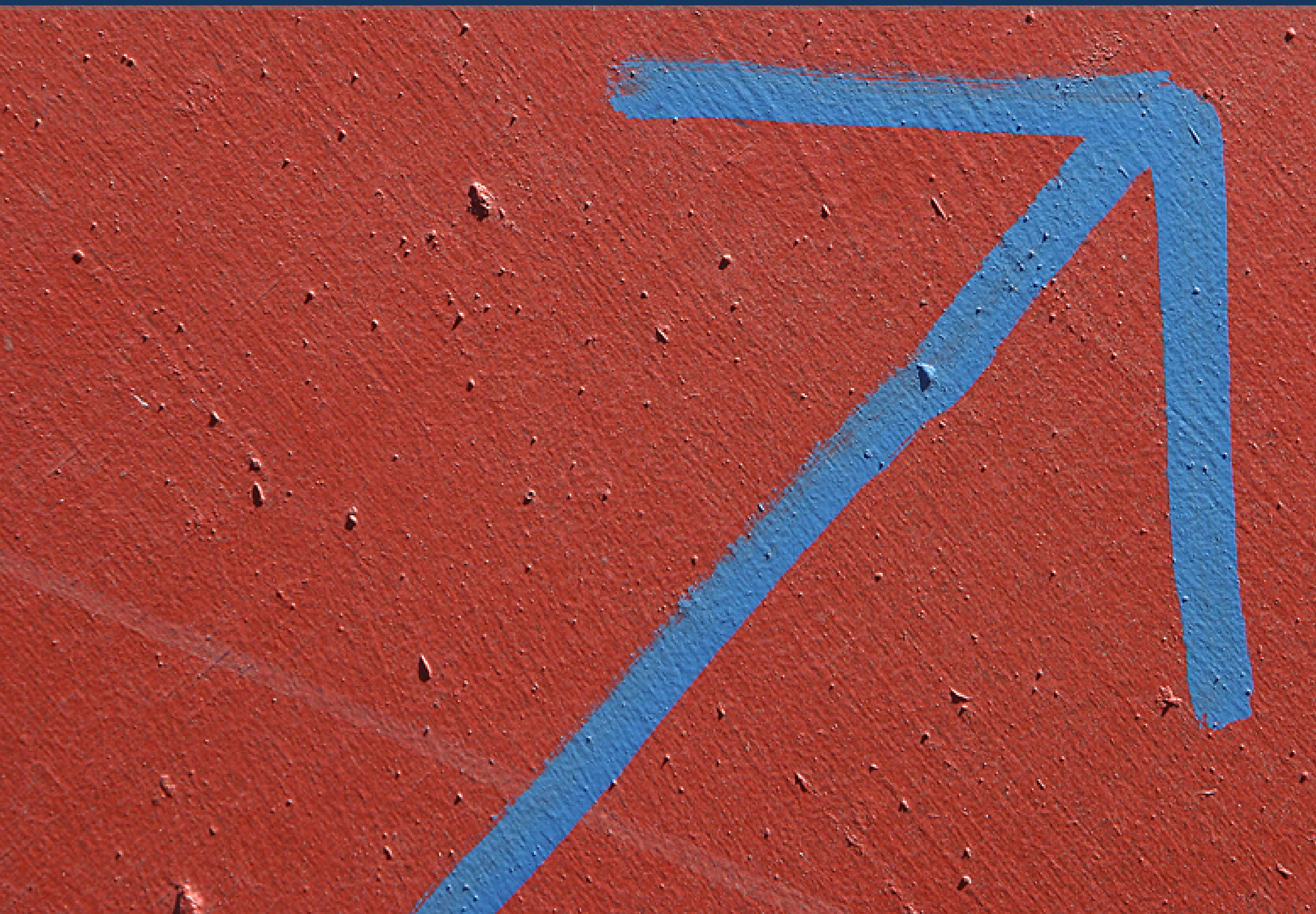
Examining the potential for a not-for-profit capital market in Australia

Finance and the Australian Not-for-Profit Sector



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Foresters Community Finance, March 2011

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Foreword from NAB

Since 2003, NAB has worked with Good Shepherd, hundreds of local community organisations and a number of government partners to develop microfinance programs that address financial exclusion, increase financial literacy and provide financial services to all Australians.

These programs, underpinned by a $130 million commitment from NAB, offer unique opportunities to people who are marginalised or excluded from mainstream financial services. They are directed at helping lower income consumers to build assets and save for important investments such as in health and education.

However, it is not only individuals who face financial exclusion. Not for profit community organisations often struggle to access financial products and services appropriate to their needs and aspiration.

This exclusion extends to the need for access to capital including debt and equity instruments focused on growing the impact, viability and sustainability of the Australian not-for-profit sector. It also includes the need for specialist financial advice from those who understand the workings of not-for-profit sector organisations.

One of the biggest challenges facing community organisations is their capacity to plan for and build a long-term sustainable future because of lack of access to appropriate property and equipment as well as cash flow uncertainty.

A small number of financial service providers operate specialist not-for-profit banking services. Foresters Community Finance has developed a niche in building capability in the community sector to increase access to capital and asset building resources. But the simple truth is that the not-for-profit capital market is at an early stage of evolution and there is a lot more to be done to properly meet the financial product and service needs of community organisations.

If Australia is truly to build a robust not-for-profit capital market we need to clearly articulate the benefit of such a market. This will also require cross sector collaboration and commitments from diverse stakeholders.

We hope that this report, by examining the state of the current data and literature that is available about the financial needs and realities of the Australian not-for-profit sector and the potentials for developing a not-for-profit capital market in Australia, will be an important early step in addressing yet another form of financial exclusion in Australia. NAB is very pleased to be involved.

Tim O'Leary
General Manager Corporate Responsibility
National Australia Bank

Executive Summary

The growth of the Australian not-for-profit sector over the past two decades has prompted an increased focus on it's social impact and the issues of access to funding and capital that underpin the sector.

This report examines the state of the current data and literature that is available about the nature of the Australian not-for-profit sector in order to describe it's financial needs and realities, and the potential for developing a not-for-profit capital market in the Australian context.

We stand at a significant juncture in the road to not-for-profit sustainability, presenting us with a choice – to pursue the traditions of old or embark upon building on these traditions with innovative approaches to providing the capital the not-for-profit sector requires. This report uses a snapshot of available data and literature about the sector to frame this new pathway. In the context of the Productivity Commission's recent report on the non-for-profit sector as well as the recent announcement of a Federal Senate Inquiry into community finance and the social sector, this report aims to stimulate debate and open up new pathways for access to capital in the not-for-profit sector.

The Australian not-for-profit sector: an overview of the market

The not-for-profit sector in Australia is large and complex. There are over 700,000 not-for-profit organisations. Over half of these are unincorporated. There are around 60,000 economically significant not-for-profit organisations (meaning that they employ staff, even if only part-time). According to the Productivity Commission, most not-for-profits (70%) are small to medium sized organisations with under $1 million per annum turnover.

Detailed market segmentation of the not-for-profit sector is difficult because of a lack of research and data sets, and lack of centralised data collection because most not-for-profit organisations are incorporated under state-based legislation.

The financial needs and realities of the not-for-profit sector

There have been arguments made that some Australian not-for-profit sector organisations actually face financial exclusion.

The characteristics of this exclusion extend beyond basic banking and transaction services. There is no evidence to suggest that the sector experiences difficulties in accessing basic banking services. Indeed many financial institutions have developed specialised services and sometimes have specialist staff focussed on the not-for-profit sector.

There has, however, been relatively little focus on the need for or establishment of a not-for-profit capital market that would include the development of debt and equity instruments focussed on growing the impact, viability and sustainability of the sector. This represents the key challenge for all of the stakeholders looking to address the financial exclusion of not-for-profit organisations.

Much of the capital focus on the not-for-profit sector has emphasised growing grant and gift capital which are linked to programs and the social impact of organisations. However there is currently no visible coordinated or organised discussion on the demand for non-grant capital from within the not-for-profit sector.

We see this demand for capital in certain parts of the sector identified in a number of government and research reports. In particular, there have been calls for:

- Hard development capital (for fixed asset acquisition);
- Closed working capital (bridging finance);
- Open working capital (smoothing cash flow); and
- Soft development capital / growth capital.

In the main, demand for access to finance and capital investment is more generally focused on small to medium sized organisations. The development of a capital market in this segment represents a challenge both in terms of the capability of organisations to access and hold capital and for financiers to provide capital.

Therefore developing a not-for-profit capital market will require structural and cultural shifts within the sector, in addition to greater understanding from financial institutions to the needs, realities and particular business models of not-for-profit organisations.

Lessons from overseas experiences of developing not-for-profit capital markets

In both the United Kingdom and the United States a not-for-profit capital market has been examined both in practice and research for well over a decade. There are lessons that can be learnt from these experiences about developing an Australian not-for-profit capital market, including the following:

- A focus on educating those providing finance to the not-for-profit markets;
- A focus on developing the capacity of the not-for-profit market to present “investable” propositions to financiers, and;
- In some cases the need for specialized intermediaries to bring the finance sector and the not-for-profit sector together.

Adopting these lessons from overseas will help us to fast track and innovate within this emerging market.

If mainstream financial institutions are to play a role in the development of a not-for-profit capital market in Australia, they could do so in three ways:

1. By engaging directly with not-for-profit organisations and developing more specialist knowledge about the sector and a broader range of capital relationships with the sector;
2. By contributing to and capitalizing the development of specialist intermediaries who could then provide capital to not-for-profit organisations. This method would pool capital from numbers of financial institutions through intermediaries who have specialist knowledge and could mitigate some of the risks of direct capital provision, and;
3. By becoming part of a range of ‘investors’ who capitalize a wholesale fund that then provides capital to a range of specialist intermediaries (blending philanthropic funds, grant funding and funds from financial institutions). This would provide the greatest potential for blended capital types and returns, but would require some kind of incentive to financial institutions for involvement.

The not-for-profit capital market in Australia is at an early stage of evolution, except in relation to banking and deposit-taking services in the sector (which paradoxically are well-developed). Lending and specialist financial advice is less well developed, and could be said to be at the stage of market creation, with substantial demand and supply issues needing to be addressed. If Australia is to build a robust not-for-profit capital market, then this will require:

- Cultural shifts (in all sectors and across the full spectrum of stakeholders);
- Political will and action at policy level;
- A degree of experimentation and risk-taking in developing the market;
- Sharing of learning’s across the commercial and social sectors.

This report provides the beginnings of a much needed engagement with and response to the findings of Productivity Commission’s call for the development of a sustainable capital market for not-for-profit organisations. The authors recommend the report as a framework for further dialogue leading to action.

1. Introduction:

Over the past decade Australia's not-for-profit sector[1] and the environment in which this sector operates, have changed significantly. The sector has expanded rapidly, though unevenly (Productivity Commission, 2010), and it's contribution to the economy and to society is increasingly recognised. Pressures on Government funding have led to increasing emphasis on the need for diversification of not-for-profit revenue and growing other resource bases such as philanthropy and earned income. The policy environment has shifted away from direct Government provision of social services, towards the contracting of both not-for-profits and for-profits as service providers within a competitive framework.

Further there has been an increased focus on linking the not-for-profit sector with the corporate sector in order to open new opportunities for both service and funding innovation. The Federal Government has initiated three major inquiries into the not-for-profit sector over the past decade (the most recent being the Productivity Commission, 2010), which have recommended numerous regulatory and policy changes, though until very recently, many of these changes have not been enacted.

The past year has seen quite remarkable shifts in the standing and the structure of the sector with: the release of the Productivity Commission report; changes in reporting compliance requirements; the adoption of the Standard Chart of Accounts by Federal funders and recommendations for its adoption by State funders; the launch of the National Compact; and proposals for sector focused research centres, sector specific regulators and a sector office at the Federal government level.

Thus there is now is an increasing focus on the not-for-profit sector in Australia and the role it plays in ensuring a strong, vibrant and secure economy and society. It is also clear that there is a growing interest in what the sector itself needs in order to optimise its capacity to fulfil its societal role. The recent Productivity Commission report outlined a number of key recommendations that could assist the sector to develop its productive capacity. One of these recommendations centred on the development of a "sustainable market for not-for-profit debt":

"Australian governments should assist in the development of a sustainable market for not for profit organisations to access debt financing through:

- *building business planning skills for not-for-profit organisations, notably social enterprises;*
- *improving funding certainty for those not-for-profit organisations involved in the delivery of government services to improve loan viability by improving clarity about funding and the appropriate length of contract;*
- *exploring options to encourage (for a limited time) community development financial institutions to develop appropriate financial products and services for the sector;*
- *exploring options to make better use of the corpus of philanthropic foundations and trusts to make loans to deductable gift recipients and endorsed charitable institutions.*

The Australian Government should establish an advisory panel, chaired by Treasury, to consider options and assess progress in developing a sustainable market for not-for-profit organisation debt products with the aim of establishing mainstream financial products for investors who are willing to accept a lower risk adjusted financial return for an accompanying social return" (Productivity Commission Research Report, 2010;pp194-5).

Though the Productivity Commission report reflects some important early work undertaken in particular by Mark Lyons, and builds from various submissions received as part of the inquiry process, it is clear that there is relatively little research about whether the not-for-profit sector in Australia in fact needs debt capital (or other forms of capital), and if so, what kinds and what for? Further, there is also a dearth of research about the financial realities of Australia's not-for-profits (particularly in relation to micro, small or medium sized organisations) and whether debt capital is an appropriate mechanism for these organisations in ensuring their viability and sustainability into the future.

In light of this and a number of other recent calls for closer examination of the financial needs of Australia's not-for-profit organisations, this report examines available data and literature to summarise what is known about the financial needs and realities of the sector. Further, it suggests ways forward in understanding the

[1] In this report the term 'not-for-profit' dominates – however other terminology such as 'non-profit' and 'third sector' is used when referring to literature sources that use these terms.

role of capital in the sector and for developing suitable financial mechanisms and instruments that could ensure responsible delivery of this capital into not-for-profit organisations.

For the purposes of this report the following definitions are important:

- **Finance** refers to understanding the management of money in the not-for-profit sector, and particularly how this can underpin impact, viability and sustainability. This report considers how savings, credit, banking and investments in particular are related to the management of money in the sector.

- **Capital** refers to money used to ensure the sustainability of an organisation into the long-term – it can be hard capital (used to purchase tangible assets) or soft capital (used to build the intangible assets or an organisations staffing capacity and innovation) or working capital (used to support and build operations while ongoing revenue is sought). Capital in this sense refers to money used for the long-term future of the organisation, that is, it is used for works and assets that have a life of more than a year or two (see for example, Lyons et al, 2007; Miller, 2007; Overholser, 2006).

- **Revenue** refers to the income that is needed to ensure the viability of an organisation's operations and to enable the provision of programs and services.

These distinctions will be explored in greater detail throughout the report.

The key questions for this research project are: **Is there a market for finance in the Australian not-for-profit sector, and if so, what is the nature of this market, and who should design and provide the services and products associated with it?**

In order to assess these questions, this review of data and literature will examine the following issues and questions:

- What is the 'Australian not-for-profit sector' and can it be understood as a 'market' with particular segments?

- What do we know about it's financial needs and realities?

- What do we know about the products and services it currently uses and what the sector currently lacks?

- What is the experience and analysis of finance for not-for-profit organisations in other countries and what can we learn from this that is applicable in the Australian context?

- What further research is needed in order to understand the market for finance in Australian not-for-profit organisations?

2. Defining the 'not for profit sector': In a complex and diverse 'sector', is market segmentation possible?

This section provides an introduction to the not-for-profit sector in Australia. In order to explore the question of whether there is market for not-for-profit finance in Australia it is first necessary to understand and appreciate the complexity of the not-for-profit landscape in this country. Second, it is important to appreciate the difficulties involved in segmenting the not-for-profit market in relation to financial needs. The section examines some of the defining characteristics of Australian not-for-profits and what evidence exists that these features may inform an assessment of the financial needs of this sector.

Defining the Australian 'not-for-profit sector' is far from an easy task. The sector includes a vast range of groups and organisations, its defining features can be complex and there is much less consolidated data and research about this sector than there is about the business sector. There are also several researchers who argue about whether the disparate organisations under its umbrella even constitute a 'sector'.

Further, if it can be defined as a sector, then there are other disagreements about what or who should be included in the sector. Should it, for example, include all the not-for-profit market-based entities such as financial mutuals, social enterprises and trading cooperatives, or do these constitute an emerging sector (sometimes referred to as a 'Fourth Sector' (see Burkett, 2010)? There are also critics who argue that the name 'not-for-profit' focuses too much on what the sector is not, rather than promoting what it is and does. Recently there have been moves to change the name to the seemingly more inclusive 'Third Sector', though this terminology remains somewhat contested in Australia, despite being generally accepted in some other contexts such as the UK.

To understand the 'sector' as a whole then, and to understand it in terms of representing any kind of 'market' for financial products and services, requires some exploration of the different ways in which the 'sector' can be characterized and segmented. Internationally the UN defines the not-for-profit sector (in the UN Handbook on Non Profit Institutions, 2002; p18) in the following way:

> *"The non-profit sector consists of units that are:*
> *(a) organisations;*
> *(b) not for profit and non-profit distributing;*
> *(c) institutionally separate from government;*
> *(d) self-governing;*
> *(e) non-compulsory"*

Not-for-profit or non-profit does not mean that such organisations do not make any surpluses. Rather it points to the fact that the organisations are not focussed on this in relation to their purpose and do not distribute the surplus to their directors or members.

According to various research, including the Productivity Commission, there are approximately 700,000 not-for-profit organisations in Australia. However over half of these are unincorporated (i.e. have no legal structure and operate as informal organisations). There is little data about these unincorporated organisations, and even the number of these groups is based on estimates. For the purposes of this report, these unincorporated organisations (whilst their importance is acknowledged) are only briefly considered in the definitions part of the report and not considered in the analysis. This is primarily because their informal structures mean that financial management often occurs through auspicing arrangements with other incorporated organisations.

