Making Impact Investible

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Executive Summary

Impact investing (also referred to as “social finance”, “social impact investing”, “blended value investing” or “impact finance”) has gained significant momentum in recent years. As we move through the first quarter of the twenty-first century, this is perhaps the biggest idea to renew the relevance of finance for the real economy and social progress. Estimates indicate that impact investing could become a new asset class or investment style that will grow to USD 1 trillion by the end of the decade. Paralleling the emergence of impact investing, research is proliferating. It aims to understand the phenomenon and strengthen the market building process currently underway.

At Impact Economy, we have worked on impact investing with a number of clients and partners since the inception of the firm with our dedicated “making impact investible” team. Over more than a decade, the author of the study has been involved in a variety of senior roles in the pioneering efforts that have led to the creation of the concept of “impact investing” in 2007-2008, investment ideas such as contingent return models that link a financial return to a social outcome, and in their mainstreaming. In 2011, we reported interim results of this work including an investor survey to a group of stakeholders and called for a “Geneva Consensus” to enhance the practical investability of impact investing.[1]

It is now time to take stock and ask how we can seize the potential and leverage impact investing to make a meaningful difference in the challenges facing our generation. Accordingly, this working paper reviews the state of action in impact investing, its potential for mainstreaming and the pathways for doing so. For the study, we screened more than 200 impact investment-related reports in a number of languages, including English, French, German, Italian, Portuguese, Spanish, Japanese, and Russian. We also conducted a media search of 26 terms related to, or viewed as some variant of, “impact investment” in six languages and returned a total of 181,357 hits (of which only 13,691 came from non-English sources), and generally leveraged our industry expertise.

The paper begins by providing a framework of understanding for the “impact investing” term, its forms of capital, institutional landscape, and blockers as well as enablers of further market growth. It then locates impact investing in the broader context of four megatrends that are creating new investment opportunities, namely massive pent-up demand at the “Bottom of the Pyramid”, the need for radical resource efficiency and green growth, the restructuring of the welfare state to drive efficiency, and the rise of “Lifestyle of Health and Sustainability” (LOHAS) consumers. We subsequently explore how to best stimulate the impact investment marketplace via capital supply, capital demand and capital use policies. The paper provides a look at the emerging ecosystem of impact investing and the role different groups of investors play, including philanthropic investors such as foundations, angel and venture stage investors, private and institutional investors, and financial services institutions. The paper concludes with recommendations for how to fully unlock the potential of impact investing, taking the sector from niche to mega as one might say. In a nutshell, two impulses are critical at the current stage of industry development: (a) intelligent policy action to build up the impact investing market; and (b) sorting out social impact measurement to achieve reliable metrics for impact. The final section provides select suggestions for further reading.

Building on more than three years of research on impact investing, and serving as a finance-focused companion to the real-economy study “CSR’s New Deal”, this working paper is also intended to provide a market and trend context to inform the wider “Building the Impact Economy Initiative” we have currently underway. The Initiative analyzes the development trajectory of a variety of industries and their potential to move sustainability from a bolt-on concept to an embedded core feature of business, thus driving both long-term profitability and greater ecological and social viability as we design and implement next gen solutions. The Initiative is set to culminate in an edited volume to be released by Springer, prepared by Dr. Maximilian Martin (editor), and currently envisioned to be co-edited by William Burckart, joined by a number of high-profile chapter authors.

[1] “Calling out for a ‘Geneva Consensus’ on impact investing”, Impact Economy, accessed April 1, 2013, http://www.impacteconomy.com/impact-investing-prestudy-launch.

1. What Is Impact Investing? Understanding the Unit of Analysis

The practice of impact investing has grown into a USD 36 billion industry over the course of just a few years. While this sounds like fast progress since the inception of the term “impact investment” in 2007, the exponential growth potential will continue for a number of years. This section defines the concept, explains the pathways for impact investment capital, and provides an overview of the impact investing landscape.

The aftermath of the financial crisis has opened the door for a thorough reassessment of the contribution of finance to economic progress and the greater public good. Combined with continued globalization, shifting attitudes toward the role of government, a technology and communications revolution underway in all corners of the globe now allowing us to hold an astonishing amount of information literally in the palm of our hands, as well as concerns about the long-term environmental and social sustainability of the global economy, these developments are not just changing the way people interact and do business with one another, but also how we allocate capital.

This paper explains a recent phenomenon in the financial industry, namely the rise of impact investing, or the notion that financial capital can intentionally achieve environmental and social outcomes in addition to financial returns. Today, impact investing is still a niche phenomenon: a USD 36 billion industry. But we are on the verge of a very significant development. An estimated industry potential to grow to USD 400-1000 billion by 2020 raises two key questions[2]:

- (a) How can this be achieved in practice given the still relatively minor “stock” of impact investments around the world; and
- (b) To what extent is this relevant for solving large-scale economic and social challenges (and thus worthy of market-building support).

There were over USD 600 trillion in financial assets globally in 2010, representing claims against a nominal global GDP of roughly USD 63 trillion. By 2020, there will be roughly an estimated USD 900 trillion in financial assets, representing claims against about USD 90 trillion/year of global GDP.[3] Taken with current projections, impact investing might grow to only 0.1 percent of all financial assets by the end of the decade.

However, the impact may be much larger than suggested by this figure. There are several reasons. Many of humanity’s same old social problems persist despite the benefits reaped from globalization and the technology revolution. Countries spend trillions of dollars combating these challenges, yet evidence suggests that this strategy is not working as well as it might. While the pace of human population growth by 2050 is expected to fall to more than half of its peak in 1989, we can expect a global population of 9 billion, not to mention an increasingly aging population owing to wider access to more and better information about healthy living along with advances in medicine.[4] With less people working and more people living well into their 80s, 90s, and longer, our social systems, and the problems they address, will get harder to fund. A recent study by Accenture and Oxford Economics projected the expenditure gap between expected demand for services and the ability to pay for them through to the year 2025. The results were startling: for Canada, the gap amounted to USD 90 billion; for France, USD 100 billion; for Germany, USD 80 billion; for Italy, USD 30 billion; for the UK, USD 170 billion; and for the US, USD 940 billion.[5]

We are in need of new pathways and solutions to finance this gap and other challenges. In the 2000s, microfinance – or financial systems at the bottom of the population pyramid that broaden access to capital for individuals with low income – transformed the view of the poor from non-bankable recipients of assistance to productive entrepreneurs capable of building wealth and taking part in the mainstream of the economy.

[2] Nick O’Donohoe et al, “Impact Investments: An Emerging Asset Class,” *J.P. Morgan* (2010): 6, accessed May 1, 2013, URL: http://www.rockefellerfoundation.org/uploads/files/2b053b2b-8feb-46ea-adbd-f89068d59785-impact.pdf.
[3] Bain & Company, “A World Awash in Money: Capital Trends through 2020,” *Bain & Company* (2012): 3 and 7, accessed May 1, 2013, URL: http://www.bain.com/Images/BAIN_REPORT_A_world_awash_in_money.pdf.
[4] “Population,” Wikipedia, accessed May 1, 2013, URL: http://en.wikipedia.org/wiki/Population_growth.
[5] Accenture, “Delivering Public Service for the Future: Navigating the Shifts,” *Accenture* (2012): 4, accessed May 1, 2013, URL: http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Delivering-Public-Service-for-the-Future-112812.pdf.

As an asset class with USD 40 billion in outstanding loans, as of 2010, microfinance has influenced international development and financial regulation in emerging economies, driving much more significant progress than the mere size of outstanding loans would suggest.[6] With major adjustment challenges ahead in the domains of education, healthcare, unemployment and the environment, impact investing can potentially play a similarly catalytic role on an even more comprehensive scale: the opportunity is to leverage innovative entrepreneurs, trillions of public and private money, and financial innovation to benefit society at large, turning our most enduring social challenges into opportunities.

1.1. Term and Context

As a term, "impact investing" was coined in 2007. The Global Impact Investing Network (GIIN) defines it as: "investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return."[7] The word "intention" in this characterization differentiates these investments from socially responsible investments. The latter aim to *avoid* social or environmental harm emanating from an asset that is otherwise managed for a single bottom line: profit.[8] An impact investment can be made in both developed and emerging countries and seeks below market or market-rate financial returns. This characteristic makes it different from a grant, which is simply a donation of funds with no expectation of financial returns. Program-related (PRI) and mission-related investments (MRI) are types of impact investments made by charitable foundations with vastly different rules governing their use.[9]

In the big scheme of things, the impact investing industry today is still small. But its stock of USD 36 billion is growing fast, with approximately 2,200 impact investments worth USD 4.3 billion made in 2011, USD 8 billion in 2012, and planned USD 9 billion in 2013. The potential returns of impact investments in emerging markets in particular are compelling. A 2010 study by J.P. Morgan, based on a survey of impact investors, found that the expected returns of many existing impact investments in emerging markets fall largely in the 8-11.9 percent bracket for debt investments, and into the 20-24.9 percent bracket for equity. This compares to developed market return expectations of 5-7.9 percent and 15-19.9 percent in debt and equity respectively.[10] This sounds quite exciting when compared to financial return expectations in the low-growth environment of the European Union, which has been in recession for a year and a half. But impact investment is not simply an emerging markets phenomenon. In the UK, the RBS Social Enterprise 100 index is now in its second year. It aims to track the success of social businesses across the UK, and examines both their growth and the impact that they make. The SE100 Index not only showed high average growth, but the growth in revenue by index entrants is thus far impressive when compared with both the FTSE100 and the SME sector.[11]

All of the above raises the question of how this market emerged in such a short period of time. Private foundations, through grants, PRIs, and MRIs, have historically played a vital role in building up the market to its current size. High net worth individuals and families have operated similarly. Apart from a few champions, large financial institutions, including banks and pension funds, have been more hesitant to join the effort, even though they are now gradually beginning to do so. Development finance institutions (DFIs) have made an important contribution through their role in the growth and professionalization of microfinance (which can be considered a subset of impact investing that focuses mainly on funding economically active low-income populations in the informal sector). DFIs have traditionally contributed funds and expertise to all five major

[6] Elisabeth Rhyne, "The State of Global Microfinance: How Public and Private Funds Can Effectively Promote Financial Inclusion for All" (testimony presented before the Subcommittee on International Monetary Policy and Trade, Committee on Financial Services, U.S. House of Representatives, January 27, 2010), accessed May 1, 2013, http://financialservices.house.gov/media/file/hearings/111/rhyne_testimony.pdf.
[7] "About Impact investing," GIIN, accessed on May 1, 2013, http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html.
[8] This paper uses "social impact investment" as coterminous with "impact investment", unless otherwise specified.
[9] David A. Levitt, "Investing In the Future: Mission-Related and Program-Related Investments for Private Foundations," *The Practical Tax Lawyer* (2011), accessed May 1, 2013. URL: http://www.adlercolvin.com/pdf/PTXL1105_Levitt.pdf.
[10] Marco Arosio, "Impact Investing in Emerging Markets," *Responsible Research* (2011), accessed May 1, 2013, URL: http://www.sustainalytics.com/sites/default/files/impact_investing_in_emerging_markets-issues_for_responsible_investors.pdf.
[11] Social Enterprise, "The RBS SE100 Data Report 2011: Charting the Growth of the UK's Top Social Businesses," *Social Enterprise and RBS Community Banking* (2011), accessed May 1, 2013, URL: http://www.socialenterpriselive.com/sites/default/files/files/supplements/SE100_DataReport_Web1.pdf.

pathways to invest in microfinance, including direct equity, specialized funds, lending and guarantee schemes, investment banking and structured products, as well as peer-to-peer investment. They can be expected to play a similarly enabling role in the expansion of the impact investing industry.

In addition to being a way of investing, impact investing is also a powerful *idea* for how to reconcile the world of investments with the greater public good. It draws much more significant media attention than the size of the industry alone would suggest and an inflow of talent from the financial industry is noticeable. The demand-side of the industry consists of companies such as small and growing businesses, as well as financially viable non-profit social enterprises with an earned income, and cooperatives. Rather than the legal form, their common denominator is working under the premise of both a financial and an extra-financial bottom line ("social impact"). These "social enterprises", "impact enterprises" or "impact businesses" receive and utilize impact investments from investors who want to both "do good" and "do well" with a part of their portfolio. Thus far, professional investors, specialized funds, and governments have been the main capital providers for impact investing, though with diverse motivations: some want low-volatility opportunities and/or segments of the market uncorrelated with mainstream global benchmarks; others have an investment theme-orientation (e.g. education, environment and renewable energy, healthcare, housing, small enterprise, sustainable development, or water); and a third group wants to achieve social or environmental objectives more efficiently via investments rather than grants. Depending on the prioritization of financial vs. impact goals, an investor can be characterized as a "financial first" or "impact first" investor.[12] Next to these capital providers and capital recipients, the impact investment market also involves intermediaries, government, and professional service providers.[13]

1.2. Forms of Impact Investment Capital

Impact investments pursue at least a double bottom line, achieving financial returns as well as social or environmental outcomes. At a fundamental level, however, the same basic tool set of finance and categories of capital are as applicable here as they are in mainstream financial markets, namely grants (not an impact investment but a subsidy), debt funding, shareholder equity, and mezzanine capital (also referred to as convertible debt) – as well as any combination of the four to achieve funding and impact goals (so-called "hybrid capital"). Moreover, impact investors can decide whether to make a direct investment into a social enterprise, fund an investment intermediary (e.g. an impact investment fund) that then invests in the underlying investees, or engage in other transactions such as absorbing risk by providing guarantees, first loss tranches, credit enhancements, or currency hedging. With the tools of structured finance, a host of impact investment products can be engineered, including financial products where the impact investor receives a positive financial return upon achievement of the projected social outcome even if the underlying asset loses money (this is the case of the "social impact bond", discussed further below). To establish a shared understanding, this section defines the four categories of capital.[14]

Grants are defined as funds disbursed by one party to another party without any expectation of repayment. Grant makers typically are government agencies, charitable foundations and trusts, or private sector entities. Recipients are often non-profit entities and educational institutions, but also individuals and businesses. Grants can be provided either through money or in-kind via volunteering or contributions. To obtain grant funding, a grant application or grant proposal is typically required. Most grants are made to fund a specific activity or project and require some level of reporting to the funder. If the grant seeker has a charitable or tax-exempt status, the funder may be able to deduct the grant or a portion of it from his tax obligations. In

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[12] Monitor Institute, "Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry," *Monitor Institute* (2009): 31, accessed May 1, 2013, URL: http://www.monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf.

[13] E.T. Jackson and Associates Ltd., "Accelerating Impact: Achievements, Challenges and What's Next in Building the Impact Investing Industry," *Rockefeller Foundation* (2012): 9, accessed May 1. 2013, URL: http://www.rockefellerfoundation.org/uploads/images/fda23ba9-ab7e-4c83-9218-24fdd79289cc.pdf.

