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IMPACT INVESTING

The Australian impact investing market has grown considerably in recent years. This growth has largely been attributed to a surge of impact investments that focus on environmental, rather than social, outcomes, which is in contrast to global investor sentiment. The Allens team analyses these trends and considers how the current growth in the broader impact investing market could be capitalised for social impact investments through the implementation of proven initiatives and the removal of barriers to growth.

Key findings

- The Australian impact investing market has grown substantially in the past few years, with investor commitments quintupling, from approximately $1.1 billion to more than $5.8 billion in the years 2015–2017.[1]
- Despite this rapid growth, it continues to be heavily weighted towards environmental outcomes, as opposed to other social outcomes. For the same period, 2015-2017, impact investments, excluding green bonds, grew from approximately $500 million to $950 million.[2]
- This contrasts with overall global investor sentiment, which has generally favoured targeting investments with social impact (with 40 per cent primarily targeting social objectives, and 6 per cent primarily targeting environmental objectives); and there is no compelling reason why the Australian social impact investing market cannot capitalise on its present growth and increase investments over the coming years.[3]
- The process can be accelerated by implementing innovative initiatives and removing barriers to growth in ways that have been successfully adopted in other jurisdictions. These include: promoting the growth of intermediaries and aggregators in the market; establishing a catalyst for social impact investment growth with support from the Federal Government; incentivising existing and prospective investors to choose investments with social impact; and supporting social enterprises to grow and develop.

1 Responsible Investment Association Australia (***RIAA***), Benchmarking Impact Report 2018, page 21.

2 RIAA, Benchmarking Impact Report 2018, page 21.

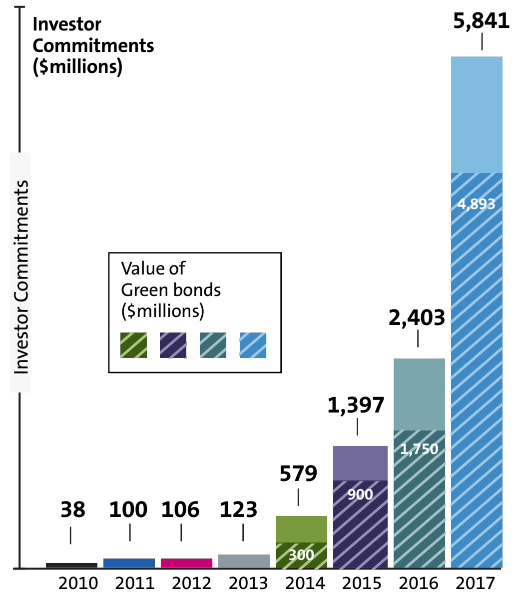
3 GIIN, Annual Investor Survey 2018, page 8.

Introduction

Global markets worldwide have continued to experience a rapid shift towards responsible investments that look beyond an expected financial return, and incorporate consideration of environmental, social, governance and ethical issues. A significant driver of this has been the growth of targeted investments (or 'social impact investments' (***SIIs***)) that aim to provide sufficient capital to projects, initiatives and businesses as a means of resolving social problems while generating sustainable financial returns for investors.

In 2015–2017, the Australian SII market saw assets under management (***AUM***) double, from about $500 million to $950 million (excluding green bonds).[4] This growth has, in large part, been attributed to investors' increased cognisance about responsible investing, which has generated significant demand from retail and institutional investors for financial institutions, investment funds and superannuation funds to, at least, consider SIIs as a viable option.

The number of impact investment products and investor commitments in Australia has grown significantly between 2010 and 2017



Despite the increase, the proportionate share of SIIs within the broader responsible investing landscape in Australia remains relatively modest. As a comparison, the core responsible investment market in Australia (which includes screening, sustainability themed investing, impact investing and community finance) had AUM in excess of $180 billion.[5]

This report explores the emergence of social impact investing in Australia, with a particular focus on investments targeting social (as opposed to environmental) outcomes; considers the barriers to the growth of such investments; and offers some suggestions to further drive growth in SIIs.

4 RIAA, Benchmarking Impact Report 2018, page 21.

5 RIAA, Benchmark Report (Australia) 2018, page 12.

What is SII?

