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Financing Solutions for Sustainable Development

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Impact Investment

Investments made into companies, organizations, and funds with the intention to generate a measurable social and environmental impact alongside a financial return ([GIIN](#)).

Key Words: Microfinance, social enterprises, patient capital, venture capital, social impact bonds

How does it work?

Impact investment is [described](#) (and differentiated from other forms of investment) by three guiding principles:

1. **The expectation of a financial return:** impact investors expect to earn a financial return on the capital invested, below the prevailing market rate, at the market rate or even above it.
2. **The intention to tackle social or environmental challenges** (i.e. the impact or intentionality): in addition to a financial return, impact investors aim to achieve a positive impact on society and/or the environment.
3. **A commitment to measuring and reporting against the intended social and environmental impact:** impact investors commit to measure performance using standardized metrics.

Impact investors have traditionally challenged the view that development is to be reached and guided only by social assistance or philanthropy. On the contrary, the implied theory predicts that business and investment are important drivers for achieving more inclusive and sustainable societies. Therefore impact investors aim to demonstrate that investment can achieve both a positive (social or environmental) impact and a financial return (or, at minimum, a return of capital).

Impact investment is not limited to a specific asset class or sector: it includes, for example, fixed income, venture capital, private equity and [social and development impact bonds](#). Private equity and private debt are the most common products adopted, with the latter taking the largest share in value terms. Impact investors often—but not exclusively—invest in innovative businesses and enterprises in sectors such as sustainable agriculture, affordable housing, healthcare, energy, clean technology, and financial services for the poor. A few examples: a fund investing in microfinance in Africa and Asia; a non-profit financial institution providing finance to farmers in Latin America; a platform that allows individual investors to make loans to women in developing markets to access clean energy; a foundation endowment's investment policy focusing on sustainable food; or an individual investment in a company that provides healthy and nutritious school lunches.

Impact investors include endowments, [high net worth individuals](#), foundations (e.g. [Bill & Melinda Gates Foundation](#), [Gatsby Charitable Foundation](#)), [pension funds](#), institutional investors (e.g. [JP Morgan](#), [South Africa PIC](#)) and retail investors that invest capital directly in social enterprises or in impact investment funds (e.g. [Acumen Fund](#), [Bridges Ventures](#), [Elevor Equity](#), [Ariya Capital](#)) and instruments (e.g. [Social Impact Bonds](#)). Impact capital has been raised mostly from banks, pension funds, and [Development Finance Institutions](#) (DFIs).

In terms of investees (receivers of the capital), impact investment can be directed both to for-profit and non-profit ventures, as long as they can produce a financial return. A number of intermediaries can connect impact investors with these impact-driven enterprises with tailored services, such as research, fundraising, certification, evaluation and impact measurement, business incubation, business acceleration and legal services.

Enablers, such as DFIs and the government, provide the enabling environment in which the market transactions can materialize, and, in certain instances, direct incentives and co-financing. An example of supportive legislation is the possibility to register [benefit corporations](#) (B-corporations) in the [US](#). This form of incorporation allows a business to balance its fiduciary duties between its shareholders and stakeholders legally. B-corporations can also be privately [certified](#) in addition to the legal registration. Moreover, it is expected that the financial market will establish benchmarks for impact investment based on previous attempts to develop [Environmental, Social and Governance](#) (ESG) market indices, e.g. the [S&P Environmental & Socially Responsible Indices](#), which tracks companies that meet certain environmental and social sustainability criteria, or the [MSCI Low Carbon Indices](#), which focuses on low carbon

Summary

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Impact Investment

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Our Perspectives

[Initiative: Impact Investment in Africa - Trends, Constraints and Opportunities](#)

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[Blog: Impact investing benefits business, people and planet](#)

[Blog: What role for the private sector in financing the new sustainable development agenda?](#)

Financial Results



[Generate Revenues](#)



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Instruments Used

businesses. DFIs (e.g. the [International Finance Corporation](#), the [African Development Bank](#), and the [European Investment Bank](#)) have spearheaded the movement, developed performance standards and often have interacted with impact investors through blended finance and risk-sharing formulas.