[14] For an analysis how the different forms of capital can be used to fund social enterprises, see Maximilian Martin, "Understanding the True Potential of Hybrid Financing Strategies for Social Entrepreneurs," *Impact Economy Working Paper* 2 (2011), accessed April 15, 2013, URL: http://ssrn.com/abstract=2208370. This section uses the definitions laid out in there.

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spite of the advantage of receiving capital at zero cost, there are important limitations to grant funding. First, grants are typically project specific. They exclude overhead and business development costs, and do not provide full internal capital allocation flexibility. Second, grants usually face a limited 3-5 year time horizon. And third, they are costly to raise – estimates of the portion of the amounts raised that is lost to costs range from 22-43 percent. Grants are very valuable to get started but they by and large cannot accompany a social entrepreneur's rising capital needs as the enterprise goes to scale.[15]

Debt capital is defined as capital that is raised by taking out a loan. There is typically an expectation to be repaid at some future date when a loan is made to a social enterprise. The repayment schedule may be structured depending on repayment ability. For example, a balloon payment loan does not fully amortize over the term of the loan, and leaves a large final payment, the so-called balloon payment. Unlike in the case of equity capital, subscribers to debt capital do not become part owners of the social enterprise, but remain creditors. Debt capital is therefore an especially important source of external financing when social enterprises are structured as non-profits. Suppliers of debt capital usually receive a contractually fixed annual, or in some cases floating, percentage-return on their loan. They provide capital on a temporary basis, with repayment due after a few years. The interest on debt capital must be repaid in full before any dividends are paid to suppliers of equity. From a business development perspective, debt capital is an attractive option whenever (a) long-term investments with stable and predictable cash flows need to be funded, (b) if the social enterprise is fundamentally creditworthy and (c) able to make an annual interest payment. Risk capital is often required to take on debt and provide layers of risk, and non-profits who cannot take on equity may need to raise grants that perform the layered risk function of equity. Moreover, in the event of bankruptcy, debt capital providers may have far-reaching rights on the organization's assets.

Shareholder equity, also referred to as risk capital, is the residual claim or interest of the most junior class of investors in assets, after payment of all liabilities. This means that equity is positive if valuations on assets exceed liabilities. Equity capital is an attractive external financing option for social enterprises structured as for-profit entities (thus able to accommodate shareholders). They can fund activities that are necessary to scale the venture but have an uncertain payoff or income generation schedule. Unlike in the case of debt, equity does not have to be repaid. Shareholders bear the full risk of the operation in exchange for certain control rights. In the event of bankruptcy of the social enterprise, all secured creditors are first paid against proceeds from assets. Subsequent claims on the residual proceeds are based on the creditor's ranking in the priority sequence; shareholders equity is then the residual claim against assets, which is paid only after the demands of all other creditors have been satisfied. Access to such risk capital is essential to scale most social enterprises. In exchange for a certain share of the company, the investor receives a share of the future profits generated by the social enterprise, rather than regular annual payments. Given the inherent riskiness of equity, investors also receive certain control and voting rights. The rights depend upon the share held in the social enterprise and the legal framework in the country where it is registered. This means that an impact investor needs to carefully consider whether his "DNA" as an equity investor is compatible with the values and philosophy of the social enterprise.

Mezzanine capital or **convertible debt** is a combination of debt and equity capital. It can be a useful alternative or complement to other funding sources, or if pure equity or debt capital cannot be accessed. Mezzanine instruments refer to either a subordinated debt or a preferred equity instrument that represents a claim on a social enterprise's assets. This means that repayment is required and ownership goes undiluted. The interest payment can be linked to the profits of the company whereas the total amount is repaid after a certain time period. Mezzanine financing is senior only to common shares and can be structured as unsecured debt or preferred stock. Given its higher risk, it is typically a more expensive financing source.

Finally, **hybrid capital** is a combination of the forms of capital listed above. To illustrate how hybrid capital can serve to take a social enterprise forward, consider the case of Husk Power Systems (HPS). Regarded as a

[15] William Meehan, "Investing in Society," Stanford Social Innovation Review (2004), accessed May 1, 2013, URL: http://www.ssireview.org/articles/entry/investing_in_society/.

leading social enterprise in India, HPS uses the throwaway portion of rice husks to generate electricity. Despite the fact that the company had a viable solution that could be scaled to bring electricity to the more than one billion Indian residents without electricity, Husk was turned down time and again by the Indian government and private investors for expansion. In 2009, OPIC saw the company's potential and made, by its standards, a relatively small loan of USD 750,000. "OPIC's funding was a game-changer for us," said Husk President Manoj Sinha. "OPIC proved that a project like this was debt financeable, and could therefore offer attractive returns for venture capitalists and more conservative investors, by leveraging assets. It's not easy finding a loan in India, so OPIC proved to be a real shot in the arm for us."[16] For its subsequent Series A share offering in 2011, HPS sought equity capital of USD 5 million and debt capital of USD 7 million to fund the execution of its ambitious expansion plans to meet its growth target for 2013.[17] Equity capital was intended to be used to recruit and train senior and mid-level managers for operations, rollout a franchisee model and to support R&D activities geared towards streamlining operations. Debt capital was earmarked for purchasing equipment. Management also envisioned a "Series B" equity round of USD 15-20 million and around USD 30 million in debt, to enable the firm to expand to 12,500 villages by 2016. Alternatively, HPS was also considering pursuing strategic buyers or private equity investors and aimed for a liquidity event for its investors in 2015.

1.3. Blockers and Enablers

The growth, and visibility, of the impact investment industry has been remarkable. But significant challenges remain. Industry players generally point to the lack of track record of successful investments as a main concern, and argue that too few established players are active in impact investing. Moreover, there are no universally accepted ratings of impact investments and there is a lack of appropriate products. Performance concerns and a lack of impact investment opportunities are also regularly cited as blockers for market development. The absence of a universally accepted rating standard reflects a lack of consensus about the language of social impact.

For example, if an investment ends up creating three jobs, the "output" of that investment would be three jobs and the "outcome" would be increased wages to the three workers, employment taxes to the state, or reduced government transfer payments. If one of the three workers would have found work without the investment, the "impact" can then calculated based on the two "net" people that started work.[18] It is not trivial to come up with reasonable assumptions about causality and track impact over time. Those pushing for wider adoption of impact investment instruments note that the inability to settle on one definition is preventing the sector from acceleration.[19]

Institutional players are bound by much stricter fiduciary obligations than private investors. The lack of track record of successful investments and shortage of attractive and scalable investment opportunities need to be addressed in order to enable institutional actors to engage in impact investing on a major scale. A further topic is profitability and impact: some impact investments are structured by "layering" financial instruments, such as grants and PRIs in order to achieve impact, but this makes it harder to precisely define the impact.[20]

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[16] "Renewable Energy in India's Rice Belt: Husk Power Systems," OPIC, accessed May 1, 2013, http://www.opic.gov/projects/husk-power-systems. For a comprehensive treatment, see Maximilian Martin, "Understanding the True Potential of Hybrid Financing Strategies for Social Entrepreneurs," *Impact Economy Working Paper 2* (2011): 23-26, accessed April 15, 2013, URL: http://ssrn.com/abstract=2208370.

[17] Series A Shares typically are the most preferred tier of classified shares and offer more voting rights than later rounds of funding via Series B Shares etc.

[18] nef consulting, "Measuring Social Impact: The Foundation of Social Return on Investment (SROI)," *nef consulting* (2004): 3.1, accessed on May 1, 2013, URL: http://sroi.london.edu/Measuring-Social-Impact.pdf.

[19] John Simon and Julia Barmeier, "More than Money: Impact Investment for Development," *The Center for Global Development* (2010): 3, accessed on May 1, 2013, URL: http://www.cgdev.org/sites/default/files/1424593_file_More_than_Money_FINAL_web.pdf.

[20] "Layering" financial instruments is known more broadly as "tranche" financing. This is the practice of slicing the risk of an investment into different segments, or "tranches." This setup provides multiple investors with different risk and reward appetites an effective way to engage in a given transaction. Due to their charitable disposition, foundations have the unique ability to take the riskiest positions in such structures, thereby absorbing the highest risk positions and incentivizing the participation of other investors. For more information about the use of PRIs and grants in layered impact investments, see Lester M. Salamon and William Burckart, "Foundations as Philanthropic Banks," in *New Frontiers of Philanthropy*, ed. Lester M. Salamon. (Oxford University Press, forthcoming).

Generally, it is difficult to imagine impact investing going to scale if it presents itself as the "poor cousin" of investing.

Despite the challenges, impact investors are forging ahead with investment deals all over the world, proving time and time again the appeal of the concept of impact investing, and that it is possible to earn both a financial and social return simultaneously. In the process, they have created major financial innovations that can be replicated on a large scale—such as social impact bonds (SIB) that were first piloted in the UK to address issues of recidivism and have since been adopted in other parts of the world to combat other serious social challenges. Yet without a facilitating hand of market-building players and government agencies, the impact investing industry is likely to continue to scrap and fight to make erratic progress, just as it has done from the start. With more concerted and coordinated government action, though, impact investments can even help achieve large-scale policy objectives such as job and business creation, economic recovery and growth, and new investments into burgeoning industries, such as renewable energy.

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2. Sustainable Value Creation: Four Megatrends

Impact investing is now becoming a sufficiently proven concept to qualify as a lever governments can use to accomplish a variety of goals, such as fulfilling development aid commitments efficiently, increasing cross-border trade and investment, developing deeper capital markets and a more viable financial services industry, addressing demographic changes such as aging, promoting long-term competitiveness, and easing the public debt burden. Just as the world changed fundamentally in the last two decades, so it will again because of four megatrends, which are described in this section, namely markets at the Bottom of the Pyramid (BoP), Lifestyles of Health and Sustainability (LOHAS), green growth and the reconfiguration of the welfare state.[21] The paper argues that businesses shifting sustainability to the core of their business model will see their ability to create value enhanced, and countries with a coherent, realistic embrace of impact investing will see the lives of their citizens improved, thus reaping the fruits of finance applied to funding solutions to real world needs.

To move truly center stage in being relevant, impact investing must help provide investment solutions to four megatrends that are reshaping how companies, governments and civil society are creating value and financing public goods: (a) massive pent-up demand at the "Bottom of the Pyramid" (BoP); (b) the need for radical resource efficiency and green growth; (c) restructuring of the welfare state to drive efficiency; and (d) the rise of the "lifestyles of health and sustainability" (LOHAS) consumers (see **Figure 1**).

	Rationale	Potential
Massive Pent Up Demand at the BoP	The BoP refers to the **4 billion people** with incomes below USD 3'000 annually in local purchasing power.	The segment will take off as BOP consumers and producers join the market, already representing a **USD 5 trillion economy**.
Driving Green Growth	The green economy results in improved human well-being and social equity, while significantly reducing environmental risks and ecological scarcities.	Investments in renewable energies alone are forecast to grow significantly, more than doubling **from USD 115 billion in 2008 to USD 325 billion in 2018.**
Reconfiguration of the Welfare State	The welfare state needs to be reconfigured as some government expenditures are structurally higher than their revenues; a large proportion of expenditure is on healthcare, education and welfare.	Fundamental shifts in the way we approach public good output will lead to opportunities for the private sector, e.g. in **2020, 20% of the worldwide population will be over 65**.
Emerging LOHAS Segment at the ToP	LOHAS consumers are willing to spend more on products designed to be environmentally conscious, sustainable, socially responsible, and better both for people and the planet.	LOHAS consumption is already a USD 300 billion+ market in the US alone and growing fast.

Figure 1: The Mega-drivers of Sustainable Value Creation[22]

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[21] This section builds on Maximilian Martin, "CSR's New Deal: A Blueprint for Your First Hundred Days in the World of Impact Economy," *Impact Economy Working Paper* 3 (2013): 18, accessed May 4, 2013, URL: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2259632.

[22] Source: Maximilian Martin, "CSR's New Deal: A Blueprint for Your First Hundred Days in the World of Impact Economy," *Impact Economy Working Paper* 3 (2013): 18, accessed May 1, 2013, URL: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2259632, 5.

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2.1. Massive Pent-up Demand at the "Bottom of the Pyramid"

The term "Bottom of the Pyramid" (BoP; often used interchangeable with "Base of the Pyramid") was first coined in the 1930s. It has since evolved to describe the 4 billion people from mostly developing countries living on less than USD 2 per day. Since 1960, the World Bank, donor nations, aid agencies, and others have expended well over four trillion dollars to eradicate the persistent problems of the BoP in areas such as health, finance, and housing.[23] But they have so far met limited success.[24] Official Development Assistance (ODA), a USD 125.6 billion industry in 2012, has come under criticism and shifted its focus toward greater aid effectiveness in the 2000s.[25]

As a result, the door is now open for private enterprises to complement the work under way and bring innovative, market-based solutions to bear on these challenges, while simultaneously unlocking the approximate USD 5 trillion in latent BoP demand, and, in so doing, stimulating their own domestic economies.[26] For example, sustainability-related global business opportunities in natural resources (including energy, forestry, agriculture and food, water and metals), health and education could build up steadily to around USD 3-10 trillion annually in 2050 at constant 2008 prices, or around 1.5-4.5 percent of world GDP at that time.[27] Moreover, private enterprise can generally help the poor "graduate" to the middle class by providing products at an affordable price. History shows us it is the middle class that provides the input for growth in an economy, such as new ideas and human and physical capital. In his book, *The Fortune at the Bottom of the Pyramid*, C.K. Prahalad describes how the poor, who live in high-cost ecosystems often run by slumlords and the like, pay a premium for everything from rice to credit. This so-called "poverty penalty" can be as high as 5 to 25 times what the rich pay and is a massive disintermediation opportunity.[28]

Part of the funding for value creation in the BoP will come from traditional capital markets and established forms of public private partnerships. An example of a company that is positioning itself to take advantage of this opportunity is the French electricity provider, Electricité de France (EDF). In 2002, it created a public-private partnership to profitably bring renewable energy to the nearly 10 percent of Moroccan citizens who, because of prohibitive costs, were off the grid. By virtue of its presence in this market, EDF has gained important insight into developing countries' market dynamics; this will pay dividends as it strives to bring solutions to challenges, energy or otherwise, faced by the BoP.[29] The growth in telecom in recent years is another example of an industry benefitting from developing countries' demand.[30]

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[23] "Net ODA Disbursements: Total DAC Countries," OECD, accessed May 1, 2013, URL: http://webnet.oecd.org/dcdgraphs/ODAhistory.

[24] C.K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits* (New Jersey: Pierce Education, Inc., 2010), 27.

