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Dear Commissioners Robson, Abramson and Seibert

SUBMISSION TO THE PRODUCTIVITY COMMISSION REVIEW OF PHILANTHROPY

Australian Impact Investments (**Aii**) commends the Productivity Commission on its inquiry into the motivations for philanthropic giving in Australia and opportunities to grow it further. We also commend you on the draft report issued 30 November 2023.

About Aii

Aii is a leading impact asset consultant in Australia. We are a trusted advisor to a wide range of asset owners engaged in impact investing, many of whom are pioneers of impact investing in Australia. Ancillary funds – private and public – and charitable trusts are a core client group with whom we work to customise investment portfolios that optimise for their financial and impact objectives.

Since our launch in 2014, we have helped our clients mobilise more than $300 million into 71 private market investments delivering positive environment and social impact.

Every dollar has impact

For ancillary funds and charitable trusts every grant and every investment has impact – positive, negative or neutral. The benefit flowing to the community of such structured giving vehicles is therefore the aggregate of the impact of these two activities, as well as that flowing from time and talent.

Acknowledging the excellent work of the Social Impact Investment Taskforce and recognising the limited scope of the inquiry by the Productivity Commission regarding impact investment, we consider it important however to not overlook the benefit to community that can be generated when structured giving vehicles intentionally seek to generate positive impact from their investment portfolios.

Increasing minimum distribution rates of ancillary funds to bolster benefit to community

Section 8 of the draft report discusses the opportunity to enhance the benefits of structured giving vehicles to the community. In particular, it explores how the benefit from ancillary funds may be bolstered through increasing the minimum distribution rate. Information request 8.1 seeks views on the likely response to a change in the minimum distribution rate.

Our expectation, derived from the experience of working with ancillary fund clients and deep understanding of the wider market, is that an increase in the minimum distribution rate is unlikely to have a material effect on the establishment of new, or contribution to existing, ancillary funds. This expectation assumes there is no adjustment to the current tax setting for ancillary funds that provide for an uncapped, 100% tax deduction for donations to ancillary funds.

We do however expect a change to the minimum distribution rate will affect the investment strategies of ancillary funds. Most ancillary funds are established with a view to being perpetual, adopting investment strategies designed to maintain purchasing power of the corpus. In turn, the investment objective most seen is to achieve a return after fees at least equal to CPI inflation + 4-5% per annum, measured over rolling seven-year periods, reflecting the current minimum distribution rates for public and private ancillary funds.

In the event the distribution rate was increased we anticipate that investment objectives for ancillary funds would be reconsidered with return targets after fees increasing to CPI inflation 5-6% per annum to maintain their perpetual nature. Return forecasts from asset allocation models suggests that to achieve such returns it is likely there would be a shift in the strategic asset allocations of ancillary funds with assets migrating to higher yielding, liquid assets – namely, listed equities.

Such migration is likely to reduce the appetite of ancillary funds for impact investments that intentionally seek positive, measurable environmental and social impact alongside financial return. Impact investments typically sit within a portfolio's allocation to alternative assets, with most being illiquid, long term and having returns weighted to the back end. For example:

- Investing to increase the stock of disability or social housing involves investors being able to withstand an initial period of no or minimal yield while housing portfolios are constructed and prior to full occupancy at which time

yield increases and presents opportunities to realise capital growth in the value of the then completed and occupied housing portfolios.
- Investing in social impact bonds involves investors being able to withstand an initial period of minimal yield (typically reflecting CPI inflation) before returns are positively impacted by outcome payments in the latter years of the term of the bond.

A shift in the investment appetite of ancillary funds away from impact investments would materially detract from the potential benefit to community. This shift would also be detrimental to the development of the impact investment market recognising ancillary funds are often the first, and sometimes the only, investors in impact investments that catalyse first-time fund managers, pilot innovations, and invest in opportunities that are sub-scale for institutional investors.

Leverage the power of AND

We strongly encourage the Productivity Commission in considering changes to the minimum distribution rate of ancillary funds to seek to leverage the power of granting AND impact investment to optimise benefit to community. Impact investment is a powerful amplifier of the positive impact of ancillary funds, not only because of the direct impact flowing from an impact investment but investment capital once returned can be recycled into grants or further impact investments thus creating a multiplier effect. Furthermore, impact investment activity of ancillary funds can have the effect of crowding-in non-philanthropic private capital thus expanding the scale of positive impact.

To encourage ancillary funds to apply their corpus to impact investment we recommend consideration be given to a shift to allow the principal value of "qualifying impact investments" to be included towards ay required minimum annual distribution. This approach would be akin to the approach to Program Related Investments in the US[1], while significantly simplifying Australia's current "discount" or "market differential" approach[2] with no cost to the Federal Budget[3]. Collaboration between the Australian Charities and Not-for-profits Commission (ACNC) and the Social Impact Investments Taskforce's recommended Commonwealth Office of Social Investment (COSI) on design of the approach and, in particular, defining a "qualifying impact investment", would streamline and optimise efforts to increase philanthropy and impact investment to the benefit of community.

Recognising there may be some impact investments that do not meet the requirements of an agreed definition of a "qualifying impact investment" for the

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[1] Internal Revenue Code Section 4944(c) and Program Related Investments

[2] Taxation Administration (Private Ancillary Funds) Guidelines 2019 Section 15 and Taxation Administration (Public Ancillary Funds) Guidelines 2022 Section 15

[3] Philanthropy Australia (2017), 'Philanthropy Australia Submission – Social Impact Investing Discussion Paper.

purpose of inclusion towards the minimum annual distribution, but do generate positive social and environmental impact, we consider it imperative that any changes to the minimum distribution rates do not discourage participation in impact investments. To this end we recommend that the minimum distribution rate be equalised at 5% for public and private ancillary funds which from our experience in working with private ancillary funds, together with consideration of asset allocation models, will continue to enable allocations of 10-20% to alternative assets (including property), the asset class to which most impact investments (market-rate or concessional rate) belong and the investment strategies with the deepest "impact classes" of "Contribute to Solutions" or "Contribute and Catalyse Solutions"[4].

While retaining the minimum distribution rate of private ancillary funds at 5% would see the potential additional distributions of $60 million from an increase in the minimum distribution to 6% foregone, we believe it will enable the continued uptake of impact investments and catalytic impact investments by ancillary funds. If all ancillary funds were to deploy 10% of current net assets to impact investments, $1.6 billion would be invested for positive impact benefiting community, comparing favourably to the $60 million in additional annual distributions foregone.

We welcome the opportunity to engage with the Commission to discuss the above points and to assist more generally in the consideration of the role of impact investment to amplify the benefits to community from structured giving vehicles.

Kind regards,

Kylie Charlton
Managing Director

[4] The Impact Spectrum, Australian Impact Investment 2023 Impact Report, p.19