

Our Ref: DFM:09/0005
Your Ref:

19 May 2011

The Senate Economics Reference Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Committee

Inquiry into finance for Social Organisations

We refer to your letter dated 13 May 2011 inviting us to make a submission to the inquiry. We thank you for this opportunity and **enclose** our submission.

This submission describes and reflects on our experience developing a micro-enterprise loan fund between 1998 and 2003. We think there is a case for government to provide loan capital to micro-enterprise loan funds, bearing in mind the comments in the Productivity Commission report¹ that such government investment be targeted at particular social problems.

Who we are

We are a boutique law firm that specialises in the law relating to charities and not-for-profit organisations. Principal of the firm, Derek Mortimer, has more than fifteen years experience advising not-for-profit organisations on legal issues. He represents the not-for-profit sector on the Law Institute Victoria commercial law executive committee.

We trust you find our submission of use. We have also enclosed further references for your assistance. Naturally we are happy to orally present or further discuss our views with you.

Yours faithfully
DF MORTIMER & ASSOCIATES

Derek Mortimer
Principal

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Inquiry into finance for Social Organisations: Micro-enterprise loan funds

Micro-enterprise loan funds: overview

In their report on Community Development Financial Institutions (“CDFI’s”), Parker and Lyons ² define “micro-enterprise loan funds” as (usually) being not for profit organisations. Micro-finance loan funds foster social and business development through loans and technical assistance. According to Parker and Lyons, foundations and governments provide funds for micro-enterprise loan funds. We **enclose** the Parker and Lyons report for your information.

We think the Parker and Lyons definition best fits the project we will shortly describe.

We have also noted that the Productivity Commission report ³ mentions micro-enterprise loan funds as being one of several types of CDFI ⁴. However not all CDFI’s are not for profit organisations. Hence our submission does not address all types of CDFI described by the Productivity Commission report.

The Landcare Revolving Loan Fund

During the period 1998 to 2003 Derek Mortimer was involved in establishing and developing a pilot project in Northeast Victoria to provide microfinance to farmers. The not for profit company established for the project was called “The Landcare Revolving Loan Fund Limited” (“the Fund”). The Fund was owned by five landcare community organisations in the region.

The Fund provided farmers with microfinance to assist them to establish farm forestry for commercial and environmental benefits. The Fund’s principal purpose in line with section 30-265(1) of the *Income Tax Assessment Act 1997*, was to “protect and enhance the natural environment and promote ecologically sustainable development”.

The Fund was entered onto the Register of Environmental Organisations and was endorsed by the Australian Taxation Office (“ATO”) as a charitable institution and deductible gift recipient. Importantly this meant loan fee income was not subject to income tax.

In accord with ATO “public fund” requirements, a majority of the Fund directors were “Responsible Persons” being persons with a degree of accountability to the wider community. The directors comprised a landcare group co-ordinator, a departmental farm forestry officer and the manager of a local credit union.

The Fund secured loan capital from:

- No interest loans provided by several of the Fund member landcare groups for a period of three years; and
- Tax deductible donations.

Applications were also made for loan capital to the then National Heritage Trust (“NHT”) administered by the Department of Agriculture, Fisheries and Forestry.

The Fund made loans to farmers at below commercial rates. A loan administration fee was calculated to provide an allowance for:

- Fund administration (such as Fund audit fees, and out of pocket expenses); and
- CPI movements to ensure that loan capital did not depreciate.

Farmers received loans to plant trees in areas identified by the Goulburn/Broken and Northeast Catchment Management Authorities as benefiting from farm forestry for erosion and salinity control, and carbon sequestration.

We think that by using Catchment Authority priorities, the Fund was able to avoid a perception of conflict of interest and that its loan transactions were at arms length. Such perception issues we think could easily arise for a small locally constituted lending body.

The Fund arranged for a departmental supported extension program to provide borrowers with technical silvicultural assistance to plant the trees.

Total loan capital during the three year pilot project was in the vicinity of \$40,000. Loans typically were in the order of \$2000 to \$5000. Demand for the loans exceeded supply.

Loans were repaid in monthly instalments. All loans were repaid. The Fund and its pilot project were eventually wound up.

The Rural Industries Research Development Corporation part funded the project with a research grant. One of the obligations arising from this research grant was at the conclusion of the project, to prepare a report for publication. A copy of the published report ("the RIRDC Report") is **enclosed**.

Experience gained

The RIRDC Report recommended that:

- Governments consider investment of capital into the Fund as a cost effective and responsible use of public monies into on ground landcare work; and
- Landcare Australia Limited encourage corporate sponsorship because the Fund offers a cost effective means of exposure for corporate brands.

The RIRDC Report suggested that for a micro-enterprise loan fund to be successful, its proponents must:

- Identify a demand for loan finance (as distinct from simply indentifying whether government grants are available);
- Ensure that loan fund operators (whether as volunteers or as professionals) have capacity and appropriate skills to develop and operate a loan fund; and
- Provide readily available technical resources (such as legal documents and farm forestry extension).

It is also worth noting at page 33 of the RIRDC Report that micro-enterprise loan funds in the USA have a default rate of around 0.5% of monies loaned (ie a lower default rate than for commercial lending institutions). This low default rate is attributed to the close relationships developed by the lender with the borrower.

