**Submission to the Social Impact Investing Discussion Paper 2017**

**To:**

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The overall view of the members of this submission is that for social impact investing to become a viable method of generating measurable social outcomes the breadth of investors needs to be increased significantly. The Social Impact Investing Discussion Paper examines the important role of service providers and philanthropic investors. Philanthropy is growing in Australia with 80.8% of the general population giving $12.5 billion in 2015-16, business $17.5 billion and more from foundations and trusts. In relation to social impact investing, there is interest from the Paul Ramsay Foundation (2015), Australia’s largest trust or foundation, which has recently engaged Social Ventures Australia (SVA) for advice on investing with social impact. While these sources are significant and will have a role to play in the social impact investing sector, if this sector is to develop, a new set of investors must be sourced. These investors may have a desire for social good but are likely to require a financial return. In sourcing these investors the diversification benefits of these types of investments is likely to play a part. Our submission does not include a response to the questions on the Australian Governments public data policy however we would like to encourage all endeavours to increase the level of data sharing discussed. We believe this type of access would greatly enhance the ability of the service providers to quantify financially the anticipated impact of their programs which in turn would enhance their ability to raise funds. In this submission we will address questions 2 and 4, although some of our recommendations may involve some overlap with other consultation questions.

**Q2. 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?**

**Response:** We believe a major contributor to the development of the sector would be to improve and increase the use of social impact bonds (SIBs)(also known as Pay for Success and Social Benefit Bonds). We believe that this type of instrument could be used successfully to innovatively deal with many social problems currently addressed by government. Examples of issues that have used Social Bonds to fund a public/private partnership are the SA bond to assist with homelessness, NSW Newpin bond and internationally to help lower recidivism rates. To encourage the growth of this market we view the following issues will need to be addressed; complexity of the instrument and clarity and amount of data available to assess the bond.

* + From the perspective of the party wishing to raise funds for a project. We are not advocating that this instrument is appropriate for all, in particular small size fund raisings due to the complex nature of some of the data requirements. As discussed in our introduction the increased level of data sharing will help the organisations raising funds to provide firstly determine the likely cost savings and social benefits that will arise from the investments and secondly clear evidence of the cash flows likely to ensue to the investors in the bonds. We believe that most of the barriers from this party can be eliminated by reducing the complexity of the instrument. The traditional bond market has a straight forward structure. This usually comprises of an initial investment, with a coupon rate which is paid either annually or semi-annually for the term of the bond, and the face value paid at the end of the term of the bond. In the case of the SIB this is exactly the same structure with a few possible variations as discussed below.
	+ The first coupon payment may not occur until one or more years into the life of the bond.
	+ The coupon amount of the coupon payments may vary directly with the success or otherwise at each stage of the project.
	+ The coupon amount may vary downwards only depending on the success or otherwise at each stage of the project – i.e. there may be an upper cap on the coupon amount.
	+ There may be no coupon payments for the duration of the bond.
	+ There may be only a part payment of the face value at the end of the life of the bond.
	+ There may be an increase in the size of the face value at the end of the life of the bond.

The set-up of the bond will be organised at its inception with the help of the intermediator. The projected cash flows will be estimated at this stage. For example, the Massachusetts Juvenile Justice Pay for Success Initiative (2014), raised $18m and aims to reduce recidivism and improve employment outcomes for young men in certain areas of Massachusetts. This project has an intensive two year period followed by two years of follow up engagement. Therefore no success measures can be determined until at least two years have transpired. The payments will then occur between the second and seventh years and is based on decreases in incarceration, increases in job readiness and increases in employment attained by those participating in the program. The Commonwealth of Massachusetts has agreed to pay up to $27 million for success of the program. The table below provides a summary of what is required for payment and what savings would be made for the Commonwealth.

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| --- |
| **Incarceration-based Payment Terms** |
| **Decrease in days of incarceration** | **Incarceration-based success payments** | **Gross Savings for Commonwealth** |
| 70.0% | $27m | $45m |
| 55.0% | $26m | $33m |
| 40.0% | $22m | $22m |
| 25.0% | $11m | $11m |
| 10.0% | $2m | $2m |
| 5.0% | $0 | $0.9m |

The projects’ target is a 40% decrease which would provide Goldman Sachs (the major investor) with a 5% rate plus face value at the end of the project. The table shows that the payment stream from the government depends on the level of success of the project. These savings are worked out in collaboration with the intermediary, the project partner and the government sector which would attain the financial benefits from a successful program. The aim of this example is to clarify the type of project analysis undertaken by the fundraiser and to show that the analysis undertaken to have a project approved for operation is similar to the data required for fundraising purposes. An SIB can be seen as an ideal source of debt for this project.

