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# NEW TRENDS IN IMPACT INVESTING POLICY

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**Executive summary**

*Impact investing is rapidly growing both in developed and developing countries. Despite lack of consensus on what impact investing exactly is, impact investing policy has become a key component of many economic policies. In recent years, several trends have emerged that are common to various countries and that can be described as best practice: improved coordination of the impact investing policy with the overall economic policy; creation of impact investing/sustainable finance platforms that allow for knowledge sharing and communication between stakeholders at the national level; development of regulation both in positive (creating new rights) or negative (dismantling obstacles to investment) steps; use of tax incentives in a coherent and targeted way; development of new tools, investments and programs; and lastly increased emphasis on the leveraging of public funds. These trends should generate increased interest both in academia and in Governments to step up efforts toward measurement of policy effectiveness.*

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While Governments both in developed and developing countries increasingly turn their eyes toward Impact Investing, opinions still differ on the relative significance of the Impact Investing paradigm, from a niche market[2] to an important trend[3]. These discrepancies may relate to differences in definition of what Impact Investing is and is not. Sustainable finance is sometimes being tantamounted to Impact Investing, with possible definition such as: "any form of financial service integrating environmental, social and governance (ESG) criteria into the business or investment decisions for the lasting benefit of both clients and society at large", which is obviously broader than the GIIN definition[5]: "Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return". Impact Investing will be identified here as any investment intended to generate a measurable impact on the social and environmental spheres, bearing in mind that Impact Investing is part of a continuum that public policies have to envisage in a holistic way.

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[2] According to a 2016 McKinsey report ("Achieving Impact for Impact Investing, a road map for developed countries") on p 6: « Impact Investing is still a niche market in most developed countries, with limited evidence of its financial performance". https://www.mckinsey.de/files/report_impact_investment.pdf

[3] See for instance the opinion of an industry expert: https://www.linkedin.com/pulse/3-reasons-why-impact-investing-becoming-mainstream-cynthia-ringo/

[5] See https://thegiin.org/impact-investing/ , homepage.

Whatever the differences in definitions, market consensus takes it for granted that Impact Investing extraordinary growth will continue in the coming years[6], which should incentivize policy makers to devote more efforts to take advantage of it and maximize its outcomes. Assuming that the objectives of Impact Investing policy can be briefly summarized as (i) increasing the Impact Investing flows; (ii) improving the efficiency of public spending through leveraging of private finance; (iii) improving the sustainability outcome and impact of private finance investment; (iv) addressing social and environmental challenges that require more attention and investment[7], many Governments are actively studying and implementing international best practice. Recent trends in Impact Investing policy are synthetized below, in the hope to support primarily emerging economies to take the necessary steps that will allow them to reap the much sought-after rewards.

**Principles of Impact Investing policy**

As Impact Investing increasingly gains in maturity after the pioneering phase, Governments are henceforth expected to implement coherent and consistent policies. Best practice underlying principles have been formulated in 2013 as the five London principles by the Impact Investing Policy Collaborative (IIPC)[8] and remain fully relevant today. They imply:

(i) clarity of purpose (which requires a good understanding of the potential and limitations of Impact Investing)
(ii) stakeholder engagement (Impact Investing policy should not be designed in an authoritarian and secretive way)
(iii) market stewardship (supply, demand and intermediation should grow harmoniously in a balanced way)
(iv) institutional capacity (public bodies should have the required expertise and know-how)
(v) universal transparency (allowing for accountability and sharing of experience and knowledge)

These principles are valid for both developed and developing countries, although relatively more emphasis may be put in the latter on capacity development and possibly less on market stewardship (as domestic capital supply may play a lesser role), while these differences can be considered only as a matter of nuances.

**Coordination with economic policy at large**

Policy makers are getting increasingly aware of the role that Impact Investing can play within the overall economic and social policy. As more Governments are trying to align the private sector with the development strategy, it is getting clearer that Impact Investing may help to reduce the social downsides often linked to the play of the market forces such as inequalities, social issues, environmental degradation. It could be argued that Impact Investing contributes to “internalize the externalities” by introducing economic incentives to social/environmental issues or allowing operators interested in those issues to enter the market.

[6] See for instance https://www.forbes.com/sites/annefield/2017/01/31/more-evidence-impact-investing-growth-and-what-it-means-for-social-entrepeneurs/

[7] For an alternative framework around three pillars (supply development, directing capital, demand development), see: Impact Investing: A Framework for Decision Making - Global Impact , GIIN, 2013.

