

more
than
money



JOURNEY TO SOCIAL INCLUSION

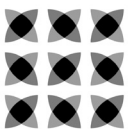
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A case study on the J2SI Impact
Investment Transaction



Report prepared by:

Dr Michael Moran
Libby Ward-Christie
Prof Kristy Muir
Centre for Social Impact



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NAB AND SHM FOREWORD



Since Sacred Heart Mission (SHM) first opened its doors in 1982, it has worked to provide people who are experiencing homelessness with access to a wide range of services that address the underlying causes of disadvantage. Over the past decade, SHM has developed, tested and refined a program that addresses chronic homelessness — the Journey to Social Inclusion (J2SI) — now known as one of the most effective programs to end chronic homelessness in Australia.

In April 2017 the Victorian Government announced SHM had been invited to develop one of Victoria's first two Social Impact Bonds (SIBs) to explore new approaches to complex social issues, by scaling J2SI to reduce the impact of chronic homelessness for 180 people over five years in Melbourne. The Department of Treasury and Finance led the negotiations with the Department of Health and Human Services, during which an innovative variation of the financing structure was developed with SHM and the National Australia Bank (NAB) Sustainable Finance team. The ultimate structure of the transaction, announced in late 2017 and with service delivery commencing in August 2018, was an innovative use of capital – funding from the Victorian Government, financial guarantees provided by philanthropy and low-cost debt from the Catholic Development Fund (CDF). Importantly, this was the first time a philanthropic guarantee had been used to finance a pay-for-performance social impact investment in Australia, significantly lowering the cost of financing. The Victorian Government's subsequent round of Partnerships Addressing Disadvantage recognises the opportunity to develop new investment mechanisms in addition to SIBs, reflecting that innovation in both the financing structures and service delivery can be delivered through these partnerships between government, not-for-profits and the financial and philanthropic sectors.

NAB has a long history with SHM – both as a customer and community partner and believe that everyone has a right to safe, affordable and adequate housing. The NAB Foundation, the philanthropic arm of NAB, is committed to engaging in financial innovation to help address complex societal challenges such as homelessness and was one of four philanthropic guarantors on the J2SI transaction including the William Buckland Foundation, the Orcadia Foundation and Robert & Irene Gilbert of the low-cost debt provided by the Catholic Development Fund (the lender).

Guarantees are an effective way to deliver low cost funding, generating savings for both government and service delivery organisations and have the potential to unlock greater amounts of capital to enable social impact at scale. In Australia, guarantees are an underutilised tool in the philanthropic tool box – they give philanthropists an opportunity to move beyond traditional grantmaking to support the scaling and sustainability of proven impactful projects like J2SI. Both NAB and SHM believe there is considerable scope to expand this approach to social impact investing in Australia by leveraging the corpuses of Australian trusts and foundations.

The social impact investment opportunity represented by J2SI was an opportunity for trusts and foundations to be the first participants in an innovative, high impact financing model – however the take up of the

opportunity was less than expected. NAB and SHM commissioned the Centre for Social Impact to research this case study. We want to share lessons learned from participants to the transaction, to understand the barriers to entry and identify possible future solutions to these barriers.

It is our hope that this case study is an important contribution in building the impact investing ecosystem in Australia by focusing on the role philanthropy can play to amplify social impact by using blended capital models. We also hope the case study provides others with practical solutions and tips that will enable these kinds of transactions in the future.

Lucy Doyle

Manager Strategic Giving
National Australia Bank

Catherine Harris

GM Business Development
Sacred Heart Mission



TREASURER FOREWORD



The Andrews Labor Government is proud to partner with Sacred Heart Mission in the Journey to Social Inclusion social impact investment, an innovative approach to tackle chronic homelessness and better support vulnerable Victorians. J2SI provides 180 Victorians experiencing chronic homelessness with three years of intensive, wrap around case management supports, with a strong focus on the rapid provision of safe and stable accommodation.

The J2SI social impact investment builds on the strong achievements of the award-winning J2SI pilot that ran between 2009 and 2012. After three years, J2SI was able to keep 85 per cent of participants in stable, safe accommodation and reduce demand on health services by about 80 per cent. Preliminary results from the second iteration of J2SI which started in 2016 are also very promising.

This social impact investment is the first of its kind in Victoria, and forms part of the Andrews Labor Government's Partnerships Addressing Disadvantage initiative, which brings together public, philanthropic, private and not-for-profit sectors to solve challenging social issues through a partnership approach. It is designed to affect meaningful and lasting change for Victorians that need it most.

The Journey to Social Inclusion case study highlights the significant potential for philanthropic organisations to help address some of society's most pressing social and entrenched economic issues. Unlocking philanthropic capital for the J2SI social impact investment allows the Victorian Government to partner with organisations that are on the ground, working directly with those in need, while also playing a fundamental role in further developing the impact investing market in Victoria and Australia.

Sharing the learnings of this model through the case study is an important step in supporting the social impact investing market to expand, while also helping other programs to explore innovative financing mechanisms and partnerships across sectors to improve social outcomes.

I would like to extend my sincere thanks to all of those involved in making the J2SI social impact investment a reality, including the National Australia Bank who were instrumental in the design of the J2SI social impact investment and the unlocking of philanthropic investment for this significant initiative.

Tim Pallas MP
Treasurer of Victoria



EXECUTIVE SUMMARY



The J2SI social impact investment (SII) transaction (Transaction), developed by Sacred Heart Mission (SHM) and the Victorian Government in 2017/2018, is significant because it is the first transaction in Australia to include a guarantee in the delivery of a government pay-for-performance contract. It represents a potentially important innovation for how organisations seek to structure and finance SII in Australia and abroad. This report provides a case study of the Transaction and provides a significant learning opportunity about the use of a guarantee structure as part of a pay-for-performance contract, identifying the challenges that were faced, so that they can be addressed for future efforts.

As an instrument of SII, guarantees coupled with a pay-for-performance contract offer many potential benefits, including lowering the cost of capital, which lowers costs for both service providers and governments, therefore unlocking greater amounts of capital to enable greater social impact.

Guarantees also offer potential benefits to philanthropy – notably Public Ancillary Funds (PuAFs – see Glossary) and Private Ancillary Funds (PAFs – see Glossary) – as both can leverage provisions in their respective legislative frameworks (the ‘Guidelines’)¹ to further their charitable purposes (Ward, 2012, 2016).