The responsible investment spectrum

Responsible investment is a broad concept that involves the consideration of environmental, social, governance and ethical issues in the investment decision-making process. There is no precise definition of the term, but responsible investment is most easily understood as a spectrum. This ranges from investments with a preference for addressing environmental, social, governance or ethical issues (while maintaining the sole purpose of obtaining financial return), to philanthropy that directly targets positive change with no expectation of financial benefit.

The most well-known form of responsible investment is the adoption and maintenance by companies, superannuation funds and fund managers of an environmental, social and governance (***ESG***) policy or procedure. It is estimated that more than $650 billion worth of AUM in Australia have investments that have integrated some form of ESG.[6]

	TRADITIONAL INVESTMENT[7]	RESPONSE & ETHICAL INVESTMENT						PHILANTHROPY
		ESG INTEGRATION (including shareholder engagement & voting)	NEGATIVE SCREENING (& norms based)	POSITIVE OR BEST-IN-CLASS SCREENING (& norms based)	THEMATIC SUSTAINABILITY THEMED INVESTMENTS	IMPACT INVESTING: MARKET RATE	IMPACT INVESTING: CONCESSIONARY RATE	
FOCUS	Limited or no regard for environmental, social and governance factors	Consideration & analysis of environmental, social and governance (ESG) factors as part of investment decision making	Industry sectors or companies excluded/ divested from to avoid risk or better align with values	Investments that target companies or industries with better ESG performance	Investments that specifically target sustainability themes eg, clean energy, green property	Investments that target social and environmental impact and deliver market rate financial returns	Investments that target social and environmental impact and deliver below market rate returns	Grants that target positive social and environmental impact with no financial return

SIIs as a responsible investment

SII is a subset of responsible investments that goes beyond merely considering environmental, social and governance factors in the investments process, and invests with the purpose of resolving particular social or environmental problems in the local or global community.

There is a lack of common understanding of what investments are. At their widest, impact investments may encompass any investment with a positive social or environmental impact. These may include investments that broadly focus on the theme of sustainability, and target areas such as sustainable property development, forestry and carbon-reduction funds, and sustainable industries and companies.

On the other hand, impact investments may adopt a much narrower meaning, and refer to investments targeting a specific social or environmental issue. Examples are investments in social enterprises that have a social or environmental purpose, or the use of social impact bonds by governments to resolve specific issues such as homelessness or reducing recidivism. This report considers SIIs within the scope of the narrower meaning of impact investments.

6 RIAA, Benchmark Report (Australia) 2018, page 12.

7 RIAA, Benchmark Report (Australia) 2018, page 7.

Environmental vs social outcomes

The current Australian impact investing market is heavily weighted towards addressing environmental outcomes. This is in contrast to overall global investor sentiment, which has generally favoured targeting investments with social impact, as opposed to environmental impact.[8] As at 31 December 2017, it was estimated that, on a dollar-weighted basis, environmental-related investments made up 96 per cent AUM of SIIs in Australia (or approximately $5.6 billion AUM).[9]

As an illustration, the total SII market for Australia in 2017 was more than $5.8 billion AUM, of which approximately $4.9 billion AUM related to investments in green bonds.[10] Green bonds are bonds that are specifically earmarked to fund particular environmental and climate projects (eg, renewable energy projects and clean energy technology).[11] The federal statutory authority, the Clean Energy Finance Corporation (the ***CEFC***), has been an important factor in the establishment and expansion of this market.[12] Green bonds have grown significantly over the past few years and at least 84 per cent of the Australian SII market is concentrated in this one type of impact investment.

8 GIIN, Annual Impact Investor Survey 2018, page 8.

9 RIAA, Benchmarking Impact Report 2018, page 10.

10 RIAA, Benchmarking Impact Report 2018, page 10.

11 Climate Bonds Initiative, Explaining green bonds.

12 Clean Energy Finance Corporation website.

While this report focuses on SIIs targeting social outcomes, the rapidly growing environmental-related SII market is a reminder of the capacity for growth that SIIs may have in Australia.

The growth of SII in Australia

In Australia, SII is still an emerging investment approach, which has experienced rapid growth over the past decade. In 2010–2017, investor commitments in SII (excluding green bonds) rose from about $38 million to $950 million, which represents a boost of 2,500 per cent within seven years.[13]

Recently, the Federal Government started to play a role in developing SIIs as a means to generate savings and avoid future costs in areas where it has direct policy responsibility (such as targeting homelessness, welfare and services for Indigenous Australians).

