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Conditions for Scaling Investment in Social Finance



BSR[®]

The Business of a Better World

About This Report

This report aims to mobilize the investment community to unlock more capital toward advancing social and environmental progress, while generating financial returns and long-term value for investors.

We use the term “social finance” to describe any investment activity that generates financial returns and considers social and environmental impact. It comprises four primary strategies: socially responsible investing, environmental finance, development finance, and impact investing. Our approach in framing social finance holistically—combining multiple strategies with similar objectives under a broader social finance taxonomy—makes social finance a more attractive opportunity for mainstream investors. Given that these investors have large pools of capital to pursue multiple strategies simultaneously and diversify risk through products with different risk-return capabilities, this holistic framing of the opportunities is a critical part of our research approach and the recommendations in this report.

The research for this report was conducted over eight months and included a comprehensive literature review to assess the latest data, analysis, and perspectives across social finance strategies. In addition, we conducted semistructured interviews and two focus groups, in Washington, D.C., and Hong Kong, to harvest lessons from leading thinkers in the field and to test our findings. Through these methods, we gathered insights from more than 40 experts across a range of strategies, issues, and asset classes.

The report is organized into four sections. The first defines social finance and demonstrates how it contributes to risk diversification, financial returns, and long-term value preservation and generation. The second provides an overview of social finance activity today and concludes with a brief overview of some of the challenges in unlocking the full potential of social finance. The third section proposes five conditions needed for mainstream investors to bring social finance to scale and offers 12 recommendations for the investment community to build and strengthen these conditions.

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Foreword

The past half-century has been a record-breaking period of human progress. Nearly 1 billion people have been lifted out of extreme poverty in the last 20 years, and nearly every country has improved its human development status since 1990. To sustain and extend these gains in this next half-century, new approaches will be necessary in the context of climate change, massive demographic shifts, and even greater technological change. Moreover, general economic advances will need to address rising economic inequality and structural unemployment, among many other trends.

It is no coincidence that we are releasing this report in 2015. The proposed Sustainable Development Goals (SDGs) and the new international climate framework that are expected to be agreed upon at the end of this year reflect an overwhelming consensus among governments and civil society that the challenges and opportunities we face require new models, more partnerships, and greater ambition.

BSR believes that the scale and complexity of the world's social and environmental challenges require financing at a level only the capital markets can provide. At the same time, we believe this presents great opportunities for innovation, market expansion, and economic growth.

Throughout more than two decades of activity, BSR has been committed to advancing business as a force for positive change. Working with investors to harness the power of the capital markets to advance social and environmental progress is an essential element of our approach. The investment community plays a critical role in sending signals to the broader business community and injecting the capital needed to scale up and catalyze solutions for many of the world's most difficult problems. To this end, this report represents an important step in engaging the investment community as a key partner.

We look forward to continuing to work with BSR members and the broader investment community to apply the findings in this report and unlock social finance at scale.

Aron Cramer, President and CEO, BSR

Executive Summary

Global environmental, social, and governance (ESG) trends are rapidly reshaping the economy and presenting significant risks and opportunities for investors.

By 2050, the population is expected to grow by more than 30 percent, to more than 9.5 billion people, with the majority of this growth happening in urban areas in the developing world. Meeting the needs of this population in an increasingly resource-constrained world will require tens of trillions of dollars in investment. This also presents compelling business growth and investment opportunities for investors in many new markets and sectors.

Ignoring the emerging risks posed by these trends also has significant implications for investors. Resource scarcity, climate-related impacts, global health dangers, social instability, and substantial demographic changes already are presenting business leaders with issues and influencing decision-making that will determine future business success and investment performance.

More investors recognize the importance of these global trends to their investment decisions and are adjusting their asset allocation and investment-management strategies accordingly. In the United States alone, the total professionally managed assets considering ESG factors expanded to nearly US\$7 trillion at the start of 2014, from just less than US\$4 trillion at the start of 2012. Despite this progress, the investment community's full potential to unlock capital at scale to advance social and environmental progress has yet to be realized.

Unlocking Capital and Value Through Social Finance

Social finance refers to any investment activity that generates financial returns and considers social and environmental impact.

It encompasses four primary strategies: socially responsible investing (SRI), environmental finance, development finance, and impact investing. These strategies are united by the common goal of delivering both financial returns and positive social and environmental change. However, the objectives differ for each of the strategies, in terms of how explicitly or intentionally they seek positive social and environmental outcomes.

Our approach in framing social finance holistically—combining multiple strategies under a broader social finance goal and taxonomy—aims to appeal to mainstream investors with large pools of capital that could be allocated to multiple strategies simultaneously. While each individual strategy has a unique value proposition for investors, viewing social finance holistically has a number of additional benefits. This approach allows investors to identify appropriate entry points to social finance based on different risk-return capabilities, and it allows them to access a larger aggregate market, increase portfolio risk diversification, and explore options across strategies to deploy capital more efficiently.

Key Trends in Social Finance Activity Today

Social finance has grown significantly over the past decade, with strategies and products across asset classes aligned with different investor needs, motivations, and return expectations.

Estimates show that social finance activity today is valued at upward of US\$22 trillion,¹ and many individual strategies have the potential for double-digit growth in the near future. The diverse motivations and trends in social finance activity for some mainstream investor groups is helping drive this growth and diversity in investment opportunities.

For example, some pension funds view social finance as a way to protect long-term value in the face of ESG risks to the economy and investments. For insurance companies, which serve as both underwriters and insurers, social finance can be integral to risk mitigation and long-term value creation, as well as a business-development opportunity to provide social and environmental solutions that are linked directly to insurance companies' core business. Many high net-worth individuals (HNWI) see social finance as a way to instill personal and family values in their investments and give back to communities while generating a financial return. Foundations and endowments find that social finance offers an opportunity to align investments with their missions by generating new models for solving some of society's most entrenched challenges. Many banks and financial institutions see social finance as a driver for new business opportunities due to growing client demand, and as a way to manage overall risk within lending, compliance, and underwriting.

Building the Conditions for Scale

Transforming growing investor interest in social finance into considerable capital allocation will necessitate systemic changes to the current system.

This includes not only improving products to meet investor goals and performance expectations, but also strengthening the enabling ecosystem, including the infrastructure, skills, and incentives that shape business decisions and are needed to execute transactions. This requires a collective effort by the investor community to overcome key challenges and dismantle barriers to entry for mainstream investors in social finance.

Investors themselves have an important role in this. They have a number of levers at their disposal, including large amounts of investment capital, the ability to partner with and engage policymakers, deep technical expertise, and the opportunity to exercise sectorwide coalition-building power. We propose five conditions that are needed for mainstream investors to bring social finance to scale. This report also offers 12 recommendations for the investment community to work alongside other actors such as policymakers to create these conditions.

¹ This figure is based on data aggregated from the following sources: JP Morgan and GIIN, "Eyes on the Horizon: The Impact Investor Survey," GIIN (2015); Global Sustainable Investment Alliance, "Global Sustainable Investment Review," Global Sustainable Investment Alliance (2014); Climate Policy Initiative; and others. For full reference, please see BNY Mellon: Social Finance at Scale: Creating Value for Investors, 2015, available at <https://www.bnymellon.com/global-assets/pdf/our-thinking/social-finance-at-scale-creating-value-for-investors.pdf>.

