CREATING IMPACT

The Promise of Impact Investing

IFC International Finance Corporation
WORLD BANK GROUP
Creating Markets, Creating Opportunities

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FOREWORD

Across the world, the appetite for impact investing is growing. Investors are eager to show that they are broadly a force for good—that profit isn't their only objective. A recent survey of asset managers conducted by the Global Impact Investing Network found that 86 percent of respondents said they ventured into impact investing because of client demand.

Demographic shifts are driving some of this demand. In North America alone, at least $30 trillion in wealth will be transferred over the next three decades from Baby Boomers to Generation X and millennials, according to Accenture. Younger investors increasingly favor socially and environmentally motivated investment strategies—and they're willing to invest larger amounts in them. In a recent survey, Barclays found that the social and environmental causes most important to investors are those embedded in the Sustainable Development Goals—health, education, and water and sanitation. In short, a potentially transformative alignment has begun to occur between key global development objectives and the immediate needs of private investors.

This is a historic opportunity that must not be squandered. As much as $269 trillion—the financial assets held by institutions and households across the world—is potentially available for investment. If just 10 percent of this were channeled toward investments focused on improving social and environmental outcomes, it would go a long way toward providing the funding necessary to achieve the SDGs including facilitating a shift to a low-carbon future.

That is why the IFC, the largest global development bank focused on the private sector in emerging markets, undertook the analysis that is contained in this report. It constitutes the most comprehensive assessment so far of the potential global market for impact investing. It also offers practical suggestions that will help harmonize and grow the market in support of the promise of impact investment, which is to have impact at greater scale in support of global development.

The market holds great potential. We estimate that investor appetite for impact investing is as high as $26 trillion—$21 trillion in publicly traded stocks and bonds, and $5 trillion in private markets involving private equity, non-sovereign private debt, and venture capital. Turning this appetite into actual investments will depend on the creation of investment opportunities and investment vehicles that enable investors to pursue impact and financial returns in ways that are sustainable.

How far has the market come in providing those opportunities? The lack of clear boundaries between impact investing and other forms of sustainable and value-aligned investing makes it difficult to say for sure. This report explores various categories of investors and assets that have potential to offer these opportunities. We know that private impact funds currently total around $71 billion. Larger amounts are invested by development finance institutions (including over $700 billion by those following harmonized measurement metrics) and in green and social bonds (over $400 billion outstanding). In addition, a share of the $8 trillion dedicated to activist investing in public markets may be managed for impact.

This lack of clear boundaries and the thus far limited role of privately managed funds is not unusual for a market under development. What's important going forward is that investors should be able to clearly identify opportunities to invest for impact, and that those opportunities can expand over time to enable larger amounts of capital to be put to work. We offer proposals in this report to enable this to happen.

We know, moreover, that it's possible to mobilize like-minded investors to collaborate in ways that can change the landscape of investing. We did so in 2003 when we helped international banks establish the Equator Principles, which have become the most tested and applied global benchmark for sustainable project finance in emerging

markets. We also worked to develop guidelines and procedures for the green bond market as a member of the Green Bond Principles Executive Committee. The principles were established five years ago to promote market discipline and transparency. Since then annual issuance of green bonds has grown from around $10 billion in 2013 to $183 billion in 2018 according to SEB.

Soon after the publication of this report, IFC and a wide cross-section of other institutions will become the first signatories to the Operating Principles for Impact Management—a market standard that we think could achieve the same discipline and transparency for impact investing that the Equator Principles did for project finance. Just as the Green Bond Principles helped avoid "greenwashing"—or deceptive environmental claims—the Operating Principles for Impact Management will help avoid "impact washing" and strengthen the development of this new market.

For six decades, IFC has been at the forefront of impact investing in emerging markets. Over the years, others joined us in the search for impact and returns. With the establishment of the Operating Principles for Impact Management—and the detailed market assessment contained in this report—we hope to work with a much broader universe of private investors and development finance institutions to mobilize the trillions of dollars in financing necessary to achieve the SDGs.

Philippe Le Houérou
IFC CEO

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ABBREVIATIONS AND ACRONYMS

AIMM Anticipated Impact Measurement and Monitoring System
AUM assets under management
BC benefit corporation
BCR benefit cost ratio
BIA B Impact Assessment
BIS Bank for International Settlements
BOP base of the pyramid
CSRC China Securities Regulatory Commission
CDVC community development venture capital
DFI development finance institution
DOTS Development Outcome Tracking System
EBRD European Bank for Reconstruction and Development
ECGI European Corporate Governance Institute
EEA European Economic Area
EM emerging market
EMPEA Emerging Market Private Equity Association
EPFI Equator Principles financial institution
ERR economic rate of return
ES environmental and social
ESG environmental, social, and governance
EU European Union
GAAP Generally Accepted Accounting Principles
GIIN Global Impact Investing Network
GIIRS Global Impact Investing Rating System
GPIF Government Pension Investment Fund (Japan)
GRI Global Reporting Initiative
GSG Global Steering Group
HBL Habib Bank Limited
HIPSO Harmonized Indicators for Private Sector Operations
HKEX Hong Kong Stock Exchange (located in Hong Kong SAR, China)
IFC International Finance Corporation
IFI international financial institution
IFRS International Financial Reporting Standards
IMM impact money multiple
IMP Impact Management Project
IORP II Institutions for Occupational Retirement Provision Directive
IPA Innovations for Poverty Action
IPO initial public offering
IRIS Impact Reporting and Investment Standards
IRR internal rate of return
J-PAL Abdul Latif Jameel Poverty Action Lab
KFW Kreditanstalt für Wiederaufbau (German Development Bank)
KPI key performance indicator
LP limited partner
MCPP Managed Co-Lending Portfolio Program
MDB multilateral development bank
MFI microfinance institution
NGO non-governmental organization
OECD Organisation for Economic Co-operation and Development
OECD-DAC Organisation for Economic Co-operation and Development–Development Assistance Committee
OJK Financial Services Authority of Indonesia
ON Omidyar Network
OPIC Overseas Private Investment Corporation
PEPP Pan-European personal pension product
PPF/SWF public pension funds and sovereign wealth funds
PME public market equivalent
PPM private placement memorandum
PRI Principles for Responsible Investing
REM rapid evidence mapping
ROI return on investment
SASB Sustainable Accounting Standards Board
SCR solvency capital requirement
SDGs Sustainable Development Goals
SEB Skandinaviska Enskilda Banken
SEBI Securities and Exchange Board of India
SEC Securities and Exchange Commission
SGX Singapore Stock Exchange
SIP statement of investment policy
SME small and medium enterprise
SRI socially responsible investing
SROI social return on investment
TOC Theory of Change
UNCTAD United National Conference on Trade and Development
VC venture capital
WEF World Economic Forum

Note: All dollar amounts are U.S. dollars unless otherwise indicated

EXECUTIVE SUMMARY

This report takes stock of the market for impact investing and examines the conditions that would allow the market to grow and realize its potential. Historically, there have always been investors who cared about more than just financial returns. Governments and philanthropists, for example, have set up investment vehicles with mandates to promote social and environmental goals. Over the last decade, impact investing has gained prominence as an approach to investment that aims to achieve both financial returns and social or environmental goals.[1] This has created a dynamic but somewhat disorganized market of diverse participants, standards, and concepts. Although still small, the market is attracting considerable interest, and it has the potential to increase in scale, and thereby contribute to the achievement of the Sustainable Development Goals (SDGs) and the Paris climate goals.

What is Impact Investing?

The emergence of impact investing, alongside related concepts such as sustainable and responsible investing, has led to some confusion about its precise place within the broader investment market. In this report, we seek to provide clarity to the market by articulating a definition commonly used within the investment industry, and by drawing a distinction between value-aligned investing and impact investing. Value alignment occurs, for example, when investors buy stocks in companies that sell products that improve the environment. In contrast, as well as achieving a financial return, impact investments are made with specific intent to make a measurable contribution to the achievement of social and environmental goals.

This report defines impact investments as investments made in companies or organizations with the intent to contribute measurable positive social or environmental impact, alongside a financial return.[2]

A key feature of this definition is that impact investments are not defined by their membership in an asset class with common risk and return characteristics, but rather by the approach of the investor. In principle, investments may be made into the full range of public and private assets, as long as by doing so the investor contributes to achieving impact. Specifically, the definition encompasses three observable attributes of impact investors that can distinguish them from other investors.

- **Intent.** The investor articulates an intent to achieve a social or environmental goal by identifying outcomes that will be pursued through the investment, and specifying who will benefit from these outcomes.
- **Contribution.** The investor follows a credible narrative, or thesis, which describes how the investment contributes to achievement of the intended goal—that is, how the actions of the impact investor will help achieve the goal. In this case, contribution is considered at the level of the impact investor, and can take financial or non-financial forms.
- **Measurement.** The investor has a system of measurement in place linking intent and contribution to the improvement in social and environmental outcomes delivered by the enterprise into which the investment has been made. The measurement system enables the investor to assess

[1] The term was coined, according to the Rockefeller Foundation, at a conference held by the organization in 2007. See: https://www.rockefellerfoundation.org/our-work/initiatives/innovative-finance/.

[2] Here investments refer to debt or equity, as well as the provision of guarantees or risk insurance, which facilitate the provision of debt by a third party.

the level of expected impact, *ex ante*, in order to continuously monitor progress and take corrective actions when appropriate, and then finally to evaluate the achievement of impact, *ex post*.

Why Does it Matter?

The potential to make a difference to global development challenges such as poverty, inclusion, and climate change is why the global development community is supporting the growth of impact investing. Indeed, by making a difference, impact investment has the potential to mobilize additional resources, and potentially generate additional momentum toward achieving the 2030 Agenda for Sustainable Development. While not all impact investments will have an equal impact, continued development of the industry improves the prospects for achieving the SDGs.

Taking Stock of the Market

This report takes stock of the size and segments of the market as of 2018 and estimates its growth potential through an analysis of the revealed preferences of investors. While it is clear that this approach to investing has become more widespread in recent years, the lack of clarity about which investment strategies and assets should be considered to be impact investment makes the total size of the market difficult to establish. Instead, we identify some classes of investors whose mandates align with the definition of impact investing. We also identify some classes of investments that lend themselves to achieving measurable impact and therefore may be utilized by investors with the intent for impact.

We begin with opportunities for impact investment available to private households and institutions. In private markets—which include markets for private

FIGURE 1 Private Investors Have Three Key Opportunities for Impact Investment, Which Span Public and Private Markets

**Total fundraising from 2008–18 by private investment funds with verifiable intent for, and measurement of, impact. These funds operate only in private markets: private debt and equity, real estate, infrastructure, and natural resources such as timber. Their fundraising is equivalent to AUM under the assumption that it takes 10 years to return capital to investors.*

***Value for year-end 2015.*

****Value of all green and social bonds outstanding as of year-end 2018. This includes sovereign issuance.*

Source: Preqin, EMPEA, ImpactBase, ImpactAsset50, Symbiotics, IRIS, B-Analytics, Gresb, HIPSO, 2016–17 DFI mobilization reports, and DFI annual reports. GSIA. PwC. ICMA. Bloomberg. Thompson Reuters.

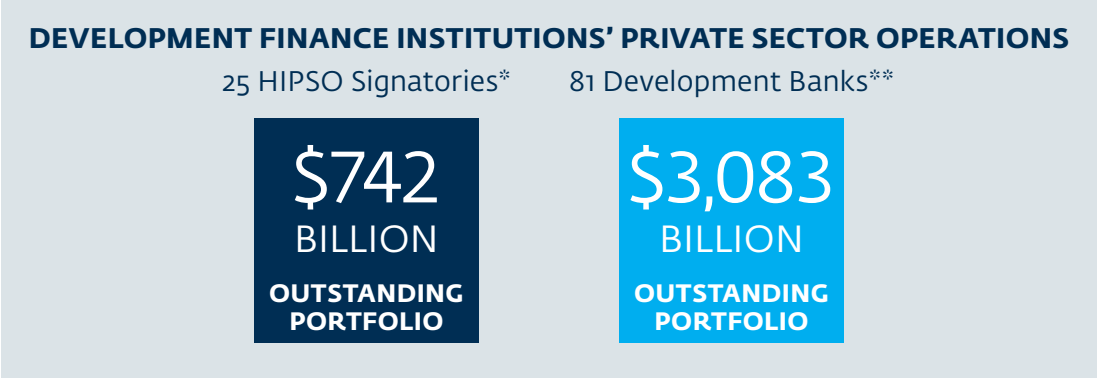
Note: There may be double counting between these two groups, to the extent that DFIs are limited partners in, or guarantors of, private investment funds

equity and debt, real estate, infrastructure and natural assets—we identify about $71 billion of assets managed by private investment fund managers with verifiable intent to contribute to measurable impact alongside financial return (Figure 1). Impact investors are heavily focused on infrastructure, with 62 percent of their assets in developed markets devoted to the asset class. In emerging markets however, impact funds invest far less—just 9 percent of assets—in infrastructure as an asset class.

Public markets, however, are where the overwhelming share of financial assets—in particular those of households—are held. In public markets, we identify two classes of investments through which one may potentially contribute to measurable impact: corporate engagement and shareholder action investment strategies ($8.4 trillion), which operate primarily in public equities, and green and social bonds ($456 billion), which are increasingly offered to the public. However, today we do not have a basis to identify how much investment in these assets is motivated by intent to contribute to measurable impact.

Beyond households and private institutions, many development finance institutions (DFIs), which are owned by governments, have mandates that could be interpreted as intended to contribute to social and environmental impact. Some also measure their impact in ways similar to private investors. This suggest a convergence of investment practice between two classes of investors previously considered to be very different—private investors and development finance institutions. Taking a more holistic view of the types of investors and assets that may deliver impact expands the potential size of the market.

FIGURE 2 Governments, Through Development Finance Institutions, Are Major Impact Investors



**Values for 2017. DFIs include 12 multilateral development banks (MDBs) and 13 bilateral DFIs, all of which are signatories to a memorandum of understanding regarding the Harmonized Indicators for Private Sector Operations (HIPSO). The committed portfolio includes: non-treasury investment portfolios of loans, equity investments, and debt securities to non-sovereign entities ($455 billion); an estimate of the stock of third-party investment that has been directly mobilized by DFIs over five years ($255 billion); and gross exposure to guarantees to non-sovereign entities ($32 billion). In general, DFIs only expect to pay claims on a small fraction of their gross exposure to guarantees or risk insurance. For MIGA, gross guarantee exposure does not include guarantees against the non-honoring of financial obligations by sovereigns, sub-sovereigns, or state-owned enterprises. Within this pool, the largest institution by far is the European Investment Bank (EIB), which has approximately $515 billion in outstanding portfolio, or 69 percent of the total, split between $322 billion in non-sovereign portfolio investments, $183 billion in estimated direct mobilization; and $10 billion in off balance sheet contingent liabilities and guarantees.*

***Includes 12 multilateral development banks and 69 national development banks with charters or mission statements describing intent to contribute to social or environmental impact alongside financial return. Given limited data on the share of portfolio allocated to treasury, sovereign and non-sovereign operations, the outstanding portfolio of these institutions is estimated at 50 percent of total assets.*

Source: HIPSO, 2016–17 DFI mobilization reports, and DFI annual reports.

For instance, 25 DFIs have signed a memorandum of understanding regarding common impact metrics—the Harmonized Indicators for Private Sector Operations (HIPSO). This group of financial institutions manages about $742 billion of investments (Figure 2). This includes investments for their own accounts, the direct mobilization of funds from co-investors, and guarantees or risk insurance. These investors' contribution to positive social and environmental impact is readily identifiable, given the mandates of these funds and institutions, their role in providing additional capital to firms, and their typically direct, and often long-term, relationship with investees that allows them to exert influence over management or transfer knowledge.

In addition to these institutions, there are many other government-owned national and regional development banks with mandates to achieve a range of policy, social, and environmental goals. We identify 81 such institutions, with outstanding portfolios of $3,083 billion (Figure 2). Much of this involves sovereign lending to governments, but to the extent that some of these assets are invested in firms and organizations with the intent to contribute to measured social and environmental impact, they could be considered as impact investments.

Based on our assessment of the current preferences of investors to take criteria other than financial return into account in their investment process, investor appetite for impact investment could, today, be as much as $5 trillion in private markets—private debt and equity, real assets, infrastructure, and natural assets—and as much as $21 trillion in public markets. These estimates do not include the activities of DFIs. Taken together these could make a substantial contribution to the SDGs and the Paris climate targets. However, this depends upon the ability of the investment industry to generate enough investment opportunities and investment vehicles that can gain investor confidence in pursuing impact and commercial financial returns in a disciplined way.

Bottlenecks to Growth: Challenges Facing Impact Investing

Despite large investor appetite, the market is far from reaching its potential as several bottlenecks constrain its development. Specifically, four key challenges prevent impact investment from realizing its promise.

First, continued uncertainty about whether impact investors can earn commercial financial returns in line with non-impact investors limits the appetite for impact investment. Impact investing first gained prominence among philanthropists and other investors willing to accept "sub-commercial returns." Today, impact investors' expectations vary, but the largest group of investors—especially the potential growth market—seeks commercial financial returns. A common belief that impact investment pays only sub-commercial returns continues to discourage these potential investors.

There is, however, increasingly solid evidence that impact investors can achieve commercial financial returns at scale, and in a variety of settings. For instance, on average, IFC's realized equity investments have delivered returns in line or better than the MSCI Emerging Market Index in vintage years from 1988 to 2016. Debt returns have been competitive with JP Morgan Corporate Emerging Market Bond Index. Together this performance has allowed IFC to achieve financial sustainability over a long period of time.

Second, a lack of clarity about how investments are managed to achieve impact gives rise to concerns about "impact washing," which deters potential investors and threatens the credibility of the industry. The industry lacks common standards covering what it means to manage an investment portfolio for impact. In line with the definition used in this report, standards should include an investment strategy that clearly links intent to asset selection, asset selection based on a credible impact thesis, and an impact measurement system that ensures accountability by establishing targets, monitoring performance, and reporting results for impact in the same way that investment managers do for financial performance.

Third, limited comparability of measured impact across projects and investment managers poses a challenge to investors who are trying to allocate capital to impact investments. Unlike financial return, the assessment of impact has not yet evolved to the point at which common approaches, metrics, and conventions have become widely accepted. Impact measurement does not yet have its equivalent of Generally Accepted Accounting Principles (GAAP).

However, several promising approaches are emerging that allow comparability across investments within an investment pipeline. Three measurement frameworks are presented in the report, in addition to the Anticipated Impact Measurement and Monitoring (AIMM) approach developed by IFC. Having choice is important, as different approaches may work for different types of investors. However, convergence of these systems' common elements, metrics, and approaches will build trust in the market and help investors to identify asset managers that pursue impact in a disciplined way.

Finally, regulatory frameworks often do not support investment managers who seek to create impact alongside financial returns. Fiduciary duty is frequently interpreted too narrowly as only concerned with maximizing financial returns. Although beneficiaries may care about more than financial returns, asset managers are often discouraged from pursuing additional objectives in their investment strategies. While fiduciary duty has an important rationale—to protect asset owners from reckless or underperforming fiduciaries—a one-dimensional interpretation constrains pension funds and other institutional investors from pursuing impact objectives when their beneficiaries would like them to do so. Likewise, many fiduciaries are unaware that they could take non-financial considerations—like impact—into account when making investment decisions, and this too discourages impact investing.

Looking Ahead: The Future of Impact Investing

To support the growth of the industry, this report identifies key solutions that can help tackle the identified bottlenecks.

First, a new set of operating principles for impact management represents an important step in bringing clarity and discipline to managing investments for impact. Developed by IFC in concert with other DFIs, asset managers, and asset allocators, the principles establish a shared understanding of the key elements of the process through which an investor integrates impact considerations with financial considerations at each stage of the investment process, and with independent verification. As more and more impact investors commit to following the principles in their operations, this will bring greater transparency to how investment funds are managed, build trust in the market, and help investors to identify the funds, institutions, and asset managers that pursue impact in a disciplined way.

Second, the adoption of uniform standards for measurement frameworks and tools will bring greater transparency and comparability to the performance of impact investments. The growth of impact investing places greater demands on companies to measure and report on their impact, and to consider the potential positive and negative impacts of their investment decisions. Initiatives to strengthen impact reporting by firms such as the Global Reporting Initiative will help provide investors with the information they need to assess impact. And uniform standards will enable the industry to better compare the effectiveness of impact strategies. As the amount of money managed for impact increases, companies that can provide this information will have an advantage in raising capital. There is a shared agenda now to build the evidence base for demonstrating the social and environmental impacts of investments.

Third, to unlock larger pools of capital, regulators should reduce the barriers faced by institutional investors that are interested in impact. The main regulatory and legal changes needed pertain to 1) investment policy, and 2) rules related to disclosure and reporting. Reforms should aim to allow asset owners to pursue additional goals beyond financial returns if they prefer to do so, while still protecting fiduciary duty. They should allow fiduciaries to include impact considerations in their fiduciary, reporting, and disclosure mandates.

For impact investing to achieve its potential, the full range of participants need to work together to create a well-functioning market in which investors can deploy their capital. This report points to a powerful potential synergy between development finance institutions and private impact investors in creating this market. In low- and middle-income countries, private-sector focused DFIs can play an important role, especially by supporting upstream policy reform and project development that creates investment opportunities for private investors sourcing investment opportunities, and creating co-investment platforms to mobilize impact investments. Leveraging over 60 years' experience as an impact investor, IFC will contribute its knowledge and experience toward achieving this goal.

CHAPTER 1

TAKING STOCK: DEFINING IMPACT INVESTING AND SIZING THE MARKET

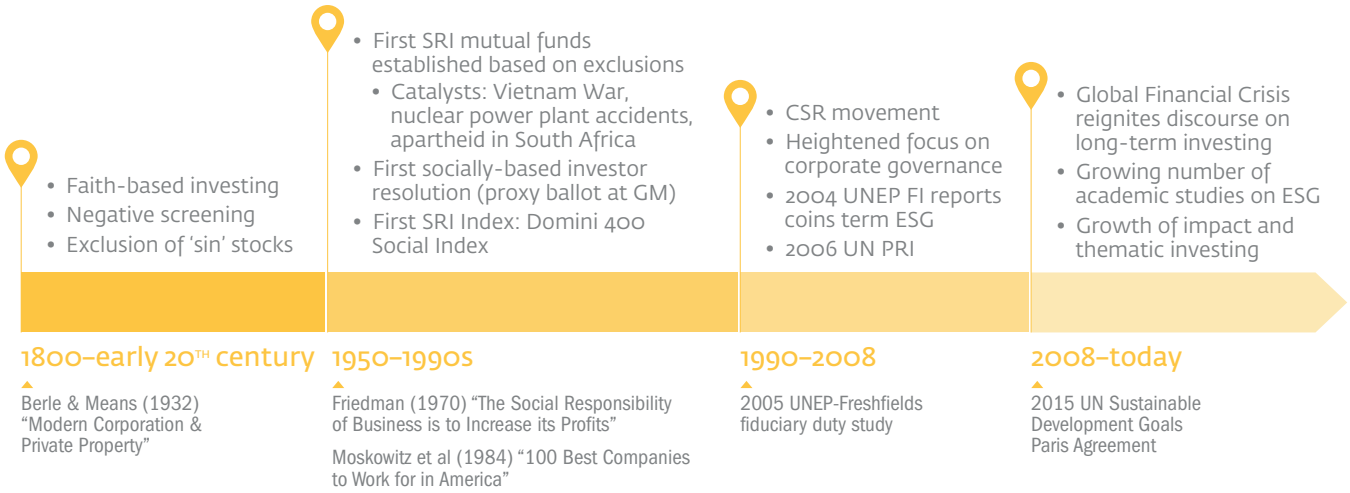
1.1. What Is Impact Investing?

An Increasing Number of Investors Have Goals Beyond Maximizing Profits

The term "impact investing" emerged only in the last decade.[3] Its origins, however, can be traced in part to concepts of ethical responsibility in many religious traditions. Islam, Judaism, and Christianity, for example, have aligned economic action with belief by establishing directives on how to invest ethically (Figure 3). The Quakers, for example, whose tradition of embracing peace and nonviolence date back to the 18th century, actively avoid investing in enterprises or products that oppress fellow humans. The modern form of Islamic finance, which started in Egypt in the 1960s, aligns with many aspects of impact investing. To promote financial inclusion, it encompasses ethical and social criteria alongside financial returns.[4]

The 1960s saw the emergence of socially responsible investing (SRI), a set of asset management strategies originally developed, in part, to meet demand from religious institutions with large endowments. The earliest socially responsible strategy involved "negative screening," or excluding from investment portfolios those industries that have negative social and environmental impacts: for example, coal, tobacco, firearms, and gambling. A series of events—ranging from the civil and women's rights movements to the antiwar and environmental movements—served to increase awareness about social responsibility. These concerns also broadened to include management and labor issues, as well as antinuclear sentiments. In the 1980s, the decision of some universities and pensions

FIGURE 3 Recent History of Responsible Investment



Source: Oxford University.

[3] According to the Rockefeller Foundation, the term was coined at a conference held by the organization in 2007. See https://www.rockefellerfoundation.org/our-work/initiatives/innovative-finance/.

[4] Hussain et al. 2015.

to divest from South Africa due to apartheid resonated strongly across the world.[5]

As understanding of the environmental, social, and governance (ESG) risks has grown, investors have moved beyond simple inclusion/exclusion portfolio decisions to strategies that assess and mitigate the ESG risks of all assets in the portfolio—an approach known as ESG integration or sustainable investing. The goal of this approach is to maximize risk adjusted return by considering additional relevant information, but in general not to alter the environmental and social impact of investees. In 2005 the United Nations created the Principles for Responsible Investment to encourage institutional investors to commit to this approach. Today, asset owners increasingly demand products that integrate ESG, and Deutsche Bank predicts that by 2030, 95 percent of professionally managed assets will have some form of ESG mandate.[6]

Assets managed under specific SRI strategies, including ESG integration and negative screening, have been growing rapidly, at 14.6 percent annually from 2011 to year-end 2015, when they accounted for $23.2 trillion in assets under management (AUM), or 8.6 percent of total financial assets.[7] Growth has been more than double the rate of growth for all assets under professional management, which during the same period was 6.0 percent.[8] Negative screening is especially popular in Europe, where 76 percent of assets managed under this strategy are held,[9] while ESG integration is relatively more popular in the United States, Canada, Australia, New Zealand, and Japan.

Although increasingly popular, a large body of empirical literature reports mixed results with respect to the financial performance of screened funds when compared to an unconstrained index.[10] The willingness of investors to apply certain strategies such as negative screening, which offers demonstrably below-market returns, suggests that some investors are willing to sacrifice the size of their returns in order to align their investments with their values.

Impact Investments are Made With the Specific Intent to Contribute to the Achievement of Measurable Social Objectives

Impact investing goes a step further as, alongside financial return, it elevates the achievement of positive social and environmental impact to that of a primary investment objective. Initially, this approach grew out of philanthropies and foundations seeking a more financially sustainable model for achieving impact than just grant giving. The approach also grew as a result of responsible investors seeking to go beyond "do no harm" to achieving good. In its early growth, impact investing was closely associated with the financing of social enterprises and innovative business models, and especially those serving the "base of the pyramid" (the poor or near-poor).

In this report, we synthesize various definitions that have been used in the industry (Online Annex A) to define impact investments as those:

investments made into companies or organizations with the intent to contribute to measurable positive social or environmental impact, alongside a financial return.

5 While divestiture has an important impact in signaling that social issues are important, there is little evidence that it has a material effect on stock prices. For example, a price index for U.S. firms operating in South Africa moved little in response to divestment announcements by investors. This is consistent with a view that the demand curves for stocks are highly elastic and so have little downward slope. Teoh et al. 1999.

6 Deutsche Bank Research 2018.

7 For total financial assets, see Online Annex B.

8 PwC 2017.

9 Ibid.

10 For examples, see: Knoll 2002; Renneboog et al. 2008; Friede et al. 2015; and Ferrell et al. 2016. As an example, the Norwegian sovereign wealth fund, with a portfolio of $11 trillion, has, over the last decade, gradually excluded from its portfolio, the stocks of companies that produce tobacco, nuclear arms, and cluster weapons. They also exclude companies that engage in coal mining and coal-fired generation. Over this period, on an annual basis, the constrained portfolio has underperformed the unconstrained benchmark by six basis points (0.06 percent). See "Return and Risk: Government Pension Fund Global 2017." *Norges Bank Investment Management*, http://www.nbim.no/en/transparency/reports/2017/return-and-risk-2017.

Here investment refers to the provision of debt or equity, as well as the provision of guarantees or risk insurance, which facilitates the provision of debt by a third party. This definition encompasses three distinctive attributes of impact investors' approach that distinguish them from other investors. First, the investors articulate an intent to achieve a social and environmental goal alongside a target financial return. Second, the investors follow a credible narrative describing how their engagement in this investment makes a contribution to the achievement of that goal—that is, how it makes a difference. Third, the investors have a system of measurement in place to assess the difference they make.

In principle, every impact investment should begin with a credible impact thesis that articulates the improvement in outcomes that the investor intends to achieve, and how the investment will contribute to that improvement. Unfortunately, however, according to the Impact Management Project (IMP), which is an industry initiative: "No clear, authoritative definition [of an impact thesis] currently exists."[11]

In principle, an impact thesis has three components:

- An impact investor's *intent* to improve social outcomes leads him or her to
- *Contribute* investment capital or additional assistance to the enterprise, which leads to
- *Measurable improvements* in the enterprise's outputs or processes (the services or products it delivers, or the ways it produces them), or in markets more broadly, that lead to measurable positive social outcomes for the investor's intended beneficiaries.

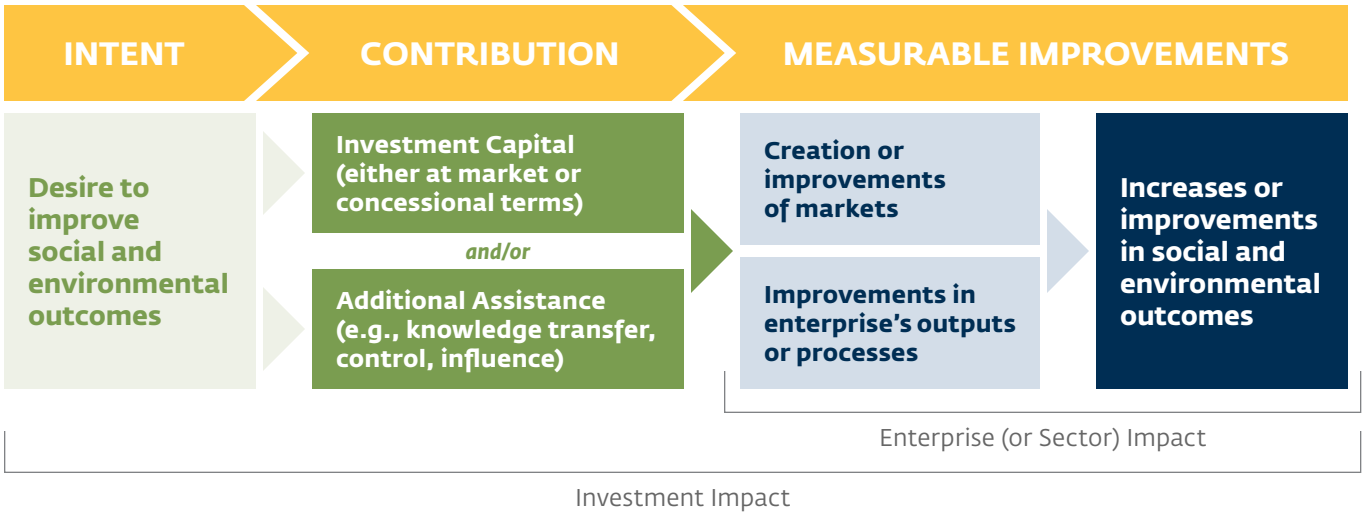
An investor has a credible narrative about investment impact only when these three components have been well defined (Figure 4).

Here, given our understanding of how financial markets function, we outline the specific challenges that an investor faces in articulating an impact thesis that is credible. In so doing, we also propose an outline for an investor's impact thesis, which may be used to establish the manager's contribution to the achievement of impact.

INTENT

The first thing that differentiates impact investors from traditional investors is their intent. In addition to seeking financial return, they seek to achieve social and environmental goals. Thus, they typically define their intent by specifying measurable improvements in social and environmental outcomes that will be pursued through the investment (and who will benefit). It is only by having an *intent* to achieve a specific, articulated

FIGURE 4 The Impact Thesis of Impact Investing



[11] In its own words, the Impact Management Project is facilitating a global network of standard-setting organizations to coordinate efforts that can accelerate widespread impact measurement and management." See https://impactmanagementproject.com/glossary/#i.

outcome that an impact investor can determine what sort of firm to invest in—for example, health services, housing, or farming—or be able to assess the investment's social impact.[12]

The key to an impact investment lies in the intent of the investor, rather than that of the investee, to create social impact. If the investor predicts that an investment in a firm will contribute to its intended social impact, it is not critical that the investee's firm share that intent. For example, an investor in a dairy may intend to increase smallholder dairy farmers' incomes. Although the dairy may only be interested in selling milk for a profit, its activities may promote the impact investor's social goal.

That said, investors are generally more likely to achieve their intended outcomes when their investees are committed to those same outcomes. The Omidyar Network, a pioneer impact investing fund, "target[s] companies that have social impact 'embedded in their business model'—regardless of whether they explicitly

BOX 1 Women Entrepreneurs in Vietnam

As in many countries, small and medium enterprises (SMEs) are vital to Vietnam's economy. They comprise more than 98 percent of businesses and provide 50 percent of employment across the country. IFC estimates that the unmet demand for credit by women SME owners in developing countries is at least $1.5 trillion (IFC, 2017). Hence, IFC's goal is to make it easier for banks to lend to women-owned SMEs, which often face lenders' biases as well as roadblocks related to their lack of collateral. This was the case with an electronics shop opened by a a woman named Ngan and her husand in 2016.