Recognising the significant benefits and opportunities offered by guarantees, the aim of this report is to detail the J2SI Transaction and to identify the opportunities and challenges presented by its incorporation of a guarantee-type structure as part of the social financing model. In particular, we aim to understand why some charitable trusts – both ancillary funds and other trust types including testamentary – decided to participate while others did not. Identifying these opportunities and challenges can therefore inform how guarantee-type models can be used more broadly as a public and social financing innovation. Where possible the opportunities and challenges have been separated into those relating to SII and Social Impact Bonds (SIBs – see Glossary) in general, and the J2SI Transaction in particular.

The J2SI program has been shown to be highly effective in addressing long-term homelessness, through randomised controlled trials (RCT). The RCT of the phase 1 pilot indicated that the J2SI approach was substantially more successful than the ‘control’. Over the three-year period starting one year after phase 1 pilot commencement, an average of 31% more clients were in stable housing and they had a 45% higher reduction in hospital bed days than the control group.

Preliminary results for Phase 2 of the program are promising and suggest the J2SI approach continues to achieve significantly positive outcomes for its clients.

The delivery of the J2SI program through a pay-for-performance contract was made possible through the low-cost financing offered through the guarantor model. This allowed SHM to secure project finance to augment payments from the Victorian Government. The requirement for project finance is characteristic of the risk-sharing principles of the pay-for-performance model; in this case the risk of the J2SI program not delivering on its contractual targets is shared equally by the Victorian Government and SHM. The project finance is provided as a loan from CDF.

For SHM to be able to access the debt finance from CDF, they sought up to an equal amount in philanthropic guarantees from charitable trusts. These guarantees reduce the return

which would be paid to traditional SIB investors if the CDF loan was not available, with SHM additionally taking a ‘first loss guarantee’ position, should J2SI not perform as expected. Therefore, the guarantees are effectively underwriting the project-delivery risk carried by SHM, with the Victorian Government carrying the balance of the risk. The guarantees would only be called upon if J2SI does not achieve its contractual targets, with the quantum of the guarantee called dependent on SHM’s performance.

Despite a strong case for significant social impact and potential financial benefits for ancillary funds, SHM had trouble in raising philanthropic guarantees to support J2SI. To date, just under one third of the guarantee goal has been raised. Whilst enough to enable the contract to commence (and with CDF taking more risk than usual in this type of structure to support the J2SI program and new transaction structure), this case aims to understand the barriers to participation to inform the ongoing fundraising effort of this Transaction and similar uses of philanthropic guarantees in the future.

1. See Public Ancillary Fund Guidelines 2011 (Cth) and the Private Ancillary Fund Guidelines 2009 (Cth)

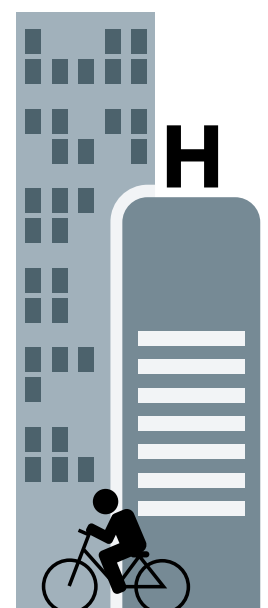


Central to the findings of this report are the challenges presented by the hybrid nature of the J2SI Transaction structure. The proposition of the J2SI Transaction for charitable trusts sits somewhere between a traditional grant – which will only be required if J2SI performs below target – and being a component of a SII structure by providing guarantees to CDF as project financier. Contributing to the complexity, SII is itself in a nascent state in Australia, with many charitable trusts having little experience of incorporating it into their operations.

This study found that the combination of the innovative nature of this hybrid transaction and the nascency of SII in Australia resulted in a number of communications, positioning and execution challenges, which underlie SHM's difficulty in raising support for this pioneering opportunity.

These included:

- An uneven distribution of available SII capital due to the nascency of the SII market, with less capital at the 'impact first' end of the spectrum (compared with the 'finance-first' end) where the J2SI Transaction is positioned;
- The J2SI Transaction structure seen as too complex, new and risky by decision makers;
- Communication (written and verbal) perceived as complex and difficult to comprehend by some potential participants;
- The communication challenge was compounded as the financing documents were being developed whilst SHM was recruiting potential philanthropic guarantors;
- Negotiating the financing documents included ensuring the risk transfer from the Victorian Government to SHM agreed for a traditional SIB structure was not impacted by the J2SI Transaction structure and CDF accepting the risks from its project finance not being fully guaranteed;
- Confusion/misassumption about the role of the guarantee and who the guarantee is underwriting – some assumed the Catholic Church could be interpreted as a beneficiary due to the CDF being the financier and/or assumed NAB Capital Markets (who were deal advisors) were material participants and could thus be interpreted as beneficiaries. A small cohort therefore questioned whether they were supporting J2SI, the CDF, the Catholic Church or NAB;
- Positioning the J2SI Transaction as an investment for potential philanthropic guarantors, resulting in a negative assessment on the basis it would not provide a financial return and/or confusion about who within a trust (grant or investment committees) should assess the opportunity;
- Over-estimation of the attractiveness of the gifting benefit as a central element of the value proposition for ancillary funds as many regularly exceed their distributions;
- Early Transaction communications not providing the specific discount rate that could be used by ancillary funds to calculate the benefits to them of the proposition;
- Perceived and real additional transaction costs to enable support, such as due diligence and additional legal and accounting advice;
- Some decision makers not liking the term 'guarantee' due to negative connotations in banking and finance; and
- A small number of potential philanthropic guarantors with the belief that government should be directly procuring the program due to its proven success.





This report discusses each of these findings in detail and proposes mitigating actions, so as to:

- (i) enable greater support for the J2SI Transaction; and
- (ii) support growth of the broader SII ecosystem so that philanthropic guarantees can be used more frequently to reduce the cost of finance necessary for the delivery of pay-for-performance contracts.

Since closing the J2SI Transaction, SHM has taken several steps to address some of the challenges raised above including:

- Producing a new pitch book which simplifies communication, including making it clear the opportunity is not an investment proposition;
- Obtaining a class ruling from the Australian Taxation Office (ATO) to provide guidance on how to quantify the gifting benefit for ancillary funds²; and
- Working with the Victorian Government to develop template financing documents³ to enable review and adoption of the fully guaranteed transaction structure by others.

The above steps may assist in providing greater clarity for potential participants in future transactions of this nature (notably ancillary funds) and reduce the transactions costs for other transactions that adopt this structure (in other jurisdictions in Australia).

