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FSC SOCIAL IMPACT INVESTING SUBMISSION

Housing Unit Manager
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The Treasury
Langton Crescent
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BY EMAIL: socialimpactinvesting@treasury.gov.au

Dear Social Impact Investing Team,

The Financial Services Council welcomes the opportunity to make a submission to the Social Impact Investing Discussion Paper to assist the Government to explore ways to develop and encourage the growth of the impact investing market in Australia.

The Financial Services Council (FSC) has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC is a strong supporter of impact investing and the removal of regulatory barriers to allow the market to grow in Australia. We also note investors currently face significant challenges in undertaking these investments. Please find our detailed submission below.

Should you wish to discuss this submission further please do not hesitate to contact me on (02) 9299 3022.

Yours sincerely,

Sara Dix
Policy Manager, Investment and Global Markets

INTRODUCTION

The FSC is a strong supporter of impact investing and the Government's commitment to develop the market in Australia. Impact investing is a unique and innovative method of both social service provision and investing – involving Government, investors and the not-for-profit sector working together for a dual purpose.

Currently the small size of the impact investing market in Australia classifies it as a niche investment – often falling within philanthropy or corporate social responsibility sectors. However, the growth of the market could see it transformed into an asset class of its own for 'traditional' or 'mainstream' investors as well with a market rate of return. The long list of challenges for investors and regulatory barriers would need to be resolved over time, and we will aim to address some of these in our submission – the largest being the clarification in regards to fiduciary duty.

We have seen a significant growth in responsible investing in Australia. While impact investing does not fall within the responsible investing bucket per se, we are seeing a large increase in demand for products and investments that are socially and environmentally responsible. Institutional investors being able to offer their members an impact investing option would be highly desirable.

The FSC supports sustainable government budgets. We also believe measures should be taken to protect public finances against increasing costs of an aging population. Certain challenges appear too large to be solved by the state alone.

Impact investing has the potential to improve the budget position over time in solving social welfare problems at lower costs. Capital will be directed to the most efficient and successful projects thus developing better outcomes for Australia, the budget and investors. Government funds will be directed more effectively and assist in social service provision with a reduced strain on government finances.

The not-for-profit sector will also benefit from improved business processes, measurement techniques, data analytics and the improvement of accountability and governance. The Government has a role to play in this as well, assisting the not-for-profit sector, as we have seen in the UK.

We will outline our views on the Government's role below. The Government has an important role to play for a successful impact investing market, and we can learn a lot from the experiences in the USA and UK. Solving some of the challenges for investors will allow increased flexibility for super funds and fund managers in participating in this market.

Australia's impact investing market is in its infancy, and so government may need to take bigger risks at the start to see growth in the market while investor confidence increases. Once there are successful projects underway and measureable results, the investments will flow.

Please find our core submission and recommendations for Government below.

REGULATORY BARRIERS

Fiduciary Duty

The most significant regulatory barrier for investors participating in the impact investing market is clarification regarding fiduciary duty. That is, would investors be fulfilling their duty by investing in this type of investment with a dual purpose of improved social outcomes as well as financial returns? Further, these financial returns may be lower than other traditional asset classes and/or the projects may carry higher risk, especially for an investor new to the market.

APRA has gone some way in clarifying fiduciary duty in terms of sustainable investing, and recently announcing they will consider climate risks as financial risks. However, largely it is up to the trustee to consider and make informed judgements.

Impact investing would similarly require clarification from regulators to ease trustee concerns in order to be able to participate in the market. Focusing the fiduciary duty over the longer term would be helpful in being able to translate social and environmental issues being faced today into the financial issues of tomorrow. This would help trustees to be able to consider the risk and return characteristics of any impact investment in the correct context and timeframe.

In addition, trustees will need to be able to draw a link between social impacts and the impact on investment performance either from a return or risk perspective. APRA has a role to play in ensuring that the regulatory framework enables trustees to draw that link.

In the UK it was recommended to develop 'options to amend the investment regulations to clarify pension fund trustee duties in relation to impact investing'. A similar amendment or clarification of the law and regulations may be required to significantly grow the market in Australia.