When Ngan's shop started doing well, she approached Vietnam Prosperity Commercial Joint Stock Bank (VPBank), an IFC partner, to help her business grow even more. VPBank loaned her $25,000—with her receivables pledged as security. This turned out to be a turning point for Ngan's business. The bank's financing allowed her to approach new corporate clients in her neighborhood, and she started installing air-conditioning systems for them. In just six months after receiving her loan, the value of Ngan's company grew fourfold to $400,000. These are exactly the kind of results that IFC envisioned when it provided a $125 million financing package to VPBank in 2016.

An IFC market study in Vietnam found a financing gap of $1.19 billion for women-owned SMEs across country. Even though female entrepreneurs bring in average annual revenues similar to those of men, women in Vietnam still receive fewer bank loans than their male counterparts. This limits opportunities for women—and that is where VPBank saw a chance to make a difference. It was one of the first Vietnamese banks to adopt a strategy specifically designed for women-owned SMEs. Its partnership with IFC also goes beyond funding; it includes advice from IFC that facilitates women-owned SMEs accessing non-financial services that make it possible for these entrepreneurs to share experiences with each other, and through networking, find new opportunities for their businesses.

The program achieved strong results within just a year of its launch, during which time VPBank lent $600 million to about 2,000 women entrepreneurs. This accounts for 25 percent of the bank's total SME client roster. There have also been gains in other aspects of the business as well: for example, nearly 2,500 women opened savings accounts, valued at almost $180 million.

[12] The following would be suggestive (though not determinative) of an investor's intent to create social impact: (a) the expected risk-adjusted financial return of the investment is concessionary, that is, below what a commercial investor would demand, and (b) the expected return was not concessionary at the time the investor decided to make the investment, but became concessionary by the time he or she had to make a commitment, and would, nonetheless, at least seriously consider making the investment because of its social impact.

pursue such impact."[13] Bridges Fund Management, another pioneer, looks for investments where financial success and impact are in "lock-step."[14]

Intended project outcomes

Many impact investors target improvements in outcomes that directly relate to project stakeholders, such as customers, employees, or suppliers. We call these project outcomes. An example of a project outcome, which has been the focus of many impact investors, is an increase in loans provided to female borrowers (Box 1).

Intended market creation

Beyond project outcomes, impact investors also have intent to create markets, or influence a sector. For example, the Omidyar Network (ON) believes that "by helping to build or shape a new market, a company can generate social impact that far exceeds its firm-level impact."[15] ON takes three basic approaches to creating markets:

- **Providing industry infrastructure.** ON may support infrastructure that enables markets where no single market player will assume the cost and risk (especially when an investment may benefit potential competitors). ON's investment in a company that helps microfinance institutions hedge foreign currencies is an example.
- **Pioneering a new model.** For example, one that serves low-income or rural consumers, with the goal of inspiring other firms to follow suit, resulting in competition that eventually drives down prices, increases quality, and sparks innovation. Examples include ON's investments in microfinance and consumer solar products.
- **Influencing policy.** ON has also sometimes prompted governments to improve the policy environment for a particular business model—for example, private elementary and secondary schools that complement public education in Africa.

An example of a market creation impact is IFC's investment in Colombia's Financiera de Desarrollo Nacional (FDN), one of the first infrastructure debt funds in Colombia, which is now opening a path for pension funds to invest in road projects that are crucial for the country (Box 2).

Negative impacts

Like any other decisions, impact investments may have unintended negative consequences. For all the social good they intend to bring about, impact investors should "first do no harm." An important strategy for both achieving positive impact and avoiding unintended negative consequences is to seek out and listen to one's intended beneficiaries and other stakeholders.[16] Avoiding unintended consequences can also be a strategy to reduce investment risk, a key motivation for the use of ESG criteria in evaluating investments.

CONTRIBUTION

Contribution is the difference that the investor makes to the firm or the market. This difference is what allows the investor to achieve impact—the investor provides something (additional financing or other value addition) to the firm that changes the activities of the firm—quantitatively or qualitatively in ways that cause an improvement in social and environmental outcomes. These positive effects are sometimes called increases in "social value" or "social value added." In terms of a results chain, contribution consists of the inputs that an impact investor provides that have a causal effect on social or environmental outcomes, and the channel of this causal effect is through the activities of the firm, which turn inputs into outputs, leading to outcomes.

It is worth noting that in the realm of impact investing, it is seldom possible to attribute a result to a single activity. A well-articulated impact thesis describes what the impact investor offers investees, which is *distinct* from what traditional investors would allow for partial attribution. Thus, the thesis is a credible narrative that explains that although the investment may not be the

[13] Bannick et al. 2017.

[14] Barby and Goodall 2014.

[15] Bannick et al. 2017.

[16] Twersky et al. 2013. All things being equal, consumers' demand for a product reflects their needs, or at least their wants. But ignorance or human behavior may undercut this easy assumption. For example, in some instances, the easy availability of microfinance loans, rather than foster financial independence has bankrupted the borrowers. For example, see: Acharya 2018; Rubtsova 2018.

BOX 2 Colombia—Bringing Jobs, Opportunities, and Growth

Every morning before first light, Wilson Medina's truck bounces along the pitted dirt roads of Colombia's central Andes range, collecting fresh milk from two dozen family farms tucked into the green hills. Business is good. The farmers' production has increased eightfold since they pooled their resources and founded a cooperative several years ago. However, transportation remains a major challenge. Rutted roads slow down Medina; the longer he is on the road, the greater the odds of spoiled milk. And the route takes so long, the cooperative cannot collect milk from new farms. "Even an hour can make a difference," said Medina.

Colombia's poor infrastructure has slowed economic growth for decades and, as a response, the government put forward an ambitious infrastructure initiative called the fourth-generation (4G) road program, which includes 32 projects to build about 8,000 kilometers of roads. This was no small task and required significant resources and expertise to succeed. The government turned to IFC for advice on designing the concession model, developing standardized contracts, and setting out project management processes. IFC also helped structure the first three transactions for the 4G program. But even with this initial success, the cost of financing the entire 8,000 kilometers was seen by some as prohibitive: $25 billion over the next seven years. That was when IFC helped the government find innovative ways to attract long-term financing.

Colombia partnered with IFC to create Financiera de Desarrollo Nacional (FDN), a financial institution that catalyzes investment in Colombian infrastructure and addresses market failures that undercut infrastructure financing. FDN then leveraged new local capital-market regulations that make it easier for pension funds to invest in infrastructure projects. These regulations were developed with support from the World Bank. With this new regulatory framework in place, IFC helped launch one of the first infrastructure debt funds in Colombia, opening a path for pension funds to invest in road projects that are crucial for the country.

The new road network is expected to provide a long-awaited boost for Colombia's competitiveness and productivity by having a 1.5 percent multiplier effect on GDP during the construction period, with long-term GDP growth reaching 4.6 to 5.6 percent. A long-term reduction in unemployment of 1.5 percent is also expected. With wide-reaching benefits for the country, the new road network will be connecting Colombian businesses and citizens like Medina to markets, jobs, and opportunities.

sole cause of the outcome, the outcome would not have occurred—at least not to the same extent—without the investment.

The Difference that the Contribution Makes Relative to a Counterfactual

To say an investment makes a difference implies a counterfactual of what would have happened without it. This may be hard to establish conclusively, but each impact investment is based on a thesis that it enables the creation of more social value than would have happened otherwise. There are many ways to estimate the counterfactual, ranging from experimental and quasi-experimental evaluation techniques, to plausible theories and hunches.

The simplest thesis, which has been used from the earliest days of impact investing, is that the investor provides capital in amounts, or on terms, not available from other investors. This thesis is most credible in countries and sectors where capital is scarce. It is less credible in markets where capital is plentiful. This thesis may also be more credible in the case of

financing for micro, small, and medium enterprises (MSMEs), including some venture capital or angel investments. The MSMEs financed are at too early a stage to receive capital from other sources that are not motivated by the potential impact of the business. An impact investment's contribution can also stem from it being managed differently from non-impact investors. For example, impact investors are often called "patient capital"—that is, they are willing to wait longer to realize a return on their investment.

Beyond their financial contribution, there are two other key ways that investors can make a difference: by providing the investee with knowledge and assistance, and by controlling or influencing management decisions. Here we describe in detail the narratives that various investors have developed about their contributions. This discussion focuses on how an investor might (or might not) contribute to meaningful improvements in the investee's enterprise and in the outcomes generated.

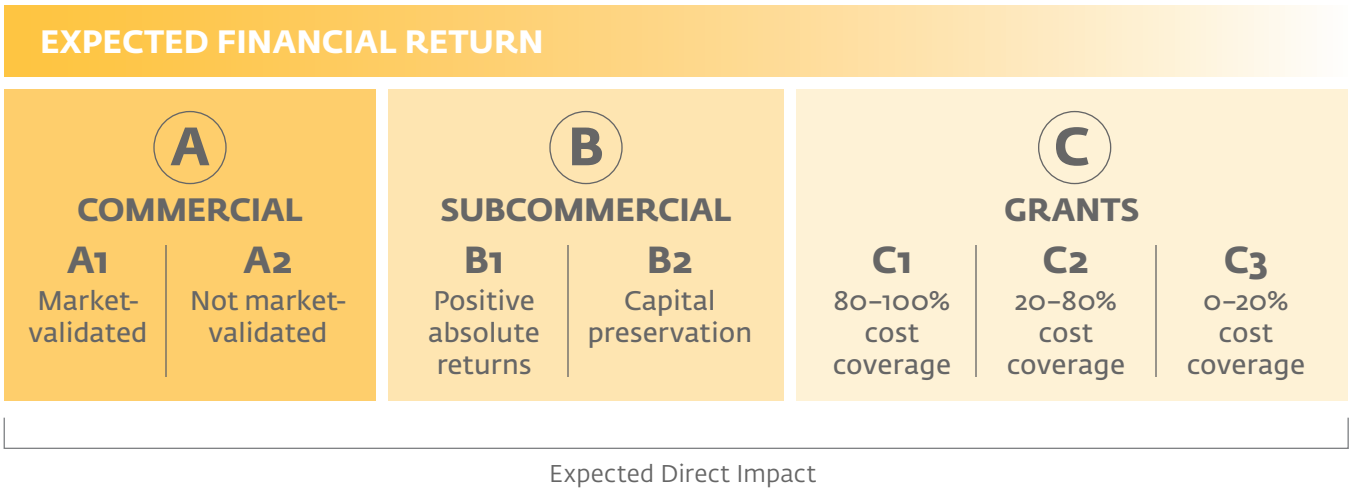
Financial Contribution

The most fundamental activity of all investors, including impact investors, is funding their investee enterprises through equity or debt, or by providing risk insurance. The financial contribution is through enabling either an expansion of the activities of the company—for instance through additional financing. Or it is through an improvement in the financial sustainability of the activities of the company—for instance by lengthening maturities, or lowering interest rates or risk. A financial contribution may also be concessional in nature, in that the investor only expects sub-commercial returns.

When defining financial contribution, is useful to consider the full spectrum of grants and investments, which are well illustrated by the chart from the Omidyar Network (Figure 5):[17]

- At the far-right of the chart are grants, which are not "investments" at all, since they produce no financial returns. From a financial point of view, a grant is a total loss.
- At the other end are commercial investments that expect a risk-adjusted market return.
- Between these poles lie sub-commercial investments, that expect to sacrifice some financial return to achieve social impact. The amount of the sacrifice is the functional equivalent of a donation or grant.[18]

FIGURE 5 The Full Spectrum of Investment Options That Can Create Social Value



Source: Stanford Social Innovation Review.

[17] Bannick et al. 2017. What the authors term "commercial" and "sub-commercial" investments are sometimes referred to, respectively, as non-concessionary and concessionary. See Brest et al. forthcoming.

[18] The U.S. Internal Revenue Code characterizes certain noncommercial impact investments by U.S. private foundations as "program related investments" and treats them like grants in many respects. Not only the amount of the sacrifice, but the entire investment counts toward a foundation's required annual minimum distribution of 5 percent of its assets, and the value must ultimately be redistributed as grants or PRIs if it is repaid. See: https://www.irs.gov/charities-non-profits/private-foundations/program-related-investments.

It is worth saying a few words about the role of grants and sub-commercial investments. In addition to serving conventional philanthropic objectives, grants are sometimes used to create sector impact along the lines mentioned above.[19] Along with grants, sub-commercial investments may be used to prove the viability of an idea that is still too risky to attract commercial investors (for example, the Bill & Melinda Gates Foundation's early investment in a mobile money company in Bangladesh) or to subsidize services that do not earn revenue for the investee firm (for example, the Gates Foundation's investment in a biotech company, coupled with a requirement that the company's technology be made available in developing countries at below-market prices).[20]

Most impact investors seek investments in the "commercial" category; that is, they seek risk-adjusted market returns.[21] To say that an investment is market-validated means that ordinary commercial investors are also investing in the enterprise. A non-market-validated investment may have other impact investors, but no commercial investors.

For ON, market-validated investments are in companies where, despite the presence of commercial investors, ON believes that additional capital or technical assistance can add to the investees' social impact. ON's non-market-validated investments tend to involve promising new companies in developing markets that serve low-income consumers, which are overlooked by commercial investors.

Financial Contribution in Private markets

Many impact investments have taken place in private markets—in private equity, including all stages of venture capital, private debt, real estate, infrastructure, and natural assets. It is in these markets where it is most straightforward to articulate an investor's contribution to impact, because in these markets it is most plausible that the investee's cost of capital would have been higher in the absence of the impact investment.

Referring to the returns continuum above, some impact investments may be sub-commercial, in that the investor seeks only below market returns. In the words of the Impact Management Project, an industry initiative, these investments "provide flexible capital, by recognizing that certain types of enterprises do require acceptance of lower risk-adjusted financial return to generate certain kinds of impact."[22] Here, the flexibility of capital is an investor's contribution: it directly lowers the investee's cost of capital, thus allowing an improvement in the firm's socially relevant outputs or processes.

But many if not most impact investors seek commercial returns, similar to traditional investors. Therefore, when seeking commercial returns, impact investors make a differential contribution by taking risks that others might not. In the words of the IMP, they may "grow new or undersupplied capital markets, by anchoring or participating in new or previously overlooked opportunities. This may involve more complex or less liquid investments, or investments in which some (but not impact investors) perceive risk to be disproportionate to return."

Private markets thrive on private information. Some impact investors' advantage, therefore, lies in their expertise in assessing the financial potential of companies whose outputs fit their social value goals. For example, the Omidyar Network argues that it is better able to assess the risks of these companies than commercial investors because ON "may have greater familiarity with a given geography (such as Africa) or sector (such as financial inclusion) or more confidence in a particular entrepreneur."[23]

Financial Contribution in Public Markets

Aside from their possible long-term signaling function, impact investors seldom make a contribution merely

[19] For more information, see "Amplifying Voices" at https://www.accountabilitycounsel.org/.

[20] Bank 2016.

[21] A recent Barclay's survey found that 82 percent of investors would expect close to, or above, market returns from an impact investment. Respondents to the 2018 GIIN survey were more likely to target below market rate returns, with only 64 percent targeting risk adjusted, market-rate returns, or greater. See Barclays 2019.

[22] Bannick et al. 2017.

[23] Ibid.

by trading securities in large-cap, secondary public markets.[24] Impact investors who value the company's social or environmental outcomes buy the company's shares in the hope that their purchase will cause the company's share price to increase, thus causing its cost of capital to fall, and thereby allowing the company to produce more socially valuable goods. As explained immediately below, however, this is unlikely to happen.

It is reasonable to assume that the marginal investor in public markets cares only about financial returns and is indifferent to social or environmental outcomes.[25] Therefore, in public markets, any premium in the valuation of shares that results from impact investors' clamoring to own them presents an opportunity for commercial bargain-hunters to profit from selling shares that are overpriced (from a purely financial perspective). For example, if two companies are alike in all respects except that one produces socially valuable goods and the other does not, any increase in the share price of the former will prompt purely commercial investors to sell their shares and buy shares of the latter. This arbitrage process would continue until the stock prices of the two companies were identical, thereby eliminating any share price impact based on the socially-motivated trading, and thus neutralizing any social value added.[26]

An alternative theory is that an impact investor may have specific information about a company's financial as well as social value that is not known in the broader marketplace, leading the impact investor to provide capital that ordinary commercial investors would not. In the absence of unlawful insider information, however, an impact investor is highly unlikely to have better knowledge about publicly traded companies than the vast number of investors who are only interested in commercial returns. Although certain good ESG practices may well increase a company's long-term shareholder value, impact investors are not better positioned to assess this value than commercial investors, at large. (We will discuss below how investors might leverage their ownership in a company to influence management decisions.)

The same arguments hold for deep markets for debt securities: buying and selling of them is unlikely to change the issuers' cost of capital in markets where most investors are indifferent to social or environmental value.

KNOWLEDGE AND TECHNICAL ASSISTANCE

Venture capital and private equity firms provide their investees with various forms of knowledge and assistance for networking and fundraising, as well as for addressing internal management and organizational issues. Impact investors in private markets can provide similar assistance to their investees, ensuring their social impact as well as their financial sustainability. An impact investor's contribution to social impact in this manner can only be assessed one investee at a time.

When, as in Bridges' ideal scenario, financial returns and social impact move in lock step, the fund manager need not make any financial sacrifice in providing assistance to achieve social goals. When the investee's financial returns are negatively correlated with improvements in outcomes, the fund manager must devote extra resources to assist with the latter. At least for a large fund, the additional costs needed to promote social impact may be insubstantial and, in any event, not passed on to the fund's limited partners.

INFLUENCE OR CONTROL OF MANAGEMENT

There is a long history of shareholder efforts to improve corporations' practices, particularly relating to ESG criteria.[27] The IMP describes how impact investors can "engage actively," using their "expertise, networks and influence to improve the environmental/societal performance of businesses. Engagement can include a wide spectrum of approaches—from dialogue with companies, to creation of industry standards, to investors taking board seats and using their own team or consultants to provide hands-on management

[24] Primary markets, where stocks are first issued, have greater resemblance to private markets.

[25] Above, for example, in 2015, SRI investment covered just 8.6 percent of total financial assets.

[26] Brest et al. Forthcoming. The best socially neutral investors need not own the overpriced shares to accomplish this arbitrage. They could borrow the shares owned by others, and sell the borrowed shares—a common practice called short-selling.

[27] For example, Ceres (Coalition for Environmentally Responsible Economies) has advocated to corporations for environmental sustainability since its founding in 1989. See https://www.ceres.org/ and https://en.wikipedia.org/wiki/Ceres_(organization).

support (as often seen in private equity). This strategy should involve, at a minimum, significant proactive efforts to improve impact."[28]

One direct approach to influence and control in private markets is what may be called *impact covenants*. Here the investor could tie the realization of certain impact metrics to paying performance bonuses to management—in the case of an equity investment—or to reducing interest rates or waiving certain debt covenants.[29]

It is in public markets where influence is more challenging, given the presence of other shareholders that may be indifferent to the social or environmental consequences of investment. We examine these issues below in the discussion of corporate engagement and shareholder action strategies.

MEASURABLE IMPROVEMENTS

The impact thesis ends with the measurable improvements in social or economic outcomes that the investor seeks. Modern practices of commercial investing depend on investors being able to measure their investees' financial outcomes on a regular basis. The observation that "you can't manage what you can't measure" applies to social impact no less than financial returns.

Impact measurement, thus, is the third defining attribute of impact investing—it demonstrates the commitment of investors to manage toward improvements in social and environmental outcomes. In addition to providing valuable information on the impact intent and results of a portfolio, impact measurement allows investors to make decisions based on the social and environmental outcomes affected by a business.[30] It also allows the investor to tell a clear, compelling story about private sector solutions to problems affecting people and the planet, which is critical for attracting capital and growing the impact investment market.[31]

Soon after the concept of impact investing was created, impact investors recognized the need for a credible, independent, common set of standard indicators to provide a foundation for market infrastructure that could facilitate the efficient flow of capital to enterprises aligned with an investor's impact objectives.[32] This formed the basis for Impact Reporting and Investment Standards (IRIS)[33] and the Global Impact Investing Rating System (GIIRS),[34] among others, which promote standard indicators and other aspects of standardization. Today, these common indicators are used to track social and environmental improvements.

Value-aligned Investments May Have Intent, but Lack Contribution or Measurement

A recent global survey of 7,100 investors by the asset manager Natixis found that 75 percent thought it was important that they invest in companies that reflect their personal values.[35] IMP describes value-aligned investments as a "signal that impact matters […] A commitment to factoring in the impact an enterprise has, such that—if all investors did the same—it would lead to a 'pricing in' of social and environmental effects by the capital markets. This strategy expresses the investors' values and is an important baseline. But alone, it is not likely to advance progress on societal issues when compared to other forms of contribution."[36]

While many investors may make investments with the *intent* of impact, these investments are not impact investments if the investor lacks a credible narrative of how the investment *contributes* to impact.

28 Impact Management Project 2019.

29 Aquino-Hagedorn and Doran 2017.

30 Schiff et al. 2016.

31 Salmon 2018.

32 Bouri 2011.

33 "What is IRIS?" Impact Reporting and Investment Standards (IRIS). For more information, see https://iris.thegiin.org/.

34 "GIIRS Funds." B-Analytics. For more information, see http://b-analytics.net/giirs-funds.

35 Natixis 2017.

36 Impact Management Project 2019.

Alternatively, impact investments may have a credible narrative of contribution, but lack a system of impact *measurement*. We call such investments value-aligned.

THE ABSENCE OF CONTRIBUTION

To understand this idea, it is first helpful to distinguish between two concepts that are frequently confused, the impact of the enterprise (or sector), and the impact of the investor (Figure 4). Enterprise impact refers to the social value that the enterprise creates through the goods and services it sells, the jobs it provides, and so on. Value-aligned investors may hold stock in a firm that already creates social value, but without changing the amount of social value the firm produces.

For example, value-aligned investors may select investments based on a firm's outputs—its products and services. For example, they might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or, investors may be concerned about a firm's practices—the way it produces its outputs. Or investors might want to own stock in companies that meet high ESG standards and eschew companies with poor ESG ratings.

But selecting investments based on enterprise (or sector) impact alone does not imply contribution. Consider, for example, an investor who invests in a microfinance institution (MFI), with the goal of increasing low-income individuals' access to finance, with these three alternative scenarios:

1. Because of the impact investment, the MFI can provide more loans, or loans on better terms, to borrowers, with an ultimate improvement in their welfare. In this case, we would say that the investment had impact.
2. The MFI does not expand or improve its lending practices, but simply uses the investment to pay down some more expensive debt or to pay out more dividends to equity holders. In this case, the investment did not have impact, because it did not lead to a change in outcomes from MFI borrowers.
3. Finally, suppose that the MFI is using additional capital to benefit its low-income borrowers. However, there is a surfeit of commercial money seeking to invest in the MFI on the same terms as the impact investor. Further, the MFI does not receive any special non-financial assistance from the investor. In this case, although the impact investor's desired outcome may have occurred, their investment did not contribute more to the outcome than commercial investors would have, and thus, ultimately, it did not have any impact.

For an investment to be an impact investment, it must have *both* an enterprise and an investment impact. Scenarios 2 and 3 would be examples of a value-aligned investment, whereas only Scenario 1 provides an example of an impact investment.

ABSENCE OF MEASUREMENT

An investment may also be value-aligned if it is made without a system in place to measure the impact that is made. Consider, for example, green and social bonds, whose key feature is that the use of proceeds is explicitly tied to environmental or social projects, thus allowing the managers of funds holding these bonds to demonstrate the investments' links to those social and environmental outcomes. The Green Bond Principles were first established in 2014, while the Social and Sustainability Bond Principles have been more recently developed.[37] According to the International Capital Markets Association, which maintains the Principles, projects are eligible for green or social bond issuance if they correspond to certain social and environmental themes such as renewable energy or affordable housing.

Although there is no evidence yet that green bonds change the issuer's cost of capital,[38] investments in such bonds may, in some cases, still have a credible narrative

[37] For more information on "Green, Social, and Sustainability Bonds," visit International Capital Market Association at https://www.icmagroup.org/green-social-and-sustainability-bonds/.

[38] A study of municipal green bond issuance has found that, for the same borrower, pricing is identical when comparing green and non-green bonds. This is not surprising given that holders of green and non-green bonds from the same issuer have similar rights under the principle of pari passu, and are therefore exposed to identical credit risk. What this study does not establish however is whether market pricing of credit risk is a function of the share of a firm's finance through green bonds. Just as ESG risk factors are used to predict credit risk, the fact that a firm secures financing through green bonds may provide information to the market that is ultimately reflected in prices. It is too soon to tell, however, the extent to which this is true. See Larcker and Watts 2019.

of contribution. Because markets for these securities are nascent, participation in a first issuance and even in purchases in secondary markets may contribute to growing the market, which is an impact in and of itself. This is an example where (to quote the IMP) an impact investor's "signal that impact matters"[39] may help attract other investors.[40]

Measurement is required so that green and social bonds satisfy the definition of impact investments: one must verify the allocation of proceeds. The Green Bond Principles recommended that the issuer make and keep readily available current information on the use of proceeds. This includes a list of projects to which proceeds have been allocated, a brief description of the projects, and their expected impact. Regular reporting of this information allows for impact measurement.

1.2. Why Impact Investing?

Impact Investing Can Help Spur Progress toward the SDGs

The investment needs required to meet the SDGs are tremendous. A 2019 estimate suggests that meeting the SDGs in just five key areas (education, health, roads, electricity, and water and sanitation) will require additional annual spending in 2030 of $0.5 trillion in low-income developing countries, and $2.1 trillion in emerging market economies.[41] In emerging markets, this additional spending amounts to 4 percentage points of GDP—an amount which is large, but not necessarily unobtainable, relative to increases in tax revenue that government might be able to achieve.[42]

BOX 3 Social Impact Bonds

Social bonds, in which the use of proceeds are tied to specific social projects, are distinct from social impact bonds (SIBs), which are structured more like pay-for-performance contracts than debt securities. SIBs are public-private partnerships designed to deliver social programs to underserved communities. These contracts—also called pay-for-success contracts—leverage private investment and expertise from service providers to improve the social outcomes of publicly funded services. Unlike typical bonds, investors who buy social impact bonds receive a fixed payment or return on their investment only if the desired social outcomes are achieved. In this respect, impact and financial goals are aligned without the need for undesirable trade-offs.

When properly implemented, SIBs have the potential to improve the efficiency and effectiveness of targeted social programs. Pioneered in 2010 by a United Kingdom program, Social Finance Ltd., to reduce the rate of recidivism at Peterborough Prison in Cambridgeshire, the market for SIBs is now expanding. In 2017, 108 impact bonds that raised more than $300 million were operating in 25 countries. Only six out of these 108 bonds are in low- and middle-income countries. The first Peterborough SIB has proven successful, with the recidivism of short-sentenced offenders declining by 9 percent, and the investors repaid in full. However, in the United States, these bonds have shown mixed results—the Utah High Quality Preschool Initiative to improve low-income preschooler school achievement has shown promising results, while a juvenile offender program in New York did not reduce recidivism.

[39] Impact Management Project 2019.

[40] BIIIX, Black Rock's Impact Bond fund, provides a more ambiguous example. The portfolio mostly holds securities issued by Freddie Mac and Fannie Mae, two U.S. state-owned enterprises focusing on development of the mortgage market, and mortgage backed securities. The use of funds in these bonds is linked to a specific social goal: the expansion of home ownership. Given the depth of U.S. debt markets, however, it is unclear that purchases of these securities will have any effect on the number of mortgages issued.

[41] Gaspar et al. 2019.

[42] Indonesia, for example, has mainstreamed the SDGs into its national development plans, and the authorities are considering a medium term-revenue strategy to raise government revenue by 5 percentage points of GDP over the medium term. Gaspar et al. 2019.

In low-income countries, however, the challenge is much greater. There, investment needs amount to 15 percent of GDP, and tax revenues will not be enough to finance this investment. The development community has also recognized that it, alone, cannot support such a level of financial commitment.[43] The private sector will have to fill the gap.

Recognition of this reality comes at a time when traditional investors show some reluctance to invest in poorer regions. In February 2019, the traditional private equity fund manager Blackstone exited its stake in BlackRhino, an infrastructure investment vehicle focused on Africa. Only a few years prior, the manager had talked of investing up to $5 billion in sub-Saharan energy projects by 2019.[44] KKR similarly disbanded its Africa deal team in 2017 because it could not find large enough companies to buy.[45]

Impact investors take a different approach compared to traditional investors. They have specified intent to contribute to improvement of measurable social and environmental outcomes. Considering this, today we see a convergence of interests between DFIs—traditionally focused on social development in low- and middle-income countries—and impact investors, who seek to solve challenging social and environmental problems through the deployment of private capital.

Increasingly, impact investors frame their intent in terms of a contribution toward achieving the SDGs. As we show below in Section 1.3, this has led to an increased focus on low- and middle-income countries, where the financing gaps to achieve the SDGs are greatest. The differential way that impact investors manage their investment process may lead them to seek out and finance projects that others would not, or to manage investments in such a way that they will generate more social value than would be the case if the investments had been made by traditional investors.

Of course, to say that a differential investment process automatically leads to differential outcomes is not correct. It is unclear whether impact investors, the majority of whom demand commercial returns, will find ways to invest capital toward social goals in places where others have found limited deal flow. An impact investor may act differently, and it is our hope that this causes differential impact, but it need not be the case.

Impact Investing has the potential to change the world, but only if it leads to different outcomes than traditional investments. Impact investors can prove that they make this additional contribution in two ways.

MOBILIZATION OF EXTRA FUNDS

First, they may support the mobilization of extra funds dedicated to impact beyond what the market would have sourced. Impact investing has emerged, in part, because of changing investor preferences: 86 percent of respondents to a survey by the Global Impact Investor Network, who are mostly private investment fund managers, said they had made impact investments in response to client demand.

These preferences may reflect the changing attitudes of investors about their role in society. In North America alone, $30 trillion in wealth will be transferred from baby boomers to Generation X and millennials over the next three decades.[46] Younger investors state a stronger interest in socially-motivated investment strategies.[47] A recent Barclay's investor survey found that the most important issues to investors relate to SDGs such as health, education, and water and sanitation—the sectors in which service provision has typically been the remit of the public sector.[48] Hence impact investment may be used as a channel to direct additional resources toward social objectives.

43 UN 2015.

44 Burkhardt and Metcalf 2019.

45 Clark et al. 2017.

46 Skinner 2015.

47 For example, an investor survey by Morgan Stanley (2017) found that 38 percent of respondents ages 18-35—"millennials"—were "very interested" in "making investments in companies or funds which aim to achieve market-rate financial returns while pursuing social and/or environmental impact," relative to 23 percent of the general population. This response coincided with younger respondents also being more likely to believe that such investment implies a financial trade off (59 versus 53 percent of the general population).

48 Barclays 2019.

ADDING VALUE IN THE DEPLOYMENT OF FUNDS

Second, by managing their investments in a different way, impact investors may help investee firms to increase their impact on social objectives. This may involve supporting a business to expand a bottom-of-the-pyramid retail strategy, or to provide services to underserved segments of the population. By managing with intent for impact—which involves a focus on their contribution to measurable outcomes—impact investors may differentiate themselves from "impact washers," who report on pro-social goods produced by their investee companies, but without contributing by helping their investees produce more of those goods than would have been produced by traditional investors.

1.3. How Large is the Market Today?

Measuring the Size of the Market is Subject to Several Complications

There is considerable uncertainty about the size of the market for impact investment today. Widely cited numbers range from $228.1 billion—the total assets managed by the 226 respondents to an annual survey by the Global Impact Investing Network (2018)—to as high as $1.3 trillion. This includes direct and indirect investments by over 450 signatories to the United Nations' Principles for Responsible Investing (PRI), which have been made in companies generating revenues from goods or services linked to specific environmental and social themes.[49]

Measuring the size of the market according to a consistent definition is subject to several complications. On the one hand, investor surveys, which are the sources of both the numbers above, include only those who chose to respond. This suggests the universe of impact investments may be larger than the AUM of respondents to surveys such as those above. On the other hand, impact means different things to different people. For example, though the GIIN provides its definition of impact investing to survey respondents, it notes that respondents applied it to their portfolios "as they saw fit."[50] This element of subjectivity implies that different respondents may have classified their AUM as impact investments according to different interpretations of the definition, some of which are possibly more credible than others.

The consequences of this may be seen most clearly when defining whether an investment has a narrative of *contribution*, which may be less credible in public markets. Both the headline GIIN and PRI numbers include investments in publicly traded securities. As discussed previously, however, in a world in which many investors trade only based on securities' financial performance, it is difficult to argue that merely trading the securities of public companies, based on social or environmental criteria, will affect the quantity of the social value they produce. If one is clear-eyed about the functioning of financial markets, only a subset of assets in the GIIN and PRI numbers may constitute a credible *contribution* to the achievement of impact.

Two other aspects of impact investments are that they have been made by an investor with *intent* for impact and a system of impact *measurement*. These are attributes of an investor's approach, rather than of particular assets. This implies that the relevant size of the impact investing market is the AUM of investors following an investment approach of impact intent and measurement.

This observation makes clear how the threat of "impact washing" looms large for the industry. Sector-based estimates of the impact investment market opportunity such as PRI (2018) are extremely valuable as they help investors direct capital toward social and environmental problems. An additional value is that they describe the value of the capital that one could feasibly impact-wash, in the sense that it is possible—without independent verification of their investment process—for investors to claim that they have contributed to impact, while not having intended it or measured it at all. The PRI survey identifies $1.3 trillion in assets of signatories linked to sectors related to specific social and environmental goals. Without further information on their investment

[49] Environmental themes include: energy efficiency, green buildings, renewable energy, sustainable agriculture, and sustainable forestry and water. Social themes include: affordable housing, education, health, and inclusive finance. Investments are not linked to certain SDGs: (5) gender equality, (10) reducing inequalities, (12) responsible consumption and production, (13) climate action, (16) peace, justice and strong institutions, and (17) partnerships for the goals, which recognizes that some problems may be difficult to solve through a market system, as impact investment requires.

[50] GIIN 2018; page viii.

approach, it is not possible to know which of these investments were made with the explicit intent to contribute to measurable impact, or a credible narrative of their contribution to impact. The introduction of Operating Principles for impact management (see Chapter 2) will for the first time make it possible to identify a set of investors following a common investment approach, and to the extent they are widely adopted, provide a basis for clearer estimates of market size.

