

1 December 2014

Inquiry Secretary, Joint Standing Committee on Foreign Affairs, Defence and Trade  
Suite R1-120  
Parliament House  
Canberra ACT 2600

**Re: Role of the private sector in promoting economic growth and reducing poverty in the Indo-Pacific region**

Impact Investment Group gave evidence at the public hearing in the above inquiry on Friday 7 November 2014 in Sydney.

This letter provides supplementary information on two of the matters discussed:

1. The situation with private ancillary funds; and
2. The potential role of government in encouraging impact investments in the Indo-Pacific region, including examples of tax incentives internationally and existing impact investments in the region.

## **1. Private Ancillary Funds**

### ***History***

In 1999, the Business and Community Partnerships Working Group on Taxation Reform released a report on improving philanthropy in Australia. In response, the Howard Government introduced the Prescribed Private Fund (PPF). Donations into PPFs were tax deductible and PPFs were required to make a minimum distribution of net income each year to eligible deductible gift recipient (DGR) organisations.

From 1 October 2009, new legislation and guidelines converted PPFs to Public Ancillary Funds (PAFs). One of the changes included replacing minimum annual distributions from an income measure to 5% of assets. This model was adopted from the United States.

### ***Clarifying whether discounted returns can count towards minimum distribution requirements***

Some PAFs are unclear whether they may count discounted financial returns towards minimum distribution requirements.

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

“If a public ancillary fund invests in a social impact bond issued by a deductible gift recipient with a return that is less than the market rate of return on a similar corporate bond issue, the fund is providing a benefit whose market value is equal to the interest saved by the deductible gift recipient from issuing the bond at a discounted rate of return.”<sup>1</sup>

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<sup>1</sup> PuAF Guidelines r 19.3.

Currently, the *Private Ancillary Fund Guidelines 2009* (Cth) do not replicate this provision. Despite this, some trustees assume that this arrangement applies in the context of PAFs. Therefore, the Government should replicate this provision in the PAF Guidelines in order to remove the current uncertainty and clarify the position of PAF trustees. The Government should clearly specify the criteria, if any, that an investment must meet before its discounted returns can count towards a PAF or PuAF's minimum distribution requirements.

In the US, program-related investments can be counted towards a foundation's 5% minimum annual distribution. A program-related investment (PRI) is a type of mission or social investment that foundations make in order to achieve their philanthropic goals. PRIs can employ a wide variety of financing methods, such as loans (senior and subordinated), loan guarantees, lines of credit, linked deposits, cash deposits, bonds, equity investments, and other transactions designed to help charitable organisations and social enterprises access capital funding. PRIs are expected to be repaid, often with a modest rate of return.

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

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

At the time the investment is made, the rate of return must be expected to be below prevailing market rates on a risk-adjusted basis in order for the investment to qualify as a PRI for tax purposes. Once repaid, these funds can be used for subsequent charitable investments. Arguably, the position should be similar in Australia. By clearly allowing PRIs, PAFs would be able to leverage their financial resources more effectively, and deliver more community benefit. It is not a market distorting mechanism.

### ***Fiduciary duties***

Some philanthropic (and superannuation) trustees consider their fiduciary duties to be a barrier to impact investment.

As Social Ventures Australia pointed out in their submission to the Financial Systems Inquiry, trust law across Australia requires all trustees, including trustees of private ancillary funds, to act on behalf of beneficiaries without the flexibility of taking into account any social or community impact of an investment. When investing trust money, case law indicates that the trustee *must be primarily concerned with the financial advantage of the trust*.<sup>4</sup> In contrast, the UK Charity Commission released guidance in 2012 explaining to UK trustees of charities that ethical considerations are relevant for investment decisions, even if the investment might provide a lower rate of return than an alternative investment.<sup>5</sup>

It would help encourage impact investment if this situation was further clarified in Australia.

