

# **Social Impact Investing**

World Vision Australia: Response to Australian Government  
Discussion Paper

February 2017

For further information on this submission, please contact:

**Chris Rowlands**

Manager, Social Entrepreneurship and Economic Development (SEED) Unit  
World Vision Australia

[chris.rowlands@worldvision.com.au](mailto:chris.rowlands@worldvision.com.au)

**Priyanka Sunder**

Senior Policy Advisor, Economic Development  
World Vision Australia

[priyanka.sunder@worldvision.com.au](mailto:priyanka.sunder@worldvision.com.au)

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# Introduction

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## THE POTENTIAL OF IMPACT INVESTING

There is a growing realisation that private enterprise and finance has a role to play in addressing the global social and environmental challenges we currently face. Impact investing has significant potential to harness private sector investment in initiatives that generate positive development outcomes alongside financial returns. The global impact investing market is growing rapidly with approximately \$US30 billion in capital committed to impact funds in 2015.<sup>1</sup> The market is expected to reach between \$US600 million and \$US1 trillion within a decade.<sup>2</sup> According to the annual Global Impact Investing Network (GIIN) survey, most current impact investors intend to substantially expand their portfolios and increase the amount of capital committed to impact investment.<sup>3</sup>

Australia's impact investing market is still in its nascence. Though its size is difficult to quantify, it is estimated to reach \$A32 billion by 2022.<sup>4</sup> In 2016, the Impact Investing Australia Investor Report surveyed 123 Australian investors who accounted for \$A333 billion funds under management – 41 per cent of respondents indicated they are already actively investing in impact investments.<sup>5</sup> While these investors currently allocate less than 10 per cent of their assets to impact investments, they stated that they would ideally triple the size of their impact portfolios over the next five years.<sup>6</sup> More than two thirds of all investors surveyed expected impact investing to become a more significant part of their investment allocation in the future.

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## WORLD VISION AUSTRALIA'S EXPERIENCE WITH IMPACT INVESTING

World Vision is a worldwide community development organisation providing short-term and long-term assistance to 100 million people worldwide. Globally, World Vision has more than 45,000 staff members working in 99 countries.

For six decades, World Vision has been engaging people to work towards eliminating poverty and its causes. Informed by Christian values, World Vision is committed to working with those living in poverty, with a particular focus on the most vulnerable children. World Vision works with people of all cultures, faiths and genders to achieve transformation. This is done through humanitarian response and ongoing community development, public policy and advocacy for change, collaboration, education about poverty and an emphasis on personal growth, social justice and spiritual values.

World Vision Australia has a productive working relationship with the Australian Government as a key partner in the delivery of the Australian aid program. Alongside its international programs, World Vision Australia also implements a range of community development programs and brokers public private partnerships to benefit indigenous communities around Australia.

World Vision Australia has extensive experience developing and implementing programs that promote economic development in developing countries. These include market system development that is inclusive of the most vulnerable communities by improving their productive capacity and linking them with the private sector; improving the overall business enabling environment to ensure private sector development; women's economic empowerment and innovative financial solutions – such as micro-finance and 'Missing Middle Finance' (see below) – which address financing constraints facing micro, small and medium enterprise and small holder farmers. Established in 2003, World Vision's micro-finance arm, VisionFund International, manages a loan portfolio of over \$US540 million with more than 1 million individual loan recipients, borrowing an average of just \$600 each.<sup>7</sup> 72 percent of these loan recipients are women.<sup>8</sup>

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<sup>1</sup> The size of the global impact investing market is difficult to estimate. According to the Global Impact Investing Network 2016 Survey, 156 respondents reported that they invested US\$15 billion in impact investments in 2015 and managed a total of US\$77 billion in impact assets. see Global Impact Investing Network: <https://thegiin.org/impact-investing/need-to-know/#8>

<sup>2</sup> Impact Investing Australia, *Interested in Investing?* Last accessed 23 Feb 2016: <https://impactinvestingaustralia.com/interested-in-investing/>

<sup>3</sup> Global Impact Investing Network, *Global Impact Investing Survey 2016*

<sup>4</sup> Impact Investing Australia, *Interested in Investing?* Last accessed 23 Feb 2016: <https://impactinvestingaustralia.com/interested-in-investing/>

<sup>5</sup> Impact Investing Australia, *Annual Investor Report 2016*

<sup>6</sup> Impact Investing Australia, *Annual Investor Report 2016*

<sup>7</sup> See Vision Fund International: <http://www.visionfund.org/2124/impact/>. Current outstanding loan portfolio is estimated to be \$US545 million.