Trustees of Charitable Foundations also have a fiduciary obligation in terms of the Prudent Person Rule for the investment of funds held in trust and to invest in lower returning or higher risk products may require considerable consideration.

CHALLENGES FOR INVESTORS

As outlined in the discussion paper, the list of challenges for investors is lengthy. We agree with the list of challenges currently facing investors in Australia and note these are hindering the scale-up in the market. Many of these are to be expected as the market in Australia is in its early stages and has so far had little Government support. The Government can address several of these challenges in its role in the impact investing market. We will address these roles in subsequent sections and provide recommendations.

A current and important key challenge for investors is the lack of data and metrics for projects. Many projects do not have a track record or measurable results upon which an investor could decide to invest. This is a challenge for several reasons – most notably for an institutional investor's fiduciary duty as discussed above. Without these metrics, it would be very challenging for a trustee to justify the investment.

We also believe the impact investment market needs to find some sort of measurement and reporting consistency. In particular, where a particular social or environmental outcome is commonly being sort by investors, specific, consistent and comparable measurement frameworks will reduce transaction and due diligence costs, as will certification and other assurance schemes (for example climate bonds).

Conversely, given the very broad range of social or environmental outcomes which could be targeted by issuers and investors this may not always be possible or desirable as it would likely result in perverse outcomes or unreasonably limit the variety of impact investments available to the market – so it would need to be carefully managed.

We acknowledge it is also challenging for the not-for-profit sector to develop extensive business plans and a track record of results in line with corporate practices. In the UK, the Government has developed a fund for 'investment readiness' grants for the not-for-profit sector to develop these business plans and develop capabilities to be able to record meaningful data sets. The Government may need to work as a capacity builder with the not-for-profit sector as these projects develop. We would encourage the Australian Government to consider developing and funding an 'investment readiness' fund for the not-for-profit sector undertaking impact investment projects.

In order for investors to invest into new projects without a track record, the Government would have to find a way to resolve this challenge as an intermediary and so investors are satisfied they are fulfilling their fiduciary duty. This could include extensive business plans and case studies of previous projects undertaken by the organisation. Independent assessments would also be required. This also ties into ensuring not-for-profits are 'investment ready' so the market works efficiently for all parties.

Other key impediments include scale, liquidity and capital intensity. As the market grows, we would expect scale and liquidity to improve in the sector. Broadening the discussion of impact investing away from niche, private-market activities would be helpful in introducing larger and more liquid sources of capital to the sector.

Impact projects should have the ability to 'scale-up' in line with the quanta of funds that institutional investors work with. The role of Government here would be supporting sectors/projects where impact investing would thrive. There are several social services that would not be good candidates for impact investing. A robust set of principles would ensure the most appropriate projects are selected and funded. For example, the NSW Government has selected a set of pilot projects in impact investment worthy sectors.

A challenge for investors is the significant risk taking which could deter them from impact investing. This is also where the Government as a risk taker comes in to solve this challenge partially. As stated above, the risk taking of Government may need to be more significant in the early stages of the market development.

PRINCIPLES

Policy Certainty

An important additional principle should be policy certainty and longevity, in addition to those mentioned in the paper. It will be important for confidence in the sector and investors to have confidence in a robust long-term policy platform.

Provide value for money

The industry should be looking to develop impact investment processes and products that are designed to produce strong market financial returns over the long term with similar fee structures to that charged for mainstream public equity products.

Have a robust approach to outcomes based measurement

Outcome measurement for public-market equity products is constrained by the quality and availability of disclosures from the investee companies. A certain level of available sufficient information is required to provide evidence of a fund's positive impact, as discussed above.

Demonstrate fair sharing of risk and return

The disclosure and transparency requirements associated with public equity markets allows a higher degree of confidence that risk and return sharing is appropriate. The volatility of an impact fund's return profile will be driven by the nature of the underlying investments. This can be measured with reference to a standard index.