In their own report, Parker and Lyons note that the Fund offered potential for growth.⁵ They commented (at page 51) that there are impediments on the demand side of microfinance such as a limited understanding by proponents of the economic aspects of community development. We think these comments reflect the success criteria identified in the RIRDC Report.

Federal Government reasons for not providing the Fund with capital

The Fund applied several times for grants from the NHT for loan capital. On each occasion the Fund was unsuccessful. Unfortunately communication between the project and the NHT was only conducted through the formal NHT funding application process. This process did not allow room for consultation or allow Fund proponents to comprehend the reasons why the NHT declined to provide loan capital.

Accordingly after the project wound up, we lodged a freedom of information request to better understand why the NHT had declined to provide capital. We **enclose** the response as we believe it will be helpful to your inquiry.

You will see a copy of a letter from the Department of Agriculture, Fisheries & Forestry Australia dated 11 April 2003 together with its two page attachment dated 18 February 1998 from the "National Landcare Section". This attachment identifies issues government agencies associated with the NHT had in providing the Fund with loan capital.

In our view the anonymous authors of the attachment displayed a cursory understanding of the Fund. Nonetheless there are issues raised in the attachment that we think are reasonable. In our summary, these issues are:

- Will the loan fund create conflicts of interest and prevent arms length transactions?;
- Does a community organisation have capacity to operate a loan fund?;
- Can the Commonwealth justify using public monies for (what appears) to be farmers' private benefit; and
- Will the loan fund be unfairly competitive?

We think the issues raised can with care, be addressed in favour of micro-enterprise loan funds. We are happy to further discuss this with you.

Legal Developments since 2003

During initial development of the Fund, proponents were (needlessly) concerned that provision of low cost loans to farmers for agricultural work such as farm forestry would not be a charitable purpose; hence there may be difficulties gaining tax privileges from the ATO. The project had to rely on a Privy Council decision⁶ that suggested agricultural loans could be made by a charity.

But in 2005 the ATO issued its tax ruling TR 2005/21 which clarified some of the concerns. In our summary:

- a charity may undertake commercial or business like activities that are in aid of a charitable purpose [see paragraph 129]; and
- the charity "public benefit" requirement does not fail where there is a private benefit, providing the public may also enjoy the benefits [see paragraph 80].

The 2008 *Word Investments Case* ⁷ is High Court authority for charities undertaking commerce. According to the judgment, any commerce must “naturally and probably” lead to charitable consequences.

Tax Ruling TR 2005/21 was recently withdrawn by the ATO and has been replaced with draft taxation ruling TR 2011/D2. This draft ruling restates and clarifies TR 2005/21. The draft ruling reiterates that charitable organisations may provide benefits to their members, and may undertake commerce that supports the charity’s charitable purpose.

Hence we think that current charity law (and the interpretation of that law by the ATO) will help to ensure that charities’ activities are directed towards providing a public benefit, even when a charity engages in commerce such as by operating a micro-enterprise loan fund.

Conclusion

Our suggestions below are made in the context of a micro-enterprise loan fund operated by a not for profit organisation such as a charity, that has by virtue of that status, a “public benefit” obligation. Our suggestions may not apply to all CDFI’s.

A grant of loan capital by government to a well managed micro-enterprise loan fund is in our view, a cost effective expenditure of public monies towards identified social problems. This is because unlike a grant directly to a citizen (eg to a farmer to plant trees), a grant of loan capital to a micro-enterprise loan fund will be used over and over again.

Accordingly we think that there is ample scope for government to assist micro-enterprise loan funds by provision of loan capital. We think government can provide loan capital in the form of:

- Direct capital grants; and
- Low or no interest loans.

Such government provided loan capital could be used by the micro-enterprise loan fund as part of a suite of funding and finance sources to provide below market rate finance for public benefit and charitable purposes.

Loan schemes operated directly by government agencies have not always been successful. We think consideration by government of any support it may make to micro-enterprise loan funds should involve a comparison with loan schemes for social projects it may consider operating through government agencies.

Government agency concerns we have seen about micro-enterprise loan funds can be addressed we think by:

- due diligence;
- ATO endorsement requirements for a charity or public fund;
- micro-enterprise loan fund lending criteria; and
- government grant/loan contract terms.

It is worth reflecting that the NHT was established by the part sale of Telstra. The NHT distributed grants for environmental works and ceased in June 2008. Imagine if some of that NHT public money had been placed in a prudently managed micro-enterprise loan fund such as the Fund described above. It may that in 2011 such a Fund could still be providing low cost loans for landcare work using loan capital provided by the original NHT grant.

¹ Productivity Commission, *Contribution of the Not for Profit Sector* January 2010, 192-193.

² Katherine Parker and Mark Lyons *Community Development Finance Institutions: Evidence from Overseas and Australia* September 2003, ACCORD Report, Australian Centre for Co-operative Research and Development, 8.

³ Productivity Commission, above n 1, 185.

⁴ As summarised in the *Issues paper* that forms part of the Senate inquiry.

⁵ Katherine Parker and Mark Lyons above n 2, 45-46.

⁶ *Hadaway v Hadaway and Anor* [1955] 1 WLR 16.

⁷ *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Ltd* (2008) 236 CLR 2004.