

Part III: Emerging investment vehicles and innovation

Encouraging innovation and diversifying finance options for social economy organisations have been key themes in the evidence presented to the committee. Part III of the report explores these issues.

Chapter 6 explores the emerging field of social impact investment (which delivers both financial and social returns for investors) and its potential to increase the capital available to the social economy sector. This market is steadily taking shape globally and is in early stages of development in Australia. The committee heard that social impact investment could become a distinct asset class as a track record of successful investment deals is developed.

Some options to encourage emerging social impact investment products are also discussed, including incentivising the social bond market. The potential benefits and challenges of social impact bonds (SIBs) are also outlined. SIBs are used to finance preventative social schemes and reward investors with a financial dividend when the project they have invested in achieves a specified social outcome. It was emphasised that SIBs can only be applied to policy areas that have measureable outcomes.

Chapter 7 discusses the critical need to develop a measurement framework to support these emerging investment vehicles, establish track records and offer potential investors an assessment of the risks and returns related to different investments. The chapter also discusses the global trends to move beyond economic indicators to more holistic measures that include social and environmental progress. The chapter notes some of the international social measurement techniques that have emerged to support these developments.

Chapter 8 discusses the specific needs and challenges relating to social enterprises in Australia, and mechanisms for strengthening the diversity in social business models. The social enterprise sector has the capability to foster a great deal of social innovation if financed accordingly. Methods of directing funding and developing capacity to build sustainable social enterprise are discussed. Possible legal structures that facilitate the divergence of the social and commercial sectors are also noted. The benefits of the government's recent Social Enterprise Development Investment Funds (SEDIF) are discussed, and options to strengthen social procurement are offered.

Chapter 6

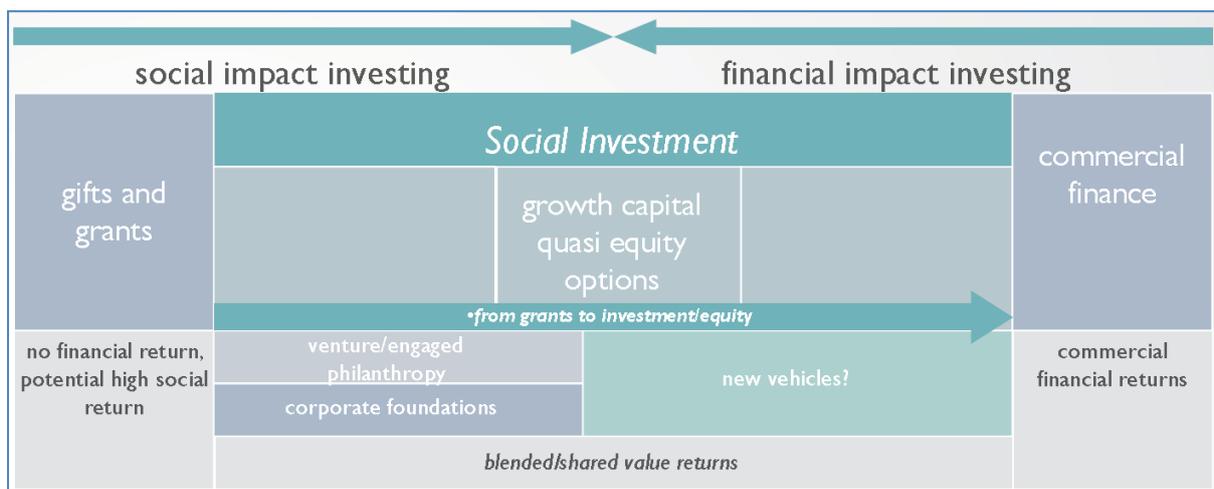
Emerging social investment options

6.1 A prominent theme during this inquiry has been the potential for Australia to develop new and innovative financing models to unlock capital for social good. This chapter examines the global context of social impact investment and investors' responses to it in Australia. Some specific emerging social impact investment products highlighted by submitters to this inquiry are also discussed, namely social bonds and social impact bonds (SIBs).¹

Social impact investment

6.2 It has been noted by several submitters that the potential range of financing options available to social economy organisations lie along a spectrum, with gifts and grant money at one end, commercial lending and investment at the other, and emerging options in between, combining some mixture of financial returns with a level of social impact.² This is summarised in Diagram 6.1.

Diagram 6.1: Spectrum of potential financing options for the social economy



Centre for Social Impact, PowerPoint presentation tabled at a public hearing, 1 August 2011.

6.3 The emerging options in the middle of this spectrum are referred to as 'social impact investment' options. Chapter 1 noted a growing global trend towards the

1 YMCA, *Submission 1*; Chris O'Brien Lifehouse at RPA, *Submission 8*, pp 4–5; Social Finance Ltd, *Submission 16*; The Archerfish Foundation, *Submission 17*; JBWere, *Submission 19*, pp 15–16; Benevolent Society, *Submission 25*; The Centre for Social Impact; *Submission 27*, pp 11–12.

2 Social Ventures Australia, *Submission 2*, p. 2; DEEWR and PM&C, *Submission 9*, pp 16–17; Centre for Social Impact, PowerPoint Presentation tabled at a public hearing, 1 August 2011.

convergence of the business and social economy sectors through this emerging field of social impact investment—the use of investment and financing mechanisms which deliver some measure of both financial and social returns. Social impact investment has the potential to greatly increase the pool of capital available to social economy organisations. This form of capital can often be invested, recovered (often with additional returns) and then reinvested, generating significant long term social impact.³

6.4 The terminology used to describe this emerging field is not uniform, with the terms 'impact investment', 'social investment', 'social finance' and 'social impact investment' often used interchangeably.⁴ Mr Christopher Thorn of Philanthropy Australia provided the following explanation of impact investment to the committee:

When I think of impact investment, it is really any investment that is creating social impact. Whether that is more at the financial end, where more of the return is financial with some social impact, or more at the impact end, which is more social impact and less financial, you will have a spectrum. So, part of the challenge is creating the vehicle, or the instrument, that is actually going to respond or attract the finance to where you are trying to make a difference. Part of the challenge around the structure that you are using is that the reason we are moving from philanthropy and government funding into commercial markets is trying to access capital that is not available. Going to your point earlier, there are unlimited grant recipients. What we are trying to do is open up sources of capital that are not otherwise available.⁵

6.5 The Global Impact Investing Network (GIIN), an international network of impact investors, was created in 2007 with the aim of developing the impact investment industry worldwide. GIIN states the aim of impact investment is 'to solve social or environmental challenges while generating financial profit' and it offers a range of investment options 'from producing a return of principal capital to offering market-rate or even market-beating financial returns'.⁶

6.6 Social impact investment can take a variety of forms, from the traditional through to more innovative financial mechanisms. As JP Morgan stated:

Impact investments take many forms, including structures that are common in traditional financial markets. Equity and debt, guarantees and deposits are all examples of commonly used investment structures. Some more innovative investment structures have also been devised, including bonds that employ equitylike features that allow the investor to benefit from

3 Department of Education, Employment and Workplace Relations (DEEWR) and Department of the Prime Minister and Cabinet (PM&C), *Submission 9*, p. 21.

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

5 *Committee Hansard*, 9 September 2011, p. 46.

6 Global Impact Investing Network, *What is Impact Investing?*, <http://www.thegiin.org/cgi-bin/iowa/investing/index.html> (accessed 1 September 2011).

financial profits or even, in the case of the UK's Social Impact Bonds, from successful social impact. The existence of such innovative structures allows investors with different (social and/or financial) return and risk appetites to invest via the vehicles that best align with their goals.⁷

6.7 A seminal report on the emergence of impact investment published by the Monitor Institute in 2009 noted that this emerging field has the potential to alter the global investment landscape:

There are moments in history when the needs of an age prompt lasting, positive innovation in finance—from ideas as big as the invention of money, to the creation of new institutions such as banks and insurance firms, to the development of new products and services such as mortgages, pensions, and mutual funds. Evidence suggests that many thousands of people and institutions around the globe believe our era needs a new type of investing. They are already experimenting with it, and many of them continue even in the midst of a financial and credit crisis.⁸

6.8 The Department of Education, Employment and Workplace Relations (DEEWR) and the Department of Prime Minister and Cabinet (PM&C) noted in their joint submission (the departments' submission) that:

A new social impact investment market is steadily taking shape globally and is emerging in Australia. It brings new financing methods with potential to leverage significant new resources and new participants toward addressing social and environmental concerns in more effective, efficient and sustainable ways.⁹

6.9 Social impact investment includes a broad range of financial investment vehicles operating in a broad range of geographical and sectoral areas. Social impact investments are being undertaken in both developed and developing nations, in fields as diverse as agriculture, water and sanitation, housing, education, health, job creation, energy and financial services.¹⁰

6.10 GIIN notes that impact investment has similarities with 'Socially Responsible Investing' (SRI). However, there are some key differences; most SRI portfolios commit to undertake negative screening of all investments to avoid 'bad' or 'harmful' companies (e.g. companies involved in the production of tobacco, weapons or other socially harmful products). Impact investors go beyond this and actively seek to place capital in businesses and funds that demonstrate a positive social impact.¹¹

7 JP Morgan, *Impact Investments: An emerging asset class*, November 2010, p. 20.

8 Monitor Institute, *Investing for Social and Environmental Impact*, January 2009, p. 5.

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

10 JP Morgan, *Impact Investments: An emerging asset class*, November 2010, p. 8.

11 Global Impact Investing Network, *What is Impact Investing?*, <http://www.thegiin.org/cgi-bin/iowa/investing/index.html> (accessed 1 September 2011).

