

# **Microfinance funds in New Zealand**

**Report for**

**The Tindall Foundation  
Ethical Investment Aotearoa**

**For public distribution**

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# 1 Summary

- 1.1.1 The EIA comprises a number of small funds acting as social businesses and providing finance for a variety of social purposes, including individual empowerment, employment generation and social and environmental purposes.
- 1.1.2 Most have been operating successfully for 10 years or more and have, in general, a good track record in delivering their stated objectives. Those focusing on employment generation are currently seeing low demand mainly because of the current strength of the New Zealand economy. However, all expect over the longer term to see continued strong demand for their services.
- 1.1.3 All bar one, Prometheus Foundation, are not operationally sustainable – the income they generate does not cover their operating costs, although several of the smaller funds make extensive use of volunteers to run themselves which allows them to break even. They are also not capital sustainable. For both, they rely on grants and donations, or soft loans, to remain solvent or increase their size.
- 1.1.4 The funds are local examples of a large international movement in the developed and developing world of community loan funds and microfinance organisations. This movement is well established and has proven highly successful in delivering its social objectives. Operational and capital sustainability are key issues and many funds are now achieving this.
- 1.1.5 Most of the New Zealand funds need to grow to become sustainable. However, growth alone is unlikely to be successful for the funds. Understanding the main factors which determine operational sustainability is key to seeing how they might move forward.
- 1.1.6 A survey of possible sources of capital for the funds within New Zealand was undertaken. Disappointingly, it concludes that there are no simple or previously untapped sources of funds available to the EIA members. Community Trusts may be one limited exception, but even this will not be sufficient for the growth needed to allow the funds to continue as they have before.
- 1.1.7 An alternative approach to achieving sustainability is difficult but possible. Some of the funds have a capital base similar in size to that of Prometheus and could emulate its success. But the latter is a deposit-taking institution and so has a much larger balance sheet. This makes it financially sustainable.
- 1.1.8 Those funds which want to follow this could do this alone, or in partnership with Prometheus, or merging together as a new entity. The relative advantages of these approaches are set out.
- 1.1.9 However, a number of the smaller funds see their lack of operational sustainability, and the need then continually to raise grants to help fund their operations, as fundamental to what they are doing. They would resist growing their funds unless they believed they needed to in order to satisfy unmet demand amongst those they seek to help. So long as they can remain solvent, this is a reasonable strategy.

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- 1.1.10 The Angel Funds, because of their particular objectives, could not follow this approach. However, a form of quasi sustainability might be possible for them, especially the Dunedin fund, by managing a stream of donations and interest-free loans from private individuals. This would require them to continue their present activities but in a more focused and systematic way.
- 1.1.11 However, without some such development, the future for the funds is not strong. The sources of grant and donation which have supported them to date are not likely to continue and no obvious alternatives exist. In addition, new competition is likely to appear.
- 1.1.12 The funds need to consider carefully what their strategic direction. This report recommends they give serious consideration to converting to deposit-taking institutions. Any available grants would probably be best used to assist this process.

## 2 Introduction and scope of the report

- 2.1.1 Ethical Investment Aotearoa (EIA) is a collection of financial organisations most of which provide small loans or specialised financial support to individuals and businesses throughout New Zealand. Most target those who are unlikely to be able to borrow from mainstream funders, typically because they are seen to be high risk or not sufficiently profitable for the lender. The funds have operated mostly successfully when assessed against their primary objectives.
- 2.1.2 However, most are also not operationally sustainable – they generate insufficient income from their operations to cover their operating costs – and are not capital sustainable – they are unable to raise additional capital to increase the funds they can lend. They tend to rely on larger grants and donations to cover both needs.
- 2.1.3 This report provides a survey of these funds. It identifies ways in which they could become operationally sustainable and to access additional capital. It also provides some assessment of their capacity and the need for the services they are providing.
- 2.1.4 It also assesses whether there were untapped sources of donation and grant, and in particular whether these could be used to increase the members' capital base to a level where they would be sustainable. The answer was a very qualified “yes”. There appear to be no sources which would not require a change in the approach to funding which members have broadly adopted to date. But, if such changes were accepted, there may be some limited possibilities. However, the thrust of the report's conclusions are that these should only be used, if at all, to assist in a more fundamental re-orientation of how most of them approach their funding and financial sustainability.
- 2.1.5 The report was commissioned by the Tindall Foundation working with EIA. An extract of the brief for the report is included as Appendix 2. The Tindall Foundation has provided both operational and capital support to a number of these funds over an extended period of time and is keen to see whether there are ways for these funds to achieve greater sustainability.
- 2.1.6 It was not part of the report's brief to assess the funds' delivery of social outcomes. Their success in this is taken as a given, which was supported by the interviews undertaken, other anecdotal evidence and the author's general experience of microfinance and social lending. For those seeking small scale lending who cannot access conventional finance through banks, or who need a more sympathetic understanding of what they are doing, the services provided by the funds are essential. Wider adoption of them throughout New Zealand would be highly beneficial.
- 2.1.7 The views set out in the report are those of the author and do not necessarily represent those of the Tindall Foundation nor of EIA or its members.

### 3 Key concepts

3.1.1 A number of concepts are useful in understanding the objectives and environment in which EIA members operate. These are explained and discussed in this section and will be referred to in subsequent sections to assess the members' performance and possibilities.

#### 3.2 Sustainability and independence

3.2.1 The notion of sustainability can be quite ambiguous and vague, something not helped by the term's wide use. The focus here is confined strictly to financial sustainability. Environmental and other forms of sustainability, while important and a strong concern for a number of the EIA members, are not considered here.

3.2.2 The basic idea is that an entity is financially sustainable if its operations generate sufficient income to cover its costs. Organisations which are not sustainable typically rely on outside subsidies to remain solvent. Dependency on government or private sector grants is an obvious indication that they are not sustainable in this sense. This is important as, should such grants cease, their operations are threatened until a new source has been identified. This clearly creates a significant vulnerability.

3.2.3 Additionally, even where an organisation can cover its day-to-day operating costs, it may still be dependent on grants or *soft capital*<sup>1</sup> to increase the size of its operations. This creates a less immediate vulnerability but one which can still be significant over the longer term and even threaten long-term solvency.

3.2.4 This general idea of financial sustainability is close to that of financial independence. However, very few organisations are genuinely independent. Most have markets they must work with and which constrain them – they must satisfy their customers. Mainstream banks and finance companies, for example, have to raise funds from savers and institutions and are far from independent.

3.2.5 Endowed funds – such as Community Trusts or the Tindall Foundation itself – probably come the closest to financial independence. Their endowment provides a relatively secure income stream from which they disburse grants and occasionally loans. Most of the EIA members use a small endowment as their capital which they lend out. Providing this is secure and does not need to be repaid, they would also be relatively independent if they were sustainable.

3.2.6 The thrust of most of the thinking in EIA to date has been how members could get to a sufficient size to be independent in this way. However, as we shall see, the most sustainable of the EIA members, Prometheus Finance, is not independent at all being a finance company and having to deal with the needs of its deposit holders. One of the conclusions of this report is that most of EIA members should abandon the pursuit of independence and focus instead on sustainability. They would then need to identify their potential markets for new funds and adopt the disciplines which these require.

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<sup>1</sup> Soft capital is explained below in section 3.7.

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3.2.7 The two types of financial sustainability outlined are then

- Operational sustainability      able to cover the day-to-day operating costs of the organisation from its operations without need for third-party subsidy;
- Capital sustainability            able to raise additional capital as needed on commercial or modified commercial terms – not from sources of soft capital.

### 3.3 Operational sustainability

3.3.1 Operational sustainability has to be taken over the longer term allowing for occasional periods when a fund may make a loss, or even more extended periods where it is investing in its own growth or other changes in its operations but has the capital reserves to fund this and a reasonable prospect of ultimately breaking even once again. As a rule of thumb, breaking even generally means *aiming* to make a small surplus of about 5% on gross income and achieving a small surplus on average.

3.3.2 Appendix 1 sets out a proforma for the financial structure of an EIA member. Following this, the margin, the income arising from the investment of its capital and deposits in its various assets (loans, liquidity and its own operations), after deducting the cost of the capital and deposits, creates its gross income. From this has to be deducted its operating costs – bad debts, people, overheads and depreciation of its fixed assets. This leaves the net profit. Operational sustainability is achieved where the net profit is a small surplus over time.

3.3.3 Following this proforma, the key drivers for achieving operational sustainability are then

percentage margin      for each dollar of the balance sheet the net earnings of the entity: **M** expressed as a percentage of **S+E**, the balance sheet size

volume                    the total funds the entity has under management: this gives **G** the gross income when multiplied by the margin

operational efficiency    for a given size of balance sheet, the level of operating costs (**B+P+O+D**) – a lower cost for a given size of balance sheet being more efficient.

3.3.4 This is key for EIA members to understand their own long-term financial prospects. There has been much discussion about the minimum size needed to achieve operational sustainability. Figures such as \$1m to \$2m of funds under management (FUM) have frequently been quoted. Clearly, below a certain volume, it would be impossible to cover a member's fixed costs and so this is a key factor. But it is not the only one and percentage margin and operational efficiency need also to be assessed.

3.3.5 The focus on volume appears to arise because the *cost of capital* for most members is nil or very low. The source of their capital is mainly grant or donation,

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or very soft loans. Thus, the margin is close to the interest on the loans the member makes and their cash deposits. There is little sense of managing this in the way a more conventional lender would have to do.

- 3.3.6 Equally, operational efficiency is not a focus as most of the members are very small and operate on a low budget. They appear to be financially highly efficient. However, this needs to be measured against what it is they seek to do. Their management of the source of their funds is a small part of their operation – mainly investigating and applying for grants and soft loans. This is again quite different from a more conventional lender.
- 3.3.7 At present, only two of the current EIA members have achieved forms of operational sustainability (Prometheus Finance and Angel Funds Dunedin) though in different ways. Most lie in a difficult space between these two, in constant need of subsidy.

