

Chapter 4

Supply of capital to the social economy

4.1 For a robust capital market to develop in support of social economy organisations in Australia, innovative approaches to financing the sector must be pursued. There is a need for more effective and coordinated demand for capital from the sector, as discussed in chapter 3, and a need to increase the supply of capital available to social economy organisations, which is the subject of this chapter. There is scope to both increase the effectiveness of existing sources of funding for the sector, as well potential to access capital from commercial sources previously untapped by the social economy sector.

4.2 The committee has heard that the following stakeholders have a role to play as potential sources of capital for the Australian social economy:

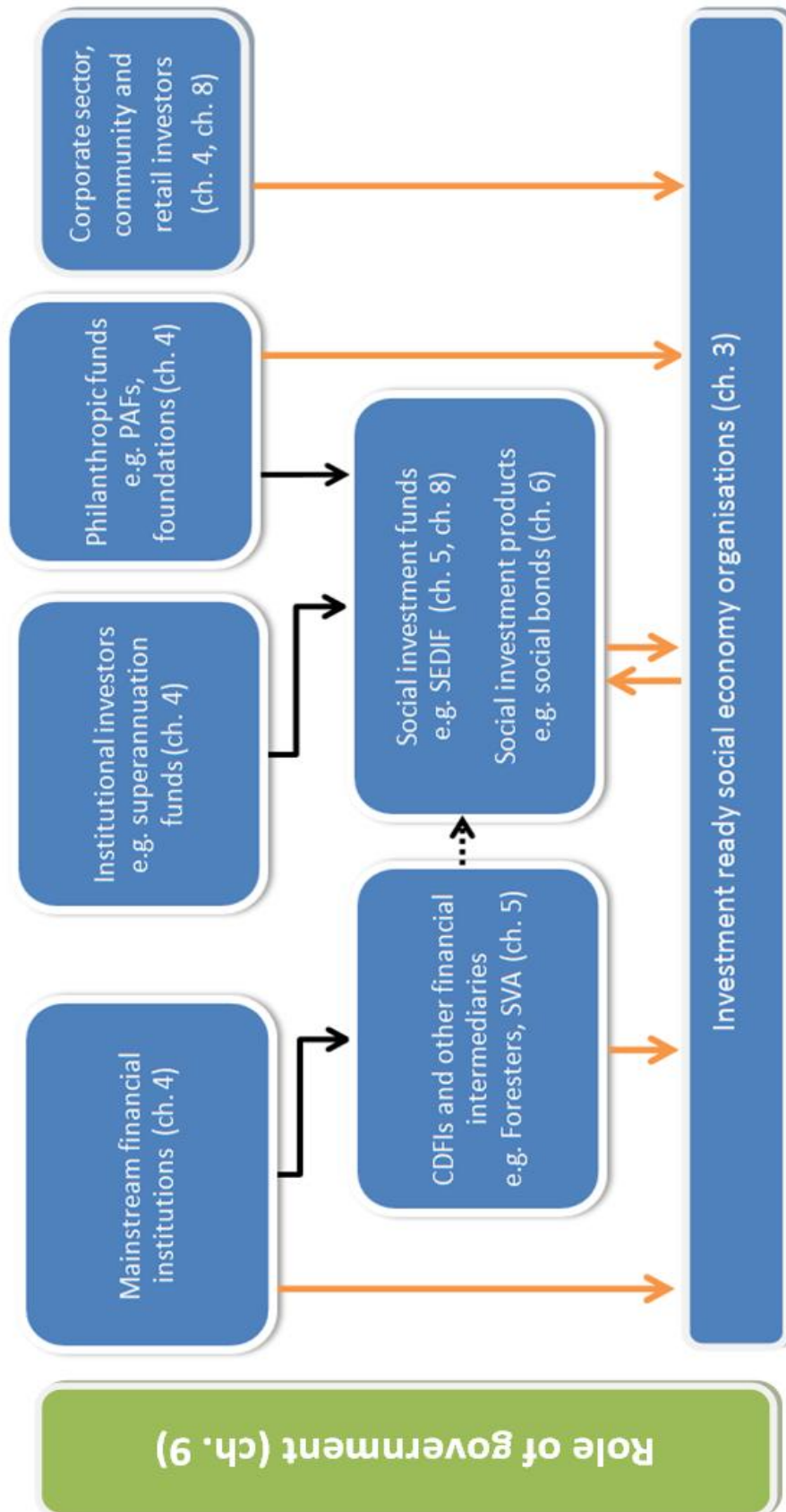
- government (federal, state and local);
- specialist financial intermediaries such as Community Development Financial Institutions (CDFIs);
- mainstream financial institutions;
- superannuation funds and other institutional investors;
- philanthropic trusts and foundations;
- the broader corporate sector; and
- individual retail or community investors.

4.3 JBWere noted that each source of capital available to the sector has its own limitations and restrictions on what it can fund and how it can provide finance.¹ Some types of investors will be better suited to offering social economy organisations existing forms of finance, such as debt and equity (or quasi-equity) capital, while other investors are unlikely to put capital into the social economy at all without new and innovative social investment products. Some will invest in social economy organisations directly, while others will invest through intermediary structures. In addition, the motivation for providing finance varies greatly across these different types of investors, which affects the kinds of investment each group is likely to make into the sector and the level of financial returns they expect.

4.4 The broad potential capital flows within a well developed social economy capital market are outlined pictorially in Diagram 4.1. This diagram does not represent capital flows as they currently exist in Australia, but is a conceptualisation of the future possibilities for this market, as suggested by submitters to this inquiry.

1 JBWere, *Submission 19*, p. 4.

Diagram 4.1: Possible investment flows in a social economy capital market



4.5 Under the depiction outlined in Diagram 4.1, the main source of direct capital for investor-ready social economy organisations is specialist financial intermediaries such as CDFIs. This would occur both through direct lending to organisations by CDFIs, and through social investment funds and new social investment products managed by these intermediaries.

4.6 This intermediary layer is in turn capitalised by investment from mainstream financial institutions, institutional investors such as superannuation funds, and philanthropic trusts and foundations. The corporate sector and community or retail investors provide additional sources of direct investment into social economy organisations, particularly organisations and projects with a specific geographic or community focus.

4.7 Diagram 4.1 also notes that there will still be some direct capital provision to social economy organisations from mainstream financial institutions (predominantly through debt financing) and philanthropic sources (through traditional philanthropic grants and increasingly through the provision of loans and equity-like investments). The role of government is seen as a cross-cutting issue, as stakeholders have informed the committee that government can play an enabling role across all three layers of organisations in the social economy.

4.8 The evidence gathered by the committee over the course of this inquiry concerning the supply of capital to the social economy has focused predominantly on three areas:

- strengthening the role of financial intermediaries in providing capital to the sector;
- expanding opportunities for philanthropic bodies to make investments into the sector; and
- encouraging institutional investors, particularly superannuation funds, to take up social investment opportunities.

4.9 In line with the weight of this evidence, the remainder of this chapter focuses mainly on the potential roles of philanthropic bodies and superannuation funds as capital providers. The role of mainstream financial institutions, the corporate sector, and retail or community investors is also discussed, and the importance of government as a social investor is highlighted. The role of financial intermediaries is briefly discussed, before a more detailed discussion in chapter 5.

Financial Intermediaries and CDFIs

4.10 Financial intermediary organisations such as CDFIs can play a key role in allowing social economy organisations to access capital. They can do this in several ways:

- by providing tailored deposit-taking and banking services for the social economy sector, as offered in Australia by organisations such as Community Sector Banking (CSB);

- by providing tailored debt products to social economy organisations (as offered by organisations such as CSB and Foresters Community Finance);
- by providing advice and consultancy services to social economy organisations to help them build capacity and become finance-ready; and
- by acting as conduits for larger wholesale investment into the sector, through mechanisms such as the social investment funds managed by Foresters through their subsidiary Social Investments Australia.

4.11 The role of financial intermediaries such as CDFIs is considered crucial in the development of social capital markets in Australia, and as such they are considered in more detail in chapter 5, which covers the broader issue of intermediary organisations required to support the growth of the social economy.

Mainstream Financial Institutions

4.12 As discussed in chapter 3, social economy organisations often lack the ability to access debt finance or other forms of capital from mainstream financial institutions. The joint submission from the Department of Education, Employment and Workplace Relations (DEEWR) and the Department of the Prime Minister and Cabinet (PM&C) (the departments' submission) noted that lenders can be myopic about the actual risks and returns associated with social investment, attributing much higher risk than is actually present.²

4.13 Foresters Community Finance (Foresters) told the committee that the credit assessment processes undertaken by mainstream lenders may not be entirely appropriate for not-for-profit organisations:

First of all in relation to the risk assessment or the credit assessment, mainstream financial institutions often struggle to understand the risk profile of not-for-profits. It is not that they are necessarily not credit worthy but just that a mainstream financial institution may not understand their sources of income, for example. What is required is a different type of credit assessment, a more individualistic credit assessment.³

4.14 Mr Glen Saunders, a Director of Triodos Bank, commented that small social organisations may receive adverse credit ratings simply because of their size:

...there is a general expectation that if you are a small initiative then you are higher risk... within the credit agencies like Standard & Poor's and so on, small organisations get an adverse credit rating simply because they are small. We think that there should be greater objectivity. If you look at where the problems arose from the global financial crisis, it was not the very small organisations that were the problem. There should be greater

2 DEEWR and PM&C, *Submission 9*, p. 15.

3 Ms Therese Wilson, Chairperson, Foresters Community Finance, *Committee Hansard*, 1 August 2011, p. 30.

rigor around how those valuations are undertaken, because they are very influential in terms of what can happen.⁴

4.15 Our Community told the committee, however, that Westpac has established a new NFP section within its structure to work specifically with community groups.⁵ Additionally, the committee heard that National Australia Bank (NAB) have introduced several initiatives designed to combat financial exclusion amongst individuals and families in Australia.⁶

4.16 A 2011 report on financing the NFP sector commissioned by the NAB and written by Foresters noted that the current services offered to social economy organisations by mainstream financial institutions in Australia do not generally extend beyond basic banking (i.e. deposit-taking) services, and discussed the potential roles for mainstream financial institutions in creating a NFP capital market.