Focus on deliverable and relevant social outcomes

A notable global focus may be on the 17 Sustainable Development Goals established by the United Nations. Domestically, social goals of a similar nature could be used as a benchmark to direct capital to companies and projects with a considerable focus on these goals.

ROLE OF GOVERNMENT

The Government will play a critical role in the impact investing market, especially during the development phase. As mentioned, the risk taking and financial outlays may be higher to begin with. However this will be more than offset by the program savings that will come from these investments.

The Governments role will also be multi-faceted, as mentioned in the discussion paper. The Government will be required to catalyse the investment environment and construct the right ecosystem. It will also become a 'purchaser' of social outcomes rather than a provider.

We see the role of the Government as follows:

- Be a catalyst: construct the right ecosystem, remove legal and regulatory barriers and encourage innovation;
- Government as a 'purchaser' of social outcomes;
- Policy certainty: ensure consistency in policy and act as a coordinator of state governments;
- Risk taker for large reward: assume risks of new projects if necessary;
- Assist the not-for-profit sector to become 'investment ready': capacity building funding and grants to create corporate business plans and measurement/metrics records;
- Act as an intermediary: support social impact investing organisations and fund managers who undertake impact investing;
- Finding and evaluating the programs that will have the highest levels of success;
- Scale-up successful programs; and
- Provide costings not available to the market: capture costs to government of various social initiatives and produce benchmark costs of social services.

In the short term, some government investment may be required to catalyse investment, build track records and enhance consumer confidence. Essentially repurposing government spending. This is important and creates a powerful signalling effect to the market. This is an example of where the Government may need to be the risk taker during the growth phase of the market.

An important element of the Governments role is providing policy certainty and coordinating state government policies. An example of this currently is that each state with a social impact bond has designed them differently and it is then hard for the market to know what they are buying. Consistency of investment principles and structures in the bond market will be important going forward.

In terms of policy consistency, which we cited as an important principle, part of the process of ensuring clarity and consistency is that the government also needs to be clear on its policy on foreign participation in projects/products, as it will be a potential sizeable source of capital for our local market.

In this regard, it would be useful for the Government to open an 'Office of Impact Investing' to be the policy maker, coordinator of states and quasi regulator in this space.

In the area of metrics and measurement, an important role for Government is sharing their knowledge and track record in providing social services. The Government has an advantage in this space and should communicate costs of various social services to the market. Releasing benchmark costs (possibly in conjunction with state governments where appropriate) would go a long way in assisting projects get off the ground.

Please see the next section for more on Government initiatives and tax policy.

FEDERAL GOVERNMENT AS A COORDINATOR

The Federal Government should act as a developer of impact investing policy and coordinator of state governments and other actors in the market. As discussed, it is important that state policies are in line with each other.

In order to undertake this, the Government should open an Office of Impact Investing. This body would create policies and regulation/deregulation, develop benchmark social services costs, maintain registers of projects and results, connect parties in the market, manage the 'investment readiness' fund, coordinate the states and catalyse investments.

This office may also release federal impact bonds and/or set standards for state governments. The UK Government has done some work on releasing 'cross-government' bonds with County Governments to great success.

The office may undertake a role in projects themselves, or coordinate other relevant Government agencies, such as Department of Employment, Education, Department of Foreign Affairs or Department of Social Services. A function of this would also be to evaluate and assist in any scale up of successful projects.

The Department of Foreign Affairs has done a lot of work in the impact investing space (and other forms including output based aid and private sector development projects). It would be advisable for Treasury to work with DFAT on policy and lessons learned for the Australian context.

In addition to this Government body, a Business Advisory Board and/or Steering Group would be extremely useful in assisting Government with policy, regulatory barriers and other market conditions it may be removed from. Government should maintain constant contact with the business and investor community in the development of the market in Australia.

Tax policy

Tax treatment in Australia remains uncertain. This may be further complicated by the fact that these investments span corporates, not-for-profits and Government sectors. A clear tax policy for impact investing will be imperative for market development and attracting capital to the sector.

The (Senate Economics) Committee recommended that "Treasury and the Department of Finance and Deregulation should examine ways to create incentives to invest in a social bond market in Australia including the feasibility of tax exempt income returns"[1].

