A new funding paradigm

Prospects for social lending and investment by foundations in New Zealand

for

ASB Community Trust
The Tindall Foundation

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1 Executive summary

1.1.1 Social enterprises have appeared over the last forty years as a new and distinctive type of entity delivering strong social outcomes. They are similar to commercial businesses in being dynamic, using many of business techniques and generally having some form of income from the provision of a service. But they are also similar to charities in having social outcomes as fundamental objectives. So it often happens that they look like charities to commercial businesses, but look like businesses to charities.

1.1.2 They are difficult to define precisely as they use various forms and are involved in many different sorts of activities, but there are a number of characteristics which they tend to share:

- They have social goals which are fundamental to their objectives
- They generate income directly from some of their activities – this usually means that a significant part of their income comes from a service they sell in some way
- They require capital – working capital, capital to acquire assets and capital to implement projects
- They usually make a surplus from their operations – and need to if they borrow to generate the funds to repay a loan
- They may be profit-seeking or simply make a sufficient surplus to service and repay borrowings.
- They may be a charity, or a company owned by a charity, but they can also be a normal limited company
- They are generally managed like a business using techniques such as business and operational plans
- They usually have an entrepreneur or a small entrepreneurial group which has created the organisation

1.1.3 Social lending and investment has arisen in parallel providing the capital and investment that social enterprises need. This also tends to sit between commercial loans and investment and charitable grants and donations and is a distinctive sort of arrangement. Social lending uses many of the disciplines of commercial lenders and only works where it is undertaken rigorously ensuring loans are repaid and serviced. But it generally provides funds where commercial lenders would not and often at lower interest rates.

1.1.4 The development of social enterprise and lending has been substantial overseas and can now show a long and successful track record, but it is relatively undeveloped in New Zealand. Internationally, this was led by specialised social lenders with foundations becoming involved over the last ten years. Reasonable estimates are that about 20% of endowed foundations have some involvement. Where they are active, they typically devote about 5% of their endowment to loans.

1.1.5 In New Zealand, two community trusts – Southland and Canterbury – have about ten years successful experience but have kept this as a small part of their overall activity. There is also a small financial company, Prometheus Finance, devoted to social lending and operating similarly to the social banks seen more extensively abroad. Commercial banks have shown little appetite. It seems likely that social lending will be led by the foundations.

1.1.6 Foundations should consider this for a number of reasons:

- Increase their impact by extending their reach both in amount and type of project
- Allow successful projects to achieve greater scale

- Build stronger projects by improving a project's management
- Provide better focus on long-term operational sustainability in projects
- Allow projects to acquire assets
- Avoid the weakening of a project through inappropriate grants
- Help build social markets
- Allow systematic interventions where a mixture of loans and grants are needed

1.1.7 Some of these are a benefit to individual foundations themselves but some represent a wider societal benefit.

1.1.8 But there are some reasons to be cautious and foundations should consider carefully whether they are ready to undertake social lending:

- A lending foundation must be willing to foreclose where a borrower fails
- There is currently limited demand for social lending
- There is the wrong culture and inadequate capacity in potential borrowers
- There is the wrong culture and inadequate capacity in the foundation itself

1.1.9 Of these, the willingness to foreclose on a failing borrower is the most important and difficult but without it lending schemes are likely to go badly wrong.

1.1.10 If a foundation decides it does want to take this up, unless there are special circumstances, it would be well-advised to subcontract the management of the lending to an experienced provider. To undertake it itself would require a substantial internal investment and mixing the different disciplines and culture of lending and grant making.

1.1.11 However, it could be that a larger foundation decided to do this and subcontracted the service to other foundations. This would help cover the investment and allow concentration of lending expertise. In the absence of that, there are three main possibilities:-

1.1.12 A commercial bank is contracted
There are no banks currently willing to do this though this may change if they were approached directly. However, overseas experience suggests this is unlikely to work well as the banks don't share the objectives of the foundations.

1.1.13 An existing social lender is contracted
This has been done successfully overseas. The only candidate in New Zealand would be Prometheus Finance and this would require them to extend their operations and expertise.

1.1.14 A new special purpose agency is created by foundations working together
This would be new and untested and incur heavier costs in starting up but would be under the foundations direct control.

In conclusion

1.1.15 New Zealand has not kept pace with the international development of social enterprise and lending. Other countries have seen many benefits in developing both. Foundations are well-placed here to lead this and there are strong reasons for them individually to take it up providing they have worked through carefully some of the difficulties they are likely to face. If they want to proceed, their best way forward would be through some form of subcontracted management.

2 Introduction and scope of the report

2.1 Structure of this report

2.1.1 This report has been commissioned by ASB Community Trust (ASBCT) and The Tindall Foundation (TTF). In summary their questions for this report to address were:

1) What are trusts and foundations doing overseas in social lending and investment?
2) What is happening in New Zealand?
3) What are the prospects for increasing this in New Zealand?
4) How might foundations go about it?

2.1.2 Questions 1) – 3) are addressed in a public report which will be circulated widely. A number of trusts and foundations are interested in developing social lending and investment activity and it's hoped that what is presented, will be useful to them in taking this forward.

2.1.3 Question 4) is more specific to ASBCT's and TTF's individual circumstances and is therefore considered and reported separately for their own use only.

2.1.4 This report is structured under the following headings:

- An overview of social lending and investment
- International experience
- New Zealand experience
- Should foundations undertake social lending?
- How can it be done?

2.2 Some vocabulary

2.2.1 Consultation undertaken in New Zealand revealed that the concepts of social lending and investment, social enterprise and entrepreneurs and many associated words and concepts have a range of meanings. These are often different from those used overseas. The various uses are all perfectly reasonable but, for this report, it's important to have clarity around these terms, particularly as there are many organisations called social enterprises which would *not* be suitable for lending and investment. Consequently, I have included an introductory section 3 which clarifies how social lending and investment work in practice and how these terms are used here.

"Grants" or "donations"?

2.2.2 ASBCT, in line with its quasi public nature, describes itself as providing *grants* while TTF, more in line with being a private foundation, provides *donations*. To avoid having to say 'grants or donations' throughout, and with TTF's consent, I use 'grants' to mean both grants and donations unless the context requires more precision.

"Trusts" or "foundations"?

2.2.3 Similarly, I use the term 'foundation' to mean both a trust like ASBCT and a foundation like TTF. They are essentially the same in that both have an endowment which is invested to produce a return from which grants are paid.

Social "loans" or "investment"?

2.2.4 The principal focus for this report is social lending – providing a loan which must be repaid. The loan may be secured in some way and may pay interest even if it is at a rate lower than that charged by a bank. But sometimes a loan is not the best arrangement. A social investor may provide a guarantee to support a loan from another lender, or they may provide funds at a high risk but for which there is a relatively high return – for example, funds which are repaid at a rate of $1.50 for every $1 advanced. These additional arrangements are forms of underwriting and quasi-equity and better described as social investment. But for brevity, the report uses the term 'social lending' but this is in reference to the full range of arrangements. More precise wording is used when needed.

3 An overview of social lending and investment

3.1 Key concepts

3.1.1 Used in the right circumstances, social lending has proven very effective as part of the funding mix for social enterprises and third sector organisations. For fund providers such as foundations, it provides a way to extend the funding methods they have available. However, social lending requires methods and concepts quite different from grants in order to work well. Used inappropriately, it can put at risk, the very projects the funder is trying to help.

3.1.2 This section sets out the basic concepts and terms as a reference point for the rest of the report.

3.2 Business and charity

3.2.1 Business and charity are usually seen as opposite but complementary activities.

Business

3.2.2 Business provides goods and services for a price or fee, has as its principal objective to make a profit – in fact, to maximise its profits – and raises capital in the form of loans and shares to give it the wherewithal to do that. Run well, responsible businesses avoid doing harm, are fair employers and good corporate citizens but they do not pursue social objectives.

3.2.3 Milton Friedman's radical view was that "the social responsibility of business is to increase its profits"[1]. A contrary view has gained much support internationally over the last thirty years with the idea that businesses cannot ignore their social and environmental impacts, even that it is bad business to try to do so. Many businesses are now committed to corporate social responsibility (CSR). However, this is still subsidiary to a business's main purpose of making profits and maximising shareholder value, and in fact the law generally requires this by making 'the maximising of profits' the fiduciary duty of the directors of a company towards its shareholders[2].

3.2.4 Historically, business and the pursuit of profit has had many negative social consequences. In response, developed economies have enacted extensive legislation constraining how businesses can act – their duties as employers, in avoiding undue harm to the environment, in fair and transparent dealings and in their social effects[3]. This has led the pursuit of profit to be seen sometimes as negative. However, Friedman is right in that the value-creating activity of business, is in itself, positive and a business's primary purpose as it generates the money needed to fund cultural, social and charitable activity.

3.2.5 Such funding is transferred in a number of ways. Every endowed foundation, is in part, a business seeking to maximise its return on the investment of its endowment. It then uses those maximised returns to make grants fulfilling its more fundamental social purpose. Government mediates extensive transfers of the profits made by business through taxes[4] and puts them to social purposes. And many individuals make their own transfers through personal donations from income derived from their economic activity.

Charity

[1] Milton Friedman, *The Social Responsibility of Business is to increase its Profits*, The New York Times Magazine, September 13, 1970
[2] New Zealand company law has softened this by making the directors' primary duty to act in the best interest of the company.
[3] In the laissez-faire environment of the nineteenth century, progressive business leaders in Britain, such as Josiah Wedgwood, were leading campaigners for such legislation. Wedgwood campaigned to stop child labour while employing children in his own factories, arguing that simply stopping it himself would make his firm uneconomic and so he needed the law to stop everyone doing it.
[4] Personal income tax is also effectively a tax on business profits.

3.2.6 Charities, on the other hand, have social objectives as their primary purpose. Their funding consumes the economic value created by business – through receipt of private grants and donations, from government which has extracted taxes, and from their own investments where they have an endowment.

3.2.7 When charities generate their own funding, this is secondary to their main purpose, and therefore, is the exact opposite of business. A charity's primary purpose is to do 'good', to pursue their social objectives and create social not economic value.

3.2.8 Charities without their own funding (such as an invested endowment or natural revenue stream) often face considerable difficulties. They must continually seek fresh funding. Businesses have something they can sell - which of course is not a certain source of revenue but is generally more robust than the perpetual funding rounds most charities must endure. Dependency on funding rounds tends to impair financial and operational sustainability. This is exacerbated by the way many larger grant givers provide funding for a limited period after which the charity is expected to find other sources of funds. Long-term sustainable funding is consequently difficult to achieve.

3.2.9 Management of traditional charity finances is usually simpler than that of a business. Charities raise funds and then spend them. They do not seek a surplus other than to create a reserve which the more prudent maintain. At their simplest, large capital projects are funded by firstly raising the needed funds through appeals and similar which, once secured, are then spent implementing the project. This is a simple cashflow approach. It doesn't require the management of a balance sheet as businesses do.

3.2.10 Businesses make profits and charities do good. The relation between the two can be summarised as:

Business	**Charity**
Generates and seeks to maximise a profit	Seeks to cover costs
Does not pursue social objectives	Solely devoted to its social purposes
Sells goods and services	Seeks grants and donations
Raises capital through loans and shares	Capital is simply a longer-period donation
Carefully manages its balance sheet	Minimal balance sheet management
Transfers part of its surplus to charity	Consumes the surplus generated by business

3.2.11 Endowed funds are a combination of both business and charity with an internal investment business generating the returns which are used to fund their charitable grants. These two aspects have traditionally been kept separate, an approach reinforced by the legal responsibilities of trustees: the investment business should maximise returns and have no element of social purpose, and the grant-making should be exclusively for charitable purposes without any commercial intent. Neither should pollute the other. Social lending blurs this distinction and has to be handled carefully to maintain clarity of purpose and to fulfil legal requirements.

3.3 Social enterprises and social entrepreneurs

3.3.1 This view of business and charity is a simplification of actual practice. Businesses are not usually quite so narrowly focused and traditional charities are often financially more complex. Nevertheless, this is a reasonable description of the two sectors and it remains largely the case in New Zealand.

3.3.2 A new type of organisation started to appear overseas about 40 years ago – **social enterprises**. These lie between business and charity integrating elements of both. They grew gradually at first but have seen considerable growth in Europe and the US from the 1980s onwards. An indication of their importance overseas is that the UK has created a new legal form to accommodate their special nature better[5] and the US has specific beneficial tax provisions for investment in them. They are usually created and run by **social entrepreneurs** who have the same skills as conventional business entrepreneurs but also have a desire to achieve some sort of social outcome. They are still comparatively few in number in New Zealand.

3.3.3 Social enterprises are the main target for social lending. Traditional charities cannot use loans and generally should *not* borrow. There are exceptions which are discussed below where, for example, the lending is to prefinance fundraising. So, it's important to be as clear as possible what social enterprises really are.

3.3.4 Social enterprises are diverse but generally have the following characteristics, they;

- have social goals which are fundamental to their objectives.
- generate income directly from some of their activities – this usually means that a significant part of their income comes from a service they sell in some way.
- require capital – eg working capital, capital to acquire assets, and capital to implement projects.
- usually make a surplus from their operations (which they would require if they borrow to generate the funds in order to repay a loan).
- may be profit-seeking or simply make a sufficient surplus in order to service and repay borrowings. Where they are profit-seeking (eg,trying to make a greater surplus than required simply to service loans and capital), this will not be at the expense of their social objectives. Therefore, some of them are 'not-only-for-profit' companies and organisations.
- may be a charity, or a company owned by a charity, but do not have to be, and may have the legal form of a normal limited company.
- are generally managed like a business using techniques such as business and operational plans.
- usually have an entrepreneur or a small entrepreneurial group which has created the organisation.

3.3.5 The above characteristics are not a precise definition of a social enterprise but should help a social lender recognise suitable candidates when they appear. The dynamism and creativity which typifies social enterprises means that they will mix and match these and other characteristics. A rough and ready test to determine a social enterprise is that;

- to a traditional charity, they look like a business, and
- to a conventional business, they look like a charity.

