NATIONAL AUSTRALIA BANK SUBMISSION

Social Impact Investing Discussion Paper

7 March 2017

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SOCIAL IMPACT INVESTING DISCUSSION PAPER

Dear Mr Crawford

National Australia Bank ("NAB") commends the Australian Government for consulting on the important issue of social impact investing ("SII") and we welcome the opportunity to respond to the Department of Treasury's *Social Impact Investing Discussion Paper*. We have chosen to respond to those questions that are particularly relevant from a financier's perspective.

Impact Investment at NAB

As a bank, we believe we have a responsibility to deliver innovative financial solutions that help our customers, community partners and government to address social and environmental problems through impact investment. Supporting SII makes commercial sense and is aligned with NAB's values.

NAB recognises the important role SII can play in reducing the gap between the demand for social services and what support governments can provide. In less than a decade, the market for impact investment is estimated to be valued at A$32 billion within Australia and between US$500 billion to US$1 trillion globally.[1]

Over the last three years NAB has played an active role in building the emerging Australian SII market, NAB has demonstrated how a bank can direct capital to SII through developing a Shared Value approach with partners in different sectors, including the Victorian, NSW and Queensland Governments (Appendix 2).

As the debt financier for the Murray-Darling Basin Balanced Water Fund, STREAT and the third social impact investment with the NSW Government referenced in this discussion paper, NAB is in a unique position to be able to comment on the challenges faced by a large financial intermediary in this nascent market.

[1] Addis, R., Bowden, A., Simpson, D. 2014, *Delivering on Impact: The Australian Advisory Board Breakthrough Strategy to Catalyse Impact Investment*, Melbourne.

NAB's views of the potential roles for the Australian Government in the SII market are outlined below.

Assist the SII market development by:

- Stimulating the flow of private sector capital to improve societal outcomes at scale, in particular championing the creation of Impact Capital Australia and an Affordable Housing Aggregator Bond model;
- Providing capacity building for innovative service providers to develop and scale up, by supporting effective programs such as the Impact Investment Ready Growth Grant;
- Supporting Impact Investing Australia and other intermediary organisations that are leading Australia's SII market building activities. The potential of this market will not be achieved without these intermediaries to coordinate the many stakeholders;
- Adapting policies to stimulate the philanthropic sector to assist with market development; and
- Establishing clear long-term policies around impact investment to encourage multi-sector participation, recognising that each sector brings its own strengths that collectively drive the best outcomes for Australia.

Participate in the SII market by:

- Working alongside the State and Territory Governments, corporates and service providers to address complex issues such as social and affordable housing;
- Providing data in an accessible form that can assist with benchmarking and measurement of impact investments similar to what was provided by the UK Cabinet Office; and
- Supporting the development of common impact measurement frameworks to address the need for comparison and to reduce high transaction costs.

Supporting SII in Australia is very important to NAB and we look forward to continuing the dialogue with the Australian Government. In particular, we would like to discuss the creation of Impact Capital Australia and an Affordable Housing Aggregator Bond model.

Should you wish to discuss this submission further, please contact Vanessa Curtain, Manager, Government Affairs and Public Policy at Vanessa.L.Curtain@nab.com.au or 0400 697 625.

Yours sincerely

Steve Lambert

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APPENDIX 1: Responses to the Social Impact Investing Discussion Paper

Overview of social impact investing

1 What do you see as the main barriers to the growth of the social impact investing market in Australia? How do these barriers differ from the perspective of investors, service providers and intermediaries?

NAB understands that barriers faced by the Australian SII market are consistent with those barriers in international SII financial markets at the same level of maturity. We believe the main barriers are:

A. Understanding impact risk and measurement of social outcomes;
B. Access to appropriate risk capital; and
C. Leadership, education and capacity building

A. Understanding impact risk and measurement of social outcomes

Understanding the risk profile of the social (which includes environmental) impact and whether it has a correlated financial impact is a global challenge. As the market's understanding of social impact risk improves, the more transparent the expected financial returns will be.

One challenge to understanding impact risk and return is measurement. In particular, the current lack of public data and absence of a consistent impact measurement framework is a key challenge to understanding this relationship. This lack of understanding has led to higher transaction costs which slow down the market.