4.17 Their discussion noted that in the United States (US), mainstream lenders offer a much wider variety of products and services to NFP organisations than in Australia. Products offered include debt capital (mainly focused on acquisition of property and facilities) and the provision of working capital, although the report noted that low transaction profitability has limited the ability of smaller organisations to access the debt market. Mainstream financial institutions in the US also provide significant capital to specialist lenders such as CDFIs.⁷

4.18 The NAB report suggests three ways in which mainstream institutions could help develop a NFP capital market in Australia, as outlined below:

- engage directly with NFP organisations, developing more specialist knowledge about the sector and a broader range of capital relationships with the sector;
- contribute to and capitalise the development of specialist intermediaries who could then provide capital for not-for-profit organisations. This method would pool capital from a number of financial institutions through intermediaries who have specialist knowledge and could mitigate the risks of direct capital provision; and
- become part of a range of investors who capitalise a wholesale fund which would provide capital to a range of specialist intermediaries (blending philanthropic funds, grant funding and funds from financial institutions). This provides the greatest potential for blended capital types and returns, and

4 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 6.

5 Mr Dennis Moriarty, Our Community, *Committee Hansard*, 9 September 2011, p. 56.

6 Foresters Community Finance, *Submission 4—attachment 2*, 'Finance and the Australian Not-for-Profit Sector', March 2011, pp 48–52. The term 'financial exclusion' refers to the state of being unable to access basic financial products and services in order to participate in the economy.

7 Foresters Community Finance, *Submission 4—attachment 2*, March 2011, p. 41.

allows for a systematic response to NFP capital needs, but would require incentives to encourage financial institutions' involvement.⁸

4.19 The three options above involve different types of risk for mainstream financial institutions which are discussed below.

4.20 The first, directly relating to investing in social economy organisations, exposes lenders directly to financial risk. As a result it requires extensive knowledge and due diligence research, which often heightens transaction costs. The public relations and social responsibility benefits associated with working with NFP organisations may encourage many mainstream lenders to engage with the sector. There is however some degree of reputational risk associated with the negative consequences of enforcing a contract should a NFP default, leading to the closure of a social service.⁹

4.21 The second option, investing in intermediaries who then provide capital to NFPs, involves less direct risk for the mainstream lenders. However, due diligence is still required to ensure that intermediary organisations are able to operate in a sustainable manner. One prominent example of this in Australia is the strategic alliance between Westpac and Many Rivers Microfinance, to deliver microfinance business loans to start-up enterprises in underserved communities.¹⁰

4.22 The third option, investing in wholesale funds which then invest in intermediaries, is viewed as a more distant possibility in Australia due to the present early stage of development in the intermediary market. Wholesale investment funds investing in intermediaries do have an active role in more developed social capital markets overseas, as discussed further in chapter 5.

Philanthropic sources of investment

4.23 Many submitters to the inquiry have commented on the potential role for philanthropic trusts and foundations to invest in social ventures in Australia.¹¹ Philanthropy is a significant contributor to the social economy; Philanthropy Australia estimates that 5000 philanthropic foundations operate in Australia, controlling seven to ten billion dollars worth of funds and disbursing between \$600 million and \$1 billion to the community sector each year.¹²

8 Foresters Community Finance, *Submission 4–attachment 2*, 'Finance and the Australian Not-for-Profit Sector', March 2011, pp 6, 42.

9 Foresters Community Finance, *Submission 4–attachment 2*, 'Finance and the Australian Not-for-Profit Sector', March 2011, p. 41; Community Sector Banking, *Submission 10*, p. 5.

10 Many Rivers Microfinance, *Submission 26, attachment 3*, pp 1-2.

11 DEEWR and PM&C, *Submission 9*, pp18–19; Social Ventures Australia, *Submission 2*, pp 2–3; YMCA, *Submission 1*, p. 1; Productivity Commission, *Submission 6*, p. 2; The Chris O'Brien Lifehouse at RPA, *Submission 8*, pp 1–2; Benevolent Society, *Submission 25*, p. 3.

12 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 42.

4.24 Over the course of this inquiry the role of traditional philanthropic grants and donations as a source of capital for social economy organisations has been discussed, and emerging possibilities for philanthropic bodies to utilise their investment corpus to finance social projects have also been canvassed.

The role of traditional philanthropic funding

4.25 Traditional grants and donations from philanthropic individuals and organisations are currently one of the major sources of funding for many social economy organisations.¹³ The committee has heard varying views about the utility of this funding source in the overall picture of financing the sector.

4.26 Several submitters highlighted the necessity for the social economy sector to move beyond dependence on grant funding from the government and philanthropic sectors to more reliable and stable forms of finance.¹⁴ JBWere argued that while incentives to promote philanthropy and encourage private giving are positive, traditional philanthropy will only ever be a small part of overall funding for the social economy.¹⁵ CSB stated that access to philanthropic grant funding can be unreliable and competitive, and using philanthropic income to leverage further finance is difficult unless there is a long history of donations to the organisation.¹⁶

4.27 Foresters noted that the utility of philanthropic donations to an organisation can depend on whether the funds are restricted (where there are conditions attached to the donation regarding how it is to be used) or unrestricted. In the case of unrestricted donations, such as those solicited through public fundraising drives, there is often pressure to spend the revenue on direct service delivery rather than 'overhead' or organisational expenses.¹⁷ Sir Ronald Cohen noted that insistence on philanthropic money reaching beneficiaries directly can preclude the structured, long-term commitments necessary to build and finance sustainable organisations.¹⁸

4.28 Despite the limitations associated with traditional philanthropic revenue, it is likely that grants and donations will still play a role in the overall financing picture for the social economy into the future. Christian Super argued that establishing new capital markets for the social economy should complement rather than supplement philanthropy, and noted that while a dependence on philanthropy alone can be

13 JBWere, *Submission 19*, p. 4.

14 Social Traders, *Submission 7*, p. 1; DEEWR and PM&C, *Submission 9*, p. 16; Social Ventures Australia, *Submission 2*, p. 3; Belinda Drew, Chief Executive Officer, Foresters Community Finance, *Committee Hansard*, 1 August 2011, p. 31.

15 JB Were, *Submission 19*, pp 4–5.

16 Community Sector Banking, *Submission 10*, p. 6.

17 Foresters Community Finance, *Submission 4–attachment 2*, 'Finance and the Australian Not-for-Profit Sector', March 2011, p. 19.

18 Social Finance Ltd, *Submission 16*, p. 13.

unstable for an organisation, philanthropic donations can be used to stabilise cash flows from other sources and provide a revenue diversification tool.¹⁹ In addition, philanthropic capital can be particularly useful at the start-up phase for social organisations when access to other forms of finance may not be viable, a practice sometimes referred to as 'venture philanthropy'.²⁰ CSB argued that the development of philanthropic venture capital markets will be critical to maximise the potential of social organisations.²¹

4.29 In addition to traditional grants and donations from philanthropic individuals and organisations, the committee has heard that there is potential for philanthropic bodies which hold investment funds to use these funds to offer loans to social economy organisations, and to invest in emerging social investment products.²² The remainder of this section will focus on these emerging possibilities.

The potential role of philanthropic intermediary bodies

4.30 The Productivity Commission (PC) report noted that while the majority of philanthropic transfers in Australia occur directly between donors and recipients, there are various types of philanthropic intermediaries which distribute donations or earnings from endowments to recipients,²³ as outlined in Diagram 4.2. These intermediaries include philanthropic foundations, of which there are various subcategories. Some of these include:

- corporate foundations;
- private foundations such as Private Ancillary Funds (PAFs); and
- public foundations such as Public Ancillary Funds and community foundations.²⁴

4.31 These intermediaries are often established with an initial capital lump sum, which is then invested in mainstream financial investment vehicles, with the return from these investments being distributed as grants to charitable causes. Different types of foundations are established for different purposes and have different rules regarding investment and grant-making.