The size of the social impact investment market

6.11 Globally, there have been some attempts to quantify the potential scale of the social impact investment market. It has been estimated that the potential size of the impact investment market could be US\$120 billion in the United States and approximately CAD\$30 billion in Canada.¹² Globally, the Monitor Institute has estimated that the impact investing market could reach one per cent of total managed global assets funds, which equates to approximately \$500 billion.¹³

6.12 No thorough research has been conducted into the size of the potential market in Australia. The Centre for Social Impact (CSI) has noted that the potential scale of the capital market for social investment in Australia could be worth \$10 billion, with \$7 billion identified in managed funds and a further \$3 billion in superannuation funds.¹⁴ Additionally, Private Ancillary Funds, which hold more than \$2 billion of investment assets and distribute \$150 million a year to eligible social economy organisations, have the potential to support the growth of the market.¹⁵

6.13 PM&C and DEEWR noted several other reference points that could be useful to help determine the potential scale of the social impact investment market in Australia. This includes:

- \$15.41 billion held in Socially Responsible Investment managed portfolios in Australia in 2010 (representing 1.66 per cent of the total \$926.8 billion in managed investment portfolios);
- \$1.23 trillion in Australia's superannuation system as at June 2010, including many super funds with SRI portfolios; and
- Australia's NFP sector made \$8.8 billion of capital investments in 2006-07, of which 61 per cent was funded from surplus from current operations.¹⁶

Social Impact Investment – an emerging asset class

6.14 The committee heard evidence that over time social impact investments could become a distinct asset class in Australia as a track record of successful social impact investment deals is developed. Mr Michael Traill from Social Ventures Australia (SVA) told the committee:

12 DEEWR and PM&C, *Submission 9*, p. 23.

13 Monitor Institute, *Investing for Social and Environmental Impact*, January 2009, p. 9.

14 Centre for Social Impact, *Report on the NSW Government Social Impact Bond Pilot*, February 2011, p. 25.

15 Centre for Social Impact, *Submission 27*, p. 5; Australian School of Business, 'Social Impact Bonds: Can This New asset Class Create More Than a Win-Win?', 15 March 2011, <http://knowledge.asb.unsw.edu.au/article.cfm?articleid=1359> (accessed 7 October 2011).

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

I have a strong belief that there is the ability to build a new asset class... I think if we can go back in three to five years and say, 'Here is a deal where investors got a 12 per cent coupon'... you start to build credibility for an asset class that provides a reliable return in the range of eight to 12 per cent.¹⁷

6.15 Sir Ronald Cohen noted in his evidence to the committee that social venture funds operating in the UK over the last decade aimed to achieve returns of 10 to 12 per cent, and that the Bridges Venture fund, with the help of some government incentives, had achieved 20 per cent returns in that time.¹⁸

6.16 JP Morgan argued that impact investments are defined not just by underlying assets, but by how investment institutions organise themselves around it. JP Morgan asserts that an emerging asset class has the following characteristics:

- requires a unique set of investment/risk management skills;
- demands organisational structures to accommodate this skillset;
- is serviced by industry organisations, associations and education; and
- encourages the development and adoption of standardised metrics, benchmarks, and/or ratings.

6.17 These characteristics are present for asset classes such as hedge funds and emerging markets which channel significant capital flows. JP Morgan argued that impact investment demonstrates these traits and should therefore be defined as a separate asset class.¹⁹

Attracting social impact investors

6.18 The motivations for social investors are varied, with some investors primarily interested in commercial rate financial returns, and other investors, particularly some in the philanthropic sector, more concerned about social returns.²⁰ For some investors, most notably wholesale investors and superannuation trustees, returns often must be commercially comparable (see chapter 4).

6.19 Social impact investing includes a range of investment options and financial mechanisms with varying levels of financial and social returns, made by investors with varied backgrounds and motivations. The Monitor Institute categorised social impact investors into two broad groups:

17 Mr Michael Traill, Chief Executive Officer, Social Ventures Australia, *Committee Hansard*, 1 August 2011, p. 20.

18 Sir Ronald Cohen, Social Finance Ltd, *Committee Hansard*, 1 August 2011, p. 64.

19 JP Morgan, *Impact Investments: An emerging asset class*, November 2010, p. 5.

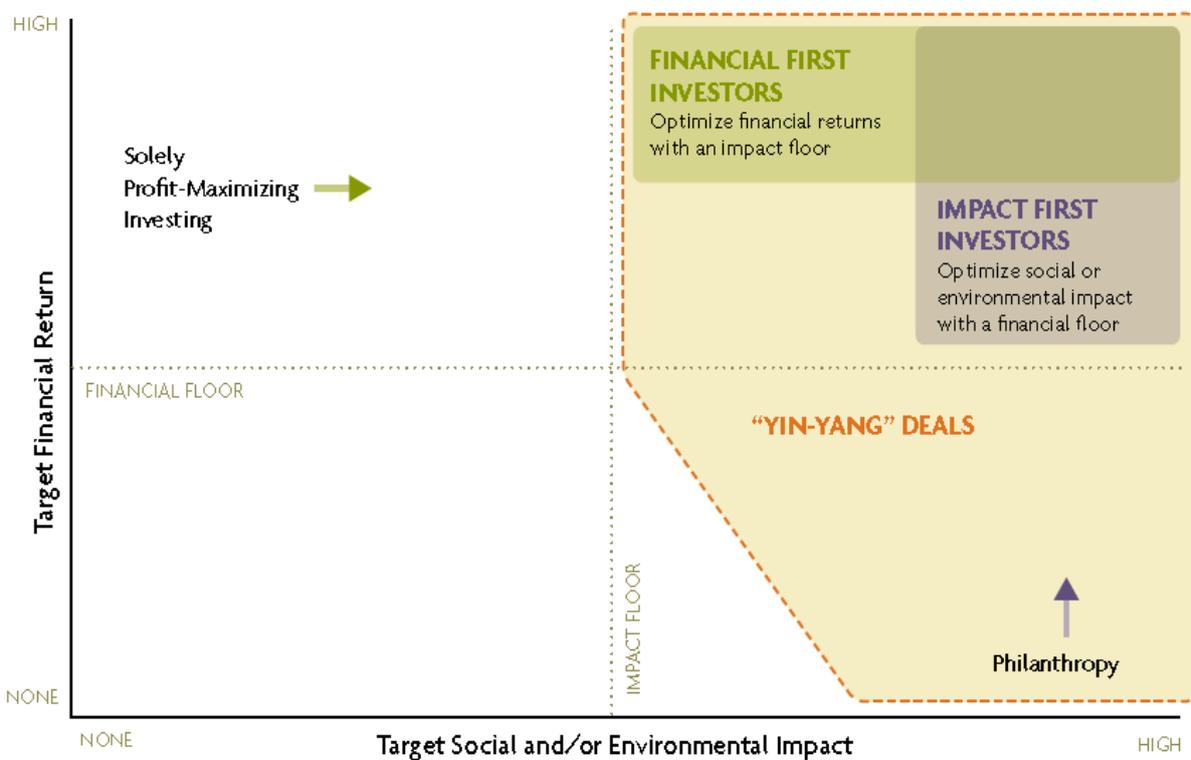
20 Monitor Institute, *Investing for Social and Environmental Impact*, January 2009, p. 31.

- impact first investors, who seek to optimise social or environmental impact with a floor for financial returns; and

financial first investors, who seek to optimise financial returns with a floor for social or environmental impact.²¹

The Monitor Institute framework on social impact investors, outlined in Diagram 6.2, noted that in some situations different investors from across the spectrum can come together to create deals with blended capital inputs from 'impact first' and 'financial first' investors, creating what they term 'yin-yang' deals.²²

Diagram 6.2: Segments of social impact investors



Monitor Institute, *Investing for Social and Environmental Impact*, January 2009, p. 33.