[8] See for instance https://www.huffingtonpost.com/ben-thornley/impact-investing-the-london-principles_b_3594304.html

At Development Finance Institutions (DFI) level, although the term of "Impact Investing" is not systematically used internally, consensus has emerged in the recent years that the mission of the respective institutions is closely linked to the growth of Impact Investing[9].

Governments as well follow suits. One of the main task of the policy makers consists in ensuring a conducive enabling environment. As private capital is involved, a large part of the required steps is included in the private sector development strategy: whether traditional or impact investment, capital flows typically require long term visibility, rule of law, clear legal framework, adequate judiciary system, macroeconomic stability, well educated workforce… all well-known requisites for a well-grounded Impact Investing strategy.

Harmonization and coordination remains a necessity: given the diversity of investors (DFI, private investors, foundations, family offices, pension funds, etc.), investment sectors (social, industry, agriculture, agri-business), community levels involved (municipalities, regions, provinces,…), public policy makers have to connect the dots by ensuring coordination and non-contradiction between the various dimensions of the economic and social development strategy.

Ultimately, Impact Investing policy may be used to mitigate the effects of other parameters of the economic policy required for macroeconomic balance or other considerations. For instance, the transition to green economy may mean to stop direct or indirect subsidy to high carbonate products. This may specifically adversely affect the poorer part of the population. In that context impact investment may alleviate the negative effects through *inter alia* developing alternative mobility modes or offering more jobs in impoverished areas.

**Impact Investing platforms**

Many governments have understood the added value of creating a sustainable finance platform where stakeholders can meet, discuss the needs, share experience and, as the case may be, prepare regulation. Such a platform aims at engaging the stakeholders to create a dynamic around the development of a financial center geared toward a sustainable and low carbon economy.

Examples of such platforms with their national specificities include UK social investment taskforce[10], French Finance for Tomorrow (launched in June 2017)[11], Swiss Sustainable Finance[12] or Dutch Sustainable Finance Platform[13]. Usually placed under the chairmanship of the Central Bank or the Ministry of Finance, they convene private (investors, banks and insurances, social enterprises, NGOs) and public sector (social and economic ministries, local collectivities) stakeholders. They normally do not have any regulatory authority but their legitimacy derived from their inclusiveness and representativeness may inspire, prepare, support and monitor public policies.

**Case study 1: Finance for tomorrow Paris**

Launched in May 2016 by Paris Europlace, the Paris Green and Sustainable Finance Initiative published a report in November 2016 detailing the long-term objectives as well as recommendations. Under this background, i, the platform Finance for Tomorrow has been created in June 2017 and

[9] See Impact Investing in development finance, initiative for responsible investing, 2014 iri.hks.harvard.edu/.../impact_investing_in_development_finance_dfis.pdf.

[10] See https://www.gov.uk/government/groups/social-impact-investment-taskforce

[11] See https://financefortomorrow.com/

[12] See http://www.sustainablefinance.ch/

[13] See https://www.dnb.nl/en/about-dnb/co-operation/platform-voor-duurzame-financiering

convenes major stakeholders under the chairmanship of Mirova, a leading social investment fund. The report identified 15 proposals to develop the Paris Financial center with regards to transition to green economy and sustainability. These proposals are being implemented by the platform through six working groups: identification of needs, green financial centers benchmarking, public affairs, climate financial disclosure, green bonds, brand and communication.

Members are both private and public organisations representing the main stakeholders. Governance bodies includes a board chaired by Mirova's Chairman, Mr. Philippe Zaouti, and a plenary committee that meets 3 or 4 times a year.

Finance for Tomorrow assumes that Paris can take advantage of its advanced positioning on the green bonds market (attributed to the inductive regulatory framework) to consolidate its leading edge in sustainable finance.

With the intensification of the competition between the financial centers, the platforms are due to play a growing role in the attractiveness of a given center. They facilitate dialogue and make sure the views of all stakeholders are taken into account when elaborating policies and regulations. In addition, they provide an important communication tool in the public relations campaigns for the promotion of the financial center in impact investing areas.

Ultimately the effectiveness and credibility of financial platforms depends to a large extent on how much their recommendations are implemented and translated into action, which is the prerogative of the market authorities.