1. The next perspective is from the investors’ viewpoint. The investor is looking for a financial return, possibly not a market rate of return as they may in part be interested in the social good, however we believe this market should be constructed in such a way as to encourage all types of investors. We would like to propose that social impact bonds could be treated in the same manner as corporate bonds. Corporate bonds have been a significant source of funds for both financial and non-financial corporations in Australia for many years. These bonds have risks which should be investigated prior to investing, such as high leverage or a history of defaults on debt obligations, and of course the risk of insolvency. In considering an investment in a corporate bond an investor will look at country risk, outlook for the industry and management as well as similar investments record. The Australian Securities and Investment Commission (ASIC) (Investing in corporate bonds? p.5) has a check list investors should look at prior to investing in a corporate bond. These are:

1. Do you know when the bonds mature (the maturity date)?

2. Do you know the length of the bonds term in years?

3. Do you know if the interest is paid at a fixed rate or floating rate?

4. If they are floating rate bonds, do you understand how the interest rate is calculated?

5. Do you know how often you will be paid interest?

6. Do you know if the company has the financial capacity to pay you interest and return your principal at maturity?

7. Do you know if the bonds are secured or unsecured?

8. Do you understand where you would stand in relation to other creditors if the company issuing the bonds couldn’t pay its debts?

9. Do you know if the company issuing the bonds can buy them back before the maturity date?

10. Do you understand the risks of investing in corporate bonds?”

This list of questions would be the same for investing in SIBs. Some of the different types of bonds in the market which may be similar to SIBs include the following:

* Guaranteed bonds – where the bond is guaranteed by a company other than the issuing company – for an SIB this may be the Government or major investor.
* Income bonds – only the principal is promised, the interest or coupon payment depends on the issuers earnings – relevant for many SIBs.
* Zero-coupon bonds – no coupon payment but bond issued at a discount such that when face value returned at the end of the bonds life there is a capital gain – a number of international SIBs have been issued using this framework.
* Speculative or junk bonds are likely to have high coupon rates but are considered very risky – some SIBs into a new type of project may fit into this category.

Ideally in the future SIBs would be able to be listed in the same way that corporate bonds are. Although we anticipate this taking some time to come to fruition it should be seen as a goal for this instrument. Australian Ratings assign ratings from AAA down to C in a similar way to the international ratings agencies of Moodys and Standard and Poors. These ratings do not provide buy or sell advice but rather an indication of credit worthiness of the financial product. As an example January 2018 exchange traded Commonwealth Treasury Bonds have a rating of AAA and are given a green complexity rating indicating they are simple and straightforward. Similarly Heritage Bank Retail Bonds also have a green complexity rating but are rated BBB+ indicating an intermediate degree of creditworthiness. The Australian Centre for Financial Studies and National Australia Banks’ 2015 report on Australian debt securities outlines the improved access to the corporate bond market for retail investors. This report notes the regulatory change aimed at stimulating this market and includes the provision for unrated corporate bonds to be issued into the OTC market and states that this “reduces barriers to accessing the Australian corporate bond market and increases the breadth and diversification options available to sophisticated investors.” (p11). It is unlikely that a reliable rating system would be viable for some time until a better data set has occurred therefore two rating types are possible. The first, and higher rated SIB, would be where the Government department associated with the project provides a capital and/or capital and return guarantee. The Newpin SIB had a 5% yield guarantee from the NSW government for the first three years of the investment while the Benevolent Society SIB had the majority of the funding with a capital return guarantee. The more common type which has occurred internationally would be lower rated and has a maximum 100% loss potential. The other measure of risk, term, would also be used by investors to determine what rate of return they would expect. We note that the RBA data shows that longer term corporate bonds have higher yields than shorter term i.e. January 2017 yield for A rated 3 year bonds was 3.04%, 5 year were 3.50%, 7 year were 3.93% and ten year 4.39%. The size of the total project and the size of the individuals’ investment would be part of the early proposal and the second would be an individuals’ decision. However worth noting that at this stage most investing, internationally, is undertaken by institutions, trusts, foundations and high net worth (professional investors) individuals with minimum investment size around $100,000. This limits investing in SIBs to experienced investors with often an emphasis in their portfolios to social good. While still a nascent product, it has been taken up to a much greater extent in the United Kingdom and the United States of America than in Australia. This may be due to the usual market constraints of market size but it is unlikely to be complete explanation. The liquidity of an investment is deemed to be a significant factor in the investing decision. Where liquidity is defined as the ability to buy or sell quantities of an asset quickly and at low cost i.e. the sale or purchase will not have a large effect on the price. In preeminent research by Ahmid and Mendelson (1986) it was found that liquidity is a key determinant of prices and expected returns. If this is the case then we can see that, with no secondary market, the SIBs are difficult to price and will have reduced investment appeal to many investors. In the World Economic Forum report (2013) it states on page 43 that “A social stock exchange, which can create a liquid market for private investments that generate social and environmental value, is one approach to unlocking a greater supply of impact investment capital. From a demand side, social stock exchanges can enable SEs to access global mission-aligned investment from diverse investors.” It goes on the show that investor demand for liquidity in impact investments is strong with 48% having a strong interest and 38% moderate interest. As a structural feature of an impact investment it had the strongest level of interest.