2. The Class Ruling (CR2019-34) is available at <https://www.ato.gov.au/law/view/pdf/pbr/cr2019-034.pdf>

3. The templates are available at <https://www.dtf.vic.gov.au/partnerships-addressing-disadvantage/tools-and-resources>

BACKGROUND



Sacred Heart Mission's J2SI program

SHM is a not-for-profit organisation based in Melbourne working to address persistent disadvantage and social exclusion, including homelessness. SHM first developed its J2SI program in 2009 (Johnson, Grigg et al, 2015). The goal of the J2SI program is to transition long-term homeless people permanently out of homelessness. It is premised on a rapid housing approach – a model that suggests that stable and secure housing is the ‘first and primary need’ in ‘strategies to tackle homelessness’ (Johnson, Parkinson et al, 2012). This contrasts with the ‘crisis-driven’ model that had previously dominated Australian responses to addressing long-term homelessness (Johnson, Parkinson et al, 2012).

In combination with the provision of affordable and permanent housing, J2SI also offers comprehensive long-term, wrap-around support to participants, including: assertive case management and service coordination; housing access and support to sustain tenancies; trauma-informed practice; and support to build social inclusion and independence.

This first iteration of the J2SI program (phase 1 pilot) was delivered over three years and was the subject of a randomised controlled trial (RCT). RCTs are the ‘gold standard’ of program evaluation (Johnson, Grigg et al, 2015: 116).

A further iteration of J2SI is being undertaken by SHM. It commenced in 2016 with promising results in line with the 2009 pilot being achieved to-date for clients.

The efficacy of the pilot and the robustness of the evaluation framework laid the foundations for SHM being awarded a Victorian Government pay-for-performance contract to scale the J2SI program.

The J2SI Social Impact Investment

In 2016, the Victorian Government called for proposals from not-for-profit organisations for programs that would seek to improve outcomes for highly disadvantaged Victorians, to be delivered through a pay-for-performance contract, specifically a SIB.

The pay-for-performance contract between SHM and the Victorian Government was to fund delivery of the J2SI program for five years, with three cohorts of 60 people in each cohort. The ultimate structure of the financing model for delivery of J2SI under the Victorian Government contract was not a traditional SIB, as program finance to cover working capital was secured by SHM from a single debt provider, CDF. To lower the cost of this finance to an affordable level for SHM, the J2SI transaction model includes third party philanthropic guarantees. The guarantees effectively underwrite SHM's share of the program delivery risk (and therefore performance payment) and enabled SHM to access project finance.

Guarantees from philanthropy have been identified, both in Australia and internationally, as a social finance instrument with significant potential. Reforms to the Australian *Ancillary Fund Guidelines* reflect this and have sought to provide clarity to trustees and other sector participants around use of corpus for guarantees to eligible Deductible Gift Recipients (DGRs).

However, the J2SI Transaction is the first in Australia to use the guarantee structure to lower the cost of debt capital to support the delivery of a pay-for-performance contract. SIBs do not generally require guarantees because the SIB investors shoulder the performance risk in exchange for the anticipated financial and social return.

Figures 1 and 2 provide an overview of the J2SI Transaction structure as compared with a generalised SIB model. Specifically, in the J2SI Transaction, some working capital to cover the cost of program delivery is paid upfront by the Government (see ① in Figure 1) with the remaining operating deficits funded by CDF in the form of a loan (see ② in Figure 1). The CDF loan is repaid with interest from the Government's performance-based payments. The philanthropic guarantee is only required if performance is not satisfactory. All values in Figure 1 are indicative as actual values are commercial-in-confidence.

The effect of this structure is that the cost of the debt capital from CDF is vastly reduced with an estimated reduction of the cost of capital down from an unsecured debt rate⁴ to a secured debt rate⁵. In contrast, in a SIB structure (Figure 2), social impact investors provide preliminary financing for delivery of the program, which is repaid with interest if government targets are met.

In addition to the resulting lower cost of capital and delivering more cost-effective social impact if the J2SI program is successful, the structure also has potential benefits for philanthropic organisations that have Deductible Gift Recipient Item 2 Status (DGR2) awarded by the Australian Tax Office. Due to Commonwealth Government reforms made in 2016, funds with DGR2 status are able to provide eligible charitable organisations (such as SHM) – with a range of supports including land, loans and guarantees at a discounted rate (Ward, 2012, 2016).

Furthermore, the DGR2 fund is permitted to claim this discount as part of their statutory obligation to distribute 4% (for PuAFs) and 5% (PAFs) of their assets annually. Therefore, PuAFs and PAFs providing a guarantee as part of

4. For example Commonwealth Bank of Australia standard non-secured debt funding interest rate for businesses of 9.31% per annum – Overdraft Index Rate on 21/5/19 (<https://www.commbank.com.au/business/rates-fees.html>)

5. For example, CDF Overdraft lending rate of 5.2% per annum on 21/5/19 (<https://www.catholicdevelopmentfund.org.au/Interest-Rates?portalid=0>)



the J2SI Transaction as shown in Figure 1 could claim the difference between the cost of the debt capital with the guarantee in place and a 'market rate' if the guarantee was not in place. Further, should the guarantee be called upon, the payment could be treated as a distribution (i.e. a grant) in a given

