IMPACT
INVESTMENT
GROUP

Submission to the Financial System Inquiry

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Certified B Corporation

Impact Investment Group Pty Ltd | ACN: 139 328 108 | E: enquiries@impact-group.com.au | W: www.impact-group.com.au

VIC: 11 Princes Street, St Kilda VIC 3182, Australia | P: +61 3 8534 8060

NSW: 602/180 Ocean Street, Edgecliff NSW 2027, Australia | P: +61 2 8957 4978

Contents

1. About Impact Investment Group 3
2. The Financial System Inquiry 4
3. Background: the role of impact investing as a catalyst for economic growth 4
4. Comments on interim report 5
5. Policy options as outlined in the interim report 5
   5.1. Policy #1: No change to current arrangements 5
   5.2. Policy #2: Provide guidance to superannuation and philanthropic trustees on impact investment........ 6
   5.3. Policy #3: Classify a private ancillary fund as a sophisticated or professional investor for the purposes of the exemptions from the prospectus regime if the sponsor of the fund meets either of these thresholds 7
   5.4 Policy #4: Simplify and streamline disclosure requirements associated with social impact bonds 8
   5.5 Policy #5: Undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks 9
   5.6 Clarifying whether discounted returns can count towards minimum distribution requirements 10

6 Additional recommendations to promote impact investing 11
   6.4 Demand Side 12
      6.4.1 Tax incentives for impact investors 12
      6.4.2 Tax breaks for B Corp entities 13
      6.4.3 Encourage institutional funds to invest 13
   6.5 Supply Side 14
      6.5.1 Social enterprise incubation 14
      6.5.2 Lower cost of capital for impact investments 15
      6.5.3 Public-private partnerships 15
      6.5.4 Achieving buy-in from financial intermediaries 16
      6.5.5 Encourage impact investing and social impact in higher education 16
      6.5.6 Encourage talented individuals to seek careers in social impact 16
      6.5.7 Promote innovative forms of funding 17
   6.6 Matching the supply and demand 17

7 Conclusion 17

1. About Impact Investment Group

The Impact Investment Group (IIG) seeks to create impact investment opportunities that generate attractive financial returns to investors and deliver meaningful change for society.

We believe in the power of commercial capital, intentionally focused for impact, to create real and measurable progress globally. Ultimately our vision is to build a fairer and more equitable world. IIG is the first Australian fund manager to become a B Corporation.

IIG has approximately $110 million in assets under management. It is owned by Chris Lock (Chief Executive Officer) and Small Giants, the family office of Daniel Almagor and Berry Liberman. IIG is an active and ethical manager that benchmarks its fees to the long term performance of its assets.

Investment History/Portfolio

In June 2013, IIG acquired 2 Johnson Street, Byron Bay, New South Wales for $5.25 million. The property is occupied as the national flagship store of Quiksilver Inc. (NYSE Listed) including top floor cutting edge apartments with spectacular views over Byron Bay's premier tourist beach. The property is subject to a ten year lease to Quiksilver Inc. IIG acquired the property with a strategy to achieve carbon neutral status within years of acquisition.

In July 2013, IIG acquired the Quiksilver Asia Pacific Distribution Centre in Geelong, Victoria for $13 million plus acquisition costs representing (at the time) a net passing yield of 12.9% per annum. The property, located at 75-95 & 10 Corio Quay Road, Geelong of just over 50,180m^2 is partially developed to a high standard and is fully leased to the Australian subsidiary of the NYSE listed Quiksilver Inc until beyond November 2020. IIG is improving the environmental performance of the property.

In July 2013, IIG successfully financed the developer (DC Capital) of the Gosford Private Hospital Medical Consulting Suites in Gosford, New South Wales. The project will feature over 2,300m^2 of strata titled medical consulting suites adjacent to Gosford Private Hospital. IIG investors received an IRR in excess of 33%.

In December 2013, IIG acquired the head office of the Environment Protection Authority Victoria (EPA) at 20 Victoria Street, Carlton, Victoria. The property is known as one of Australia's most environmentally sound commercial office buildings with rare Star green rating. The purchase price of $33.5 million represented fully leased yield of 8.7%. In July 2014, IIG entered into an option to sell the building for $42.3 million to the Australian Unity Diversified Property Fund (DPF), representing a 26.1% premium to the purchase price. Settlement of the sale is scheduled for late October 2014.

In February 2014, IIG acquired the global headquarters of Roy Morgan Research at 401 Collins Street, Melbourne Victoria for $32 million with a goal to substantially improve the landmark heritage building's energy performance. The property is fully leased to Roy Morgan Research for 10 years on an initial net yield of 7.81%.

In June 2014, IIG financed the construction of the Chepstowe Wind Farm in regional Victoria. The three-turbine wind farm will provide clean electricity for approximately 4000 homes. The target IRR of 10.5%

pa is underpinned by a 10-year power purchase agreement for 100% of wind generated at escalating prices.

