Community Development Finance in Australia A Discussion Paper

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1. Objective of this discussion paper

The objective of this discussion paper is to explore Community Development Finance in Australia. It also highlights some of the key questions to be addressed to ensure the concept — and any related program to be developed — is successful in the long term.

ANZ invites comments from interested parties on a number of issues raised in this discussion paper: the extent and nature of the problem to be addressed by Community Development Finance, the lessons to be learned from overseas experience, the role of the financial services sector, Government and community groups, regulation, tax and welfare aspects and the commercial management of such programs.

2. Why is ANZ involved?

The *Banking on the Margins* forum held by the Brotherhood of St Laurence in October 2003 aimed to open discussions about moving Australians who are currently 'on the margins' or 'underbanked' into the mainstream economy. The discussions focused on microfinance (or Community Development Finance as we refer to it here) and the potential it offers to assist people who are currently 'underbanked' or 'underserved' by mainstream financial institutions in Australia.

There was an overwhelming view at the forum that the business sector, in particular the banks, need to take a leadership position on this issue. While there are examples of Community Development Finance projects being trialled in Australia, the limited reach and relatively low levels of success were argued to support strongly the need for ownership and leadership from the business sector. In the UK, for example, the Social Investment Task Force found the banking sector had a significant role to play in under-invested communities. Specifically, the Task Force argued in addition to providing finance for bankable businesses in under-invested communities, banks should undertake to ensure viable businesses operating below market levels of financial acceptability can grow and become bankable. Accordingly, the Task Force recommended banks disclose their individual lending activities in under-invested areas. It was argued while this ideally should be undertaken on a voluntary basis, legislation might be required.

ANZ has undertaken to examine further the potential for Community Development Finance in Australia. This examination will be in two parts — research into the size and nature of financial exclusion in Australia (the market that could be served by Community Development Finance) and a consultation process, of which this paper forms part, to determine how a program could be developed.

3. What is Community Development Finance?

Community Development Finance (CDF) can be used essentially as an 'umbrella term' to describe the areas of 'microfinance', 'microcredit', 'microbanking', 'microinsurance' and 'microenterprise'. CDF can include the provision of small loans, acceptance of small savings deposits, provision of insurance and financial literacy training (Burkett, 2003).

These tools have been developed to meet the financial needs of people who do not have ready access to mainstream financial services, i.e. are financially excluded or underbanked. Financial exclusion is the lack of access to financial services by individuals or communities due to their geographic location, economic situation or other social condition preventing people from fully participating in the structures or institutions of mainstream society (Connolly and Hajaj, 2001).

Low-income communities can become stuck in a cycle of under-investment, low levels of enterprise, poor employment prospects and stagnant asset values. People also may be restricted in their personal lives, for example being unable to obtain credit when unforeseen expenses arise.

CDF programs provide a potential avenue for helping individuals within these communities break out of this cycle. Their aim is to stimulate enterprise, employment, increases in asset values and purchasing power, wealth accumulation, profitable local entrepreneurship, investment and so on. They can also help people better manage their personal finances and so improve the way they live, their confidence and opportunities.

Importantly, however, while CDF programs can be potentially useful as a means of alleviating poverty and social exclusion, it is certainly not the only means, or even the most important means, of achieving this objective. The causes of poverty in modern societies are complex and only partly related to the ability to access credit and other financial services. CDF should be seen as complementary to, not a substitute for, other ways to help people out of poverty. In this regard, the international evidence suggests CDF programs are generally unsuccessful in helping the 'poorest of the poor' (Copisarow, 2000). In the Australian context, that might mean the potential for CDF programs to assist particularly disadvantaged groups may be limited. Nevertheless, there remains promising scope.

4. Is there a need for Community Development Finance in Australia?

There is limited research available on CDF programs in the Australian context. Ingrid Burkett from the University of Queensland conducted a stocktake of programs already operating in Australia. These programs ranged from interest-free loans and lending for enterprise development, to matched savings schemes. The study highlighted the need for more focused research on the potential for these programs in Australia, greater levels of support for experimentation with new models and approaches and further consideration of regulatory constraints (Burkett, 2003).