An example of a ‘less mainstream’ bond market is the Green Bonds which are now listed on a dedicated platform on the Luxembourg Stock Exchange since September 2016 as well as included in more general Corporate Bond Markets around the world. In Australia the first Government issue of Green Bonds was by the Victorian Government in July 2016 where they raised $300 million. The investor base was quite wide and represented insurance companies and fund management organisations with a specific green or socially responsible investment mandate. The funds raised for green bonds are used for investments in energy efficiency, low carbon transport and similar government projects. Internationally this market is increasing at a fast pace. As Ben Warren, EY Global Power and Utilities Corporate Finance Leader states in his report ‘Green Bonds: Power Surge’ (p. 2) “Issuance is soaring this year, with green bond sales typically several times oversubscribed by investors hungry for yields from environmentally friendly assets.” While there are some concerns raised in this report around the integrity of some of these bonds it has certainly provided a strong source of funds. Environmental Finance held a roundtable event in November 2015 which included senior members of large investment managers, the London Stock Exchange, Treasury and other international and local issuers and investor groups in the UK. Many of the comments were of relevance to the task of enhancing the SIB market. These included from Cathrine de Coninck Lopez SRI officer for Coumbia Threadneedle Investments on fiduciary responsibilities“We would not invest in a green bond if it had worse financial characteristics than other issues, just because it was green. It is the same for our UK Social Bond Fund – we aim for social outcomes, yield and liquidity and we have very competitive returns in that portfolio and in our other funds that invest in green bonds.” Targeting new investors was also included in the discussion, Charles Smith a Senior Manager in Funding at ERBD said “..diversification of the investor base was a key reason. We specifically put together a small dark green bond programme dedicated to finding new investors.”

An innovation in the United Kingdom was the establishing of a platform listed on the London Stock Exchange called Retail Charity Bonds. This initiative was started by Allia, a charity that supports impact entrepreneurs and ventures. Overall they supply business support and finance solutions to help various ventures for social good to develop and be successful. The platform was designed to provide a “simple and transparent structure through which they (charitable organisations) could access £10-50 million of unsecured loan finance via the retail bond market at affordable transaction costs.” (Allia website) This scheme was supported by the Cabinet Office, Big Society Capital and the London Stock Exchange among other investment and legal organisations. The bonds are issued through a special purpose vehicle (SPV) called Retail Charity Bonds plc., they are listed on the London Stock Exchange and may be bought and sold on the secondary market. The bondholders receive their payment from Retail Charity Bonds plc who have been paid directly from the charities who pays them the interest on the loan the loan at the end of its term. Investors take on all the risk and are dependent solely on the charity making the payments on the loan not unlike the SIBs discussed above. These bonds are listed and can be traded on the Order Book for Retail Bonds (ORB) alongside bonds from organisations such as Tesco and the Royal Bank of Scotland. Currently there are three bonds listed, summaries of recent activity can be seen in the following table. In January 2017 Charities Aid Foundation traded 13 times for a total value of £208,384, Hightown Praetorian & Churches Housing Assoc. Ltd traded 9 times for a total value of £190,611 and Golden Lane House 3 times for a total value of £24,325. The trading is small relative to the other bonds listed on the ORB however it does provide some liquidity for the investor which is likely to increase as the market matures.

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| **Name** | **Issue Date** | **Maturity Date** | **Coupon value** | **Price range last 5 trades** | **Total Volume last 5 trades** |
| Charities Aid Foundation | 4/4/16 | 12/4/26 | 5% | 111.63 – 113.60 | 38,800 |
| Hightown Praetorian & Churches Housing Assoc. Ltd | 20/4/15 | 30/4/25 | 4% | 106.25 – 108.20 | 107,900 |
| Golden Lane House | 15/7/14 | 29/7/21 | 4.375% | 107.62 – 111.59 | 31,900 |

Source: London Stock Exchange (accessed in January, 2017)

Other markets for social investments commenced such as the UK Social Stock Exchange, Social Venture Connexion in Canada and Singapore Impact Exchange in 2013. These and the US Mission Markets launched in 2010 have not listed social investment instruments but rather appear to act more as intermediaries to some extent. So while the Retail Charity Bonds have only three bonds listed they do have transactions and are easily accessible for investors to view the market prices and the ability to trade. A similar innovation to this should be being targeted for the future to enable strong investible SIB and/or other social investment instruments in Australia.

