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10th June 2011

Mr Richard Grant
The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra
ACT 2600

Reference: Inquiry into Finance for Social Organisations

Dear Mr Grant

Please find attached a submission from Community Sector Banking in response to the Inquiry into Finance for Social Organisations, as requested in your letter of 13th May 2011.

I would welcome an opportunity to discuss any issue relating to this submission should you require.

Yours sincerely,

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Mr Greg Peel
Chief Executive Officer
Community Sector Banking

SENATE INQUIRY

Community Sector Banking Submission to the Economics Reference Committee

Community Sector Banking activities and key findings impacting on the Finance of Social Organisations.

1. Overview of current finance markets;
2. Different streams of capital;
3. Should the sector borrow funds/is it investor ready;
4. Structuring Government and philanthropic support;
5. Subsectors are not the same and have different capacity for different type of capital (Some opportunity for Government);
6. The corporate structures and access to capital;
7. The investment products;
8. Community investment strategies;
9. Community Development Finance (FaHSCIA's CDFI pilot in micro credit) (DEEWR's SEDIF programme);
10. Philanthropy and investing;
11. Social impact and cost benefit analysis, a potential way forward;
12. Liquidity in the market underwriting risk and yield (Homesafe example of equity release); and
13. Recommendations.

Community Sector Banking

Community Sector Banking and Existing Lending Activities

Community Sector Banking (CSB) was established as a form of collective action by Community Sector organisations under Community 21 Ltd and the Bendigo Bank to enhance the capacity of the sector to better achieve its objectives. Essentially, this entails the harnessing and mobilising of capital managed by Community Sector social organisations.

The core of CSB's activities is the provision of banking products and services, along with the development of strategies specifically designed to enhance the contribution of the Community Sector to the social fabric of Australia.

The broad goal of CSB is to engage in activities that will result in building the capacity of the sector by making a positive contribution to its economic growth, prosperity and building social financial capital solutions.

CSB has now been in operation for nearly 10 years. We have provided loan facilities to not-for-profit social enterprises of over $120m. However, our banking business remains deposit driven, approx. $500m. The limitation in growing our loan book has not been from the lack of willingness to lend but reflects amongst other things:

- Debt finance may not be the best form of finance;
- The actual organisation risk profile, surety of income stream, asset backing, is limited ; and
- Growth through debt finance is seen as too high risk by the organisation.

> *Comment:* *It is our view that the sector requires access to different streams/forms of financial capital, of which debt is but one, coupled with development and support mechanisms designed to enhance the "investor/debt readiness, the capacity and capability to perform" of the sector.*

It is also apparent that there are subsectors within the overall social organisations market which better avail themselves to different forms of financial capital. Housing, aged care, childcare, health and education, for example, provide structures that deliver asset backing surety of income streams and potential capital growth and potential growth in social impact and hence may support debt and quasi equity and equity markets. Whereas, others such as small to medium services providers such as Job Services, welfare based, drug and alcohol, mental health, disabilities, indigenous organisations and clubs and neighbourhood community centres, for example, rely on donation and Government grants/contract income.

> *Comment: Organisations that demonstrate surety of income streams and asset backing presents the most leverage opportunities.*

1. Overview of Current Finance Markets

When CSB was formed the community sector social enterprise were not well understood by financial institutions. Lending to the majority of not-for-profits was somewhat foreign. The requirement to box not-for-profits into either a small to medium business presented lenders and the sector some difficulty.

Issues such as a requirement for Director's guarantee, the nature of contract payments and ability to secure income streams, and ability to allocate free capital to support debt to build the sustainability of the business was not clearly evident or known.

Lack of asset backing for not-for-profits to leverage was seen as a critical disadvantage.

But like small to medium business lending the finance market is somewhat tight in any case. The lack of mature venture capital and development of capital markets in Australia affects these businesses equally. Cashflow lending rests on the ability of the financier to understand and mitigate risks and while some small business lend themselves toward this type of financing, (manufacturing and trade based) service based companies are more difficult.

Lending generally will relay on a "three way" out structure.

Debt repayment by:
1. Cashflow and contracted income
2. Asset sale
3. Secured take out and or guarantees

> *Comment: In many cases social organisation do not demonstrate acceptable credit profile and exit strategies under a worst case scenario. But these strategies are equally important for the organisation itself as it is for the financier.*

It is also noted that unlike many generic business lending there is greater emphasis placed on perceived "reputation risk."

This risk may be defined when the financier considers the flow-on impact of taking action under a defaulting credit will have a detrimental impact on the financier's brand.

