investment intermediaries as a wholesaler.
- Developing investable propositions working directly with charities and social enterprises – normally the role of intermediaries in established markets. There has never been a queue of investment-ready charities and social enterprises waiting for funding.
- Actively engaging in growing the number of intermediaries from a handful to 40+, shaping intermediaries' investment strategies, often sitting on their investment committees and thereby seeing 2,000 frontline business plans, and sometimes directly funding their establishment.
- Using BSC's influential position in the social investment eco-system to establish norms for financial returns.

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Greater flexibility in approach

Many interviewees, whilst appreciating BSC's rigour and professionalism, criticised BSC as inflexible in its investment approach, both philosophy and process, compared to other commercial and public bodies. Examples:

- Both investors and investees cited co-investments where BSC was late in agreeing and completing its participation as a result of needing to fit every deal into an established framework in order to gain approval across its leadership.

- We heard of deals that were developed with the investment team over an extended period in a partnership approach – but then, in order to close the deal, BSC was able to impose its terms as the dominant player. BSC co-investors and intermediaries have learned that BSC will not hesitate to use its market power to lead in partnerships.

- Co-investors and intermediaries also gave the example of BSC being rigid in its approach and insisting on the intermediary using a different impact measurement taxonomy than they had planned or used historically to serve their in-house need, rather than being alive to other alternatives and cost implications of this requirement.

As touched upon in Issue 1, whilst BSC's status as a regulated entity and a recipient of public money is appreciated, a greater degree of pragmatism is also much wished for by many stakeholders. Many intermediaries and other investors recognise that BSC's behaviour is, to some extent, shaped by the context of its creation – and especially the Dormant Account legislation and the agreements with its shareholders. Many interviewees and some BSC leaders suggested that BSC takes an unduly rigid interpretation of these constraints in terms of the returns expected from investments, the extensive due diligence and the high bar for investment. For example, compared to BSC's target return of 4.5%, the British Business Bank targets the return on 30-year Government bonds. The Panel acknowledges that BSC has shown flexibility in individual cases and we suggest BSC could usefully revisit some of these restrictions with stakeholders, in addition to questioning the flexibility of its investment methodology and technical approach.

As also mentioned in Issue 1 above, some mainstream investors described their social investment strategy as "more an extension of corporate social responsibility rather than commercial investment" … "clearly not to make a return, more to achieve impact and get our money back". Given that positioning, they found that BSC's focus on making a commercial return from most investments and being on same terms with them as a co-investor does not necessarily align with some investors' views, as they are supportive of a more flexible approach.

Overall, whilst it is difficult for the Panel to judge the validity of criticisms as to mandate interpretations, investment process flexibility and approach, the Panel's view is that BSC should look to improve its dialogue and relationships with investors and in doing so consider exploring changes in its strategy and investment approach where advantageous.

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Need to address relationships with investees

Given BSC's initial brief to create the social investment market and to work with bank shareholders, BSC was perceived as modelling itself on its City investors. Its first chief executive came from investment banking, as did many of the investment team, while it was set in up City offices and acquired corporate services on a scale arguably comparable to a City firm.

Perceptions matter (especially among the main beneficiaries of BSC's capital) and social enterprises and charities comment regularly on the high level of BSC resourcing compared to the social sector (which has been hit hard by austerity) and compared to intermediaries that run on much thinner resourcing models. Unsurprisingly, BSC has developed closer relationships with potential co-investors than it has with potential investees among charities and social enterprises. It was noticeable to the Panel how some BSC Board members had much to say during interviews on the topic of BSC's relationships with investors – but very little to say on the topic of relationships with investees.

From the start, BSC has identified a 'communications challenge' dealing with the social sector, attributing it in part to resentment over the defined scope of BSC's role, in part to the difficulty in creating 'investment-ready propositions' with a funding model that is unfamiliar, risky or impractical for many social enterprises and charities. The Panel believes that pigeon-holing this challenge as 'a communications issue' under-states what should be viewed as a substantive issue for BSC action.