## **2. Role of government in encouraging impact investments in the Indo-Pacific region**

There were four initiatives that were specifically discussed at the hearing:

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<sup>2</sup> The exempt purposes are described in s170(c)(2)(B) of the Internal Revenue Code.

<sup>3</sup> Mission Investors Exchange, Linklaters, TrustLaw, *Strategies to maximize your philanthropic capital: a guide to program related investments*, April 2012

<sup>4</sup> *Cowan v Scargill* [1985] 1 Ch 270.

<sup>5</sup> See more at [http://www.charitycommission.gov.uk/publications/cc14.aspx#c3\\_](http://www.charitycommission.gov.uk/publications/cc14.aspx#c3_)

1. Development impact bonds. These were also discussed by Professor Shergold and will not be further elaborated on here.
2. Government providing catalytic capital for impact investments. The Government could provide first-loss investment capital or bank guarantees/underwrites to support capital structures that would otherwise not be viable. This kind of catalytic capital de-risks investments for other investors, enabling higher loan to value ratios and/or reduced cost of funds from debt providers.
3. Tax incentives for impact investments. These will be discussed further below.
4. Capacity building funding for social enterprises. Social enterprise is a more sustainable way to alleviate poverty and accelerate economic growth in some areas than traditional grant funding. If government used some of the aid budget to capacity build social enterprises in the Indo-Pacific region, it would arguably help create more sustainable solutions to some of the problems in the region. There are many social enterprises relating to health and education, the areas that form the largest part of the foreign aid budget.

All four of these initiatives could help catalyse private investment in initiatives that promote economic growth and reduce poverty in the Indo-Pacific region. As Mr Ruddock commented, if the Government has \$1 billion to spend on overseas aid, and uses it in a different way to get \$1.5 billion, that is a very good outcome.

### **Tax incentives**

The Committee asked for examples of tax incentives to promote private sector impact investment.

The March 2013 Report, *The Role of Tax Incentives in Encouraging Social Investment*, published by the City of London and Big Society Capital, is a useful resource. It is available here: <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-WebPDF.pdf>

This study discusses the implications of providing tax incentives specifically for social investments.<sup>6</sup> The major challenge in the market was identified as the funding gap between investors and social enterprises. The report emphasises that growing the social investment market requires a move away from the provision of grants and subsidies that reinforce a culture of reliance and dependence. The report found that tax relief for social investment would be most likely to be utilised by high net worth individuals who are interested in social investment. Those individuals indicated that the lack of tax incentives acted as a barrier to making such investments.

This paper greatly influenced the creation of the Social Investment Tax Relief Scheme (SITR) in the UK. Under the SITR scheme, announced in 2014, investors are able to deduct 30% of the cost of an eligible investment, with a minimum investment period and a maximum investment amount imposed.<sup>7</sup> There are certain eligibility requirements for the investment, for the investor, and for the social enterprise invested in.

Under the United Kingdom's *Finance Act 2014*, tax relief is provided for investments in charities, community interest companies and community benefit societies, and in certain types of social impact bonds.

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<sup>6</sup> Worthstone 2013, *The Role of Tax Incentives in Encouraging Social Investment*. Available at: <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-WebPDF.pdf>

<sup>7</sup> UK Government – Cabinet Office, *Social Investment Tax Relief*. Available at: <https://www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief> [6 April 2014].

The Government should consider the UK experience as it contemplates using some of the aid budget to incentivise private investors to invest in the Indo-Pacific region.

### **Examples of impact investment in the region**

The Jasmine Foundation in New Zealand has made a number of impact investments in the Indo-Pacific region. If the government put in place the right incentives, arguably Australian foundations would be more likely to make impact investments that would help promote economic growth and reduce poverty in our region.