In this subsection, we identify some types of investors that may meet the definition of impact investors, and some large asset classes that may be considered impact investments. This discussion is summarized in Table 1, which shows different pools of assets under management, and the extent to which these pools of assets may have the three attributes of impact investment—intent, contribution, and measurement.

TABLE 1 Investors and Types of Assets, and Whether They Have the Three Distinctive Attributes of Impact Investment

ASSET POOL	AUM US$, billions (2018)	MARKET(S) OF OPERATION	DEFINING ATTRIBUTES OF IMPACT INVESTMENT		
			INTENT for social or environmental impact	Credibly established CONTRIBUTION to the achievement of impact	MEASUREMENT of improvements in social or environmental outcomes
Outstanding Private Sector Operations Portfolio of 25 HIPSO Signatory DFIs	$742	**Private**	YES, the investor has an explicit mandate to promote social and economic impact	YES, insofar as the investor can: (a) change the investee's cost of capital, (b) transfer knowledge or technology to investees, or (c) exert influence that induces investees to improve relevant outputs or processes	YES, the investor uses indicators to assess whether the investment contributes to improvement
Non-Treasury Assets of 81 Development Banks	$3,083				
Private Investment Funds with Intent for and Measurement of Impact	$71				
Green and Social Bonds Outstanding	$456	**Public and Private**	POSSIBLY, one might purchase the product with intent to create social or environmental value The manager's marketing materials may emphasize "sustainable" or "responsible" investment, rather than "impact" Alternatively, one might purchase the product with a desire to gain (or reduce) exposure to ESG risk factors		POSSIBLY, to the extent indicators are reported by investees
ESG integration strategies*	$10,369			NO, particularly in public portfolios, strategies are unlikely to (a) change investee's cost of capital in the presence of other investors indifferent to social or environmental impact. Further, limited direct relationship with investees precludes managers from (b) transferring knowledge or (c) exerting influence	
Negative screening of securities (e.g., "sin" or "dirty" stocks)*	$15,023			NO, securities negatively screened may end up being held by those who would prefer to produce less social value	
Corporate engagement and shareholder action*	$8,365			UNCERTAIN, given board members' fiduciary duty of obedience to shareholders who are indifferent to social value	YES, through reporting on whether engagements and actions are successful

**Values refer to year-end, 2015.*

Sources: Preqin, Impact Base, Impact Asset, EMPEA, Symbiotics, Bloomberg, Thompson Reuters, Global Sustainable Investment Alliance, PwC, and Development Bank annual reports. Note: Asset values are not mutually exclusive.

Private Investment Funds with Intent for and Measurement of Impact: $71 Billion

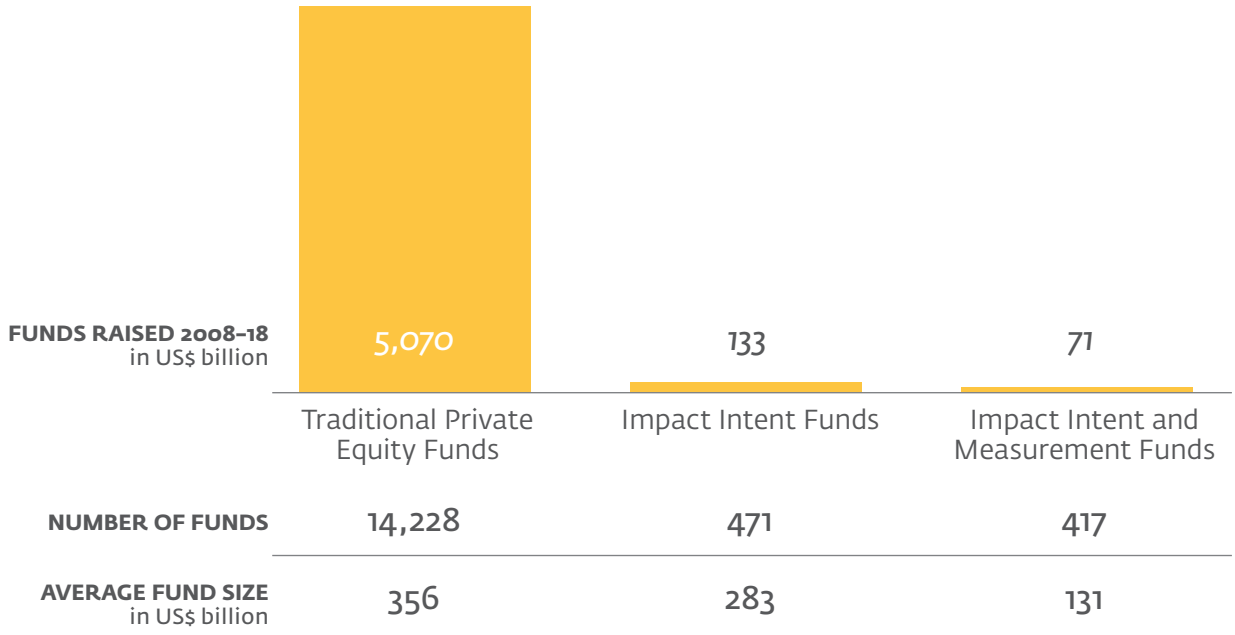
Impact investors can get exposure to private market assets by investing directly through private managers or through DFI co-investment vehicles. There is little public information available on direct impact investments by private investors, but we can find information on investments through private fund managers.

Here, we identify the AUM of private investment funds and managers whose operations have two attributes of impact investment: *intent* and *measurement*. These funds are assumed to have a well-defined contribution by virtue of their operation in private markets.

Intent and measurement are verified through the presence of a fund in various databases, which indicates that it is indeed managed with the intent to create measurable impact; or by the fact that it is owned or managed by an institution using a recognized set of private sector impact measurement tools: those of either IRIS, B-Analytics, or Gresb, which relates to real estate and infrastructure. By using these criteria, we ensure that our estimate of market size accounts only for those investors currently implementing the investment approach required by our proposed definition of impact investment. As discussed previously, this definition is broadly consistent with other definitions that have been used in the industry (Online Annex A).

Impact intent and measurement fund managers have raised approximately $71 billion dollars for 417 funds, in vintage years 2008–18, which is just more than 1 percent of all funds raised by traditional private equity funds over the same period (Figure 6). In the databases, we are also able to identify an additional set of funds which we call impact intent funds—those funds, for which measurement could not be verified, but in a database survey the fund managers expressed an "ethos" related to economic development, microfinance, or social or environmental responsibility. These funds have raised more—approximately $133 billion across 471 funds.

FIGURE 6 Private Investment Funds Raised by Asset Managers Since 2008



Sources: Preqin, EMPEA, ImpactBase, ImpactAsset50, Symbiotics, IRIS, B-Analytics, and Gresb.

Note: Includes all commitments to funds with a vintage year of 2008, or later, up to 2018Q2. In ImpactBase and Symbiotics, where some data are missing, the inception year is used in place of the vintage year. For impact intent and measurement funds, fundraising by 417 funds has been augmented with the additional AUM, not already identified in a fund, of 50 asset managers identified in 2018 by ImpactAsset 50 as managing with intent for measurable impact. For these funds, the average fund size calculation does not include these additional assets.

Until recently, impact funds have remained smaller than the average private equity fund, suggesting that—at least in the past—asset owners may have had limited appetite for such products, and especially for funds offering impact measurement. The average for funds raised by all private equity funds since 2008 was $356 million. For intent funds the average was $283 million, while for intent and measurement funds the average was $131 million. The persistent average size gap may reflect limited investor demand for impact measurement, which may reflect impact measurement's limited track record. In our data, impact intent funds are less likely than impact intent and measurement funds to be those of first-time fund managers.

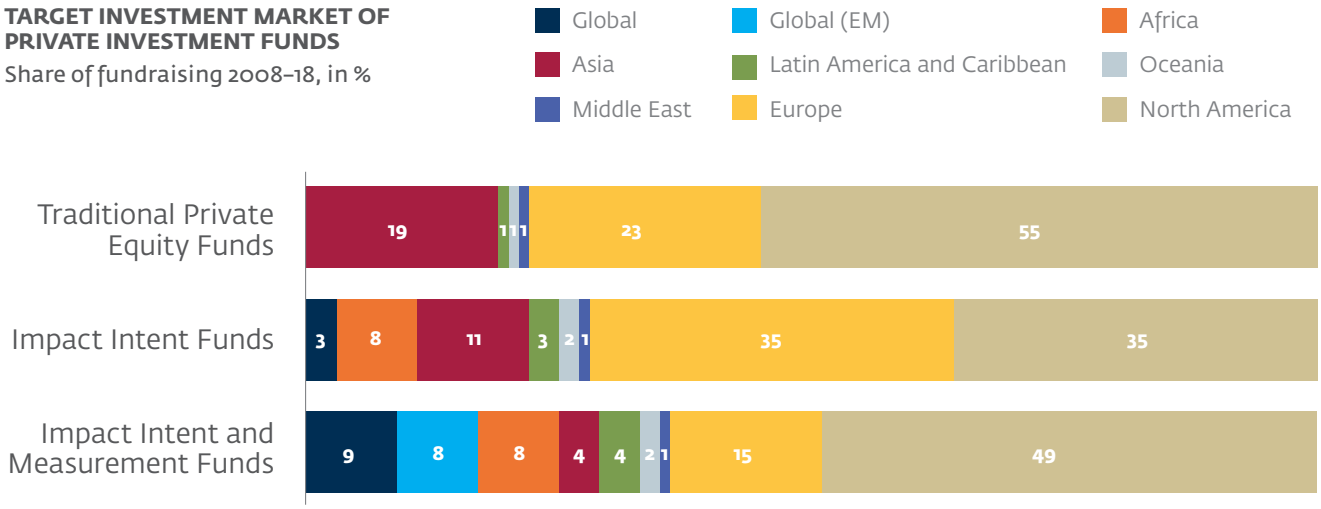
INVESTMENT FOCUS BY GEOGRAPHIC AREA AND ASSET CLASS

Impact funds, however, have a higher proportion of their portfolios in regions outside of Europe and North America, or in emerging regions (Figure 7). This suggests that impact investors have a special willingness to invest in locations that traditional investors may avoid, and also where the investment needed to meet the SDGs is the greatest.[51]

Notably, approximately 8 percent of the assets of impact intent funds are focused on Africa, as are 8 percent of impact intent and measurement funds, while less than 1 percent of traditional private equity funds go to the African continent. Intent and measurement funds are also more likely to take global, rather than regional, approaches to sourcing transactions. Eighteen percent of the assets of impact intent and measurement funds are focused on global emerging markets, whereas no impact intent funds or traditional private equity funds take this strategy.[52] Among impact intent and measurement investment funds, measurement is disproportionately focused on North America, relative to Europe, which may reflect impact investment's origins among United States philanthropists.

A large share of the investment needs identified to meet the Sustainable Development Goals are in

FIGURE 7 Impact Intent and Measurement Funds Disproportionately Focus on Emerging Markets

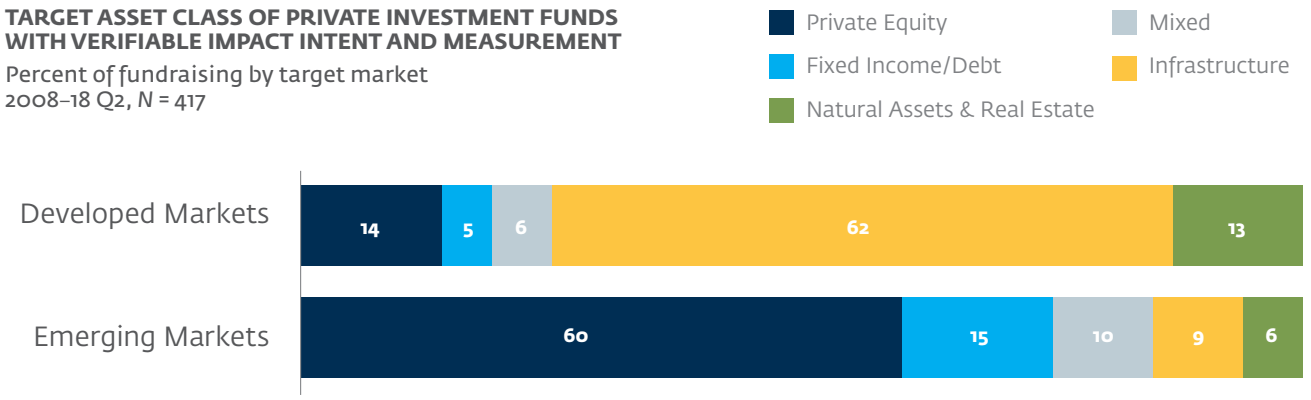


Sources: Preqin, EMPEA, ImpactBase, Symbiotics, IRIS, B-Analytics, and Gresb.
Note: Assets under management is given by cumulative fundraising since 2008. The number of traditional private equity funds included is 14,226; impact intent funds, 445; and impact intent and measurement funds, 417. The discrepancy in the number of funds between this and the figure above is the absence of information on the regional focus for some funds.

[51] On investment needs, see UNCTAD 2014; Rozenberg and Fay 2019.

[52] Sourcing funds from a global, rather than a regional pool, however, may lead to additional costs of origination, which may be an issue, especially for smaller funds with few investment staff.

FIGURE 8 Impact Intent and Measurement Funds are Focused on Infrastructure in Developed Markets



Sources: Preqin, EMPEA, ImpactBase, Symbiotics, IRIS, B-Analytics, and Gresb.
Note: Assets under management is given by cumulative fundraising since 2008. The number of funds with impact intent and measurement is 417. The discrepancy in the number of funds between this, and the figures above, is the absence of asset class information for some funds. Mixed refers to funds reporting that they invest in multiple asset classes, as well as funds of funds. Developed Markets refers to Europe, North America, and Oceania, which is primarily Australia and New Zealand; Emerging Markets refers to all others. Geographic focus information is only available at the region level.

infrastructure.[53] While impact intent and measurement funds are focused on emerging markets, very little of their investment there (just 9 percent by AUM), is focused on infrastructure as an asset class (Figure 8). This is notable because in developed markets, the majority of such funds' investment (62 percent) is focused on the asset class. Specifically, in developed markets, we have classified 25 infrastructure funds as impact intent and measurement funds because their managers are investor members of the Gresb, a measurement system to evaluate the environmental and social implications of infrastructure and real estate investments; and because they self-report having an "ethos" related to economic development or responsibility, which we take as a proxy for impact intent. Many of these funds have over $1 billion AUM. In emerging markets, however, we identified only four intent and measurement funds focused on infrastructure, and they were also substantially smaller.

This result highlights that the infrastructure investment gap is more likely due to the absence of bankable projects rather than an absence of capital. Investors can only have impact if opportunities for commercial returns are available. Impact and measurement funds have shown a special desire to go to emerging markets, but when they get there, so far, they have not been able to invest in infrastructure as an asset class, or achieve scale in doing so.[54]

A CHANGING MARKET?

For impact intent and measurement funds, fundraising has consistently fallen below target by approximately one third (Figure 9). Except for 2016, intent and measurement funds have failed to meet expectations. In contrast, traditional private equity funds have been beating fundraising expectations consistently since 2012.

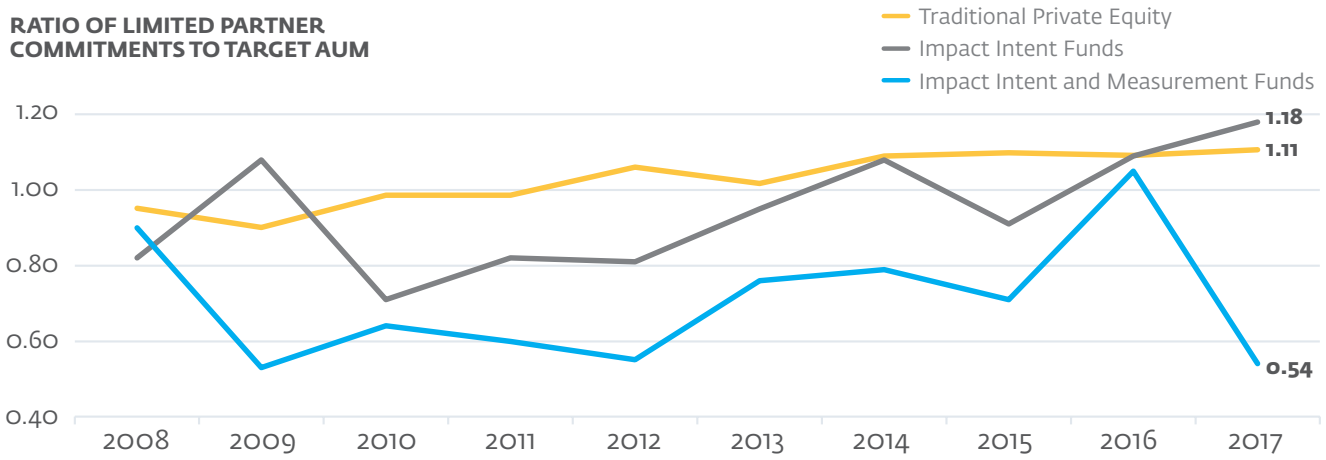
The market for managed private impact investment funds may be changing, however, as four major private equity managers have entered the market since 2017. By 2017, TPG closed its Rise Fund, having raised $2.1 billion, substantially more than its $1.5 billion target.[55] Bain Capital closed its Double Impact Fund too, at $390 million, which is also more than its target. In 2018, two other major private equity firms,

53 UNCTAD 2014; Rozenberg and Fay 2019.

54 Some private equity and debt funds may invest in smaller-scale renewable energy projects.

55 Information based on Preqin database.

FIGURE 9 Impact Intent and Measurement Funds Have Consistently Failed to Meet Fundraising Expectations



Sources: Preqin, EMPEA, ImpactBase, Symbiotics, IRIS, B-Analytics, and Gresb.
Note: Funds raised are commitments by limited partners (LPs). This only includes funds for which both target AUM and funds raised are available. For ImpactBase, missing vintage years were proxied by inception year. The number of funds: in Traditional Private Equity (6,675); in Impact intent (252); and in Impact Intent and Measurement (300).

Partners Group and KKR, each began fundraising for an impact-focused fund with a target of $1 billon. Each fund offers both intent and measurement. These managers are among the largest in the private equity industry, having raised $192 billion, collectively, since 2018. The fact that impact funds have been oversubscribed so far may indicate that demand for products that offer impact intent and measurement is changing, or that the credibility of a large manager is particularly helpful to attract investors to funds with impact intent and measurement.

Shareholder Action Strategies and Green and Social Bonds May Offer Investors Opportunities to Invest for Impact in Public Markets: $8,821 Billion

In addition to private market investments, we can identify two larger investment classes that offer the potential for investors to invest for impact in public markets, where the vast majority of assets, particularly those of households, are held. We do not have enough information on the purchasers of these assets to know to what extent they buy them with the intent to achieve impact, but we can quantify the total value of assets in each investment class.

PUBLIC EQUITIES WITH CORPORATE ENGAGEMENT AND SHAREHOLDER ACTION: $8,365 BILLION

At year-end 2015, the last year for which global data are available, $8,365 billion in assets, which were generally public equities, were managed under strategies of "corporate engagement," or "shareholder action." These strategies seek to influence or control investee companies through proxy voting or shareholder resolutions, and also less direct attempts at influence, such as writing letters to boards and management regarding ESG issues.

Most corporate engagement today may be said to lack intent for impact. Under these strategies, investors typically voice an interest in shareholder value rather than environmental or social outcomes. Governance issues (the "G" in ESG), such as proxy access, corporate political activity, and an independent board chair, are among the most common issues raised in corporate engagement.[56] This is not surprising, given

[56] US SIF Foundation 2018.

the copious literature that has shown that weak corporate governance can destroy shareholder value.[57]

However, shareholder action related to environmental and social (ES) issues is on the rise, suggesting that some of these strategies may be implemented by those with intent for social impact. In the United States, where segmented data on ES-specific resolutions are reported, and where approximately 41 percent of the value of all public equities is located, the number of resolutions filed on ES issues has risen 19 percent over the last decade, though more than half of these resolutions were withdrawn or omitted, rather than put to a vote.[58]

Recently, efforts to influence firms on these issues got a boost from the 2017 annual letter by Larry Fink, CEO of BlackRock, Inc., one of the world's largest index funds, who wrote:[59]

> *To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all their stakeholders, including shareholders, employees, customers, and the communities in which they operate.*
>
> *BlackRock can choose to sell the securities of a company if we are doubtful about its strategic direction or long-term growth. In managing our index funds, however, BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever. In this sense, index investors are the ultimate long-term investors—providing patient capital for companies to grow and prosper.*

In 2017, BlackRock voted for resolutions by shareholders (and opposed by management) requiring that Occidental Petroleum and Exxon Mobil assess the impact of long-term climate change on their businesses. And after the 2018 Parkland, Florida school shooting, BlackRock urged firearms manufacturers to assess the distribution of their products, noting that it might vote against directors of companies that did not respond appropriately.[60]

For the most part, perhaps because of uncertainties about the fiduciary duties of corporate management,[61] active ownership regarding environmental and social issues has typically focused on information disclosure or the establishment of review processes on specific issues. For example, in 2017, BNP Paribas Asset Management co-filed a resolution demanding that Exxon Mobil make deeper disclosure of climate change risks and the extent of research and development into low-carbon energy sources.[62] That same year, State Street Global Advisors successfully exhorted Liquide S.A., a French industrial gas company, to establish an Environment and Society Committee to make recommendations to management on a sustainable development strategy.[63]

It may be difficult for active owners to exert influence on issues closer to day-to-day operations, leading to some uncertainty about the ultimate contribution of such strategies. For example, in 2015, a U.S. court blocked a proposal by Trinity Church of Manhattan and other shareholders to require Walmart's management to oversee the sale of "products that especially endanger public safety," with the goal of banning the sale of guns with high-capacity magazines. The court concluded that the resolution contravened a federal prohibition against shareholders' micromanaging "ordinary business

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57 See Shleifer and Vishny 1997; Bebchuk et al. 2008; and Claessens and Yurtoglu 2013.

58 Institutional Shareholder Services (ISS), Voting Analytics U.S. Most shareholders have the right to file proposals. However, companies naturally seek to quash them on the grounds that they interfere with ordinary management decisions. In the U.S, the Securities and Exchange Commission (SEC) then decides whether to allow the proposal. If allowed, the company may negotiate with the proposer to make changes and persuade the proposer to withdraw; or let it go to a vote. If it goes to a vote, it is not binding, but there is a lot of moral suasion and power.

59 BlackRock 2017.

60 BlackRock 2018.

61 It is not clear whether U.S. law requires corporate management to maximize shareholder value to the exclusion of social goals or to obey the commands of shareholders. On this, see Blair and Stout 1999 and Elhauge 2005. Nonetheless, claims that management or directors are not maximizing shareholder value have been used frequently to justify lawsuits or corporate takeovers. On this topic and the specific case of the attempted takeover of the DuPont Corporation by activist investor, Nelson Peltz, see Strine 2017.

62 Williams 2018.

63 State Street Global Advisors 2017.

operations."[64] Although Walmart did, in fact, stop selling such guns in the Unite States that year, this may have been in response to customer sentiment, rather than shareholder action.[65] Given the court's ruling, had the issue been less salient to the public, it is unclear whether there would have been the same outcome.

In any event, owners may be less constrained in the influence they can exert when firms are structured as benefit corporations (BCs), which have emerged recently in many jurisdictions in the U.S. Under such a structure, directors are legally obligated to consider interests beyond those of shareholders, including those of others materially affected by the business—workers, customers, suppliers, the communities in which the firm operates, and the environment. Further, BCs must show that they deliver a public benefit, or "a material positive impact on society and the environment [...] assessed against a third-party standard."[66]

So far, more than 5,000 companies have adopted the BC structure in the U.S. alone.[67] Though a few are large and publicly traded, notably Danone, the French food company, which has adopted the structure for its the North American subsidiary, most BCs remain small and/or privately held. This reflects an initial motivation for the structure, which is that it may allow entrepreneurs to protect the values of their business in the event of an acquisition.[68] If large shareholders were to advocate for firms to adopt a BC structure, it would give investors greater scope to exert influence or control over management, and thus greater scope to create impact.

Ultimately, growth in voting against management has marked a significant break from the practice of large fund managers, and offers a view of how impact—a change in management behavior that creates new social value—may be achieved in public markets. Further, asset managers typically measure the success of their engagements in reports to asset owners. In this sense, corporate engagement frequently has impact measurement. Some managers evaluate success based on different criteria: while some firms focus only on whether their action changes a company's behavior, others may show they have achieved success when they feel they have influenced the opinions of other market participants through their actions.[69]

GREEN AND SOCIAL BONDS OUTSTANDING: $456 BILLION

Green and social bonds aligned with the Green Bond Principles can channel funds to firms for environmental and social purposes. As described above, this can also make a contribution to the development of a nascent market (Box 3). However, many outstanding green and social bonds lack reporting on allocation of proceeds, making impact measurement a challenge. The Green Bond Principles, developed in collaboration with IFC and other issuers, have created a common standard for reporting on use of proceeds, and may, over time, establish common impact reporting standards. The establishment of the Principles in 2014 was instrumental in attracting larger amounts of capital to this asset class.

The market has grown rapidly since 2007 (Figure 10). As of 2018, $456 billion in green and social bonds was outstanding comprising less than 1 percent of the total debt securities, outstanding.[70] So far, governments have issued the greatest share of these bonds outstanding by value (73 percent of social bonds and 38 percent of green bonds), followed by financial firms (24 percent of social bonds and 29 percent of green bonds).[71] Non-financial firms have the smallest share of the overall bond market.

64 Bainbridge 2016.

65 Tabuchi 2015.

66 Hiller 2013.

67 For a database, see http://benefitcorp.net/businesses/find-a-benefit-corp.

68 On the incentives of shareholders to take such action see Hart and Zingales 2017.

69 For example, BNP Paribas Asset Management defines success of an engagement as when the company withdraws the proposal and/or when BNPP AM's vote is changed in favor of the proposal after a modification of the resolution, or if additional information is obtained. For more information, see BNP Asset Management 2018. State Street Global Advisors (SSGA) defines the success of an engagement when at least one of the following happens: (a) a company implements changes to their ESG-related programs, practices, or processes, consistent with SSGA's engagement or voting feedback, (b) several market participants, such as asset owners, asset managers, consultants, regulators, and proxy advisory firms, are influenced by SSGA's thought leadership on thematic ESG issues. For more information, see State Street Global Advisors 2017.

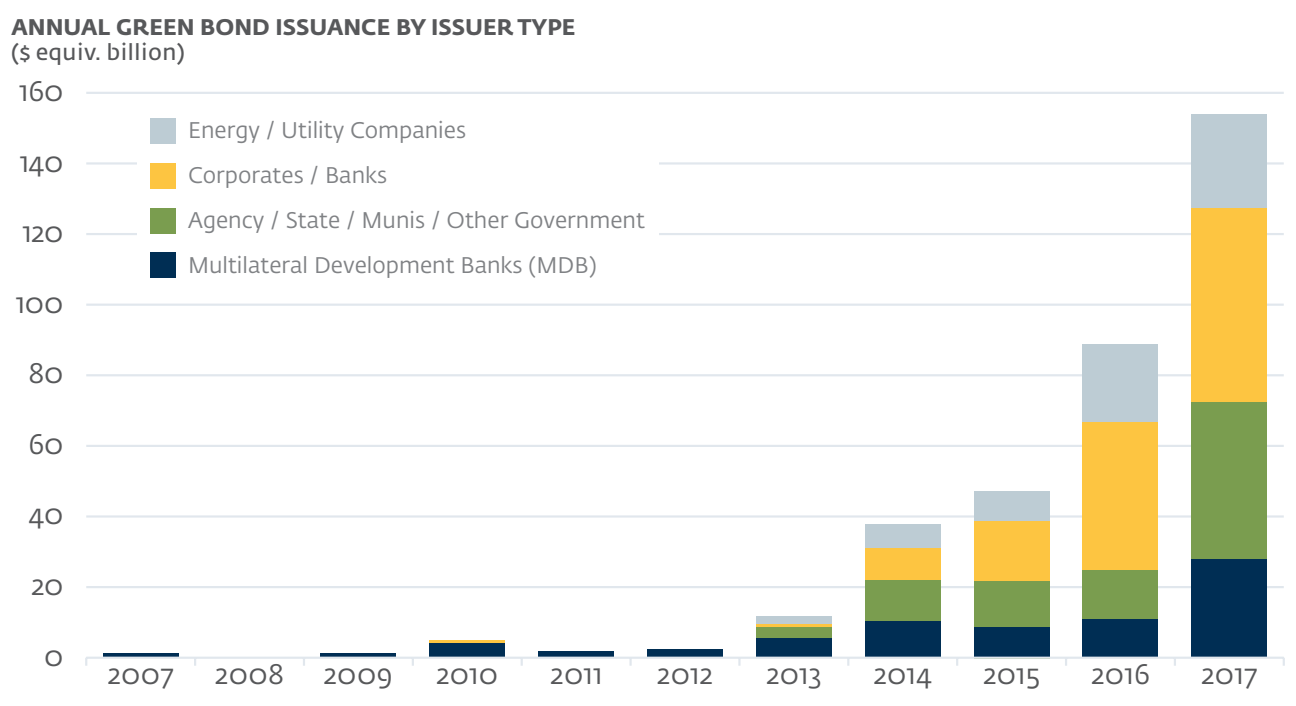
70 According to BIS, Capital Market Association, Bloomberg, and Thompson Reuters.

71 According to International Capital Markets Association, Bloomberg, and Thompson Reuters.

BOX 4 The Role of Investment Principles in the Growth of the Green Bond Market

To help develop and coordinate public and private sector activity to combat climate change, the IBRD and IFC launched their Green Bond Programs in 2008 and 2010, respectively. Green Bonds are an innovative financial instrument to address climate change. They are defined as any type of bond instrument where the proceeds will be exclusively applied to finance or refinance new or existing projects that provide clear environmental benefits. Hence, green bonds generate financing for projects in renewable energy, energy efficiency, sustainable housing, and other eco-friendly industries. The issuer assesses and, where possible, quantifies these benefits. The Green Bond issuer classifies the use of proceeds based upon its primary objective for the underlying projects and provides a description of the use of proceeds in the underlying legal documentation. Issuers must inform investors of the environmental sustainability objectives, the process used to determine that the projects fit within the eligible green project categories, and the process applied to identify and manage potentially material environmental and social risks.

FIGURE 10 The Green Bond Market Has Grown Rapidly, With an Increasing Share of Issuance Coming from Corporates



Source: IFC 2018; p. 8.

The green bond market has seen explosive growth in the past decade (Figure 10), presenting an unrivaled opportunity in climate finance. Annual issuance has risen from zero to over $150 billion globally. To promote issuance and maintain integrity, the green bond industry needed to be guided by agreed environmental, social and governance standards and terms for transparency, responsible investor behavior, and impact evaluation. For this purpose, the Green Bond Principles were developed by the Executive Committee of the Green Bond Principles, a collaborative industry group combining issuers, underwriters, and investors. The Green Bond Principles (GBP) were established in 2014 as voluntary guidelines for issuers and underwriters of Green Bonds. They were created to promote discipline in the Green Bond market, recommending transparency, disclosure and reporting of the environmental sustainability of the underlying bond issues. The GBP focus on the use of proceeds with the aim to support environmental sustainability through specific projects and foster an increase in capital allocated to such projects. There are four core components of the GBP: 1) use of proceeds; 2) process for project evaluation and selection; 3) management of proceeds; and 4) reporting. The GBP also recommend that issuers have an independent external review to confirm the alignment of their bond or bond program with the four core components of the GBP. Most green bonds have been issued in developed nations, although many experts see great growth for green bonds in emerging markets.

Examples of Green Bonds that could qualify as impact investments in alignment with the Operating Principles for Impact Management are:

1. Green Bonds issued by a signatory to the Principles: use of proceeds would fund investments targeting positive and measurable environmental impact. As a signatory to the Principles, the issuer will have provided a disclosure statement that it has an impact management system to monitor the use of proceeds and measure impact of the use of proceeds, bringing these investments in alignment with the Principles.

2. Green Bonds for which the issuer adheres to the GBP and:
   a. the issuer manages, reports on and assesses the impact of the use of proceeds of the bonds, or
   b. the investor monitors the use of proceeds and assesses the impact of the proceeds of the bonds.

Source: IFC 2018a.

Governments Are Also Impact Investors, Through the Outstanding Private Investment Portfolios of Development Finance Institutions: $3,825 Billion

Development finance institutions have been created by governments to fill gaps in the market for certain financial products such as long-term credit, or finance for small and medium enterprises (SMEs). Typically, DFIs have a mandate to pursue some combination of economic, social and/or environmental goals, which may be understood as intent to create social and environmental impact.

These institutions have been included in many estimates of the size of the market for impact investment, comprising for example 45 percent of AUM of GIIN survey respondents in 2018.

Across the world, we have identified at least 106 government-owned development banks with mission statements that could be interpreted as intent for impact (Online Annex B).[72] Many of these banks invest without sovereign guarantees, taking commercial risk. Other parts of their operations seek sub-commercial returns, for instance through the blending of concessional capital from donors with funds seeking commercial terms (Box 6).

INVESTMENTS IN FIRMS BY 25 HIPSO SIGNATORY DFIS: $742 BILLION

25 DFIs have shown their intent to measure impact by signing a memorandum of understanding on Harmonized Indicators for Private Sector Operations (HIPSO), which supports a framework for impact measurement. Their combined outstanding private sector operations portfolio is around $742 billion.

The largest of these banks by assets is the European Investment Bank. By the Treaty on the Functioning of the European Union, the European Investment Bank's intent is to "contribute [...] to the balanced and steady development of the internal market in the interest of the Union."[73] The second largest is the International Finance Corporation (IFC), whose chartered intent is to "further economic development by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas."[74]

This estimate of their outstanding portfolio comprises three components: non-treasury investment portfolios of loans and equity investments, and debt securities to non-sovereign entities ($455 billion); an estimate of the stock of third-party investment that has been directly mobilized by DFIs over five years ($255 billion); and gross exposure to guarantees to non-sovereign entities ($32 billion).