2. The Financial System Inquiry

IIG is very pleased that the Financial System Inquiry has considered impact investing in its Interim Report. IIG believes that impact investing plays a critical role in positioning the financial system to best meet Australia's evolving needs and support the country's economic growth. This submission responds to the Funding - Impact investment and social impact bonds section of the Interim Report, specifically pages 2-73, 2-74 and 2-75. This submission addresses the costs, benefits and trade-offs of the policy options outlined in the section as well as other ways in which the Government can facilitate the deployment of commercial capital in impact investing. IIG believes that impact investing has the potential to drive meaningful positive social and environmental change and thus ensure sustainable economic growth in Australia.

The following assessments and recommendations are made from IIG's perspective as an Australia-focused, finance-first, impact investment group.

IIG is grateful for the assistance of Johnny Zhang and Angus Ryan, UNSW Law students completing the Social Impact Hub Clinic, in the preparation of this submission, as well as Chris Collins, Wharton MBA student and IIG intern.

3. Background: the role of impact investing as a catalyst for economic growth

well-functioning financial system is critical for a growing economy. As means through which parties can exchange funds in order to promote greater economic activity and prosperity, a financial system allows individuals and businesses to build organisations that fill market gaps and mobilise capital to meet societal needs.

The well-being of the country's communities is important because it affects the country's economic future. For example, greater access to quality education affects not only those individuals' personal development, but also means that they will be more likely to excel in their careers and make substantial contributions to society. On the environmental side, safe methods of recycling waste and preventing hazardous toxins from contaminating the environment would ultimately improve the long term health of the population. In both cases, businesses that provide critical services ultimately end u affecting the community at large, demonstrating that we are all stakeholders in the success of these businesses. The financial system needs to facilitate the access to capital for businesses who provide critical services and promote sustainable outcomes.

Impact investing drives capital to properties and businesses (in industries such as renewable energy, agriculture, waste management, and health care) that have the long-term well-being of their communities as core mission. As these methods of doing business become more widely implemented, economic growth will follow. The Government must prioritise creating an enabling environment where impact investing can flourish.

Historically, the private sector has been driven by the opportunity to maximise profits, either by addressing needs not currently met by the existing market, or by developing cost-cutting measures to generate larger margins. Free market forces provide a natural impetus for companies to fill market gaps, which is a continuous process as consumer needs and technology continue to evolve.

While these forces have often encouraged economic growth, they have not necessarily ameliorated many of the intractable social, economic or environmental challenges faced by Australia. However, a growing movement that applies business principles to address social inequity and environmental issues has been gaining substantial momentum over the last decade. The idea of investing in (and thus empowering) enterprises and assets aiming to address these issues is gaining traction as complement to traditional philanthropy.

In order to encourage the flow of capital into these impact-oriented enterprises, the Australian Government should undertake a range of initiatives that stimulate investor demand as well as grow the supply of these investment alternatives.

4. Comments on Interim Report

IIG would like to make a few comments in relation to the definition and content of the Interim Report.

Firstly, impact investment describes opportunities that offer social **and/or environmental** and financial returns. Environmental should be included alongside social in the upfront description of impact investment. It is acknowledged that the Interim Report describes impact investors as actively seeking social or environmental objectives, but the opening paragraph only refers to social and financial returns.

Secondly, social enterprises are not the only recipients of impact investment. The first paragraph states "capital can flow from impact investments made by mainstream financial institutions, institutional investors, and philanthropic funds, either directly into social enterprises or via specialist financial intermediaries." Figure 3.2 only refers to sources of funding for social enterprises. Impact investing is an approach across asset classes, not an asset class itself. It is lense through which investment decisions are made. For example, there can be impact investments in property or infrastructure, in addition to equity or debt to social enterprises and mature businesses.

IIG endorses all the comments in the section 'barriers to impact investment'. More impact investment activity could trigger significant change in the way government addresses social or environmental problems. Mobilising the impact investment market certainly requires Government support. IIG addresses the barriers and the policy options for consultation in the section below.

5. Policy options as outlined in the Interim Report

This section will address the advantages and disadvantages of the policy options set forth in the interim report. For each, we will provide thorough assessment and plan of action for those that should be pursued.

5.1. Policy #1: No change to current arrangements

IIG is acutely aware of the challenges investors face when they consider committing funds to an impact investment. Unfortunately, many investors follow the mentality that profit-generating businesses and societal or environmental impact are mutually exclusive. The philosophy that businesses exist for the sole reason of generating profits and that the task of improving the world in which we live rests solely with the Government is one that has shaped not only the way many investors think, but also how the financial regulatory environment has evolved. In order to accommodate and encourage impact investing, a range of Governmental changes in investment regulation must take place. The paradigm that societal/environmental impact and profits are mutually exclusive is n longer valid in today's world. Therefore, pursuing no change to the current arrangements is not viable option if the goal is to encourage sustainable, significant and meaningful impact investing.

5.2. Policy #2: Provide guidance to superannuation and philanthropic trustees on impact investment

As at 31 March 2014 there was $1.8 trillion invested in Australian superannuation funds.[1] Given the scale of funds that these institutions manage, even a small allocation would give the impact investing industry a large boost in funds available for investment. Likewise, foundations represent large pools of capital that could be put towards impact investing.

As stated in the Interim Report, some superannuation and philanthropic trustees consider their fiduciary duties to be a barrier to impact investment. This was discussed in the recently released *Impact Investing: Perspectives for Charitable Trusts and Foundations* report[2] and similar report in relation to superannuation funds.