On 20 October 2015, the Government committed to preparing a discussion paper to explore ways to facilitate methods to develop SII in response to the Financial System Inquiry's recommendation to develop the Australian SII market and encourage innovation in funding social service delivery.

The discussion paper was released in January 2017, and the Government subsequently announced approximately $38 million of funding to develop SII in Australia in its 2017–2018 and 2018–2019 Federal Budgets. The budget measures included $22 million used to support Commonwealth–state social impact investments, and a further $7.5 million for a Sector Readiness Fund to support non-governmental organisations bringing new SIIs to the Australian market.[14] Recently, the 2019–2020 Federal Budget committed $5 million to establish a taskforce to examine the Government's role in the SII market, and a further $14.1 million over the next five years to establish three SII trials in the social services sector.[15] Despite the significant growth in SII since 2010, these amounts are still tiny when compared with Australian funds under management (with, for example, superannuation fund assets totalling $2.7 trillion as at December 2018). [16]

Sector Readiness Fund

The Sector Readiness Fund (the ***SRF***) was established as part of the Federal Government's 2018–2019 Budget. The SRF's purpose is to assist with 'capability building for non-government organisations to bring new social impact investments to market'.

Throughout May 2018 to June 2018, the Federal Government invited applicants to undertake the role of fund administrator for the SRF, for the purpose of selecting and distributing grants from it. In November 2018, Impact Investing Australia was appointed fund administrator.

The SRF commenced operation shortly afterwards, and has been rolled into the existing Impact Investment Ready Growth Grant established in 2015 by Impact Investing Australia, with seed-funding from National Australia Bank, to provide grants of up to $140,000 to the SII market. [17]

13 RIAA, Benchmarking Impact Report 2018, page 21.

14 Pro Bono Australia, Impact Investing Budget Update.

15 Treasury, Budget Measures Budget Paper No. 2 (2019-20).

16 ASFA, Superannuation Statements (December 2018 quarter).

17 Impact Investment Ready Growth Grant, Introducing: Growth Grants.

The global state of SII

The emerging nature of the Australian SII market is in contrast to other well-established markets worldwide. By the end of 2017, the global impact investing market had approximately US$228 billion AUM, of which only around US$18 billion was within the Oceania region, compared with US$45 billion in US and Canada. The impact investing market continues to gather pace, and an additional US$38 billion of capital was expected to be invested throughout last year.[18]

While Australia has started to build the infrastructure to support the growth of SIIs (such as the Sector Readiness Fund), other developed countries have had such infrastructure for a number of years. For example, in 2012, the UK Government, with the support of major UK banks, set up an independent specialist financial institution, Big Society Capital, to support social investment in that jurisdiction.

Big Society Capital

Big Society Capital (***BSC***) was established in 2012, as a joint project between the UK Government and major UK banks (Barclays, HSBC, Lloyds and RBS) with the mission of 'improv[ing] the lives of people in the UK by connecting investment to charities and social enterprises that are creating social change'.[19] The capital is sourced from dormant bank and building society accounts (~£300 million) provided through Big Society Trust's investment in Class A shares, and the participating banks' investment in Class B Shares (~£200 million, but with voting rights capped at 5 per cent).

Since inception, BSC has either established or funded innovative initiatives, with the purpose of growing the impact investing market and 'ecosystem' in the UK, helping social enterprises to build capacity, and generating additional scale for investments. The intention is that BSC should ultimately run down its funding when an ecosystem would (hopefully) be in place. A few notable examples BSC has pioneered (which could also be implemented in Australia) are:

- in conjunction with the UK Government and the Big Lottery Fund, BSC launched the Foundation for Social Investment (***Access***) in 2015. Access was established with the purpose of assisting the 'emerging social investment market' in the UK by improving access to funding for certain social enterprises and charities.[20] This is achieved in two ways: providing flexible finance (in the form of grants with loans of up to £150,000) to social impact intermediaries, which then offer direct funding to charities and social enterprises; and supporting existing charities and social enterprises through grants and peer-based learning;[21]
- the establishment of the Crowd Match Fund in December 2016, which aimed to take advantage of the growth in crowdfunding platforms.[22] BSC committed £10 million to

