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Good Practices and Policy Options on Impact Investing – Financing Innovation for Sustainable Development

Note by the secretariat

I. Introduction

1. The present note presents good practices and policy recommendations on Impact Investing – Financing Innovation for Sustainable Development. It is based on the presentations and discussions at the substantive segment of the ninth session of the Team of Specialists on Innovation and Competitiveness Policies (TOS–ICP), held in Geneva on 3 and 4 November 2016. It reflects and benefits from the experiences of all relevant participating stakeholder groups, including national government agencies, academic institutions, the business sector and international organisations.

2. Following this introduction, the second section discusses the relationship between impact investing, sustainable development and innovation. The third section covers recent trends and future prospects of impact investing and its potential contribution to the 2030 Agenda. The fourth section discusses ways and means of measuring impact, while the fifth section discusses good practices on stimulating the supply of impact investment capital and matching it to the demand for such capital from companies and other investible projects.

II. Impact Investing – Financing Innovation for Sustainable Development

3. In September 2015, the General Assembly of the United Nations adopted the 2030 Sustainable Development Agenda, which set ambitious global goals that commit the...
countries of the world to work towards achieving economic prosperity while protecting our planet and ensuring social inclusion.

4. The 2030 Agenda acknowledges the potential that innovation offers for achieving its goals. Sustainable Development Goal 9 is inter alia about promoting innovation. Innovation is also essential for achieving the entire 2030 Agenda.

5. The Agenda recognizes the central role that the enterprise sector has in driving innovation for sustainable development. It thus calls for a renewed partnership between governments and the business community.

6. Entrepreneurs throughout the UNECE region have put much effort into developing innovative solutions that contribute to sustainable development in fields as diverse as healthcare, renewable energy, sustainable agriculture and clean technologies, among others. Enterprises small and large are also implementing innovative solutions to make their production and distribution processes sustainable.

7. This requires massive investments, by the private sector, and in partnership with the public sector. Investors are increasingly interested in opportunities to invest in innovative companies that combine economic return with a positive impact on society.

8. Impact investing is a relatively new phenomenon, whose scope and size is still relatively in flux. Various definitions have been offered. The Global Impact Investing Network for instance defines it as “investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.”

9. Thus two defining characteristics of impact investing are intentionality (an investor’s intention to have a positive social or environmental impact) and the expectation of a financial return.

10. Intentionality sets impact investing apart from traditional investments which are motivated purely by financial gain, and which may happen to also generate some social or environmental benefits. As such, impact investing is an expression of the investors’ personal values and their intention to see these values manifest themselves in investment and asset allocation decisions.

11. The expectation of a financial return sets impact investing apart from pure philanthropy, where no financial return is expected. At the same time, impact investors may be ready to accept below-market financial returns, depending on the nature of the investment project. This will also affect the type of finance provided.

12. Impact investing can be seen as part of a broader trend of socially responsible or ethical investing. The latter also includes investment strategies that exclude companies perceived as having unsustainable (or unethical) business models or practices (“negative screening”), or investment strategies that focus on companies that emphasize sustainability in their products and operations (“positive screening”), such as mutual funds specializing e.g. in green technologies. In this sense, impact investing is sometimes narrowly defined as a private equity form of positive screening.

13. However, most practitioners agree that impact investing can take many different forms, including loans, and can be undertaken by many different actors, including fund managers, banks, pension funds and insurance companies, development finance institutions.

14. Given its goal to simultaneously achieve an economic return and to deliver social or environmental benefits, impact investing is a form of financing that has significant potential to contribute to the financing of the 2030 Sustainable Development Agenda.
15. In turn, as an expression of shared values, the 2030 Agenda has the potential to galvanize an increasing number of value-based investors into contributing increasing amounts of funds to the cause of sustainable development.

16. Governments have recognized this potential explicitly in the Addis Ababa Action Agenda on Financing for Development, which complements the 2030 Agenda: “We encourage impact investing, which combines a return on investment with non-financial impacts. We will promote sustainable corporate practices, including integrating environmental, social and governance factors into company reporting as appropriate, with countries deciding on the appropriate balance of voluntary and mandatory rules. We encourage businesses to adopt principles for responsible business and investing, and we support the work of the Global Compact in this regard. We will work towards harmonizing the various initiatives on sustainable business and financing, identifying gaps, including in relation to gender equality, and strengthening the mechanisms and incentives for compliance. […] We also encourage philanthropic donors to consider managing their endowments through impact investment, which considers both profit and non-financial impacts in its investment criteria.”

