

# Social Impact Investing

## Response to Discussion Paper February 2017

HESTA welcomes the opportunity to submit a response to the Social Impact Investing Discussion Paper (the Discussion Paper).

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### Executive Summary

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HESTA is an industry superannuation fund, established in 1987 to provide retirement benefits for workers in the Health and Community Services Sector, and we operate only to benefit members. We have over 820,000 members and manage over \$37 billion of members' assets.

HESTA has been a leader in the establishment and operation of a systematic approach to embedding environmental, social and governance ("**ESG**") standards into all investment decisions.

We have implemented a number of strategies across our listed and unlisted investments which deliver environmental and social impact as well as a financial return, although the impact outcome is not the primary purpose of the investment. Examples include:

- Low-carbon and sustainability-themed strategies in Australian and international listed equities;
- Renewable power generation investments (solar and wind) in the infrastructure portfolio;
- Property investment strategies focused on properties with a minimum energy efficiency rating; and
- Thematic private equity strategies targeting exposure to growth-stage companies focused on sustainability and the transition to a low carbon economy.

We see our impact investment strategy as complementary to this focus on ESG and consistent with our position as a long-term responsible investor, particularly within the health and community services sectors (where the majority of our members are employed and engaged). In September 2013, the HESTA Board approved an allocation within the investment portfolio for a strategy focused on impact investments ("**Impact Investment**") – the approved allocation represented a small percentage of total Fund assets. In February 2017, the HESTA Board approved an increase in this allocation. Our allocation to Impact Investments is focused on investments which have as a primary purpose the delivery of a positive social and/or environmental impact and which generate appropriate financial net return to members – consistent with our obligations under the SIS Act (including the "sole purpose" test).

To implement this strategy, we have established a dedicated impact investment fund – the Social Impact Investment Trust ("**Trust**"), which is managed by Social Ventures Australia ("**SVA**"). With committed capital of A\$30 million, the Trust is one of Australia's largest impact investment funds and represents the single biggest commitment from an Australian superannuation fund to the local impact investing market. Through the Trust, HESTA seeks to identify investments aligned with members' values which deliver both a financial return and a definable and measurable social impact.

Consistent with our approach to ESG, our Impact Investment strategy is sophisticated and systematic. We have detailed our approach further in the document.

We are pleased to be able to contribute further to the discussion on ways the Australian Government can play an important role growing the Impact Investment market in Australia. We feel we can best contribute to the discussion in the following areas:

- Understanding the optimal roles of the Government, institutional investors and service providers to enable investments and ensure there is no inefficient competition for capital; and
- Reducing regulatory barriers with particular reference to superannuation law and our ability to work within the constraints of current regulation and still achieve meaningful outcomes.

We acknowledge the important responsibility that governments have in delivering social programs, and our Impact Investment activities are not intended to replace public sector provision of these important programs. With our Impact Investment strategy, we are seeking to support (mainly) private sector strategies which complement those undertaken through public sector or which the public sector has chosen to have delivered through private sector programs.

We welcome the opportunity to further discuss our submission with The Australian Government and The Treasury.

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## About the HESTA Impact Investment Strategy

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### Overview

At HESTA, we believe that it is consistent with our fiduciary responsibility to our members to adopt a long-term responsible approach to our investment strategies. Our focus on incorporating ESG considerations into all investment decisions reflects this approach, as does our Impact Investment strategy. The establishment of our Impact Investment strategy in 2013 recognized a number of important factors:

- A growing recognition in the community (following the Global Financial Crisis) that a financial return is necessary, but may not be sufficient, to ensure an investment contributes to a healthy and robust economy, society or environment.
- As universal and long-term stewards of a large and growing pool of capital from a broad population of members, superannuation funds are uniquely placed to understand and take advantage of the benefits from impact investment.

The objectives of HESTA's Impact Investment strategy are to:

- Identify investments aligned with members' values which can achieve an appropriate financial net return and measurable social impact. It is critical for each investment to deliver a financial return to members which reflects the risk/return profile of the investment, in order for HESTA to meet our fiduciary and statutory obligations to members.
- Further enhance HESTA's standing as a long-term investor whose activities have a positive impact on the economy, society and environment, and to provide an additional opportunity to continue to build an enduring relationship with members.
- Engage with other stakeholders to help build the Impact Investment market in Australia.
- Develop investment partnerships to allow HESTA to access Investments of a smaller scale, which would not justify team attention relative to other opportunities (given investment size below HESTA's meaningful investment threshold levels).