18 GIIN, Annual Impact Investor Survey 2018, page 7.

19 BSC, About Us.

20 BSC, The launch of Access: The Foundation for Social Investment.

21 Access, The Growth Fund and the Enterprise Development Programme.

22 BSC, Crowd Match Fund.

match crowdfunded investments in Social Investment Tax Relief eligible charities and social enterprises (which may raise a maximum amount of £1.5 million through such investments), in order to 'encourage greater participation by the crowd in funding socially motivated projects' and to promote additional capital raising by charities and social enterprises; and

- providing grants to social enterprises to help them build scale and capacity.

At a practical level, BSC has also found it was able to act as an 'interpreter' between social enterprises seeking investment and institutional investors, who often spoke a different commercial language.

By the end of 2018, BSC and its co-investors had, since its establishment, made cumulative investments of more than £1.7 billion to charities and social enterprises.[23] Importantly, BSC does not typically directly invest in such charities and social enterprises, but invests through intermediaries that provide finance to those entities. Examples of those intermediaries are social venture funds, social impact bonds, social banks and advisers and arrangers. In this way, it is able to support the growth of a broader SII ecosystem.

BSC itself has confronted some of the barriers identified below, such as the difficulties in measuring the performance of impact investments; and has also faced some criticism (eg, that it is simply a more complicated and inefficient way to spend money that the UK Government would have spent on social matters anyway).

Barriers to impact investing

One of the factors in the underdeveloped nature of SIIs in Australia is the relatively late entrance of impact investing as a viable investment option in the market. This contrasts with countries such as the UK that have considered SII as a means to resolve social issues since at least 2011, when the Government published its policy paper on growing the social investment market.[24]

In Australia, as demand for social impact investing rises, it continues to face a number of barriers that constrain further development or slow down its rapid growth. It is generally accepted that ways to tackle the following barriers should be looked at, so as to further develop the SII market
in Australia:

- insufficient scale for SIIs in the market;
- investor concerns regarding measurement and quantum of financial and/or social return;
- uncertainty regarding the interaction of the *Superannuation Industry (Supervision) Act 1993* (Cth) (the ***SIS Act***) and SIIs for superannuation funds; and
- the potential for additional government policies or initiatives to further SII growth.

23 Big Society Capital, Our Investment Numbers .

24 UK Government, Growing the social investment market: a vision and strategy report
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Insufficient scale / high start-up costs

The lack of scalability for SIIs has acted as an effective barrier for many investors. Scale in this context encompasses factors including the investment size of viable SIIs; the availability of SII opportunities in the market; the cost of investing in SIIs; and the leveraging of SIIs for more substantive social outcomes (in contrast to focusing on a single project or initiative).

This problem is particularly prevalent for institutional investors, who, although generally having a much greater investment appetite, experience difficulty identifying sufficiently large SII opportunities that are both viable from a risk/return perspective and readily available. As a large superannuation fund has commented: '*Impact investing is challenging for most funds because it is hard to find opportunities in an immature market that isn't yet scalable*'.[25]

The emergence of government-supported funds and initiatives, such as the SRF, may assist by providing much-needed funds for small-scale innovators with a view to generating scale and impact, but the investment size and availability of SIIs in the market for current investors still have a way to go before being comparable to those in countries such as the UK and US.

Further, the lack of sufficiently large-scale and viable SII opportunities has the consequence of requiring higher start-up costs for investors wishing to enter the market. This results from both the lack of a broader pool of specialists for investors to draw upon (as there is insufficient incentive to train experts in a small market) and the lower quantum of returns from smaller-scale investments. For example, from a cost/benefit perspective, the high due diligence costs may act as an effective deterrence for institutional investors, on the basis that such costs are disproportionately high in comparison with the estimated returns from a small-scale SII.