<sup>8</sup> See Vision Fund International: <http://www.visionfund.org/2128/percent-of-female-clients/impact/>

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## WORLD VISION AUSTRALIA CASE STUDY: USING IMPACT INVESTING TO PROVIDE FINANCE TO THE ‘MISSING MIDDLE’

Small and medium enterprises (SMEs) in developing countries are hindered by a range of factors such as inadequate infrastructure, restrictive taxes and regulations, and discriminatory social barriers.<sup>9</sup> Despite these barriers, overall they contribute 67 percent to their national GDPs and employ 80 percent of workers. Poor access to finance remains the single biggest constraint to the growth of SMEs in developing economies.<sup>10</sup> While financing solutions exist for other segments of financial markets, private finance typically bypasses SMEs in developing countries, which have come to be known as the ‘missing middle’. Microfinance caters to microenterprise but is poorly suited, in size and risk profile, to provide the larger loans needed by SMEs to reach scale.<sup>11</sup> Conversely, SMEs are associated with higher transaction costs and are considered too small to attract finance from banks and large commercial lenders.

The lack of finance to the missing middle is a global market failure. Estimates suggest that the current credit gap for SMEs could be as high as \$US 2.6 trillion.<sup>12</sup> By preventing large numbers of people living in poverty from growing their businesses and participating in the labour market, the financing constraints facing the missing middle is a sizable obstacle to economic growth and poverty reduction.

With the support of the Australian Department of Foreign Affairs and Trade (DFAT), World Vision Australia has recently commenced a three-year pilot program to address the missing middle in Sri Lanka. The program provides growth capital to SMEs to enable them to scale their operations to stimulate local economies through providing increased marketing and employment opportunities. To mitigate risk and lower transaction costs, the program also provides technical assistance and mentoring to build the capacity of targeted entrepreneurs. Additionally, World Vision sources its loan pipeline primarily from its base of successful microfinance clients, most of whom are women entrepreneurs. The current plan would see a portfolio of 100 loans in Sri Lanka by end of 2018 and presents the opportunity to provide an indicative return to future investors of approximately 3% per annum on their capital.

World Vision Australia believes this project represents an opportunity to attract impact investors. Based on the success of the pilot, World Vision intends to grow the program in Sri Lanka and expand into Myanmar and beyond. Loans will range from \$5,000 to \$25,000 to cater for the most critical financing gap faced by SMEs within the missing middle.

World Vision Australia and its financial industry partner/s will target ‘impact-first’ investors – investors who are seeking higher social returns and willing to accept lower financial returns with the understanding that their patient capital will attract further private capital in the future. World Vision will utilise grants alongside this patient capital to both leverage and de-risk additional debt from private sources that would not otherwise fund such investments. Additionally, World Vision is providing ongoing technical assistance to the loan recipients and detailed impact measurement. Returns on investment will either be disbursed or reinvested to expand the loan portfolio and increase overall impact achieved.

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<sup>9</sup> See: Klapper, Laeven, & Rajan, *Entry regulation as a barrier to entrepreneurship*, 2006, *Journal of Financial Economics* 82:591-629; and Beck, *Financing Constraints of SMEs in Developing Countries: Evidence, Determinants and Solutions*, 2007

<sup>10</sup> Beck, *Financing Constraints of SMEs in Developing Countries: Evidence, Determinants and Solutions*, 2007

<sup>11</sup> Center for International Development, Harvard University, *The Missing Middle* Last accessed 23 Feb 2017:

<https://www.hks.harvard.edu/centers/cid/programs/entrepreneurial-finance-lab-research-initiative/the-missing-middle>

<sup>12</sup> World Bank Group, *Small and Medium Enterprise Finance*, Last accessed 23 Feb 2017:

<http://www.worldbank.org/en/topic/financialsector/brief/smes-finance>

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## WORLD VISION AUSTRALIA'S RESPONSE TO DISCUSSION PAPER

World Vision Australia is a leading international development organisation. In writing this submission, World Vision Australia has drawn from its expertise providing financing solutions to disadvantaged individuals, households and communities in developing countries, and its experience developing and trialling new financing models.

World Vision Australia understands the Social Impact Investing Discussion Paper predominantly focuses on attracting impact investment funds to solve challenges faced by the Australian community. However, World Vision Australia believes that there are important lessons from global impact investing and international development that can be readily applied to Australia's domestic community development sector. Furthermore, given the discussion paper takes a whole-of-government approach, World Vision's submission provides recommendations on how the Australian Government can encourage social impact investing in developing countries through Australia's aid program.

