



**Financial Inclusion, market failures and
new markets:
Possibilities for Community Development
Finance Institutions in Australia**

**A Foresters Community Finance Occasional Paper written by
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Abstract

This report explores the nature of financial exclusion in Australia and argues that the development of specific and independent Community Development Finance Institutions could make a significant contribution to addressing this exclusion. Financial exclusion is redefined as much broader than has been the case in Australian research. While most definitions to date have focussed on the exclusion of individuals, this report argues that exclusion extends to non-profit organisations, social enterprises and micro enterprises. In understanding why financial exclusion occurs, this report makes a link between capability and market failure, and argues that the opportunities to address financial exclusion must address these two factors in combination. Whilst many Community Service Organisations and some of the mainstream financial institutions have, in recent years, made attempts to address financial exclusion (particularly as it relates to individuals), these initiatives have been relatively small scale and have lacked the impact needed to make significant inroads to addressing exclusion across the country. The report concludes that new approaches are needed which can build on current responses to develop innovative solutions to the issues involved in financial exclusion. Community Development Finance Institutions harness such new approaches. They are independent organisations focussed on the use of financial mechanisms to develop and service people, organisations and communities who have been excluded from or underserved by mainstream financial institutions. Though there are a handful of such organisations operating in Australia, the sector is very much underdeveloped – particularly compared to other ‘developed’ economies such as the United Kingdom and the United States. The report concludes with an overview of what could be learnt from these two countries and how a thriving CDFI sector could be developed in Australia in coming years.

Introduction:

As we near the end of the first decade of the 21st Century, Australia appears to be at an economic crossroads. On the one hand, Australia has benefited from extraordinary growth and prosperity linked in a large part to a prolonged resources boom and the development of the services sector. On the other hand, global economic volatility, an emerging credit crisis affecting a large part of the financial sector and the evolving economic pressures of climate change and peak oil have highlighted a range of key challenges for the years ahead.

These challenges do and will effect different groups in Australia differently, with the poorest members of society often bearing the brunt of the impacts they present. Economic challenges have real effects on those people experiencing income and asset poverty – as the following examples illustrate:

- Rising rents and house prices resulting in unprecedented levels of housing stress;
- Record levels of debt, fuelled by an almost excessive availability of credit, the rise of fringe lenders and unscrupulous and irresponsible lending practices often targeting people and groups who cannot necessarily afford to service it;
- Recognition that climate change and rising energy costs impact most acutely on those living on low and fixed incomes; and
- The continued chronic poverty and disadvantage in Indigenous communities.

In order to address these challenges there will need to be significant investment in ensuring that the most disadvantaged groups in Australian society are able to access the opportunities that come with economic growth and are also able to mitigate the effects of the negative consequences of this growth.

This paper focuses the spotlight on financial exclusion - one of the key challenges facing the poorest groups in Australian society.

1. What is financial exclusion?

Financial exclusion research in Australia has been sparse, and has focused particularly on individuals and groups who have been excluded from mainstream financial services because of:

- Decreased geographical **access**;
- Decreased **awareness** of a range of fair products (this can be a lack of awareness on the part of individuals, but is also the result of a lack of adequate promotion of basic fair products by financial service providers);
- **Inappropriateness** of certain products;
- **Higher fees and costs** associated with small-scale financial transactions;
- Lack of a **diversity** of multi-cultural financial systems in Australia; and
- **Non-existence** of products for certain groups of people

The most often cited Australian definition of financial exclusion is:

“A lack of access to financial services by individuals or communities due to their geographic location, economic situation or any other ‘anomalous’ social conditions which prevents people from fully participating in the economic and social structures of mainstream communities” (Connelly and Hajaj, 2001;p.4).

Internationally research has highlighted the need for definitions of financial exclusion to move beyond a focus on ‘access’ to include ‘usage’, which then includes focus on the conditions, price, and marketing of products and services. Corr (2006) outlines the multidimensional nature of financial exclusion and includes the following dimensions in her definition:

Dimension	Explanation
Geographical Exclusion	Reduced access or usage of mainstream financial services due to closures or lack of service provision in certain localities or regions.
Access Exclusion	People who are excluded from mainstream financial services because of their performance in risk assessment – particularly relevant to those who have poor credit records and are therefore not able to access mainstream credit.
Condition Exclusion	The “conditions attached to financial products make them inappropriate for the needs of some people” (Kempson et al in Corr, 2006;p11). This could also reflect a lack of appropriate products that relate to the financial needs of certain groups – for example, few insurance products are available to people living on low incomes.
Price Exclusion	Financial products are too costly for certain groups of people or the costs are skewed so that people requiring small transactions or who have small pools of money are charged higher proportionate fees.
Marketing Exclusion	Marketing and information are targeted only at certain cohorts, excluding those groups who are considered less profitable.
Self-Exclusion	Based on their experiences with mainstream financial services people exclude themselves from accessing these services because of beliefs that they will be discriminated against.
Resource Exclusion	Related particularly to savings products, when people do not have sufficient discretionary income to adequately engage with products.
Electronic Exclusion	Research in the UK suggests that people on low incomes are less able to access the increasingly electronic financial systems such as internet banking.

(Based on Corr, 2006;p10-13)

In addition to highlighting that financial exclusion is complex and multidimensional, it is also important to recognise the contextual nature of financial exclusion and the different forms it takes in different societies. The definition put forward by the European Commission seems to take this into account in their definition:

“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).

Definitions of financial exclusion have focused almost exclusively on individuals, families or households. If, however, we define financial exclusion broadly as any person or group who is excluded (through access, awareness, appropriateness) from mainstream financial services and products, then we see that financial exclusion extends to include organisations (and most particularly, non-profit organisations, both formal and informal), businesses and enterprises (most particularly, micro-enterprises, social businesses, social enterprises and early stage small businesses). Three clusters of financial exclusions could be seen to exist in Australia, as outlined in the table below.

Individuals, families and households	Non-profit groups and organisations	Social and Micro Enterprises and Businesses
Particularly people living on low and fixed incomes; People with a poor credit history; People living in remote areas; People with a disability.	Particularly small to medium organisations with no assets, where grants are the primary source of income. This applies to a range of civil society organisations focused on welfare provision, arts, housing, care and support, recreation and health.	Particularly start-up enterprises, social enterprises, social businesses (see appendix four for definitions of these), microenterprises and some small businesses.
Exclusion relates to one or more of the following services and products: <ul style="list-style-type: none"> - transaction banking; - credit; - savings; - insurance products; - superannuation. 	<ul style="list-style-type: none"> - Lack of capital other than philanthropy and grant funding; - Lack of access to sources of investment capital and loan capital; - Lack of capital for asset development, growth capital and working capital; - Questions around skills and capacities to engage with other forms of capital. 	<ul style="list-style-type: none"> - Lack of start-up capital; - Lack of working capital; - Lack of growth capital; - Lack of asset development capital; - Lack of equity capital; - Often ineligible for grant funding and business funding because they sit between 'charitable' and 'business' objectives.

In Australia, relatively little attention has been focused on the financial exclusion of broader groups and organisations such as civil society organisations, social and micro enterprises and micro and social businesses. Some efforts have been made to provide specific banking services to non profit organisations in Australia (such as Bendigo Bank's Community Sector Bank and MECU), but this has primarily focused on offering low-cost deposit taking accounts and tailor made banking services. Very little attention has been paid to the capital needs of this sector and lending or investment into the non-profit sector, particularly when it comes to small to medium sized organisations.

Interestingly, however, these groups often experience issues such as lack of capital other than philanthropic and grant funding, lack of access to fair and adequate sources of investment and loan capital, inability to raise start-up capital for social

innovations, and the inability to access loans and investment which would assist them to build wealth through assets and thereby gradually reduce total dependence on external grant funding.

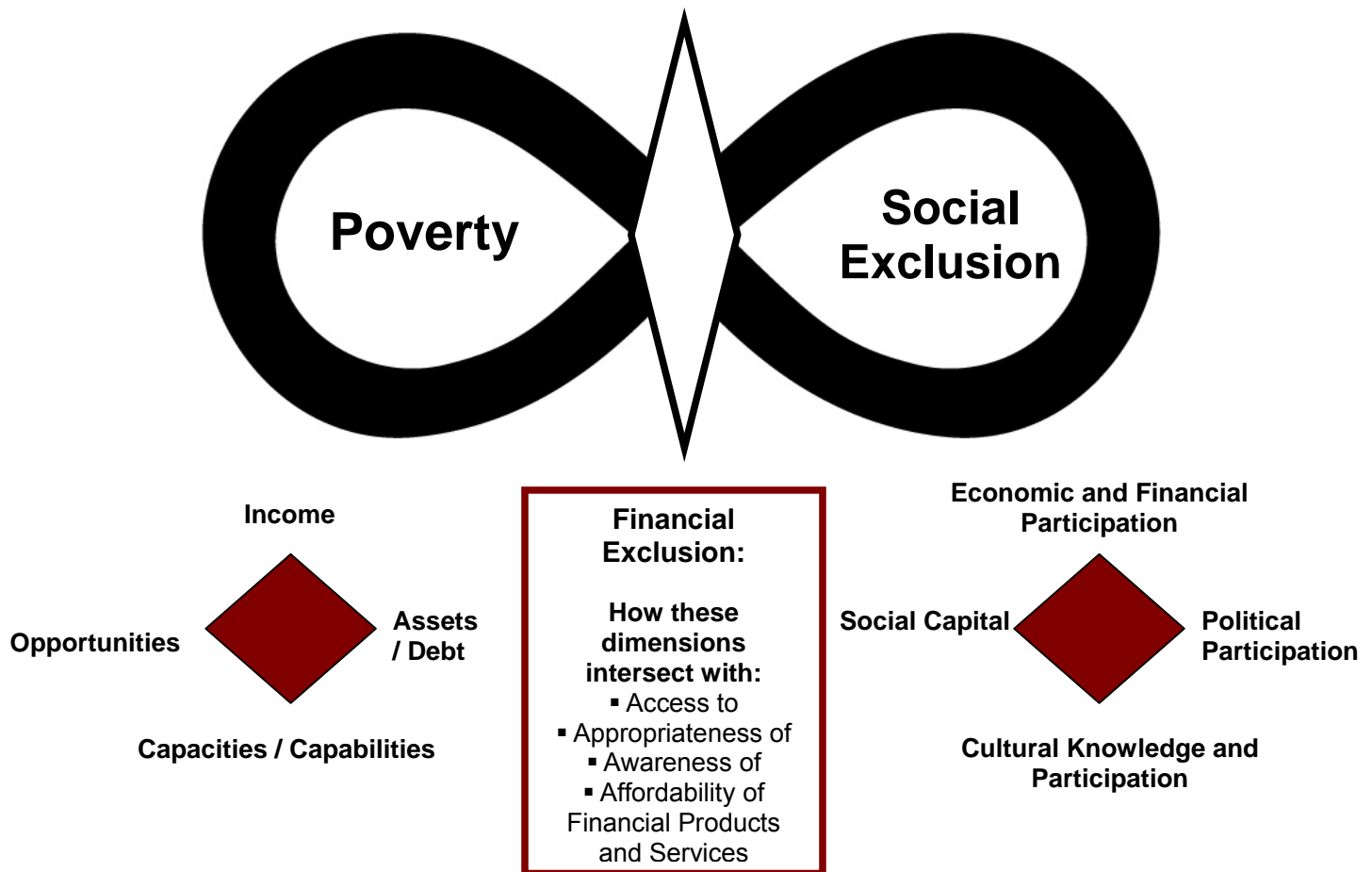
The three clusters of financial exclusion in Australia and the consequences of this exclusion will be outlined in the following section.

2. The Nature And Consequences Of The Financial Exclusion Of Individuals, Organisations And Enterprises

This section outlines the key ways in which each of the clusters identified above experience financial exclusion and examines some of the consequences of this exclusion.

Financial Exclusion of Individuals

Relatively little attention has been paid to researching the financial exclusion of individuals, families and households in Australia (two notable exceptions being Connolly and Hajaj (2001) and the ANZ/Chant Link study of 2004). Financial exclusion of individuals, families and households is a complex matter. The complexity arises partly out of definitional issues (as discussed above), but also stems from the relationship between financial exclusion, social exclusion and poverty, which itself is complex. Certainly it could be seen that financial exclusion is a dimension of social exclusion – but it could also be a cause of social exclusion (see Chant Link). Further, financial exclusion is very much linked to poverty with the poorest people in society experiencing the highest levels of financial exclusion. Linking all these concepts together, the following diagram outlines the elements and complex links between poverty, social exclusion and financial exclusion.



Research into financial exclusion requires an assessment of both the supply and demand sides of financial exclusion (that is, what products and services are currently supplied to people experiencing financial exclusion, and what is needed or what is the demand for products and services). Financial exclusion, by its definition, relates very much to people's access to and use of *mainstream* financial systems – banks, registered financial institutions and companies, insurance companies, superannuation funds and so on. Yet if there is a demand from enough people for products that are either not available in the mainstream system or not accessible by certain groups, then people will very often look for other ways or forms to fulfill their needs. So, for example, if people cannot access credit from banks, the options in Australia currently are threefold – access through informal systems such as friends and family; access to welfare systems such as No Interest Loan Schemes; or access through fringe systems, such as Pay Day lenders, cheque cashers, non-bank personal finance companies or pawnbrokers.

The following table outlines the strengths and limitations of each of these lending systems for people living on low and fixed incomes.

	<i>Informal systems:</i>	<i>Welfare Systems:</i>	<i>Fringe Systems:</i>	<i>Formal Systems:</i>
Example:	Borrowing from friends and family	Borrowing from NILS or Centrelink	Borrowing from Pay Day Lenders	Borrowing from Banks
Strengths:	Accessible, often no-cost options, particularly good in an emergency.	Fair, flexible options for people who cannot access mainstream.	Accessible, fast option for people unable to lend small amounts from mainstream (ie. under \$5000).	Regulated costs and conditions and terms of lending so that irresponsible service / products are less likely.
Limitations:	Can result in conflict if not managed properly.	Often restricted either geographically or for particular purposes (eg. loans for whitegoods).	Often predatory and/or unfair both in terms of costs and conditions.	Often difficult to access (esp credit) if people are living on a low or fixed income. Low cost / flexible products are either not available and/or not effectively advertised.

The consequences of financial exclusion for individuals include:

- Greater susceptibility to predatory or fringe products (particularly credit) due to lack of access, awareness or appropriateness of other options – despite these products being least affordable to lower income groups;
- Greater difficulties in accumulation of assets and savings due to lack of appropriate credit and savings mechanisms;

- Greater susceptibility to debt cycles, gaps in safety nets and debt caused by emergencies for which there are no saved funds, especially as people on low incomes do not tend to have adequate insurance.