An important first step is to clarify what the need is in Australia for CDF. Who is underbanked or underserved by financial services? What financial services do they need? How can those services best be provided?

As part of this process, ANZ is conducting research into the size and nature of financial exclusion in Australia. The objectives of the research are to identify:

- the proportion of the population impacted by financial exclusion across core products and services (basic accounts, savings, insurance, superannuation, credit etc);
- the main causes of financial exclusion across these products and services (risk policies, affordability, physical access, language issues, financial literacy, etc); and
- the groups in the community most impacted by financial exclusion across these products and services.

The research will be conducted in stages. First, a comprehensive review of existing information sources and consultation with key stakeholders is planned to develop a definition of financial exclusion. Second, quantitative research to assess the areas of financial exclusion having the most impact on the community, the causes of exclusion and groups in the community most impacted. Third, qualitative research among key segments in the community identified by the quantitative research to validate the causes of exclusion, investigate these in more detail and provide an in-depth understanding of possible solutions.

ANZ welcomes any comments which may assist this research addressing, for example, what may be the main causes of financial exclusion, which groups in the Australian community are most likely to be impacted by financial exclusion and which aspects of 'underbanking' are the most prevalent (e.g. access to credit, savings products, financial advice).

The 2003 ANZ National Survey of Adult Financial Literacy examined adult use of financial products and services and may assist as a starting point (Table 1).

Table 1 – Use of Financial Products and Services[a]

Financial product/service	% all adults using
Ordinary/everyday account with a bank, building society or credit union	97
Vehicle insurance	80
House or contents insurance	75
Superannuation	71
Credit cards	64
Private health insurance	57
Financial specialist (accountant, financial planner/adviser or tax specialist)	51
Shares	44
Life insurance	33
Mortgage for own home	32
Managed investments (other than superannuation)	29
Term deposits	24
Personal loan	18
Investment property	18
Loan by line of credit or overdraft	14
Lease or hire purchase agreement	11
Mortgage on investment property	10
Home equity loan	8
Margin loan (loan solely to purchase shares or managed investments)	2
Total with at least one insurance product (vehicle, house, contents, life or private health insurance)	91
Total with at least one loan (personal, home equity, loan by line of credit or overdraft, margin loan)	34

(a) Response to question "which of the following do you have yourself or jointly with someone else?"
Source: ANZ, 2003

If a need for CDF programs is identified (for example, a sufficient number of people would benefit from CDF to sustain a program) some thought will need to be given to the program's aims. This will need to take into account a number of key aspects including:

- the social impact of the program on those participating and the broader community;
- how best to implement CDF programs, with a view to maximising their net social benefit;
- how best to integrate new CDF programs with existing programs, such as the Saver Plus Program (as described in Box 1); and
- the scope of Government support needed for CDF programs, given Governments would be affected through the interaction of these programs with regulatory, welfare and tax systems (discussed later).

Box 1
Saver Plus Program

Saver Plus is a matched savings program based on the Individual Development Accounts (IDA) model of the United States. This model of community development finance is based on using savings as a means of poverty alleviation.

The Saver Plus program aims to assist people on low incomes to develop a sustainable savings habit, build their assets and improve their financial well-being. The program focuses on working with people on low incomes to save for education-related expenses, such as the transition from primary to secondary school or from middle high school to senior high school. As part of the program ANZ matches every dollar saved by participants with a further two dollars. Matched funds provided by ANZ are capped at $2000.

ANZ developed the program in partnership with the Brotherhood of St Laurence. A pilot program commenced in Frankston, Victoria in July 2003. Two further pilots were established in Shepparton, Victoria, in partnership with Berry Street Victoria (from October 2003) and Campbelltown, NSW, in partnership with the Benevolent Society (from November 2003). It is anticipated up to 100 parents or guardians will participate at each location. At present there are 250 families participating.

Participants are invited to join Saver Plus through local school networks. To be eligible to join Saver Plus, the account holder and/or their partner must:

- be a parent or guardian of a student/s who will be attending secondary school in 2005;
- have children attending Government schools in the Saver Plus pilot program areas;
- have a current Health Care Card or Pension Card;
- have regular income from paid employment; and
- be able to demonstrate a capacity to save after regular expenses have been paid.