World Vision Australia's submission identifies the barriers faced by the impact investing market and the role the Australian Government can play to facilitate the growth of the market. In doing so, this submission primarily responds to consultation questions 1, 3 and 4, and provides recommendations to inform the Australian Government's principles for social impact investing.

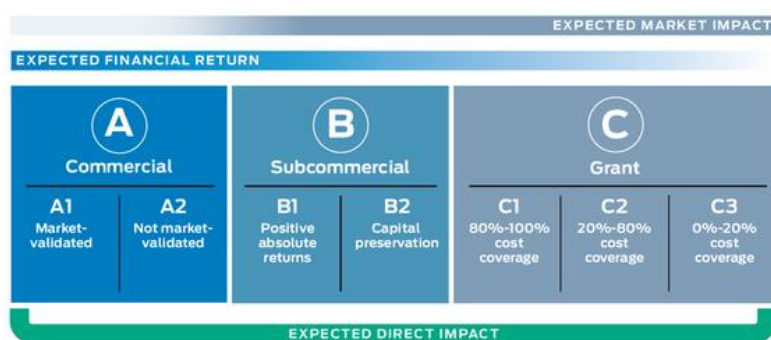
# The Challenge of Impact Investing

Impact investing has significant potential to channel private sector capital to address social and environmental problems faced by the community, both in Australia and in developing countries. A central debate across the impact investing industry is whether sustained and meaningful social impact can be achieved alongside market-rate financial returns. Some believe that chasing higher financial returns will inevitably lead to reduced social impact, whilst others argue that investing in firms that are profitable will have a far greater social impact on the wider community.<sup>13</sup>

While in practice there is no necessary trade-off between social impact and financial returns, there is undoubtedly a relationship between risk, return, and social impact. This relationship is best modelled as a returns/impact spectrum or continuum, where financial returns tend to be lower for investments that generate significant market-level social impact. For example, the Omidyar Network has developed a returns continuum (see below, Figure 1) which depicts the relationship between social impact and financial returns. Many variations of this spectrum can be found across impact investing literature.<sup>14</sup>

FIGURE 1

## The Returns Continuum Framework – Omidyar Network<sup>15</sup>



This relationship between social impact and financial returns, though well understood, is often overlooked by investors. This creates two key challenges for the impact investing industry and its ability to achieve social and environmental outcomes:

### I. Targeting complex, social challenges

A large proportion of investors interested in impact investing are looking for market or even above market returns. According to the 2016 Annual Impact Investor Survey conducted by the Global Impact Investing Network (GIIN), nearly 60 per cent of impact investors target risk-adjusted market-rate returns, while a further 25 per cent sought returns just under market rates.<sup>16</sup> More than half of impact investors surveyed invested in mature companies. The picture is similar in Australia, with more than 60 per cent of prospective and current impact investors expecting competitive market rates of return from impact investments.<sup>17</sup>

While not inevitable, investor expectations of market-rate returns can alter the type of social impact that impact investments achieve. Impact investments seeking higher returns are more likely to target less complex social problems, subject to less risk and shorter timeframes. In some cases, social impact organisations will shift their business models to focus on beneficiaries who are easier to reach. This is

<sup>13</sup> Bannick, Goldman, Kubzansky & Sultuk, *Across the Returns Continuum*, Stanford Social Innovation Review Winter 2017

<sup>14</sup> See for example: Bridges Ventures, *Spectrum of Capital 2015*, Last accessed 23 Feb 2017: <http://bridgesventures.com/wp-content/uploads/2015/11/Spectrum-of-Capital-online-version.pdf>

<sup>15</sup> Bannick, Goldman, Kubzansky & Sultuk, *Across the Returns Continuum*, Stanford Social Innovation Review Winter 2017

<sup>16</sup> Global Impact Investing Network, *Global Impact Investing Survey 2016*

<sup>17</sup> Impact Investing Australia, *Annual Investor Report 2016*

problematic as it undermines the potential of impact investing to drive positive social change across communities.

This is a particular problem for developing and emerging markets whose risk profile means impact investors often expect market returns regardless of social impact. Impact investing in this context risks crowding out local private capital.

## **2. Attracting patient, impact first capital**

Investment across the impact/returns continuum is critical for the health of the impact investing market. Finance first investors, who seek market or close to market returns, play an important role in scaling up proven solutions to social problems. Patient, long-term, impact first capital is critical to find, test and re-test commercial solutions, particularly to complex and entrenched social challenges that have a significant impact on the community.