Many investees expressed to the Panel their appreciation of the talented one or two individuals with whom they worked at BSC, naming them and commenting on their expertise and personal commitment to landing the deal. However, the same investees then went on to comment on the same individuals' lack of connection with frontline social challenges and the 'education' that they provided to their BSC contacts. There were many anecdotes suggesting lack of understanding among BSC people of the human issues being addressed through social investment or the eye-opening experiences when some BSC people actively engaged and began to identify with end-users of the investments or the journey that enabled BSC people to move on from 'seeing all the problems' to 'seeing the opportunities for impact'.

BSC co-investors and intermediaries described many mainstream investors as being 'on a journey from expectation to reality', because initially many mainstream investors expected (and some still do) that social investment opportunities will be as large and liquid as commercial opportunities.

Improving human interaction with investors and investees

Interviewees have clearly seen a shift in the mix of BSC staff over time. Some initial BSC recruits appear to have struggled to connect their finance background to the different world of social investment. Currently, there seems to be much more diverse backgrounds within BSC from the social sector, with many perhaps lacking an investment background. Interviewees comment on now facing the reverse challenge of BSC people who under-estimate the relatively greater financial expertise and client experience in co-investors and intermediaries. Many interviewees who described themselves as "fans of BSC" and BSC as "a game-changer" nevertheless highlighted the BSC culture as overbearing at times, especially for smaller partners and described how they pushed back – see the discussion under Issue 5.

The Panel's view is that BSC would benefit from investing more time and effort to build stronger relationships with investors and investees alike.

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3. Strategic focus, impact and investing in innovation

Given its purpose in being a wholesaler of investment capital, there will always be critics who point out that the bulk of social enterprises and charities will not benefit from BSC's funding.

Often characterised as a 'communications issue', as noted in Issue 2 above, this has been a challenge at BSC from its inception which still persists. There is likely to be an ongoing fundamental mis-match in expectations that interviewees expressed as 'the social sector expected BSC to capitalise it, whereas BSC see its role as market builder', even though the majority of interviewees are cogniscent of BSC's objectives and constraints. However, there seem to the Panel to be legitimate questions over strategy and policy formed within BSC's defined role and BSC's challenge to and interpretation of constraints.

Greater clarity and openness on objectives and learning

The majority of interviewees were unclear about the original definition of 'success' for BSC for its various objectives and the effectiveness through time of BSC's strategy and activities. Most think it would be helpful to the market to have much greater external clarity and openness as to:

- BSC's objectives and its key role in the social investment market.
- How BSC intends to deliver against its objectives and role.
- Constraints on BSC, both externally imposed in its creation and internally set.

The need for this clarity alongside greater transparency from BSC – beyond aspirations and data to include learnings and failures – was often cited as a missed opportunity. One interviewee posed the question "who is BSC here for – the investor or the investee – and if it's both is success equally balanced?".

There is a perceived lack of confidence on the part of BSC in stating its own unique contribution to social investment and value-added through acting as a wholesaler and developer of the market, and through its unique position of working with market participants across the board. For some interviewees a dislike was expressed for what is seen as a 'procurement' or 'pre-emption' of the social impact of the ultimate investee social sector organisations' impact by BSC for its own claimed social impact – rather than clarity as to the role of BSC as distinct from and additional to, that of the intermediaries and social sector organisation investees. Others cautioned against a perceived 'overclaiming' of BSC's own effect on ultimate investees.

A number of interviewees particularly mentioned the need for BSC to be more open to discuss and recognise the increasingly held view that, for some sectors of the market, social investment is proving not to be the 'free lunch' originally hoped for and that financial return is very often likely to be lower than a commercial 'market' return. Rather than be nervous of acknowledging this, BSC should champion the view that the exceptional social impact achieved is compensatory in part and that, as a result, investors will still be keen to invest. This is especially important in light of the growing interest and investment in 'impact investment' – i.e. investing in 'for profit with purpose organisations' primarily for financial return. Differentiating between impact investing (i.e. profit with purpose) and social investment (i.e. investing in charities and social enterprises) is viewed as essential by many to ensure social investment does not get lost in the substantial amount of capital now looking for impact investing opportunities.

