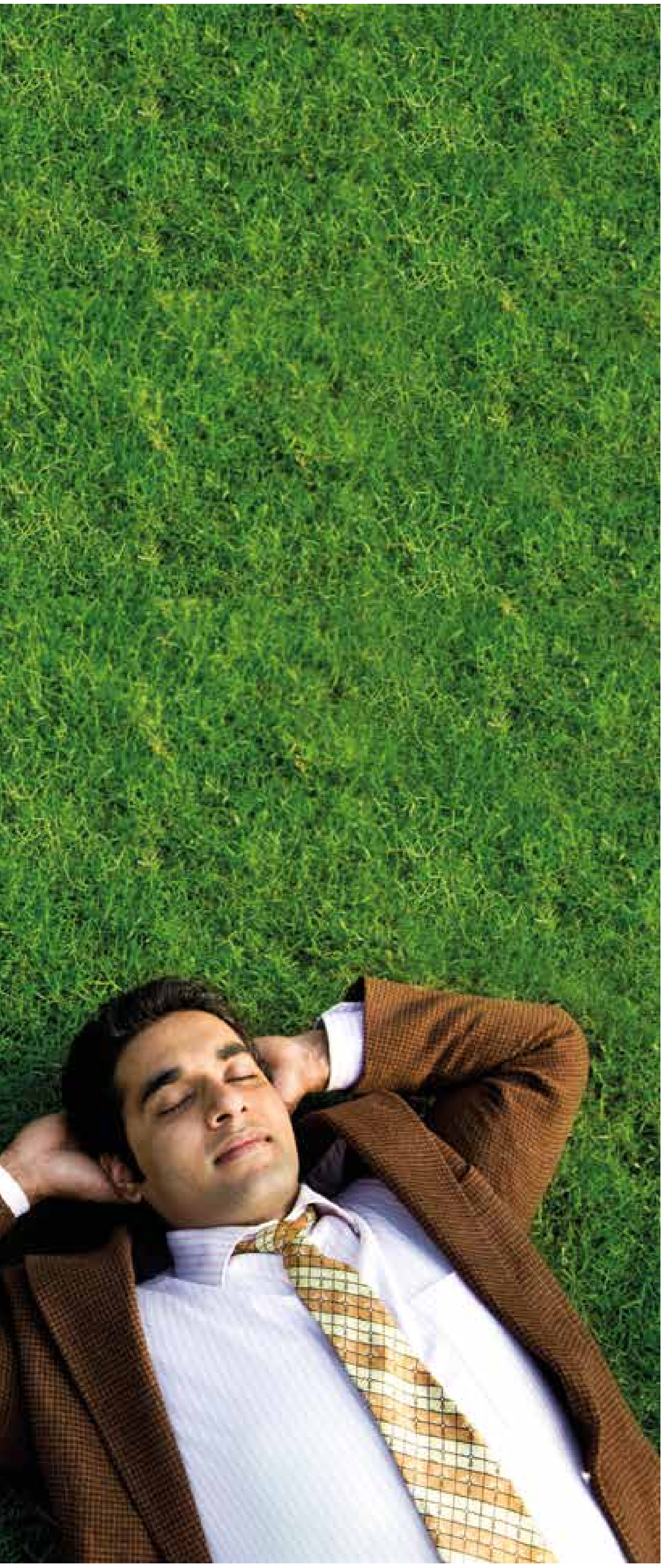
Will impact investing save our souls?

Uli Grabenwarter
Deputy Director
Equity Investments
European Investment Fund
(EIF)



Social impact investing has come to the fore in the debate about financial markets and how they can more responsibly serve the sustainable development of society. The Impact Investing Task Force of the G8 identified impact investing as a possible means of overcoming major societal challenges at national level, dealing with the aftermath of the global financial crisis and addressing global social disparities.

The emergence of impact investing has set in motion actors along the entire social action chain, from philanthropists to charities, foundations, social sector organisations, NGOs, public sector actors, social sector financial intermediaries and asset managers and, last but not least, the emerging community of social enterprises.

The question of what precisely is to be understood by social impact investing is no longer at the heart of the debate among those various stakeholders, even if differences in the definition of this market space continue to exist. Consensus has emerged that social impact investing seeks to realise concrete societal objectives and requires transparency and accountability from the various actors along the social value creation chain.

Impact metrics that drive decision-making

The debate has moved on to how best to ensure transparency and accountability, which ultimately converges in the requirement for meaningful social impact metrics. Also, substantial progress has been made in this area of impact measurement, despite the still prevailing disagreement on specific impact metrics to be used. Whatever system and metrics approach is taken, stakeholders increasingly agree that the relevance of performance indicators for a specific social action must not be sacrificed for the sake of a claimed comparability or aggregation of social impact performance across various projects, activities or sectors.

An important sign of the progress in this debate is reflected in concrete examples where impact metrics go beyond the mere tool for transparency and become genuine drivers in economic decision-making and the associated distribution of financial value:

- Investment vehicles have been launched whereby the financial performance incentive for the investment manager is linked to social impact performance metrics alongside financial performance
- New corporate structures that link dividend pay-outs to shareholders to the social performance of the business have entered the legislative process
- Increasing number of payment-by-results structures such as social impact bonds are using social impact metrics for defining the payment streams between a commissioner of social services, the executing social sector organisations and the investor community that provides the funding

Moving on from metrics to pricing social value

This extended use of social impact indicators in the economic decision-making and performance-monitoring process has revealed a new dimension that so far has not been addressed in a conclusive way: the pricing of social value. If social action moves away from a philanthropy-based funding approach (where impact metrics at best serve the monitoring of efficient capital allocation in pursuit of a given social goal) and enters the space where social impact becomes the substance of economic trade, the question of how to attribute economic value to social impact becomes central.