### 3.4 Capital sustainability

3.4.1 This refers to an organisation's ability to raise additional capital over time. The need for additional capital is usually to grow the organisation's operations but other reasons will arise from time to time

- To maintain the capital base if it is depleted by extraordinary operating deficits. Operational sustainability should ensure that this does not happen in normal circumstances, but extraordinary events, such as a single large bad debt, may make it necessary.
- To maintain the capital base in real terms Over time, the organisation's capital will be depleted by inflation – 3% annual inflation reduce the real capital by 25% after 10 years. Long term, this will become an important issue for organisations which seek only to break even.
- To increase the capital base and so the volume of operations to cope with pressure on margin This is mainly an issue at present for Prometheus Finance and less severe for all EIA members operating outside of market interest rates, but still a factor over time.
- To fund the investment needed for changes in the organisation's operations Most organisations need to reorganise and change themselves over time and this usually requires some capital. Again, where an organisation at best breaks even, such investment will require outside capital rather than being funded from retained reserves.
- To increase its capital base to comply with regulatory requirements This is a more esoteric reason which currently only applies to Prometheus Finance which is a finance company and must maintain its capital adequacy. However, if the recommendations of this report are accepted, other EIA members are likely to have to comply with this also. This then becomes an important requirement on the organisation.

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- 3.4.2 Prometheus Finance, which has been profitable over a number of years, has used retained reserves to fund its need to increase capital. However, it appears likely that they will have to seek outside capital at some point in the near future but that this is likely to be successful.
- 3.4.3 Since new capital, other than retained profits, is provided by third-parties when can it be said to be sustainable? The sense used here is for any source which is stable, not subject to a single decision and available under some sort of market conditions. Examples include
- retained reserves
  - capital raised under normal commercial terms – unlikely to be of use to EIA members
  - soft capital – see 3.7.
- 3.4.4 It excludes grants and donations in most instances. The sources for these
- are few in number
  - tend to be time-limited – even if more than one, an organisation can usually only expect a few successful applications to a provider
  - success or failure depends on a single decision.
- 3.4.5 Capital sustainability and operational sustainability are interlinked. Failure to achieve the latter will deplete the organisation's capital. And, in most cases, capital can only be raised its providers are confident that the organisation's long-term solvency is not in question.

## 3.5 Social business

- 3.5.1 Conventional business has as its primary objective the maximisation of shareholder value. It exists to make a profit and the specific goods or services it provides are the means to this end. Most businesses have many other objectives as well but these are secondary to this primary goal.
- 3.5.2 Social businesses, by contrast, have other objectives which are at least as important as maximising shareholder value and often supersede it. Maximisation may not be an objective at all but simply that a "reasonable" level of profitability is achieved. Sometimes, and in the case of most of the EIA members, profitability is not a goal at all. Maintaining solvency is sufficient.
- 3.5.3 The social business sector is growing but still relatively undeveloped in New Zealand compared with, for example, Western Europe and the USA. There, while there have always been some businesses with aspects of social businesses, they were largely isolated exceptions. Since the late 1970's / early 1980's this has grown substantially and is now seen as a distinctive sector. Part of its success can be seen in the recognition of social entrepreneurship and the growth of support services for it. A few of many examples illustrate this: the growth of social banks

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and specialised investment and lending schemes geared to their needs<sup>2</sup>; the creation of academic centres and foundations studying and supporting it<sup>3</sup>; the appearance of government schemes supporting it<sup>4</sup>.

- 3.5.4 Social businesses are distinct from the growing body of conventional businesses which are adopting policies for corporate social responsibility. These latter still make maximisation of shareholder value their primary objective but seek what are considered more socially and environmentally responsible ways of achieving this. There has been speculation that the two sectors might overlap but they are separate now.
- 3.5.5 Social businesses are also characterised by seeking to achieve their ends using business methods. Some EIA members have as a primary goal the alleviation of poverty but their method for achieving this is the provision of credit, not grant and donation as a more traditional charity might. A parallel example is a fair-trade coffee producer which seeks to alleviate poverty amongst third-world producers, in this case by buying and selling coffee on what are considered to be fairer terms instead of the provision of aid.
- 3.5.6 In many cases, and for most of the EIA members, the business service is provided outside of conventional market terms – at a lower interest rate than would normally be required or accepting higher risks without a corresponding increase in the cost of credit. Nevertheless, the organisation of the service and its essential elements are that of a business.
- 3.5.7 All the EIA members are social businesses in this sense but they differ in their approach to these two aspects – profitability and closeness to a market-based services.

### 3.6 Social return

- 3.6.1 Many social businesses provide a financial return on their capital and, in the case of deposit-taking organisations, their savings accounts. Of EIA members, Prometheus Finance seeks to do both. It's quite common that this return is lower than a commercial market return. This can be because they offer lower rates to borrowers, or because the social nature of the projects they finance mean that their operating costs will be higher – or, of course, that they are inefficient or too small to benefit from economies of scale.
- 3.6.2 The lower return is often seen as being compensated by a *social return* which may justify the discount to a market return. Providers of capital or deposits, or donations in some cases, have decided that they want to see certain ends pursued

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<sup>2</sup> An association of such banks and funds is INAISE, the International Association of Investors in the Social Economy – see [www.inaise.org/EN/fr\\_1.html](http://www.inaise.org/EN/fr_1.html).

<sup>3</sup> See The Skoll Foundation ([www.skollfoundation.org](http://www.skollfoundation.org)) and its Skoll Centre for Social Entrepreneurship at Oxford University's Said Business school ([www.sbs.ox.ac.uk/skoll](http://www.sbs.ox.ac.uk/skoll)), and the New Academy of Business ([www.new-academy.ac.uk](http://www.new-academy.ac.uk)).

<sup>4</sup> See the Local Investment Fund in the UK ([www.lif.org.uk](http://www.lif.org.uk)), a private-public sector initiative, and the increasing number of initiatives for social enterprises from the Department of Trade and Industry again in the UK (see <http://www.sbs.gov.uk/sbsgov/action/layer?r.s=tl&topicId=7000000412>).

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and evaluate the services on offer accordingly. They are what is often called *ethical investors* and willing to accept a lower return providing the social objectives are achieved.

- 3.6.3 This is little different from the normal decisions that users of services make. An expensive product finds buyers where it's perceived to be of higher quality than a cheaper alternative. They trade quality for price just as ethical investors are trading social return for financial return.
- 3.6.4 Social return is important to understanding the market in which EIA members are, or could be, active. In New Zealand there are currently very few opportunities to receive a social return on financial services and so there is a reasonable prospect of there being demand which EIA members could meet.

### 3.7 Social and soft capital

- 3.7.1 Social capital are funds provided with a social return. Following the argument of the previous section, such funds, which are often provided a rate lower than the usual market rate, are still provided under market conditions.
- 3.7.2 Soft capital is something further. It is also provided at sub-market rates but outside of a social market. Loans provided by a foundation or community trust to an EIA member could be an example. Here, typically the funds provided are a form of returnable donation and the funder is making no or a very limited assessment of a need for any return on the capital. Most EIA members have been substantially funded by soft capital.
- 3.7.3 There is considerable greyness in the distinctions being made here. Nevertheless, the argument is that there is a difference between social and soft capital and that a number of the EIA members, if they wish to grow, should turn their attention from raising soft capital to social capital.

## 4 Community loan funds and microfinance

4.1.1 This section provides a brief overview of community loan funds and microfinance internationally to provide the context within which the New Zealand funds operate.

### 4.2 The developing world – microcredit and microfinance

4.2.1 2005 was the international year of microcredit<sup>5</sup>. *Microcredit* mainly refers to the type of lending undertaken by numerous funds, banks and other financial organisations providing small loans to microentrepreneurs in the developing world. Small in this context can mean short-term loans of \$100 or less. The microentrepreneurs in question are poor people, sometimes very poor people, who have no access to credit other than that from traditional moneylenders and then usually at very high interest rates.

4.2.2 The movement's first beginnings were in the 1970's. It is now world-wide. One of its best known and earliest representatives is the Grameen Bank which was started in 1976 in Bangladesh by Muhammad Yunus, then an academic with an interest in rural economics<sup>6</sup>. Yunus, along with others, had several fundamental insights

- Poor people are naturally entrepreneurial – indeed, poor people in societies with a very limited and even non-existent system of welfare have to be entrepreneurial to survive and so are natural initiative takers.
- They can handle credit and frequently do so borrowing from traditional moneylenders albeit usually to cope with short-term needs and not to fund economic activity.
- Aid – grant, donation – while essential for dealing with disasters, tends to undermine their capacity to lift themselves from poverty,
- The increase in productivity which arises from credit extended for economic purposes in such circumstances are very substantial and can easily pay the costs of providing credit.

4.2.3 Yunus realised that the perceived “unbankability” of poor people was a function of the usual ways in which banks delivered credit. This did not fit their circumstances. Typically, banks require fixed collateral, a business plan, provide particular forms of credit (term loans, overdrafts) and expect borrowers to present themselves in a certain way. As lending to the poor was unlikely to be a very profitable activity for banks, which had other more cultural barriers to providing credit to such a group, there was no incentive for them to develop new techniques and mechanisms. The problem lay with the banks not with those who needed the credit.

4.2.4 From this began the development of group lending schemes, community guarantees, incremental lending, very short loan terms, “barefoot” branches and the many other innovations which has led to the Grameen bank's own success.

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<sup>5</sup> See [www.yearofmicrocredit.org](http://www.yearofmicrocredit.org).

<sup>6</sup> See [www.grameen-info.org/bank](http://www.grameen-info.org/bank).

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Many other similar organisations have been created successfully throughout the developing world. Despite some initial resistance to microcredit, it is now generally accepted that it works, is sustainable and is a major mechanism for overcoming poverty when well-managed.

- 4.2.5 *Microfinance* is the broader development of financial services for poor people. The provision of appropriate savings services is as important as provision of credit. Insurance, money transfer services, risk sharing, trade finance are other examples<sup>7</sup>. They directly help economic development within micro-economies. The needs they meet are often as sophisticated as those in developed economies. They simply needed redesigning and made easily accessible.
- 4.2.6 Microcredit and microfinance, where it is been successfully implemented, is also profitable. It has never been a business activity set up to make money – it has always been a form of social business – but in order to be sustainable and to grow, it needed to be both operationally sustainable and to make a sufficient return to access additional capital.
- 4.2.7 Many of these organisations started with grants and donations. Many still require these or soft capital to grow. However, a number of providers are now commercially successful banks or finance companies. One example is Bancosol in Bolivia, part of the ACCION network of microfinance organisations in Latin America<sup>8</sup>. This raised capital in 1994 through selling certificates of deposit on the US market making a direct link between the sophisticated financial markets of the developed world.

### 4.3 The developed world – community loan funds and social banking

- 4.3.1 Microcredit and microfinance successfully overcome a form of financial exclusion in the developing world. Financial exclusion is also encountered in the developed economies of the west – principally of the poor, the unemployed and of social and environmental projects. These have been countered by parallel financial initiatives.
- 4.3.2 Exclusion of the poor and the unemployed has been most extensively addressed in North America, particularly the USA. A leading example here is the South Shore Bank, based in the South Shore district of Chicago. This was a small regional bank which was operating in a depressed area. It was taken over by a group of community activists in the 1970's<sup>9</sup>. Instead of seeing the restrictions on relocation and investment on retail banks in the USA as an impediment<sup>10</sup>, they

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<sup>7</sup> See, for example, [www.microfinancegateway.org](http://www.microfinancegateway.org).