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Balancing self-sustainability whilst growing the market – an increasing challenge

Many believe that, as the market matures further, BSC will have an ever increasingly difficult balance to maintain, and potentially even a conflict to manage, between acting as a self-sustaining wholesaler of capital, and 'proving the model' as discussed in Issue 1, whilst building the social investment market. There is a risk that as certain aspects of the market mature, with proven sustainable rates of return attracting capital from elsewhere, the more difficult and financially risky areas will be left behind. BSC is well placed to continue its focus on the risky and innovative end of the social investment market – having invested 75% of its capital in new teams, managers and products to date – but balancing its portfolio to achieve its shareholders' target returns as some of the less risky investment opportunities scale and arguably no longer need its funding may only further increase pressure on its ability to achieve its return target. In the view of the Panel any future BSC strategic review needs to consider this potential building pressure and the related risk of shying away from innovative and risky investments and the longer-term implications.

Broaden from the current three focus areas of social impact

Since 2017, BSC has worked through a phase of its development where it focussed on three social impact areas: homes for people in need; places and communities; and early action. Internally within BSC, this strategy was driven by a need to focus resource on those areas where it was forecast that most social impact could be achieved through the tool of social investment.

It is not unexpected then that this strategy has included a focus on property investments. Most interviewees who commented on the three focus areas strategy picked up particularly on this aspect. Property investments were seen by critics of the strategy as already commercially-investable because the asset backed nature of the investment typically generates low risk and reliable returns – therefore they are arguably not the most effective use of BSC's capital. BSC, and those interviewees closer to the property investment part of BSC's portfolio, assert that the property investments it has made are innovative, risky and deliver high social impact investments. In addition, without BSC as a co-developer or commissioner and key cornerstone investor, it is asserted that these projects would not have received commercial investment. Further, proponents point to the success of these property investments over time – not just social impact – but also that they have gone on to attract follow-on new commercial capital at scale and thus contributed to building the social investment market. Most interviewees, on both sides of the argument, recognise that property risk and return profiles assist BSC's overall portfolio position but caution that BSC then be wary of investing past the point when BSC's capital is needed to attract commercial investors.

BSC believes, and interviewees concur, that the addition of the strategy to invest in the three focus areas where social investment could have the most social impact has led to a greater expertise, data and helped drive those sectors towards scale at a faster rate. There was a broad consensus amongst interviewees that BSC being the driver and initial repository of expertise in these areas has been hugely helpful to the sector, but that in the long run in its role as a wholesaler BSC should probably be a generalist, with the narrow sector expertise belonging to intermediaries. Indeed, the narrowing of focus was questioned by some interviewees as being at odds with the objective of being an investment wholesaler. Interviewees also questioned if the addition of the three focus areas has led to a more limited investment opportunity set available to BSC. This does not appear to be the case with BSC identifying a pipeline of investments in development within its focus areas of close to £250m in early 2020. It is worth highlighting that BSC, whilst primarily making new investments in the three focus areas, has maintained its

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commitments to pre-existing investments, and contributed follow-on monies in areas where it had invested previously.

Almost all interviewees recommended, and the Panel agree, that BSC should now consider broadening out its investment focus with a continued emphasis on risky and innovative social investment.

4. Influencing Government across the UK as part of developing the social investment market

BSC in 2012 had a profile and influence championed by the Prime Minister while by 2020 the relationship with Government seems to be much more distant. This is partly due to BSC wanting to demonstrate its independence from Government, partly due to a natural maturing of the relationship between Government and BSC as the wider social investment market has developed, and partly due to Government since 2016 being dominated by first Brexit and more recently the COVID19 pandemic.

In 2012 the Prime Minister, David Cameron, launched BSC. At the event to launch BSC the Prime Minister described it as the world's first social investment bank arguing that "BSC is going to encourage charities and social enterprises to prove their business models – and then replicate them. Once they've proved that success in one area they'll be able – just as a business can – to seek investment for expansion into the wider region and into the country."[12]

Tensions in relationships with Government

Investors and investees in interviews with the Panel cited examples which in their view underlined that more distant BSC relationship. These included "lack of voice" in the debate on outcome-based contracting, "lacking influence" in regulatory issues and "not the key voice" on the future of Access. However, those comments must be balanced against the important role that BSC played in the setting up of Access and being involved in senior-level Whitehall discussions on the future of outcome-based contracting. BSC does not have today the connection and influence with Government that, for example, its intermediary Social Investment Scotland (SIS) appears to enjoy and visibly exploit in the form of a number of initiatives and actions with high level political support. A recent example of SIS engaging to rapid effect was the 18th March 2020 announcement by the Scottish Cabinet Secretary for Communities and Local Government of the setting up of the Third Sector Resilience Fund[13] as part of the COVID19 response with SIS as one of the three deliverers of the Fund.