Recommendations for the Investment Community

CONDITIONS FOR SCALE²

<p>ACCESSIBILITY</p> <p><i>Aligning expectations to create attractive investment products</i></p>	<ul style="list-style-type: none"> » Facilitate asset allocation across multiple social finance strategies that cater to varying risk appetites and return expectations. » Codesign products with established return expectations and clear impact objectives for easier adoption. » Deepen social finance expertise and knowledge across the investment value chain, particularly among advisory and investment teams.
<p>MEASUREMENT</p> <p><i>Building track records, frameworks, and presentation standards necessary to generate investor confidence</i></p>	<ul style="list-style-type: none"> » Develop and adopt standardized nonfinancial metrics across investment activities. » Integrate social and environmental impact into valuation and pricing of risk.
<p>TRANSPARENCY</p> <p><i>Institutionalizing the sharing of information among investors and stakeholders as best practices to promote efficient use of capital</i></p>	<ul style="list-style-type: none"> » Drive consistent and material disclosure of social and environmental impacts on financial performance and impacts on shareholders. » Share best practices on the integration of social finance into portfolios with stakeholders, peers, and other beneficiaries to promote learning and increase awareness.
<p>SYSTEMIC CHANGE</p> <p><i>Creating incentives that shift thinking about value creation and support good governance and positive policy frameworks</i></p>	<ul style="list-style-type: none"> » Participate in industry dialogues to clarify and reinforce the interpretation of fiduciary duty to include ESG factors. » Align internal and external incentives with long-term value. » Encourage good governance and positive policies that can respond to and support broader uptake of social finance.
<p>COLLABORATION</p> <p><i>Pursuing innovation and risk mitigation by leveraging expertise through partnerships</i></p>	<ul style="list-style-type: none"> » Cultivate partnerships among stakeholders to de-risk investments and accelerate product innovation and testing. » Provide guidance and technical assistance to strengthen the pipeline of investment opportunities for both investors and intermediaries.

² For additional information on BNY Mellon's conditions and recommends, shaped from their own insights, this research, and conversations with mainstream and social finance investors, please see BNY Mellon: Social Finance at Scale: Creating Value for Investors" 2015, available at <https://www.bnymellon.com/global-assets/pdf/our-thinking/social-finance-at-scale-creating-value-for-investors.pdf>.

Protecting and Generating Value Through Social Finance

Achieving inclusive sustainable development on a global scale for 9 billion people, without exceeding planetary boundaries, is the defining challenge of the 21st century.

We are publishing this report in 2015—a critical year with the promise of commitments by the international community to advance human progress and environmental sustainability. At the end of the year, national government leaders are expected to agree on the SDGs, which will set a universal set of targets for international development. In December, 196 countries will meet in Paris to sign a new global agreement to address climate change.

These milestones reflect a recognition by government, business, and civil society that we live in a different reality than we did two decades ago. Our world today is defined by significant natural resource constraints, social instability, inequality, political uncertainty, and massive demographic and economic changes. By 2050, the population is expected to grow by more than 30 percent, to more than 9.5 billion people, with the majority of this growth happening in urban areas in the developing world.³

Ignoring the risks presented by major social and environmental trends can have significant implications for business and investors. These trends are already shaping business leaders' decisions to ensure long-term success and investment performance. For example, climate change poses a growing set of risks to business, including disruptions to supply systems, damages to vital infrastructure, impacts on communities and workforces, and heightened price and market volatility.⁴ If current emissions trends continue unchecked, and if average global temperatures rise 2°C above pre-industrial levels, scientists predict devastating impacts for people and business.

Meeting the health, education, infrastructure, and other needs of this growing population, in an increasingly resource-constrained world, will require tens of trillions of dollars in investment, which cannot be financed without the active involvement of the private sector.⁵ To accommodate the increasing population, the UN Food and Agriculture Organization estimates that food production will need to increase by 60 percent by 2050.⁶ At the same time, meeting these needs presents compelling business growth and investment opportunities for investors in many new markets and sectors.

Converging Interests and Goals

More investors recognize the importance of these global trends in their investment decisions and are adjusting their asset allocation and investment-management strategies accordingly. In the United States

³ UN Department of Economic and Social Affairs, 2012.

⁴ Cameron, Erickson, and Schuchard, 2014.

⁵ UN Conference on Trade and Development, 2014. The "World Investment Report" estimates that an additional US\$2.5 trillion will be needed annually to achieve the proposed SDGs.

⁶ FAO, 2012.

alone, the total professionally managed assets considering ESG factors expanded to nearly US\$7 trillion at the start of 2014, from just under US\$4 trillion at the start of 2012—an increase of more than 75 percent.⁷ Another positive sign of investor interest: Today, more than 1,300 asset owners and investment managers, representing more than US\$45 trillion assets under management (AUM), have signed onto the UN Principles for Responsible Investment (UNPRI).⁸ As part of UNPRI, signatories commit to promote transparency and integrate ESG factors into investment decision-making and ownership practices.

BOX 1**Definition of ‘Mainstream Investor’ and ‘Investment Community’**

We use the term “mainstream investor”⁹ to refer to two primary groups of actors: institutional investors and individual investors who are not primarily engaged in social finance.

This typically includes insurance companies, HNWIIs, family offices, pension funds, foundations, endowments, mutual funds, hedge funds, private-equity companies, venture capital firms, and financial institutions/banks. These investors often have large pools of capital. Therefore, their engagement is critical to bringing social finance to scale.

We use the term “investment community” to include investors as well as intermediaries such as stock exchanges, brokers, data providers, and research and raters.

For the purpose of this report, we are defining these groups as they relate to the social finance space, understanding that there may be other applications of the terms.

Increasingly, leading global companies are addressing social and environmental challenges as operational and strategic necessities. These challenges are informing business decisions about developing new products and services for health-conscious consumers, strengthening supply chain management resilience in the face of climate risk, or investing in education and skill development for the next generation of talent. More than 72 percent of the S&P 500 companies now report on their social and environmental activities, a significant increase from the 20 percent of S&P 500 companies that did this in 2011.¹⁰

At the same time, many public-sector actors seek to engage the private sector as a critical partner in addressing complex and interconnected social and environmental challenges. The G8, the UN, and many national governments have prioritized catalyzing and scaling private-sector finance for a range of local and international issues. The leaders developing the proposed SDGs and the new international climate

⁷ US SIF, 2014.

⁸ Signatories to the UNPRI are available at www.unpri.org/signatories/signatories.

⁹ For further references to this definition, please see BNY Mellon: Social Finance at Scale: Creating Value for Investors, 2015, available at <https://www.bnymellon.com/global-assets/pdf/our-thinking/social-finance-at-scale-creating-value-for-investors.pdf>.

¹⁰ Boerner, 2013.

agreement have stressed the need to expand private financial flows if there is any chance of meeting these new commitments.¹¹

The UN Conference on Trade and Development estimates that the global investment needed in key sectors related to the SDGs is approximately US\$5 trillion to US\$7 trillion per year. In developing countries alone, the estimated needs range from US\$3.3 trillion to US\$4.5 trillion. Current investment in these sectors is around US\$1.4 trillion, leaving an investment gap of between US\$1.9 trillion and US\$3.1 trillion per year (see Figure 1 below).¹² In addition, some estimates indicate that US\$44 trillion in clean energy—more than US\$1 trillion per year for the next 36 years—will be needed to avoid the worst effects of climate change.¹³

¹¹ UNCTAD, *World Investment Report*, 2014.