In Australia the law states that trustee has duty to invest trust money even if no direction has been given in the trust instrument to this effect.[3] When investing this trust money the trustee *must be primarily concerned with the financial advantage of the trust*.[4] If there is no contrary direction in the trust instrument, a trustee must duly and promptly invest all trust money for this purpose.[5] Should the trustee not invest trust money in this manner or in accordance with another direction of the trust instrument, then the trustee/s has committed a breach of trust and is liable for any consequent loss.[6]

The concern is that those trusts and funds that possess ambiguity in their trust instrument as to the priority that is to be given between investing for social impact and financial gain place the trustee in a vulnerable position. Given the above authority, there is a risk that a trustee who invests for social impact and sacrifices financial return may become personally liable to the trust. While it is true that trustee must have regard to the purposes of the trust and the needs and circumstances of the beneficiaries, which enables the trustee to accommodate the purpose of the trust, arguably this offers only meagre protection.[7]

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[1] Association of Superannuation Funds of Australia 2014, *Superannuation Statistics - ASFA*. Available at: <http://www.superannuation.asn.au/resources/superannuation-statistics/> [Accessed 6 Aug. 2014].

[2] Charlton, K, Donald, S, Ormiston, J and Seymour, R 2014, *Impact Investments: Perspectives for Australian*

[2] Charlton, K, Donald, S, Ormiston, J and Seymour, R 2014, *Impact Investments: Perspectives for Australian Charitable Trusts and Foundations.* Available at: <http://sydney.edu.au/business/__data/assets/pdf_file/0004/199768/BUS10008_Impact_Investments_web_sml_3.pdf>

[3] *Adamson v Reid* (1880) 6 VLR (E) 164; 2 ALT 69; *In the Will of Sherriff* [1971] 2 NSWLR 438 at 442 per Helsham J; *Authorson v Canada* (A-G) (2002) 215 DLR (4th) 496 at 517-23 per Austin and Goudge JJA, CA (Ontario)

[4] *Cowan v Scargill* [1985] 1 Ch 270.

[5] *Cann v Cann* (1884) 51 LT 770 at 771; 33 WR 40 per Kaye J (the maximum period for which trust capital can remain uninvested is six months).

[6] *Speight v Gaunt* (1883) 9 App Cas 1 at 19; 50 LT 330 per Lord Blackburn, HL.

[7] For example *Trustee Act 1925* (NSW) s14C (1) (a).

It is interesting to examine the situation in other jurisdictions. The legal position in the United Kingdom is particularly insightful. In the UK, trustees of any charity can decide to invest ethically even if the investment may result in a lower return than an alternate investment. Here an ethical investment is understood as an investment that reflects the charity's mission. The law does require, however, justification from the trustee as to why it is in the best interest of the charity to invest in this way. The law permits the following reasons:

- particular investment conflicts with the aims of the charity; or
- the charity might lose supporters or beneficiaries if it does not invest ethically; or
- there is no significant financial detriment.[8]

In summary, providing guidance to philanthropic and superannuation trustees that impact investing is permitted is desirable so trustees are able to confidently make impact investments without worrying that they are breaching their fiduciary duties.

5.3. Policy #3: Classify a private ancillary fund as a sophisticated or professional investor for the purposes of the exemptions from the prospectus regime if the sponsor of the fund meets either of these thresholds

This policy option directly responds to the third barrier identified: "some private ancillary funds do not meet sophisticated or professional investor tests under the exemptions from the prospectus regime, despite very high net worth individuals or organisations having established them."

Th effects of PAFs not being sophisticated investors

Many impact investing funds or social benefit bond offerings can only accept investors if they meet requirements that categorise them as sophisticated investors. From regulatory standpoint this restriction is logical, however there are a multitude of private ancillary funds (PAFs) that do not meet the thresholds to be considered as sophisticated or professional investors, yet are sponsored by individuals that meet the requirements themselves. The average PAF has consistently had assets valued in the $2-3m range,[9] so the definition of sophisticated investors is crucial for many PAFs. Many do not meet the $2.5m threshold themselves, and this has served as an impediment for some PAFs in participating in offerings of social impact investments. Offerings have largely been structured so that they comply with the prospectus exemptions, for example in the case of NSW Social Benefit Bonds.

PAFs act as significance source of capital, which could be leveraged to support private sector funding for social and environmental projects. Taking away source of demand for social investments in turn increases the burden on tax payers to fund these projects.

Current legal ambiguities

Currently, there is ambiguity in interpreting the legislative provisions relating to whether or not a PAF meets the test. Section 708 of the *Corporations Act 200* (Cth) states the types of investment offerings in which the issuer is exempt from prospectus requirements.

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[8] See more at http://www.charitycommission.gov.uk/publications/cc14.aspx#c3
[9] John McLeod, *The PAF Report – Private Ancillary Funds after 12 Years*, August 2014.