6.20 JBWere agreed that social impact investment could be developed across many different types of investors in the Australian market:

Impact investments should be for all investors, including superannuation funds, trusts and foundations, individual investors, managed funds, pension funds, insurance funds and common funds. If the supply of impact investment products can be built up to meet the needs of all investors then the social outcome of an impact investment market will be maximised. To do this the investments and professionalism of the market and its participants needs to hold up against traditional and existing non-impact

21 Monitor Institute, *Investing for Social and Environmental Impact*, January 2009, p. 31.

22 Monitor Institute, *Investing for Social and Environmental Impact*, January 2009, p. 32.

investments.... While it is not a replacement for philanthropy, nor the 'silver bullet' that solves every funding challenge, it does have the potential to complement and diversify the funding sources for non-profit organisations and allow supporters to further aid the community sector with capital otherwise not intended to deliver social outcomes.²³

6.21 CSI noted that there is potential for philanthropists and high-net-worth individuals (HNWIs) in Australia to become impact first investors, and that the social impact investment market is likely to be catalysed initially from philanthropic sources, with commercial financiers coming on board more gradually once a track record has been established:

The predominance of philanthropic foundations and HNWIs, as seen in the UK Peterborough precedent and GoodStart, closely reflects the experience in other sectors within impact investing such as microfinance or social enterprise. Philanthropic foundations and HNWIs have typically been the first movers to prove or mitigate the perceived risk of the asset class to enable engagement of institutional investors in due course.²⁴

6.22 Mr Michael Traill of SVA told the committee that anecdotal evidence in the UK suggests 'if you can get a single-digit to low teens rate of return you will attract capital for social purpose business driven organisations'. He argued that the same opportunity is present in Australia.²⁵

Recognising the 'blended value' of social investment opportunities

6.23 One of the major barriers to investors of all types becoming involved in the social economy is a lack of awareness (see chapter 2) and understanding about the blended value of social investment projects. According to JP Morgan, most institutional investors, philanthropic fund managers and the community at large think in terms of 'the binary choice between investing for maximum risk-adjusted returns or donating for social purpose'.²⁶ The idea of blending financial and social value is still relatively new, and needs developing in the Australian context. SVA commented:

You need to get people away from that binary decision making, on the one side, of giving donations and grants with their philanthropic hat on and then putting their money into the most high-yielding investments on the other side. Anything to bring people into that middle ground I think is helpful and both improving the tax and legal environment for investing in social finance

23 JBWere, *Submission 19*, pp 21, 29.

24 Centre for Social Impact, *Report on the NSW Government Social Impact Bond Pilot*, February 2011, p. 24.

25 Mr Michael Traill, Chief Executive Officer, Social Ventures Australia, *Committee Hansard*, 1 August 2011, p. 19.

26 JP Morgan, *Impact Investments: An emerging asset class*, November 2010, p. 5.

and having this social capital discussion that we are having I think is important.²⁷

6.24 Investors need clarity around the proposed business and social case for a particular project in order to be confident enough to put capital into such a venture. Mr Traill commented:

You need to be very clear about the mix of business and social returns. We think the core proposition in our social enterprise and GoodStart funding was the ability to access money from funders who wanted a 'reasonable' but below commercial rate of return. We think the number on that is a mix of art and science, mostly art.²⁸

6.25 JBWere noted the importance of being able to measure the social impact being generated for any reduced financial returns, and articulate the social dividend of a social investment to investors:

For this type of financing to be successfully supported, the returns to investors need to be made as commercial as possible. Furthermore, the social return needs to be measurable and identifiable so that a hybrid investor is able to assess what level of discount is appropriate for the social outcome achieved. An informed decision can then be made as to whether the return is appropriate for the term and risks being undertaken by the 'investor'.²⁹

6.26 The need for effective measurement, evaluation and reporting frameworks for social investment options is detailed in chapter 7.

Developing a track record of social investment deals

6.27 Without a significant track record of successful social investment deals, investors will be hesitant to invest in the emerging market. For example, Community Sector Banking noted that one of the reasons institutional and wholesale investors have not yet put significant capital into the National Rental Affordability Scheme (NRAS) is the uncertainty around the performance of this new investment product:

...the wholesale markets and superannuation funds are still lagging in [take] up of this asset. Part of the reason is that it is still considered a new asset class and track record as to how that asset will perform and compare to traditional residential assets will take some time.³⁰

27 Mr Ian Learmonth, Director, Social Finance, Social Ventures Australia, *Committee Hansard*, 1 August 2011, p. 23.

28 Mr Michael Traill, Chief Executive Officer, Social Ventures Australia, *Committee Hansard*, 1 August 2011, p. 19.

29 JBWere, *Submission 19*, p. 8.

30 Community Sector Banking, *Submission 10*, p. 8.

6.28 Mr Glen Saunders of Triodos Bank noted that with super funds investing in the social economy, there will likely be early adopters seeking to enter the sector, with more funds following after the market is more established.³¹

The need for incentives

6.29 Foresters argued that incentives are needed to generate interest among social investors and 'that at this point in time the market is not ready to accept the risk-return ratio of investing in this space and needs incentives to do so'.³² Using superannuation funds as an example, Foresters suggested that government provide a tax incentive or top-up for returns on social investments that are considered sub-market:

Ms Drew: ...So in the context of superannuation funds, if you are going to offer an investment which is discounted to market there could be an argument for the gap to be made up through some mechanism. Certainly in the UK the tax incentive scheme they have used has had some limited benefit in those institutional settings.

CHAIR: So looking at a mechanism where, in the event that trustees made a decision to invest for social benefit dividend in addition to the financial dividend, they could offset the financial dividend they have forgone by doing that in another way, so still meet the sole purpose test.

Ms Drew: Yes.³³

6.30 The potential role of government top-ups is discussed further below in relation to social bonds, and more broadly in chapter 9.

Committee view

6.31 The committee recognises that a lack of awareness about the 'blended value' proposition of social impact investment is a barrier to investors becoming more engaged with social impact investment opportunities. The committee believes that this awareness and acceptance of social impact investment will be achieved over time as a track record develops, however initiatives to promote social impact investment could help expedite this process.

Recommendation 6.1

6.32 The committee recommends that programs and workshops relating to social impact investment be developed by investment organisations to encourage investors to engage in social investment projects and opportunities.

31 Mr Glen Saunders, Senior Advisor to the Executive Board, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 5.

32 Ms Belinda Drew, Chief Executive Officer, Foresters Community Finance, *Committee Hansard*, 1 August 2011, p. 31.

33 Ms Belinda Drew, Chief Executive Officer, Foresters Community Finance, *Committee Hansard*, 1 August 2011, p. 33.

Social bonds

6.33 Social bonds have many of the same features as conventional bonds. Once purchased, interest is paid throughout the life of the bond and the principal is redeemed at maturity. Further, bonds typically pay a coupon, or yield, where the interest rate can be fixed, floating or 'step-up'.³⁴ Issuers of a social bond tend to heavily discount the coupons in comparison to commercial equivalents; this is justified as an appropriate social dividend.³⁵ As the interest paid is often less than that of a corporate bond, attracting investors presents a challenge for the social bond market. The uptake of social bond opportunities in Australia has thus far usually been limited to investors with a direct or personal connection with the social venture and the opportunities have struggled to raise capital from a wider group of investors.³⁶

6.34 The GoodStart Consortium was an exception to this trend, successfully raising \$22.5 million in social bonds to fund the acquisition of 659 ABC Learning Centres in 2010. The original GoodStart bond offered a 12 per cent coupon to investors over eight years and was effectively a mezzanine debt instrument.³⁷ JBWere observed that a major characteristic of the consortium was the use of different types of capital sourced from a variety of providers. It argued 'a major reason this transaction was successful was that those involved had significant understanding of the various capital markets — philanthropic, hybrid and commercial'.³⁸

6.35 In December 2010, the Benevolent Society introduced a series of social bonds to raise funds for a new model of housing, care and support for older Australians. The bond issue aims to generate \$10 million towards meeting the \$100 million cost of a retirement complex at Bondi in Sydney called Apartments for Life. The project will be built on an 11,080 square metre site owned by the Society and aims to include 40 per cent affordable housing. The bond will pay annual interest of five per cent for up to

34 A step-up bond pays an initial coupon rate for the first term and then an increased rate for the following periods.

35 JBWere, *Submission 19*, p. 14.

36 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 2; The Benevolent Society, *Submission 25*, pp 2–3; JBWere, *Submission 19*, p. 14.

37 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 1; The Benevolent Society, *Submission 25*, p. 2; Social Ventures Australia, *Committee Hansard*, 1 August 2011, p. 18. Mezzanine finance is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies or build development projects. It is usually debt capital that gives the lender the right to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full (taken from Australian Securities and Investment Commission, Money Smart website glossary, <http://www.moneysmart.gov.au/glossary/m>) (accessed 28 October 2011).

38 JBWere, *Submission 19*, pp 12–13.

eight years plus a bonus interest component linked to the cash flow performance of the project.³⁹

6.36 The Chris O'Brien Lifehouse at RPA has also utilised social bonds to generate a portion of the capital required to construct a Cancer Centre in Camperdown, Sydney (opening in autumn 2013). The project will cost \$230 million, \$160 million of which will be funded by the federal government and \$20 million by the ANZ. The initial offer for the bond closed in December 2010. The bond offered a fixed term deposit of 6-8 years of a minimum \$20,000 with an interest rate of 6 per cent paid annually. The interest will be paid from the operating surplus generated by the hospital after opening. Lifehouse was able to raise \$3 million from the initial bond offer.⁴⁰

6.37 A number of submitters, including the Productivity Commission (PC), maintain that government support is required to stimulate the social bond market.⁴¹ The Benevolent Society argue a 'functioning social bond market will relieve the public purse of bearing the full capital burden of social infrastructure projects'.⁴² Some submitters offered suggestions to incentivise the market including tax exempt income returns, government 'top-ups' on coupons and a government guarantee on bonds issued.⁴³ These issues are considered further in chapter 9.