The experience of similar programs overseas highlights participants are more successful if they receive one-on-one coaching. Saver Plus has taken this into account by providing a ‘relationship manager’ (similar to a case manager) to work with participants to make sure the program meets their individual needs. Participants are also provided with opportunities to develop their financial skills through money management training programs and advice from financial counsellors. This means by its very nature, the program is resource-intensive and highly reliant on the capacity of the community organisation to provide this coaching.

The effectiveness of the pilot is being assessed by RMIT University. Preliminary data show the savings pattern is encouraging. Overall 96 per cent of participants make a monthly deposit at an average of $68 per month. This compares with almost half of the participants in one pilot location having less than $50 in their bank account prior to commencing the program and 70 per cent not setting a savings goal in more than five years.

Source: ANZ

Issues for Discussion:
What is the need in Australia?
ANZ seeks comment on the extent of the problem of 'underbanking' or financial exclusion in Australia. Which groups in the community are most affected by this problem? What are the main causes of the problem? Is this a problem for most people on low incomes or is it concentrated among some groups in particular, such as women, people with disabilities and people from non-English speaking backgrounds? Is it especially a problem in particular areas or communities?

ANZ seeks comment on which aspects of 'underbanking' are most prevalent: lack of access to credit, financial advice, insurance, savings products?

5. Lessons from overseas experience

While the experience of CDF programs is limited in Australia, there is a long history of these programs in both developing and developed countries from which we can gain some understanding.

CDF initiatives have been around for some time in developing countries such as Bangladesh, India, Bolivia, Indonesia and many countries in Africa, with the Grameen Bank in Bangladesh particularly active (Box 2). In recent years they have been used as a tool to alleviate pockets of poverty in developed countries such as the US, UK, Europe and Canada, where the social environment is very different (Burkett, 2003).

In the 1990s, CDF programs were also introduced to Central and Eastern European countries to provide essential support to societies as they made the transition from command economies to market-based economies. While the client base was well educated and not poor (by developing country standards), the banking system was antiquated and unable to perform basic tasks like credit assessment, especially for small businesses. CDF programs played an important role in the creation of private enterprises in these countries.

Box 2
The Grameen Bank Model (Bangladesh)
The Grameen Bank is a licensed bank largely owned by its borrowers (93 per cent) who become members of the bank and commit to a list of responsibilities. Key features include:

- the bank operates only in rural and semi-rural areas;
- 95 per cent of the borrowers are women;
- 'peer groups' of five borrowers become mutually accountable for each other's loans;
- the program is minimalist: small, short-term loans at above the cost of capital; borrowing groups do much of their own administration; and
- saving programs are compulsory.

Source: Burkett, 2003

There are significant difficulties with adapting developing country models to Australia, where the aim of these programs is to fill a gap in the welfare system. The *Banking on the Margins* forum acknowledged current models in Australia may have been unduly influenced by models considered successful in developing countries without taking into account the domestic market, differences in respective cultures and the presence of a significant welfare system.

There also may be difficulties applying models from other developed countries to Australia given the unique social or economic issues they are trying to address.

United States

In the United States, which has had the most experience among developed countries, CDF programs grew out of a regulatory response to discrimination, the 1977 Community Reinvestment Act (CRA). The CRA, which requires banks to serve poor communities while still making prudent lending decisions, was introduced essentially to address evidence of commercial banks and savings associations choosing not to offer loans in areas based on their racial composition, age of housing stock or other factors, regardless of the creditworthiness of individual applications (White Haag, 2000).

An example of CDF is ACCION USA, a network of lending programs providing credit to low- and moderate-income business owners in the United States (Box 3).

The United States is characterised by historical 'underserving' of low-income communities compared with the almost universal take-up of everyday bank accounts in Australia (97 per cent of Australian adults use a transaction account - Table 1). Further, in the United States poorer communities are often closely clustered and have a relatively homogeneous ethnic base, so CDF programs are often tailored with this feature in mind. For example, many CDF programs are targeted at Hispanic communities where there is a strong sense of cultural identity. This sense of identity may be a contributing factor to the success of some programs and needs to be taken into account when adapting this experience to Australia.