These comments in interviews would no doubt be debated by BSC, who would for example point to the mention by Baroness Barran, Minister for Civil Society, in the House of Lords debate on 30th April 2020. The Minister made reference to the support from BSC to address cash-flow problems within the social enterprise sector.[14] This reflected the positive view of how BSC had worked with Government and other bodies to support social sector during the COVID19 crisis. Initial feedback that the Panel had from interviewees reflects this, although clearly the impact of actions to support the social sector will be judged over time. A number of those interviewed also saw this as the time to explain the positive – and potentially huge – role of social enterprise for the recovery of the UK economy.

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Perceived as London-centric

BSC has had a strong investment partnership with SIS since 2014 but it is not a major player in Wales or Northern Ireland. In addition, some of those whom the Panel interviewed saw BSC as London-centric, which is picked up in more detail in Issue 5 which covers BSC's powerful internal culture. Social investment in Wales and Northern Ireland has been led by support from the Welsh Government and Northern Ireland Executive. There are opportunities for strengthening the partnership with SIS in Scotland, as well building one in Wales and Northern Ireland in a collaborative way with the Welsh Council for Voluntary Action (WCVA), Social Investment Cymru (SIC) and the Ulster Community Investment Trust (UCIT).

If BSC wants to change the relationship with the UK Government it will need to consider a repositioning of its strategy. A greater emphasis on innovation, higher risk social enterprise and charities, diverse business owners and stronger advocacy for social investment solutions, even when BSC has not driven them, would all play a part in this. In the Panel's view such a narrative could help BSC become more relevant to the 'levelling up' agenda and, as one of those interviewed put it, "an opportunity for BSC to be seen as less London-centric". This could open up a broader dialogue across Government, not just DCMS but also MHCLG, HMT and BEIS, as well as extending existing collaborations with Metro Mayors and Council leaders.

5. Balancing the powerful internal culture

BSC shares many of the organisational characteristics of a successful investment bank, management consultancy or professional services firm. It has recruited very talented people from a wide range of backgrounds including journalism, investment banking, professional services, FTSE 100 companies, civil service and the charitable sector. In early 2020 a survey of BSC people showed that:

- 38% had a background/experience in the Voluntary, Community and Social Enterprise sector and 46% in Financial Services.
- 57% of the workforce is female, compared to 51% in the social investment sector.
- 70% of the workforce is white, compared to 87% of employed people and 73% in the social investment sector.
- 6% of the workforce identify as being disabled, compared to 12% of employed people and 7% in the social investment sector.

This diverse and talented group has come together under strong leadership in the last eight years to build a powerful internal culture.

Positives of talented people and clear direction

This culture was evident from interviews with people who had worked for and with BSC since its creation. Among those who worked with BSC, whether the person interviewed was an investee, an intermediary or a co-investor, there was a broad consensus that BSC was an organisation of "great people", which "stands out" because of a shared "clarity of purpose". Overwhelmingly investors, investees and intermediaries interviewed appreciated the quality of the leadership and staff of BSC. The expertise was recognised, the generosity of knowledge sharing and time spent was appreciated. Many individuals, covering BSC past and present employees, were praised by those interviewed by the Panel.

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In 2020 this BSC culture is underpinned by a strong leadership team; a clear corporate image; an insistence on standard management processes to ensure coherence and consistency across BSC; a flat and broad decision-making structure and a united voice articulating a unified narrative about BSC strategy and priorities. The striking part is that the success which has already been outlined which has been delivered because of the people, culture and leadership of BSC was recognised and given credit even by those who characterised themselves as critics. Indeed the next two quotes from interviews – one who works for BSC and one who is an intermediary – could easily have come from the other. "BSC's skillset is to use the tool of social investment to achieve a positive impact" and "BSC has a clarity and confidence about the role it plays and the impact it makes". They underline the strength of the culture, the focus of BSC and the narrative at its best.

