Chris O’Brien Lifehouse at RPA (Lifehouse) – Submission to Senate Economics Committee Enquiry, Finance for the Not for Profit Sector

Background

- This submission is based upon a paper already presented to the Assistant Treasurer’s office in March 2016 and is focused on Lifehouse’s experience in selling one of Australia’s initial “Social Bond” products and what can be done to create a legitimate market for *Social Bonds* in Australia.
- In 2010 the GoodStart consortium successfully raised $22.5 million social bond raising to fund the acquisition of the *ABC Learning Centres.* Lifehouse recently sought commitments from investors to participate in social bonds to assist in funding of the new Cancer Centre we are developing primarily from Federal Government funds in Camperdown, Sydney (opening autumn 2013). The Bond issue was undertaken owing to tight restrictions surrounding the security we could provide under normal bank debt facilities and the lease arrangements with respect to the land the building occupies.
- The original GoodStart bond offered a 12 per cent coupon to investors over eight years and was effectively a mezzanine debt instrument. The Lifehouse issue is closer to corporate bonds and therefore offers a lower coupon. Our experience is that while there is significant interest in both social bonds and our project that the market is in its early stage of development and if we are required to rely on philanthropist funding alone – it is unlikely the social bond market will develop in any meaningful way. This will leave the Government as the major funder of the nation’s social infrastructure projects.

Feedback on current social bond issues

- **Initial research** conducted by both Lifehouse was positive. We spoke with a number of Private Banks, Financial Planning Groups, PAFs and High Net Worth individuals who all thought social bonds were a good concept.
- **Market Reaction**: However, converting initial interest into funding commitments has proved challenging. Philanthropic investors did not see the bond as a way of increasing their existing commitments. As an example, major donors to Lifehouse in the past (>$100,000) who indicated they may support the issue preferred to continue making donations and to maximise their investments through traditional avenues. At the same time return focused investors struggled to value the social return and therefore worried the overall return was too low. However, without a new group of investors we are concerned social bonds will not be viable.
- **Retail Investors** – For many charities retail investors might provide a useful source of funds for a social bond raising. However, based on our experience meaningful commitment by retail investors and their adviser will require the development of a research product. That is the advisers require a Research Report / Credit rating on a product before it can be placed on the Approved Product Lists for their various planning groups. Our discussions with potential rating agencies suggest that until a recognized “Social Infrastructure” market develops further they are hesitant to commit resources to the sector.
- **PAFs** – with over $1.5B in over 500 PAFs in Australia we thought this would be the perfect investment for this group, as they have to allocate 5% a year to maintain their ATO status. While Lifehouse has managed to attract some PAF investors (including some with no particular mandate for medical research and two

which elected to donate the interest back), the general reception has been disappointing considering this was one of the initial reasons the PAF legislation was introduced.

- **Fund managers** – currently similar attitude to PAF Investment Committees, their focus is on cash/ capital return, i.e they place no value on social return – which leads to the next point.
- **Need for "Independent Valuation" on social return –** this is currently being considered in the US and UK following reports undertaken by Government committees. This would be similar to the carbon credit market and enable investors to have an extra tangible asset over and above the principal investment. By having an independent body measuring the social value it would ensure the general public also recognise the objective value attached to the social project.

Social Bonds and Portfolio Construction

The social bond market is a mature well recognised market in the USA, it was established in 1994 and has over $15 billion invested today in numerous hospitals and other critical social infrastructure throughout the USA. This growth has been assisted by the generous tax incentives for investors (who receive a tax credit from income paid by a qualifying entity). It is this market we need to also develop in Australia in order to gain support from the investment community.

- Investment in Social Impact Bonds follows the same process as for all investment, starting with the asset allocation, which are typically in the following areas:
    - Fixed Income (where Social Bonds would be)
    - Property
    - Equities
    - Alternatives/ Other (Venture capital, Private Equity, etc)
- Fixed Income – also have Corporate, Government and Semi Government Bonds plus Bank Bills
- Investors allocation will depend on their risk profile (age, retirement status, etc)
- Social Bonds have many of the same features as conventional bonds – including:
    - Stable income is required
    - Low level of volatility (for risk adverse investors)
    - Interest is generally paid throughout the life of the Bond, principal being redeemed at maturity
    - Bonds typically pay a coupon (yield) which can be fixed, floating or step-up
- Social Bonds also have the following added benefits to corporate bonds
    - Funds borrowed are used for a social benefit
    - Allows investors to align their investments and philanthropic activities
    - Investors have an option to donate interest and or principal to issuer
    - For some bonds invested in services that are proven to make a difference – the return improves (i.e Social Impact bonds) – as seen in the UK and USA
- There can be more risks investing in Social Bonds – including:
    - Social Bonds are less liquid than typical bonds (i.e no secondary market)
    - Interest paid can often be less than Corporate Bonds (hence proposal below for franking)
    - Charities do not have credit ratings which are often required for a Bond issue.