Direct mobilization refers to assets managed and invested by DFIs on behalf of others. For example, IFC has a Managed Co-Lending Portfolio Platform (MCPP), which is essentially an investment fund allowing other investors to gain exposure to subsets of the IFC debt portfolio such as through tranches of a syndicated loan or by providing credit insurance to IFC's own account. As of 2018, the MCPP had raised $7.1 billion from eight institutional investors, six of which are private institutions.[75] IFC also has a separate asset management company that from its inception to 2018 had raised $7.8 billion from outside investors (Box 5).

There is no standardized reporting on the *stock* of assets managed by DFIs in this way. However, since 2016, many DFIs have reported on private direct mobilization: the annual *flow* of investment from private entities on commercial terms "due to the active and direct involvement of an MDB leading to commitment.

[72] We have done our best to compile a list of development banks—institutions with a mission statement to promote economic development and some government ownership. In addition to lists kept by associations such as the OECD and the International Development Finance Institution Club, we conducted a web search for "development bank" for each World Bank member country. Banks were included in the list if it satisfied three criteria: (a) their mission statement and reference documents suggests a mission that relates to social and economic development, as opposed to just financial return, and (b) they have some government ownership or were originally formed by an act of government (multiple banks are identified in some countries), and (c) recent balance sheets were available.

[73] Article 309. Treaty on the Functioning of the European Union. See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT.

[74] IFC Articles of Agreement: Article 1.

[75] These six are the private insurers: Allianz, Axa, Liberty Mutual, Munich Re, Prudential, and SwissRe, who together have committed $3.1 billion. The remaining $4.0 billion was committed by two sovereign investors—China's State Administration of Foreign Exchange (SAFE), which manages state foreign-exchange reserves, and the Hong Kong Monetary Authority, the currency board of Hong Kong SAR, China. See https://www.ifc.org/wps/wcm/connect/17c06221-61f2-4c26-b028-4ddb29f4d3e8/MCPP+Overview+Flyer+2018.pdf?MOD=AJPERES.

Evidence of active and direct involvement include mandate letters, fees linked to financial commitment or other validated or auditable evidence of a DFI's active and direct role leading to commitment of other private financiers."[76] In 2016, these DFIs recorded $50 billion in direct mobilization for long-term financing in all countries, and in 2017 they recorded $52 billion. Taking the average of these two numbers, times five, is approximately $255 billion—a rough estimate of the stock of private assets under management by DFIs, assuming funds are committed for five years at a constant rate. This number may be lower, of course, if DFIs' direct mobilization was less before it was measured.

NON-SOVEREIGN LENDING BY OTHER NATIONAL AND REGIONAL DEVELOPMENT BANKS: $3,083 BILLION

In addition to these DFIs that have adopted the HIPSO framework, there are a large number of other government-owned national and regional development banks with mandates to achieve a range of policy, economic, and social goals. In addition to lending to governments, and with sovereign guarantees, many of these institutions lend to private firms. We have identified 81 such development banks which have mission statements describing intent to promote economic or social development (Online Annex B).

BOX 5 Women Entrepreneurs Debt Fund

Women play a critical role in the global economy as entrepreneurs. They help create jobs, generate income, and boost revenue—driving economies, while reducing inequalities between women and men. Yet, when compared with men, women face greater obstacles in almost all spheres of economic activity—including access to finance and assets, technology, and peer-to-peer networks. According to the World Bank Group's 2018 *Women, Business and the Law* report, in more than one-third of economies, women do not have the same legal rights as men with regard to freedom of movement. In some countries, women cannot register a business, sign a contract, or open a bank account.

Access to financial and nonfinancial services is one of the key barriers for women. A recent IFC study noted that the SME finance gap for female entrepreneurs in developing countries is $1.48 trillion (IFC 2017). The private sector is key to bridging this gap.

The Women Entrepreneurs Debt Fund, which is managed by the IFC Asset Management Company, is part of the overall Women Entrepreneurs Opportunity Facility that was launched in March 2014 by IFC and the Goldman Sachs Foundation. The Fund provides a platform for investing at scale in commercial banks in developing countries, which are essential to bridging the financing gap for woman entrepreneurs and achieving a larger reach. The investments being made in the Fund by investors go to national banks, which then increase their lending to local women entrepreneurs. To-date, the Fund has invested in nine banks in Africa, Asia, and Latin America.

The Fund has had a positive impact in supporting entrepreneurship, the largest source of female employment in emerging markets. It has helped to close the credit gap for women-owned SMEs, which should significantly boost income per capita. It has also had a catalytic impact in changing financial institutions' approach to lending to women's SMEs. Overall, the Fund has demonstrated that women's SMEs are an investable asset class, and this is sparking attention and interest for future financial support.

[76] Direct mobilization refers to investments by private households and institutions, though some may be from publicly owned institutions, such as sovereign wealth funds, which operate on commercial terms. These reports also report indirect mobilization, which, for example, includes sponsor financing of projects in which MDBs invest. Since these funds are not managed directly by MDBs, we exclude indirect mobilization from the analysis. The methodology used by these MDBs is described here, http://documents.worldbank.org/curated/en/813091529416636675/pdf/WP-PUBLIC-DocumentsPrivInvestMob-Draft-Ref-Guide-Master-June2018-v3.pdf.

Given limited data on the share of portfolio allocated to treasury, sovereign and non-sovereign operations, the outstanding impact investment portfolio of these institutions is estimated, roughly, at 50 percent of total assets. This amounts to $3,083 billion. The largest bank in this group is the China Development Bank, the stated mission of which is "enhancing national competitiveness and improving people's livelihoods."[77]

To the extent that these assets are invested with the intent to contribute to measured social and environmental impact, they could be considered as impact investments. However, the role and performance of these development banks is beyond the scope of this report.

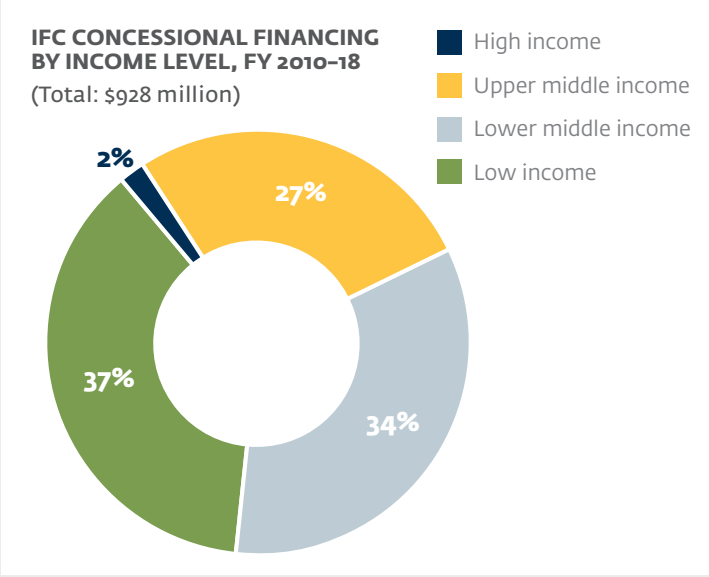
BOX 6 Blended Concessional Finance

Blended concessional finance is an investment approach used by DFIs to blend concessional funds—typically from donors—with commercial funding. Many investment projects in developing countries are unable to attract private sector financing, either because returns are unproven or they are not commensurate with the high level of risk. Blended finance can mitigate early-entrant costs or project risks, thereby re-balancing the risk-reward profiles for pioneering investments. This, in turn, helps mobilize private capital flows that would otherwise not be available to projects with high development impact.

DFIs use blended concessional finance to initiate private investments that contribute to the Sustainable Development Goals. To avoid misuse of subsidies, DFIs have agreed to implement joint principles for blended concessional finance. IFC relies on blended finance to support high-impact projects in priority areas such as climate change, agribusiness and food security, and finance for SMEs, including women entrepreneurs. From fiscal years 2010 to 2018, IFC deployed nearly $1 billion in concessional donor funds to support 169 high-impact projects in more than 50 countries. These leveraged $3.5 billion in IFC financing and more than $4 billion from private sources. IFC uses instruments such as guarantees, concessional debt, equity participation, and performance-based incentives to implement blended finance.

Blended concessional finance is particularly prevalent in low- and lower-middle income countries, and in Sub-Saharan Africa, where access to private investment is often rare due to both real and perceived market risks. About 71 percent of the amount of IFC concessional financing ($661 million) was directed to low- and lower-middle income countries over the fiscal years 2010–18 (Figure 11).

FIGURE 11 IFC Concessional Financing by Income Level



Source: IFC data and Sierra-Escalante et al. 2019.

[77] Mission Statement. See http://www.cdb.com.cn/English/qywh/khsm/.

1.4. What is the Growth Potential?

Various forecasts of growth have been made for the impact investment industry. In 2010, JP Morgan estimated that between $400 and $1,000 billion could be invested for impact by 2020.[78] This is based on a forecast of investments that could be made in firms selling products or services to customers earning less than $3,000 annually. In 2015, using a similar "bottom of the pyramid" approach, a study commissioned by the Global Steering Group for Impact Investment predicted that the market would reach $307 billion in the same year.[79] Most recently a private equity executive issued a provocative challenge for his industry: "What if we could do this at institutional scale? What if we could attract $10 trillion to invest in impact?"[80]

Forecasting this industry's growth has distinct challenges. First, different impact investors are trying to solve different social and environmental problems. Since 2015, the private sector has aligned with the SDGs as a broad, overarching framework to quantify social and environmental goals.[81] This raises the proposition that the market for impact investment is larger than that which exists in firms with lower-income customers. Second, and most fundamentally, under such a broad set of goals—including, for instance, decent work and economic growth and the assumption that one may earn a commercial return while creating impact (as notions of "shared value" may seem to imply)[82]—defining the boundaries of the potential market becomes extremely difficult. If one can do well while doing good, who would not do this? At first glance, it may appear that investor appetite for impact investment is only limited by the stock of capital.

These issues become clear when looking at the investments of the self-identified impact investors today. Impact investors have identified managed funds that span diverse impact objectives and operate in public and private markets. For example, Toniic, a network of high-net-worth individuals, and their family offices and foundations, has compiled a database of the impact investments of its members, which are coded by asset class and have been aligned with specific SDGs (Figure 12). The database reflects the preferences of these individuals, and also the supply of impact products currently in the market. The largest number of products available is tagged as private equity. Fixed income (loans and bonds) is a close second, reflecting individuals' demand for safer assets. Real estate also features prominently, especially in SDGs 11 and 15, which relate to land, cities, and communities. Public equity funds are held too, especially in SDGs 12 and 13, which concern climate action and responsible consumption and production—the two themes frequently emphasized by large public corporates. The most commonly aligned SDG is 8: Decent Work and Economic Growth, which is perhaps not surprising given the direct link between economic growth and investment.

Here, in a speculative exercise, we estimate investor appetite for impact investment today by all *asset owners*. This corresponds to the assets that could be captured by professional impact investment fund managers, or alternatively those that asset owners might invest for impact directly from their own account. Rather than being based on a bottom up approach—either an investor survey or market scan of which investments might be impactful, as in previous estimates—the estimate is top-down. Starting with the total financial assets owned by households and public and private institutions, we generate two scenarios of appetite for impact investment, one at commercial returns and one at sub-commercial returns.

Under the scenario in which they earn commercial returns, we assume that investor appetite corresponds to the 29 percent or the share of assets managed under SRI strategies, which perhaps signal interest of investors

[78] J.P. Morgan Global Research 2010.

[79] For more information, visit http://gsgii.org/reports/global-impact-investing-market-size-and-forecast-from-2015-till-2020/.

[80] Bank 2018.

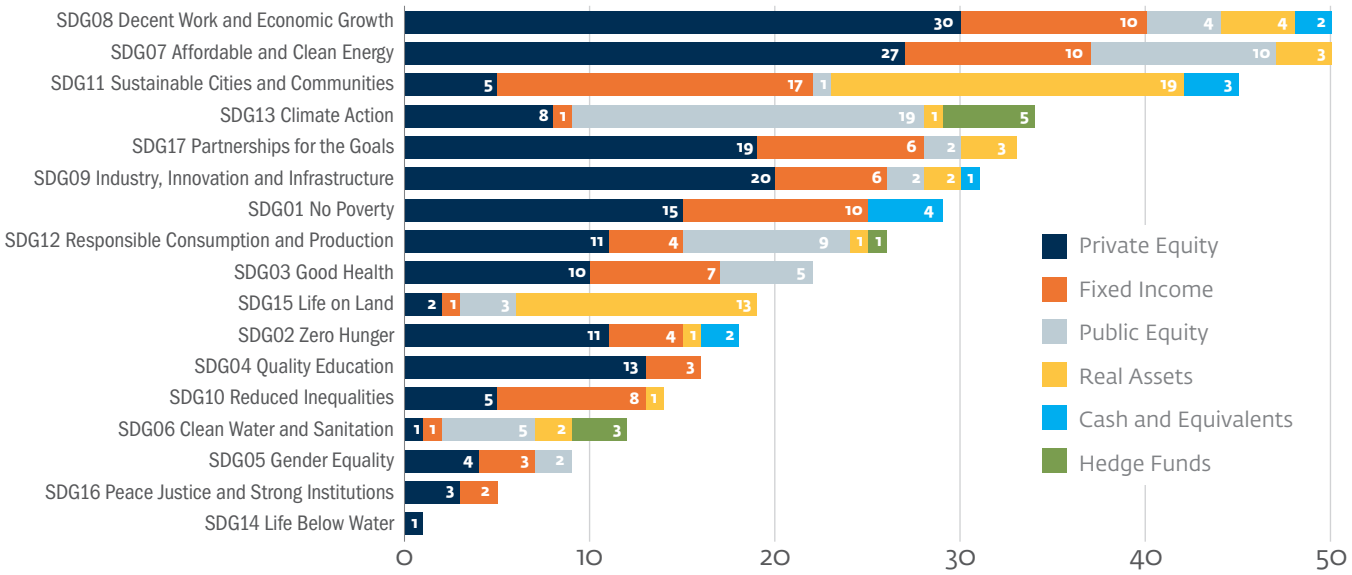
[81] For example, the World Benchmarking Alliance, an initiative of Aviva, the insurer; the Index Initiative, a non-profit; and the United Nations Foundation, has undertaken to develop benchmarks quantifying the contribution that major industries and firms make to the goals.

[82] Shared value is introduced by Porter and Kramer 2006.

FIGURE 12 Impact Investors Purchase Professionally Managed Investment Products in Public and Private Markets

INVESTMENTS IN MANAGED PRODUCTS BY TONIIC MEMBERS, BY ASSET CLASS

Number of funds aligned with each Sustainable Development Goal



Source: Toniic Directory.
Note: Includes actively and passively managed funds.

in social or environmental outcomes alongside financial return.[83] Under the scenario of sub-commercial returns, we assume that households invest only 19 percent of their assets for impact, or the share of managed assets under negative screening strategies, which arguably indicates a willingness of asset owners to sacrifice returns.[84] Online Annex B reviews the methodology.

Crucially, our analysis accounts for the fact that investors hold financial assets in three broad asset classes, which vary substantially in their liquidity.[85] These are: (a) cash, (b) assets traded in public markets, namely as debt securities and public stock, and (c) assets traded in private markets, such as alternative managed investment products, including private equity and debt funds, and other direct own-account investments. Investments in cash do not generate impact. The overwhelming share of financial assets, 74 percent, are held in stocks and bonds, which are traded in public markets (Figure 13).[86]

To account for additional uncertainty about how and whether one may have impact by investing in public markets, we further discount investor appetite for impact investment in public markets. Out of debt securities, we remove the 49 percent of assets that are held in government securities, focusing only on debt securities issued by corporates. Out of public stocks, we retain only 9 percent of their value; this corresponds to the value of assets managed under corporate engagement and shareholder action strategies. This assumes that appetite for shareholder action strategies remains fixed, independent of appetite to invest for impact. Using this conservative approach, we estimate that, under the assumption of commercial returns, appetite for impact investment in private markets by

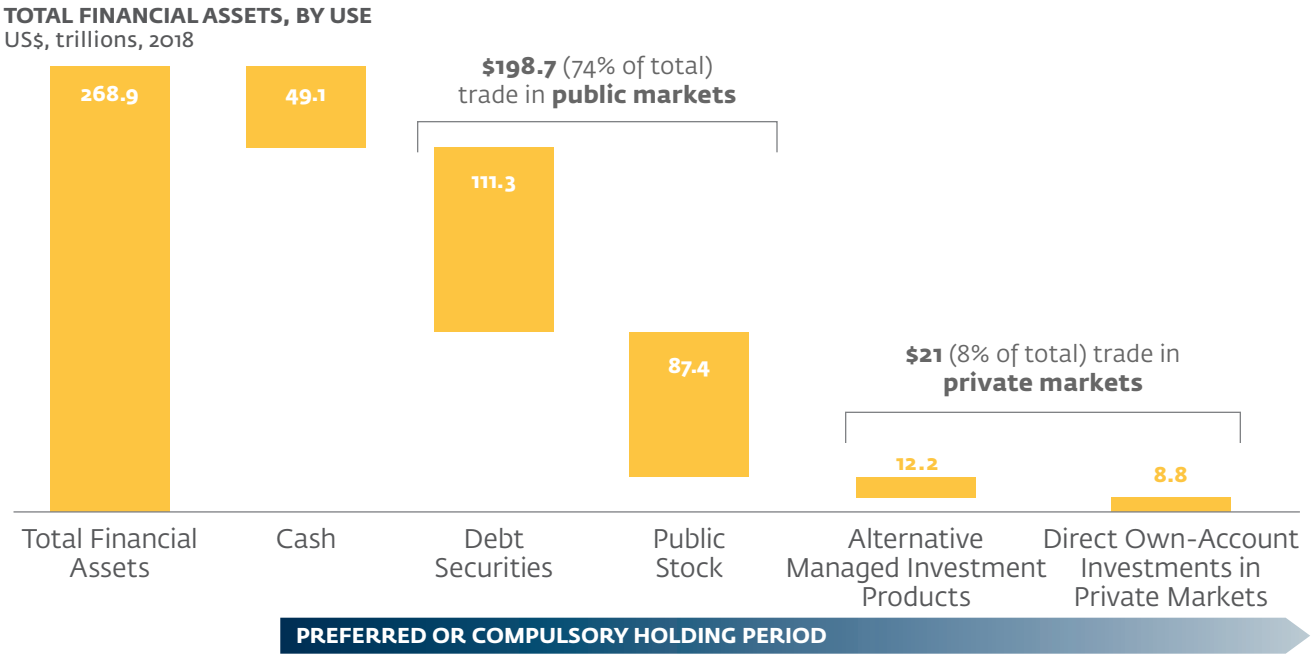
[83] Twenty-nine percent is the total $22.89 trillion in assets reported by the Global Sustainable Investment Alliance, divided by an estimate of the total managed assets for the same year, based on data from PwC. See GSIA 2017.

[84] Percentage also based on PwC and GSIA. See GSIA 2017.

[85] As described above, our estimate of total financial assets may not include certain illiquid assets, such as housing.

[86] Notably, bonds are not typically sold on exchanges, but rather in brokered transactions. Nonetheless, some markets, most notably the United States by asset value, have obtained substantial depth and liquidity.

FIGURE 13 Only 8 Percent of Assets Trade in Private Markets Offering Less Liquidity



Source: PwC, Credit Suisse, Bank for International Settlements (BIS), World Development Indicators, World Federation of Exchanges, and development bank annual reports.

Note: The figure is illustrative. The value of public debt securities and equities oustanding may fluctuate substantially day to day with market prices. The value of less liquid alternatives will also fluctuate, if marked to market. As a consequence, total financial assets should be expected to fluctuate by trillions daily. Public stock refers to the domestic market capitalization of all stock exchanges in the World Federation of Exchanges, as reported by the World Development Indicators. Debt Securities refers to the sum of total debt securities reported by BIS, and for countries with missing data (primarily those in emerging markets), the sum of domestic and international securities, as reported by BIS. Total financial assets include the total assets of 106 DFIs with intent to promote economic development ($7.4 trillion).

TABLE 2 Private Household and Institutional Investor Appetite for Impact Investment is $5.1 Trillion in Private Markets; $21.4 Trillion in Public Markets

POTENTIAL INVESTOR APPETITE FOR IMPACT INVESTMENT	AUM US$, trillions (2018)	
	Commercial Return	Sub-Commercial Return
PRIVATE MARKETS	8.7	1.5
Private Institutions and Households	5.1	1.5
DFI own account	3.6	-
PUBLIC MARKETS	22.8	3.2
Private Institutions and Households	21.4	3.2
DFI own account	1.4	-
TOTAL	31.5	4.7

Source: PwC, Credit Suisse, BIS, World Federation of Exchanges, OECD, National Association of Insurance Commissioners, GSIA.

private institutions and households, is $5.1 trillion; appetite in public markets, however, is much larger, at $21.4 trillion (Table 2). Of course, at sub-commercial returns, the appetite is much lower.

The Promise of Impact Investing to Contribute to Achieving the SDGs

This analysis highlights two requirements of impact investing if it is to achieve scale in asset value. First, and perhaps most obvious, the growth of the market is limited by the return it can deliver. Second, the bulk of demand is in public markets, especially given households' preferences for liquid securities (Online Annex B).

This demand estimate is also informative about how, and to what extent, impact investors may contribute to the effort to meet the Sustainable Development Goals. Consider the widely cited estimate by the United National Conference on Trade and Development (UNCTAD): At the global level, total investment needed to meet the SDGs are on the order of $5 trillion to $7 trillion per year.[87] In developing countries, needs are estimated at $3.3 trillion to $4.5 trillion, with a midpoint of $3.9 trillion. This capital expenditure spans many sectors: hospitals, schools, telecommunications infrastructure, water and sanitation, railways, airports, irrigation, and conservation projects.

Such investments have a long payback period of seven years, at the very least.[88] Investing at this rate, under the assumption that they earn a commercial return—private institutions and households can be expected to invest $728 billion for impact annually ($5.1 trillion over seven years) in private markets—a substantial contribution toward SDG needs. If they earn a sub-commercial return, however, they have appetite to invest $214 billion for impact annually, less than 10 percent of investment needs.

In public markets, of course, the potential is much greater. There, impact investors could invest $3.1 trillion annually ($21.4 trillion over seven years), within the range of what is needed in developing countries today. This implies that investment by public companies—those whose equity is traded on stock exchanges, or who issue debt securities—must play a role if we are to mobilize financing on a scale needed to finance the SDGs.

Ultimately, the extent of impact investors' contribution toward the SDGs depends on two crucial factors: one, whether they can influence the behavior of firms by investing in securities traded in public markets; and two, whether they can earn commercial returns while solving the social, environmental, and economic problems outlined in the SDGs.[89]

[87] UNCTAD 2014.

[88] An IFC senior loan has a typical tenure of 7–12 years.

[89] The United Nations has provided a list of 230 indicators corresponding to each of the SDGs, which may help focus investors' attention on specific problems, rather than on broad themes. A review of these indicators suggests that it may be very difficult to achieve certain goals through investment that delivers a commercial return, given the limited ability of beneficiaries to pay. For instance, one observes that Goal 3 (good health and well-being for people) is primarily about solving problems such as maternal and infant mortality, rather than more quotidian problems such as personal care. Although the latter problem is addressed by private firms which can earn commercial returns selling soap and toothpaste, the former problems may not be. UN 2016.

CHAPTER 2

ADDRESSING THE CHALLENGES FACING THE IMPACT INVESTMENT INDUSTRY

2.1. Establishing that Impact Investments Can Offer Commercial Returns

A primary challenge facing the impact investment industry is uncertainty about whether investors should expect commercial or sub-commercial returns from impact investments. Perhaps not surprisingly, given the industry's origins in philanthropy, some potential investors believe impact investments must inevitably yield returns that are sub-commercial. A Morgan Stanley investor survey found that 63 percent of respondents under age 35 agreed that investors face a trade-off with regard to the size of their returns if they invest for "positive impact."[90]

How do the returns of impact investors compare with those of purely financial investors? Here, we review the empirical literature so far on this topic, which finds that while some impact investors have achieved sub-commercial returns, others have obtained commercial returns. We then contribute to that literature by showing that IFC projects on average have delivered returns that are in line with relevant public market indices for emerging markets, allowing it to achieve financial sustainability over a long period of time. Together, these findings suggest it is possible to invest with intent for impact and achieve reasonable financial returns.

Theoretically, the relationship could go either way. On one hand, an impact investment strategy may incur search or technical assistance costs that are greater than those of traditional investing. On the other hand, in seeking high-impact projects in markets with limited information, impact investors may identify opportunities that others miss, leading to better performance. Managing for impact after one has already invested may also lead to greater profits, as notions of "shared value" imply.[91] That said, it may not make a difference either way, given that returns are so variable, in particular across equity investments

While Some Impact Investors have Obtained Sub-Commercial Returns, Others Have Earned Commercial Returns

There are two challenges in assessing the returns to impact investment strategies. First, to characterize the average return to an investment strategy requires a dataset that includes the population of managers that implement that strategy. Without such a dataset, an estimate of average returns may be biased to the extent that managers with higher or lower returns fail to appear in the dataset. For example, in a seminal study, Malkiel finds that between 1971 and 1991, U.S. mutual funds underperformed the market on average, even gross of expenses. This leads to the conclusion that "investors would be considerably better off by purchasing a low expense index fund, than by trying to select an active fund manager who appears to possess a 'hot hand.'"[92] Malkiel shows that previous studies had found the opposite because the datasets used included only mutual funds currently in existence and excluded those funds that had terminated operations, and had systematically lower returns. Selection bias in a sample can, therefore, lead to substantially different conclusions.

Second, even if selection bias can be overcome, it may not be possible to determine whether those investors in the dataset are trying to achieve commercial returns

[90] Morgan Stanley Institute for Sustainable Investing 2017.

[91] Porter and Kramer 2006.

[92] Malkiel 1995; p. 571.

in the first place. Lower average returns among impact investors may simply reflect the fact that investors in these funds were willing to accept sub-commercial returns to begin with. This uncertainty makes it difficult in any given dataset to test whether impact investors seeking commercial returns perform better or worse than traditional investors.

Two recent studies make great advances in overcoming selection bias by identifying impact investment funds within a comprehensive dataset of venture capital funds (VCs), and comparing their performance to those of all other funds in the dataset. Both find that impact funds deliver relatively lower returns, on average. Barber, Morse, and Yasuda (2017), using the Preqin database, identify impact funds through keyword searches using phrases such as "social objectives," "impact investing," and "double bottom line." Controlling for vintage year, fund size, sequence, geography, and industry, they find that the internal rate of return (IRR) of impact funds was 4.7 percentage points lower than those of all VCs (net of fees). Kovner and Lerner (2015) used the Thomson Reuters VentureXpert database to study Community Development Venture Capital (CDVC) funds, which receive tax credits from the U.S. Treasury for investments in poor areas. They find that investees of these funds are substantially less likely to reach an initial public offering (IPO) or be acquired than was the case with investees of traditional VC funds. Some private impact investment funds, it appears, have performed worse than conventional funds.

Both papers find that the performance gap between impact funds and other VC funds is smaller once one controls for industry and geography, suggesting that managers have systematically selected sectors and locations with lower average returns.[93] However, because prior expectations on returns could not be factored in, it remains unclear whether impact investors knew upfront that their returns would be lower.

Recognizing this, Barber, Morse, and Yasuda (2017) argue that one may infer that investors in impact funds have a preference to accept lower returns than traditional investors. They identify such investors as DFIs, Europeans, and PRI signatories, among others.

Other studies, summarized recently by the GIIN, report average returns specifically for impact funds seeking market rates.[94] These studies, however, do not characterize fund performance, on average, given the issue of selection bias described above. At minimum, they show that market-rate-seeking impact investments can earn market-like returns in certain instances. For example, Cambridge Associates, a consultancy that manages the Impact Investment Benchmark Index, initially identified 138 eligible funds for inclusion.[95] The resulting index, however, included only 51 private investment funds (37 percent of those eligible) for which the consultancy was able to collect data. In this sample, they find that smaller funds—those raising less than $100 million—returned a net IRR of 9.5 percent to investors, while funds over $100 million returned 6.2 percent. One should be cautious before concluding that smaller impact funds perform better, on average, since it is possible that smaller funds with poor returns were less likely to participate than larger firms, which may have already had a relationship with the consultancy. Another study by researchers at the Wharton School of Business finds that, gross of expenses, a sample of 53 market rate-seeking funds delivered an IRR of 12.9 percent and performed almost identically to a "spliced" Russell Microcap/Russell 2000 index.[96] Again, it is possible that funds with lower returns were less likely to submit their data for this study, biasing average returns upwards.

Related literature focuses on the relationship between ESG risk factors and firm-level financial performance. This literature examines whether investors selecting investments using environmental and social performance indicators (the "E" and "S") perform better financially.

[93] In the case of CDVCs, this result suggests that the subsidies the funds received may have, indeed, encouraged more investment in poor areas than would have otherwise occurred. Such subsidies would be justified if the difference between the social return on investment in poor communities and the private return is greater than the value of the subsidy.

[94] Mudaliar and Bass 2017. A separate report reports specifically on the returns to private debt funds. See: GIIN and Symbiotics 2018.

[95] CA and GIIN 2017.

[96] Gray et al. 2017. When comparing private investment performance to public indices, it is advisable to use publicly available reference indexes, rather than bespoke indices designed to match the investment portfolio. This is to guard against the selective design of a reference index that leads to favorable results. S&P 500 is a common benchmark used in the academic finance literature, see Harris et al. 2014. Below, to benchmark IFC's equity portfolio, we use the MSCI EM index, which is a standard reference for emerging markets.

There are good theoretical reasons as to why they would. For example, after the Deepwater Horizon oil spill in 2010, BP was required to pay an $18.7 billion settlement—a substantial hit to its bottom line.[97] Alternatively, it may be that the most profitable firms are those that can afford risk mitigation. In either case, these arguments imply that social and environmental criteria may be positively correlated with returns, suggesting that impact investors are able to identify better investments precisely because they seek an impact.

Some literature presents an alternative view: a firm's good performance on certain ESG risk correlates may be detrimental to firm value. For example, Cheng, Hong and Shue (2016) find that managers significantly reduce employee benefits and environmental standards in response to a dividend tax cut that particularly benefits managers who own stock. This coincides with subsequent increases in valuations. This result suggests that those aspects of a business leading to a greater enterprise contribution to social outcomes may also result in higher operating costs. Employee benefits, for example, have a salient effect on net income today, even if they also increase retention, lowering long-run costs.[98]

There is, therefore, a basis for the commitment of PRI signatories stating: "we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios."[99] Taken together, the empirical literature suggests that in most cases, the relationship is likely to be positive, or at least non-negative. For example, in their study of the IFC portfolio, Desai, Kharas, and Amin (2017) find a positive correlation between project financial performance and an index of environmental and social performance.[100] In a meta-analysis of 1,812 studies, Friede, Busch, and Bassen (2015) find a positive relationship between ESG risk factors and financial performance in 48 percent of studies, and a non-negative relationship in 93 percent of studies. The authors find that those studies in which the unit of observation is an investment portfolio, rather than a firm, are less likely to find a positive relationship. This suggests that while ESG factors may help investors select better investments, superior performance of managed ESG funds is not guaranteed.

This last result is consistent with a recurrent finding of finance economists: that, on average, professional asset managers in general struggle to beat public markets. Not all fund managers are able to achieve above-market returns, even in private markets where a liquidity premium may justify them. As shown by Malkiel (1995), French (2008), and Fama and French (2010), actively managed mutual funds, where many households and institutions hold their assets, have historically not been worth their fees.[101] Harris, Jenkinson and Kaplan (2014) find that while U.S. leveraged buyout funds have outperformed the S&P 500, on average, venture capital funds did so only in the 1990s, and underperformed in the 2000s. Together, these results lead to a note of caution for impact investors: regardless of whether asset managers intend to deliver impact, one should be extremely skeptical that they can beat a relevant public market index. If impact fund managers charge expenses above those of low-cost index funds, it is worth asking whether the impact they deliver is worth it. Returns alone may not justify the expense.

Financial Returns of Realized IFC Projects

Founded in 1956, IFC is one of the original impact investors. Like other development finance institutions, IFC has measured its impact, in part, by the share of commitments to specific geographies and sectors. Today, for instance, IFC has strategic targets for commitments in low-income and fragile countries.[102]

97 Wade and Hays 2015.

98 For arguments as to why firms might prefer to offer employees above market wages and benefits, see Stiglitz 1976; Yellen 1984.

99 "What are the Principles for Responsible Investment?" Principles for Responsible Investment, https://www.unpri.org/signatories/what-are-the-principles-for-responsible-investment.

100 Moving beyond the issue of selecting companies based on ESG issues to shareholder action regarding such issues, Dimson et al. 2015, find that, for one large institutional investor, corporate engagements on ESG issues, judged successful by the investor, were followed by one year of positive abnormal returns.

101 French 2008, for example, estimates "the cost of active investing," arguing that under reasonable assumptions, the typical investor would increase their average annual return by 67 basis points over the 1980–2006 period if they switched from actively managed funds to a passive market portfolio.

102 IFC 2018b.

Like many impact investors, IFC has also had a strategic focus on certain sectors. For instance, its most recent strategy emphasizes infrastructure, agribusiness, and subsectors that promote financial and social inclusion.

In our discussion of IFC's financial returns below, we emphasize an investment-level financial return indicator called the public market equivalent, or PME, which compares the investment to an equivalently timed investment in a relevant public market index.[103] The PME is a method of correcting returns for aggregate market risk in a way that makes them more comparable over time and across portfolios. It has become the preferred method of returns assessment in financial economics and at many private investment firms because of its transparency: here, with the PME, the reader is readily able to compare IFC's returns to a hypothetical portfolio of emerging market equity and debt.

