Issue 35
Fourth Quarter 2014
Editor: Paul Richards

ICMA quarterly report

Assessment of Market Practice and Regulatory Policy

ICMA
International Capital Market Association

8 October 2014

Social Impact Investment

Personal view by René Karsenti

The growth of Socially Responsible Investment (SRI) has been impressive. Established as a general values-based investment approach, SRI has quickly grown to about $10 trillion over the last 20 years or an estimated 15% of global capital. More than €3 trillion of bond investments in Europe are estimated to be managed under SRI criteria. SRI has mostly focused on negative screening of investment in public companies in areas such as tobacco, defence and occasionally fossil fuel, as well as positive screening of environmentally aware, health, green energy or socially conscious projects or companies.

An example of innovative and successful SRI is a total of $5 billion "Vaccine Bonds" financing the GAVI Vaccine Alliance which has been issued by the International Financing Facility for Immunisation (IFFIm) since its 2006 inception and which I have had the honour to chair since 2012. (See my article in ICMA QR 4Q2012.) Other investments have involved the fast developing Green Bonds segment in which ICMA plays an important role, since its inaugural issue in 2006 by the European Investment Bank.

On 15 September, The Social Impact Investment Taskforce established by the G8 published its report. The report, entitled *Impact Investment: The Invisible Heart of Markets – Harnessing the Power of Entrepreneurship, Innovation and Capital for Public Good*, calls on governments and the financial sector to take action to unleash $1 trillion of private sector impact investment to tackle social problems.

More than 200 government and private sector experts, of which I am honoured to be part, have been engaged across the G8, Australia and the EU, in national advisory boards focused on establishing impact investment as a powerful force in each country, and in working groups formulating recommendations on measurement of impact, asset allocation, international development and mission alignment for profit-with-purpose businesses.

The report lays out several clear recommendations which include:

- encouraging pension funds and providers of tax-advantaged savings schemes and products to include impact investments as part of their offering;
- enabling impact-driven businesses to lock-in their social mission through legal forms and removing regulatory obstacles around fiduciary duty;
- expanding regulatory and tax incentives offered for investment in social enterprises and charitable organisations, enabling investors to offset their impact investment income against tax;
- establishing a kitemark for impact investment products to make them quality certified, accredited, recognisable and differentiated in a complex marketplace;
- developing social impact bonds and development impact bonds;
- appointing a senior government Minister to champion impact investment within and beyond government;

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- reforming legal and regulatory frameworks for charitable organisations to help them to embrace entrepreneurial risk-taking and innovation where it furthers their mission;
- publishing better and clearer data about the cost to government of addressing social issues to encourage more impact investment participants to the market place.

The report also:

- calls on charitable foundations and trusts to allocate part of every charitable endowment and high net worth investment portfolio to impact investments;
- encourages mainstream investors and the wider public to engage in impact investment by providing some investment protection;
- calls on investors, including foundations, pension funds, sovereign wealth funds and independent investment managers to consider impact, risk and return in making investment decisions. Where investors wish to invest in impact-driven businesses, they can encourage them to pursue specific measurable social impact;
- calls on the G20, ASEAN, OAS, and the African Union to put on their agendas the development of social impact investment;
- calls on inter-governmental institutions such as the World Bank, IFC and regional development banks to play a leading role in a new market for social impact and development impact bonds;
- calls on the United Nations, as it resets its Millennium Goals in 2015, to support impact investment as an innovative way of tackling social issues that constrain private sector development and economic growth.

The Task Force has been led by Sir Ronald Cohen, founder of APAX, who had been a key player in the venture capital revolution in the 1970s. And indeed forty years later, our lives have been completely transformed by tech entrepreneurs, who have revolutionised the way we live.

How come these attitudes changed so fundamentally? They did so because the challenge of high-risk/high-return investments was met by the creation of a totally new investment class: venture capital and private equity. Venture capital was a response to the needs of ambitious new companies engaged in high-risk innovation.