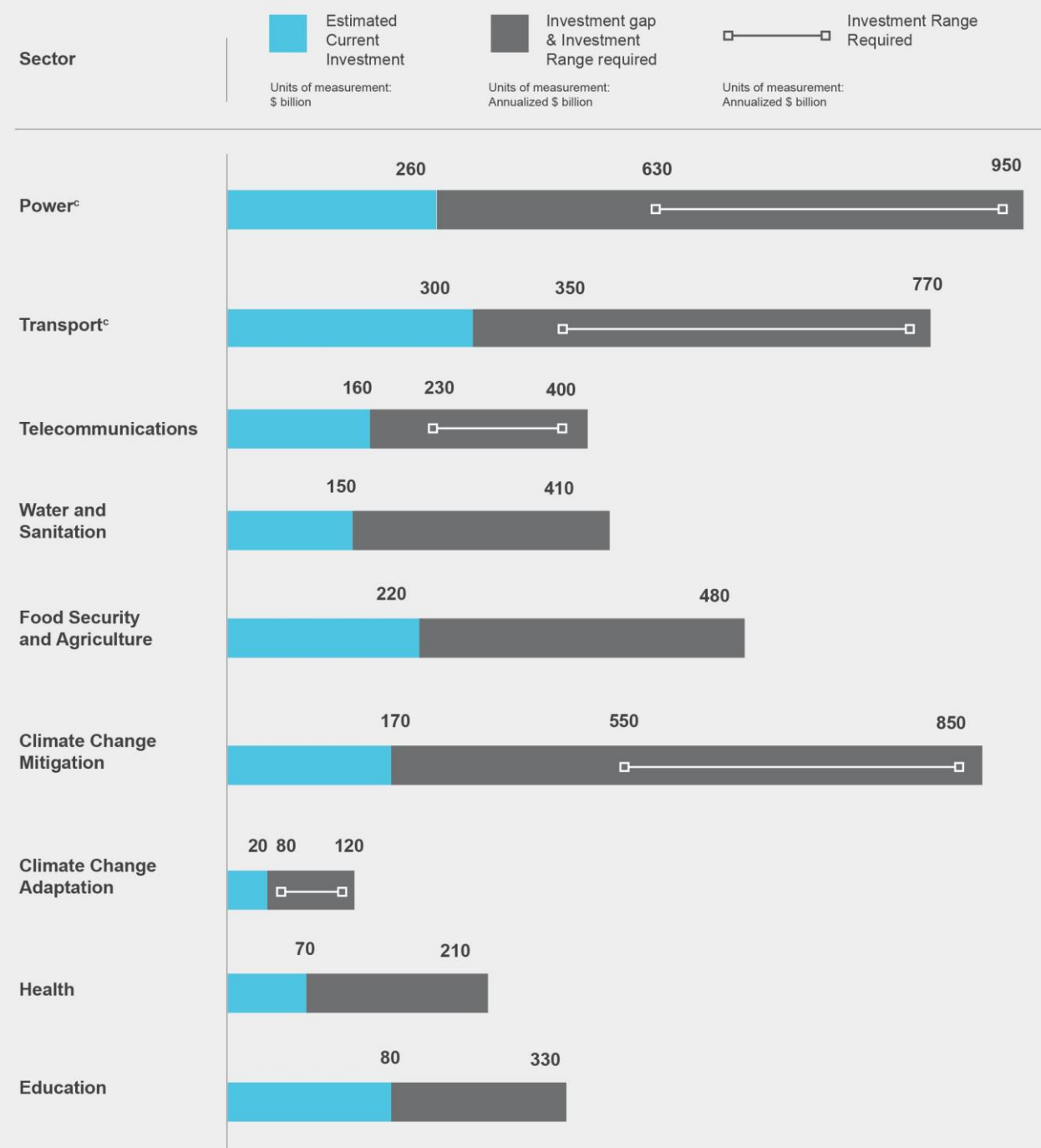
¹² Ibid.

¹³ Fulton, 2014.

Figure 1. Investment in Key SDG Sectors

Investment Gap in Key SDG Sectors

Financing sectors that support the Sustainable Development Goals requires substantial capital from multiple sources including private sector investments. The following figure outlines the current level of investments, the investment need, and the investment gap for various SDG sectors.



Source: UNCTAD, World Investment Report, 2014.

This convergence of public- and private-sector interests and goals offers promise for mobilizing significantly more capital in pursuit of social and environmental progress and for generating value for investors. The G8 Social Impact Investment Taskforce, which has been spearheading engagement with governments to strengthen impact investing, opened its landmark 2014 report by arguing that “the world is on the brink of a revolution in how we solve society’s toughest problems.”¹⁴ Capitalizing on this critical moment in time is in the best interest of all investors.

What Is Social Finance?

Global trends are rapidly reshaping the economy, presenting risks and opportunities that no longer can be ignored by the investment community. The future of finance requires investors to consider financial goals alongside broader goals in society.

This report uses the term “social finance” to refer to any investment activity that generates financial returns and considers social and environmental impact. The term encompasses investment strategies and products across asset classes that deliver varying levels of risk-adjusted returns and align with various investor motivations and goals. It comprises four primary strategies: SRI, environmental finance, development finance, and impact investing.

BOX 2

Social Finance Terminology

This report uses the term “social finance” to refer to a very broad set of investment activities that generate financial returns and consider social and environmental impact.

Some stakeholders may refer to the definition by other terms and may include different strategies and products within this framework. We expect the terms and definitions will continue to evolve as the field matures.

This term, its definition, and the taxonomy of strategies was developed through discussions between BSR and BNY Mellon.

Figure 2 offers a snapshot of the primary social finance strategies, including their objectives, potential motivations for investors to deploy each strategy, and examples of products and fund structures. These strategies are united by their common purpose to deliver both financial returns and positive social and environmental change. However, the specific objectives differ for each of the strategies in terms of how explicitly or intentionally they seek positive social and environmental outcomes. For example, SRI considers ESG factors in investment decisions, whereas impact investing intentionally strives for positive social and environmental impact. (See the appendix for a complete list of definitions.) Figure 2 builds on a visual developed by Bridges Ventures to highlight the spectrum of capital across a range of investment strategies.¹⁵

¹⁴ G8 Social Impact Investment Taskforce, 2014.

¹⁵ Bridges Ventures, 2012.

Figure 2. Overview of Social Finance Strategies


SOCIAL FINANCE STRATEGIES	Investment activities that generate financial returns and consider social and environmental impact			
	SRI ⁱ	Environmental Finance ⁱⁱ	Development Finance ⁱⁱⁱ	Impact Investing ^{iv}
SOCIAL AND ENVIRONMENTAL IMPACT MORE EXPLICITLY CONSIDERED 				
OBJECTIVES	Incorporate ESG considerations into investment decisions and portfolio management.	Contribute to low-carbon and climate-resilient economic growth and the protection of ecological systems.	Advance sustainable economic development in emerging and developing markets through the de-risking of investments to mobilize private-sector finance.	Generate intentional positive social and/or environmental impact through investments in funds, companies, or organizations.
POTENTIAL INVESTOR MOTIVATIONS	<p>Incorporate ESG risks and opportunities and support fulfillment of fiduciary duty in part by using ESG criteria within individual investments to determine portfolio resilience.^v</p> <p>Secure financial performance over the long-term, given increasingly positive links between ESG performance and financial performance.^{vi}</p> <p>In some cases, actively seek out specific investments that aim to provide environmental or social benefits.^{vii}</p>	<p>Offset rising economic costs and increasing risks by investing in strategies that combat climate change.^{viii}</p> <p>Engage in portfolio diversification through investments that offer stable cash flows, and have low volatility, low correlation to other assets, and are often indexed to inflation.^{ix}</p> <p>Capture opportunities for innovation and market growth in areas such as renewable energy and other low-carbon solutions.^x</p>	<p>Access and generate investment opportunities in new geographies and sectors.^{xi}</p> <p>Engage in portfolio diversification and adopt a long-term view by expanding investments to new economies.^{xii}</p> <p>Pursue lower-risk investment opportunities in new geographies and sectors where credit, partial risk, and political guarantees have been provided by catalytic partners.^{xiii}</p>	<p>Create intentional and transformative social impact.^{xiv}</p> <p>Catalyze innovative solutions and public-private partnerships to advance public good.^{xv}</p> <p>Adopt a long-term view of financial performance by pursuing investments that have an intentional social mandate.^{xvi}</p> <p>Improve overall portfolio risk by including investments with strong social impacts, offsetting short-term gains as track records continue to develop.^{xvii}</p>
EXAMPLES	Pax World Balanced Mutual Fund uses negative screening and ESG incorporation. Year-to-date rate of return as of February 28, 2015, was 8.57 percent; standard deviation is 5.67.	European Investment Bank Climate Awareness Bond; US\$1 billion bond with a maturity of 10 years.	Pledge Guarantee for Health to increase funding from international donors for health commodities—Swedish International Development Agency (SIDA) and USAID provide 50 percent guarantee facility.	Aavishkar India MicroVenture Capital Fund invests equity in early-stage rural enterprises in India.

Table Notes

ⁱ Other terms may be used to describe SRI, including responsible investing, sustainable investing, socially conscious investing, ethical investing, and ESG investing, among others. Our definition draws on the UNPRI definition of responsible investment; US SIF definition of responsible, sustainable, and impact investing; and the Global Sustainable Investment Alliance definition of sustainable investing. See appendix for more details.

ⁱⁱ The definition of environmental finance draws largely on definitions of climate finance used by various actors, including the United Nations Development Programme (UNDP), the Global Commission on the Economy and Climate, and the Climate Policy Initiative. Our definition considers potential application to a broader set of environmental issues, including water and biodiversity, among others. See appendix for more details.