Market

Stakeholders

- **Impact investor(s):** provide the capital and include individual investors, high net worth individuals, foundations, DFIs, and a wide range of institutional investors such as [pension funds](#) and insurance companies.
- **Investees:** for-profit enterprises and non-profit ventures that along with running profitable businesses, are able to generate measurable social and environmental impacts. Investees include multinational spin-offs, [social enterprises](#), microfinance institutions, [small and medium-size enterprises](#) (SMEs), cooperatives, etc. The term [benefit corporation](#) (or B-corporations) has been introduced in Europe and the US, while the term impact-driven organizations had been used in G20 discussions.
- **Intermediaries:** link investors, investees and stakeholders providing them with innovative solutions and services. They can also facilitate the emission of structured financial products and help to reduce the costs of impact investing. They provide advice as well as help in structuring deals and in managing funds. Intermediaries can be commercial banks, investment banks, independent financial advisors, brokers, dealers, international organizations, consulting firms, etc.
- **Enablers:** governments can help by creating an enabling regulatory environment and by the provision of direct or direct incentives. The cost of capital can be reduced with tax reliefs, guarantees or subsidies aligned with government programmes and priorities. Regulations can be enacted to recognize impact investors (e.g. [European Social Entrepreneurship Funds in the European Union](#)), encourage transparency, produce and share information, establish peers' working groups, etc. Besides governments, international organizations, DFIs, and development agencies can also play a supporting role and enter into impact investment deals with co-financing or [credit enhancement](#).
- **Beneficiaries:** stakeholders that benefit from the investment through improved social and environmental conditions.

Potential in monetary terms (revenues, realignment or savings)

The volume of impact investment cannot be officially recorded due to the unclear definition of the term, but there are estimates. The Global Impact Investing Network (GIIN) estimates a market of [US\\$77.4 billion in impact investing assets](#), of which US\$15.2 billion committed in 2015. The expected growth in commitment in 2016 is of 17.7 per cent. The supply of impact capital is expected to rise but, as yet, impact investment's share in global financial markets is estimated to be at around only 0.2 per cent of global wealth. If this share rises to 2 percent, it could mean over US\$2 trillion invested in impact-driven assets. Some 1,276 asset managers, with combined assets of over US\$45 trillion, have signed up to the six [United Nations Principles for Responsible Investment](#) while the larger definition of [sustainable investment](#) (including [ESG](#) compliance and managers applying investment exclusion lists) encompasses an estimated total of US\$21.4 trillion.

Impact investment has also become widespread across the globe. A survey among the [GIIN ImpactBase](#) reported that 38 per cent of the participants had invested in North America, 15 per cent in Sub-Saharan Africa, 13 per cent in Asia and 10 per cent in Latin America. Forty-two out of the 310 [funds](#), have invested both in emerging and developed markets. Several leading financial firms have also entered the market in recent years with the creation of dedicated units or platforms dedicated to impact investment, including [BlackRock](#) and [Goldman Sachs](#).

The above trends in the supply and management of capital are supported by polls covering the [preference of the millennials](#) as new job-seekers or investors: many believe that the number one purpose of business is to benefit society and they want to work for a business pursuing ethical practices. Another [survey](#) reports that wealthy millennials are almost twice as likely as their grandparents to regard their investments as a way to express social, political, or environmental values. These millennials – i.e. those born after 1980 and the first generation to come of age in the new millennium – will soon experience an unusual intergenerational wealth transfer that has been estimated at US\$41 trillion in the United States alone, thus creating additional expectations for a growing number of impact investors.

There are also [patterns](#) connected to the impact's theme or sector: whereas one-third of socially-focused impact funds expect below market returns, environmentally-focused funds overwhelmingly expect market rate returns. On average impact investment in the environment is also found to be as much as five times larger in volume than in social sectors. According to the last GIIN survey, microfinance, energy, housing, and other financial services (excluding microfinance) attract the greatest allocations. Among environmental themes, the focus is on renewable energy, energy efficiency, and clean technology.

When is it feasible?

Legal and/or other feasibility requirements

Sources of Finance

PRIVATE

NATIONAL

INTERNATIONAL

Related SDG



Local regulations and markets determine the investment climate, the availability of financial products, and the prevailing—mandatory or voluntary—fiduciary, environmental and social standards. Regulators can provide tailored incentives (e.g. tax breaks) or provisions for impact entrepreneurs and investors within their jurisdiction, but there is no specific or additional legal requirement for impact investment. A common provision for impact investment organizations is that social and environmental impact goals are built into legal documentation, as well as a requirement to report on impact.