[25] "Aid to Poor Countries Slips Further as Governments Tighten Budgets," OECD, accessed May 1, 2013, http://www.oecd.org/dac/stats/aidtopoorcountriesslipsfurtherasgovernmentstightenbudgets.htm; Dambisa Moyo, *Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa* (New York: Farrar, Straus and Giroux, 2010); OECD, "The Paris Declaration on Aid Effectiveness and the Accra Agenda for Action," *OECD* (2005/2008) and "The Accra Agenda for Action", 3rd High Level Forum on Aid Effectiveness, September 4, 2008, accessed May 1, 2013, URL: http://www.oecd.org/development/effectiveness/34428351.pdf; International Conference on Financing for Development, "Monterrey Consensus of the International Conference on Financing for Development" (final text of agreements and commitments adopted at the International Conference on Financing Development Monterrey, Mexico, 18-22 March 2002), *United Nations Department of Economic and Social Affairs*, accessed May 1, 2013, URL: http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf.

[26] CNNMoney.com, "What Will the Global 500 Look Like in 2021?," accessed April 1, 2013, URL: http://money.cnn.com/galleries/2012/news/companies/1207/gallery.global-500-future.fortune/index.html.

[27] World Business Council for Sustainable Development, "Vision 2050: Executive Summary," *WBSCD* (2010): 34, accessed May 1, 2013, URL: http://www.wbcsd.org/pages/edocument/edocumentdetails.aspx?id=219.

[28] C.K. Prahalad, *The Fortune at The Bottom of the Pyramid: Eradicating Poverty through Profits* (New Jersey: Pierce Education, Inc., 2010), 35.

[29] Kai Hockerts and Mette Morsing, "A Literature Review on Corporate Social Responsibility in the Innovation Process," *Copenhagen Business School (CBS), Center for Corporate Social Responsibility* (2008), accessed May 1,2013, URL: http://www.samfundsansvar.dk/file/318819/a_literature_review_corporate_social_responsibility_innovation_process_september_2008.pdf.

[30] International Telecommunications Union, "Measuring the Information Society," *International Telecommunications Union* (2012), accessed May 1, 2013, URL: http://www.itu.int/ITU-D/ict/publications/idi/material/2012/MIS2012_without_Annex_4.pdf.

In many cases, companies who can provide desirable products to BoP populations can simply drive out inefficiencies and create profits. Some markets, however, are harder to serve and need impact investments to get off the ground. Healthcare provides an illustrative example. 37 million people globally are blind and approximately 150 million people have serious visual impairments. 90 percent live in the developing world and 1-2 million people lose their sight each year. Cataracts are the leading cause of preventable blindness and an estimated 75 percent of these incidences are treatable or preventable. There are over 120 eye care programs around the world that profitably offer quality services to middle class clients alongside free operations for the poor. Properly run and scaled, such programs generate sufficient cash flow to support debt financing at manageable levels of risk and can access capital markets on quasi-commercial terms.[31] But impact investments are instrumental in providing funding that allows for market building. For example, Deutsche Bank closed the Eye Fund in 2010, a USD 14.5 million fund launched in partnership with non-profit organizations, which finances expanded eye care services to the poor in developing countries.[32] Commercial investors receive a market rate of return and US foundations making program-related investments (PRI) receive lower returns, but still achieve their mission by mobilizing non-grant capital for health outcomes. This solution can serve as a blueprint for other development challenges that can be addressed through market mechanisms. In grasping the full potential of impact investment, it is important to remember that the financial services industry has the expertise to engineer a positive financial return even when the underlying asset loses money.[33] Impact investing at the BoP creates new opportunities to leverage scarce ODA and philanthropic resources. By funding first-loss tranches or issuing guarantees, they can serve as a catalyst for bringing additional private capital to the table in pursuit of development outcomes, alongside the massive commercial investments in the BoP already under way.

2.2. Radical Resource Efficiency and Green Growth

The annual percentage reduction in carbon currently required to limit global warming to two degrees Celsius is 4.8 percent per year, a figure in excess of what has been proven to be historically achievable.[34] The World Economic Forum and Bloomberg New Energy Finance estimate the needed reduction will require low-carbon funding of USD 500 billion per year by 2020. The investment gap is substantial: actual clean investment in 2010 was estimated at USD 243 billion.[35]

Whether or not the rate of global warming can be slowed, the needs of a global population estimated to reach 9 billion by 2050 will likely push natural resource limits, demanding for investments in new infrastructure, as well as radical resource efficiency. The challenge is daunting but, by adopting more of a long-term view, investments in energy efficiency can produce cost savings and promote job growth. For example, a study by McKinsey revealed 60 measures that Russia, with its diverse energy resources, can implement now while maintaining energy consumption and greenhouse gas emissions at their current levels. The program would require EUR 150 billion in investments over the next twenty years, but would save up to EUR 345 billion over the same period.[36] In Europe, one million jobs could be created from a 20 percent cut in present energy consumption, the equivalent of EUR 60 billion annually. This type of job stimulant could be a great opportunity for young people to shape the energy future of Europe. Unemployment among those aged 15 to 24 is 22 percent in France, 51 percent in Spain, and 36 percent in Italy. This figure includes those looking for work, with one estimate of those "not in employment, education or training" at 14 million. Both groups together

[31] Maximilian Martin, "F4F – Finance for Foundations," *UBS* (2007), accessed April 1, 2013, URL: http://ssrn.com/abstract=1322388
[32] "Eye Fund Finances Eye Care for the Poor," Deutsche Bank Corporate Social Responsibility, accessed May 1, 2013, https://www.db.com/csr/en/social_investments/eye_fund_finances_eye_care_for_the_poor.html.
[33] Arthur Wood and Maximilian Martin, "Market Based Solutions for Financing Philanthropy," *UBS Philanthropy Services* (2006), accessed April 15, 2013, URL: http://ssrn.com/abstract=98009
[34] PWC, "Counting the Cost of Carbon: Low Carbon Economy Index 2011," PWC (2011): 4, accessed May 1, 2013, URL: http://www.pwc.com/en_GX/gx/low-carbon-economy-index/assets/Low-Carbon-Economy-Index-2011.pdf
[35] PWC, "Counting the Cost of Carbon," 12.
[36] McKinsey & Company, "Pathways to an Energy and Carbon Efficient Russia: Opportunities to Increase Energy Efficiency and Reduce Greenhouse Gas Emissions," *McKinsey & Company* (2009), accessed May 1, 2013, URL: http://www.mckinsey.com/client_service/sustainability/latest_thinking/greenhouse_gas_abatement_cost_curves.

cost member states an estimated USD 200 billion a year in welfare benefits and lost production — 1.2 percent of the EU's gross domestic product.[37]

While impact investing is about private initiative and risk-taking, framework conditions set by governments matter. Approximately half of the 20 percent reduction could be achieved with a fuller embrace of European Community Directives already in place. Some of the impediments so far concern a lack of information and training on the latest technologies, which can ultimately lead to risk-averse investors endorsing outdated technology even when it might not be the most efficient. Policies promoting transparency, education, and industry cohesion, all supported by broader financial incentives, could begin to reduce Europe's steep reliance on oil and gas imports, estimated to reach 90 percent and 80 percent, respectively, by 2030, based on current trends.[38]

Substantial work has been under way in green finance since the Kyoto Protocol. Even so, making the connection with impact investing and engaging corporations, investors, non-profit organizations, and governments in new ways would go a long way towards closing the investment gap. For example, R20 Regions of Climate Action, a non-profit organization founded in 2010 by former Governor of California Arnold Schwarzenegger, has formed a strategic partnership with the Asian Development Bank (ADB) to develop a project pipeline to be financed through various ADB facilities where R20 member regions, national governments and R20 partners such as the International Chamber of Commerce mitigate some of the risks associated with the potential projects and identify additional investors that would either co-invest with ADB or create their own syndicate for supporting low-carbon projects.[39] One of the areas where green finance can pay off fast is street lighting. About 20 percent of the world's electricity is used to power lights and the lighting of streets. This accounts for 159 terawatt-hours of electricity each year globally, which is equivalent to the annual output of three-dozen 500-megawatt power plants. Advanced LED lights can cut energy usage, maintenance costs and reduce emissions, all while delivering better light quality for improved visibility and community safety. The costs of the LED lights can often be covered from the savings in avoided electricity costs in 36 to 72 months.[40] Unfortunately, many other green finance opportunities have much longer payback times.

Next to clear and stable regulatory parameters, impact investments in the green economy need mechanisms that bring transparency to the market by drawing together players that can aggregate demand on platforms where the risk can be defined, next to clear benchmarks of success to allow further injections of capital. Just as in the case of Eye Fund mentioned earlier, layered investment structures and public-private-non-profit partnerships are often a key to mobilizing new capital and achieving investment periods that are viable for investors.[41]

2.3. Restructuring the Welfare State to Drive Efficiency

Private investors are increasingly funding the provision of public goods. In some fields this is already standard practice, such as the case of toll roads or airports. But the concept can be extended to cover countries' key social challenges as well. In fact, this is also needed given the magnitude of the adjustment ahead. The ratio of workers contributing to the welfare system to dependents (that is, those benefiting from said welfare system) peaked for all advanced economies (North America, Europe, East Asia) between 2000 and 2010.[42] For

[37] Steven Erlanger, "Young, Educated and Jobless in France," The New York Times, accessed May 1, 2013, http://www.nytimes.com/2012/12/03/world/europe/young-and-educated-in-france-find-employment-elusive.html?pagewanted=all&_r=0.

[38] European Commission, "Doing More with Less: Green Paper on Energy Efficiency," *European Commission* (2005): 4, accessed May 1, 2013, URL: http://ec.europa.eu/energy/efficiency/doc/2005_06_green_paper_book_en.pdf.

[39] "Programs in Action," Regions of Climate Action, accessed May 1, 2013, http://regions20.org/programs-action/finance-action/creating-dedicated-financial-vehicle.

[40] "Programs in Action," Regions of Climate Action, accessed May 1, 2013, http://regions20.org/programs-action/technology-action/lighting-efficiency-project.

[41] Maximilian Martin, "After Copenhagen: Perspectives on Energy," *Viewpoint* (2010): 54-65, accessed May 1, 2013, URL: http://ssrn.com/abstract=1532825.

[42] David E. Bloom and David Canning, "Demographics and Development Policy," *Harvard Program on the Global Demography of Aging* (2011), accessed on May 1, 2013, URL: http://www.hsph.harvard.edu/pgda/WorkingPapers/2011/PGDA_WP_66.pdf.

these countries, the welfare state is no longer sustainable without major reforms. The issue of aging is particularly illustrative. Life expectancy has increased worldwide by 21 years since 1950. In addition, most developed countries are far below the so-called 2.1 replacement rate needed to maintain a stable population from one generation to the next. The following figures estimate total public benefits to the elderly as share of GDP in 2007 and what they are expected to be in 2040: Canada 8.3/14.7; Russia 5.8/10.2; US 8.9/16.3; UK 12.1/18.2; Italy 18.0/24.7; France 16.6/23.5; Germany 15.8/21.7; and Japan 14.1/18.4.[43] Other challenges, such as poverty and recidivism, also prove persistent.

Fortunately, new impact investment financing mechanisms have begun to emerge to address these challenges. The UK, like many countries, struggles with the issue of recidivism: about half of all crime is committed by people who have already been through the criminal justice system. The cost to the UK taxpayer of reoffending is estimated to be GBP 9.5 to GBP 13 billion per year.[44]

Piloted in 2010 and based on work on contingent financial return models since 2005, so-called "social impact bonds" (or SIBs) shift risk away from government and onto other stakeholders. SIBs finance the service delivery upfront and are only paid if certain outcomes (i.e. reduced reoffending rates) occur.[45] The public sector benefits because it pays out to investors only for positive social outcomes and only up to a fixed share of the cost savings achieved (impact investors bear the risk that the funded measures do not lead to better social outcomes). But impact investors also benefit since they can achieve a blended return composed of a social and a financial return. These social and financial return requirements are consistent in that the financial return is determined by the magnitude of the social return actually generated. If no positive outcome is achieved, the investor may lose his entire capital. So the social impact bond is, in actuality, a structured product where the underlying investment is spent on social services, and principal and return are paid out on the contingent achievement of a social objective. Social services benefit as well since the proceeds of the "bond issue" allow for paying the providers of social services upon delivery. They are thus encouraged to focus on results as opposed to just the absolute cost of their services. SIBs are useful under four conditions, including: (a) the social problem is measurable and causes the public high costs; (b) the target group is clearly identifiable; (c) the proposed measures are known and tested; and (d) they cost considerably less than the cost savings they achieve. Given their direct involvement with public value creation, SIBs require favorable regulation and likely direct government incentives.[46] Setting up dedicated task forces and vehicles to pioneer the solution can also be instrumental, as was the case in the UK with the creation of Social Finance, the developer of the first SIBs, which was initially financed by a group of private philanthropists.[47]

SIBs have great potential to make inroads in another major challenge: unemployment. It is well known that some retraining programs are better than others but reallocating assets accordingly is often difficult. For example, take the German case of the "Joblinge" program.[48] Joblinge is a joint initiative by the Eberhard von Kuenheim Foundation and The Boston Consulting Group; it is a successful and cost-effective program for addressing youth unemployment, yielding a reinsertion rate of 70 percent. Even though Joblinge is much more cost effective than competitor programs offered by other providers and yields a higher reinsertion rate of unemployed youth, the program only covers a fraction of the 70,000 unemployed youth awaiting labor market reinsertion. Instead, the bulk of the target group goes through less efficient programs, costing more money and yielding less impact. Given that the pilot Joblinge works, further funding and replication could be addressed through a SIB. Based on reinsertion success and the resulting public budget savings and tax revenue

[43] Richard Jackson et al, "The Global Aging Preparedness Index," *The Center for Strategic and International Studies* (2010), accessed on May 1, 2013, URL: http://csis.org/files/publication/101014_GlobalAgingIndex_DL_Jackson_LR.pdf.
[44] "Reducing Reoffending and Improving Rehabilitation," Home Office and Ministry of Justice, accessed May 1, 2013, https://www.gov.uk/government/policies/reducing-reoffending-and-improving-rehabilitation.
[45] Luther Ragin and Tracy Palandjian, "Social Impact Bonds: Using Impact Investment to Expand Effective Social Programs," *Federal Reserve Bank of San Francisco* (2013), accessed May 1, 2013, URL: http://www.frbsf.org/publications/community/review/vol9_issue1/social-impact-bonds-impact-investment-expand-effective-social-programs.pdf; Maximilian Martin, "Four Revolutions in Global Philanthropy," *Impact Economy Working Paper* 1 (2011), accessed on May 1, 2013, URL: http://dx.doi.org/10.2139/ssrn.2209746.
[46] Maximilian Martin, "A Funding Revolution for Public Goods: Social Impact Bonds" Impact Economy (2010).
[47] "Social Finance," Social Finance, accessed on May 1, 2013, http://www.socialfinance.org.uk/.
[48] "Joblinge," Joblinge, accessed May 1, 2013, http://www.joblinge.de/; Maximilian Martin, "Four Revolutions in Global Philanthropy," *Impact Economy Working Paper* 1 (2011), accessed on May 1, 2013, URL: http://dx.doi.org/10.2139/ssrn.2209746.

instead of a transfer payment, the public sector could in turn financially reward private investors, provided the majority of the savings stay with the public sector.