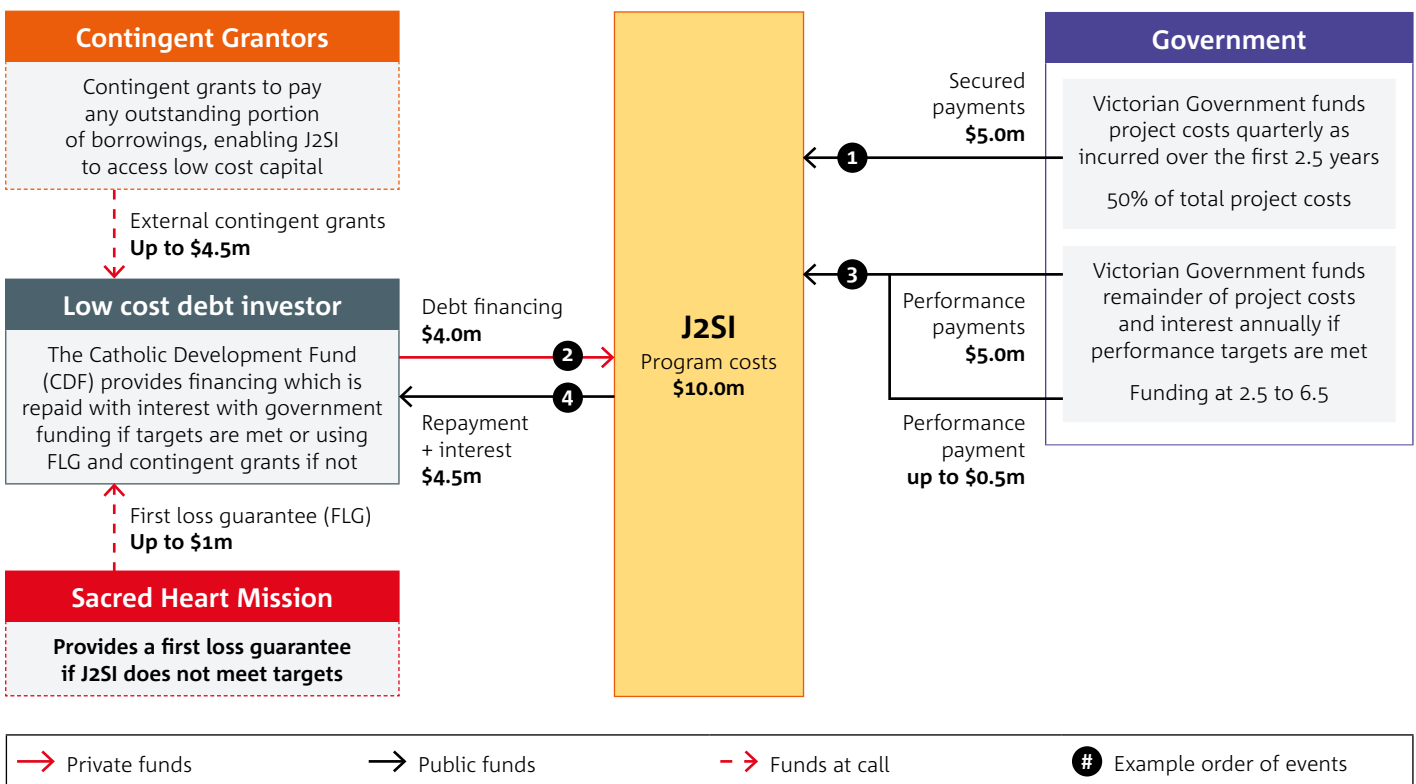
year and be incorporated in their 4/5% gifting requirement.⁶

Adding to the complexity of the J2SI Transaction structure (Figure 1), the degree to which the philanthropic guarantees will be called upon, should the J2SI program not meet its performance targets, varies. This is

due to the risk sharing arrangement with the Victorian Government, who are contracted to provide 50% of the program costs plus the variable nature of the performance payments, based on SHM's achievement of the program targets (see Figure 3).

Figure 1: Summary of the J2SI Transaction Structure (adapted from the new SHM communication pack)

Overview of the J2SI low cost debt / contingent grants financing structure



All values are indicative as actual values are commercial in confidence

6. Examples 5 and 6 of the Ancillary Fund Guidelines (s19.3) detail how ancillary funds can use guarantees to assist eligible entities. The benefit that DGR2 ancillary funds have does not apply for other charitable trusts, such as wills or testamentary trusts.



Figure 2: Summary of a generalized Social Impact Bond Structure (from the new SHM communication pack)

Overview of a 'TYPICAL SIB' financing structure

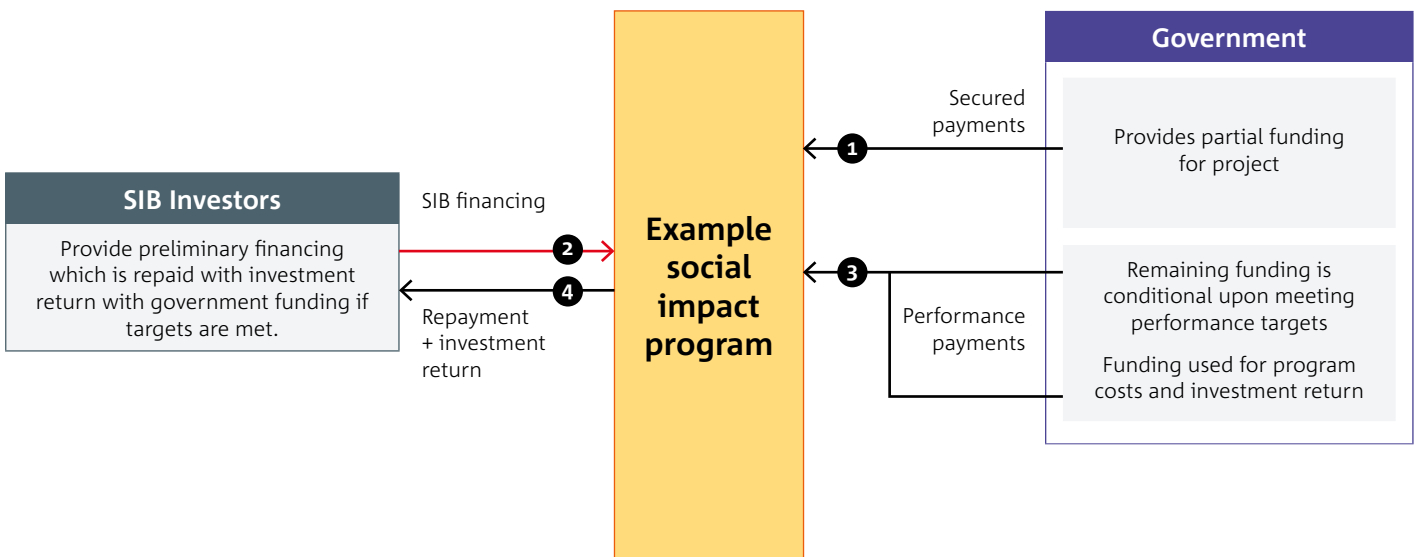


Figure 3: Illustration of the requirement for use of the guarantees based on J2SI performance (adapted from the new SHM communication pack)

Funding Outcomes Based On Performance

	Housing	HBD	Performance payment	Conditional grant used
Outperform	>40%	>50%	✓	0%
Above target	30-40%	40-50%	✓	0%
Target	20-30%	30-40%	✓	0%
Below target	15-20%	20-30%	-	X%
Underperform	10-15%	10-20%	-	XX%
Marginal	<10%	<10%	-	XX%

CASE STUDY METHOD



The findings presented in this report are based on qualitative research that consisted of seven focus groups, each of which included between 2 and 5 participants. Each focus group was targeted at a specific stakeholder group relevant to the transaction, as summarised in Table 1.