The productivity commission also excluded from their report: body corporates (n=103,000); financial and insurance mutuals (n=2000); and trading cooperatives (n=450).

Without these organisations, there are almost 180,000 incorporated not-for-profit organisations in Australia (the ATO, in the Productivity Commission report, suggested that there were "177 109 organisations with an active tax status classified as not-for-profit" (p59). Of the incorporated organisations, the Productivity Commission suggests that most are small to medium in size. By this the Commission means that:

- 70% have a revenue of less than $1million per annum
- 60% have a turnover of $150,000 or less as reported in their ABN applications

The ABS suggests that 58 779 of the incorporated organisations are 'economically significant', meaning that they employ staff or if they do not employ staff their revenue exceeded a certain ABS determined level.

In order to develop a clearer and deeper understanding of these 'economically significant' not-for-profit organisations and begin to understand the market segments that may exist amongst them it is necessary to examine the sector through a number of lenses, seeking out certain characteristics. This is particularly important in understanding the financial needs and realities of various parts of the sector. The lenses that have been used in this report are as follows:

(1) **Activities** – the industry and activity of the organisation and what distinguishing features this adds to the broad concept of 'not-for-profit'.

(2) **Size** – the size of organisations (micro, small, medium, large) and how this shapes their financial needs and capacities.

(3) **Legal Structure and Charitable Status** – the different legal structures of organisations and whether they have charitable status and how this shapes their financial realities and management systems.

(4) **Resourcing** – the nature and diversity of not-for-profits' resource base; their revenue; how this relates to their expenditure; and what this means for their financial realities and needs.

(5) **Focus** – the nature of an organisations geographic and issues-based focus (e.g. are they locality focussed or focussed on particular characteristics/ interests of clients/constituents; member focussed or community-serving?).

Unfortunately, one of the great limitations of making assessments about the financial needs and realities of not-for-profit organisations is the lack of available data. This is made all the more stark when compared to the data sets that have been developed in the UK, USA and Canada. This lack of data has been highlighted in all the government inquiries into the sector, and by numbers of researchers (see for example ANZTSR, 2008; Lyons et al, 2007).

The ABS has responded to the latest recommendations by the Productivity Commission for further data; however the funding to support greater levels of data collections is yet to be secured. Further, some of the data that is needed to examine effectiveness and efficiency of the sector relate to financial and evaluation information, which is not necessarily the ambit of ABS data collection. Much of this data is collected by funders, but is not necessarily aggregated, analysed, nor made publicly available. The proposed single office or regulator for not-for-profits may also improve access to data (though this will depend on whether State-based regulators continue to grow at present rates, as most not-for-profits are currently regulated by State government offices).

This has certainly been the case in the UK, where the office of the Third Sector (now the Office for Civil Society, in the Cabinet Office) has systematically collected, analysed and made available a great deal of information about and for the sector. The ABS (2010; p18) suggests that:

> *"Financial information is routinely available for for-profit businesses from taxation statistics and through analysis of public information held by government regulators (e.g. APRA and ASIC). Financial and program evaluation information needs to be more widely available for Non-Profit Institutions."*

Further collection and availability of data will greatly improve the ability to be able to generate detailed assessments about different segments of the not-for-profit sector. Therefore, though the above 'lenses' will now be applied to the available data, it should be noted that there are large gaps in this data and therefore the conclusions drawn about the sector should be treated with a degree of caution.

2.1 Activities

Key segmentations: Defining not-for-profits according to their activities or purpose: Culture and Recreation; Education and Research; Health; Social Services; Environment; Development and Housing; Law, Advocacy and Politics; Philanthropic Intermediaries and Voluntarism Promotion; International; Religion; Business, Professional Associations and Unions; Not Elsewhere Classified.

Key ways this impacts on financing Not for Profits: Does not necessarily impact in its own right, but in conjunction with other characteristics can provide defining information for market segments.

The ways in which the activities of not-for-profit organisations have been segmented for the purposes of research and data collection has, in some ways, been standardised through the International Classification of Not-for-profit Organisations led by Johns Hopkins University Centre for Civil Society Studies. The classification identifies 12 activity or purpose groups of not-for-profits, and then divides these into a further 24 sub-groups. This classification now forms the basis of international data collections relating to not-for-profit organisations, including the Australian ABS Non-profit Institutions Satellite Account (see ABS, 2009). The classification is outlined in table 1 below.

Group One: Culture and Recreation	Arts and cultural organisations; performing arts; sports organisations; museums, zoos and aquariums, galleries; media and communications organisations; service clubs; recreation and social clubs.
Group Two: Education and Research	Non-profit schools, tertiary education providers; vocational, informal, adult and community education organisations; research organisations; early childhood services such as kindergartens; policy organisations.
Group Three: Health	Hospitals, nursing homes and aged care facilities; health, public health and health promotion services; palliative care services; health-related crisis and emergency services; rehabilitation; mental health services.
Group Four: Social Services	Child, youth and family services; disability services; self-help services; services for the elderly; emergency and disaster response services; refugee services; emergency and temporary accommodation services; income support services; material assistance services.
Group Five: Environment	Pollution abatement and control; natural resources conservation and protection; environmental beautification and open spaces; animal protection and welfare; wildlife preservation and protection; veterinary services.
Group Six: Development and Housing	Community and Neighbourhood organisations; economic and social development organisations; housing associations and services; employment and vocational services; vocational rehabilitation and disability enterprises; job training services.
Group Seven: Law, Advocacy and Politics	Advocacy organisations; civil rights organisations; legal services; ethnic associations; civic associations; crime prevention and public policy organisations; victim support; rehabilitation of offenders; consumer protection organisations; political parties and organisations.
Group Eight: Philanthropic intermediaries and voluntarism promotion	Grant-making foundations; volunteerism promotion and services; fund-raising organisations.
Group Nine: International	Exchange/friendship/cultural programs; development assistance associations; international disaster and relief organisations; international human rights and peace organisations.
Group Ten: Religion	Congregations, Associations of congregations.
Group Eleven: Business, Professional Associations, Unions	Business associations; professional associations; unions.
Group Twelve: Not elsewhere classified	--

Table1: International Classification of Not-for-profit Organisations

Some of these very broad categorisations are not completely helpful when it comes to differentiating the market in relation to financial services and products (e.g. the housing and development area has very broad inclusions, which reflect quite different financial realities and needs). In Australia, some of the data for certain categories are even further aggregated. So, for example, the ABS Non-Profit Institutions Satellite Accounts aggregate or merge Groups 5-9 to form one group – "Environment, development, housing, employment, law, philanthropic and international".

Further, much of the data analysis that has been undertaken in relation to the classification offers broad comparative data rather than nuanced and detailed data about each group and subgroup (see for example, Lyons, 2008). This is helpful for enabling assessments to be made about the size, structure and economic contribution of the sector, but is less helpful in making assessments as to the financial needs and impact of segments of the sector.

Despite these shortcomings of data, the classification of not-for-profits by activity is important in terms of understanding basic segments of this market, particularly when this data is correlated with other market data. When the economically significant not-for-profits are considered, the distribution of activities across the sector indicates that the three largest segments are Culture and Recreation (20%); Advocacy and Development (18%); and in joint third position, Social Services (14%) and Education and Research (14%) (See figure 1).

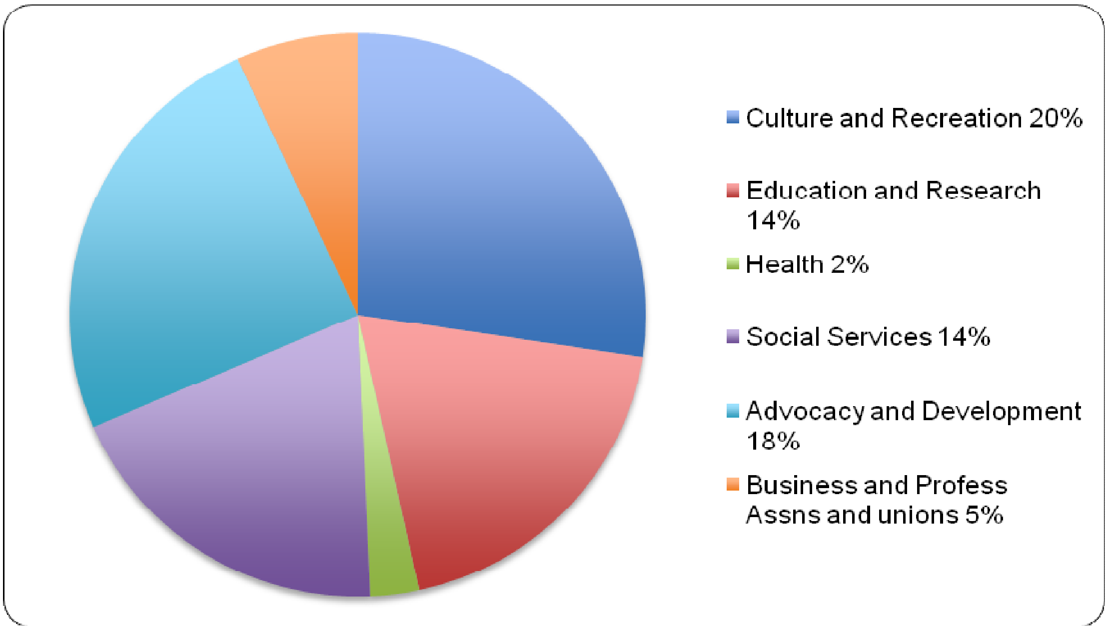


Figure 1: Distribution of Economically Significant Not-for-Profits by field
Source: Lyons (2008)

2.2 Size

Key segmentations: Defining Not for Profits according to their size – micro, small, medium, large and very large.

Key ways this impacts on financing Not for Profits: size can be a reasonable indicator of financial exclusion. Large and very large Not for Profits are often much more commercial in nature and many are able to and do access many mainstream financial services, including debt capital.

Definitions of businesses in terms of their size, (particularly in relation to SMEs) is well developed and yet still debated and contested internationally. The framework and methodology for defining SMEs is sometimes based on numbers of staff, sometimes on annual turnovers and sometimes on net assets (the latest European Union definition takes into consideration all three).

In Australia, the Corporations Act (2001, sec 45A) defines what is considered to be ‘small’ and ‘large’ proprietary companies. Recent changes to the Corporations Act (2001, sec 45B) have resulted in an inclusion of a definition of what is considered to be a ‘small company limited by guarantee’ (i.e. a not-for-profit company), which in broad terms is defined as having less than $250,000 in consolidated revenue in any given financial year. Not-for-profit organisations clearly have a very different size profile to that of for-profit or proprietary companies. In revenue terms, what would be considered a ‘small’ proprietary company would, in the not-for-profit sector, be considered a very large organisation (see Woodward and Marshall, 2003).

Several states have also examined the Incorporated Associations acts, to include some reference to size, in relation particularly to reporting and auditing requirements. Some states have developed tiered understandings of association size, however there is no standard definition of what constitutes or defines these tiers and therefore no standard definition of what constitutes a small not-for-profit across the states. Some states include both income and assets in their definitions of small, others only consider income.

In the not-for-profit arena there is much rhetorical discussion of size in relation to economic significance, sustainability and impact, and yet there is very little analysis (particularly relative to the business sector) of how size is determined and defined, and in reality, whether it has any significant effect on any of the above. The 2008 Senate Standing Committee on Disclosure Regimes for Charities and Not-for-Profit Organisations recommended that common terminology for referring to the size of organisations within the Sector be adopted. However this recommendation has not yet been enacted.

Size is an important but much under-researched factor in the not-for-profit sector. Large and very large not-for-profits obviously have very different financial needs and realities than smaller organisations, and often the larger not-for-profits have few problems engaging directly with the commercial arms of mainstream financial institutions.

Size is also increasingly a policy and political issue. An emerging debate and discussion happening across the not-for-profit sector (in response to various policy initiatives), centres on how size relates to impact and efficiency (see for example, Wiseman et al, 2009). This has implications for the financing of the sector because there is a growing sense that small and medium sized organisations can, particularly if they are locality based, have a deep impact on addressing social and economic exclusion (see for example, Wiseman, 2009).

The evidence for the contribution of the small to medium sized not-for-profit organisations is not yet strong, and neither is the lobbying power of these organisations (particularly when we compare these to the power of the SME lobby in relation to their contribution to the business sector and the economy generally). However, as there is likely to be much greater attention paid to the contribution of the small to medium not-for-profit sector over coming years, it is worth considering their financial realities and needs at this moment in time.

Size is also an important consideration within the particularities of different activity groupings in the sector – as will become clear in the next section. While we can generally segment the not-for-profit sector according to size, there are particular parts of the sector in which size also matters in particular ways, therefore shaping the financial needs and realities of that specific part of the sector. This will be examined the in the next section.

The difficulty in understanding and segmenting the sector according to size is that there is no standard measurement of what constitutes small or large or anything in between! Further, most disaggregated information about not-for-profits comes from data collected by Federal government sources, primarily related to companies limited by guarantee (which is not the dominant legal form for not-for-profit organisations), or from tax data. There is relatively little data available about incorporated associations on the basis of income or employment because there is no central regulator or data collection, and therefore information is dispersed across state-based regulators.

Using all the available data in literature, only the outline of an analysis of the not-for-profit sector according to size can be constructed (see table 2, below). Only 'small' not-for-profits that are Companies Limited by Guarantee now have a legal definition (in the Corporations Act), so the other definitions have been developed based on an aggregation of other ways in which the sector has been defined across the literature. It should be noted, however, that these definitions are somewhat arbitrary and are not standard, nor agreed on, in the sector. The following table does not include unincorporated groups who have no legal structure though they may have bank accounts and income flowing into them through auspicing arrangements with other formalised organisations (as indicated above, there are approximately 440,000 of these groups in Australia).

As can be seen from this table, there are large gaps in the available data about the market size for these various categories – and this is particularly so for the small to medium organisations. The larger organisations, though they represent only a fraction of the whole market, have, to some extent, skewed available data on the not-for-profit sector, particularly in terms of income and expenditure data.

<table>
<tr><th>Size</th><th>Definition</th><th>Size of market in Australia</th><th>Cross Category Data</th></tr>
<tr><td>Micro</td><td>Revenue less than $80,000pa</td><td>Large majority of not-for-profits in Australia (Senate, 2008; PC report), but no figures attached.</td><td rowspan="3">More than 60% of NFPs have revenue of $150,000 or less as reported in their ABN applications (PC report).

According to research undertaken by MacGregor-Lowndes (2006), Deductible Gift Recipient (DGR) endorsement returns (2005/6) suggest that 25% of DGRs have an annual income of less than $8,213 and 50% less than $55,304.

Around 70% of companies limited by guarantee have an income of less than $1million pa. (PC report; Woodward and Marshall, 2003).

30% of companies limited by guarantee in a 2003 survey had an income of less than $100,000 and 53% had an income of less than $500,000. 36% had $1million or more gross income in the last financial year (Woodward and Marshall, 2003).</td></tr>
<tr><td>Small</td><td>Revenue less than $250,000 pa.

Based on: Definition of small Company Ltd by guarantee in the Corps Act. Sec 45B</td><td>47% of companies limited by guarantee (that is, 47% of 11,700, which is approx. 5,500).
No specific data available for other forms of not-for-profits.</td></tr>
<tr><td>Medium</td><td>Revenue more than $250,000 but less than $5million pa.
A sub-set of this is those NFPs under $1million pa. as defined by</td><td>No specific data available.</td></tr>
<tr><td>Large</td><td>Revenues more than $5 million but under $25million pa.</td><td>No specific data available.</td><td>-</td></tr>
<tr><td>Extra Large</td><td>Revenues over $25million</td><td>Represent only 2% of registered companies limited by guarantee (PC report, ABS).</td><td>-</td></tr>
</table>

Table 2: Defining the Not-for-Profit Sector by Size.
Source: various

Further, when linked to available data centred on not-for-profit activities, the determination of size can change dramatically. So, for example, the latest ACOSS (2010) survey of the Australian Community Sector (which includes predominantly social service and development and housing groupings, and was based on a survey of almost 600 organisations), defined size in the following terms:

- Very small (less than $250,000) (18%);
- Small (between $250,000 and $500,000) (21%);
- Medium (between $500,000 and $1million) (21%);
- Large (between $1million and $3.5million) (21%);
- Very Large (over $3.5million) (19%).

In conclusion then, size is important, but it is not well defined and there is little data from which to build definitions, and therefore it is almost impossible to segment the not-for-profit market according to standardised and agreed upon measures of size.

The impact of size on financial on an organisations access to financial services and on financial management is often critical, but needs to be considered alongside other factors such as resourcing. The large and very large not-for-profit organisations frequently make highly sophisticated financial decisions, and are much more likely to have access to both mainstream financial services and to specialised not-for-profit funds and products. Financially they many function in ways that are much like commercial businesses, and frequently have dedicated financial management staff. They may access specialised banking services, but are more likely to have well developed banking and financial relationships and arrangements. It should be noted that this is represents the minority of the not-for-profit market, (according to data represents only between 2% and 5% of the total not-for-profit market, taking into account available data on companies limited by guarantee and incorporated associations).

The fact that size here is measured by revenue means that the large and extra-large organisations represent that end of the market that is most attractive to mainstream financial institutions. There is increasing competition amongst financial institutions interested in banking the not-for-profit sector, particularly around the large to very large organisations. Though most of these financial institutions will have undertaken specific market research about the size of this market and its needs in designing their products, there is little publicly available evidence about what kinds of financial products and services various sized organisations are currently accessing (and whether they commercial or more specialised not-for-profit); nor about what kinds of gaps exist for organisations. More detailed market research is needed to determine this. However, anecdotal evidence based on Foresters work would indicate that:

- The needs for basic banking (deposit-taking and transaction accounts) have been fulfilled across the spectrum of organisational size, with many organisations attracted to specialised not-for-profit products.