Obligations of superannuation trustees

The superannuation industry has long been perceived as a latent capital source for investment in SIIs. As at 2018, pension funds and insurance companies had almost US$30 billion AUM (or 13 per cent of total AUM) in impact investments worldwide.[26] Australian superannuation funds could undertake a similar role locally, with the Australian Prudential Regulation Authority (***APRA***) estimating that superannuation assets totalled around A$2.8 trillion at the end of the September 2018 quarter (or A$1.8 trillion excluding self-managed superannuation funds).[27]

Superannuation funds are required to make decisions in the best interests of members, under both general trust law and section 52 of the SIS Act. Traditionally, this duty has been interpreted as synonymous with maximising financial return for members. Superannuation trustees must also comply with the overriding 'sole purpose test' in section 62 of the SIS Act, which requires that the fund is maintained solely to provide retirement benefits to members.

25 Investment Magazine, Christian Super, HESTA: impact investing two ways, Andrew Major, General Manager, Unlisted Assets, HESTA.

26 GIIN, Annual Impact Investor Survey 2018, page 22.

27 APRA, Superannuation Statistics for September 2018.

In 2014, the Financial Systems Inquiry queried whether explicit guidance is required from APRA in relation to the appropriateness of SII in light of the aforementioned obligations. APRA addresses ethical investments in its existing SPG 530: *Investment Governance*, which clarifies that trustees 'may take additional factors into account where there is no conflict with the requirements in the SIS Act'. APRA provides an example in relation to offering an ethical investment option that has an added focus on ESG considerations, or incorporates such considerations in the formulation of the investment strategy and supporting analysis.

Industry responses to this issue have been mixed. Some respondents to the Government's position paper dated January 2017 have noted that the APRA guidance conflates ESG and other forms of responsible investment (such as SII) that are not purely non-financial or are more than simply 'considerations' for the investment decision-making process.[28]

This position contrasts with the view taken by many superannuation funds that no additional guidance is required.[29] In their view, ancillary benefits, such as positive social outcomes, do not deter investment by superannuation funds but trustees must consider them as if they were any other investment by the fund (ie, the decision-making process should be the same as for any other investment, such as those that have a pure financial benefit).

APRA could provide additional clarification and guidance (such as explicitly referencing SIIs) to remove all uncertainty in relation to superannuation trustees pursuing SIIs. However, this is unlikely to change the existing position adopted by the industry that is already participating in SIIs. For example, superannuation funds such as HESTA and Christian Super already have strategies to specifically target impact investing on behalf of its members.

Given the increasing focus of investors on 'ethical investing', funds may also consider offering products which explicitly allocate part of the relevant portfolio to SII – members who choose to invest in this portfolio would be signalling their express desire to invest in SII.

HESTA

HESTA is an example of an Australian superannuation fund actively engaging with social impact investing.

It launched its Social Impact Investment Trust in 2015, with an initial commitment of $30 million. The fund has historically invested in a broad range of investments, including debt, capital and social impact bonds in sectors such as health, housing and community services. Last year, the fund size more than doubled, with HESTA making an additional commitment of $40 million.[30]

The fund leverages the expertise of Social Ventures Australia as investment manager. To date, key investments made by the fund have included a $6.7 million loan for the development of social and affordable housing in Queensland, and a $19 million loan to fund the design and construction of a specialist dementia care facility in Tasmania.

Government policies to promote further growth

The Federal Government has adopted a facilitative role in the development of the Australian SII market. This includes funding of the SRF and state governments through their existing social impact bond programs, and committing to support 'priority groups', to identify further local SII opportunities. To date, however, the Government has not proposed to amend existing laws or to lead any project with the purpose of promoting further SII growth.

This position contrasts with, for example, the UK Government assisting with the establishment of BSC, which was partly funded using dormant bank and building society account funds. In Australia, such funds would be akin to unclaimed monies in deposit accounts that are transferred to the Commonwealth of Australia Consolidated Revenue Fund.

The Government's position paper dated January 2017 flagged a number of additional considerations regarding promoting SII growth in Australia, such as: taxation law in relation to impact investments by certain investors (eg ancillary funds); and the lack of a purpose-built legal structure being available to social enterprises.

Perceived concerns with metrics and return

A lack of reliable data in an emerging market continues to generate a level of uncertainty for investors about the expected financial return for SIIs. This is in contrast to impact investments in other developed jurisdictions, which have the benefit of a track record that has generally resulted in financial returns at prevailing market rates.[31]

For the Australian SII market, investors may take comfort from the fact that existing data on expected financial returns will only become more reliable and accurate as further investments are undertaken over time. This process is already taking place with the assistance of not-for-profit and industry bodies (such as the Responsible Investment Association Australasia), which are gathering and publishing data on investment returns in the SII market.