The collapse of any not-for-profits providing essential social services has a flow-on impact to the most needy people. The financier potentially sees action to recover debt resulting in forcing people out of their homes, remove essential services and having not only impacting on the financier brand but in fact having some very real adverse broader economic and social impacts.

In addition, it would seem that reputation risk does not rest purely with the financier. Many Directors will be risk averse due to their own potential reputation risk of making the wrong decision.

> *Comment: Structures that provide third way out strategies and mechanism to deliver on going supply of essential services would broaden the appetite for risk in the market.*
>
> *It is noted, for example, that the NSW Department of Housing, Community Housing Organisations and Financiers are currently working through this process under a "Tripartite agreement" where protocols are established in the event of default.*

In more recent time, CSB has been able to increase its lending into the sector and has established with Bendigo Bank credit policy strategies covering affordable housing, aged care, child care and schools.

Policy frameworks are built on calculating the "affordable finance amount" based on secured income streams. Generally asset backing and loan to valuation ratios are somewhat less than tradition small business markets. This is due to the net available income streams to support debt servicing being less. Performance risk is based amongst other things on the capabilities of the Executive and the Board. **As a general comment it is becoming increasingly important to have a skills based board.**

2. Different Streams of Capital

> *Comment: Access to debt finance is a significant issue but it is our view that a "cocktail" of capital solutions is required to maximise the capability and*

impact of the sector. Importantly, it is how these different streams of capital actually work together.

Other than debt and contracted income, the social organisation with DGR status has access to donations as its main alternate source of finance.

The reliability of, the competition for and the surety of these philanthropic income streams places the organisation under constant financial pressure.

Leveraging these income streams presents some difficulty for financiers given the lack of control and surety of such financial support. However, organisations that present long history of donations provide an opportunity for additional debt finance support.

Importantly it is how both Government contracted income and donations are applied in order to support/underwrite risk and yield to financiers/investors that will maximise the leverage opportunity.

In many circumstances a gap analysis between acceptable risk and yield of financiers/investors and the actual income, asset backing, capital growth of the social organisation demonstrates a shortfall. In a commercial sense, this gap from a debt funding perspective is plugged with equity. From a social organisation sense it may be plugged though grant/donations quasi equity or soft capital.

It is clear however that there are broader sources of capital to commercial enterprises, albeit somewhat limited, such as Venture and Development Capital not available to social enterprise.

Comment: *We consider that the development of the following will be critical to maximise the potential of social organisations and the economic and social benefit received by all:*

- *Philanthropy venture capital markets;*
- *Outcomes based social investment funds;*
- *Social impact bond markets; and*
- *Other social and community investment products.*

The development therefore of the Community Development Finance Institute markets in a manner that maximises co-contributions from corporate/philanthropic and social investor markets is a key element of this strategy.

3. Should the Sector Borrow Funds/Is it Investor Ready

As indicated above, in many circumstances debt finance is not the most appropriate capital source for growth.

However, working capital, lease finance and other financial products may complement the cashflow management and financial requirements of the social organisation.

The question as to debt appropriateness relates to risk and the obligation to repay. The question is one equally for the Board and the financier and the decision should be underpinned by appropriate business case, cashflow analysis, performance risk analysis etc.

If the Board and the financier are unable to deliver a high degree of certainty with the respect to the ability to repay, then the social organisation should not proceed.

> *Comment: The ability of the Board and the Executive to make valued judgment is for many small–medium social organisations difficult due to the lack of experience and appropriate analytical support. This will require investment in the robustness and capability the sector. It may also be support by the appropriate regulatory framework and peer benchmarking.*

4. Structuring Government and Philanthropic Support to Mobilise/Incentive Debt and Equity Markets

During the GFC the Government undertook a programme of economic stimulus to create activity. At that same time discussions were held as to how economic stimulus could be structure to maximise co-contributions from the debt and equity markets.

Simply put, if the Government has $100m to grant or contract for the delivery of services/social infrastructure, does it apply this as $100m in underwriting liquidity, risk and yield to investor/financiers who with this support would allocate $300m.

The more recent development in affordable housing provides an example of how this is operating in practice.

The National Rent Affordability Scheme is designed to mobilise debt and equity markets by supporting risk and yield in what is considered an under-performing asset.

In effect, the discounted net rental yield on the tenant properties reflected a 20-25% below market rate of return. The NRAS programme was designed to subsidise this return.

The market is now seeing increased appetite, predominantly from the residential investment/high net worth individual market to invest in the NRAS linked properties.

However, the wholesale markets and superannuation funds are still lagging in tack up of this asset.

Part of the reason is that it is still considered a new asset class and track record as to how that asset will perform and compare to traditional residential assets will take some time.