Other impact investors are encouraged to report returns in the same way. The PME may be understood as a market-adjusted multiple of invested capital, greater than 1.00 if the investment delivers more than the relevant market index. A PME of 1.20, for example, implies that, at the end of the investment, an investor ended up with 20 percent more than they would have if they had invested in the public market. In this example, if $100 invested in public markets would have yielded $200 after seven years, then the private investment yielded $240 over the same time. For equity, we use the MSCI Emerging Market (EM) index as a reference. For debt, we use J.P. Morgan's Broad Diversified Corporate Emerging Market Bond Index (JPM CEMBI), which is a standard reference for hard currency emerging market debt.

It is important to understand that the PME does not provide an assessment of whether IFC (or any other investor) has "beat the market," performing better than another private investor trying to replicate the same investment strategy. This is for two reasons. First, securities in public indices have fundamentally different risk and liquidity profiles than IFC projects. An ideal market benchmark for IFC projects would be the portfolio of a private equity or debt fund with the same appetite for risk and liquidity. This comparison however is not possible, because a comparable institution with publicly available returns does not exist. Second, the country and sector composition of IFC's portfolio varies substantially from the indexes. For instance, both market indexes are heavily weighted towards East Asia, given the region's disproportionate market capitalization, whereas IFC's portfolio is by design overweight with regions with less developed capital markets. IFC's portfolio has also historically been more concentrated in financial services and infrastructure.

IFC PROJECTS ACHIEVE RETURNS COMMENSURATE WITH RETURNS ON PUBLIC INDICES FOR EMERGING MARKETS

Realized IFC equity projects with vintage years 1988-2016 have performed competitively with emerging markets public equities, and senior loans of vintage years 2002-2015 have performed competitively with emerging market hard currency corporate bonds.

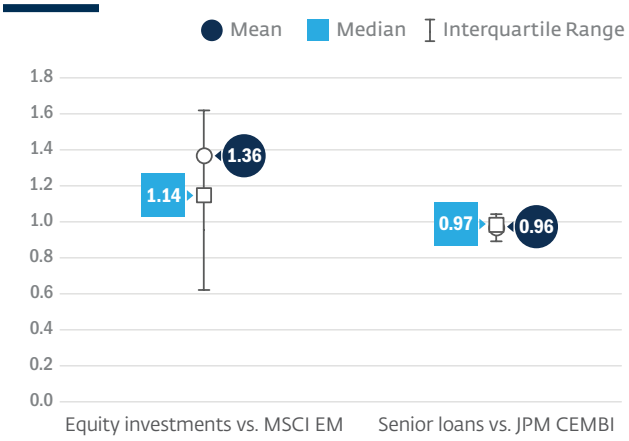
Specifically, IFC's realized equity investment projects had an average (mean value-weighted) PME of 1.36 since 1988 (Figure 14 and Table C.1 in Online Annex C), indicating that, on average, IFC projects have returned 36 percent more than an equivalently timed investment in the MSCI EM index. The median equity PME has been 1.14. IFC's senior loans have returned 4 percent less relative to the JPM CEMBI index, with an average (mean value-weighted) PME of 0.96. The median PME was slightly higher, at 0.97. The PME less than one likely reflects the fact that senior loans are priced lower than

[103] Specifically, we use the PME statistic proposed by Kaplan and Schoar 2005, which is:

$$PME \equiv \frac{PV_{CashIn}}{PV_{CashOut}} = \frac{\sum_t \frac{CashIn(t)}{1+R(t)}}{\sum_t \frac{CashOut(t)}{1+R(t)}}$$

where R(t) equals the total return of the relevant market index from time t=0 to time t. Sorensen and Jagannathan. 2015. show that using the PME to evaluate returns is equivalent to using the stochastic discount factor of the log utility investor to value risky cash flows, when the return on the investor's total wealth equals the return to the market index. The PME statistic therefore corrects returns for some market risk in a way the IRR does not. For equity, using the MSCI EM index as a reference corrects for overall equity risk in emerging markets. For debt, using JPM CEMBI corrects for overall debt risk in emerging markets, as well as, critically, underlying variation in LIBOR. In this sense, for debt, analyzing the PME is analogous to analyzing interest rate spreads.

FIGURE 14 The Public Market Equivalent (PME) of Realized IFC Investment Projects



Source: IFC realized portfolio—1,266 equity investments (vintage years 1988–2016) and 1,109 senior loans (vintage years 2002–2015). Projects are grouped by vintage year, so that a project in the data dated 2008 may have been closed as recently as June 2018.

Note: Distributions are weighted by the nominal value of total disbursement. Includes only equity investments that have been fully exited (or written off), and senior loans that have been fully paid off (or written off). PME is calculated following Kaplan and Schoar. 2005., and may be understood as a market-adjusted multiple of invested capital, greater than 1.0 if the investment delivers more return than an equivalently timed investment in the market index. A PME of 1.20, for example, implies that, at the end of the investment, an investor ended up with 20 percent more than they would have if they had invested in the public market. In this example, if $100 invested in public markets would have yielded $200 after seven years, the private investment yielded $240 over the same time. As of June 2018, since its inception in 1988 the MSCI EM index had grown by a factor of 23.5. The JPM CEMBI index had grown by a factor of 3.1 since its inception in 2002.

the bond index, given collateral.[104] In annualized terms, the difference in returns between the loan portfolio and the index is relatively small. A loss of 4 percent over 7–12 years, the standard tenure range of IFC loans, implies a loss of 33–56 basis points annually. These results show that IFC has been able to identify investments that deliver returns competitive with international capital markets.

It is apparent, however, that average returns have fallen significantly in the last decade (Table C.1). From 2008 to 2016, the average (mean value-weighted) PME of realized projects was 1.13 for equity. For debt, in vintage years 2002-2007, the only time series of JPM CEMBI before the crisis, average PME was 1.01. Median PMEs have also fallen. One explanation for this decline may be cyclical. Some countries and clients suffered adverse shocks that will smooth out over time. However, part of the decline is also likely due to improvements in the efficiency of capital markets, which have lowered interest rate spreads, and raised purchase price multiples for equity investments.

An important caveat to the discussion above and Table C.1 is that we report only on the returns of realized projects, given that valuations of unrealized projects do change from quarter to quarter, particularly for more recent projects. Looking at only closed projects is a standard approach in the literature, given uncertainty about exit timing and values.

A final caveat to these results is that they do not include expenses associated with origination and supervision of investments, or overhead. In fiscal year 2018, IFC had a non-interest expense of $1.66 billion and total assets of $94.27 billion, implying an expense ratio of 1.76 percent, which is high relative to mutual funds that typically charge below 1 percent, but less than the 2 percent of asset value, and 20 percent of capital gains typically charged by private equity and hedge fund managers.[105]

Shaping Market Perceptions: Sharing Data on Financial Returns

The analysis of IFC returns is intended to contribute to greater understanding of the potential of impact investments to deliver commercial returns. Clearly, additional information about the financial performance of a range of impact investment strategies will help to shape market perceptions of the potential for commercial returns. Because of commercial confidentiality, individual fund managers may not be prepared to share the performance of specific funds. There is, therefore, value in initiatives to pool financial performance data across investment managers. The GIIN has published several reports along these lines,[106] and the Wharton Social Impact Initiative[107] is building a database on impact fund performance. Information on financial return is an essential piece of impact evidence and a public good, which helps investors measure the potential and actual impact of their investments.

[104] Differences in tenure, however, may push the PME toward one. Seventy percent of bonds in the index have tenure of less than seven years. Longer tenure typically corresponds to higher return, in compensation for less liquidity.

[105] This number includes IFC expenditures on supporting public goods, such as investment principles, and contributions to common knowledge.

[106] Most recently, GIIN and Symbiotics 2018.

[107] For more information, see www.socialimpact.wharton.penn.edu.

2.2 Bringing Transparency and Discipline to How Investments are Managed to Achieve Impact

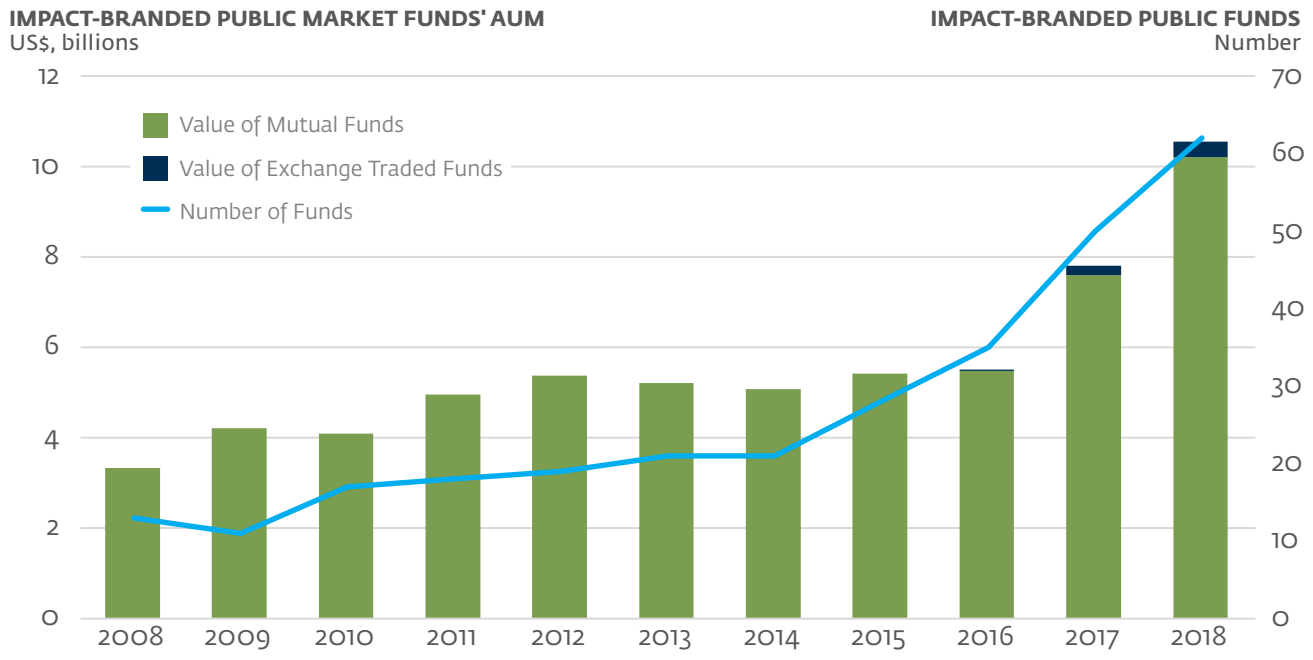
Operating Principles for Impact Management

Trends in the asset management industry have made it increasingly attractive for managers to use the "impact" brand while marketing their funds to asset owners. Managers of securities traded in public markets, in particular, have lately seen a shift in demand from asset owners toward passive index funds that are lower margin.[108] SRI investment screens, for which managers have historically charged a premium expense ratio, offer managers an opportunity to recoup some of their falling margins.

In the past three years, there has been substantial growth in the use of the word "impact" as a brand for mutual funds and ETFs, and the number of impact-branded funds in public markets has grown from 13 to 62 since 2008 (Figure 15). Many of these funds simply apply ESG screens to investments. Given that until now there have not been standards regarding what it means to manage for impact, asset owners will have difficulty assessing which of these funds are truly managed for impact, and which are not. There is also confusion in the market between responsible investment, ESG, and impact products. If the label of "impact" is applied loosely, it may become devalued, leaving good-intentioned investors disillusioned.

With more investment managers introducing impact investing vehicles, there is growing market demand for a common standard for how to do this. This demand comes from asset owners who are confused by investment funds and vehicles that use the impact label, but are not clear about how they integrate impact into investment management. The demand also comes from investment managers who are new to managing for impact, and who are looking for guidance on what they need to do differently to deliver impact in a disciplined way.

FIGURE 15 The Number of Publicly Traded Funds with "Impact" in Their Name Has Grown Substantially



Sources: Bloomberg and Thompson Reuters.
Note: Includes all funds identified in the two sources with the word "impact" in the name.

[108] Sushko and Turner 2018.

A key step toward bringing transparency and discipline to the market is the introduction of the Operating Principles for Impact Management (hereafter, the Principles). IFC convened a group of financial institutions that have experience and expertise in managing for impact in order to reach a common understanding of these practices and codify them into a set of operational principles. Following wide industry consultation, and in collaboration with the GIIN and the Impact Management Project, the Principles have now been finalized.[109]

The process of developing the Principles followed IFC's earlier roles in developing the Equator Principles, which brought discipline to ESG integration in project finance (see Box 7), and in the development of the Green Bonds Principles (see Box 4 in Chapter 1). The Operating Principles for Impact Management thus build on, and complement, the range of existing standards, tools, and frameworks in order to help investors define, measure, and manage their impact (Table 3).

The Operating Principles for Impact Management are deliberately short and high-level because they

TABLE 3 Comparison of the Operating Principles for Impact Management with Related Initiatives

Initiative	Summary	Areas of complementary overlap	Operating Principles for Impact Management value-added
UN Principles for Responsible Investing (PRI)	The PRI is an international network of investors working together to put a set of six responsible investment principles into practice. Its goal is to support signatories to incorporate these principles into their investment decision-making and ownership practices.	The PRI's six overarching principles and the corresponding Reporting and Assessment Frameworks provide guidance on incorporating ESG considerations into strategy, diligence, management, and reporting.	The PRI is focused on ESG risk management, whereas the Principles are focused on an investment process that actively seeks to create impact.
UNEP Finance Initiative—Principles for Positive Impact Finance	The Principles for Positive Impact Finance is a framework to help banks and investors adopt an impact-based approach so that they can increase their positive impact on the economy, society, and the environment, and, more specifically, actively participate in bridging the financing gap for sustainable development.	Similar to the Principles, the UNEP FI Principles call for the appraisal of both positive and negative impacts, and support delivering sustainable financial products.	The UNEP FI's four overarching principles are not process-based.
The Impact Management Project (IMP)	The IMP is an initiative focused on coalescing over 700 practitioners—from asset owners to fund managers, to enterprise standards agencies—to build consensus about what is relevant when referring to, and managing impact.	The IMP has defined five dimensions of impact (who, what, how much, contribution, and risk). These dimensions align nicely with various aspects of the IM Principles.	The IMP is focused on measurement and is not focused on process. The Principles will build on the five dimensions by providing principles related to process and practice.
Global Impact Investing Rating System (GIIRS)	GIIRS is a rating system developed by B Lab that delivers comprehensive accounting of a portfolio's impact on workers, customers, communities, and the environment.	The GIIRS fund ratings look at the impact business model, and the overall impact performance of a portfolio and a fund manager. The fund manager assessment aligns nicely with various aspects of the Principles.	GIIRS certification requires a fee, and the assessment itself is not publicly available. Funds that abide by the Principles will be well placed to score highly on the fund manager's assessment portion.

[109] Available at www.impactprinciples.org.

BOX 7 The Equator Principles

Since large-scale projects can have significant social and environment impact, the Equator Principles (EPs) were developed as a risk management framework for determining, assessing and managing environmental and social risk. The primary goal of the Principles is to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making by financial institutions. The EPs apply across emerging markets, to all industry sectors and to four financial products: 1) Project Finance 2) Project-Related Corporate Loans, 3) Bridge Loans, and 4) Project Finance Advisory Services.

IFC has played a leading role in the development of these principles. In the early 2000s, pressure was mounting against the lending practices of major banks. IFC began to build the business case for sustainability, demonstrating that companies in emerging markets could actually boost their financial results by taking steps to improve environmental, social, and corporate governance processes. This sparked a new set of conversations between IFC and its clients around the area of sustainability. At the same time ABN AMRO ruled out the option of adopting principles on its own—it would put ABN AMRO at a disadvantage among its peers—and instead chose to try to convince other banks to follow the same policies. The bank was able to bring together a group of banks that originally included Citibank and Barclays. IFC provided advice to the group so it could create a new industrywide framework to manage environmental and social risks in project lending. This common approach could help reduce important risks related to deal structuring, project completion, credit, and reputational risks. A few months later they agreed to adopt IFC's policies to avoid being consistently arbitraged by NGOs against IFC's standards. Negotiations wrapped up in June 2003, when 10 banks announced that they were adopting the Equator Principles.

In the 15 years since their launch, the EPs have greatly increased the attention and focus on social standards and responsibility, including robust standards for indigenous peoples, labor standards, and consultation with locally affected communities. They have also promoted convergence around common environmental and social standards. Multilateral development banks, including the European Bank for Reconstruction & Development, and export credit agencies through the OECD Common Approaches, are increasingly drawing on the same standards as the EPs. The EPs have also helped spur the development of other responsible environmental and social management practices in the financial sector and banking industry and have supported member banks in developing their own Environmental and Social Risk Management Systems.

Currently 94 Equator Principles Financial Institutions (EPFIs) in 37 countries have officially adopted the EPs, covering the majority of international project finance debt within emerging markets.

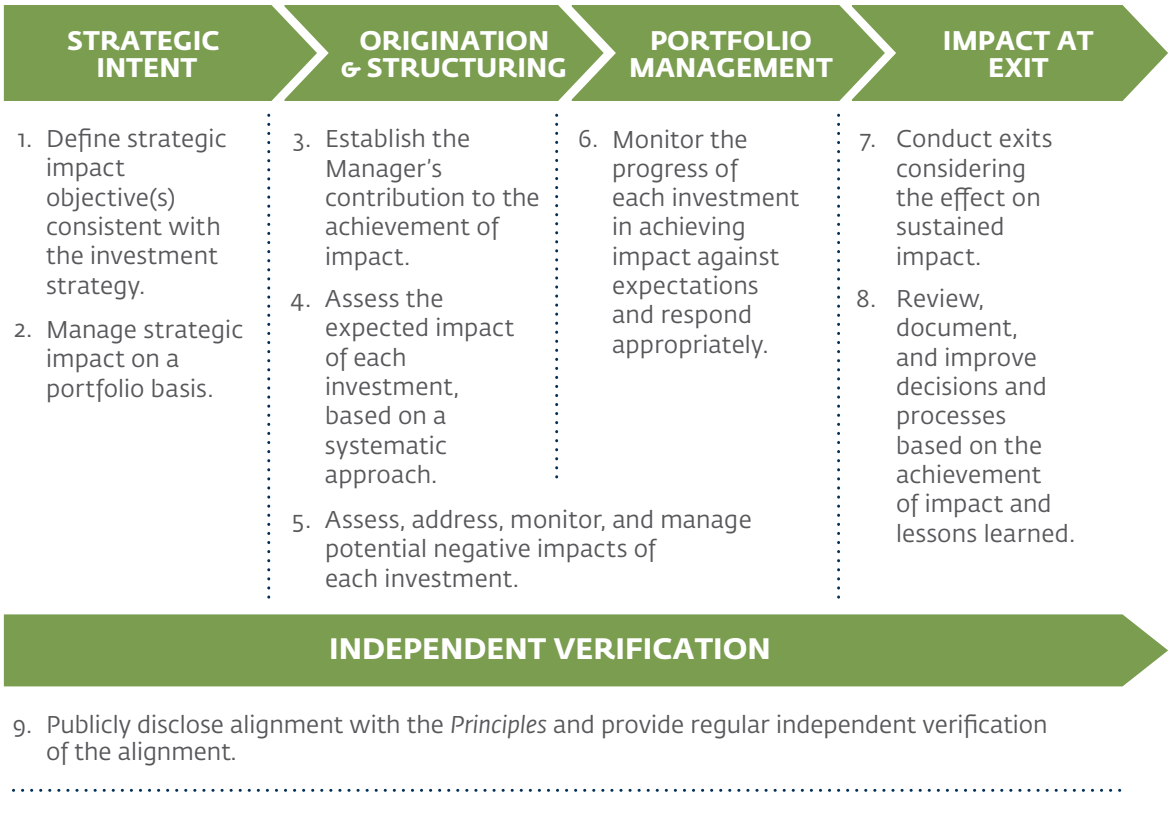
Source: For more information, visit https://equator-principles.com/tag/epfi/.

are designed to be applied across a range of asset classes, investment strategies, portfolio sizes, and other dimensions. As the Principles do not prescribe a specific impact management system, investment managers can follow the impact management system that suits the size and type of investment portfolio they manage. The Principles therefore respect the fact that many institutions have developed robust impact management systems that differ in their mechanics, but which share common features and perform the same functions. They are also aligned with the Impact Management Project's five shared fundamentals for impact management (see Box 8).

The Principles address the key stages of the investment process, showing how they should be adapted in cases where the fund has an impact objective as well as a financial objective. The Principles are neutral concerning which impacts are targeted and which financial returns are targeted. The general rule is that impact should be integrated with financial considerations at all stages of decision-making, and they should address four stages: setting the investment strategy, origination and structuring, portfolio management, and (where appropriate) portfolio exits (Figure 16).

While prescribing the continuous tracking of impact performance and data verification, the Principles do not prescribe the metrics to be used in impact measurement, as market standards already exist. Similarly, they prescribe that impact management systems should be built upon the foundation of good ESG management practices, without prescribing those practices, which are described elsewhere—including in IFC's widely-used Performance Standards. The Principles therefore further entrench good ESG practices within impact investing, ensuring that before considering positive impact, that impact investors "do no harm."

FIGURE 16 Operating Principles for Impact Management



Source: IFC 2019.

The Principles are intended to be adopted at the fund level—that is, an asset manager like TPG Capital may follow the Principles for an impact fund (for example, the RISE Fund) but not for its other growth funds. Multilateral development banks/development finance institutions may wish to adopt them at an institutional level.

Asset owners may also adopt the Principles for use in selecting assets that fit a portfolio allocation to impact assets.

To bring the required transparency and credibility to the market, institutions that adopt the Principles for one or more of their funds or investment vehicles commit to publishing annual statements disclosing how they follow the Principles. This allows a balance between allowing for innovation and diversity of approaches, and providing asset owners and other stakeholders with clarity on how an investment manager is implementing the Principles. Transparency and credibility are enhanced by Principle 9, which requires investment managers to go beyond self-disclosure and seek independent third-party verification of their impact management system.

Widespread adoption of the Principles will ensure that the impact investor articulates a credible impact thesis linked to a measurement framework that they used to evaluate the impact of investments. Ultimately, they will support the implementation of three attributes of an impact investor: (a) intent for impact, (b) a credible contribution thesis, and (c) an impact measurement system. This will help asset owners decide where to allocate funds for impact by signaling which asset managers are following a disciplined impact management process. It will also help asset managers to design and implement impact management systems that reflect industry consensus on what constitutes best practice.

A wide cross-section of asset owners, asset allocators, and asset managers are expected to adopt the Principles when they are launched in April 2019. This includes development finance institutions, investment banks, asset managers, and specialist impact fund managers, as well as asset owners who intend to allocate part of their investment portfolio to impact assets. Adoption of the Principles by asset owners will exert a powerful influence on asset managers to adopt them too.

2.3. Building Clarity, Credibility, and Comparability in Impact Measurement

Alongside an investor's intent for and contribution to impact, impact measurement is one of the defining attributes of impact investment—it provides investors with the information they need to manage their portfolio for social value.[110] Over the last decade, much progress has been made in tracking changes in social and environmental outcomes that are associated with investments.[111] Also, there are now numerous thoughtful approaches to the processes, tools, and systems that impact investors can use to measure impact.[112] However, there is still confusion about the core concepts related to impact measurement, which creates inconsistency in how impact investors approach impact measurement and hinders the increased standardization of approaches.[113] In the 2018 Global Impact Investing Network (GIIN) investor survey, 76 percent of respondents noted that the sophistication of impact measurement practice was a significant or moderate challenge.[114]

Impact measurement is based on the premise that investors managing for impact should do so *alongside* managing for financial returns, and thus should follow the same management decision-making process through

[110] As defined earlier in this report; covers social and environmental effects.

[111] According to the GIIN Annual Impact Investor Survey 2018, 88 percent of respondents note that significant—or some—progress has been made regarding the sophistication of impact measurement. See Figure 13, page 10 of the survey. https://thegiin.org/research/publication/annualsurvey2018.

[112] The Global Value Toolkit highlights more than 220 impact measurement tools, methods, and services available. See https://www.global-value.eu/toolkit/.

[113] Reeder and Colantonio 2013.

[114] See the GIIN Annual Impact Investor Survey 2018, Figure 14, page 11; https://thegiin.org/research/publication/annualsurvey2018.

the *planning, designing, checking, and adjusting stages*.[115] Impact measurement frameworks also play a role in creating a market for impact investment, by creating 1) *clarity* about what impact investing is, 2) *credibility* about what impact investing delivers, and 3) *comparability*, allowing for allocation of resources within and between portfolios. These aspects of the design of an impact measurement framework is discussed in more detail in Online Annex D.

Strong performance management rests on the simple principle that "what gets measured, gets done."[116] As with any type of performance management, a framework should be used as part of an end-to-end process to align ongoing activities with strategic goals.[117] From an impact perspective, the decision-making process outlined above has the following components: impact thesis, impact assessment, impact monitoring, and impact evidence (Figure 17). All dimensions are interrelated, and no one dimension is static. For example, an impact thesis and impact assessment need to be grounded in evidence. Impact monitoring can create the evidence that feeds back into a refined thesis and assessment. Online Annex E includes some key considerations in drafting an impact thesis from a measurement perspective. Online Annex F provides a hypothetical project example to which the measurement frameworks introduced below have been applied.

FIGURE 17 The Core Dimensions of an Impact Measurement Framework and Their Interlinkages

Beyond the dimensions highlighted above, impact measurement frameworks should incorporate assessments of risk and uncertainties linked to the achievement of intended impact.[118] Just as traditional investors assess the factors and likelihood of achieving the intended financial returns, impact investors should assess the factors as well as the likelihood of achieving the intended impact.[119]

IMPACT ASSESSMENT AND MONITORING

It is important to keep in mind that impact assessment and monitoring can, and should be, a value-driver, but at the same time recognize that adding impact objectives alongside financial returns also comes with a cost. Establishing an impact measurement framework with a process to assess impact and monitor performance will introduce new cost and skill requirements into the investor's business model.[120] Keeping the impact measurement cost-effective is a natural ambition, just as it would be for any other operating cost. However, it should also be recognized that impact assessment and monitoring is an investment that aligns with increasing demand from key shareholders and society at large. Thus, it has the potential to open up new sources of financing for fund managers, and possibly even new financial return streams that otherwise might not have been identified.

Ex-ante impact assessment and continuous monitoring lie at the heart of managing for impact, as they allow the investor to increase impact in the "design" phase and understand how impact performance relates to impact expectations during the "checking" phase, and also serve as the basis for corrective actions, if needed.

To credibly assess impact during the investment origination/structuring phase, the investor should follow a predefined approach and methodology. This approach should be based on a balanced use of impact evidence that is relevant for the specific investment, and should

[115] Based on the Deming PDCA (Plan, Do, Check, Act) cycle for continuous quality improvement. See Ishikawa 1985.

[116] Carpi et al. 2017.

[117] Parmenter 2010.

[118] Calandro 2016.

[119] IMP has outlined nine different types of impact risks an investor may be exposed to: "Risk." For more information, see Impact Management Project 2019.

[120] For more information, see http://reports.weforum.org/impact-investment/4-challenges-that-institutional-investors-face/4-4-double-bottom-line/.

be linked to the selection of indicators.[121] Selection of indicators is essential for continuous monitoring of progress. The impact data collected, which are based on the selected indicators, provide the foundation for comparability of impact performance. Throughout the following section we focus on impact indicators as the key component of assessment and monitoring.

Although we recognize that the impact industry's use of standardized impact data/indicators is a long-term ambition for how impact should be monitored (and reported), we must first step back and acknowledge what needs to be in place before standardized impact monitoring will work. Thus, while indicator standardization is very valuable, we want to emphasize the importance of shared fundamentals[122] when approaching impact considerations. Capital markets function because of a shared convention underpinned by fundamentals (financial risk, return, volatility, liquidity).[123] The same holds true when thinking about the impact side of the equation.

Within the impact investing industry, significant progress over a short period has been made to standardize indicators for investors to use in their impact measurement and reporting. Each solution addresses a certain area of the market and plays a unique role in the industry's attempt to move toward comparable impact data. However, this proliferation of standards has led to what many refer to as an "alphabet soup" of acronyms, tools, and metrics. The use of standardized indicators is a key step in moving the industry toward comparability. However, rather than using these standards as a starting point, we recommend that investors determine what is important to measure, aligned with their impact thesis (and why), and then consider aligning these standard indicators, as relevant for the targeted stakeholders. Online Annex G provides a high-level summary of some of the most dominant industry indicator standards.

In discussions with industry participants, it appears that the industry has converged on three norms regarding the ex-ante assessment and monitoring for the investor:

First, acknowledge and account for the multiple dimensions of impact. In the nascent stages of impact investing, the industry was satisfied with seeing the impact of investments communicated in ways such as "the number of lives touched" or "the number of jobs supported." This remains important, and while these can be enticing headline messages, this view of impact does not tell stakeholders anything about the significance of the challenge addressed, the quality of impact (such as wages or benefits), the end-beneficiaries (for example, women, youth, or the poor), and/or other dimensions that provide a more robust understanding of the impact provided. Adopting a common set of fundamentals for how we consider impact, and therefore measure the data that result, will enable the industry to share values and performance more clearly, and result in a more efficient marketplace—ultimately driving more capital into impact solutions. See Box 8 with the shared fundamentals for impact measurement, as outlined within the Impact Management Project.

Second, focus on what is material.[124] When considering impact indicators, another challenge has been the perception that "the more impact data, the better it is" which has become increasingly common in the impact measurement space. Some investors and their underlying assets have fallen into the trap of collecting data based on things they could collect rather than assessing what is needed for decision-making.[125] This has resulted in surveys and data requests that have led to measurement fatigue for investment managers, investees, and the intended beneficiaries.[126] Effects that do not significantly affect people and/or the planet in

[121] Indicators are quantitative or qualitative factors that provide a simple means to measure achievements that reflect changes connected to an intervention or help assess performance. They should be considered as a proxy, and part of a larger picture of performance. Adapted from the OECD Development Assistance Committee (OECD DAC).

[122] "Impact Measurement and Management (IMM)." For more information, see Global Impact Investing Network at https://thegiin.org/imm.

[123] Alam 2017.

[124] Materiality is a core concept in financial accounting (and now, sustainability reporting) that encourages companies to manage toward and report on aspects of their business that potentially have significant effects (positive or negative) on people and/or the planet. See Thornley and Locascio 2018.

[125] Emerson 2015.

[126] BBC World Service 2013.

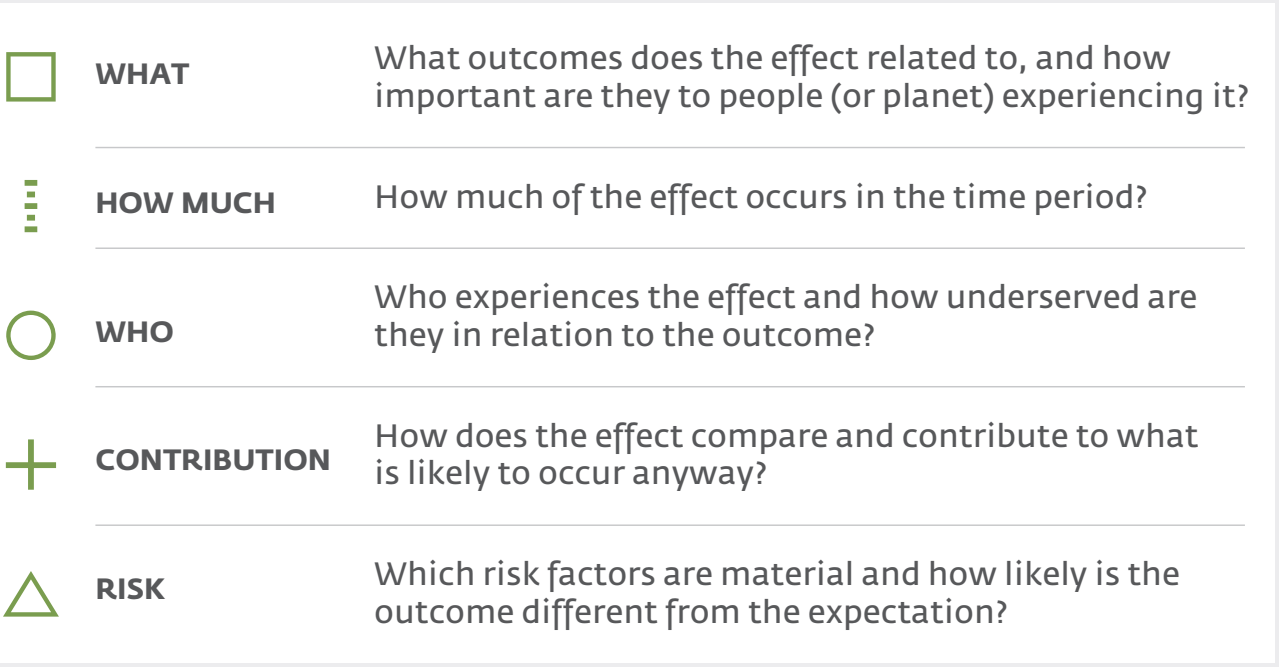
meaningful ways (positive of negative) should not be considered. What is critical in managing for impact is not a plethora of monitoring data, but rather to identify what is material to understand the impact achieved.

Third, align with existing market data. Most investments' direct impact data are also good business intelligence data for the enterprise;[127] thus, following this logic will reduce the cost and burden of data collection. For example, a hospital should be able to report on the number of patients served, and a solar lantern company should be able to report on the number of lanterns sold. If systemic effects are part of the impact thesis, tapping into existing market data/research should prove sufficient for many impact investors. For example, investors interested in spurring the growth of the mobile money sector can draw on market research that measures this growth.

Ex-ante impact assessment and monitoring allows for the *design* and *checking* of actual achievement of impact, as aligned with the impact thesis. The selection of indicators is a key part of impact assessment and monitoring. Impact assessment is a critical part of an investor's impact measurement framework as it links the impact thesis (*plan*) with its execution, and may help drive increased impact effectiveness. Impact monitoring is tightly linked to design, providing the basis for documenting progress against expectations. It also generates the data—the basis of evidence—needed to *adjust* through course corrections to ensure impact delivery.

BOX 8 The Multiple Dimensions of Impact—the Shared Fundamentals

The Impact Management Project (IMP) is a multi-stakeholder effort that has brought together over 2,000 stakeholders from different contexts and countries. The intent has not been to agree upon a single framework or tool, but rather to agree on shared fundamentals for defining and managing impact. The agreed upon five dimensions of impact are discussed in the image below.



