Submission

Contribution of the Not for Profit Sector

Draft Report 2009

Section 7 and Appendix G

Approach Underpinning this Submission

The following commentary is provided on Section 7 of the Productivity Commission's draft report in the same layout as the draft is presented. The submission is made through the lens of the work undertaken by Foresters Community Finance. As background a description of Foresters Community Finance (Foresters) is provided, as well as a brief overview of the work Foresters undertakes in the community sector. The not for profit sector will be referred to for the purposes of this paper as community sector which Foresters takes to mean community organisations providing a range of community or social welfare services. The submission assumes a level of understanding about the concepts under discussion, however, where necessary terms have been defined. The commentary does not focus on:

- Large not for profits;
- Large fundraising organisations or charities;
- Social Enterprises/Social Businesses.

About Foresters

Foresters Community Finance Ltd (Foresters) is a Community Development Finance Institution (CDFI). CDFI's are defined as:

Independent organisations focused on the use of financial mechanisms to develop and service people, organisations and communities who are often disadvantaged and have been underserved by mainstream financial institutions.

The function of CDFI as a response to financial exclusion is central to their purpose. CDFI's operate in new markets that emerge out of the inability of the traditional financial and capital markets to effectively respond to the needs of these individual, groups and organisations.

"Financial exclusion refers to a process whereby people encounter difficulties accessing and/or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in the society in which they belong" (European Commission, 2008;p9).

CDFI's address financial exclusion by:

- Engaging individuals, groups, organisations and communities in developmental opportunities that can build their financial capabilities, develop economic security and eventually establish a degree of financial sustainability (including financial literacy and capability education);
- Developing innovative financial mechanisms that facilitate the financial inclusion of individuals, organisations, and enterprises.
- Providing access to capital (through investment, loans, debt finance and / or equity) for organisations, businesses and individuals who would otherwise not be able to access loans or other capital.

CDFI's and their associated businesses and companies operate as intermediaries between excluded markets and mainstream financial and investment markets.

Intermediaries have been defined as:

Organisations that collect capital from multiple sources and reinvest it in people and enterprises…"
(Cooch and Kramer, 2007)

The Foresters model is ***investment based*** - given that we source our capital from social investors who expect capital preservation and income returns. As a result we explore and identify opportunities to design investment products where we can balance the needs of community organisations with the needs of investors who expect both a financial and social return. This point of difference in the Foresters model underpins the following commentary.

Foresters and the community sector

Foresters Community Finance has more than two decades experience working with individuals, social enterprises and community organisations, who are largely excluded from access to mainstream financial services. Foresters work in the community sector has typically been with organisations that are referred to as small to medium in size and often with a strong service delivery or community development approach.

As a result of the community finance and social investment activities Foresters undertakes it is necessary to develop a deep and thorough understanding of the organisational form, capacity and operation of the community organisation. In fact, this understanding is a critical part of the due diligence process that Foresters undertakes in order to make prudent loans and investment. It is our view that this rigour is not always present in other forms of funding delivery.

For example grant making requires a well developed understanding of the future capacity of an organisation to deliver on its social mission (program and service delivery). In general, an understanding the broader resource base of a community organisation, its surpluses it past financial performance and future strategic plans it secondary to the grant funding decision.

Therefore, we would assert that a rigorous organisational analysis is critical to the successful delivery of community finance and social investment strategies. This organisational analysis has in turn beneficial effects on the development of the community organisation and may in turn build greater strategic focus on the philanthropic and funding dimensions of the organisations resource base.

Foresters understands that although these organisations may not in each case be economically significant, the social impact they deliver and the contribution they make to the fabric of civil society is substantial. They also represent a broad and diverse foundation from which to extend responses to marginalised and disadvantaged Australians. These organisations are best described by their characteristics, which include but are not limited to:

- Annual turnover generally less than $10 million;
- A significant reliance on government funding (85-95%);
- Very little earned income;
- Small exposure to the philanthropic dollar;
- Highly dedicated but overstretched workforce;
- Strong reliance on volunteer management committees; and
- Lack of access to skills, experience and networks beyond the traditional not-for-profit sector.

The three key areas of concern in Foresters work when assessing the deficits in these organisations is the lack of unrestricted income, a lack of sophistication in decision making beyond program and service delivery and limited strategic financial management skills. Forester has addressed these deficits by building capacity through education which is targeted at the organisation before any finance is provided or investment made. Specifically the capacity building that Foresters provides focuses on:

- Understanding Financial Statements;
- Building Sustainability through Community Asset Building;
- Moving Beyond Funding to a Resource Base;
- Creating Planning and Decision Making Processes that are Alive in Organisations; and

- Assessing the Role of Governance in Innovation.