While the number of investors seeking market returns is high, there is a growing shortage of investors willing to accept higher social returns in lieu of higher financial returns. In particular, there is a lack of patient, long-term capital as well as seed, early and venture-stage capital.<sup>18</sup> The Global Impact Investing Network has consistently identified the lack of impact first capital as the most critical challenge to the growth of the impact investing industry.<sup>19</sup> Patient, long-term capital is needed to nurture early stage firms to help them hone and perfect their business models and commercial approaches, so that over time, they are able to generate market returns. This is vital for building a future pipeline of bankable, finance first impact investments.

The Australian Government has an essential role to play to facilitate impact investments which target complex social problems, and to help attract impact first capital to the industry. The recommendations outlined in the section below identify ways the Australian Government can address constraints in the impact investing market and address the challenges outlined above.

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<sup>18</sup> Global Impact Investing Network, *Global Impact Investing Survey 2016*

<sup>19</sup> Global Impact Investing Network, *Global Impact Investing Survey 2016*



# The Role of the Australian Government

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## THE AUSTRALIAN GOVERNMENT SHOULD STRENGTHEN THE ENABLING ENVIRONMENT FOR IMPACT INVESTING

### 1. Classify impact investments by impact class

The impact investment market, like broader financial markets, is comprised of a range of investors with varying appetites for risk, social impact and financial returns. Whereas in traditional investing, asset classes provide a framework for classifying assets according to their risk/return features, there are few frameworks for grouping impact investments. This makes it difficult for investors to identify impact investments that match their financial and impact expectations, and hinders those seeking to attract impact capital from identifying investors likely to be interested in their product offering.

The Australian Government should work with industry experts to develop impact classes for impact investments in Australia. The impact classes developed by the Tideline Group provide a useful starting point.<sup>20</sup> Developing a framework for grouping impact investments would assist Australia's impact investing market by enabling both investors and social enterprises to find common grounds to understand impact investments, and to better find the right capital and products. Such a framework would also highlight the wide spectrum of financial returns and social impact available for investors, and may attract investors willing to sacrifice financial returns for higher social impact.

**Recommendation 1:** The Australian Government should develop impact classes that group impact investments according to the impact/return spectrum.

### 2. Offer tax incentives to encourage impact first investors

Impact first investors offering patient, long-term capital are critical to the health and expansion of the Australian and global impact investing market. International experience demonstrates that tax incentives can be instrumental in attracting impact first capital from a range of private sources. In the UK market, research suggests that there is unmet appetite among High Net Worth Individuals (HNWIs) for financial products that provide social and ethical returns alongside financial returns.<sup>21</sup> Tax incentives were found to be highly influential in encouraging HNWIs to invest in social impact, while the lack of tax benefits were an impediment as tax breaks existed for competing investments in venture capital and charitable activities.<sup>22</sup>

In World Vision Australia's experience, while not their primary motivation, Australian HNWIs would also be more likely to invest impact first capital if tax incentives were provided. In particular, World Vision Australia is exploring blended financing structures to encourage Private Ancillary Funds (PAFs), Public Ancillary Funds (PuAFs) and Foundations to provide impact first capital. Such organisations could provide grants, as part of their annual compulsory grant-making, in the form of tax deductible donations alongside further investment from their corpus capital which seeks a small financial return.

This blended finance would enable World Vision to offset the costs associated with working on complex social issues through the grant, whilst still providing a financial return upon the proportion of corpus capital invested. This would build the overall assets of the PAF, PuAF or Foundation. World Vision Australia has found that even this relatively small benefit is useful in unlocking private impact first capital. The Australian Government could increase the availability of impact first capital by exploring options to provide tax benefits for impact first investors.

**Recommendation 2:** The Australian Government should explore options to provide tax incentives for impact first capital.

### 3. Develop a set of standardised metrics to measure impact

Defining and evaluating impact is a critical aspect of impact investing. Investors and organisations receiving funds need a clear bar against which to measure impact and assess returns. Yet addressing social and environmental programs is a complex task and involves a number of dynamic factors. For example, programs to promote women's economic empowerment can require a range of interventions to increase financial literacy, tackle discriminatory social norms and improve access to credit. Progress in these sorts of programs takes time, is not always easy to define and is even harder to measure. This is particularly true when tackling entrenched poverty, and social and economic disadvantage.

While some standardised measures exist, such as the Impact Reporting and Investment Standards (IRIS) and the Global Impact Investment Rating System (GIIRS), these tend to focus more on operational and financial measures rather than impact.<sup>23</sup> For example, IRIS measures a program's impact in increasing student attendance in school, but does not measure the impact on educational outcomes.

A lack of standardised impact metrics is problematic for the industry as it makes it difficult to connect investors with products, and erodes certainty that investments will achieve the expected social returns. The Australian Government should work with industry experts to develop a set of standardised metrics to measure impact for Australian impact investments. The metrics should take into account the complexities of tackling entrenched social problems and provide ways to measure and assess incremental progress made.