Source: Impact Management Project 2019.

[127] Working Group on Impact Measurement 2014.

IMPACT EVIDENCE

From an industry perspective, a solid evidence base is needed to credibly establish the ability of impact investing to deliver positive social and environmental outcomes, alongside financial returns. This credibility is a critical element in scaling the impact investment market.[128] Industry-level evidence is needed to answer questions such as, "Are there trade-offs or synergies between financial and impact returns?" Initiatives by the GIIN, the World Economic Forum (WEF), IMP, OECD, the European Union (EU), and others have been launched to strengthen this macro-focused evidence base. Most of these initiatives focus on establishing the needed market data infrastructure, based on robust standardized indicators. These efforts are critical, complex, and will most likely take years[129] to materialize, given the current level of the market's maturity and inherent diversity.

Evidence at the micro-level is directly linked to the individual investor and serves as the foundation of an impact thesis and impact assessment. At this micro-level, evidence may be from ongoing performance data that provides the basis for continuously adjusting and improving the investor's impact approach, or it can be from evaluation-based evidence[130] such as: a) evidence from rapid types of evaluations, which may include qualitative comparative analysis, process tracing, and end-beneficiary feedback via surveys. These rapid, yet rigorous, approaches to collecting data can provide valuable information to investors (and enterprises) that can feed into product design and understanding of the impact being generated; or b) it can be evidence from (quasi) experimental evaluation. These types of rigorous evaluations can provide valuable information that can influence impact and other business decisions, but they can be costly and take significant time to complete. Impact investors may leverage all types of evidence to improve impact effectiveness, establish credibility of an impact investor's impact thesis, and support monitoring through relevant impact indicators.

Strengthening evaluation-based evidence within impact investing has the potential to play a proactive role in shaping market growth by being time-responsive and action-oriented. Solid evidence can increase impact investors' effectiveness by allowing for better ex-ante decision-making and portfolio management, and helping to reduce investors' reputational risk from negative social and environmental consequences.[131] Online Annex H provides a simple evaluation evidence process (Theory of Change) that may help guide the strengthening of the evaluation evidence base. However, producing rigorous impact evaluation evidence must not become a market entry barrier.

Three Impact Measurement Frameworks

Impact investors face many decisions and uncertainties in designing their impact measurement frameworks. These can take many shapes and sizes, depending on the characteristics of investors, their investments, other stakeholders, and available resources. Within the current impact investing market, we have observed the emergence of three dominant framework archetypes. Each of these archetypes can be developed in such a way that they are embedded throughout an end-to-end impact management process, and each includes:

- An impact thesis, anchored in evidence
- An evidence-based, ex-ante assessment, and
- Continuous monitoring of impact-creating evidence.

Two key aspects that distinguish each of the three frameworks are: (a) how they are used to assess impact, ex-ante; and (b) how they support clarity, credibility, and comparability.

Below we briefly describe each of the three types of measurement frameworks, and outline its key strengths and challenges. To support this analysis, a hypothetical example of an investment is provided in Online Annex D, which applies the logic from each archetype. Following the descriptions of each type of framework, below we provide three case studies from

[128] OECD 2015.

[129] As an example, the E&S evidence base has taken over a decade to establish with standardized compliance data. Only recently have robust analyses started to emerge that document a positive correlation between E&S compliance and financial returns.

[130] Evaluative evidence may be defined as information indicating qualitative and quantitative values of the investment processes and outcomes, which are derived from multiple sources of information, and compiled in an evaluation exercise (based on Evalpartners.org toolkit for use of monitoring and evaluation information).

[131] Ibid.

established, large-fund managers, showing how each type of framework is applied in real life. These cases are LeapFrog Investments, Partner's Group, and TPG.

As highlighted below, all three measurement frameworks can be used as part of a robust impact management system, benefit from its strengths, and mitigate against its challenges. The first and predominant framework is that applied by MDBs and DFIs. This is a variation of an *impact rating* framework, but with a high level of sophistication and variance in method. The second type of framework is the *impact target* framework, which is more widely used by private institutional investors. The third type of framework, the *impact monetization* framework, is the least widely used. An overview of IFC's Anticipated Impact Measurement and Monitoring (AIMM) system, which combines aspects of impact ratings and impact targets, is provided in the Spotlight below.

Within an investor's impact management system, features from multiple archetypes are often used. For example, regardless of the ex-ante impact assessment framework used, many investors use a type of *impact target framework* to monitor the impact of an investment. Many include monitorization tools such as value for money, economic rate of return, or another cost-benefit valuation within their impact management systems.

1. IMPACT TARGETS

Description: The characteristics of this framework are based on the investor setting targets for indicators across the portfolio and/or specific to each investment. The targets are often expressed through some type of "reach": for example, X # of individuals are provided with improved access to a service (financial, education, or health), but targets can cover multiple aspects of impact (such as depth, duration, and type of target beneficiary). Baseline data are collected at the time of investment, and targets are (ideally) agreed in conjunction with the investee, and monitored throughout the course of the investment. Investees are typically assessed based on how well they have progressed against the targets, assuming targets are relevant throughout the course of the investment. Table 4 outlines the strengths and challenges of this archetype.

TABLE 4 Impact Target Archetype

STRENGTHS
These frameworks are typically easy for internal and external stakeholders to understand, therefore providing *clarity* and *credibility* about the investor's intent and progress against performance goals.
CHALLENGES
Because different types of investments will have different targets, this approach does not easily provide a basis for *comparison* between different investments, and particularly across different geographies and industries.
Credibility may be a challenge, as many observed target frameworks tend to be focused primarily on "reach" indicators and do not explicitly account for context within certain targets. For example, it is easy to define and discuss progress against a goal of providing access to water for 100,000 people, but more difficult to capture who exactly these people are (such as women and children), whether or not they had access to water before, and other important contextual elements. Thus, it is a challenge not to push for the "big number" without considering the level of need addressed and the intensity of the impact achieved.

2. IMPACT RATINGS

Description: This framework uses an overarching impact scoring or rating system that can capture multiple dimensions within an investment, including multiple stakeholder, environmental, and systemic effects. Ratings can be on a numeric scale (for example, 1–5) or qualitative (high, medium, low). This requires the establishment of a scale, typology, or benchmark against which the specific investment may be assessed. Aspects of an investment that can be "rated" could include a combination of reach of impact, depth of impact, target beneficiary, geography, or any number of other aspects. These selected aspects can be weighted (or not) and aggregated into a single score for each investment. This archetype builds on the "balanced scorecard" performance management tool,[132] and investments are often rated based on current and potential level of impact.

Rating frameworks can also measure the quantitative and qualitative aspects of an investment, and therefore are as much of an art form (subjective) as a science (objective). A key aspect of this approach is developing a transparent, rigorous, and systematic application of

[132] Kaplan and Norton 1992.

the assessment methodology. It is also worth noting that many rating systems used by MDBs and DFIs allow for the inclusion of systemic effects beyond the project outcomes, which is a priority for MDBs/DFIs. Specific "reach" targets are often included for monitoring and reporting purposes, building on features from the target framework outlined above. Table 5 outlines the strengths and challenges of this archetype.

TABLE 5 Impact Rating Archetype

STRENGTHS
Because investments within an investor's portfolio are scored using the same (or similar) rating system, this provides a common way to compare and possibly aggregate results across a portfolio and geographies
This approach allows investors to create their own rating system for scoring, thereby allowing them to emphasize and credibly communicate what is important to them. For example, for investors with the intent to serve young women, the scoring could be adjusted to rank investments that serve this population well.
CHALLENGES
Clarity is needed about the meaning of a rating, and deciding how to rate different aspects of an investment can be complex (for example, how does an investor distinguish between a "high" versus a "medium" score). Setting thresholds for scoring often requires data on benchmarks which may not exist and/or may be difficult to access, especially in new and innovative markets.
Because each investor creates their own rating rubric, external comparability is not possible unless a harmonized approach is used.[133]

3. IMPACT MONETIZATION

Description: Just as investors use expected measures of return to calculate the expected financial value of their investments, impact investors can use a similar approach to assess expected impact returns. This type of approach has been used for decades,[134] particularly by the public sector to help governments make decisions about major public projects through comparing project costs and benefits, discounted to the value of today's currency. This approach has many different names, including social return on investment (SROI), benefit cost ratio (BCR), social cost benefit analysis (SCBA), and economic rate of return (ERR).[135] Specific "reach" targets are often included for monitoring purposes, building on features from the target framework outlined above. Table 6 outlines the strengths and challenges of this archetype.

TABLE 6 Impact Monetization Archetype

STRENGTHS
This type of approach holds the promise of measuring social returns in the most-used language of value: finance. It can be viewed as the ideal, gold-standard solution to provide clarity on the overall impact generated, and credibility to drive resources to the programs with the most impact. Finally, because impacts are translated into a monetary value, the framework can allow comparability,[136] both internally (within the portfolio) and externally (among investment opportunities).
CHALLENGES
Clarity can be a challenge due to the technical difficulty (and lack of feasibility) of compiling all externalities into the monitorization calculations. This approach faces challenges too in identifying which stakeholders are benefiting.[137]
Given the technical rigor required, and the data needed to fully monetize different types of impacts, this framework can be technically difficult to implement, and thus challenging to use for internal comparison across diverse portfolios and geographic areas.[138] Similar to the rating archetype, external comparability is only possible if a harmonized approach is used.
Credibility of impact may also be challenged as monetization may lead to higher value impact in higher income area. For example, an education investment may reach more people more effectively in an urban developed country than in a rural part of sub-Saharan Africa; or the statistical value of a human life may be higher in countries with higher wages. Because of this, using the monetization framework may penalize interventions which work with vulnerable populations and fragile states.[139]

[133] Comparing the results of rating frameworks between investors is entirely possible if the assumptions and rubrics for scoring are the same.

[134] Riek 1987.

[135] So and Staskevicius 2015.

[136] Cooney and Lynch-Cerullo 2014.

[137] Ibid.

[138] Riek 1987.

[139] So and Staskevcius 2015.

Assessing the Most Appropriate Framework

All three frameworks may be used as part of a robust impact management system. Well-developed impact measurement frameworks can build on the strengths and attempt to mitigate against the challenges highlighted above. When thinking about the right framework archetype to pick, it is important that investors consider what is most fit for purpose, based on their objectives, portfolio, stakeholders, and resources.

Each framework highlighted above can be implemented in a simple or more complex way. The target framework, which sets basic goals, is a useful starting approach, one to which the other two could be added As indicated in the introduction to this section, all three archetypes can be embedded throughout an impact measurement system, and should be built on an impact thesis, anchored in evidence, and used to assess and monitor impact.

As investors think about the archetype(s) that are most fit for purpose, below are some general considerations:

Monetization framework: Because of the complexity and economic rigor required to implement this type of framework, this approach is often best suited for larger investors that may be selective in their choice of industries and geographies to ensure data availability, comparability, and strong evidence of causality from output to outcomes. The approach is attractive for investors seeking to bridge the communication between impact and the more mainstream investment industry, as it uses one financial metric to define both dimensions.

Rating framework: Because of the many quantitative and qualitative dimensions that can be incorporated into an overall rating, this approach is often best-suited for investors that prioritize and seek to manage against multiple aspects of impact (for example, direct project impact and systemic impact, impact aspects beyond

TABLE 7 Compatibility Within the Impact Measurement Framework Archetypes

ARCHETYPE	TARGET	RATING	MONETIZATION
IMPACT THESIS	Often for investments seeking impact within in a specific or limited number of sectors (such as financial services).	Often for investments seeking to deliver on multiple aspects of impact (such as direct project impact and systemic impact, and/or impact across multiple dimensions).	Often for investments seeking impact within certain industries and geographies, with rich data available.
IMPACT ASSESSMENT & MONITORING	Relatively straightforward and cost-effective approach.	Builds extra dimension onto the target framework.	Builds extra dimension onto the target framework.
	Specific impact assessment and monitoring skills may be needed, but to a high degree, possible to embed.	The complexity of approach may be scalable, but will include an additional level of sector economic competences and some additional monitoring resources.	Complexity will be high and require significant ex-ante economic competence and analysis, as well as some increased monitoring resources.
IMPACT EVIDENCE	The stronger the evidence of causality, the stronger the impact's credibility.	The stronger the evidence of causality, the stronger the impact's credibility.	The stronger the evidence of causality, the stronger the impact's credibility.
	Evidence use can be relatively simple and built on a sector's overall Theory of Change.	The multi-dimensional approach and benchmarking requires use of investment and context-specific evidence.	Placing a monetized value on externality requires a very high level of evidence, preferably with a clear, proven Theory of Change.

"reach" including breadth, depth, duration, and so forth). Rating impact measurement frameworks are often suitable for impact investors covering multiple sectors and geographies, as it allows for comparability within a portfolio. The frameworks are also well suited for investors operating in more challenging contexts, as the rating design through definition of the benchmark/typology/scale may explicitly take this into account.

Target framework: Because of the challenge of cross-industry comparability, this approach is often best-suited for more specialized investors that operate in a specific or a limited number of sectors (such as financial services). Due to the clarity and simplicity of this approach, it is often the impact measurement framework requiring the least upfront investment, operational costs, and skills, making it attractive to many new and/or smaller impact investors. Target impact frameworks may also be more attractive for investors focusing on sectors with established Theories of Change, supported by strong evidence of causality between output (reach) and outcomes.

CASE EXAMPLES FROM THREE LARGE IMPACT INVESTORS

Here we showcase a concrete example for each archetype. It is worth noting that while each fund manager is classified according to one type of framework archetype, each investor uses multiple framework archetypes throughout the investment management process.

Case 1: LeapFrog Investments—FIIRM—a Target Framework

Overview of the fund(s): LeapFrog Investments is a profit-with-purpose investor. By backing high-growth, innovative, scalable businesses in Africa and Asia, the company seeks to fulfill the global unmet demand of billions of low-income, emerging-market consumers for critical services. LeapFrog launched its first fund 10 years ago with the goals of generating top-tier, private equity returns and reaching 25 million consumers classified as living on less than $10 a day. Today, the group manages over $1.2 billion in commitments across four funds, reaching 131.4 million emerging consumers[140] with affordable healthcare and finance.

Framework details: Key to the success of the company's approach is the ability to measure "Purpose" as rigorously as "Profit." To achieve this, LeapFrog undertook three steps from the start:

- **Step 1: Setting clear targets**—All LeapFrog funds have defined dual targets: top-quartile returns (profit) and emerging consumers reached with essential products or services (purpose). These are distilled to the level of each investee company, providing them with a clear measure of success.
- **Step 2: Establishing a theory of change**—LeapFrog's approach to impact is built upon a clear theory of change,[141] which is that by investing capital and expertise (inputs) in innovative companies, LeapFrog aims to equip emerging consumers with essential tools (outputs) that enable better risk mitigation, enhancement of financial and health well-being (outcomes), and that ultimately empower the customer to take entrepreneurial leaps out of poverty as a result of different life choices (impact).
- **Step 3: Measuring what matters**—LeapFrog pioneered an integrated approach to tracking and driving the social and financial performance of investee businesses. The measurement approach is built on two pillars, FIIRM, LeapFrog's proprietary measurement framework, and Consumer Insights, both of which incorporate the measurement of outputs, outcomes, and impact.

FIIRM encompasses a matrix of operational key performance indicators (KPIs) to track financial performance (F), impact and innovation (II), and risk management (RM). FIIRM is designed to drive businesses around outputs (scale) and outcomes (depth) that are critical to ultimate impact, but are directly measurable and aligned with the company's financial bottom line. Tracking of impact is done through quantitative and qualitative KPIs that measure the scale of people reached, quality of products being offered,

[140] FIIRM results, September 2018.

[141] The goal of enabling choices, or capabilities, is based on the pioneering work of Nobel Prize-winning economist, Amartya Sen, and his Capability Approach for human development. See Sen 1999.

FIGURE 18 FIIRM Indicators and Consumer Insights

affordability relative to low-income consumers, and institutionalization of good governance standards.

The FIIRM framework was designed with a number of key characteristics in mind, including:[142]

- Measuring what the business can control directly: outputs and outcomes vs impact
- Integrating financial and social performance through data and evidence
- Using KPIs and targets strategically to drive ongoing management decision making and performance (not just measure it)

Consumer Insights captures, first-hand, the experience of low-income consumers who are the target beneficiaries. LeapFrog's consumer research data set is built on learnings from field interviews about consumers' diverse needs and preferences. Together, FIIRM and Consumer Insights provide a rich dataset of financial and non-financial indicators, often incorporating global standards.

Application of the framework: LeapFrog's framework was designed to integrate impact considerations throughout the investment lifecycle. Highlights of this integration include:

- **Screening**—Each investment opportunity is evaluated from the start using FIIRM on key financial and impact considerations, including ESG and sustainability. The results enable clear identification of the profit-with-purpose opportunity, and highlight areas of focus for further diligence.
- **Due diligence**—All aspects of the FIIRM framework are applied with due diligence to each investment. Impact considerations are examined, both top-down and bottom-up, by assessing alignment and performance of the company against the four tenets of scale, quality, affordability, and governance. At the same time, the Consumer Insights team collects data from a range of consumers on their unmet demands, "pain points," perceived future risks, and drivers of satisfaction.
- **Investment decision**—The investment committee integrates FIIRM results and Customer Insights to holistically evaluate the performance of potential investments. The due diligence results from FIIRM help crystalize company-level impact targets and action plans, and enable alignment with LeapFrog's principles for responsible investment.
- **Investment management**—FIIRM forms the backbone of ongoing portfolio review and management. All companies report FIIRM data quarterly, ensuring timely and integrated results. Targeted consumer feedback further supplements FIIRM results, charting the trajectory for value creation and risk management across a range of financial, impact, and ESG considerations.
- **Exit**—The data and insights captured since investment are used to evaluate impact, and financial and ESG performance at exit against

[142] EY 2014.

initial targets in order to prove decisively the value generated by LeapFrog's profit-with-purpose approach. A Responsible Exits Framework also helps ensure companies graduate to a suitable next owner, while protecting emerging consumers.

Why this framework is fit-for-purpose for LeapFrog: Ultimately, FIIRM is fit-for-purpose for LeapFrog, its investors, and 26 portfolio companies because it enables full alignment across stakeholder groups, using actual performance data on whether financial and social targets are being achieved.

Additional information on LeapFrog's FIIRM framework can be found here:

- E&Y. 2014. "Driving Integrated Social and Financial Returns." Case Study. https://www.ey.com/Publication/vwLUAssets/ey-driving-integrated-financial-and-social-returns/$FILE/ey-driving-integrated-financial-and-social-returns.pdf.
- Pilling, David. 2018. "Profit with Purpose Unlocked in Africa and Asia." *Financial Times*, September 23. https://www.ft.com/content/9dc5f35c-7ba0-11e8-af48-190d103e32a4.

Case 2. Partner's Group (PG LIFE Fund)[143]—a Rating Framework

Overview of the fund: PG LIFE is a private markets strategy with "the dual mandate of achieving attractive risk-adjusted financial returns alongside measurable, positive social and environmental impact."[144] The strategy addresses global social and environmental challenges by investing exclusively in line with the UN Sustainable Development Goals, and with a particular focus on the goals relating to education, healthcare, energy access, clean energy, and social inclusion.

Framework details: To ensure that positive SDG impact is achieved through its investments, Partners Group has developed an integrated framework that considers environmental and social factors throughout the investment lifecycle.

PG LIFE's framework is built around three key aspects, applied to every investment:

- **Logic model**—A logic model is created for each investment that links a company's outputs to SDG-related outcomes to establish a basic impact thesis focused on a particular beneficiary group. This thesis is anchored in evidence linking outputs to outcomes.[145]
- **Impact assessment**—Using the shared norms and fundamentals of impact,[146] each investment is rated across the five dimensions of impact, ranging from 1 (low) to 5 (high).
  - WHAT—What are the SDG-related impact(s) and how important are they to the people or planet?[147]
  - HOW MUCH—How significant will the impact likely be, within the given time period?
  - WHO—Who experiences the effect?[148]
  - CONTRIBUTION—To what extent would the impacts have happened anyway?
  - RISKS—What are the risks to the intended delivery of the impact and how likely are they?
- **KPI selection**—Focusing on materiality and streamlined reporting for investees, a shortlist of impact KPIs are agreed upon with companies to ensure that impacts on all stakeholders are trackable, measurable, and reportable.

Application of the framework: This framework was designed to integrate impact considerations throughout the PG LIFE investment lifecycle. Highlights of this integration are as follows:

- **Sourcing:** At this stage, each opportunity is assessed to check that it meets all the minimum impact

[143] Partners Group PG LIFE risk factors and suitability considerations are provided in Online Annex I.

[144] Partners Group 2018.

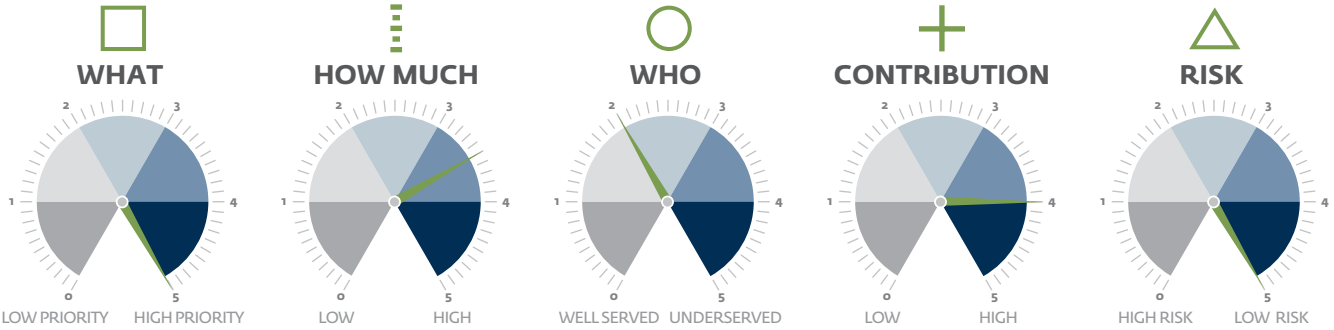
[145] PG LIFE's approach to evidence linking outputs and outcomes is aligned with NESTA. See https://www.nesta.org.uk/report/nesta-standards-of-evidence/.

[146] Impact Management Project 2019.

[147] When evaluating the WHAT, Partners Group assigned low scores when the SDG target was a relatively low priority for the investment country, and high scores when the SDG target was a high priority.

[148] A specific rating scale was created for each type of investment. For example, when evaluating the HOW MUCH for renewable energy investments (SDG target 7.2), the rating scale is, in part, based on the projected percent contribution to a country's renewable energy goals.

FIGURE 19 Partners Group—PG LIFE's Fund Development Impact Framework



Scores 5.0 on the basis that SDG target 7.2 is very high priority in host country, based on its current performance relative to other countries.

Scores 3.5 because target investment is expected to contribute up to 1.6% of country's annual need to meet renewable energy-related targets. Moreover, the assets are expected to generate impact for 23 of the next 25 years.

Scores 2.0 on the basis that there are numerous other providers of renewable energy in host country.

Scores 4.0 as PG would be 'engaging actively' i.e. would use its influence to enhance target's ability to deliver renewable energy, and have majority governance rights.

Scores 5.0 as stakeholder commitment and mission drift are very low risk, and there are low social and environmental risks for target.

FIGURE 20 PG Life Fund Development Impact Framework Application

1 SOURCING	2 DUE DILIGENCE	3 IMPACT DECISION	4 OWNERSHIP	5 EXIT
ATTRACTIVE INVESTMENT OPPORTUNITIES are pursued leveraging Partners Group's global deal flow	**DUE DILIGENCE AND IMPACT ASSESSMENT** consistent with Partners Group's standard process	**IMPACT COMMITTEE** reviews impact assessment and SDG value creation initiatives	**MONITOR AND MANAGE SDG IMPACT** through annual data collection and validation process	**IMPACT MEASUREMENT LEARNINGS** integrated into new and existing LIFE investments

inclusion criteria. One of the criteria is establishing a clear link between the products/services of the investment and at least one SDG target (see Logic Model bullet above).

- **Due Diligence:** At this stage, the full framework described above is applied to all investments. Assets are assessed based on both their current and potential level of impact, as aligned with business plans developed as part of the investment process.
- **Impact Decision:** The PG LIFE Impact Committee convenes weekly and evaluates deals holistically based on the impact thesis and the five dimensions of the impact assessment. Based on this evaluation, votes are cast based on whether an impact committee member has a low conviction (1) that the deal should be included in PG LIFE, or a high conviction (4).
- **Ownership:** PG LIFE confirms the proposed impact metrics (3 to 5 core metrics) to be tracked and reported (annually) with the asset's executive team. These metrics communicate the asset's most compelling potential impacts and tie with the asset's core operating model. PG LIFE also ensures that assets have the appropriate systems in place to be able to track and report these metrics credibly.
- **Exit:** PG LIFE will utilize exits as an opportunity to reflect on lessons learned over the period of ownership of the asset in terms of creating, optimizing, and sustaining positive impact. These lessons will be shared internally and externally through impact exit reports.

Why this framework is fit-for-purpose for PG LIFE: Through all its investments (also outside of PG LIFE), Partners Group aims to drive value creation, which includes helping companies improve the management of material ESG topics such as energy management, health & safety, and diversity. Partners Group has an approach and framework for capturing the impact of these improvements in *business practices* and sees the

PG LIFE framework as an extension of that, by being able to capture the positive social impacts of companies based on their core *products and services*. Because the success of PG LIFE lies both in its financial returns *and* its impact returns, Partners Group sees its approach to measuring impact as a core and integral part of how it manages the strategy.

Additional information on PG LIFE's framework can be found:

- GIIN. 2018. "Financing the Sustainable Development Goals: Impact Investing in Action: PG LIFE case study." Strategy note. https://www.ft.com/content/9dc5f35c-7ba0-11e8-af48-190d103e32a4.
- Impact Management Project. 2019. "Managing impact at scale in a blended private markets portfolio." Report. https://impactmanagementproject.com/wp-content/uploads/Investors-Perspective-Partners-Group-report.pdf.

Case 3. TPG (RISE Fund)—a Monetization Framework

Overview of the fund: The Rise Fund has the stated objective of "achieving social and environmental impact alongside financial returns."[149] It is focused on investments in seven sectors: education, energy, food and agriculture, financial services, healthcare, information and communication technology, industrials, and infrastructure. The fund targets investments in both emerging and developed countries and hit its $2 billion close in October of 2017.

Framework description: The Rise Fund worked with Bridgespan Group to develop an approach to measuring impact that can be used across a diverse set of assets. Their approach builds on earlier contributions to quantifying impact, including cost-benefit analysis, and social return on investment. The basis for their framework is an impact money multiple (IMM) that quantifies and monetizes an investment's net social and environmental impact on the basis of rigorous, quantitative evidence.

Outlined below is a summary of the three-part approach used to calculate an IMM, which is applied to every investment, ex-ante, and updated during the investment holding period:

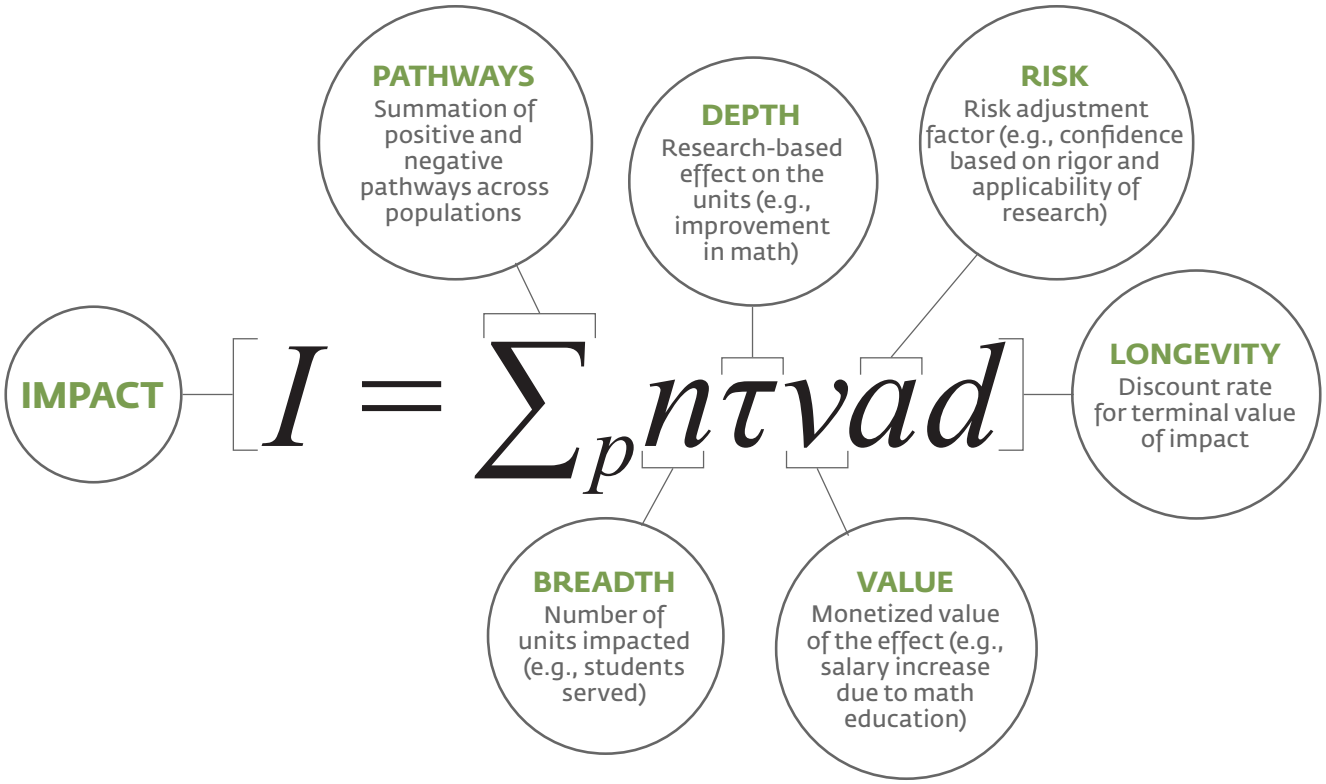
- Conduct a rigorous assessment of published research to develop impact pathways and to translate outputs to monetary outcomes. Impact pathways are identified for each investment and evidence is sought for each pathway that monetizes the expected value of impact (such as the expected annual increase in customer income). This value of impact is multiplied by the expected reach of an investment (for example, the expected number of customers, annually).
- Adjust underwritten impact based on the risks of not realizing impact. For each investment, different types of risks are fed into an estimation of the likelihood for achieving the intended impact. As an example, one of the risks examines the level of assumptions required to monetize the value of the impact of a company's products/services. These risks are assessed and rolled-up into a likelihood of realizing the impact for a given pathway. This likelihood is then multiplied by the total expected value of impact (from above) to get a targeted annual outcome of that specific pathway.
- Forecast future expected impact and adjust for investment stake. To account for impact over time, the Rise Fund holding period, plus the Rise Fund terminal value period, are taken into consideration to calculate the total impact across the specified timeline. All impact pathways are then added up and adjusted for the stake held by the Rise Fund, and the amount of investment.

Application of the framework: The heavy-lifting for the IMM calculation occurs during due diligence but provides the basis for ongoing monitoring throughout the life of the investment.

- **Screening:** Rise does a qualitative impact assessment of potential investments to filter out deals that are unlikely to pass the IMM hurdle. Companies with a potentially measurable impact proceed through the screening process.
- **Due Diligence:** In collaboration with outside advisors, Rise completes an impact review, including

[149] For more information on the Rise Fund, visit https://therisefund.com/.

FIGURE 21 TPG (RISE Fund)—Impact Monetization Formula



an IMM calculation to the extent of the available data for a particular investment.

- **Impact Decision:** In evaluating potential investment opportunities, Rise looks to generate a minimum social return on investment.
- **Ownership:** The IMM framework identifies KPIs for each investment that are aligned with key business outputs (for example, the number of customers). These KPIs are reported by investments on a quarterly basis. Similar to how financial performance is monitored, investment teams monitor impact performance on an ongoing basis, and address issues with company management when impact results are less than expected. The IMM calculation is updated on an annual basis.
- **Exit:** The actual IMM at exit (including the implied terminal value) is calculated and evaluated relative to expectations upon initial investment. The Rise Fund works to evaluate impact in order to improve the accuracy of future underwritings and impact maximization efforts.

Why this framework is fit-for-purpose for the Rise Fund: The Rise Fund views the IMM as an evidence-based approach to quantifying impact, similar to how IRR assesses financial return. They believe this approach allows them to direct capital where research and evidence points, allowing them to compare investments across sectors and regions, and build trust and confidence from their stakeholders and the industry through transparently, credibly, and rigorously assessing impact.

Additional information on the Rise Fund's IMM framework can be found:

- Addy, Chris et al. 2019. "Calculating the Value of Impact Investing." *Harvard Business Review*, January/February. https://hbr.org/2019/01/calculating-the-value-of-impact-investing.
- Chorengel, Maya and Michael Etzel 2018. "How TPG's Rise Fund underwrites impact to guide its global investments." *Impact Alpha*, December 18. https://impactalpha.com/tpgs-rise-fund-underwrites-impact-to-guide-its-global-investments/.

SUMMARY

This section does not provide an assessment or critique of each framework, but rather showcases the summary of a concrete example for each archetype. It is worth noting that while each fund manager is classified as one type of framework archetype, each investor uses multiple framework archetypes throughout their investment management process.

All three examples are illustrations of well-functioning, robust frameworks that are fit for purpose for each specific investor. The three case-studies also illustrate that there is not one ideal way to measure (and manage) the impact of a portfolio.