III. Impact Investing Trends and Prospects

17. Because impact investing is a relatively new phenomenon and there is as yet not full agreement on its scope and boundaries, it is difficult to quantify the size of the market. Based on surveys of its members, the Global Impact Investing Network estimated the overall size of the impact investment industry in 2015 at close to US$80 billion.

18. This is still less than one percent of assets under management globally. At the same time, it is not insignificant compared, for example, to total angel investments in the European Union (€6 billion in 2015), and it has been growing very strongly in many places in recent years. The growth trend also reflects the growing interest among innovative entrepreneurs in helping to solve global challenges.

19. The balance between financial performance and social or environmental impact can vary significantly across investment projects. On one end of the spectrum, technology-driven investments in particular often create “win-wins” where impact investors achieve risk-adjusted financial returns comparable to, or even in excess of, those seen in “non-impact” investments. Around 60 percent of impact investors aim for at least a market rate of return.

20. On the other end of the spectrum, impact investments that focus on firms addressing purely social objectives (e.g. the advancement of disadvantaged groups in society or persons with disabilities) may find it harder to achieve market rates of return. However, the number of impact investors aiming only for returns close to capital preservation is relatively small.

21. Ninety percent of impact investors report achieving or exceeding their targeted rates of financial return, and almost all report achieving their targeted social or environmental impact. However, measurement issues are still pervasive, and significantly more work and analysis will be required to obtain a full picture of the actual trade-offs across sectors and investors between financial return and social or environmental impact.

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2 Addis Ababa Action Agenda for Sustainable Development, paras. 37 and 41.
3 In fact, a lack of common understanding of the definition and segmentation of the impact investment market has been cited as a challenge to its growth.
4 https://thegiin.org/impact-investing/need-to-know/#s1
22. Impact investors in firms creating innovative solutions to sustainable development challenges share many of the characteristics of “non-impact” investors in innovative firms, such as high risk tolerance, a capacity to identify high potential early and to react flexibly to change, the capacity to bridge key funding gaps; and an ability to help investee companies through their personal networks and connections as well as through mentoring.

23. The additional dimension which characterizes impact investing is that while impact investors seek to invest in companies that promise a financial return, they also wish to invest in companies whose business models and products are aligned with their personal values.

24. Impact investing is prevalent today in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education.

25. With regard to international initiatives, important inter-governmental processes have been initiated in recent years, such as the G8 Global Social Impact Investment Steering group, which brings together policymakers and practitioners in finance, philanthropy, and business, in order to serve as a facilitator and a catalyst for a global market in impact investment. Such work can contribute to increased international collaboration across countries in particular by helping to establish benchmarks and by sharing best practices.

IV. Measuring Impact – Standards, Certification, Regulation

26. There have long been well-established methods, standards and regulations to account for and report on financial performance. These are used by investors, asset managers and companies routinely when making financing and investment decisions. Measured financial performance has real consequences for companies: strong performance enables them to attract additional investments, while poor performance, over an extended period of time, will force them to down-size or even close down.

27. By contrast, the measurement of social and environmental impact is still at a relatively early stage. Many companies, especially large ones, and impact investors use their own idiosyncratic measures, and many do not consistently measure impact at all. Rather than trying to measure actual impact ex post, some investors target sectors and business models where, ex ante, they expect to generate a large positive impact.

28. In part this is due to the value-driven nature of impact investing and an element of subjectivity in how well an investment aligns with the underlying values of the investor.

29. Measurement of impact is also complicated by the fact that ideally, objective information of impact should be collected directly from the stakeholders whose lives the investments intend to impact, especially vulnerable or disadvantaged groups, rather than from the social-impact companies themselves. Traditional methods of collecting and analysing financial performance measures are not suited for this purpose.

30. Another conceptual difficulty is uncertainty regarding the extent to which a positive impact measured at the level of beneficiaries can be attributed to a specific investment rather than to possible contemporaneous changes unrelated to the investment.