Box 3
An example of a US micro lender

ACCION USA is a network of lending programs with the mission of making access to credit a permanent resource to low- and moderate-income business owners in the United States. It operates in nine states: Florida, California, Georgia, Illinois, Massachusetts, New Mexico, New York, Rhode Island and Texas.

In 2002, ACCION disbursed more than US$18.9 million in small business loans to almost 3000 home-based and storefront business owners, such as owners of fruit stands and corner markets. ACCION's clients often face language barriers or lack the collateral and credit history necessary to borrow from a bank.

From inception in 1991 to the end of 2002, ACCION lent US$67 million to 8041 clients. The average loan size is US$6079, and the average loan term is 17 months. The loss rate over the life of the program has been 5.9 per cent. Thirty six per cent of ACCION's clients are women. Micro credit has boosted the business profitability of ACCION's clients by up to 72 per cent, and sales and take-home pay for business owners by more than 50 per cent.

ACCION is supported by a number of large banks including JP Morgan Chase, Citibank, Bank of America and Deutsche Bank Microcredit Development Fund.

Source: www.accionusa.org

United Kingdom

In the United Kingdom, the potential for CDF programs was considered as part of the Social Investment Task Force mandate, established in February 2000. The Task Force included stakeholders from interested groups including community organisations and the financial services industry. The purpose of the Task Force was to determine "ways in which the UK can achieve a radical improvement in its capacity to create wealth, economic growth, employment and an improved social

fabric in its most under-invested, that is to say its poorest, communities" (Social Investment Task Force 2000, p. 2). The initial stocktake of CDF programs highlighted that in 2000, community loan funds totalled £80 million, of which £65.6 million was funded by the private sector and 93 per cent of the total private sector funding was sourced from companies including banking and financial institutions (Social Investment Task Force 2000).

The Task Force report concluded under-invested communities offer many profitable opportunities for companies, banks and other investors and recommended a number of approaches to stimulate investment that had been successful in other countries, in particular:

- a Community Investment Tax Credit to encourage private investment via Community Development Financial Institutions (see Box 6);
- the development of a Community Development Venture Fund, a partnership between Government and the venture capital industry, entrepreneurs, institutional investors and banks, where private funds are matched by the Government;
- disclosure by banks of their investment in poorer communities;
- greater latitude and encouragement for charitable trusts and foundations to invest in community development initiatives; and
- support for Community Development Financial Institutions such as an effective trade association and new mechanisms to collect funds at the wholesale level (see Box 4 for an example) (Social Investment Task Force 2000).

Since the release of the report, a Community Development Venture Fund — the Bridges Community Ventures Fund — was established in May 2002 to provide equity to businesses in under-invested areas throughout the United Kingdom. The Fund has received £20 million in Government funding as well as £20 million from private sector participants including HSBC, Lehman Brothers, Lloyds TSB Scotland, Merrill Lynch, Schroder Salomon Smith Barney and The Royal Bank of Scotland (www.bridgesventures.com).

Box 4
UK initiatives: Community Development Financial institutions

The Phoenix Fund provides funding to projects stimulating enterprise in deprived areas of the UK.

In 2000, £100 million was given to the Phoenix Fund and divided between several funding streams:

- a Challenge Fund for Community Development Financial Institutions;
- a Development Fund to promote innovate ways of supporting enterprise in deprived areas;
- support for a Community Development Venture Fund;
- four pilot City Growth Strategies; and
- support for the development of the Business Volunteer Mentoring Association.

In 2001, the first round of the Phoenix Challenge Fund for Community Development Financial Institutions awarded £5 million to 16 organisations. The second round in 2002 awarded £14 million to 32 organisations. Matched funding of £20 million also went to Bridges Community Ventures, a new Community Development Venture Fund launched in May 2002, to create a £40 million fund providing equity finance to SMEs in deprived communities.

In April 2004, the Government allocated £10.5 million in additional funding to 25 organisations.