TABLE 8 Framework Archetypes Summary

IMPACT MEASUREMENT FRAMEWORK FEATURE	LEAPFROG—A TARGET FRAMEWORK	PARTNER GROUP'S LIFE FUND—A RATING FRAMEWORK	TPG'S RISE FUND—A MONETIZATION FRAMEWORK
IMPACT THESIS	LeapFrog has an overall investment thesis for each fund, which is supported by theories of change. These theses and theories of change are based on global needs and gaps in the market.	Each investment within PG LIFE has a thesis based on a logic model that links a company's products/services to SDG-related outcomes.	The Rise Fund has investment objectives at the fund and sector level, accompanied by a specific impact thesis for each investment.
IMPACT EVIDENCE	Leapfrog leverages external evidence and research to connect their theories of change to the ultimate impact they seek. Leapfrog Customer Insights produces evidence directly from their customers based on surveys.	A core feature of each thesis is understanding the evidence that links outputs to outcomes.	The IMM approach is heavily grounded in academic research. Each impact pathway articulated in the investment thesis is backed up by a rigorous study that translate outputs to (monetary) outcomes.
IMPACT ASSESSMENT & MONITORING	FIIRM KPIs are collected from businesses on a quarterly basis. These are a combination of standard KPIs, supplemented with company-specific KPIs that are deemed critical to portfolio management.	PG LIFE assesses impact based on a rating of expected outcomes related to the SDGs and the five dimensions of impact (as defined by the IMP).	The Rise Fund assesses impact based on business indicators related to the social/environmental outcomes being targeted, combined with an economic valuation of those outcomes.
	Consumer insights data are collected based on the needs of the company.	The fund monitors impact throughout the ownership period by using three to five metrics agreed upon with the company. These are reported annually.	KPIs that are part of the IMM calculation are reported and monitored quarterly. IMM calculations are updated on an annual basis.

SPOTLIGHT

IFC'S ANTICIPATED IMPACT MEASUREMENT AND MONITORING SYSTEM

IFC revisited its approach to assess and measure impact in response to a paradigm shift in the global agenda for development. While IFC's strategy and projects have included impact considerations throughout its history, and the introduction of the Development Outcome Tracking System (DOTS) in the early 2000s strengthened IFC's capacity to monitor its development results,[150] IFC needed to intensify its focus on development impact to effectively contribute to the ambitious global agenda of increasingly relying on the private sector to finance development.

IFC launched the AIMM system in 2017 to provide: (a) a systematic and rigorous framework to assess the development impact of investment operations ex-ante, and monitor results ex-post, which has strengthened IFC's ability to select, design, and adjust projects to maximize impact; (b) a structured approach to assess catalytic market effects that fosters IFC's strategic mandate to Create Markets and support the *Billions* to *Trillions* agenda;[151] and (c) an effective way to employ a portfolio approach to balance IFC's double bottom line and generate development impact through financially sustainable operations. Overall, in the words of IFC management, the AIMM system is "*putting development impact at the heart of IFC, and IFC at the heart of development impact*."

Beyond a framework to estimate and monitor the development impact of investment operations, the AIMM system has become a key component of IFC's decision-making and incentives structure. AIMM ex-ante impact assessments not only allow IFC to systematically articulate the development impact thesis of its interventions, and support expected outcomes through following a rigorous evidence-based approach, the assessments also provide concrete inputs into the investment decision process in the form of development impact ratings. These ratings are embedded at the core of the incentives system and, thus, have become effective game changers in the decision-making dynamics within IFC.

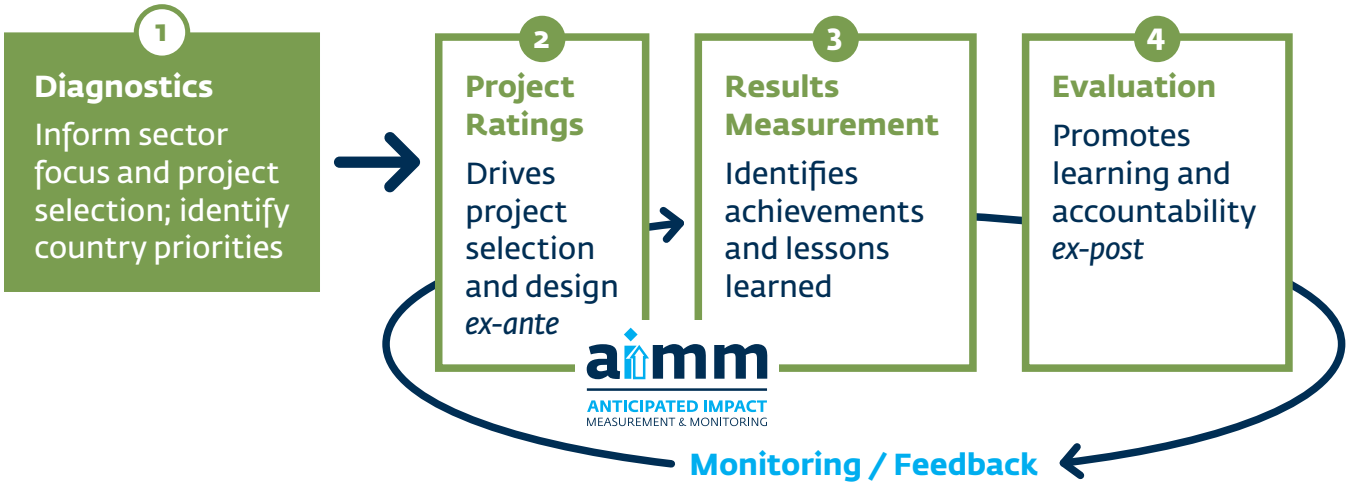
Moreover, the availability of development impact metrics, along with financial performance indicators, allows IFC to elevate the internal and external strategic dialogue about its double-bottom line at the aggregate level, as well as through portfolio construction, composition, and management, which are beyond the micro optics of individual transactions. By including a monitoring (or results measurement) system that captures relevant indicators and evidence in order to assess the realization of expected outcomes during project implementation, AIMM not only provides a way to document progress about IFC's delivery on its mandates, but also—through ex-post ratings—to generate incentives to make feasible adjustments during the supervision cycle. These can maximize impact at the individual transaction level, as well as at the portfolio level, through strategic asset reallocations. Furthermore, by serving as a link between diagnostics, ex-ante assessment, results measurement/monitoring, and ex-post evaluation functions, the AIMM system provides the needed connectivity of an "end-to-end" support and impact assessment architecture for IFC operations. This is also closely aligned with the impact measurement framework elements described above, which include appropriate and effective feedback loops.[152]

[150] IFC introduced the Advisory Services Operations Portal (ASOP) in 2010 to manage its advisory operations.

[151] See "From Billions to Trillions: Transforming Development Finance Post-2015 Financing for Development: Multilateral Development Finance" prepared jointly by the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the International Monetary Fund, and the World Bank Group.

[152] With ex-ante and ex-post ratings as part of the incentives system, it is in the best interest of the organization to use evidence collected during supervision and evaluations in order to recalibrate assessment criteria and parameters.

FIGURE 22 End-to-End Support System for Impact Assessment



The structure of the AIMM framework provides a flexible multi-dimensional approach to reflect the development impact thesis of private investment operations. The framework reflects a broad theory of change, under which private sector investments generate a combination of (positive and/or negative) direct, indirect, and catalytic effects that impact different stakeholders and markets. Altogether these depict the multi-dimensionality of the development process (and inherent in the design of the SDGs). AIMM also draws from IFC's core mandates to: (a) support private activity that generates impact, and (b) enable the development of new markets or systemic changes to existing markets,[153] as illustrated in Figure 23.

Following the continuum from IFC's mandate to the SDGs, the AIMM system specifically assesses the development impact of IFC's interventions across two dimensions:

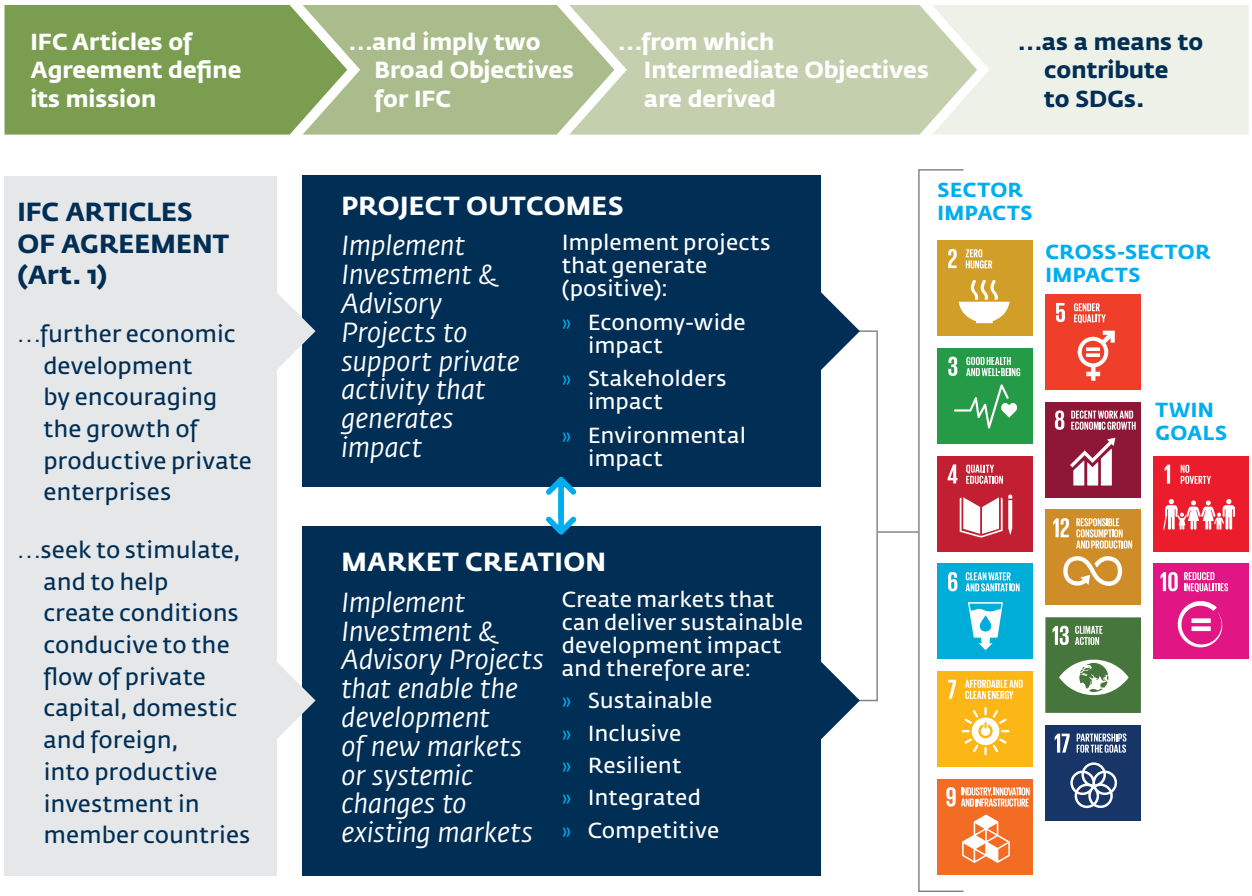
1. **Project outcomes:** including direct effects on stakeholders (such as customers, suppliers, employees, neighboring community, and government) as well as indirect effects on the economy (for example, value added, and employment), as well as society, overall (including broad environmental and social effects).[154]
2. **Contribution to market creation:** to reflect systemic changes catalyzed in the market (for example, market outcomes) beyond those generated by the project (directly and/or indirectly) through forward, financial, and physical linkages. Market outcomes recognize potential systemic changes on markets' competitiveness, integration, inclusiveness, resilience, and/or sustainability.

The AIMM construct allows systematically incorporating in the impact analysis: individual investments within specific sectors; cross cutting development impact dimensions such as gender, base of the pyramid (BOP), and other vulnerable groups; economic impacts such as value added and employment; and environmental and social impacts. These are common themes that imply inherent complexities for impact investors. Regardless of the sector specifics, the structure of AIMM incorporates reach vis-à-vis vulnerable groups (gender, BOP, youth, among others) within the analysis of stakeholders, while recognizing that the target population within these groups could be customers, suppliers and/or employees of private sector firms in the different sectors. In addition, by including economy-wide

[153] For IFC Articles of Agreement, see: https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/ifc+governance/articles/about+ifc+-+ifc+articles+of+agreement.

[154] IFC has developed economic modeling tools to estimate the economic impact of its investments across many of the sectors in which it operates, including manufacturing, agribusiness, services, oil and gas, mining, power generation, transportation infrastructure (airports, ports and roads), SME finance (SME employment only), housing finance, trade finance, and telecoms. Work on methodological refinements and increasing sector coverage will continue going forward. For environmental effects, IFC has also developed methodologies to estimate the emissions and emission reductions that are used in AIMM project assessments.

FIGURE 23 The AIMM Two Dimensions: Project Outcomes and Market Creation



impacts as well as environmental and social impacts as part of the overarching structure of project outcomes, AIMM not only recognizes that different firms and sectors can have impacts along these dimensions, but also harmonizes the estimation and measurement approaches across these cross-cutting areas.

To operationalize these concepts, IFC is developing detailed sector frameworks to apply across more than 20 industry sectors. The objective of sector-specific frameworks is to guide assessments of impact that on the one hand reflect the core outcomes of different sectors (such as the provision of access to the specific services of different infrastructure sectors, or total employment generation in manufacturing), and on the other hand use standard industry measurements (the number and volume of loans for financial intermediaries, and capacity indicators for infrastructure sectors). But the frameworks also guarantee consistency of the approach by following an overarching structure (and assessment approach).

Therefore, each sector framework includes: different impact components under project outcomes and market attributes that are relevant for their industry; sector-specific as well cross-cutting indicators and benchmarks that reflect development challenges and the extent of project-specific claims; market typologies that define stages of market development within each sector; and detailed guidance notes defining critical aspects for impact assessment within the corresponding industry. Figure 24 lists the AIMM sector frameworks being developed by IFC to assess the development impact of its global operations, and across its functional industry groups. This toolkit will be an ongoing construction since it not only includes conceptual elements, but also a body of underlying indicators and evidence that is expected to evolve over time. Currently, across IFC's sectors, development of the frameworks is at different stages.

FIGURE 24 AIMM Sector Frameworks

MANUFACTURING, AGRIBUSINESS & SERVICES	FINANCIAL INTERMEDIARIES	INFRASTRUCTURE & NATURAL RESOURCES	TELECOMS, MEDIA, TECH & VENTURE INVESTING
Agribusiness	SME Finance	Power	PE Funds
Manufacturing	Microfinance	Airports	Venture Capital
Tourism	Climate Finance	Ports	Towers
Property	Housing Finance	Roads	Mobile Operators
Retail	Trade Finance	Water and Waste	Broadband
Health	Capital Markets	Oil and Gas	Satellite
Education	Distressed Assets	Mining	Data Centers
	Insurance		

Through the analysis of impact potential and likelihood, AIMM ratings reflect risk-adjusted expectations of impact. Following the same approach of financial performance analysis, which divides risk-adjusted return between the expected rates of return and the associated investment risk, AIMM ratings are based on a measure of potential impact that is adjusted for the likelihood of both the project and market outcomes materializing. The separation of potential from likelihood allows the analysis of potential to focus on the capacity of an intervention to generate expected impacts, regardless of the surrounding risk. To determine potential, the individual (project and market) effects are evaluated through evidence that supports: (a) the development challenge being addressed; and (b) the intensity (extent or efficiency) of the project in addressing the relevant development gap. On the other hand, analysis of likelihood focuses on the main factors that could impede the realization of the expected impacts, including the operational risks (such as the quality and experience of the sponsor in the relevant sector and geography, and the operational complexities, but only those applicable to project outcomes); the sector risks (for example, those related to demand and investment trends, and regulatory issues); the country risks (macroeconomic and political factors); and the political economy and policy issues (such as the political economy contextual issues that define or influence specific markets and sectors, interest groups, and pending, ongoing, or expected market-wide reforms that, in general, are applicable only to market creation).

The distribution of AIMM ratings already signals the spectrum of development impact for IFC operations across different sectors, geographies, and country contexts. In this regard, although early in the implementation process, AIMM ratings are already providing an immediate feedback loop about the weakest, as well as the strongest projects, in terms of

FIGURE 25 AIMM Ratings Structure

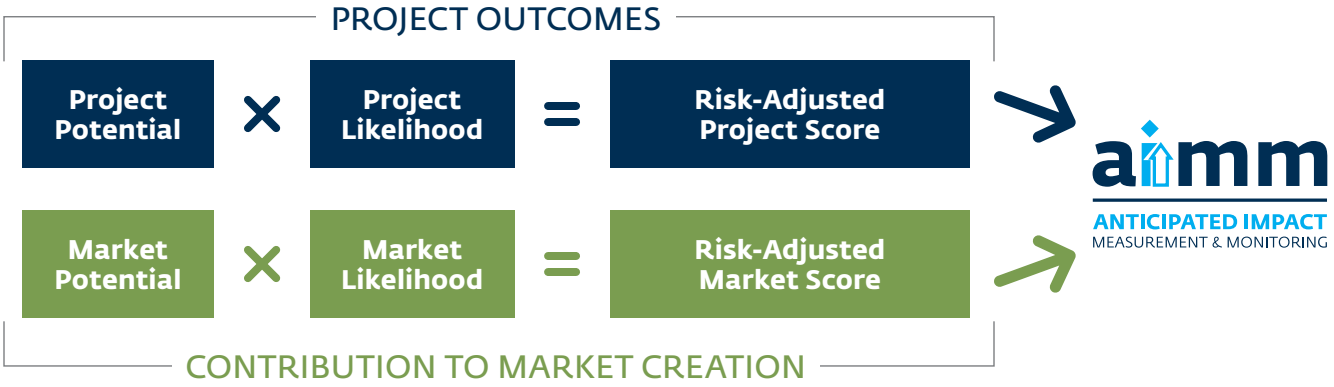
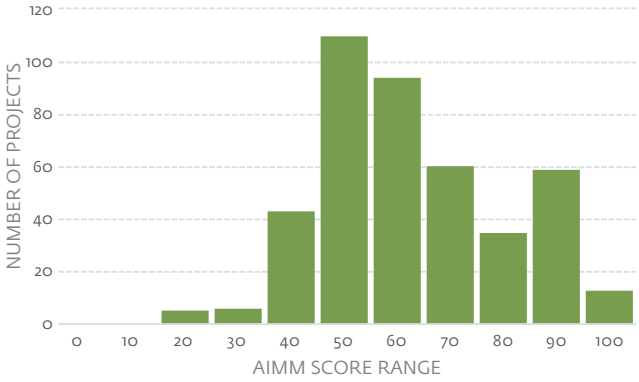


FIGURE 26 AIMM Score Distribution

Projects scored between Jul 2017–Dec 2018



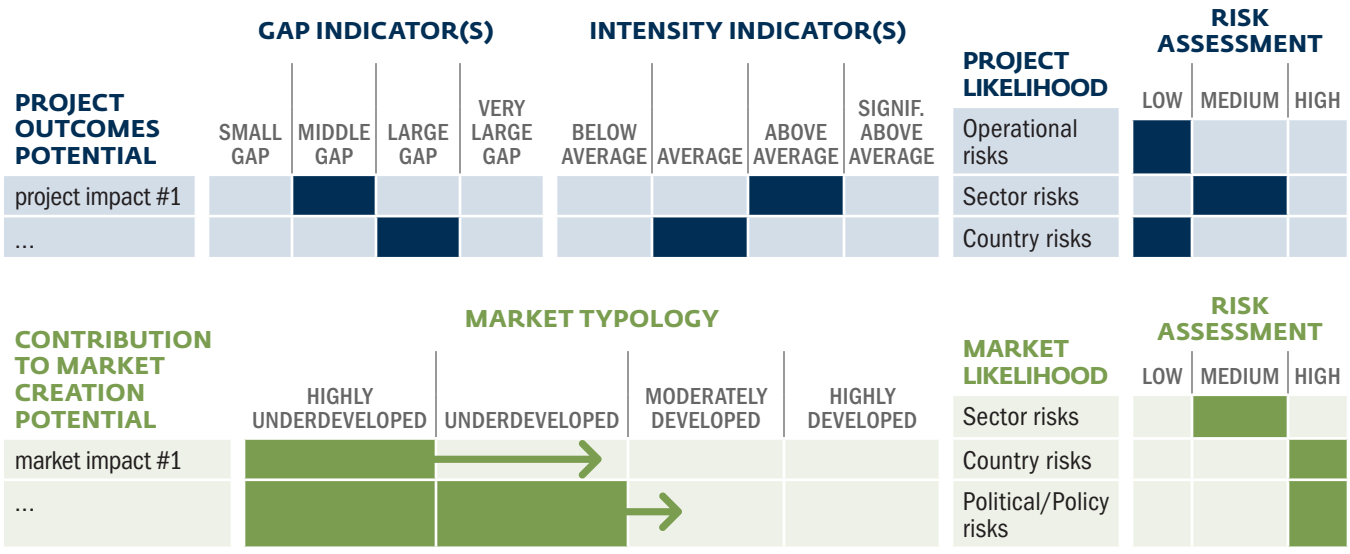
their impact. And these are starting to generate a cultural change throughout IFC operations about the need to incorporate development impact as a core element of project design, conceptualization, and decision-making.

For rating purposes, AIMM sector frameworks include the tools to substantiate evidence-based judgments about potential and likelihood. AIMM uses quantitative and qualitative indicators to support the potential of assessment-specific interventions across the AIMM dimensions (and sectors). For project outcomes, these indicators provide a basis for assessing development gaps (such as the SME financing gap as a percentage of GDP, or electrification rates) as well as their intensity/efficiency (for example, farmers reached per dollar of project cost, or employment multipliers). Also benchmarks are provided for each indicator to help assess, on a relative basis, the extent of a gap or its intensity.[155] For contribution, market creation indicators (when available) and other observed characteristics are used in a sector to build market typologies that define various stages of market development across the market attributes (for example, market structure in the housing finance sector, as a component of market competitiveness).

For market creation, the current market stage when a project is being implemented defines the development gap, while the expected change from the current to the future market stage defines intensity (see Figure 27).

Thus, the AIMM system seeks to provide a rigorous evidence-based structure and process to achieve IFC's double bottom line by: selecting investments for their potential development impact in addition to their financial performance (both on a risk-adjusted basis); and including in the selection criteria systemic market effects in addition to project-related outcomes.

FIGURE 27 AIMM's Underlying Evidence-based Approach



[155] With the development of AIMM, IFC is building a database of indicators and benchmarks for project and market impact components (and sub-components) across sectors. In general, benchmarks for project outcomes' development gaps compare metrics across countries, while benchmarks for project outcomes' intensity compare metrics across projects within a sector. These benchmarks are derived from the distribution of the data (when available), combined with sector expertise.

BOX 9 AIMM Private Equity Funds Sector Framework

This box briefly presents the specific AIMM sector framework for investments in private equity (PE) funds. The IFC development impact thesis for this sector is that investing in PE funds contributes to addressing the financing and growth needs of underserved and financially constrained businesses. To deliver on this central development thesis, IFC's investment in PE funds focuses primarily on attracting institutional equity to fund the needs of early-stage to mid-market companies, develop and attract qualified fund managers who can select these companies and provide them with funding and business advice to support their growth; and through these activities, ultimately develop innovation, institutionalization, more dynamic and integrated business ecosystems, and economic growth.

While IFC's PE investments are made through fund managers, the bulk of project outcomes will occur at the investee level, where investee firms provided with risk capital and expertise through a fund manager are expected to become more efficient, expand operations (and therefore, increase their impact on the economy), achieve higher growth, and increase reach. With regard to market outcomes, these include broader issues beyond individual investee firms. Examples of these include the strengthening of an asset class that remains largely underdeveloped in most developing economies by attracting various types of fund managers, especially locally-based, investors (for example, limited partners that come from developed economies and are willing to diversify their portfolio) and, more generally, increase PE activity through different channels. Other market impacts relate to the strengthening of domestic and international trade and value chain links, of the digital economy, and the promotion of advanced business standards and sustainability practices.

The figure below *summarizes the PE funds' AIMM sector framework.* Under project outcomes, three stakeholders are identified: investee firms, investee's customers, and fund managers. The core project outcomes (highlighted in green) are the impacts on investees through investee growth, and transfer of expertise and know-how. IFC's inputs are ultimately expected to lead to investee growth through the provision of risk capital and the build-up of local knowledge, networks, and expertise for both the local fund managers' teams and investee firms, which can, in some cases, support underserved/underrepresented groups or be run by underrepresented groups (such as women or youth). In the case of sector-focused funds, investees' customers can be a key stakeholder, for which the development impact assessment is performed using the relevant AIMM sector framework. Investees' business growth implies not only direct value added and employment effects, but also indirect economic effects captured under economy-wide impacts, which are mainly estimated through economic models. For sector funds, other sector-specific outcomes will be considered—for example, investments in climate-focused funds will have environmental and social impacts, assessed using the relevant AIMM sector frameworks.

Beyond project outcomes, PE fund investments are expected to result in a fall in the risk perception of local PE markets by demonstrating the viability of PE investments in relatively underserved markets. This increases the number and value of PE deals, the number of actively engaged, country-focused fund managers, and/or the number and type of limited partners investing in the market. In addition, local domestic investment in PE will strengthen the ability of the domestic PE market to face retreats of international investors. Economic integration can also increase, for example, innovative technology platforms introduced through the fund's investees, and can help connect markets, while externalities from the capacity building of investees may trigger competition in the real sector as well.

For instance, fund investments in technology, such as those from venture capital funds, may increase economic integration by strengthening the digital economy. And generalist funds may improve domestic consolidation/institutionalization of businesses by growing local companies into regional/national providers and competitors, or through establishing new international trade links by connecting value chains across borders. The adoption of inclusive or sustainable business models, instruments, and best practices may demonstrate new opportunities for the PE market to grow.

The assessment of PE investments under AIMM follows the evidence-based approach described above. It recognizes that at the time of the ex-ante assessment, there is uncertainty about which investees will receive

PRIVATE EQUITY FUNDS' AIMM SECTOR FRAMEWORK IMPACT COMPONENTS

PROJECT OUTCOMES

STAKEHOLDERS IMPACTS

Impact on Investees

Investee growth

- Percentage of investees with improved revenue 5% higher than nominal GDP
- Other financial measures

Transfer of expertise and know-how

- Knowledge transfer and Operational Value-Add to Investee

Additonal Considerations

- Percentage of Investees that are SMEs at the time of Initial Investment
- Percentage of Investees targeting underrepresented groups
- Number of Investees with Women owners or in executive positions

Impact on Investees' Customers (sector-specific)

- Access to goods or services for the end customers of the investee companies of the fund

Impact on Local Fund Manager Teams

- Advanced Capacity Building of Fund Manager Teams

ECONOMY-WIDE IMPACTS

Impact on value-added

- Value-add (GDP)

Impact on employment

- Jobs Created

ENVIRONMENTAL IMPACTS

SECTOR SPECIFIC FRAMEWORKS APPLY

CONTRIBUTION TO MARKET CREATION

COMPETITIVENESS *(Market structure and functioning)*

Market Structure

- PE investment level - Number and Value of Deals within the targeted country(ies)/ segment(s).
- Number of Country-Focused and actively engaged Fund Manager
- Strength of the local PE market eco-system

Market Regulation

- Level of development of the PE related regulation

INTEGRATION *(With external and other domestic sectors; incl. capital mobilization at scale)*

Capital Mobilization

- New Private Institutional Limited Partners engaging in the PE market

Trade Links

- New international partnerships/companies established as a result of the intervention

Digital Economy

- Domestic strengthening of the Digital Economy

RESILIENCE *(Capacity to face shocks)*

Capacity of Domestic Markets to withstand Market Shocks

- Changes in PE fundraising trends across economic cycles

INCLUSIVENESS *(Market-wide focus and access for underserved groups)*

Participation

- Inclusive business models and practices
- Diversity in Funds' workforce

SUSTAINABILITY *(Environmental and social sustainability)*

ESG

- Adoption of sustainability practices by businesses operating in the market
- Financial sector policies and instruments to enable and support ESG risk and opportunities

funding—and, as such, when available, a fund's strategy and track record is considered to estimate potential outcomes. It is expected that throughout the monitoring phase, once there is clarity about the investees, certain outcomes may become clearer and can be better assessed. Recognizing that PE markets remain significantly underdeveloped across emerging markets, and that this asset class is not suitable for all economies, to assess gaps related to access to risk capital, the framework uses cross-country data on PE volumes, penetration rates (defined as the ratio of a country's PE volumes to GDP), as well as broad measures of financial market and private credit development. Regarding intensity, investee growth is measured by primarily considering the percentage of investees with revenue growth beyond nominal GDP growth, as well as other financial metrics associated with investees' performance. Given the ex-ante uncertainty about which investees will be funded, specific targets for other metrics such as job creation, or increases in reach, cannot be set in advance. However, these will be monitored and reported on, ex post. Along these lines, market typologies that use available indicators have been developed for each of the market impacts outlined in the framework.

The structure of AIMM ex-ante assessments set the stage for impact measurement during the project life cycle. It is worth recalling that the second "M" in AIMM refers to *Monitoring*. In this regard, target (project and market) outcomes and associated indicators used for ex-ante assessments, provide the basis to collect relevant data, allow for corrective actions, and confirm the realization of expected impacts. AIMM monitoring guidance defines the internal processes and accountabilities for data and evidence collection (including quality assurance), as well as the rules to adjust AIMM ratings according to observed results, relative to ex-ante targets.[156] In addition, observed project and market outcomes serve as the basis for reporting on development impact for the IFC portfolio.

IFC investments' mandatory and demand-driven self-evaluations[157] will provide evidence and lessons learned to improve AIMM structure and processes going forward. For more than a decade, a sample of IFC investments have been subject to mandatory and demand-driven self-evaluations. On a continuous basis, mandatory self-evaluations are validated by the World Bank Group's Independent Evaluation Group (IEG) for a representative sample of IFC investments. Demand-driven self-evaluations are run by a dedicated IFC team, using a combination of internal and external resources, and following a strategic approach that prioritizes filling evidence gaps in the theories of change for specific sectors, as well as drawing lessons learned from IFC's individual investments or programmatic sector investments.[158] Evidence collected through these self-evaluations is expected to provide continuous feedback to improve the AIMM structure and processes over time, and make AIMM a truly dynamic system that is subject to continuous improvement, based on lessons learned and improved knowledge generation from internal and external sources.

In sum, the AIMM system plays a central role in IFC's management of investment for impact, as outlined in the *Operating Principles for Impact Management*, **while also being a tool that fits the institution's purpose.** The AIMM system provides a basis for IFC to operationalize the Impact Investing Principles, by providing a framework to reflect development impact theses, as well as support impact measurement, monitoring, and reporting. More broadly, AIMM allows IFC to effectively address its double bottom line through the implementation of a portfolio approach that balances financial performance and development impact. AIMM is IFC's ultimate effort in the construction of an appropriate development impact architecture that reflects its organizational mandates, and is therefore fit for purpose.

[156] While monitoring of project outcomes will draw from the ample experience of IFC through the implementation of DOTS for more than a decade, an appropriate approach is being developed to monitor market outcomes.

[157] IFC self-evaluation program is defined within the World Bank Group Evaluation Principles. See http://ieg.worldbankgroup.org/.

[158] For further information, visit http://ieg.worldbankgroup.org/.

2.4. Addressing Regulatory Barriers Facing Investors

Philanthropies, foundations, religious organizations, family companies, and households have a lot of freedom in choosing what to invest in, and how. This flexibility has allowed them to be at the forefront of impact investing. As noted in Online Annex B, while these groups, as a whole, hold a greater proportion of financial assets than institutional investors, their assets are primarily held in stocks and bonds traded in public markets.

To scale impact investing in private markets, it will be necessary to attract funds from asset owners who manage and allocate large pools of capital on behalf of their beneficiaries. Only a very few high-net-worth individuals have sufficient capital to invest $10 million in a private equity fund. If impact investment is to grow in private markets, it will therefore, need to unlock institutional capital. This section discusses specifically the barriers facing institutional investors who seek to invest for impact. For the purposes of this section—"asset owners," therefore, refers to public pension funds, sovereign funds, and insurance companies, that collectively control tens of trillions of dollars in assets.

Asset owners are subject to various forms of regulation to ensure that they act prudentially, and in the interests of their beneficiaries, and this section analyzes the barriers they face when it comes to investing for impact. This section also focuses on impact investments that target market-rate financial returns alongside social and environmental goals.[159]

While the term "impact investing" is rarely referred to in regulations, relevant provisions discuss issues such as consideration of ESG factors and general responsible investing strategies—necessary first steps toward impact investing. Regulations in most jurisdictions do not prohibit asset owners from engaging in impact investing, but often discourage it due to lack of information, confusion about unclear provisions, and the imposition of constraints and limitations.

Regulatory barriers for public pension and sovereign fund fiduciaries are clustered around several issues, including the primacy of maximizing financial returns, an emphasis on short-term time horizons, provisions that discourage the consideration of non-traditional financial factors (such as ESG), and the limited guidance on incorporating the ethical views and preferences of stakeholders. Insurance companies are the exception among asset owners, as they face geographic limits on their portfolios, as well as solvency requirements that make many forms of impact investing economically unattractive. For example, investments in unlisted, alternative asset classes, and in emerging markets, can carry steep capital charges.

Changes in public attitudes about investing to solve social challenges, advances in technology that make impact investing more economical, and a sense of urgency about issues such as climate change, are leading to rapid growth in impact investing, albeit from a low base. Regulators can be supportive by clarifying provisions to dispel uncertainty, removing unnecessary constraints, and by supporting collaboration for the development of standards and guidelines.