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

**Response:**

Our response to question 2 above provides some explanation of part of our answer here. We have mentioned the international ratings agencies but suggested it is more likely to be Australian Ratings initially. However we believe the market in SIBs internationally would benefit from participation from Moodys and Standard and Poors in this market.

We also wish to note the importance of more specific government support for this investment sector. We believe the government will need to take a proactive role in encouraging the ASX to list the SIBs and for ratings agencies to commence rating the bonds. We note again in the response to question 2 the role of support from Cabinet, as well as Big Society Capital. The Bonds listed on the London Stock Exchange discussed above have a number of tax concessions which provide a significant incentive to investors in this market. These bonds are able to be included in a Self-Invested Pension Fund (SIPP) which, like all pensions in the UK, have up to 45% tax relief. Brandstetter and Lehner (2014) discuss the need for mainstream pension funds to be convinced this type of investment upholds their fiduciary duties.

The UK Government allowing SIBs to be included in a SIPP and to receive the tax relief is just the sort of convincing that is likely to be required globally. The amount of funds invested in superannuation in Australia has grown significantly in recent years since the implementation of compulsory employee super contributions. It has also seen a growth in self-managed superannuation to over $650 billion as at the end of 2016 according to APRA and the ATO. If the Australian Government could allow this type of investment to be included in superannuation investments, and thereby attaining the tax concessions in a similar way to the UK it would benefit this sector considerably. Similarly in the UK they can be included in an Individual Savings Account (ISA) where you can invest up to a set amount (approx. £15,240) and pay no interest on the interest or profits from any capital gain. While this type of tax relief is not yet available in Australia it is certainly worth noting as an indication of Government support in the UK. We can relate this market to the relatively new microfinance market. The OECD (Social Impact Bonds: State of Play and Lessons Learnt, 2016) report looks at the growth in the microfinance industry as an early model for financing social needs. This market, although it has slowed in recent years, grew significantly over the period 1997 to 2010 as can be seen below. Both in terms of the numbers of programs and the total number of clients reached.



Source: Reed and Maes, State of the Microcredit Summit Campaign Report 2012 – note data not collected for 2008.

 It was noted by the OECD report that this market had a lot of government support in the way of grants and low interest loans in its early stages. This is likely to be a significant contributor to enabling this market to grow to its current stable and self-sustaining state.

The role of the Government is significant and allows confidence in the process, the very nature of the link between the project, its benefits and the cost savings to government allows the investor to invest with confidence in the social good as the goal. This was seen in the earliest impact investment of its type, the GoodStart childcare project, while not being strictly an SIB benefited greatly from the investor confidence provided by its investment of $15million in November, 2009. It was noted in the KPMG report (2014) on the NSW Social Benefit Bonds trial the importance of the specific government department targeted to have the capacity and skills to work on the project in particular in the early stages. This aligns closely with the need for the government to be transparent about the costs and savings possible from the proposal. So who are the investors in SIBs internationally? In the SIBs that we have studied there has been, in the majority of bonds, one significant investor in each one. In the UK SIBs this has often been Big Society Capital, in the USA it has been Goldman Sachs while in Australia we find no such dominant player. We note that high wealth individuals, self-managed superannuation funds, trusts and institutions have all played a role. The 2015 Blueprint to Market (Impact Investing Australia) written by the Australian Advisory Board on Impact Investment focuses on the need for a scalable impact investment company which they have called Impact Capital Australia. Big Society Capital (BSC) also provided insights into how it has contributed to the SIB market in the UK as part of the Blueprint. The role of this company would be to provide wholesale investments into impact investments and to act as a market champion whereby it could accelerate the growth in this nascent market. The Blueprint suggests the funding for this company would initially come from government and financial institutions predominantly. This would provide strong signals to the market that the government and the finance industry in Australia support impact investing as another investment opportunity. In the Report of the Social Impact Investment Taskforce (G8, 2014) they recommended setting up an impact investment wholesales to act as a market champion. It was suggested it could be funded by unclaimed assets in bank accounts, insurance companies and pension (superannuation) funds and it would promote and support innovative finance products. It would do this by providing first loss facilities, encouraging pension funds and the like to invest in impact investment products and generally assisting the growth of this market.

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