<sup>8</sup> See [www.accion.org](http://www.accion.org).

<sup>9</sup> For an excellent early description of the South Shore Bank and its development, see *Community Capitalism*, Richard Taub, Harvard Business School Press, 1988. A short interview with Taub which provides a good flavour of the circumstances and approach of the bank can be found at [www.pbs.org/capital/stories/richard-taub-print.html](http://www.pbs.org/capital/stories/richard-taub-print.html).

<sup>10</sup> The USA has been unusual in having an extensive network of small regional retail banks, instead of a few large banks with an extensive branch network in the style of New Zealand and Australia. These banks have an obligation imposed on them by the Community Reinvestment Act to recycle investment in their neighbourhoods. This helps minimise the tendency seen elsewhere for banks to collect funds in poorer areas and invest them in richer areas exacerbating pockets of economic deprivation.

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systematically used the bank's ability to collect savings and recycle them through investment in economically productive enterprises as a means to develop the South Shore. After some false starts, this proved highly successful resulting in a benign cycle of investment leading to economic development which led to increased earnings in the area, generating in turn new savings which were then further invested.

- 4.3.3 Key to their success was working out what would make good investments. An example was the "Ma and Pa rehabbers". The area had a large amount of formerly substantial properties which now provided substandard housing. Ma and Pa rehabbers were small family businesses which took over properties, refurbish them and then rent or sold them. This provided economic activity, a substantial improvement in the area's housing stock over time. The activity contributed to an increase in prosperity which meant local people could afford the improved housing.
- 4.3.4 South Shore Bank was addressing the problems of relative poverty and unemployment. As such it was an early example of a CDFI – a community development financial institution – of which there are a large number in the USA. Most of these are not banks but community loan funds. South Shore Bank is a regulated bank and so licensed to raise deposits from the public. Community loan funds are restricted to raising forms of capital and grant for lending. In this they are closer to the way most EIA members operate in New Zealand.
- 4.3.5 A different but successful initiative is the Princes Trust<sup>11</sup> based in the UK and established over 30 years ago. This has been internationalising more recently. It is mentioned here because there is a local New Zealand initiative under consideration (see 6.2.27).
- 4.3.6 This was designed to support young people who wanted to start businesses. The trust provided small loans and support to help them get under way. It accepted very high loss rates (typically 30% to 40%). The Trust's attitude is that it is better that young people are active and try something even if they fail in the conventional sense than that they have no opportunity.
- 4.3.7 Another UK initiative is the Aston Reinvestment Trust<sup>12</sup>. This is closer to some of the New Zealand initiatives being considered here. It has been capitalised by grants and soft capital which have been much more readily available in the UK. It is operationally sustainable having funds under management of just under £1.4m (approximately \$3.8m) and minimal costs of capital. Their lending focus is employment and self-employment generation.
- 4.3.8 More typical of European financial initiatives has been the development of social banks which have a stronger orientation towards social, environmental and cultural projects. Most of the European members of INAISE are examples. One of the largest is Triodos Bank, based in The Netherlands with branches in Belgium, Spain and the UK, and investment activities throughout western Europe and in the

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<sup>11</sup> Formerly the Prince's Youth Business Trust. See [www.princes-trust.org.uk](http://www.princes-trust.org.uk).

<sup>12</sup> See [www.reinvest.co.uk/](http://www.reinvest.co.uk/).

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developing world<sup>13</sup>. In New Zealand, Prometheus Finance is closest in orientation to Triodos, and Triodos has supported Prometheus' development in the past.

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<sup>13</sup> See [www.triodos.com](http://www.triodos.com).

## 5 EIA members

### 5.1 Overview

- 5.1.1 The members of EIA are a heterogeneous group of entities despite sharing a common orientation to using finance as a means to achieving social ends. Most provide credit and operate as community loan funds. All are social businesses. Most have been funded by soft capital, a few also by social capital.
- 5.1.2 Two – the Trade Aid Ethical Investment Trust and the Greens Super Fund – have other purposes and so have not been included in this study. One other – RecycLoans Fund – has recently been incorporated into Prometheus Finance and so has been included as part of that. Those included in this study are described in tables 1 and 2 below.
- 5.1.3 Not shown in the tables, but an important additional general aspect of the EIA members was that at the time of this study *none*, with the possible exception of Prometheus Finance, needed to grow to fulfil unmet demand. This means that they have sufficient funds to meet their expected demand for loans over the next 12 months and probably longer. This is considered further in section 5.7.

### 5.2 Individual funds

#### *Angel Funds Christchurch and Dunedin*

- 5.2.1 Both are part of a national network of 12 small locally-based organisations providing support and finance for women. Most other members of this network focus more strongly on mentoring and support and less on the provision of finance.
- 5.2.2 It is a fundamental to their approach that no interest is charged. The Dunedin fund does charge an arrangement fee of 10%. Since loans are generally for a period of two years this is effectively 5% flat rate interest. Other funds mostly charge a \$10 joining fee and a membership fee.
- 5.2.3 The Dunedin fund was visited and examined in detail. It appears to be well run and active in promoting its services in the local market. It has a stronger focus on providing finance than many of the other Angel Funds.
- 5.2.4 They are also active in raising gifts and soft loans in their localities, the idea being that they recycle money from women to help women. This could be developed to provide a form of sustainability in the longer term.
- 5.2.5 Both believe they could grow providing they could secure additional funds. However, they have sufficient funds at the moment. Both are broadly sustainable at the moment, using some paid but mainly voluntary help to run themselves.

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### *Just Dollar\$, Methodist Employment Generation Fund (MEGF) and Nelson Enterprise Loan Trust (NELT)*

- 5.2.6 These have different origins but they all share a broad similarity of approach and are close to the community loan fund model. They have an amount of capital which they use to lend to small business ventures. Their purpose is to promote employment, self-employment and small business development. Their capital has come from charitable donations and some low-interest loans. NELT is especially interesting for this report in having received a loan from the Canterbury Community Trust to use for lending. All have more funds to lend than demand for them. The Methodist Employment Generation Fund and Just Dollar\$ have seen low demand in recent years. NELT appears to be seeing higher demand but is still not fully lent out.
- 5.2.7 All need an annual subsidy to cover their running costs and so are not operationally sustainable. NELT believe they are close to this which is discussed in more detail in section 7.3.

### *Prometheus Finance*

- 5.2.8 Prometheus Finance is now a finance company and was until recently a credit union and charitable trust combined. It operates in effect as a small savings bank. It is regulated and has to maintain a sufficient capital adequacy ratio. It raises deposits from the public on which it pays interest. It divides its investments between loans and cash placements to provide sufficient liquidity to repay demands on its deposits.
- 5.2.9 It has a strong social and environmental focus and is closer in concept to the European social banks. It doesn't support small business or employment generation unless the borrower falls within its wider ethical policy.
- 5.2.10 It has grown steadily for a number of years (by as much as 25% a year). It could potentially have unmet demand for loans as a result but the steady growth in savings make this unlikely.
- 5.2.11 Most of its growth has been from deposits. However, to maintain its capital adequacy it must also increase its capital but has been able to do this using retained earnings to date. However, it looks likely that it will have to raise capital from third parties within the foreseeable future. At present, its share capital is held by a charity, Prometheus Foundation. This is likely to change when it raises additional capital.
- 5.2.12 Prometheus' relatively strong focus on deposit-taking is in sharp contrast with the other EIA members. The Angel Fund shares this to a small degree in nurturing its circle of interest-free lenders and donors. Prometheus devotes a significant part of its resources to raising and retaining deposits. It undertakes systematic marketing which is almost entirely devoted to deposits and not to loans – it seems rarely to have difficulties finding new borrowers. It publishes regular newsletters, attends eco-shows, Prometheus co-workers travel around New Zealand giving presentations to potential depositors, and so on. And, it has to service the needs of

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the depositors undertaking transactions, producing account statements and similar. This takes about a third of its resources in effort and time.

- 5.2.13 However, Prometheus' orientation is clearly towards its lending activities. Its main objective is to fund social and environmental projects. Its deposit taking activities are undertaken to service this, though it has some more general aims to increase awareness of and opportunities for socially responsible investment.
- 5.2.14 It is operationally sustainable. Whether it will be capital sustainable is uncertain but seems likely given its existing very committed customer base as a source of new shareholders.

### *Quaker Investment Ethical Trust*

- 5.2.15 This fund has a form similar to that of MEGF, Just Dollar\$ and NELT but an investment focus closer to that of Prometheus. It has raised its funding from Quakers, much of it as low-interest long-term loans but some from donation. A sizable part of this could probably be converted to some form of fixed capital if QIET desired it.
- 5.2.16 It operates with very low costs and is sustainable on that basis. However, this has meant that it has had a low level of activity. It appears to want to become more active and would not be operationally sustainable should it do so.

## 5.3 Specific objectives and levels of demand

- 5.3.1 The funds are all social businesses but their specific objectives vary. Despite some overlap, they fall into the three groups which have a significant effect on their pattern of demand

- individual empowerment
- employment generation and business development
- social and environmental activities

- 5.3.2 *Individual empowerment* appears to enjoy steady demand over time. It does not seem to have been affected by the business cycle or other factors for some years. However, there is some evidence that when the business cycle is recessionary, more loans are used to help borrowers into self-employment – overlapping with the second group – but when the business cycle is expansionary, the loans move more to educational purposes. Either way, the demand stays broadly constant.

- 5.3.3 *Employment and business development*, however, has seen very low demand in the last two years. This could be expected given the strong performance of the New Zealand economy and very low unemployment rates. Thus, demand for their services may naturally depend on the business cycle with the funds growing and prospering when the economy slows and declining when the economy improves. With the expected future slowing of the economy, they may see an increase in demand. However, this may be muted because of the growth of government schemes providing funding and support for employment and self-employment.

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- 5.3.4 *Social and environmental activities* have seen strong and continually growing demand for an extended period – more than a decade. There is some evidence of it being affected by the business cycle but this seems merely to slow the upward trend. That said, QIET has not seen strong growth. This appears to reflect a weaker business focus within the fund rather than a lack of demand.