- In relation to access to credit and debt capital, size often determines access. The very large organisations often have developed asset bases, and have access to commercial lending services like most businesses. The large organisations have variable access to credit, depending on where they sit in the broad size spectrum (those at the upper end of the category obviously have different needs and different access to those closer to $5M revenue); their relationships to financial institutions; and also on the activities of the organisations and their focus (for example, there are some anecdotal reports in the sector that suggest that Indigenous organisations, even if they are large, still have difficulties accessing credit from mainstream financial institutions). Smaller and medium sized orgs are very often unable to access debt capital. Their risk profile is poorly understood by most financial institutions, and they may require more specialised capital assessments which may be more expensive than mainstream financial institutions are willing to entertain.

2.3 Legal Structure and Charitable Status

Key segmentations: Legal Structure (Companies limited by guarantee; Incorporated Associations; Cooperatives; Aboriginal Councils and Associations: special legal structures); Charitable Status (Public Benevolent Institutions; Health Promotion Charities; Charitable Institutions; Income Tax Exempt Funds; Deductible Gift Recipient Status).

Key ways this impacts on financing Not for Profits: There are few direct implications of legal structure and charitable status for financing (except when it comes to equity), though there are cultural implications and some potential implications for developing earned income sources, which could impact on financing options.

The most common legal structures for not-for-profit organisations in Australia are[2]:

- **Companies limited by guarantee** (n=11 700)
- **Incorporated Associations** (n=136 000)

There are relatively few not-for-profits that are cooperatives (1850), and a much larger number that are incorporated under either industrial legislation; the Aboriginal Councils and Associations Act; Friendly Society Acts; Education Acts or specific acts of parliament (totalling around 9000 organisations) (PC report, 2010;p.58).

In relation to the current report (and as has already been stated), it is important to understand that the Incorporated Associations are regulated under state-based legislation, and the nature of this legislation varies from state to state. In addition, even at Commonwealth level, the regulation of not-for-profits is spread across numbers of bodies, causing not only inefficiencies in terms of regulatory compliance, but also impacting on the nature of data that is available about not-for-profits, and therefore on capacity for policy and practice development of the sector as a whole.

Currently, Incorporated Associations are the most numerous and also the structure experiencing the greatest growth (up from 120,000 in 1995/6 to 136, 000 in 2008/9). There is an expectation that there will be considerable growth in the number of companies limited by guarantee now that the new reporting/compliance changes have been made for smaller not-for-profit companies in the Corporations Act (this expectation was also expressed in the PC report, p.120). There is likely also to be an increased push for new not-for-profits in the future to be incorporated as companies limited by guarantees due to the Federal Government's increased interest in Third Sector reform and development (see for example, National Compact, PC report etc).

Taxation regulation in Australia can have implications for not-for-profit organisations in relation to their:

- income and inputs concessions (can relate to fringe benefit tax, goods and services tax, payroll tax, stamp duty, and to income tax, for example);

- wealth tax concessions (such as land tax);

- whether they are able to receive deductible gifts (meaning their donors can claim tax deductibility for eligible donations). (See PC report, 2010; ATO, 2007).

This has implications for both attracting income and for expenditure in not-for-profit organisations. While the full impact of these concessions and their in-depth exploration are beyond the scope of this literature review, they represent important considerations in relation to both the types of income generated, and to structures and cultures within organisations around income / expenditure reporting and performance.

For this reason, some understanding of the market segmentation of not-for-profits in relation to their legal structure and their charitable status is important in developing a picture of finance in the sector.

[2] This data does not include Body Corporates

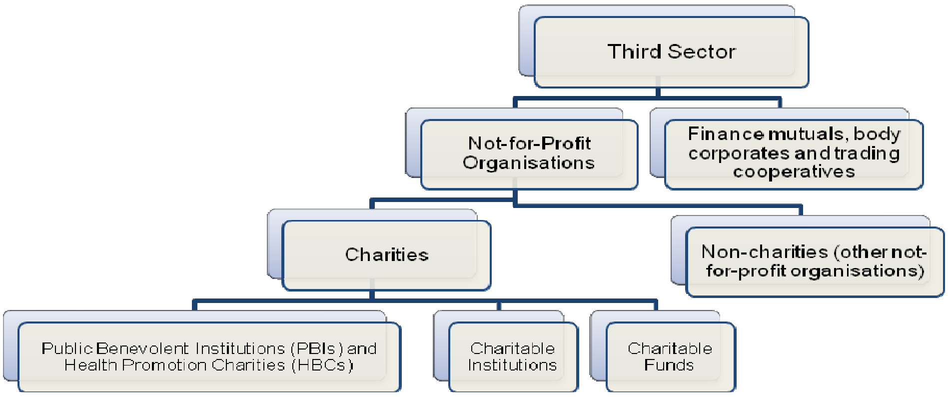


Figure 2: Understanding the Not-for-Profit / Charity connection
Source: Australian Senate, 2008; p.16; ATO, 2007.

The ATO latest data (2006-2008 figures) indicates the following market size for not-for-profit organisations with charitable status.

Entity type	Number
Charitable institution	35,892
Public benevolent institution	9,711
Charitable fund	5,237
Health promotion charity	715
Income tax-exempt fund	116
Total	51,671

Table 3: Market Size of Charitable Organisations in Australia
Source: ATO, 2009

In addition, there are just over 25,000 not-for-profits who have Deductible Gift Recipient Status, meaning that their donors can claim tax deductions for eligible donations (source: ATO, 2009).

While it could not be said that there are direct implications of legal structures and charitable status on the financing of not-for-profits, there are a number of key issues that are raised by both these characteristics, which potentially have implications both for actual financing of not-for-profits and for market segmentation:

- There is a need for greater education and awareness about legal structures (see for example, Woodward and Marshall, 2003), particularly about some of the advantages of company structures over association structures;

- Association structures are state-specific, and therefore most associations are not able to operate nationally or in multiple states unless they also incorporate in those states. This potentially limits the scale and reach of their operations, though this may not be an issue if they are locality-focussed (see section 2.5);

- There have been recent investigations of the extent to which tax-exempt charities can conduct commercial activities to raise funds. Recent tax cases (see for example, High Court rulings in Word Investments, 2008) and the Henry Review (Australia's Future Tax Systems Report) have provided some reassurance to such organisations (Recommendation 42 of the Henry Review went so far as to say "NFP organisations should be permitted to apply their income tax concessions to their commercial activities"). As earned income streams become more important for not-for-profit organisations (and this has implications for how they can be financed), this debate will continue to some extent because of the different jurisdictional variations in regulations. The reports and reviews that have recommended a single Not-for-Profit regulator will, over time, help to address the inconsistencies and anomalies of the current system;

- There are cultural differences influenced both by legal structure and charitable status, that can lead to rejection in some organisations and in particular parts of the sector, of surplus generation, enterprising/trading activities, and asset development – all of which impact on an organisations capacity to engage with a full range of potentially beneficial financial products and services.

2.4 Resourcing

Key segmentations: Market, Non-Market Not-for-Profit Organisations – and market and non-market activities within organisations.

Key ways this impacts on financing Not for Profits: The type of revenue (restricted or unrestricted) and the source of revenue (e.g. grant funding, earned income, donations) determine the use and availability of the revenue with a not-for-profit organisations, and therefore determine whether it can be used to service debt, invest in assets, underpin service innovation or increase net assets.

This section examines resourcing in a broad sense, for this is an area that will be explored in more depth in later sections of this report.

In Australian Bureau of Statistics not-for-profit data sets a key distinguishing characteristic of organisations is whether they are 'market' or 'non-market' institutions.

- **Market Not-for-profits** "are those that sell their output at prices which have a 'significant' influence on amounts producers are willing to supply and purchasers are willing to buy" (PC report, p62);

- **Non-market Not-for-profits** "provide most of their output to other free or at prices which are not economically significant and must rely principally on funds other than receipts from sales to cover their costs" (PC report, p62).

To understand how this segments the not-for-profit market, it is necessary to add another characteristic to the analysis, that of 'focus' (which will be explored in section 2.5 below). Figure 3 below illustrates the connection between these two characteristics, as outlined in the Productivity Commission report.

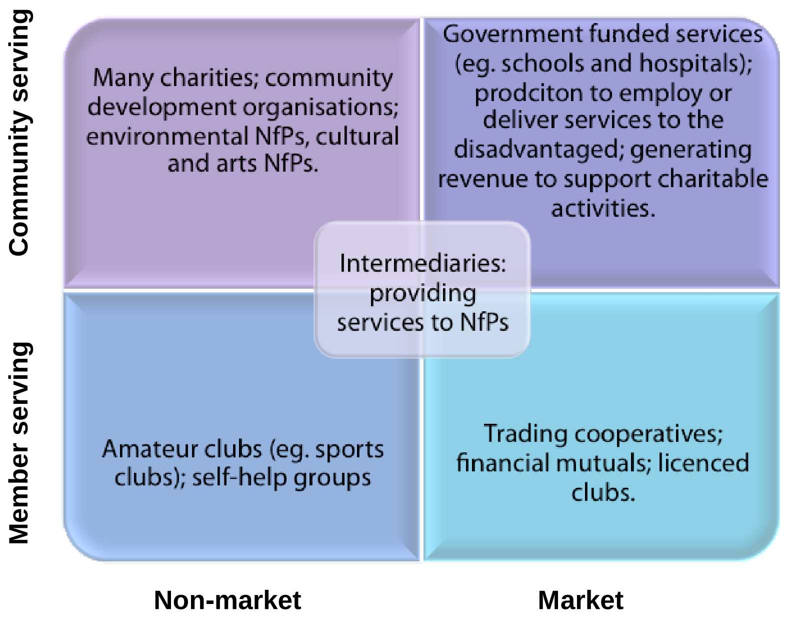


Figure 3: Differentiating market and non-market oriented Not-for-profits
Source: Productivity Commission, 2010.

While this framework is very helpful in understanding some broad characteristics of the not-for-profit sector, changes in the resourcing of organisations has meant that the boundaries between non-market and market oriented Not-for-profits is becoming less distinct, and many Not-for-profits are developing market-based strategies to sit alongside or even subsidise their non-market activities. This is particularly the case for Not-for-profits in the top two quadrants (see for example Burkett, 2010). There are some important distinctions that need to be made in relation to not-for-profit resourcing, which also help to understand differences in the market.

Restricted and Unrestricted Revenue

Not-for-profits **revenues are of different types and purposes**. It is important to distinguish between 'restricted' and 'unrestricted' revenue. **Restricted revenue** can only be used for the purpose for which it was given (e.g. Program-related grant monies); **unrestricted revenue** is not tied to particular purposes and a NFP can determine how it will be used. In terms of understanding the potential for certain types of finance in this sector (particularly around debt), unrestricted income is critically important, though as will be discussed later, it can be difficult to identify in financial statements, and not all Not-for-profits are aware of its potential power.

Recurrent and Project Related Revenue

The linkage of source to **whether the funding is recurrent** (i.e. ongoing, over a period of some years, beyond a single funding agreement period) or **non-recurrent, project focused**, is important as this can help to build a picture of the financial realities of a not-for-profit organisation. Organisations who have large amounts of **non-recurrent project funding** are often in a much more precarious situation financially as the transaction costs involved in obtaining, administering, operationalising and reporting on such funding relative to the amounts involved are usually very high. Further, recurrent funding makes it much more likely that not-for-profit organisations will be able to charge appropriate management and other fees to enable them to subsidize operational costs not covered by most grant funding (see section 5 below).

Source of Revenue

The **source of revenue** in Not-for-profits often determines if it is restricted or unrestricted. Revenue that is classed as '**funding'** is often program related and therefore restricted. Revenue that is **earned** or **gifted** is often unrestricted (except under some contract conditions). **Fundraising** and **philanthropic** income can be either restricted (if there are conditions attached to the donation) or unrestricted (for example, public fundraising, though there is often pressure in this instance to spend the revenue on direct service delivery rather than 'overheads'). Aggregated data examining sources of revenue in the not-for-profit sector has often skewed because market and non-market Not-for-profits have been aggregated, and because other characteristics (such as size) have not been correlated with income source data (so that, in this instance, data can be skewed by the volume of income that flows into large and extra-large Not-for-profits). The latest ABS Satellite Account data has addressed only the former difficulties by separating out market and non-market data.

According to the ABS, in market not-for-profits, the main source of income in 2006-07 was sales of service, whereas for non-market organisations, the main source was volume based government funding (which refers to "funding provided subject to an agreement or contract specifying the volume of services to be delivered, and paid in proportion to the volume of services delivered" (ABS, 2009)).

To find a more nuanced picture of sources of revenue for small to medium sized not-for-profits, two other data sets are of interest. The ACOSS Community Sector Survey (2010) surveyed 582 community sector organisations (which includes organisations from Groups 3, 4, 6 and 7 of the ICNO Classification). The aggregated findings suggest that the majority of revenue for respondents came from Government sources. The survey identifies the following primary sources of revenue (table 4), and importantly, outlines whether this funding was recurrent (i.e. ongoing over numbers of years) or project based (one-off funding). As the authors of this report suggest:

> *"Many organisations are, therefore, subject to funding arrangements that do not guarantee recurrent or ongoing funding. This limits organisational capacity to plan adequately for the future, especially in terms of service provision and staffing" (ACOSS, 2010; p28).*

Funding Source	Organisations primary source of funding %	Funding is ongoing/recurrent %
Commonwealth Government	23%	72%
State/Territory Government	40%	80%
Local Government	6%	52%
Client Fees	10%	68%
Donations	10%	44%
Corporate	3%	36%
Other	8%	77%

Table 4: Primary Sources of Revenue and Recurrence
Source: ACOSS Community Survey, 2010, p. 26

Another recent survey of the not-for-profit sector in which half of those surveyed could be said to be small to medium sized organisations (153 organisations were surveyed, Centre for Corporate Public Affairs, 2008) indicated that the percentage of their revenue from key sources were as follows:

Source	% of income	Restricted or Unrestricted (in the main)
Government Funding	47.2	Restricted
Taxable donations from Public	15.4	Unrestricted but reportable
Corporations	9.4	May be Restricted or Unrestricted
Fee for Service (non-government)	9	Unrestricted
Income from Investments	5.7	Unrestricted
Merchandising	4.3	Unrestricted

Table 5: Percentage of Income from Key Sources and Restrictions
Source: Centre for Corporate Public Affairs 2008, p.8.

Diversity of Revenue Sources

There is no data that examines how diverse the sources of revenue are in not-for-profit organisations, however anecdotal evidence from Foresters action learning work suggests that many small to medium sized organisations particularly in the social services, development and housing areas are over 90% dependent on revenue from one type of source (i.e. government funding),;and within this a majority are dependent on one funding body (predominantly State government for small to medium sized organisations). This is associated with both risk and pressure for these organisations, and this in turn impacts on both their viability and sustainability.

Distinguishing Revenue from Capital

According to the ACOSS Community Sector Survey (2010; p27), 80% of respondents indicated that government funding did not cover the full cost of delivering contracted services. This is an important point in the context of the current report as it points to a distinction between ‘revenue’ needs (which are consistently articulated in the ACOSS and other surveys) and ‘capital’ needs (which are not as well documented nor researched in the Australian context). This distinction is further explored in section 5 below.

Balance Sheets and Net Worth

ABS data includes some analysis of not-for-profit balance sheets. It suggests that the net worth of market and non-market not-for-profits is not significantly different, but again it is difficult to use this data in the context of making assessments of the net worth of small to medium sized organisations. Other smaller surveys of the sector tend not to focus on balance sheet assessments, choosing instead to detail income and expenditure. This mirrors a tendency in the sector to focus on revenue and viability (as portrayed on the profit and loss statement) over attention to net worth and sustainability (as related to the balance sheet).

Access to Capital

Currently, across the not-for-profit sector, savings, in the form of surplus revenue, represents the key mechanism for sector investment (over 60 percent of sector investment) (ABS, 2009, in PC report, 2010; p184). Debt capital, on the other hand, “accounts for only 15 per cent of gross capital formation” (PC report, 2010; 184). In other words, the not-for-profit sector in Australia generally tends to rely more on internally generated capital than engaging in accessing external capital such as loans or equity.

2.5 Focus

Key segmentations: Concentration focus: Geographical / Locality focus or Issue focus; Locality Focus: Urban, Rural, Regional, Remote. People Focus: Public/Community-serving or Member-serving;

Key ways this impacts on financing Not for Profits: Focus can have an impact on financial sustainability of organisations – both in terms of the people focus (that is, whether an organisation is 'community-serving' or 'member-serving' and its geographical focus.

This feature has three dimensions to it – none of which are very well documented in the Australian data about not-for-profits, but which can each shape organisations in relation to their impact, viability and sustainability.

1. **The concentration of the organisation**: whether it concentrates on a geographical / locality focus (such as, for example, a community centre, neighbourhood house or local health service); or whether it concentrates on an issue without locality focus (for example, a support service for people with a hearing disability, or a not-for-profit focussed on IT access for older people).

2. **The location of the organisation** (and therefore what the **focus of its reach** is likely to be): whether an organisation is based or headquartered in an urban, regional, rural or remote context.

3. **The people focus of the organisation**: whether it is public / community serving or member serving.

Each of these foci can have particular implications for an organisations need for and capacity to manage finance and capital. A locality focus can shape the sorts of funding that is available to a not-for-profit, depending on the demographics of the particular locality on which the organisation is focussed. An issue-focussed organisation may also face questions of capital because the lack of geographic focus means that resources can be stretched across a wider area, and the issue can be either more or less attractive to funders over time. There appears to be no data available that could help to determine the size of the market in relation to either of these two focus areas.

There is also relatively little data available about the nature of not-for-profit organisations in rural and regional Australia. As Mission Australia (2006) highlight:

> *"National information on the demand and provision of community services in rural and regional areas is difficult to access".*

O'Donoghue et al (2006) suggest, however that fundraising pressures are most pronounced for smaller organisations in regional, rural and remote communities because of their smaller population and economic base. It could be assumed that such organisations would also face greater exclusion from non-grant capital and finance than their urban counterparts, however no data exists to support this assumption.