The Chris O'Brien Lifehouse at RPA

Conclusions

- From the extensive market feedback (over 500 potential investors spoken to) we have received in our efforts to market social bonds, it is clear that in the absence of a catalyst, this will remain a small underdeveloped market. In this scenario, the social bond market will be unable to provide meaningful capital to the construction of social infrastructure. In our opinion, Government support is required to stimulate the market and facilitate the creation of a new asset category for "Social Infrastructure". This could be achieved in a number of ways, with the two most obvious being:
  - **Government Guarantee** – The Federal Government could provide a guarantee of repayment for qualifying social bonds. Unlike financial institutions charitable organisations would be unable to pay for this guarantee however, once potential investors could be completely confident of the return of their principal, then we would expect that significant additional demand would be uncovered.
  - **Yield needs to be Higher** - We expect that the Government would be hesitant to guarantee the credit of a large number of charitable organizations. Accordingly, we believe that a top up of coupon or beneficial tax treatment might be the answer. The advantage with this structure – is that a small top up of coupon – either in cash or via tax credit – could lead to a large increase in social investment. One possible way to do this is via franking credits which have the benefit of being tax neutral across different tax rates (PAF, super fund, corporate, individual)

Offering Franking Credit (50%) on Interest Paid (see example attached)

- This will benefit all types of investors including:
  - those who pay **nil** tax such as Retirees using their Self managed super fund and PAFs. After tax return *improves from 6% to 9%.*
  - SMSF in pre-retirement (15% tax rate) – *after tax return from 5.1% to 7.7%*
  - Corporates (30% tax rate) – *after tax return from 4.2% to 6.3%*
  - Individuals on High Marginal Tax rate (46.5%) - *after tax return 3.2 to 4.8%*
- We consider this will attract investors for the 'right reasons' as opposed to the old film funds and Infrastructure Bonds – which were only useful for Individuals on a high tax rate who just wanted their tax refund.
- The advantage of using the franking credit is that it is an established form of tax relief and will be seen to have the ATO stamp of approval.
- Should be limited to bond issues by Charities which are Public Benevolent Institutions registered as a DGR (Deductible Gift Recipient) and only for infrastructure that results in buildings and equipment being built – not for operations.
- If the Superannuation Levy increases to 10% - this would be the perfect opportunity to encourage all funds to invest this extra 1% in the new "Social Infrastructure" category.
- See attached financial summary to Government

Relevant DGR (Deductible Gift Recipient) who may apply: Those organizations that own or operate social infrastructure – including hospitals, aged care, services for disabled, homeless, etc. We believe there would be up to 50 in Australia that may be interested (including Church groups and others). The facility or entity needs to generate sufficient income to pay the 6% interest rate on any issued bonds.

Also refer to the **Productivity Commission** reports on *Aged Care* and *disability insurance scheme* and the projected demand for facilities in Australia in these two areas alone.

Impact of Offering Franking Credit to Commonwealth

- **Most logical investors are SMSF** –
  - Assume 1% of SMSF funds ($400b) were invested in them = **$4Billion**
  - Of this 1/3 will be in retiree accounts and 2/3 in non retiree (ie pay 15% tax on interest)
  - Total Interest Paid on Above @ 6% = $240m
  - Current tax paid on non retiree portion = $24m
  - Franking Credit Applies – tax refunded = $96m
  - **Potential Opportunity Cost to Govt = $120m**

- **Potential PAF Impact** - currently $1.5b invested in PAFS – assume 5% invested in Social Bonds
  - Total invested = $75m @ 6% = $4.5m interest
  - Franking credit refund = $2.25m

Summary –

- Almost $4.1 Billion would become available for Social Infrastructure
- Large multiplier impact on the economy from such projects and on-going employment
- Opportunity Cost to Govt in offering franking credit on interest = $122m p.a for 5 yrs

Lifehouse are also available to attend the public hearing if required, as we feel we have a real case study we can all learn from and think this is a critical initiative by the Government for Australia's future.

See Attached Impact on Investors by offering a "Franking Credit" on interest paid

Social Bonds - Improved return using Franking Credits

FV	100
Coupon rate	6%
Coupon payment	6
Franking credit (50%)	3.00

Investor Type	A	B	C	D
	Retirees Super Funds PAFs	Super Funds - pre retirement	Corporates	Individual on Top Marginal Rate & Medicare

With Franking Credits

	A	B	C	D
Individual tax rate	**0.0%**	**15.0%**	**30.0%**	**46.5%**
Coupon received	6.0	6.0	6.0	6.0
Franking credit	3.0	3.0	3.0	3.0
Grossed up income	9.0	9.0	9.0	9.0
Tax assessed	0.0	1.4	2.7	4.2
Less: Imputation tax offset	(3.0)	(3.0)	(3.0)	(3.0)
Tax payable / (refund)	(3.0)	(1.7)	(0.3)	1.2
Net income after tax (cash coupon - cash tax)	**9.0**	**7.7**	**6.3**	**4.8**

Without Franking Credit

	A	B	C	D
Individual tax rate + medicare levy	**0.0%**	**15.0%**	**30.0%**	**46.5%**
Assessable income	6.0	6.0	6.0	6.0
Tax payable	0.0	0.9	1.8	2.8
Net income after tax	**6.0**	**5.1**	**4.2**	**3.2**