Tax exempt income returns

6.38 JBWere and YMCA proposed amending tax legislation to enable charities to issue bonds that deliver a tax exempt coupon (or yield) from a bond to offset the lower return, and make the bond more attractive to a wider group of investors. Mr Colin Organ of the YMCA outlined how a tax exempt charity bond could leverage capital for the social economy:

The yields on these income tax effective bonds would effectively be improved through the ability to have an income tax exempt status. For instance, in the example we have given in our paper, a four per cent coupon on a bond to a taxable, tax assessed individual who pays the highest rate of tax would be able to earn a yield of 7.5 per cent. So, it does not penalise the

39 Benevolent Society, 'New social bond issue for pioneering retirement project', http://www.bensoc.org.au/search/result.cfm?item_id=E73BA3CCD765A8612BD4CDFFD1CC CAB5 (accessed 7 February 2011); Benevolent Society, *Submission 25*, p. 2.

40 Mr Brent Cubis, Chief Finance Officer, The Chris O'Brien Lifehouse at RPA, *Committee Hansard*, 23 September 2011, p. 18; The Centre for Social Impact, *Submission 27*, p. 19.

41 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 3; JBWere, *Submission 19*, pp 12–13; Benevolent Society, *Submission 25*, p. 3; Mr Robert Fitzgerald, Commissioner, Productivity Commission, *Committee Hansard*, 26 September 2011, p. 23.

42 Mr Stephen Hawkins, Executive, Social Initiatives, The Benevolent Society, *Committee Hansard*, 23 September 2011, p. 19.

43 Mr Toby Hall, Chief Executive Officer, Mission Australia, *Committee Hansard*, 23 September 2011, p. 54; YMCA, *Submission 1*, pp 3–4; JBWere, *Submission 19*, p. 14; Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 3; Benevolent Society, *Submission 25*, p. 4.

philanthropist or the investor for investing in this type of bond, but it gives the opportunity for the charity to raise funds at a cost-effective level in terms of raising capital.⁴⁴

6.39 Mission Australia, a member of the GoodStart consortium, also agreed that lowering the tax paid on returns from social bonds could help attract investment.⁴⁵ JBWere and YMCA proposed that this mechanism could be regulated by limiting this form of instrument to organisations with deductible gift recipient (DGR) status.⁴⁶

6.40 YMCA argued that the tax exempt charity bonds would create both a sustainable option for charities to raise finance, while convincing investors of a strong probability of the return of capital at the maturity of the bond. Additionally, YMCA stated that Australia has an underdeveloped bond market relative to other countries, and that the creation of charity bonds would provide another option for investors who want to weight part of their portfolios to fixed income investments such as bonds.⁴⁷

6.41 YMCA asserted that Australian charity bonds would not require agreement of complex delivery measurements such as those of social impact bond programmes (see paragraph 6.54). Further, the existing mechanisms of the Australian Taxation Office (ATO) and the Australian Securities and Investments Commission (ASIC) would avoid the need for creation of additional government bodies to regulate the bond and that these compliance measures would protect investors.⁴⁸

6.42 At this stage the YMCA has not done a scoping study on the cost to government for the proposed tax exempt coupons.⁴⁹

Government 'top up' on coupons

6.43 Lifehouse and the Benevolent Society proposed that the government could offer a top up on coupons through cash or tax credit to subsidise the lower return rates of a social bond. This could be done through franking credits, the advantage being that franking credits are an established form of tax relief and would 'have the ATO stamp of approval'.⁵⁰ Mission Australia agreed with the approach and suggested it would be

44 *Committee Hansard*, 9 September 2011, p. 42.

45 Mr Toby Hall, Chief Executive Officer, Mission Australia, *Committee Hansard*, 23 September 2011, p. 54; YMCA, *Submission 1*, pp 3–4; JBWere, *Submission 19*, p. 14.

46 YMCA, *Submission 1*, pp 3–4; JBWere, *Submission 19*, p. 14.

47 YMCA, *Submission 1*, pp 3–5.

48 YMCA, *Submission 1*, pp 3–6.

49 Mr Colin Organ, Group Manager, Finance, YMCA, *Committee Hansard*, 9 September 2011, p. 45.

50 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 3; Benevolent Society, *Submission 25*, p. 4.

best suited over a long-term period, and would need to offer three per cent interest in order to bridge the gap between a social and commercial bond offering.⁵¹

Franking credits

6.44 When a company pays tax on its profits and then distributes after-tax dividends they are described as 'franked'. Franked dividends are distributed to shareholders with a franking credit which represents the amount of tax the company has already paid. An investor then receives a credit for any tax the company has already paid based on the rate of tax the individual pays.⁵²

6.45 As mentioned, Lifehouse and the Benevolent Society suggest that franking credits could be a component of certain social bonds to provide a 'top-up' for returns to investors. They propose that the franking credits be limited to bonds used for the acquisition of social purpose infrastructure, and that this form of bond only be issued by Public Benevolent Institutions.⁵³

6.46 They argue the credits would benefit all types of investors, improving the tax rates for retirees using their self-managed super fund (SMSFs) and PAFs, SMSFs in pre-retirement. They will also benefit corporates and individuals on a high marginal tax rate.⁵⁴ The committee questioned the feasibility of the government giving a further tax concession to PAFs and SMSFs that already receive preferential tax treatment. Mr Cubis, Chief Finance Officer of Lifehouse, responded:

...if you offered a neutral tax rate it would not improve the return for the self-managed super funds and the PAFs. You would get back to the problem we had with the infrastructure bonds 10 or 12 years ago. When we were talking to a lot of the self-managed super funds and the PAFs, offering six per cent return was not enough for them. Most of the trustees of those super funds and PAFs, quite rightly, are there to maximise the returns. They can distribute back to charities, in the case of PAFS, or in the case of super funds they have to try to maximise their returns.

By offering this rebate with the franking credit it lifts it from six per cent to about nine per cent, which was a level where a lot of the investors who had said no said they would entertain investing in the bonds. So it really was just a mechanism to lift the return to a level which corporate bonds would offer and be more competitive against the commercial sector. We cannot really afford to pay nine per cent, otherwise we would just go out and do that straight away. This is a way to try and lift the return and make sure that

51 Mr Toby Hall, Chief Executive Officer, Mission Australia, *Committee Hansard*, 23 September 2011, p. 54.

52 Australian Securities and Investments Commission, Money Smart website, 'Dividends', <http://www.moneysmart.gov.au/investing/shares/keeping-track-of-your-shares/dividends> (accessed 6 October 2011).

53 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 3; Benevolent Society, *Submission 25*, p. 4.

54 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 3; Benevolent Society, *Submission 25*, p. 4.

the trustees of the PAFs and the super funds can meet their role—their fiduciary duty to maximise returns for those funds.⁵⁵

6.47 Lifehouse and the Benevolent Society estimate the opportunity cost to government for the franking credit would be \$122 million per annum for five years, and that the proposed bonds could inject \$4.1 billion into social infrastructure.⁵⁶

6.48 Lifehouse argued that the credit would act as a catalyst for a social infrastructure market, and the franking credit could be adjusted over time if the market became oversubscribed.⁵⁷ The Benevolent Society envisioned that the 'incentive that you provide to get people to start a market would be very different from the incentives you need to keep a market going' and 'as efficiencies occur the government contribution to this could be reduced'.⁵⁸

6.49 Mr Robert Fitzgerald, the commissioner who oversaw the 2010 PC report, argued that government assistance to support a system of social bonds should be considered on a case-by-case basis:

We would imagine that if a particular activity or program was in the public interest it may well be that on a cost-benefit analysis the government were to determine that it would be more cost effective for it to top up the initiatives of another party, that is, for example, social bonds being offered by the not-for-profit sector, than if it were to bear the whole cost of that particular initiative. There may well be an exceptionally sound economic reason the top up by the government might be the appropriate strategy. You can think of a number of instances where unless the government is prepared to do that then in fact that particular initiative will not be undertaken by any other source, but that initiative might be undertaken by a partnership between for profits, not-for-profits and philanthropy if the government were to provide an additional input into that...

However, there is one caveat on that. We think the government has to be very careful about not crowding out other initiatives. This is a term that people use very dangerously, so let me be very careful. If it is the case that people believe that the government will intervene and take all of the risk, then human nature says that is exactly what they will allow to happen. We would not be supportive of that in these initiatives. We believe that genuine collaboration between government, philanthropists, for profit and not-for-profit is a very appropriate way forward, each of those playing a discrete and important part. What part that is will depend on the actual circumstances. Our report is open. It does not say that you should and it

55 Mr Brent Cubis, Chief Finance Officer, The Chris O'Brien Lifehouse at RPA, *Committee Hansard*, 23 September 2011, p. 20.

56 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 4; Benevolent Society, *Submission 25*, p. 5.