There is not yet enough evidence about the efficacy of SIBs to make any definite conclusions about them. However, they are considered to be the flagship of impact investment instruments aimed at keeping the welfare state fundable in the twenty-first century and hold great promise to harness both public and private resources. Contingent financial instruments that produce a financial outcome dependent on achievement of a social objective are gaining traction across a broad front. They can be expected to have significant implications for a broad range of sectors—from moderate-income housing, to health care, water and sanitation, and rural development. At least six states in the US are exploring SIB programs.[49] The question remains open today whether SIBs represent such an effective new tool that they are likely to reach the scale necessary to be part of an overall domestic and development strategy. While such funding approaches require changes in standard practice, there will ultimately be no alternative to greater resource efficiency action in the future that results in some form of market-based solutions.

2.4. The Rise of the "Lifestyles of Health and Sustainability" (LOHAS) Consumers

Impact investors investing in advanced economies are very active in the "LOHAS" segment. While the concept of healthy and sustainable living is certainly not new, the acronym "LOHAS" originated around the time we ushered in the new millennium. It has proven to be a unifying term for consumers who, individually, want their products to reflect their personal values and, collectively, aspire to positively influence society with their purchases.[50] LOHAS consumers can be found across a broad array of industries, such as food, fashion, real estate, and transportation. Consumers in the US have built their LOHAS market to over USD 300 billion, growing at more than 10 percent per annum.[51] More than 80 percent of US adults are somehow engaged in sustainability, whether they are consciously part of the LOHAS movement or not.[52] While the US consumer has traditionally been viewed as the driver of global growth, change is already occurring. By 2025, consumption in emerging markets is forecast to have grown by 150 percent from 2010 levels, while just 31 percent in developed markets. Emerging markets will be nearly on par with developed markets in trillions of consumption dollars. Companies from developed countries will have to learn how to tap this growth, which has so far proven to be a tall order: McKinsey surveyed 100 leading companies from developed countries and revealed that 83 percent of revenues came from developed markets despite the fact that emerging markets' share of global gross GDP has nearly doubled from 19 percent to 36 percent in just two decades. [53]

It is predicted that emerging markets will drive global middle-class consumption, and the nature of their consumers is different from consumers in developed markets. For example, a lot of the wealth is recent: individuals are five times wealthier than they were just a decade ago. Much of this wealth is simply sitting in savings, ready to be deployed for products and services aligned with the values of consumers.[54] Unlike US consumers who are among the most sensitive to the sometimes-higher prices of green products and services, emerging market consumers are not.[55] Data suggests that approximately 84 percent of consumers from emerging market players like China, India, Malaysia, and Singapore would pay a premium for environmentally-

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[49] Sonal Shah and Kristina Costa, "Social Impact Bonds: White House Budget Drives Pay for Success and Social Impact Bonds Forward," Center for American Progress, accessed on May 1, 2013, http://www.americanprogress.org/issues/economy/news/2013/04/23/61163/white-house-budget-drives-pay-for-success-and-social-impact-bonds-forward/.

[50] Adam Horler, "LOHAS: A New Era of Green Consumption?," ecopoint.asia, accessed on May 1, 2013, http://www.ecopoint.asia/2011/03/11/%E2%80%9Clohas%E2%80%9D-a-new-era-of-green-consumption/.

[51] "LOHAS Market," ONELIFE MEDIA, accessed on May 1, 2013, http://www.effectpartners.com/onelifetour/the-lohas-market/.

[52] John Marshall Roberts, "LOHAS Consumers around the World," *Natural Marketing Institute* (2010): 12; accessed on May 1, 2013, URL: http://www.lohas.com/sites/default/files/lohasconsumers.pdf.

[53] "Winning the $30 Trillion Decathlon," McKinsey & Company, accessed on May 1, 2013, http://www.mckinsey.com/features/30_trillion_decathlon; Brandes Investment Partners, "Five Compelling Reasons to Allocate to Emerging Markets," *Brandes Investment Partners* (2012), accessed May 1, 2013, URL: http://www.brandes.com/Documents/Publications/Five%20Compelling%20Reasons%20to%20Allocate%20to%20EM.pdf.

[54] Brandes Investment Partners, "Five Compelling Reasons to Allocate to Emerging Markets".

[55] John Marshall Roberts, "LOHAS Consumers around the World," 13.

friendly products, compared to just 50 percent for consumers from the US, Japan, France, and Germany.[56] The proliferation of the sustainable consumer in these emerging markets is supposedly so strong that a study by Edelman labels them “Purpose Bull Markets.”[57] Accenture warns, though, that, “with the exception of products and services that are niche, clearly offering added value or representing genuine innovation, the market for purposely designed sustainable alternatives will not likely command premium prices in the long run.”[58]

Impact investing and the LOHAS segment appear to be a natural fit. Numerous such investment deals are transacted in international impact investor networks such as Toniic, who often back early and growth stage venture capital investments. Established LOHAS topics are organic food, fair trade, and health, with large players such as publicly listed Wholefoods Markets, with over 50,000 employees and almost USD 10 billion turnover, present in the market.[59]

But impact investors now invest in a cohort of potential future Wholefoods that comprises pretty much anything sustainable ranging from sustainable jeans to sustainable seafood. LOHAS businesses typically produce responsibly along the entire supply chain, and some turn a mainstream product such as shoes or glasses into a LOHAS product by building charity into a brand and product offering. For example, TOMS, a US for-profit company with a non-profit subsidiary, Friends of Toms, has pioneered the one-for-one model. Founded in 2006, it designs and sells shoes based on the Argentine Alpargata design and eyewear.[60] For every pair of shoes sold, a pair of shoes is given to an impoverished child; and for every pair of eyewear sold, part of the profit is donated to help restore eyesight for people in developing countries. Sustainable products will become the new normal in due course. Companies unwilling to adjust their supply chains or even reconfigure their business offerings to prepare for this changing market paradigm are, at best, missing out on an enormous growth opportunity and, at worst, sealing their fates. As strategist Michael Porter points out, government can be instrumental in the continued competitiveness of these companies: “On the one hand, firms and the private sector are the ultimate engines of innovation. On the other hand, the innovative activities of firms within a country are strongly influenced by national policy and the presence and vitality of public institutions. In other words, innovation intensity depends on an interaction between private sector strategies and public sector policies and institutions. Competitiveness advances when the public and private sectors together promote a favorable environment for innovation.”[61] This insight also holds true for the impact investment industry.

However, in the LOHAS segment, where impact investment deal flow is strong, the most logical policy intervention is to provide for quality health, safety and consumer protection regulation, as well as incentives for sustainable supply chains, rather than necessarily seeding new businesses or intermediaries directly.

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[56]“Emerging-Market Consumers Also More Willing to Pay a Premium for ‘Environmentally Friendly’ Consumer Products,” Accenture, accessed May 1, 2013, http://newsroom.accenture.com/article_display.cfm?article_id=4921.
[57] Edelman INSIGHTS, “good purpose 2012: Global Consumer Survey,” *Edelman INSIGHTS* (2012), accessed May 1, 2013, URL: http://www.slideshare.net/secret/4FBiBICpOiDK3r.
[58] Accenture, “Long-Term Growth, Short-Term Differentiation and Profits from Sustainable Products and Services: A Global Survey of Business Executives,” *Accenture* (2011), accessed May 1, 2013, URL: http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Long-Term-Growth-Short-Term-Differentiation-and-Profits-from-Sustainable-Products-and-Services.pdf; “Home,” Toniic, accessed May 1, 2013, http://toniic.com/.
[59] “Whole Foods Market,” Whole Foods Market, accessed May 1, 2013, http://www.wholefoodsmarket.com/.
[60] “TOMS,” TOMS, accessed May 1, 2013, http://www.toms.com/.
[61] Michael E. Porter and Scott Stern, “National Innovative Capacity,” *Harvard Business School* (2002), accessed May 1, 2013, URL: http://www.isc.hbs.edu/Innov_9211.pdf.

3. Growing the Supply and Demand Sides of the Impact Investing Industry

The fundamentals of the real economy that will allow for impact investment to grow massively are strengthening more and more every day. But the impact investment market needs to become more efficient before it can capitalize on these fundamentals and emerge to be able to better match supply and demand. This section analyzes how capital supply, capital demand and capital use policies can help to stimulate the impact investing industry. To overcome fragmentation and sub-scale activity, and enable the impact investment market to unlock its full potential, governments now have an important role in setting framework conditions that accelerate impact investment demand, supply and the creation or scaling of the intermediaries needed for a well-functioning market.

As discussed above, the combination of the characteristics that are peculiar to impact investing and the megatrends emerging—developments that will only intensify the need for a dynamic tool like impact investment for addressing global challenges such as unemployment, climate change and country indebtedness—raises questions around the role government can play to help create an enabling, as opposed to inhibiting, environment for the growth of the impact investment industry. For an overview of the yin and yang of market stimulation, see **Figure 2**.

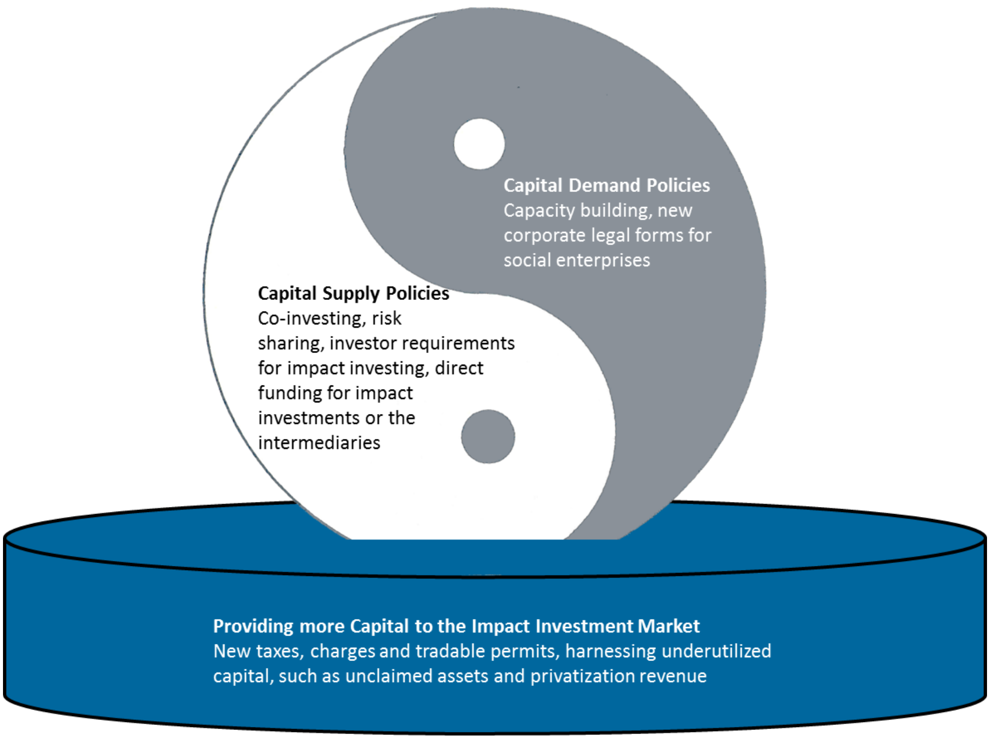

Figure 2: Growing the Supply and Demand Sides of the Impact Investing Industry

3.1. Overview of Policy Levers

Government can support the impact investment industry in three primary ways, including: stimulating supply, directing capital and regulating demand.

Government can use "supply development policies" to increase the supply of impact investment capital. These policies can take the form of incentives to invest through co-investing or risk sharing with the government, creating investor requirements for impact investing, or directly providing funding for impact investments or the intermediaries that invest in them. Investing in intermediaries is typically preferred over direct investments. For example, in India, the government mandates that a certain amount be loaned to underserved markets. In the European Union, the European Investment Fund (EIF) launched the Social Impact Accelerator (SIA) in 2013, a pioneering pan-European public-private partnership pilot for impact investing in partnership with Crédit Coopératif and Deutsche Bank. Structured as a fund-of-funds, it seeks to mobilize an initial amount of EUR 60 million of capital for investment in impact funds that provide equity finance to social enterprises that promote social inclusion, provide alternative sources of employment for marginalized social groups, and contribute to growth.[62] This approach mirrors Big Society Capital (BSC), set up in the UK in 2011 and discussed in greater detail below. BSC is an independent financial institution authorized and regulated by the UK Financial Services Authority that acts as a social impact investment bank and invests in intermediaries focusing on the UK (rather than the whole of the European Union as in the case of SIA above). BSC launched a GBP 600 million fund in 2012.[63] In the US, the Small Business Association has helped to create six equity funds that invest in businesses in low-income communities.[64]

Alternatively, government can direct how capital is used and can better leverage existing investments for social impact. These policies change the risk and return features of impact investments by adjusting market prices, and improving transaction efficiency and market information, such as harmonizing impact measurement standards. In the Netherlands, the Green Funds Scheme offers a tax credit to investors devoting some capital to environmental initiatives. The EU directs funds to climate projects by issuing its "Climate Awareness" bonds.[65]

Lastly, by stimulating the demand for impact investment and promoting investment readiness, government can further encourage its growth. Demand development policies increase the demand for impact investment by building the capacity of impact investment recipients to absorb capital. There are several examples of these types of policies from around the world. In the UK the Investment and Contract Readiness Fund (ICRF), launched in 2012 with GBP 10 million over three years, provides grants between GBP 50,000-150,000 to social enterprises who seek to (a) raise at least GBP 500,000 investment, or (b) bid for public service contracts over GBP 1 million.[66] The National High-Tech R&D program in China prepares sectors like environmental protection and renewable energy for private investment. Mexico has a small business technical assistance and training program.[67]

Another structural demand enabler are new corporate legal forms for social enterprises such as the UK Community Interest Company (CIC) or the US Low Profit Limited Liability Company (L3C), which receive preferential tax treatment for commitments to serving the public good and accepting an asset lock.[68] Such legal forms increase transparency and tradability of social enterprises; the CIC in particular is required to conduct annual reporting, which is a major precondition for the development of a viable secondary market for impact investments. Once tradable, such securities would make the social capital market more liquid,

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62 "EIF launches a social impact investing fund of funds," European Investment Fund, accessed May 14, 2013, http://www.eif.org/what_we_do/equity/news/2013/social_impact_accelerator.htm.
63 "Big Society Capital," Big Society Capital, accessed May 1, 2013, URL: http://www.bigsocietycapital.com/.
64 Ben Thornley et al, "Impact Investing: A Framework for Policy Design and Analysis," *Insight at Pacific Community Ventures and The Initiative for Responsible Investment at Harvard University* (2011): 20, accessed May 1, 2013, URL: http://www.pacificcommunityventures.org/uploads/reports-and-publications/Impact_Investing_Policy_Full_Report.pdf.
65 Ben Thornley et al, "Impact Investing: A Framework for Policy Design and Analysis," 20.
66 "Investment and Contract Readiness Fund," Investment and Contract Readiness Fund, accessed May 1, 2013, URL: http://www.beinvestmentready.org.uk/.
67 Ben Thornley et al, "Impact Investing: A Framework for Policy Design and Analysis," 21.
68 Maximilian Martin and Arthur Wood, "Unfreezing the Foundation Asset Landscape to Create a Liquid Capital Market," *Viewpoints* (2008): 104-107, accessed April 1, 2013, URL: http://ssrn.com/abstract=1322308.

again encouraging greater participation. Moreover, some of these new social enterprise legal forms enable layered investing: for example, as an LLC, an L3C can distinguish between its members. This allows different entities to buy memberships with different levels of return and risk. Philanthropists could buy the highest-risk membership of an L3C from the grant component of their portfolios, for example, while a small foundation may buy the lowest-risk membership of the same vehicle from its bond component. This layering would allow a variety of investors to participate in L3Cs, depending on their risk preference, thus expanding the capital pool available in the process.