3.3.6 This dichotomy reflects the two historical roots of social enterprise.

3.3.7 The first are charities which have developed income-generating activities and increasingly organised themselves along business lines. An example would be a large charity like *Barnardos* providing social services under contract alongside its donation-supported activities. But a more modest example is a local sports club which runs a bar and social centre which generates income for the club is doing much the same thing[6].

[5] Community Interest Companies – see www.cicregulator.gov.uk.
[6] Charlie Leadbetter's *The Rise of the Social Entrepreneur*, published in 1997, focused on the entrepreneur not the enterprise. This was recording what by then had become a well-established phenomenon in the UK and elsewhere. It highlights well the supposed paradoxical combination of social/charitable intent and business ability which was coming into focus. However, the description is more heroic than it needs to be. Just as there are many successful businesses

3.3.8 The other type are 'social businesses' set up with an explicit social intention fundamental to their objectives. Two examples in New Zealand are *Trade Aid* which imports and sells fairly-traded coffee, or *Ceres* providing organic and wholefoods. Both were set up to fulfil their social objectives but are businesses and seek to make profits. Making profits is often an objective but, unlike a conventional business, this is either subservient or has equal weight to the social objective. They are *not* profit 'maximising' as this would then have to supersede their other fundamental goals. More examples of this type of group are given in Appendix 2.

3.3.9 The terms 'social enterprise' and 'social entrepreneur' are used more generally in New Zealand. An example is the *New Zealand Social Entrepreneur Fellowship*[7] which includes organisations which are highly innovative in how they address a range of social issues. Some of them are income-generating but some are essentially reliant on grant income and therefore have the financial form of a traditional charity depending on grants to fund their operations so would not be considered social enterprises in the sense used here.

3.3.10 Some conventional businesses have adopted strong Corporate Social Responsibility CSR policies and sometimes describe themselves as social businesses but are also not social enterprises in the sense used here. Their fundamental objective remains the maximisation of profits. Their CSR policies, while serious, are secondary to this. Often they will justify their CSR policies to shareholders as increasing their profitability in the long term. This is different from using business methods to achieve a social outcome.

3.3.11 An international and well-known example that illustrates the difference is the *Body Shop*, set up by Anita and Gordon Roddick which grew rapidly in the UK and became a successful international brand. Part of their success was due to a commitment to numerous social and charitable objectives – such as fair trade, opposing animal testing and being an active supporter of many charities and not-for-profit organisations (NGOs). The Roddicks' personal commitment to these objectives was strong and genuine. However, the business itself largely pursued commercial objectives including profit maximisation, a listing on the London Unlisted Securities Market in 1984, and then on the London Stock Exchange and ultimately its sale to *L'Oréal* in 2006. Anita Roddick regretted the listing and the requirements it placed on the company[8]. She continued to pursue social objectives through the company as well as personally but these became more marginal and seen by its management as a means of maintaining the brand. This is not intended to be critical of The Body Shop which continues to be an exemplary business in many ways, but it is to point to a fundamental difference: The Body Shop always had maximisation of profit to shareholder as its main purpose. Its social objectives were genuine, certainly initially, but always secondary and so in time, they became part of the brand serving the company's commercial objectives. This is fundamentally different from a business such as Trade Aid which makes a social objective fundamental to what it is doing.

3.3.12 Similarly, a company set up as a wholly-owned subsidiary of a charity, which is run to generate the maximum profits for the charity, is not really a social enterprise in the sense used here. It's another example of where the charitable and business approaches are kept separate but support one another. These subsidiaries of a charity are different from an entity which combines a business or business-like methods and organisation to activities which create a social outcome.

3.3.13 In conclusion of this section regarding the definitions of social enterprise, social enterprises are difficult to define but, like elephants, generally easy to recognise. Codification and mechanical definition has generally been unhelpful either excluding organisations which should be included, or including those which only formally meet a set of criteria. More importantly, the sector has been typified by its creativity and ability to use a wide range of techniques and approaches in delivering social outcomes. Any prospective social lender might use guidelines in assessing the delivery of social outcomes and be clear about what aspects

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which are run by modest entrepreneurs, so there are many social enterprises. The point is that this type of activity can spread wide and needs reasonable initiative-taking and management skills, but not more. Overseas' experience shows it can be for the many not the few.

[7] See www.nzsef.org.nz. TTF was instrumental in starting this and continues to provide active support.

[8] Publicly reported but expressed strongly to me in private conversations.

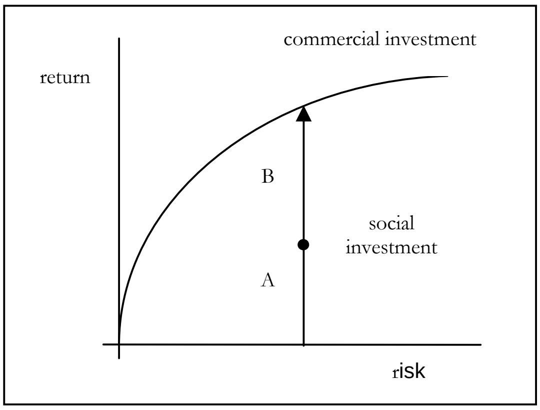
should be present to make social lending appropriate for them, however, it is recommended that an open attitude remains present about what forms it can take. This is what enhances and encourages the social enterprise sector's natural creativity instead of constraining it.

3.4 Social lending and social investment

3.4.1 Social lending and investment are the financial counterpart to social enterprise both in their characteristic arrangements (which lie between mainstream finance and charitable grant) and in who they seek to finance (eg projects pursuing social objectives). These are looked at separately in what follows.

Conventional loans and investment and charitable grants

3.4.2 Conventional loans and investment seek to maximise the return to the lender/investor mirroring the approach of commercial businesses. They are, in general, not interested in how the finance is used except to understand the commercial risks they are taking and the characteristics of the investment. They get their return from interest, dividends and capital gains which is the price of the funds.



3.4.3 Risk is the main driver for the different price – interest rates, rates of return – conventional finance costs. Early stage venture capital is very risky in its high probability of losing the amount invested or in achieving a disappointing return and so this carries a high price. Well-secured home loans carry a low risk and so a low return[9]. This creates the familiar risk-return graph: the greater the risk, the higher the return.

3.4.4 Grants, by contrast, expect no financial return at all, not even the return of the money advanced but do expect a social return. Grants are advanced to allow specific social and charitable purposes to be fulfilled. A project seeking grants will be carefully assessed on the quality and efficiency of the social return it provides – in fact they are often more onerously assessed for this than the commercial assessment a business has to undergo for a loan.

3.4.5 Reflecting on the contrast between conventional business and traditional charities,

- conventional loans – expect a market return adjusted for risk but no social return
- grants – expect no return but a substantial social return.

Social lending and investment

3.4.6 Social lending and investment is directly interested in the nature of the activity under consideration, so the investor will only invest if the social purposes are what he/she wishes to support. In assessing this, a lending foundation will generally apply similar if not the same criteria as they would apply to making grants.

3.4.7 A potential social borrower has then to meet the social purposes test as well as meeting the other financial and risk requirements that the lender applies. Some social lenders have a clearly-defined double process where an application for funds is firstly evaluated as to its purpose and then, assuming this is successful, evaluated for its financial and risk profile.

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[9] The recent severe events in the global financial markets and more locally with some New Zealand finance companies reinforce rather than contradict this. A key problem was that *risk was mispriced* through financial products and arrangements which effectively disguised their true nature. Finance company debentures and deposit accounts offering better-than-bank-returns, for example, but only marginally better where realistic pricing would have required returns of 30% pa or more. Investors were not being paid for the true risks they were taking. This created an unrealistic bubble of cheap money which is now rapidly deflating.

3.4.8 Some social lending, particularly that undertaken by foundations and other charitable lenders, is undertaken on a sub-commercial basis judged by a conventional risk-return profile. In the diagram, the social investment if undertaken commercially would theoretically look for a return of A+B but only looks for a return of A forgoing B.

3.4.9 But it's important to realise that much social lending, probably the majority, undertaken by non-charitable social lenders such as social banks (described in section 4) is provided on a broadly commercial basis. The rates tend to be 'reasonable' – usually slightly lower than the middle of the relevant market rate – and often less volatile than commercial rates. Therefore there is no discount to the market rate: e.g; the borrower pays the 'full' rate of A+B but has still has to meet the lender's social criteria[10].

3.4.10 There have been some attempts to equate social return with the foregone return, B. The argument is that social investment at a sub-market financial return is fully compensated once the social return is added to the financial return. A different and perhaps more fruitful line of analysis is the idea of *blended value* developed by Jed Emerson and others[11]. Under this, *every* investment is seen as providing financial, social and environmental returns and, by implication, should be assessed according to all three. This is seen as an essentially judgemental process which cannot be reduced to simple metrics.

3.4.11 Thus, just as social enterprise lies somewhere between conventional business and charity but is something distinctive and more than an uneasy amalgam of the two, social investment lies between grant and commercial loan and is also something distinctive.

Cost of finance and access to finance

3.4.12 As we have seen, market return is more complex than a single number and that it varies with the level of risk. A sub-market social loan could, therefore, be at the same rate as a commercial bank loan but might be taking a higher risk than a commercial bank would accept for that rate. For example, a commercial loan will typically ask for adequate security and the interest rate will be adjusted to reflect the strength of that security. A sub-market social loan might require the same rate as a secured commercial loan but be unsecured because there is no or insufficient security on offer. Because it is not asking for a higher rate of return to compensate for this, the rate charged might look commercial but actually be below the real market rate. Social lenders often offer finance where a commercial bank will not offer finance on any terms. So, there are two related motivations for social finance;

- lower the ***cost*** of finance
- increase ***access*** to finance

3.4.13 It's often assumed that social investment is mainly about lowering the cost of finance for social enterprises. However, while every borrower will naturally prefer a lower interest rate over a higher one, unless general rates are unusually high, a borrower which cannot pay a secured bank loan rate probably has too weak a lending proposition to be safely lent to unless the lender has decided to make a loan which is akin to a returnable donation such as a suspensory loan[12]. Social finance is more often about offering *access* to finance on 'reasonable' terms which would not be available in any other way. Social lenders, even sub-market lenders such as foundations should in general plan to make a return. This helps the

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[10] So why does the borrower not just go to a commercial bank? Often they do, but more commercially-based social lenders have built successful businesses through the other benefits they bring – offering more flexibility and more appropriate arrangements, having a better understanding of the real risks which social borrowers run, being more culturally attuned. This is discussed in more detail below at 4.1.8.

[11] See, for example, www.blendedvalue.org for a range of resources and publications. Jed Emerson was one of the main instigators of the term 'blended value' in early papers such as *The Blended Value Proposition: Integrating Social and Financial Returns* in California Management Review, Summer 2003, Vol 45, No 4, pp 35-51 available from the www.blendedvalue.org website..

[12] A suspensory loan is a loan which is only repayable in certain circumstances. A typical arrangement would be a ten-year loan which would be repaid if the property for which it was lent was sold before the ten years was up. After the ten years, it becomes a pure grant.

borrower realise that the loan is not a donation which has yet to be declared as such and helps the lender cover the costs of the lending activity.

Additionality

3.4.14 Non-charitable social lenders are usually providing loans and investment on broadly the same terms as commercial banks. Non-charitable social lenders are successful to the extent that social enterprises prefer to use them over commercial banks for the following reasons;

- because they are better aligned to their borrowers
- are more knowledgeable about what they are trying to achieve
- are better able to judge the real risks they face
- are more flexible, etc.

3.4.15 Good charitable social lenders will be all of these things above as well. However, if the terms of the loans offered are effectively identical to commercial loans, then this may represent insufficient additionality: a commercial bank should do it so what's the point of us doing it too?

3.4.16 Through the consultation process, banks were clear in stating that there would be no point in foundations duplicating what they do. They took this further with the question that, since they would anyway lend on a reasonable proposition, that would only leave 'unreasonable' ones which would be risky and which foundations would be well advised to avoid.

3.4.17 The argument here, which is now largely accepted overseas, is that social lending is a particular sort of lending, no less rigorous than different types of commercial lending. It is just managed within different parameters.

Risk

3.4.18 'Risk' is another complex term which needs clearer definition within the discussion of this paper. In a lending context[13] it means the likelihood of the borrower, either;

- failing and not repaying the amount lent
- failing and only partially repaying the amount lent
- getting into difficulties and having to extend the term of the loan.

Risk can also mean the interest on a loan that is not paid, but in a well-managed loan book that risk should be limited because difficulties with a borrower will be managed promptly and so arrears in interest should be minimal.

3.4.19 Any loan incurs risk. It depends on; guesses about the future, the quality of the borrower's management and so their ability to deal with any problems as they arise (and they almost always arise), the soundness of the plans, and plain good luck. There are no risk-free loans. However, there are objective risks and perceived risks. Any lending in a new area represents a higher level of risk for the lender because they lack experience. A commercial bank not used to social lending will perceive a higher level of risk in a similar way to an experienced home mortgage lender perceiving higher risks in business lending. Their unfamiliarity makes it difficult for them to see the key drivers – what is likely to work and what not. This is different from the real risks the lender is incurring. The expertise of social lenders lies in differentiating between the real/objective risks and the perceived risks.

[13] The other main financial context is the financial markets where most endowed foundations have a substantial amount invested. There it usually means the volatility of an asset class – the frequency and extent of peaks and troughs in the return on an investment within reasonably well-defined bandings. Recent events have made clear that this can mean the possibility of long-term losses or even the absolute failure of the investment even there.

4 International experience

4.1 New social lenders

4.1.1 Social lending has been a feature of the financial landscape for a long time. Some go back to the 17th century but have lost their original social orientation. Credit unions, building societies, co-operative banks and special loan funds all have a long history. Their initial motivation was to achieve a social end, often through mutual self-help. Finance has always straddled an uneasy compromise between being a conventional, even aggressive, commercial activity and a form of social service. Recent events in the financial markets and failing banks make it clear that where most other businesses can just fail if they make bad bets however big they get, banks and finance companies generally constitute a type of social infrastructure which will only be allowed to fail where the social consequences are not too high.