The 2018 BSC Stakeholder Survey had responses from over 200 stakeholders. 57% felt that they had a good or extremely good relationship with BSC. Where the relationships were strong, they were often very strong. It is worth noting that this survey brought out similar results to interviews in that BSC employees were seen as supportive, providing valuable advice and a sympathetic ear.

Downsides of lack of empathy and diversity of views

Most co-investors and investees interviewed commented on the opacity and slowness of decision-taking, of which the complexity of and difficulty engaging with BSC on legal issues was a regularly mentioned example – discussed further under Issue 7. More importantly, many interviewees used blunt language to describe the tone of interaction with some BSC people as lacking appropriate openness and empathy.

The 2018 Stakeholder Survey is again powerful in that respondents called for greater respect so that BSC recognises and understands their value as partners. The challenge for BSC was to show more "humility" so that there is a "parity of esteem" between organisations. As Panel interviews found, this included intermediaries who in the survey felt that the realities of being an intermediary were not acknowledged or recognised. This reflects the lack of diversity in organisational outlook which often is the flipside of a powerful internal culture, albeit that the organisation is on many occasions surprised by the feedback. Many in the survey, as well as the interviews, wanted to change the dynamic of their relationship with BSC through partnership, co-design and collaboration.

Investees admired the skills of BSC people but recommended greater exposure to, and being more open to learning from, frontline social enterprises/charities, as well as from co-investors and intermediaries. BSC has a policy of encouraging front-line volunteering in work time up to three days a year and some 35 charitable organisations are supported by BSC staff in this way. In addition, BSC receives secondees from frontline organisations and participates in the 2027 programme improving access to roles. In the view of the Panel further consideration could be given to a structured secondment programme from BSC to social enterprises and charities.

Matching the exposure sought by other social investment organisations could better enable BSC people to understand 'investment-ready' activity. It would arguably help BSC to act as a wholesaler, by opening up some new insights into what they could support and champion within the social sector. This could also assist BSC to increase the speed of decision-taking, which is likely to be seen as even more important in these tougher economic and social times. It is the view of the Panel that BSC leadership should invest in understanding and acting on this issue, possibly following examples from other organisations that hear difficult feedback.

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On the wider topic of gender and ethnic diversity, BSC has made considerable progress on the diversity of its own staff below Board level. However, there is only partial data from BSC and its intermediaries on the key outcome-diversity issue: the frontline share of BSC investment that goes to women-led and BAME-operated charities and social enterprises. Relevant interviews highlighted this question and the Panel's view is that BSC should complete this analysis and make it publicly available.

6. Operating cost-effectively

Consideration of BSC's cost-effectiveness, and any related cost comparison analysis, needs to recognise BSC's multiple objectives to:

- Grow the market.
- Act as a wholesaler.
- Achieve self-sustainability and deliver its shareholder return targets.

The tensions between these objectives have cost effectiveness implications for BSC and therefore impact the cost of capital it can provide to investees.

Considering each objective in turn:

Grow the market
BSC's broader market-building activities mostly do not result in any income to BSC, therefore they are an additional cost burden when compared to a mainstream investor. As discussed in Issue 1, BSC's objective of growing the market includes the ambition to leverage funds from more mainstream investors into social investment. This arguably needs to be at a reasonable risk-adjusted rate of return to attract such investors and, therefore, BSC's target for returns from its total portfolio (net of costs) is in part to enable it to prove that the social investment model is financially viable to mainstream investors. This then puts pressure on BSC's total costs, including market building costs, which arguably need to appear competitive within the wider investment industry.

Act as a wholesaler
As a wholesaler, BSC needs to be able to provide capital to social investment intermediaries at affordable rates that enable them to grow and to become sustainable themselves as well as on-invest into social sector organisation investees, also at affordable rates. Therefore BSC's cost base impacts the rates at which it can offer capital.