ⁱⁱⁱ The definition of development finance draws on the mission statements and goals of a number of development finance institutions and multilateral banks, including the International Finance Corporation (IFC), CDC (the UK government's development finance institution), and the Overseas Private Investment Corporation. See appendix for more details.

^{iv} The definition draws on the Global Impact Investing Network's (GIIN's) definition of impact investing. See appendix for more details.

^v US SIF, 2015.

^{vi} Ibid.

^{vii} Ibid.

^{viii} Deichmann and Zhang, 2013.

^{ix} Fulton, 2014.

^x Global Commission on the Economy and Climate, 2014.

^{xi} IFC, 2011.

^{xii} IMF, 2010.

^{xiii} World Bank, 2013.

^{xiv} World Economic Forum: Mainstreaming Sustainable and Impact Investing, <http://www.weforum.org/projects/mainstreaming-sustainable-and-impact-investing>.

^{xv} G8 Social Impact Investment Taskforce, "Invisible Heart of Markets," 2014.

^{xvi} WEF, "From Ideas to Practice, Pilots to Strategy Practical Solutions and Actionable Insights on How to Do Impact Investing," 2013.

^{xvii} G8 Social Impact Investment Taskforce, "Allocating for Impact," 2014.

THE BENEFITS OF A HOLISTIC FRAMEWORK

We believe that framing social finance holistically—combining multiple strategies together under a broader social finance goal and taxonomy—is critical to achieving scale, considering the unique needs of mainstream investors who have large pools of capital to allocate to multiple strategies simultaneously. While each strategy has a unique value proposition for investors, viewing social finance holistically has a number of additional benefits. For example, this framing allows investors to:

- » **Simplify entry points and explore options across strategies.** Many individual strategies within social finance appear complex to the traditional investor and often include higher transaction costs to identify investment opportunities and evaluate, structure, and monitor deals. Through a holistic approach, investors can create an overarching framework for considering social and environmental impacts in investment practices. This can help identify entry points that are aligned with risk and return expectations. They also can create efficiencies and preserve capital by identifying synergies, common tools, and systems, such as due diligence processes, across strategies. Box 3 offers an example of different strategies or entry points for investors to obtain financial returns and advance gender equality.
- » **Increase portfolio risk diversification.** As a holistic approach, social finance can enhance diversification. This is true when considering the inclusion of ESG risks within specific asset classes, thematic areas (e.g. energy or health), as well as overall investment performance.¹⁶ For example, some investors are interested in deploying capital toward deals that have longer tenures and higher risk, but also offer greater opportunities for direct impact. Simultaneously, an investor might put capital to work investing in green bonds, which offer market-based returns with lower risk and slightly less scalable impact, but faster yield timelines. With social finance strategies and products now sitting across asset classes, the opportunities for risk diversification are improving. These benefits are needed particularly in the face of commodity-price volatility (as seen with fossil fuel prices), environmental disasters, and political instability, among other shocks.
- » **Capture a larger aggregate market.** Viewing the market holistically helps dispel notions that social finance strategies are “niche” by pointing to the large market potential of many different strategies combined. For example, US\$60 billion worth of impact investments are currently under management.¹⁷ Aggregated with other strategies that share the desire for both social and financial returns, the total social finance market activity today represents US\$22 trillion (see next chapter for detailed breakdown.) Data show that the average individual investment in private equity by public pension funds ranges from US\$17 million to US\$53 million. However, currently, impact investing funds typically seek capital ranges from US\$3.5 to US\$12 million.¹⁸ The perception of these strategies as niche has made it difficult for impact investing to penetrate mainstream investors’ portfolios.

¹⁶ Emerson, 2011.

¹⁷ JPMorgan and GIIN, “Perspectives on Progress: The Impact Investor Survey,” 2013.

¹⁸ WEF, “From Margins to the Mainstream,” 2013.

BOX 3

Advancing Gender Equality and Generating Returns Through Social Finance

Nearly 1 billion women are poised to enter the global economy over the next decade. These women will shape business decisions—as employees and producers, business owners and executives, and consumers and political leaders. Despite their strength in numbers, women still face significant barriers to realizing their potential as contributors to inclusive economic growth. This has been recognized in the proposed SDGs, which include a specific goal (goal 5) to achieve gender equality and empower all women and girls.

Social finance offers investors many ways to drive positive change in society and generate a financial return. In fact, in the case of investments that advance gender equality, there is a growing body of evidence showing that gender is material to financial outcomes, and financial outcomes are material to gender. A recent Credit Suisse report found that companies with greater gender diversity in senior management have higher returns on equity, higher valuations, better stock performance, and higher payouts of dividends. Investing in women also opens up significant new business opportunities. Data show that women start new businesses at twice the rate of men, make 85 percent of all consumer purchases, and outnumber men in the attainment of college degrees in the United States. Moreover, unlocking women's full potential has multiplier effects on families, communities, and economies as a whole.

Within social finance, there is a wide range of opportunities to invest with a gender lens, and there is an opportunity to reshape the systems and structures around women to help them succeed. The following graphic captures some of the different opportunities for mainstream investors to advance gender equality and women's empowerment. These include a variety of tools and products within SRI, development finance, and impact investing strategies.

Figure 3. Illustrative Example: Gender Equality



Short-Term Benefits, Long-Term Returns

As highlighted above, the holistic framing makes social finance particularly attractive to mainstream investors. Framing aside, by including social and environmental impacts in investment activities, social finance helps investors obtain financial returns while also mitigating investment and portfolio risk, which generates long-term value and creates positive impacts on society—concerns that are increasingly important to clients and employees.

OFFERING A RANGE OF FINANCIAL RETURNS

First and foremost, social finance offers investors an attractive opportunity to obtain risk-adjusted financial returns ranging from concessionary to market rate and above-market rate. While returns can vary significantly,¹⁹ a number of social finance investments are boasting strong financial performance. For example:

- » Morgan Stanley research of 10,228 open-ended, U.S.-based mutual funds found that the Sustainable Equity Mutual Funds had equal or higher median returns and equal or lower volatility than traditional funds, for 64 percent of the periods examined. It also found that long-term annual returns of the MSCI KLD index, which is comprised of firms that scored high on ESG metrics, outperformed the S&P 500 by 45 basis points since its inception in 1990.²⁰
- » A National Bureau of Economic Research study found that companies with clear environmental and social goals had share prices that outperformed those without goals by 47 percent between 1993 and 2010.²¹
- » Between October 2010 and August 2014, the CDP Climate Leadership Index (made up of 187 companies taking the strongest action on climate) outperformed the Bloomberg World Index of major companies by 9.1 percent.²²
- » A Deutsche Bank study that examined more than 100 case studies found that companies that integrate ESG considerations generally enjoy a lower cost of capital and market-rate returns.²³

While the track record for strategies such as impact investing is still maturing, 2014 research by JPMorgan and the Global Impact Investing Network (GIIN) found that 55 percent of the nearly 146 impact investors studied were pursuing competitive market-rate financial returns, using a number of standard index benchmarks. The vast majority of respondents (92 percent) reported that their portfolio performance was either in line with their financial return expectations (78 percent) or outperformed their expectations (14 percent). While this is positive, the percentage of respondents reporting outperformance of their portfolios against their financial return expectations decreased slightly between the 2014 survey (16 percent) and the 2015 survey (14 percent).²⁴ There are also particular impact investing funds that have

¹⁹ Some studies indicate the financial performance results of SRI funds can be mixed. For example, a review of 21 academic studies examining SRI funds' performance found that in two-thirds of the studies (13/21) found there was no obvious connection between SRI funds and higher returns (either there were mixed results or neutral performance). Five of the studies showed that SRI funds outperformed conventional funds while three showed under performance. Source: Emma Sjöström, "The Performance of Socially Responsible Investment." AP7, (2011), <http://www.gruenesgeld.at/downloads/The-Performance-of-SRI.pdf>.

²⁰ Morgan Stanley, "Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies," 2015.

²¹ Eccles, Ioannou, and Serafeim, 2012.

²² The Global Commission on Economy and Climate, 2015.

