Impact investing: the missing link in sustainable development finance?

Understanding impact investing and its role in development finance

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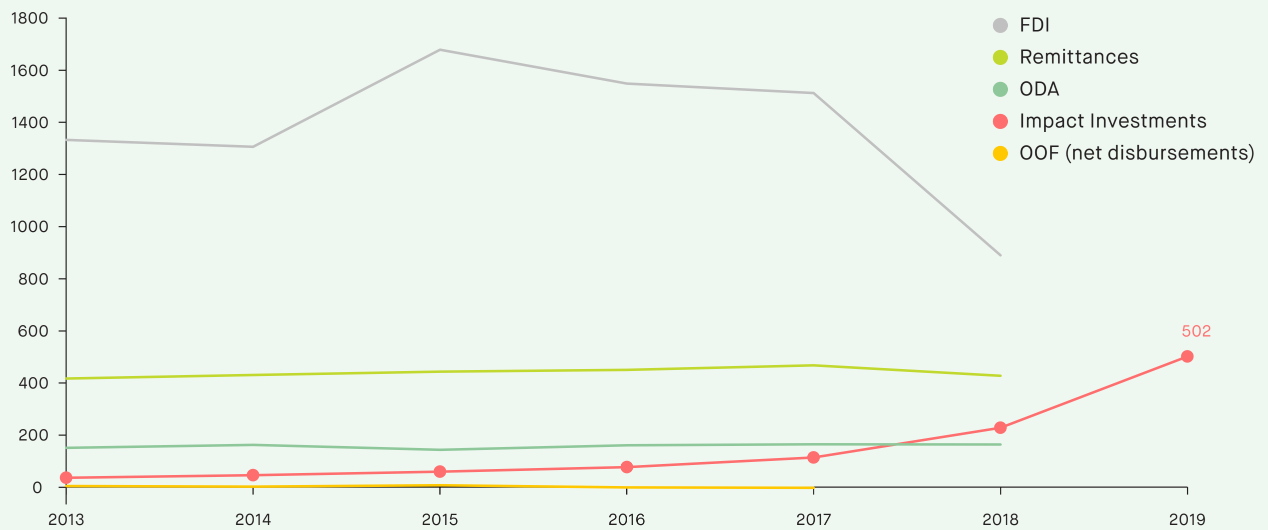
In recent years, impact investing — investing done with the intention of generating social impact alongside financial returns — has become a top trend in development finance. Seen by its proponents as an attractive way of financing large-scale social impact, particularly in developing countries, impact investing is a growing field with the potential to bridge the chasmic financing gap between current official development assistance (ODA) levels and the UN Sustainable Development (SDGs). Could it be the next-generation solution to sustainably and sufficiently finance global development?

Impact investing: an alternative way of financing the SDGs?

According to the 2014 UN World Investment Report, the financing gap to achieve the SDGs in developing countries is estimated to be US$2.5 trillion per year. Meanwhile, current data on both official development assistance (ODA) and foreign direct investment (FDI) shows a steep decline in external financial flows to countries.

Figure 1: Growth trend — impact investing compared to other development finance, US$ billions



Source: Impact investing data from Global Impact Investing Network (latest data available as of April 2019). Foreign Direct Investments (FDI; outward flows), official development assistance (ODA; net disbursements) and other official flows (OOF; net disbursements, unavailable for 2018) according to OECD. Remittances (outflows) according to World Bank. All data shown in current prices.

Evidently, much of this gap will need to be filled by private finance, and the impact investing market is well-poised to make this leap. At a current value of US$502 billion, the impact investing market is roughly triple the size of net ODA from all OECD DAC donors (US$149.3 billion in 2018). And its size is growing: impact investing is predicted to reach as much as US$1 trillion by 2020, while other forms of development finance – including for foreign direct investment (FDI), ODA, and Other Official Flows (OOF) – are on the decline.

What is impact investing?

Impact investing falls under the broader umbrella of social investing, which encompasses other types of investments such as social-enterprise investing, sustainable and responsible investing, ethical investing, blended value investing, and social enterprise investing.

Impact investing is the approach of investing in organizations, companies, or funds with the intention of creating measurable social impact alongside the potential to yield financial returns. Impact investing falls in between traditional investing — investing for the sole purpose of financial return— and traditional philanthropy — using grant-based funding for social purposes without expecting financial returns.