4.32 The PC report noted that 'even if only a small proportion, say 5 per cent, of the billions of dollars held by philanthropic intermediaries in Australia were made

19 Christian Super, *Submission 12*, p. 6.

20 Social Finance Ltd, *Submission 16*, p. 14.

21 Community Sector Banking, *Submission 10*, p. 6.

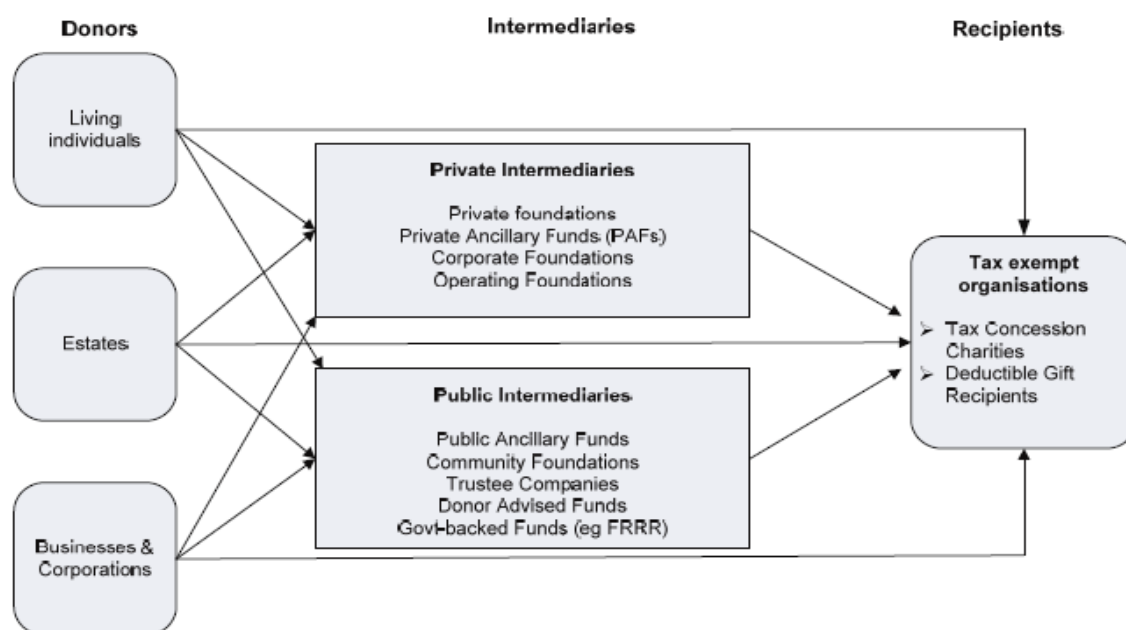
22 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, pp 191–192.

23 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 169.

24 Philanthropy Australia, 'Foundations and Trusts', <http://www.philanthropy.org.au/fdntrust/index.html> (accessed 14 November 2011). The terms 'foundation' and 'philanthropic foundation' are used broadly in the remainder of this report to refer to this entire class of intermediary bodies.

available as a source of capital for NFP investment, it would greatly increase the supply of finance available to NFPs'.²⁵ Ms Kylie Charlton, an expert in the field of impact investment and social innovation, argued that with an enabling policy environment, philanthropic foundations can play a catalytic role in the development of a robust social capital market in Australia.²⁶

Diagram 4.2: The structure of philanthropy in Australia



Productivity Commission, *Contribution of the Not-For-Profit Sector*, January 2010, p. 169.

4.33 Accessing the corpus of philanthropic intermediaries would involve changing the traditional investment approach of these foundations, whereby they would invest some amount of their funds into social investment opportunities with a social benefit and potentially lower financial return, rather than simply investing their entire corpus into the highest-yielding investments. The committee heard that within the philanthropic sector there is some movement towards a social investment mindset, where a blended financial and social return is gained.²⁷

4.34 This shift towards social investment among philanthropic foundations is more clearly developed in the UK. Sir Ronald Cohen noted in his evidence to the committee that in a recent offering of a new social investment product—social impact bonds (discussed further in chapter 6)—capital was accessed from the balance sheets of

25 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, pp 191–192.

26 Ms Kylie Charlton, private capacity, *Committee Hansard*, 26 September, p. 9.

27 Social Traders, *Submission 7*, p. 7; Community Sector Banking, *Submission 10*, p. 12; Mr Simon Lewis, Head of Strategic Partnerships, Communications and Community, The Trust Company, *Committee Hansard*, 9 September 2011, pp 48–49.

philanthropic foundations (i.e. their investment corpus), rather than from their grants allocation:

In September last year, having raised the money, we launched the first social impact bond...we raised £5 million entirely from foundations, and two-thirds of the 17 foundations and charitable trusts that put money up kept it on their balance sheets rather than taking it out of their grants allocation. That is a very significant development because you have £100 billion of assets in foundation balance sheets, and you have a couple of billion pounds that are given away by foundations—£2 billion to £3 billion—a year [in the UK]. So if you can begin to use these financial instruments to attract capital from the balance sheets of charitable foundations, you start off with a massive amount of money that can be focused on social issues.²⁸

4.35 Evidence has also been given to the committee on the potential role of Private and Public Ancillary Funds, the possibilities presented by mission and program-related investments, and the role of community foundations.

Private and Public Ancillary Funds

4.36 Mr David Ward from Philanthropy Australia noted that Private and Public Ancillary Funds are the two most likely segments of the philanthropic sector to take up new social investment options.²⁹ There are currently approximately 900 Private Ancillary Funds (PAFs) operating in Australia holding over \$2 billion in 2008-09, as well as around 1600 Public Ancillary Funds.³⁰

4.37 Private Ancillary Funds (PAFs) are a type of tax-deductible private foundation. They are unable to raise funds from the general public and must be controlled by a body corporate. A PAF can be endorsed as a charity, in which case it must fund only charitable deductible gift recipient (DGR) organisations, or it can be endorsed as an Income Tax Exempt Fund (ITEF), in which case it may be able to distribute to a wider range of DGRs depending on the state in which it is established.³¹ PAFs cannot make grants to other ancillary funds or other PAFs. Commonwealth guidelines for PAFs specify that a PAF must distribute at least five per cent of the market value of the fund's net assets every year, and must have a formal investment strategy.³²

28 Sir Ronald Cohen, *Committee Hansard*, 1 August 2011, p. 66.

29 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

30 DEEWR and PM&C, *Submission 9*, p. 24; The Hon Bill Shorten MP, Assistant Treasurer and Minister for Financial Services and Superannuation, 'Changes to the way Philanthropic Funds are Managed', Media Release 113, 14 July 2011.

31 Vanessa Meachen, Philanthropy Australia, *A Guide to Giving for Australians*, April 2010, p. 28.

32 Guidelines 19 and 30-32, *Taxation Administration Act 1953 – Private Ancillary Fund Guidelines 2009*.

4.38 Public Ancillary Funds are similar to Private Ancillary Funds in that they are DGR funds which receive donations which are then distributed through to other DGR organisations for the stated purposes of the fund. The main differences are that Public Ancillary Funds must offer opportunities for the general public to contribute to the fund, and must be managed by members of a committee or board, meaning that donors may have no control over the investment decisions of the fund.³³

4.39 The public ancillary fund structure is currently under review. Legislation currently before the federal parliament would enable the Treasurer to issue guidelines relating to the establishment and operation of public ancillary funds.³⁴ Draft guidelines for public ancillary funds were released for public consultation in July 2011. These draft guidelines include provisions stating that public ancillary funds must have a formal investment strategy and must distribute at least four per cent of the market value of the fund's net assets every year.³⁵ This review is intended to bring the standards of accountability and governance of public ancillary funds in line with private ancillary funds.

Program and mission related investments

4.40 The PC report also noted that in the US, philanthropic intermediaries are encouraged to undertake 'program related investments' and 'mission related investments'³⁶ to further the impact of their philanthropic activities, which can take on a variety of investment forms, including common loans, cash equivalent deposits, equity stakes and loan guarantees.³⁷ This type of investment is aimed at furthering the social objectives of the foundation (for example, education or healthcare), and is based on the premise that the purpose of a foundation is to facilitate the creation of social value, through both investing foundation assets and grant-making.³⁸

4.41 The Canadian Taskforce on Social Finance, which presented its initial report to government in December 2010 (see chapter 2), recommended that Canada's public and private foundations should invest at least 10 per cent of their capital in mission-

33 Vanessa Meachen, *Philanthropy Australia, A Guide to Giving for Australians*, April 2010, p. 29.

34 Explanatory Memorandum, *Tax Laws Amendment (2011 Measures No. 7) Bill 2011*, p. 86.

35 Department of the Treasury, *Draft Public Ancillary Fund Guidelines 2011*, available at <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2048> (accessed 30 August 2011).

36 The distinction between 'program' and 'mission' related investments is that program related investments seek to further the charity's aims directly whilst potentially making some return, whereas mission related investments seek to make the best financial return but also further the organisation's aims.

37 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2011, pp 191–192.

38 DEEWR and PM&C, *Submission 9*, p. 19.

related investments by 2020 and report annually to the public on their activity.³⁹ Provided there is an enabling environment, there is potential for this kind of investment to be encouraged by philanthropic intermediaries in Australia.