The section 70 requirements in the context of PAF are ambiguous, causing some PAFs to miss out on investment offerings, simply because lack of clarity, even if they were legally eligible. Section 708(8) covers an investment offer to 'sophisticated investors'. The section states that a 'sophisticated investor' includes a 'trust that is controlled by a person who meets the requirements of [being a sophisticated investor]'.[10] Although Section 50AA provides some guidance as to the definition of 'control', there is still n clarity as to scope of 'control' in the context of a PAF.

Additionally, Chapter 7 of the *Corporations Act 200* (Cth) covers the provision of a financial product. The relevant sections are sections 761G(7), 763A and 761FA as well as regulation 7.1.28 of the *Corporations Regulations 200* (Cth) which work in unison. It is unclear as to whether financial product, a facility in which a trust makes a financial investment, may be provided to a trust as a wholesale client as opposed to a retail client, and if so provide for less stringent regulations. Section 761FA(3)(a) specifies that any obligations are imposed on each trustee, but may be discharged by any of the trustees. The interaction of this section and s761G(7) is unclear. Can any of the trustees prove they are sophisticated investor to be exempt? Or are majority of trustees required to be sophisticated investors?

Government response

Similar issues have arisen concerning uncertainties relating to the status of Self-managed Super Funds. In response, the Australian Securities and Investments Commission (ASIC) acknowledged the legal uncertainty and provided clarity that the law can see the trustees' in their personal capacities as a wholesale investor, rather than trustees needing to meet the $10 million threshold of net assets in their superannuation fund.[11]

PAFs require similar clarification from ASIC. Regarding section 708(8), ASIC may consider clarifying the interpretation of 'control'. It is suggested that ASIC should take a stance that acknowledges 'substance over form'. For example, if an investment decision maker, such as the Chief Investment Officer, is considered a sophisticated investor, the underlying PAF should similarly be classified as a sophisticated investor. This would enable the PAF to access a greater number of investment offerings.

In summary, there would be benefit in ASIC providing regulatory guidance specifically directed at PAFs which clarifies the operation of the relevant provisions of the *Corporations Act 2001* (Cth). This would clearly allow the corpus of PAFs to promote positive change through impact investments that are limited to sophisticated or professional investors.

5.4 Policy #4: Simplify and streamline disclosure requirements associated with social impact bonds

Social impact bonds are playing significant role around the world in helping Governments effectively tackle social issues. It is a desirable tool for Government since it does not have to pay to fund the service or program unless the project achieves certain pre-agreed outcomes. Even when it does have to pay, the cost is generally lower than what it would have had to spend o other programs had the problem gone unaddressed. As the Interim Report states, examples in Australia include $7m raised for UnitingCare

[10] Section 708(8)(d)

[11] http://www.asic.gov.au/asic/asic.nsf/byHeadline/14-191MR%20Statement%20on%20wholesale%20and%20retail%20investors%20and%20SMSFs?opendocument

Burnside to support the return of foster care children to their homes and $10m raised for the Benevolent Society to provide family support programs.[12]

As this method of funding impactful initiatives proves to be a valuable and cost-effective tool to effect positive change, the Australian Government must make sure that unnecessary and onerous requirements are removed in order to facilitate and encourage these investments. The setup and due diligence costs already act as large barriers to creating social impact bonds so it is critical that the government does whatever it can to facilitate these kinds of impact investments.

5.5 Policy #5: Undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks

If the Government takes more active role in expanding impact investment, Australia's future economic prospects will greatly improve. Providing risk capital and establishing social investment bank are important steps to facilitate the growth of the impact investing industry.

Providing risk capital will serve to de-risk impact investments for investors and encourage more impact investments, especially from investors who have limited experience with impact investments or have a more conservative approach. Several mechanisms can be implemented to minimise the risk of impact investments. Catalytic first-loss capital can be used to mitigate risk to the investor by absorbing a set amount of losses before the investor does. This protective layer is often funded by organisations that are strongly aligned with the investee's social and/or environmental goals, but Government funds can also be used in this catalytic way. This first-loss capital is called catalytic because it attracts the participation of commercial investment that would otherwise not be there.

Another way to de-risk impact investments is for Government to leverage its balance sheet by underwriting investments or providing capital guarantees o loans provided to impact transactions. This low-cost approach is also catalytic in its ability to leverage private capital that would otherwise perceive such investments as too risky. In reducing risk to lenders, such guarantees can also help reduce the cost of capital, which in turn can make the opportunities more attractive to equity investors.

In order to further facilitate access to capital for social enterprises, an Australian Social Investment Bank needs to be established. Governments can help to provide investment funding for programs in developing communities through social investment banks, which encourage the development of social enterprises and social/environmental infrastructure. For example, in 2011 the UK Government launched Big Society Capital, a UK social investment bank that seeks to develop and support social investment and will receive funding of u to £400m from English dormant bank accounts and up to £200m from four UK banks.[13] As at December 2013, £149.1m has been committed to charities and social enterprises spanning sectors such as housing, physical and mental health, education, financial inclusion and infrastructure.[14]

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[12] Westpac 2013, 'Social Benefit Bond Raises $10 million to Support Family Preservation Service in New South Wales.' 4 Oct. Available at: <http://www.westpac.com.au/about-westpac/media/media-releases/2013/4-october> [Accessed 6 Aug 2014]

[13] Big Society Capital 2014, *About Big Society Capital*. <http://www.bigsocietycapital.com/about-big-society-capital> [Accessed 5 Aug 2014].