**Regulation**

While platforms are encouraged as an important element of the sustainable finance ecosystem, appropriate regulation (or its absence) is widely viewed as key factor in the development of impact investing.

Theoretically regulation policy can include two dimensions: a positive one, with measures conducive to impact investing, and a "negative" one, with the dismantling of barriers to investment.

In the first category, small steps can be taken to encourage social investment or help secure their impact. They may involve corporate law to protect the social missions of social entrepreneurships, even in the case of majority shareholders' adverse decision. Some States in the US have gone down that road. For instance, a 2010 Maryland law allows 5% of shareholders to sue a "benefits corporation" if it does not respect its social mission; a Californian law puts the bar to change the purpose of a Flexible purpose corporation to two thirds of the voting rights among shareholders. Such mechanisms of mission lock, as well as of third party evaluation of the social mission (whose report must be considered by to the Board), are seen as encouraging social investment, although it is not clear whether the overall effect on the market is positive.

A maybe more spectacular example is the 2015 French so-called "law on energetic transition (TEE)". Its article 173 imposes large corporates, banks and investors to disclose information on carbon footprint. It seems that this regulation has been very effective in creating a growing awareness in the environmental effects of economic activities and supporting investors willing to reallocate their portfolio among these lines as well as efforts to reduce negative environmental impact.

Regulation policy consists also in screening the existing regulatory framework to identify obstacles to impact investing. Most of the existing regulation were implemented with the objective to reduce risks for investors, which sometimes comes at odd with the development of impact investing. An example deals with the regulations around the promissory notes, which are a financing tool well suited to the needs of social enterprises. Under the European directive "Undertakings for the Collective investments in transferable securities", promissory notes are not considered as transferable securities, and as such cannot benefit from the European passport. This creates a major issue for the so called 90/10 funds (French funds that can be invested for 10% in social projects and benefit from tax breaks) that cannot be marketed in Europe. Another example involves the 2008 rescinding by the US Department of Labor of a regulation submitting pension funds impact investment to extra scrutiny, which in practice prevented any transaction

The regulatory framework should be reviewed on a permanent basis to be adapted to the development of the market, get inspiration from the competitors and constantly modernize the legal environment in line with shifting priorities. However, the pace of change should not be seen as threatening the visibility and stability which are required by the long-term investors.

**Tax**

Tax law is traditionally one of the most powerful instrument that policy makers may play with. It is increasingly taken into account by Governments to make with the specificities of Impact Investing.

A rapid view of tax law in the USA and France would allow to mention the following examples:

- A 2015 IRS revised guidance for foundations missions related investments. Foundations can now invest their assets in projects aligned with their mission without fearing tax penalties for below-market investment.
- Program related investments (PRI) that finance social projects offer income tax advantages
- The French 2014 law on the "économie solidaire" requires a significant social impact for the social companies eligible to company staff savings (providing tax advantages to the subscribers)
- French life Insurance contracts ("contrat vie génération") benefit from death tax exemptions since 2013

In tax matters however, it easily happens that windfall profit behaviors distort economic activity, which generates suboptimal capital allocation. Caution must therefore be exerted before creating undue advantages for certain categories of investment. Besides effective capacity of the Government to implement its policies is also required, for instance when the investor has to demonstrate environmental or social impact to take advantage of the tax break. Arbitrary decisions may have an adverse effect on investors, and the market place in general.

**Developing new tools, instruments and programs**

The development of financial innovation goes hand in hand with market growth both as cause and response to growing demand. Policy makers need to facilitate or stimulate the supply to keep pace with the movement. A non-limitative list could mention *inter alia*:

- Green bonds, which are no longer a novelty in mature markets. However, developing countries could have a more aggressive policy in this regard, at least as issuers tapping advanced financial places as London or Paris.
- Social bonds could take off following the same path. They originated in the UK with Program Related Investments (PRI) consisting in the Government issuing bonds which remuneration is linked to the success of the social program. If the program is successful, the investor perceives higher interest. The cost is not necessarily heavier to the Government or to the public interest as a successful social program may result in lower ulterior social spending. For

instance, a program for drug addicts cure and reinsertion may generate economic gains for the beneficiaries as well as for social security systems. Similar schemes may be developed elsewhere: for instance, French working groups have proposed that the Government (or a third party) may finance the interest incentive in case the bond is issued by a social enterprise. In developing countries, DFI under a financing support program could play the role of the public authority.