For example, the quick growth of the clean energy finance market has been supported by a clear framework for measuring carbon emissions avoided and mitigated that can be compared across the market. In the case of data, the UK Cabinet Office released a comprehensive list of unit cost budget figures which enabled services providers to determine whether their innovative solutions would deliver better societal outcomes while also delivering cost savings to the Government.

B. Access to capital

Access to capital for SII ranges from philanthropic funds, early stage risk capital to mainstream debt and equity. At all levels, there are barriers to accessing appropriate funding. Other than green bonds, NAB's experience in the impact investing market reflects the small scale, bespoke and illiquid nature of the transactions over the last three years. As a bank we are well placed to direct more capital into SII however the challenges we see include:

- **Lack of early-stage risk capital:** to grow the number and size of the transactions, more funding is required at the early, pre-investment phase. This includes philanthropy or equivalent for start-ups (depending on their legal form see Question 2) and early stage capital (Angel and venture capital ("VC")) to scale service providers. These funding gaps were frustrating for our customers, both the service providers seeking early-stage investment and potential impact investors. This led NAB to invest $2m into Impact Investment Ready grants to bridge these funding gaps.
- **Market rate return:** NAB supports the assumption that the rate of return (market rate returns) will be commensurate with the risk taken as this will support the sustainability of the SII market. We recognise however, that factors such as high

transaction costs or perceived risk, in the early market building phase, may require de-risking the investment. To support this evolution, philanthropic funding can focus on creating an environment where innovative solutions to social issues will be supported. Government funding and guarantees can also play this role.

- **Lessons from overseas:** We have looked at other countries for inspiration on how to stimulate private sector investment.

  UK:

  - UK Government played a direct role in creating Big Capital Society to stimulate the impact investing market. In Australia, its equivalent is Impact Capital Australia (ICA) which has been developed by a working group convened by Impact Investing Australia.
  - A report by the advisory panel to the Mission Led Business Review[2] highlighted the need for different legal frameworks and government structures that support businesses addressing societal issues to drive market scale. (Refer to Question 2 for further discussion)

  US:

  - The US introduced a benefit corporation as a structure to provide directors a framework to pursue both profit and purpose. We observe that this structure appears to clarify directors' responsibilities and the uptake is quickly gaining momentum with 30 US states adopting this structure along with countries like Italy, Argentina and Colombia.

C. Leadership, education and capacity building

As an intermediary, NAB bridges the gap between investors and service providers and recognises the challenges faced by each.

Investors, led by High Net Worth (HNW) individuals are seeking to invest with a different values-led lens and education is critical to assist different investors to transition. On the other hand, service providers require support to understand how access to capital can increase their impact but also need the skills to understand the requirements of investors.

NAB has led education and capacity building activities in partnership with Impact Investing Australia, Philanthropy Australia and The Difference Incubator over the past three years to address the barriers that prevent the growth of the impact investing market.

Other examples of leadership include the CEFC's recent investment into a clean-tech VC and the Department of Foreign Affairs and Trade's Global Innovation Fund which demonstrates how the Australian Government can attract people and ideas to address social issues.

Other barriers not raised in the discussion paper include:

- The need for cross-sector and cross-jurisdictional collaboration to design programs that address complex social issues in new ways; and
- Strong leadership and the need for long-term certainty to unlock private sector capital to grow the SII in Australia.

[2] Wilson, N., et al, *On a Mission in the UK Economy: Current state of play, vision and recommendations from the advisory panel to the Mission-led Business Review 2016*, December 2016

2 What do you see as the future for social impact investing in Australia: for example, can you foresee the development of new structures for social impact investing?

In Australia, a diverse group of committed organisations have laid the foundations for the impact investing market. To enhance the development of SII, the Australian Government can help to speed up and scale the progress of the market building activities.

NAB sees success as addressing the barriers that restrict the growth of impact investing to allow the market to reach its full potential for addressing social issues at scale. NAB has been working collaboratively to develop different structures to address these barriers; particularly those associated with access to capital, but see the need for:

1. Common and more transparent outcome measurement and evaluation frameworks and access to social data; and
2. Development of investment structures that unlock private investment, to supplement government funding, in tackling complex social issues.