The same investor and stakeholder concerns apply in relation to the measurement of social impact for Australian SIIs. Existing measurements are, at times, seen as being overly complex and hard to quantify or compare, due to difficulties in assessing the performance of assets designed to deliver social benefits.[32] For example, social impact bonds targeting the specific issue of homelessness may have far broader implications for society (such as reduced recidivism).

While this may currently be the case, market-standard metrics for social impact are likely to develop alongside the growth of transactions undertaken in the market. This may, in part, be assisted by existing activities undertaken by research bodies specialising in measuring social impact, or by the Federal Government, which allocated around $6.7 million in the 2018–2019 Budget to conduct longitudinal studies and develop an impact framework over the next four years.

28 See eg, the RIAA and Impact Investing Australia submissions.

29 See eg, the HESTA, UniSuper and ASFA submissions.

30 See Pro Bono Australia, HESTA commits $40 million to Australia's impact investment market and Social Ventures Australia, Social Impact Investment Trust .

31 See eg the GIIN, Annual Impact Investor Survey 2018, page 3.

32 RIAA, Benchmarking Impact Report 2018, page 37.

Possible solutions

This report does not propose to offer an in-depth or exhaustive set of solutions to the issues raised in the previous section. Rather, it will outline a number of ideas proposed by SII market stakeholders that may, in our opinion (and with appropriate development), be viable methods of reducing barriers to the existing Australian SII market.

Intermediaries and aggregators in the SII market

Intermediaries that are focused on mobilising SII are often seen as a driving force behind the rapid growth of these investments globally. Some countries, such as the UK, are actively supporting intermediaries as a way to generate scale in the SII market. With more than £500 million in capital, BSC's strategy is to invest only in intermediaries, with the view that they are in the best position to generate even greater investment in SIIs. Having been in operation for over eight years, BSC has experience in fostering intermediaries; experience from which other catalysts might learn. For example, BSC learned not to impose too many financial restrictions on intermediaries which are starting out – an intermediary might benefit more from being given three years' working capital than a smaller stipend linked to performance.

Many intermediaries effectively act as aggregators for SIIs, and can range from social venture funds that aggregate investor funds with the purpose of targeting specific types of SIIs on a large scale (such as investments in social impact bonds), to social banks, which use their capital to offer funding to charitable groups, social enterprises or the local community.

In the Australian SII market, the use of intermediaries to generate scale is still a developing concept, but one that has so far proven successful. For example, companies such as Social Ventures Australia (***SVA***) are establishing investment funds to support a broad range of social enterprises and impact initiatives. As an aggregator in the SII market for investments that would otherwise lack scale, these intermediaries will continue to play a major role in the future of social impact investments in Australia.

SVA Diversified Impact Fund

Last year, SVA closed its second wholesale fund, the SVA Diversified Impact Fund, which invests in social impact organisations and housing projects (with key focuses on disability, education, employment, First Australians, health and housing). The fund reached its maximum investment size of $15 million, and will provide finance (with a target size of $500,000 to $1.5 million) in the form of debt, equity or social impact bonds to its target investees.[33]

Notably, the fund featured a 'downside protection' of 20 per cent of total capital commitments ($3 million), to incentivise investment. The downside protection will be exercised if, at the time capital and income distributions are paid, investors receive less than $1 per unit (ie, investors receive the benefit of any positive return and are guaranteed to be repaid their capital commitment to the extent that there is a negative return up to $0.20 per unit). This downside protection is funded by callable loans with eight different private ancillary funds.

33 SVA Diversified Impact Fund Information Memorandum.

Leveraging banks in the SII market

Major global retail, commercial and investment banks are starting to become involved in the SII market, leveraging their strong reputations and existing networks of investors to establish or advise on new funds and investments with a social or environmental impact purpose. An example is the UBS Oncology Impact Fund, which raised US$471 million when it was established in 2016. The fund's purpose is to invest in oncology research and cancer care access in emerging markets.[34]

In Australia, banks have already dived into the impact investment market but, so far, have mostly been involved in relation to impact investments that target environmental (as opposed to social) outcomes. The four largest banks have all issued their own green or climate bonds. For example, Westpac raised $500 million for its first-issued climate bond in 2016, which had the purpose of funding renewable energy and carbon-friendly commercial property.[35]