4.1.2 A general pattern seems to have appeared where banking and investment businesses which were founded on a mixture of financial prudence and good investment(and sometimes with social intentions of various sorts) gradually lose that inspiration and become conventional businesses.

4.1.3 In the late 1970's, there were a number of new initiatives in continental Europe, the US and the UK to create new socially-orientated financing organisations. Some became banks, some community loan funds, some investment services providing information about company performance, and some "ethical investment" funds seeking to invest and try to change or avoid companies with what were considered to be performing badly in some non-financial sense. Gambling, alcohol, tobacco, armaments, apartheid were some of the issues at that time.

4.1.4 Some of the socially-orientated financing organisations who achieved long-term success and operational sustainability are listed in the box to the right (however this list is far from being exhaustive). Of special note on the list are anomalies like *Vancity* which started just after the Second World War and has become a leading financial institution in Canada without entirely losing its original social impulse. The *Co-operative Bank* in the UK, was founded in the late nineteenth century as part of the *Co-operative Wholesale Society*, which was formally a mutual savings bank that had largely lost any active social motivation. This changed in 1992 with the launch of an ethical policy[14].

Continental Europe	
Triodos Bank	Netherlands
GLS Gemeinschaftsbank	Germany
Merkur	Denmark
Banca Etica	Italy
UK	
Mercury Provident (now Triodos UK)	
Ecology Building Society	
Charity Bank	
Co-operative Bank	
Aston Reinvestment Trust	
Glasgow Regeneration Fund	
USA	
ShoreBank Corporation	Chicago
RSF Social Finance	San Francisco
Self Help Credit Union	
Canada	
Vancity	Vancouver

4.1.5 This list mainly concentrates on those who have been directly involved in lending. It doesn't include the many stock-market based 'ethical' investment funds which grew up over the same period. These offered ethical investment screens avoiding investment in certain sorts of company such as those involved in armaments, alcohol, tobacco, gambling and so on[15]. Such funds, even in their most aggressive forms, are not social investors in the sense used here as their investment target is still mainstream companies, but their presence and development in the USA, Europe and the UK were

[14] Terry Thomas the former CEO who was responsible for the new ethical policy and the general drive to re-orientate the bank along these lines saw the introduction of the policy as both a commercial and a principled matter, and that it would be good business for a smaller bank to distinguish itself in this way. It has indeed been very successful.
[15] Ethical investment funds gradually became socially responsible investment (SRI) funds which in turn has led to the current move to responsible investment amongst mainstream investment funds.

important in creating a climate where increasing numbers of savers were encouraged to look for savings products which offered some social and ethical return as well as a financial one.

4.1.6 Such social and ethical savers fuelled the growth of the direct social lenders, but it's important to realise that most of these banks and funds had to raise their money from the public which meant offering products and services that were commercially competitive. In the very early days, they tended to offer lower rates of return but as their growth continued, they had to offer 'reasonable' rates: eg not the highest in the market but typically around the middle of the market and had to avoid taking unreasonable risks. Therefore, regarding risk and return, they were needing to offer a full financial return, as well as, a social return.

4.1.7 This meant that the terms and rates for their loans had also to be broadly similar to those offered by mainstream banks and that they had to compete on factors other than the cost of the funds alone. They did have some advantage on cost in the early days when they attracted lower cost funds, and then later because they were generally better able to assess the real risks social enterprises were running because of their greater knowledge of the field. As was noted above in section 3, mainstream banks tended to perceive social enterprises as inherently risky and so priced their loans higher and made more onerous security requirements. Social lenders' rates were reasonable and tended to be more stable.

4.1.8 However, more than cost, social lenders were committed to the sector, were knowledgeable about what was happening, were culturally aligned with their borrowers, were often more flexible and provided terms which fitted better with their borrowers' situation. For example, community-based projects typically have a largish network supporting them. Where conventional security is weak or absent, some social lenders use community guarantees whereby a larger number of smaller guarantees are obtained from that 'community of support'. This is potentially administratively burdensome and costly so social lenders developed efficient systems to reduce the costs to something acceptable.

4.1.9 Mainstream banks simply didn't see this as an interesting area to develop. However, this has started to change. Social enterprises themselves have developed and become more conventionally bankable. They have reached a size and number to become commercially interesting. The perception of inherent riskiness has abated, and the banks have been able to follow the techniques and approaches developed by the social lenders. Some have created special units to manage this. Examples are *NatWest Community Finance Fund*, part of *NatWest*, itself a part of *RBS* in the UK, and *Rabobank's Sustainable Finance Unit* in the Netherlands. Some, believing they have a responsibility to provide banking services to sections of the community they find difficult to reach, have opted to fund the social lenders themselves since they appear to be more efficient in providing services for this sector[16].

4.1.10 The social lenders took different forms in Europe and North America. In Europe the main development has been social banking and social loan funds. These focus on borrowers demonstrating 'positive social and environmental values' which included quite a wide range of sectors such as environmental initiatives, charities, social businesses, social and affordable housing and community groups. Triodos Bank, for example, was an early investor in renewable energy projects such as wind farms in Europe before the mainstream banks became involved.

4.1.11 In North America, the focus is more on community finance, particularly through community development finance institutions (CDFIs). These targeted employment creation and economic regeneration of depressed areas. A well-known example and leader in the field is ShoreBank, a registered bank where many CDFIs are funds often raising finance through sponsorship and large grants from foundations. Shorebank has its operations located in the south shore district of Chicago city since the 1970s and has been directly responsible for turning around an area which was rapidly 'under-developing' and now reaching its prosperity today. Most of the loans made by Shorebank are not to social enterprises but to local people for employment, self-

[16] Barclays Bank in the late 1990s experimented with funding community loan funds on the basis that if the bank was suffering losses in the region of 10% they could provide funding to a community loan fund at a discount of 5% and save money. The exercise had limited success mainly because of the difficulties the bank and the loan funds had in working together.

employment, housing renovation and improvement and so on, but in ways which supported economic development.

4.1.12 The list given above is very abbreviated. For example, there are now over a thousand community development finance institutions in the US and some 200 social banks and loan funds throughout western Europe. There has also been a parallel phenomenon in the developing world which is that of the microfinance institutions. These provide financial services to the very poor – savings, lending, insurance, etc. A well-known example and one of the pioneers is the Grameen Bank in Bangladesh[17] started in 1976. The growth of the microfinance institutions has been in many ways even more impressive than the community banks and funds in North America and the social banks and funds in Europe. Most developing countries have microfinance initiatives, usually several, and many of these are banks some with millions of customers. However, other than being a third leg in the international development of social finance since the 1970s – in addition to the European social banks and the North American CDFIs – they are outside the scope of this report.

4.2 Foundations

4.2.1 Some foundations were part of this development from the start. Ford Foundation in the US began in 1969 with a fund lending to black and minority-owned businesses. This was initially unsuccessful incurring substantial losses. The Foundation analysed what was happening and re-launched the fund a few years later but this time providing the funding to community development initiatives which would then manage the funds. This proved to be far more successful.

4.2.2 Very few foundations were involved in social lending throughout the first twenty years of social lending development from the 1970s. The strong separation between commercial investment of their endowments and the grant basis of their programmes appears to have been a major factor. US foundations were active but followed the experience of the Ford Foundation and did this mainly by supporting CDFIs. This was a main factor in the latter's significant expansion. They made extensive use of non-commercial investments – which were beginning to be called program-related investments or PRI – and also in some cases substantial grants. Most did not undertake lending themselves except in this specific sense. And even as late as 2003, Jed Emerson argued that foundations should look more broadly at loosening the strictures on how foundation endowments might be invested[18].

4.2.3 In the UK, there was a general view that PRI might breach a foundation's charitable status even if it could actually be done[19]. But some experiments started towards the end of the 1990s. Charities Aid Foundation (CAF), a service charity supporting the development of philanthropy in the UK, was particularly active in encouraging the idea of charity banking. It set up its own lending service[20] in 1995. In 2001, this became Charity Bank, a registered bank which is also a charity that takes deposits from the public and lends entirely for charitable activities. A number of UK foundations led in providing the bank with its capital. CAF then also created a higher risk entity called Venturesome which acts as a specialist investor for charities.

4.2.4 Tudor Trust had been experimenting with loans and direct investments, usually property related, since the mid 1980s. Some of these were equity linked, whereby it would share in the increase in value of a property. *City Parochial Foundation* – established to support the poor in London – had invested in a resource centre for voluntary organisations in Holloway in the mid 1990s. Other foundations were making loans to UK housing associations[21]. The Sainsbury Family Trusts were also providing some loans and were particularly interested in providing

[17] Mohammed Yunus, its founder, received the Nobel peace prize in 2006 for his work at Grameen.
[18] *Where Money Meets Mission: Breaking Down the Firewall Between Foundation Investments and Programming*, Jed Emerson, Stanford Social Innovation Review, Summer 2003.
[19] I attended a number of meetings and seminars with foundations in the UK in the late 1990s to discuss lending to chariites and recall being asked with sympathetic incredulity by a director of the Baring Foundation, "but how on Earth do you lend to them and get the money back?"
[20] Called Investors in Society.
[21] UK housing associations are providers of social housing.

funding for microfinance initiatives in the developing world. So, by 2000 there was a small but fairly high profile body of activity testing the social lending space.

4.2.5 But there was still uncertainty about how far this could go. The UK Charity Commission addressed the issue of whether PRI was allowable in guidance notes issued in 2002. It made clear that it was and that this was a separate matter from a more general debate about whether foundations, in the commercial investment of their endowments, could apply socially responsible investment policies[22]. This, along with Charity Bank, the much higher profile of social lenders in the UK like Triodos Bank, and the example of those foundations who had some experience in this, gave substantial encouragement for the development to continue.

4.2.6 Estimates vary of its size. I have been unable to find any systematic contemporary published survey and believe none are available. The Foundation Center in the USA published a survey of PRI in 2003 which, at that time, showed about $223m invested mainly in CDFIs in addition to the substantial capital grants which had been made. Margaret Bolton in a 2005 publication[23] reported unpublished UK information from the Association of Charitable Foundations. This indicated that over 20 of slightly more than 300 member organisations had offered loan finance. However, based on discussions with various practitioners in both the USA and the UK, a reasonable estimate is that about 20% of foundations are now undertaking PRI in some form, and where they are doing this it typically represents about 5% of their endowment. Some have made a more substantial commitment. FB Heron Foundation appears to have committed about 20% but part of this may be mission-connected investment (MCI – see Appendix 1).

4.2.7 Where PRI is undertaken it is generally done so via a specialist provider. Few foundations undertake it directly. Where they do, this tends to be for a small number of larger investments where they use professional advisors. There are a number of exceptions to this. In the UK, foundations like Tudor Trust continue to undertake some direct investments, but the development of organisations like Charity Bank and Venturesome and also the greater prominence of social lenders have provided other routes to achieving this end.

4.2.8 The US has a longer history of this with the CDFIs. There have also been developments with specialist foundations such as the Calvert Foundation offering services similar to Charity Bank and Venturesome in the UK managing specific portfolios. However, they tend to offer services more through pooled products such as their community investment notes which a number of foundations have taken up as a form of PRI.

[22] At around that time, the Charity Commission was also moderately supportive of socially responsible investment policies for the investment of the endowment on the grounds that this was likely to ‘deliver the best long term balance between risk and return’. *CC14: Investment of Charitable Funds*, February 2003.
[23] *Foundations and Social Investment: making money work harder in order to achieve more*, Margaret Bolton, Esmee Fairbairn Foundation, 2005, p9.

5 New Zealand experience

5.1 History

5.1.1 New Zealand saw some developments similar to that overseas but on a smaller scale. What is now Prometheus Finance, a finance company, was launched in 1983. CELT – the Community Enterprise Loan Trust – was launched around the same time but failed after a few years. It inspired other initiatives such as NELT, the Nelson Enterprise Loan Trust, which are still active today and other small local investment organisations. These include the Methodist Employment Generation Fund in Auckland and Northland, Just Dollars in Christchurch and the various Angel Funds in different centres throughout New Zealand.

5.1.2 Two of New Zealand's community trusts – eg *Southland Community Trust* and *Canterbury Community Trust* - have each been making loans for over a decade as a reasonable but relatively quiet activity. The Tindall Foundation has also experimented with loans in the past and has now begun to use them more actively.

5.1.3 Some local councils have also offered local groups loans on soft terms. For example Christchurch City Council has run a Community Organisations Loan Scheme for some years as part of its general community funding activities.

5.2 Current social lending in New Zealand

Community Trusts

5.2.1 **Southland Community Trust** has tended to use its loans scheme as a reserve offering where it doesn't consider it can make a grant but still wishes to support the activity. It might be because the amount needed is too great or that the activity is not one they consider suitable for a direct grant. For example, they might assist a sports club invest in its recreational facilities.

5.2.2 Southland Community Trust makes about five loans a year. John Prendergast, the CEO, manages these loans directly which includes undertaking the loan assessment, doing the due diligence, and dealing with any issues which arise. They do not use external services other than occasional legal advice for documentation. The trustees of the trust make all final decisions based on John's recommendations.

5.2.3 Amounts are generally in the $20-50k range but can be higher. Loans will typically be secured in some way though the security may have limited or no real value – for example, a property which has no real alternative use or where Southland ranks behind the security for a bank loan. They also make use of guarantees.

5.2.4 The term of the loan is tailored to what is appropriate for the purpose of the lending. So this can be quite short term, say about three years, or much longer term, as much as twenty years.

5.2.5 They charge an arrangement fee for making a loan and they will charge interest in some cases but many loans are interest free. The loans sit on their balance sheet as part of the endowment. They calculate the loss of commercial return by reference to a fair assessment of a market rate. The discount is then paid as an internal grant from the programme budget.