Community Foundations

4.42 Submitters have also noted the importance of community foundations in the philanthropic landscape in Australia. Community Foundations are public funds established to serve a particular geographic region, which build up a corpus of donations from the local community in order to invest in social causes within that community.⁴⁰ Ms Rosalind Strong from the Sydney Community Foundation noted that the potential role of community foundations is underdeveloped, largely due to the fact that community foundations are not widely recognised in Australia and do not attract the same public attention as PAFs.⁴¹ Catherine Brown and Associates contended that the amount of philanthropic funds available to community foundations could be broadened if Deductible Gift Recipient (DGR) Item 1 status was extended to all community foundations.⁴²

4.43 Mr Paul Ronalds from the PM&C told the committee that there is potential for community foundations to play a greater role in supporting local initiatives, and eventually transition to become fully-fledged CDFIs in some circumstances.⁴³

Religious charitable development funds

4.44 The committee has also heard about the role of religious charitable development funds, a funding mechanism utilised by many churches and religious organisations in Australia.⁴⁴ Father Brian Lucas, General Secretary of the Australian Catholic Bishops Conference, explained how these funds generally operate:

Parishioners will make a deposit, generally on slightly less than commercial terms—and that will vary from place to place: perhaps 50 basis points or a percent below what they might get in a more commercial setting. That enables the church to use those funds to construct a school or other capital

39 Canadian Taskforce on Social Finance, *Mobilizing Private Capital for Public Good*, December 2010, p. 3.

40 Philanthropy Australia, *What is a Community Foundation?*, <http://communityfoundations.philanthropy.org.au/about-community-foundations/what-is-a-community-foundation/> (accessed 30 August 2011).

41 Ms Rosalind Strong, Chair, Sydney Community Foundation, *Committee Hansard*, 23 September 2011, pp 6-7.

42 Catherine Brown and Associates Pty Ltd, *Submission 11*, p. 3.

43 Mr Paul Ronalds, First Assistant Secretary, Department of Prime Minister and Cabinet, *Committee Hansard*, 26 September 2011, pp 28–29.

44 Australian Catholic Bishops Conference, *Submission 28*, p. 2; Lutheran Church of Australia, *Submission 34*, pp 2, 5; Mr Michael Nicholls, Business Manager, General Synod, Anglican Church of Australia, *Committee Hansard*, 23 September 2011, p. 27.

facility. Those parishioners then have the money on deposit, generally at call, sometimes on a term-deposit basis. But the capital that was able to be acquired in that way is combined with other provisions and investment opportunities that the church has. They have become very successful and are [a] very important vehicle for providing capital.⁴⁵

Committee view

4.45 Given the inherent social purpose for which philanthropic intermediaries are created, the committee believes that philanthropic intermediaries should have the option to invest a percentage of their corpus in social investment products.

4.46 The committee urges that the Australian Taxation Office (ATO), in conjunction with the Australian Charities and Not-for-Profits Commission (ACNC), work to develop guidance material outlining the ability of all philanthropic trusts and foundations to make mission-related and social impact investments.

Unlocking philanthropic investment

4.47 The PC report noted that for the philanthropic corpus to be made available as capital for the sector, it would require 'the development of appropriate investment vehicles and clarification of the fiduciary duties of trustees, allowing approved loans to be included in meeting (possibly expanded) disbursement requirements'.⁴⁶ Each of these issues were raised in evidence given to the committee, and are discussed below.

Appropriate investment mechanisms

4.48 A lack of appropriate investment mechanisms could hinder the ability of philanthropic intermediaries to make social or mission-related investments. There are only a limited number of examples of philanthropic bodies providing loan financing to social organisations using existing mechanisms:

Philanthropic trusts and foundations have occasionally provid[ed] finance to enable the purchase of key real estate, usually through the provision of bridging finance. One excellent example of this was the loan giv[en] to Trust for Nature Victoria by The R E Ross Trust to enable the purchase of Ned's Corner Station, a site of conservation significance on the Murray near Mildura. Trust for Nature was able to fundraise and repay the large grant within a reasonable period. This was considered quite ground breaking and is a model that could be replicated more often.⁴⁷

4.49 Mr Robert Fitzgerald from the PC told the committee that mechanisms to allow loan financing from philanthropic funds would have a significant impact for the NFP sector:

45 *Committee Hansard*, 23 September 2011, pp 26-27.

46 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2011, pp 191–192.

47 Catherine Brown, *Submission 11*, p. 1.

One of the things that we are very clear about is that even a small releasing of the corpus by way of loans to non-profit organisations at favourable terms and conditions would have a significant impact. We believe there needs to be serious consideration of amendments to the fiduciary duties that would allow philanthropic foundations and trusts, more generally, to be able to lend at favourable terms a portion of the corpus.⁴⁸

4.50 As well as the potential for providing loans directly to organisations, there is potential for philanthropic funds such as PAFs to invest in emerging social impact investment vehicles such as social bonds and social impact bonds (which are discussed further in chapter 6).

Fiduciary duties of trustees

4.51 A trustee is an individual or organisation which holds or manages and invests assets for the benefit of another. Trustees are obligated to act in accordance with certain fiduciary duties in the investment decisions they make in their role. Broadly speaking, fiduciary duties are duties imposed upon a person who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence.⁴⁹ Fiduciary duties are the key source of limitations on the discretion of investment trustees in common law jurisdictions such as Australia. The most important fiduciary duties are the duty to act prudently and the duty to act in accordance with the purpose for which investment powers are granted (also known as the duty of loyalty).⁵⁰

4.52 The specific requirements or fiduciary duties which must be considered by trustees differ between types of investment funds, such as superannuation funds, managed investment schemes, and philanthropic funds. The fiduciary duties that need to be considered by a trustee of a philanthropic trust or foundation are as follows:

- foundations and trusts need to comply with any limitations in their governing constitutions and/or trust deeds.⁵¹ A foundation's investment strategy must be in line with its purpose as stated in these governing documents.
- for philanthropic trusts, the trust must comply with the Trustee Act of the state or territory in which it is established.⁵² This includes complying with the

48 *Committee Hansard*, 26 September 2011, p. 22.

49 Freshfields Bruckhaus Deringer, produced for the Asset Management Working Group of the UNEP Finance Initiative, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, October 2005, p. 8, http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (accessed 17 October 2011).

50 Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, October 2005, p. 8.

51 Catherine Brown, *Submission 11*, pp 2–3.

52 JB Were, *Submission 19*, p. 21.

'Prudent Person Rule' which states that trustees must act as a prudent person would, performing their duties with diligence, care and skill.

4.53 The fiduciary framework for philanthropic intermediaries necessitates the development of social impact investment products which are structured so as not to breach the obligations of trustees.⁵³ Philanthropy Australia noted that many foundations will not be able to consider specific social investments simply because of restrictions in their deeds about use of capital, or restrictive defined purposes of those trusts.⁵⁴

4.54 The committee has heard, however, that trustees arguably do have a duty to consider the social and environmental implications of their investment strategies. In April 2010 the then Assistant Treasurer, Senator the Hon Nick Sherry, noted at an address for the Centre for Social Impact (CSI) *Investing for Impact Conference*, that the obligations of trustees evolve with the societies in which they operate:

The argument about trustees' duties and obligations is that trustees, in common law, broadly need to reflect society and, particularly, the goals of the organisation that they owe a fiduciary duty to. Therefore, the role of a trustee in a superannuation fund, and the role of a trustee in a PAF, today is very different from the role they would have had 20 or 25 years ago, for the obvious reason that the world has changed. The world in which we are considering issues of investment, the placement of funds and the distribution of funds requires a consideration of a much broader and almost certainly more complex set of issues than 20 or 25 years ago. I think for a PAF, it's even more important to consider these issues because invariably, the stated goal of a PAF will have a direct link to issues relating to socially responsible investment...

Trustees, I would argue in today's world, actually need to go further than simply passing the money over to a financial institution. They need to be actively engaged in examining where that financial institution is placing those investments - not just to maximise the return to the fund but also to ensure that where those monies are invested aligns with the interests of the fund itself. So what the law arguably requires from trustees is a significantly broader range of activities than in the past, as well as a consideration of a more complex set of issues.⁵⁵

4.55 Philanthropy Australia noted that there are many foundations that are not overly restricted in their governing documents and that could, in the right

53 JB Were, *Submission 19*, p. 21.

54 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

55 Senator the Hon Nick Sherry, comments in an address to the Centre for Social Impact's *Investing for Impact* conference, 8 April 2010, as cited in the power point presentation 'Capital Market for Social Investment' tabled by the Centre for Social Impact at a public hearing in Canberra on 1 August 2011.

circumstances, seek social returns as well as financial returns on their investment portfolio.

4.56 Despite this, it is clear that currently philanthropic trustees are generally conservative in their investment strategies. Representatives from Philanthropy Australia told the committee that philanthropic trustees tend to exercise caution rather than innovation in their investment strategies in order to protect their donated corpus, and foundations are less able to take risks in their investments than larger institutional investors.⁵⁶ Ms Catherine Brown agreed with this sentiment, noting that it would be unlikely that foundations and trusts could invest in untried, speculative businesses.⁵⁷

4.57 JBWere also commented on this issue, and expressed concern that if foundations target investments with a social benefit but decreased financial returns, they may gradually lose their ability to provide grant capital to the causes for which they were established:

All investments, whether they have a social impact or not, will have varying levels of risk associated with them. Therefore, different forms of impact investments will not be suitable for Trusts and Foundations as they provide an inappropriate balance of risk and return when considered in the light of the objectives of the trust.⁵⁸

...with the existing philanthropic capital that is being used to invest to generate an income stream to provide social benefit, it is important that it does not get diverted into products or investments that might take it away from funding the reason it was set up.⁵⁹

Disbursement requirements for ancillary funds

4.58 Regulatory guidelines determine how some philanthropic foundations can manage and distribute their funds, including setting minimum annual disbursement requirements (see paragraphs 4.37–4.39). Submitters to the inquiry noted that the reluctance by trustees to invest in social investment opportunities that offer lower financial returns may be ameliorated by including social investments as part of a foundation's mandatory distribution requirements:

PAFs are required to distribute five per cent of their previous 30 June corpus each 12 months. There are costs to cover and inflation to offset to preserve the value of the fund. Many PAF trustees believe they cannot afford to have a significant amount of fund tied up in low yielding assets however socially beneficial those investments may be. But if any discount

56 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43; Mr Christopher Thorn, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 50.