Impact investments issued by banks could be expanded to incorporate a broader range of impact investments, including those targeting social outcomes. Involvement by banks in SIIs would not be a novel concept, with NAB issuing an innovative $500 million social bond targeting Australian businesses that promote gender equality and women in 2017.[36]

Establishing SII-friendly vehicles

Innovative corporate structures can encourage impact investment at the social enterprise level by facilitating their growth. There are two examples of such corporate structures in the US:

- **Benefit corporation**: Multiple US states permit the incorporation of a 'benefit corporation'. These corporations must generally pursue a 'public benefit', and directors have an expanded fiduciary duty to consider non-financial interests (in contrast to the established purpose of maximising financial gain for shareholders).[37] While benefit corporations may cater to a larger group of entities and are not limited to those with a social impact purpose (eg Patagonia, the outdoor clothing and gear company, is a registered benefit corporation), the corporate structure would assist social enterprises to focus primarily on their impact.
- **Low-profit limited liability company (*L3C*)**: Similar to the benefit corporation, a L3C must significantly further one or more charitable or educational purposes (within the meaning of the Internal Revenue Code: ie religious, charitable, scientific or educational purposes, etc.) and not have a significant purpose to produce income or acquire property. This does not, however, prohibit the L3C from producing significant income or capital appreciation in the course of its operations (eg, to return to investors).[38]

While the above may assist the supply-side for SIIs, the demand-side can be addressed with the establishment of new investment

34 UBS, Crossing the valley .

35 Westpac, Wesptac prices its first Climate Bond.

36 NAB, Investors put $500 million behind world's first social bond promoting workplace gender equality.

37 See eg Justice & Diversity Center's Memorandum on Benefit Corporations in California.

38 See eg Low-profit limited liability companies legislation in Vermont.

vehicles that incentivise impact investing. These investment vehicles are likely already to exist in Australia and simply need to be modified for SIIs. For example, early stage venture capital limited partnerships incentivise investment in the early stage venture capital market, by offering tax benefits for both fund managers and investors.[39] Could these be modified so that the same tax benefits apply to SIIs (eg, with the establishment of a 'social impact investment limited partnership')?

Presence of a SII catalyst

As noted above, BSC and its mandate to develop an SII ecosystem, to directly invest in intermediaries, and to 'crowd in' investment by co-investors, has been a key factor in the significant growth of the UK impact investment market. More recently, Japan adopted a similar approach to addressing scale in the impact investing market, and passed the *Dormant Deposit Utilisation Act* to establish a fund similar to BSC.[40] The fund will commence this year and capital for it (an estimated ¥50 billion) will be derived from dormant bank accounts.[41]

An SII catalyst would likely be equally as effective in Australia. Similar to the CEFC in Australia and the impact investing catalysts established in the UK and Japan, this catalyst is likely to require initial funding from both the Government and private institutions (such as banks) to obtain sufficient capital to grow the impact investing market. While proposals for a catalyst have previously been made (eg Impact Capital Australia), the Federal Government has not committed to the funding or establishment of such an entity.

Impact Capital Australia

In a submission to the Federal Government's 2018–2019 Pre-Budget, Impact Investing Australia suggested that a new wholesale institution, Impact Capital Australia (***ICA***), could be the catalyst for impact investing in Australia, by acting as a national wholesaler investing in intermediaries.[42]

ICA would require a one-off $150 million Federal Government grant, and would seek the remainder of the funding from mainstream financial institutions ($120 million) and through philanthropy and from other high-net wealth investors ($30 million). It was estimated that ICA would be able to continue to grow the market into the long term and would have a self-sustaining cash flow within seven years.

The investment mandate for ICA would be substantially similar to BSC's, and include supporting and funding new and existing intermediaries and aggregators in the impact investing market. While the Pre-Budget submission noted that ICA could have been operational after December 2018, the Federal Government did not allocate funding in the 2018–2019 Budget.

Clean Energy Finance Corporation

In Australia, the use of a catalyst to stimulate private-sector investment has been proven to work, including in the area of investing for environmental impact and innovation.