3.2. From Concept to Implementation

Impact investment is not the first financial industry to go through a market-building phase and useful lessons can be drawn from similar past efforts, perhaps most beneficially from the industry that shares many of the features also present in impact investment, namely venture capital.

Venture capital (VC)—broadly defined—is the capital dedicated to equity or equity-linked investments in privately held growth companies.[69] The first venture capital firm was established in the US in 1946 to invest in companies that sprung up after World War II. This first fund was primarily made of individuals, as institutions were reluctant to invest.[70] This structure generally continued until the 1980s, when a clarification in a US Department of Labor classification for retirement investments allowed pension funds to invest in venture capital firms.[71]

The US has developed a clear competitive advantage in venture capital over other countries since the 1980s. Part of this advantage may be due to a robust initial public offering (IPO) market, but it also has been determined that government policy has played an important role in growing the VC sector.[72] Examples like the U.S. Small Business Investment Company (SBIC) and Small Business Innovation Research (SBIR) programs have "disbursed USD 2.4 billion in 1995, more than 60 percent of the amount from venture capital in that year."[73] Other countries, such as Germany and Sweden, have replicated the US model and developed substantial VC supportive government programs.[74]

Accordingly, government support that encouraged the growth of the venture capital industry in both the US and Europe took the form of programs that increased the number of investment funds, adjusted tax policies (income and capital gains), provided employment restrictions, and invested in public R&D. Results indicate that the most effective of these policies tend to be the ones that promote a more active VC industry, not simply those that increase the amount of VC funds. Reductions in capital gains taxes have also had a positive effect on VC development. Stock markets for VC-backed companies provide exit opportunities for investors, thus reducing risk. Finally, flexible hiring and firing regulations improve the productivity of the fast-moving VC industry.[75]

An implication from the growth of the VC industry for the impact investment industry is that programs ideally enhance the demand for impact investment funds, rather than simply increase the supply of capital.[76] Examples of these types of policies include "efforts to facilitate the commercialization of early-stage technology, such as the Bayh-Dole Act of 1980 and the Federal Technology Transfer Act of 1986, both of which eased entrepreneurs' ability to access early-stage research."[77] Tax policies—which in the VC world took the

[69] Bronwyn H. Hall and Josh Lerner, "Financing of R&D and Innovation," *National Bureau of Economic Research* (2009): 24, accessed May 1, 2013, URL: http://www.nber.org/papers/w15325.pdf?new_window=1.
[70] Ibid, 24 and 25.
[71] Ibid, 25.
[72] Ibid, 33.
[73] Ibid, 37 and 38.
[74] Ibid.
[75] Marco Da Rin et al, "Public Policy and the Creation of Active Venture Capital Markets," *European Central Bank* (2005), accessed May 1, 2013, URL: http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp430.pdf.
[76] Josh Lerner, "Boom and Bust in the Venture Capital Industry and the Impact on Innovation," *Federal Reserve Bank of Atlanta* (2002), accessed May 1, 2013, URL: https://www.frbatlanta.org/filelegacydocs/erq402_lerner.pdf.
[77] Josh Lerner, "Boom and Bust in the Venture Capital Industry and the Impact on Innovation," 38.

form of lowered tax rates on capital gains—have also served a similar function and have had “a substantial impact on the amount of venture capital provided and the returns that these investors may yield.”[78]

3.3. Blueprints and Examples

Against the backdrop of lessons from government efforts to build the VC industry, let us now examine a few key examples of how different countries have approached the construction of domestic impact investment and innovation markets, and the important implications of these efforts for the policy makers whose role is critical at the current stage of industry development.

Established in 2009, the White House Office of Social Innovation and Civic Participation (SICP) in the United States has three primary purposes: promote service and volunteerism, increase investment in new solutions that demonstrate outcomes, and encourage innovative partnership models.[79] In the UK, Big Society Capital (BSC), referred to earlier, supports the development of social investment finance intermediaries and works to increase awareness of and confidence in social investment via promotion of best practices, sharing information and improving links between social investment and mainstream financial markets, and by working with other investors to embed social impact assessment into the decision-making framework.[80] Lastly, the Community Economy Development Investment Funds (CEDIFs), established in Canada in 1999, were created to surmount financial hurdles faced by local entrepreneurs and to generate economic development in Nova Scotia.[81] An early key success that led to the formalization of the CEDIF program was the Nova Scotia Equity Tax Credit, which “[…] offered a personal tax credit of 30 percent to encourage investors to participate. The Equity Tax Credit [allowed] equity investment in corporations, co-operatives and community economic development initiatives. In the case of corporations, eligible investments [had to] be newly-issued common voting shares without par value.”[82]

The lessons these efforts hold for policy makers looking to similarly grow their domestic impact investment and innovation markets are compelling. In the case of the US, the three key takeaways are that governments should “[place] policy offices where champions already exist,” “[create] opportunity for creativity and innovation by cutting across existing sectors and silos, being mindful of bureaucratic barriers” and “[be] politically astute and willing to make adjustments as long as core tenets are not compromised.”[83] The UK experience with BSC highlights the need to “[garner] consensus and collaboration across parties, political bodies and the public and private sectors to mobilize a unified vision, over time,” “[identify] a champion who understands and can represent both public and private sector interests,” and “[develop] complementary policies to support the market’s balanced and sustainable growth, covering both the ‘supply’ and ‘demand’ sides of social investment.”[84] The CEDIFs in Canada show that in order to grow and direct private capital, government must help to “[reduce] the transaction costs of investment opportunities,” “[reinforce] current investment activities by incorporating other innovations,” and “[identify] opportunities to engage new investors and generate larger supplies of capital.”[85] One recurrent lesson learned from these initiatives is the need for government to create units that can put capital in the hands of social enterprise investment specialists who know how to conduct professional direct impact investments, rather than building up fully-fledged direct impact investment facilities inside the public sector at great cost. Another major lesson learned

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[78] Ibid, 38.
[79] “About SICP – The Community Solutions Agenda,” White House Office of Social Innovation and Civic Participation, accessed May 1, 2013, http://www.whitehouse.gov/administration/eop/sicp/about.
[80] “Our Vision and Mission,” Big Society Capital, accessed May 1, 2013, URL: http://www.bigsocietycapital.com/our-vision-and-mission.
[81] “What is a CEDIF?,” Community Economic Development Investment Funds, accessed May 1, 2013, http://www.gov.ns.ca/econ/cedif/background/.
[82] Ibid.
[83] Schwab Foundation for Social Entrepreneurship, “Breaking the Binary: Policy Guide to Scaling Social Innovation,” *World Economic Forum* (2013): 22, accessed May 1, 2013, URL: http://www.weforum.org/pdf/schwabfound/PolicyGuide_to_ScalingSocial%20Innovation.pdf.
[84] Ibid, 25.
[85] Ibid, 40.

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is the need to identify champions across government agencies and sectors in order to establish consensus on what is needed to best grow the market.

3.4. Barriers to Address

The lessons from the development of the VC industry and the attempts by different countries to grow their domestic impact investment markets are helpful, particularly when it comes to addressing the barriers that still exist for the industry. Included here are the lack of a set of meaningful rules governing impact investment; limited availability of capital; market imperfections; a lack of needed skills and expertise and overall investment readiness; as well as striking the balance between ensuring a level playing field in this new industry in the early phase of an innovation cycle; and the frequent desire to pick winners to fast-track implementation and success.

Addressing the set of rules governing impact investment is not trivial. In the case of Canada, an early high profile task force dedicated to exploring how to better mobilize private and public sector support for social finance surfaced a number of critical challenges inhibiting the growth of the domestic market and proposed a host of corresponding recommendations. For example, impact investment "has the potential to deliver [USD 30 billion] to public benefit initiatives across Canada;" however, this will only happen if the government is able to create "a regulatory environment that actively encourages the development of investment-ready social enterprises."[86] The task force also called for Canada's Department of Finance "to amend the Income Tax Act to establish a profits 'destination test' treatment of related business, to serve as the primary regulatory mechanism for social enterprises established and run by charities and non-profit organizations."[87] Other findings included the need to "review existing legislation and regulations governing charities, non-profits and co-operatives, to remove other outstanding barriers to social enterprise activities (e.g. clarifying the asset lock)" and urgency for the federal government to take the lead in establishing a consultative process to examine the need for a new class of hybrid corporation, subject to a community interest test, for social enterprises and, if appropriate, explore options for a made-in-Canada model. This process should leverage the recently launched consultations by the BC government around a proposed Community Interest Company model." [88]

The limited availability of government supplied capital to kick-start a national impact investment industry is another critical barrier that needs to be addressed. The UK's Big Society Capital (BSC) is a compelling example of public sector ingenuity in solving the problem; in this case by mobilizing unclaimed assets from dormant bank accounts and deploying them in a new way. But this is not the only option on the horizon to obtain the initial funding. Another interesting innovation is what leading scholar Lester Salamon has dubbed the "philanthropication thru privatization." Simply put, massive community-based foundations and philanthropic institutions are being created around the world as a by-product of privatization transactions (i.e., a portion of the proceeds from various privatization transactions have been redirected to seed endowments of charitable foundations).[89] The so-called foundations of banking origin in Italy provide a helpful illustration. In 1990, "Italy converted its network of small, non-profit, and quasi-public, savings banks into joint stock companies, but vested the ownership of the resulting stock in a set of foundations, some of them newly formed and some already in existence as operating arms of the former savings banks." The value of the stock that the foundations were able to sell in 1994 was EUR 24 billion and has continued to increase in worth since. By 1998, "the combined assets of Italy's foundations of banking origin exceeded EUR 50 billion. Cariplo and Compagnia di San Paolo, two of the largest of these foundations, both have assets in excess of EUR 9 billion each, or approximately USD 13 billion, which puts both of them ahead of such major U.S. foundations as the Rockefeller Foundation (USD 3.1 billion in assets as of 2008), and the Ford Foundation (America's second

[86] Canadian Task Force on Social Finance, "Mobilizing Private Capital for Public Good," *Canadian Task Force on Social Finance* (2010): 21, accessed May 1, 2013, URL: http://socialfinance.ca/uploads/documents/FinalReport_MobilizingPrivateCapitalforPublicGood_30Nov10.pdf.
[87] Ibid, 22.
[88] Ibid, 22.
[89] Lester M. Salamon, "Privatization for the Social Good: A New Avenue for Global Foundation-Building," *Privatization Barometer* (2009): 48, accessed May 1, 2013, URL: http://www.feem.it/userfiles/attach/2010525173904PB_Annual_Report_2009.pdf.

largest with USD 11 billion in assets as of 2008)."[90] As a result, a foundation landscape has been seeded that is now increasingly active in impact investing.

The lack of skills and expertise is another barrier that is inhibiting the growth of the impact investment industry, because it holds back possible investments, raises costs, and lowers liquidity. For example, there is currently not enough depth in hedging or trading in exotic currencies even in fairly active emerging markets (e.g. the Kenyan Shilling) in the impact investment space. While many impact investments are made into emerging markets, where currency risk arises, most of these investments are made in hard currency (in a recent investor survey, 91 percent of investments were made in USD, EUR, CAD or GBP, and only 9 percent in one of 38 other currencies).[91] The foreign exchange markets pose an interesting opportunity and challenge for impact investors who wish to engage in BoP markets: to bring the cost of hedging down and increase liquidity, large institutions that have the ingredients of the capabilities in-house need to make them available. In their market-building efforts, governments could incentivize such financial institutions to do so.

[90] Lester M. Salamon, "Privatization for the Social Good: A New Avenue for Global Foundation-Building," 50.

[91] Yasemin Saltuk et al, "Insight into the Impact Investment Market: An In-depth Analysis of Investors Perspectives and over 2,200 Transactions," *J.P. Morgan* and *the Global Impact Investing Network* (2011): 11; accessed May 1, 2013, URL: http://www.thegiin.org/cgi-bin/iowa/download?row=334&field=gated_download_1.

4. The Ecosystem of Impact Investment

For the impact investing industry to realize its potential, it is important that in addition to intelligent market building and stimulation policies as discussed in the previous section, the different groups of investors in the industry perform their synergistic roles and jointly establish a veritable ecosystem. Apart from government, they range from philanthropic investors such as foundations via angel and venture stage investors, private and institutional investors to financial services institutions. Understanding their respective roles and where each investor has comparative advantage will be important to fulfilling the market's promise.

If impact investing is to respond to megatrends, thrive in an enabling policy environment, and take advantage of the expertise and value chains of large corporations to scale social impact, it needs a lot of capital at all investment stages, and from a variety of sources. As mentioned above, the industry is currently growing from a low capital base of USD 36 billion and is nevertheless expected to reach USD 400-1000 billion by the end of the decade. This section describes the division of labor among key players in the investor ecosystem (see **Figure 3**).