57 Catherine Brown, *Submission 11*, pp 2–3.

58 JBWere, *Submission 19*, p. 21.

59 Mr Christopher Thorn, Chief Executive Officer, JBWere Philanthropic Services, *Committee Hansard*, 1 August 2011, p. 11.

to the market returns on social investments can be treated as benefit for the purpose of the five per cent minimum distribution, the calculation is changed significantly.⁶⁰

4.59 Existing PAF guidelines do provide for this kind of distribution in some circumstances. Example 2 under PAF guideline 19.3 states: '[i]f a private ancillary fund leases office space to a deductible gift recipient at a discount to the market price the fund is providing a benefit, the value of which is equal to the amount of the discount'.⁶¹ The PC report noted that this provision can be used to allow funds to offer organisations sub-commercial transactions to DGR organisations:

Public and private ancillary funds can enter into uncommercial transactions (for example, subsidised loans) with DGRs that are in furtherance of the PAF's purpose. The difference between the interest on the actual loan and the interest that would have accrued if it were provided on a commercial basis is considered to be a charitable DGR distribution by the ATO. These funds may engage with non-DGRs but only for commercial transactions. It is unknown exactly how many loans are provided to the NFP sector by these funds but it is thought to be relatively low.⁶²

4.60 Mr Les Hems, Director of Research at CSI, agreed that this framework should allow PAFs to make social investments. Mr Hems told the committee:

As part of the New South Wales government work looking at the tax implications, we have had a look at the private ancillary funds, and we think the existing rules would allow PAFs to invest in, say, a social impact bond or, indeed, any investment which might offer a below-market rate of return. The PAF guidelines already articulate that, if a PAF holds office space which it decides to rent out at a peppercorn rent, it can include the difference between the market rate and the peppercorn rate as part of its distribution. If that is a precedent, then I do not see how that is any different from a PAF investing in a financial instrument which may not yield a full market return.⁶³

4.61 Philanthropy Australia noted that they are only aware of one instance of this provision in the PAF guidelines being utilised beyond rent, with limited success. They state the reasons for this are a lack of awareness among trustees and a lack of clear benchmarks for what constitutes standard returns for different social investment products.⁶⁴

60 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

61 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

62 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 191.

63 Mr Les Hems, Centre for Social Impact, *Committee Hansard*, 1 August 2011, pp 41–42.

64 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

Awareness and education for philanthropic trustees

4.62 The first issue, lack of awareness amongst trustees, can be addressed through the education of trustees. This includes raising awareness about the potential for PAFs to make social investment, and also ensuring that foundations include a clause in their investment strategy documents enabling them to invest in social investments as an asset class.⁶⁵ This call for greater education and assistance for philanthropic trustees was echoed by the Macquarie Group Foundation:

I think one of the things with the growth of PAFs and the various changes to the legislation around PAFs is that it is a matter of education—of people not understanding what it is they can and cannot do within a PAF. It sounds silly, but I think it is as simple as that in some cases. They are really confused. They are focused on the fact that they need to distribute 10 per cent and that they must have an external trustee, but then they begin to get bogged down in what it is they can and cannot do. I think it comes down to having better awareness and better education.⁶⁶

4.63 The departments' submission noted that clarification of fiduciary duties through the provision of guidelines for trustees has helped clarify how foundations can make social investments overseas:

In some jurisdictions, research reinforces that trustees and boards are more likely to proceed if they are confident they can manage the risks and if there is clear policy and regulatory guidance. This has led to the development of guidance material. For example, in the United Kingdom the Charities Commission publishes a detailed guidance note on the duties of trustees and potential for funds to make mission related investments.⁶⁷

Setting benchmarks on standard returns for social investment products

4.64 In order for PAFs to count the discount provided in social investments as part of their mandatory disbursements they need to demonstrate that they are providing a loan or investment at a sub-commercial rate of return. Philanthropy Australia recommended that benchmark rates for various classes of social investment be established:

Our suggested response to this is that between the Office for the Not-for-Profit Sector, PM&C, Treasury, which we know is supportive of this concept, and the Commissioner of Taxation along with some of Philanthropy Australia's members who have expertise in this area, we draw up and publish a set of market prices for different classes of social investment—secured debt, bonds and subordinated debt, to name three.

65 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

66 Ms Julie White, Global Head, Macquarie Group Foundation, *Committee Hansard*, 23 September 2011, p. 55.

67 DEEWR and PM&C, *Submission 9*, p. 20.

Philanthropy Australia suggests that an early establishment of some market benchmarks would be beneficial and these rates can always be adjusted in following issues if they turn out to be not exactly right, but the benchmark rate needs to be publicly available prior to the issue launch and needs to apply for the whole term of the issue, hence I believe that the commissioner needs to be involved in the setting of those market rates.⁶⁸

4.65 Mr Brent Cubis from the Chris O'Brien Lifehouse at RPA agreed that the ATO should issue clear guidelines about benchmark rates for these investments, in order to assist PAFs invest in emerging social investment products.⁶⁹

4.66 The current guideline which enables PAFs to make sub-commercial transactions does not currently apply to other types of philanthropic foundations. This limits the opportunity for other types of foundations to make similar investments without breaching their fiduciary obligations.⁷⁰

Committee view

4.67 The committee notes the potential for philanthropic intermediaries, particularly private and public ancillary funds, to invest a percentage of their corpus in approved social impact investment vehicles. To enable this to occur more broadly, there needs to be clarification of the ability of foundations to treat any discount to market returns on social investment as part of their minimum distribution requirements. Appropriate benchmarks and standards also need to be established for social investment products. The committee also considers that the role of philanthropic trustees needs to be strengthened through the provision of more adequate support and advisory services (see recommendation 5.1 in chapter 5).

4.68 Given that this potential for philanthropic funds to invest in social economy organisations and social investment products is at an early stage, the committee believes that the proposed Social Finance Taskforce should consider this issue as part of its deliberations, with a view to providing further recommendations about how philanthropic bodies can become informed and engaged with social investment opportunities.

Recommendation 4.1

4.69 The committee recommends that the Australian Taxation Office, in consultation with the Australian Charities and Not-for-Profits Commission and other relevant stakeholders, issue explanatory material for Private Ancillary Fund trustees informing them of:

68 Mr David Ward, Philanthropy Australia, *Committee Hansard*, 9 September 2011, p. 43.

69 Mr Brent Cubis, Chief Financial Officer and Company Secretary, Chris O'Brien Lifehouse at RPA, *Committee Hansard*, 23 September 2011, p. 22.

70 Mr Robert Fitzgerald, Commissioner, Productivity Commission, *Committee Hansard*, Monday 26 September, p. 22.

- **the ability of these funds to treat any discount to the market returns on social investments as benefit for the purpose of the minimum distribution requirements; and**
- **the necessity of including a clause regarding social investment classes in their investment strategy documents in order to invest in social investment products.**

Recommendation 4.2

4.70 The committee recommends that the Commissioner of Taxation, Treasury and the Office for the Not-For-Profit Sector work to create benchmarks and standards for financial returns on social investment classes such as debt products and social bonds, in order to help trustees and fund managers make informed investment decisions in this area.

Recommendation 4.3

4.71 The committee recommends that the proposed Social Finance Taskforce consider the potential for philanthropic trusts and foundations to invest a percentage of their corpus in social investment options, particularly with regard to:

- **whether a requirement for philanthropic foundations to invest a percentage of their corpus in mission or program related investments is appropriate in the Australian context;**
- **how to develop appropriate social investment vehicles for philanthropic intermediaries; and**
- **any other mechanisms by which the corpus of philanthropic funds could be better utilised to invest in the social economy.**

Superannuation Funds

4.72 As of June 2010, the superannuation industry in Australia held approximately \$1.23 trillion dollars in funds.⁷¹ Numerous submitters have noted the potential for superannuation funds to engage with social investment opportunities.⁷² Mr Gordon Noble from the Association of Superannuation Funds of Australia (ASFA) told the committee that there is a high level of interest within the superannuation sector about making investments which take into account environmental, social and corporate governance (ESG) factors.⁷³

71 DEEWR and PM&C, *Submission 9*, p. 24.

72 JBWere, *Submission 19*, pp 21, 29; Christian Super Fund, *Submission 12*; Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 5.