The Productivity Commission report differentiates between organisations that are "community-serving or public-serving" and those that are "member-serving", such as clubs, mutuals and self-help groups. It suggests that this distinction is one of the key ways in which to differentiate the not-for-profit sector. In some ways in order for this to be a distinction that is useful in segmenting the sector for the purposes of understanding its financial needs it needs to be linked with other characteristics, such as size and resourcing (see section 2.4 above).

2.6 Towards market segmentation: some conclusions

This section began with a question – 'in a complex and diverse 'sector', is market segmentation possible?' The answer is not definitive. Certainly there are some clear characteristics that can segment and define the not-for-profit sector, but the lack of data and the sheer complexity of the sector make it difficult to objectively segment this market except in broad terms. Figure 4 divides the not-for-profit sector in very broad terms to identify those characteristics, when combined, could define the 'most excluded' and 'least excluded' organisations in financial terms. This is not, however, definitive, and not all organisations fitting these characteristics could be said to be either excluded or included.

There is no doubt that size, resourcing and focus are defining characteristics in understanding the financial needs and realities of not-for-profit organisations. Legal structure, charitable status and activity focus may not have a direct impact on determining an organisations access and use of financial services and products, but they can influence both what kinds of products are more likely to be needed and the appropriateness of these products and services. This will be explored in more detail in the next section.

In terms of the market development across each of these segments, this also varies according to the types of products and services and particularly their accessibility in relation to size and revenue types of organisations. Table 6 below outlines some of the key products that are currently available in some form to Australian not-for-profit organisations, and makes some commentary about their accessibility in relation to these characteristics. As this table and the above analysis suggests, accounts and deposit products are readily accessible to the Australian not-for-profit market, and the market for such products is well developed across the breadth of not-for-profit organisations. Credit facilities, of various kinds, are currently underdeveloped in the Australian context, particularly across small, medium and lower ends of the large sized organisations, and especially amongst those that are non-market based.

The next section, then, examines the financial need of not-for-profit organisations more closely and explores the research that has been undertaken about both financial needs and capacities of this sector.

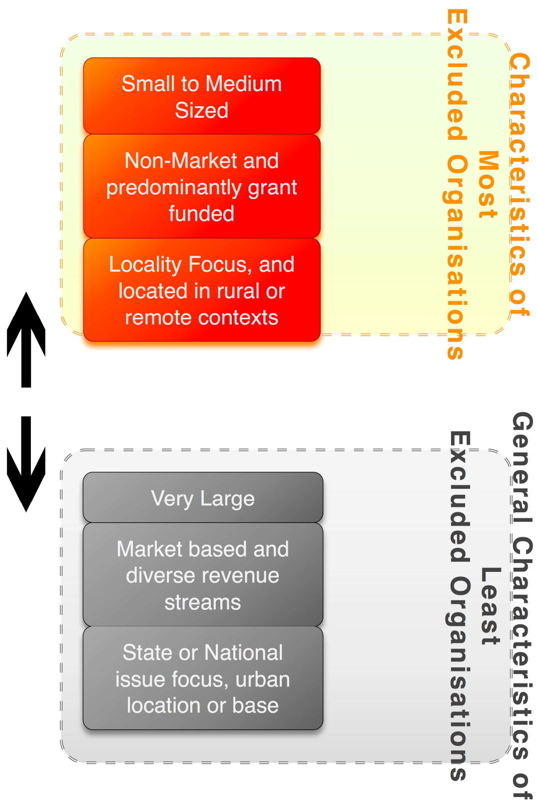


Figure 4: Broad characteristics of most and least financially excluded organisations

Product	Australian Product Information	Market Commentary
Transaction accounts	Most mainstream banks and all of the specialised community banks have a bank account targeted to not-for-profits, many not-for-profits access ordinary transaction accounts (NAB, CBA, Westpac, ANZ, mecu, CSB, Bendigo).	The vast majority of not-for-profits have at least one and possibly more accounts (including a great many informal or unincorporated organisations).
Savings accounts	Most mainstream banks and all of the specialised community banks have savings accounts with a higher rate of interest that not-for-profits take advantage of. (NAB, CAB, Westpac, ANZ, mecu, CSB, Bendigo)	Internet banking and direct debit have become a popular and almost standard way of tracking and checking transactions, except in the smallest organisations.
Term investments	Most mainstream banks and all of the specialised community banks have a range of term investments that not-for-profits take advantage of.	More sophisticated not-for-profits with finance officers often 'shop around' for term investments for provision and reserve monies.
Credit Cards	Many not-for-profits access mainstream credit facilities for operational purposes. These tend to be the standard facility; no specialist product has been identified. Many smaller not-for-profits use debit rather than credit cards.	Smaller not-for-profits have reported some difficulties accessing credit cards, and some are wary of such facilities, however many use debit cards as an alternative.
Lease facilities	Used for cars and photocopiers, standard rates usually apply, some specialised product is available through the likes of CSB.	Most utilised by larger not-for-profits and those in contexts where regular servicing of equipment as part of a contract can be important.
Overdraft	Standard product (offered by all the majors and community focussed banks)	Most relevant to those who have some level of trading, sales etc. Smaller organisations with diverse revenue streams (including grant funding) often report difficulties accessing overdrafts and loans. Commercial loans are difficult for a range of not-for-profits other than those who are very large.
Commercial Loans	Standard commercial loan, offered by all of the majors and the community banks, however, prove very difficult for many not-for-profits to access.	

Table 6: Financial Products and Services currently available to various segments of the not-for-profit market

3. Examining the Need: What Research has been undertaken about the financial needs and capacities of not-for-profits

Both within Australia and internationally there has been limited quantitative research on the financial needs and realities of not-for-profit organisations (see for example, Goodall and Kingston, 2009;p3).

According to Lyons et al (2007; pp2-3) much of the discussion about the capital needs of not-for-profits in Australia is based on case studies rather than empirical data:

> *"It is sometimes claimed that Australia's non-profit sector, or important parts of it, face difficulties in accessing capital, that is the finance they need to invest in new assets or to renew existing assets. These difficulties are said to be a consequence of the drying up of government capital grants and the reluctance of banks to lend to nonprofits. It is sometimes suggested that, in the context of increasing competition with for-profit enterprises, these difficulties constitute a crisis which, if not resolved will lead to a decline in levels of participation by non-profit organisations in many industries or field of activity. These claims are based on anecdote and while they provide convincing examples, it is not clear how large the problem is." (Lyons et al, 2007; pp2-3).*

This assessment still applies in the current context, with little or no empirical data available to establish whether there actually is a potential not-for-profit capital market in Australia.

This section, then, draws together the market analysis of the previous section, with literature relating to the capital needs of not-for-profits in Australia, and some analysis of the potential capacity, particularly of small to medium sized organisations. This will provide a foundation from which to make some assessments about the potential for a not-for-profit capital market in Australia (as illustrated in figure 5 below).

Figure 5: Linking Need and Capacity to the Potential Not-for-Profit Capital Market
Source: Foresters Community Finance

3.1 Is There a Need for Capital Amongst Not-for-Profit Organisations?

In Australia the recognition of the sector's need for financial services extends back almost two decades (for example, the Community Sector Bank joint venture was begun in the early 1990s, and Foresters Community Finance was providing mortgage loans to not-for-profit organisations in the mid-1990s). However, this recognition has not gained as much momentum as in the US or the UK, and with only a few exceptions, has not extended much beyond exploration of the banking needs of not-for-profit organisations (in the form of transaction accounts and deposit-taking services).

Further, calls for capital needs amongst not-for-profits have traditionally not differentiated 'which parts' of the sector require capital. Obviously the large and very large organisations are most attractive to mainstream a financial institution, which means they are often best served and most targeted by marketing. Small to medium sized organisations have not been as well serviced, and there is less understanding of what their need for capital may be.

Despite mentions in each of the Federal Government Inquiries focussed on not-for-profit organisations, there has in reality been little systematic exploration or policy level debate about the finance and capital needs of the sector (with the notable exception being the work undertaken by the late Mark Lyons, particularly with the Non-profit Roundtable in 2007). The research work undertaken to date is based, in the main, on aggregated statistical data analysis rather than detailed analysis of organisation's finances or their own assessments of needs. From this perspective there are certain broad conclusions that can be drawn about the need for capital in Australia's not-for-profit sector – for example:

> *"Do Australia's nonprofits face a capital crisis? The short answer to the question is no. Most of Australia's non-profit organisations are not in a position where they have an immediate need for capital which they cannot satisfy and without which they jeopardise their future. However, some nonprofits in certain fields, and in regional and rural areas, do face an immediate crisis. As well, over the longer term the difficulties faced by many nonprofits in accessing capital slow the development of the sector. It distorts the ability of many nonprofits to compete with for-profit organisations and inhibits the potential of the sector to be a major source of social innovation. These distortions in the Australian capital market will only be overcome by the development of specialist financial instruments and institutions" (Lyons et al, 2007; p7).*

Lyons et al, (2007) identify the following areas of Australia's not-for-profit sector as having particular needs for capital:

Not-for-Profit Market Segment	Capital Needs identified by Lyons et al	Degree of Need as determined by Lyons et al
Social Assistance organisations (services for elderly, people with disabilities, people living in poverty, including child care facilities and accommodation facilities such as hostels and nursing homes)	▪ Capital expenditure no longer funded through capital grants; ▪ Facilities purchase, refurbishment, specialised accommodation renovation and renewal; ▪ Equipment – e.g. motor vehicles, computers; ▪ Capital costs associated with changed compliance regimes.	**High but periodic** need for capital particularly amongst those that provide services through specialised accommodation or facilities.
Community Development (community renewal and job creation focussed organisations)	▪ Capital projects for purposes of enterprise development; ▪ Start-up capital for enterprise development.	**High need**, particularly for enterprise and innovation start-up.
Health	▪ Capital for medical technology purchase; ▪ Refurbishment and re-equipping facilities; ▪ Start-up, development and growth capital for health promotion, research and support services.	**High need**, particularly for small to medium health care services.

Education	▪ Start-up capital for new schools; ▪ Major capital works, facilities upgrade and refurbishment; ▪ New equipment, particularly IT; ▪ Replacement of buildings (e.g. demountables) to comply with new standards.	**Moderate need** particularly for smaller, non-elite schools, but also often insufficient revenue for servicing loans.
Housing	▪ Building housing stock for affordable housing	**High need**
Creative and Performing Arts	▪ Working capital for performance/events, prior to generation of ticket sale revenue; ▪ Re-equipment of facilities with new equipment (esp. media, information centred not-for-profits)	**Low need**
Employment and Training	▪ Bridging capital for employment and training service expansion prior to receiving grant funding; ▪ Growth capital	**Moderate need**
Sport and Recreation	▪ Facilities improvement capital not covered by capital grants	**Low need**

Table 6: Capital Needs of Not-for-Profit Organisations as Assessed by Lyons et. al. 2007
Source: Summary of data presented in Lyons et. al. 2007.

There is no methodological information provided in the above research that would indicate how these assessments were made, though given the principal author's knowledge and experience of not-for-profit data sets and his networks, one could assume that it was built on some quantitative analysis and informal qualitative inquiry. There has been no empirical testing of these assessments to date. However, using unpublished aggregated data from Foresters Community Finance analyses of small to medium sized organisations from across the sector[3], some conclusions could be drawn that both confirm but also challenge Lyons et al's assessments.

Like Lyons et al (2007) this data confirms some key capital needs in the sector that are centred around the following areas:

- **Property purchase, specialised refurbishment and improvement** (this is particularly the case as capital grants to not-for-profits have decreased over the past decade);
- **Enterprise development, including equipment and facilities** associated with establishing and growing income generating, mission oriented social enterprises, or enterprises linked to growing the revenue base of not-for-profits themselves;
- **Bridging or working capital** particularly focussed on activities where there is an ensured but delayed revenue source;
- **Innovations around service delivery and/or impact generation** that involves building staff and organisational capacity prior to funding being sought or achieved.

The assessments made by Lyons et al (2007) regarding the degree of need are generally confirmed in the Foresters data, however this data challenges the idea that there is no or low need in the Arts and Culture sector, and would suggest that there is actually a high need in relation to all the areas identified above amongst organisations in this group. This is supported by recent research and reports (see for example, Arts Queensland and Centre for Social Impact, 2010; Hunt, 2009).

Further, Lyons et al (2007) suggest it is more likely to be smaller organisations that have greatest difficulties in accessing capital. This is supported by Foresters data and also overseas research (see, for example, Goodall and Kingston, (2008;p16) who argue that "access to capital is more of an issue for smaller entities than large, established organisations").

Apart from the first area (i.e. property purchase and improvement) Foresters data indicates that the other needs are currently primarily met through internal 'investment', that is drawing down on internal savings or retained earnings, or in some cases specific capital grants that arise when policy and funding conditions are

[3] This data has been used for internal organisational impact measurement and is not publicly accessible. As it is centred on aggregated data from a range of organisations linked to Foresters Community Finance the data has certain limitations and is not a statistically significant sample.

favourable (such as occurred in relation to the recent Federal Government stimulus package). Unfortunately there is no particularly coordinated or organised articulation of demand for non-grant capital from the sector itself, though there is an ongoing and strongly articulated demand for greater levels of grant funding. This is not unlike the situation in the UK, where, despite the growth in supply of not-for-profit capital, the demand is not strongly articulated in the sector, as Goodall and Kingston (2009; p4) suggest:

> *"There is no strong or coherent voice clamouring for access to capital".*

Despite this lack of a "strong or coherent voice", there has been *steady* demand for capital (particularly for property purchase and asset development) across the sector both in Australia and internationally, and supply has developed from and around this demand.

In the case of the UK and the US the scale of not-for-profit capital supply has been heightened by government intervention. Government in both contexts has played a key role in the development of this market. In the US, through the Community Reinvestment Act (CRA), focus was drawn to how financial institutions could engage and invest in economically disadvantaged areas. This in turn drew attention to the financial needs and realities of organisations working in these areas, in particular, not-for-profits. In the UK, the impetus came both from a broader policy focus on under-investment in what are termed 'deprived' communities, and also from a recognition that not-for-profit organisations needed more than grant funding in order to build their capacity to respond to complex social needs (see SITF, 2000).

In the UK, though these issues were faced from within the sector itself (and through organisations such as CAF (Charities Aid Foundation), who have a long history of responding to the financial needs of not-for-profit organisations), government has played a key role as both an enabler and a provider of capital. Until the recent change of government, this had resulted in an enormous growth of the not-for-profit capital market, at least from a supply side perspective. This has meant that in the UK and the US, a growing number of policy initiatives and practical innovations have been developed which have opened up sources of capital and investment to the not-for-profit sector (see appendix one), almost despite the lack of coherent or strong demand. Though the evolution and learning from these two contexts is explored in greater detail in section 4 below, at this point it is helpful to examine what, in these contexts, was identified as the capital needs of the sector.

Firstly, it should be said that a lack of evidence regarding the capital needs of not-for-profit organisations is an international issue, not one only facing Australia. Goodall and Kingston (2009) writing in the UK argue that:

> "*Evidence of need and demand relies too heavily on anecdote. Research into the understanding and needs of charities themselves in relation to capital is overdue" (p.16).*

This does not, however, stop many within and outside the sector claiming that "capital has a complementary role in building strong and effective civil society organisations" (Mitchell et al, 2008; p5). A seminal article in the UK (quoted in almost every other report about not-for-profit finance) argues that not-for-profit organisations have a range of capital needs (Mitchell et al, 2008; p11-13), including:

Capital Needs	Uses
Hard Development Capital (Fixed Asset Acquisition Capital)	To purchase tangible and fixed assets such as land, buildings, technology, and equipment.
Closed Working Capital (Bridging finance)	To assist with short-term cash flow shortages such as when a grant or contract is paid in arrears.
Open Working Capital (Reserve Capital)	To meet immediate needs before monies are raised or grants are committed; or to smooth cash flow fluctuations.
Soft Development Capital (Growth Capital)	To fund significant growth, innovation, service or product development or build the capacity of the staff / organisation to enhance the organisation's social impact.

Table 7: The Capital Needs of Civil Society
Source: Based on Mitchell et al, 2008; pp11-13.

In addition to grant and philanthropic funding, Mitchell et al (2008; p15) argue that Not-for-Profit organisations in the UK require access various non-grant capital that is fair and flexible. The instruments they recommend include:

- Secured loans (for asset acquisition);
- Standby facilities;
- Overdraft facilities;
- Unsecured loans;
- Patient capital (loans that are offered for long terms and flexible terms, with reduced expectations of high financial returns but expectations of positive social returns);
- Quasi-equity, and;
- Equity.

In the US there is some recent debate about whether in fact not-for-profits have less access to the capital they need than their for-profit counterparts. In a recent interview the CEO of one of America's largest not-for-profit capital funds, Clara Miller, argues that:

> *"The vast majority of both nonprofits and for-profits (that are small, with less than $200K in revenue) have approximately the same level of access to similar financing vehicles: sweat equity, seed/angel funders/investors (friends and family, the first foundation grants, etc.), credit card debt, bank loans, retained earnings, etc. Then there is "growth capital" or "capital grants," which a very small proportion can access in either sector. And while large for-profits are much, much larger than large nonprofits, large nonprofits have reliable access to some highly sophisticated funding and financing vehicles that for-profits don't (and vice versa).*
>
> *Some very large nonprofits have access to for-profit subsidiary ventures and investments—and some are highly sophisticated (universities investing in development of intellectual property and associated products, CDFIs with venture funds, public media with development and sales of program assets, and others). And on the debt side, much of nonprofits' "capital market" is for-profit-run (bank debt, investments, tax-exempt bonds, etc.). The most important barrier to enterprise scale (for either sector) is not so much lack of access to capital as it is a scalable, focused business model with reliable net revenue. Once you have those—or evidence that they are possible—capital will flow" (Miller, 2010).*

3.2 If there is a Need, What is the Financial Capacity to Manage Non-Grant Capital in the Sector?

What is not highlighted by Lyons et al (2007), however, and which is borne out in an analysis of the Foresters data, is a question of whether these needs can be adequately addressed by non-grant capital, and whether (even if there was a supply of such capital), not-for-profit organisations, particularly small to medium sized organisations, currently have the capacity to manage non-grant capital, particularly on commercial terms. By capacity we are not referring to skills or knowledge of the management or governing body of the organisation, but rather only to whether the financial performance and position of the organisation indicate that non-grant capital (either commercially priced or not) is feasible.

