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Dear David

Social impact investing

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission on social impact investing in response to the Government's discussion paper released on 28 January 2017. ASFA's submission focuses on issues raised in the discussion paper that are directly relevant to superannuation funds.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system so people can live in retirement with increasing prosperity. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90 per cent of the 14.8 million Australians with superannuation.

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If you have any queries regarding the contents of our submission please contact Andrew Craston on (02) 8079 0817 or by email acraston@superannuation.asn.au or me on (02) 8079 0808 or by email gmccrea@superannuation.asn.au,

Yours sincerely

Glen McCrea
Chief Policy Officer

Introduction

ASFA considers that the current policy and legislative settings that guide fund trustees to make investment decisions in the best interests of members are appropriate – including with respect to social impact investments (hereon referred to as impact investments).

ASFA recognises that although the Australian impact investment market is in the early stages of development, a mature impact investment market potentially would change the way in which Australian society deals with certain social (or environmental) problems.

Fundamentally, impact investments alter the way in which services are provided (by government or other sectors), from one focused on the delivery of services, to one focused on the outcomes of those services. Broadly speaking, an outcomes-based approach is more likely to encourage innovation in models of service provision, with funding (including from institutional investors) allocated to the best prospects. This is likely to improve the quality of outcomes and reduce the cost of successful interventions.[1]

In Australia, as is the case in other developed financial systems, impact investments comprise a very small component of the broader investment landscape. Data on the Australian impact investment market is limited. However, industry estimates suggest that the total market value of Australian impact investment assets is $1-2 billion.[2] The Australian impact investment market represents less than 0.1% of total assets under institutional funds management in Australia – which stands at approximately $2.7 trillion.[3]

Superannuation funds are, and will continue to be, a significant source of capital for the Australian economy. At present, the superannuation sector has total assets of $2.1 trillion (or 128% of annual nominal GDP), with around half of that allocated to domestic assets via institutional funds management.[4] Over coming decades, total superannuation assets are projected to increase markedly – in absolute terms and as a share of GDP.

There are, however, barriers to superannuation funds investing in impact investment assets. Some of these barriers relate to the inherent nature of markets that are in the early stages of development. The main barriers to superannuation funds investing in impact investment assets include:

- lack of large-scale, investment-ready opportunities
- the relatively high cost of impact investing (on a per assets basis)
- lack of expertise on impact investing within funds, and the lack of well-developed intermediaries that would reduce the need for internal expertise
- lack of good quality data on the performance of impact investment assets and on the outcomes of government services (which makes it difficult for funds to assess the viability of potential impact investments).

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[1] G8 Social Impact Investment Taskforce 2015, *Impact Investment: The Invisible Heart of Markets*, 15 September.

[2] Impact Investing Australia 2016, *Benchmarking Impact: Australian Impact Investment Activity and Performance Report 2016* and Addis, R., McLeod, J. and Raine, A. 2013, *Impact Australia: Investment for Social and Economic Benefit*, Australian Government, Department of Education, Employment and Workplace Relations.

[3] Australian Bureau of Statistics, *Managed Funds Australia*, ABS Cat no. 5655.0, September quarter 2016.

[4] APRA, *Quarterly Superannuation Performance*, September quarter 2016.

Others barriers relate more to the nature of impact investments. In particular, it can be challenging to generate the rates of return required by funds (for a given risk profile) from the provision of social services – particularly in the early stages of market development. This explains governments' use of co-funding or de-risking mechanisms to make impact investments more attractive for institutional investors.

Ultimately, ASFA considers that the active participation of superannuation funds in the impact investment market should be determined as and when particular impact investments are identified as being in the best interests of members.

Current extent of impact investing by superannuation funds

To date, only a small number of superannuation funds have invested in impact investments. Of all Australian superannuation funds, Christian Super is the most active fund in impact investing. As well as investing in numerous impact investment assets, Christian Super has founded an impact investment intermediary to provide investment services to other funds (and institutional investors).[5]

Potential benefits of impact investing for superannuation funds

Notwithstanding limited participation by institutional investors, surveys of investor attitudes show a growing interest in impact investing. This points to the potential benefits of impact investments for some superannuation funds.[6]

Impact investment assets may provide diversification benefits for funds. This is particularly the case where the return on an impact investment is a function of the social outcomes that the investment achieves – for example, where there are financial rewards for meeting specified goals. As such, those returns are likely to have a low correlation with returns from traditional investments via capital markets – where returns reflect economic and financial market factors.[7] In a maturing market, the diversification benefits would likely improve as more products are developed.[8]

For superannuation funds, impact investing may allow funds to meet demand from their members for investments that align with members' social values (where investments are consistent with funds' fiduciary duty). Christian Super is a case in point – the fund's allocation to ethical/impact investments is influenced by the values held by its membership. To the degree that a fund is able to achieve this, greater alignment may translate into a deeper degree of engagement of fund members with the fund.

