



CENTRE FOR SOCIAL IMPACT

Submission to the Productivity Commission's
Draft Research Report (released 14 October 2009)
on the contribution of the not-for-profit sector

NO. 3 : BUILDING A SOCIAL FINANCE SYSTEM

BUILDING A SOCIAL FINANCE SYSTEM

The following comments have been developed by members of the Centre for Social Impact (CSI), Kylie Charlton, Cheryl Kernot and Gianni Zappala.

Background

CSI commends the Productivity Commission on its comprehensive review of the not-for-profit sector and the synthesis presented in its draft research report on the key issues facing the sector. If enacted, the recommendations made by the Productivity Commission have potential for wide reaching impact on the future of the not-for-profit sector in Australia and, more broadly, the environment under which social innovation and change is seeded and implemented in Australia.

This submission responds specifically to the recommendation and request for comments on the 'Access to Capital' as discussed at Section 7.4. The comments contained in this submission reflect closely the contributions of CSI to the financing roundtable held by the Productivity Commission in Sydney on 19 November 2009.

The Case for Change

Capital is a vital resource of any business, for-profit or not-for profit alike, and is required throughout the business lifecycle. Capital is needed to seed innovation and to invest in development that allows innovation to move beyond concept, achieve scale and replication, and underpin long-term operational and financial sustainability. Capital can also act to bridge the gaps between business income and help social enterprises to weather stormy times. The form and type of capital required varies across the business lifecycle, ranging from equity to quasi-equity to debt.

To improve access to capital of the 'third sector' it is essential to create a system of social finance. Social finance, or more broadly, social investment bridges the not-for-profit and the for-profit worlds by generating both financial returns and social or environmental benefits. A system of social finance recognises that there is no single way to direct capital to meet the diverse needs of the wide range of organisations existing within the sector today.

Social financing, at best, is in the nascent stages of development in Australia. There are few Australian institutions geared to providing the necessary capital to catalyze new organizations capable of designing and implementing innovative solutions to social challenges. There is,

however, growing realisation around the world that institutional mechanisms are needed to direct large volumes of capital efficiently towards social change. Social finance is not a substitute for philanthropic or public monies. Rather it is complementary. It provides an alternative pool of capital capable of meeting the diverse financing needs of a wide-ranging group of not-for profits, social enterprises and social businesses.

CSI strongly considers the development of a social finance system in Australia to be vital to the development of a robust third sector that is best able to address current and future social and environmental challenges facing our communities.

Proposed Ways Forward

Three core foundations are required to catalyze a social finance system. These foundations are: (1) efficient intermediation; (2) enabling infrastructure; and (3) absorptive capacity. Efficient intermediation is required to unlock the supply of capital. Enabling infrastructure is essential to facilitate transactions. Absorptive capacity must be developed to ensure opportunity is created for capital to flow to and support the development of scalable and sustainable social change.

Broad initiatives to establish these three foundations are outlined in Table One. CSI recommends the following specific actions:

1. *Establishment of a pool of dedicated risk capital to facilitate the establishment of a range of social finance intermediaries (including community development investment banks, community development loan funds and community development venture funds) along with developing the necessary enabling infrastructure and absorptive capacity for a vibrant social finance system.*

This pool of capital should be flexible in terms of its ability to provide funding in the form of grants, guarantees, debt or equity as deemed appropriate for the target social finance intermediary or supporting infrastructure. Importantly, the pool should be established in such a manner that government monies work to effectively 'crowd-in' all forms of private capital ranging from philanthropic, subsidized investment capital to fully commercial investment capital.

2. *Introduction of policy to encourage charitable foundations, trusts and public auxiliary funds to complement their grant making activity with social investment.* CSI believes that social investment should be counted towards annual mandatory distributions.
3. *Establishment of a new legal form (or specialized category of existing legal form) designed specifically for social purpose entities.* This would bring together different classes of investors with different institutional risks and embrace a range of forms from grant capital through to full commercial capital in a single legal entity.

CSI supports draft recommendations directed at building a better knowledge base. Draft Recommendations 5.1 – 5.4 will in part contribute to establishing enabling infrastructure, while Draft Recommendations 9.1 – 9.3 focused on facilitating social innovation and sector development will assist in developing absorptive capacity.

TABLE ONE: Core Foundations of a Social Finance System

CREATE EFFICIENT INTERMEDIATION	ESTABLISH ENABLING INFRASTRUCTURE	DEVELOP ABSORPTIVE CAPACITY
<ul style="list-style-type: none"> • Create industry defining funds to serve as demonstration vehicles • Dedicate substantial risk capital into catalytic financing structure • Develop dedicated investment banking capabilities and pull existing intermediaries into impact investing • Support the development of backable fund managers • Create financial products to increase accessibility 	<ul style="list-style-type: none"> • Set industry standards for social measurement • Implement policy & regulatory changes • Develop risk assessment tools • Develop a common language platform • Create publicly available benchmarking data • Integrate social and environmental factors into economic and finance theory • Promote demonstrated successes 	<ul style="list-style-type: none"> • Develop management capacity • Support tools for research and development of innovative scalable models

Source: Monitor Institute (January 2009), Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry

CSI is also supportive of Draft Recommendation 7.4 which proposes the establishment of a joint working party to examine access to capital for the not-for-profit sector and believes that the framework outlined above provides a sound framework for such a group.

As evidenced in the US and UK, however, the design and roll out of a social finance system requires not only political support but also sufficient investment. Setting up a working party alone is not sufficient.

CSI strongly encourages the Productivity Commission to extend its draft recommendation to include a non-rebuttable commitment by the Australian Government to contribute capital to the formation of a risk capital pool, with the details of this pool to be determined by the working party. Additionally, linking the pool to commercial banks (as in the UK and US) and to superannuation funds should be explored. Pairing a committed investment by Government (and private sector financial institutions and managed funds) with the proposed working party that has collaborative, cross-sector participation will enable a social finance system in Australia to be catalyzed in a timely manner.

CSI also recommends that the terms of reference for the proposed working party should include consideration of the introduction of a new legal form for social purpose entities plus the legal and policy environment required to crowd-in private investment.

CSI welcomes the opportunity to further discuss this submission with the Productivity Commission.