Sixty four community organisations have attended training workshops or strategic planning sessions facilitated by Foresters over the last eight months. All of these organisations have identified multiple funding pressures which include but are not limited to:

- Threats to funding continuity;
- Overreliance on one source of funding;
- Lack of long term focus of resource diversification (including earned income and philanthropy);
- Recent changes to salary conditions (Queensland).

Forester has seen a sharp increase in interest in demand for information about community asset building strategies and social investment in the last 12 months. There are a range of factors at play and no doubt many of these relate to external funding pressures placed on community organisations. The result of these funding pressures, in the face of demand that is not decreasing, is a desire for change and innovation.

Section 7.1 - Sources of Funds used by not-for-profits

Further analysis of the revenue base of the small to medium sized not-for-profits is required if we are to properly respond to their requirements for capital as this has a direct impact on the community organisations capacity to access finance capital.

It is our view that a majority the community organisations that Foresters works with fall into the 'social' category of economically significant organisations referred to in Figure 7.1 of the draft report. Foresters have had exposure to others areas including culture, education, health and environment and demand from these areas is growing. As referred to above Forester has developed a deep understanding of the resource base from which community organisations within our market operate.

This understanding does not reinforce the data contained in Figure 7.1 – it is our view that this data is skewed by the dominance of larger not-for-profits and their well developed capacity to earn revenue. The organisations that Foresters work with have a much higher reliance on government funding and a lower capacity to generate income. Typically the breakdown is as follows, with some exceptions depending on size and service delivery area:

- Eight-five to ninety-five per cent government funding (usually state based funding);
- The balance, five per cent, made up of donations, membership income, and earned income in that order.

The major contradiction to the data in the report is the volume of earned income against funding. This is not to suggest that community sector organisations in our market are not generating revenue, they are beginning to explore community and social enterprise activities as a method of achieving this. But these strategies are at the early stages of development and as yet we cannot be assured of the success these organisations will have using earned income as a strategy for resource base expansion.

This data is critical from the point of view of a CDFI as earned income or unrestricted income present in the financials of a community organisation is one of the factors critical to the successful delivery of community finance and social investment strategies. The reason for this is that community finance and social investment strategies rely on the underlying strength of a community organisations unrestricted income. For example, if an organisation is to access a loan to purchase property they will need to demonstrate that:

- They have sufficient financial capacity to service debt or meet lease commitments;
- Capacity to provide a deposit from savings that are unrestricted;

In the circumstances that an organisation is not able to meet these commitments there are alternative options, however these will also rely on the underlying financial sophistication of the organisation and its resource base. In situations such as this philanthropic funding can play a partnering role – managing the gap between what the organisations can afford and what the cost of being located in such a community asset would be.

Therefore to use this data without segmenting for organisational type and capacity will skew the view and potential development of CDFI activity as at face value there seems to be more capacity than we know there is.

Finally, the data in figure 7.2 of the Draft Report reinforces the view held by Foresters:

- That the capital requirements for dwellings, building and structures is significant within the sector and reflects the intersection between service delivery, locality and space;

- That as these assets are investable and coupled with the demand that is present among community organisations this represents and strong market for the activities of CDFI's.

7.2 Taxation arrangements affecting not-for-profits

Tax incentives for community organisations provide and important tool for surplus generation if tied exclusively back into organisational development and capacity building to extend the reach of the organisations social mission.

Foresters agrees with the broadly held view that access to tax concessions for emerging or existing community organisations is challenging and that for existing organisations it is ad hoc, confusing and costly from a resource perspective to achieve. We concur with Lyons as he is quoted in the Draft Report - tax concessions should be aimed at maximising the social objectives or mission of an organisation. The benefits to government and other stakeholders although valuable are secondary to this goal. Further to this the tax concessions should be provided to community organisations so that they may maximise surpluses from their activities and turn these surpluses to the important and often unfunded organisational capacity building strategies required to underpin more innovative social programs, like community asset building.

Tax concessions are clearly beneficial in a range of ways including:

- Maximising donor income and associated potential relationships;
- Maximising the use of surpluses for social mission; and
- Maximising employee retention and in turn minimising skill and knowledge leakage;

Foresters has formed the view that tax concessions provided to community organisations are underutilised as a tool to leverage new sources of capital and expand the resource base of the community organisation. Broadly speaking the nexus between tax concessions and increased resources in community organisation is under explored among small to medium community organisations. To realise increased value from tax concessions organisations will require increased investment in skills and organisational capacity building. Government has a role to play here in terms of a short term investment in organisational capacity for the longer term gain of organisations with greater resource diversity.