Source: www.sbs.gov.uk

One of the most successful CDF organisations providing microenterprise loans in the United Kingdom is Street (UK) (Box 5). However, discussions with Street (UK), banks associated with ACCION USA and other microfinance stakeholders in both countries indicate they have difficulties attracting clients to these programs. For example, ACCION has attracted less than 1000 customers per year after 10 years of operation (Box 3). While some stakeholders characterised this as further evidence of the cycle of social and economic under-investment in 'depressed' communities, it may also indicate relatively narrow demand for such services in developed market economies.

Box 5
An example of a UK micro lender
Founded by former JP Morgan banker Rosalind Copisarow, Street (UK) was launched in September 2000 and made its first loan in April 2001. Street (UK)'s mission is to support microentrepreneurs in the UK with financial and business services and offer a pathway out of welfare/cash economy dependency to those aspiring to become bankable small businesses.

Street (UK)'s clients fall into three main groups: *start-ups,* a person or activity that has generated a positive cash flow for at least six months; *sole traders,* who trade while still in receipt of (usually non-work) benefits or who trade on a cash basis or part cash basis only; and *established microbusinesses* that are too small or appear too risky for mainstream banks.

Operating in Newcastle, Birmingham and East London, as of 31 March 2004, Street (UK) has made over 250 loans and lent over £600 000 to microentrepreneurs, each borrowing an average of £1800. Its loan repayment rate is 95 per cent. Street (UK) also provides business advice. Street (UK)'s clients include a car mechanic who was lent £1000 to purchase a vehicle lift and other equipment, a vendor of fast food who was lent £5000 for freezing equipment and the owner of a women's clothing shop who was lent £600 for security shutters.

Street (UK) is funded by commercial bank loans from such institutions as Bank of Scotland and Barclays Bank. These are unsecured facilities, based on Street (UK)'s business plan and track record, and are on-lent to Street (UK)'s clients at interest rates of between 12 per cent and 26 per cent per annum. Additionally, Street (UK) has raised grant funds from charitable foundations towards operating expenses.

Street (UK) is run as a social business. Its parent entity Street (UK) Foundation is a registered charity.

Source: Street (UK)

There is also evidence from the overseas experience in both developed and developing economies that the long-term viability of CDF programs may be doubtful. The international experience suggests CDF programs may need to be subsidised indefinitely and this is more likely to be the case in developed countries such as Australia. For example, of the 7000 to 10 000 CDF institutions worldwide, no more than 100 to 200 are profitable and none of these is located in an industrialised country (Copisarow, 2000).

It may be the case neither the developing country models, which seem to suit small rural communities well, nor the United States or United Kingdom models — which particularly help communities in economically depressed urban districts — are necessarily best for Australia. This may be for several reasons, including the impact of local regulations, cultural factors and the interaction between existing welfare systems and CDF approaches (discussed later). Nevertheless, the wealth of experience overseas should provide some guidance on what may or may not be successful in Australia.

Issues for Discussion:
What can we learn from overseas?
ANZ seeks comment on features of CDF programs in other countries likely to be most readily applicable in Australia. Further, which features of CDF programs in other countries will be least applicable?

6. The role of the financial services sector, Government and community groups

It is widely acknowledged by those working in the field if CDF programs in Australia are to gain any momentum, Governments need to be engaged and their support sought. Equally important is the participation of community groups working with those people in the community most likely to benefit. Banks and other financial institutions will clearly have roles to play.

At the *Banking on the Margins* forum Rosalind Copisarow, CEO of Street (UK), outlined possible roles for financial institutions and Government. These include for financial institutions, client referrals, technical/financial expertise and wholesale funding and for Governments, providing incentives in welfare payments for people to advance in life, reducing red tape for small business, funding for organisations delivering CDF programs and addressing tax impediments hindering the transfer from welfare and investment in community finance organisations (Brotherhood of St Laurence, 2003).