It should be noted that (given the small sample size) this analysis of capacity is indicative only and that what it points to is the need for much more detailed empirical analysis if clear assessments are to be made of whether there is a not-for-profit capital market in Australia. The organisations from which the Foresters data was drawn also had certain characteristics which limit ability to generalise (again emphasising that analysis is indicative only):

- They were organisations seeking capital, primarily for property purchase (and in the main had been rejected by mainstream lenders), therefore the sample is not a random selection of organisations but rather they self-assessed as needing capital and then sought this capital;

- They were predominantly Queensland-based, so state differences should be examined, particularly given the fact that the largest funder of small/medium organisations is State Government;

- Because the sample was not drawn for purposes of research (but rather for internal organisational purposes), the data was not standardised across the sample (so, for example, the financials were not all drawn from the same year, but rather came from a range of years according to the latest records relevant to the work Foresters was undertaking with the organisations.

Not withstanding these limitations, the Foresters data is based on a detailed assessment of the financial realities of a range of not-for-profit organisations (n=16) from across the spectrum of activities. Using the size categorisation on page 11, the majority were medium sized organisations (n= 11), with a handful of small organisations (n=3) and a couple of large organisations (n=2).

An analysis of the data points to a number of salient insights about the capacity of the organisations to hold and manage non-grant capital and which should be tested in further research.

Like the data from the ABS, ACOSS Community Sector Survey and Centre for Corporate Public Affairs Survey, an analysis of the Foresters data revealed that **most revenue in the organisations was sourced from government**, and most of this was from State Government funders.

The organisations had **relatively little unrestricted revenue** in relation to their overall revenue – only around 6% of their total revenue was unrestricted, as compared to almost 90% being restricted (with the remainder being difficult to determine). Of course the smaller organisations had the smallest amount of unrestricted revenue (an average of 88% restricted; 11% unrestricted; 1% difficult to determine), medium organisations had slightly more unrestricted revenue (78% restricted; 15% unrestricted; 7% difficult to determine) but interestingly, the larger organisations actually had less unrestricted income relative to their total revenue (95% restricted and 5% unrestricted).

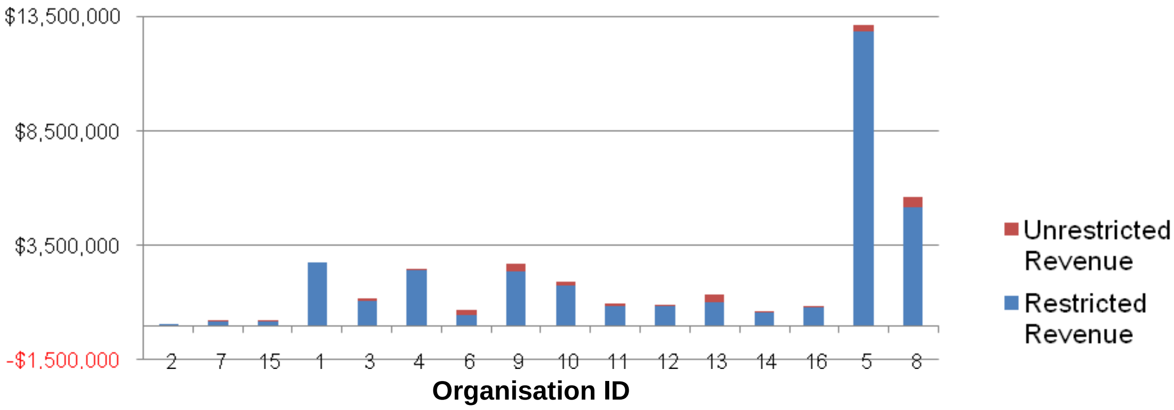


Figure 6: Restricted and Unrestricted Revenue (latest year figures)
Source: Foresters Community Finance

Restricted income cannot be used to repay loans or undertake activities/projects outside those specified in the funding agreement. Therefore, organisations wishing to access non-grant capital such as loans for property purchase must have adequate levels of unrestricted revenue that can be used to service the repayments.

The other important point here is that **an increase in income does not necessarily increase the capacity of an organisation to service repayments**, and nor does it mean that the organisation becomes more viable or less vulnerable – particularly if the restricted revenue comes from a small number of sources or it is non-recurrent in nature. Further, as literature also suggests, **sometimes increases in restricted income can actually cost an organisation in financial terms** and require them to use their own reserves to subsidise what is not covered in the restricted grant:

> *"As a good manager in the non-profit economy, you bring in revenue from direct customers, donors, foundations – a large group of interested 'buyers'. These buyers often restrict their purchases and gifts to specific purposes – teacher salaries for example, or books. It's understandable: this gives your donors a direct, defined connection between their funds and the program. Nevertheless, by non-profit accounting rules, the restricted cash must then sit in the bank until you go out and buy the item or perform the service its purchaser or donor prescribes. This (can) create the impression among some that a non-profit is solvent – flush, even – when it's actually (potentially) in a cash crisis". (Miller, 2005; p3).*

This highlights another insight – the fact that **almost half of the organisations in the sample were operating in deficit** in the year of the sample (very often the year in which they sought property capital). On closer examination it was clear that the operating deficit was covering programmatic revenue shortfalls. All the organisations were able to draw down on their retained earnings in order to deal with the deficit in the short term. In other words, they were drawing down on organisational savings in order to cover programmatic shortfalls. All the small organisations and a third of the medium sized organisations in the sample were operating in deficit.

One quarter of the organisations in the sample had **assets that could be used as security** for loans / debt capital (i.e. property assets), however the value of these assets was relatively low, with an average value of under $350,000. It was also clear from examining the situation of these organisations further, that valuations of the assets had not been completed regularly, and therefore the actual value of the asset was not necessarily included on the balance sheet. This could point to a cultural rather than a structural issue, in that the 'culture' of charity or service provision in many not-for-profits is centred on ensuring that they focus not on their own sustainability but on the welfare of their client group. The result of this is a pervasive quest (perpetuated by most funders) to reduce the 'wealth' of the organisation as much as possible to appear to be focussing as much as possible on their mission. This is supported in literature also, with one respected US author suggesting that:

> *"Among nonprofits, profit margins are frequently thin, discouraged or simply prohibited. Both government contracting rules and non-profit culture discourage the development of operating surpluses (if you have a surplus, why should we give you a grant?) or induce nonprofits to hide them" (Miller, 2003; p6).*

The above analysis points to some capacity issues that need to be further researched and addressed if the potential for a not-for-profit capital market is to be realised. The capacity issues do not, however, only relate to not-for-profit organisations. Throughout the literature there is reference made to barriers on both the demand side and the supply side in relation to capacity. The barriers identified in the literature to the development of a not-for-profit capital market are outlined in table 8 below.

Demand-side	Supply-side
Financial Barriers: - Lack of assets for security; - Lack of sufficient unrestricted revenues to repay loans.	**Cost Barriers**: - High transaction costs for relatively low borrowings; - Lack of clear, accessible, agreed upon and inexpensive measurement tools for social returns; -
Management Barriers: - Unclear / difficult to understand systems /reports; - Lack of business plans; - Lack of articulation of social impact;	**Capacity Barriers**: - Lack of knowledge of not-for-profit sector; - Lack of knowledge about not-for-profit financial management and business models; - Lack of market segmentation in order to understand the market; - Lack of capacity to assess investment quality in this sector.
Structural Barriers: - Lack of legal structures for raising equity capital; - Funding agreements that do not recognise and incentivise saving, surplus generation, sustainability and efficiency.	**Structural Barriers**: - Credit risk policies mean that not-for-profits are almost immediately rejected – very little flexibility in conditions and pricing; - Lack of clarity about profitability in this sector makes it unattractive.
Cultural Barriers: - Aversion of risk and fear of debt; - Reluctance to build surpluses; - Focus on spending all for purposes of achieving their social mission; - Lack of recognition amongst funders and donors about the importance of building sustainability; - Ideological issues about linking social and financial objectives.	**Market Barriers**: - Lack of specialized market, lack of not-for-profit market; - Lack of understanding of risk in the context of not-for-profits; - Lack of diversity in pricing products for not-for-profits.

Table 8: Key barriers to developing a potential not-for-profit market as identified in Australian and international literature.
Source: Aggregated analysis of a range of literature sources.

4. Examining Overseas Not-for-Profit Capital Markets

In the United States there has been focus on the capital needs and the mechanisms for 'investing' in not-for-profits for well over a decade (see for example, Emerson (2000); Dees (1996; 1998); Letts et al (1997)). Recent reports in the United Kingdom about what is termed 'social investment' (which includes not-for-profit sector finance[4]) have explored the advancements that have occurred in this space over the past ten years (see Social Investment Task Force, 2010). In both these contexts the developments of the past decade have occurred in response to a recognition that:

> *"Lack of access to capital is acting as a barrier to charities achieving their social mission" (Goodall and Kingston, 2009; p3)*

An analysis of research and literature from both these markets can yield important insights for the Australian market both at policy and practice levels.

4.1 The United States and the idea of "Non-profit Growth Capital"

In the US, there has been a focus on examining the economics and finance of the not-for-profit sector and how it differs from for-profit assumptions. Increasingly this has led to shifts in how 'investment' into the sector is understood. There has, for example, been a push to **distinguish not-for-profit revenue from** growth **capital** (see for example, Miller, 2007; Overholser, 2006), and an emphasis on the difference between 'buying' and 'building' approaches to capitalising not-for-profit organisations (Overholser, 2006).

What needs to be highlighted in relation to the American literature is the use of the language of capital and investment. In Australia there has long been a debate about the use of 'investment' language in the not-for-profit sector – with various organisations using 'investment' as a reference to both grant funding and philanthropy, and some arguing that it should be reserved for 'true' investment where there are financial in addition to social, returns. In the American context this debate has moved towards understanding '**investment' as an approach** rather than as a reference to the type of capital. For example, Emerson (2000; p221) suggests that:

> *"Success in positioning the non-profit sector to effectively pursue its social mission will not come through the provision of one-time grants between practitioners and funders. Success will come over time as individuals and organisations develop long-term, multi-year relationships. This long-term relationship will require a shift in the funder perspective. … Philanthropic and other resources should be viewed as various forms of investment in individuals, organisations and the broader social agenda of the non-profit sector. The funder must become an investor."*

Thus, 'investment' refers to how the capital is used in an organisation and the type of relationship this engenders between the 'investor' and the organisation. This reorientation of the concept of investment has underpinned the movement in the US towards a diverse understanding of the role of different kinds of capital in the not-for-profit sector, and an exploration of the strengths and limitations of grants, debt capital and equity (or equity-like) capital.

The impact of taking an 'investment' approach to not-for-profit capital is to move discussion away from revenue (i.e. income on the profit and loss statement) and towards capital and what Miller (2003) refers to as an organisation's "capital structure", or the "distribution, nature and magnitude of an organisation's assets, liabilities and net assets" (p.1). The 'capital structure' of an organisation, then, refers to its balance sheet, which "is linked directly to a non-profits' underlying business, which is distinct from, though clearly related to, its program" (Miller, 2003; p1).

This understanding is important in terms of any consideration of a not-for-profit capital market for two key reasons:

1. A distinction can be made between increasing revenue (e.g. grant funding for 'buying' services and programs) and 'building' the organisation (which in the US is referred to as 'growth capital') (see Overholser, 2006). "Buying" generates revenue, whereas "building" should be considered 'investment' into the organisation (Overholser, 2005). This highlights the need to see capital not as

[4] It should be noted that in the UK and the US the entities of not-for-profit and social enterprise have, to a large extent, merged or at least the edges are increasingly blurred. Therefore much of the literature from both these contexts refers variously and often interchangeably to 'nonprofits', 'social enterprises', 'social ventures' and 'charities'.

an addition to service delivery or programs, but as a means to move non-profit organisations out of the financial "starvation cycle" and towards sustainability (see Goggins-Gregory and Howard, 2009).

2. Capital investment into not-for-profits (whether in the form of debt capital, capital grants or some form of equity) requires that attention be paid to the capital structure – that is, the whole balance sheet, not just the fixed and net assets – and in turn, it requires a different kind of attention be paid to the revenue of the organisation. This means ensuring that the organisation has both enough liquidity and enough unrestricted revenue to maximise its viability and generate sustainability (see section 5 below). Otherwise, as Miller (2003;p2) highlights:

   "The investment looks great on paper, expanding the organisation's unrestricted net assets. But program success requires that cash be maintained in balance with the new building, or the program will be hurt. This is intuitively obvious with respect to the need for cash and, generally, unrestricted revenue. It may be less obvious that cash reserves need to be expanded or rebuilt as part of the new capital structure".

This effectively means that the 'impact' of capital in terms of the whole business of the not-for-profit needs to be considered if it is truly to be an investment in the organisation. If a financial institution is to consider lending to not-for-profits, then, it needs to understand both the business model and the capital structure of these organisations. Further, according to this perspective, 'one-size fits all' solutions such as property purchase for all not-for-profits, will ***not*** lead to better social impacts but rather, could endanger the sector (see Miller, 2010). This is further explored in section 5 below.

The debt capital market for not-for-profit organisations in the US is relatively well developed, with many Community Development Finance Institutions and also mainstream financial services providing commercial loan facilities to the sector. In addition there have been developments in the use of Program Related Investments by foundations and philanthropists as a means to provide below-market loans to not-for-profit organisations (see Emerson, 2000). Though there have been extensive reductions in access to mainstream financial institutions in relation to debt capital since the global financial crisis (Miller, 2010), not-for-profits in the United States are generally not considered to be overly excluded from access to mainstream lenders.

Recent literature from the US highlights the limitations of debt capital for not-for-profits but at the same time suggests that it has an important function to play.

A recent critique of increasing debt capital for the not-for-profit sector argues that there are four key observations that should be considered in the debate:

1. *"Debt is not a good fit for many capital needs (of the sector);*
2. *Transaction profitability, not repayment risk, is the biggest barrier to mainstream debt access for social sector organisations;*
3. *Conventional debt finance may push capital into the wrong activities;*
4. *Debt is less critical than equity" (Miller, 2010; p18).*

The critique goes on to argue that it is important to examine the type and purpose of debt in not-for-profit organisations to ensure that it is engaged with carefully and appropriately, for:

> *"The wrong sort of debt can cripple even large organisations, depriving the public of the benefit of their programs and services" (Miller, 2010; p18).*

Indeed this points to the current move in relation to not-for-profit capital in the US, which is centred on explorations of equity-like capital, providing patient investments and capacity building in the organisation rather than just the programs of the organisation (see section 5 below).

> *"Without a non-profit equity equivalent, and with the public policy trend towards removal of major public support, the social purpose enterprise will be unable to finance the growth of its ventures and programs. Equity equivalents may best be considered as capital investments made available to the non-profit sector in exchange for both market and non-market returns" (Emerson, 2000;p221).*

> *"We need equity, not just debt. That's how it works in the general capitalist market. That's what we need in the non-profit sector as well" (Walls, 2007; p14).*

Much of this discussion is centred not on financial institutions but rather on philanthropists and foundations, because these institutions are much more likely to consider equity investments.

One of the key lessons from the American literature centres on the need for much greater levels of awareness, capacity building and dialogue between funders, financiers and not-for-profit leaders, including some questioning of common assumptions and misperceptions about the economics of the sector and possibilities for financing it. As Emerson (2000; p222) suggests:

> *"The most challenging question for the sector is whether or not the non-profit community and its supporters have the ability and willingness to question the fundamentals of and core approaches to the execution of its work".*

4.2 The United Kingdom and the "Social Investment Market"

In 2000 the UK government led "Social Investment Task Force" released it's first report, Enterprising Communities: Wealth Beyond Welfare, which mapped out how underinvestment in 'deprived' communities could be addressed.

The aim of the Task Force was to investigate how a cultural shift could be initiated which would move communities and the organisations that worked in them away from a "culture of philanthropy, paternalism and dependence towards one of empowerment, entrepreneurship and initiative" (SITF, 2000). This year, ten years after the first report, the final report of the Task Force was released, claiming substantial changes:

> *"Over the last decade, there has been a significant increase in the flow of investment to disadvantaged communities and there are some encouraging developments in social investment, together with significantly greater interest from mainstream financial institutions as well as trusts and foundations"* (SITF, 2010;p??).

Certainly there have been some significant developments, with new 'social investment' (i.e. the provision and use of finance for social impact, generating blended financial and social returns) entities providing grant, debt, risk and venture capital in addition to advice and capacity building to not-for-profits and social enterprises (see appendix one). In addition numbers of intermediaries and associations that promote social investment have developed, along with a proposal to use unclaimed assets for the establishment of a 'Social Investment Bank', which is likely to continue to be developed (though in a different form) despite the change of government in the UK.

Despite the developments, the latest report also outlines some ongoing challenges, including:

- *"Most social investment funds are small and lack a developed track record of performance;*
- *The market is still poorly defined and there is confusion over terminology;*
- *There are no accepted standards for measuring social impact against performance benchmarks; and*
- *Although some of the required market infrastructure is emerging, the market lacks the clarity of structure and diversity of organisations that characterise mainstream financial markets, including advisory/corporate finance functions, specialised investment banking and effective secondary markets" (SITF, 2010;p9).*

One of the difficulties is that 'social investment' is a far-reaching framework, covering not just not-for-profit finance, but also personal microfinance and community reinvestment by banks and mainstream financial institutions (based on the disclosure principles of the Community Reinvestment Act in the US). Further, 'investment' in this context can refer to anything from grants (i.e. 'investing' in society's future and providing social value) to opening up commercial opportunities for investors seeking new markets in the social sector.