- New resources for impact investment may be gained with the development of investment funds. In England the Big Society capital was created using resources coming from unclaimed bank accounts.
- A strong incentive to the development of the social investment market has been observed in France with the creation of the so called 90/10 Savings products: 90% of the funds are invested on the conventional market and 10% on the social market, which offers the benefits of an exposure to the social investment while limiting the risks. Every corporate has to propose its staff such savings products opportunities which are offered tax breaks. Life insurance and pension funds can also implement similar schemes.
- Financial innovation is not limited to new products but may also involve market infrastructure. In that sense the facilitation of crowdfunding (largely hampered by regulatory restrictions on offering of financial products) helps providing easier access to financing for small social entrepreneurs. According to a EU report from January 2017[14], crowdfunding is still concentrated in a handful of countries in Europe (UK, France, Germany, Italy, Netherlands). But the market is rapidly growing. Developing countries could take advantage of existing platforms or regroup to promote regional platforms well adapted to their needs[15].

**Leveraging public finance**

Renewed emphasis on the catalytic character of public finance has been observed in the last few years. As a sign of growing interest for the matter, OECD is expected to publish blending guidelines for policy makers and stakeholders in late 2017. In general terms, blending means that a project is financed with a mix of public and private financing sources. Under such a scheme, one dollar of public investment generates a number of times more private investment (which require to make it happen the intervention of the public finance). Through public finance, private capital risk is limited (through first loss mechanism or risk sharing schemes) and private flow is stimulated via demonstration/umbrella effect. Another formula for blending is the use of concessional funds to finance part of a project, the remaining utilizing commercial funds. The overall cost for the borrower is lowered, making the project more affordable, especially in the case of a Public Private Partnership (PPP) where the project delivers a public service in which tariff is a major issue. Blending under a different name (such as viability gap) was traditionally used in PPPs when the commercial financing made the project too expensive to be self-sustainable, especially when targeting poorer part of the population that cannot afford to pay market rates. Under a viability gap scheme, the Government participate in the capital investment, reducing in this way the need for private finance.

Climate finance has so far made an extensive use of blending. The incoming challenge is to duplicate this experience toward the social sphere, which may prove difficult as public funds may not be as

[14] Crowdfunding in Europe, introduction and state of play
www.europarl.europa.eu/.../EPRS_BRI(2017)595882_EN.pdf

[15] Diasporas could play an important role in this regard as platforms' stakeholders. See for instance the works of C. Kingombe on this topic (i.a in DRC:
http://www.academia.edu/31428506/Diaspora_Direct_Investment_Inflow_into_Democratic_Republic_of_Congo_v2)

readily available as those which have been committed for climate funds. Another difficulty to overcome in blending is the induced complexity and excessive delays in the closing of projects. In this regards it is striking to notice that the rate of utilization of the climate funds is significantly lower than expected.

Another approach is to make the whole PPP project an impact investment. Infrastructure finance is particularly well-suited to maximize the social and environmental impact, for instance through the integration of the impact elements in the competition between bidders as evaluation criteria, relating to factors such as:

- Number of local jobs (including youth or women)
- Percentage of national jobs
- Industrial integration
- Program of support for the local economy

During contract operating period, the remuneration of the operator may depend on key performance indicators (KPI) linked to social performance.

**Case study 2: Morocco solar power program Noor**

Under this successful program, the Morocco Agency for Solar Energy (MASEN) implemented in the impoverished Ouarzazate region at total of 580 MW consisting in 3 solar power plants.

- Project debt was a pass-through from MASEN to the project company, thus providing concessional financing conditions to the project. Equity was injected by the sponsors on a commercial basis.

- Industrial integration (Moroccan subcontractors) amounted to 30% of the project capital costs for Noor I and 35% for Noor II and III

- local youth and women to primarily benefit from the job offers

- social investment program for the development of the area

- Affordable energy generation costs

- Carbon import substitution

**Conclusion**

The trends briefly described in the above will no doubt continue to dominate the scene in the coming years. Innovation and knowledge sharing being part of any successful policy, the “toolbox” initiated here is meant as a starting point to support the efforts of policy makers to take advantage of the international best practice and adapt them to the specific needs of their country. Impact investment is characterized by the drive to measure impact. The same should be said of impact investment policy, for which too little research is currently undertaken. It is hoped that more researchers will take interest in impact policy effectiveness and contribute to its continuous improvement.