Table 1: Summary of focus group participants

Focus Group #	Stakeholder group	
1	Service provider (<i>SHM</i>)	SHM staff (n=3)
2	Advisors	Legal advisors (n=2) and capital advisor NAB Capital Markets (n=1)
3	Debt provider	CDF staff (n=3)
4	Commissioner	Victorian Government staff (n=5)
5	Guarantor/pledgers	Deal participants (n=3)
6	Guarantor/pledgers	Non-participants in the deal (n=2)
7	Industry experts in philanthropy and impact investment	Prime Minister's Community Business Partnership (n=3)

In addition to these focus groups, six individual interviews were undertaken with representatives of organisations that elected not to participate in J2SI (or whose clients elected not to participate).

Further detail on the methodology used for this case study can be found in Appendix 1.



FINDINGS



This study found that the combination of the innovative nature of this hybrid transaction and the nascency of SII in Australia resulted in a number of transaction-specific challenges (namely, challenges around the guarantee as an instrument alongside communication and positioning challenges), which contributed to the difficulty in raising support for this pioneering opportunity. These findings are described in more detail below.

Contextual issues

The J2SI Transaction occurred within a broader context that resulted in a number of challenges and barriers to participation for both participants and non-participants alike. These include:

- **The nascency of the impact investment market; and**
- **The complexity of SIBs in general and the J2SI Transaction specifically.**

Each of these challenges is described in more detail below.

A nascent SII market in Australia

Although SII has been actively developing for close to a decade, the market remains nascent and is still emerging globally – including in Australia. Research has shown (Castellas and Findlay, 2018; Sharam, Moran et al, 2018) that private market activity, including by charitable trusts (both testamentary and ancillary funds), remains relatively small. In addition, the Australian SII market continues to lag market expectations at the ‘impact first’ end of the spectrum (Castellas and Findlay, 2018), where the J2SI Transaction is positioned.

Australia is still in the early days of impact investing. We've been talking about it for a long time. I don't know the actual numbers on it. It took us two years to participate in our first impact investment, which was a SIB Manager – charitable trust – J2SI participant

Our interviews and focus groups reinforced that SII remains an embryonic area of focus for charitable trusts, trustee companies and family offices. For example, one trustee noted that a predecessor had established a SII target of 5% of corpus. Yet despite having this target in place, J2SI was their first SII transaction. Another testamentary trust reported also having a 5% target but expressed difficulty with identifying appropriate SII opportunities to meet their objectives.

The developmental state of SII in Australia means that many philanthropic trusts and foundations are not seeking to engage in impact investment and/or explicitly support SII ecosystem development.

The prevalence of this view impacts on the value of philanthropic capital available for guarantee-type structures such as the J2SI Transaction.

... the Bequest Committee is charged with the responsibility of making the decisions as to where the grants are made. But, there is no engagement, at all, between the role of that committee and the [trustee company], who manage the corpus. And, the guidelines around managing the corpus are fairly defined, and the committee has no input
Trustee – philanthropic sector leader

For some of the trusts and foundations that were approached with the J2SI opportunity, the structure was seen as ‘too experimental’. This reluctance is a reflection of the frequent risk aversion of philanthropic decision makers and trustees who have a fiduciary obligation to be prudent. Relatively new approaches, such as SII, SIBs and the use

of philanthropic guarantee structures are often met with caution. A complex and layered deal like the J2SI transaction augments this challenge.

Complexity

Both SIBs in general and the J2SI Transaction are complex structures. To achieve the benefits from the lower cost of capital of debt and guarantees, the J2SI Transaction introduced additional elements of complexity by introducing a new financing structure.

The number of parties to the contract, associated due diligence, and staggered nature of outcomes payments render SIBs a uniquely complex instrument of program finance (Dey and Gibbon, 2018). Unsurprisingly, all stakeholders – from government to the service provider to the debt funder to guarantors and pledgers – reported that these complexities of SIBs were also challenges for the J2SI Transaction. These included common observations that SIBs have high transaction costs associated with the complexity of due diligence, which many Australian charitable trusts have neither the resources nor internal capacity to sufficiently bear.

As with all pay-for-performance transactions, decision-makers must consider the added complexity of the performance elements of the intervention and understand the risk that the program will not be delivered to successfully satisfy the contractually specified outcome measures. Whilst our research indicated a broad, though not universal, confidence in the J2SI program, due to the rigor and



Treasury and Finance and Department of Health and Human Services, and with a range of professional service providers – from lawyers and others working in a pro bono and low bono capacity including consultants with an interest in SII and sector building to develop documentation.

However, several themes have emerged that impacted on the success of the communication effort, aimed at recruiting philanthropic guarantors, namely:

- **Clarity** – there was a consensus across stakeholder groups that written communications were not easy to comprehend or digest. The density of the documentation was a reflection of a complex value proposition for potential participants – even for advisors and sophisticated investors whose clients were familiar with SIBs. In one instance, an ancillary fund advisor developed their own communications materials to share the opportunity with clients. Similarly, there was confusion about whether J2SI was a traditional SIB, a guarantee proposition or a hybrid arrangement. This confusion was compounded by the option to offer a traditional SIB to investors if SHM was unable to attract sufficient interest from guarantors to support the J2SI Transaction approach and the parallel negotiations with the Victorian Government on the financing documents for the J2SI Transaction.

The other reason was I think there was a philosophical view or the fact that there shouldn't have really needed to be a guarantee arrangement in the first place – that the Catholic Development Fund and NAB and others, they have stronger balance sheets, so they should be able to lend more money and waive some of the guarantee

Manager – ancillary fund – non-participant

In addition, some interviewees felt that the communications did not make clear who the beneficiary of their guarantee is. A small cohort questioned whether they were supporting J2SI, the CDF, the Catholic Church or NAB. This manifested as a question around the beneficiary for the purposes of compliance with charity law.

- **Positioning** – is it an (impact) investment? To reflect the introduction of the guarantee structure into the model, the language used to describe the Transaction was changed from a SIB to an 'impact investment'. This shift in language was designed to clarify one of the unique elements of this particular transaction, namely that it was not a SIB in the traditional sense. However, whilst the J2SI Transaction does represent a SII for the debt funder, CDF, the transaction did not constitute an impact investment for the philanthropic guarantors. This is because, SII has an accepted definition that centres on meeting three criteria: intentionality, measurement and returns (Findlay and Moran, 2018). The J2SI Transaction clearly met the first two criteria, but there is no financial return to those participating to provide the guarantee.