How is impact investing different from other forms of investing?

The United Nations Development Program (UNDP) distinguishes impact investing from these other forms of investments by three criteria:

- The expectation of a financial return: investments are made with the intention of generating positive social impact and the expectation of yielding financial returns, which then ensure supply of private financial flows essential for sustaining the model in the long run.
- The commitment to measure impact: As a result of the clear-cut expectation of financial return, impact investments are mandatorily subject to impact measurements. Currently, there are multiple methods of measuring non-financial impact with no unified system of harmonizing data or comparing impact across sectors (see textbox for more information).
- The intention to tackle social challenges: this includes not only providing capital to positive-impact businesses (i.e. social enterprise investing) or excluding negative outcomes (i.e. ethical investing) but also taking the process a step further by intentionally integrating social value creation ("impact") into investment decisions. (i.e. impact investing).

Systems for measuring impact in impact investments:

- Impact Reporting and Investment Standard (IRIS): collects and aggregates data from organizations anonymously and provides generally accepted performance measurement metrics.
- Global Impact Investing Rating (GIRS) System: conducts impact rating analytics based on company performance and portfolio impact.
- Sustainable Accounting Standards Board (SASB Standards): develops accounting standards to facilitate the disclosure of material sustainability information for investors.

Who are impact investors?

According to estimates from the Global Impact Investing Network (GIIN), there are more than 1,340 organizations managing impact investing assets worldwide and this number is growing, in both OECD and non-OECD countries.

Impact investors range from government institutions and development finance institutions (DFIs) to banks and pension funds. Impact investing can be made across asset classes, including through private or public equity, fixed income, real assets, hedge funds, and cash. Goals of these investments can encompass a broad range of social issues, such as restructuring loans to facilitate credit lending in developing countries, using shareholder engagement to advance racial and gender justice, diversifying investments to coordinate disaster relief and humanitarian aid to developing countries, and providing risk capital to catalyze sustainable green businesses.

What are the implications of impact investments on ODA?

Impact investments overcome several key challenges associated with traditional development finance

For several decades now, the traditional loan-based development financing model has been critiqued as counterproductive to long-term growth and economic stability in recipient countries, due to issues around economic dependency, political compromise, and structural adjustment. Impact investing could move beyond some of these challenges given its ability to:

- Generate profits to sustain long-term development: by channeling private sector funding into social impact services and bringing the financial returns back to investors, impact investing attracts additional private finance and encourages private-public cooperation in the development space.

- Broaden the scope of social impact: private funding leveraged through impact investing can be used to supplement government funding for social issues which may not have received dedicated financial resources otherwise. Additionally, impact investing ventures that work directly with local enterprises contribute to the long term development of local financial markets and communities.

- Increase accountability and evidence-based learning: impact investing measurements maintain accountability and ensure transparency. This data can also be used to guide the development of new models.

A growing number of impact investors (see textbox) are seen to be aligning their investment performances according to the 2030 Agenda Goals. This signals a powerful change in investment strategies, with the potential to reshape the global development financing landscape.

Current challenges with impact investing

Despite the progress made thus far in impact investing, it is yet to maximize its full potential as a development financing instrument. Currently, most impact investing comes from DFIs and major social foundations. The full power of the private capital market is waiting to be harnessed.

Another key challenge is the issue of measuring and quantifying impact. As impact investing ventures vary, so do their measurement techniques, making it difficult to attain universal standardization. Lack of standardized metrics makes it harder to quantify and compare non-financial impact, thereby reducing consistency across sectors.

Finally, because the impact investing market is still in its intermediary stages, there is a lack of widespread awareness on investing options. According to a recent study by Financial Times, the biggest concern for investors is finding suitable impact investing opportunities and obtaining tailored mentorship for the process. The lack of an efficient impact investing "ecosystem" results in significant time and resources being consumed before investors can successfully venture into the market.

Investors to watch

- Encourage Capital: deploys private capital to solve critical environmental and social problems.

- Aavishkaar: invests in early-stage enterprises in rural and underserved geographies, through venture capital financing.

- Leapfrog Investments: invests in high-growth financial services and healthcare companies in emerging markets.

More research on investing options will strengthen investors' interest in the area

Although launching impact investing can be complex, additional research and market experience could increase the efficiency of impact investing as a large-scale social service delivery model – which in turn could be invaluable for solving world's most pressing development challenges.