5.2.6 They place emphasis on additionality and will assess whether an applicant could raise the money elsewhere. If so, then they won't fund.

5.2.7 They have had occasional difficulties in getting repayment. Where this happens, they are active in engaging with the project and seeing the difficulties get managed through. They are prepared to foreclose but they consider they have the strong sanction in the borrower knowing that failure to repay would be well known and that the Trust would not fund again. Most borrowers are likely to need grant funding from the Trust at some point in the future.

5.2.8 **Canterbury Community Trust** has a lending scheme with a higher profile and activity than Southland's. They will also lend where they might not be willing to provide a grant. They advertise the fact that they make loans and they make about 12 a year. Wayne Ward, the CEO, is similarly directly involved in management of the loan in assessment and dealing with later issues although a sub-committee of trustees will meet potential borrowers as well. They use standard documentation for the most part and modify this where needed.

5.2.9 Amounts are generally in the $20-50k range but they will make substantially larger loans in some cases but they won't go above $500k and they average about $100k. They are willing to lend unsecured but will take security where its available or will be helpful in managing the loan[24]. They keep loans to less than 1% of the value of their endowment.

5.2.10 The terms of loans should be 10 years or less with loans less than $50k repayable within 5 years.

5.2.11 They don't charge an arrangement fee. They will charge interest on some occasions and sometimes on larger loans provide an interest-free segment as well as an interest charging one. They use a similar method to Southland in charging the programme budget for the lost income on the endowment.

5.2.12 They also place emphasis on additionality and won't lend where there are alternative sources of funding.

5.2.13 Wayne inherited some bad loans about 10 years ago when he took up the role of CEO and managed these through over several years with some write-offs. They would be prepared to foreclose but they find they can manage most difficulties through and believe that reputational sanctions are usually sufficient.

5.2.14 Interestingly, they have lent to the Nelson Enterprise Loan Trust to enable them to extend their economic development funding.

Private foundations

5.2.15 TTF has undertaken some lending in the past and, partly in connection with this report, is beginning to offer loans case by case. It recently concluded a several million dollar loan to the New Zealand Housing Foundation and has been actively considering a smaller loan to another potential borrower. They are clear that they want to keep it under the control of their trustees but that they don't want to manage this directly themselves.

5.2.16 Several other private foundations[25] have been considering lending. One example is Todd Foundation who prepared a short internal assessment. These foundations are interested in exploring the possibility, understanding what it might involve and would be willing in principle to take it up subject to seeing a practical way in which they could implement it. This would mean some third-party assistance being available.

Social lenders

5.2.17 **Prometheus Finance**[26] is a small finance company started 26 years ago firstly as a foundation and then as a credit union before adopting its current form. It is based in Napier but operates throughout New Zealand. In style it is similar to the European social banks[27] in lending to projects which it considers can demonstrate positive social and environmental activities. Examples are charities, eco-housing, organic agriculture, energy efficiency

[24] Social lenders will sometimes use security as a sanction should a loan get in difficulty. The security may have little commercial value but calling the security will have serious consequences for the borrower. This can be important to prevent a borrower walking away from the debt. However, I should say that the Trust gave no indication that they would use it in that way.
[25] Who don't wish to be named.
[26] I am a director of Prometheus Finance.
[27] Two of the European social banks, the Dutch Triodos Bank and the German GLS Gemenischaftsbank, have invested in share capital in Prometheus Finance.

schemes, waste recycling, education, cultural projects. It raises its funding mainly from savings accounts offered to the public. It has about $16m of funds under management.

5.2.18 Prometheus has three staff based in Napier and also uses the services of two active directors and an experienced banking associate when needed.

5.2.19 It mainly provides term loans up to $500k but also runs a scheme with EECA providing small consumer loans for solar water heating. Term loans are always secured calculating the value of the security on a commercial basis using a range of types of security including property, guarantees and GSAs. The consumer loans are effectively unsecured.

5.2.20 The terms of loans varies considerably being from 1 year to 25 years depending on the nature of the borrower's needs.

5.2.21 Arrangement fees and interest are always charged. The rates are broadly the same as the commercial banks.

5.2.22 There is no requirement for additionality only that a borrower demonstrates positive social and environmental activities. Most borrowers could borrow from a commercial bank.

5.2.23 Prometheus will definitely foreclose where other options have been exhausted. It had to manage some bad loans early in its life but has since then had almost no bad debts. However, towards the end of last year it made a loss on a commercially-based project.

5.2.24 A number of **small community-based loan funds** have been operating for a number of years[29]. The main ones are the **Nelson Enterprise Loan Trust** and the **Methodist Employment Generation Fund**. They take slightly different approaches, but both are targeted at employment generation and small business development. Both are more akin to the US CDFIs in terms of their objectives.

	Area of operation	Approx funds under management $'000	Typical loan size $
NELT	Nelson	400	20,000
MEGF	Auckland and Northland	550	15,000[28]

5.2.25 They generally lend unsecured. They charge interest usually at sub-commercial rates. NELT has a very good record on bad loans claiming only one small one throughout its life. MEGF has had a higher level at about 10% but believes this is an appropriate level for the type of lending it is doing.

5.2.26 They are funded mainly by historical capital grants but NELT, as noted above, has also benefited from a loan from Canterbury Community Trust. Operational sustainability is a challenge both given their small size. NELT believes it can reach that with a slight increase in funding but has been unsuccessful in that over several years now. MEGF considers it would need a substantial increase to achieve that.

5.2.27 There are some **special purpose loan schemes** within in New Zealand with a specific local and operational focus. A good example is the **Sustainable Initiatives Fund Trust (SIFT)** based in Canterbury which is independent but was set up with funding from Christchurch City Council from landfill levies. Its objectives are to fund projects based in Canterbury which will themselves reduce waste or help develop new technologies leading to that. It provides grants and loans.

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[28] This is the historical figure for MEGF but they are increasing the amount they will invest in a single project.
[29] In 2006, I prepared a report for the Tindall Foundation which analysed in detail these funds and specifically what would be needed to get them to operational sustainability. The Tindall Foundation had supported their operational budgets over several years. The report is available on the Tindall Foundation website www.tindall.org.nz.

5.2.28 It mainly focuses on small loans in several bands up to $50k but will provide larger loans. It takes security – typically personal guarantees and charges over company assets – and may charge interest.

5.2.29 It has one staff member but also has experienced trustees who are actively involved in loan assessment.

5.2.30 During the period of the consultation, a new initiative called **Ripple** was in preparation. If this is successful in being launched, this would is an interesting lending initiative targeted specifically at larger charities. The basis of the scheme[30] is to raise funding from high-net worth individuals through the issue of a limited term low-coupon charity bond. The funds raised would then be used to make loans with a similar term to larger charities. The amounts lent would be in the region of $1.5m. Typical term would be about 5 years and the rates at which funds were lent would be below typical market rates. Unfortunately the initiative has been paused because of difficulties in raising the funding given the general financial crisis. Considerable interest had been generated and it seems likely that the initiative would have been successful but for that crisis. Those behind the initiative have decided to wait until conditions improve before attempting to launch it again.

Public sector lending schemes

5.2.31 Several local authorities offer community loans or guarantees. For example, Christchurch City Council offer **Community Organisation Loans** for typically 5 years but up to 10 years at 4.5% a year for community projects based in the city. Amounts are flexible but are usually no more than $30k. Hamilton will provide loan guarantees for sports and recreational organisations. These are intended to expedite bank lending where there is inadequate security.

5.2.32 Central government departments provide a range of welfare-based loans, and some government department agencies provide lending support for specific schemes. For example, the **Energy Efficiency and Conservation Authority** provide small loan subsidies for solar water heating installation in a scheme run in partnership with Prometheus.

5.2.33 The Ministry for Social Development is planning research into a broader social lending scheme in 2010 but nothing is offered at the moment.

Maori schemes

5.2.34 I could find no examples of Maori schemes. There is extensive and very competent investment activity within Maori incorporations and trusts but this was always on a fully commercial basis, maximising returns and using those returns to benefit iwi through grants and direct self-investment in community facilities.

5.2.35 Interest in a potential scheme was limited. Generally, the view seemed to be that this would require a fundamental re-evaluation of how they were operating. There's wide recognition of the need for investment but this was more in terms of creating opportunities for young people especially to attain stronger educational outcomes.

5.2.36 That said, I encountered a number of situations where there were projects which would make good social borrowers. Thus, I suspect that there needs to be some steps taken in demonstrating what could be done and probably it would proceed through borrowing in the first instance which might then stimulate incorporations and trusts to set up their own lending schemes over time.

[30] As with some other developments described in this report, considerations of confidentiality and commercial sensitivity mean that only a limited outline of what is proposed can be given.

5.3 Potential borrowers

5.3.1 As the above indicates, the level of activity in New Zealand is low. If social lending was on offer, would there be borrowers who would want to take it up? The answer is that there would, that it is already happening but is not especially visible because borrowers have to find other sources, and the level of activity is low partly because there are so few providers. My reasons for concluding this are the following.

Experience of Southland and Canterbury Community Trusts

5.3.2 Each has demonstrated a steady stream of successful lending over 10 years. It seems very unlikely that other community trusts, and private foundations, would not find a similar flow of smaller borrowers if they began offering such funding. It appears that they are either declining applications for grants or agreeing them and simply not seeing the applications as potential loans. In discussion with both John Prendergast and Wayne Ward, both appeared to think there was a larger population of potential borrowers out there but, partly because of the need to constrain who they would lend to because of their regional focus and because they were each managing the loan books personally, they had decided to keep at the current levels.

Experience of TTF

5.3.3 TTF's initial forays, with almost no publicity, indicate that there are others who would take up loans. Of course, a project which believes it can get a grant – seen as 'free' money – will typically seek that rather than a loan. It's when a grant is declined or simply not feasible because of the amount of funding needed, that borrowing will be sought.

Large projects coming to other trusts and foundations

5.3.4 A number of trusts and foundations gave examples of projects which had approached them for large capital grants in the last 5 years but which they had declined as they would take too much of their grant budget or because a loan of some sort was clearly needed rather than a grant but the foundation had no realistic way of managing such an arrangement.

Activity of Prometheus and Ripple

5.3.5 As described, Prometheus has an active loan book and can service projects who can borrow on broadly commercial terms up to $500k. However, it is regularly approached by projects which cannot meet its criteria either because they need to borrow more than $500k – projects needing $1m are not uncommon – or because the nature of the project means that they cannot provide adequate security. They are then declined and these projects either do not proceed or have to find way of securing commercial bank loans. Very often where they do this, they will raise insufficient funding, or get it in a form which will not suit the real profile of the project. Paradoxically, this increases the risk of failure.

5.3.6 Ripple, in its preparations for launch which have now been postponed, had already identified a potential initial loan book of approximately $15m. These were specific charities which had projects ready to run and for which it had taken the first steps in due diligence but which would not have been possible with normal bank lending not because the projects were weak but because they didn't conform to the requirements a fully commercial lender would have had.

Projects already borrowing

5.3.7 There are a number of organisations already raising finance. These might be social businesses, such as Trade Aid which have raised funding directly from the public through a type of share issue; or they are borrowing to the extent that a commercial bank will allow them and constraining their activity to that; or simply ideas of already successful entities which fall by the wayside. Those wanting to get underway but who cannot find suitable funding are, of course, not visible because they are not there.

5.3.8 Examples of potential borrowers I met during the consultation were in fields as diverse as waste recycling, social and affordable housing, charities with a regular stream of donations which had attempted to buy their own premises but been declined by commercial banks who considered a donation stream as unreliable income[31], community development initiatives, artistic and cultural initiatives had an income stream but no security.

Projects not yet borrowing

5.3.9 This is all happening where there is little encouragement. It's clear from experience overseas that people start to create projects around funding prospects. This needs to be carefully qualified. Creation and advertising the presence of pots of money easily leads to weak projects which simply chase the money. Every foundation will be aware of this. What is meant here is something different, that there are projects which are not taken forward because there is no realistic way to get them funded. Foundations won't because they are too large or look too commercial; commercial banks won't because they don't fit the profile they need in terms of security and return, and they look too risky.

More generally

5.3.10 So I think it's reasonable to suppose that there would already be a reasonable base of projects which would take social lending opportunities should they be more generally available. However, what was also clear was that this would take time to develop as new sources of finance were offered. Potential borrowers would arise gradually in part stimulated by the presence of such funding.

5.3.11 Overseas, there was a gradual build up as the examples and successes of early projects showed how it could be done. There's already a fair flow of such projects. Provision of more appropriate funding is likely to engender more longer term.

5.4 Attitude of banks

5.4.1 No commercial banks are providing any sort of social lending scheme. The one possible exception is Kiwibank which is providing some forms of community-based banking derived from the Australian Bendigo Bank model[32]. However, for Kiwibank, these are essentially commercial distribution arrangements.

5.4.2 In the course of the consultation I talked directly with TSB Bank – which is the source funds for the TSB Community Trust – Westpac, ASB Bank[33] and Kiwibank. I also checked the services provided by the other main banks and some of the smaller local banks. The questions were

- Were they undertaking or considering any forms of social lending or special provision for charities?
- Would this be interesting?
- If foundations were looking to undertake social lending, would they be interested in providing such a service on a sub-contracted basis?

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[31] Even with a steady and demonstrable track record of 7 years in one instance.

[32] Bendigo Bank has been very successful in Australia in providing banking services to remote communities of which Australia has a lot. If a small community becomes 'unbanked' – there is no local bank branch or facilities – access to a banking services, online banking notwithstanding, becomes a major issue. Basic arrangements and facilities, such as business loans and similar, become very difficult requiring a day's journey to go to the bank. Bendigo developed a model where local communities would buy in to using the bank and get commercial and social benefits through, for example, Bendigo sharing some of the profits from its local business to provide community facilities and funding. Rob Lake the now retired CEO of Bendigo had some genius in developing this service in a way which was both commercially and socially successful. It remains to be seen whether it will survive Rob's departure and the wider consolidation of the Australian banks. New Zealand has no communities so remote but the community franchise model may still have sufficient attractions to be successful. Kiwibank's experiment with setting up branches in local offices with some local donation funding will be interesting.