While it is clear that the creation of a not-for-profit capital market is part of a broader social investment framework, it should be noted from the UK experience that this is only part of this framework, and thus the two should not be conflated. Figure 7 below outlines the different aspects of social investment as it has been used in the UK, and the spectrum of interpretations of social returns that have emerged from this framework.

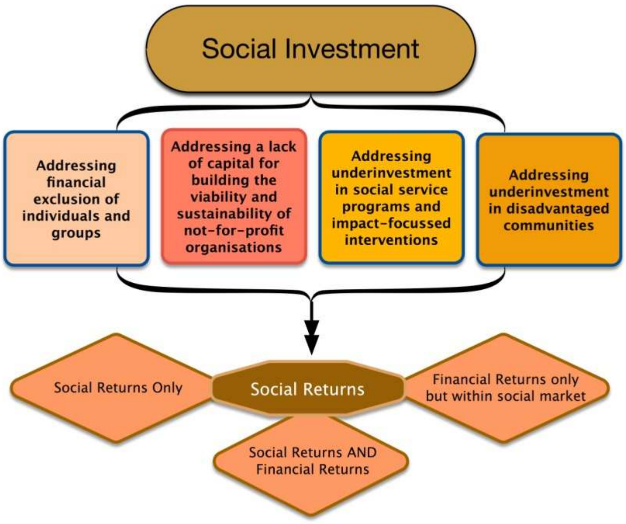


Figure 7: Not-for-profit capital is only one aspect of the social investment framework developed in the UK

There is no doubt that the social investment market as a whole is growing in the UK (though the impact of the change of government on the overall development of the market is yet to be felt). However, in relation specifically to the not-for-profit capital market, there are still some deep-seated issues to be addressed – as one research group highlights:

> *"It is clear from our research that a growing number of financial intermediaries, social enterprises, charities and other social organisations are raising debt or other funds for investment and a range of new investors are being drawn into the market. However our research also reveals insufficient overall capital and mismatches between the capital available and market demand. This nascent market also suffers from high transaction costs and a lack of investment-ready propositions" (Social Finance, 2008; p1).*

Social Finance, a London-based intermediary, suggests that there is currently a mismatch of capital and need in the UK social investment market. They argue that currently the capital availability from those 'investors' seeking market returns exceeds other types of capital, but that the 'social enterprises' (which includes not-for-profits and charities) seeking capital are predominantly those "in markets where revenue is not predictably tied to effectiveness", as depicted in figure 8 below.

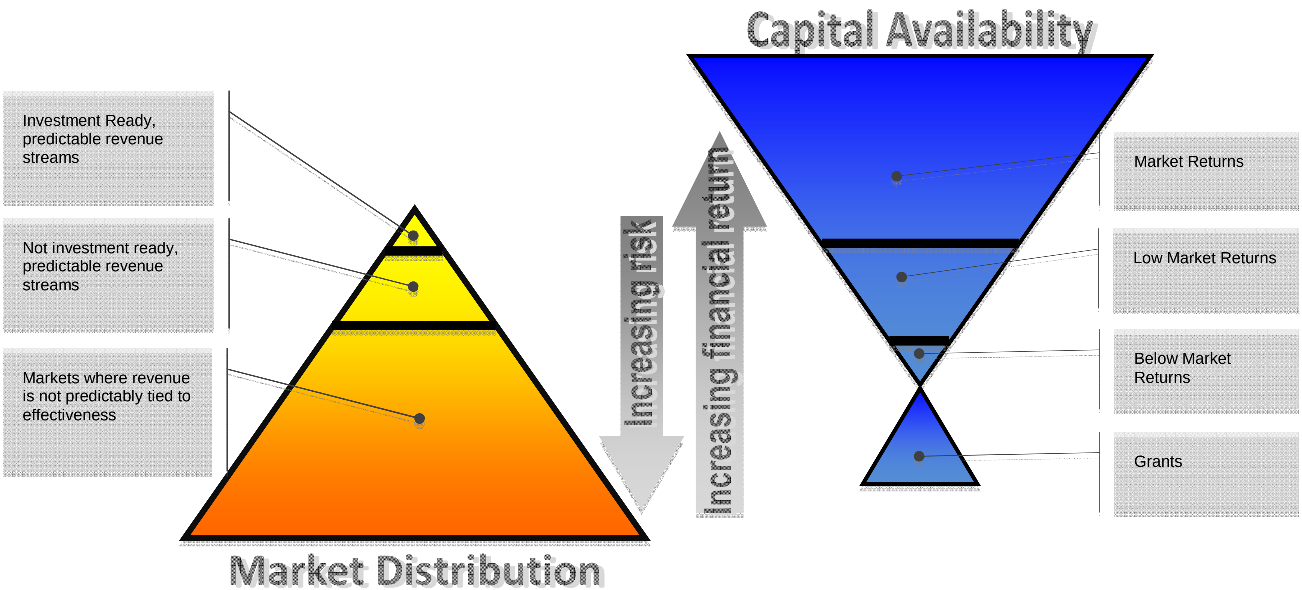


Figure 8: The Mismatch between Available Capital and Not-for-profit Market Need in the UK
Source: Social Finance Ltd, UK, http://www.socialfinance.org.uk

It is also worth noting that recent reports have pointed to the need to ensure that capital is sourced in ways that actually build the not-for-profit sector and the impact that it generates rather than seeing it as a means for generating a niche commercial market:

> *"(There are) potential sensitivities of commercially-motivated investors extracting capital from the sector. How can we ensure that funds flowing to the sector are catalytic, that is, help develop the sector, as opposed to flowing out as quickly as they flowed in which risks weakening the existing ecology" (Goodall and Kingston, 2009;p16*).

5. Bringing it back home: How does this inform the potential for a not-for-profit capital market in the Australian context?

There are three key learnings that can be gleaned from experiences in overseas contexts (and particularly in the UK and the US) and which should be considered when examining possibilities for financing the not-for-profit sector in the Australian context.

1. **Any exploration of financing not-for-profit organisations cannot only focus on debt capital** but needs to consider how capital of all kinds could strengthen the impact and build the viability and sustainability of not-for-profit organisations. In this way it is imperative to understand how the policy and economic context of the not-for-profit sector shapes the need for different types of capital.

2. In order to maximise impact and minimise risk it is important to **align the type of capital to its purpose in the context of a not-for-profit business model**.

3. Given the particularities of the Australian context and the undeveloped nature of the not-for-profit capital market in this context, **it is important to explore the potential roles of mainstream financial institutions** in this space, and further, the role of intermediaries who are specialists in not-for-profit finance and capacity building.

5.1 A Spectrum of Financing Options within the Context

What is very clear in the UK and the US is that debt capital is not, in and of itself, the answer to the financial needs of not-for-profit organisations, and rather, what is needed is a wholistic approach to examining the capital and capacity issues of the sector. In the Australian context the concept of 'finance' for the sector is relatively new (see Lyons et al, 2007). Focus has been on increasing grant income and engaged philanthropy, including corporate-community partnerships. There have, however, been significant changes in each of these arenas over the past decade, as outlined in figure 9 below.

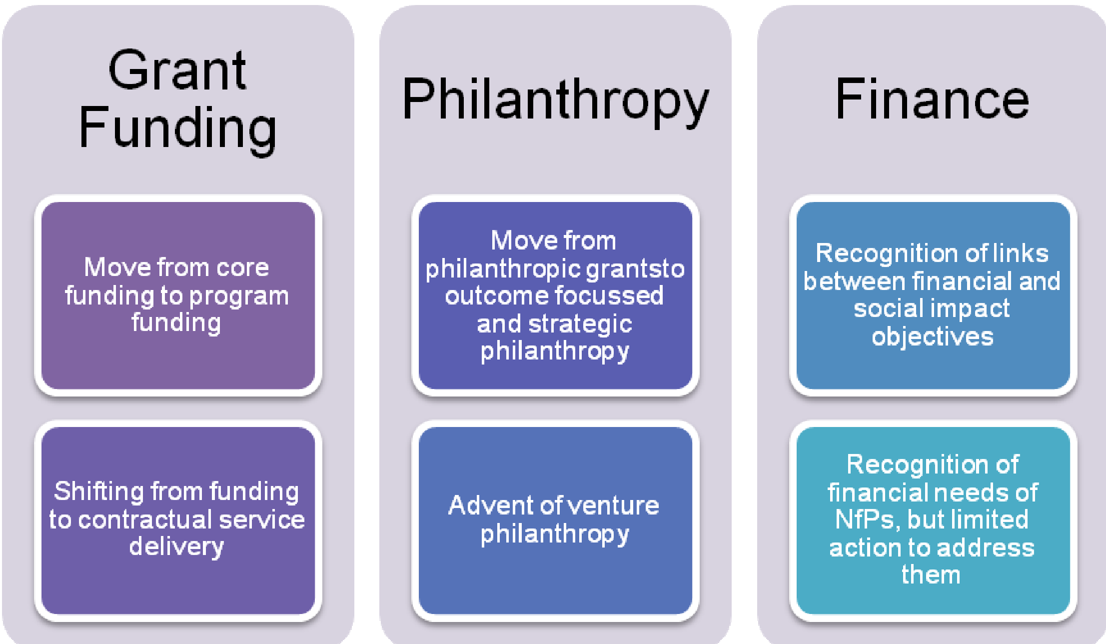


Figure 9: The Shifting Funding and Financial Context for Australian Not-for-Profits
Source: Foresters Community Finance

As has occurred in both the United States and the United Kingdom, it is important to understand the development of a not-for-profit capital market as encompassing a spectrum of responses – each of which has important functions to play, and has different risk and return profiles (as depicted in figure 10 below). Perhaps the most interesting and most challenging work, however, is taking place in the spaces between the traditional capital sources and types, particularly in relation to the exploration of blended capital models and blended returns[5]. There are now a handful of key players operating in these spaces (e.g. Foresters Community Finance, SVA, CAF), and some cross-fertilisation is occurring from and with overseas players (such as Triodos, Big Issue Invest). Though there is little developed literature or research as yet which documents the challenges and successes of this work, this will crucially shape all parts of the spectrum in coming years.

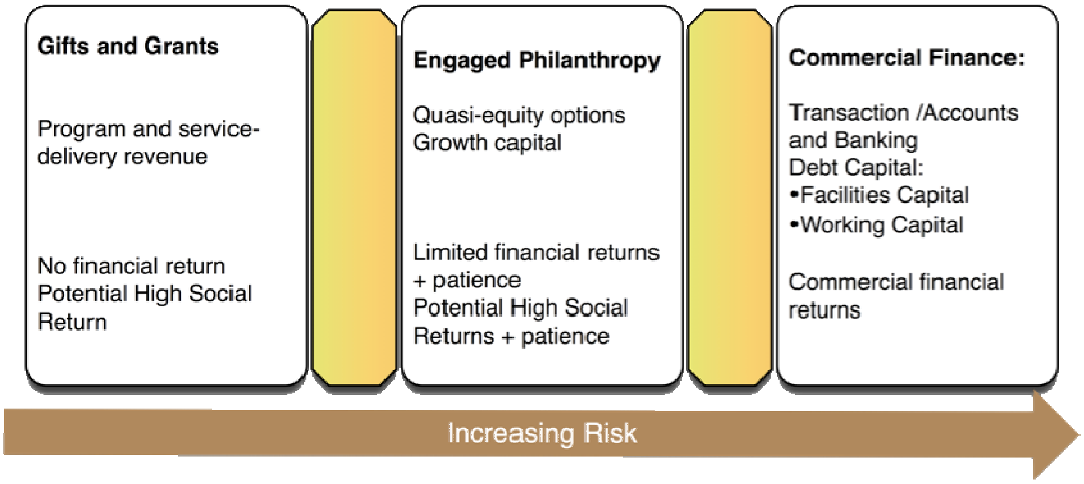


Figure 10: The Key Parts of the Not-for-Profit Capital Market, and the Spaces In-between
Source: Various

It is clear that there are gaps in the Australian not-for-profit capital market along this whole spectrum. This stems from the lack of policy direction at government level, the lack of data regarding the demand, needs and realities of not-for-profits in relation to capital, and a general timidity of the mainstream financial sector to move much beyond banking (i.e. deposit-taking) the sector.

5.2 Aligning the type and purpose of capital with understandings of not-for-profit business models

In the academic and practice literature examined, both from overseas and in the Australian context, it is clear that any examination of finance in the context of the not-for-profit sector needs to consider the role of capital in relation to the 'business model' of the organisations involved. Not-for-profits business models differ from for-profits in some key ways, which need to be understood because they affect the sustainability and the investability of the sector, and constitute a large reason why many not-for-profits find it difficult to access capital. In general many not-for-profits have three core parts to their 'business' model:

1. **The programs and services** it delivers either to the public or to it's members;
2. **The operational infrastructure** it needs to hold, manage and deliver these programs; and
3. **The organisation** itself, which houses a mission and a governance framework that goes beyond the programs it operates.

These parts of the 'business model' of not-for-profit organisations are outlined in figure 11 below.

The first two parts of the not-for-profit business model require adequate revenue (mostly in the form of funding or philanthropic grants/gifts). The programs at the core are often what generate the seen and measured impact of the organisation. However, they do not constitute the whole organisation. Interestingly, the capital that flows into not-for profits currently is very much focussed on the program part of the business. Most funders concede that there needs to be a degree of overhead and operations to administer programs, but only very rarely acknowledge that, in order to generate sustainability, the nourishment of the 'organisation' as a whole is key.

[5] Blended capital models are those in which there is a mixture of non-repayable and repayable capital types and blended returns refer to a mix of financial and social returns on investment.

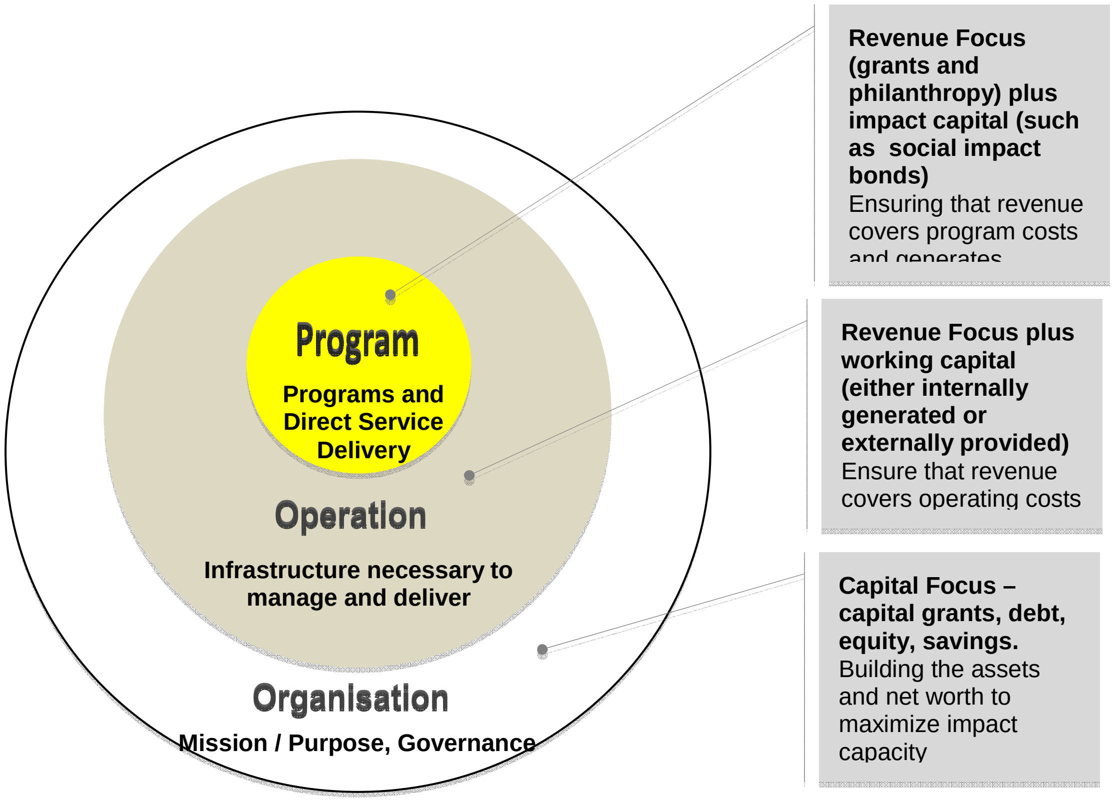


Figure 11: Differentiating the Parts of a Not-for-Profit Organisation / Business
Source: Foresters Community Finance, generated from experience and an aggregation of many literature sources

Much of the literature speaks about the need to ensure that any increase in capital flows into the sector actually contributes to growing the organisations, rather than only providing increased program-focussed revenue (though this is of course also important). Examining the Foresters data in addition to the literature and other available financial data about the sector, it is clear that increasing revenue alone does not build either viability or sustainability. Therefore any exploration of 'new' capital in the sector should be what Goodall and Kingston (2009) call 'catalytic', focussing on enhancing impact, viability and sustainability (as depicted in figure 12 below).

What is clear from the examination of not-for-profit data and literature is that in order for capital involving repayment and/or payment of financial returns to investors to be 'catalytic' in nature, certain things need to be in place.

First, it is important that the true 'costs' of capital be ascertained and conveyed. These 'costs' can include not just interest rates and fees, but also, the overall financial costs and implications of the capital on the operational and organisational levels – including how much new unrestricted revenue needs to be generated to pay costs and the real costs of the infrastructure that is needed to generate this new revenue.

Second, repayable and return generating capital requires certain kinds of 'assets' in an organisation – which can sometimes act as security, but which also need to ensure that the organisation remains liquid enough to absorb the cost implications of things such as owning a building or facility (see Miller, 2010).