There have been a number of changes in the regulatory and policy environment as it relates to the financial exclusion of individuals over recent years. A number of States in Australia have introduced a cap of rates and fees, and in 2010 the consumer credit regulation will be taken over to the Federal government. This will cover all providers of finance (mortgage and non-mortgage providers of finance) and all financial brokers. These shifts have responded to a growth in fringe lending in Australia over the past decade. It remains to be seen whether regulatory instruments such as caps and the federalisation of consumer credit will fundamentally alter the nature of financial exclusion in Australia. Signs would indicate that it may impact some of the more predatory fringe elements currently operating, but that it may not alter the nature of financial exclusion overall other than offering an opportunity to shine the light on an area that has been in the dark for many years in Australia. There are also some indications that new and perhaps more sinister and less detectable forms of financial predation could potentially emerge as legislative loop holes are tightened and closed. The next few years will certainly shape Australia's response to financial exclusion for many years to come.

Financial Exclusion of Third Sector and Civil Society Organisations

In the 1990s there was a realisation in parts of the Australian banking industry that non-profit organisations (or third sector organisations) required special terms and conditions on some banking products and services that differentiated costs and benefits from those affordable and appropriate to 'for-profit' businesses and corporations. Indeed the non-profit sector came to be seen as an underserved niche market that could be developed profitably and responsibly with the development of well designed products and services. Most mainstream banks now offer reduced fees for non-profit organisations and have designed particular accounts and transaction conditions specifically for this sector. In addition, the Community Sector Bank was launched by Bendigo Bank with the express mission to serve this sector with a full range of banking products and services. Numbers of other financial institutions are following this lead and developing this previously rather ignored market. In relation to the provision of accounts and transaction services to the non-profit sector these initiatives have been very successful both for the non-profit organisations and for the banks / credit unions involved.

However, and this is a big however, it has not been successful in opening up much needed access to capital and investment in the non-profit or third sector. Access to credit, working capital, growth capital and capital for asset building in the third sector is still difficult, especially for small to medium sized organisations which have no independent income or assets with which they can secure loans.

Lyons et al (2007) suggest that for many non-profits, "capital is either difficult to raise or is inaccessible". Action research in the UK suggests that non profit organisations need a variety of types of capital – start-up capital, working capital, development capital, re-development capital, and pre-funding of capital fundraising (Bolton et al, 2007;p10).

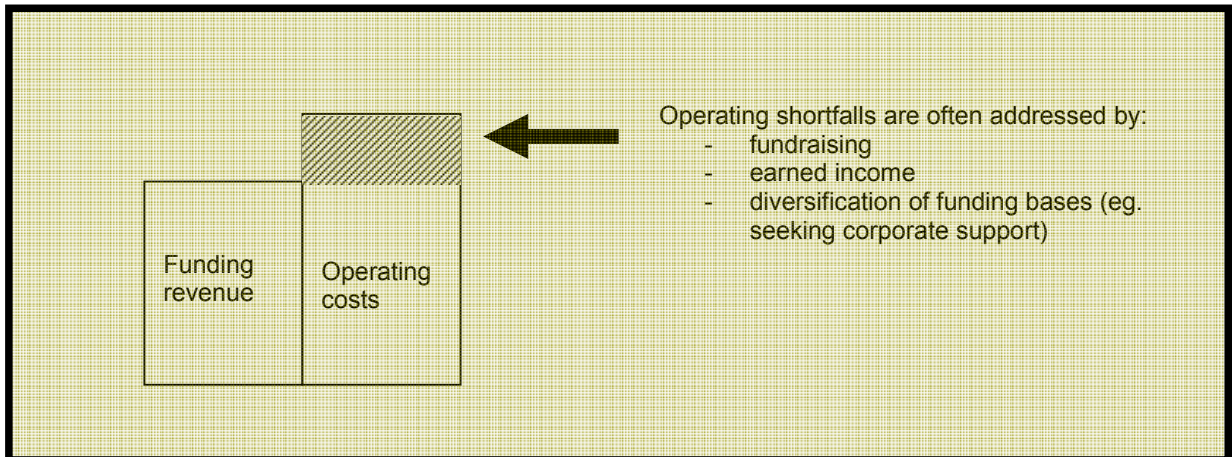
In Australia there are similar capital needs, particularly in certain parts of the non-profit sector. As Lyons et al (2006;p21) argue:

“Australia’s nonprofit sector is a vital part of our society, yet significant parts of it face pressing capital needs. More importantly, the capacity of the sector to renew itself and to generate innovative new programs and institutional solutions to social and environmental problems, as it has done before, is inhibited by failures in existing capital markets. Some action is called for in the public interest.”

Robert Fitzgerald, Productivity Commissioner and former Chair of the Non Profit Roundtable, also suggests that capital shortage and the need for new capital raising strategies currently represent key challenges for the non profit sector (Fitzgerald, 2007;p.3):

“In a competitive environment the current funding arrangements, both through government and through philanthropic endeavours will be insufficient into the future. It’s time that we now worked with the finance sector in looking at new ways that we can raise capital for the sector as a whole.”

It is clear that Australia’s third sector is experiencing pressures and tensions between the available revenue for program and service delivery and the needs and opportunities that exist in their constituencies. In many small to medium sized third sector organisations there is a growing gap between the funding revenue available and the actual operating costs of the organisations, which is often plugged by diversification of funding, fundraising activities and increasingly, explorations of earned income.



The consequences of long-term continual shortfalls in revenue compared to operating costs are serious, and include:

- An inability to develop reserves, reducing the resilience of organisations and making it difficult to plan for certain contingencies, resulting in somewhat precarious financial situations if funding is cut or reduced;
- A high level of dependence on the continuation of grant funding;

- A reduced capacity for innovation, experimentation and exploration of non-fundable activities;
- A lack of capacity to save for the purchase of assets through which organisations could build their independence and resilience;
- A constrained ability to maximise their social impact rather than merely meeting the required outcomes and objectives according of funding guidelines and contracts;
- A degree of uncertainty that makes long-term planning difficult and can result in lowering of morale, commitment and staffing issues;
- Unfair and unsafe working conditions.

To date much of the work that has been done in the Australian context in relation to assisting third sector organisations to meet revenue shortfalls has centred on introduction of new sources of funding (eg. corporate philanthropy) and improving organisation’s capacities to access funding (eg. through the provision of grant writing training).

It is still somewhat ideologically and sometimes legally difficult for non-profit organisations to engage in exploration of financial sustainability that goes beyond funding, philanthropy and fundraising options. The capacity of non-profit organisations to earn income has been challenged in relation to taxation and charitable status regulations (though it is currently thought that earned income is acceptable so long as it is utilised to further the social objective of the organisation). Further, there has been little research or experimentation in relation to role of capital and investment in the third sector (with the work of Foresters being a rare exception).

According to the ABS the current sources of income for the **social service sector** looks like this:

Government Grant Revenue	Income from Services	Sale of Goods	All other income (including fundraising and foundation funding)
(55%)	(22%)	(9%)	(14%)

<http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8106.0Main+Features12006-07?OpenDocument>

However, in the non-profit sector as a whole (including social service sectors, health, education and sport/recreation sectors), the figures suggest that just over a third of income is from Government funding, with the next biggest source being income from services, then donations and sale of goods representing just under 10% of income each. What these figures do not examine is the ‘wealth’ of the non-profit or third sector – that is, what their current assets are and what their net worth is. This could give a more holistic picture of the long-term sustainability potential of the sector and also indicate what role non-grant capital could play in the sector.

Again it is important to understand both the supply and demand side of the financial exclusion of third sector and civil society organisations. Unfortunately little research has focused on this arena in the Australian context. In Australia two key research streams are needed to understand the financial exclusion of the third sector and civil society organisations:

- i. Understanding the financial needs of the Third Sector, the barriers to meeting these needs and the impact of organisations not being able to meet their financial needs;
- ii. Understanding the practice and policy of how capital could be added to the repertoire of financial options for the third sector – this requires action research and support of initiatives such as Foresters Community Finance which has a fifteen year track record of work in this space.

In contrast, in the UK and the US, a growing number of research projects, policy initiatives and practical innovations have been developed which have opened up sources of capital and investment to the third sector. The authors of one such initiative argue that “capital has a complementary role in building strong and effective civil society organisations” (Mitchell et al, 2008;5). They argue that third sector organisations have a range of capital needs (Mitchell et al, 2008;11-13), 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.

(Based on Mitchell et al, 2008;pp11-13).

In addition to grant and philanthropic funding, Mitchell et al (2008;p15) argue that third sector organisations require access to fair and flexible capital in the following forms:

- o Secured loans (for asset acquisition);
- o Standby facilities;
- o Overdraft facilities;
- o Unsecured loans;
- o 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);
- o Quasi-equity
- o Equity.

In the UK and the US the demand for such capital from the Third Sector is increasingly matched by supply of products and services across this capital spectrum from specialist banks, social venture capital providers, government backed funds, philanthropic trusts and foundations, specialist social investment funds and Community Development Finance Institutions. The potential for development of this space in the Australian context is explored in a later section of this report.

Exploration of the role of capital and investment in the third sector is crucial if this sector is to be truly innovative and sustainable. If civil society and non profit organisations are continually restricted from building up surpluses, owning assets

and building their wealth (ie. owning assets and building capital funds), they will always have difficulties reducing dependence on ongoing grants and gifts. They will also find it harder to engage in long term planning and will be less likely to engage in entrepreneurial and innovative initiatives. This is because innovation is more difficult to fund through grant income which relies on the demonstration of ‘runs on the board’ and demonstrated outcomes. As one commentator recently suggested: “many successful nonprofits are constrained from expansion by difficulties in raising capital and many potentially important social innovations are strangled by their inability to raise start-up capital” (Lyons, 2007;99).

Financial exclusion will be most acute for the following third sector organisations:

- small to medium sized organisations;
- independent localised community organisations – that is, entities such as neighbourhood centres who are independent and locally focused;
- start-up organisations in the first five years of operations, or those who do not have secure, recurrent or ongoing funding;
- organisations who wish to grow or expand into innovative areas that are not currently the focus of grant, funding or philanthropic bodies.

Financial Exclusion of Social Enterprises, Social Businesses, and Microenterprises

The arena of social enterprise is emerging in Australia as a key method of addressing social, cultural, environmental and economic issues that have not been resolved using traditional means nor by the efforts of any of the traditional sectors (non-profit/third sector, public sector or private sector). Social enterprise remains somewhat conceptually slippery in Australia, as the context and the structures that have emerged here are different in nature and form from those that have emerged in the UK from where most of the research and writing on social enterprises originates. Conceptual clarity is a key issue for the emerging field of social enterprise as it is often a lack of understanding that acts as a barrier to such entities accessing financial services and products. It is important at this point to examine some of the key features of the sorts of enterprises and businesses that are subject to financial exclusion as it is defined here. A fuller typology is outlined in Appendix Four.

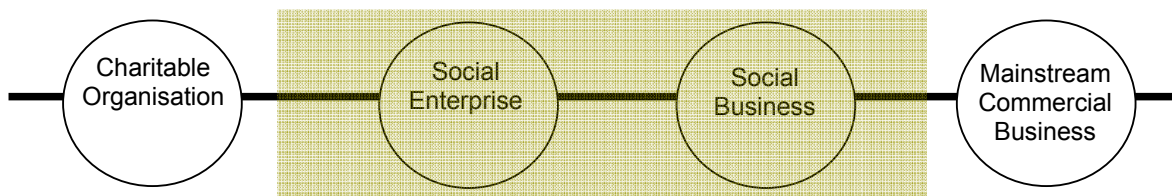
Type of enterprise / business	Definition	Example of financial exclusion ¹
Microenterprise	A commercial venture initiated by an individual or household previously excluded from mainstream employment, with the purpose of securing a stable livelihood or improving their economic condition.	A woman who had recently arrived in Australia as a refugee had operated a successful sewing business in her home country but was unable to access the capital needed to start up a similar business here.
Community Enterprise	An enterprise whose focus and purpose is to address local issues using enterprising means – could be local social issues, ecological issues, cultural issues etc. It is focused on a geographic location and the outcomes it is seeking are located in that geographic region.	An informal arts network operating in a regional community decided to formalise and become a cooperative. They won a large contract from the regional council to undertake

¹ These examples are representations of stories told to Foresters over the past five years as enterprises and businesses have approached us for financial assistance and capital. The identity of the enterprises involved have been disguised to protect their privacy.

	<p>Type A: Community Objectives and Community Outcomes – the enterprise seeks to address local issues and achieve community outcomes by utilising an enterprising orientation.</p> <p>Type B: Local Employment Creation – the enterprise seeks to build local employment, particularly focused on building jobs within regional, remote, and/or disadvantaged communities. It may or may not focus on employment creation with people who have been excluded from mainstream jobs.</p> <p>Type C: Community Wealth Creation – the enterprise seeks to establish local community-owned assets in order to create community benefits and address community issues.</p>	<p>an arts project to beautify the local streets. The contract conditions stated that payment would be made in arrears and in tranches over the course of two years. The cooperative could not access up-front or bridging capital to employ artists or buy equipment prior to the first contract payments and so they had to withdraw from the process, leaving them in a very difficult position.</p>
<p>Social Enterprise</p>	<p>Common to all social enterprise:</p> <ul style="list-style-type: none"> • Social Objectives are core to the purposes and focus of the enterprise • Limited distribution of profits...the majority of profits are reinvested in the enterprise and/or an associated social entity. • Mixture of capital inputs...the enterprise is supported through a mixture of grant income / subsidised income and earned income • Generation of a social return in addition to a financial return <p>Type A: Social Objectives and Social Outcomes: An enterprise whose focus and purpose is to address a social issue using enterprising means.</p> <p>Type B: Employment Creation: Create employment and integrate people who have been excluded from employment into the workforce – if such an enterprise focuses on people who have been excluded from employment because of a disability or health related issues, these enterprises are also sometimes referred to as ‘social firms’.</p> <p>Type C: Social Wealth Generation: An enterprise that is often linked with a non-profit organisation, which has at its core social objectives and which generates a financial return for the non-profit organisation.</p>	<p>An enterprise established to provide employment for people with mental health issues was unable to access an overdraft facility from a mainstream bank because at the time they were supplementing their earned income with grant income as they established themselves as a viable business.</p>
<p>Community and Social Business</p>	<p>A commercial business that has community or social objectives at its core. A community / social business, unlike a social enterprise, is not capitalised through grants or subsidised income. It is a commercial entity, so all its income is derived from commercial undertakings. It may, however, undertake activities that are non-commercial in nature (or approach issues from a ‘more-than-commercial frame of reference) or conduct itself as a hybrid between the commercial and social spheres.</p>	<p>A long-standing non-profit social business focused on incubating social innovations reached a point where they needed growth capital if they were to achieve their potential and achieve scale. They explored many options but realised that what they actually required was some form of venture capital. Because of their social objectives all attempts at</p>

Eco or Green Business	A commercial business that has environmental objectives at its core. It can be for profit, or not-for-profit. A green business, unlike a social enterprise, is not capitalised through grant or subsidised income. It is a commercial entity, so all its income is derived from commercial undertakings.	attracting this capital failed. A small cooperative focused on restoring and reselling used furniture wanted to develop a new arm to their business. To do this they needed working capital – they were able to get a line of credit from a finance company, but the terms were so onerous that eventually it began to risk their long term viability.
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In some reports (see for example New Economics Foundation (2001), Langdon and Burkett (2004) and Mitchell et al (2008)) a linear interpretation of where social enterprise fits, is offered – such as in the following diagram.