NAB has been working collaboratively to develop different structures to support the growth of SII. In particular:

1. Impact measurement: undertaken research with The Difference Incubator to conduct a global scan of impact measurement tools and suitability for different purposes.
2. Development of investment structures:
    - Supporting the development of Impact Capital Australia with Impact Investing Australia; a wholesale fund-of-funds designed to stimulate the intermediary market and drive scale in the impact investment sector by unlocking private capital to leverage government funding.
    - Developing aggregated funding solutions for investors which would address the barriers of risk diversification, liquidity and scarcity.
    - Supporting new legal forms and governance structures for mission led businesses. Currently the choice of legal structure for a start-up social enterprise (company or not-for-profit legal structure) determines its funding options. We have seen that philanthropic funding is helpful in the early stages but is usually only available to Incorporated Associations with a DGR 1 status. The corporate legal form can access equity finance and is best suited to scale up their impact, provided they were able to survive the early stage growth phase. As discussed in Question 1, the US and UK demonstrate that a hybrid model could assist the development of a vibrant social enterprise sector.

3 Are there any Australian Government legislative or regulatory barriers constraining the growth of the social impact investing market?

As outlined in our submission to the Financial Services Inquiry, NAB supports a review of Government legislative or regulatory barriers relating to stimulating SII, including exemptions to private ancillary funds and other recommendations made by the Productivity Commission and Senate Economics References Committee, including the:

- Potential to invest a percentage of their corpus into impact investment;
- Development of social investment funds to attract institutional investors; and
- Harmonisation of tax concessional status definitions at the Commonwealth level.

At a more issue-specific level, we see areas where legislative and regulatory barriers can constrain the market from addressing complex issues.

4. What do you see as the role of the Australian Government in developing the social impact investing market?

The Australian Government could play a significant role in addressing the barriers that prevent the growth of impact investment. NAB would welcome participation in:

- Building the capacity of the market to support the growth of the impact investing market, in particular by providing financial support to intermediaries such as Impact Investing Australia to coordinate this;
- Incentivising impact investors to provide capital to seed the market, attracting private sector funds to complement the government spend already dedicated to addressing social outcomes;
- Incubating social impact projects – early stage investment to de-risk and open up more private funding;
- Partnerships across the social, corporate and government sectors that will develop social innovation ideas; and
- Collaborating across levels of government to overcome the barriers relating cross-government initiatives.

The potential benefits to the Australian Government include the delivery of better outcomes, the ability to efficiently utilise scarce public resources and the creation of a multiplier effect for the funding provided by utilising private sector capital.

5. Do you see different roles for different levels of government in the Australian social impact investing market? For example, the Australian Government as co-funder with State and Territory Governments continuing to take the lead in developing social impact investments?

We do see different roles for the Australian, State and Territory and Local Governments but the roles may vary depending on the social or environmental issue being addressed.

The key reasons that the Australian government should take a role in SII include:

- By participating in transactions, the Australian Government can ensure that policy objectives are aligned. A current example is the role the CEFC plays to support environmental financing through partnering with State Governments and the private sector to catalyse other private capital into the sector;
- By enabling an equitable sharing of cost savings the Australian Government is able to facilitate transactions/interventions/programs that are only marginal from a State and Territory Government perspective but are valuable to society from a whole of government perspective; and
- Reviewing State and Territory Government activities would enable alignment and efficiency and could be a role that the Australian Government can play.

6. Are there areas where funding through a social investment framework may generate more effective and efficient policy outcomes than direct grant funding?

The Australian Government can play a unique and important role to stimulate the flow of private sector capital to improve societal outcomes at scale. Two potential opportunities that

NAB believes will generate more effective and efficient outcomes but require immediate funding are:

Impact Capital Australia (ICA)

The Australian Advisory Board report into Impact Investing for the G8 Taskforce recommended the need for an independent 'flagship institution' that will catalyse the flow of capital and stimulate the growth of the impact investing market. The UK Government led with the creation of Big Society Capital, and similar initiatives are being considered in countries including Japan, Portugal, Canada and Israel. Over the past 2 years, Impact Investing Australia and the Australian Advisory Board working group have developed Impact Capital Australia (ICA). Currently NAB has made an in-principal commitment for a significant financial contribution to support ICA. We would welcome the opportunity to discuss the Australian Government's involvement in ICA to enhance its development and reach.