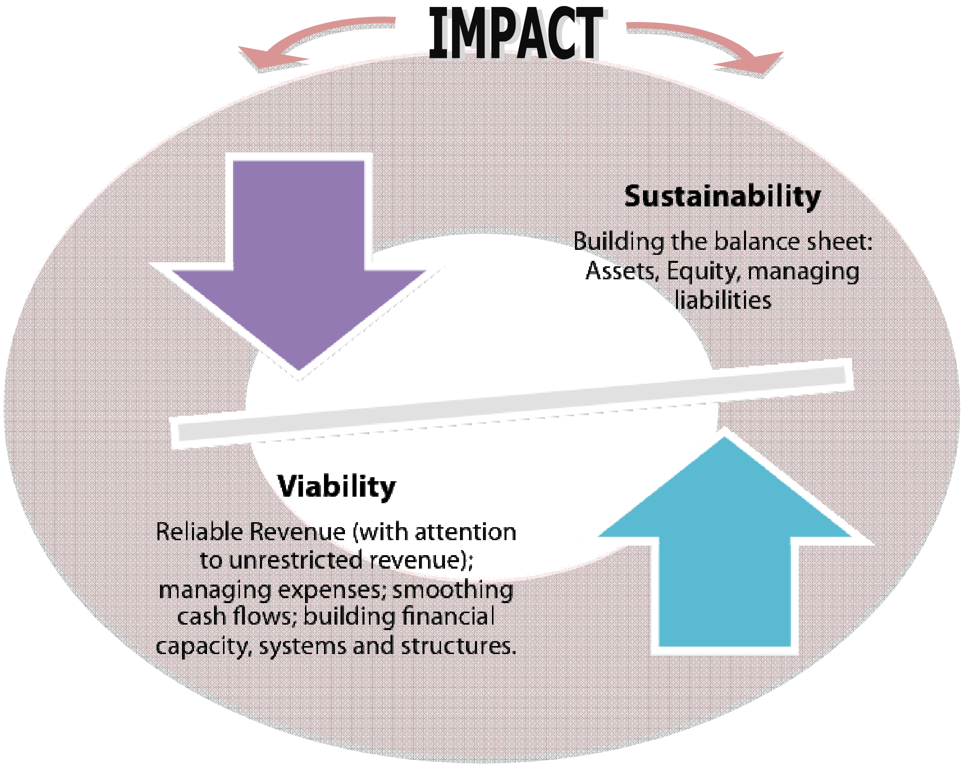


Figure 12: The Three Elements for Ensuring 'Catalytic' Capital in the Not-for-Profit Sector
Source: Foresters Community Finance

Finally, if capital is to be catalytic in not-for-profit organisations then there needs to be more effective reporting of both financial and social returns. Currently there are some serious limitations in not-for-profit financial reporting (focussed particularly around differentiating unrestricted and restricted revenue and assets) and on structural and funding imperatives which tend to push organisations to undervalue a focus on building sustainability. Further, there is a need to improve social reporting in not-for-profits in ways that do not represent a further administrative burden and which are accessible and affordable particularly for small to medium organisations (see for example, Wood and Leighton, 2010).

Importantly, this social reporting should focus not only on the social impacts of programs but also on the overall health and well-being of the organisations delivering the programs, as this is what will sustain quality program delivery over time. The development of social reporting will enable some of the blended return models of capital provision (where both financial and social returns are expected) to develop further in the Australian context.

If capital is to be 'catalytic' in nature and purpose, then, it needs to centre on answering three core questions:

1. How will this capital grow the impact of the programs and services of the organisations? (Impact and Quality focus)

2. How will this capital impact the viability and efficiency of the operations? (Revenue and Viability focus)

3. How will this capital contribute to building the ongoing sustainability of the organisation? (Investment and Sustainability focus).

5.3 The potential roles for mainstream financial institutions in creating a not-for-profit capital market

An examination of the involvement of mainstream financial institutions in the not-for-profit capital markets overseas yields mixed commentary about both their role and their contribution.

In the US there is no doubt that mainstream financial institutions offer a range of products and services to the not-for-profit sector that extend beyond transaction banking into debt centred on property and facilities and the provision of working capital. In addition, many mainstream financial institutions provide capital to specialist lenders such as CDFIs in part as a response to their obligations under the Community Reinvestment Act. However, some suggest that commercial imperatives have limited the reach of the debt capital market, particularly in relation to smaller not-for-profit organisations:

> *"Transaction profitability, not repayment risk, is the biggest barrier to mainstream debt access for social sector organisations" (Miller, 2010; p18).*

There is no doubt that there are commercial, regulatory and risk considerations involved in engaging with the not-for-profit sector, particularly in relation to services and products beyond banking (i.e. deposit taking and transaction accounts) – as the following report suggests:

> *"Whilst there appear to be public relations and social responsibility advantages in working with social enterprises, fully commercial banks also face a reputational risk in working in this market. These centre around the negative consequences of enforcing a contract should a social enterprise default, leading to the closure of a social service" (JPA, 2010; p20-1).*

However, it is also the case that banks with progressive social responsibility programs seem to be actively exploring potential opportunities in the not-for-profit market in both the US and the UK:

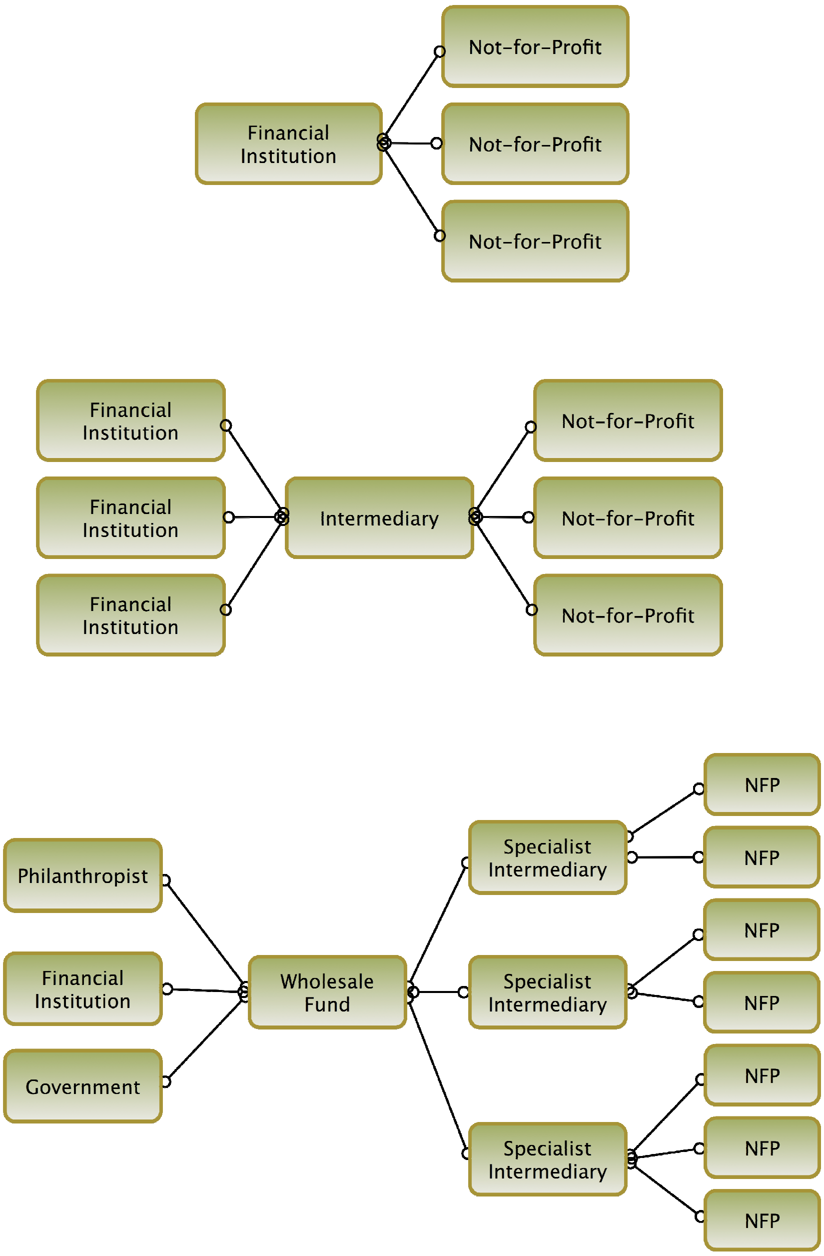
> *"The mainstream banks in the UK have begun to address the potential business opportunities in the growing social sector, arguably having been led to this market by the specialist lenders such as the Charity Bank". (JPA, 2010; p20).*

There is also an increasing recognition of the specialised knowledge that is needed if mainstream financial institutions are to engage with not-for-profit organisations:

> *"Mainstream banks have also found it important to gain specialist knowledge and understanding of the social enterprise sector's culture and business models. This has led to the creation of specialist charity and social enterprise departments at, for example Barclays Bank and NatWest Bank" (JPA, 2010;p21).*

Developing specialist units inside mainstream financial institutions is not, however, the only way to engage with financing the sector. Figure 13 below outlines three different ways in which mainstream financial institutions can become either directly or indirectly involved in the provision of capital into the sector. Each of these models has particular advantages and disadvantages, and variations of each can be identified in models developed overseas (see appendix 1).

As currently the market is underdeveloped in the Australian context (other than for not-for-profit deposit taking and basic banking services), each of these models requires further exploration in relation to its feasibility in this context.



Financial Institution engages directly with not-for-profits
- Direct Relationship but also direct risks;
- Requires specialist knowledge building.

Financial Institutions relate to and capitalize specialist intermediaries
- take advantage of specialist knowledge;
- risk mitigation;
- pool of capital can be much larger than one financial institution can contribute.

Financial institution becomes part of a range of capital 'investors' who capitalize a wholesale fund which then provides capital to a range of specialist intermediaries.
- greatest potential for blended capital types and returns;
- systemic response to not-for-profit capital needs;
- blended returns for greatest impact.

Figure 13: Different Roles and Relationships for Mainstream Financial Institutions in a Not-for-Profit Capital Market
Source: Foresters Community Finance

6. Conclusions and Recommendations

Overall, the not-for-profit capital market in Australia is at an early stage of evolution, particularly in relation to financial services and products beyond banking and deposit-taking services. Bolton et al (2007) suggest that there are three core stages to the evolution of this market (the explanations in the three boxes underneath figure 14 are based on Bolton et al, 2007; SITF, 2010; and some linkages to the Australian context).

Market Creation	Market Development	Robust Market
▪ Developing an understanding of the functions of finance in the Not for Profit sector; ▪ Sharing and building on the experiences of early adopters of not-for profit capital; ▪ Developing a case for sustainable not-for-profits and debating links between sustainability and impact; ▪ Unpacking and understanding the risk profile of not-for-profits; ▪ Requires leadership from all sectors – not-for-profits, government and business.	▪ Developing mechanisms for building the capacity of both demand and supply side; ▪ Developing systems, processes, structures and mechanisms for reducing the transaction costs and risks of financing not-for-profits; ▪ Developing more suppliers; ▪ Policy leadership and significant involvement of mainstream financial institutions and investors.	▪ Steady demand and ready supply of capital; ▪ Range of finance and capital choices for Not-for-profits and demand for this range; ▪ Diversity of suppliers – mainstream and specialist; ▪ Social investment is a recognized asset class; ▪ Financing Not-for-profits is becoming a viable and sustainable concern; ▪ Active intermediaries.

Figure 14: Core Stages in the Evolution of a Not-for-Profit Capital Market
Source: Bolton et al (2007) and Foresters Community Finance

Parts of this market are already well developed in the Australian context. The deposit-taking and banking of not-for-profits has proliferated over recent years and most of the major banks and credit unions now have specialised banking focus on this sector.

In addition, the Community Sector Bank represents an example of a specialised banking service focused on the sector. The deposit-taking area is heading rapidly towards the robust market end of the evolution continuum. However, other financial services, in particular, lending (for property and working capital), other investment models and specialist financial advice, are at the early stages of market creation, with substantial demand and supply issues needing to be addressed.

From a pragmatic perspective, Goodall and Kingston (2009) from the United Kingdom argue that there are four key elements, or “critical pillars” that need to be in place for a robust not-for-profit capital market to develop:

(a) “Confident and informed demand from the voluntary and community sector;
(b) Efficient matching of supply and demand;
(c) Variety of investment mechanisms;
(d) Resilient supply of finance” (Goodall and Kingston, 2009; p3).

In Australia there are challenges to be faced in relation to each of these elements and in reality mainstream financial institutions can only play a part in helping to build these critical pillars. If Australia is truly to build a robust not-for-profit capital market, this will require cross sector collaboration and commitments from diverse stakeholders.

Further, it requires not just technical skills and the development of suitable financial products and services. It will require cultural shifts (in all sectors and across the full spectrum of stakeholders); political will; a degree of experimentation and risk-taking in order that there is a movement from concept to action; and a sharing of learnings across commercial and social sectors. This report marks the beginning of a much longer and courageous conversation-in-action that is needed to realise the potentials of creating, developing and growing a not-for-profit capital market in Australia.

Recommendations

Based on the above analysis, the following recommendations are made to financial institutions, government and the not-for-profit sector itself about the roles each could play in developing an Australian not-for-profit capital market.

Recommendation 1: That financial institutions take note of the findings of the Productivity Commissions Report to participate in the development of a not-for-profit capital market.

Most mainstream financial institutions in Australia are already engaged with and are seeking to extend their engagement with the not-for-profit market, particularly in relation to transaction banking.

Some of these institutions have a general aim to engage further with the not-for-profit sector (egg. MECU, Bendigo); some have a specialist focus on this sector (e.g. Community Sector Bank); and others are pursuing a particular focus or niche within the sector (e.g. NAB, Westpac and CBA appear to be focussing on social enterprises in particula'). Certainly other financial institutions could join this increasingly crowded market and find a niche within the not- for-profit market to focus on.

However, the most underserved part of the sector (the small to medium not-for-profit organisations), and those financial services and products that are currently underdeveloped in the sector (those focused on credit and investment of various kinds), are the spaces in the market that remain unaddressed in relation to a not-for-profit capital market. Any financial institutions extending into these spaces would be innovating beyond the basic banking and transaction focus of other financial institutions, into the heart of what the Productivity Commission identified as both a core problem and an opportunity in the development of the not-for-profit sector. That is, capitalisatio and ultimately then, the development of an Australian not-for-profit capital market. Financial institutions willing to examine this territory could play a key leadership role in the development of this not-for-profit capital market.

Recommendation 2: That both Government and the Financial Services Industry contribute to the development of an Australian not-for-profit capital market by supporting further and deeper research into the financial needs and realities of the sector.

There is an urgent need for more comprehensive research regarding the financial needs and realities of the not-for-profit sector. Unfortunately this is not research that can be undertaken using only existing data sets as these are limited in nature, definition and scope.

This research will require engagement with a range of not for-profit organisations and a detailed examination of their financial needs and realities and engagement with financial institutions; policy makers; funders; and philanthropists. This research should focus on the full range of capital needs in the sector and not be limited to debt capital, nor only to commercially profitable needs nor only to traditional financial instruments and mechanisms. It should include an examination of what an enabling policy environment would look like and should explore any regulatory implications of developing a not-for profit capital market.

Mainstream financial institutions could play a leadership role in generating and/or supporting this research with other key stakeholders in this field.

Recommendation 3: That Government build on the findings of the Productivity Commission report in relation to the capital needs of the not-for-profit sector and develop a policy framework that encourages and develops a not-for-profit capital market, and draws attention to the need for capital that ensures the ongoing sustainability of not-for-profit organisations.

Government has a key role to play in the development of a not-for-profit capital market and can do so in many different ways. In both the UK and the US, government has initiated the market, has invested in it in very substantial ways, and has developed mechanisms and/or regulatory frameworks that either incentivise or obligate mainstream financial institutions to engage with the financing of not-for-profits. The issue of the access of not-for-profit organisations to non-grant capital has been raised consistently in recent Australian Government reports and inquiries. In order for this market to develop further there is now a need for government engagement beyond such research and into policy and practice.

Recommendation 4: That mainstream financial institutions examine possible partnerships to support and develop different models of structuring investment in the not-for-profit sector.

The last few years has seen a growing interest in the financial needs underpinning the development of the not-for-profit sector, but also in particular parts of this sector (see for example the announcement and discussion paper regarding the Social Enterprise Development Investment Fund www.socialinclusion.gov.au).

Mainstream financial institutions will no doubt be positioning themselves in relation to market opportunities as this space begins to grow and develop. It is likely that this market will be based on the blending of various sources of capital rather than exploration only of commercial debt capital. For this reason it is important that mainstream financial institutions begin to explore this market, and to position themselves in relation to the potential investment models that could be used to deliver capital into the not-for-profit sector (see figure 13 above). Further, they should seek to proactively develop relationships with other key stakeholders so as to be in a position to take full advantage of the possible market developments as they progress.

Recommendation 5: That the not-for-profit sector itself begins to articulate and publicly discuss their financial needs and realities and develop better understandings of the role that non-grant capital could play in building their impacts and sustainability.

The development of a not-for-profit capital market should not be something that is done for or to the not-for-profit sector – it must be developed with the support and from the experiences of the sector itself. Therefore it is imperative that needs for debt and equity capital in the sector are discussed, debated and articulated through entities such as sector peak bodies. The development of a not-for-profit capital market cannot be supply driven – it must be demand driven as this is the only way to ensure that the financing of the sector will be catalytic in nature rather than merely another way to open up new commercial niche markets.

The sector itself must participate in the design of new financial services and products to ensure a focus on increasing the impact and sustainability of not-for-profit organisations in Australia.