Trustees' duty to fund members

ASFA considers that funds should consider impact investments as they would any other investment – that investment decisions are made to deliver retirement savings for fund members. As such, ASFA considers that the current regulatory framework that guides trustee (fund) decision-making is appropriate.

[5] Smith, M. 2016, 'Why the cost of impact investing is coming down', Finsia, 3 November.
[6] Impact Investing Australia 2016, *2016 Investor Report*.
[7] G8 Social Impact Investment Taskforce 2014, *Allocating for Impact: Subject Paper of the Asset Allocation Working Group*, September.
[8] G8 Social Impact Investment Taskforce 2015, *Impact Investment: The Invisible Heart of Markets*, September.

The regulatory framework does not dictate what investments superannuation funds should or should not make. Instead, it deals with the process of investment decision-making. In particular, the framework is designed to ensure that decision-making is free from distraction and directed towards long-term investment performance.[9] In this sense, for impact investments, trustees must simply apply the same financial criteria as for any investment proposition and remain focused on the best interests of their members (part of this duty would be to consider the unique features of impact investments).

This is reflected in APRA guidance on investment governance. APRA guidance requires RSE licensees, when formulating an investment strategy, to give regard to the risk and the likely return from the investments, diversification, liquidity, valuation and other relevant factors. An RSE licensee may take additional factors into account where there is no conflict with these foremost considerations.[10]

Answers to specific issues raised in discussion paper

The main barriers to active participation of superannuation funds in the impact investment market and the development of that market (Question 1).

ASFA notes that there are a number of structural factors that constrain the active participation of superannuation funds in the impact investment market. The main barriers are discussed below.

There is a strong degree of interdependence between participation of institutional investors and market development. On the one hand, without the supply of capital from institutional investors, many prospective impact investments will not go ahead. However, institutional investors will only be willing to invest in robust propositions – which are likely to become more prevalent as the market matures.[11] Ultimately, active participation of superannuation funds will depend on such barriers diminishing.

The lack of large-scale, investment-ready opportunities

One of the main barriers to funds' active participation in the impact investment market is the lack of large-scale, investment-ready opportunities. Though the Australian market has grown somewhat in recent years, growth has been driven by small-scale investments that are illiquid. This limits the appeal of impact investments for some superannuation funds. Development of more standardised investment products may make impact investments more attractive to funds – though this is only likely to occur as the market matures.[12]

Impact investing is relatively costly for funds

On a per cent of assets basis, impact investing is relatively costly compared with investments in other assets – though costs differ from case to case.[13]

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[9] Donald, S. M., Ormiston, J. and Charlton, K. 2014,'The potential for superannuation funds to make investments with a social impact', University of New South Wales, Centre for Law, Markets and Regulation, working paper no.14-3, May.

[10] APRA 2013, *Prudential Practice Guide: SPG 530 – Investment Governance*, November.

[11] Addis, R., McLeod, J. and Raine, A. 2013, *Impact Australia: Investment for Social and Economic Benefit*, Australian Government, Department of Education, Employment and Workplace Relations.

[12] Social Ventures Australia 2015, 'Implications of new growth phase in Australian impact investing', 22 September.

[13] For example, investment in an impact-style fund can cost as much as 2 per cent of assets invested - although as scale builds, costs are likely to come down (Smith, M. 2016, 'Why the cost of impact investing is coming down', Finsia, 3 November).

Generally speaking, for trustees, investments packaged in unfamiliar forms carry greater due diligence risks compared with 'traditional' assets. Individual impact investments typically have unique features, such as different underlying assets and different financing structures.[14] Therefore, impact investment propositions typically require intensive, case-by-case analysis. Other costs that make impact investments relatively expensive include the costs of locating and brokering appropriate investments. Although funds incur similar types of costs with respect to other asset classes – such as infrastructure – the relatively small-scale of impact investments magnifies the size of those costs on a per assets basis.