In several instances, the result of the J2SI Transaction being positioned as a SII with potential philanthropic guarantors was: rejection of the opportunity on the basis that it would not provide a financial return; and/or further challenges communicating the benefit and value proposition to investment committees and trustees.

So effectively this was a lot closer to being a grant than to being an investment from our perspective
CEO – ancillary fund – non-participant

As a result of the Transaction communications (written and verbal) emphasising the investment logic (rather than the impact logic), many potential philanthropic guarantors were confused about who within their organisation should assess the opportunity. Utilising the traditional tools of fundraising associated with SIBs – including financial product-style documentation heavy with disclaimers, charts and figures – may have hindered generating support. Several interviewees indicated that, based on the positioning as a SII, the proposition was referred to their investment committee⁷ who then rejected the proposition due to the absence of a financial return.

The bit I grappled with from the information I had initially was it wasn't clear whether it was a social impact bond with investors taking on – expecting a variable return based on performance, almost like a standard social impact bond, or whether it was a guarantee situation. They seemed to have both of them discussed in the one document
Advisor – ancillary funds – non-participant

When participation in the Transaction was positioned as either playing an essential role in a larger SII (i.e. the overall J2SI Transaction) and/or supporting the development of the SII ecosystem, the proposition was easier to communicate to decision makers. However, it should be noted that positioning the Transaction as ecosystem building may restrict the addressable market for philanthropic guarantees as research shows that this segment of the Australian charitable trust sector is relatively small (Castellas and Findlay, 2018; Sharam, Moran et al, 2018).

7. Australian charitable trusts, by virtue of charitable law, tend to have a clear demarcation between the investment arm and the grant function (Charlton, Donald et al, 2014: 24). In practice this generally means there are very clear boundaries between the investment and grant functions.



A number of stakeholders made clear that the ambiguity around the positioning of the transaction – sitting somewhere on the spectrum between an investment and a grant – made it difficult for their board to fully comprehend.

- **The value proposition of the 4/5 percent** – the appetite for the Transaction’s innovative use of the PAF/PuAF Guidelines to enable the grantee as part of their minimum distribution requirements⁸ was less than expected. The reasons for this included the fact that early Transaction communications did not provide the specific figure (the discount rate) that could be used to advise clients on the benefits of the proposition. This made communicating the benefits of participation in the Transaction as a philanthropic guarantor difficult. Ensuring clarity around the difference between the market rate and the cost of capital once a guarantee is placed before beginning the fundraising campaign is important. Recent J2SI communications make the benefit clear and this is supported by a class ruling from the ATO.

Our concerns, which were largely verified, are that the clients would either not understand it, not understand how their proposition works, or it wouldn’t be applicable because they are already over their gifting requirements. So essentially they’re providing a guarantee for no benefit. So that guarantee which enabled you to count towards your gifting requirements was irrelevant if you were already providing the 4% or 5% or whatever your requirement is Advisor – ancillary funds – non-participant

Another important observation from this research is that the gifting benefit was not as attractive a position as expected due to the majority of ancillary funds having already exceeded their gifting requirements for the year (or planning to). For this group, the proposition is of no benefit to their gifting obligations.

It should also be noted that this part of the proposition is only applicable to some potential philanthropic funders. As discussed earlier, those charitable trusts that are not ancillary funds, such as testamentary trusts and wills, are not eligible for this benefit. Communications need to be targeted specifically to the potential philanthropic guarantor taking this technical detail into account.

Challenges presented by the guarantee as an instrument

The J2SI Transaction was the first guarantee to be coupled with a pay-for-performance contract in Australia. However, this research suggests that there are mixed views on this innovation. Specific issues that we identified, include:

- An aversion to the term ‘guarantee’;
- The perceived complexity of due diligence driven by trustee prudence (including in relation to outcomes payments);
- Perceived and real transaction costs such as resolving legal issues and how to account for the guarantee; and,
- Views about the role of government in social service delivery.

We discuss each of these issues below.

- **An aversion to the term ‘guarantee’** – the term was not received well by a number of those invited to participate in the J2SI Transaction. Some interviewees stated that their executive, boards and trustees, many of whom have backgrounds in banking, associate the term with loan failure. In addition, many were challenged by the concept of guaranteeing program ‘performance’ (rather than the purchase of a capital asset) and found this difficult to process. This was true of even relatively experienced impact investors.

- **Perceived complexity of due diligence for a guarantee** – owing to the requirement to guarantee program performance, many potential participants felt there was a requirement for additional or different due diligence to what they would normally conduct for an impact investment.⁹ There was a view expressed that guaranteeing the J2SI Transaction required additional or different due diligence that was beyond the capacity of even the most sophisticated decision-makers. There was a prevailing view that the prudence and time poor nature of trustees results in an aversion to propositions that are new and, as one interviewee put it *‘it’s not clear what the liabilities might be’*.

It is perhaps telling that the charitable trusts that participated in J2SI had an existing philanthropic relationship with SHM and they indicated their strong confidence in the organisation and J2SI as an approach to tackling homelessness. However, even these organisations still needed to work hard to support their trustees to overcome their nervousness about the guarantee structure.

8. As outlined earlier, one innovative aspect of the Transaction is its potential for participants to utilise provisions in the *Ancillary Fund Guidelines*. By using the 2016 amendments, specifically ‘Example 6’, the guarantee offers ancillary funds a means to support the Transaction and also ensure that they meet their obligations to distribute 4 percent of assets for PuAFs and 5 percent for PAFs in a given financial year.

9. This point is particularly relevant when one considers that the majority of SII in Australia is for asset purchase (Castellas and Findlay, 2018) and hence assessing performance-based risk is novel in this context.



- **Perceived and real transaction costs**

– the guarantee presented a range of transactional challenges that were interpreted by some as barriers, such as resolving legal concerns and accounting issues. One such issue was organisations determining how the guarantee would be accounted for, and in what year the liability would hypothetically fall. For smaller, familial trusts this was not as much of an issue – they have flexibility, are relatively nimble, and less encumbered by accountability to principals. However, the novelty of the guarantee is more challenging for established trusts. For some, determining how the guarantee would be treated from an accounting perspective heightened the perception that the transaction costs of participation outweighed the benefits.