73 Mr Gordon Noble, ASFA, *Committee Hansard*, 26 September, p. 14.

4.73 Over 100 superannuation funds and investment management companies in Australia have signed the UN Principles for Responsible Investment, a voluntary set of six principles devised to encourage institutional investors to incorporate ESG issues into investment analysis and decision-making.⁷⁴ These principles are implemented through a variety of investment practices, as outlined by the Responsible Investment Association of Australasia in their annual research report on responsible investment in Australia and New Zealand.⁷⁵

4.74 Christian Super, a relatively small Australian superannuation fund with approximately \$560 million in funds under management and around 20,000 members,⁷⁶ is taking a leading role in this area through its investments in the Australian social economy. Christian Super was recently announced as a \$6 million investor in Foresters' Social Enterprise Solutions Program, an investment that was matched with \$6 million in funding from the federal government under the Social Enterprise Development and Investment Fund (SEDIF) initiative.⁷⁷ Christian Super also holds over \$15 million of investment capital in microfinance initiatives.⁷⁸

4.75 Mr Glen Saunders, a director of Triodos Bank, a social investment bank based in the Netherlands, told the committee that while there are limited current examples of super funds engaging with the sector, as much as two to four per cent of some superannuation fund portfolios could be invested in this area within the next few years.⁷⁹ This represents a large potential pool of capital for social investment.

4.76 Several factors were discussed over the course of this inquiry in relation to super funds engaging with the social economy sector, including:

- the requirement for super funds to focus solely on maximising financial returns on their investments;
- the potential to use social investment types as a portfolio diversification tool;
- the need to create appropriate risk and return structures for investments;

74 The UN Principles for Responsible Investment can be found at 'The Principles for Responsible Investment', <http://www.unpri.org/principles/> (accessed 26 September 2011). The full list of Australian signatories to the Principles can be found at 'Signatories to the Principles for Responsible Investment', <http://www.unpri.org/signatories/index.php?country=Australia> (accessed 26 September 2011).

75 Responsible Investment Association Australasia, *Responsible Investment 2010*, November 2010, p. 7.

76 Mr Peter Murphy, Chief Executive Officer, Christian Super, *Committee Hansard*, 23 September 2011, p. 2.

77 Additional information received from the Department of Education, Employment and Workplace Relations, 'Foresters Community Finance profile', 12 August 2011.

78 Mr Peter Murphy, Christian Super, *Committee Hansard*, 23 September 2011, p. 5.

79 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 5.

- the need for investment vehicles large enough to attract investment from wholesale funds; and
- the lack of awareness among fund managers about social investment options (as discussed above in relation to philanthropic trustees).

The 'sole purpose test' for superannuation funds

4.77 Superannuation funds are governed by a principle known as the 'sole purpose test', which is established in section 62 of the *Superannuation Industry (Supervision) Act 1993*. The section states in essence that superannuation funds must provide retirement benefits to members, or death benefits to their dependents or deceased's estate in the event of death. This means that superannuation funds must have regard only for maximising the financial returns for their members for these purposes, and therefore cannot consider any potential social benefits when making investment decisions.

4.78 Mr Gordon Noble from the Association of Superannuation Funds of Australia commented that there is universal support for the sole purpose test in its current form within the superannuation industry, and that there would not be support for any attempts to require superannuation funds to invest in any particular asset classes.⁸⁰

4.79 CSB noted that the sole purpose test, which is designed to protect the interests of fund members, has not prevented superannuation funds from investing in new or speculative financial products in the past:

Mr Quarmby: I think the whole notion of the 'sole purpose' test is somewhat of a shield for the superannuation funds. It is a sacred cow, but what it has not done is truly protect the members of super funds. We have seen huge volatility over the last 15 years where super funds were investing in highly speculative ventures, and when the market goes down we see people losing 10 or 15 per cent of the value of their superannuation funds, and it takes some years to come back. If we are able to manufacture a product that is a capital guaranteed product then I truly believe that that can satisfy the 'sole purpose' test.⁸¹

4.80 Within the sole purpose test framework there is still scope for superannuation funds to invest in social investment classes in the right circumstances, for instance when social projects can produce a return that is comparable to commercial rates of return. JBWere discussed this matter with the committee:

CHAIR: ...To what extent does the sole purpose test that applies to trustees impact on trustees' decision-making powers? Are they constrained from marketing themselves as a superannuation fund that invests in socially beneficial investments? Are they constrained by taking a cut in the

80 Mr Gordon Noble, *Committee Hansard*, 26 September 2011, p. 16.

81 Mr Peter Quarmby, Community Sector Banking, *Committee Hansard*, 23 September 2011, p. 57.

commercial return which they would accept in return for a social return by the sole purpose test and other regulations that apply to them?

Mr Thorn: Again it depends a little bit on which investment we are talking about in the sense that if you are supplying capital at a commercial rate of return that is commensurate with a return you get from the sole purpose test then that is fine but if it is not it does become an issue. It just depends where you sit along the spectrum of what the investment you are looking at is. If you can get the same commercial return with an ethical screen arguably there is not an issue. If all of a sudden the discount is such that it is taking you out of the realm of that sole purpose test, that is an issue you need to consider.⁸²

4.81 Foresters told the committee that it had operated a superannuation fund which made investments that were of a social nature, without breaching the sole purpose test:

Ms Drew: ... We previously operated a superannuation fund and we made investments through that fund which were of a social nature. The regulator, APRA, said very clearly to us at the time that if we wanted change in the space we ought not talk to them, that they are just the regulator, that we ought to talk to the politicians. That comment stuck with me over a number of years.

CHAIR: Did APRA have a view at the time on those investments?

Ms Drew: Yes, a very clear view that as long as the investments were considered with financial returns first and the best interests of the members of the funds first, and all those criteria were met, there was no impediment to making the investment, which I think is a very important point.⁸³

4.82 Mr Fitzgerald told the committee that superannuation funds can currently offer members a choice of investment options with various projected rates of return, with the onus falling on the member to decide what risk profile is appropriate for them:

One of the significant issues that people fail to understand is that currently members of funds are able to in fact invest in products that provide less than a commercial return through a superannuation fund. The issue here is the choices with the member, but of course the fund has to actually provide the product. So, whilst there is debate about whether or not superannuation funds should be required to invest any portion of their activities in social purpose investments, what is clear is that there should be a much greater activity on the part of superannuation funds in finding products, including in the non-profit space, and offering that to members who may choose to invest part of their superannuation funds in that product. That is an attractive way. Again, it does not in any way conflict with the fiduciary

82 Mr Christopher Thorn, Executive Director, JBWere Philanthropic Services, *Committee Hansard*, 1 August 2011, pp 16–17.

83 Ms Belinda Drew, Foresters Community Finance, *Committee Hansard*, 1 August 2011, pp 32-33.

duties of the trustees, because the decision is with the members. The members are currently able to choose a whole range of investments from very high risk to very low risk. We think that avenue is also available. With a freeing up of some of the corpus in trusts more generally, with a new product mix in superannuation funds, you start to get potential sources from a number of different areas without in any way conflicting trustees of these sorts of instruments.⁸⁴

4.83 Despite this, there is a reluctance on the part of superannuation funds to offer their members investment options with sub-commercial financial returns. The committee had the following exchange with Christian Super:

Senator STEPHENS: Just getting back to the crux of the issue: lots of submissions asked us to look at how we can facilitate superannuation funds investing in this very nascent market. Can you very succinctly tell us where you think the sole purpose test lies in terms of your fiduciary duty and the capacity you might see that super funds have to invest in this?

Mr Macready: Our sole purpose is to provide superannuation benefits, retirement benefits, to our members. We, as all super funds do, have to do that in a way that is consistent with our values. We have been very clear in nailing our colours to the mast there and saying to our members, 'We will reflect your values in the way we invest and we will not take a penalty in terms of risk adjusted returns for doing so.' It is a fairly clear position of the fund.

Senator STEPHENS: That is a challenge.

Mr Macready: Over the time I have been at Christian Super, there have been a number of times when we have had people ring up say, 'But you're a Christian fund, can't you invest at subcommercial rates?' We have members—both people who want the money and people who have given us their money—saying, 'I'd be willing to accept a lower return if you could do excellent things with it,' and we have to say, 'No. Our purpose is to provide you with the best retirement benefits.'

CHAIR: So it rests on the fiduciary duty to discover that? You have the flexibility to look at allowing your members to take a social return in addition to the economic return.

Mr Macready: Yes, that is right. We do not feel that there is a strong enough argument to be made that we could do that. We did have some discussions with APRA along those lines a few years ago, and they ultimately said, 'If you disclose everything to the members you're probably fine.' But we felt that it was not in our mandate as a superannuation fund within the regulatory framework. That being said, I think reflecting the values of our members gives us opportunities to look at things that other funds would not.⁸⁵

84 *Committee Hansard*, 26 September 2011, p. 22.

85 *Committee Hansard*, 23 September 2011, pp 4–5.

4.84 Mr Saunders of Triodos Bank told the committee that another complicating factor when considering fiduciary duties for superannuation trustees and expected returns on investments is that there is no simple definition of what is a commercial market return.⁸⁶ This lack of clarity can make it more difficult to ascertain whether or not a particular investment in a social investment product is a prudent one. This highlights the need for appropriate benchmarks and standards to be developed for social investment options (see recommendation 4.2).