[33] The meeting with ASB Bank was undertaken with Jenny Gill, CEO of ASB Community Trust. ASB Community Trust has an active and continuing relationship with ASB Bank.

The answers were as follows:-

5.4.3 None of the banks is undertaking or considering any such service other than Kiwibank's experiment with a form of the Bendigo community distribution model. Several of the banks see themselves as active in corporate social responsibility and publish social reports alongside their annual reports. Some of the banks offer affinity schemes such as BNZ's 'Save the Kiwi'. Valuable those these are, they are the 'community affairs' type of activity which many large companies undertake.

5.4.4 All considered that this would be insufficiently remunerative to be of particular interest. This also applied to providing a lending service to foundations which all thought would be expensive. However, this has not been tested commercially.

5.4.5 ASB Bank has a close relationship with ASBCT. ASB Bank was sceptical whether social lending could work. They were particularly concerned that it would cause problems under the legal doctrine of lender liability. Lender liability applies in a number of jurisdictions including New Zealand. In its weak form, it holds that where a lender gives advice to a borrower which the borrower then relies on and subsequently fails, the borrower can then claim that they have no liability to the lender as it was effectively the lender's doing. In its strong form, it applies where a lender makes a loan knowing, or with reasonable care should have known, that the borrower was not really in a position to repay the loan: you shouldn't have lent to me because you should have realised I wouldn't be able to repay and so it's your fault[34]. Wouldn't social lending, where loans were being made on a non-commercial basis, create a presumption that a failing loan should never have been made? Further discussion placated these concerns but it is clear that this would require special consideration from the bank which it may be willing to do but likely only for ASBCT.

5.4.6 My assessment is that this is something which a couple of the banks might pursue should social lending be better established and gain currency in New Zealand. They appear to have no appetite for it now. They certainly have no real experience other than, of course, good general banking skills.

5.5 New Zealand experience: in conclusion

5.5.1 There has been some development of social lending and there are some borrowers already with social loans, but it's limited and far less than has developed overseas. The local banks do not see this as an interesting area to develop at the moment. There have been some steady but not spectacular lending activities over a reasonably long time. There are also some local and more narrowly focused lending activities which appear to be doing well. All these have been stable and successful and show there's no particular reason why it cannot work here. There also appears to be demand not being well serviced at the moment.

5.5.2 There appears to be an opportunity. For those foundations who do want to take this forward, the next section considers how they might do it.

[34] New Zealand law appears to hover between the two positions. However, similar laws apply in the UK and the US and have proven no impediment. It's clear that as a matter of good lending practice a lender should *not* give advice in a direct form – else it is simply assessing its own recommendations. Social lending is no different in this than any other lending. And that any loan contract should make it clear that the borrower takes full responsibility for its borrowing and the fact that the risks are clearly understood. And that above all, social lending is lending within a specific context applying a reasonable duty of care. Lender liability has been established to stop reckless lenders taking punts on unreasonable lending propositions. The practice of good social lending is, if anything, far more careful than routine commercial lending.

6 Should foundations undertake social lending?

6.1 General considerations

6.1.1 The report's recommendation is, yes they should, and thereby lead development of this activity and the related increase in social entrepreneurship and social enterprises in New Zealand to match what has been achieved overseas. This would open up a sector of financially-sustainable organisations delivering social outcomes complementary to the existing charitable and third-sector organisations. Such organisations can more easily go to a larger scale and work in ways out of the reach of grant- and donation-based entities. This would greatly increase the social impact of the third sector and of foundations themselves.

6.1.2 However, that is a wider societal recommendation. What are the factors individual foundations should consider in deciding whether this is something they in particular should do?

6.1.3 As I hope I've shown, lending and giving are quite different activities. In the simplest case, a grant to a project takes place at a single point in time. Once paid, the transaction between the foundation and project is finished *financially*. Most importantly, it is finished in the accounts of the foundation because it has been expensed as a disbursement. Even if the recipient fails to fulfil the objectives for which the grant was made, there is no obligation to return the funds and no sanction the foundation will apply to the project[35]. It might be disappointing but it's finished. Once paid, the financial relationship between the foundation and project ceases and, most importantly, the financial effect on the foundation has already been crystallised.

6.1.4 By contrast, loans create a financial relationship over time. The loan and interest must be repaid, the lender keeps the borrower on its books and remains financially interested in the project's success potentially losing money if the loan fails where it was counting on getting the funds back. A large project or a number of smaller projects failing can have a serious effect on the financial health of the foundation itself[36]. What appeared to be assets in the balance sheet become write offs in the income and expenditure account. The foundation is budgeting to get this money back where, for a grant, it has already budgeted it as an expense and so effectively written off with no further financial effect.

6.1.5 So having planned to make loans and discovered later it had made a series of grants, a foundation can itself be badly affected and its ability to make future grants unexpectedly curtailed. It can avoid this by managing the lending well, and good management will be the single most important factor in making the lending work. To give a sense of scale, let's look at a foundation earning an average return of 5% a year on its endowment after paying costs and maintaining its real value, and giving all this away. If it establishes a lending programme of 10% of its endowment and in the course of a year lost 50% of this, then in that year it would have to reduce its normal grant programme by an unplanned 5% to stay within its financial policies – ie, it would have to make no grants in that year to recover its losses. This can, and has been[37], a serious problem for some foundations in the past.

6.1.6 Similarly, if lending is used for a large project where a grant, because of the size, wouldn't be used – say a $5m loan in the example – and this goes bad, then programme lending will have to be reduced by that amount or the foundation's policies breached once again. The point is to be very clear where it is a loan and where it is a donation and not to indulge in sloppy lending. As we have discussed, social lending is sometimes seen as 'soft' lending as it may not seek 'hard' commercial terms, but this should be clearly distinguished from 'sloppy' lending – badly

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[35] Of course, grants sometimes occur as a series of payments over time, funds used fraudulently may have to be repaid and a foundation, disappointed in the performance of a project, might well decline to provide future grants which for many projects will be devastating. All this moves in the direction of the relationship created by a loan but it doesn't disturb the basic nature of a grant.
[36] The old saw has it that before the loan is made the borrower has the problem but afterwards the lender does, especially if it's a large one or many smaller ones. The effect would be similar to a loss of income or value in the endowment – though one hopes not to the extent seen recently.
[37] Ford Foundation's early experiences were described above. In that case, it eased itself into lending activities committing a small part of its assets and learnt its lessons quickly.

managed, outside of a reasonable policy framework, on terms where the risks have not be properly identified. Social lending needs a rigorous approach even though its terms will generally be softer than commercial loans.

6.1.7 This requires a foundation to adopt a different administration, and probably more importantly, a different culture for its lending. In particular, the foundation must be ready to deal with the harder side of providing loans: it must be ready to foreclose when a project fails financially.

6.1.8 These factors are organisationally and reputationally challenging and are discussed in more detail below but, for an individual foundation setting aside that they might do it for the 'good of New Zealand', a reasonable question is why does it not leave it to other braver souls to take up. How does social lending help a foundation fulfil its mission?

6.2 Reasons to lend

6.2.1 The main reasons for a foundation to lend are discussed below. In summary, they are to

A Increase its impact by extending its reach both in amount and type of project
B Allow successful projects to achieve greater scale
C Build stronger projects by improving a project's management
D Provide better focus on long-term operational sustainability in projects
E Allow projects to acquire assets
F Avoid the weakening of a project through inappropriate grants
G Help build social markets
H Allow systematic interventions where a mixture of loans and grants are needed

A Increase impact: extend a foundation's reach

6.2.2 Most foundations receive many more applications for funding than they can satisfy. Even pruning the poorer of those, there are usually a significant number which would have been funded if money had been available. Estimates vary, but somewhere between 10% and 50% would have been funded. This appears to be the same whether a foundation is large or small. Small foundations want to extend their reach, while larger foundations are more visible and so are approached more often.

6.2.3 If a project can achieve its aims and repay the funds advanced then they are available to advance again. To give some sense of the increase in impact this might represent on some simple but reasonable assumptions, I'll assume again a net budget for grants after all costs of 5% of the endowed funds. If 10% of a foundation's endowment is used for lending, and the average period of a loan is 5 years, then once its lending has reached full capacity, an additional 2% of the endowment value would be advanced a year[38]. So, as set out in the table, a foundation with an endowment of $100m making grants of $5m a year would be providing new loans each year of $2m, an increase in funds disbursed of 40% a year. Different assumptions will, of course, lead to different values. For example, reducing the average loan term to 3 years, increases the percentage of additional disbursements in a year from 40% to 67%.

	$m	$m
Endowment	**100**	**100**
Net return after costs and maintaining the value of the endowment	5%	5%
Grants paid in the year	5	5
Lending		
Endowment allocated to social lending	10%	10%
Social loan book	10	10
Average loan term (years)	5	3
New lending a year	2	3
Funds disbursed in a year		
Grants	5	5
New loans	2	3

6.2.4 This all assumes that funds are provided at 'market rate', ie that there is no loss of income to foundation's endowment in providing these funds. This is not realistic and there will be some

[38] The calculation is 20% of loans are repaid in each year and so available to advance to new loans – ie, 20% of 10% = 2% of endowed funds.

loss but, as I hope I have shown, most social lending is about *access* to funds, not so much the *cost* of funds. Foundations undertaking social lending can reckon on a reasonable return on the funds advanced. If the borrowers can't pay that, then probably the borrowers probably should not be taking on loans at all.

6.2.5 At the time of writing, most foundations in New Zealand are having to limit grants severely because of the drop in the value of their endowments arising from the general decline in the financial markets. For foundations like community trusts, which generally seek to maintain the value of their endowment for future generations, it looks likely that this will take 5 years or more to recover the losses which have been suffered. So, the constraint on making grants is likely to continue for several years. This will be at a time when the need for funds from foundations is likely to increase because of the economic downturn. So, the demand for funds is increasing at exactly the time when the available funds is decreasing.

6.2.6 However, the additional 2% of the endowment advanced in new loans would be constant because there is no cost to the foundation, *providing* the loans are repaid – ie, they don't turn out to be bad loans and so 'grants' after all. In the current conditions, providing the funds provide a market return this activity can continue even where the traditional grant budget has to be constrained. So, had a foundation already had a social lending programme in place, this would have allowed a greater level of activity to continue.

6.2.7 As well as the quantity of the extended outreach, the broadening of the *type* of project reached may be more dramatic. Large capital projects might not be fundable simply because they would use up too much of the annual programme budget. For example, one foundation with an endowment of $100m achieving net returns of 5% will have $5m to give in a year. A project requiring $1m would use up 20% of that budget. However, on the assumptions used above, one such project could be undertaken each year without affecting the programme budget of $5m a year[39].

6.2.8 Additionally, where a project is seeking a capital grant to acquire a property, the foundation can fund it through a suspensory loan. This ensures that if the project sells the property in the short term, potentially making a substantial capital gain, the Foundation can participate in that and get it repaid, reusing those resources for other projects.

6.2.9 Thus, the foundation's reach is increased in quantity, in a way which is more constant, and also in being able to fund projects which may be currently beyond their capacity. This applies to all foundations but is arguably even more beneficial to smaller foundations where the much smaller size of grants they can make means that even medium-sized projects are often beyond their reach.

B Allow successful projects to achieve greater scale

6.2.10 Social enterprises which have a natural propensity to larger scale are currently limited, sometimes severely, in their ability to grow their operations. For example, a local community-based project such as a community centre wanting to acquire a building is unlikely to need to go beyond a fairly limited scale. They may generate income and so be suitable for a loan, but it's likely that a foundation will be able to provide a capital grant to provide sufficient assistance. A reasonably-sized social housing project, on the other hand, building properties will easily scale up. If it has developed a successful approach and has a natural market for what it is doing – affordable housing, eco-housing, housing for special groups, and so on – it can easily increase its activity providing the right sort of finance is available. A single building might require $150,000 which would be repayable as a short-term development loan of, say, a year. 10 similar buildings would require either 10 years of building single house, or a single loan of $1.5m for one year.

[39] I am making the further simplification that the return on the loan is a market return. For most social lending it will be a reduced return which will then either reduce the overall return on the endowment, or will draw on programme funds to top up the return to a market level. This means that less could be lent in fact but typically by a small factor as I discuss later.

6.2.11 Such a project might well be able to raise a substantial amount of its funds from commercial banks. But the terms of the loan tend then to assume commercial profitability and this will often limit or completely derail the project's social purposes. Affordable housing is an obvious example, where the affordability will be directly affected by the cost of finance. Access to lower cost, or even more predictable cost of finance, can make a considerable difference. Equally, such a project may want to experiment with social programmes which might not be possible with a conventional commercial lender. In these and similar cases, a social lender sharing the projects objectives and approach will usually be the better lender but often commercial lending has to be sought because it is in the only way to secure the level of funds needed for the type of activity. Thus, the foundation is able to fulfil its mission more effectively.

C Build stronger projects by improving a project's management

6.2.12 As discussed earlier, managing borrowing requires more sophisticated financial management of a third-sector organisation than a conventional 'fundraise and spend' model. This does not mean that the latter type of third-sector organisations are poorly managed in terms of what they need to do, but managing a balance sheet beyond 'fundraise and spend' does require stronger financial and organisational skills. This often results in a sharper focus on how the organisation is trying to deliver its objectives.

6.2.13 Done well, this will lead to better strategy, a better use of assets and opportunities and a more conscious approach to risk[40]. These tend to flow through to other aspects of an organisation's direction and management and so improve this overall. Overseas, some foundations have found that they help an organisation by offering a loan where they could easily have provided a grant. In the right circumstances, where the nature of the activity genuinely justifies it, a loan maintains creative tension and tight management where a grant tends to diffuse it.