Achieve self-sustainability and deliver its shareholder return targets
BSC's objective to be self-sufficient, and the target returns agreed with its shareholders, means that its total cost base needs to allow it to generate total returns net of costs that enables it to at least break-even and ultimately to satisfy its shareholders' target returns.

In summary, BSC needs to maintain and balance its cost base such that it can: break even and achieve self-sustainability (enabling it to continue to fund the social investment market, and to achieve continued and greater social impact in the future) while delivering reasonable positive net returns for its shareholders; while simultaneously providing capital to the social investment market at affordable rates that enables the sector to grow – and fund its broader market building activities.

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Cost of capital impact

For 2020, BSC has budgeted to spend circa £8m on all its activities – i.e. 2.22% of 'portfolio at risk' (funds already drawn down by intermediaries), and 1.46% of Net Asset Value (balance sheet total net assets). To achieve its target shareholder returns of circa 4-4.5% net of costs, BSC then needs to achieve gross portfolio-level returns of 5.5-6%. This 5.5-6% BSC gross return target plus an average 1% cost for intermediaries' fees gives 6.5-7% total cost. In the current low interest rate environment, this appears to be a high starting point for the average cost of capital to the ultimate social sector investees.

The wholesaler/intermediary model arguably adds a layer of costs to the cost of capital to the ultimate social sector organisations, who are already often surviving on small profit margins and small balance sheets. The value-added in this model by each party needs therefore to be clearly articulated and evidenced and, as the market grows, this is likely to come under increasing scrutiny.

Interviews raised a series of questions as to:

- BSC's shareholder return target and whether it could be revisited with shareholders, especially in light of the current low interest rate environment.

- Whether mainstream investors place greater value on social impact than may be thought and would accept lower than purely commercial returns.

- Could BSC share more detailed risk/return analysis of the different sections of the social investment market, in order to attract more mainstream investors to invest in the different sectors of the market most appropriate for their clients.

BSC estimate that 40-45% of expenditure, or 0.6% of net asset value, relates to its market development role. This includes activities such as pipeline development and origination and executing its engagement plan. These costs represent a significant and much needed investment in these activities and thus are a real challenge to BSC in terms of how best to balance such investment with achieving the net returns needed for self-sustainability, satisfying its shareholders' return targets and proving the social investment model to mainstream investors.

The critical nature of BSC's market building activities is well-recognised and applauded and indeed most interviewees would welcome further investment in it by BSC and others. Recognising the impact on BSC's return and cost of capital, interviewees queried whether BSC's market development activities could be structured or funded in an alternate way to allow BSC to do more of this. Some interviewees suggested BSC could do more working in partnership with others, thereby reducing their own costs, and consider stepping back from some areas and trusting others to take initiatives forward. Examples given included: impact measurement and product research and development which overlaps into social issue solutions.

The Panel's view is that, whilst the preservation of its own capital mandate remains key to BSC's ongoing activities and successes, there appear to be various options worth exploring that could give BSC greater flexibility and make the challenging balance of its objectives more manageable and transparent.

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Cost-effectiveness comparisons

BSC estimates that 50-55% of expenditure, or 0.8% of net asset value, relates to its fund management role. Taken on its own when compared to mainstream fund managers, this cost base is closest to a public equities fund manager and is probably less than half the fees of a typical venture capital fund. In that context, BSC looks very cost-effective, especially given the complex and risky nature of its investments when compared to the public equity markets. However, as mentioned above, BSC has the additional cost of its market development role which a mainstream fund manager does not have to bear and these additional costs put pressure on the comparability of BSC's net returns.

Given the broader context, in that BSC not just funds but also works with and supports the social sector, it is also relevant and appropriate to compare BSC's cost base to similar organisations financing the social sector and indeed the wider social sector. Under BSC's own analysis of comparable organisations, it is at the less expensive end of the range. Costs at entities such as CDC Group, British Business Bank and Green Investment Bank range from 1.38-4.02% of net asset value. However, when considering the wider social sector funded by BSC, a significant majority of interviewees point to the relative disparity between BSC's cost base and that of the intermediaries and social sector organisations which it funds.