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5 According to a recent survey among the members of TONIIC, a global network of impact investors, 96 percent of respondents intended to introduce impact measurement within the coming three years, implying that at the time of the survey, there was virtually no measurement.
31. It is also not always clear, along which dimensions impact needs to be measured for a given investment project and whether a proposed measure is not only factually accurate in itself but also complete in not leaving out significant dimensions of an investment’s impact.

32. In addition to conceptual and methodological difficulties in measurement, there are also still significant skill gaps. Skill gaps in measuring and analysing impact exist at the level of investors, investee companies and projects, and also in the audit profession.

33. As a result, the costs of measuring impact and producing audited impact statements can be high, especially for start-ups and other small firms resulting in relatively low rates of impact reporting. At the same time, there are also examples of companies, even small ones, who are already voluntarily publishing audited impact reports on a regular basis.

34. Going forward, adopting reliable, realistic and comparable impact measurements will be critical in order to grow both supply and demand for impact investment and for the market to realize its full potential in contributing to the 2030 Sustainable Development Agenda. It is only when performance on social or environmental impact can be measured accurately and in a way that is comparable across companies and sectors, that investors can allocate capital to those companies and projects that deliver good performance, and that poor performance can have real consequences.

35. Reliable measurement will also be critical for designing and implementing effective policies that could support the sector. Without solid measures of impact, it will not be possible to target policies to those who will benefit the most, and it will not be possible to assess the effectiveness of policies, and to learn from the policy experience.

36. Several voluntary standards and methods are currently being used in the industry, such as the Impact Reporting and Investment Standards (IRIS) promulgated by the Global Impact Investing Network, and its associated methodologies, including the B Impact Assessment and Global Impact Investment Rating System; social return on investment; Environment-Social Justice-Corporate Governance (ESG) metrics; the Pinchot Impact Index, the UN Global Compact Framework for Action on Social Enterprise and Impact Investing; the IFC’s Environmental and Social Performance Standards; OECD Guidelines for Multinational Enterprises; and ISO 26000.

37. While the development of more harmonized standards for impact measurement and reporting is being driven by the impact investing industry itself, there is broad agreement that additional government legislation is needed in order to ensure the broad-based adoption of independently certified reporting.

V. Match-making – Connecting Supply and Demand

38. A mismatch between the capital available for impact investment and investment opportunities is often cited as one of the main obstacles to the further growth of the impact investment market.

39. Networking by business and financial associations, awareness raising programmes, and other initiatives can enhance the positive impacts of capital by matching it with a wider selection of start-ups and other innovators working on solutions for sustainable development challenges.

40. For instance, measures to foster capital mobilization for climate change through match-making include improving decision metrics to ensure investors adequately assess risk-adjusted return related to climate change; unlocking investments through novel approaches such as blended finance; and raising awareness through education for decision
makers so that they better understand climate risks and the benefits of impact investment become more tangible in public discourse.

41. Among the financing models that could foster the mobilization of impact capital are community shares, social impact bonds, impact funds, impact banking, micro-finance, crowd funding, and different examples of public-private cooperation through partnerships.

42. Each of these models have their strengths and weaknesses and need to be customised according to a project’s sector, firm size, stage of development, and degree of innovativeness. Some are better suited to small ventures and early-stage firms, others are more suited to scaling up successful businesses. Another challenge is to identify financing models that are adapted to the realities in the field, where the business environment may not be adequate and classic marketing strategies and business models cannot be copied.

43. Financial instruments need to be tailored to the investment project in question, and to the intended balance between financial return and non-financial impact. Where the financial return is expected to be below market, grants and subordinated loans may be provided instead of or in addition to equity, senior loans or guarantees.

44. In some countries, programmes have been put in place to promote impact investments through social impact bonds; in others, some financial rules have been modified to allow the issuance of shares with lower reporting requirements and costs for firms (e.g. regarding prospectus, financial regulations) that will reportedly achieve a higher social or environmental impact.

45. Another key dimension when matching investors and projects is the allocation of risks. There are examples of public-private partnerships that mobilize private capital for high-risk, high-impact projects in developing and emerging economies in the sectors of finance, agriculture and renewable energy by implementing a layered financial structure in which the public sector investor provides first-loss risk protection to the private investors.