An example of a successful catalyst is the CEFC, which was established as a statutory authority by the Federal Government in August 2012, to 'mobilise investment in renewable energy, low-emissions and energy efficiency projects and technologies in Australia, as well as manufacturing businesses and services that produce the required inputs'.[43]

The CEFC was provided with $10 billion in funding over a period of five years, from 2013 to 2017, using annual appropriations. In contrast to the BSC in the UK and the proposed catalyst fund in Japan, which invest in intermediaries, the CEFC directly invests alongside private investors in projects, technologies and initiatives that reduce Australia's carbon emissions.[44]

As at 30 June 2018, the CEFC had committed in excess of $6.6 billion to clean energy investments, with a corresponding commitment by private investors of more than $11.5 billion. As a catalyst in the clean energy and renewables investments market, each dollar of CEFC investment commitments made in 2017–2018 were matched by more than $1.80 of private sector finance.[45]

Removing existing regulatory barriers

The Federal Government may – in addition to providing support to SIIs by funding initiatives and projects (whether partnering with state governments to issue new social impact bonds or to provide capital for a catalyst in the market) – incentivise new investment, or assist existing stakeholders in the SII market, by removing existing regulatory barriers in the following two areas.

A relatively untapped sector of investors that the Government could open up to SIIs is registered public and private ancillary funds. Registered ancillary funds are trusts that have registered with the Australian Charities and Not-for-Profits Commission and been endorsed by the Australian Tax Office (the ***ATO***) in order to receive exemption from tax on the fund's income and the capacity to receive donations that are tax deductible to the donors.[46] In 2018, private ancillary funds alone distributed an estimated $500 million to deductible gift recipients.[47]

At present, ancillary funds:

- must invest their funds under an investment strategy that is aimed at achieving a return on funds to maximise its capacity to make payments to eligible recipients (taking into account various factors, including risks); and

39 Federal Government, Early Stage Venture Capital Limited Partnerships (ESVCLP).

40 Euromoney, Dorman bank accounts boost social finance growth.

41 The Japan Times, The rise of social impact bonds in Japan.

42 ICA, Pre-Budget Submission 2018-2019.

43 CEFC, Complying Investments Guidelines. See also the *Clean Energy Finance Corporations Investment Mandate Direction 2018.*

44 CEFC, Where we invest'.

45 CEFC, Annual Report (Investing for impact and innovation).

46 See information on ancillary funds at the ACNC and ATO websites.

47 AFR, Philanthropy 50: Australia's most generous givers.

- are limited to providing benefits to eligible recipients that are themselves deductible gift recipients endorsed by the ATO, such as an entity engaged in activities for the relief of poverty, the advancement of education or other endorsed benevolent activities.

A SII may not necessarily fall within either of these categories for the placement of funds by investment or grants by ancillary funds. The uncertainty could be overcome by expressly permitting ancillary funds to make an investment in, or a grant of funds to, an entity that is implementing an SII, according to well-defined criteria that align with SII principles.

To assist existing stakeholders in the SII market, compliance costs associated with the disclosure obligations, such as the preparation of a prospectus in relation to the issue or sale of securities (which includes debentures and interests in a managed investment scheme) could be either waived or modified for SIIs. A waiver of this regulatory requirement would not be novel, as existing charitable investment fundraisers are already exempt from complying with such requirements.[48] Any compliance cost saved could be used by the entity subject to disclosure (eg, an intermediary) to undertake further activities to grow the SII market in Australia.

Next steps

The Australian SII market will no doubt gather pace as interest in responsible investment options grows. This doesn't mean that stakeholders and the Federal Government should sit idle and await organic growth in the market.

This report has proposed a number of additional steps in the short term to accelerate the expansion and scaling of Australian SIIs. They include:

- capitalising on the introduction of new and innovative intermediaries in the market, including entities undertaking the role of aggregator for SIIs;
- encouraging growth at the downstream level, by providing more flexible and suitable corporate structures for social enterprises;
- establishing an SII catalyst that is able to invest in and support the growth of intermediaries to create sufficient scale and expertise in the market, and to be a steward of that market; and
- removing existing regulatory barriers that may either be inhibiting growth of existing stakeholders in the market or are currently acting as a disincentive to investment.

48 See the *ASIC Corporations (Charitable Investment Fundraising) Instrument* 2016/813.

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