A more diversified resource base will result in:

- Increased access to unrestricted income for organisational development;

- Decreased reliance on sole or majority source income like government funding;
- Increased financial sophistication within the community organisation;
- Increased exploration of the links between financial objectives and social mission.

7.3 Philanthropic support by individuals and business

The sophistication of Australia's Philanthropic activity and the mechanisms for focussing these funds will not only be critical to expanding the resources base of community organisations but will also impact the capacity of other sectors to drive lasting sector development strategies.

The challenges faced in relation to the philanthropic sector and community organisations will not be solved by increased volumes of giving alone. The most important and pressing issues related to increasing philanthropy in the community sector relate to distribution and capacity.

In addition, philanthropy in Australia is still relatively underdeveloped compared to contexts such as the United States and the United Kingdom. From the perspective of community development finance this is significant because in both the US and the UK it was more sophisticated forms of institutional philanthropy and precise government policy intervention that stimulated the development of a CDFI sector and in turn delivered new capital to the community sector.

There are two intersecting issues that Foresters observes as a result of working with community organisations. The first most of the giving is being done by individuals (and this makes up a large proportion of Australian giving) - to sophisticated philanthropic intermediaries or fundraisers who go to the market with a particular "cause" for their donors. Many small to medium sized organisations do not have the skills, programs, or resources to concentrate on strategies which capture individual giving. In this respect some of organisations in most need of philanthropy to widen their resource base have least access.

Secondly, the facts that philanthropic intermediaries who capture the individual donor dollar are largely cause focussed and have predetermined uses for this capital. Many of the small to medium sized community organisations work with some of the most disadvantaged and marginalised in our society. In some instances telling an "appealing" story to the donor is difficult to say the least and in some instances perhaps not appropriate. This coupled with a lack of fundraising infrastructure puts many community organisations at a real disadvantage.

There is very little emphasis in Australia on capturing the individual donor dollar for capacity building within the community sector. Some of the large corporate foundations and high net worth individuals with their own private funds are the exception. They are still by far the smaller contributors.

However, a focus on capacity building may provide a real alternative to cause related philanthropy for the community sector and provide access to donors for the community organisation who are currently without access. This would require a concerted effort to build an argument for donor capital making a direct contribution to the strength and capacity of community organisations, leaving them in turn to use this increased capacity to address their particular cause.

In summary, the causal focus of individual giving is having a direct impact on the small to medium organisations access to the individual donor dollar. In addition, a general lack of sophistication within the small to medium sized community organisation means that philanthropic funding does not form a large part of their resource base. This has a direct impact on the ability of these organisations to attract other forms of capital such as finance and investment.

7.4 Access to capital

Do not-for-profits have difficulty accessing capital?

We concur with the draft report, community organisations do have difficulty accessing capital. It is our view that this is due to the following:

On the demand side:

- In the main community organisations have been less focussed on finance and investment and more focussed on social mission and therefore have underinvested in planning for their financial sustainability for the long term;
- Competition among community organisations for any capital (grant funding) that does exists is fierce and often distracts organisations from thinking about other strategies;
- Poor foundational development i.e. a lack of longer term strategy, poor access to tax concessions, unsophisticated governance and decision making, limited access to a diverse skill base.

On the supply side:

- There are cultural factors at play that prevent mainstream financial markets and indeed some governments from seeing community organisations as serious contenders for investment – meaning that charities end up being treated with charity;

- There is a perception from a finance and investment perspective that community organisations are a higher risk both commercially and reputationally;
- Community organisations may not present to the mainstream financial markets in the way that they are used to having businesses present their case;

In between:

- There is a paucity of real alternatives to the mainstream and what exists may also be viewed by mainstream financial markets as obscure and marginal in impact;
- The range of intermediaries that do exist in the Australian context who are focussed with a view to solve the capital issues of community organisations have as yet not coordinated their efforts successfully;

Policy:

- There is no comprehensive policy framework at any level of Australian Government that comprehensively addresses the capital needs of community organisations and then goes further to lead the way in terms of enabling solutions.

One of the critical overarching issues in relation to access to capital lies in the fact that community organisations have become overly reliant on one source of funding, government. This has meant that many community organisations have become program driven rather than organisationally driven, in turn, resulting in a lack of focus on the long term sustainability of the organisation. Sectoral change that shifts the focus from a funding base to a resource base may be the key to creating further stimulus to the demand for capital from sources outside government funding by community organisations. Foresters are beginning to see this trend in our work day to day.