²³ Deutsche Bank, 2012.

²⁴ JPMorgan and GIIN, "Eyes on the Horizon, the Impact Investor Survey," 2015.

performed well, including the Global Commercial Microfinance Consortium I, which met its investor targets regarding rates of return (3 to 7 percent rate of return) for 2010.²⁵

While financial performance often varies, and evidence of consistently strong financial returns needs to be improved to attract investors to social finance, existing data dispel myths that there is always a trade-off between financial returns and positive social impacts.

MANAGING ESG-RELATED RISKS

Some research shows that social finance, with its inclusion of social and environmental impact in investment decisions, offers investors an advantage in evaluating and managing risk. According to the Global Sustainable Investment Alliance (GSIA), managers around the world increasingly are using ESG factors to identify risks that are inadequately addressed through traditional investment analysis.²⁶ In the United States, more than 70 percent of money managers cited risk management as one of the top reasons they consider ESG criteria in investments.²⁷

Natural resource constraints, workforce, health and safety considerations, and civil unrest, among other factors, can pose operational, regulatory, and financial risks to companies and compromise the financial performance of investments and the reputation of investors.²⁸ According to some studies, investment portfolios comprising companies with better ESG ratings display substantially less downside risk.²⁹ For example, investors that fail to consider ESG factors such as community relations and human rights when investing in extractives companies could face significant risks: According to one study, community conflict involving a mining project with capital expenditures between US\$3 billion and US\$5 billion can cost roughly US\$20 million per week in lost net present value due to delayed production.³⁰

A number of the people interviewed for this paper argued that strong ESG performance is now synonymous with well-managed companies and good strategic planning. Companies that include social and environmental impacts as part of business decision-making are better equipped to manage risks that directly impact business activities in the short and the long term. These companies also tend to manage resources more efficiently and anticipate market needs.³¹

MEETING GROWING CLIENT AND EMPLOYEE DEMANDS FOR POSITIVE IMPACT

Demand for social finance is on the rise, thanks in part to growing interest among clients and beneficiaries in aligning investments with values. More than half of the individuals surveyed as part of the 2014 “U.S. Trust Insights on Wealth and Worth” survey said they believe the social and environmental impact of their investments is important. In the UK, a recent survey of investors found that 39 percent of respondents would consider accepting a “below market” financial return on investments with

²⁵ Pacific Community Ventures, 2014.

²⁶ GSIA, 2014.

²⁷ Ibid.

²⁸ Skroupa, 2015.

²⁹ Hoepner, et al., 2011.

³⁰ Davis and Franks, 2014.

³¹ Skroupa, 2015.

demonstrated social and/or environmental value-creation potential.³² Similar results have been found in other markets.³³

For millennials³⁴ and women, the desire for positive impact is even higher. A survey of 800 individual investors conducted in November 2014 by Morgan Stanley found that compared to the overall individual investor population, millennial investors are nearly twice as likely to invest in companies or funds that target specific social or environmental outcomes. Survey data also revealed that women are substantially more likely than men to factor sustainability into their investment decisions.³⁵ This presents significant promise for social finance, with women set to inherit the majority of the US\$41 trillion in intergenerational wealth over the next few decades.³⁶

The desire for positive impact is also an important factor in employment. It is estimated that millennials will comprise 75 percent of the global workforce by 2025.³⁷ Meeting this generation's desire to be part of designing and implementing impact could provide an advantage in attracting top talent.³⁸

US\$4.2T

**EXPECTED LOSSES
TO ASSETS DUE TO
CLIMATE CHANGE
BY 2100**

US\$4.7T

**ADDITIONAL
INVESTMENT
OPPORTUNITY IN
LOW-CARBON TECH**

PRESERVING AND GENERATING LONG-TERM VALUE

Tackling social and environmental challenges can help bolster the economy's long-term health. Resource constraints and the rising demand for food globally, coupled with impacts related to climate change, will significantly affect asset owners' ability to create value for their beneficiaries over the long term. According to a Mercer report, the global cost of climate impacts on the environment, health, and food

³² Elliott, 2013.

³³ Capgemini, 2014.

³⁴ Generation born between 1980 and 1995.

³⁵ Morgan Stanley, 2015.

³⁶ Havens and Schervish, 2003.

³⁷ Barrett, 2011.

³⁸ Egan, 2014.

security will reach between US\$2 trillion and US\$4 trillion by 2030.³⁹ An Economist Intelligence Unit study warned that by the year 2100, climate change impacts could cause private investors to lose US\$4.2 trillion on the value of their holdings, even if global warming does not exceed 2°C.⁴⁰

Moreover, taking global trends into account could also unleash many opportunities in new sectors and markets. As carbon regulation grows and alternatives to fossil fuels become more attractive, there is the potential for growth in alternative energy sources such as wind, solar, and hydrogen. Energy-efficiency improvements in end-use sectors such as buildings, industry, and transport could account for an additional US\$8.8 trillion of incremental investments. The deployment of low-carbon technologies including renewables, nuclear, and carbon capture and storage could lead to an additional US\$4.7 trillion in investments.⁴¹ Investments within the renewable energy sub-sector could see average annual returns increase by between 6 and 54 percent over a 35-year period, or between 4 and 97 percent over a 10-year period.⁴²

In the next 40 years, 70 percent of global population growth is expected to take place in 24 of today's poorest countries.⁴³ By 2035, Africa, where half of the current population is under 20, will have the largest workforce. And by 2020, Africa's revenue across resources, agriculture, consumer, and infrastructure is expected to reach US\$2.6 trillion—of which, US\$1.4 trillion will be in consumer industries. The emergence of the middle class in Africa and Asia is one of the major drivers of economic growth.⁴⁴ Today's investments in these markets can create long-term value.

While more research is needed to explore how social finance can create value for investors, existing data are starting to make a compelling case for the inclusion of social and environmental impacts in investments. The next chapter examines how greater awareness of the value of social finance is leading to more activity by mainstream investors and diverse and innovative products across social finance strategies.

³⁹ Mercer, 2011.

⁴⁰ Economist Intelligence Unit, 2015.

⁴¹ Global Commission on the Economy and Climate, 2014.

⁴² Mercer, 2015.

⁴³ Oxford Martin School, 2013.

⁴⁴ Ernst & Young, 2013.

Advancing Toward Scale

Social finance activity has grown significantly over the past decade. Strategies and products across asset classes aligned with many different investor motivations, risk tolerances, and return expectations. Early adopters from the mainstream investment community have helped drive this diversity and product innovation, and have generated momentum among a broader group of mainstream investors. Despite this progress, social finance still faces a number of challenges when it comes to attracting capital at significant scale.

This section offers a brief overview of social finance activity today. In doing so, it seeks to provide insight on key opportunities for mainstream investors and it seeks to identify the remaining gaps to bring social finance to scale.

Social Finance Activity Today

Much has been written about the evolution of social finance, from the early days of socially conscious investing aligned with religious values, and, later, to the use of social finance as a tool to eliminate racial discrimination and apartheid in South Africa. This focus on values and ethics has promoted the growth of strategies such as negative screening, which uses ESG factors as a basis to exclude sectors, countries, or practices from portfolios or funds.⁴⁵ Today, the SRI world has moved from a practice of negative screening and exclusion to one of seeking or encouraging certain characteristics in portfolio companies.

Social finance today offers a wide range of options aligned with different risk appetites, return expectations, liquidity needs, and investors' expectations of impact. For example, the Domini Social Equity Fund invests in U.S.-based midsize and large companies with good records of performance on environmental sustainability and human rights. It has delivered a five-year rate of return of 14.16 percent and has a standard deviation of 9.75 percent, as of July 31, 2015.⁴⁶ Alternatively, the US\$100 million Massachusetts Green Bond that Standard & Poor's rated AA+ delivers yields comparable to a general obligation bond.⁴⁷ The bond uses the proceeds for projects such as clean water, energy efficiency, and conservation. Within impact investing, the RSF Social Investment Fund, a direct loan investment fund for social enterprises that have higher risk profiles according to commercial lenders' standards, has historical rates of return similar to those of certificates of deposits from commercial banks.⁴⁸

⁴⁵ US SIF, "ESG Incorporation," <http://www.ussif.org/esg>.