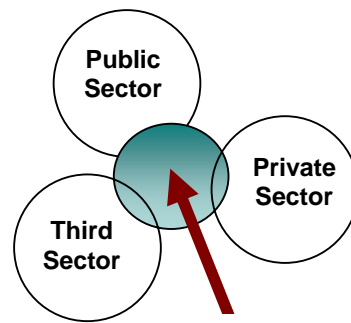
Although many people are now using the terms interchangeably, there is some value in speaking of social enterprise and social business in slightly different terms based on the following characteristics. It should be noted that these differences are not seen as definite or applicable in every case and are indicative only:

Characteristics	Social Enterprise	Social Business
Origins – where and how did the entity start?	Often started with a charitable intent, by people working from within the third sector who have an enterprising orientation.	Often started with a business intent, by people working from within the private sector who see an opportunity to create social impact.
Size / Scale	Usually smaller turnovers	Usually larger turnovers
Funding / Capital	Often have blended funding – some grant, some earned, the balance between the two shifts over the course of the lifecycle of the enterprise	Rarely seek or attract grant funding – much more likely to concentrate on earned income and commercially oriented capital.
Balance between social and commercial objectives under pressure	Tend to skew more towards social objectives if under pressure.	Tend to skew more towards commercial objectives if under pressure.

Within the space between charitable organisations and mainstream commercial businesses sit a variety of organisational forms, articulated by Mitchell et al (2008) as (moving from the charity end of the continuum to the business end):

- Charities with 'mission focussed' trading arms;
- Social benefit enterprises;
- Social purpose businesses;
- Socially responsible businesses;
- Businesses whose purpose is to generate funds for charities.

Another way to interpret the position of social enterprise is to see it as sitting between the traditional sectors and occupying a new sector – the fourth sector, which has features of each of the other sectors but with a new form.



Fourth Sector: Social Enterprise, Social Business, Green / Eco Enterprise, Community Enterprise, Arts Enterprises etc.

The financial exclusion of this sector stems from two core areas:

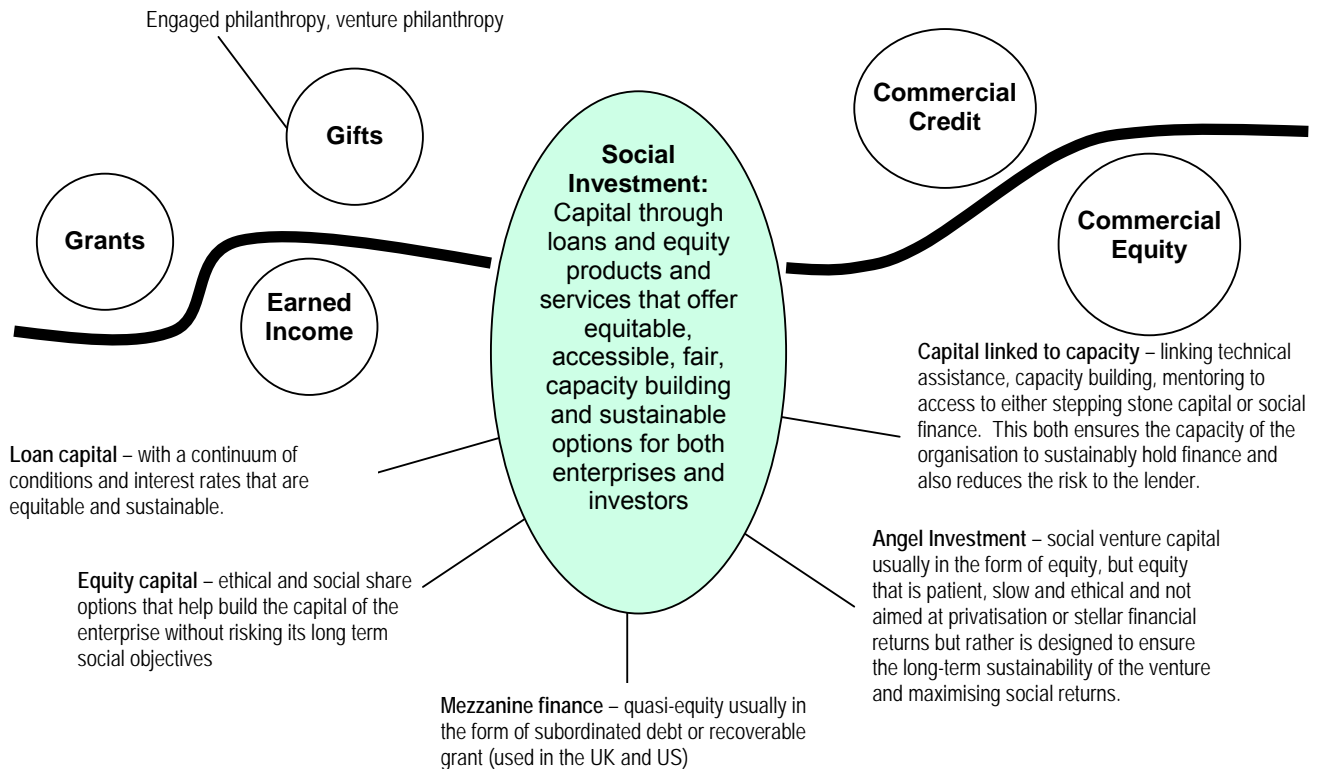
- **Capital** – the Fourth sector experiences similar capital needs as those experienced in the third sector, that is, asset acquisition capital, working capital and growth capital, in addition to needing capital for market development.
- **Low Cost Banking** – because the legal structures of social enterprises and social businesses do not always fit the categories of 'charitable' entities (though they clearly have social objectives and are often still non-profit in nature), it can be difficult for these entities to access low-cost banking products and services.

The lack of access to affordable capital is a major barrier to the development of a thriving and innovative Fourth sector in Australia. Further, the conditions attached to the majority of commercial loans in Australia exclude many social and micro enterprises. Research in the UK suggests that what is needed by these entities is "equitable, 'patient', 'up close' (ie. local), participation finance" (Conaty and McGeehan, 2001;p5)². The capital requirements of the Fourth sector in Australia need to be seen in relation to the income needs of entities such as social enterprises, micro-enterprises and social businesses.

Many enterprises require a blend of income sources – grant, gifts and earned income – for long periods as they develop both their financial and social sustainability. In addition, they often access commercial capital at some time in their development –

² Foresters Community Finance is currently undertaking action research to examine the types of finance and the appropriate conditions required by a range of microenterprises, social enterprises, social businesses and eco businesses. This research will assist the development of a number of pilot products and services to be trialled in 2009.

but they often need stepping stones in order to build their financial and skill capacity to hold such finance. There are, however, a range of other potential capital and finance sources that could be used to enable social enterprises, social businesses, eco businesses and microenterprises to thrive. The following diagram provides an overview of the range of income and capital needs of Fourth sector entities including a range of potential options which come under the heading ‘social investment’.



The range of capital options under the heading of ‘social investment’ is not generally available in Australia, though they have been explored extensively in the UK and the US. The development of these forms of capital in the Australian context will help address the financial exclusion of social enterprises, social businesses, eco businesses and microenterprises. How this could be achieved in Australia is the topic of a later section of this paper.

Many statistics demonstrate the difficulties and high failure rates of starting any small business in Australia. For micro-enterprises, social enterprises, and social businesses these potential difficulties are often exacerbated because of their blended structures, their social objectives and their connection to people and groups who are marginalised. This makes access to capital (either through grants or loans) even more difficult.

One of the key barriers to adequate capitalisation of social enterprises and social businesses in Australia centres on the currently available legal structures for these entities which do not enable or reflect the complex capital needs of social enterprises over their lifetimes. In the UK there are specific legal structures that can be adopted by social enterprises that recognise both their social objectives and their commercial imperatives (see for example the Community Interest Company and the Industrial Provident Societies structure) and which enable specific forms of capital such as

equity to be utilised. In Australia, a great deal more work needs to be undertaken such that these enterprises are better understood and recognised for their blended status.

Australia's social enterprise and social business sector is only just beginning to develop – but the need for finance, capital and development support is already noted as a major barrier to the growth of this sector. Very little capital exists for start-up and development of such initiatives, and often the options for capital raising in this sector are hampered by the fact that many enterprises blur the line between the traditional charitable and business models. They become alienated from the mechanisms for fundraising associated with both these models by virtue of the fact that they do not fit neatly or solely into either.

There is no tradition of venture philanthropy nor of social venture capital in Australia and the options for new social enterprises or social businesses to access funds are still very limited. Although there have been some small attempts to address the needs of micro-entrepreneurs in relation to capital (see for example NAB microenterprise loans and the work undertaken by Westpac in relation to the Cape York Partnerships), this is still in its infancy and is accessible only to a relatively small population of social and micro entrepreneurs.

Further, the need for business support and capacity building linked to finance options has been explored in only a limited fashion to date in Australia (see for example the work of Opportunity International in Northern Rivers). It is clear from the work that Foresters has undertaken in this arena over the past decade that financial exclusion of the Fourth sector is not merely linked to supply issues – there are very real issues related to the internal capacities and capabilities of many organisations in this sector to be able to plan for and sustainably hold financial products such as loans and working capital. These issues need to be addressed alongside the development of appropriate and affordable products and services if the financial exclusion of this sector is to be redressed.

3. Why does financial exclusion occur? The links between capability and market failure

A more complex and richer interpretation of financial exclusion which incorporates both a wider view and a deeper perspective demands an equally robust analysis of why exclusion occurs. Two contrasting and under-researched reasons for financial exclusion currently dominate discussion:

1. *“Financial exclusion is the result of a lack of capacity or capability”*. This is almost exclusively linked in literature and policy debates to the capability of those who are excluded – that is, the argument suggests that individuals, organisations or groups are excluded because they lack certain financial competencies and capabilities or have low levels of financial literacy.
2. *“Financial exclusion is the result of market failure”*. This argument proposes that the costs of including certain people, organisations and groups into mainstream financial services is too high and therefore not viable as a commercial exercise.

These ‘reasons’ for financial exclusion and the links between them will be explored in this section.

Financial Exclusion and Capability:

Financial exclusion has often been linked to a lack of financial literacy, financial capacity or financial capability. Each of these terms suggests that there is a possibility that this lack may be addressed through the development of literacy, capacity or the building of capability. However, it is only the latter term ‘financial capability’ which implies that the lack goes beyond the “deficits” of individuals and groups, and has a social or structural context (see Sen’s definition of capability, 1999). Kempson (2006) uses the term ‘financial capability’ to denote *how capable people define themselves* to be in relation to five areas:

- in making ends meet
- in keeping track of finances
- in planning ahead
- in choosing financial products and
- in staying informed about financial matters.

This approach to assessing financial capability is probably the most sensitive to contextualise and could be equally applied to groups, enterprises and organisations as it could to individuals.

However, what is often left out of notions of financial capability is any assessment of how capable financial institutions are (through their staff) and how capable policy and regulatory bodies are of understanding the financial needs and realities of excluded individuals and groups. Often the response to financial exclusion is quite simplistic – it is about building the capacity of those who are excluded - ‘teach them how to budget’, ‘teach them how to read financial statements’, ‘train them to understand the financial world’. Unfortunately, this assumes that the ‘deficit’ rests with those who are excluded – which does not take into account the complexity of types of financial exclusion outlined earlier. It may not be the case that people or groups ‘don’t know how to use a financial tool’ – rather, it may be that the financial tool itself is inappropriate to the circumstances of that person or group. Of course we cannot expect financial services to design products and services that suit every individual or group, but we can expect some greater levels of engagement and innovation from financial services around the needs and realities of particular groups when it comes to financial exclusion. This means that the capability of both financial institutions and

policy/regulatory bodies may need some development – and that the focus needs to be widened beyond building the capability of consumers.

Financial Exclusion and Market Failure:

Market failure results when:

- beneficiaries of products and services do not have the capacity to pay for these;
- where the costs and risks of providing products and services to certain groups outweigh the profit benefits; and/or
- where moderate to significant modifications need to be made to certain products and services in order to suit particular groups, and the costs of these modifications outweigh the income potential.

When market failures occur, governments often step in to directly provide services or fund services through non-profit organisations such that the outcomes for people concerned are improved. Governments may also address market failures by intervening to change the behaviour of businesses and individuals through regulation.

Financial exclusion in Australia could be interpreted as a market failure because of complex interplays between market imperatives and unintended consequences of regulation. There are inbuilt assumptions in the Australian financial services market about the provision of services and products to people living on low or fixed incomes, and organisations and enterprises associated with the Third and Fourth sectors.

These assumptions include:

- There are higher costs associated with the provision of financial services and products to these groups – particularly centred on transaction costs;
- There are higher risks in lending to these groups;
- There are greater brand and reputation risks associated with engaging in financial services with these groups.

Unfortunately in Australia there has been very little attention paid to unpacking these assumptions or testing them either through research or practice so they continue to limit the involvement of financial institutions in addressing exclusion. Though many banks have either signed up to the Banking code or developed voluntary codes and practices related to engagement particularly with individuals living on low and fixed incomes, there is no regulatory imperative for bank transparency so that these and other financial institutions are forced to disclose the nature of this engagement.

For many this means that addressing financial exclusion is therefore relegated to the margins (and limited to, for example, the provision of low fee accounts for people on low incomes³) or to philanthropic or corporate social responsibility (CSR) agendas rather than being seen as part of their core business⁴. Regulation could potentially address this by demanding compliance with basic service provision and transparent reporting of financial institutions' engagement with excluded groups – much as the US Community Reinvestment Act does.