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**Table 1: EIA members included in the study**

	Started	Based	Area of operation	Structure	Activity	Purpose
Christchurch Angel Fund	1990	Christchurch	Local	Project run by Women in Enterprise, an incorporated society	Interest-free loans for women on low incomes in Christchurch for education and training, transition to work and small business set-up	Individual empowerment
Dunedin YWCA Angel Fund	1997	Dunedin	Local	Part of Dunedin YWCA, an incorporated society	As for Angel Fund Christchurch but for Dunedin	Individual empowerment
Golden Bay Work Centre Trust	1979	Golden Bay	Local	Trust	Community services and support for initiatives in Golden Bay	Employment generation and business development
Just Dollar\$	1992	Christchurch	Local	Charitable trust	Loans for small businesses in Canterbury	Employment generation and business development
Methodist Employment Generation Fund (MEGF)	1992	Auckland	Auckland and Northland	Charitable trust	Loans for small businesses in Auckland and Northland	Employment generation and business development
Nelson Enterprise Loan Trust (NELT)	1997	Nelson	Nelson	Charitable trust	Loans for small businesses, co-operatives and community ventures in the region covered by the Nelson City and Tasman District Councils	Employment generation and business development
Prometheus Finance	1983	Napier	National	Limited company Finance company	Savings and loans for education and art, holistic healthcare, sustainable agriculture, environment and general ethical initiatives	Social and environmental activities
Quaker Investment Ethical Trust (QIET)	1989	Christchurch	National	Charitable trust	Ethical savings, investment and loan services reflecting Quaker concerns	Social and environmental activities

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**Table 2: Analysis of funds' activity**

	Maximum Loan size \$	Typical loan size \$'000	Loans since inception #	Loans since inception \$'000	Average failure rate %	Balance Sheet Size <sup>2</sup> \$'000	Capital <sup>3</sup> \$'000	Operationally sustainable <sup>4</sup>	Capital sustainable	Wishes to grow
Christchurch Angel Fund	500	500	238	104	5% - 10%	43	24	Limited operation	n/a	No
Dunedin YWCA Angel Fund	1,500	1,000	360	285	4.7%	150	80	Donation basis	Donation basis	Yes
Golden Bay Work Centre Trust	5,000	1,200	-	-	-	28	0	Limited operation	n/a	No
Just Dollar\$	10,000	4,000	290	940	4.5%	136	0	No	No	Yes
Methodist Employment Generation Fund	15,000	10,000	181	1,366	12.4%	548	548	No	No	Possibly <sup>1</sup>
Nelson Enterprise Loan Trust (NELT)	20,000	9,000	86	600	0.8%	376	82	No	No	Yes
Prometheus Finance	200,000	50,000	-	-	0.5%	9,522	677	Yes	Yes	Yes
Quaker Investment Ethical Trust	-	-	-	-	-	1,100	347	Limited operation	No	Possibly <sup>1</sup>

1 Growth considered in so far as it would help achieve operational sustainability

2 The fund's total assets – total loans, cash reserves and any other assets it may hold. In every case, other assets are a small proportion of the total.

3 An estimate of the member's *effective* capital. This includes share capital, subordinated loan, retained reserves and accumulated capital donations, which would conventionally be considered capital. It also includes what appear to be “very sticky” loans to the member – loans which have been held long-term and which probably could be converted to more conventional forms of capital should the lender be approached.

4 No – not currently operationally sustainable and requiring grants and donations annually to break even.

Limited operation – operationally sustainable by running on a very low cost base which is accepted as the long-term way to operate.

Donation basis – organisation is essentially donation based which could be developed to create a form of operational sustainability.

Yes – operationally sustainable.

## 5.4 Additionality

- 5.4.1 Part of the rationale for EIA members is that they are doing something which the conventional finance world does not. Otherwise, why intervene if banks and finance companies are providing the finance needed on acceptable terms? Are they providing additionality, providing services which would not otherwise be available?
- 5.4.2 An absolute requirement for additionality on EIA members – that every loan provided should have no other potential provider – is probably too strong. This would inevitably result in members funding the highest risk borrowers which is likely to undermine any chance of operational sustainability. Or, that qualitative aspects of their services – their approach to the borrower, greater flexibility in the terms offered, special expertise in the sector – would not be available: borrowers may prefer to use them for these reasons even where they could secure finance from other sources.
- 5.4.3 A weaker requirement that their focus be providing services which, taken together, are not otherwise available is probably more appropriate. This was not independently tested as part of this report. However, there is good evidence that all members are providing this:

Angel Funds	Some types of finance they provide appear also to be available under government funded schemes from the Ministry for Social Development. However, the funds provide finance and support for women, are run by women and raise a measure of their funding from women in the locality in which they work. This context, along with their way of working appears to create a context which is attractive to those funded even where the terms may be slightly disadvantageous.
Employment funds	As noted, these have seen low demand in recent times. However, they generally provide funds at a cost and risk which would not be available from mainstream funders – for example, unsecured loans at lower than market rates. Their additionality is clear.
Social and environmental funders	Particularly in the case of Prometheus, most of their projects could raise loans on comparable terms from High Street banks who have a locally based office. Even so, Prometheus has considerable experience in the sectors in which it lends, is able to offer advice and contacts and tends to tailor facilities to the individual needs of its borrowers. For these reasons, its additionality seems clear although it is probably closest to mainstream funders in other respects.

## **5.5 Bad debt rates**

- 5.5.1 Information on bad debt rates is difficult to compare as the funds have quite different approaches and methods of recording their financial information and understandings of what constitutes a bad debt. For example, some only record a loan as failing at the point it is written off. Others make more prudent provisions where they believe they may have difficulty collecting the full amount. This can change the statistics significantly. Thus, the rates shown should be seen as indicative only.
- 5.5.2 In general, the bad debt rates are low. In the case of Prometheus and NELT, they are extremely low. This appears to reflect their knowledge of their market place and possibly a measure of good luck.
- 5.5.3 The rates achieved by the Dunedin Angel Fund and Just Dollar\$ are both good given the context in which they are working and comparable to that achieved for domestic credit. The Methodist Fund appeared to have a more aggressive policy in terms of the risks it would take coupled with a strong policy for making provision for bad debts. However, the higher rate also appeared to be due in part to the extended area in which it operates and possibly a need to improve its speed of response in dealing with delinquent loans. This might need some attention longer term.
- 5.5.4 Overall, the collection rates seemed to range between very good to reasonable. To the contrary, given the higher risk of some of the markets in which they operate, the funds' performance is considered good.

## **5.6 Attitudes to profitability, social return and financial return**

- 5.6.1 Several members provide some financial return on their funds under management. Prometheus does this systematically providing savings accounts and providing returns generally lower but comparable in structure to that found in mainstream banks. NELT and QIET pay interest on some of their funding, but these are not accounts but individually negotiated arrangements. Just Dollar\$ offers interest at about 80% of market rates but about 50% of funders forego this. The rest have been funded by grants or raise donations.
- 5.6.2 Only Prometheus has a specific objective to make a profit but this is limited to a "reasonable" profit, not maximising it within the context in which it operates. The rest seek to break even but in all cases can only do so with the addition of grants.
- 5.6.3 The Angel Funds seek funding through donations or interest-free loans which are in effect a form of returnable donation. Thus, they provide no financial return and focus entirely on social return to their funders.

## **5.7 The need for growth**

- 5.7.1 The report's conclusion is that most of the fund's need to grow to achieve operational sustainability. Other factors are also relevant, but growth of the balance sheet is an essential element as, below a certain size, there are simply insufficient funds to generate sufficient income. However, as noted, most

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members do not need to grow to meet the demand for their services: they are not turning away potential borrowers for lack of funds and are holding funds as cash.

- 5.7.2 Partly this is because of New Zealand's currently strong economy with very low levels of unemployment. Those funds targeting unemployment can expect to see an increase in demand as the business cycle develops and the economy weakens. The Dunedin Angel Fund appears to avoid this as its target shifts a little with the economic cycle. Prometheus has quite a different focus which is growing and so creates steady demand whatever stage the business cycle is in. One of the medium-sized loan funds, probably because of the effort of its chief executive, has been able to find demand for its services in any case. A more general focus on small business development may assist this.
- 5.7.3 Trying to obtain funds to grow purely to become operationally sustainability – which would mean holding the new funds almost entirely as cash – is hardly attractive and very unlikely to be successful. This suggests that those funds affected by the business cycle should review and change or extend their lending focus so that they maintain a reasonable level of activity during periods of low unemployment. This would maintain a healthy level of demand and provide the commercial rationale for them to grow as well. Prometheus, the Angel Fund and some of the other funds suggest this is possible.

## 6 Other organisations: sources of funds, competitors and partners

### 6.1 Overview

6.1.1 EIA members operate in an environment where a number of other agencies are also active. Their relationships are potentially complex as, in some cases, they could be a source of funds, a competitor or a partner, or a combination. This section sets out who they are and how they should be regarded.

6.1.2 It also seeks to identify, to the extent that they exist, potential sources of funds which would provide some or all of the capital EIA members need to increase their volume and become operationally sustainable.

6.1.3 These terms signify the following:

- **Sources** Organisations like the Tindall Foundation and some government agencies have been sources of grant and donation for EIA members. What was investigated was similar large agencies who might be additional sources of funds.
- **Competitors** Banks and finance companies are potential competitors to EIA members, but so are government agencies providing supportive funding – in the case of the Angel Funds – and even to support of business development.
- **Partners** Some organisations, such as some Community Trusts, have been sources of funds, could also be competitors, but could be partners to EIA members. The funding of NELT by the Canterbury Community Trust is the latter acting as a source of funds, but starts to be close to acting as a partner – providing funding or other support in return for NELT providing given services.

6.1.4 The organisations and agencies approached are described individually below, but their different possible significance for EIA members is summarised in the following chart.

**Table 3: Other organisations**

	Sources	Competitors	Partners
Foundations	Yes	No	No
Community Trusts	Yes	Yes	Yes
Credit unions	No	Yes	No
Finance companies	No	Yes	No
Smaller banks/building societies	Yes	Yes	Yes
Large banks	No	Yes	No
Government	Yes	Yes	Yes
Bank-Able, PYBT	No	Yes	No

## 6.2 Detailed assessment of other organisations

### *Foundations*

- 6.2.1 Foundations, like the Tindall Foundation, have been an important source of large grants to EIA members. Tindall is probably unique in the extent of its support. However, the general approach of foundations is to fund for a limited period, if not only once. Thus, such sources are unlikely to continue long term and may cease altogether unless new circumstances arise.
- 6.2.2 The Tindall Foundation does not appear to want to be a competitor – setting up their own lending schemes – nor longer-term partners. It may be willing to fund developmental activities undertaken by EIA members, particularly in making changes which would lead to their operational sustainability.
- 6.2.3 A number of other larger foundations were consulted, such as the JR McKenzie Trust, but these do not see EIA members as being within their target objectives.