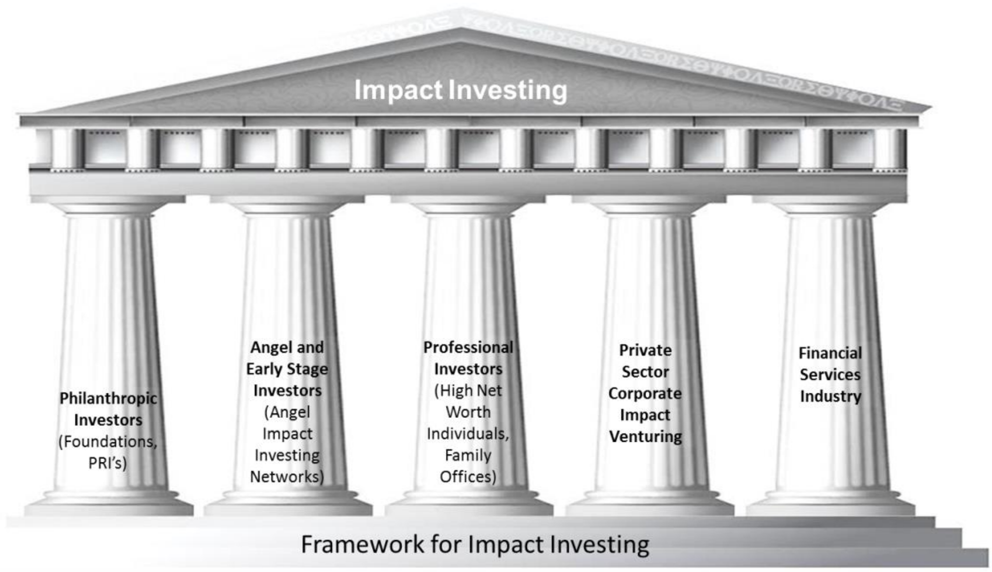

Figure 3: The Impact Investor Ecosystem

4.1. Sector-Building: Comparative Advantage of Philanthropic Investors

Much of the work to develop the impact investing industry as we know it today has been performed by foundation philanthropy. This is where foundations seem to have comparative advantage. In fact, the program-related investments (PRI) described in the introduction were pioneered by the Ford Foundation in 1968. Along with grants, they are occasionally used today to help social enterprises in the seed or early stage. However, due to cost and complexity, they are generally passed up.[92] For example, in 2009, only five one-hundredths of one percent of US foundation capital deployed went to equity PRIs.[93] While PRIs have not gained much of a following, they have prompted an important dialogue about earning social returns from giving and investments. In recent years, private investors have been gravitating toward a more business-like approach to philanthropy, emphasizing positive societal outcomes that can be empirically verified and seeking greater accountability in the charitable sector. Foundations nevertheless continue to play an important role

[92] "Program-Related Investment," Ford Foundation, accessed May 1, 2013, http://www.fordfoundation.org/grants/program-related-investment; "Program-related investments (PRIs): A potential funding source for community economic development?," UNC School of Government, accessed May 1, 2013, http://ced.sog.unc.edu/?p=4515.
[93] Matt Bannick and Paula Goldman, "Gaps in the Impact Investing Capital Curve," Stanford Social Innovation Review, accessed September 27, 2012, http://www.ssireview.org/blog/entry/gaps_in_the_impact_investing_capital_curve.

as the impact investing industry matures, especially with respect to disseminating knowledge on best practices and capacity building to get meaningful deal flow started and cut transaction costs. A well-regulated charitable foundation sector is a major asset in getting the impact investment industry off the ground in any jurisdiction.

4.2. Deal Flow Generation and Buy and Build: Angel and Early Stage Investors

Impact investing also needs bottom-up innovation and deal flow in order to thrive. This is where angel investors come in with their “buy and build” strategies and expertise. In the US and Europe, angel investors have served as a reliable source of financing for high-growth companies over the past couple of decades. The angel investment sector is continually growing and organizing through groups and networks. Although venture capital draws the majority of the attention from policy makers, it is angel investment that is the primary supply of external seed and early-stage equity financing in many countries. Angel investors also tend to be less sensitive to market cycles than venture capitalists.[94] Since the financial crisis, VC sources of funds have dropped and the businesses they once supported are in dire need of financing by angel investors who can fill the equity gap between funding by founders and later-stage venture funds.[95]

Angel investors can bring more to the table than just provide money. They are pivotal for the impact investing industry because they can: first, bring expertise in assessing deals (angel investors know how to identify good projects and teams and evaluate them); second, support a wider range of innovation (angel investors usually invest locally and in a wider range of sectors than venture capital firms, they support a wider range of innovation); third, reduce transaction costs (angel investors can connect high-quality entrepreneurs to more investors via groups and networks); fourth, they can help build the track-record for impact investments (a lack of track record is often cited as a major barrier for investors and angel investment can help to build such a record); and, lastly, they can support the growth of start-ups in their field of expertise (support can be both financial and through business advice).[96] By providing these critical services, angels can bring more impact investments to a later-stage of financing.

Angel investment helps more than just the investee. In the US, estimates suggest that approximately 250,000 new jobs were created in 2009 by firms supported by angel investment, representing 5 percent of new jobs in the country.[97] Additionally, early stage firms with angel financing have an increased probability of survival and improved performance and growth by 30 percent to 50 percent on average.[98]

For these reasons, greater government support to lower risk for angel impact investment seems like an interesting opportunity. Angel impact investing is currently in its formative stage in Europe, with a first dedicated session and training conducted at the 2013 Annual Conference of the European Business Angels Network (EBAN).[99] Angel investment framework conditions vary, so policy makers should take certain factors into account when drafting helpful legislation, such as the level, sophistication, and volume of angel activity in a particular area. Effective policies in one country may not translate well in another. In fact, in the US and Canada, angel policies are implemented at the regional rather than the national level.[100]

Tax incentives are a popular policy tool for angel support but must be monitored and evaluated since they can be difficult to structure.[101] The UK has long-standing angel tax incentive programs that have been shown to have a beneficial effect on the economy. Approximately 24 percent of investments would not have been made without one program in particular, the Enterprise Investment Scheme (EIS). Japan implemented an “income exemption system” in which an angel can deduct from his income the amount of his investment up

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[94] OECD, “Financing High-Growth Firms: The Role of Angel Investors,” *OECD* (2011), accessed May 1, 2013, URL: http://www.eban.org/wp-content/uploads/2013/03/OECD-Angel-Financing-Publication.pdf.
[95] Ibid, 9.
[96] Ibid.
[97] William R. Kerr et al, “The Consequences of Entrepreneurial Finance: A Regression Discontinuity Analysis,” *Harvard Business School* (2010), accessed May 1, 2013, URL: http://www.hbs.edu/faculty/Publication%20Files/10-086.pdf.
[98] William R. Kerr et al, “The Consequences of Entrepreneurial Finance.”
[99] “Impact Economy at EBAN’s Annual Congress—Europe’s Answer to Silicon Valley,“ Impact Economy, accessed May 16, 2013, http://www.impacteconomy.com/EBAN_Annual_Congress.
[100] OECD, “Financing High-Growth Firms,” 11.
[101] Ibid, 12.

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to a certain limit. In France, the innovation agency OSEO devised a unique funding structure for innovative, early stage companies. The amount of funding is limited to 50 percent of the capital needed so as to draw in other investors. One third of the amount is a grant and two thirds is a loan. This approach has reduced the risk associated with the development and commercialization of novel technology.

4.3. Seeding Scale: Professional Investors

Professional investors such as high net worth individuals and family offices have been the backbone of funding impact investing transactions to date, similar to the state of affairs when microfinance opened up for private investment ten years earlier when, for example, Pierre Omidyar (Founder of eBay and of the Omidyar Network), initiated and funded the Omidyar Tufts Microfinance Fund, a part of the Tufts endowment with USD 100 million that has to be invested in microfinance.[102]

The contribution of professional investors to the industry is documented in a number of studies.[103] They increasingly want to both “do good” and “do well” with a part of their portfolio. Thus, they look for ethical funds, “socially responsible investments” (SRI, estimated at about USD 3.74 trillion worldwide), and impact investments.[104] Driven by personal interest, deep-seated worries about the future of the planet as well as interest in low-volatility opportunities and/or segments of the market uncorrelated with mainstream global benchmarks (e.g. absolute return and capital guarantee products), they help to increasingly drive capital towards impact investments. Their desire for results could be seen before the financial crisis, and it has become much more intense in the years since.[105]

Policy makers can help to build this market. They can stimulate professional investor engagement by facilitating impact investing products with clear risk-return characteristics, product quality and tax transparency. The case of the EU’s new EuSEF law illustrates this approach. The EuSEF law is a designation for funds allocating at least 70 percent of their capital towards ‘social undertakings’ via a broad range of financial instruments ranging across the spectrum from equity to debt, with the exception of social undertakings listed on regulated markets or on multilateral trading facilities (MTF). This renders cross-border fundraising quicker and easier.

4.4. Mainstreaming: Institutional Investors

Another example highlights that even institutional sentiment is shifting: a survey of 47 organizations with GBP 143 billion under management and 4.5 million pension holders revealed that 20 percent of respondents thought it was the role of pension funds to invest in impact investment. 47 percent of all respondents expected to have some form of impact investments in their portfolio within the next two years. Thus far, however, institutional investors have not been overly active in impact investing, unlike in Socially Responsible Investing (SRI).[106] A big barrier to institutional impact investing is the discomfort that many investment

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102 Michael Chu and Lauren Barley, “Omidyar Network: Pioneering Impact Investment Harvard Case Study Solution & Analysis,” *Harvard Business School* (2013), accessed May 1, 2013, URL: http://www.harvardsolution.com/omidyar-network-pioneering-impact-investment-589.

103 E.T. Jackson and Associates Ltd., “Accelerating Impact: Achievements, Challenges and What’s Next in Building the Impact Investing Industry,” *Rockefeller Foundation* (2012): xi, accessed May 1. 2013, URL: http://www.rockefellerfoundation.org/uploads/images/fda23ba9-ab7e-4c83-9218-24fdd79289cc.pdf.

104 US SIF Foundation, “Report on Sustainable and Responsible Investing Trends in the United States,” *US SIF* (2012): 11, accessed May 1, 2013, URL: http://www.ussif.org/files/Publications/12_Trends_Exec_Summary.pdf; Michael Chamberlain, “Socially Responsible Investing: What You Need To Know,” Forbes, accessed April 24, 2013, http://www.forbes.com/sites/feeonlyplanner/2013/04/24/socially-responsible-investing-what-you-need-to-know/.

105 Economist Intelligence Unit, “The New World of Wealth: Seven Key Trends for Investing, Giving and Spending among the Very Rich,” *The Economist* (2010), accessed May 1, 2013, URL: http://evpa.eu.com/wp-content/uploads/2010/10/The-new-world-of-wealth-Seven-key-trends-for-investing-giving-and-spending-among-the-very-rich.pdf.

106 SRI refers to an investment concept that seeks to integrate non-financial criteria, encompassing Environmental, Social and Governance (ESG) issues, in its investment decision-making process and portfolio management of publicly listed for-profit companies. The four major approaches commonly used to implement and interpret SRI are positive screening, negative screening, engagement, or integration.

managers feel in pursuing something other than risk-adjusted financial return, namely social return. The lack of track record does not help either.[107]

Nonetheless, there are encouraging examples of how impact investments suitable for institutional investors can be generated. This is especially the case when a patient player such as a foundation plays an active role in making the solution happen. For example, from 1993 to 2004, real estate rents in Italy were outstripping increases in family income by four times, creating an urgent need for affordable housing. The Italian government was more accustomed to passing legislation for the vast majority of Italians who own their homes. It had no easily available solution.[108] Instead, the Fondazione Cariplo, an Italian foundation, created the Fondazione Housing Sociale (FHS) in 2004 to act as an innovator of housing policy in the Italian real estate sector and to promote the growth and enhancement of social housing. The foundation did not design FHS to simply create living space; its aim was to build an integrated, lively community, complete with services and easy-to-access businesses.[109] In 2006, with initial foundation funding of EUR 85 million, FHS started the first ethical real estate fund, Fondo Abitare Sociale 1, for institutional investors only.[110] The Fund's investors accepted a target yield of two percent over inflation, capped at four percent over inflation with any excess going to other social housing initiatives. Importantly, the structure of the Fondo Abitare Sociale 1 was such that it set up a working party to collaborate with the municipal authority and the other sponsors of the initiative, assigning the role of developer of the social housing project to this multi-faceted group.[111] The fund was so successful in developing units, services, and public benefit structures that in 2008 it caught the attention of certain ministers of the Italian government.[112] Realizing the potential of the model, they injected further investments. This catalyzed more than EUR 2 billion from banks, insurance companies, and government in a matter of months.[113] The Fondo Investimenti per l'Abitare (FIA), a national fund of funds, was established as a result to manage this capital, which is being used to build social housing units for families "unable to meet their housing needs on the marketplace, but with incomes higher than those which would entitle them to public housing."[114] The foundation's first fund is the model upon which the FIA is based.[115]

To gain traction in scale, the impact investing industry needs to systematically produce products that are suitable to institutional investors. Despite some changes in attitude, modest margins and the long time period to scale impact investments have thus far made them largely unattractive to institutional investors, not to mention the high risk of failure.[116] But this is gradually changing. With the advancing discussion on the risk of "stranded assets" of blue chip companies that pension funds typically invest in – investments with large negative externalities that are likely to depress their value in the long run, such as in the oil and gas industry – impact investments are bound to become more attractive to this group over time.[117]

4.5. Impact Business Innovation: Private Sector Corporate Impact Venturing

With the economy in Europe struggling and in its sixth consecutive quarter of decline as of mid-2013, new sources of growth are essential. An increasingly interesting opportunity comes from corporate impact venturing: corporations tend to have smaller average deal sizes when they invest than traditional venture

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[107] Social Finance and Finetic, "Microfinance, Impact Investing, and Pension Fund Investment Policy Survey," *Social Finance* and *Finetic* (2012): 4, accessed May 1, 2013, URL: http://www.socialfinance.org.uk/sites/default/files/final_pension_fund_survey_october_2012.pdf.
[108] Fondazione Housing Sociale, "A Foundation for Social Housing in Italy," *Fondazione Housing Sociale* (2013): 2, accessed May 1, 2013. URL: http://www.fhs.it/eng.pdf.
[109] Genius Loci, "Fondazione Housing Sociale: Getting the Market to Target Public Needs," Social Innovation Europe, accessed May 1, 2013, https://webgate.ec.europa.eu/socialinnovationeurope/directory/news/fondazione-housing-sociale-getting-market-target-public-needs.
[110] Fondazione Housing Sociale, "A Foundation for Social Housing in Italy," 29; Genius Loci, "Fondazione Housing Sociale."
[111] Fondazione Housing Sociale, "A Foundation for Social Housing in Italy," 29.
[112] Ibid, 29.
[113] Genius Loci, "Fondazione Housing Sociale."
[114] Fondazione Housing Sociale, "A Foundation for Social Housing in Italy," 31.
[115] Ibid, 31.
[116] Harvey Koh et al, "From Blueprint to Scale: A Case for Philanthropy in Impact Investing," *Monitor Group* (2012): 7, accessed May 1, 2013, URL: http://www.mim.monitor.com/downloads/Blueprint_To_Scale/From%20Blueprint%20to%20Scale%20-%20Case%20for%20Philanthropy%20in%20Impact%20Investing_Full%20report.pdf.
[117] "Home," Carbon Tracker Initiative, accessed May 1, 2013, http://www.carbontracker.org/.