Appendix One:

Overview of key US and UK players in the Not-for-Profit Capital Market

Organisation	Core Elements of their Products / Programs
Community Development Finance Institutions	
IFF http://www.iff.org/ Based in Chicago and serving the American Midwest: Illinois, Indiana, Iowa, Missouri and Wisconsin A specialist CDFI focused on lending into the not-for-profit sector. In operation since 1988 and in this time have lent $269.7 million into the sector.	IFF provides flexible, below market loans to not-for-profits serving low-income and special needs populations for property and asset development. They also offer real estate services (real estate consulting, including project feasibility, planning studies, site evaluation and selection, property acquisition, development team selection). Finally they undertake research and policy work that is focused on strengthening the not-for-profit sector and promoting community development finance. IFF's standard loan product is a 15-year mortgage up to US$1.5 million for real estate acquisition, renovation and construction. Loans as small as $10,000 are available to purchase equipment or vehicles, complete facility repairs, or undertake maintenance. There are no appraisal requirements, fees, points or rate variances based on risk. The loans cover up to 95 percent of total project costs and terms are up to 15 years. IFF also makes second position loans and offers financing for leasehold improvements. Loan capital comes from foundations, state and federal government, financial institutions, insurance companies, and individuals. Foundation grants, contracts and fees support consulting and other initiatives.
Non-profit Finance Fund http://nonprofitfinancefund.org/ Based in New York, with offices also in Boston, Newark, Los Angeles, Philadelphia, Washington DC, Detroit, and San Francisco. A Community Development Finance Institution (CDFI) specialising exclusively in not-for-profits. In operation since 1980, and in this time have lent over $200 million and leveraged $1 billion of capital investment on behalf of clients. NFF has also provided $1.2 million in loan guarantees, $10.3 million in 9/11 recovery grants, about $13 million in capital grants, and $2 million in planning grants.	Provide a continuum of financing, consulting, and advocacy services to nonprofits and funders across the USA. Focussed on helping organisations to adapt to changing financial circumstances (i.e. build some sustainability), grow and innovate. In addition to offering loans and credit for various purposes, NFF organizes financial training workshops, performs business analyses, and customized services. They also offer services for funders, such as assistance with structuring philanthropic capital and program-related investments, managing capital for guided investment in programs, and providing advice and research to maximize the impact of grants. **Lending**: US$100,000 to $2M for: **Facility Loans** • Acquisition • Construction, renovation and leasehold improvement • Related soft costs, such as professional fees and permits • Relocation costs **Working Capital Loans** • Bridging capital campaign receipts, grants, government contracts, and other receivables • Lines of credit to support temporary cash flow needs • Program expansion **Equipment Loans** • Office equipment and furniture • Computer hardware and software • HVAC and security systems • Other program-and facility-related equipment Interest rates vary according to the loan type and structure but are based on the Wall Street Journal Prime Rate plus a margin, and can be fixed or variable.

	Capital for this lending comes from loans, program related investments, and grants from financial institutions, foundations/philanthropic bodies, corporations, public sector entities, nonprofits, and individuals. Banks have an incentive to lend to CDFIs because of the Community Reinvestment Act.
Venturesome (Charities Aid Foundation) www.cafonline.org/ A CDFI based in London, United Kingdom. Venturesome was initiated in 2002 and since this time has lent over £20m to 270 not-for-profit organisations.	A social investment fund that provides debt and equity-like finance to not-for profits, (in the UK they are referred to as 'charities' and 'social enterprises'), to assist them in meeting their social missions. Loans range from £20,000 and £400,000. Venturesome provides three types of finance: 1. **Pre-funding capital fundraising:** bridging finance for fundraised projects (30%) 2. **Working capital**: underpinning cash flow/ financial stabilisation (40%) 3. **Development capital**: building new streams of income generation (30%) Venturesome uses various financial instruments in its work including unsecured loans, underwriting and quasi-equity / equity tools. Loan terms are usually between 3 to 5 years at a fixed interest rate of between 5-7%. Equity investments have an internal rate of return of around 10%. There is a 1% upfront commitment fee and a 1% per annum fee for underwriting, payable in advance. Capital is sourced primarily from philanthropic sources - from individual donors, foundations, corporations and other philanthropists. The fund is also backed by Barclays Bank, CAF, Esmée Fairbairn Foundation, Lloyds/TSB Foundation, the Tudor Trust and the Wates Foundation, as well as by six individual philanthropists.
Big Issue Invest www.bigissueinvest.com/ An investment fund focussed on lending and equity for growth of the business of trading not-for-profits.	Provide loans and equity to social enterprises and trading arms of not-for-profit organisations. Finance is tailored to suit the realities and capacities of each not-for-profit and comes in the form of loans, participation loans (where repayment is linked to the future performance of the enterprise) and equity. Loans are for between £50,000 and £500,000. BII can also arrange financing in partnership with other social finance institutions for amounts over £500,000. Loans are focused on property, equipment, growth capital and working capital. Capital is sourced via wholesale means (high-net worth and sophisticated investors) and from philanthropic sources. The aim is to retain investors' capital, together with a reasonable financial return, and high social and environmental returns. It is not a regulated investment fund.
Registered Banks	
Charity Bank www.charitybank.org/ UK-wide registered and regulated bank.	A charity itself, the Charity Bank is a fully registered bank serving the not-for-profit sector, using 100% of deposited funds to lend back to and support not-for-profit organisations. Loans range from £50k up to £2m, with larger deals arranged in partnership with other lenders. These can be unsecured loans for terms of up to 5 years, or where tangible security is available, as secured loans up to 25 years. Interest rates depend on the size, type and length of loan required, but typically vary between 5.5% and 7.5%. Capital is sourced from deposits, socially motivated shareholders, subordinated debt and through grants and donations.

Appendix Two

NAB's Commitment to Promoting Financial Inclusion

While, the great majority of Australians are well served by a strong financial services sector, there is a significant group of Australians who are excluded from, or have limited access to, mainstream financial products and services.

There are many definitions as to what constitutes financial exclusion, at NAB we look at it as:

Financial exclusion is the process whereby a person, group or organisation lacks or is denied access to affordable, appropriate and fair financial products and services, with the result that their ability to participate fully in social and economic activities is reduced, financial hardship is increased and poverty (measured by income, debt and assets) is exacerbated." (Burkett and Sheehan, 2009)

Core to NAB's corporate responsibility strategy and activities, is the need to address financial exclusion and promote financial inclusion in Australia - providing financial services for all Australians.

We have four key platforms to achieve this:

1. World leading microfinance programs for low income earners - a partnership with Good Shepherd, governments and more than 200 community agencies around the country that draws on a capital commitment from NAB of $130m and equates to 15,000 loans per annum;
2. Indigenous programs, to provide better access to banking services to some of the most financially disadvantaged communities in Australia;
3. "More give, less take" - making banking more accessible, by abolishing a range of fees, doubling our ATM network, providing essential credit for small businesses and ensuring all customers have support when in financial difficulty; and
4. Research and advocacy, to better understand the problem, provide a voice to those excluded and gain insights into what works to address it.

Microfinance Programs

Since 2003 NAB, in partnership with Good Shepherd, State and Federal Governments and other community agencies, has been developing microfinance solutions to help address financial exclusion and to help all financially disadvantaged Australians climb out of poverty by providing safe, ethical and affordable financial products, services and advice; helping them avoid exploitation; and helping them develop financial capability.

What is microfinance?
Microfinance seeks to provide fair, safe and ethical financial services (such as loans, savings accounts and insurance) for people who, because of their circumstances, are not able to access mainstream financial services. Microfinance's purpose is to alleviate and eliminate poverty. (Burkett and Sheehan, 2009)

Why microfinance?
Microfinance programs work. Different to grant programs, microfinance programs being a loan, or an opportunity to establish savings offer "a hand up, not a hand out" (www.kiva.org) and provide the individual with an opportunity to take responsibility for themselves.

Microfinance programs offer people real solutions to essential needs; they help people experiencing real distress and hardship improving lives; they reduce welfare dependency; they help strengthen money management skills; and they help people feel more positive about the future.

NAB's commitment, which is in excess of $130 million is focussed on delivering the following microfinance programs:

No Interest Loan Scheme (NILS®)
Developed by Good Shepherd Youth & Family Services 30 years ago, NILS® is based on the concept of circular community credit. Through NILS, low income consumers are provided with access to funds so they can purchase essential household items.

NAB has provided loan capital to NILS® since 2003, this is currently $23 million and 200 of the community agencies that offer NILS® run their loan books using NAB capital, operated via an overdraft facility provided free of charge.

As well as the loan capital, NAB covers the costs of loan defaults for the programs it funds, is a sponsor of the annual NILS® Forum and provides a range of in-kind support.

Step UP Loans
In 2004 NAB and Good Shepherd Youth & Family Service designed and launched Step UP Loans – a low cost credit product for financially disadvantaged Australians.

Step UP Loans sit between NILS® and mainstream credit, helping low income consumers transition into mainstream products and experiences. The program enables individuals to develop a credit history and improve their financial literacy and confidence, thus providing them with an informed entry into mainstream banking.

These safe, affordable, low interest loans (the current annual percentage rate is 3.99%) of between $800 and $3,000 are for individuals or families to purchase essential personal, household and domestic goods and services.

Unlike NILS®, Step UP Loans are essentially a bank product. Step UP Loans are offered at more than 40 community agencies Australia, where applicants participate in a face-to-face interview with a microfinance worker who helps them complete an application form and then mentors them throughout the life of the loan. The customer then goes to the nearest NAB branch to drawn down the loan.

Adds UP Savings Plan
In May 2009, NAB and Good Shepherd Youth & Family Service launched the Adds UP Savings Plan, which aims to help low income Australians achieve their goals and further build on the discipline developed through repaying a loan. The Adds UP Savings Plan does not specify what people need to save for.

Adds UP is offered through close to 100 community agencies providing NILS® and is offered to clients who have successfully paid a NILS® or Step UP Loan. All customers have a discussion with a community worker about saving and setting realistic goals and are then referred to NAB to open a NAB Concession Account.

Once an individual has saved $300 on a designated NAB Concession Account, they have the opportunity to have these funds matched by NAB, once in the lifetime of the account. NAB will match amounts up to $500.

If someone saves $20 a fortnight, in a year they can earn a total of $1,020 with NAB's matching.

NAB Microenterprise Loans
Developed in 2007, these unsecured business loans between $500 and $20,000 are for people who have few or no avenues to access affordable business credit.

The loans are provided on a not-for-profit basis at a low interest rate (the current annual percentage rate is 5.99%) and are available to help start up or support an existing business.

The loans are offered through a number of program partners who provide loan recipients with business skills training and advice during the first year of their business such as the New Enterprise Incentive Scheme (NEIS), and Business Enterprise Centres Australia (BECA).

After developing a business plan and receiving a letter of support from a program partner, the program partner will forward this and an application form to NAB and clients are then managed by a small business banker and the loan is essentially a bank product.

Community Finance Hubs
NAB, Good Shepherd Youth & Family Service and the Victorian Government, are also developing three 'community finance hubs' to service the further delivery of financial services to Victorians living on low incomes.

The hubs will operate as three 'shop fronts' – a unique distribution model to take on payday lending and provide microfinance products, financial counselling and other community services for people living on low and limited incomes. This initiative is the first of its kind in Australia and represents a unique opportunity to shift microfinance from the periphery to the mainstream or 'high street'.

The hubs will strengthen the financial capability of low income Victorians providing:

- access to appropriate and affordable financial products such as NILS®, Step UP, Adds UP, and a pilot product called Debt Deduct loans to help low income earners out of existing debts;
- access and referral to relevant local support services such as Financial Counselling, Emergency Relief and Gambler's Help; and
- access and referral to information and programs which enhance financial understanding, including training to establish a small business.

The new community finance hubs will open starting June 2011 in Collingwood, Dandenong and Geelong.

Community Development Financial Institution Pilot
In 2011 the Federal Government, through FaHCSIA, is running a $7.5 million Community Development Financial Institution (CDFI) Pilot to test the potential of the community finance model to provide access to financial services and products to disadvantaged Australians. This model seeks to build on and complement the activities of mainstream financial institutions.

NAB has committed to support the CDFI Pilot by participating in the Investment Circle and is supporting two participants, Foresters Community Finance and the Fair Loans Financial Health Foundation, with $1 million each in loan capital at no charge.

The Fair Loans Financial Health Foundation (formerly Money Fast) ran the Small Loans Pilot with NAB in 2008-2009, a pilot to demonstrate the costs of offering short-term, small loans in the fringe credit market and to draw attention to the high interest rates and charges prevalent in that market. A report detailing the findings of the pilot titled, *Do you really want to hurt me?*, was released in March 2010. Since the report launch and prior to the CDFI pilot commencement, NAB has been trialing other online lending models with Money Fast on a not-for-profit basis as an extension of our microfinance programs.

Programs for Indigenous Australia

Since launching its first Reconciliation Action Plan (RAP) in 2008, NAB's strategy for Indigenous Australia aims to build on what a financial services organisation can bring to address areas of Indigenous disadvantage and focuses on three areas:

- providing greater access to financial products and services to promote financial inclusion;
- building access to real long-term jobs in a sustainable way; and
- supporting greater organisational understanding of and respect for Indigenous Australians, their culture and aspirations.

We believe many Indigenous people on low incomes are financially marginalised as a result of specific cultural and geographic challenges and a strong focus of NAB's commitment to addressing financial exclusion is about providing greater access to financial products and services for Indigenous Australians. This is delivered through a couple of key strategic programs:

Partnership with the Traditional Credit Union
NAB has a partnership with the Traditional Credit Union Limited (TCU) to provide in-kind support and strategic advice with the aim of expanding the TCU's branch network and providing access to financial services for more Indigenous customers.

This partnership has offered opportunities for two-way learning - NAB employees have the opportunity to work with the TCU through secondment and have assisted the TCU in expanding its branch network, and at the same time gained an enormous appreciation for the challenges of banking in remote communities.

NAB has also provided interest free loans to the TCU enable them to open branches in remote locations in the Northern Territory and has given the TCU a grant of $200,000 to fund activities as the new branches are opened such as advertising, legal costs, development of brochures and website upgrades.

Indigenous Money Mentor Network
To promote financial inclusion, NAB is piloting an Indigenous Money Mentor ("IMM") network to provide Indigenous people with access culturally appropriate financial literacy information and assistance with money management issues.

NAB has established partnerships with seven Indigenous and Community organisations to host Money Mentors in Western Sydney, Alice Springs, Mackay, Lismore, Darwin, Melbourne and a state-wide position based at the NSW Aboriginal Land Council.

The primary functions of the Money Mentors are to:

- provide ongoing financial literacy education for Aboriginal and Torres Strait Islander communities using culturally appropriate materials, including a DVD, and education techniques.
- engage in casework with clients to improve the clients' financial wellbeing (including assistance when in financial crisis and supporting the client to adopt preventative strategies).
- provide a supported referral service to help clients obtain assistance from other service providers to address broader issues which may be impacting on a clients' financial wellbeing (e.g. consumer protection agencies, health, housing, employment and education services).
- provide access to microfinance products (No Interest Loans Scheme (NILS), StepUP Loans and AddsUP Savings Program) in circumstances where the client identifies that such products will improve their financial wellbeing.

Over 400 clients were assisted by Mentors, during the first year of operation and 130 of these accessed a community microfinance product.

To find out more about NAB's indigenous programs visit: www.nab.com.au/indigenous

More Give, Less Take – making banking more accessible

We aim to do the right thing for all our customers by delivering fairer banking with clear value and making quality advice available to Australian consumers and businesses – this underpins NAB's More Give, Less Take approach.

More Give, Less Take began by listening and then taking meaningful action on the issues that most annoyed our customers - fees and charges. In 2009, 73% of complaints received by NAB related to fees & charges. In September 2009, we took our first steps of the More Give, Less Take journey to deliver fairer banking. In 2010, we'd reduced the percentage of complaints related to fees & charges to 61%. Our action on fees to date is estimated to put $200 million back in the pockets of our customers per annum

Priorities include:

Addressing fairness concerns - Fees and charges continue to be important issues for our customers. We continue to review our fees and charges and look for ways to ensure we charge an appropriate fee for a commensurate service.

Providing access to financial services and help - We offer assistance to customers who find themselves in financial difficulty. In fact, we want to work with our customers and help them before they get into financial difficulty.

Improving customer service - We are constantly working on opportunities to improve and enhance the banking and customer service available to our customers.
Some recent examples include:

- Helping customers avoid ATM direct charges by setting up an alliance with the RediATM network.
- Introducing a free email or SMS alert service to remind customers of upcoming credit card payment and better help them manage their monies.
- Extending the hours of our Customer Contact Centres to be available at more convenient times for our customers.
- Continuing to invest more than ever to open, refurbish and relocate branches to more convenient locations for our customers
- Hiring an additional 150 business bankers and specialists with plans for 200 more in 2010, ensuring we are well placed to continue providing guidance and support to our business customers
- Introducing the Bushfire Recovery Network an online directory that promotes businesses affected by the fires - to connect businesses with their local community
- Lending to during a time of immense economic uncertainty, NAB lent more to business than any other major Australian bank*, during a time of immense economic uncertainty.

* Source: APRA Monthly Banking Statistics, October 2008-October 2009. Based on actual lending dollar value of new and existing lending

Research and Advocacy

Given the issue of public awareness of financial exclusion in Australia is low, it's NAB's view that research is important to define and raise awareness of the problem of financial exclusion in Australia and its relationship with social and economic disadvantage.

To do this, NAB has also commissioned the Centre for Social Impact at the University of New South Wales to develop an indicator to measure the extent of financial exclusion in Australia including a demographic profile of those excluded. The indicator is currently being developed and will be released in May 2011.

NAB has also partnered in a number of research projects to look at the experiences of using fringe lenders with University of Queensland and Good Shepherd; the small loans pilot which explored the costs of fringe lending, through an independent lender, Money Fast; reports on our microfinance programs; and campaigns and lobbying on financial exclusion issues.

To find out more about NAB's financial inclusion agenda visit: www.nab.com.au/microfinance

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