[14] Big Society Capital 2013, *Annual Review 2013*. Available at: <http://www.bigsocietycapital.com/sites/default/files/BSC_AR_2013.pdf> [Accessed 6 Aug 2014].

5.6 Clarifying whether discounted returns can count towards minimum distribution requirements

The Interim Report identifies another barrier to impact investment in Australia in that "private and public ancillary funds, which provide a link between donors and organisations that can receive tax deductible donations, are unclear whether they may count discounted returns towards minimum distribution requirements." There is no policy option for consultation that addresses this barrier, but IIG believes that it should be addressed.

This position seems clear in the context of Public Ancillary Fund (PuAF) but remains uncertain for a PAF.

Legal ambiguities

Currently, rule 19.3 in the *Public Ancillary Fund Guidelines 2011* (Cth) provides guidance as to this concern for PuAFs. Example 3 under rule 19.3 in the *PuAF Guidelines* states:

> "If a public ancillary fund invests in a social impact bond issued by a deductible gift recipient with a return that is less than the market rate of return on a similar corporate bond issue, the fund is providing a benefit whose market value is equal to the interest saved by the deductible gift recipient from issuing the bond at a discounted rate of return."[15]

Currently, the *Private Ancillary Fund Guidelines 2009* (Cth) does not replicate this provision. Despite this, some trustees assume that this arrangement applies in the context of PAFs. Therefore, the Government should replicate this provision in the *PAF Guidelines* in order to remove the current uncertainty and clarify the position of PAF trustees.

Which investments?

Furthermore, for trustees of both PAFs and PuAFs, there is further uncertainty as to whether discounted returns can be based off *any* investment or must be in a specific class of investment opportunities connected to a PAF or PuAF's established purpose. For example, can a discounted return o a Social Impact Bond investment covering general public schemes contribute towards the distribution requirements for a PAF or PuAF that is supporting a very specific cause? The Government should similarly clarify the uncertainty by specifying the criteria, if any, that an investment must meet before its discounted returns can count towards a PAF or PuAF's minimum distribution requirements.

Uncertainty of trustee duties

Under general law in Australia, a trustee of any trust, including a PAF, has a duty to invest the corpus of trust,[16] with the primary concern being the financial advantage of the trust.[17]

If the position is established that discounted returns on investment could contribute to a PAF's minimum 5% distribution requirements, the Government should additionally clarify the interaction of this position with trustees' investment duties (as discussed above). If a trustee is allowed per the *PAF Guidelines* to make below-market returns, which in turn would contribute towards minimum

[15] PuAF Guidelines r 19.3.
[16] *Adamson v Reid*
[17] *Cowan v Scargill*

distribution requirements, logically a trustee should not breach their duty to invest and should suffer no legal liability for making an investment with a below market return given that it contributes to a trust's minimum distribution requirements.

In the US, program-related investments can be counted towards a foundation's 5% minimum annual distribution.

program-related investment (PRI) is a type of mission or social investment that foundations make in order to achieve their philanthropic goals. PRIs can employ wide variety of financing methods, such as loans (senior and subordinated), loan guarantees, lines of credit, linked deposits, cash deposits, bonds, equity investments, and other transactions designed to help charitable organisations and social enterprises access capital funding. PRIs are expected to be repaid, often with modest rate of return.

According to the US Internal Revenue Code, to qualify as a PRI:

1. The primary purpose of the investment must be to accomplish one or more of the charitable, religious, scientific, literary, educational and other exempt purposes described in the Code;[18]
2. No significant purpose of the investment should be the production of income or the appreciation of property; and
3. The investment must not have any political purposes.[19]

At the time the investment is made, the rate of return must be expected to be below prevailing market rates on a risk-adjusted basis in order for the investment to qualify as PRI for tax purposes. Once repaid, these funds can be used for subsequent charitable investments.

Arguably, the position should be similar in Australia. By clearly allowing PRIs, PAFs are able to leverage their financial resources more effectively.

6 Additional recommendations to promote impact investing

This submission now focuses on potential opportunities for the Government to facilitate progress on both the supply and demand side of the equation of attracting private investment for impact. On the supply side, there needs to be a larger and more robust supply of quality investment product and o the demand side, a range of interventions could be implemented to attract more private capital into appropriate investment opportunities.

Our recommendations focus on each side of the equation in turn. Even though the Interim Report states that tax concessions should be considered as part of the Tax White Paper process, we have included some recommendations in relation to tax reform here as well.

[18] The exempt purposes are described in s170(c)(2)(B) of the Internal Revenue Code.

[19] Mission Investors Exchange, Linklaters, TrustLaw, *Strategies to maximize your philanthropic capital: a guide to program related investments*, April 2012

6.4 Demand Side

6.4.1 Tax incentives for impact investors

Similarly to the tax incentives individuals receive for making charitable contributions, incentives could be created for those who have made investments with impact investing firms. For example, in the US, the Low-Income Housing Tax Credit (LIHTC) awards tax credits to developers of qualifying projects, who in turn raise capital by selling these credits to investors. This capital reduces the amount that the developer would otherwise have to borrow. The cost savings are passed o to tenants, creating affordable housing. This program has been very effective and accounts for about 90%[20] (as of 2012) of affordable housing created in the US.