**Recommendation 3:** The Australian Government, working with industry experts, should develop a set of standardised metrics to measure the impact of Australian impact investments.

### 4. Increasing the pipeline of impact investments

An ongoing challenge for the impact investing industry is ensuring a pipeline of investable projects which generate positive social and financial returns. There are a number of factors underlying this challenge. Organisations face significant obstacles developing financial products based on the social programs they implement. Australia's tax and regulatory environment is complex and its application can be opaque. Moreover, structuring and marketing financial products is typically not the core business of entities – such as not-for-profit organisations – which offer impact investments. Not-for-profit organisations have limited funds and face particular challenges navigating the impact investment market. For example, it is unclear how offering financial products could impact an organisation's not-for-profit tax status.

Many organisations, particularly not-for-profits, also lack upfront funds to cover the cost of seeking the financial, legal and regulatory advice necessary to establish an impact investment product, social enterprise or social impact bond. Similarly, not-for-profits tend to lack access to training services to improve their financial and business modelling capabilities. Available training programs are costly and typically do not address the particular challenges faced by not-for-profits entering the market. This can act as a significant impediment to organisations which are otherwise willing to seek impact capital.

The Australian Government has a role to play in enabling organisations, particularly not-for-profits, to better navigate Australia's regulatory environment and enter the impact investment market. The Australian Government should:

**Recommendation 4:** Offer clear and specific guidance to organisations about Australia's regulation of impact investments;

**Recommendation 5:** Provide funding to enable not-for-profit organisations and others to access legal, financial and regulatory advice on entering the impact investment market; and

**Recommendation 6:** Provide not-for-profit organisations with tailored training programs or funding to attend training programs which improve their financial and business modelling capabilities, to in turn support their involvement in the impact investing industry.

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<sup>20</sup> Tideline Group, *Navigating Impact Investing Working Paper*, 2016

<sup>21</sup> City of London, *The Role of Tax Incentives in Encouraging Social Investment*, 2013

<sup>22</sup> City of London, *The Role of Tax Incentives in Encouraging Social Investment*, 2013

<sup>23</sup> Brest & Born, *When can impact investing create real impact?* Stanford Social Innovation Review Fall 2013

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## THE AUSTRALIAN GOVERNMENT SHOULD PARTICIPATE DIRECTLY IN THE IMPACT INVESTMENT MARKET

In addition to encouraging new entrants and capital into the impact investing market, the Australian Government has a role to play as a key market participant:

### 1. As a funder

As discussed above, there is a need for patient, long-term capital that prioritises social and development impact over financial returns. This impact first capital is critical to find and test solutions to complex social problems, which over time will generate financial returns. The Australian Government is an important source of impact first capital which can be provided in the form of interest free or low interest loans, grants or guarantee instruments. Government capital in these forms can strengthen the impact investing market by (1) encouraging private investors to co-invest (as finance or impact first investors); and (2) enabling organisations to offer blended products which use impact first capital to free up returns for private investors.

**Recommendation 7:** The Australian Government should provide impact first capital in the form of low interest or interest-free loans, grants and guarantees to strengthen the impact investing market.

### 2. As a convenor

The Australian Government has substantial power to raise awareness and bring together a diverse range of stakeholders across the impact investing industry. World Vision Australia encourages the Australian Government to help build partnerships between Australian not-for-profit organisations and private sector financial institutions looking for exposure to impact investing. In particular, there is significant scope for not-for-profits to partner with financial institutions to jointly develop, structure and market impact investing opportunities. While there is appetite from financial firms to enter the impact investing space, there is often a lack of understanding and trust of the non-government sector.

The Australian Government could assist by helping broker these partnerships but also creating a list of accredited not-for-profits that have been vetted and adhere to high standards of effectiveness, transparency and accountability. One example is the existing accreditation process for Australian aid and development NGOs to receive government funding.

**Recommendation 8:** The Australian Government should broker partnerships between accredited Australian not-for-profit organisations and private sector financial institutions to encourage new entrants into the impact investing market.

As discussed above, there are also a number of hurdles preventing not-for-profits and other organisations from entering the impact investing market. The high, upfront cost of negotiating the regulatory, tax and legal environment is a particular barrier to entry, as is the costs involved in raising capital. The Australian Government could address these obstacles by launching a challenge fund which would cover the upfront costs of the winning organisations.

**Recommendation 9:** Launch a challenge fund that enables not-for-profits cover the upfront costs of establishing an impact investment product.