In addition, one participant – an established charitable trust not structured as an ancillary fund – did encounter a legal impediment to entering into a guarantee, due to their deed precluding them from entering into a master guarantee arrangement. In this instance, the charitable trust had to engage external legal counsel to assist with finding a way for them to participate. The solution was to structure the relationship as a ‘pledge’ rather than a guarantee. This same solution was then applied to another testamentary trust that wished to participate.

During the research, it was suggested by several stakeholders that the use of the term ‘pledge’ may be preferable to ‘guarantee’ for this type of transaction.

- **Views about the role of government**

– there was a sense that, particularly because the evidence base for the J2SI intervention is so strong, government should be directly procuring the program. This view, which extends to an aversion to the SIB model in general, led to rejection of the J2SI opportunity; this perhaps needs to be considered in screening possible targets for future participation.

Another barrier that came up when I was at the launch of the J2SI. I was having a conversation with some people who had their own private foundations ...their reason for not partaking was because they didn't, fundamentally, understand why this model of blended finance was being used, and why the government didn't just straight-up pay for J2SI. So, why were they going through this hassle of getting the guarantees? So, I think that connects into the maturity of the market

Manager – charitable trust – participant



SYNTHESIS AND RECOMMENDATIONS



The table below summarises the challenges and issues that the J2SI case has illuminated and offers suggested solutions to mitigate these.

Table 2: Summary of possible solutions to the identified barriers and challenges

Issue	Implications	Solution/Action	Mitigation likely to benefit current J2SI Transaction?	Mitigation likely to benefit ecosystem/future transactions?
Nascent SII market	Less capital at the 'impact first' end of the spectrum where the J2SI Transaction is positioned.	Communication and advocacy with philanthropy and other potential impact investors about the impact investment spectrum and the importance of concessionary finance for social impact initiatives.	✓	✓✓
Nascent SII market	Philanthropic trusts and foundations are not engaged in impact investment and/or explicitly support SII ecosystem development	Communication and advocacy with government and philanthropy about the potential of SII and specifically the use of guarantees as part of a pay-for-performance contract to reduce the cost of capital and therefore make more funding available for broader social impact.	✓	✓✓
Risk aversion / perceived complexity and risk	The J2SI Transaction structure seen as too complex, new and risky.	Case study and ongoing communications about the progress (and success) of the J2SI Transaction and others as they come on line.	✓	✓✓
Clarity of communication	Written communications were not easy to comprehend or digest. The density of the documentation was a reflection of a complex value proposition for potential participants.	Simplify initial communications and then provide potential guarantors with more detailed information as requested. A new pitchbook has been developed.	✓✓	✓ (can be applied in principle)
Negotiation of financing documents occurring whilst SHM was recruiting potential philanthropic guarantors	Compounded communication difficulties with potential deal participants.	Development of template financing documents for Transaction structure.	Not applicable	✓✓
Beneficiary of guarantee unclear to some potential guarantors	Confusion/misassumption that the guarantee was underwriting the CDF, the Catholic Church or NAB.	Clarify the transaction structure and role of the guarantee in enabling the social impact by lowering the cost of capital.	✓✓	✓ (can be applied in principle)



Issue	Implications	Solution/Action	Mitigation likely to benefit current J2SI Transaction?	Mitigation likely to benefit ecosystem/future transactions?
Positioning the J2SI Transaction as a SII for potential philanthropic guarantors	Rejection of the opportunity on the basis that it would not provide a financial return; and/or further challenges communicating the benefit and value proposition to investment committees and trustees.	Focus on the social benefit of the scheme not the deal structure - lead all discussion with the social impact and beneficiaries of the initiative. Positioning can be (i) playing an essential role in a larger SII (i.e. the overall J2SI Transaction) and/or; (ii) supporting the development of the SII ecosystem. Informed by the focus of each charitable trust.	✓✓	✓
Positioning the J2SI Transaction as a SII for potential philanthropic guarantors	Potential philanthropic guarantors confused about which function within their organization should assess the opportunity.	Do not frame the opportunity to charitable trusts as an impact investment/ investment. Relegate the traditional tools of commercial/SIB/SII fundraising such as financial product-style documentation heavy with disclaimers to the back of the pitch document or provide separately, after initial pitch discussion.	✓✓	✓✓
Early communications did not provide the specific discount rate that could be used to advise clients on the benefits of the proposition	Less than expected appetite for the Transaction's innovative use of the PAF/PuAF Guidelines to enable the grantee as part of their minimum distribution requirements.	Ensuring clarity around the difference between the market rate and the cost of capital once a guarantee is placed before beginning the fundraising campaign is important. Recent J2SI communications make the benefit clear and this is to be supported by a class ruling from the Australian Taxation Office.	✓ (has been addressed for J2SI Transaction)	✓✓
Gifted benefit was not as attractive a position as expected due to the majority of ancillary funds having already exceeded their gifting requirements for the year (or planning to)	Over-estimation of the attractiveness of the gifting benefit as a central element of the value proposition for ancillary trusts resulting in less than expected uptake of the proposition.	The timing of pitching to ancillary funds may be important. Early in the financial year enables them to build the opportunity into their distribution cycles. Later in the financial year may assist those that are under their distribution threshold. Either way, it should be acknowledged that gaining support via this sort of mechanism may take several months of elapsed time for each charitable trust.	✓	✓✓



Issue	Implications	Solution/Action	Mitigation likely to benefit current J2SI Transaction?	Mitigation likely to benefit ecosystem/future transactions?
The proposition is only applicable to some potential philanthropic funders. Those charitable trusts that are not ancillary funds such as testamentary trusts and wills are not eligible for this benefit	Charitable trusts that are approached that are not ancillary funds may reject the proposal if other aspects of the value proposition are not emphasised.	Target communications specifically to the potential philanthropic guarantor taking this technical detail into account.	✓✓	✓✓
The term 'guarantee' was not received well by a number of those invited to participate in the J2SI transaction	Rejection of the opportunity.	Consider use of alternate terms such as 'pledge' or 'contingent grant'.	✓✓	✓✓
Perceived complexity of due diligence for a guarantee – owing to the requirement to guarantee program performance	Many potential participants felt there was a requirement for additional or different due diligence to what they would normally conduct for an asset based SII or a commercial investment due to the performance-based nature of revenue.	Position the guarantee as a 'grant' or 'contingent grant'. Grant-making staff in trusts and foundations have core capability in the assessment of likely program performance. In addition, donation/grant capital is by definition higher risk. Also, empathise capability of service provider and ensure good evidence of program legitimacy.	✓✓	✓✓
Transaction cost for philanthropic guarantees	The guarantee presented a range of transactional challenges that were interpreted by some as barriers, such as resolving legal concerns and accounting issues. One such issue was organisations determining how the guarantee would be accounted for.	Service provider to include in the cost of deal preparation development of standard advice on possible accounting treatments and legal matters. This cost will reduce over time as transaction structures of this type become more common.	✓ (largely resolved for this Transaction)	✓✓
Cultural/philosophical barriers	A small number of potential philanthropic guarantors rejected the proposition due to a belief that the government should be directly procuring the program due to its proven success.	Stress the scale benefits of this model and the additional impact per dollar that can be achieved, particularly with the addition of the guarantee to lower the cost of capital. Also emphasise the risk shared by government, SHM and the debt funder.	✓	✓✓