Affordable Housing Bond aggregator

A Bond Aggregator model has been proposed as a way of attracting greater private sector funding for new social and affordable housing. The Housing Finance Corporation (THFC) in the UK is a good example of how this financial tool can stimulate the creation of new housing supply. By using a bond aggregator to direct subsidised funding toward social or affordable housing the Australian Government could mobilise significant volumes of private/superannuation capital into the community housing sector. This will enable a significant, permanent increase in the stock of affordable housing.

NAB has been actively working with several partners and interested parties to design an effective financing solution to address social and affordable housing but it requires Government engagement and involvement to rapidly unlock private or institutional investor capital.

7. What Australian Government policy or service delivery areas hold the most potential for social impact investing? Are there any specific opportunities you are aware of?

The areas of housing, health and education are important public policy areas for the Government and also offer large scale opportunities for social impact investment.

In addition to the opportunities outlined in question 6, we are also aware of several other opportunities that could be accelerated with the Australian Government's support. These are:

- Indigenous health, especially the area of diabetes prevention and delaying dialysis;
- Provision of social, affordable, disability and age appropriate housing; and
- Early childhood education.

8. Are there opportunities for the Australian Government to collaborate with State and Territory Governments to develop or support joint social impact investments?

The specific areas outlined in Question 7 cross over both Australian and State and Territory jurisdiction and create opportunities to jointly solve complex issues because of mixed responsibility for:

- Funding services;
- Service delivery; and
- Outcomes and benefits.

9. What are the biggest challenges for implementing the Australian Government's public data policy in the social impact investing market? What can the Australian Government do to address these challenges?

Data sharing is critical to accelerating the social impact investment market, especially in the area of health. The UK Government released unit-cost budget data which enabled the market to develop innovative ideas and proposals for the Government to address social issues with better outcomes while reducing costs. Similar data could be released to understand the Australian perspective and to stimulate the SII market.

It is not only the datasets but the interconnection of the datasets that is valuable, in particular, the clear and transparent linkage between social impact and economic outcomes. The challenges to achieving this include:

- Datasets required to understand this relationship not being designed with the right questions or several datasets needing to be combined to demonstrate this correlation;
- Data privacy constraints preventing the economic and environmental data from being considered together; and
- Datasets being held not just by different government departments but by a mix of public and private organisations.

NAB has previously commented on the specific challenges of data privacy and in particular to the 'underlying public interest test' and requests for further information on databases that are of national interest. We uphold our support for appropriate de-identification and security controls and frameworks and acknowledge these considerations are balanced with the need for public data that can help solve some of the on-going social challenges facing Australia.

10. Are there opportunities for the Australian Government to form data sharing partnerships with State and Territory Governments, intermediaries and/or service providers?

Government could play a role in creating the protocols, processes and facilities to enable disparate datasets to be aggregated and analysed whilst acknowledging the challenges identified in Question 9 regarding data privacy.

11. We are seeking your feedback on the four proposed Principles for social impact investing.

Our feedback on the Principles for SII has been informed by:

- Our experiences working with community organisations, social enterprises and intermediaries to design and fund innovative programs;
- Listening to funders, such as philanthropists, foundations, trusts and institutional investors about their needs; and
- Our own experiences driving social innovation through NAB.

From a funder's perspective, the most important principles are the risk and return profiles they will be willing to accept, as risk is transferred from the Australian Government to the private sector. We recognise many investors have a higher tolerance for risk at this stage in the market and, occasionally, a willingness to accept lower than market returns to demonstrate the viability of this type of investment product. The other key area is the outcomes measurement frameworks which triggers the payment mechanism. The pragmatic suggestions of using proxy measures, transparent evaluation methodologies and recognition that benefits are delivered over a longer time horizon are welcome but need to be balanced with reasonable repayment timeframes and the cost of outcome measurement.