Similarly, the New Markets Tax Credit (NMTC) has helped to attract private sector investment in low-income communities. The NMTC has helped to attract investment in commercial real estate by providing tax credits amounting to 39% for equity investments in Community Development Entities, which make these types of investments in low-income communities. The program, which lasted a little over a decade, created or retained over 358,800 jobs in low-income communities and improved access to public facilities, goods and services. Furthermore, the program generated over $8 for every $1 invested by the US Government.[21] This example is demonstration of a successful outcome achieved by incentivising investors through the provision of tax credits for social investments.

In the UK, there are tax incentive schemes specific to the social enterprise sector. Under the Social Investment Tax Relief (SITR) scheme, announced in 2014, investors are able to deduct 30% of the cost of an eligible investment, with minimum investment period and maximum investment amount imposed.[22] There are certain eligibility requirements for the investment, for the investor, and for the social enterprise invested in. The creation of the SITR was greatly influenced by a study commissioned by the Big Society Capital o the implications of providing tax incentives specific for social investments.[23] The major challenge in the market was identified as the funding gap between investors and social enterprises. Big Society Capital emphasises that growing the social investment market requires move away from the provision of grants and subsidies that reinforce culture of reliance and dependence. The report found that tax relief for social investment would be most likely to be utilised by high net worth individuals who are interested in social investment. Those individuals indicated that the lack of tax incentives acted as a barrier to making such investments.

The SITR scheme complements the Community Investment Tax Relief (CITR) scheme which encourages investment in disadvantaged communities by giving tax relief worth up to 25% of the value of the

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[20] Editorial 2012, 'A Tax Credit Worth Preserving.' *The New York Times*. Available at: <http://www.nytimes.com/2012/12/21/opinion/a-tax-credit-worth-preserving.html?_r=1&> [20 Dec 2012].

[21] Community Development Financial Institutions Fund, *New Markets Tax Credit Program Fact* Sheet. Available at: <http://www.cdfifund.gov/docs/factsheets/CDFI_NMTC.pdf> [Accessed 6 Aug 2014].

[22] UK Government – Cabinet Office, *Social Investment Tax Relief*. Available at: <https://www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief> [6 April 2014].

[23] Worthstone 2013, *The Role of Tax Incentives in Encouraging Social Investment*. Available at: <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-WebPDF.pdf>

investment made by investors into accredited Community Development Finance Institutions (CDFIs). This scheme appears to be less successful than the NMTC program in the US discussed above.[24]

In order to provide these tax incentives, the Government may have to create a legal definition of 'impact investing' so that the appropriate firms could file to be formally considered as such. This definition would outline the minimum criteria an investment firm must meet. This would not only assist with identifying which investments qualify for tax deductions, but also explicitly state the requirements to help guide investment firms seeking to achieve this classification.

6.4.2 Tax breaks for B Corp entities

Tax incentives would push more companies to strive to achieve the B Corps certification, which is given to companies that meet rigorous standards of social and environmental performance, accountability, and transparency and are committed to leveraging their business model as force for good. Currently, B Corp entities exist across a wide range of industries and almost 1,100 companies worldwide have achieved the certification. The increased demand to achieve this status will naturally drive social and environmental change in the region.

Additionally, the 'benefit corporation' could be created as a new legal form and the tax incentives could be attached to the legal structure, rather than the certification. The 'benefit corporation' is a for-profit legal structure that has been adopted in over 25 US states and one district. It removes the reluctance of directors to take into account the interests of non-financial stakeholders by creating a new statutory entity, the 'benefit corporation,' that requires companies to provide public social benefit. In other words, the directors are required to consider the impact of decisions o all stakeholders, rather than shareholders alone, as assessed against a third party standard.

6.4.3 Encourage institutional funds to invest

Superannuation funds have $1.8 trillion AUD (as of year-end 2013)[25] in assets under management, so having even small portion of their assets allocated to impact investing would dramatically increase the amount of funds dedicated toward this space. However, there are several issues that discourage these funds from considering impact investing:

1. Trustee concerns over whether the investment is permissible under applicable regulatory regime (this is discussed above);
2. Absence of commonly accepted framework for inclusion of impact investing within modern investment portfolios;
3. Limited availability of appropriately designed investment opportunities;
4. Lack of developed supporting infrastructure assisting investors in origination, analysis, and portfolio management.[26]

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[24] Community Development Finance Development, *Community Investment Tax Relief*. Available at: <http://www.cdfa.org.uk/policy/community-investment-tax-relief/> [Accessed 6 Aug 2014].

[25] The Association of Superannuation Funds of Australia 2014, *Superannuation Statistics*. Available at: <http://www.superannuation.asn.au/resources/superannuation-statistics/>. [Accessed 6 Aug 2014].

[26] Charlton, K, Donald, S, Ormiston, J and Seymour, R 2013, *Impact Investments: Perspectives for Australian Superannuation Funds.* Available at:

As explained earlier, by clarifying fiduciary duties, hopefully institutional fund managers will be less hesitant to seek impact investments and increased demand will eventually lead to the establishment of investment frameworks, increased investment opportunities, and improved infrastructure supporting investments in this area.

