Impact Insight

THE INSTITUTIONAL IMPACT INVESTING REVOLUTION

Rodolfo Fracassi
Managing Director

Harry Hummels
Senior Advisor

ABP, Europe's second largest pension fund, with more than 380 billion euros (about $430 billion) under management, announced last year that it would increase its allocation to high sustainability investments (those aiming to create positive and measurable social or environmental value) to 58 billion euros in 2020, up from 29 billion in 2015. Meanwhile, the Dutch pension fund PFZW intends to allocate 12 percent of its entire investment portfolio to solutions in renewable energy, water, food security, and healthcare. By 2020, this will reach 25 billion euros (about $28 billion)—up from 5 billion at the end of 2014. In addition, insurance companies such as AXA and Zurich, and banks like BNP Paribas, JP Morgan, and Barclays have committed up to 5 billion euros of their proprietary capital to impact investment programs while developing solutions for their clients.

These examples show that institutional investors are accelerating their pace of investment in what many see as opportunities to positively impact our global society, environment, and economy. They are investing increasing amounts of money in the reduction of carbon emissions, improvement of global supply chains, developing tiered capital structures and public-private partnerships, and building "digital supply chains" in business and financial services. These efforts will not only help solve some of the biggest challenges of our times, but also help transform the current practice of impact investing, as they did with socially responsible investing a little over a decade ago.

Looking at the gigantic efforts required to solve global problems, institutional investors tend to think *big, differently*, and *historically.* And their efforts will redefine how we view finance for societal purposes—slowly, but gradually.

Thinking Big

In 2015, the Global Impact Investing Network (GIIN) and J.P. Morgan reported a total amount of some 60 billon dollars in impact investments—up from 48 billion in 2014. This indication of the steady growth of the impact investing market is encouraging. Compared to the capital required for boost sustainable development across the globe, however, it's a drop in the ocean. The social, environmental, and economic challenges at hand were defined in 2015 at some landslide events. In July, world leaders came together in Addis Ababa for the Third UN Financing for Development Conference to discuss the most pressing issues to finance development. The launch of the Sustainable Development Goals (SDGs) in New York in September followed, and the year ended with the Climate Agreement in Paris. Implementing the intended outcomes of these goals will require trillions of dollars in *additional investments annually*. Both the Ababa Action Agenda and the Paris Climate Agreement need investments of 13.5 trillion dollars in the next 15 years. And the UN Conference on Trade and Development estimated in 2014 that bridging the SDG gap in developing countries demands additional funding—on top of the investments already committed to development—of some 2.5 trillion dollars annually between 2015 and 2030. This money can only come from the private sector, since multilateral and bilateral donors provide only an annual 140 billion dollars in core and non-core development assistance. Primarily governments and donors are looking at institutional investors such as pension funds, insurance companies and the world's leading asset managers to bridge the gap.

Thinking Differently

Leading pension funds, insurance companies, foundations, and asset managers across Europe and North America are pushing the responsible investment envelope. As signatories of the Principles for Responsible Investment (PRI), they employ highly developed environmental, social, and governance (ESG) strategies, such as the use of voting and engagement power and the exclusion of highly controversial investments. They have also started investing in assets such as sustainable real estate that intentionally generate positive financial and ESG returns. Commitments include investment in the Global Real Estate Sustainability Benchmark (GRESB) and the 600-billion-dollar climate bond market. Institutional investors are also increasingly interested in direct infrastructure investments in renewable energy, solid waste management, water treatment, housing, small and medium enterprise finance, and microfinance—a shift from allocating capital to niche initiatives such as social businesses, smallholder agriculture, and single projects in developing countries, to more scalable instruments and business models.

It's important to note that institutional investors are changing their approaches and developing new financial products that match the institutional logic of investment, which consists of: remaining within the perceived limits of fiduciary responsibility, the size of the investments, the track record of the investment manager, and the rules and regulations set by the supervisory authorities. Examples of new products include green bonds based on criteria developed by the Climate Bond Initiative; bonds issued by the International Finance Facility for Immunisation (IFFIM), which have provided vaccines to 400 million children in developing countries; and Climate Investor One, which accelerates renewable energy in emerging markets.

While institutional investors don't use the term "impact investing" to describe these efforts, they are nevertheless meeting the three core criteria of impact investments: intention to create a positive impact, measuring output and outcomes, and generating market rate financial returns. Critics have pointed out that impact investing runs the risk of becoming the emperor's new clothes—that, at its core, impact investing is about developing, stimulating, and protecting the social, environmental, and economic values that make our world a place worth living in, and that financial returns are important but do not constitute the essence of impact investing. But this won't stop institutional investors from developing their own agenda and gradually transforming the impact investment market.

Thinking Historically

The PRI replaced traditional ethical or socially responsible investments, and popularized the notion of ESG. Importantly, it captured and promoted the idea that responsible investing should focus on good governance first and foremost; environmental and social objectives were also important, but came second to proper management, oversight and control of a company. By shifting the focus from ethics to governance, the idea of responsible investments suddenly became acceptable to institutional investors—most notably after research demonstrated that a focus on governance resulted in a clear financial outperformance. It is not difficult to imagine how institutional investors could similarly apply the logic of institutional investment to this emerging field and increase the relevance of impact investing for a wider community of investors. In doing so, they would also contribute to solving some of the most pertinent social and environmental challenges of our times.

The Future

The biggest challenge investors currently face is finding *investable deals and projects.* Money hardly ever is the problem. In emerging markets and developing countries, numerous projects are available in areas like solar, wind, or hydro energy; waste-to-energy conversion; and social housing. But most of these aren't the right size or don't yet have the right risk-return-impact profile to qualify for institutional investment. Here lies an opportunity for "traditional" impact investors—in collaboration with international finance organizations, development banks, large foundations focusing on market transformation, and governments—to develop projects that contribute to the realization of the SDGs and other goals. New, blended financial arrangements that bring together investors with different risk-return-impact profiles may prompt a large-scale infusion of institutional capital focused on solving the world's largest problems. The current impact investment community can also function as a critical observer of the institutional investors when they develop large-scale projects, and thereby create social and environmental outcomes for the communities that are intended to benefit from these investments. This requires that governments, project developers, consultants, and financiers collaborate and fine-tune risks during the various stages of development.

It won't take long before the institutional investment community becomes a force to reckon with in impact investing. It has the power and resources to contribute, but it also stands to transform the impact investment market through thinking differently and big, and applying lessons from the past. We welcome this development as an opportunity to build a better world, but we must remain critical about the potential downsides. The traditional impact investment community can help institutional investors create opportunities for development, while at the same time keeping an eye on the potential social, economic, and environmental risks.

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