I believe we are now in the early days of a revolution of social investment. A rising wave of social entrepreneurship follows the wave of business entrepreneurship. It seeks to make a difference, to be meaningful, to improve people's lives. Today, welfare states designed for the 20th century are throwing up their arms in face of the struggle against the new century's social challenges. They realise that they are not best placed to innovate to bring solutions to social issues. Their projected social expenditure falls far short of expected needs and the yawning gap poses grave challenges for them and for the nature of our society, as mounting social issues impact our values, our social cohesion, and our lives. The primary reason is that traditional philanthropy has focused on the act of charitable giving rather than on achieving social outcomes.

How can we do for social entrepreneurs and organisations what has been successfully done for business entrepreneurs? How can we connect them to the capital markets? The answer is through greater innovation, effectiveness and scale. This requires access to capital providers seeking social improvement and prepared to accept the risks that accompany innovation and growth.

Impact investing is an important part of the answer. Social impact investment aims directly to improve lives. Its objective can be social, environmental or developmental. It includes investment in non-profit organisations and "profit-with-purpose" businesses.

Impact investing is a hybrid of philanthropy and investment that creates a blend of financial, social and environmental benefits. Impact investments are directed into companies, organizations and funds with the intent of generating both financial returns and social or environmental impact.

And what is a Social Impact Bond, its main financial instrument to date? A Social Impact Bond (SIB) is a type of impact investment designed to raise private sector capital to expand effective social service programmes. This mechanism is used to finance a Pay for Success contract, which allows government to pay only for results. In such an arrangement:

- private investors fund a social service programme;
- government repays investors based on the programme's success in achieving predetermined social outcomes;
- if successful, investors can recoup their principal plus a rate of return;
- if the programme does not achieve those outcomes, then government is not obligated to repay investors.

SIBs have the potential to unlock a new and vast pool of investment capital to finance the expansion of effective, preventive social services focusing on measurable outcomes and generating social and financial returns to investors.

In this way, five direct benefits are created: the investor may earn an acceptable rate of capital return; the not-for-profit is financed using new, sustainable capital which enables it to scale-up successful social interventions; the government enjoys a cost-saving (with no up-front investment); financial risk is transferred to the private investor; and the "underlying" social-issue is ameliorated. Therefore, the Social Impact Bond uniquely links the monetary return on the financial product with its social delivery.

These bonds promise not-for-profit up-front capital for their operations while encouraging them to adopt a measurement system which accurately quantifies their social performance. This will, in turn, create innovation within the not-for-profit sector and, for the first time, allow investors to accurately correlate their financial return with the social performance of their investment.

Beyond SIBs, we are seeing quasi-equity, unsecured debt and senior debt coming to supplement grant funding in creating proper balance sheets for non-profits. We see the emergence of a spectrum of investors in search of different combinations of social and financial returns: from those like charitable foundations, prepared to accept low returns, through individual investors who require somewhat higher ones, all the way to pension funds that aim for near market returns. All these investors are motivated by a shared desire to improve lives. It is they who are funding the revolution in philanthropy.

What benefits does impact investment bring to government? The first is innovation. The second is investment to fund it on the basis that government only pays if successful outcomes have been achieved. The third is prevention. Governments everywhere concentrate on the most urgent consequences of social issues. They have little money to spend on prevention. SIBs generally focus on prevention, recidivism, school drop-out rates, homelessness, and so on, and set benchmarks for the effectiveness and cost of social interventions.

So contrary to the fears of some, impact investment is not about government relinquishing responsibility for social issues. It is about government encouraging innovation, paying for successful interventions and driving down the cost of achieving a successful outcome. Nor is it about privatisation.

I am confident that Impact investment represents a real revolution, driven by innovation. We estimate that it will settle over two or three decades between the $60 billon of microfinance and the $3 trillion of venture capital and private equity.

It will drive great innovation particularly as a new asset class in our capital markets and it will come to characterise our times.

Further reading: The Social Impact Task Force Report and Recommendations, and Sir Ronald Cohen's presentation at the Mansion House in January 2014.

Contact: René Karsenti
rene.karsenti@icmagroup.org