⁴⁶ USSIF, "Sustainable & Responsibly Mutual Fund Chart," http://charts.ussif.org/mfpc/fund_profile_display.php?FundID=94.

⁴⁷ As You Sow, 2014.

⁴⁸ Pacific Community Ventures, 2014.

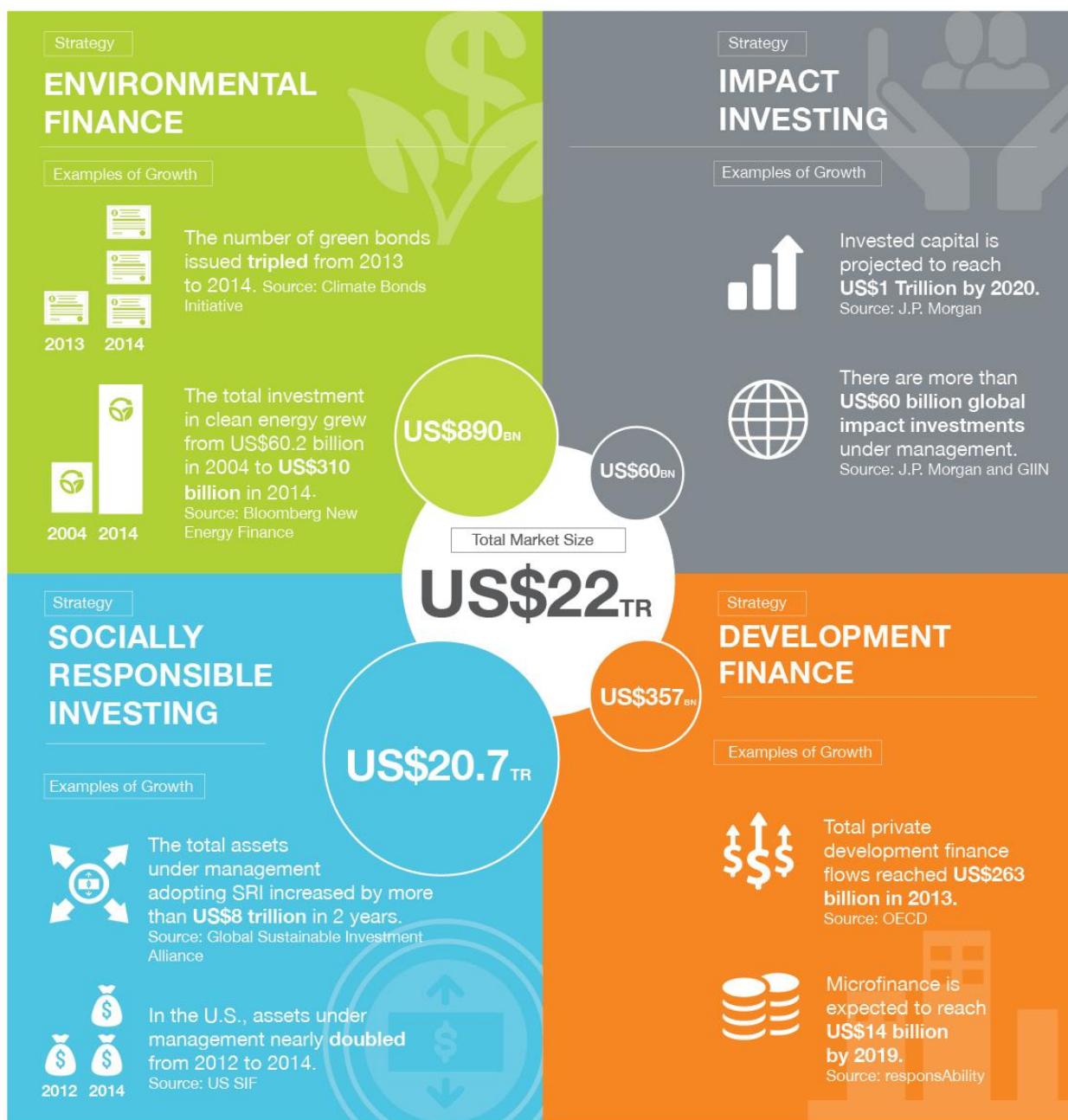
BNY Mellon estimates that social finance activity today is worth upward of US\$22 trillion, and many individual strategies have the potential for double-digit growth in the near future.⁴⁹

⁴⁹ BNY Mellon, 2015.

Figure 4. Social Finance Market

Global Social Finance Market

The total social finance market size is valued at US\$22 trillion and consists of four major strategies: Environmental Finance, Development Finance and Microfinance, Impact Investing, and Socially Responsible Investing. The figure below outlines the size of each of these strategies as well as the examples of growth within each strategy.



A number of products within individual social finance strategies have experienced significant and/or rapid growth and are attracting more mainstream investors.

For example, within SRI, ESG integration—the explicit consideration of ESG factors in investment analysis—has exhibited a 117 percent growth rate between 2012 and 2014 and is estimated to represent US\$12.9 trillion in assets globally.⁵⁰ After significant penetration in public equity, ESG integration has expanded across all asset classes, thanks in part to institutional investors' demands for strategies that conform to their asset-allocation preferences and their desires to mitigate risk exposure.⁵¹ According to a UNPRI survey of more than 800 pension funds, investment managers, and other institutional investors, nearly 70 percent of fixed-income assets incorporated ESG considerations.⁵² In 2014, 336 U.S.-based private equity and alternative investment funds used ESG integration for US\$224 billion in assets. This is up from 301 funds with US\$132 billion in assets in 2012.⁵³

Green bonds also have experienced rapid growth, capturing the interest of new purchasers and issuers across sectors. As of August 21, 2015, green bond issuance for 2015 was estimated at US\$22.68 billion, and projections indicate that by the end of 2015, green bond issuance could total US\$100 billion, tripling issuance in 2014.⁵⁴ In 2014, 73 different issuers put out US\$36.6 billion in green bonds, bringing the total outstanding to US\$53.2 billion. Issuances in 2013 and 2014 represented 80 percent of the total outstanding.⁵⁵ By 2020, corporate green bonds are expected to represent 10 to 15 percent alone of the global bonds market.⁵⁶ In November 2013, Bank of America issued the first corporate green bond, valued at US\$500 million.⁵⁷ Since then, other corporations such as Unilever and Toyota have issued green bonds. This is part of a larger trend in investors increasingly considering climate risks and opportunities as part of investment decision-making. In 2014, the number of U.S. investment vehicles that considered climate change grew to 325, with US\$276 billion in assets. That's up from 280 U.S. investment vehicles with US\$134 billion in assets in 2012.⁵⁸

Although impact investing comprises a small portion of total social finance activity, some research estimates that it could reach US\$1 trillion by 2020.⁵⁹ Within Europe, impact investing is the fastest-growing social finance strategy, with a 146 percent increase between 2012 and 2014.⁶⁰ Since the Rockefeller Foundation coined the term “impact investing” in 2007,⁶¹ there has been a proliferation of activity within the arena. However, it is no longer exclusively the domain of smaller investment firms. A growing number of large asset managers and financial institutions are seizing opportunities to gain a competitive edge with clients and tap new markets and sectors. JPMorgan, for example, has been a key

⁵⁰ GSIA, 2015.

⁵¹ *Responsible Investor*, “Fixed Income: ESG in the World's Largest Assets Class,” February 2014.

⁵² UNEPFI and UN Global Compact, 2011. See also *Responsible Investor*, 2014.

⁵³ GSIA 2014.

⁵⁴ Climate Bonds Initiative, 2014.

⁵⁵ *Ibid.*

⁵⁶ *Responsible Investor*, 2014.

⁵⁷ Bank of America, “Bank of America Issues \$500 Million Green Bond,” November 2013. <http://about.bankofamerica.com/en-us/green-bond-overview.html#fbid=vryw4k8jKR2>.

⁵⁸ GSIA, 2015.

⁵⁹ JPMorgan and GIIN, 2010.

⁶⁰ GSIA, 2015.