³ There is no requirement for banks to either market nor report on these basic bank accounts, therefore making it difficult to establish how widespread their use is or what impact they are having in relation to financial exclusion.

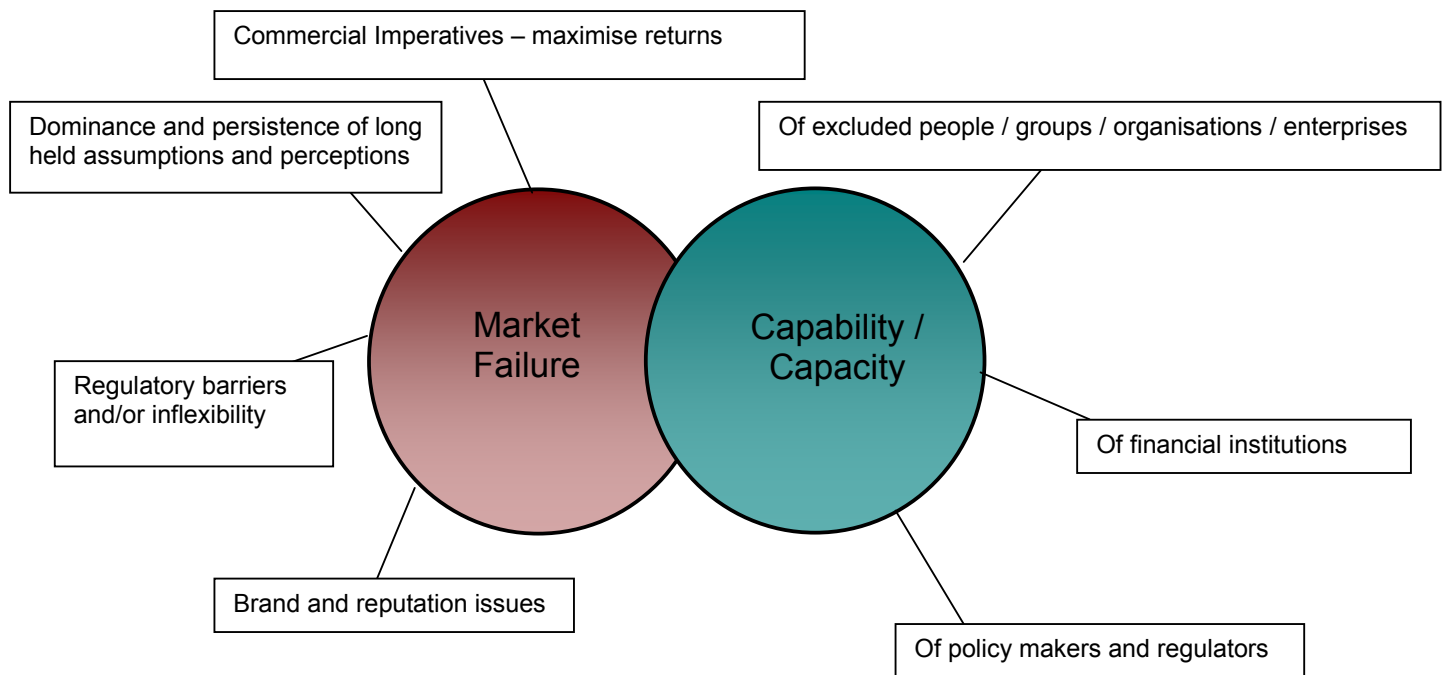
⁴ Of course, there are some banks in Australia that have made much greater efforts than others – but often this is very much due to the efforts of certain individuals or teams and the efforts are not always 'structured' into the broader culture or institutionalised into the organisation for the long-term.

Though financial regulation has contributed broadly to consumer protection through the development of a strong and relatively stable financial sector in Australia, there are also some unintended consequences of financial services regulation that exacerbate market failure in this arena. Regulation has certainly assisted greatly in preventing overly exploitative practices through the development of standards and compliance regimes for financial services. Regulation has required financial service providers to demonstrate their strength and financial sustainability through their size, their capital adequacy, their assets and their compliance with various regulatory regimes. The shadow of this regulation, however, is that Australia has developed a highly uniform framework for financial services and products, which has put considerable pressure on smaller and more specialist financial providers, many of whom have opted for mergers with larger providers as compliance requirements and costs have exceeded their capacity.

Unfortunately this push for scale has also meant that some very innovative financial services whose focus has been on serving marginalised or underserved communities have been lost or are in decline. Credit unions with a focus on serving remote Indigenous communities and small rural areas have merged with larger institutions that may not have the same orientation to addressing the needs of their members, and small funds with more social and ethical missions have disappeared as size begins to matter. Further, it is harder for institutions such as credit unions to offer alternative services to their members as the regulatory structures aim for a homogenous, secure and standardised financial services market.

Australia's financial regulators have not directly developed a specific response or interest in addressing financial exclusion, relying instead on voluntary codes developed by the banking and finance sector, which include such things as the provision of 'basic' (low fee) bank accounts to people living on low and fixed incomes. The difficulty with this approach is that commercial imperatives often outweigh deep and structural commitment to voluntary codes. In the absence of transparency regulations, it is often very difficult to get beyond the public relations spin to accurately assess what financial institutions are doing to address financial exclusion and what impact this is having across the board. Interestingly, it is also the case internationally that voluntary charters and codes have had limited success in ensuring that mainstream financial institutions address financial exclusion (see for example, Kempson, 2004).

The reasons for financial exclusion are presented diagrammatically below. Importantly, between market failure and capability lie many opportunities to address financial exclusion.



New Market Opportunities

To understand how to best respond to new market opportunities that are set against the backdrop of market failure it is essential to build capability amongst and across all the stakeholders and develop an analysis of:

- the people, groups and organisations for whom the financial services market fails;
- the particular causes and consequences of their financial exclusion;
- the impact of this failure;
- the structures, programs and practices that can be implemented to respond innovatively;
- strategies for bringing new capital into the market, with a particular focus on what form that capital should take.

Some particular opportunities to address financial exclusion which take account of these issues are explored further below.

Finally, in harnessing the opportunities around financial exclusion it is crucial to develop ethical and sustainable frameworks within which innovation can occur. In the development of lending practices it is particularly important to be clear about the nature of responsible, sustainable and ethical lending to people and groups who are not able to borrow from mainstream financial institutions. It is also critical to distinguish this absolutely and fundamentally from exploitative and predatory practices that take advantage of people who are financially excluded and actually further entrench their exclusion through irresponsible and unethical lending. This is a particularly important distinction in the light of the sub-prime mortgage scandal that has recently occurred in the US. The sub-prime mortgage scandal was the result of **irresponsible** and unethical lending practices – where financial institutions knew that people could not afford the costs or meet the terms or conditions of a loan. Despite this knowledge lenders proceeded to approve the loan with the result that many of these home loans have been foreclosed.

Yet, lending to people and groups who are excluded from mainstream credit provision is not automatically irresponsible, if it is done in a way that ensures that the impact of those loans is positive rather than negative and exploitative. The fact is that there are some people, organisations and enterprises who should not in their current circumstances be given credit no matter what conditions are attached to the loans. If people do not have enough income to repay a loan, if they are over-indebted already, if their outgoings already exceed their income, then it can be irresponsible to lend to them, even if the loan is at no interest.

No Interest Loans	Social Loans	Social Investment	Commercial Loans
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Irresponsible lending can occur across any of these types of loans

If, however, people or organisations do not qualify for mainstream lending but they could clearly repay a loan, then lending can be completely responsible if the costs, terms and conditions are made enabling rather than burdensome or onerous.

4. What has been done about financial exclusion in Australia?

There have been a number of approaches to addressing the issues of financial exclusion in Australia:

1. Mainstream financial institutions have used their **Corporate Social Responsibility** systems to address specific needs or issues (see for example, NABs work in relation to microfinance and fringe lenders, ANZ's work on microlending and home ownership in Indigenous communities, Westpac's work through the Westpac Foundation and the Cape York Partnerships);
2. Mainstream financial institutions have **partnered** with community organisations and social welfare organisations to address specific needs or issues (for example, NAB and the Good Shepard Youth and Family Services; ANZ and the Brotherhood of St Laurence);
3. **Non-government and community organisations** have developed specific programs to address needs (for example, the NILS program of Good Shepard Youth and Family Services has been operational for many years prior to receiving the capital it now does from NAB);
4. A handful of **small, non-profit financial institutions** have developed specific programs to address needs or issues (for example, Fitzroy-Carlton Credit Cooperative has developed specific products and services for their low and fixed income constituents; Foresters Community Finance has developed processes, products and services for specific capital needs and asset building in small to medium sized non-profit community organisations).

However, all of the initiatives have been relatively small-scale, discrete projects, and have not to date represented a concerted, cross-sectoral response to the issues of financial exclusion⁵. Although many of the organisations and groups who are involved in these responses are known to one another and many have joined networks associated with 'microfinance', there is little recognition of this as a distinct but diverse sector.

Further, most of the responses have focused on the financial exclusion of individuals, with fewer initiatives focused on the financial exclusion of non profit organisations and enterprises. Finally, all the initiatives have been developed in either a policy vacuum or even a hostile policy environment⁶. There has been a dearth of interest from government bodies in financial exclusion (with two notable exceptions being Consumer Affairs in Victoria, and more recently, the Office of Fair Trading in Queensland).

When there have been attempts to initiate governmental responses or develop policy (as was the case in Victoria where the Department of Communities became involved in a number of corporate–community partnerships focused on microfinance), these have focused only on the financial exclusion of individuals and households, with very little or no attention focused on the financial exclusion of non-profit organisations and enterprises.

⁵ The exception could be NILS which is at least national in nature, but it's reach still varies across the different States.

⁶ For example, some service agreements between government funders and CSOs in various jurisdictions have expressly forbidden CSOs to develop an asset base or build their reserves.

The question then arises as to who **should** be responsible for addressing the financial exclusion of individuals, organisations and enterprises who are marginalised from mainstream services? If financial exclusion does indeed result at least in part from a market failure – the market considers people on low income, non-profit organisations and social enterprises to be too risky, not profitable enough and too expensive in terms of transaction costs – then whose responsibility is it to address the market failure?

Certainly those who generate profits from the market and who determine the nature of market failures (ie. corporations, in this case banks and large financial institutions) should bear some responsibility. Corporate financial institutions can respond to financial exclusion in a number of ways:

- Building their own capacity to deliver appropriate products and services to excluded people, groups and organisations;
- Helping to develop and build specific entities such as a social bank or charity banks or community finance intermediaries who could develop and deliver appropriate products and services;
- Partnering with other organisations such as Community Service Organisations who can act as a filter between excluded people and mainstream financial institutions.

Governments and regulators have a responsibility to ensure that there is a policy and regulatory framework in place to mitigate the effects of market failures. This can be a framework that enforces a degree of action or reparation on those responsible for the market failure (such as parts of the Community Reinvestment Act in the US). In addition to regulatory regimes to force financial institutions to address financial exclusion governments can also create enabling environments. This can be done through policy and funding initiatives where organisations and entities such as Civil Society Organisations or Community Service Organisations (CSOs) and non-profits can develop sustainable responses to the effects of the failure. This has happened in both the UK and the US through CDFIs which are explored in a later section of this paper.

CSOs, especially in the welfare and community sectors, are often placed in a situation of mitigating the worst effects of market failures on people who are marginalised or excluded in society. In relation to financial exclusion, civil society organisations have contributed much in terms of designing and delivering services to assist particularly individuals. Though this is generally laudable, it does raise some tensions for these organisations. Essentially it is not the responsibility of civil society alone to mitigate the effects of market failure – particularly if those responsible do not contribute to this service. Shifting expensive transaction costs or responsibilities to the social sector can only ever be a band-aid response to a systemic problem. An appropriate action by CSOs in the future could be to engage in both advocacy and service provision. On the one hand CSOs could advocate that corporations and government act appropriately to mitigate the effects of financial exclusion. On the other hand they could play a role in developing a recognised, adequately funded and legitimate *part* of the solution through developmental work and service delivery to those most affected by the exclusion.

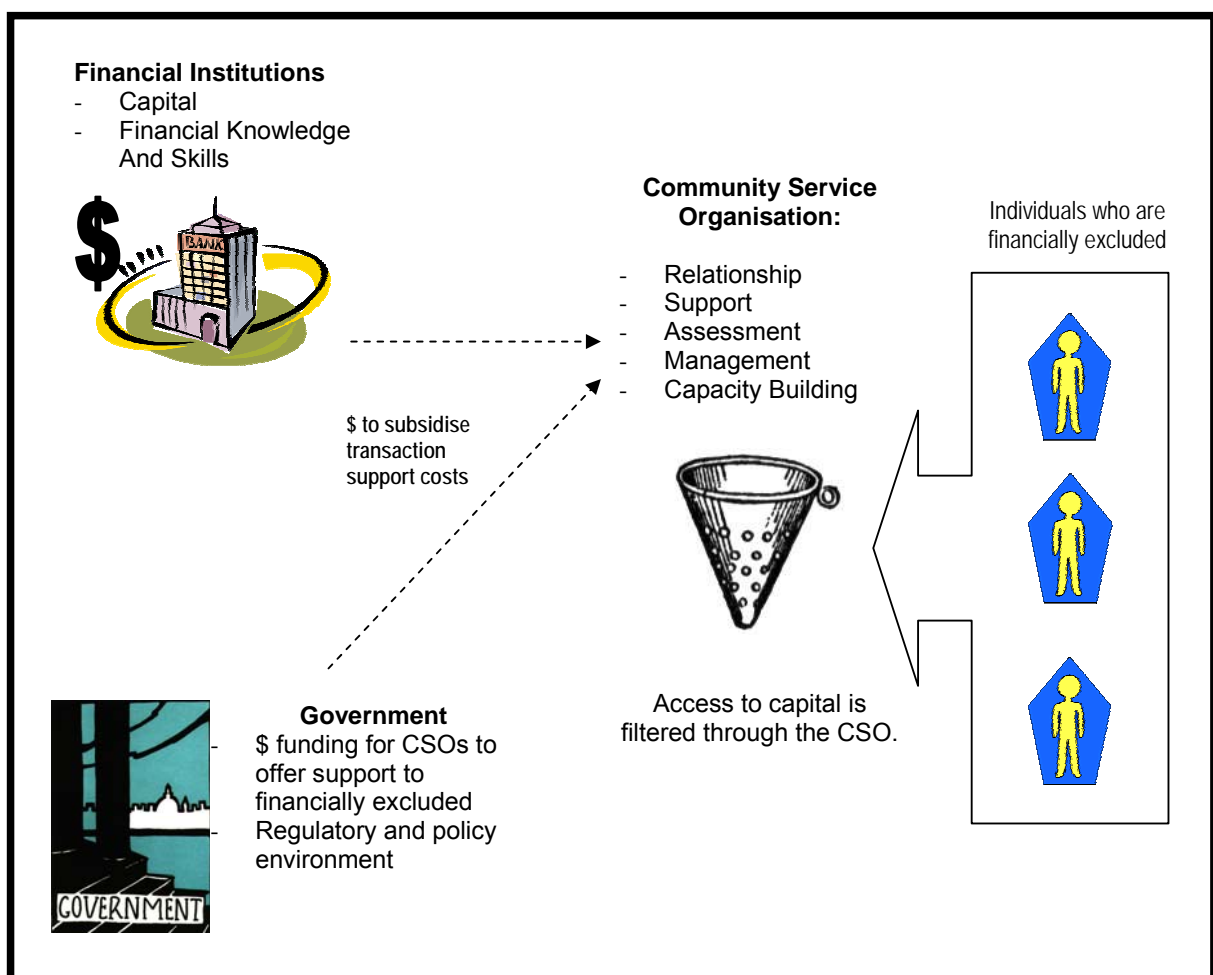
In Australia some CSOs have been paid by larger financial institutions and governments to deliver services and products that mitigate the effects of market failure. Some of these arrangements have been called 'cross-sector partnerships', but in reality many have become merely service delivery arrangements or contracts where the bank and sometimes government departments contract the CSO to deliver

the products which will mitigate some of the effects of market failure without necessarily addressing the systemic causes of exclusion.