As of 31st December 2019, BSC has 71 staff, 26 of whom are paid more than £60,000 per annum, albeit in line with public sector and not for profit sector comparators, as per BSC's senior salaries policy. Whilst interviewees recognise the challenge posed to BSC in recruiting talent from high paying financial services and other backgrounds, this is not seen as a challenge that is unique to BSC in the social sector. BSC's own analysis shows that its staff are paid comparably to Foundations and other similar organisations, and considerably less than mainstream fund managers. BSC also occupies central London premises in an expensive part of the City of London, while many other social investors are located in shared spaces with charities and social enterprises and close to the communities they primarily serve. Whilst BSC staffing and premises may be appropriate and proportional to BSC's work, and particularly their need to work with mainstream financial institutions, the disparity is noticeable and the Panel suggests BSC be more sensitive to it with external audiences.

7. Governing the activities of the organisation

BSC follows compliance and regulatory standards set by the FCA as its City regulator and expectations of publicly-constituted bodies. The Merlin bank shareholders are satisfied that governance and risk management are well-led, with BSC plugged into Merlin risk systems and, for example, following IPEV portfolio valuation guidelines. Stakeholders typically summarised their experiences of BSC in a governance context as having done well on risk management and nimbleness, but suggested that BSC processes appear in need of learning and focus.

Investment decisions/completion

Interviewees comment that the positives of BSC's open culture through deal origination become negatives at the stage of closing the deal. BSC operates with a flat organisation and, like many investment or consulting partnerships, is described by many staff as having a 'show and tell' culture – i.e. ideas are promoted and critiqued in large audiences. This is a helpful approach in promoting debate and sharing ideas. However – as mentioned earlier under Issue 5 – two issues came up repeatedly:

- *Who takes the final decision?*
  Opacity in investment decision-making came up in almost all interviews with intermediaries. We noticed frequent comments that intermediaries had many points of contact at BSC with overlapping interests, so they felt compelled to engage in multiple repeat briefings. Many

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intermediaries and co-investors commented on the size of nominal decision-making bodies and their experiences that it took unnecessary time and effort to navigate BSC decision-making.

- *Unnecessary friction*
  The near-universal comment from interviewees is that the completion process is laborious, while the legal engagement is disproportionate regardless of the transaction. Many examples were quoted to us of apparent over-complication of routine deals and BSC taking much longer than other public bodies and investors. It is clear that less-resourced intermediaries and investees resent resulting time frictions, unnecessary work and delays.

Although hard for the Panel to evaluate, we suggest that BSC consults participants and reviews its completion, legal and decision-making processes.

Openness to challenge

We have already commented that BSC is an influential player in UK social investment and as such can dictate terms in key relationships with co-investors, intermediaries and social enterprises and charities. In addition, BSC has a powerful internal culture and a well-grooved narrative as to BSC's role and approach. Given that backdrop, it seems to us particularly important that BSC is open to challenge and alternative ideas from diverse stakeholders.

From our interviews, the Panel concludes that BSC could do more to take full advantage of channels of challenge and advice:

- Board membership could be reviewed / expanded to give further consideration to the balance of voices from mainstream investors and banks, impact investment, large and small charities, social enterprises, policy makers, philanthropists, foundations and intermediaries.

- Board members' experience of engagement with BSC senior management appears quite varied, consideration of more systematic engagement may be beneficial.

- Board agendas understandably emphasise financial strategy and investment decisions. Balance as to broader strategic direction and building relationships and partnerships could be considered.

- The Advisory Board appears to have played a varied role over time. This could be usefully revisited to bring greater challenge to strategy, assist advocacy, build wider relationships with government, mainstream investors, current and potential investees and engage a broader range of voices, including BAME-led social enterprises.

- BSC could consider a more structured means to advocate and tap into ideas across Government in the UK.

- Although many investees play occasional roles in promoting social investment across the social sector, BSC could invest in a more sustained approach to input and challenge from the lives and expectations of affected individuals and families.

It appears that BSC has an opportunity to encourage greater challenge, build partnerships and recruit advocates – from existing and new channels – that could be relatively easily realised. The Panel anticipates that BSC people would enjoy greater connection with wider networks and growing BSC's advocacy role.