6.2.14 Done badly, borrowing can lead a social enterprise to lose sight of its social objectives, to chase contracts and money because they must maintain solvency and meet loan repayments. However, there's little evidence that this is any more endemic than the loss of focus which grant-based organisations suffer as they repeatedly chase the next funding opportunity.

6.2.15 So, unlikely though it may sound, and with the overall caveat that this only works where the activity genuinely supports borrowing, lending tends to improve the overall management of third-sector organisations where grants weaken them.

D Provide better focus on long-term operational sustainability in projects

6.2.16 This follows the previous point. Long-term operational sustainability is an endemic problem for the third-sector. Their lot is often arduous. They must secure grants to provide the funds to achieve their objectives. The grants are almost always committed for a limited period, at best three or four years, often only for the current year though sometimes grants will be provided each year over several years. They are completely dependent on these and must return annually to foundations, government, donors in general, to raise this funding. The process is time-consuming. The difference in requirements of each funder can be substantial. Long-term strategies are a distraction and they have little hope of achieving any sort of financial or operational sustainability. This is highly dysfunctional. Reform of this, which is being actively pursued by some groups[41], is an important objective beyond this report.

6.2.17 It also saps the organisation's independence as they must adjust their activities to appeal to funders. It creates a strong culture of dependency. It also often creates an attitude of entitlement: we're doing these good things: you with the money should pay us to do them.

6.2.18 Income-generating organisations[42] naturally have a different orientation. They can plan and think longer-term. They can adjust their activities gradually responding to the financial signals

[40] Sometimes taking greater risk but in a managed way.
[41] Such as the Social Innovation Investment Group (see www.nzsef.org.nz/SIIG). As noted, the SIIG uses the term social investment differently from this report, meaning something more grant based albeit a more stable and reliable funding base for organisations focusing on social objectives who in most cases should not be considering loans.
[42] This includes organisations which have a relatively secure long-term income stream from private donors.

provided by their income flow. They have a naturally secure and manageable source of income and using this they can borrow and invest in their activities. Done well, this strengthens what they are doing – by extending their range, increasing their size and so reducing the proportion of their fixed overheads and improving efficiency.

6.2.19 Some third-sector organisations could be income generating even if only in part but remain grant-based because that is all that is offered by their current funding possibilities. Often this will require some investment, possibly only working capital investment. Of course, if they are so minded, this can be done through grants. However, this is quite a change in culture, and the focus on grants undermines this. This would change, has changed substantially overseas, where social loans are available and there is an expectation that this will have been thoroughly explored before grants are sought. This naturally leads to better long-term sustainability.

E Allow projects to acquire assets

6.2.20 Development Trusts[43] in the UK are local community-based organisations trying to help local disadvantaged communities cultivate enterprise and improve their communities. Central to their approach is the acquisition of community-owned assets, typically buildings. They provide income, an equity base over time, a resource which can accommodate community activities which provides greater independence for the localities. The funding for the assets is generally a mixture of grant and loans. The servicing and repayment of the loans is usually through subsequent fundraising and the income generated from the assets – rent but also, for example, returns from social businesses housed in the building.

6.2.21 Development Trusts have found that owning and managing assets supports more independence and resilience, creates a base from which they can develop activities and encourages stronger management. This has application to most reasonably-sized charities and social enterprises. The assets are generally buildings and land which typically increase in value over time which creates equity which the organisation can then use. An organisation which rents its accommodation will see a gradual increase in rents over time which exacerbates the problems of the perpetual fundraising cycle. For example, a derelict building can be renovated and brought into use (also creating local employment and general community benefit) and realises a development gain. This provides a financial buffer for a community project as it can more easily borrow and so even out its annual cashflows.

6.2.22 Thus, this is supportive of the sector in general, but significant asset acquisition is only possible if loans are available – or large capital grants, and these will be much more limited. Commercial lenders will generally be wary of lending into the sector as its characteristic sources of income are unfamiliar and different from commercial sources of income. Social lenders can make a significant contribution in this particularly if they target types of lending and make clear that funds are available.

F Avoid the weakening of a project through inappropriate grants

6.2.23 A project's long-term success depends essentially on the strength of its management. Where resources are too readily available, this tends to lead to looser management and poor decisions which will weaken a project. This is widely recognised in conventional business. The third sector is generally poor in resources and so might be thought unlikely to suffer from this. Nevertheless, it is often so especially where a grant is given for, say, a large capital project which could have supported a loan. The grant, "free" money, removes the need to use the assets acquired as efficiently as possible and poor management can easily follow. As controversial as this point may be for those working in the third sector, there are many examples which support it.

[43] See www.dta.org.uk.

G Help build social markets

6.2.24 Overseas, as described, there has been a substantial development of social enterprise. Most of these are social businesses, which have something they sell and so are naturally income generating. But, those sales are the way in which what is provided is paid for: it's not a means to make money and it's never profit maximising, and may not even be for profit at all. And the social outcome is primary in the transaction. It's a way of delivering social outcomes which those benefiting vote with their dollars, probably the strongest verification that what's provided is valuable. Or which becomes a self-scaling activity if government pays each time the service is delivered. Examples are social housing, fairly traded products, recycling, environmental goods and services, sheltered accommodation, employment generation, and so on.

6.2.25 Such activities face many of the challenges of small to medium sized businesses even though they are not profit maximising, including raising capital to set up and provide the working capital for their operations. This generally needs social not commercial loans and so is a key element in the development of so-called social markets.

H Allow systematic interventions where a mixture of loans and grants are needed

6.2.26 Certain types of community development require a number of different approaches acting in concert. For example, a disadvantaged community may need improvement in health care, housing stock, educational provision and small business development. Action which focuses on only one is likely to prove futile and lead to cosmetic changes. Where a foundation wants to work systematically in such situations and provide funding for several simultaneous interventions it will usually need to provide loans as well as grants. This might be done by commercial lenders and there are examples of successful projects, but a commercial lender's focus is (rightly) on pursuing its own interests and so it's likely that their intervention will be too narrow with a reluctance to lend even for good commercial propositions where they are insufficiently profitable. This risks weakening the intervention. Being able to provide loans alongside grants gives the foundation more freedom in how it can work in such situations.

6.3 Reasons not to lend

6.3.1 The previous section sets out the main reasons why foundations *should* lend as well as provide grants. Each of the reasons have been found compelling by other foundations overseas. Combined they set out a strong case for foundations being social lenders and thereby adding to their role as systemic actors for social change, for extending their reach and promoting a wider approach to the activities of charities and the third sector. New Zealand has not developed this strongly to date but the re-thinking of philanthropy which the economic crisis has engendered should, in my view, make the case compelling. It's important then to realise that there are some equally compelling reasons why foundations should *not* do it beyond the very understandable desire of trustees to seek a reasonably quiet life. Once again, in summary

A A lending foundation must be willing to foreclose where a borrower fails
B There is limited demand for social lending
C There is the wrong culture and inadequate capacity in potential borrowers
D There is the wrong culture and inadequate capacity in the foundation.

6.3.2 However, before addressing the real reasons why foundations should be wary of taking up social lending, we perhaps need to dispose of an often-stated false reason. In the course of my consultations for this report, I encountered the arguments which once had wide currency in Europe and the US but which have long faded.

6.3.3 The first argument ran from the 1970s until the mid 1980s and it was that social lending would not work as social borrowers would be too risky and couldn't handle loans. Today, the sheer number of successful social borrowers makes that impossible to maintain. Later, mainstream lenders have argued that this is not an area for them because it is insufficiently remunerative and doesn't fit with their approaches to lending. This may well be so but is not an argument against social lending, but only that commercial lenders are not naturally suited to it.

6.3.4 In New Zealand today, there appears to be a widespread view amongst commercial lenders that social borrowers represent a higher risk than commercial borrowers. Overseas and the experience to date in New Zealand with organisations like Prometheus show that this is not so. Indeed, providing the lending is done well, the risks appear to be lower. Commercial borrowers are usually isolated, standalone businesses. That means, should they get into difficulty, they will sink or swim by their own efforts. Social enterprises, by contrast, because of their social objectives or community orientation, usually have a substantial body of support around them which can be a considerable resource should they get into difficulties. This significantly reduces the risk of failure.

6.3.5 The perception of risk amongst commercial lenders is broadly correct but it is generally a statement about their own competence rather than the standing of the borrower – the important caveats set out below notwithstanding. One of the canons of banking is that you should know your customer. This is especially important when it comes to lending as, if you don't, you will not understand the real risks you are taking, nor pick up on key signals that the lending proposal is not well founded. For social projects, which may, for example, rely on an income which depends on a stream of donations, a commercial lender will often regard this as insubstantial preferring a history of commercial sales of a product. But of course sales are not in themselves robust and commercial businesses often find that their sales drop enormously in economic downturns. Perhaps surprisingly, donations from individuals tend to be more robust providing that the recipient charity manages its reputation and activities effectively. Lacking experience of this type of income, a conventional lender often concludes there is nothing sufficiently substantial on which they can lend. They are often right in their conclusion but don't always realise that it's them that's lacking in capacity to assess a strong donation stream from a weak one. As with any area of commercial investment and lending, the risk to a lender *is* higher if they are venturing into activities which they understand poorly. The injunction to the lender is understand your sector, know your customers, and then you will be in a position to lend well.

6.3.6 This is why well-run social lenders tend to do much better with social enterprises. Commercial lenders can do well too but are more successful where they set up special-purpose units which focus on social enterprise as has happened in the US and the UK. In the consultations for this report, Sam Knowles, the CEO of Kiwibank expressed interest and considerable insight into what would be needed for the Kiwibank to take up social lending. But his response was that it would not be commercial for the bank because he would need to assign his most experienced and insightful managers, and so the most expensive, to such an activity to make it work, and that the returns could never pay for that. I think this is probably correct.

6.3.7 The false reason is that this does not work. The correct reason is that this does not work for a particular lender, be it a commercial lender without the necessary expertise or commitment to developing it, or a foundation which will not take on the difficult disciplines needed. The latter are what we turn to next.

A The foundation must be willing to foreclose

6.3.8 Foundations generally have a deep knowledge of the sorts of third sector projects they support. This includes being able to distinguish between those run well and those badly, and those which are likely to succeed longer term who are most likely to be effective in realising their goals. On the face of it, they are potentially better lenders to this sector than a commercial lender being more knowledgeable and better aligned with a social project's objectives. However, commercial lenders have a very significant advantage: they accept and are willing to foreclose on a project when it is clear that it is failing, .

6.3.9 One of the most important factors determining whether a loan will be repaid is the borrower's belief that it must be repaid. As soon as this is in doubt, a borrower, especially one in difficulty who is having to juggle creditors, will start to subordinate the lender's interests to those of other creditors, to give less attention to meeting the lender's financial deadlines and payments and even to hope or rely on leniency or possible forgiveness of the loan. If the lender is not staunch in its readiness to foreclose if needed, this will communicate itself to the borrower in many subtle ways.

6.3.10 To be clear, this is not the same as being an overly aggressive lender who is too quick to foreclose before working with a struggling borrower to find possible solutions to the difficulties being faced. Many borrowers have to amend their plans as they proceed. This sometimes means they will need to re-negotiate the terms of a loan and a good lender should be ready to accommodate this and apply some leniency where it is rational to do so. This saves borrowers who would otherwise fail and avoids needless losses to the lender.

6.3.11 However, this has to be done in a way which does not call into question that the lender will foreclose, realise security and potentially close the project if it has to. Paradoxically, the borrower's understanding of the lender's readiness to do this assists rescheduling. Commercial lenders have the advantage that this will be the presumption; social lenders, by contrast, will struggle with the opposite presumption and then have to work harder to prove their mettle.

6.3.12 Even more seriously for the lender, if it gradually becomes known that they are 'soft', all their other loans are put at serious risk. Such information spreads rapidly.

6.3.13 This is the most difficult issues for a foundation to face in offering loans. Its *raison d'être* is to support projects and their work. Clearly, foreclosing will almost always end a project's life, where forgiving the loan may make it possible for it to proceed. The main reason not to do that is because it undermines the foundation's lending programme. That requires trustees to be ready to sacrifice a single failing project for the good of a number of other performing projects.

6.3.14 This is one reason why microfinance in the developing world has generally been most successfully developed by specialist providers and not by NGOs who have traditionally provided aid. Where such NGOs have tried to provide microfinance services, they have generally been unable to run them sufficiently rigorously to make them work because the individual hardship for the failing borrower is not something they are willing to countenance. If you lend money to a poor person and they fail they are poorer, but if you don't follow through the whole scheme fails and everyone is poorer.

6.3.15 This is sufficiently serious an issue that approaches and mechanisms need to be in place to *protect* trustees from having to face such difficult decisions when they arise. The trustees' staunchness needs to be discussed fully and some training undertaken, but this in itself will probably be insufficient when faced with the individual plight of the borrower. It's not unusual for struggling borrowers believing they are about to fail to try to contact trustees directly and make their case putting the trustee under huge pressure. It is then better that the decision is no longer the trustees to make which reduce the chances that such an approach is made[44].

6.3.16 Additionally, higher profile projects will sometimes try to use reputational threats to the foundation through the media or networks protesting their case and making the foundation appear uncaring acting in its own interests alone. A foundation needs to be ready for this and *make use of it* – ie, to accept the publicity and make a virtue of it so that other borrowers will understand that the foundation's loans really must be repaid. Trustees and the foundation's management need to be sure that they are ready to do this.

6.3.17 This all presents a very black view and is dealing with the problems which in a well-run loan book, where the lending decisions have been made carefully, and the foundation keeps close to its borrowers, will arise infrequently: most loans will go well. But accepting what's needed at the outset and then being consequent in following it through is essential on those few cases

[44] Some commercial banks move a struggling borrower to a new lending manager once it becomes clear that it's very likely to fail. Bankers, contrary to popular perception, often do identify with their borrowers and can lose their objectivity in assessing the real chances of success. Passing to a new lending manager who lacks the emotional history, can help rescue the situation.

where it will be necessary – and it will almost certainly be necessary at some point. Trustees who don't feel that they are ready for this should not undertake social lending.