There may need to be exploration of the potential for partnerships between banks and other financial service providers such as credit unions to deliver CDF programs. Credit unions have played a role in the delivery of some CDF programs in the United Kingdom and are well-placed to tackle financial exclusion given their commitment to provide services to people in financial difficulty on low incomes and often excluded from the mainstream (Jones, 2003). For example, Barclays Bank in the United Kingdom is funding a number of projects with credit unions which tackle financial exclusion, ranging from donations to financing loan guarantee schemes, a form of CDF.

There are, however, some differences between the role credit unions have played in the United Kingdom and their role in Australia. Historically, credit unions have not had as significant a role in competition in the United Kingdom financial services market as they have in Australia. Until recently, credit unions were not subject to full regulation in the United Kingdom and were therefore considered riskier than traditional financial service providers. To increase the potential for competition from credit unions in the financial services market, from July 2002 credit unions were brought under the auspices of the Financial Services Authority (FSA) and are now subject to the requirements of the Financial Services and Markets Act and the rules in the FSA Handbook (www.fsa.gov.uk).

Issues for Discussion:
Which organisations can play a role?
ANZ seeks comment on the appropriate roles of business, community organisations and Government in the development of CDF programs. Who is best-placed to assess the needs of low-income communities and low-income individuals or families for CDF? Who is best-placed to be the point of contact for people in need of CDF?

ANZ seeks comment on the extent to which small-scale lenders like credit unions can be seen as providing CDF and conversely, what the limitations may be for these existing lenders in Australia.

7. Regulation, tax and welfare aspects

Regulation of the financial services industry and Government welfare and taxation policy was seen at the *Banking on the Margins* forum as a potential barrier to the progress of CDF initiatives and microenterprise development. A consensus was reached that there is a need to further analyse:

- credit regulation to determine whether it is hindering the development of CDF programs;
- small business tax regulations to determine whether they are limiting the establishment of CDF programs; and
- welfare policy to determine whether it is encouraging the move to economic independence (Brotherhood of St Laurence, 2003).

There are also other tax issues that must be explored, such as whether CDF funds received by program participants will be considered income for tax purposes, how business funding in this area will be classified for tax purposes, as a gift or an expense and the scope for tax credits as an incentive for businesses to invest in CDF programs, similar to those recommended in the UK (Box 6).

The regulatory framework governing the provision of financial services in Australia is complex and designed to protect the interests of investors, depositors, consumers, creditors and the stability of the financial system. Legislation governing the provision of financial services such as the Banking Act, Corporations Act, Privacy Act, Insurance Act, Financial Services Reform Act and Uniform Consumer Credit Code has not been designed with the particular needs of CDF in mind.

Any potentially limiting aspects of these regulatory frameworks and potential methods for overcoming any barriers will need to be considered. For example, in the United Kingdom, discussions have just started regarding the merit of introducing ‘para-banking’ legislation, along the lines already instituted in a number of countries, including South Africa and Bosnia. This should provide CDF programs with a limited form of deposit-taking licence, based on their capital, management and lending track record, enabling them to help their clients build their savings and become more creditworthy.

If CDF is to be developed in Australia, regulations relevant to welfare payments require the most scrutiny given people on benefits face earning restrictions which limit their ability to participate in the development of microenterprises and other forms of CDF as is the case in other countries with significant welfare systems, such as the United Kingdom and the US. This suggests further study needs to include consideration of:

- the extent to which existing welfare programs consider and respond to failure rates of small businesses and fluctuation of incomes which are characteristic of small start-up enterprises;
- whether recipients of CDF become ineligible for welfare payments (or part thereof), and if so how this affects their incentives to take part in CDF programs;
- the incentives required for consumers who currently receive welfare and may be eligible for CDF (e.g. will an individual’s welfare payments be affected by their participation in the program if CDF funds were considered income); and
- whether a safety net needs to be created for these consumers to support them transition from welfare to income.

Box 6
UK initiatives: Community Investment Tax Credits
In an effort to encourage private investment in not-for-profit and profit-seeking enterprises in under-invested communities, the Social Investment Task Force in the UK recommended the Government establish a Community Investment Tax Credit. In response to this recommendation the Government has implemented a tax credit whereby individuals and corporates investing in enterprises in disadvantaged communities (through a CDF Institution) receive a 25 per cent tax credit over five years (five per cent per annum), set against the investors' tax liabilities. This credit applies to both debt and equity investments and to both individual and institutional investors and is administered by the Small Business Service.