Use of the term "impact investment" is becoming increasingly common in the institutional investment environment and there is no clear standard meaning of the expression. HESTA's definition of Impact Investments is intentionally narrow as it is designed to:

- Facilitate investments which have as a primary purpose the delivery of a positive social and/or environmental impact and which generate appropriate financial net return to members, where:

- The “impact” (whether social or environmental) can be clearly defined and measured and is not an ancillary outcome of the investment.
  - The investment targets positive outcomes in new sectors or sectors not yet receiving broad attention by the investment community.
  - The investment aligns with HESTA’s investment strategy with the focus on HESTA’s key market segments, employers and members.
- Accommodate smaller investments, which do not meet HESTA’s meaningful investment thresholds.

Investments falling outside of HESTA’s Impact Investment strategy allocation include:

- Investments with positive social and environmental outcomes which are of a scale to consider within HESTA’s broader portfolio and where returns are consistent with other opportunities in asset class (e.g. renewable energy).
- Investments with positive impact although where this impact is not the business purpose, or definable and measurable (e.g. listed equity funds with “impact screen”).

The identified benefits arising from establishment of the Impact Investment strategy included:

- A diversified source of investment returns.
- Delivering a range of social and/or environmental benefits.
- Brand and reputation value from demonstrated leadership and in responsible investment.
- Experience in the development of innovative investment practices, including the creation of new investment vehicles.

### Implementation

When considering the optimal implementation approach for the HESTA Impact Investment strategy, we had to balance a number of interests, particularly relating to:

- the scale of investment opportunities that would be available – both in absolute terms (with many investment opportunities falling within a range of <\$1 million to \$5 million) and relative to other investments under consideration for the portfolio (with a minimum investment size in excess of A\$40 million); and
- the level of expertise within the HESTA investment team to consider these opportunities and the time and attention required of a small team to source, analyse, execute and manage Impact Investment opportunities.

The development of the Trust was an important step towards achieving the objectives for our Impact Investment program (as set out above) and addressing the implementation challenges. We utilized an investment structure similar to that established for other investment strategies within HESTA’s investment portfolio, being an open-ended, special purpose trust, with HESTA as the single beneficiary and SVA as the trustee and manager. The proposed structure enables HESTA to:

- utilize the skill, expertise and assistance of SVA in assessing investment opportunities which are too “small” for HESTA’s internal investment team to analyse;
- maintain control over investment selection to ensure that investments are aligned with our members’ values;
- establish a relationship to which HESTA can direct potential impact investment opportunities which arise from employer sponsor (and other) groups; and

- ensure that appropriate return outcomes are achieved for the risk being assumed in each investment (consistent with our fiduciary and statutory obligations to HESTA members, including the “sole purpose” test).

The Trust allows HESTA to make investments which focus on core social issues in Australia including, but not limited to, health, social and affordable housing, employment, disability, and education, which deliver financial returns and identifiable and quantifiable social impact.

To date, the Trust has made three debt investments to not for profit businesses and community housing providers, allowing the borrowers to generate positive social impact through expansion of the available supply of social, affordable and disability housing dwellings. Each of these loans have been made at commercial rates similar to the rates we would expect from HESTA’s traditional debt portfolio, although with other terms which provide the borrowers with more flexibility in relation to interest and principal repayments.

By way of example, the Trust’s first investment (completed in 2016) was a \$6.7 million investment in Horizon Housing, a community housing provider operating in Queensland. Horizon Housing is focused on increasing the supply of affordable housing and helping low income earners achieve home ownership in targeted areas. The investment with Horizon Housing will help finance the purchase of management rights for 995 existing affordable housing properties and the future development of up to 60 new social and affordable homes. The new homes will be in targeted areas around the Gold Coast and Brisbane.

The Trust’s investment also allowed SVA and Horizon Housing to secure a majority stake in Australian Affordable Housing Securities (“**AAHS**”), an entity responsible for managing compliance of National Rental Affordability Scheme incentives for over 2,500 properties. Through AAHS, SVA and Horizon Housing plan to develop innovative financing products to assist low income earners achieve home ownership.