Creating an appropriate risk and return profile for social impact investments

4.85 Christian Super highlighted that the primary concern for superannuation funds is not purely the rate of financial return, but the level of risk associated with an investment yielding a particular return. This 'risk-adjusted return' is generally the primary determinant of whether or not an investment deal is an attractive proposition for institutional investors.⁸⁷

4.86 Newer investment types without a well established track record are generally considered to be higher-risk, lowering their risk-adjusted return. Over time as new asset classes develop and there is less uncertainty about their performance, the risk allocation can drop. In this context, Christian Super noted that government involvement in a project can substantially lower the risk of an investment proposition, making the risk-adjusted return more attractive. Mr Peter Murphy, Chief Executive Officer of Christian Super, told the committee:

It all comes down to providing adequate risk-adjusted returns. We looked at the Foresters program, probably 12 to 18 months prior to investing in it, and we actually could not invest in it at that point because we did not believe the risk-adjusted return was significant. But with the work done by the Australian government in being a subordinated co-investor changed the risk structure of that very significantly, and made the risk-adjusted return fine for us to invest in it. As a result it is actually a good investment for us.⁸⁸

4.87 Mr Michael Traill from Social Ventures Australia noted that when establishing the Goodstart consortium, it was not allowed to state that government was an investor, which would potentially have made the proposition more attractive to other investors:

Accessing that funding is extremely challenging and, if you know where to go to find it, we believe that it is possible to access it and that it can be accelerated if you can access it in partnership with government. Very simply, the GoodStart transaction would not have happened without the \$15 million of government support...

86 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 5.

87 Christian Super, *Committee Hansard*, 23 September 2011, pp 4–5, 7–8.

88 *Committee Hansard*, 23 September 2011, p. 2.

The double jeopardy with the fundraising hat on was that I understood some of this in terms of the commercial sensitivities. I could not actually advertise to potential funders that the government would be a prospective funder of this initiative. That would have had significant consequences for the ease of raising that funding.⁸⁹

Using social investments as a portfolio diversification tool

4.88 ASFA noted that some social investment asset classes such as microfinance, which generally provide lower returns than other traditional asset classes, could still be useful to superannuation funds as a means of diversifying their portfolio:

In terms of our superannuation sector, we have some areas where impact investments are moving forward at a greater rate of knots. Globally microfinance has become an asset class. We have at least one super fund, Christian Super, investing in that. One of the reasons something like that would become an asset class that is supported and invested in globally is to understand that there is a range of factors as to why a super fund would invest. Returns and fees are not just the issue. A key thing is to understand the way a portfolio is constructed, and in particular the essential principle around building an investment portfolio is diversification. In the context of microfinance, the benefit of something like microfinance is that within a fixed interest portfolio it can actually diversify that portfolio. This is all about correlation in our language. What that means is that the performance of a microfinance investment may have a different attribute and a different profile in the way it performs than other fixed interest investments. In simple terms that might mean that when one goes down another one goes up and, therefore, overall your portfolio is strengthened. Risk and return are fundamental, but it is important to understand that diversification is a way that superannuation funds invest.⁹⁰

4.89 The value of investments in the NFP sector for diversification purposes was also highlighted by Christian Super in its evidence to the committee:

The not-for-profit sector has a number of attractive characteristics when looked at from a diversification perspective. We have a lot of assets exposed to global market conditions, which are linked to the global economy, the Australian economy and investor sentiment around the world. The not-for-profit sector in Australia is countercyclical to a lot of those in that when the economy is performing poorly the not-for-profit sector is more needed and its role is more significant. What we are looking for as investors are opportunities to invest in ways that are uncorrelated so that we have diversified returns. The not-for-profit sector has some excellent characteristics in providing exposure to assets that will continue to perform well even when our equities and our global investments are performing

89 Mr Michael Traill, Social Ventures Australia, *Committee Hansard*, 1 August 2011, pp 19, 21.

90 Mr Gordon Noble, ASFA, *Committee Hansard*, 26 September 2011, pp 14–15.

poorly. That makes the sector attractive, but the returns still have to be there.⁹¹

Transaction costs and deal size necessary for institutional investors

4.90 Institutional investors such as superannuation funds manage sizable investment portfolios and undertake significant due diligence and research work on potential new investment options, particularly when considering new or emerging asset classes. Hepburn Wind Park noted that for an institutional investor it takes as much effort to analyse a \$25 million deal as it does a \$250 million deal, thereby lowering the transaction profitability for large investment funds on smaller deals. In Hepburn Wind's case, their \$13.5 million project was considered too small for institutional investors such as superannuation funds.⁹²

4.91 Mr Andrew Tyndale of Grace Mutual noted that some large superannuation funds will not look at an investment of less than \$50 million, and in many cases cannot take more than a five or ten per cent stake in the total value of a fund; consequently, a minimum total fund size of \$500 million may be required before being able to attract investment from large superannuation funds. Mr Tyndale argued that this lack of sufficient deal size was one of the reasons the National Rental Affordability Scheme had largely failed to attract investment from institutional investors such as superannuation funds.⁹³

4.92 Mr David Waldren from Grocon, the property developer responsible for construction of a Common Ground housing facility in Melbourne (see paragraph 4.99), noted the difficulties of scale for large commercial developers when trying to offer assistance to the social sector:

...not just Grocon, but other[s] of our colleagues in the sector would find a very small project to be \$50 million to \$100 million. In the sector we are coming to try and assist, \$50 million to \$100 million is a very big project, and prior to perhaps the last stimulus package they were perhaps few and far between. So, there was a nexus there about how we could get involved.

The opportunity was identified for the common ground project in Elizabeth Street, which in round numbers was a \$50 million project. The problem with it being any smaller than that, and even at that scale, is that we cannot be efficient in that space. We are just too big to be efficient in that space, but we do have access to equity and we do have access to debt that we can bring to the table, so we were keen to see how we could assist.⁹⁴

91 Mr Timothy Macready, Chief Investment Officer, Christian Super, *Committee Hansard*, 23 September 2011, p. 2.

92 Hepburn Community Wind Park Co-operative Limited, *Submission 20*, pp 4–5.

93 Mr Andrew Tyndale, Director, Grace Mutual, *Committee Hansard*, 9 September 2011, p. 61.

94 Mr David Waldren, General Manager, Carlton Brewery Redevelopment, Grocon, *Committee Hansard*, 9 September 2011, p. 67.

4.93 Christian Super's \$6 million investment in Foresters shows that smaller deals in the social economy sector can be appropriate for smaller superannuation funds, particularly those like Christian Super with an ethical investment mandate. Christian Super noted that investing in a social investment managed fund administered by an intermediary such as Foresters can be a good way for a super fund to obtain exposure to the social economy sector without the risks associated with investing directly in a social enterprise.⁹⁵ These social investment funds (discussed further in chapter 5) can also provide a larger scale for investment than directly investing in a single organisation or project.

Committee view

4.94 The committee considers that there is definite potential for the superannuation industry to become more involved in investing in the social economy, and notes the commendable work of Christian Super in being an industry leader in this investment area. The committee believes that superannuation funds should be encouraged to offer members social investment options as part of their overall portfolio composition.

4.95 The committee notes that consultation between the superannuation and social economy sectors will be the critical factor that determines how the superannuation industry engages with the emerging possibilities of social investment. As such, the committee considers that the proposed Social Finance Taskforce should include a representative from the superannuation industry, so as to lead dialogue on how superannuation funds can engage with this emerging sector.

Recommendation 4.4

4.96 The committee recommends that the proposed Social Finance Taskforce consider the potential for superannuation funds and other institutional investors to invest in emerging social impact investment products, with particular regard to ascertaining:

- **what clarification, if any, is necessary regarding the fiduciary duties of superannuation funds and their ability to engage with social impact investment opportunities;**
- **how social impact investment classes can be used as a portfolio diversification tool by superannuation funds;**
- **whether incentives may be required in order to attract institutional investment to the sector;**
- **how social investment funds can be developed to attract institutional investment; and**
- **what possible mechanisms are available to lower the transaction costs for institutional investors seeking to engage with social investment opportunities.**

95 Christian Super, *Submission 12*, pp 3–4.

Corporate sector investment in the social economy

4.97 The committee has heard that the private sector has a role in creating social value and addressing social issues. The departments' submission suggested there is an emerging awareness that corporate social responsibility (CSR) activities are not periphery to a company's interests, but are in fact in the best interests of shareholders and fundamental to profit creation and sustainability.⁹⁶ Mr Andrew MacLeod from the Committee for Melbourne told the committee:

...we are very optimistic about the future as we see a growing professionalisation and growing strength of corporate social responsibility and social investment programs worldwide, and in fact Australia is the home of many of the globe's leading companies...The combined corporate social responsibility spend of the private sector worldwide is estimated to be \$59 billion a year and growing. That is four times the budget of the entire United Nations system.⁹⁷

4.98 Mr MacLeod contended that the effectiveness and efficiency of the private sector's involvement in administering social programs is often greater than that of publicly administered programs. He cited the example of a BHP Billiton anti-malaria campaign in Mozambique which has reduced adult malaria infection rates from 82 per cent of the local population to eight per cent.⁹⁸ Mr MacLeod also noted the potential for partnerships to be established between the corporate sector, social sector organisations and government to create powerful solutions to social problems.⁹⁹

4.99 The committee heard of several such collaborative partnerships in Australia. One prominent example is a collaborative venture in Melbourne between homelessness service provider Home Ground Services, the Victorian government and property developer Grocon, which jointly oversaw the construction of a \$50 million facility to provide permanent accommodation for chronically homeless individuals in Melbourne. Grocon donated up to \$10 million worth of savings for the project by providing their services at cost, making it far easier for the project to be completed.¹⁰⁰

4.100 Mr Gordon Noble from ASFA noted that the contributions from corporations to philanthropic funds could potentially drive innovative work around social investment:

96 DEEWR and PM&C, *Submission 9*, p. 7 and Appendix 1 p. v. Chapter 7 explores how companies can report on CSR activities through initiatives such as 'integrated reporting'.