Source: www.enterprising-communities.org.uk/update4.shtml

Issues for Discussion:
What regulation, tax and welfare aspects need to be addressed?
ANZ seeks comment on how the existing regulatory tax and welfare systems may interact with CDF programs and what changes to those systems may be required to enhance the effectiveness of programs. In particular:

- are there aspects of banking and credit regulation limiting the development of CDF programs?
- are there regulatory approaches overseas assisting the development of CDF programs, which could be useful in the Australian context?
- what aspects, if any, of small business tax regulations need to be addressed?
- would current tax treatment of business funding to these programs present any obstacles to investment?
- is there a role for tax credits as an incentive for businesses to invest in CDF programs?
- is refinement of current welfare policy and income tax policy needed to accommodate CDF programs?

8. Commercial management

This research will be incorporated into the consultation report.

The business systems of Australian financial institutions, especially at large banks like ANZ, have not been designed to take on the demanding and complex task of implementing CDF programs. If the concept is to be taken further to implementation stage, a number of issues must be addressed.

As discussed earlier, the experience of CDF programs in developed countries suggests these often have mixed performance, not always consistent with commercial sustainability and rely on subsidies from Governments and foundations to cover a large proportion of operating budgets and specific business education services (Burkett, 2003). An examination of best practice microenterprise development by USAID highlighted the importance of achieving sustainability and in order to do so, CDF institutions need to offer their services on a commercial basis, otherwise performance would be distorted. This includes the need to charge interest rates high enough to cover all ongoing costs such as loan losses and the cost of raising new capital to expand (US Department of State, 2004).

A further key to sustainability of these programs highlighted in overseas experience is the need for these programs to be part of a wider strategy for developing services for people on low incomes including:

- one-to-one personal support and money advice;
- assistance with budgeting;
- financial education;
- programs encouraging participants to develop a regular savings habit; and
- access to affordable credit (Jones, 2003).

All of this means the risks for businesses that become involved in CDF programs may be high, not least because elements of their implementation may be beyond their control. Nevertheless, there will be scope to manage or mitigate some of the risks. From a business perspective, the conclusion is not to avoid the area but to recognise a number of issues will need to be carefully considered if involvement in CDF programs is to be realised. These include the following:

Program costs

As with any policy measure, there will be a need to ensure the costs of providing the program do not outweigh the overall benefits. Rules and procedures will need to be put in place to ensure loans are made in a prudent manner.

The cost of administering the program could be high, resulting in a relatively inefficient social welfare tool. The experiences of Street (UK) and ACCION highlight the likelihood of high administrative costs. Aside from the time taken to set up, process and service a loan (around 14 hours), program participants often need one-on-one coaching and assistance with their application for a CDF loan, which can require many hours in itself.

Regulatory risks

Any regulatory requirements (for example, compliance with the Uniform Consumer Credit Code) will need to be considered and met, unless special exemptions can be obtained.

The question of how much capital needs to be held against these loans will also require resolution. If the viability or sustainability of the programs becomes questionable, APRA may have some concerns about the exposure of any lenders for whom the activity is a significant part of their business.

Reputational risks

While the objectives of CDF programs are laudable, such programs may fail to achieve their social objectives. Depending on the circumstances, the reputations of the businesses involved may be put at risk.

Lending risks

Given the core element of CDF is typically lending to people with low incomes, few assets and little, if any, credit history (although CDF may extend to other services), it needs to be determined whether it is consistent with a program's social objectives to charge a genuine risk premium to the participants. If not, the issue of how higher levels of lending risk are managed will need to be addressed.

Nonetheless, a number of basic principles identified in the evaluation of similar programs can provide a sound basis for a CDF program and limit the commercial risks:

- All key stakeholder groups should be involved in partnerships to ensure cross-sectoral buy-in and mutual involvement in the management of issues important for program sustainability.
- Parties involved should regard the CDF program as a business and not as charitable undertakings. This involves the realistic identification of costs to determine what cross-subsidies or donations are needed. They need to ensure effective credit administration and control systems are in place.