57 Mr Brent Cubis, Chief Finance Officer, The Chris O'Brien Lifehouse at RPA, *Committee Hansard*, 23 September 2011, p. 21.

58 Mr Stephen Hawkins, Executive, Social Initiatives, The Benevolent Society, *Committee Hansard*, 23 September 2011, p. 21.

does not say that you should not. It says that you should look at it on a case-by-case basis.⁵⁹

Government guarantee

6.50 Lifehouse and the Benevolent Society suggested the bond market could be stimulated through a government guarantee of repayment for qualifying social bonds. This would bring confidence to investors that they will see a return on their principal.⁶⁰

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, if potential investors could be completely confident of the return of their principal, then we would expect that significant additional demand would be uncovered.⁶¹

6.51 The Benevolent Society does acknowledge, however, that a government guarantee on the social bonds may present monitoring issues and a moral hazard to government.⁶²

Arbitrage bonds

6.52 JBWere proposed the use of an arbitrage bond as a means of providing finance for social ventures, suggesting that 'it has the scope to dramatically change the way certain social and environmental programs could be funded in this country'.⁶³

6.53 The concept hinges on the establishment of a Special Purpose Vehicle (SPV) which is guaranteed by government. JBWere proposed an example in which the SPV issues a ten-year Medium Term Note (MTN) with a five per cent indicative return. The SPV invests the funds raised by the MTN in a portfolio of fixed income securities (such as through the major banks) on a return of seven per cent. The bank then pays a coupon to the SPV, and the SPV distributes the proceeds to investors. The remaining profit from the fixed income securities would be used to provide an annual payment to the chosen social organisation. Upon maturity of the bond, the securities are redeemed by the banks and the SPV issues the proceeds to repay the investors. 'The ultimate outcome being the tax pay[er] is relieved of any repayment or funding obligation via

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

60 Chris O'Brien Lifehouse at RPA, *Submission 8*, p. 3; The Benevolent Society, *Submission 25*, pp 3–4.

61 The Benevolent Society, *Submission 25*, p. 4.

62 Mr Stephen Hawkins, Executive, Social Initiatives, The Benevolent Society, *Committee Hansard*, 23 September 2011, p. 19.

63 JBWere, *Submission 19*, p. 15.

this instrument'.⁶⁴ Further, the final 'pay-out' of the SPV places a time constraint for the term of the government's involvement.⁶⁵

Social impact bonds

6.54 Social impact bonds (SIBs) are a new financial instrument to fund the activity of social economy organisations that address complex societal problems through preventative social schemes.⁶⁶ A bond-issuing organisation offers bonds to investors, based on a contract with government, to deliver improved social outcomes that generate future cost savings for government. The government uses these savings to pay investors a reward, in addition to their principal, if improved outcomes are achieved.⁶⁷ If improved outcomes are not achieved however, the investor is not paid. For example, investors could develop a social bond with a juvenile reoffending program, with a target to decrease reoffending rates by an agreed percentage. If this target is met then a success fee would be paid to the investors by government.⁶⁸

6.55 SIBs have the potential to help fund a number of policy applications, including rehabilitating prisoners, reducing homelessness, providing parenting skills for at-risk families and helping ill patients to live at home.⁶⁹

6.56 The implementation of social impact bonds internationally has led to a growing interest and application of Social Impact Bonds (SIBs) to generate capital for social ventures within Australia:

The emergence of a range of 'social impact bonds' in Australia provides a timely opportunity for Government to take a new concept to scale quickly and as a cornerstone investor potentially play an important role in redefining the scale of social finance in Australia. If successful, this would

64 JBWere, *Submission 19*, pp 15–16.

65 Mr Christopher Thorn, Executive Director, JBWere, *Committee Hansard*, 1 August 2011, p. 11.

66 Sir Ronald Cohen, Interview with Dr Peter Shergold, *Sky News Australia*, 14 January 2011, <http://www.skynews.com.au/video/?vId=2092636&cId=Programs&play=true> (accessed 5 February 2011); Australian School of Business, 'Social Impact Bonds: Can This New asset Class Create More Than a Win-Win?', 15 March 2011, <http://knowledge.asb.unsw.edu.au/article.cfm?articleid=1359> (accessed 7 October 2011).

67 Australian School of Business, 'Social Impact Bonds: Can This New asset Class Create More Than a Win-Win?', 15 March 2011, <http://knowledge.asb.unsw.edu.au/article.cfm?articleid=1359> (accessed 7 October 2011).

68 Government of New South Wales, 'Social Impact Bonds—First in Australia', Media release, 25 November 2010, <http://www.csi.edu.au/assets/document/NR%20-%20SOCIAL%20IMPACT%20BONDS%20%E2%80%93%20FIRST%20IN%20AUSTRALIA.pdf> (accessed 7 November 2011).

69 The Young Foundation, *Social Impact Investment: the challenge and opportunity of Social Impact Bonds*, March 2011, pp 23–27; Centre for Social Impact, *Report on the NSW Government Social Impact Bond Pilot*, February 2011, p. 19.

provide crucial impetus in attracting new players and investment of resources into this activity.⁷⁰

6.57 A number of submitters expressed interest in SIBs.⁷¹ The Community Council for Australia noted that despite the limited demand for SIBs and limited capacity currently within social economy organisations, a number of dedicated organisations continue to pioneer the concept.⁷² Social Finance Pty Ltd found that while many social economy organisations showed interest in SIBs, few had the experience and the resources required and instead 'are looking for an experienced intermediary to broker the requisite deals and assume appropriate contract risk'.⁷³ Sir Ronald Cohen argued that supply of new investment products such as SIBs will create its own demand:

First, let's remind ourselves that all new investment products begin without a track record and with a very limited pool of available capital. They have to create their own market. We know that, so far as entrepreneurs are concerned, the supply of money creates its own demand, and in the debate about capacity-building and the flow of capital – a debate akin to the conundrum about whether the chicken or the egg comes first - the answer is always that both must happen at the same time. Other new forms of investment, including venture capital, private equity and hedge funds - and, more recently, micro-finance - have successfully been built from lowly beginnings into significant new asset classes in a relatively short time. There is a need and an opportunity for impact investments to do the same.⁷⁴

6.58 Developing the capacity of social economy organisations is discussed further in chapters 2 and 3, and the role that intermediaries play in developing the capacity of social organisations is discussed in chapter 5.

Advantages of social impact bonds

6.59 For governments, SIBs are a way of addressing an intractable social problem and raising funds for the provision of services. For the private sector, the bonds are an opportunity to invest in non-government community programmes.

6.60 Sir Ronald Cohen emphasised the benefit of SIBs in terms of attracting capital for social economy organisations in a way that is not possible through philanthropy.

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

71 Social Ventures Australia, *Submission 2*, p. 1; Archerfish Foundation, *Submission 17*; JBWere, *Submission 19*, p. 15; Social Finance Pty Ltd, *Submission 21*, p. 2; The Centre for Social Impact, *Submission 27*, pp 11–12; Life Without Barriers, *Submission 33*.

72 Community Council for Australia, *Submission 15*, p. 5.

73 Social Finance Pty Ltd, *Submission 21*, p. 2.

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

He argued that the key to establishing the bonds is the ability to accurately measure policy outcomes.⁷⁵

6.61 The Office for the Not-for-Profit Sector in the Department of the Prime Minister and Cabinet made the following comment:

We suggest that there are six characteristics that are important for successful social impact bonds, and they are as follows. Firstly, they bring new resources to the table. Secondly, they harness social innovation by both the not-for-profit sector and social investors more broadly. Thirdly, they support participation and community based action to help solve problems. Fourthly, they share risk between government and the private social investors. Fifthly, they have clear and measureable outcomes as the basis for incentive payments to investors. Sixthly, they focus on interventions that prevent consequential social problems and their associated costs to government.⁷⁶

6.62 In a November 2010 paper, the Young Foundation in the UK identified some of the following advantages of SIBs:

- they act to correct poor incentives and attain new sources of funding;
- they promote evidence based action;
- they allocate resources to where they can achieve greatest impact; and
- SIBs achieve real risk transfer.⁷⁷

6.63 The Archerfish Foundation contended that SIBs may be utilised both as a means to invest in social innovation and a way to provide ongoing funding for proven service delivery methods. It noted that organisations with new ideas for social service delivery that may need investment funds in order to develop and scale up their innovations could benefit from small scale SIB opportunities (i.e. \$5-10 million in funding over 2-5 year time periods). Concurrently, larger scale SIB offerings managed by intermediary organisations, referred to as Social Impact Bond Issuing Organisations (SIBIOs), could help address areas of persistent social policy failure by incentivising the provision of clear social outcomes.⁷⁸

75 Sir Ronald Cohen, Interview with Dr Peter Shergold, *Sky News Australia*, 14 January 2011, <http://www.skynews.com.au/video/?vId=2092636&cId=Programs&play=true> (accessed 5 February 2011).

76 Mr Paul Ronalds, First Assistant Secretary, Department of the Prime Minister and Cabinet, *Committee Hansard*, 26 September 2011, p. 28.