capitalists. Impact investment deals also tend to be smaller than traditional investments.[118] Thus, linking these two industries could be an untapped opportunity to better match deal sourcing and deal demand. The relatively high costs of the underwriting models of traditional commercial banks inhibit most from pursuing many of the available opportunities on the demand side of the impact investment space, and corporations could step in.[119] Corporate venturing could also help to overcome lack of skills and expertise, considered a major barrier to the growth of the impact investment industry. Most start-ups struggle in the go-to market phase of their development, as qualified sales specialists are expensive, established customers are wary to adopt products and services from unproven and young companies, and sales cycles can be lengthy."[120] As a result, "a partnership with a large corporation can deliver immediate and significant benefits for any type of start-up, whether socially focused or not. Not only can the partnering corporation be a client (as well as a beta-tester and first customer), but it can also open doors for the start-up with other corporations, shortening the sales cycle. Often enough, the start-up can tap additional resources such as advice; value added services, and sometimes executives from the corporation. The company is subsequently a potential buyer for the start-up."[121] Corporations are constantly looking for sources of non-traditional growth, and many engage in corporate venturing to this end with an innovative development leading to a trade sale. "For financial, strategic, and commercial reasons, companies are increasingly engaging in venture finance and supporting start-ups or spin-offs. For example, in the classical corporate venturing space, Intel Capital has done very well by financing start-ups that build an ecosystem for the flagship products of the semi-conductors specialist."[122] In 2011 alone, investments of USD 12 billion were raised for 83 corporate venturing funds from either a sole or a predominant corporate backer; the top 10 funds with a sole commitment by a corporation raised more than USD 8 billion.[123] These funds help companies to "harness external factors, trends, or ideas for sustainable business growth through impact venturing: essentially investing in, copying, or cloning sustainable value creation models from elsewhere."[124] From a policy perspective, corporate venturing can be stimulated with recipes similar to what has been described earlier in the discussion of the VC industry, in addition to generally providing an enabling business environment for the corporate venturing arms' parent companies.

4.6. Intermediation and Wholesaling: Financial Services

Finally, leading financial institutions are crucial for any functioning financial market. They are now starting to embrace impact investment on a global scale and are positioning themselves as potential key actors in order to mainstream this nascent space. Traditionally concerned with achieving financial returns for clients, major financial institutions are starting to see impact investments as an integral product of their offering for various reasons. First, there is latent client demand. Impact investment products present an adequate response to the rising investor appetite for investment decisions aligned with personal values calling for a larger individual and measurable impact. Second, with falling profitability in established asset classes, the impact industry presents an attractive potential for profit over the long term while the achievement of social returns can also boost reputation. Since the financial crisis of 2008, there has been a rise in such financial products in a number of countries.

Examples of large historical banks entering the impact investing space are JP Morgan Social Finance, a dedicated unit launched in 2007 to service the growing market for impact investments, or the "Investing with

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[118] Impact Investing Nieuws, accessed May 1, 2013, http://impactinvestingnews.blogspot.ch/.

[119] Association for Enterprise Opportunity (AEO), "The Power of One in Three: Creating Opportunities for All Americans to Bounce Back," *AEO*: 1, accessed May 1, 2013, URL: http://www.oneinthree.biz/documents/OneInThree_WebBrochure.pdf; The "One in Three Campaign" is a Clinton Global Initiative (CGI) America effort that seeks to accomplish the CGI goals of developing solutions that increase employment, advance access to education and skills development, strengthen energy security, and promote an environment for business growth and innovation by raising public awareness of the power of Main Street USA.

[120] Maximilian Martin, "CSR's New Deal: A Blueprint for Your First Hundred Days in the World of Impact Economy," *Impact Economy Working Paper* 3 (2013): 18, accessed May 1, 2013, URL: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2259632.

[121] Ibid, 18.

[122] Ibid, 18.

[123] James Mawson, "2011 Fundraising Reaches Record Levels: A Record Number of Corporate Venturing Funds Have Been Raised This Year," Global Corporate Venturing, accessed May 1, 2013, http://www.globalcorporateventuring.com/article.php/2855/2011-fundraising-reaches-record-levels?article_id=2855&tag_id=572.

[124] Ibid, 18.

Impact Platform" from Morgan Stanley launched in April 2012.[125] The key idea is to allow investors to access a range of investments that have been evaluated for their financial return potential as well as societal impact.[126] UBS, an early financial services philanthropy and impact investing pioneer that became active in the space in the mid-2000s, launched an impact investing fund-of-funds in 2013 together with Swiss emerging market private equity boutique Obviam.[127]

While many financial services firms are promoting their impact investing offering, the reliability and availability of the data is often fairly limited. There are some cases of disconnect between the state of implementation and what is being communicated to the industry and to clients. However, there are also well-established examples, showcasing the rise of impact investing. Deutsche Bank, which has been a pioneer in microfinance and currently manages over USD 200 million in microfinance assets, and community development funds with more than USD 1 billion in the US, is a leading player in the impact investing industry. The New Initiatives Fund (NIF) of the Deutsche Bank Americas Foundations, established in 1997, provides flexible financing for community development projects that serve the needs of poor and disadvantaged communities within the United States and throughout the developing world through a more than USD 16 million program-related investment portfolio.[128] Another leading actor is Credit Suisse, managing USD 1.8 billion in impact investments, primarily focused on microfinance and sustainable agriculture, on behalf of approximately 4,000 clients, including private individuals, institutional investors, and development finance institutions.[129] Frequently lacking in-house expertise, banks often collaborate with established and specialized investment firms. In January 2012, responsAbility, a Swiss fund manager, and Credit Suisse structured and distributed the Fair Trade Fund, which provides working capital to agricultural cooperatives supporting the development potential of small farmers in developing countries.[130]

Multilateral public agencies are active as well and are developing their potential for impact through partnerships with other impact investors, often through loan syndications and equity funds. The Dutch development bank (FMO), one of the largest European bilateral private sector development banks with a EUR 5.3 billion portfolio, communicates enthusiastically about its impact investment activities.[131] FMO seeks to specialize in sectors where its contribution can have the highest long-term impact, such as financial institutions, energy, housing, and agribusiness, food, and water. Furthermore, the UK's Department for International Development (DFID) also recently established a GBP 69 million Impact Fund that will be managed by a development finance institution (CDC) and will invest in impact investment intermediaries internationally with a mix of instruments that will include debt, direct equity investments, and guarantees. The CDC aims to invest GBP 2 billion from 2011 to 2015, averaging GBP 400 million per year; debt and direct investments shall each represent up to 20 percent of CDC's portfolio towards 2015.[132] The IDB Group is another DFI leader in channeling impact investing capital, this time to Latin America, particularly to countries underserved by commercial banks. The IDB Group states that each of its four private sector windows engage in impact investing, partnering with impact investors to co-finance deals: (a) the Multilateral Investment Fund (MIF) supports access to finance, markets, and basic services through loans, guarantees, equity and quasi-equity, as well as grants and technical assistance; (b) the Opportunities for the Majority Initiative (OMJ) invests in innovative business models that provide high-quality goods and services to low-income people; (c) Structured and Corporate Finance (SCF) leads the IDB's non-sovereign guaranteed lending in areas of infrastructure,

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125 "J.P. Morgan Social Finance," J.P. Morgan Chase and Co., accessed May 1, 2013, http://www.jpmorganchase.com/corporate/socialfinance/social-finance.htm.

126 "Investing with Impact," Morgan Stanley, accessed May 1, 2013, http://www.morganstanley.com/globalcitizen/investing-impact.html.

127 "Investing for Impact," Obviam, accessed May 1, 2013, http://www.obviam.ch/.

128 Deutsche Bank, "The New Initiatives Fund: A Portfolio of Social Investments," *Deutsche Bank* (1996), accessed May 1, 2013, URL: https://www.db.com/csr/en/docs/NIF_Brochure.pdf.

129 "Investors' Council Members," GIIN, accessed May 1, 2013, http://www.thegiin.org/cgi-bin/iowa/council/member/index.html#73.

130 responsAbility, "First Global Fair Trade Fund Launched," responsAbility (2012), accessed May 1, 2013, URL: http://www.responsability.com/domains%5Cresponsability_ch/data/secure_pdf/20120112_fairtradefund_e.pdf.

131 "Strong Growth Portfolio and Development Impact FMO," FMO Development Entrepreneur Bank, accessed May 1, 2013, http://www.fmo.nl/k/news/view/1757/179/Strong-growth-portfolio-and-development-impact-FMO.html.

132 "DFID Impact Fund," CDC, accessed May 1, 2013, http://www.cdcgroup.com/dfid-impact-fund.aspx.

financial markets, services and industries; and (d) Inter-American Investment Corporation (IIC) provides direct debt and equity financing and technical assistance to small and medium-size enterprises (SMEs).[133]

Together with the other players discussed above, the financial services industry has a unique potential to develop new products and channel capital to the real economy as sustainability becomes the new normal of doing business.

[133] “Impact Investing in Latin America and the Caribbean with the IDB Group,” IDB, accessed May 1, 2013, http://www.iadb.org/en/resources-for-businesses/impact-investing-in-latin-america-and-the-caribbean,5752.html.

5. Conclusion: From Niche to Mega

The reputation of mainstream finance has been called into question around the world in the aftermath of the financial crisis. Impact investing provides a major opportunity to demonstrate how finance and financial innovation are fundamental to making finance work for the long-term viability of the real economy and society, showing a way forward for the stewardship of society’s assets in the emerging sustainability imperative of the early twenty-first century.[134] However, as this section argues, to translate potential into scale, impact investing will need not only to engage in market-building facilitated by smart policy making and the emergence of a veritable impact investor ecosystem, but also have to come to terms with the need for increased transparency and forms of social impact measurement that are able to achieve industry consensus. Disclosure of reliable, credible, and comparable performance data is as critical a dimension in impact investment as it is in traditional investment.

The sheer breadth, depth and speed of progress makes a compelling case for the emerging impact investing industry as an innovation in finance whose time has come, especially in the aftermath of the financial crisis. To be able to deliver on its promise, the challenge now is to calibrate efforts and manage expectations.

The opportunity is massive. In *Finance and the Good Society*, Robert Shiller, one of the only experts to actually predict the financial crisis, makes the case that what is needed now is more financial innovation, not less. He states, “The financial crisis was not due simply to greed or dishonesty of players in the world of finance; it was ultimately due to fundamental structural shortcomings in our financial institutions.”[135] The irony, as Shiller emphasizes, is that “better financial instruments, not less activity in finance, is what we need to reduce the probability of financial crises in the future.”[136] Intermediation will be a key feature of the ability to grow the impact investment market, as it has been in traditional theatres of finance. A deeper review by government of “the requirements of obtaining licenses and registration could be modified to recognize that many of the potential players may come from backgrounds other than financial services and will be performing only limited activities typically associated with a financial professional.”[137]

The previous sections described the impact investing landscape and players, capital transmission channels and blueprints for solutions, and pointed to the need for market-building, policy, and eco-system design. In addition to the many activities under way, in closing it now examines the key impulses to best enable the impact investing industry, and “make impact investible” beyond a narrow field, and go from niche to mega.

5.1. Overcoming Market Building Barriers

Market-building is one key deliverable, as discussed earlier. Barriers to developing a more effective marketplace of impact investment persist. Fortunately, there are a number of straightforward steps that policy makers can take to help harmonize the field, leverage the megatrends, define the roles of investors and corporations, and increase transparency and harmonization. They include the long-term creation of more strategic commitments to stimulating, directing, or otherwise regulating the market, as well as more immediate and tactical repositioning, amending, or otherwise changing existing government policies. To obtain backing and maintain commitment, it is best to secure the quick wins first. Here are the four buckets of low-hanging fruits.

5.1.1 Choose new tools, optimize existing policies

More seed capital is needed, and governments need mechanisms for providing more capital to the market. This can be achieved via implementing new taxes, charges, and tradable permits; or perhaps more easily

[134] The Task Force for Global Health, “Collaborate and Innovate to Transform Global Health: 2012 Annual Report,” *The Task Force for Global Health* (2012), accessed May 1, 2013. URL: http://www.taskforce.org/sites/default/files/final_tfgh_ar12updated.pdf.
[135] Robert Shiller. *Finance and the Good Society. Kindle version. Loc 138 of 7174.*
[136] Shiller, Loc 171 of 7174.
[137] John Simon and Julia Barmeier, “More than Money: Impact Investment for Development,” *The Center for Global Development* (2010): 5, accessed May 19, 201, URL: http://www.cgdev.org/sites/default/files/1424593_file_More_than_Money_FINAL_web.pdf.

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harnessing underutilized capital, such as unclaimed assets and privatization revenue. Policy makers also need to be careful to create the right balance of regulatory restrictions so as to enable a fully functioning market. To do this, they can leverage existing institutions and provide grant-based funding to field studies, seed new market players, and replicate existing mechanisms, as some countries have already done successfully. Also needed is smart market-building action that allows for generally greater liquidity—the efficient clearing of impact investment capital supply and demand—by establishing market clearing mechanisms such as social stock exchanges or providing critical mass via wholesale financing entities.

5.1.2 Create, clarify, and combine legal structures

Policy is also instrumental when it comes to creating a basic level of transparency regarding fiduciary responsibility for impact investments. Moreover, some new legal structures can be created or copied from elsewhere. For instance, the L3C (low-profit limited liability corporation) mirrors the traditional LLC in the US, but allows for less of a focus on profitability. Yet it is also possible to simply clarify existing legal structures that are already on the shelf. For example, US tax structures allow foundations to invest directly in for-profit companies as long as the investment fits in line with a social mission. Most foundations do not take advantage of these program related investments (or PRIs) because the tax “rules create sufficient ambiguity to deter many foundations from making these investments.”[138] Interesting additional options between for-profit investments and tax-deductible donations are also conceivable, where a social investment contains some kind of tax deduction or incentive for the investor.