From a service provider's perspective the Principles capture many of our experiences from the State Government-led payment for outcomes initiatives. We agree with the majority of the recommendations but highlight that standing charges are required to attract the level of returns that investors need in the current nascent market.

It is because the market is at this early development stage, that NAB suggests that the Principles, though suited to the Government's own procurement process, do not completely capture the Australian Government's participation in the SII market.

Firstly, the Australian Government could play a key role in developing the ecosystem required to support impact investment. This cost is an investment to pave the way for others, in particular private investors to contribute. It may not always be possible to demonstrate that the expected benefits will exceed the costs but, by enabling the market, the impact of each $1 of taxpayers money spent will have a greater impact at addressing the social issue.

Secondly, innovation is often not easy to assess at the early stages in both the outcomes measurement as well as understanding the risk and return profile. The riskiest innovations often can deliver the most impactful solutions in addressing intractable social issues but also have the greatest risk of failure. The Principles currently suggest a conservative risk appetite for innovation and there is potentially a role for Government to play in supporting early stage social innovation at scale.

12. Are there any issues other than those identified relating to control that would suggest the options presented will not be sufficient to solve the problem?

The evidence suggests the controls seem sufficient. The average Private Ancillary Fund ("PAF") has net assets of around $3m and as such will qualify itself as a sophisticated investor[3]. For PAFs with assets under $3m, it is common that it was founded by a single donor, who is also a director, and has enough personal assets to qualify as a sophisticated investor themselves.

For the few other situations where there is a smaller than average PAF (assets under $500k) without the founder/major donor or the majority of directors qualifying as sophisticated investors, it is less likely that they would want to direct a significant asset allocation toward social impact investments.

13. Are there examples of recent situations where a PAF has considered that it is sufficiently controlled, or not sufficiently controlled, that fall outside these situations?

We are not aware of any situations of this type but acknowledge the market is still nascent. The more significant issue has been that the opportunities for social impact investing are not being seen by PAFs in the first place.

14. Do the options canvassed provide sufficient certainty around when a PAF is controlled by a sophisticated investor? Are there better options that are not discussed?

The clarity of either the PAF itself qualifying or the director/major donor qualifying or the majority of the directors qualifying through either the net assets or gross income test is clear and acceptable.

15. How could these options be best incorporated within the appropriate legislation?

The one additional consideration might be around the ease of PAFs making loans to eligible DGR type 1s. While they are still an investment, the relationship between a PAF and a DGR type 1 is different to that between a PAF and social entrepreneur with an impactful project but outside the DGR category.

16. Is a written statement from the board of directors of the PAF sufficient evidence of the status of the trust as a sophisticated investor, or should a letter from an independent third party be required?

It would provide certainty for the investee if an independent third party letter was available. As the PAF needs to be audited each year, its independent third party letter should be easily obtained.

17. What qualifications should the independent third party person be required to hold?

The current situation through a qualified accountant seems adequate.

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[3] PAF would be deemed a sophisticated investor under s761G of the Corporations Act 2001 if it has assets of at least $2.5m or has income of at least $250,000 in each of the past two years.

22. Are there relevant parts of the Corporations law, or other Commonwealth legislation and guidelines, which represent a barrier to PAFs investing in impact investment products?

Not that we are aware of, from the PAF perspective.

24. To what extent are the current arrangements for program related investments appropriate? Should changes be made to:

24.1. Recognise the total loan, rather than only the discount rate between a commercial rate and the concessional loan rate, for the purposes of meeting the ancillary's funds minimum annual distribution

While there is a re-distribution clause which would re-cycle the eventual repayments of loans to DGRs under a PRI system, there is a risk that at an extreme, we could see a significant reduction of grants made in favour of investments. One of the real advantages of philanthropy, compared to other charity funding sources, is the "risk capital" role it plays that rarely comes from other sources. If this change caused a major shift, that would damage some of the effectiveness of the system. The US experience shows this hasn't been an issue, but perhaps a percentage maximum limit on loan valuations to grant distributions might provide a safeguard.