### *Community Trusts*

- 6.2.4 The Trusts are unique to New Zealand, being set up on the take over of the old Trust Bank, and have an interesting remit to provide an independent source of charitable funding for community projects in their areas.
- 6.2.5 To date, they have predominantly operated as large endowed funds which apply their income to a wide range of projects. Many of these might be called forms of civic good works. However, in recent years, they have included local economic development, social development and the environmental improvement of their localities. Several have also started to undertake limited forms of lending having realised that some projects provide a service from which they can derive and income stream from which a soft loan could be repaid.
- 6.2.6 Relevant to this report has been the Canterbury Community Trust's decision to provide NELT with a loan. The NELT loan is interest-bearing at a subsidised rate, and provided interest-only for 5 years. Unless NELT can build its capital reserves in the meantime or find an alternative source of capital to replace the loan, repayment will be difficult. Since this was an experiment for the trust, there are grounds to think that the facility might be extended or changed into something more permanent.
- 6.2.7 Slightly more conventionally, ASB Trusts have recently provided MEGF with an operational subsidy. It is not clear whether they will continue to provide this in the future but thought unlikely in the longer term.
- 6.2.8 Thus, the Trusts are clearly a potential source of funds and possibly in more innovative ways than providing operational subsidies alone, though they may be a valuable source of those as well. However, they may wish to extend their lending activity, a process which could greatly leverage the impact of the funds they have available. They could do this as either a competitor, setting up their own similar operations, or as a partner. The latter, possibly building on Canterbury Community Trust's loan to NELT, is something which the EIA members should

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approach as a potential opportunity to increase their funds under management and increase their capital base.

### *Credit unions*

- 6.2.9 In New Zealand, credit unions operate as quasi-savings banks and are restricted to providing personal savings and short term loans. There are currently 40 credit unions and no new ones have been created in the last 7 years. This is mainly because of the capital requirements – at least \$500,000 of capital would be required – but also because of the regulatory requirements they face. However, the sector as a whole has grown indicating that there is interest in using locally based savings and lending services.
- 6.2.10 They are regulated financial entities and have a national association, the New Zealand Association of Credit Unions. Broad proposals to amend this to allow credit unions to admit as members incorporated societies which comply with the credit unions common bond<sup>14</sup>, have been in discussion for some time and look likely to be accepted in due course. Prometheus Finance was previously a credit union but changed to a finance company to overcome the restriction on lending being limited to individuals (most of Prometheus' lending is to incorporated entities).
- 6.2.11 Credit unions are not a source of funds for EIA members. They may in some instances be competitors – for example, to Angel Funds. They may also be a *model* for how some of the EIA members could develop.
- 6.2.12 They are unlikely to be partners as their operations are very tightly constrained. Should new legislation free them up, particularly in the direction of the Canadian model where some credit unions are effectively large banks<sup>15</sup>, they could become serious competitors.

### *Finance companies*

- 6.2.13 Finance companies in the New Zealand context are a form of regulated deposit-taking institution, able to raise funds from the public and apply them to an effectively unlimited range of investments. In practice, they usually offer higher returns to their investors and find higher risk but also higher return investment niches in which to apply the funds. Examples include embedded consumer finance, property investment, financial services to higher risk borrowers, and similar. A number are subsidiaries of banks. They are generally at the sharper end of the finance spectrum. They have flourished during New Zealand's economic boom. There is concern that some may be at risk as the economy contracts.
- 6.2.14 Prometheus Finance is a finance company and so the form is clearly a potential model for EIA members. Seen as lightly-regulated quasi banks, the form is very

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<sup>14</sup> To use a credit union's services, a member has to comply with its common bond. This could be membership of a profession or a society.

<sup>15</sup> For example, Vancity, based in Vancouver, is a large and very interesting multi-service financial institution, indistinguishable in most respects from any bank other than its community emphasis and strong SRI policies – see [www.vancity.com](http://www.vancity.com).

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flexible. Several other EIA members could become finance companies and this is one route to operational sustainability.

- 6.2.15 Given their generally strong focus on profitability, finance companies are not a source of funds for EIA members. They are neither competitors nor potential partners. The one exception is Prometheus. It is highly unlikely to want to compete with fellow EIA members but could be a potential partner. For some members, this should be given serious consideration and is discussed in detail below (see 7.5).

### *Smaller banks and building societies*

- 6.2.16 In New Zealand, the large banks are foreign-owned. The smaller banks and building societies are, as a general rule, locally-owned. The latter include TSB, SBS and PSIS. Kiwibank, a state-owned enterprise, is relatively new and, though already well-established, is still in development.
- 6.2.17 The smaller banks mainly concentrate on personal banking services. As such, they are incidental competitors to EIA members. Contact with each of them revealed no inclination to become sources of funds, nor partners. Any social remit appears mainly limited to retaining their local ownership and a focus on providing competitive services to New Zealanders with little room for other activities. Possibly indicative of this is SBS's withdrawal from a joint venture with the Southland Community Trust to fund higher risk growth businesses.

### *Large banks*

- 6.2.18 The large banks in New Zealand are part of larger, Australian-owned groups. They undertake various sorts of community orientated activities. These are mainly focused on traditional "good works" and not likely to be of interest to EIA members. The one possible exception is Westpac which has a relatively strong corporate social responsibility orientation in Australia and is developing this in New Zealand. However, this is still at a formative stage. Discussion with each of the banks showed little interest in funding EIA members or entering into any form of partnership. They will be competitors from time to time where a member's loans are more mainstream.
- 6.2.19 By contrast, the author's own experience in the UK shows that there can be a beneficial partnership between banks and community loan funds. The latter can lend more effectively – they are closer to their clients, lower loss rates – than the mainstream banks. Barclays Bank, in the UK, calculated that it would be more cost effective to place funds with community loan funds than to lend themselves for certain types of lending. However, there was no interest in such approach amongst the local banks. EIA members consulted indicated that they would not favour such partnerships unless they could be undertaken with New Zealand owned entities – which means the smaller banks. Nevertheless, this may be a development which could be taken up longer term.

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### *Government initiatives*

- 6.2.20 The study consulted with the Ministry of Social Development, Ministry of Economic Development, Ministry for the Environment, Department of Labour and the Treasury. This revealed that there are numerous initiatives providing various forms of support and funding in the general area of interest to EIA members – especially in employment support and business development.
- 6.2.21 However, there is no systematic overview of what is being done. This applies even within the specific ministries. Indeed, one of them, the MSD, is undertaking an internal project to draw up a list of its own programmes. A government-wide survey is not in prospect. Since providing one here was beyond the remit of this report, while we have been reasonably diligent in assessing a number of schemes, there may be one or two which could be of help to EIA members which has not been covered. However, the representatives of the Ministries approached did not themselves think so.
- 6.2.22 Nevertheless, what became clear was
- There are schemes which overlap with the Angel Funds, but these appear to present no very effective competition because of the more direct and personal approach which the funds take.
  - General employment generation is a low priority at the moment. The focus is on identifying potential fast-growth high-technology companies and supporting them.
  - There is openness to schemes which would help bring potentially good business ideas into the conventional finance net, and a willingness for limited experiments – Bank-Able described below is a good example – these are not a priority and would need to be very focused and time-limited.
  - Environmental initiatives are either specific schemes such as the EECA scheme which Prometheus was a part of until recently, or more general support for areas such as organic agriculture. Otherwise, direct action is more educational and “encouragement”.
- 6.2.23 There was no interest expressed in partnering or supporting EIA members. However, this is at the administrative level. A specific political initiative cannot be ruled out although it is considered highly unlikely.
- 6.2.24 Overall, there appeared to be little interest to EIA members in government schemes. Securing any funding is considered unlikely and pursuit of it probably a distraction. Even if successful, any arrangement is likely to lead to forms of dependence rather than genuine sustainability. Some EIA members appear to disagree and may wish to pursue it further. If so, it is recommended that genuine partnering is sought rather than outsourcing of a government programme, and to consider how they might strengthen themselves in order to maintain their independence.

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### *Other initiatives – (1) Bank-Able*

- 6.2.25 In the course of the study, several other initiatives were encountered which are close to what EIA members are doing. One of these is Bank-Able. This is based in the Business Development Centre in Hamilton. It

*identifies individuals with a promising business idea, but who lack a banking history or the collateral to secure a bank loan to fund their business start-up.*

After a successful evaluation, it backs applicants with a time-limited loan guarantee which allows them to secure a bank overdraft. It is partly funded by WINZ and had developed a strong working relationship with a local branch of the ANZ. From the author's experience, personal commitment to such projects by the partners is key to getting them to work properly.

- 6.2.26 Bank-Able is not a source of funds nor a potential partner, but it is a different model to secure funding for seeking to increase employment and self-employment. With its emphasis on bridging finance into the mainstream sector, it may be a serious competitor to this strand of the EIA members' activity longer term. It is hoping to start to roll out the scheme in stages nationally. This will require substantial risk funding from WINZ or a similar provider.

### *Other initiatives – (2) Youth Business International*

- 6.2.27 The Prince's Trust is a UK-based initiative set up to provide funding for young people who show potential entrepreneurial ability. It has a radical funding model whereby it accepted a very high failure rate (it has averaged about 30%) as justified as, even if the young person failed in the business venture, they would still have learnt valuable lessons and benefited. A number of evaluations over the years appear to have validated the approach<sup>16</sup>.
- 6.2.28 There is an initiative at a very early stage sponsored by a socially-minded business group looking to create a version of this in New Zealand under the name "Youth Business International". This appears to have been paused for now, partly because of a perceived lack of demand with high employment. However, low unemployment across all sectors often disguises high employment within specific sectors – youth unemployment, particularly amongst ethnic minorities, being a common example. It's likely that this initiative will be taken up in New Zealand in which case it is a potential competitor to those EIA members focusing on employment creation.

## 6.3 Conclusions

- 6.3.1 An underlying question which led to this study being undertaken was whether there were untapped sources of funding which might allow members to grow. The conclusion is fairly clear and, probably disappointingly, "no" with the one possible exception of Community Trusts. In addition, the members are likely to see a gradual increase in competition longer term.

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<sup>16</sup> See, for example, *An Evaluation of the Prince's Youth Business Trust*, Mary Dalgleish, Great Britain: Employment Gazette (January 1993). No version available on the internet.