In drilling down on the issues impacting on the wholesale investor activity, or lack thereof, may provide insight into how we better stimulate this activity.

In effect how does the Government utilise funds to:

- Invest directly into targeted funds;
- Provide liquidity support;
- Take first loss risk positions; and
- Adopt CDFI strategies to incentivise and or mandate investments.

Comment: The use and application of Government funds as a stimulus to develop greater co-contributions is a key ingredient to building a robust social economy. It is also important the Government bring the markets along with their strategy and build collaborative solutions.

5. Subsectors are Not the Same and Have Different Capacity for Different Types of Capital (Some Opportunity for Government)

As indicated above, certain types of social organisations have greater leverage capacity. If we utilise the Government funds in a manner that stimulates this leverage, as per the above point, then this would provide a budget or capital release.

In effect the Government needs less capital if it stimulates co-contributions from the debt and equity markets for certain social sector activities but will require greater grant based funding in other social sector markets where leverage opportunities are not evident and or not appropriate.

6. The Corporate Structures and Access to Capital

The not-for-profit structure of many social organisations does not avail itself to usual equity structures. Providing divided based return to investors is contrary to not-for-profit guidelines. Hence, the development of quasi equity products and/or structures that provide an equity based return to investors is a key element in building alternate sources of financial capital.

In certain circumstances structures may be developed that divide the operational activities and or assets on a group basis.

For example, a for profit management company sitting on the side of the not-for-profit provide an opportunity to raise capital and generate income streams from services provide to the not-for-profit. (While not promoting this model it is designed to demonstrate the structures may be adopted).

Other structures include:

- Quasi equity, notes and or subordinated loans products;
- Philanthropic venture capital or soft or patient capital; and
- Project financing structures.

While the market in quasi equity and Philanthropic venture capital is immature, there are project finance structures in the affordable housing, aged care and child care markets.

These structures see the development of Trusts as a vehicle for investor and debt participation, supported by a not-for-profit management company as a service provider. The investor return is based on net income and capital growth.

The not-for-profit is rewarded through fee for services but importantly the social economy has maximised the opportunity to receive capital.

> *Comment: There are numerous issues to be tested around the structures for not-for-profits, the commercialisation of activities, the activities test and DGR status in raising alternate forms of capital and this paper does not address these issue but suggests that there is balance required in the new Regulatory framework that on one hand maximises the potential for*

alternate form of capital, while on the other protects the interest of the community, social benefit and intent.

7. The Investment Products

The Social or Ethical Investment markets have to date focused on positive and negative screened ASX listed investment strategies. Outcomes-based social investments, both on a wholesale and retail basis are still limited if not asset specific.

In order to build market activity it is therefore not just a matter of establishing a Social Infrastructure Fund or Social Enterprise Fund.

Investment product attached to such funds may be required to protect risk and yield.

> *Comment:* *Capital guaranteed products, community bonds, liquidity enhancement, risk enhancements are required to attract investors. In particular, if these enhancements are provides by the structure of Government support then in part the market would respond. The product then suggests that it is not an assessment of an alternate asset class and how that asset class performs but rather it is a ratable investment instrument. It will therefore fit with cash and fixed interest rate securities.*

8. Community Investment Strategies

In social financial capital markets dividend is only one measure of return. How the funds are applied to building the local economy and addressing the social agenda issues of that economy have a direct economic benefit for local investors beyond the rate of return on the investment.

An example of this was seen in a small regional community that had a major issue in affordable and appropriate housing. A major employer in that community could not attract staff and there was also difficulty attracting key workers in other areas due to this problem.

Building investment structures that provide a pathway for investment in affordable housing in that economy not only would provide a sustainable rate of return to that investor but also provides the flow-on economic effect.

It could be said that a small retailer is as only as large or valuable as the local GDP. Investing in the growth of the local economy underpins the performance and value of the business.

> *Comment: The major issue would appear that lack of financing product and investment pathways to support this activity.*
>
> *The Bendigo Bank's Community Bank model is also a structure that provides a framework for local investors to build their local economy and receive multiple value.*
>
> *The development of these products again needs the types of support as indicated above.*

9. Community Development Finance Institutions (FaHSCIA's CDFI Pilot in Micro Credit) and (DEEWR's SEDIF Programme)

The development of the CDFI markets in the US and Europe provide us with some direction for Australia. CSB as a CDFI is in the process of implementing a micro credit and micro enterprise pilot programme to address social and financial exclusion issues. The business model CSB is adopting seeks to build alternate social capital to co-invest in the provision of services and takes first loss risk in these markets.

It is done under a structure that utilises the social organisations and relationships to manage the process. The sustainability of the model beyond the Government's support is, however, predicated on the development of these capital markets.