The lack of internal expertise and well-developed intermediaries

Given that the impact investment market is in its early stages of development, many funds lack the required internal expertise to invest in impact investments, and there is a lack of intermediaries (where the presence of intermediaries would reduce the need for internal expertise). Required expertise is similar to that for venture capital with respect to originating, analysing and managing investments.

Intermediaries to facilitate impact investments in Australia are only beginning to emerge. Currently, intermediation capacity is highly concentrated and still dependent on the networks of a relatively small number of people and organisations. For intermediaries to have broad appeal to superannuation funds, they will need to scale and build a track record of sound and consistent returns over time.[15]

The lack of good quality data

The appeal of impact investments to superannuation funds is also limited by the lack of good quality performance data on impact investment assets. As an emerging asset class, there is a limited track record of the social and environmental impacts of individual impact investments and the financial returns that those investments generate. As the number of Australian impact investment deals increase, so will the amount of performance data.

For areas where governments provide specific services, there is typically a lack of good quality data on the outcomes of those services and on the costs of providing those services. Better data on both would allow the private sector to determine the best investment opportunities and would facilitate development of models of service delivery/funding. It should be noted that the New South Wales Government is building a service cost database and is working with agencies to populate it for specific policy areas.[16] ASFA supports such initiatives.

Australian Government legislative or regulatory barriers constraining the growth of the impact investment market (Questions 3 and 23)

ASFA considers that the current legislative framework for superannuation funds is not a barrier to superannuation funds investing in impact investments.

There is an ongoing debate whether regulatory guidance with respect to funds' investment decisions should explicitly account for impact investments. For example, the final report of the Financial System Inquiry noted that APRA could provide clearer guidance on how the regulatory framework

[14] Charlton, K., Donald, S. M., Ormiston, J. and Seymour, R. 2013, *Impact Investments: Perspectives for Australian Superannuation Funds*, October.
[15] Ibid.
[16] NSW Government 2015, *Social Impact Investment Policy*.

applies to funds' decision-making regarding impact investments.[17] On balance, however, ASFA does not consider that additional guidance is required.

The regulatory regime for superannuation funds is designed to ensure that funds make investment decisions in the best interests of their members. The sole purpose test requires that the sole purpose of superannuation is to provide retirement income to members, while fund trustees are under a fiduciary duty to consider only the interests of fund members when exercising their trust powers, including investment.

ASFA considers that this is well understood by fund trustees and that little, if any, additional guidance for trustees is needed. Under the current regime, funds should consider impact investments as they would any other investment. Trustees must simply apply the same criteria as for any investment proposition and remain focused on the best interests of their members.

An investment that delivers ancillary social benefits does not rule out superannuation funds making such an investment. Superannuation funds have invested, and will continue to invest, in a number of areas where investments will deliver positive social outcomes along with financial returns for funds. However, clearly the primary aim of superannuation funds is to deliver retirement savings for fund members.

The role of government in developing the impact investment market (Question 4)

The foremost role for government in the impact investment market should be to facilitate increased private sector participation.

The most effective way to facilitate market development would be to develop further funding models for the provision of social and like services that involve payment for outcomes that are achieved. This would provide service providers with an income stream that could be used to support the financial obligations associated with social impact bonds or like financial instruments.

Whether or not such investment opportunities are suitable for a superannuation fund or funds depends on the nature of the bond or financing instrument on offer. One consideration for fund trustees will be the risk profile attached to the bond or like instrument. Some such bonds offer high face value interest rates if specified outcomes are achieved but also the possibility of a capital loss if a specified outcome is not achieved.

In this regard, governments in Australia that have been involved in impact investment have – in some instances – sought to make impact investment products more attractive to institutional investors by providing some degree of government support. For example, for its Benevolent Society Social Benefit Bond, the New South Wales Government provided a capital guaranteed tranche – that was taken up by local institutional investors.[18] Whether government support is appropriate – regardless of its form – is a matter solely for government.

[17] Australian Government 2014, *Financial System Inquiry: Final Report*.
[18] Charlton, K., Donald, S. M., Ormiston, J. and Seymour, R. 2013, *Impact Investments: Perspectives for Australian Superannuation Funds*, October.