⁶¹ E.T. Jackson Associates & Ltd., 2012.

partner with the GIIN, conducting comprehensive surveys of impact investing activity. The firm has a portfolio of US\$60 million committed across nine impact investing funds. Many governments are helping accelerate this growth. The G8 Social Impact Investment Taskforce, established by the UK government, comprises representatives from government, finance, business, and philanthropy from the G8 countries. It is dedicated to developing the impact investment market through metrics, policies, and asset-allocation strategies.⁶²

Similarly, while development finance is currently not a large component of social finance investment flows, it is a strategy poised for growth. To realize the SDGs, development finance will need to significantly increase the resources for development beyond official development assistance (ODA) and leverage both public- and private-sector investment in the developing world. This is beginning to be achieved through both foreign and domestic private-sector investment, remittances, blended finance, and domestic tax revenue, among others venues.⁶³

The quotes throughout this report, such as the one below, offer a sample of some mainstream investors' motivations and trends in social finance activity, which are helping drive growth and diversity in investment opportunities.⁶⁴

“

Asset owners are long-term players in the sustainable economy and leaders of the market. They can drive the market, and by watching them, other players can determine where the market is going to go.

”

—CEO of a nonprofit organization interviewed

⁶² G8 Social Impact Investment Taskforce, <http://socialimpactinvestment.org/>.

⁶³ UN Third International Conference on Financing for Development, 2015.

⁶⁴ These represent a sample of major actors but do not include other stakeholder categories involved in this space, such as sovereign wealth funds, and the role they play in investments related to ESG factors.

Figure 5. Motivations and Trends for Major Investor Groups

Pension Funds

Some pension funds are drawn to social finance as a way to protect long-term value in the face of a growing number of ESG risks. In recognition of this, a number of different geographies are mandating disclosure on the inclusion of ESG factors within investment policies, which also is driving more allocation to social finance.

Social finance strategies also offer pension funds the opportunity to adapt to demographic shifts and expand offerings. As the baby boomer generation ages, pension funds will need to replace plan participants and market to younger clients, such as millennials,⁶⁵ and research shows that millennials are more interested in aligning investment decisions with their values. This focus on protecting long-term value is why SRI is one of the social finance strategies European pension funds use most frequently.⁶⁶ Beyond SRI, a few pension funds are also exploring impact investing, primarily in Europe.

Examples include the two largest Malaysian pension funds, Kumpulan Wang Persaraan (KWP) and Employee Provident Fund (EPF), which adopted ESG integration and have issued mandates on ESG investment as part of their fundamental strategies to drive long-term value and diversification strategies.⁶⁷ The New York State Retirement Fund, CalPERS, and the Connecticut Retirement plans and trusts funds all require ESG considerations within investment policies.

Foundations/Endowments

As primarily mission-driven institutions, many foundations engage in social finance to align their investments with organizational values. Given their primary focus on social impact, foundations often are in the unique position to provide capital that absorbs risk to entice other investors to engage in more impactful, riskier strategies within social finance, such as development finance and impact investing. Within many foundations, there often is disharmony between program objectives and investment goals. As a result, foundations often allocate only a small portion of their endowment funds to program objectives that are aligned with their mission. A growing number of foundations and endowments are pursuing social finance strategies for their endowments, particularly through ESG integration.

Examples include the F.B. Heron Foundation, which recently adopted a revised investment policy statement that says the foundation will invest 100 percent of its endowment toward its mission. Heron operates with the view that “all investing is impact investing” because all enterprises have varying degrees of impact (positive and negative) on society. The organization monitors all investment holdings on both social and financial dimensions so that it can evolve its investments over time to account for more positive results for negative or neutral ones.⁶⁸

The Rockefeller Foundation and OPIC entered into an agreement in May 2014 to jointly support impact investing transactions whose sponsors are looking for early-stage capital and senior debt from other investors and OPIC to help poor and vulnerable people.

⁶⁵ As You Sow, 2014.

⁶⁶ Eurosif, 2011.

⁶⁷ ASRIA, 2014.

⁶⁸ F.B Heron Foundation's Investment Policy Statement, June 2014, <http://fbheron.org/investments/investment-policy-statement/>.

Insurance Companies

Social finance helps many insurance companies maintain a competitive edge, break into new markets with emerging insurance needs, minimize long-term risks, and create long-term value. Insurance and reinsurance companies' unique role as both underwriters and insurers means they are exposed to a range of ESG risks across regions and sectors, including natural and human-caused disasters, climate change, disease, and resource constraints.

These risks also present new investment opportunities in solutions that are linked directly to insurance companies' core business of risk protection.⁶⁹ Weather-based index insurance is one such example, as it helps farmers within developing countries withstand severe weather impacts that are exacerbated by climate change. These impacts can drastically affect crop yields.⁷⁰

Many insurance companies also are investing in micro-insurance and microfinance to complement existing business lines and introduce new product lines within emerging markets, particularly for lower income groups. The micro-insurance market grew to more than 263 million clients in 2013, from an estimated 78 million clients in 2007.⁷¹ Emerging markets are seen as areas for tremendous growth and profits as the insurance markets within developed countries are largely saturated.

Examples include reinsurers such as Swiss Re, which is providing innovative risk-transfer solutions, including some public-private partnerships that help governments absorb economic losses from weather-related disasters and hedge against risk. Swiss Re committed to providing US\$5 million to the World Bank, which pays the Malawi government in the event of a drought under Malawi's weather-index-based insurance scheme.⁷²

Zurich Insurance Group has committed to spend US\$1 billion on green bonds, acknowledging its exposure to the impact of climate change and the intensive use of scarce natural resources. With this investment, Zurich will become the biggest holder of dollar-denominated green bonds, holding about 10 percent of the global market.⁷³

HNWIs

Many HNWIs generally allocate capital to social finance to align investments with their values and generate a return. Many are motivated by personal and family values, with the desire to instill the same thinking, and a responsibility to give back,⁷⁴ in the next generation. In a survey of their investment priorities, 92 percent of HNWIs indicated that driving social impact was important.⁷⁵

HNWIs are not bound by the same fiduciary duty or due-diligence requirements that can prohibit institutional investors from engaging in values-based investing. They also are subject to limited regulation

⁶⁹ MSCI, 2014.

⁷⁰ World Bank, 2014.

⁷¹ Leach and Ncube, 2014.

⁷² Swiss Re, 2011.

⁷³ Thompson, 2013.

⁷⁴ Capgemini, 2014.

⁷⁵ Ibid.

such as laws governing transgenerational wealth preservation, and therefore have the flexibility to pursue long-term investments with higher risk and return thresholds such as impact investing.⁷⁶

Intergenerational wealth transfer may also accelerate interest in social finance.⁷⁷ In a 2008 Eurosif study, 75 percent of family offices and HNWLs indicated that investments that advance sustainability will increase with the generational transfer of their family's wealth.⁷⁸

Examples include the Unitus Seed Fund, which raised about US\$7 million in funding from HNWLs for base-of-the-pyramid, early-stage enterprises in India.⁷⁹

The 100% IMPACT Network is a global, peer-to-peer network of HNWLs, family offices, and foundation principals who have intentionally committed 100 percent of their assets to investments in positive social and/or environmental impact. It includes 73 individuals globally, with cumulative committed capital of approximately US\$4.5 billion, of which US\$1 billion has been deployed.⁸⁰

Financial Institutions/Banks

Some banks and financial institutions engage in social finance to develop new business opportunities due to growing client demand, overall risk management within lending, compliance, and underwriting. As both lenders and issuers, banks are exposed to ESG-related risks through the balance sheets. To mitigate risk, banks often incorporate ESG considerations within missions, policies, and product design.

Social finance offers banks myriad opportunities across strategies to develop new products that meet client needs, from green bonds to microfinance to social impact bonds. Investment banks and asset-management firms responding to SRI mandates from institutional investors also use SRI.

Examples include Bank of America Merrill Lynch, which partnered with Social Finance US and the state of New York to develop a social impact bond to reduce recidivism and increase employment of formerly incarcerated individuals. This was in response to client demand necessitating the design and offering of a new investment product that meets HNWLs unique social and financial objectives.⁸¹

Citi has made a US\$100 billion commitment over 10 years to finance activities designed to mitigate climate impacts and address environmental issues.⁸²

Challenges to Scale

While social finance is gaining traction among many mainstream investors, there remain challenges to unlocking its full potential in generating value for investors and advancing social and environmental progress. Considering that the primary purpose of our research was to focus on the key ingredients to

⁷⁶ Eurosif, 2012.