Minimum investment required and running costs

The specific project and business model determines the investment requirement along with the relevant market size, maturity and other factors such as human capital or political and commercial risks. While larger companies may require financing of US\$10 million or more, SMEs tend to require between US\$25,000 and US\$2 million. The cost structure and amount are also linked to the target investor and the asset class of the financial product. According to UNDP, deals in Africa vary from US\$50,000 to a few million in the case of early stage impact funds and foundations, and up to US\$200 million in the case of private equity funds and institutional investors. Data from the GIIN ImpactBase show that deals tend to be larger in developed markets than in emerging markets. The median value of an impact investment deal as reported by GIIN is US\$ 12 million.

Impact investment has a capital cost for the investee. While impact investors have diverse expectations about financial returns, according to GIIN, most prefer to operate at market rates. What impact investment often does is thus to expand access to capital, even when the investment positions are high risk. Despite the preference for market rates, about 40 per cent of impact investors are willing to accept a return on investment that is lower than the market rate. The pooled internal rate of return for the Impact Investing Benchmark is 6.3 per cent (compared with a commercial benchmark of 8.6 per cent) and higher in emerging markets (7.7 per cent) than in developed markets (4.7 per cent).

In terms of return expectations, a recent study by J.P. Morgan reports that market-rate financial returns typically fall in the 8-12 per cent (debt) and 20-25 per cent (equity) range for emerging markets and 5-8 per cent (debt) and 15-20 per cent (equity) range for developed markets.

While aggregated data provide little evidence of additional costs, impact investment might result in short term higher-cost transactions compared with traditional investment because of to the implementation of rigorous social and environmental reporting requirements and the conduct of extra due diligence processes.

In what context/when it is more appropriate

Impact investment is appropriate where private capital can address social and/or environmental challenges in innovative ways, while still pursuing commercial viability. Impact investment can address public failures, but it is by definition not a solution when there is no viable business opportunity. Impact investment is not a substitute for the provision of social services or philanthropy. Rather, it aims to complement and broaden the range of available options to promote sustainable development, drive innovation and achieve a positive social and environmental impact. Impact investors can also pave the way for larger public interventions, by underwriting risks that cannot be taken up by public intuitions in the first instance.

What are the main risks and challenges?

Pros

- Impact investing challenges the long-held view that market investments should focus exclusively on achieving financial returns.
- Impact investment can catalyse additional capital flows into developing economies, and stimulate private sector development where this is otherwise absent.
- The impact investment market offers diverse and viable opportunities for investors to advance social and environmental agendas through investments that also produce financial returns.
- Impact investments can compete with, and at times even outperform, traditional asset class strategies.
- By combining various forms of capital with different return requirements, social challenges can be addressed in more scalable ways than is achievable by the government alone.
- Impact investors provide new ways to allocate public and private capital more efficiently and effectively. It can facilitate cooperation between public and private sector actors.
- Impact investment can strengthen social sector organisations and enterprises, by giving them access to the full range of financing options available to regular businesses.
- Impact investment can stimulate the creation and growth of innovative enterprises, and hence also expand the whole economy.

Cons

- Impact investment can generate higher transaction costs compared with similar private equity or venture capital investments.
- The basic definition of impact investment is still debated. While some organizations are producing impact certification schemes with independent third party verification and such regimes exist in some sectors (e.g.



Related Sector

WATER

TOURISM

MINING

TRANSPORT

AGRICULTURE

FORESTRY

ENERGY

FISHERY

FINANCE

MANUFACTURING

organic food or fair trade), there is still no accepted standard or definition.

- The lack of reliable research and evidence on financial performance. Credible data on risk and return can help both existing and future impact investors better identify strategies that best suit their desired social, environmental, and financial criteria.

Risks

- The lack of intermediation services can raise the transaction costs due to fragmentation, the complexity of deals, and a lack of understanding of risks.
- The lack of an enabling infrastructure can inflate impact investment's costs. Networks are underdeveloped, and the lack of widely accepted and reliable social metrics makes the trade-off between financial and social returns difficult to assess.
- Lack of absorptive capacity for large investments. Investment readiness (availability of good projects) remains a key issue in developing countries, beyond impact investment.
- Limited options for co-financing.
- Hying market solutions to "do good" can create a bubble – especially if there is a gap between expectations about financial and social returns and actual performance – thus diverting capital away from philanthropy and decreasing the grants allocated to social and environmental challenges.
- Greenwashing can damage the appeal of the impact investment market and ultimately the trust of investors. For example, unscrupulous asset managers could fraudulently label and sell traditional investment products as impact investment.
- Financial and operational risks common to traditional investment apply (e.g. liquidity, currency, political risks, etc.). Additional risks are related to the understanding of impact investment by stakeholders (e.g. confusion between grants and impact investment). The latter encompass working with different cultures, including for example taking into account different understanding of the financial risks and intended impact between a global investment committee and a local community.