Sources of Capital

Foresters Community Finance identifies four main sources of capital for the not-for profit sector. Grant funding, philanthropic funding, earned income and investment. Each of these forms of capital can be used by a not-for-profit for different purposes. For example the philanthropic dollar could be used to start up a community enterprise, while the investment dollar is used to purchase the building from which the enterprise operates.

Further to the previous section of this submission each of these will be discussed briefly below:

- Grant funding – sourced from government, a significant source of funding for not-for-profits, however not an endless stream of income and now in some areas funding is static or shrinking.
- Philanthropic funding – sourced from individual donors, corporate entities and foundations (private, corporate and community), an important source of funding, difficult to rely on long term.
- Earned Income – a growing focus of the not-for-profit sector as we witness the emergence of social and community enterprise activity, difficult to establish yet highly valuable once sustainable as it represents a supply of unrestricted income often tied to social agenda.
- Investment income – in the form of community finance or social investment, valuable because it builds the balance sheet and can help leverage other income opportunities, limited access as yet in Australia.

Sources of Investment Capital

Sources of finance or investment capital for not-for-profits include mainstream financial institutions, special purpose community banks and specialist financial intermediaries. The reasons that the not-for-profit sector does not get access to mainstream capital are discussed previously in this submission. It is also widely understood that existing special purpose community banks have difficulty lending to the not-for-profit sector due to internal credit policies that often mirror the larger financial institutions.

The role of a financial intermediary like a CDFI therefore becomes critical to unlock and mobilise capital from within the mainstream financial markets, where it is currently inaccessible to the community organisations. The CDFI model structures itself with a view to avoid the limitations faced by the mainstream market. In the case of Foresters this has meant going outside banking structures and using alternative investment mechanisms. This enables us to pool the capital of social investors to provide either finance in the form of mortgages or direct property purchase for lease by the community organisation. Part of the provision of this capital in a way that is constructive for the community organisation and appropriately risk managed for investors is to provide very rigorous capacity building and project management strategies.

The sources of capital for an investment based CDFI like Foresters include:

- Institutional investors like superannuation funds, asset managers and other fund managers including boutique investment firms;
- Individuals i.e. High Net Worth Individuals who are often philanthropic, people with self managed super funds, Mum and Dad investors with a passion for ethical investment;
- Foundations i.e. large family foundations, corporate foundations, PAFs.
- Not-For-Profits from cash reserves (charities, religious groups, associations, etc);
- Government i.e. from capital grant sources.

These sources of capital are as yet relatively untapped and have the potential to provide a real alternative to government funding assets that are otherwise investable through social investment strategies.

It is our experience in the Australian Market that to unlock capital on the scale required it is necessary to go to the market with investment products that have a familiar investment proposition with a point of difference that is social. Therefore Foresters through its subsidiary company has secured through ASIC an Australian Financial Services Licence. This Licence will provide the capacity to design and develop social investment products palatable to the mainstream investment market at the same time as holding intact our focus on community asset building and the benefits this strategy brings to the not-for-profit sector.

Matched funds programs

Matched funding programs are very valuable in the context of government capital and can be equally valuable in the context of leveraging investment capital. Foresters has been exploring a range of models where matched government or philanthropic investment can play a valuable role in sourcing investment capital whilst providing access to new capital for not-for-profits who would find it difficult to access capital at market rates.

New legal forms to access equity capital

Forester has a significant level of experience in terms of structuring activities in the community sector from the perspective of legal form. The concept of creating a company structure for a community organisation through which it may raise capital is a reasonable proposition, but its execution another thing altogether. Foresters suspects that this debate has gained momentum as a result of the rise of social enterprise in the community sector.

A deeper analysis of both community sector organisations and social enterprises would highlight that there are significant barriers to the effective use of such a company form, including capacity issues, business and revenue generation issues and investor appetite to name a few. Legal forms like the Community Investment Company in the UK are really designed for the quite sophisticated community enterprise or social business. It is our view that the Australian market is not at this level of sophistication and therefore the establishment of such a structure would not necessarily bring the outcomes or solutions sought. The solutions lie in capacity building rather than structuring.

Conclusion

This submission is provided through the lense of a Community Development Finance Institution. It is the view of Foresters that there are many knowledgeable commentators on the broader issues of the not-for-profit sector and so we have chosen to concentrate our comments in section 7G of the draft report. If there is any further information that can be provided to clarify any of the points that Foresters has made we are open to further dialogue.

Belinda Drew

Chief executive Officer

Foresters Community Finance Ltd.