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- 6.3.2 Providing this sort of funding to members is not a focus for government in any of the three types of area in which EIA member are active – individual empowerment, employment generation, social and environmental projects. Or, where it is a focus, the approach is to provide their own direct schemes which they can control and will then have national coverage. This may change for employment generation if there is a sustained economic downturn but this would be a couple of years away. Environmental projects may well be supported – such as the EECA solar energy scheme – in a way which makes use of third parties. But this will be programme specific and will not provide general help to EIA members.
- 6.3.3 Foundations are disinclined to fund this sort of activity. There are hardly any which see the activity of EIA members as part of their objectives. There may be some exceptions in the case of the Angel Funds for particular localities, but this is likely to be limited. The one clear general exception is the Tindall Foundation itself. This report does not seek to set out the Foundation’s longer-term policy but it seems unlikely that it will provide significant capital funding for EIA members and that its support for operational costs is likely to be limited in time. However, some funding for undertaking new strategic developments might be available.
- 6.3.4 Credit unions and finance companies would not fund EIA members for differing reasons and, in so far as they interact, are either competitors or models for what how some EIA members might develop themselves.
- 6.3.5 Both small and large banks showed no inclination to provide funding for EIA members. This is disappointing given the precedent from overseas, particularly in the USA and the UK. There, banks have partnered with loan funds using their specific focus and expertise to provide lending services which they would not wish or feel unable to do themselves. The general response here was a mixture of “no need for it” and “not an area where we would want to focus”.
- 6.3.6 Community trusts may be the exception to this generally disappointing picture. Some of the Trusts are interested in developing their initial experiments with lending into something more systematic and into areas which may overlap with EIA members’ activity. This could create competition if Trusts set up their own operations. Alternatively, members could try to enter into partnerships with their local community trust to provide some of the lending services in return for providing some of the capital needed. There is already a partial precedent in the arrangements NELT has negotiated with the Canterbury Community Trust. Coupled with the suggestions made in the next section which would create considerable leverage on the capital advanced, this could be attractive for the trusts and the EIA members.
- 6.3.7 Lastly, other initiatives – such as Bank-Able and a local version of Youth Business International – may appear which take a different approach to that of EIA members but which present them with competition longer term.

## 7 Strategies towards sustainability

### 7.1 Different models

7.1.1 Does the conclusion of the previous section imply that EIA members must simply continue to struggle year to year trying to raise grants to cover their operating costs without any real prospect of increasing their funds under management? The answers are different for each but this report suggests that most could achieve some form of sustainability.

7.1.2 However, it requires a re-thinking of their operations and strategy, different for each fund depending on its circumstances. Such changes might not be acceptable for a particular fund but there would appear to be no fundamental conflict with their objectives. And, while in each case the basic approach is fairly clear, implementing it would be difficult. How this might be done is set out in 7.5.

7.1.3 The routes towards sustainability for the funds differ:

Prometheus Finance Prometheus is already operationally sustainable and very likely to be capital sustainable. It provides the model for most of the other funds.

Larger loan funds QIET and MEGF have a reasonable capital base – about \$500,000 – which is similar to that of Prometheus, and could use this to raise deposits in a similar way, greatly increasing their funds under management.

NELT's capital base is too small at \$82,000 to proceed in this way, but its existing link with Canterbury Community Trust and in some of the tactical ways forward set out below, it may be able to follow this approach.

Smaller loan funds This includes Golden Bay Work Centre Trust, Just Dollar\$ and possibly NELT.

Golden Bay gave clear indications that it does not wish to grow and can achieve a form of limited sustainability through operating on a voluntary basis.

NELT wishes to grow but both have a non-existent or small capital base. This makes their challenge the most difficult.

Just Dollar\$ is not attempting to increase its investment funds as it considers it has sufficient for its current lending needs.

Angel Funds These have a small capital base but, more importantly, principles which mean they cannot follow the Prometheus model – they will not charge interest, for example. However, the report's contention is that a modified form of sustainability is available through a more systematic marketing of donations and interest-free

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loans from individuals.

- 7.1.4 The strategies are best understood by considering three underlying operating models.

### 7.2 The Prometheus model

- 7.2.1 The Prometheus model is simply that of any savings bank. The proforma set out in Appendix 1 shows the main components of its finances and has already been discussed. Funds are raised as capital and deposits and are lent on apart from a proportion which are held as cash to meet the demands of depositors. The margin, the difference between the return it receives on its loans and cash and what it pays on its capital and deposits, funds its operating costs.

- 7.2.2 The approximate figures for Prometheus, reorganised and simplified according to the proforma, are shown in the adjacent chart. The first column shows its balance sheet. The second its income and expenditure. The third what is earned or paid as a percentage of the total balance sheet.

	BS	PL	
	\$k	\$k	
C Cash	3,243	140	4.32%
L Loans	6,261	602	9.62%
F Fixed assets	19	0	0.00%
	<u>9,523</u>	<u>742</u>	
E Equity	677	85	12.56%
S Savings/Deposits	8,579	316	3.68%
Other liabilities	267	0	0.00%
	<u>9,523</u>	<u>401</u>	
G Gross profit		<u>341</u>	3.58%
B Bad debts		0	
P People		208	
O Overheads		32	
D Depreciation		10	
		<u>250</u>	
N Net profit		<u>91</u>	0.96%

- 7.2.3 What this shows is the considerable leveraging of Prometheus' capital through its ability to accept deposits. Its total funds under management is \$9.5m of which only \$677k is capital – a gearing of 14 times<sup>17</sup>. It earns a net margin on this of 3.58%, or \$341k gross profit, which is more than adequate to pay its operating costs.

### 7.3 The loan fund model

- 7.3.1 If Prometheus was limited to lending only its capital – even if it paid no return on capital, earned 9.62% on its loans and had lent out all its funds – its gross profit would be \$65k. Its operations would obviously be greatly reduced. Even so, unless it was run almost entirely pro bono, it would not be able to cover its costs. This is the operating model of most of the smaller and larger loan funds.

- 7.3.2 Reversing the calculation, Prometheus runs with approximately 3 full-time equivalent employees. Assuming a reduced operation supporting 1 full-time employee, and assuming other operating costs could be reduced by a half, the total

<sup>17</sup> 10 times is more likely longer term.

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operating costs would be about \$90k. Assuming the same loan terms, that the fund was 2/3 lent out, the capital then needed would be just over \$1.3m to break even. This is the approximate amount needed of free capital – under the given assumptions – for the loan fund model to achieve operational sustainability.

- 7.3.3 This calculation provides an optimistic estimate of what is needed to operate as a loan fund. Changes in the interest rates for loans and cash, and the proportion of funds lent out, will, of course, change the amount of free capital needed. The need to pay any return on the capital would increase the total capital needed too.
- 7.3.4 Perhaps more importantly, a higher bad debt rate (Prometheus has been successful in maintaining very low bad debt rates) would also make a difference. A rate of 2.5% written off in a year is low for this type of lending. On a loan book of around \$1m this would add \$25,000 to a fund's costs. Keeping the other assumptions the same, the amount of free capital then needed is nearly \$1.7m.
- 7.3.5 Thus, a better estimate of the free capital needed is probably somewhere between \$1.5m and \$1.7m. This means even for QIET and MEGF, additional free capital of \$1m or more, and correspondingly more for the others. Even Prometheus, with its capital of \$677k, is not near this.
- 7.3.6 However, it's important to note that this is a generalised calculation and that individual funds may be able to achieve a sustainability on a smaller balance sheet if their operations change some of the main assumptions. One of the medium-sized funds believes itself to be close to operational sustainability on a recent balance sheet of \$423k. It made loss of just under \$10k on this before taking account of grants and other income. It believes that it can achieve sustainability in the current financial year with roughly a 50% increase in its balance sheet size to about \$610k.
- 7.3.7 Does this invalidate the general calculation? One main assumption is its interest margin – the difference between what it receives on loans it has made and its cash held on deposit on the one side and what it has to pay for loans. The fund achieves about 7.4%. Implicit in the Prometheus model is a margin of 3.58%. By way of a further comparison, an organisation like Southland Building Society achieves about 2.4%. These are small numbers and the differences may not appear large, but, arguably, they reflect the graduation from soft capital, to social capital and then to commercial capital. In fact, the differences are substantial. 7.4% more than doubles what Prometheus can achieve, and Prometheus itself operates for the most part at sub-market interest rates. Thus, by charging more for loans and paying less on the funds it has received, the gross profit will be much higher for each dollar in its balance sheet.
- 7.3.8 A second main assumption is in the level of operating costs. Here again, the medium sized loan funds all have lower costs than Prometheus, and much lower than SBS. This is mainly because their main cost, salaries, are lower than they would be in the general market per matching full-time equivalent co-worker. Once again, there appears to be a graduation from such funds to Prometheus, then to SBS, where personal commitment provides what can be seen as a form of donation. This is taken much further with funds such as the Christchurch Angel Fund where most work is undertaken on a voluntary basis.

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- 7.3.9 Does this then mean that such organisations can achieve sustainability at a lower level and that it is almost within their grasp? Taking one fund as an example, it needs to grow by 50% while maintaining an interest margin at about 7.1%. This assumes (a) sufficient sources of free or almost-free loans and long-term capital, (b) that most of this (at least 2/3) can be lent out relatively quickly at high interest rates, (c) that overheads will not need grow to accommodate this growth, and (d) that bad debts will not increase. None of this is absolutely impossible but it is unlikely, and less likely still taken in combination. This is the common phenomenon amongst lenders of increasing volume being accompanied by tightening margins, increasing overheads and greater operating challenges. Thus, as the balance sheet grows, it's highly likely that the underlying assumptions will move in the direction of those of Prometheus making true sustainability always beguiling just beyond reach.
- 7.3.10 If there were ready sources of free capital available, this might still be a feasible route to operational sustainability but the survey undertaken makes it clear that this has a very low chance of success unless new sources of funds appear in New Zealand. Some funds may be able to do this. The test would be in the doing, of course, but the better basis for this as a strategy would be a careful development plan which factors in some of these changing aspects. Once this is done, sustainability might then be achieved on a smaller balance sheet than the generalised calculation but it is still likely to be an absolute minimum of about \$800k – a challenging sum to reach.
- 7.3.11 This report's conclusion is that the loan fund offers little realistic prospects for EIA members to achieve sustainability long term. The main reason is the absence of ready sources of low cost capital and long-term loans. Elsewhere, where these are more readily available, this model has been used successfully. However, where a fund believes it may achieve sustainability and on a smaller balance sheet than that indicated here, it is recommended that the fund undertakes a very careful strategic evaluation of what this would require. It is likely to be more challenging than some currently believe.
- 7.3.12 But why should the loan fund model be preferred? It seeks to make loans from what is a scarce resource – capital, preferably free capital. Prometheus with a roughly similar capital base to QIET and MEGF has grown into a \$9.5m fund because it uses its capital not as a source of funds but as a means to leverage in a much larger body of deposits. It then lends these at much lower margins, but the end result is a size of activity which is operationally sustainable. Arguably, QIET and MEGF, analysed purely financially, with their capital bases of \$347k and \$548k, respectively, already have a basis on which they could proceed to sustainability. Probably the minimum hurdle to consider this is about \$500k of capital<sup>18</sup>.
- 7.3.13 NELT has further to go with capital of \$82k. However, its success to date suggests that it could raise the amounts needed providing it planned to pay a return on the capital. NELT themselves confirm their confidence that they could raise

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<sup>18</sup> This is the figure that the New Zealand Association of Credit Unions quotes as a starting point to create a new credit union.