Unfortunately this has not, in the main, delivered scalable solutions to the problem as many of the CSOs are either state-based or even locality-based. Further, in some cases this has also resulted in a reduction of advocacy about the effects of financial exclusion as the banks are seen as major funders of the CSOs involved and there is a perception that 'one should not bite the hand that feeds one'. Further, the CSOs are, in some cases, becoming filters between excluded individuals and mainstream financial institutions. Questions do need to be asked about whether this is an effective task for CSOs – particularly when the banks argue that the transaction costs (in terms of time taken to process what are effectively very small loans or savings) are not financially viable for them. Of course these transaction costs are no more financially viable for CSOs. While it is cheaper for the banks to use such an arrangement, the total costs incurred by the CSO (particularly if volunteers are involved) are not always accurately counted or compensated for.

5. How to turn market failure into market opportunity: What more could be done in the Australian context?

Currently the approaches used to address financial exclusion are predominantly welfare oriented and almost exclusively focussed on addressing the exclusion of individuals. The approaches primarily centre on the delivery of services to excluded individuals via Community Service Organisations (CSOs). The key sources of capital supporting these responses are grants and gifts. The position of CSOs in addressing the financial exclusion of individuals is akin to **a filter to the financial institutions** – they provide the assessments and manage the flow of people to the financial institutions (or at least to the capital that those institutions hold), and in turn the financial institutions (and sometimes government too), provide some funding to subsidise the CSO to undertake this transaction work.



The Current Response: CSOs as filters to financial institutions

Such approaches, whilst providing some relief for the most excluded people in society, suggest that the only effective response to market failure is to build alternatives outside the market. This of course requires a continual growth of funding. Further, the current 'solutions' rely on the continued willingness of CSOs to be an under-resourced filter between the financial system and the individuals

excluded from mainstream services. Current initiatives mostly lack scale, are dependent on growing the funding pool and have not demonstrated consistent impact in relation to addressing financial exclusion in Australia.

In relation to addressing the financial exclusion of individuals this approach of engaging CSOs to act as a filter between mainstream financial institutions and people who are excluded from accessing or using their services has achieved a degree of impact. However, the limitations of this approach include the following:

1. It has been difficult to build scale in most of the models, particularly as many CSOs have a particular geographic focus;
2. If CSOs act as filters for the financial institutions rather than directly handling and managing the capital, it limits their own development (because they cannot build their own financial sustainability by holding the capital on their balance sheets) which in turn effects the impacts they can achieve;
3. CSOs have most of the social sector skills – and the financial organisations have most of the financial skills. It has been difficult to synthesise the two skill sets or to exchange capacity-building across the two different sectors. Therefore, for example, the capacity of financial institutions to directly engage with people who are excluded has not been built which could make the longevity and structural nature of change somewhat tenuous;
4. The approach assumes that welfare responses are the only viable responses for addressing the financial exclusion of individuals. This means that innovative or market-based approaches have not been adequately explored. Nor have approaches that could open up a range of new sources of capital beyond grant funding and philanthropic funds to support the work of addressing financial exclusion; and
5. CSOs can play a role in addressing the needs of financially excluded individuals. However, this is not the most appropriate structure through which to examine and develop responses to the financial exclusion of community organisations, non-profits and social enterprises. Provision of capital and addressing the financial needs of these entities is not, for the most part, the core mission of CSOs and is probably also outside their area of expertise.

In order to address this situation and truly engage with the issue of financial exclusion in Australia, we need more than **new** initiatives using **old** approaches.

The emerging field of social innovation has shifted thinking so that the focus is no longer the ‘burden’ of market failures, but rather, the various opportunities that can be harnessed to address these market failures. With careful appraisal of the actual nature of and assumptions underlying market failure, ‘new markets’ could be developed which offer opportunities for innovative responses to seemingly intractable and complex problems. Wolk (2007) suggests that there are three approaches to market failure:

Approach One: No Market	Approach Two: Limited Market	Approach Three: Social Market
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The **first approach** is to equate all market failures with the immediate need for a welfare response as the only option. From this approach market failure occurs because there is ‘**no market**’ and “the beneficiaries of the potential product or service will not be able to pay for it” (Wolk, 2007;p18). From this approach the only

response is to harness public funds to address the situation. This thinking underpins many approaches to addressing financial exclusion. That is, it is assumed that if people or organisations cannot afford to pay mainstream or commercial prices for financial services or products, then the only alternative is to offer products that are no cost or at the very least low cost. Examples include loan products with no interest, or the pursuit of philanthropic or gift funds to support third and fourth sector organisations to grow as the only option for capitalising such organisations.

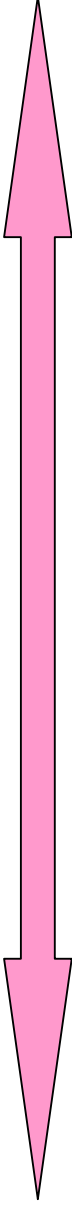
The **second approach** is to examine possibilities for some kind of cost recovery mechanisms to compensate for the provision of specialist services to certain sectors, whilst also relying on blended funding to support the ongoing sustainability of initiatives. This approach explores the possibility of any kind of **'limited market'** in which beneficiaries "have some ability to pay" (Wolk, 2007;p18) and therefore add to revenues that could support any response. This approach is increasingly used by non-profit groups, sometimes funded philanthropically by corporates. It often results in special products for people, organisations and groups who are excluded. These products have nominal charges attached to them. An example is a social loan where some interest is charged but this does not reflect the true cost of the product which is also subsidised through grant or gift funding.

The **third approach** is to explore opportunities for social innovation and explore possibilities for a **'low-profit market'** in which beneficiaries have the potential to pay back a loan; or, income can be generated in ways that ensure a profit or surplus, though this may be at below market rates. Often these markets are underdeveloped because for-profit entities do not wish to expend resources on them and/or investments in the market "yield returns that are less than typical for for-profit ventures" (Wolk, 2007;p18). This creates opportunities for the development of social businesses that may not be interested in maximising profit but which focus on generating a surplus to build the business but seek most importantly to maximise social returns or impact. Examples include the social investment work of Foresters Community Finance which offers loans to non-profit organisations that are unable to access such loans from mainstream financial institutions for the purposes of asset building. These loans attract a commercial rate of interest and are capitalised by social investors who receive a financial return (which is steady but below market in nature) but who also look for a high social return on their investment. The fact that there are both realities and perceptions at work in our determination of what constitutes a market failure needs to be added to Wolk's (2007) analysis of these different approaches.

Within Wolk's three approaches it is necessary to unpack the complex interplay between reality and perception when it comes to addressing market failures. There is no doubt that there are areas of financial exclusion where we could say there is complete market failure. This includes situations where there are no possibilities for, or where it would be exploitative to, attempt to develop a market response to people's situations. For example, emergency relief for people experiencing severe unexpected financial stress or hardship is an appropriate welfare response to complete market failure. However, there are also assumptions made and conclusions drawn about the nature and extent of market failures which can prevent us from seeing and exploring other options.

It should be noted that in the area of financial exclusion, market failure has also been approached from a fourth perspective – that is, the development of an alternative market. Unfortunately this has been based on the fact that people will pay much more than the mainstream market asks in order to gain access to capital. This approach has led to the development and growth of an exploitative and often

predatory alternative market where those excluded from mainstream finance pay extraordinary costs and endure difficult conditions in order to access credit and other financial services. The following table examines some of the complex terrain between reality and perception as it applies to market failure.

<p>Reality</p>  <p>Perception</p>	<p>Complete Market Failure – there is no realistic opportunity to develop any kind of market around the issues / exclusions and the only viable response is a welfare response requiring public funding and/or philanthropic responses.</p> <p><i>Example:</i> Emergency relief for people experiencing financial distress.</p>	<p>Partial Market Failure and the need for blended funding approaches – there is some realistic opportunity to develop cost recovery products whereby lower than market rates apply to products to add to the mix of how they are paid for</p> <p><i>Example:</i> Many social enterprises, particularly in early stages, are not viable on purely commercial grounds, but with a mixed or blended revenue and investment, they can achieve a level of financial sustainability whilst maintaining high impact on their social objectives.</p>	<p>Social Market Innovations exist where products and services can be developed to ensure both financial sustainability and maximum social impact into the future. The surplus and the returns generated are not equivalent to those achieved by commercial entities but they include the delivery of high social returns on investment.</p> <p><i>Example:</i> Foresters' social investment work enables investment into the Third Sector with stable financial returns and significant social impacts.</p>
	<p>No 'Market</p> <p>There is an assumption that there is no market, but this has not been examined or tested.</p> <p><i>Example:</i> Mohammed Yunus' loans to poor women for micro-enterprise, overturned the assumption that they could not repay the loans. The Grameen Bank has demonstrated that the assumption was false.</p>	<p>Limited Market</p> <p>There is an assumption that a limited market exists or is the only option into the future.</p> <p><i>Example:</i> some microfinance initiatives have assumed that people accessing such products will always need access to non-mainstream products and services. Numbers of experiments have now demonstrated, however, that as people's capacities, confidence and economic well-being change over time they can use alternative products as a stepping stone to mainstream products.</p>	<p>Social Market</p> <p>There is an assumption that all conditions need to be altered in order for social markets to succeed – but this is not always the case and needs to be tested in each scenario. Financial and social modelling can assist.</p> <p><i>Example:</i> It is often assumed that non-profit organisations cannot repay commercial loans, when the work of Foresters over the past 15 years has clearly demonstrated that this is not the case if the loan conditions are structured appropriately.</p>

From this analysis it is clear that welfare and philanthropic responses continue to be necessary and should be grown and adequately funded. What is also clear is that the second and third approaches have been grossly under-explored in the Australian context. These are the approaches that suggest that there may be market and innovation-based responses to financial exclusions that could be developed and sustained to complement and build on the welfare and philanthropic responses.

Examining opportunities to develop responses based on the second and third approaches could open new innovative spaces in which to explore and address the root causes of financial exclusion in Australia. These new spaces will require thinking beyond the role of each of the traditional sectors – though each of these will need to play a role in the innovation. Rather, the new space will need to address some of the shortcomings of current responses to financial exclusion, in particular:

- **Building scale into responses.** If there is to be a concerted effort to address financial exclusion in Australia, there either needs to be large-scale investment into a thriving and diverse range of local organisations, and/or capacity needs to be built for larger scale initiatives that can respond to the diversity of needs at the level of personal finance, investment in civil society organisations and social/micro enterprises;
- **Providing a structural mechanism for effective and long-term cross sector partnerships.** Currently, cross-sector partnerships are quite weak and often more akin to contract or service delivery arrangements rather than a synthesis of strengths and skills. Effective cross-sector partnerships require a structure and environment in which each sector and all stakeholders can work together. Currently there is no enabling policy/regulatory framework for this to happen, nor an effective organisational structure through which this can happen. The right structural mechanism could enable each of the sectors to enjoin their key strengths to address the issues of financial exclusion. This could happen with the development of particular organisations whose role is to catalyse and synthesise the strengths and skills of each sector;
- **Providing a structure or organisation that can dedicate itself to sit in the complex space between exclusion, poverty and the financial world.** Traditional welfare organisations often cannot sit comfortably in this space – but neither can the mainstream financial institutions. The appropriate organisations need to fully understand and appreciate the nature of financial exclusion, but be able to also understand and be prepared to innovate around financial mechanisms to address these issues. Effectively what is needed is ‘fourth sector organisations’ that can blend social and financial skills, analyses and approaches;
- **The capacity to advocate for an enabling and engaged regulatory and policy framework** which openly and specifically addresses the complexity of financial exclusion in Australia, and canvases a range of possible structures, mechanisms and organisational forms that could support the blending of non-profit values with innovation and enterprise.
- **Enabling the flow of new capital and investment into explorations of innovative approaches to financial exclusion across individuals, organisations and enterprises.** Effectively, the new space represents the opportunity for the development of new intermediaries that can join entities that have capital and those that are able to mobilise this capital to effectively address financial exclusion.

In summary, the gaps in this space need to be filled with new and innovative approaches to addressing financial exclusion. This is not to suggest in any way that current initiatives should be replaced or abandoned. Rather, we should ask how we can build on and learn from these current responses to innovate and diversify responses.

The following table summarises how we can build on current realities towards innovative responses – but again, this should not be interpreted in an ‘either-or’ manner, rather, it could and should be thought of from a ‘both/and’ position.