Public Pension Funds and Sovereign Wealth Funds

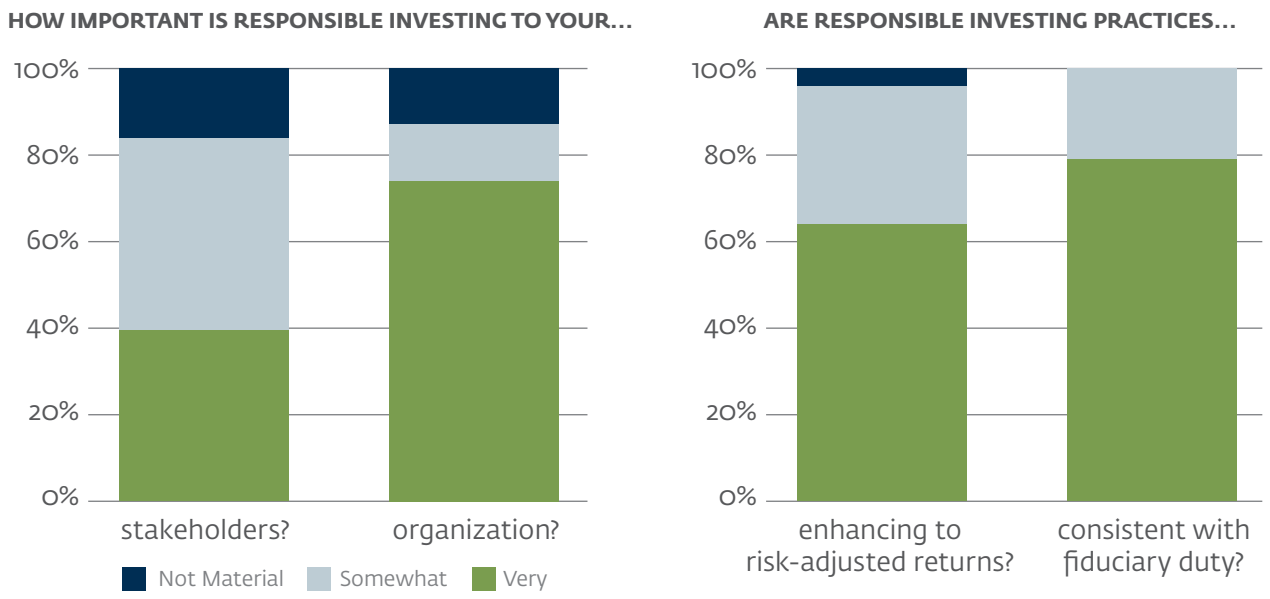
Public pension funds and sovereign wealth funds (PPF/SWF) are among the largest and most influential investors in the world. Globally, pension funds hold $48.9 trillion in assets and sovereign wealth funds hold $9.3 trillion.[160] As public entities, PPF/SWF seek to generate appropriate risk-adjusted returns to pay for the retirement, healthcare, and long-term savings needs of the peoples of their states. PPF/SWF have long-term investment horizons that enable them to weather short-term declines in the financial markets and invest in promising sectors that require patient capital, such as green technology and sustainable infrastructure. These attributes make them ideal impact investors.

Over the last decade, PPF/SWF have increasingly been incorporating responsible investing practices into their investment decision-making process, a necessary first step toward impact investing. One driver for this development has been the growing number of academic

[159] More detailed recommendations for regulatory reform are provided in Section 3. Finally, a summary of the regulatory environment, as it pertains to impact investment, is provided in Online Annex I.

[160] Online Annex B.

FIGURE 28 Attitudes of Asset Owners Toward Responsible Investing, 2017–18



Source: Sovereign Investor Institute, Institutional Investor, 2018.
Note: Based on weighted average polling data collected from 230 public pension funds and sovereign wealth funds in 2017–18.

studies demonstrating that, over time, companies with higher scores on material ESG factors generate higher financial returns. Another driver has been mounting pressure from stakeholders and beneficiaries who would like to see responsible investing principles incorporated into their savings.

Eighty-four percent of PPFs/SWFs polled in 2017–18 felt that responsible investing is somewhat-to-very important to both their stakeholders and their organizations (Figure 28). About 80 percent believe that responsible investing is consistent with fiduciary duty, and over 90 percent believe that it is neutral-to-positive for risk-adjusted returns.

Although PPF/SWFs have invested trillions of dollars in a variety of responsible investing strategies, including exclusions, ESG integration, engagement and thematic investments, capital deployed in impact investing (the newest of these strategies), is quite low.[161] As shown in Figure 29, only 9 percent of PPF/SWFs are currently deploying capital in impact investing strategies.

THE PRIMACY OF RETURNS MAXIMIZATION

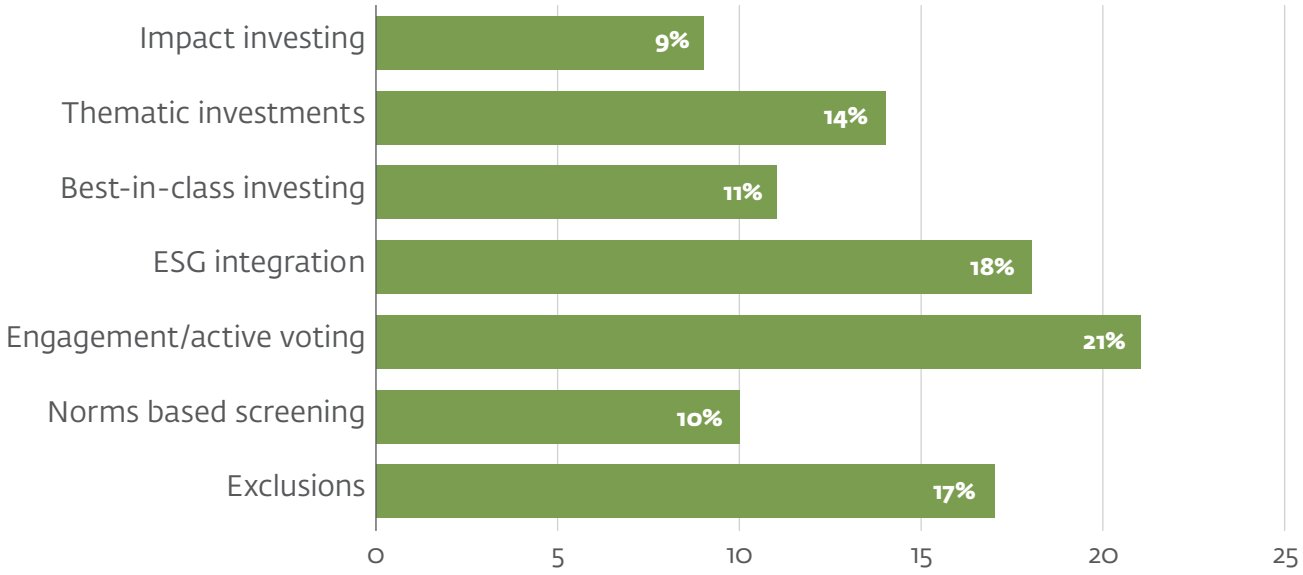
Regulators may not explicitly require pension fund fiduciaries to maximize financial returns, but they often include provisions emphasizing that financial returns should take precedence. Erring on the side of caution, most pension funds and their advisors interpret this to mean that it is their fiduciary duty to maximize returns. "The specific duties of a fiduciary depend on the organization's mission (for example, to generate returns within an appropriate level of risk, to deliver on the organization's promises, and so forth), but in practice fiduciary duty is interpreted as meaning that asset owners need to focus primarily on maximizing the financial interests of their beneficiaries."[162]

Regulatory guidance emphasizing narrowly drawn financial interests is problematic. Fiduciaries that focus on financial returns at the expense of all else, including ESG considerations, may make investments that are not in the best interests of beneficiaries. This further limits fiduciaries from considering impact investing, which targets social and environmental goals

[161] GSIA 2017.

[162] Sullivan et al. 2015.

FIGURE 29 Asset Owners' Responsible Investing Strategies, 2017–18



Source: Sovereign Investor Institutional Investor, 2018.
Note: Based on weighted average polling data collected from 230 public pension funds and sovereign wealth funds in 2017–18.

alongside financial returns. Regulators should clarify that fiduciaries are required to generate appropriate risk-adjusted returns in line with the mission of their organizations, and to represent the best interests of their beneficiaries, including but not limited to protecting their economic interests.

CONSIDERATION OF ESG FACTORS IN INVESTMENT PROCESSES THAT MAY BE NONMATERIAL TO FINANCIAL RETURN

Many fiduciaries are uncertain if they can consider ESG factors in their investment decision-making processes. One problem is that regulations sometimes refer to ESG factors as non-financial, while imposing strict limitations on the consideration of non-financial factors. Another is that regulators often urge caution regarding the consideration of ESG factors—expressing concerns about costs, liquidity, and general complexity—that tend to cause asset owners to back away. In addition, legal advisors and consultants often act as a brake on the consideration of ESG factors by asset owners. As Mark Womersley, a partner at Osborne Clarke LLP, the legal counsel to the U.K. Environment Agency Pension Fund, explains: "…much of the legal profession is well behind the curve, thinking that ESG issues cannot be relevant to their clients and that taking such issues into account may even run counter to their fiduciary duties. There is clearly a need to move legal thinking away from the perceived dichotomy between being ethical and achieving the best returns and shifting focus instead onto the importance of ESG considerations as a key financial factor for investment decision-making."[163]

Except for the largest and most sophisticated asset owners already engaged in impact investing, these issues tend to discourage institutions from making initial commitments. But remedies are straightforward. Regulators should make it clear that material ESG factors are financial in nature, with important risk-and-return implications for the portfolio. They should require fiduciaries to include them, the same way that traditional financial metrics are used when assessing investments. As for costs and other considerations,

[163] Martindale et al. 2016; p. 13.

fiduciaries should be required to treat these issues no differently than what is required for other investment strategies. Regulators should make it clear that these requirements should in no way be considered a ban impact investing.[164]

CLEAR STATEMENT OF IMPACT INVESTMENT POLICY

While regulations in many countries permit fiduciaries to make a statement regarding the organization's views on responsible investing and to include it in the statement of investment policy (SIP), they generally stop short of requiring it. As a result, some asset owners make no mention at all of ESG or responsible investing in their public documents. While market demand may well push managers to make disclosures in the future, requirements to do so could jump-start disclosures, particularly for smaller managers without dedicated resources committed to ESG or responsible investing issues.

Omitting such disclosures may lead to a lack of trust and confidence in the industry, and make it more difficult to hold fiduciaries accountable. Further, it limits beneficiaries' ability to verify if their savings are being invested in line with their beliefs and preferences. In principle, requiring a statement helps to reduce the risk that asset owners fail to comply with their own principles and the wishes of stakeholders.[165] Justin Atkinson, an executive with the asset manager Alliance Trust, describes the issue well: "Publicly stating our investment beliefs guards against falling for anything by standing for nothing. Given the many misaligned incentives that persist in the investment industry, beneficiaries and policy makers should require those investing on beneficiaries' behalf to state the basis on which they do so. If those publicly stated investment beliefs do not chime with beneficiaries' own views, beneficiaries should be enabled to find other providers with concordant beliefs. Greater clarity and transparency of investment beliefs should increase the professionalism and trustworthiness of the investment industry, with resultant benefits for all of our society."[166]

In many countries, fiduciaries are not required to report how investment policy, including social impact considerations, reflects the beliefs of stakeholders and beneficiaries, nor are they required to engage with stakeholders on responsible investing practices. Introducing such requirements may better protect the best interests of stakeholders, promote engagement between savers and their pensions, and encourage pensioners to save more by identifying investment as a force for social good, alongside financial returns.

In the United Kingdom, for example, the regulator expects trustees to take account of members' views, including on social impact, when investing their savings. "We should not forget the savers who are the ultimate beneficiaries of pension investment—the people whose money is being invested, ideally in a way that supports the sort of world they want to live in. We know that an increasing number of people want to reflect their values in the things they choose to buy, the places they live and visit, and the jobs they do. People care about the impact that their choices have on our environment and humankind. Pension scheme members should therefore be able to see how their money is being put to work, and to make their views heard."[167] In the Netherlands, taking account of savers preferences also is required.[168] In both countries, this does not mean pension funds must reach 100 percent agreement from beneficiaries. Rather, "if the issue is not controversial, and there is good evidence of agreement from members, we think that trustees may act on these views even if many members fail to engage."[169]

[164] De Nederlandsche Bank N.V. 2016.

[165] Pension fund boards must document their considerations with respect to sustainable investment and make them available to their stakeholders. See Federation of the Dutch Pension Funds and the Labour Foundation 2013.

[166] Martindale et al. 2016.

[167] Department for Digital, Culture, Media & Sport and Department for Work & Pensions 2018.

[168] Pension Boards must create commitment among stakeholders for sustainable investment decisions. See Federation of the Dutch Pension Funds and the Labour Foundation 2013.

[169] The Law Commission 2017.

Insurance Companies

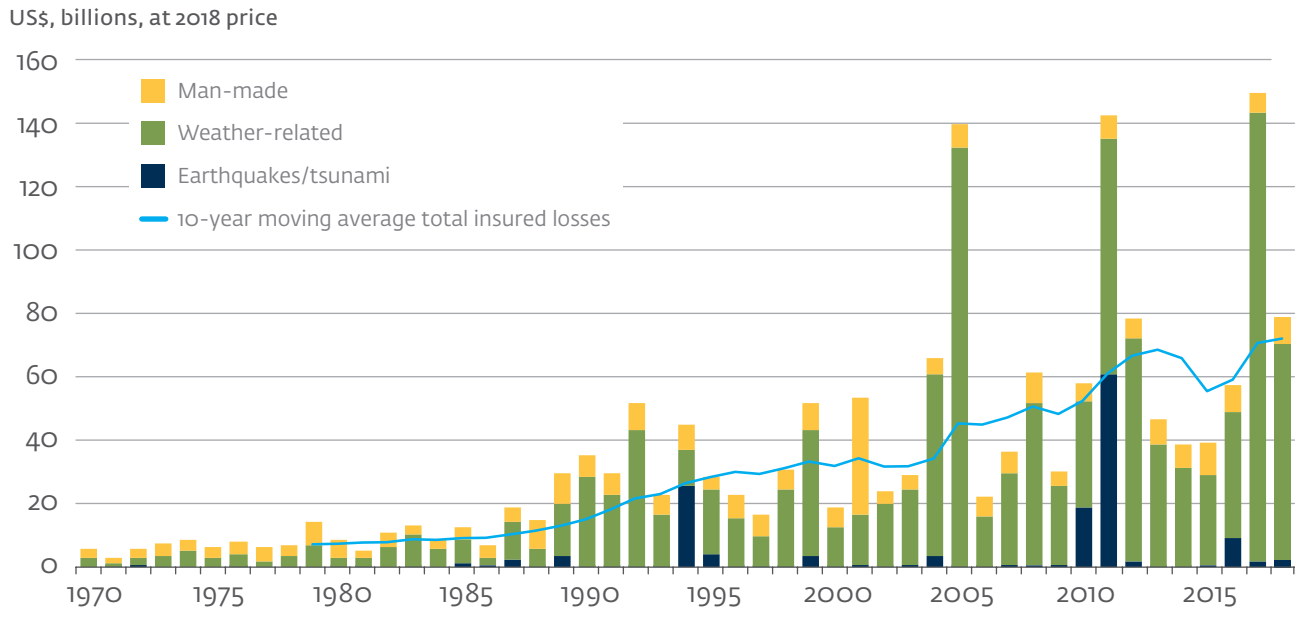
Insurance companies are unique players in the investment value chain as they have a role to play, both as asset owners and asset managers, collectively controlling assets of $35.9 trillion globally.[170] This means they manage both a general account, the investment risk of which is born by the shareholders of the insurance company, and separate accounts, where policyholders assume investment-related risk.

Through the investment of life insurance assets, managed via their own balance sheet, life insurance companies are natural long-term investors with asset-liability management considerations that drive their search for diversified, long-term investments. In addition, insurance companies are some of the world's largest asset managers, managing funds for pension schemes and other institutions, as well as offering retail savings products. As general asset managers also are finding, insurance company clients increasingly are demanding products that can demonstrate environmental and social impact, in addition to delivering financial returns.

In their core business, among asset owners, insurance companies are arguably the most vulnerable to climate change and many other types of non-traditional risks. This is due to the potentially enormous effect these factors can have on insurance company balance sheets—as the main absorbers, globally, of financial and physical risks. In 2017, insured losses from natural disasters and catastrophic events reached an all-time high, at $144 billion, increasing by 158 percent over the previous year (Figure 30).[171] If the industry is to endure, the incorporation of ESG considerations is of utmost urgency for both global insurance regulators and companies.

It is therefore not surprising that major international insurance companies, including, for example, Aviva, Zurich, Prudential Financial, and Sompo Japan Nipponkoa, have been the leading advocates of sustainable investment, and particularly climate-change related investment. Heads of these companies have participated in global initiatives aimed at tackling the world's largest social and environmental challenges, and they are outspoken about impact investing as a

FIGURE 30 Global Catastrophe-related Insured Losses from 1970 to 2018



Source: Swiss Re Institute 2018.

[170] Online Annex B.

[171] ARTEMIS 2018.

necessary move to manage climate change risks, help communities, and secure long-term growth. As one firm stated, "Reducing risks and helping communities, these are among our aims in providing insurance, and in managing customers' premiums."[172]

RESTRICTIONS AND CHARGES ON INSURANCE COMPANIES

In some cases, regulations intended to promote solvency limits insurance companies' portfolio exposure to select asset classes—for example, unlisted equity or non-investment grade securities—that make it difficult to invest in many impact-related strategies. This is the case in the United States, for example, where non-investment grade investments should not exceed 20 percent of an insurance company's assets.[173] A cap of 5 percent is also recommended for unlisted equity, 15 percent for real estate, and 20 percent for foreign assets. In many African and Latin American countries, asset owners face limits on how much of the portfolio may be invested outside national borders. In contrast, deregulation has removed most of these restrictions in Europe and Japan. Overall, solvency requirements typically push insurance companies toward investment in listed fixed income products in their home countries.

Finally, insurance companies utilizing external asset managers to gain exposure to impact investments face further complications and risks of punitive capital charges. Regulators require insurance companies to be able to "look-through" to the underlying investments of their external managers. In some jurisdictions, where no look-through is possible, these assets are treated as unlisted equity, and consequently may be subject to the highest capital charges.

Creating a Friendlier Regulatory Environment

The expansion of this industry also poses a challenge for regulators. They must balance their mandate to safeguard fiduciary duty while also recognizing that for a large share of owners, financial performance is no longer all that counts toward the performance of their portfolios.

Policymakers can create a friendlier regulatory environment by clarifying that fiduciary duty entails impartially representing the best interests of beneficiaries, including, but not limited to, their economic interests. Regulators should permit fiduciaries to consider non-financial objectives, as long as they have been agreed upon with beneficiaries.

Beyond fiduciary regulation, creating an enabling environment for corporate structures like benefit corporations will allow investors to exert greater influence over firms with regard to non-financial objectives. Promoting the disclosure of information regarding environmental and social outcomes material to businesses will allow investors to better measure the impacts of their investment.

Finally, given the unique regulatory constraints on insurance companies, which require substantial investment in fixed income, special attention must be paid to support impact investment funds offering products in this asset class such as green and social bonds. If fixed income products do not develop alongside those in equities, a substantial portion of insurer's capital will remain untapped.

[172] Zurich Insurance Group 2017.

[173] According to the Investments of Insurers Model Act, which is a recommendation to each state regulator developed by the National Association of Insurance Companies (NAIC).

CHAPTER 3

LOOKING AHEAD: SCALING IMPACT INVESTING

From Youth to Maturity

Impact investing is still a young discipline. Impact investing has come a long way in the decade since the term first came into use. Initially, some envisaged it developing into a new asset class.[174] Ten years on, it is now clearer that it is an investment approach that can be applied across multiple asset classes. It is about how you invest, not just what you invest in. In its initial growth phase, most of the action has been in private debt and equity, including venture capital and project finance. Here, the investor can be very "hands on" in its engagement with the firm, and provide additional financial and non-financial support. But this approach has its limitations in going to scale. Even in the most developed capital markets, only a small share of the economy receives private equity (PE) and venture capital (VC) funding.[175] In most countries, businesses rely on bank lending and retained earnings for early-stage financing, and public debt and equity markets for later-stage financing. The challenge and the opportunity for the next decade is whether impact investing can scale in two ways. First, by expanding the availability of private debt and equity to new segments and countries, and second, by offering credible mechanisms to achieve impact in financing public debt and equity, and through bank lending. Investors' growing appetite for impact in publicly traded liquid assets offering fully commercial returns poses a challenge for the industry—can it offer investment vehicles at scale to this set of investors which can make a real impact contribution? This calls for innovation and fresh thinking, rooted in a common understanding of what defines an impact investment, and in standard practices for managing investment portfolios for impact.

The experience of the green bond market (see Box 4 in chapter 1) shows that, with appropriate standards, it is possible to rapidly grow the allocation of capital to impact in bond markets. The experience of the Equator Principles (see Box 7) shows the potential for banks to come together to adopt common approaches to lending and project finance. Importantly, the Operational Principles for Impact Management have been developed to be applicable across asset classes. Early adopters include DFIs doing project finance, and asset managers doing private equity and debt. But already, several banks are exploring how to apply the Principles to their lending portfolios. Similarly, the UNEP-FI Positive Finance Initiative is working with banks to go beyond ESG integration toward achievement of positive impact. UN-PRI is also engaged with its large membership, many of whom invest mainly in public markets and are thinking about going beyond ESG integration toward impact.

The industry is characterized by diversity and innovation. A feature of young industries is the diversity and innovation that happens as entrepreneurs try out different business models and approaches. This includes experimentation with pay-for-performance approaches like social impact bonds and performance-based loans; and experimentation with new capital structures, including income-participating loans and various subordinated debt structures. Investors with unique circumstances and more tolerance for risk or illiquidity can take the lead by being the first to demonstrate the feasibility of new projects.

In this report, we have only been able to discuss some of these approaches. For a fuller survey, see the recent OECD report.[176] This innovation is helpful in exploring new approaches that enable capital to achieve impact. However, to reach scale, approaches that

[174] J.P. Morgan Global Research 2010.

[175] Lerner 2009.

[176] OECD 2019.

prove effective need to become more standardized and comparable, in order to reduce the transactions costs of investors, which are searching out and evaluating different impact opportunities.

The challenge facing the investment industry today is to find a balance between convergence on common standards and approaches and continued innovation, and this tension is felt acutely in impact measurement. On the one hand, asset owners are calling for common impact measurement systems, common indicator sets, and common reporting frameworks, which will make it easier for them to compare across investment opportunities and build an aggregate view of the impact performance of different investments. On the other hand, innovation continues to improve the quality and rigor of impact measurement.

IFC has experienced this tension itself—its DOTS ex post impact measurement system was widely seen as an industry benchmark, and its indicator sets formed the basis for the widely used IRIS impact indicators. However, IFC came to see that ex post measurement was insufficient to drive ex ante investment decisions, while the DOTS framework paid insufficient attention to market level systemic impacts. IFC therefore rebuilt its impact management system into AIMM, which is described in Chapter 2. The transition has been challenging for the organization, but IFC's willingness to push forward and innovate in its impact management was key to obtaining shareholder support for a historic capital increase.

So it is important to be judicious regarding where to standardize and where to leave space for innovation. For this reason, the Operational Principles articulate high-level principles about what needs to be managed and measured in a robust impact management system, but leave it to the adopters of the Principles to select specific impact management systems and indicators that are fit for purpose for their business model and asset class. Over time, convergence toward a few common approaches would benefit the industry, but it may be premature to push too hard for that now, while many investment managers are considering whether or not to meet the demands of complying with the Principles in their own business.

As Sir Ronald Cohen has noted, it took the management of financial performance over 300 years to go from double-entry bookkeeping to internationally accepted accounting standards, return on investment, and Sharpe ratios.[177] Impact management and measurement has moved beyond the crude bookkeeping of counting beneficiaries and outputs, but it is not yet at the stage of standardized metrics and accounting standards. The expansion of the impact investing industry brings to bear more resources on these challenges, and so may accelerate progress in bringing the impact side of investing to the same level of sophistication as the financial side.

The Path to Scale: Opportunities, Credibility, and Evidence

The biggest challenge to scaling up is the generation of investible opportunities. Underlying every impact investment is a firm that has a business model and a market in which to operate, and where it can make a positive impact in a financially sustainable way. There is no shortage of business model innovations and entrepreneurs aiming for impact. However, not all of these business models, capital structures, and management teams will be scalable, so it is important that impact investors consider scalability when selecting investments. If investors want to have bigger impact, it is important to back businesses that can scale.

It is also important to expand the market opportunities for private firms that deliver positive impact. If impact investing is going to make a significant contribution to improving social and environmental outcomes, it will not only need to scale, but to focus on creating systemic change at the level of markets. The largest financing gap to the achievement of the Sustainable Development Goals is in low-income countries, and yet it is here that markets are often missing, obstructed by heavy-handed government regulations and policies, or dominated by monopolies. Markets often fail to serve low-income and other marginalized groups, and are often not integrated across large enough populations to allow economies of scale in serving them. Therefore there is an important agenda to create markets that are competitive, integrated, sustainable, resilient, and inclusive.

[177] Cohen 2018.

This involves a combination of supportive government policies and regulations, and private entrepreneurship to enter and shape new markets. The DFIs have a critical role to play in helping create markets, particularly those DFIs such as the World Bank Group that have the ability to engage with both government and the private sector. Recently, as part of its business strategy that focuses on market creation, IFC launched a program to produce Country Private Sector Diagnostics that identify opportunities to create and transform markets. In line with this focus, IFC's AIMM management system assesses its investments on their market creation potential as well as their project-level impact. Risk-tolerant early stage impact investors can also play an important role in creating new markets, especially at the base of the pyramid. A credo of the Acumen fund, a pioneering impact fund, is "to go where markets have failed."[178] To create the greatest impact relative to the size of their investment, impact investors should remember this motto.

To attract more capital, provide credible evidence on process and results. It is a common complaint that impact management and measurement is costly, and either eats into meager management fees, or pushes up the fees that managers charge to investors. To some extent, this reflects the lack of scale in the industry. There are economies of scale in implementing impact management and measurement in larger investment portfolios, and where investments in firms are larger. So the answer is not to cut corners on impact management and measurement, but to double down on doing these things well in order to attract capital at a larger scale.

To attract more capital, what is needed is credible evidence on expected financial performance and on impact process and results. As most impact funds are quite recent, they have limited track records to share with potential investors, and find it hard to attract funds. Several MDBs and DFIs, with their longer track records, have been able to attract participation in loan syndication and attract capital to co-investment funds. For example, IFC has raised $10 billion AUM for its Asset Management Company and $7 billion in its managed co-lending program, the Managed Co-Lending Portfolio Platform. There is scope to increase investor appetite for impact investments through sharing, pooling, and aggregation of the financial performance of impact assets versus non-impact assets in different asset classes, sectors, and geographies. IFC's own portfolio and those of other impact investors have shown that commercial returns can be obtained in emerging markets and developing economies when investing for impact. With wider understanding of this track record, as shown in Chapter 1, there will be greater appetite to invest for impact. The analysis of IFC's return performance that is presented in this report is offered as a first step toward providing this evidence of financial performance. IFC is now sharing its methodology with other impact investors who want to publish their results on a comparable basis.

The challenge of having a short history is even greater for impact performance, as the full impact of investments may take longer to materialize than financial performance. For this reason, many asset owners understand that they may not have all the evidence they would like to have on the actual performance of their investment portfolios. Instead, they show considerable willingness to rely on investment managers to have a robust process to manage and measure impact through use of standard indicators. The Operational Principles provide a benchmark for the key elements of a robust impact management system that will give comfort to investors that managers are investing their funds for impact in a disciplined way.

The industry should compete on performance, not on approaches and evidence. Asset managers may see opportunities to compete for capital by offering a better impact management system and better results metrics. However, while this can drive innovation and efforts to improve performance in these areas, there is a danger in competing on process rather than outcomes, as this can lead to fragmented approaches and a siloed approach to evidence collection. In the end, investors care about the achievement of actual impact. Over time, as investments mature and deliver results, it will become clearer which impact management systems are effective in managing for results, and investors will want to base their decisions on the best evidence from all sources.

[178] See https://acumen.org/manifesto/.

This should lead the industry toward competing on evidence of actual impact, not on competing information and systems.

For this to happen, common reporting standards will be needed. This can build on current efforts to define and harmonize indicators, including the Impact Management Project and the IRIS dataset. Efforts to improve impact reporting by firms can underpin this. To the extent that firms get better at analyzing and reporting on their performance in rigorous and comparable ways, this will provide a solid basis for impact investors to assess impact. The continued growth of impact investing creates greater demands on companies to measure and report on their impact, and to consider the potential positive and negative impacts of their investment decisions. For instance, the UN Global Compact principles provide a framework for businesses to incorporate human rights, environmental, and labor considerations into their strategies. The Global Reporting Initiative provides international standards for businesses to understand and communicate their impact on similar issues. As impact investing goes mainstream, companies that can provide this information will have an advantage in raising capital. It is notable that Ronnie Cohen, one of the pioneers of impact investing, is now devoting his attention to promoting impact reporting by firms.[179]

Scaling Together: Collaboration and Collective Action

Collective action is needed on standards, pooled information, and the evidence base. For the industry to grow, there needs to be both competition among funds to deliver the best performance for asset owners, and collaboration to build common standards and a shared evidence base. While each investor has proprietary information on the relationship between their investment and outputs, the relationship between outputs and outcomes relates to knowledge that is not specific to particular investments. Therefore, it is inefficient for each investor to try and gather its own evidence on these relationships. Much more will be learned from pooled efforts to build the evidence base on the relationship between firm outputs and outcomes, and impacts on shared goals such as greenhouse gases avoided or the achievement of specific SDG-related targets.

For example, different education-focused funds may invest in different firms that provide primary education to low-income groups in Africa. The evidence on how effective these firms are in educating girls is proprietary to each investment. But evidence on the relationship between better-educated girls (the output) and outcomes related to health and incomes is not specific to the individual firm educating them. Therefore collective action is needed to build this evidence, which all education-focused funds can use in building their results chains and assessing the impact of their investments. The initiative of TPG to set up a non-profit Y Analytica to assemble rigorous experimental evidence is one example of how investors can contribute to building a shared evidence base.

Role for convening organizations. The need for collective action is well understood by the convening bodies and those who fund their work. The Global Impact Investing Network, the Global Steering Group for Impact Investing, and the Impact Management Project have made important contributions in bringing together impact investors to learn from each other and shape the field. There will continue to be a role for such bodies to help the industry mature, as described in the GIIN Roadmap for the next ten years.[180] By drawing on their operational experience, leading impact investors like IFC can also contribute to convening and helping to shape the industry. Over time, there will be a need to develop industry bodies that can support self-regulation and standard setting for the industry as a whole, but the industry has not yet reached the stage of maturity where a single coordinating body has emerged. At the same time, there is a role for regulators to help provide supportive regulatory frameworks, as described in the previous chapter. As in other areas of financial markets, it will be important to strike a good balance between self-regulation and industry regulation.

[179] Cohen 2018.

[180] GIIN 2018.

There are complementary roles for social entrepreneurship, venture capital policy reform, and regulation to create markets. Growing the impact investing industry requires a combination of entrepreneurship, a mix of both early-stage and mature firms providing financing across a range of asset classes, and supportive actions by governments, regulators, convening bodies, and DFIs. This might seem a daunting coalition to assemble, but there are promising signs that these groups are coming into alignment. First, the Sustainable Development Goals and the Paris Climate Goals have, for the first time, provided a shared set of environmental and social goals. Increasingly, all of these parties are referring to the SDGs as a starting point in thinking about their objectives and strategy. Second, we are starting to see the different sub-communities talk to each other more frequently. Only a few years ago, impact investors, mainstream investors, and DFIs talked within their own groups, but not to each other very much. Today, when you attend a GIIN conference, for example, you will find yourself rubbing shoulders with representatives from all these groups. They do not all speak the same language yet, but they are increasingly discovering that they have much to learn from each other. Third, governments and regulators are starting to see the potential and consider how they can be supportive: this year the OECD mapped 590 policy initiatives related to impact investing in 45 countries.[181]

Some early impact investors have been unhappy to see mainstream investment banks and asset managers moving into their market, and they ask questions about big players' motivation, commitment, and methods. But this discomfort may be productive as it challenges the incumbents to consider what they can learn from new entrants about mobilizing money at scale, and it challenges the newcomers to demonstrate that they live up to the standards and norms of behavior, which the pioneers have established. GIIN is developing a set of "Core Characteristics" of impact investors to help the industry "grow with integrity." Eventually, most industries need a healthy mix of pioneers and mainstream firms that can take products to scale.

Recent interest in the market from mainstream financial institutions holds out the promise that the impact investing industry may generate that kind of mix in the future.

A Vision for the Future

In the end, it all comes down to the potential to move the needle on the development challenges facing our world. Challenges that include climate change, fragility and poverty, social inequality, and environmental destruction. Challenges of the scale that all contributions to addressing them are welcome. We have moved beyond debates about public versus private sector, investment versus philanthropy, and grants versus equity. The world we live in and the challenges we face are large enough to provide room for "all of the above." Just as impact investing should not by hyped as the silver bullet to creating a better world, nor should its potential contribution be discounted.

This does not mean that any time soon impact investing will become more than a small share of total financial assets of about $269 trillion dollars.[182] It is uncertain whether certain sectors preferred by impact investors, such as health and education, are able to offer commercial returns when compared to all other investments grouped together. We have shown that private institutions and households could potentially reach a scale of $5.1 trillion for assets managed for impact in private markets, and up to $25 trillion if investments for impact in green and social bonds and in public equities are included, which could make an important contribution to meeting the financing needs to achieve the SDGs. However, they will only do so if they can achieve a commercial return.

But investors are no longer satisfied with compartmentalization either. They do not want to make money in one part of their life and do good in another. They want opportunities to make money while doing good. If the impact investing industry, in all its diversity, innovation and creativity, can respond to that basic demand from investors, then it can play its part in creating a world we will all want to live in.

[181] OECD 2019.

[182] See Online Annex B for an estimate of total global financial assets in 2018.

We hope that this report provides a useful companion to this evolution of the impact investing industry by shedding light on the types of investing that can contribute to impact; on the current size of the market; on the experience of IFC in achieving both impact and financial returns; on the regulatory challenges; and on the state of play in measuring impact. We hope that the Operational Principles will help bring transparency and discipline to the industry as it grows, and we hope that the AIMM framework will be one of several impact management systems that can provide inspiration to others in developing their own systems.

IFC has been following its own journey toward creating impact in emerging and frontier markets for over 60 years. Over these years, we have found more companions on the journey, as other development finance institutions and private investors have joined in the search for impact and returns. We welcome others to join us on the journey.

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