- Parties should resist establishing CDF programs that treat loans as a small donation made available for on-lending to those in need. This approach is unsustainable as loss rates are likely to be high.
- Credit standards must be maintained. A responsible approach to credit assessment is needed including a well-based determination of the borrower's capacity to repay the loan. The goal should not be free and easy credit.
- Delinquency rates for loans underwritten by these schemes should be treated no differently to standard loans.
- All strategies aimed at serving those on low incomes should also encourage programs of regular saving. This will lead to people gaining a greater sense of financial control, confidence and independence in the long run.
- The partnership should include an element of money advice or financial counselling for the individuals assisted.
- The program should involve promoting participation in financial literacy programs to build the financial capability of its participants (Jones, 2003).

An example of a CDF program that could be tested in the Australian context is operated by Deutsche Bank in the United States, which acts as a provider of (wholesale) finance to microcredit institutions. The key features of this program are outlined in Box 7.

Box 7
Deutsche Bank Microcredit Development Fund (MDF)
Deutsche Bank MDF was conceived as a vehicle to support the long-term sustainability of microcredit institutions in the United States by:

- offering funds to fuel the growth and reach of microcredit programs; and
- increase the capacity of microcredit institutions to obtain leveraged capital from local commercial financial institutions.

The objectives of the MDF are to:

- encourage financial and operational self-sufficiency; and
- foster partnership between those administering microfinance and those funding microfinance.

The MDF is not-for-profit, i.e. it does not have a hard commercial focus and is funded by a combination of tax-deductible donations of cash or appreciated securities from individuals and foundations. No return of principal or interest is paid to donors. Any income generated by the MDF is added to its capital base.

The MDF Board of Directors is composed of individual donors, representatives from Deutsche Bank and at least one expert in the area of Microcredit Institution lending. The board's function includes making policy decisions as well as amending the lending criteria.

MDF provides loans to non-profit microcredit institutions as equity-like debt. The terms of these loans are usually 1 per cent to 3 per cent interest over a 3- to 8-year period. Loans are made on the basis the microcredit institution will hold the debt on its balance sheet for the purposes of obtaining leveraged capital from local commercial financial institutions. Loans made cannot be used to fund direct lending programs. Rather, loans from the MDF (typically around US$100 000 in size) are used to leverage capital from local commercial financial institutions, at least at a 2:1 ratio, which is then lent to microentrepreneurs.

The rationale behind the MDF is the loans made allow individual microcredit institutions to better leverage conventional debt. This in turn allows individual microcredit institutions to grow their direct lending programs and achieve the economies of scale needed for self-sufficiency.

Source: www.cib.db.com/community

Issues for Discussion:
How do we manage CDF programs commercially?
ANZ seeks comment on how the commercial risks of a CDF program can be best managed. To what extent can a business partner in these programs expect to gain a normal commercial return on its investment? What are the elements of program design to best aid the management of those risks? What is the best way of achieving the social objectives of a CDF program consistent with the management of those risks?

9. Next steps

ANZ seeks to consult widely on the issues raised in this paper. As this paper has highlighted, there are many complex issues that will need to be carefully considered if models similar to Street (UK) or ACCION USA are to be developed in Australia.

ANZ invites comments on the issues raised in this Discussion Paper until Friday 2nd of July. ANZ wishes to conduct in-depth discussions with interested parties and receive written responses for this paper. Comments should be preferably emailed to **painen@anz.com** or alternatively mailed to:

Natalie Paine
Manager Public Policy
ANZ Group Corporate Affairs
Level 22, 100 Queen Street
Melbourne, Victoria 3000

Should you or your organisation wish to meet with ANZ to discuss this paper, please contact Patricia Toohey, Head of Community Relations at **tooheyp@anz.com** or Natalie Paine at **painen@anz.com.**

Alternatively, if you have any questions regarding ANZ's research into financial exclusion please contact Michael Bloomfield, Head of Market Research at **bloomfm2@anz.com.** ANZ will report on the outcomes of the consultation process, any related research initiatives undertaken and any further analysis of CDF, in September 2004.

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