97 Mr Andrew MacLeod, Chief Executive Officer, Committee for Melbourne and Chairman, United National Principles for Social Investment, *Committee Hansard*, 9 September 2011, p. 20.

98 Mr Andrew MacLeod, *Committee Hansard*, 9 September 2011, pp 20, 23.

99 Mr Andrew MacLeod, *Committee Hansard*, 9 September 2011, p. 20.

100 Mr Stephen Nash, Chief Executive Officer, Home Ground Services, *Committee Hansard*, 9 September 2011, pp 66–67.

A lot of the companies that we invest in will contribute one per cent of their pre-tax profits into a philanthropic fund. A good example of that would be BHP Billiton. That is approximately \$200 million each year that they make a contribution on. That is an area of capital where I would encourage engagement with the corporate sector, that is, the money it puts into the philanthropic community. That area of fund[ing] may be able to do a lot of the developmental work around some of these innovative ideas that come forward.¹⁰¹

4.101 The PC report estimated that corporate philanthropy contributed around \$3.3 billion to Australia's NFP bodies in 2003–04.¹⁰² The departments' submission noted that corporate philanthropy and community investment is increasingly becoming more strategic and aligned with core business activities. This is reflected in an increase in the level of board and CEO involvement in setting a company's community investment activities.¹⁰³ In this context, it is important that company directors and management are aware of opportunities to invest in the social economy.

Committee view

4.102 The committee believes that the corporate sector has a crucial role to play in investing in the social economy, and has the potential to provide capital to the sector through corporate philanthropy and community investment. For the corporate sector's contribution to the social economy to be fully realised, company directors and senior managers must become more aware of opportunities to engage with the social economy sector and new social investment initiatives.

4.103 Increased awareness of these issues in the corporate sector should be promoted through training and educational opportunities about social impact investment and how to engage with social economy organisations, directed at executive level staff. Some training of this kind is available through universities and other training organisations (see chapter 5), and the committee believes that additional training courses could be offered by organisations such as the Australian Institute of Company Directors. The Office for the Not-for-Profit Sector should play a role in publicising the training and educational opportunities available in this area through its website.

Recommendation 4.5

4.104 The committee recommends that professional organisations such as the Australian Institute of Company Directors and investment advisory services develop materials and professional development workshops to inform the corporate sector of investment opportunities in the social economy.

101 Mr Gordon Noble, Director of Government Relations and Strategy, ASFA, *Committee Hansard*, 26 September 2011, p. 19.

102 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 352.

103 DEEWR and PM&C, *Submission 9*, pp ix–x.

Retail and community investors

4.105 The committee has heard that individual investors (often referred to as 'retail' investors) can contribute significantly to capital-raising for social ventures, particularly when the initiatives are based in a local community. SENTECH noted in its submission to the inquiry that community investment offers an alternative approach to social investment, looking to generate capital from individuals rather than from corporate or institutional investors.¹⁰⁴

4.106 The potential for community investment is underdeveloped in Australia, although there are several notable examples. Hepburn Community Wind Park Cooperative, based in Daylesford approximately 100 kilometres north west of Melbourne, have pioneered a model for community-owned wind power generation in Australia. A significant portion of the \$13.5 million of capital required for the project was raised by the cooperative's 1900 members, over half of whom live in the local area of the project.¹⁰⁵

4.107 Mt Buffalo Community Enterprise is another Victorian community investment initiative attempting to raise finance to restore and operate a 100 year old heritage chalet in one of Victoria's National Parks. This initiative is aiming to raise equity capital by finding five to ten thousand 'social investors' who are willing to invest \$1000 to \$10 000 each in the project:

Our proposal is based on the assumption that there exists a cohort of 'social investors' who will willingly invest a small component of their total discretionary investment funds in a project that they adjudge as delivering a form of 'social or community good'.¹⁰⁶

4.108 SENTECH argued in its submission to the inquiry that the role community investment can play in the social economy should not be overlooked, and that community enterprises and investment opportunities confer the additional benefits of increasing community engagement and strengthening ties within local communities.¹⁰⁷ This is discussed further in chapter 8, under 'member owned businesses'.

Social economy organisations reinvesting in the sector

4.109 The committee has heard that there is potential for social economy organisations themselves to reinvest in other social organisations and social impact investment opportunities. Mission Australia told the committee it is investigating opportunities to invest capital into an innovative social impact investment product.¹⁰⁸

104 SENTECH, *Submission 18*, p. 2.

105 Hepburn Community Wind Park Co-operative, *Submission 20*, p. 1.

106 Mt Buffalo Community Enterprise, *Submission 24*, p. 7.

107 SENTECH, *Submission 18*, p. 2.

108 Mr Toby Hall, Mission Australia, *Committee Hansard*, 23 September 2011, p. 54.

CSI noted that there is potential for churches to engage in emerging social impact investment opportunities, particularly those that involve service provision from the churches' own service agencies.¹⁰⁹

Government as a social investor

4.110 In Australia, state governments and the commonwealth have traditionally funded the social sector through the provision of grant funding for the delivery of social services, as well as providing occasional grants for capital growth. Several submitters have highlighted a trend towards government 'outsourcing' the provision of social services to non-government organisations.¹¹⁰ The Community Council for Australia suggested that the government could take a different role by focusing on policy outcomes in the social economy sector and promoting innovation within the sector:

The role of government can be enhanced by taking a much stronger policy outcome approach that enables NFPs and their communities to develop and innovate around finances, funding and service provision to better meet their own needs as well as the goals of government.

Government can also take a lead in piloting new ways of funding the NFP sector and underwriting some investment approaches.¹¹¹

4.111 DEEWR and PM&C noted the potential roles of government as an investor in the social economy:

Governments can also provide incentives for collaboration and investment around particular policy priorities such as health or education. In appropriate cases, governments can 'go first', providing the drive for social innovation and catalysing action to encourage others into the market and build investor confidence.¹¹²

4.112 Mr Glen Saunders noted that overseas there have been examples of government expediting lending in certain areas through tax incentives. He cited the Green Funds Scheme for environmentally-friendly investment projects in the Netherlands, which was time limited and attracted significant funds from financial institutions to sustainability projects.¹¹³ In catalysing an emerging market for social impact investment opportunities, Triodos Bank cautioned that the provision of funding over a significant time period has the potential to distort the development of the market:

109 Mr Les Hems, Centre for Social Impact, *Committee Hansard*, 1 August 2011, p. 42.

110 Community Council for Australia, *Submission 15*, pp 3–4; Fundraising Institute Australia, *Submission 23*, pp 4–5.

111 *Submission 15*, p. 4.

112 DEEWR and PM&C, *Submission 9*, p. 35.

113 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 3.

If the Australian government is interested in promoting this area, we would suggest two things. Firstly, that you do not get directly involved, and so you do not start providing lots of funds other than possibly seed funds, because if you provide funds you will provide them in a way that will distort the market. The point is to develop a social investment market. So, somebody coming in without the same capital constraints that everybody else has tends to distort the development of that and holds it back in the end. We have seen that elsewhere, particularly in the UK, and we do not think that is helpful for the long-term development... Our experience has been that where governments get directly involved, other than in some limited seed funding—which I think you have done—becomes dysfunctional very quickly.¹¹⁴

4.113 Mr Fitzgerald noted that government providing incentives or 'top-up' payments may be desirable in some circumstances where it is more cost effective to top up the initiatives of a third party than to bear the whole cost of an initiative, stating that there may be a number of instances where, unless government is willing to contribute, the initiative will not be undertaken by any other source.¹¹⁵

Balancing supply and demand

4.114 While this chapter has discussed the organisations with the potential to supply capital to the social economy sector, there is a need to balance the supply of capital with the quality of the organisations and products requesting it. Glen Saunders from Triodos Bank noted that simply supplying more capital to the sector is counterproductive:

You want the amount of funds available to develop in parallel with the project that can take up those funds. If you get an imbalance on either side, that really creates problems. So, you do not want a huge surge of funds to be available because then there is pressure to invest in substandard projects. That is not very good. Nor do you want suddenly to see a huge surge in projects looking for funds where funds are not available... in the Australian context it should develop not too quickly and not with a sudden surge of funds, because you have to find credible projects in which to invest.¹¹⁶

4.115 This need to balance the supply of credible and sustainable investment projects from the social economy sector with the right kinds of finance at the appropriate time necessitates the involvement of strong intermediaries in the sector, which is the subject of chapter 5.

114 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, pp 6–7.

115 *Committee Hansard*, 26 September 2011, p. 26.

116 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 4.

Conclusion

4.116 The committee considers that attracting new sources of investment capital and strengthening existing capital sources are critical to the long term development of the social economy sector. The supply of capital to social economy organisations in Australia can be strengthened through encouraging greater involvement from mainstream financial institutions, institutional investors and philanthropic bodies. The corporate sector and community investors also provide valuable sources of capital for the sector.

4.117 The committee's recommendations in this chapter reflect that there are some actions that can be taken, particularly relating to the ability of philanthropic trustees to make social investments. Additionally, the proposed Social Finance Taskforce should continue to investigate options for increasing the supply of capital to the social economy.