These changes will allow members, who are owners and control these funds, to have more flexibility in the investments they can choose. This expansion of the investment mandate opens up significant opportunities for greater alignment between the need for market-rate financial returns and achieving social impact that is of particular interest to members. There is particular opportunity in this regard in relation to union superannuation funds. For example, Cbus, an industry superannuation fund with members of the building, construction and allied industries, could invest in a green commercial office development that is being built by Cbus members. In this particular example, Cbus's members would not only be employed to construct the development but they would also be investors through their super fund. Similarly, a teachers' union could invest in businesses that improve education outcomes, a health services union in businesses that drive health and wellbeing outcomes, and so on.

6.5 Supply Side

6.5.1 Social enterprise incubation

Programs that assist entrepreneurs in launching and scaling socially-minded businesses would enhance social enterprises' investment readiness and therefore increase investment options available to impact investors. For example, GoodCompany Group, the US's first accelerator exclusively focused o social entrepreneurs,[27] supports businesses with innovative ideas that tackle unmet social and environmental needs. It provides workspace, mentoring, and access to a network of sources of capital. Companies that have gone through the program have raised US$40.1m to date.

The Investment Contract Readiness Fund (ICRF) in the UK provides an interesting model for Australia. The Office of Civil Society launched the ICRF in 201 for the purpose of supporting social ventures to build their capacity to secure new forms of investment and compete for public service contracts.[28] The rationale behind the establishment of the ICRF was that social ventures are often run by management teams with enthusiasm and expertise in the social sector, but they lack commercial skill and experience.[29] Social ventures must fulfil certain criteria in order to apply, and the ICRF Investors Panel awards the grants. A prerequisite is that social ventures must partner up with ICRF Approved Providers, generally firms and organisations that provide professional investment and contract readiness support such as developing a sustainable business model, training in financial management skills and making

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<http://sydney.edu.au/business/__data/assets/pdf_file/0005/186863/bus10006_superannuation_report_2013_WEB.pdf>

[27] Collins, S 2012, 'Purpose Meets Profit: Free Summer Incubator for Social Enterprises at GoodCompany Ventures', *Generocity* 16 May. Available at: <http://www.generocity.org/purpose-meets-profit-free-summer-incubator-for-social-enterprises-at-goodcompany-ventures/> [Accessed 27 May 2014].

[28] Investment and Contract Readiness Fund, *About the Fund.* Available at: <http://www.beinvestmentready.org.uk/offer/>. [Accessed 28 May 2014].

[29] Brown, Adrian and Swersky, Adam 2012, 'The First Billion' *The Boston Consulting Group* <https://www.bcg.com/documents/file115598.pdf>

cash flow projections. The ICRF requires the grant money to be principally used to pay for such business advisory services. The program was launched as a 3 year program with £10 million, which was initially only distributed as grants. However, the ICRF Investors Panel now reserves the right to offer partially repayable grants depending on successfully raising capital in the future.[30] From April 201 all investment readiness awards over £75,000 are subject to repayment clauses.

Creating an investment readiness fund in Australia, supported by Government, was one of the four key recommendations to catalyse the impact investing market suggested by Impact Investing Australia following their sector consultation.[31]

6.5.2 Lower cost of capital for impact investments

Reducing the cost of debt capital for socially and environmentally focused businesses and infrastructure investments would enable more impact ventures to get off the ground. There are various examples illustrating how the Government might consider facilitating this.

For example, Green Bonds were launched by the World Bank in order to support projects that seek to promote low-carbon development and thus have a positive impact on the environment (e.g., over 1,480,000 ton carbon dioxide reduction projected per year in Turkey as at May 2013).[32] The Australian Government could issue similar bonds, with longer tenors and at a similarly low cost of capital to fill the gap that senior lenders won't, enabling more attractive returns to equity investors for the risk undertaken.

As explained earlier, the Government can also provide first-loss investment capital or bank guarantees/underwrites to support capital structures that would otherwise not be viable. This kind of catalytic capital de-risks investments for other investors, enabling higher loan to value ratios and/or reduced cost of funds from debt providers.

6.5.3 Public-private partnerships

The Government can work side by side with the private sector in promoting social change. In South Africa, Business Partners Limited (BPL), a specialist risk finance company focused on small and medium enterprises (SME), was founded as partnership between the South African Government and many of the country's largest corporations. The Government, cognisant of its shared goals with BPL regarding small business development, decided to match all funding that the founding corporations contributed to the firm. BPL has deployed over $1.5 billion USD to over 69,500 SMEs, creating more than 550,000

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[30] The Social Investment Business, *Frequently Asked Questions* http://www.beinvestmentready.org.uk/fileadmin/tsib_users/Our_Funds/ICRF/Investment_and_Contract_Readiness_Fund_-_FAQs_v4__no_retail_repayable_.pdf [Accessed 18 May 2012].

[31] Impact Investing Australia, *Sector Consultation*. Available at: <http://impactinvestingaustralia.com/sector-consultation/> [Accessed 6 Aug 2014].