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additional funds from a range of bodies who see them as an essential part of local business support and development in the Nelson area.

### 7.4 The Angel Fund model

7.4.1 The Angel Funds could not use this approach even if they were close to the basic capital needed. They don't charge interest as a matter of principle, even though the Dunedin Angel Fund charges a substantial arrangement fee. The effect is roughly to double the amount of capital needed. And, they concentrate on very small loans which means they could not carry a loan book of about \$1m even assuming there was the demand for it. A single person running the fund would be looking after roughly 1,000 loans. 100 is a more realistic even if still challenging maximum. However, quite a different approach is possible and would confer a form of quasi sustainability. It is close to what the Angel Fund is already doing in Dunedin. The following comments apply specifically to the Dunedin fund which appears to have a stronger financial focus than others within the national network.

7.4.2 They have a good track record delivering credit within a supportive context to women who are either moving into employment or self-employment, or are undertaking various forms of education and training. Some of this is parallel to government schemes. Even so, they see steady demand and believe they could extend their services to slightly larger loans and to wider purposes.

7.4.3 It appears that about half of their funds are effectively capital – permanent donation or very long-term interest-free loans. They are partly subsidised in their operation by being a part of the Dunedin YWCA, although it seems likely they will have gradually to pay their full costs. Assuming so, and that they may have to pay their co-worker directly for some of her time, they are likely to have an operating budget of about \$30,000 a year. Additionally, they need to fund approximately \$100,000 of an extended loan book through interest free loans. Assuming about \$40,000 a year of new lending with an arrangement fee of 10% each time, their requirement for funds will be approximately

- \$26,000 a year of new donations
- \$100,000 a year maintained of interest-free loans

7.4.4 The contention here is that a concerted marketing campaign, building on their existing support and track record, could raise these amounts on a quasi sustainable basis. For example, securing commitments of annual gifts of \$500 for a period of 4 years from 52 donors would cover the operating costs. Similar calculations could be applied to the interest-free loans.

7.4.5 The fund has a well-defined target group, continuing demand for its services, has a good track record, has a clear local base and an existing history of raising small donations. Well marketed, it is likely to be attractive to private individuals within its locality. Clearer analysis of its funding needs is likely to assist this.

7.4.6 Assuming the donation targets can be met, there will be some attrition over time. Interest-free loans will need to be repaid and donors may well not be able to sustain a four-year term. However, there will be no single large gap appearing. This should become a routine part of the fund's activity so that replacement loans

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and new donors are being solicited continuously. Better focus and a clear message will help this.

7.4.7 Large donations could still be sought but these should be used for development of the fund rather than for its day-to-day operation.

7.4.8 This is not sustainability in the strict sense but a limited form using donation streams. Even so, it is different in kind from reliance on a few large donors. It replaces customers/clients with a large number of small private donors. Management of them, providing them with regular information and continued marketing, would look very similar to any small business activity.

7.4.9 This could provide a strong basis for the Angel Fund albeit different in kind from the Prometheus model.

### **7.5 What's needed to adopt the Prometheus model**

7.5.1 The rest of the discussion considers what would be required of the smaller and larger loan funds if they moved to the Prometheus model and, in the next section, how they might achieve this.

7.5.2 Adopting the Prometheus model would represent a considerable change in how the loan funds managed themselves. This would not be an easy or straightforward option. An indication of the difficulty is that there have been no new credit unions in the last decade despite a number of attempts. The process was simply too arduous.

#### *Review of objectives*

7.5.3 Operating under the Prometheus model is compatible with the funds' existing objectives. There are two possible exceptions

- Where the demand for their services is weak or they are lacking strategic focus, this will have to be strengthened. This will typically show in lack of demand for their lending services. In the case of the employment generation funds, lack of demand is most likely because of changes in the New Zealand economy. However, rather than simply accepting this, this needs to be responded to and would require continual review
- Bad debt rates would need to be well managed and kept within pre-determined limits. Most are managing this reasonably well. Where higher rates are accepted deliberately, the overall operating budget would need to be able to carry this. This would probably require some tightening of the approach.

#### *Deposit holders*

7.5.4 The most obvious change is that the funds would acquire a relatively large number of deposit holders. These would require much more activity than their funders have to date requiring routine administration, communication and marketing, and continual consideration of how to keep the fund attractive to their savers. Within Prometheus, this takes at least a third of their activity and sometimes more. From a few applications seeking large grants, they move to managing a large number of

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small accounts. This would require a considerable change in orientation and in most cases the learning of new skills.

### *Margin*

- 7.5.5 To date, margin for the loan funds has been almost identical with the rate they earn on loans and any cash placements – their cost of funds has been close to nil. With depositors, they will have to offer an interest rate and so start to consider trade offs between maintaining the volume of funds under management with their cost – the management of their margin.

### *Cashflow*

- 7.5.6 The longer-term cashflow, matching the potential liability to pay depositors within the terms of their accounts with cash on hand, would need to be managed. This is a delicate matter as no bank can entirely match its potential liabilities. However, maintenance of confidence, keeping sufficient cash reserves to meet depositors needs, offering deposits on appropriate terms, would all have to be learnt.

### *Acceptance of regulation and compliance*

- 7.5.7 The Prometheus model requires some form of regulatory regime. As soon as an organisation becomes a deposit taker, it will be regulated to protect the deposit holders. If a credit union, then by the National Association of Credit Unions; if a finance company, then by an authorised trustee company. Compared with bank regulation, the regime in both cases is relatively light. However, it would introduce new aspects to their operations<sup>19</sup>.

## 7.6 Making the transition

- 7.6.1 How could a fund make this transition? There are three ways.

### *Individual conversion to a new credit union or finance company*

- 7.6.2 Prometheus operated as a credit union until relatively recently but has converted itself into a finance company. Credit unions, as was noted above, are limited to lending to individuals under the current New Zealand regime. This may change but until it does, this would appear to make the form too restrictive for the type of activity the loan funds wish to undertake.
- 7.6.3 Some credit unions lend to businesses by lending to one of the principals in the business. However, this is still restrictive and often dysfunctional creating conflicts of interest. Accordingly, this report does not recommend converting to a credit union.
- 7.6.4 Finance companies, on the other hand, are far more flexible. They are regulated fairly lightly by trustee companies. The main matters which would need to be

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<sup>19</sup> And is anyway likely to tighten: finance companies are likely to come under the regulation of the Reserve Bank. Any changes are likely to come in 2008.

See [www.med.govt.nz/templates/ContentTopicSummary\\_479.aspx](http://www.med.govt.nz/templates/ContentTopicSummary_479.aspx).

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addressed are the funds capital adequacy and some demonstration of its ability to manage its operations.

- 7.6.5 Capital adequacy, in the process of transition, would not be an issue. The regulator's concern is that the amount of capital is too low relative to the funds under management. If the starting point is that it is all capital, this would not be a concern.
- 7.6.6 However, monitoring the strength of the loan book and the risks it presented, including what security had been taken, would require some adjustment of how funds currently work.
- 7.6.7 Proving a fund's ability to manage operations will focus on how it undertakes its lending. This is likely to require greater formalisation of lending decisions and stronger systems to monitor repayments and taking of security. Most of the funds have a good basis for this and an existing track record. But it would also require adequate systems for managing deposits which would be largely new.
- 7.6.8 Conversion to a finance company would be an expensive process. It would require specialised and expensive legal help. A conservative estimate of the costs would be about \$100,000. It would also consume a significant amount of time. For what is essentially a one-person operation, it is likely to take half a person year and extend over an eighteen-month period.
- 7.6.9 Thus, conversion to a credit union is not recommended as the form does not really fit, and to a finance company, it is recommended only where the fund is highly committed to taking this step. However, this is a realistic possibility for those funds with about \$500k of capital now.
- 7.6.10 For those with less, the first step would be to increase the capital base to about this level, and then proceed. Provision of capital by a Community Trust could help fund a self-sustaining community lending activity in its locality appears to be a real possibility if a fund can create a strong enough plan.

### *Partnership with Prometheus Finance*

- 7.6.11 A second route is to become part of Prometheus Finance. This, of course, makes the assumption that Prometheus would want to do this. Discussions with their board suggests that this may be possible but would need to be individually negotiated.
- 7.6.12 Prometheus has already established the systems needed to operate as a finance company. It has existing regulatory relationships. It has long experience of managing deposits and the administration needed. Thus, it is potentially an existing shell into which a loan fund could transfer its operations and activity.
- 7.6.13 Prometheus also has experience of managing "themed" accounts within its overall operations. A loan fund could become a themed aspect of Prometheus' activity.
- 7.6.14 The effect financially would be to expand Prometheus' balance sheet primarily with capital, on the one side, and loans and some cash on the other. In principle,

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this is likely to strengthen the balance sheet introducing a greater proportion of capital.

- 7.6.15 The effect on the profit and loss account should also be beneficial. The combined operation should benefit from some economies of larger scale. However, its likely that there would be some adjustment of costs and operations to ensure that the overall result was cost-effective.
- 7.6.16 The main difficulties which are likely to arise are
- Difference in objectives: Prometheus' focus has been social and environmental projects, not employment generation. This would require considerable negotiation to ensure that there was sufficient overlap. The most natural fit would probably be between QIET and Prometheus.
  - Difference in operating style: merging of operations, even if the objectives are agreed and the formal terms clear, still requires that those in the two organisations feel they can work fruitfully together.
  - Negotiation of terms: while the loan funds and Prometheus are colleague organisations with EIA, each party would need to negotiate carefully the terms of any merger or association to ensure that its interests were protected.
  - Need for extensive due diligence: the fund's loan book would be transferred into Prometheus' balance sheet. This would require careful verification of the worth of the loans for Prometheus to be sure it was protecting its interests.
- 7.6.17 These are all significant matters. Nevertheless, where Prometheus and the fund consider that the outcome would be positive, this is likely to be a far easier route to follow with considerable benefits to both sides. Prometheus will strengthen and grow its overall activity, with access to a larger lending and savings base; the fund acquires Prometheus' long experience many areas with which is unfamiliar, becomes part of a much larger organisation without the long process of building this up for itself, and avoids having to bear the heaviest strictures a new compliance regime would impose.
- 7.6.18 For those funds where this seems to be a fruitful way forward, it is one which is most strongly recommended.