B There is limited demand for social lending

6.3.18 I encountered this comment a number of times during the consultation and, of course, it's true. There are not many social enterprises in New Zealand looking for capital, and most charities have organised their affairs to seek grants and are only rarely looking for loans. Where they do need loans, they will use the bank. So where's the demand?

6.3.19 However, this is the classic reinforcement where there is little demand for something because it's not generally on offer, and it's not generally on offer because there is little demand. Overseas, when social lending started it was small scale and mirrored the development of social enterprise. As each gradually came to be understood, the demand increased as did the supply. The same will happen in New Zealand.

6.3.20 But the take up will be gradual and this is to be welcomed. It allows new ways of working to bed in both in lenders and borrowers, new skills to be developed, additional care to be taken in the early period, and mistakes to be limited and learnt from before the activity becomes more extensive.

6.3.21 In fact, the demand is already probably greater than is realised. Firstly, grants are being used at the moment where loans might be better used to the foundation's advantage and, for the reasons set out above, to the project's longer-term advantage in some cases. Secondly, projects will be using commercial bank loans which do not fit their circumstances well putting them at greater risk.

C There is the wrong culture and inadequate capacity in potential borrowers

6.3.22 Many charities have limited financial management capacity. This is not a slur on their abilities but simple recognition that they are set up to achieve specific social purposes, often have a strong volunteer culture, are struggling with limited funding and have a long history of keeping their administrative costs to a minimum. They will be allocating the minimum they can to their financial management.

6.3.23 This is then coupled with a financial approach which is largely fundraise and then spend. A simple cashflow approach will be adequate to their needs so that they proceed with activities when they have the money in the bank and not before, and have limited longer-term financial planning. It's simply not needed.

6.3.24 There are, of course, charities which do have the skills and administration needed but my experience and what I saw during the consultation leads me to expect that these will be in a minority.

6.3.25 The skills and administration of many charities is probably adequate for simple lending situations. However, that will usually still require some sort of longer-term projection and management of resources. The need for this might not be well understood or given sufficient importance. An attitude of solving problems 'when we get there' may prevail. Even if the capacity is there, the general culture will often be at odds with the sort of disciplines which borrowing requires.

6.3.26 This can be helped by the way in which the lender structures the lending process. Paradoxically, the way to do this is usually not to be overly helpful, not to do it for the borrower as the capacity and culture needs to be within the borrower. They need to be able to do it for themselves but the questions that the lender asks can make clear to both lender and borrower that work needs to be done on this. During the consultation, many consultees thought it would be good if lending foundations provided assistance in preparing applications and provided management help, and that this would be a contrast with banks who leave the borrower to sort themselves out. However, there is good reason why the banks take this approach: if they help, assuming they can, they are then judging their own work in assessing the application. Clearly, that's not what's needed.

6.3.27 Simple loans can also be structured to assist the borrower in this. For example, monthly rather than annual payments are often helpful to get the loan into the cashflow thinking of the project even if this then means a slightly larger loan is needed to manage the additional working capital needed. Similarly, sharp administration on the part of the lender so that a missed payment is followed up the next day to prevent problems ballooning will help.

6.3.28 As social lending becomes more commonplace, both culture and capacity will improve, but for now there is a need for careful implementation and greater care in assessing these more qualitative factors.

6.3.29 So, while simple loans will often be possible, anything more complex will need better skills. And, signs that the borrower has the right approach for lending and is encouraged in that will also be essential. A lending foundation would then need to be prepared to decline a loan request where it considers the capacity or culture is not sufficient, or, in the case of larger loans, to insist on a tangible improvement in the borrower's capacity as part of the loan conditions.

D There is the wrong culture and inadequate capacity in the foundation

6.3.30 The willingness to foreclose is the key cultural and has been set out above. This is the main cultural change which is needed and probably needs to be reinforced by appropriate procedures and arrangements.

6.3.31 Larger foundations have skilled teams but their skills will be those needed for assessing and providing grants, their motivation, culture and approach will be similarly orientated, and the administrative systems will be tailored to disbursing and monitoring grant payments. But assessing a project for a grant will rarely require the grant officer to ask themselves 'will we get the money back?'. That's a simple question with a complex answer. The grant officer's financial skills, their assessment of the potential borrower's management capacity and approach, the type of judgement that's required are all quite different. The grant officer's own motivation and culture will often also be inappropriate to the task of lending. Of course, many skills are transferable between making grants and lending, but the two are not identical, not everyone who can do one can do the other (both ways), and even those who can do both will often have difficulties having a workload which requires them to keep both sets of skills in play.

6.3.32 A foundation's administrative systems will also usually need considerable enhancement. The accounting system will need to be able to handle a loan book, recording and charging interest and details of security taken. To maintain effective control, the system will need to process payments and receipts daily so that if a loan or interest payment is missed, this is picked up immediately and the borrower contacted straightaway as this is a very effective way of reducing the risk of bad loans. Picking this up some time after the month end will generally not be sufficient.

6.3.33 After a loan is agreed, a contract will need to be drawn up and generally security put in place. This will usually be subcontracted to a legal firm but, even where it is, there needs to be an understanding of the arrangements by the borrower to be sure that they are appropriate and correctly processed.

6.3.34 It's conceivable that a large foundation could add to its team and its systems to do all this and could undergo the training for its trustees and management. But this is unlikely to be cost effective and is clearly beyond the reach of small foundations.

6.4 Conclusions

6.4.1 There are strong reasons to implement social lending which will increase a foundation's financial and organisational reach and capacity, help to promote social enterprise in New Zealand, and provide more appropriate funding for certain types of project. These present benefits to the foundations themselves, to their projects and to the wider social economy in New Zealand.

6.4.2 However, individual foundations need to consider very carefully their capacity and desire to do this. It is a fundamentally new type of activity and would require some substantial changes both to a foundation's culture and capacity to manage it properly. It's likely to present new types of challenge in the future and it does involve risk. So, while the argument to see it developed more generally might be accepted, an individual foundation's own decision might be not to proceed, or at least not to proceed until others have tested the ground and there's already wider acceptance and understanding of how it can be done.

7 How can it be done?

7.1 The basic choices

7.1.1 I now assume that a foundation has decided it wants to pursue this. What are the options for implementing it?

7.1.2 The basic choice is to manage it internally or to outsource it. This is discussed first of all. Outsourcing can then be undertaken in several different ways and I look at those. In summary, the options are

A Manage it internally B Manage it internally and provide is a service to other foundations C Outsource to a commercial bank D Outsource to an existing social lender E Outsource to a new special purpose agency for foundations

7.2 Manage it internally or outsource it?

Existing internal management approaches

7.2.1 Internal management of a loan book by a foundation is clearly possible as Southland and Canterbury community trusts have shown for over a decade. Both consider it has been a useful extension to their grant making. In neither case is it a major activity. Southland keep in reserve as something offered where a grant is considered inappropriate. Canterbury has been a little more front-footed in letting people know they will provide loans. In both cases, the lending is not a major activity but used regularly with as many as 12 loans being made in a year.

7.2.2 In both cases, the lending is directly handled by the CEO and relies heavily on their skills. This creates a key person risk, of course. In the case of Canterbury, some trustees are directly involved, and in both cases trustees in committee are directly involved in lending decisions, but the practical management lies with the CEO. Should the CEO not be available, these skills would need to be replaced. Both believe they could be but this would be an issue for the trust to face.

Internal management

7.2.3 So, internal management has worked for a low level of lending where the CEO has the right skills and manages it directly. Given that, and the acceptance of the key person risk, there are some clear advantages. Where a foundation like a community trust has a local remit, managing the lending internally will make good use of local networks which will provide key informal information and will alert them to problems which an agency from outside the area would not have. This sort of knowledge and information is invaluable and greatly increases the success of the lending.

7.2.4 The local context can also improve the longer term management of a loan. A failing project in a smaller constituency knows that it will be dependent longer term on future grants and loans from the foundation. It is strongly incentivised to ensure it meets its obligations under the loan. This can be an informal sanction which avoids some of the reputational and other difficulties discussed above.

7.2.5 More generally, where there is no local context, where a reasonable level of lending is intended above, say, 24 loans a year, or where there isn't a senior staff member who can take direct responsibility for the lending, internal management will require a considerable change to the organisation. In summary,

- grant officers need to acquire new skills, or new staff need to be recruited with lending skills – preferably social lending skills

- loan and securities administration on setting up a loan, even if outsourced to lawyers, still need internal staff to understand and manage it

- administrative systems need to be enhanced to be able to record loan information, process interest payments and record security information

- administrative processing needs to work on a daily basis, ideally, to pick up missed payments immediately.

7.2.6 This will be out of the reach of a smaller foundation and costly to a larger one. It's akin to creating a completely new division. The additional costs could be offset by offering the service to other foundations where the constitution allows this – option B above. This follows the approach taken by some overseas foundations, such as the Calvert Foundation in the US, which offers investment services and products to its fellow foundations. This creates contractual liabilities of a sort foundations are not generally used to but could be an interesting possibility for a larger foundation which would also help develop the sector. This is, for any but the foundation providing the service, a form of outsourcing and is discussed below.

Outsourcing

7.2.7 While management and trustees will still need to address the issues raised whether lending is internally managed or outsourced, there is an important difference. Outsourcing passes the detailed management responsibility for making this work to an external agency so that the foundation can concentrate on higher-level issues. This means that trustees and management of the foundation will focus on policy and service delivery leaving the agent to deal with the specific problems this creates: they can focus on *what* they want done and don't need to manage directly *how* it is done. If managed internally, a greater level of management skill and understanding will be needed about loan assessment, administration and servicing.

7.2.8 Perhaps more significantly outsourcing distances the foundation from the lending. This reduces its reputational risk and the potential pressures on management and trustees when dealing with loans in difficulties. Once a management contract has been set up, the agent will then be the body directly in contact with the borrower. The agency arrangements can delegate powers to the agent, or can create soft delegations whereby certain decisions remain in the hands of the foundation – for example, the decision to lend to a project based on their activities but not their financial standing, or provide the foundation with the possibility to override the agent's decision to foreclose. This latter would need to be carefully considered lest it removes one of the strong advantages of outsourcing.

7.2.9 Use of an agency should also help borrowers to understand that they are getting a loan and not something akin to a grant. The agent will be more readily seen as a lender and its role and approach better understood. This may also assist situations where a combination of grant and loan would be most beneficial. Separation of the decisions is made with the foundation's grant officers able to deal with the agency as a co-operative third party operating under well-defined policies.

7.2.10 Outsourcing is also likely to be cheaper as the agency will likely be providing the service to several social lenders, or will already have lending systems in place. It would also make it possible for improvement in the lending skills to be concentrated as the agency would be focusing on social lending and building its expertise – or drawing on its existing expertise – more extensively.

7.2.11 Such an outsourced arrangement would be similar to a mandate given to a fund manager for the commercial investment of the endowment. The management and trustees would expect regular reports, agree well-defined policies and could retain some control over aspects of the lending process.

7.2.12 Lastly, this is how most overseas foundations have taken up social lending. Some undertake large projects in-house but then make use of external advisors. In general, they subcontract it.

Small loan books of a few larger loans

7.2.13 Most of these comments assume a reasonably-sized loan book and an intention to take up lending across a range of sectors. This requires the lending to be systemised rather than individually managed. Where a larger foundation intends to make relatively few loans – for example, 5 substantial loans above $1m each – then a different management regime could be more easily considered.

7.2.14 The loans could then be internally managed using external advisers for the lending process. Accountants can be used for the financial analysis and lawyers for the loan formalities. A few loans can be handled by ad hoc accounting processes. The foundation's management can then call in professional help should additional help be needed later in the loan's life.

7.2.15 This is a workable but not necessarily a good solution. Accountants can of course provide an effective financial analysis, but lending depends on a broader assessment of the organisation's capacity, the strength of its management and similar. And lawyers will provide a good analysis of the formal risks any lending arrangement is subject to but lending, while tying down its risks, is often handled more pragmatically – legal rights are often not effective rights and structuring the lending to be well positioned can be more important. But more generally, this results in a formal analysis of the lending proposition and most social lending for larger loans, especially because it will be individually negotiated, depends on the building of the relationship between the lender and the borrower. Use of accountants and lawyers tends to work against this even if their expertise can be helpful in the background.

7.2.16 However, where senior management of the foundation are happy to be fully involved and take responsibility for the loan, this can be a workable solution for a few larger loans.

Provision of loan services to other foundations and social lenders

7.2.17 Most of the considerations above apply where the foundation is seeking to manage its own loan book in isolation. Development of social lending would be a large and costly undertaking, effectively the setting up of a new division within the foundation. However, the costs of this could be significantly reduced if a foundation set up such services and then offered acted as a third party offering them to other foundations and social lenders.

7.2.18 The two basic issues with undertaking social lending are (i) that sufficient expertise is developed, and (ii) that the costs of doing this are reasonable. In the New Zealand context, given that social lending will be a niche within a small population of projects, the appearance of a number of competing social lenders is unlikely to be practical or cost effective. So an enthusiastic foundation which undertakes such services for itself and then offers them to others will reduce its own costs – and those of other foundations wanting to take up social lending – and concentrate expertise. What would be needed is considered in more detail below when discussing setting up a special purpose agency of which this is a special case.

7.2.19 However, most foundations do not provide services to others under contract. This in itself would be a new arrangement which might be allowable under the foundation's constitution and might anyway be something that their board or trustees want to take on.

Outsource to a commercial bank

7.2.20 From previous experience and the results of the consultation, this looks an unlikely way forward. Overseas, commercial banks only slowly 'got it' after seeing it being done by experienced social lenders. Until then, their systems and culture tended to undermine its development. I doubt the experience would be different here.