Starting From and Strengthening: (the current reality)	Building Towards: (further innovations)
<p>Generalist Responses Most responses are offered by generalist community sector and welfare organisations as programs or projects – they are part of much more general programs of these organisations.</p>	<p>Specialised and Synthesised Responses Organisations and structures that have a core focus on addressing financial exclusion and can work in partnership with more generalist organisations as part of a holistic response. The response needs to synthesise knowledge and skills from the social sectors and from the financial sectors.</p>
<p>Exploratory Cross-Sector Partnerships Many responses have benefited from cross-sector partnerships but these partnerships are somewhat tentative and exploratory.</p>	<p>Strong and Enduring Cross-Sector Partnerships Cross-sector partnerships need to be strengthened and lengthened. They must involve robust and vigorous dialogue and action rather than centre on donor-recipient power relationships and funding arrangements.</p>
<p>Third Sector Responses The key players in the actual delivery of services to address financial exclusion are third sector organisations (CSOs) funded by government and corporations.</p>	<p>Fourth Sector Responses Fourth sector organisations could synthesise the skills of the social and financial sectors to create innovative, market aligned responses to financial exclusion, which could add to the diversity, scale and impact of the current responses.</p>
<p>Benign and ad-hoc regulatory and policy environment There is some interest from policy stakeholders in addressing financial exclusion – though this is often only conceived of as relating to individuals. There is no consistent or structured policy or regulatory framework around financial exclusion and particularly, no regulatory framework which could ‘force’ financial institutions to disclose and act on addressing this exclusion.</p>	<p>Enabling and Engaged Policy and Regulatory environment Policy interest in financial exclusion could be strengthened at all levels of government. It is particularly important to provide some structural and probably regulatory incentives so that mainstream financial institutions act on financial exclusion and disclose this action publicly.</p>

<p>Welfare, funded and philanthropic Approach Approaches are dependent on grant and philanthropic income to build and sustain the work.</p>	<p>Investment Approach Explores all the ways in which capital could be sourced to develop and sustain the work and to build scale and impact. This approach could initiate flows of capital which over time build the possibility for independent sources of income.</p>
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Finally, innovative responses require more diverse structures and broader opportunities for the sourcing of capital so that market failures can be addressed in the fullest sense. In order to explore innovative and social market approaches to address financial exclusion, a more integrated and robust set of structures needs to be added to the current mix of responses. One way to do this is to open up a space for the further development of intermediary structures where social and financial skill sets can be synthesised. Most importantly this space needs to be able to directly hold, pool and manage capital from a variety of sources such that it can be directly applied to address financial exclusion of individuals, organisations and enterprises.

“Intermediaries: Organisations that collect capital from multiple sources and reinvest it in people and enterprises...”
(Cooch and Kramer, 2007;p5)

Creating Intermediaries to link finance and social sector skills:

New organisations (fourth sector organisations) which synthesise skills from social and financial sectors in order to develop appropriate products and services for people, groups and organisations who are excluded from mainstream institutions.

These organisations will have the capacities and structures required to bring new capital into previously excluded markets. New capital could include investment, equity, and debt capital and could flow into the intermediaries from financial institutions, government, private investors, organisations or foundations.

Intermediaries will ensure that the flow of capital into excluded markets is appropriate and sustainable and will result in maximum social impact. They will also have specialised expertise that links financial and social sectors, which:

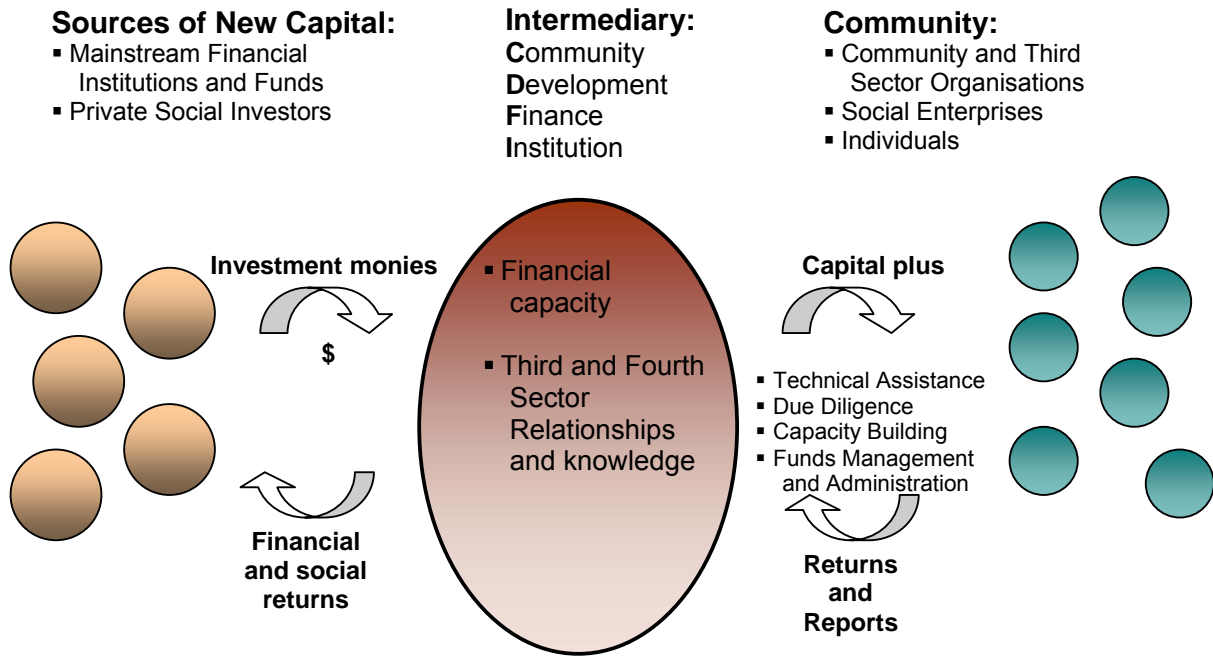
- reduces the costs and risks associated with using capital to address a market failure,
- delivers real and measurable levels of social impact through financial mechanisms; and
- reports on both financial and social performance.

Intermediaries will have the capacity to hold capital that flows into them to re-invest it in people and organisations excluded from mainstream finance.

Fostering intermediary organisations could open up a broader range of responses to financial exclusion that could adequately and appropriately explore limited market and social market responses. Additionally they could broaden the ways in which

capital could be utilised to address financial exclusion in all its forms. This could, for example, lead to the development of investable models for addressing financial exclusion, and options for accessing equity and debt capital to address the exclusion of organisations and enterprises. This in turn could radically alter the depth and breadth of what is possible in relation to addressing financial exclusion in Australia.

Intermediaries: The Missing Link Between New Capital and Communities



Based, in part on Cooch and Kramer, 2007, p12

The remainder of this paper will argue that this new space in Australia could be occupied by 'Community Development Finance Institutions' (CDFIs) – which have effectively contributed to addressing financial exclusion in the UK and US, but which are in their infancy in the Australian context, with only a handful of such organisations in existence.

6. Community Development Finance Institutions: What are they and what role could they play?

Community Development Finance Institutions:

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.

CDFIs do this by:

- Providing specialised financial services appropriate to people, groups and organisations excluded from mainstream services;
- 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);
- Fostering community economic development in disadvantaged and underinvested communities;
- 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;
- Developing innovative financial mechanisms that facilitate financial inclusion of individuals, organisations, and enterprises.

CDFIs are independent organisations that focus on developing financial services and products specifically designed to redress financial exclusion of individuals, groups, organisations, enterprises and communities. They are 'fourth sector' organisations, blending the strengths of business, civil society, and government in order to address intractable or multi-dimensional issues. They are often but not always non-profit in nature, but they also strive to create surpluses, move beyond 'charity' models and generate both social and financial returns for investors **and** for the communities they serve.

CDFIs occupy the space between formal, mainstream financial institutions such as banks and credit unions, and civil society organisations, community and social service organisations. CDFIs are not usually registered banks or credit unions, but are independent financial institutions that specifically focus on addressing the market failures of the mainstream financial service providers.

They may be regulated under some parts of the financial services regulation, but they are not generally deposit taking institutions, and do not neatly and clearly fit into any current regulatory space. In the UK and the US CDFIs have emerged with the support (and to some extent the encouragement) of regulatory bodies. They are not exempt from all regulations, but the regulators see the need for some flexibility and grace as the sector develops. It may be the case in the future that CDFIs will have their own or some form of blended regulatory regime, but the important thing to note for the Australian context is that the sector cannot develop without some understanding and engagement from the financial regulators.

CDFIs utilise financial tools and mechanisms to promote investment, economic development and social infrastructure in underinvested communities. In particular, CDFIs promote lending and investment in areas and regions that are underserved by mainstream financial institutions. They are a means through which individuals, microenterprises, community organisations and social businesses can access loans, financial services and training in order to promote growth, renewal or sustainability. CDFIs are designed to use financial tools and skills to build employment, strong community and civil organisations, enhance confidence and strength in areas that have traditionally been neglected or underserved by mainstream banks, investors, governments and businesses. CDFIs focus primarily on addressing the market failures that underpin financial exclusion. Some, but not all also turn their attention to capability and capacity issues related to financial exclusion (see appendix five for an overview of the different ways in which CDFIs can engage with capacity building).

Community Development Finance is a broad umbrella and CDFIs are a diverse group of institutions – different CDFIs focus on different communities, on different issues faced by people and groups who are excluded from mainstream financial institutions and have different visions about how financial tools can be used to grow wealth in disadvantaged communities. Some CDFIs are designed to build assets in communities and with community organisations (such as Foresters Community Finance), others focus on providing capital for microenterprises, and others are much more like community credit unions or microfinance institutions, lending to individuals and providing basic banking services for people on lower-incomes.

Focus of the CDFI	Functions / Purpose
Microfinance and Personal Finance	Alternatives to predatory or exploitative lending – focus on amounts under \$5000
Third Sector (Community, Social Service and Civil Society Organisations) Finance and Support	Support, education and capital for organisations that are excluded from mainstream lending. Capital can be used to build assets, as working capital, development or re-development capital, or to establish affiliated innovative enterprises or programs.
Social and Micro Enterprise Finance and Support	Support and capital for establishment and growth of micro and social enterprises – job creation and sustainability in local communities.

Community Development Finance Institutions (CDFIs) are now common place in the UK, Europe and the United States. In Australia the CDFI arena is very small, but there is enormous potential for growing this sector as we begin to realise the important influence that financial institutions can have on local development. The factors which will influence a growth in CDFIs in Australia include:

- Recognition of the important role that finance and financial institutions play in community development, and a broader recognition of financial exclusion of individuals and communities in the Australian context;
- Policy and regulations which support the development of CDFIs as a legitimate vehicle for enhancing community investment and building social infrastructure, particularly in disadvantaged communities;
- Discussion, debate and practical initiatives focused on how CDFIs can be initiated and grown in Australia and how this could be funded;

- Increased support for the few CDFIs that currently exist in Australia and publicity around their successes in promoting social enterprise, addressing financial exclusion and engaging in community investment.

It is unfortunate that in Australia definitions of Community Development Finance have become unclear due to inappropriate and/or misleading usage of the term. Banks have labelled their CSR initiatives ‘Community Development Finance’, the term has been confused with ‘microfinance’ initiatives (which constitute only one part of CDF), and organisations associated with developing the business capacity of the non profit sector in Australia have wrongly referred to themselves or been labelled ‘Community Development Finance Institutions’.

This has resulted in a ‘muddying of the waters’ in relation to the core attributes of CDFIs – they are **independent financial institutions**, focused both on the arena of microfinance and personal finance, and on the broader goals of ensuring access to financial services and products by those groups and organisations excluded from mainstream services. They stimulate the economic development of under-invested and excluded communities. In Australia the following organisations could currently come under the banner of CDFIs.

Focus of the CDFI	Australian Examples and Gaps
Microfinance and Personal Finance	<p>The Fitzroy Carlton Credit Cooperative probably fits most clearly into this space – it has developed savings and credit products that are clearly targeted at people on low and fixed incomes and/or who have difficult credit histories. There are also examples of Government organisations supporting some financial needs of Indigenous Australians, such as Indigenous Business Australia which provides home loan products to Indigenous people.</p> <p>In relation to personal finance generally, there remains a big gap in this space in terms of independent financial institutions – most of the work in this space has been undertaken by welfare and social service organisations in partnership with big banks.</p> <p>An initiative by Foresters Community Finance to develop an ethical, non-profit personal finance company that is in direct competition with fringe and predatory lenders is potentially the closest Australia has come to the creation of an independent, non-credit union CDFI working in the microfinance / personal finance space.</p>
Third Sector (Community, Social Service and Civil Society Organisations) Finance and Support	<p>Foresters Community Finance is the only CDFI in Australia operating in this space. It lends capital and support to third sector organisations in order to build their asset base, grow their independent income base and develop resilience from funding policy shifts.</p> <p>Although Bendigo Banks’ Community Sector Bank was initially conceptualised as a kind of CDFI to support the community sector, it has not been able to fulfill this role in the same way as a CDFI could because it is hampered by banking regulations and internal banking policies. Therefore, while it has succeeded in fulfilling some basic banking functions for community sector organisations, it has</p>

	<p>not been able to develop loan capital and investment products to meet the needs of this sector.</p> <p>Maleny Credit Union could also be considered to have undertaken some work in the space of Community Development Finance. In the past as it has supported the economic development of the Maleny region. However, due to the current regulatory restrictions on credit unions, the potential for Maleny Credit Union to further this work has been considerably curtailed.</p>
Social and Micro Enterprise Finance and Support	<p>While there are some government programs who lend for enterprise development (eg. Indigenous Business Australia provides loans for Indigenous enterprise development), and some private sector lending in this space (eg. NAB's microenterprise loans), there are currently no independent financial institutions working in this space in Australia.</p> <p>Opportunity International undertook some pilot work in Indigenous communities around the Northern Rivers Region that could have developed into a CDFI but was discontinued.</p> <p>Social Ventures Australia is in the process of establishing a Social Enterprise Fund which could potentially operate as a CDFI (though at this stage its structure and operations remain unclear). Foresters Community Finance is currently undertaking action research into the capital and finance needs of social enterprises and will use this research to develop a range of appropriate financial products for social enterprises.</p>

If CDFIs were further developed in Australia, a range of market-based possibilities could be opened up that could complement the current welfare responses and the 'limited market' responses that have emerged from CSR and Corporate-Community partnerships around financial exclusion. This could also help to counter and provide a very real and scalable alternative to the fringe markets that are often exploitative. It may even stimulate the mainstream financial institutions to engage more structurally and sustainably in addressing financial exclusion. The table below outlines how the landscape of organisations addressing financial exclusion could be broadened with the development of a CDFI sector in Australia.