### *Partnering of funds and conversion to a finance company*

- 7.6.19 Most of the funds have very similar objectives and styles of operation. Prometheus is more dissimilar because of its strong environmental focus and the fact that it has operated as a deposit taking institution for many years. It may be easier for the funds to consider merging with each other, and the merged operation to convert to a finance company.
- 7.6.20 This then becomes a version of the first proposal but with the greater complexity of the initial merger. The advantage is that it creates a more substantial entity and, if several proceed to undertake the conversion, this is done once and for all, rather than several times over.

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- 7.6.21 It is still considered a less-advantageous option over the merger with Prometheus where that is possible.

## 8 Conclusions

- 8.1.1 This report's brief is included as Appendix 2. The report's principal aim was to report on the financial sustainability of the funds making up the EIA, their attitude and their prospects for achieving this, to assess what sources of funds might be available to help with this, and what strategies they might follow. Taking these questions in turn:-

### *Financial sustainability*

- 8.1.2 Only Prometheus Finance is financially sustainable at the moment. Operationally, it is strong. It will need to raise *social capital* from third parties in the near future and looks very likely to be successful in this.
- 8.1.3 The Angel Fund Dunedin is close to a form of quasi sustainability using donation streams and interest-free loans. This could be developed more systematically to provide them with an unusual but strong basis for the future.
- 8.1.4 The remainder of the funds are not financially sustainable except where they are run to a large degree on a pro bono basis and with a corresponding low level of activity. This is likely to worsen in the future with the exhaustion of existing donors and the gradual appearance of competition in the areas in which they work.

### *Attitude and prospects*

- 8.1.5 Most of the funds wish to be sustainable and to grow to achieve this. However, in most cases, they wish to retain their current operating model – the “loan fund” model.
- 8.1.6 Accordingly, a key question has been how big a loan fund do you need to be to be sustainable? However, calculation of this is dependent on a number of factors other than size. But making reasonable assumptions for these, the size needed is somewhere between \$1.5m and \$1.7m of *free capital* – capital on which no return has to be paid. The larger funds are some \$1m short of this.
- 8.1.7 Demand for loans for funds concentrating on employment generation is low at the moment. This is probably due to the strong economy and may change to some extent over the next two years or so. However, these funds need to re-consider their specific focus to see whether they could be better aligned to current needs. Otherwise, assuming they could secure the free capital needed to grow, it is unlikely that they would be able to lend it on.

### *Sources of funds*

- 8.1.8 There appear to be no sources of funds likely to be available to EIA members other than those already known to them, and these are likely to cease before too long.
- 8.1.9 There is one possible exception in the developing activity of Community Trusts into forms of lending and local economic development. There is an experimental precedent for this with a loan from Canterbury Community Trust to NELT. The

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report recommends that this is pursued further. However, it is unlikely to provide the amount and type of capital needed by the funds in the longer term and is more likely to be a contributor to the capital needs for those funds which rethink their operating model.

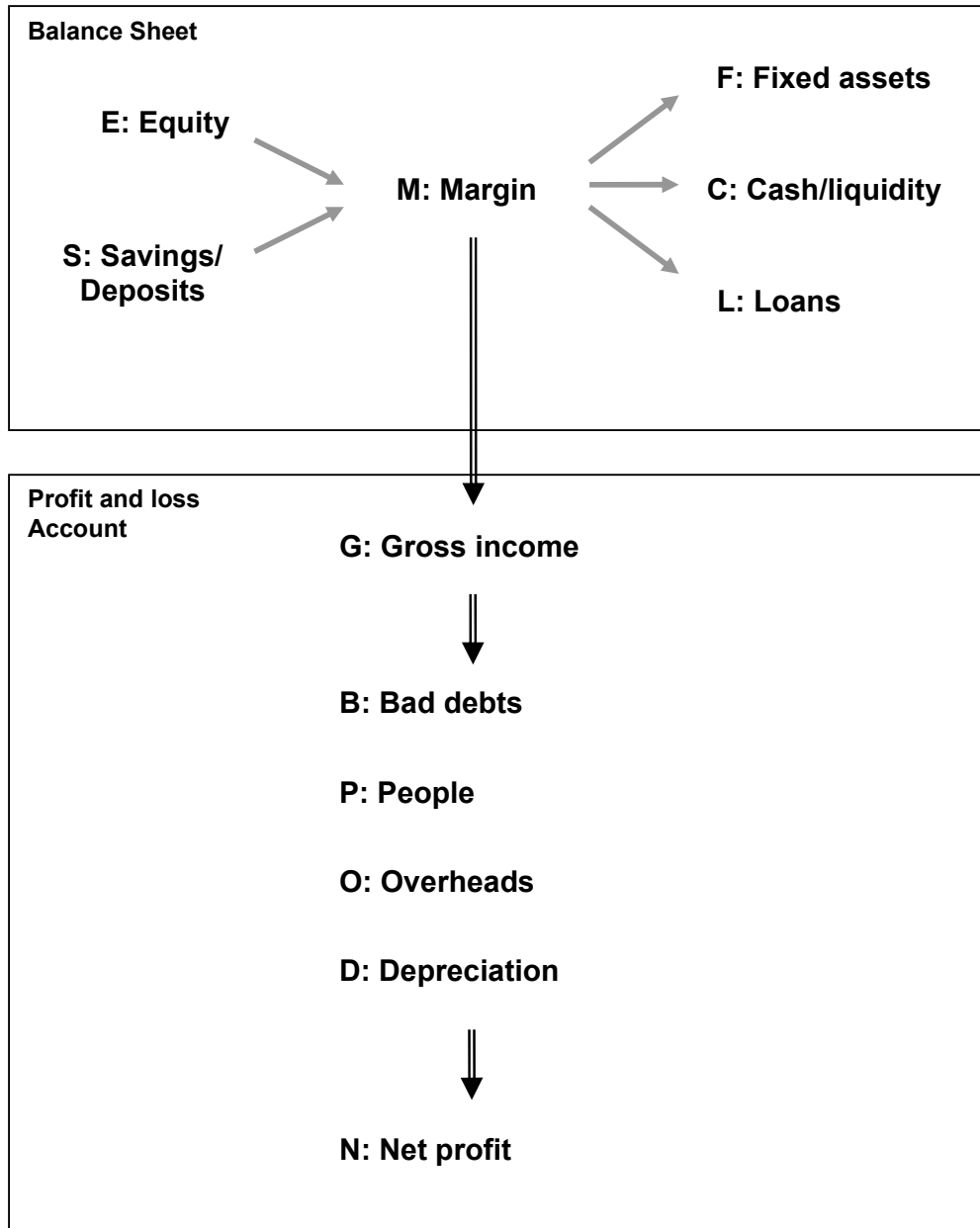
### *Strategies*

- 8.1.10 This presents a despondent view. There are no sources of capital available of the sort or the amount needed, and the existing sources which have covered operating deficits to date are likely to discontinue in the future.
- 8.1.11 However, Prometheus and the Dunedin Angel Fund are sustainable or can achieve quasi sustainability and have good prospects. The very small funds which operate on a pro bono basis should be able to continue as they are indefinitely.
- 8.1.12 It is the middle layer of funds which need to consider their strategies for the future. These have a difficult but entirely feasible way forward if they are prepared to change their operating model, from a “loan fund” model to the “Prometheus model”, using their capital to leverage in additional funding as deposits instead as the source of funds for lending. Some are already very close to Prometheus in the size of their capital base.
- 8.1.13 There are several routes to achieving this, standing alone or in partnership with others. In all cases, this would be a difficult process and would require considerable commitment on the part of the fund. It appears to be their only realistic way forward. If taken up, it would greatly strengthen this type of activity throughout New Zealand.

## 9 Appendix 1: Proforma financial structure

9.1.1 The following chart sets out a simplified proforma for the profit and loss account of an EIA member. It shows the basic financial structure ignoring grants and donations for capital and revenue. The labels for the various elements are used throughout this report and used in the analysis of the EIA members' accounts.

9.1.2 It shows the basic financial drivers of any organisation raising and providing credit. Most banks and finance companies will have other income streams but this will still apply for their credit operations.



## 10 Appendix 2: Report brief

The following is an extract from the brief for this report:

*Ethical Investment Aotearoa (EIA) is an informal grouping of community loan and microfinance funds in New Zealand (the “Funds”). Many of these Funds have not been able to achieve operational self-sufficiency and report they have difficulty in raising capital to develop their operations. They can only continue operations with the help of external grants and support. Why is this? Can it be overcome? Is there seed or pump-priming support which would enable them to do so? Do the Funds, themselves, wish to achieve self-sufficiency in their operations and in capital-raising?*

*A report on these and related questions will be prepared principally for the trustees of the Foundation. A summary, protecting the individual Funds’ confidentiality, will also be prepared along with individual feedback to selected Funds. A public summary may also be prepared if required but has not been included in this proposal.*

*The report will cover*

- *A brief overview of microfinance in the developed and developing world*
- *An overview of currently accepted best practice in assessing and achieving operational sustainability for microfinance funds*
- *An overview of the regulatory framework within which such Funds must operate in New Zealand*
- *A desktop survey of potential sources of capital in New Zealand for the Funds and what regulatory obstacles would need to be overcome*
- *An assessment, based on direct interviews with selected representatives of sources of capital, of the availability of capital for the sector*
- *A desktop survey of Funds willing to participate in this survey and selected according to their basic financial and operational characteristics*
- *Individual reviews of the selected group of the Funds based on interviews and data provided by the Funds themselves*
- *A financial and organisational assessment of these Fund’s operational shortfall and difficulties in raising capital and their main reasons*
- *Recommendations of what action could be taken by the Fund to reduce an operational shortfall if it exists while maintaining its special objectives – this may conclude that a level of shortfall is inherent in the Fund’s objectives*
- *Recommendations of what action could be taken to raise capital from third party sources*
- *Suggestions for how the Foundation might proceed in supporting the sector.*