24.2. Allow ancillary funds to make program related investments to non DGR organisations?

They can of course already make investments to them, but not at sub-market rate returns and/or not counting either the foregone interest or the whole loan as part of their distribution requirements. Extending the ability for PAFs to make non DGR investments at sub market rate returns for an agreed group of social projects would be positive while still allowing control over the project types. It would also allow the investment in equity rather than just debt by PAFs, something not currently available for PAFs investing in a charity. Further extending this to either allowing the interest foregone or even the total loan value counting as part of annual distributions runs the risk of shifting support too far from DGR type 1s and losing the connection of the original deduction given to the PAF donor and the support which the PAF in turn gives to DGRs.

25. What is the level of demand from both DGR and non DGR organisations who could be recipients of program related investments?

It is difficult to say given the limited knowledge and low technical readiness of organisations to undertake social impact investments and/or program related investments. Our experience is that there is a strong increase in the number of organisations that want to discuss the options available, but few have progressed ideas to an investable offering. While DGR and non DGR organisations have expressed interest, far more have come from DGRs given their already good knowledge of philanthropy, relationship with donors and the generally larger infrastructure of their organisations.

26. What are the costs of administration for organisations receiving program related investments compared with receiving irrevocable donations?

Irrevocable donations are much lower cost due to a number of factors. Systems already exist for the initial fundraising, receipt and reporting of donations. The costs of program related investment contracts/agreements are high, particularly compared to their usually small size. In addition, there is a greater on-going cost of monitoring and recording a program related investment and of course, there is the intention of repayment of the interest and capital at some point as their ultimate cost compared to a donation.

27. Given the recent changes to the ancillary fund guidelines regarding program related investments, and noting the issues associated with making further changes, are there alternative mechanisms for promoting program related investments outside of ancillary funds?

With the size of the charitable trust sector having greater visibility due to the Australian Charities and Not-for-profits Commission (“ACNC”) reporting requirements, that sector is as important as PAFs in capital availability. However, with their distributions linked to income rather than a percentage of capital (as is the case for PAFs), there is a reduced incentive for them to count foregone income as part of their required distributions. Altering their distribution requirements could provide an incentive to participate in both social impact investments and program-related investments. The distribution requirements for PAFs changed from an income to percentage of asset base in 2009.

APPENDIX 2: Impact Investment at NAB

Key achievements

Market building activities

- Contributed to Impact Investing Australia's *Australian Advisory Board Report* which was submitted to the G8 Taskforce on Social Innovation in 2014 which set the strategic direction for developing Impact Investment in Australia;
- Helped to develop Impact Capital Australia and made a recent commitment to contribute $60m to seed this catalytic capital fund;
- Created and seeded the Impact Investment Ready Growth Grant (previously the NAB Impact Investment Readiness Fund) of which 8 of the 16 successful recipients have raised additional capital – approximately $23 for every $1 of grant funding received; and
- Contributed to research - JB Were co-authored *IMPACT-Australia* and contributed to *Place-based impact investment in Australia*.

Participating in the market[4]

- Demonstrated the viability of impact investing through transactions valued at over $400m, including innovative market based solutions like Goodstart Early Learning and The Nature Conservancy's Australia Water Fund;
- Leading the growth of clean energy finance in Australia, including launching a Climate Bond Standards certified $300m green bond (the first by an Australian issuer), partnering with the Clean Energy Finance Corporation ("CEFC") to provide discounted finance for energy efficient equipment and leading the first US Private Placement ("USPP") issuance for an Australian wind farm;
- Co-financed Australia's third social impact investment with Australian Community Support Organisation ("ACSO"), arbias Ltd and the New South Wales Government; and
- Built knowledge of social outcome measurement, through NAB's 12 years of experience with microfinance and measurement research

Developing a Shared Value approach

- Collaborating with organisations such as Impact Investing Australia, The Difference Incubator, Social Enterprise Finance Australia and Philanthropy Australia under a common goal to support the development of SII in Australia; and
- Working with our customers who are invested in social innovation, need capital to grow or are seeking values-aligned investment.

[4] For the avoidance of any doubt, this document is not intended, in any jurisdiction, to be a recommendation, invitation, offer, solicitation or inducement to buy or sell any financial instrument or product or to engage in or refrain from engaging in any transaction and is not intended to be a complete summary or statement of a relevant transaction.