77 The Young Foundation, *Social Impact Investment: The opportunity and challenge of social impact bonds*, March 2011, pp 16–17.

78 The Archerfish Foundation, *Submission 17*, pp 8–10.

Challenges for social impact bonds

6.64 The Young Foundation also identified four challenges for SIBs, and the means to address them:

- a general caution that social policy innovations should not aim to achieve too much—the Foundation suggests that SIBs should aim to achieve an impact of between 10 and 20 per cent;
- investors and the government must be 'confident that the metric used in the bond has no systematic bias and is on average a fair measure of performance';
- be clear about what constitutes a saving to the government purse; the Foundation noted that SIB partners will take advantage of the scheme design by putting resources into those aspects of the program that will achieve greatest savings; and
- be aware that unintended consequences from SIBs could potentially alter incentives for existing funders and providers.⁷⁹

6.65 Submitters to the inquiry emphasised that SIBs can only be applied to policy areas that have measureable results.⁸⁰ Developing a measurement framework is discussed further in chapter 8.

The UK social impact bonds trial

6.66 In September 2010, the UK formally introduced a SIB programme based on prisoner rehabilitation targets. It is the first programme of its kind in the world and will run for six years.⁸¹

6.67 The scheme is jointly run by the Ministry of Justice and an ethical investment bank, *Social Finance*. Investors have bought £5 million in SIBs—issued by the British Government—to fund rehabilitation work with 3000 Peterborough Prison inmates. They could earn a return of up to £8 million from the government and the Big Lottery Fund (BLF)⁸² if their cash helps rehabilitate criminals. Reoffending among the target group must fall by at least 7.5 per cent to trigger the dividend payments in each of the six years of the bond's operation. It is estimated that the UK government will save £10

79 The Young Foundation, *Social Impact Investment: The opportunity and challenge of social impact bonds*, March 2011, pp 16–17.

80 The Archerfish Foundation, *Submission 17*, p. 7; Social Finance Ltd, *Submission 16*, pp 10–11; Life Without Barriers, *Submission 34*, pp 3–4; Associate Professor Cheryl Kernot, Director of Social Business, Centre for Social Impact, *Committee Hansard*, 1 August 2011, p. 39.

81 Social Finance Ltd, *Submission 16*, p. 10; An explanation of the project by the United Kingdom's Justice Secretary Kenneth Clarke QC MP can be found at http://www.youtube.com/watch?v=z6RymEOSQjY&feature=player_embedded.

82 The Big Lottery Fund uses proceeds from the National Lottery to finance community groups and projects that improve health, education and the environment, <http://www.biglotteryfund.org.uk/> (accessed 7 October 2011).

per participant for each pound invested in the resettlement scheme.⁸³ Sir Ronald Cohen discussed details of the pilot with the committee:

We [Social Finance] use this money to initially fund three not-for-profits that are working with prisoners—that is, training them while they are in prison, funding them when they leave prison so they can make it to their first benefits cheque, helping them to find jobs and giving them the community and psychological support that they need to reintegrate into society. If, over a period of six or seven years, these not-for-profits are unable to reduce the rate of recidivism measured against the control group—this being a group of prisoners 10 times the size of the assisted prisoners with similar demographics across the UK—by 7½ per cent then the money is lost by the investors, so it ends up being a philanthropic donation. But if we are successful in reducing it by between 7½ per cent and 15 per cent, the government will pay back the capital and a yield of 2½ per cent to 13 per cent a year. According to our calculations, government would be paying out one-third of the saving. So you can see that it is a very powerful instrument because for the first time the St Giles Trust and the other not-for-profits that are being funded have access to significant capital over many years and are focused on achieving social outcomes; their performance becomes crucial to their ability to raise bonds in the future.⁸⁴

6.68 Of the £5 million raised through the SIB, two-thirds of the 17 foundations and charitable trusts opted to allocate the finance through their balance sheets rather than out of their grant allocations. Sir Ronald Cohen noted that: 'you have £100 billion of assets in foundation balance sheets, and you have a couple of billion pounds that are given away by foundations...so if you can begin to use these financial instruments to attract capital from the balance sheets...you start off with a massive amount of money that can be focused on social issues'.⁸⁵

Challenges associated with the pilot

6.69 In January 2011, it was reported that the UK Treasury was yet to decide on how it would underwrite the bonds, and there were departmental questions about who would issue and pay out on the bonds.⁸⁶ A report commissioned by the UK Ministry of Justice and completed by RAND Europe in May 2011 examined the lessons learned from the early stages of the Peterborough pilot, and confirmed that these outstanding issues with the pilot have been resolved. The report noted that developing the payment model for the pilot, whereby successful outcome payments will be made by the

83 BBC News, 'Private backers fund scheme to cut prisoner reoffending', <http://www.bbc.co.uk/news/uk-11254308> (accessed 10 February 2011).

84 *Committee Hansard*, 1 August 2011, pp 65–66.

85 *Committee Hansard*, 1 August 2011, p. 65.

86 Mark Easton, BBC News, 'The name is bond: social impact bond', 19 January 2011, http://www.bbc.co.uk/blogs/thereporters/markeaston/2011/01/the_name_is_bond_social_impact.html?page=333 (accessed 1 November 2011).

Ministry of Justice and the BLF, demanded considerable analysis and resources.⁸⁷ The report noted that future SIBs may share outcome payments across central and local government departments and other agencies, in cases where potential savings occur across multiple portfolio areas.⁸⁸

6.70 BLF have agreed to contribute to up to £6.25 million to the Peterborough SIB.⁸⁹ Sir Ronald justified the involvement of the BLF as a means to overcome Treasury's limitation in forecasting outcome payments for the bonds in 6-8 years time:

The big question is, 'Do we give government departments the budgets to pay out several years from now?' Again, there was a reference in the report I read that somehow a weakness of the first bond was that the Big Lottery Fund in the UK, which is a charitable pool funded by the lottery, had had to put money up. The only reason the Big Lottery Fund came in alongside government is that the Ministry of Justice did not have sufficient money in its budgets, six to eight years out, to pay out in the event the bond was successful. We are talking with the government in the UK in order to get social impact bonds going. The second one is being funded now. The first investment of Big Society Capital is in fact in backing the Private Equity Foundation to launch a social impact bond dealing with adolescents at school who are in danger of not finding a job. I think we can already see that governments are going to need to make a pool of capital available six to eight years out to pay out on the success of social impact bonds, which government departments either have a specific allocation from or compete for.⁹⁰

6.71 Since the establishment of the Peterborough trial, there has been the announcement of an additional £40 million SIB trial targeting disadvantaged families in four communities in the UK.⁹¹ It has been reported that investments in future SIBs will attract tax concessions under the Community Investment Tax Relief program.⁹²

87 Disley et al., RAND Europe, commissioned by the UK Ministry of Justice, *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, May 2011, p. 43.

88 Disley et al., RAND Europe, *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, May 2011, p. iv.

89 Big Lottery Fund, *BIG paves way forward through social investment*, Press release, 31 August 2010, http://news.biglotteryfund.org.uk/pr_310810_uk_ri_big_paves_way_forward (accessed 2 November 2011).

90 *Committee Hansard*, 1 August 2011, p. 66.

91 Cabinet Office, 'Big Society innovation aims to get families out of deprivation', Media Release, 26 August 2011, <http://www.cabinetoffice.gov.uk/news/big-society-innovation-aims-get-families-out-deprivation> (accessed 6 October 2011).

92 Associate Professor Cheryl Kernot, 'Social Impact/Social Benefit Bonds grow ... an update', *Centre for Social Impact blogs*, 4 November 2011, <http://blogs.unsw.edu.au/knowledgetoday/blog/2011/11/social-impactsocial-benefit-bonds-grow-%E2%80%A6-an-update/> (accessed 10 November 2011).

Funding for 'pay for success bonds' in the United States

6.72 The President of the United States, Barack Obama, allocated US\$100 million for seven pilot programmes using 'pay-for-success' bonds (conceptually the same as the social impact bond). The terms of the US budget appropriations allows funds for the bonds to support long-term performance agreements, beyond the traditional 1-2 year grant programs. It also allows any unused funds for the bonds to be re-used for other high priority activities in the future. The mayors of New York City and Baltimore have shown interest in the bonds. A possible candidate for a pilot in the US is the National Guard Youth Challenge, which applies military discipline to provide skills training to at-risk youth.⁹³

6.73 In addition, the state of Massachusetts, USA, has recently issued a call for information on social innovation financing, including pay-for-success contracts and social impact bonds.⁹⁴

The New South Wales social impact bonds trial

6.74 In November 2010, the New South Wales (NSW) Government announced that it would trial SIBs to deliver non-government community programmes.⁹⁵ The CSI was appointed to formally provide advice on the programme:

CSI consulted with a range of potential social investors and their advisors, who confirmed that there is an appetite amongst investors for the use of SIBs. SIBs offer social investors a method of achieving blended value with both commercial and measurable social return on their investment. A SIB provides social investors with a more effective method of holding a [NFP] to account in terms of setting targets and monitoring performance akin to that used in commercial investment decisions.⁹⁶

6.75 CSI identified a range of policy areas and program interventions that address complex problems suitable for a SIB pilot that are close to realisation. These include

93 The Economist, 'Performance Bonds, Who succeeds gets paid: Barack Obama imports a big idea from Britain', 17 February 2011, <http://www.economist.com/node/18180436> (accessed 7 October 2011); The Office of Management and Budget, the White House, 'The Federal Budget Fiscal Year 2012: Paying for Success', <http://www.whitehouse.gov/omb/factsheet/paying-for-success> (accessed 7 October 2011).