CONCLUSION



As a new and highly innovative structure to achieve social impact in Australia, there are a number of contextual factors that hampered participation in the J2SI Transaction by charitable trusts. Some of these require a 'bigger picture' approach to engaging and building the knowledge of the social finance ecosystem, including philanthropy; cases such as this demonstrate innovative approaches to addressing complex social issues such as homelessness and the role that private capital can play. Communication of this transaction and its challenges and successes as they unfold is an important step in this engagement effort and can be used to inform future transactions that leverage the potential of a guarantee-type structure to cost effectively deliver social impact.

I asked, 'Are there any others that have been done like this?' and there weren't; they couldn't give me another example. So it was a bit pioneering really. Whereas now this is done it'll be easier, I think, to say, 'Look, this one's going to go, you go and talk to some people'

Trustee – ancillary fund – J2SI participant

On the other side of the transaction, it is important to understand and acknowledge the magnitude of the departure from current charitable trust operations that a transaction such as J2SI represents. Many of the barriers and challenges to participation identified in this case are attributable

to the hybrid nature of the J2SI Transaction and the melding of social/welfare and investment/finance logics in new ways for all involved. The time and resource effort that such hybridity necessitates should not be underestimated; the timelines of this transaction were ambitious and many of the communication and engagement challenges summarised in Table 2 are a result of that pressure. Given the gifting benefit of the proposition for ancillary funds, their granting and disbursement timelines need to be considered – they may be more likely to commit earlier in the financial year when their grant-making requirements have not been reached and/or they may hold-over the opportunity in case they are under allocated towards the end of the financial year.

... there was a number of concerns raised by the board about how the transaction was structured. And the difficulty for this specific example was that it fell between two stools – one being the extreme of having a grant, if you like, where it's a gift versus the other extreme being something that is investible on financial terms

CEO – ancillary fund – non-participant

Similarly, appreciation for the hybridity of this transaction and the 'starting position' of each stakeholder should inform greater targeting of the value proposition and communications.

This is likely to result in more efficient recruitment of supporters. In general, for charitable trusts, the positioning should focus on the social benefit of the scheme, not the structure, and all discussion should be led by the social impact and beneficiaries of the initiative. Importantly, for most charitable trusts, framing and communicating the opportunity as an impact investment/investment creates confusion and results in the proposition being assessed using a financial risk/return schema. We would recommend using language familiar to grant-makers and removing the disclosure statements from the front of all documentation – grant proposals do not include disclosure statements as grant capital is, by definition, high risk. It is also important to consider the use of alternative terms to guarantee, such as 'contingent grant' and 'pledge', and to consider how to combine terms to address communication, legal and accounting challenges.

Most importantly, the J2SI Transaction structure demonstrates the potential of combining public, commercial and philanthropic capital to support evidence-based approaches to addressing intractable social problems. Its innovative approach and the willingness of all participants to engage in new and creative approaches to address homelessness at scale is to be applauded.



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GLOSSARY OF TERMS



Pay-for-performance contract: a means by which governments commission service providers (generally a not-for-profit (NFP) organisation) to deliver specified social outcomes, with payment to the service provider being contingent on the achievement of agreed outcomes (Muir, Moran et al, 2017). SIBs are a form of pay-for-performance contract.

Private Ancillary Fund (PAF): a form of private charitable trust to which a close group of individuals, (often a family) and other Australian taxable entities can make tax-deductible donations. PAFs can only make distributions to organisations designated by the Australian Tax Office as Deductible Gift Recipient Item 1 (DGR1). PAFs need to have a formal investment plan and to distribute at least 5% of their corpus value each year' (Baker, Barraket et al, 2016: 3).

Public Ancillary Fund (PuAF): a type of 'charitable trust to which the public are able and invited to contribute tax-deductible donations. A PuAF is required to be operated in a public manner for public benefit and must make distributions only to other entities endorsed by the Australian Tax Office as Deductible Gift Recipient Item 1 (DGR1)' (Baker, Barraket et al, 2016: 3). A PuAF must distribute at least 4% of their corpus value each year.

Social Impact Bond (SIB): a means by which governments commission service providers (generally a NFP organisation) to deliver specified social outcomes, with payment to the service provider being contingent on the outcomes achieved (Muir, Moran et al, 2017). Full payment is made after the outcomes are achieved, often necessitating the service provider to access external finance to fund the working capital required to deliver the services (Fox and Albertson, 2011). Therefore, SIBs are regarded as a category of social impact investment. In Australia and internationally, SIBs are used to fund programmatic interventions that address complicated and intractable social policy issues such as homelessness, childcare and offender rehabilitation (Warner, 2013).

Social impact investment (SII): an investment approach that intentionally seeks to create both financial return and a measured, positive social or environmental impact (Findlay and Moran, 2018).

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Appendix 1: Additional notes on methodology

Interviews and focus groups were transcribed and coded using the computer-assisted qualitative data analysis software package, NVivo. The majority of coding was undertaken by one of the principal researchers. To ensure intra-rater reliability another principal researcher coded four (n = 4) interviews. From these four interviews a deductive coding frame was agreed upon. This was applied to guarantors/pledgers and non-guarantors/pledgers. For other stakeholder groups (service provider; structurers; the debt provider; experts) and inductive approach was adopted. In these cases, the coder developed an inductive frame and coded the data based on the findings that emerged among each stakeholder.

The findings of this report are a result of qualitative data analysis of the guarantors/pledgers and non-guarantors/pledgers.

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