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Appendices

Terms of Reference

Purpose

To examine the effectiveness of each organisation within the TopCo Group in delivering against its respective Objects/Mission, as set out in its governance documents

Output

A brief, high level report, envisaged at less than 20 pages, which is intended to be focused rather than comprehensive. The review team will identify (i) the organisation's key achievements and successes; and (ii) strategic issues where the review team believe further consideration is required. The Chair of the reviewed OpCo will be expected to offer a public response.

The review will <u>not</u> attempt to offer specific recommendations to the organisation's management.

Data

Primary data: interviews with key stakeholders; open call for evidence; interviews with key staff.

Secondary data: governing documents / articles of association; internal policies and procedures; published financial accounts; published impact data.

	Social impact	Systems Change	Operational effectiveness	Organisation specific
Potential guiding criteria	Does OpCo have a clear and ambitious strategy for achieving social impact which is in line with its mission? Has effective execution of this strategy delivered social impact? Do both the OpCo's mission and strategy meet a need which is not adequately met by alternative interventions?	Has OpCo articulated a clearly stated Theory of Change in line with its mission? Does OpCo's Business Plan reflect the Theory of Change? Has OpCo attracted other funding or other resources through partnerships to leverage its activities?	Does OpCo have well functioning governance structures? Is the organisation operating with appropriate levels of transparency? Are the operating costs of OpCo in line with comparable organisations?	What are the particular challenges faced by OpCo? How well has OpCo responded to these challenges? Is the organisation prepared for changes to the conditions it may face in the future?
Potential points to consider	OpCo's approach to measuring the impact of, reporting the impact of, and learning from its programmes [OpCo's ability to deliver sustained improvement in the social issue; its approach to longevity (i.e. spend down vs evergreen)] [OpCo's approach to making returns on programme related investments]	OpCo's role in the wider ecosystem Evidence for the System Change that OpCo has achieved The partnerships that OpCo has formed, resources OpCo has leveraged, and funding it has unlocked for use on the social issue	OpCo's approach to its operating costs OpCo's pace of deploying funds OpCo's ability to identify and manage risks (appropriate risk appetite) OpCo's controls and procedures around deploying funds	To be determined by the review panel, in association with TopCo board members and key stakeholders

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Reviewers

Keith Leslie

Keith is Chair of the Mental Health Foundation and Mental Health At Work CIC, formerly a partner at Deloitte and McKinsey.

Neil Sherlock CBE

Neil is a Trustee of National Literacy Trust, was a partner at KPMG and then PwC and served as a special adviser to Deputy Prime Minister, Nick Clegg in the Coalition Government.

Claire Brown

Claire sits on the Advisory Board of Cazenove's Charity Authorised Investment Funds and is a trustee of various charities, formerly she was the Finance & Investment Director at the Esmée Fairbairn Foundation.

Interviewees' organisations

1	Access – The Foundation for Social Investment
2	Barclays Bank
3	Bethnal Green Ventures
4	Big Issue Invest
5	Big Society Capital
6	Big Society Trust
7	Bridges Fund Management
8	Bristol & Bath Regional Capital
9	British Business Bank
10	Cabinet Office
11	CAF Venturesome
12	CCLA
13	CDC Group
14	Charity Bank
15	Cheyne Capital
16	Department for Digital, Culture, Media & Sport
17	Diversity Forum
18	Environmental Finance
19	Esmée Fairbairn Foundation
20	Foresight Lincolnshire
21	Global Impact Investing Network
22	Guy's and St Thomas' Trust Foundation
23	Hatch Enterprise
24	HSBC
25	Hull Women's Network & Preston Road

26	Impact Investing Institute
27	Impact Management Project
28	Key Fund
29	Lloyds Banking Group
30	Mustard Seed
31	National Lottery Community Fund
32	NPC
33	P3
34	Path Group
35	Rathbones
36	RBS International / NatWest
37	Resonance
38	Rockefeller Foundation
39	Sarasin
40	Schroders Investment Management Limited
41	Scottish Communities Finance
42	Snowball LLP
43	Social and Sustainable Capital
44	Social Finance
45	Social Investment Scotland
46	Social Spider
47	St Mungo's
48	Triodos Bank
49	Ulster Community Trust
50	Wales Council for Voluntary Action

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