94 Commonwealth of Massachusetts Executive Office for Administration and Finance, 'Massachusetts Pursues Social Innovation Financing to Spur Innovation and Build on Program Success', Media Release, 6 May 2011, <http://www.mass.gov/anf/mass-pursues-social-innovation-financing.html> (accessed 1 November 2011).

95 Government of New South Wales, 'Social Impact Bonds—First in Australia', Media release, 25 November 2010, <http://www.csi.edu.au/assets/document/NR%20-%20SOCIAL%20IMPACT%20BONDS%20%E2%80%93%20FIRST%20IN%20AUSTRALIA.pdf> (accessed 7 November 2011).

96 Centre for Social Impact, 'Report on the NSW Government Social Impact Bond Pilot: Executive Summary', 5 February 2011, pp 4–5.

juvenile justice, parenting support for vulnerable families, disability, homelessness and mental health.⁹⁷ Mr Les Hems, Director of Research at CSI, elaborated on how a SIB could act as a cost-saving measure for the NSW government in relation to foster care:

The idea of being able to restore a child to the family of origin then when we know that the cost per child in New South Wales is around \$40,000 per year. We know there are 17,500 children currently in foster care. If there is a program which is efficacious in terms of preparing the family of origin to receive their child back again, then clearly that presents huge future cost savings to government. Clearly you would need to measure it over a period of time, so you structure something like a bond with perhaps a five-year term and then during that five years you actually seek to restore, say, a number of children over that period of time. Units of reward payments are paid to the initial capital investors—the private capital that comes in is from investors. They will get their principal repaid and also a reward payment on the basis of delivering a certain number of children.⁹⁸

6.76 CSI has also identified a range of social economy organisations with the capacity to host a SIB program and who have the legal power to issue a bond. CSI proposes that a social finance intermediary (as used in the UK model) is not necessary for the NSW pilot as social economy organisations that are incorporated have the powers to issue bonds.⁹⁹ Larger social economy organisations usually operate within a framework of result-based accountability, employing professional staff, utilising professional advice, engaging with social investors and having research or evaluation teams. They also have large asset bases which could be rated using an independent rating service to evaluate financial strength and the ability to pay the bond's principal and interest in a timely fashion.¹⁰⁰ Christian Super discussed in its submission how the government's involvement in a SIB contract acts as a form of guarantee, and would in turn improve the rating of a SIB:

According to the Rating Agencies models, the rating of an issuance of bonds or loans is as high as the rating of the institution that guarantees the scheduled principal and interest payments on that issuance. If the government guarantees issuance of Social Impact Bonds, for example, then that issuance should have an implied rating of the government i.e. AAA. This will lower the cost of funds, increase liquidity and diversify funding sources as institutions with a lot of funds but low risk appetite like

97 *Committee Hansard*, 1 August 2011, p. 38-39; Centre for Social Impact, 'Report on the NSW Government Social Impact Bond Pilot: Executive Summary', 5 February 2011, pp 8–9, 20–21.

98 *Committee Hansard*, 1 August 2011, pp 38–39.

99 Centre for Social Impact, *Submission 27*, p. 11; *Committee Hansard*, 1 August 2011, p. 37, pp 43–44; Centre for Social Impact, 'Report on the NSW Government Social Impact Bond Pilot: Executive Summary', 5 February 2011, pp 8–9, 20–21.

100 Australian School of Business, 'Social Impact Bonds: Can This New asset Class Create More Than a Win-Win?', 15 March 2011, <http://knowledge.asb.unsw.edu.au/article.cfm?articleid=1359> (accessed 7 October 2011).

insurance companies and superannuation funds add Social Impact Bonds into their portfolio. Naturally this is dependent on the details of the each underlying investment.¹⁰¹

6.77 CSI argued that Australian interest in SIBs is from, 'not just the philanthropically minded social investors but also some of the mainstream banks and investment houses like AMP Foundation':¹⁰²

In the UK it was all charitable trusts, but within our discussions with investors we found a broader set of support. We have spoken to a number of mainstream financial institutions who have expressed support in these types of initiatives as long as they are big enough. For them it is the deal size that is the problem. Fundamentally, it is all about negotiation. This is all based on an outcome based agreement between government and a not for profit, but pricing can only be done when governments have agreed what outcomes it is achieving with a not for profit, the scale and the reward payment for a child being restored or a period of reoffending. That negotiation is the key. To articulate how far we have got in some of the discussions, some of these are pretty close to being investment-grade products, so these will be attractive to all investors.¹⁰³

Sharing the risk

6.78 CSI has identified a range of options for the terms of the bond that provide different levels of risk sharing across government, the social economy organisation and social investors. The options allocate a greater reward to a high risk capital investment, while the rate of return will be lower as the risk decreases.

6.79 At one end of the risk spectrum, the principal and reward payment (return on investment) to investors is completely dependent on a successful outcome. In this instance, the full transfer of risk lies with the social investor as reflected by a higher indicative reward payment. However, the number of investors prepared to take this option is limited. At the other end of the risk transfer spectrum is an option for social investors to protect their capital, where only the reward payment is at risk. This option offers little incentive to government as there is only minimal risk transfer to social investors and the social economy organisation.

6.80 CSI has therefore formulated an option to balance risk sharing between government, social economy organisations and social investors. This option requires that a portion of the costs the social economy organisation incurs delivering the program is to be paid by government through a standing charge. The remaining costs and reward payment will be dependent on a successful outcome of the programme.

101 Christian Super, *Submission 12*, p. 5.

102 Mr Les Hems, Director of Research, Centre for Social Impact, *Committee Hansard*, 1 August 2011, p. 37.

103 Mr Les Hems, Director of Research, Centre for Social Impact, *Committee Hansard*, 1 August 2011, p. 45.

This risk sharing arrangement will lead to a moderate level of reward payments. CSI reported that social investors responded positively to the option which included the standing charge.¹⁰⁴

Benefits a number of stakeholders

6.81 Mr Les Hems of the CSI has outlined the benefits for social economy organisations as well as financial investors, noting that a SIB can remove the burden of high-level government involvement in non government organisation (NGO) programs:

SIBs encourage social innovation and the development of programs which focus on early intervention, prevention or breaking the cycle of dependence. The performance nature of SIB focuses stakeholders' attention on the delivery of the agreed outcomes. NFPs will be attracted because SIBs provide them with capital up front and remove government involvement from the day-to-day delivery of programs.

The SIB mechanism is also attractive to philanthropists and social investors who often find it difficult to know which NFP to support and cannot assess what their generosity has actually achieved. For philanthropists with a grantmaking mindset, a successful SIB offers the opportunity to recycle their philanthropic funds. However, it is the potential for SIBs to substantially grow the overall capital and revenue funding base of the sector which makes them most attractive.¹⁰⁵

6.82 The NSW Government is estimating savings of between \$4 and \$17 for every \$1 it invests¹⁰⁶ and announced on 6 September 2011 that it will launch a pilot tender process for 'Social Benefit Bonds'. The first two bonds will be aimed at foster care and lowering reoffending rates among former prisoners. NSW Treasurer Mike Baird said the trial provides an opportunity to 'creatively look at delivery of critical social outcomes while at the same time minimising long-term fiscal risks to the budget'.¹⁰⁷

104 Centre for Social Impact, 'Report on the NSW Government Social Impact Bond Pilot: Executive Summary', 5 February 2011, pp 9–10.

105 Mr Les Hems, Centre for Social Impact, 'Social impact bonds – not a panacea but worth investing in', <https://secure.csi.edu.au/site/Home/Blog.aspx?defaultblog=https://blog.csi.edu.au/2011/03/social-impact-bonds-%e2%80%93-not-a-panacea-but-worth-investing-in/> (accessed 12 September 2011).

106 Australian School of Business, 'Social Impact Bonds: Can This New asset Class Create More Than a Win-Win?', 15 March 2011, <http://knowledge.asb.unsw.edu.au/article.cfm?articleid=1359> (accessed 7 October 2011).

107 'Social Impact bonds Tipped as Win for All', *Australian Financial Review*, 5 September 2011, p. 7.