This extended use of impact indicators in the economic decision-making has revealed a new dimension for social impact metrics: the pricing of social value

The debate on this topic has so far been largely avoided. Social impact inclined stakeholders such as philanthropists, charities and foundations have dodged it, possibly because it feels ethically uncomfortable to attribute financial value to social benefit. The basic assumption in a socially-focused mindset is that social value is beyond the notion of money.

On the other hand, stakeholders seeking benefits from social service delivery (such as e.g. commissioners of social impact bonds) have been happy to skirt around the issue of pricing social value because to do so result in cost savings, offering an easy, if not to say cheap, way of offering social value in lieu of financial return to investors investing for social purposes. Under the pretext of a new form of investment return concept, investors were invited to look at the combined return of social outcome and financial profit rather than just at financial profit alone.

The true cost of failing to price social value

Considering social value alongside financial return may well be what we aspire to in terms of a new financial market logic, but in order to arrive at this ideal such thinking must be accepted along the entire social value creation chain.

Yet, this is far from being the case: how else can we explain that the pricing of social value used in social impact bond structures, for example, is still almost exclusively based on the cost structure of the social sector organisation delivering the underlying social service and largely dismisses any reasonable expectations of a financial return for the investors funding such an activity?

It is strange to observe that investors in the social impact space are urged to look at their combined return, aggregating social and financial value creation, when other stakeholders in the ecosystem still refuse to do so.

Isn't it counterintuitive that we accept it when "traditional" markets trade goods and services at their market value (rather than at a price equivalent to the cost incurred by the supplier), yet fail to apply a similar value-based logic when contracting social goods and services?

This inconsistency is one of the major threats to the development of a market space for social enterprises that clearly depends on a shift in the mindset of how social value is assessed.

If social enterprises, because of our "traditional thinking", are only compensated for the cost incurred in fulfilling their social mission, we implicitly accept that they will be prevented from growing, be it organically or through external funding. And in doing so, we won't be able to raise impact investing to an asset class in its own right.

Not surprisingly, the most frequent argument put forward in preventing social enterprises from becoming profit-seeking actors of the economic system is to say that the pursuit of financial objectives diverts the attention from the pursuit of social impact and consequently, endangers the enterprise's social mission.

Whilst this thought may be strongly anchored in our minds and most certainly has its roots in the unethical excesses of capitalism, we cannot deny being at a historic crossroads where a number of important choices are to be made.

Finding new alliances for saving the welfare state concept

With the fallout from the financial crisis affecting state finances, it has become clear that the concept of the European-style welfare state is unsustainable in its pre-crisis form. If we want to maintain the concept of community solidarity, we must forge new alliances between the private and the public sector in the delivery of social services.

This shift in social service delivery requires a new understanding of the various stakeholders in their respective roles, including the one of social enterprises taking on parts of what was previously the responsibility of the public sector. However, if this shift is supposed to become a reality, the public sector can no longer be a tax-funded provider of social services but needs to accept a new role as a market participant in a social impact market. Being a market participant, however, requires that public service commissioners move beyond considering only the cost of a product or service and instead find ways for compensating social enterprises for the value they create.

Of course, the debate on what exactly is the value of a social service is ongoing as is the debate on what "fair" return social impact bond investors should be entitled to. Nonetheless, the principle must be accepted that investors taking on the execution risk of social enterprises and their funding have a legitimate right to seek a return commensurate with the risk they accept. If we are ready to accept the cost of capital of a social enterprise as being part of the "production cost" of the product or service it delivers, linking this to common sense market logic can't be too big a leap to take.

Unaddressed societal issues grow at a faster pace than the philanthropic money available to cure them. Hence, new sources of funding are needed to address these challenges. In the absence of new philanthropic resources and in the light of a virtually disappearing margin of manoeuvre in public finance, the future of our welfare system depends on the ability to attract private sector investment.

Such a shift is unlikely to happen by converting the institutional investing community into philanthropists. However, growing in financial markets of the need for a social equilibrium as a prerequisite for economic prosperity offers an opportunity for a new, economically sustainable welfare state concept.

We have spent decades blaming the financial markets for their lack of responsibility towards society by single-mindedly focusing on financial returns. Now that financial markets are finally starting to comprehend social impact as an integral component of economic life by accepting economic risks linked to social outcomes, we cannot respond to the dawn of this new market logic by an equally short-sighted and unidimensional attempt to shift responsibilities for no reward. There is a wealth of insight to be gained from impact investing when defining a new financial market logic if we can simply get past the perceived contradiction between financial return and social value: if the wisdom of separating financial return from social benefit left us with the 2008 crisis, we might as well take our chances and try an approach that seeks to reconcile the two going forward.

To the **point**:

- As impact investing gains ground in the investment space, the purpose of impact metrics evolves towards driving economic decision-making
- As transparency is no longer the sole purpose of impact metrics, their use for enabling the pricing of created social value gains increasing attention
- Social enterprises still suffer from the fact that traditional remuneration models compensate only for the cost of social action, not for the value it creates
- A new pricing logic for social value has to emerge if impact investing were to play a meaningful role in solving societal issues

The growth of the social impact investing market is unlikely to happen by converting the institutional investment community into philanthropists