5.1.3 Leverage the private sector

Much could be gained from a more robust and incentivized engagement of the traditional finance industry. Investors could provide necessary expertise on how the various elements of the financial market could and should interact, and how the fragments of the impact investment market could become a more coherent and integrated social capital marketplace. Moreover, experts could help bring clarity to investments, create champions based on functional knowledge, and educate on topics such as currency and credit risk, as well as structuring new products, building needed market components and engaging in market-making for the impact investing industry. Doing this would serve the additional purpose of gaining a toehold in repositioning the financial services industry towards a more responsible state of practice.

5.1.4 Copy, clone and adapt best-practice instruments

The social impact bond (or pay for success program as it is known in the US) is a potentially effective new investment model being heavily replicated around the world. But there are other innovative financing mechanisms in the offering that could be explored and harnessed, such as the UK Big Society Capital (BSC) as a wholesaler of impact investment capital or the US CDFI Loan Fund, a program within the U.S. Department of the Treasury. The US CDFI Loan Fund allocates money and tax credits to community-based organizations in low-income communities across the US that provide financing for the purchase of a first home or starting a business, and works directly on improving recipients’ credit rating or helping them to create a monthly budget.[139] Governments can help to internationalize impact investment markets by collaborating on shared standards that will facilitate cross-border investment and overall growth of the impact investing industry nationally and internationally.

Government can also utilize its bully pulpit to educate and raise awareness, and create consensus around decision makers/stakeholders. Task forces such as the one that led to the creation of BSC might serve as another. This would enable different stakeholder groups to engage around an efficient impact investing value chain (e.g. business angels in the early stage, large corporations in the growth stage or via their corporate venturing arms in the go-to-market stage, or civil society with respect to the problem of identification of underserved segments of the population).

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[138] John Simon and Julia Barmeier, 5.
[139] “Information for the General Public,” Community Development Financial Institutions Fund, accessed May 1, 2013, http://www.cdfifund.gov/what_we_do/need_a_loan.asp.

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In terms of implementation, governments can appoint task forces to help create possible road maps that contain the right balance of regulatory restrictions and incentives so as to enable a fully functioning market, paired with market-building measures that leverage the competences of existing institutions and provide capital. When such task forces in different member countries share lessons learned, they can accelerate goal achievement in their respective jurisdictions as well as prepare the ground for international harmonization. For an overview of building blocks, see **Figure 4** below.

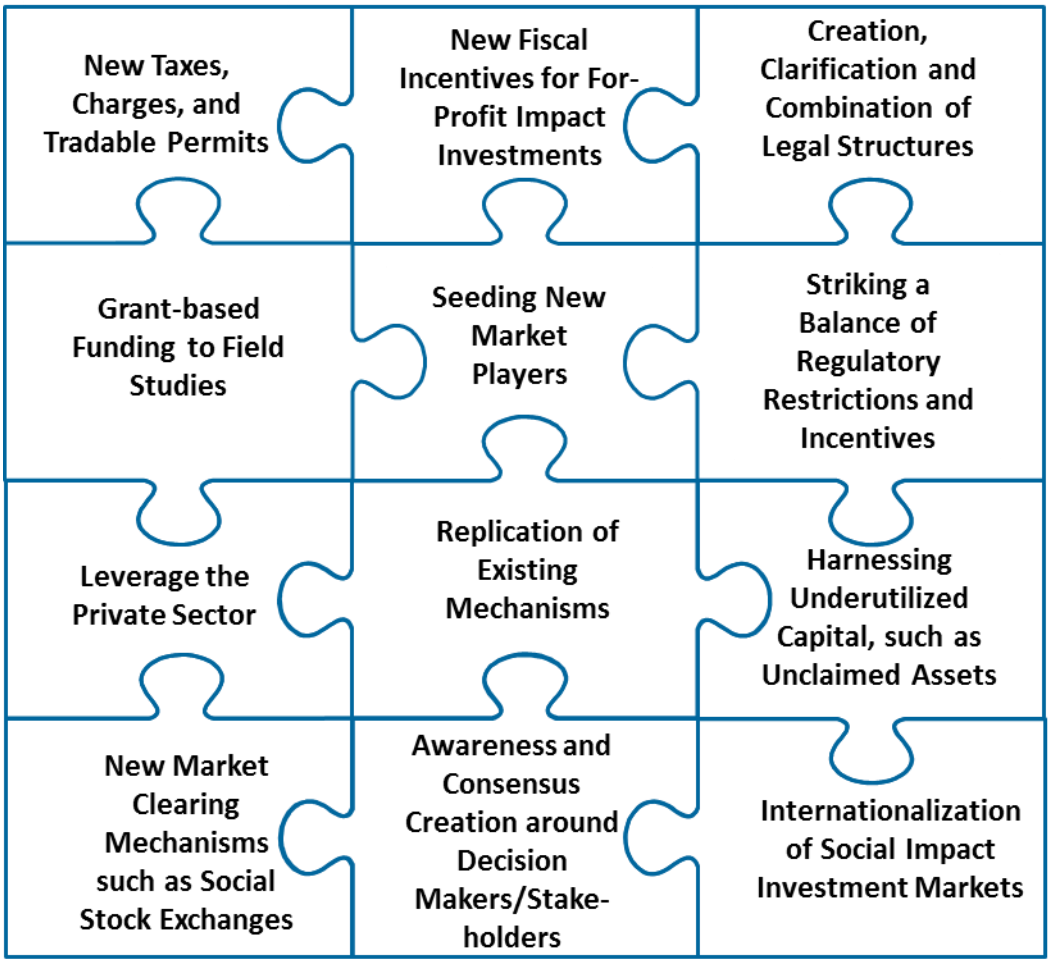

Figure 4: Building Blocks for a Fertile Environment for Impact Investments

5.2. Making Impact Mega: Displacing the Limitations of Current Measurement Systems

The state of the impact investing industry and the issues examined thus far provide grounds for optimism. Mainstreaming impact investment is possible – a key focus of the UK's Presidency of the Group of Eight (G8) in 2013. The development of a far more effective and larger marketplace could be around the corner.

But while the advancements achieved thus far are impressive, there is a key blocker that could stand in the way of scale: impact measurement. True progress will be hampered until we begin to focus on this final variable, discussed in this concluding section: the need for greater transparency about social impact. At the most basic level, "Investment capital moves based upon its understanding of future opportunity—the risk, reward and performance offered by any given investment, fund or manager." Disclosure of reliable, credible, and comparable performance data is a critical dimension of traditional investment and similar transparency must become a part of impact investment. "One cannot frame an understanding of future potential in the absence of insights regarding past experience. In the absence of existing data, and without a basic level of data integrity, investors have nothing upon which to build projections of future performance and prospects.”[140]

Whether increased transparency is a viable way to mainstream impact investment remains to be seen, but evidence strongly points to it being the most significant opportunity on the horizon. “The lack of information on the success (or failure) of social investments inhibits the flow of capital into the sector and forces analysts to rely on anecdotes and case studies to outline social impacts.”[141] One central element in increasing the potential attractiveness of impact investing to investors is to increase awareness about what sets impact investments apart from traditional investments: the creation of positive impact. If this impact creation is not demonstrable, the entire concept of impact investing becomes moot. Indeed, the persistent lack of universally applicable and accepted impact measurement standards is repeatedly cited as one of the top issues facing impact investing.[142]

To that end, efforts both direct and indirect to the impact investment industry have attempted to increase transparency via the creation of a few notable, leading measurement systems. Direct systems are the Impact Reporting & Investment Standards (IRIS) and the Global Impact Investment Rating System (GIIRS); and indirect systems include ESG standards, UN Global Compact, UN PRI and the Global Reporting Initiative (GRI). The systems mentioned above show that the impact investing industry in general and impact measurement specifically have been characterized by fast-paced and stringent innovations. It is clearly neither lack of effort or lack of competence that hampers the industry’s ascent into the financial mainstream. These individual systems have made great strides in creating the ability for investors to measure the nonfinancial performance of their investments and, in some cases, the opportunity to compare the relative nonfinancial performance of one investment to another investment, or aggregate benchmark of investments.

However, these systems are limited. A March 2011 meeting hosted by the Federal Reserve Bank of San Francisco discussed “Advancing Social Impact Investments through Measurement,” and enumerated many of the issues with the current measurement landscape. The main barriers to impact measurement that were highlighted in the discussion focused on lack of longitudinal data; benchmarks; third party verification; transparent methodologies; and publicly available and voluntarily provided reporting.[143] Most of the systems discussed here focus on performance data from developing countries, and more work will need to be done to truly standardize the field.[144]

Large, institutional investors need clear, actionable data to join in on impact investments. The importance of transparency and disclosure is so critical to the development of the sector that one prominent impact investing thought leader said that impact investing’s “yellow brick road may well wind through ESG reporting.”[145] Increased impact reporting through greater transparency is the key to scale up the social investment market. Governments and philanthropic funders can help build that “yellow brick road” and respond to the limitations of current leading systems by incentivizing harmonization and emergence of measurement standards apt to support institutional investment. With greater disclosure of returns—both social and financial—of impact investments, a large-scale marketplace can begin to develop and flourish.

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[140] Cathy Clark et al, “The Impact Investors: The Need for Evidence and Engagement,” *Pacific Community Ventures, Inc., ImpactAssets,* and *Duke University’s Fuqua School of Business* (2012): 7, accessed May 1, 2013, URL: http://www.pacificcommunityventures.org/uploads/reports-and-publications/The_Impact_Investor_201203.pdf.
[141] John Simon and Julia Barmeier, 3.
[142] For reference, see for instance Credit Suisse (2012), Monitor Institute (2009), or J.P. Morgan (2010).
[143] Ben Thornley et al, “Advancing Social Impact Investments through Measurement Conference: Summary and Themes,” *Community Development INVESTMENT REVIEW* (2011), accessed May 1, 2013, URL: http://www.frbsf.org/publications/community/review/vol7_issue2/Review_vol7_issue2.pdf.
[144] For example, “A number of foundations have expressed concerns about the applicability of the IRIS indicators to its portfolio of domestic PRIs. In addition, some foundations are questioning whether the types of measures that can be standardized into common indicators (e.g., acres of land, number of seats in schools) are sufficient to demonstrate social impact.” Melinda T. Tuan, “Impact Capital Measurement: Approaches to Measuring the Social Impact of Program-Related Investments,” *Robert Wood Johnson Foundation* (2011): 27, accessed on May 1, 2013, URL: http://www.rwjf.org/content/dam/web-assets/2011/11/impact-capital-measurement.
[145] David Bank, “Yellow Brick Road to Impact Economy,” Huffington Post (2012), accessed May 1, 2013, http://www.huffingtonpost.com/david-bank/bloomberg-impact-investing_b_2322665.html.

Better infrastructure, systems, and processes across investment platforms will help drive a global impact investment marketplace.

In addition to capital supply, capital demand, and capital use policies, philanthropic funders keen on market-building play a critical role in developing the different industry components mentioned above to support the growth of the marketplace. Creating standards and establishing norms will set the stage for further development by actors at all levels of the social investment landscape, including mainstream businesses. Traditional businesses and investors all have an important role to play in supporting and driving these infrastructure developments, as they will eventually benefit financially from the increased market opportunity, as shown in the section on "megatrends."

Let's be clear: impact investment as a field of practice is at an inflection point. Either it will address the critical barriers still limiting broader growth and capitalize on its amazing potential – or, if history is any indication, it will settle on the margins of conventional investment and be replaced by a new term and concept sometime in the next five to ten years. Making impact investible is the biggest opportunity in finance in at least a generation, and the adjustment needs in our sustainability century are real. If impact investment does its homework, and asserts itself as an investment style rather than an asset class, the ramifications of this USD 36 billion industry for the overall competitiveness, prosperity and sustainability of the world's market economies could very well exceed the estimate of an asset class reaching 0.1 percent of all financial assets by 2020.

6. Twelve Suggestions for Further Reading[146]

Accenture, "Long-Term Growth, Short-Term Differentiation and Profits from Sustainable Products and Services: A global survey of business executives," *Accenture* (2011), URL: http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Long-Term-Growth-Short-Term-Differentiation-and-Profits-from-Sustainable-Products-and-Services.pdf.

Bain & Company, "A World Awash in Money: Capital trends through 2020," *Bain & Company* (2012), URL: http://www.bain.com/Images/BAIN_REPORT_A_world_awash_in_money.pdf .

Ben Thornley et al, "Impact Investing: A Framework for Policy Design and Analysis." *Insight at Pacific Community Ventures & The Initiative for Responsible Investment at Harvard University* (2011), URL: http://www.pacificcommunityventures.org/reports-and-publications/impact-investing-a-framework-for-policy-design-and-analysis/.

Canadian Task Force on Social Finance, "Mobilizing Private Capital for Public Good," *Canadian Task Force on Social Finance* (2010), URL: http://socialfinance.ca/uploads/documents/FinalReport_MobilizingPrivateCapitalforPublicGood_30Nov10.pdf.

Harvey Koh et al, "From Blueprint to Scale: A Case for Philanthropy in Impact Investing," *Monitor* (2012), URL: http://www.mim.monitor.com/downloads/Blueprint_To_Scale/From%20Blueprint%20to%20Scale%20-%20Case%20for%20Philanthropy%20in%20Impact%20Investing_Full%20report.pdf.

E.T. Jackson and Associates Ltd., "Accelerating Impact: Achievements, Challenges and What's Next in Building the Impact Investing Industry," *Rockefeller Foundation* (2012), URL: http://www.rockefellerfoundation.org/uploads/images/fda23ba9-ab7e-4c83-9218-24fdd79289cc.pdf.

Marco Da Rin et al, "Public Policy and the Creation of Active Venture Capital Markets," *European Central Bank* (2005), URL: http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp430.pdf.

Maximilian Martin. CSR's New Deal: A Blueprint for Your First Hundred Days in the World of Impact Economy (April 1, 2013). *Impact Economy Working Paper, Vol. 3*. URL: http://www.impacteconomy.com/en/wp3.php.

Monitor Institute, "Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry," *Monitor Institute* (2009), URL: http://www.monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf.

Nick O'Donohoe et al, "Impact Investments: An Emerging Asset Class," *J.P. Morgan* (2010), URL: http://www.rockefellerfoundation.org/uploads/files/2b053b2b-8feb-46ea-adbd-f89068d59785-impact.pdf.

UK Cabinet Office. "Achieving social Impact at scale: Case studies of seven pioneering co-mingling social investment funds." Social Investment and Finance Team (2013), URL: https://www.gov.uk/government/publications/achieving-social-impact-at-scale.

World Business Council for Sustainable Development, "Vision 2050: Executive Summary," *WBSCD* (2010), URL: http://www.wbcsd.org/pages/edocument/edocumentdetails.aspx?id=219.

[146] For general ease of access, this section recommends reports in English only. Depending on the national language of the reader, there may be other reports that are of interest. We plan to publish a comprehensive bibliography for sector research in due course.

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