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## Role of the Australian Government, Investors and Service Providers

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All three tiers of government in Australia have an important role to play in the Impact Investment market. For the purpose of this submission we have focused only on the Federal Government (“**Government**”).

The discussion paper outlines many roles the Government could assume, and we endorse the view that the government needs to be a champion of the Impact Investment market and play a facilitative role in coordinating interested parties and sharing expertise.

Beyond this, there are a number of ways government participation would aid the growth of the impact market and enable the mobilization of private capital. Fiduciaries have a fundamental risk and return issue, and ensuring an acceptable return for the risk being taken. To address this in the context of building an Impact Investment market, the Government involvement can focus on enhancing return or reducing risk.

### The Government can address market inefficiency (enhancing return)

The Australian Impact Investment market is small, highly fragmented and expensive for institutional investors to access. It is reliant on traditional structures including:

- “vanilla” debt investments (small loans to not for profits) and social impact bonds;
- private equity/ venture capital-style investments, although returns may be sub-optimal given the high risk associated with such investments; and
- grant funding, which provides no financial return and generally does not specify any social impact outcomes targets or accountability on the part of the recipient of the funding.

With very limited investment opportunities of scale available in the market, large institutional investors such as superannuation funds have struggled to build the case for focusing on the Impact Investment market. We have outlined above how HESTA has developed an investment structure to address these market inefficiencies,

although we are aware of many peers for whom investment scale and market immaturity/inefficiency are threshold issues.

In order to help drive efficiencies and create investment opportunities of the scale required by large institutional investors, the Government could act as, or develop, one or more “aggregator” vehicles to help address the challenges of a small, high cost and fragmented Impact Investment market. The “aggregator” vehicle could be structured with tiers of capital with differing risk and return profiles, allowing investors to participate in a way which best suits their risk/return appetite and objectives (e.g. similar to a securitization vehicle, capital could be tiered to provide for a range of outcomes, from equity-like risk/return to senior-debt like risk/return). An “aggregator” vehicle would provide institutional investors with investment opportunities of greater scale and with a more efficient cost structure.

The “aggregator” vehicle would also be staffed by specialists in a number of different areas, particularly in sourcing, assessing, executing and managing Impact investments.

Another example of an aggregator model is the Government issuing a bond which raises capital to fund the expansion of social and affordable housing. The Government can provide the appropriate return guarantees dependent on the underlying risk characteristics of the bond.

#### The Government can participate in the market (reducing risk)

In order to help drive further institutional investment into Impact Investment, scalable investments which bring investments to an appropriate financial return outcome will facilitate further capital into the sector.

One of the significant challenges faced by institutional investors is the ability to find scalable Impact Investment opportunities, particularly when, in certain circumstances, financial returns may be sub-optimal. In the context of social and affordable housing, for example, a property owner’s return will be a below-market return, given the below-market rent paid by tenants. An institutional investor with a fiduciary responsibility to achieve an appropriate financial return for members would require a market-based return to justify an investment, meaning that return enhancement would be required to make an investment of this nature suitable for an institutional investor. The Government could play a role in providing this return enhancement.

For other investment strategies, the Government has provided innovative structures and return outcomes for institutional investors. Below are examples of ways the Government can support investment from institutional investors such as superannuation funds, by creating investment structures with appropriate risk/return outcomes.

- *Public Private Partnership (“PPP”) structures.* PPPs are used commonly for social infrastructure investments, which generally involve private sector development and delivery of an asset and/or services which would otherwise be provided by government. PPP investments are generally supported by a government payment stream in return for private sector provision of the asset/services, with investor returns reflecting the relatively low-risk government revenue stream.

An example of a model which was accepted by superannuation funds and other institutional investors is the NSW’s Government’s Social and Affordable Housing Fund structure (offered to the market in 2016), which provided a concession to equity investors to fund the development and management of up to 3,000 social and affordable housing dwellings across metro and regional Sydney, supported by a payment stream from the NSW Government to support the equity investors’ investment return.

- *Risk and return sharing.* One of the critical considerations for institutional investors in assessing investment opportunities lies in achieving an appropriate risk/return outcome – for any investment, the investor must be comfortable that its return from an investment provides adequate compensation for the risks inherent in the investment.