7.2.21 However, the banks do have very efficient administrative systems, have lending skills which are in principle transferable and often have a residual interest and feeling of obligation to provide community service. None of the banks consulted showed any desire to do it but this could be discussed further and some, such as ASB Bank with ASBCT, or TTF with Kiwibank, have a longer standing relationship which may persuade them to give this special consideration. To be viable, this would probably need to be a service provided to more foundations than just one particularly with commercial banks strong profitability objectives. Other foundations with no special connection to bank might not feel the same attachment to any particular provider[45].

7.2.22 I find it hard to see why this is likely to succeed.

Outsource to an existing social lender

7.2.23 There are no social lenders in New Zealand with the level of experience adequate to this task. Prometheus[46] is the only one of reasonable size with a long track record for any but very small projects. It has a long history, has good systems in place, makes loans up to $500k, is used to working with the charities and social projects, is well attuned to them and used to unconventional lending arrangements. But it hasn't undertaken larger loans – perhaps in the range of $1m-5m – which might be needed and would need to extend its abilities in that respect and for more complex loans. However, it does have access and use the skills of more experienced social bankers when it needs them. It also would have minimal set up costs to provide such a service and could be expected to cover those itself.

7.2.24 Some other existing social lenders, such as NELT and MEGF might be used if small scale employment generation is a focus and relevant to a foundation. That is what Canterbury Community Trust has effectively done already with NELT. However, in the absence of such a specific operational and regional focus, they could not be considered.

7.2.25 Ripple, should it launch, would be another option. However that would be new and untested and for the time being is not in operation.

7.2.26 Thus, of the existing social lenders, probably only Prometheus, with some clear caveats, would be the only realistic possibility.

Outsource to a new special purpose agency created for foundations

7.2.27 This is very similar to a foundation setting up its own lending services and then offering them to others. The advantage of a special purpose agency are that it can be separately branded, and so distanced from any specific foundation which may help with the difficulties that foundation might have in foreclosing on particular loans. Such an agency would also have a service mentality from the beginning and would probably adapt better to those disciplines: an existing foundation might find this difficult.

7.2.28 If the agency was set up as a joint venture between several foundations they would have greater control over how it develops. With Prometheus this would be a service and contractual relationship. With an agency, this could be also an ownership relationship.

7.2.29 The principal disadvantage is that it would all be new and so untested. It also incurs the costs of setting up the systems, employing staff and creating an operational setting, though this latter might be hosted by an existing foundation. Prometheus has insufficient skills as it stands but it does have considerable skills, existing systems and a long track record.

Conclusions

7.2.30 Of the options, my recommendations are that the realistic alternatives are

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[45] In the course of the consultation, the view that there is a positive benefit to the banks – it would be good for them – was expressed a number of times. I am very doubtful about this. If they want to do it, then perhaps, but if they don't what realistic expectations are there of how this would work? A small, possibly troublesome activity which is unremunerative and unlikely to advance the careers of those assigned to it will not be well served. I have seen this a number of times in the UK and Europe and have no reason to suppose it will be otherwise here.
[46] I remind readers that I am a non-executive director of Prometheus and so have a potential conflict of interest.

- A foundation setting up the service in house and offering it to others
- Asking Prometheus to provide a service but subjecting this to rigorous due diligence
- Setting up a new foundation lending service.

Of these, noting my own conflict of interest, I suspect that Prometheus would be the best option.

7.2.31 This might change if a commercial bank showed willingness in offering a service but this would then need to be subject to its own rigorous due diligence.

7.2.32 Straight internal management, though this has worked for Southland and Canterbury Community Trusts, is not recommended unless the same sort of lending is undertaken and a similar level of skills is identified in existing staff members.

8 Appendix 1: PRI and MCI

8.1.1 Overseas, most social lending to date has been undertaken by social banks and funds[47] and not by foundations, though foundations are now catching up fast. Many of social banks raise their funds from the public and are competing with other banks. Part of their offering is that they provide a social return as well as a financial return – ie, that the saver knows that their funds are avoiding harm and even doing good, harm and good being understood in terms of the values their savers hold. Early on, such savers tended to be 'dark green' – strongly motivated by the social purposes to which their funds were put and less interested in the financial return – and so these banks and funds could provide funds more cheaply than commercial banks. But as their client bases grew, increasing numbers of 'light green' customers were attracted and these want *both* a social return and a reasonable financial return and so savings are raised at reasonable rates – usually at rates slightly higher than the middle of the savings market – and the loans also supplied at around the same rates as commercial banks. The reason why social enterprises tend to prefer working with social banks is that they are more knowledgeable of what the enterprise is doing, have better cultural alignment and provide terms which meet their situation better. That proves to be a strong incentive sufficient for the social banks' businesses to thrive, but the commercial terms are very similar, if not identical, to High Street banks.

8.1.2 There is another strand of lending which foundations are better able to provide because they are not subject to the same financial disciplines. This is where the rate of return needs to be lower, or the access to finance is more difficult because there is insufficient security or the risks are too high. In general, social banks cannot lend in such circumstances because they will not make a sufficient return on their lending to pay a sufficient return to their savers, but foundations can because they can agree to a *sub-market return*. Following the example of Southland and Canterbury Community Trusts – and many other overseas foundations – how they do this is to establish the expected market return for the commercial investment of their endowment, and then allocate a part of their grant funding to compensate for the lower return they receive. So, if the market return for the endowment is decided as 7% a year and a social loan of $100k earns only 5% a year, then the additional 2% a year is paid out of programme funds – ie, it is a grant of $2k a year[48] as well as a loan of $100k. Paying this from the programme budget means that the foundation can then regard the endowment as performing fully commercially but has reduced the funds available for grants.

8.1.3 While this may sound like robbing Peter to pay Paul, this is an effective way of keeping the three elements – commercially invested endowment, pure grant funding and sub-market social lending – in balance. It allows the application of clear policies for each which is necessary to ensure the foundation protects its own long-term viability.

8.1.4 Such sub-market lending is PRI – programme-related investment – and is the main focus of this report and the way in which most social lending by foundations has been undertaken. MCI – mission-connected investment – is a more recent phenomenon and more controversial. MCI claims that there are investments which provide both a social return *and* a market return. Examples are social housing, microfinance and commercial environmentally-focused investment such as cleantech[49].

8.1.5 MCI is usually defined more precisely defined as "investment which *promises* a market return but also helps to achieve mission"[50] – the emphasis is mine. The promise is an indication of

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[47] Examples include Triodos Bank (The Netherlands, UK, Belgium, Spain, etc), GLS Gemeinschaftsbank (Germany), Banca Etica (Italy), South Shore Bank, New Resource Bank (both USA), BRAC (Bangladesh),
[48] $100k at 2% a year
[49] Cleantech refers to a wide range of commercial activities including renewable energy, energy saving, waste recycling and similar. It has experienced something of a boom in recent years as investors try to find the 'industries of the future' which will provide services which address climate change and environmental issues while also making commercial profits. New investment funds such as Generation Investment Management (see www.generationim.com) and Triodos Values Pioneer Fund (see www.triodos.com/com/who_we_finance/funds/293998/) investing in cleantech do so on the basis that investors will get higher returns and incidentally contribute to environmental benefit.
[50] See *Mission Possible: Emerging opportunities for mission-connected investment,* Margaret Bolton, p2, New Economics Foundation, 2008.

the investor's intention as well as the investment's possibility. Whether a market return is achieved, as with any investment, will only later be confirmed.

8.1.6 The definition of MCI also anchors it in the objectives – the mission – of the investor. Social housing might be a good investment in the sense of the more general pursuit of social outcomes but it's not mission connected for a foundation for which this is not an objective.

8.1.7 Some of the investment sectors for MCI are being taken up by non-mission based, fully commercial investors. PGGM is a large Dutch superannuation fund with no social objectives as part of its mission but a clear commercial objective to maximise the returns on its investments for the benefit of its beneficiaries. It is a signatory to the UN-linked Principles of Responsible Investment and a leading 'responsible investor'. It believes that there are good investment returns in some sorts of social and environmental investment. Accordingly, it has started making substantial investments in MCI type areas such as microfinance[51].

8.1.8 Some foundations embarked on PRI but discovered that some of their investments were achieving better and more stable returns than their commercial investments. The current downturn and the extreme drop in the value of foundations' endowments may make this more understandable. A steady real return (after inflation) of 5% a year on social housing loans, for example, which is relatively unaffected by the economic cycle, could well be a part of the asset allocation for a portfolio of commercially investments. And so, they have ceased to regard it as PRI and brought it into the MCI element of their investments[52].

8.1.9 Clearly, MCI, to the extent it's possible, presents a real win-win for a foundation: it can fulfil its fiduciary duty in investing its endowment while achieving its mission. And the debate around MCI has the secondary benefit of getting foundations to look at their total social impact which includes the social consequences of how they invest their endowments. This reinforces the general adoption by many foundations of responsible investment practices. "Do no evil" can be strengthened to "do some good".

8.1.10 The fact that many of the original social investors and lenders overseas are not foundations but businesses, albeit social businesses, needing to provide reasonable returns to their investors suggests that there are reasonable commercial opportunities which foundations can also make use of. An inventory of MCI opportunities provided in the Margaret Bolton report[53] in 2008 includes a number of typical social lending and banking areas which are provided on a commercial basis.

8.1.11 However, it's clear that the opportunities for MCI are limited internationally and there are no realistic opportunities in New Zealand at the moment. This may improve as more investors investigate the possibilities but social lending and investment here will be PRI. For some foundations, given their mission, this will always be limited, even non-existent. And in any case pursuit of MCI alone will miss the opportunities that PRI presents understood as a distinctive sort of investment. For now, foundations here should focus on this, but the lesson of MCI and traditional social lending is that the returns from PRI could be reasonable and it should not be assumed that they will be nil.

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[51] See, for example, www.microcapital.org/press-release-dutch-pension-manager-pggm-launches-304m-commitment-to-microfinance-with-41m-investment-in-blueorchards-dexia-micro-credit-fund-dmcf/ announcing its €200m (NZ$433m) allocation to microfinance investments.

[52] See, for example, www.socialfunds.com/news/article.cgi/996.html where Luther Ragin at FB Heron Foundation in the USA describes how the foundation was achieving better returns on some of its community investment over what it was achieving on its commercial investments.

[53] *Mission Possible, p28-29.*

9 Appendix 2: Examples of social lending

9.1.1 All the following examples are projects I was directly involved in from the UK while a director of Triodos Bank. These are all real projects which borrowed and successfully repaid loans. They are obviously specific in many cases to that context but similar such projects are easily found in New Zealand.

Project	Description	Purpose of funding
Bognor Housing Trust	Provides short-stay housing in two hostels, pending the provision of permanent accommodation for people in special need	Property acquisition and renovation
British Institute for Brain Injured Children	National UK charity working with children with complex sensory and learning difficulties, such as autism and Down's syndrome. Provides a home based therapy regime with support from education, medical and social care teams, and respite care	Working capital
Caring For Life	Provides protection and support for vulnerable young adults from inner-city Leeds	Working capital
Centre for Alternative Technology	Renewable energy and sustainable technologies visitor and educational centre attracting over 66,000 visitors a year	Working capital, business and property development
Groundwork Trust	Public/private partnership in the UK Undertakes local environmental clean up projects and provides local work training for young people	Pre-funding grants and some working capital funding of services provided to local councils for a fee
Henry Doubleday Research Association	Europe's largest organic horticultural research organisation, with demonstration organic gardens	Property purchase and development and working capital
Karuna Trust	Charity supporting long-term development projects with a focus on education of women and children, and working with 'untouchables' in India	Working capital
Komedia Theatre	Presents and produces small-scale theatre and is a leading provider in its local area of children's and young people's theatre-based educational programmes	Property acquisition and working capital
Lambeth Self Help Housing Association	A housing cooperative which has purchased 62 units from the local council to be used as residential accommodation for people in need	Property acquisition
London Tamil Centre	Provides lessons in English and Mathematics to Tamil immigrants, a day centre for the elderly, traditional Indian dance and music, and Tamil language classes to resident Tamil children	Property renovation and working capital
Peter Bedford Trust	Providing supported housing and training facilities for people who have experienced long-term social exclusion through homelessness mental health problems, or learning difficulties	Property renovation and working capital
Rugby Bareboards Trust	***Not*** the game, but based in Rugby! A centre established to reduce poverty in the area by recycling furniture and other household items and distributing them to those in need, selling surplus goods through a charity shop	Working capital

Soil Association	Charity involved with the promotion of organic production and consumption	Capital expenditure including property
The Ethical Property Company	Provides office space for charities, NGOs and initiatives involved in positive social change	Funding of property purchases
The Knoydart Foundation	The Knoydart peninsula is in one of the most remote areas of the UK on the west coast of Scotland. The Knoydart Foundation purchased the Knoydart Estate from the receivers for the benefit of local people. Has established residential properties, a backpackers hostel and a small-scale hydro-electric scheme	Property acquisition and renovation, working capital
The Trigonos Centre	Not-for-profit organisation providing training and consultancy to community-based social initiatives	Property acquisition
Weir Quay Boatyard	A redevelopment of a boatyard to attract visitors to the Tamar River in Somerset in the UK for environmental research and educational boat trips, providing employment for local people	Property renovation

10 Appendix 3: Declaration of interests

10.1.1 I am or have been directly involved in a number of the organisations referred to in this report, which is probably in part why I was commissioned to write it: first-hand knowledge of these matters is probably an advantage. But it could lead to bias. I have tried to be scrupulous in providing objective information about these organisations but unintentional bias may be present.

10.1.2 Those associations are

UNPRI (UN principles of responsible investment)	International investor initiative linked to the UN promoting responsible investment practices in mainstream funds	Board member and treasurer
Prometheus Finance	New Zealand based finance company operating for 25 years, focusing on social and environmental lending	Board member
Ripple	Potential new New Zealand-based charitable lender	Advisor and invited board member
Triodos Bank	European social bank active since 1980 in social lending	Main board member until 2001 for a number of years and responsible for its UK operations amongst other things