Investment	Location	Activities	Outcomes/ Impact
<b>SPBD Network</b>  Source:  <a href="http://www.spbd.ws">www.spbd.ws</a>  <a href="http://www.jasmine.org.nz/who-we-fund/">http://www.jasmine.org.nz/who-we-fund/</a>	Samoa/ Fiji/ Tonga/ Solomon Islands	<p><b>Mission:</b> moving families out of poverty. SPBD hopes to establish a region-wide, well-managed, efficient and financially sustainable microfinance network that will improve the quality of life of people living in poverty in the South Pacific.</p> <p><b>Business model:</b> microfinance institution that follows a modified Grameen Bank methodology in providing financial services to the poor. SPBD provides unsecured credit for micro-entrepreneurial purposes, home improvements and childhood education. It also provides micro-enterprise training and access to savings and insurance services.</p> <p><b>Annual budget:</b> US\$1.1m in Samoa, US\$820k in Tonga and US\$1.2m in Fiji and \$270k in Solomon Islands for FY13 (Dec-13).</p> <p><b>Jasmine Foundation's investment so far:</b> Loans to Samoa (WST1.4 million), Tonga (TOP\$1 million), Fiji (NZ\$750,000) and Singapore (NZ\$500,000, AU\$400,000 and US\$400,000). Disaster relief grants to Samoa (WST100k) and Tonga (NZ\$100k).</p>	<p><b>Delivered to date:</b> Provided over 40,000 unsecured loans totalling over US\$42 million, helping launch over 27,000 micro-businesses maintaining a default rate of less than 2%.</p> <p><b>Outcomes:</b> Financed housing improvements for 20,000 families and education for over 40,000 children.</p>
<b>Medic Mobile</b>  Source: <a href="http://www.jasmine.org.nz/who-we-fund/">http://www.jasmine.org.nz/who-we-fund/</a>  <a href="http://medicmobile.org/">http://medicmobile.org/</a>	Asia	<p><b>Mission:</b> improve health in underserved communities.</p> <p>They hope to have 200,000 frontline health workers using mobile applications to improve community-based health care for 100 million people by 2020.</p> <p>Current active programs in 20 countries in Africa, Asia, Latin America and the Caribbean, and the United States.</p> <p><b>Business model:</b> build mobile and web tools for frontline health workers, patients, and families and co-design and implement new systems using these tools.</p> <p><b>Annual budget:</b> US\$1.2 million FY13 (Dec13).</p>	<p><b>Delivered to date:</b> Supported 7,836 health workers and 3,450 patients through 54 partners across 20 countries that serve over 5 million people.</p> <p><b>Impact:</b> Focus on increasing access to care for people who need it, help people stay in care programs and improve the quality of care, wherever it is delivered.</p>

		<b>Jasmine Foundation's investment so far:</b> US\$400,000.	
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Barefoot Power Australia has made a number of impact investments in the region. For example, One Renewable Energy (One Renewable) in the Philippines helps provide affordable and accessible safe power. It was established in 2008 by former employees of Shell Solar Philippines Corporation after the global scale down of Shell Renewables. The team pioneered the development of a rural retail market for the solar energy business in the Philippines.

In a market that is considered the 'bottom of the pyramid', it is very important to create an ecosystem that supports both the buyer and the seller so it can become sustainable business model. The traditional approach of government has been to give systems to recipients as a one-time transaction. This has a limited reach and duration as there is no after sales service and often the product becomes useless after the first year or so. To change this way of thinking, One Renewable has partnered with microfinance institutions and local distributors and contractors to create a livelihood program that will provide business opportunities for the community as well as maintain a strong and reliable sales and after sales network.<sup>8</sup>

For the last five years, One Renewable have penetrated rural communities all around the Philippines. One Renewable have also made Barefoot Power Micro Solar home systems available, affordable and a household "must have" in these remote communities. It is a successful example of developing a sustainable social enterprise that helps promote economic growth and lift people out of poverty.

We hope this material assists the Committee. Please do not hesitate to be in touch if we can help in any other way.

Kind Regards,

Impact Investment Group

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<sup>8</sup> For further information about this case study, see <http://www.barefootpower.com/index.php/social-impact/85-successful-story-of-one-renewable-energy-inc>.