Similarly the SEDIF programme is designed to attract investor funds in a Social Enterprise Loan Fund. This is supported by a $10m contribution form DEEWR on a matched funded basis. But the demand for this type of capital and fund structures is considered far beyond this support.

> *Comment: The success of this development would be greatly enhanced if there was appropriate legislative framework and incentive to mobilise markets in this direction.*

10. Philanthropy and Investing

Philanthropy is seen as an integral part of the capital mix; it provides another stream of capital, at a different investment return criteria.

The philanthropic market is moving toward more strategic distribution strategies and longer term partnerships. There is potential to move beyond pure grant making to be more philanthropic investment structure.

In effect, the opportunity for grants to become soft loans, repayable in certain circumstances and achievement of goals and objectives is clearly apparent and has been the focus of Philanthropic investment in the US.

It is considered however that further work is required to maximise the use and application of PAFs.

The distribution of corpus and the investment strategy of this corpus is the next critical step.

Fund Managers and investment strategies are more focused on building and protecting corpus rather than providing a balance between social outcomes and use of funds.

At the same time there is few social impact or outcomes based investment funds and or products that would provide a pathway to direct Foundation funds.

> *Comment:* *Stimulating positive social impact through better direction in the use of PAF corpus is core to mobilising additional capital. Building funds and investment products that provide a pathway for this to occur is equally critical.*

11. Social Impact Bonds and Cost Benefit Analysis: A Potential Way Forward

The Social Impact Bond structure provides a mechanism to reward investors through additional Government contributions or reward based on the cost benefit to Government stemming from the economic and social impact of that investment.

Recent studies with respect to the Social Impact Bond markets in the UK and now through studies by the Centre of Social Impact here in Australia suggest that the following:

- There is a positive correlation between the financial strength of an organisation and the social impact that it delivers;
- That there is a cost benefit to Government demonstrated through maximising social impact; and
- There is a cost benefit of stimulating and rewarding investment in social impact.

CSB's experience in the affordable housing markets supports this thinking. As Community Housing Organisation has increased housing stock, tenancy management and provided greater solutions for homelessness and hence maximise their social impact, they have also strengthened their balance sheet.

The CHO's ability to access capital, both in the debt and quasi equity markets are becoming more apparent as is the potential reward to investors.

The suggestion is that the flow-on economic and social impact of increasing housing outcomes has a positive cost benefit to the Government. If this cost benefit is shared with investors we stimulate greater co-contribution from the market.

> *Comment:* *The development of the social impact bond market needs Government support and will be linked to the CDFI strategies and the establishment of investment pathways as indicated above.*

12. Liquidity in the Market Underwriting Risk and Yield (Homesafe Example of Equity Release)

In some cases stimulating the market may be through direct investment by Government into funds and or products. In other cases it is providing enhancements to the product or fund to underpin risk and yield and or liquidity in the market.

One example of this is the Bendigo Bank's Homesafe product. This is an equity release product. Amongst other things, the product may be structured to provide a solution for the aged seeking at-home care services but require capital to support their requirement. The product is an equity release product enabling the participant to pre-sell a portion of their home and receive payment now.

The product would have considerable advantage in the total aged care solutions and support Government allocation of funds to meet demand.

Comment: From an investor point of view the product requires volume and liquidity to underpin returns. How the Government supports these types of products and incentivises co- contributions given the social impact requires further consideration.

13. Additional strategies

. Kids super

In 2007 CSB introduced a policy recommendation to the Government which sought to build an endowment for the child when the child turned 18. The endowment while initial funded by a contribution from Government at birth, would also receive co contributions from family through the course of the childs life.

Importantly the funds generate would be invested in society building assets and social infrastructure, thus creating a sustainable investment pool to meet the demand for continued investment in society.

. Mining/Royalties tax

We also believe that there is an opportunity to better structure the proposed mining/royalties tax under a community investment strategy.

A strategy that would see the mining companies either pay a tax or invest in community development would provide a mechanism where the mining companies were still forced to better distribute profits but do so in a way that they have some determination as to the application of funds.

If a mining company is investing in building the communities in which it operates then this is equally as important and beneficial to all. At the same time it would create some self determination for the mining companies.

14. Recommendations

- Enhancing the robustness and capability of the sector through business mentorship
- Consider how the Governments support the continuation of services and debt restructure strategies in a defaulting situation
- Invest in building alternate capital streams and investment products
- Mobilise the debt and equity markets may depend on how the Government structures its support, liquidity, first loss risk etc
- Build CDFI markets and incentive or mandate investment
- Legislate investment strategies for PAF corpus
- Re-consider Kids super and Community Investment strategies