[32] Treasury, The World Bank 2013, *Green Bond: Fifth Annual Investor Update*, Available from: <http://treasury.worldbank.org/cmd/pdf/WorldBankGreenBondNewsletter.pdf>. [Accessed 27 May 2014].

jobs.[33] The Australian Government should seek similar partnerships which can help both parties attain a shared goal.

6.5.4 Achieving buy-in from financial intermediaries

The largest financial intermediaries have the ability to leverage their global presence and respected brands to help bring impact investing to the mainstream. With their vast resources, they can aggregate data o impact investing deals which would assist potential investors in assessing investment opportunities o metrics such as risk, performance, and returns (financial, social, and environmental).[34] They can further deploy meaningful sums of capital and significant human resources at their disposal to generate investment product and up skill a generation of bankers and financiers who understand how to structure and execute impact investments.

6.5.5 Encourage impact investing and social impact in higher education

Impact investing came about through financial innovation and the idea that proven business principles can be applied to addressing the world's social and environmental problems. It is important that such thinking be encouraged and taught in higher education so as to cultivate the industry's leaders of the future.

In order to achieve this objective, tertiary institutions should be encouraged to offer substantive coursework and practical learning experiences in the fields of social enterprise and social finance. Institutions of higher learning should invest in academic research and also endow teaching posts to ensure appropriate thought leadership and research development. Scholarship funds targeting students demonstrating interest in the field could be set up to improve access to targeted areas of higher education. Also, scholarship funds could be established to help fund students' cost of living if they are pursuing internships in the field, which in many cases offer little to no compensation.

6.5.6 Encourage talented individuals to seek careers in social impact

In order to encourage individuals to seek full-time careers in areas of social impact, tax incentives could be provided for employees working at companies that are defined as 'impact investing' or have been identified as having a social impact focus.

It is also necessary to lift the profile of social enterprise in Australia. This could be done in a myriad of ways, such as national competitions, bringing international social enterprise networks to Australia, such as Ashoka or Un Ltd, and funding professional development opportunities for entrepreneurs and current fund managers.

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[33] McCallick, B and Emerson, J. 2014, 'Business Partners Limited: Lessons Learned from Veteran Impact Investors in South Africa', *Pacific Community Ventures* 3 March. Available at: <http://www.pacificcommunityventures.org/impinv2/business-partners-limited-lessons-learned-from-veteran-impact-investors-in-south-africa>. [Accessed 27 May 2014]

[34] World Economic Forum 2013, *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors.* Available at: <http://www3.weforum.org/docs/WEF_II_FromMarginsMainstream_Report_2013.pdf>

6.5.7 Promote innovative forms of funding

Innovative forms of funding are emerging all the time as creative thinkers seek to provide financing solutions to overcome existing challenges. One example of such an innovation is Environment Upgrade Agreements (EUAs). EUAs are agreements where providers lend funds to building owners o favourable terms for energy, water, and other environmental upgrades. This is a low-risk loan that is repaid through local council rates notices.

For example, the Sustainable Melbourne Fund allows building owners, tenants, and investors to gain access to well-priced long term financing for retrofits of existing commercial buildings which reduce energy use, reduce carbon emissions, and save water. Building owners looking to make their buildings more environmentally friendly can ask tenants to contribute to the costs. These additional costs are then offset by their reduced energy and water bills.

6.6 Matching the supply and demand

Effectively matching the supply of product and private investment is crucial to increasing the role of the private sector in promoting economic growth.

The establishment of social stock exchange is one idea to this end and would help impact investors connect with investable opportunities. Asia Impact Investment Exchange (Asia IIX) calls itself a 'social enterprise with social mission: to provide social enterprises in Asia with greater access to capital'.[35] Although Asia IIX emphasises that it is not a 'securities exchange', it has established investment platforms including a social stock exchange and incubators. Similar platforms include Social Stock Exchange (UK), Impact Exchange (Singapore), Social Venture Connexion (Canada), and Mission Markets (US).[36]

7 Conclusion

Impact investment, while experiencing tremendous growth, is still very much in its infancy. In order to truly promote impact investing it is crucial that the Australian regulatory environment be reformed to remove the existing barriers to impact investment. Indeed the law must encourage a culture of impact investment. Hence we emphasise ideas such as clarifying fiduciary duties, making it easier for private ancillary funds to meet the sophisticated investor requirements, clarifying whether discounted returns can count towards minimum distribution requirements and the establishment of social investment bank. These ideas, as well as the many others discussed above, will help foster an environment in which impact investing can thrive, and, as a result, society more broadly. Impact Investment Group would be pleased to participate further in any future community consultation by the Financial Services Inquiry.

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[35] Impact Investment Exchange, *Mission*. Available at: <http://www.asiaiix.com/mission/> [Accessed 6 Aug 2014].

[36] Ashoka 2014, 'Stock Exchanges for Social Enterprises? Here's Where You Can Find Them', *Forbes* 27 March. Available at: <http://www.forbes.com/sites/ashoka/2014/03/27/stock-exchanges-for-social-enterprises-heres-where-you-can-find-them/> [Accessed 7 Aug 2014].