How can the design be ameliorated to improve the impact?

Impact investment seeks to achieve social or environmental outcomes that would not occur if the investment were not made (additionality). The impact can be exemplified by improvements in healthcare services, access to financial services, access to clean water, and employment/income generation in rural or poor communities. For example, Root Capital—a non-profit social investment fund that fosters rural prosperity—enabled Fruiteq to buy higher quality mangoes from 830 farmers in Burkina Faso at three times the local price, increasing farmers' income by 43 per cent. Similarly, with the support of the Calvert Foundation, the EcoEnterprises Fund (EcoE2) has invested US\$5.5 million in three fair trade companies committed to habitat protection and restoration, responsible forest management, and community service in Latin America. Through these investments, EcoE2 has preserved over 800,000 hectares of land, maintained 300 full-time employees, and supported over 5,000 suppliers. The acumen investment fund alone has created over 58,000 jobs worldwide with an investment portfolio of US\$100 million.

In addition to investment-specific impact, the impact movement can help to transform markets structurally. By channelling capital to productive activities in developing countries, nascent sectors, and innovative social enterprises, impact investment can drive larger and significant impacts, by increasing local income levels, supporting job creation and building local markets via imitation effects. The acumen investment fund estimates that it has enhanced over 189 million lives through its activities.

The value of impact investment can be enhanced by:

- **Mission lock-in:** The mission of an impact investor or investee should define the intended impact it seeks to achieve. The latter should be embedded explicitly in the company's charter or investment strategy. For example the W.K. Kellogg Foundation's mission-driven investment policy ties portfolio allocation to supporting vulnerable children. Similarly, the RSF Social Enterprise Lending Program offers mortgage loans and construction loans to both non-profit and for-profit social enterprises that meet a set of stringent criteria.
- **Greater accountability:** A commitment to transparency and rigorous reporting is essential. The resources devoted to demonstrating impact should be proportional to the liabilities. Reliable metrics should allow investors to understand if the performance of the investment is consistent with its impact mission. Setting industry standards for measurement can help establish trust and compare products, such as the Impact Reporting and Investment Standards (IRIS) and the Global Impact Investment Rating System.
- **Multi-layered capital structures:** the public sector, DFIs and foundations can play different roles along with impact and traditional investors. Public entities can provide the "first layer" investment or extend credit enhancement services (e.g. guarantees) in order to crowd-in private investment. For example the Deutsche Bank's Microfinance Consortium—a US\$80 million microfinance fund—became viable thanks to an initial grant that provided the initial operating income and mitigated the investment risk.
- **Supportive regulations:** regulatory changes can create incentives—fiscal incentives, subsidies, mandatory certification—to attract an even broader range of investors. An example is the European Commission

Communication, *Social Business Initiative: Creating a favourable climate for social enterprises, key stakeholders in the social economy and innovation* and the related Regulation 346/2014 establishing the labelling of European Social Entrepreneurship Fund. In addition, it might be necessary to relax regulations that prevent social sector organizations from being engaged in profit-making ventures.

- **Continue to improve the measurement of impact:** reporting can be carried out with a mix of qualitative and quantitative techniques and enriched by the use and sharing of best practices (e.g. about 5,000 firms from 148 countries report their social and environmental performance to the [IRIS initiative](#)).
- **Manage the potential trade-offs** between commercial viability and social and environmental impact. Participation of stakeholders and independent verifiers is key to establish accountability.

Guidelines and Case Studies

Detailed guidance

- [GIIN: What You Need to Know About Impact Investing](#)
- [Impact investment in Africa \(UNDP\)](#)
- [Impact Investment: The Invisible Heart of Markets](#)
- [Social Impact Investment \(OECD\)](#)

Case studies

- [Root Capital](#)
- [Acumen investment fund](#)
- [Rockefeller Foundation](#)

Our work

[International Guidebook of Environmental Finance Tools](#)



Sustainable Development Goals



Environmental finance

Our Perspective

09 Jul 2015

We should reach a consensus on the fact that macroeconomic policies in low-income economies need to also jettison the conventional wisdom of undue restrictiveness.