As noted above, the risk/return outcomes in the Impact Investment sector may not be sufficiently compelling to attract institutional investors. Accordingly, Government involvement in the Impact

Investment market could be focused on reducing/mitigating risk and/or enhancing return for institutional investors, in order to help facilitate commercial return outcomes for institutional investors.

The Biomedical Transitional Fund (“**BTF**”) program, launched and completed in 2016, is an example of how the Government can help facilitate investment into the growth of Australia’s life sciences industry by providing favorable terms and return outcomes to investors. This program was modelled on the earlier Innovation Investment Fund (“**IIF**”) programs, under which the Government’s return was capped and subordinated to the return of private investors.

Another example of how the Government can help drive investment with a positive social outcome is through providing first loss capital on the underlying investment, similar to the Good Start Early Learning investment. These types of investment structures can be applied to investment in businesses that are seeking to drive a positive social outcome for Australia.

### An enabler of Impact Investment rather than a competitor

The total pool of capital in Australia’s superannuation sector currently sits at just under A\$2trillion, and will continue to grow each year. A small allocation of capital to Impact investments (approximately 2-5%) will significantly alter the Australian Impact Investment landscape and would create meaningful positive social outcomes for Australians. Given this significant pool of capital in superannuation, the Government should not play a competitive role; rather, the Government’s role is to be an enabler by supporting Impact Investment opportunities and strategies and contributing to the efficient operation of the market, to ensure that appropriate risk and return outcomes are achieved for institutional investors and, in particular, for superannuation trustees to discharge their fiduciary duties to members (enshrined in the Superannuation Industry (Supervision) Act (“**SIS Act**”)).

It is widely recognized that the UK legislators have been leaders in the impact market and their structures are advanced. A good example of positive government actions in the UK is the establishment of Big Society Capital (“**BSC**”) – described as the world’s first social investment bank.

BSC came to fruition in 2012 as a social investment wholesaler with an aim to grow the impact market in the UK by using dormant money, attract additional investment, and allocate funds and resources efficiently. An excerpt from the press release at the time of announcement –

*\*The purpose of the BSC group is to support the growth of a market for social investment in the UK - investments made for social as well as financial returns; to be able to attract greater levels of capital from a more diverse range of sources to address social issues; and to be able to allocate capital more effectively to achieve greater social impact. By supporting the growth of this market, BSC aims to improve very significantly the social sector’s ability to access capital and deliver positive benefits to society.*

The Outline Proposal for a “Big Society Bank” submitted by Sir Ronald Cohen and Nick O’Donohoe in May 2011 can be found at [www.cabinetoffice.gov.uk/resource-library/big-society-bank-outline-proposal](http://www.cabinetoffice.gov.uk/resource-library/big-society-bank-outline-proposal)

(\*source: <https://www.gov.uk/government/news/big-society-bank-launched>)

HESTA is also aware of activities being undertaken by the Japanese government to consider whether money sitting in dormant bank accounts can be utilised for investment in Impact Investment strategies and opportunities.

In November 2016, the Japanese Parliament enacted an act to take cash in dormant bank accounts left intact for at least 101 years to support social purpose activities.

These activities will be executed by private bodies intended to contribute to the public interest through resolving social problems that have been difficult for the national and local government to address, aiming to achieve beneficial changes in economic and social conditions such as population decreases and the ageing of society.

Within the Australian superannuation market, the amount of “unclaimed super moneys” currently sits at *\$17 billion sitting in 3.4 million lost accounts in superannuation funds\** this money, similar to the use of dormant money elsewhere, could be an initial pool of capital for a government sponsored investment fund.

(\*source:

[http://www.billshorten.com.au/government\\_reforms\\_boost\\_super\\_savings\\_and\\_lower\\_industrycosts](http://www.billshorten.com.au/government_reforms_boost_super_savings_and_lower_industrycosts))

**RECOMMENDATION – We recommend that the Government consider:**

- Feasibility of establishing one or more “aggregator” vehicles to support institutional investment into Impact Investment strategies and to build “centres of excellence” and expertise in sourcing, assessing executing and managing Impact Investments.
- The suitability of industry-specific support programs (such as the IIF and BTF structure in the venture capital sector) to the Impact Investment market.
- Further understand how the Australian Government might make best use of unclaimed monies to catalyse opportunities in the Impact Investment sector.