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1 http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Completed_inquiries/2010-13/capitalmarket2011/report/c06

In the UK they have implemented social investment tax relief, which is investor based tax relief targeted at social investments. Australia should explore this and implement a similar initiative as well as a clear tax policy.

There are also other tax initiatives to explore. For example Low Income Housing Tax Credits, as seen in the US and UK markets.

PHILANTHROPY AND PRIVATE ANCILLIARY FUNDS

Private Ancillary Funds as Sophisticated Investors

We support the papers' general policy options outlined for Private Ancillary Funds and the recommendations seem sensible. Removal of regulatory barriers to allow Private Ancillary Funds (PAF) to participate in impact investing would be optimal.

In relation to the sophisticated investor question, there is a minimum hurdle in terms of assets/income required to be treated as a sophisticated investor – and this should not be a hurdle for the majority of PAF "clients" as they typically tend to be over $1 million in assets under management.

Generally speaking, we understand that clients also have the discretion to be treated as a retail client if they want to be.

As a retail client, you have protections that are built into law around disclosure, advice and reporting requirements. It does restrict investments to purely those offered under a retail product structure. This is essentially an issue in the impact investment space because many impact/social/SIB products are only offered wholesale. If one of these wholesale only (sophisticated) investments "failed" and essentially partially or wholly destroyed capital, there would be an erosion of confidence in the impact investment sector and in turn, the broader Not-For-Profit (NFP) sector.

Even high risk investments (think social venture capital or private equity), where the risk of loss is high, wouldn't be immune. As such, some investments wouldn't be suitable for retail investment if these expectations weren't able to be managed.

The biggest responsibility of government in formulating guidance on this issue is to protect both the integrity of the investment process and confidence in the NFP and philanthropic sector.

Perpetual Charitable Trusts

The rules around Private Ancillary Funds and writing off losses should be extended to Perpetual Charitable Trusts (PCTs). This would allow PCTs to participate in impact investing as well.

Program Related Investments

(24.1) To limit confusion around the treatment of loans and to provide confidence to philanthropists and NFPs - the total loan, rather than the discount rate between commercial and concessional rates, should be recognised.

(24.2)To ensure the confidence of philanthropy is maintained as a vehicle for community benefit, the funding of non-DGR entities should not be considered at this time.

(26) On the surface PRI at the full rate of the loan should be easier to administer and therefore more fully incentivised than the current concessional loan option available within the guidelines. That said, any NFP entering into an agreement with a philanthropic foundation should be aware of the

reporting needs of the funder and make a decision on the balance of ongoing administration requirements and the size of the loan, whether it is worthwhile. This is no different to the considerations most NFPs would be making with regards to grant-seeking from philanthropy.

(27) To provide clarity to philanthropy any changes or incentives for PRIs should be changed within the guidelines.

RECOMMENDATIONS

Please see our full list of recommendations below:

1. Australian regulators clarify fiduciary duty in the context of impact investing and take a long term focus to enable current social issues to be translated to financial issues of the future.
2. The Federal Government should open an ‘Office of Impact Investing’ – either within Treasury or spanning multiple Government departments. This office would have multiple functions including:
    a. create policy and assess regulation/deregulation;
    b. develop benchmark social services costs;
    c. maintain registers of projects and results;
    d. connect parties in the market;
    e. manage an ‘investment readiness’ fund;
    f. coordinate the states; and
    g. construct the right market ecosystem.
3. Alongside this new body, create a ‘Business Advisory Council’ to advise Government on impact investing policy, regulations and principles.
4. Treasury should develop a clear tax policy for impact investing and include tax exemptions for social investments.
5. Develop and fund an ‘investment readiness’ fund for not-for-profits undertaking impact investing projects, specifically to develop business plans, metrics and data sets.
6. The impact investment market should develop measurement and reporting consistency with Government coordination.
7. We support the discussion paper’s options for private ancillary funds. Government, in formulating guidance on this issue, should protect both the integrity of the investment process and confidence in the Not-For-Profit and philanthropic sector.