Banks, Credit Unions, Other mainstream financial institutions	Mainstream Market
Fringe Lenders, Exploitative Micro-lenders, Cheque Cashers, Pawn Brokers, Pay Day Lenders	Fringe Market
Potential for CDFI Development	Social Market
Currently occupied by small number of cross-sector partnerships operating for example, Low Interest Loan products. Further potential for CDFI development – or CDFIs and CSOs in	Limited Market

partnership.	
Community Sector Organisations	No Market – Welfare Response

The development of a strong and identifiable CDFI sector in Australia could lead to the creation of responses to financial exclusion that are both diverse and broad. Ultimately they would have a significant impact on resolving the causes and addressing the consequences of this exclusion. The next section outlines some of the functions of CDFIs in the UK and the US that could help further the development of the sector in Australia.

7. Community Development Finance Institutions in the UK and the US

In the US Community Development Finance Institutions have existed since the Johnson administration launched the ‘War on Poverty’ in the 1960s, through which Community Development Corporations (CDC) were initiated⁷ to enable capital to flow to small business and affordable housing in low-income localities. These effectively created the foundations of the CDFIs of today, and CDCs are now recognised as a type of CDFI. Financing of the CDFI sector was strengthened in the 1970s when an enquiry into the underinvestment of banks in low-income communities resulted in the Community Reinvestment Act (1977)⁸, though CDFIs did not officially qualify as a CRA activity until the mid 1990s. In the 1990s the CDFI industry flourished and expanded rapidly through the development of a CDFI Fund by the US Department of Treasury, which was designed to strengthen and provide capital to CDFIs to stimulate their growth and channel capital to underinvested communities. The strengthening of the CRA in the mid 1990s also ensured that investment into CDFIs qualified as a CRA activity which led to much greater investment in the sector from mainstream financial institutions. These changes and the resultant success of the sector started to attract other sources of investment and funding into CDFIs. There are now over 1000 CDFIs in the USA comprising community development loan funds, social venture capital funds, community development credit unions and community development banks. Appendix three outlines the six types of CDFIs that operate in the US.

In the UK the CDFI sector has emerged and been strengthened over the past decade. Its foundations and roots have a much longer history extending back to the cooperative and credit union movements. In 2000 the Social Investment Task Force, initiated by the Blair Government, presented its report *Enterprising Communities: Wealth Beyond Welfare* to the Chancellor of the Exchequer (who then was Gordon Brown). This report set out a series of recommendations to build and strengthen a CDFI sector in the UK, including recommending tax credits for community investment, bank disclosure of lending in under-invested areas, greater support for CDFIs including the establishment of a CDFI trade association, the establishment of

⁷ Some argue that the roots of the CDFI industry go back much further in the US to the deposit taking institutions that emerged in local communities in the early 1900s to collect savings in localities that could be used to deliver capital back to consumers and businesses in those same communities (see for example, CDFI data project, <http://cdfi.org/index.php?page=datapoint-c>).

⁸ Of course some forms of CDFI such as the Community Development Credit Unions operated successfully for much longer and can be traced back to the 1800s.

a community development venture fund, and the provision of greater latitude for investment by charities and foundations in relation to community investment and community development activities. A timeline outlining the activities since this point is included in Appendix Two.

The impact of the CDFI sectors in both the US and the UK has extended from community revitalisation to affordable housing, small business development, job creation, community asset building, microfinance, fair personal finance, community economic development and social enterprise development. Key learnings from the development and growth of the CDFI sector in the US and UK are outlined in the table below:

Key Learnings	Explanations
Enabling policy / legislative / regulatory framework.	<p>There is a need for an enabling policy and regulatory environment for the development of CDFIs –which is flexible, responsible, visionary, and innovative and which has a focus on addressing financial exclusion.</p> <p>Important initiatives that have fostered the growth of CDFIs are centred on the development of:</p> <ul style="list-style-type: none"> - investment ‘encouragers’ such as tax mechanisms that reward investors in CDFIs. - Regulatory ‘enforcements’ such as disclosure mechanisms about bank’s performance in relation to financial exclusion
Realistic development approaches and timeframes for building sustainability and growing a CDFI sector	<p>The UK CDFI sector has experienced rapid growth over the past few years. However, a recent New Economics Foundation report suggests that it is crucial development timeframes be realistic to ensure the long term sustainability of the sector (see Nissan, 2008)</p>
Asset Based models for CDFIs	<p>CDFIs need to be able to build their own sustainability in addition to ensuring adequate capital flows into underinvested markets. This means that they need to build their balance sheet assets in addition to offering a range of products that assist them to diversify and reduce risks.</p>
Capacity to attract a diversity of sources of capital and funding	<p>Government and philanthropic funding is important but needs to be carefully considered and aimed at enabling longer term viability of the CDFI sector.</p> <p>Mixed funding and investment is the most viable way to ensure the future of CDFIs. Blended funding models need to be considered but with enough control in the hands of the CDFI to ensure innovation and entrepreneurial drive.</p> <p>Incentives for private investors and social investors to invest in CDFIs are important policy considerations, but they need to be made effective rather than merely rhetorical.</p>
Development of	Banks and large financial institutions can play a crucial

partnerships opportunities with banks and other financial institutions	role in the success of the CDFI sector. If this is not voluntarily engaged in by the banks, a local version of the CRA (Community Reinvestment Act) which incentivises banks to engage with financial exclusion and CDFIs should be considered.
Need for ideological and paradigm shifts...in all sectors to ensure open and exploratory responses to CDFI development	This requires shifts from: <ul style="list-style-type: none"> - Grant-making to Social Investment - Charity to Enterprising Solutions - Dependence to Interdependence and genuine cross-sector partnerships
A peak body and CDFI champions at political and business levels are crucial – particularly at the early stages of the development of this sector.	Seed funding would facilitate the development of such a peak body. A peak body with a well-known patron or champion could lead the development of the sector in Australia as has been the case with the CDFA in the UK under the patronage of Sir Ronald Cohen.
Need for good evaluation tools for the sector. Sustainability must be considered holistically. SROI measures and frameworks for engaging with the changes are needed.	Quality research needs to be undertaken to ensure the validity and comprehensiveness of evaluation tools. There are currently a number of social impact and Social Return on Investment (SROI) tools available but they are under developed and under researched.

The CDFI sector does not need to be invented in Australia. Neither do we need to import the foundations of a sector from either the US or the UK. There are a number of key organisations and institutions who could form the founders of the sectors and from whom we can learn and grow a thriving sector in Australia. These organisations currently cover five core areas as outlined in the table below.

Types of CDFI that could be built / strengthened in Australia:

Type of CDFI	Core Business	Actual or Potential Regulatory Framework in Australia	Australian, US and UK examples
Social Banks	Provision of capital to underserved markets – communities and/or individuals, through financial services, products and targeted loans and investment.	Federally regulated: Banking license and banking regulations, sometimes with some incentives, exemptions or relaxations.	Australian: There is a big gap in this space. CSB (Bendigo) had the intention of filling this space but has not done so in any real sense beyond deposit taking. UK: Triodos, Charity Bank. US: Shorebank
Community Development Credit Unions	Provision of financial services to people living in underserved communities, people living on low incomes	Federally regulated under Banking Act, through APRA.	Australian: Fitzroy-Carlton Credit Cooperative UK: Southwark Credit

	and people excluded from mainstream financial services. They provide fair, accessible and safe alternatives to predatory lenders.		Union US: ASI FCU, Lower East Side People's FCU
Social / Community Investment Funds	Hold and pool the money of private and institutional investors to reinvest into underserved communities and / or organisations.	Regulated under ASIC. Some exemptions are possible for loan funds with charitable purposes.	Australian: Foresters Community Finance UK: Future Builders US: Calvert Social Investment Foundation; Chicago Community Loan Fund
Enterprise Loan Funds	Provision of loans and financial services to microenterprises, social enterprises and social/eco businesses.	Regulated under ASIC and/or credit codes.	Australian: Foresters Community Finance is exploring this territory but nothing is offered at this stage. UK: Bridges Community Ventures Ltd; London Rebuilding Society Social Enterprise Fund. US: ACCION USA
Microfinance / Personal Finance Providers	Provision of small personal and enterprise loans to individuals who are excluded from mainstream financial services. These providers could compete directly with predatory lenders and represent a fair alternative.	Regulated under consumer credit codes.	Australian: Fair Finance Australia is under construction but not operational at this stage. UK: Fair Finance UK

8. Conclusion

The uncertainties and difficulties of the past year have highlighted the key role that financial institutions and financial regulators play in our economies and ultimately, in the stability of our societies. What has also been highlighted is the need for responsible, fair and sustainable financial services – particularly for those parts of our society who are underserved by or excluded from the mainstream financial institutions. Whilst some focus has, over recent years, been given to individuals who experience financial exclusion, Australia remains a long way behind other developed economies such as the United Kingdom and the United States in tackling the depth and breadth of financial exclusion. The development of a strong and independent Community Development Finance Sector in Australia could go a long way to beginning this task. This will, however, require more than piecemeal policies and discrete actions within each of the sectors. It will require “joined up solutions to joined up problems” (Swan, 2005) – rigorous debate, courageous conversation, true

cross-sector partnership and an investment in the development of a sector that currently exists in only a skeletal form in this country. We can certainly learn from what has happened elsewhere, but we must also realise that the challenges we face here are very different in nature to other contexts and we must therefore be bold enough to recognise how a number of small home-grown initiatives could lead the way for a unique and innovative CDFI sector that is truly Australian. There is much to be done, but the beginnings are there and the future awaits us.

Appendix One: Brief Case Studies of Different CDFIs in the UK and US

Personal and Micro Finance focused CDFI
<p>Fair Finance UK www.fairfinance.org.uk info@fairfinance.org.uk East End Fair Finance Limited (trading name Fair Finance) is incorporated under the Industrial and Provident Societies Act 1965 and registered by the Financial Services Authority.</p>
<p>Fair Finance offers affordable, flexible and accessible personal and micro-enterprise loans to individuals in direct competition to loansharks, finance companies and fringe lenders who charge much higher interest rates than mainstream lenders. In addition to loan products, Fair Finance operates a financial and debt advice service and conducts research and advocacy in relation to addressing unfair practices, and developing sustainable, fair alternatives.</p>

Micro-enterprise focused CDFI

ELSBC: East London Small Business Centre

www.goeast.org

elsbc@goeast.org

Purpose: "To increase social wealth and mobility through the stimulation and support of micro-enterprises and small businesses across East London".

ELSBC operates a number of loan funds that provide capital for start-up and existing microenterprises and small businesses in particular boroughs in East London who are not eligible or able to access finance from mainstream providers. They do not merely lend to enterprises but work with them to support each enterprise's development, build the capacity of the people running the enterprise and thereby hopefully ensure the long term sustainability of the enterprise.

The loans are up to £20,000 for start up enterprises and up to £50,000 for established businesses. These loans are repayable over a maximum of 5 years and are offered at a less than market interest rate, or what the CEO of ELSBC termed a 'morally appropriate interest rate'. ELSBC also operates funds for short term loans for production capital, Muslim business lending, and staged lending to people working in home-based businesses. Often loans are unsecured, but the process of applying for and getting a loan ensures that there is sufficient confidence in the enterprise to warrant a loan. The process involves linking the business owners with a 'business counsellor', working with the owners to develop a business plan (which may involve attendance at a business training course), and having a panel assessment of the completed business plans prior to loan approval. ELSBC also offers access to business space and ongoing business support and training.

Since its inception in 1978 ELSBC has helped over 12,000 new businesses begin. Since the loan program began in 1987 ELSBC has lent over £8 million to microenterprises and small businesses in East London. The majority of ELSBCs income comes from grant funding (around 70% from the London Development Agency), though there has been a growing base of private sector supporters.

Social Enterprise focused CDFI

Local Investment Fund (LIF)

www.lif.org.uk

“Our vision is to support the creation and growth of financially viable social enterprises especially in deprived areas where regeneration is a priority. We do this by providing loan finance to Social Enterprises who cannot raise funds from normal High Street lenders”.

LIF is a CDFI specialising in lending to social enterprises. It is focused on finance-only model and has purposely steered away from offering advice, support and capacity-building to social enterprises. LIF is a registered charity, established in 1995 with £1million from the Government, and a £300,000 interest free loan from NatWest Bank. It has loan managers in five regions across England. Its aim is to create a commercially sustainable fund that can fill a market-failure niche, ie. lending to social enterprises. Currently the size of the fund is £3.1million, its average loan size is £50,000 and it has a current portfolio of 76 clients. Interest is charged on a commercial basis.

LIF measures its social impact analysing its portfolio:

- the proportion of borrowers turned down by mainstream lenders;
- the proportion of loans into deprived areas
- the proportion of loans serviced without financial hardship.

LIF's portfolio includes enterprises in the following areas:

- community transport, community laundry, community security;
- heritage centres and museums;
- care – mental health, aged care, childcare, care of people with disabilities, health education and disability equipment;
- farming, food cooperatives, food production, food and drink services;
- community / local enterprise facilities, workspaces, artist studios, community meeting centres, social enterprise support and consultancy;
- recycling and charity shops, eco-businesses;
- housing
- direct employment and training for people excluded from mainstream employment;
- arts-based enterprises, leisure activities and sports.

Social Enterprise / Third Sector focused CDFI

London Rebuilding Society (LRS)

www.londonrebuilding.com

info@londonrebuilding.com

London Rebuilding Society's Aims:

- to provide London with a permanent, independent CDFI
- to lend and provide support to social enterprises and businesses with social objectives;
- to make a real impact on regeneration initiatives.

LRS lends and offers support and advice to organisations and enterprises that are not able to borrow from mainstream providers. It is an Industrial and Provident Society, and though most of its revenue to date has been from grants, it is working towards enhancing and diversifying its revenue stream and thereby moving towards financial sustainability. LRS lends to social enterprises, ethical enterprises, third sector organisations, and for the purposes of asset building, working capital and bridging finance. LRS has also developed a social co-ownership scheme for equity releases for home repairs for people living on low incomes but who have substantial equity in their homes. Through LRS's Social Enterprise Fund loans are made to social enterprises, community sector organisations and charities with revenue streams and capacity to repay loans with interest and charges. Loans are mostly between £5,000 and £50,000 (though larger loans are possible in partnership with other lenders), and an interest rate of between 6% and 12%. LRS will provide capital for start-ups but only to a maximum of 50% of start up capital needs. LRS has tried to address what they see as a huge problem with access to finance right across the third sector, social enterprises, cooperatives and the regeneration arena.