Indigenous impact bonds

6.83 Ecotrust Australia highlights the need for innovation to create sustainable prosperity for Indigenous Australians. Its research indicates that Commonwealth, State and Territory governments have spent \$4.2 billion on indigenous programs which have been 'disappointing at best and appalling at worst'.¹⁰⁸ Ecotrust proposes the creation of an indigenous impact bond, or I2B to 'attack intractable problems in the indigenous space'¹⁰⁹ and facilitate investors' 'eagerness to invest in better outcomes for indigenous people'.¹¹⁰ The risk would then transfer to corporate and philanthropic capital, and government would only reward investors if social impact is achieved.¹¹¹

6.84 Ecotrust suggested that the I2Bs will create a different role for government, one 'that is less about delivery and more about supporting outcomes'.¹¹² Ecotrust intend to act as a facilitator for social impact partnerships and aggregate capital by convening investors for the bonds.¹¹³ Ecotrust identified three key elements to implementing the I2Bs; interest in Indigenous communities, willing investors and political will to issue the bonds.

6.85 Cape York Institute's (CYI) sister organisations have conducted preliminary studies into SIBs and concluded that they are not appropriate for them at this stage due to their scale and the lack of measurable outcomes. CYI was, however, interested in SIBs as a catalyst for the sector to move from outputs based measurement to outcomes, and how this would specifically benefit indigenous programs:

What was particularly interesting to me about reading about the structure of the UK social impact bond was the clear tie between reward to investor and actual tangible social outcome. That is not something that exists in many of the funding arrangements which we have to deal with on a regular basis. In fact Noel Pearson is on record quite recently for talking about the nature of incentives to job service providers in remote Indigenous communities; the extent to which training is incentivised and a churn of people is incentivised rather than placing and keeping people in long-term employment. A similar comment could be made in relation to Indigenous health initiatives where, again, it is the number of healthcare checks you have rather than the level of, say, blood pressure in the community or the instance of diabetes. They should really be the guiding principles.¹¹⁴

108 Mr Patrick Dodson and Mr Ian Gill, 'A Bran Nue Way ahead, *The Age*, 17 August 2011.

109 Mr Ian Gill, Chief Executive Officer, Ecotrust, *Committee Hansard*, 23 September 2011, p. 12.

110 Mr Patrick Dodson and Mr Ian Gill, 'A Bran Nue Way ahead, *The Age*, 17 August 2011.

111 Mr Patrick Dodson and Mr Ian Gill, 'A Bran Nue Way ahead, *The Age*, 17 August 2011.

112 Mr Ian Gill, Chief Executive Officer, Ecotrust, *Committee Hansard*, 23 September 2011, p. 12.

113 Mr Ian Gill, Chief Executive Officer, Ecotrust, *Committee Hansard*, 23 September 2011, pp 12-13.

114 Mr Sandy Cameron, Manager, Policy, Research, Cape York Institute for Policy and Leadership, *Committee Hansard*, 23 September 2011, p. 33.

6.86 The committee pursued the concept of an indigenous SIB utilising multiple service providers with Sir Ronald Cohen:

Senator STEPHENS: ...if we were to look at a social impact bond being developed to address issues of Indigenous disadvantage, we would be unlikely to have one organisation. We would need to have a network of not-for-profit organisations involved in trying to really drive a significant social outcome. Can you see that that would work in that kind of an environment, where you would have many players?

Sir Ronald Cohen: Yes, indeed. In the case of the Peterborough bond, we start off with three players. I think the number has been expanded to five as others are becoming interested in it. I could see that there would be many bonds that are raised by organisations which have the internal expertise to deploy the money to a number of not-for-profits and to test the not-for-profits for their effectiveness and then give more of the social impact bonds issued in subsequent years to those who are performing better. So the model does not require you to raise social impact bonds for one organisation, although there will be some organisations with the credibility to do that.¹¹⁵

6.87 Ecotrust is currently consulting with a number of governments and agencies about the potential to run I2B pilots.¹¹⁶ Mr Ian Gill, Chief Executive Officer of Ecotrust, maintains that SIBs present a 'leadership moment' for Australia to address the intractable problems that have emerged in remote indigenous communities:

The government's role in the end in a bond is to basically say, 'If you achieve your outcomes, which are our outcomes as government, we will pay for those outcomes. We will be bonded to pay for the productive outcomes that you have set out and that you are taking the risk on.' The real sticking point becomes in the end: does the government have the appetite to underwrite such a bond. To some degree, again not to be impolite, does the bureaucracy, which at the moment is currently in the grip of this \$4 billion box, have the will to pull back a bit and let Indigenous people and their social impact partners actually take a lead in delivering outcomes for themselves. If that magic can somehow be created, then I think there is the possibility well beyond just replicating CDFIs or doing something like somebody else has done somewhere else in the world. I think there is a leadership moment for Australia here, which is not easy to achieve but can be achieved...The need is there. Do we have the wherewithal to step up is really my question.¹¹⁷

115 *Committee Hansard*, 1 August 2011, p. 67.

116 Mr Ian Gill, Chief Executive Officer, Ecotrust, *Committee Hansard*, 23 September 2011, p. 17.

117 *Committee Hansard*, 23 September 2011, p. 17.

Federal government application of a SIB

6.88 Associate Professor Cheryl Kernot of the CSI told the committee that a SIB could work jointly between the Commonwealth and a state government, particularly in the area of housing, and that the savings could be disaggregated at both levels.¹¹⁸

6.89 The federal government has been monitoring the progress of SIBs both in Australia and abroad. The Department of the Prime Minister and Cabinet noted that while this form of investment vehicle may not suit every situation, there may be some instances that warrant a SIB pilot at a federal level:

We have been looking at this [SIBs] and carefully watching some of the examples that are going on both in Australia and overseas and determining the advantages and disadvantages and some of the pitfalls. As I said earlier, we are cautious in relation to them. They will not suit every circumstance, and it has been quite interesting watching where some of the early examples of social impact bonds are being applied and in what sorts of policy settings...¹¹⁹

...given the pioneering work in the UK and more recently here in New South Wales, we believe there is merit in considering the potential of social impact bonds. The groundwork has been done in other jurisdictions and they provide useful foundations for broader action in Australia. As a new financing vehicle, social impact bonds appear to provide promising community benefits.¹²⁰

Conclusion

6.90 The committee acknowledges the global trends in social impact investing, and the suggestion that a new asset class may well be emerging. There are a number of measures that can be undertaken in the Australian setting to keep pace with these developments.

6.91 The development of a social bond market in Australia could bring significant finance to the social economy and thereby relieve the government of some social infrastructure costs. There are, however, significant hurdles to overcome in order to attract investors to this market. The lower rate of return on a social bond coupon (due to the social dividend component) presents challenges when competing in the commercial market. As a result, the current market for social bonds would be somewhat limited, and most suited to investment minded philanthropists. The committee considers that government support is required to catalyse this market and

118 Associate Professor Cheryl Kernot, Director of Social Business, Centre for Social Impact, *Committee Hansard*, 1 August 2011, p. 40.

119 Mr Paul Ronalds, First Assistant Secretary, Department of the Prime Minister and Cabinet, *Committee Hansard*, 1 August 2011, p. 57.

120 Mr Paul Ronalds, First Assistant Secretary, Department of the Prime Minister and Cabinet, *Committee Hansard*, 26 September 2011, p. 28.

that further research should be conducted to determine the feasibility of government top-ups for social bond coupons in the form of either cash or tax credit, or alternatively tax exempt coupons. A government guarantee on social bonds should also be examined.

6.92 The committee notes the SIB pilots in Peterborough in the UK and in NSW. SIBs present an opportunity for government to ensure that service delivery contracts produce their intended outcomes as well as delivering significant savings for government. They leverage additional capital for the social economy through government partnerships with philanthropists and the wider investment community. SIBs also expand the impact investment market by offering an investment mechanism to diversify the portfolios of investors that may not otherwise consider social investments a viable option.

6.93 The committee considers SIBs to be a mechanism to move beyond funding regimes for social economy organisations that are built around the three year political cycle. Although forecasting the government's budget has created some difficulties in the UK, the committee acknowledges the recent announcement of the US governments 'pay-for-success' bonds and the special funding provisions included in their budget papers.

6.94 The committee recommends that the government identify policy areas where SIBs could be applied, including consideration of indigenous policy and programmes. Partnerships with state governments should be considered in cases where policy areas, such as social housing, require state government involvement.

6.95 The committee does, however, acknowledge that SIBs and Social Bonds are not in themselves a panacea to financing social economy organisations. They are but two mechanisms among an emerging spectrum of capital options within the social economy. The committee also notes that SIBs will not apply in the following settings:

- where there are no clear social performance metrics (see chapter 8);
- where the risk is too high; and
- where the financial return is too low.

Recommendation 6.2

6.96 The committee recommends that the Departments of Treasury and Finance and Deregulation to examine ways to create incentives to invest in a social bond market in Australia including the feasibility of tax exempt income returns, a government top up on coupons through cash or tax credits and the use of government guarantees.

Recommendation 6.3

6.97 The committee recommends that the Office for the Not-for-Profit Sector identify policy areas where social impact bonds could be applied, including intractable problems in indigenous communities. The plausibility of creating

social impact bonds in partnership with state governments should also be examined.

6.98 The Office for the Not-for-Profit Sector should work with relevant government departments and agencies and social organisations to implement a social impact bond trial.