Loans are assessed on the basis of social impact and relationship rather than credit scoring. Solid relationships are necessary and LRS monitors their loans through regular information sharing and visits. The application process requires organisations and enterprises to present a business plan and applications are appraised by an investment team and loan panel. For organisations and enterprises not considered 'investment ready', LRS offers a technical assistance program. They recognise that CDFIs need to develop their market and create pathways to investment. They also work with capacity building partners to support social enterprises, create awareness about CDFIs, build markets and support applicants who are not investment ready. LRS offers the following analysis of the need for diversification of funding and financing for community sector organisations:

- Revenue grants → no capital accumulation
- No capital accumulation → weak asset base
- Weak asset base → high lending risk
- High lending risk → no capital inflow
- Lack of capital → low productivity
- Low productivity → no surplus
- No surplus → grant dependency

Third Sector and Civil Society focused CDFI

Boston Community Capital

www.bostoncommunitycapital.org

“The mission of Boston Community Capital is to build healthy communities where low-income people live and work”

Though it began as an initiative to make loans to non-profits developing affordable housing, it is now an umbrella company operating four non-profit organisations which include a CDFI loan fund, CDFI venture fund and managed asset fund; two CDFI for-profit limited liability community development venture capital funds, and nine for-profit limited liability companies serving as equity investment vehicles – all these entities together are responding to credit and capital needs in low-income communities in Boston and across the US. Its record is impressive – since 1985 Boston Community Capital has committed more than \$250million to low income communities (more than 80% of this in the past five years). This money has created or preserved housing for more than 8,000 families and individuals, strengthened more than 200 community organisations, renovated over 530,000 square feet of inner city commercial space and created more than 1,300 jobs in low income communities.

Established in 1985 Boston Community Capital began with a series of questions:

- Can housing for low income families and individuals be designed, built and managed to remain affordable and well-maintained over time, and help strengthen our communities?
- Can distressed inner-city neighbourhoods be transformed into thriving and welcoming communities that are home to a diverse population of residents who live there by choice?
- Is debt a useful tool to finance the transformation of inner-city neighbourhoods, and can we demonstrate that loan dollars will not only be repaid by also recycled?

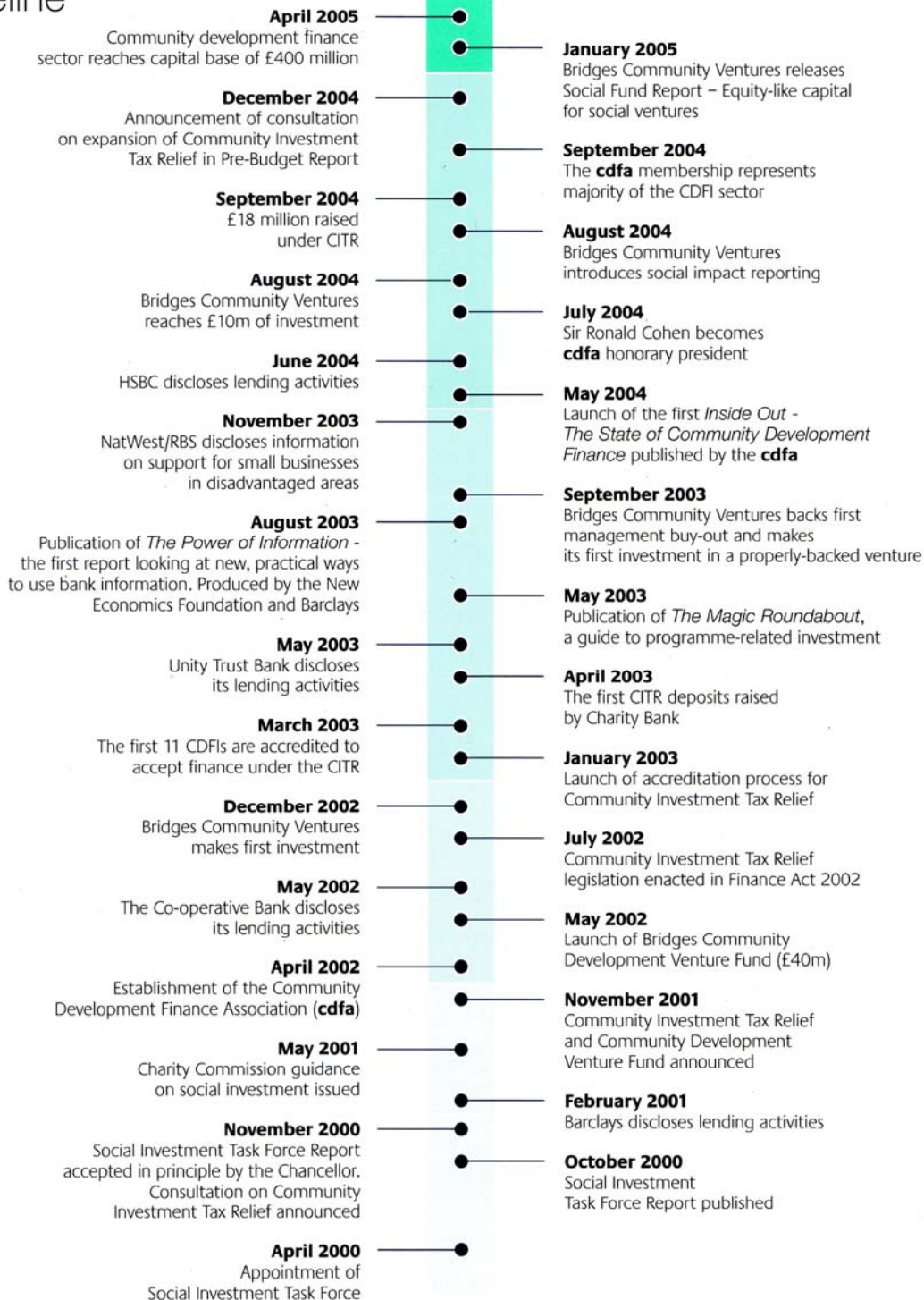
More than twenty years later, after answering ‘yes’ to all these questions, Boston Community Capital is now asking a new set of questions:

- How do powerful regional, national and global trends intersect with community development strategies that are intended to create meaningful and wide-scale economic and social opportunities for low-income people?
- Can we (and should we) expand our services and financing from a focus on organisations to a focus on the unmet needs of individuals, particularly those in emerging communities?
- By building new alliances with new partners in commercial finance, organised labour, education, health and environmental services, and with partners across neighbourhood, state and even national boundaries, can we magnify our impact to substantially address the housing, economic development and educational needs of a changing demographic?

(From Boston Community Capital Strategic Plan, Fall, 2006).

Appendix Two: UK CDFI Development Timeline:

timeline



From: Social Investment Task Force Report to the Chancellor of the Exchequer, *Enterprising Communities: Wealth Beyond Welfare*, 18th October, 2000, London.

Appendix Three: Types of CDFI operating in the USA

	Purpose	Sources of Capital	Borrowers	Governance and ownership	Regulators
Community Development Banks	To provide capital to rebuild lower-income communities through targeted lending and investment	Deposits (often below market investments) from individuals and institutions; government.	Non-profit community organisations, individual entrepreneurs, small businesses, housing developers.	For profit corporations, stock ownership; community representation on boards.	Federally regulated and insured by the Federal Depository Insurance Corporation (FDIC), the Federal Reserve, the Office of the Controller of Currency, and state banking agencies.
Community Development Credit Unions	To promote community ownership of assets and savings, provide affordable credit card and retail financial services to lower income people with special outreach to minority communities, take deposits and make loans only to members	Member deposit and limited non-member deposits from social investors; government.	Members of credit union (usually individuals)	Non-profit financial cooperative owned and operated by lower-income people (members)	Federally and state regulated; insured by the National Credit Union Administration.
Community Development Loan Funds	To aggregate capital from individuals and institutional social investors at below-market rates and re-lend this money primarily to non-profit housing and business developers in urban and rural lower-income communities.	Foundations, banks, religious organisations, corporations, government, insurance companies and individuals.	Non-profit community organisations; social service providers; facilities and small businesses.	Non-profit, democratic; community investors, borrowers, and technical experts serve on board and loan committees.	Self-regulated except for non-profit (501) (C) (3) regulations and state securities law where applicable.
Community Development Venture Capital Funds	To provide equity and debt with equity features for medium-sized businesses to create jobs,	Foundations, corporations, individuals, government.	Small business in distressed communities.	For profit or non-profit; varied community representation.	Variable, depends on funding sources.

	entrepreneurial capacity and wealth that benefit low-income people and communities.				
Micro-enterprise Development Loan Funds	To foster social and business development through loans and technical assistance to low-income people involved in very small businesses or self-employed and unable to access conventional credit.	Foundations, government	Low-income individuals and entrepreneurs.	Non-profit democratic; in peer lending model, borrower groups make loan decisions.	Regulated by the IRS and grant makers as any other 501 (c) (3) non-profit.
Community Development Corporations	To revitalise neighbourhoods by producing affordable housing, creating jobs, and providing social services to low income communities.	Banks, foundations, corporations, other private support, the government.	Entrepreneurs, homeowners, business owners, consortia of community residents.	Non-profit; formed by local community residents; operated by a volunteer board, community residents are board members.	Regulated by the IRS and grant makers as any other 501 (c) (3) non-profit.

Source: Coalition of Community Development Finance Institutions (USA) <http://cdfi.org/index.php?page=info-3>

Appendix Four: Defining Enterprises: Micro, Community and Social Enterprise in Australia

Microenterprise

A small (usually 1-5 people) commercial venture initiated by an individual, household or family previously excluded from mainstream employment, with the purpose of securing a stable livelihood or improving their economic condition. What distinguishes this from 'small business' development is that those who begin microenterprises usually do so as a means out of poverty or to assist with moving off or supplementing welfare payments. They often do not have the resources that small business entrepreneurs have.

Community and Social Enterprise

Common to all community and social enterprises:

- **Social Objectives are core** to the purposes and focus of the enterprise
- **Limited distribution of profits**...the majority of profits are reinvested in the enterprise and/or an associated social entity.
- **Mixture of capital inputs**...the enterprise is supported through a mixture of grant income / subsidised income and earned income
- **Generation of a social return in addition to a financial return**

Community Enterprise

An enterprise whose focus and purpose is to address local and community issues using enterprising means – could be particular community or relational issues, ecological issues, cultural issues etc. It is focused on a geographic location and the outcomes it is seeking are located in that geographic region.

Type A: Community Objectives and Community Outcomes – the enterprise seeks to address local issues and achieve community outcomes by utilising an enterprising orientation.

Type B: Local Employment Creation – the enterprise seeks to build local employment, particularly focused on building jobs within regional, remote, and/or disadvantaged communities. It may or may not focus on employment creation with people who have been excluded from mainstream jobs.

Type C: Community Wealth Creation – the enterprise seeks to establish local community-owned assets in order to create community benefits and address community issues.

Social Enterprise:

Type A: Social Objectives and Social Outcomes: An enterprise whose focus and purpose is to address a social issue using enterprising means. It could be an enterprise focused on direct social outcomes, such as supported accommodation, care, provision of social service etc. Alternatively it could be an enterprise that has at its core the creation of social outcomes through indirect means (eg. arts practice).

Type B: Employment Creation: Create employment and integrate people who have been excluded from employment into the workforce – if such an enterprise focuses on people who have been excluded from employment because of a disability or health related issues, these enterprises are also sometimes referred to as ‘**social firms**’.

Type C: Social Wealth Generation: An enterprise that is often linked with a non-profit organisation, which has at its core social objectives and which generates a financial return for the non-profit organisation. An example might be the development of a subsidiary of the non-profit which holds an asset base for the organisation focussed on generating sustainable housing for the organisation’s constituents and which therefore generates both a social return and a financial return for the organisation and thereby contributes to the achievement of social objectives. This type of social enterprise **needs to be distinguished from the “enterprising third sector organisation”** which seeks to generate surplus for a third sector organisation through the use of commercial means. An example could be the development of training based on the experience of the non-profit organisation which is then ‘sold’ to other parties in order to generate a profit which can then be used to further the work of the non-profit organisation.

Community and Social Businesses:

A commercial business that has community and/or social objectives at its core. A community or social business, unlike a community or social enterprise, is not capitalised through grants or subsidised income. It is a commercial entity, so all its income is derived from commercial undertakings. It may, however, undertake activities that are non-commercial in nature (or approach issues from a ‘more-than-commercial frame of reference) or conduct itself as a hybrid between the commercial and community / social spheres. A community business is focussed particularly on addressing community and locality issues (for example a community based credit union which focuses on building the economic and financial sustainability of the community and region). A social business focuses more on addressing social issues or achieving social impact (for example, a business that focuses on driving investment into the social sector, such as what Foresters Community Finance is currently doing).



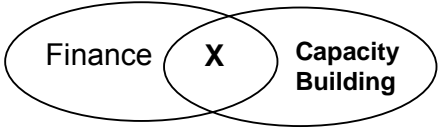
A Community or Social Business can be not-for-profit. However, this does not mean no profit is generated, rather, that any profit is reinvested in the business and ultimately towards the achievement of the business’s social objectives. A Community or Social Business can also be ‘for profit’. However, if this is the case, there must be clearly articulated provisos in relation to the way in which this profit is realised and distributed. First, the profit of a social business must be based on holistic and reasonable returns (incorporating social, environmental and financial returns). Second, there is consideration of the social and environmental costs of generating a profit. Finally, there must be a questioning of where the benefits of the profits flow (in other words, whose wealth is being grown through the generation of profit?).

Green Business / Eco-business:

A commercial business that has environmental objectives at its core. It can be for profit, or not-for-profit. A green business, unlike a social enterprise, is not capitalised through grant or subsidised income. It is a commercial entity, so all its income is derived from commercial undertakings.

Appendix Five: CDFIs and Capacity Building

CDFIs vary in their interpretation of the links between provision of financial services and capacity building. Some will not engage with individuals and entities who do not have the capacity to manage access to capital, and others see it as an integral role of CDFIs to build this capacity. The table below outlines the three most common approaches of CDFIs to capacity building.

 <p>Finance Only CDFIs</p>	<p>The mission and concern of these CDFIs is purely focussed on creating access to capital and developing financial mechanisms for individuals and entities who cannot access these from mainstream institutions.</p>
 <p>Finance focussed CDFIs</p> <p>Links and partnerships with other organisations focussed on support and capacity building (eg. CSOs)</p>	<p>These CDFIs are concerned about capability development but are not directly involved in the provision of this support themselves. Rather, they partner with a range of other organisations (such as CSOs) who can offer the support needed to ensure that the financial services provided by the CDFI are appropriate and sustainable.</p>
 <p>Finance X Capacity Building</p>	<p>These CDFIs see the sustainable and appropriate provision of financial services to those who are excluded from the mainstream as fundamentally tied or linked to the building of capacity / the development of capabilities.</p>

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