⁷⁷ McKeever, 2011.

⁷⁸ Eurosif, 2008.

⁷⁹ Bank, 2014.

⁸⁰ 100% IMPACT Network, <http://www.toniic.com/100-impact-network/>.

⁸¹ Bank of America Merrill Lynch, 2013.

⁸² Citigroup, 2015.

scale, and recognizing that a solid body of research on challenges and barriers already exists, we have provided just a brief overview of four key challenges to scale.

- » **Insufficient supply of scalable products that offer attractive risk-adjusted returns:** Despite demonstrated progress within social finance, there remains a lack of products that satisfy the risk appetites and return requirements of most mainstream investors. Some social finance products have longer durations and maturities, leading to higher risk and limited or no liquidity, especially among impact investments.⁸³ Moreover, some of the areas of greatest need—including gender equality, human rights, and poverty alleviation—lack a sufficient supply of products that would bridge the gap between investor preferences and scalable solutions.⁸⁴
- » **Lack of investor awareness and understanding of social finance’s value proposition:** Diverse and evolving terms and definitions, nontraditional language, confusion about how to engage in social finance, and indeterminate value propositions have prevented some investors from exploring social finance.⁸⁵ This is reinforced by outdated beliefs and myths within the industry that financial returns *must* be sacrificed for positive impact on society, and that social finance *cannot* yield competitive or benchmark returns.
- » **Lack of demonstrable track record, underdeveloped infrastructure, and fragile enabling environments:** As a new field, social finance still must develop a strong track record, benchmarks, metrics, and rating systems that enable investors to assess opportunities against standardized criteria.⁸⁶ A lack of services to facilitate connections between investors and verifiable projects and investees necessitates greater due diligence on the part of investors, which increases transaction costs. Additionally, emerging and developing markets, while presenting incredible investment opportunities, also present political, currency, and inflationary risks for many risk-averse investors.
- » **Lack of incentives for long-term impact or measurement of social and environmental performance:** One of the most significant barriers to unlocking the potential of social finance is the deeply entwined cultural, governance, and behavioral factors that influence investors’ decision-making. Incentive structures and benchmarks that asset owners use for evaluating asset managers are heavily weighted toward short-term and quarterly performance. This reality fails to consider social and environmental impacts. Additionally, conflicting and unclear interpretations of the role of ESG factors in fiduciary duty are preventing some private investors from investing in social finance strategies.

Overcoming these challenges will help lower barriers to entry for investors, while allowing the market to respond to increased demand for innovative products. In the next section, we discuss some of the key conditions needed to fill these gaps, which will ultimately enable scale.

⁸³ JPMorgan and GIIN, 2015.

⁸⁴ Interviewees noted the need for more products that meet risk-return expectations of investors, particularly in areas such as gender equality and human rights.

⁸⁵ TIAA-CREF, 2014.

⁸⁶ JPMorgan and GIIN, 2014.

Building the Conditions for Scale

Translating growing investor interest in social finance into significant capital allocation will require fundamental changes in the current system. This includes not only improving products to meet investor goals and performance expectations, but also strengthening the enabling environment, including the infrastructure, skills, and incentives that shape business decisions and are necessary to execute transactions.

It also requires a collective effort by all actors in the investor community to overcome key challenges and dismantle barriers to entry for mainstream investors in social finance. Investors have an important role to play. They can use their investment capital, partner with and engage policymakers, use technical expertise to create best practices, share lessons learned, pilot innovations, and help build coalitions within their sector.

We offer five conditions that are essential for mainstream investors to increase capital allocation across the social finance spectrum. Within these five categories, we identify 12 specific recommendations for the investment community—including investors, intermediaries, and issuers—to collaborate with other stakeholders and construct these conditions. While we believe these conditions are relevant to all of the social finance strategies, they may play out differently or be at different stages of development for individual social finance strategies.

“

*There is a need to reconcile long-term sustainability
with short-term returns.*

—Co-founder of an environmental nonprofit organization interviewed

”

Conditions for Scale

Recommendations for the Investment Community

ACCESSIBILITY

Aligning expectations to create attractive investment products



- Facilitate asset allocation across multiple social finance strategies that cater to varying risk appetites and return expectations.
- Codesign products with established return expectations and clear impact objectives for easier adoption.
- Deepen social finance expertise and knowledge across the investment value chain, particularly among advisory and investment teams.

MEASUREMENT

Building track records, frameworks, and presentation standards necessary to generate investor confidence



- Develop and adopt standardized nonfinancial metrics across investment activities.
- Integrate social and environmental impact into valuation and pricing of risk.

TRANSPARENCY

Institutionalizing sharing of information among investors and stakeholders as best practices to promote efficient use of capital



- Drive consistent and material disclosure of social and environmental impacts on financial performance and impacts on shareholders.
- Share best practices on the integration of social finance into portfolios with stakeholders, peers, and other beneficiaries to promote learning and increase awareness.

SYSTEMIC CHANGE

Creating incentives that shift thinking about value creation and support good governance and positive policy frameworks



- Participate in industry dialogues to clarify and reinforce the interpretation of fiduciary duty to include ESG factors.
- Align internal and external incentives with long-term value.
- Encourage good governance and positive policies that can respond to and support broader uptake of social finance.

COLLABORATION

Pursuing innovation and risk mitigation by leveraging expertise through partnerships



- Cultivate partnerships among stakeholders to de-risk investments and accelerate product innovation and testing.
- Provide guidance and technical assistance to strengthen the pipeline of investment opportunities for both investors and intermediaries.

Accessibility

As highlighted in the previous chapter, many mainstream investors are unclear about how to align their investment goals with the opportunities presented by social finance. As one interviewee put it, there is a need to “demystify” social finance and make it accessible to and easy to understand for the mainstream investor. A holistic approach to social finance (as explained in the first chapter) can help investors identify appropriate entry points and develop an asset-allocation strategy aligned with their risk tolerance and return expectations.

Making social finance more accessible to investors also requires the creation of more products that have clear, well-defined return expectations and impact objectives aligned with investor needs. Indexes and stock exchanges that filter and classify social finance products and ESG performance of investments also play an important role in simplifying investment opportunities.

Lastly, making social finance more accessible requires improving the knowledge and skills of investors, managers, and advisors who play critical roles in translating some of the real and perceived complexities of social finance into language investors can understand.

ASSET ALLOCATION ACROSS MULTIPLE SOCIAL FINANCE STRATEGIES

As noted earlier, viewing many different social finance strategies as part of a broader, holistic framework offers numerous entry points for investors that are aligned with different motivations and expectations of risk, return, liquidity, and impact. This helps investors optimize social finance’s returns potential by simultaneously employing multiple strategies that, individually, may not be able to absorb large pools of capital. *Asset managers and investment advisors* play a critical role in helping investors allocate assets across a wide spectrum of social finance strategies in order to maximize impact and financial returns.

Some mainstream investors are already pursuing such an approach. For example, many foundations that have been leaders in impact investing through programmatic investments now are exploring other social finance strategies and products such as SRI through endowments. This holistic approach is helping foundations align both programmatic and endowment investments with positive social and environmental outcomes. As an example, the Divest-Invest movement, which is dedicated to the divestment of fossil fuel assets, has attracted the support of a number of leading foundations, including the Rockefeller Brothers Fund.⁸⁷ After starting out with 17 institutions in 2014, the Global Divest-Invest Coalition has grown to comprise 180 institutions and local governments, including 71 foundations.⁸⁸

Large institutional investors such as pension funds are also adopting this approach. CalPERS, the largest U.S. public pension fund, has expanded its investment strategy beyond negative screening to include other aspects of social finance such as ESG integration, shareholder activism, emerging markets investments, green bonds, and community investing. This allows CalPERS to develop an asset-allocation strategy that combines some well-established social finance products with newer, riskier investments.

⁸⁷ Rockefeller Brothers Fund Divestment Statement, September 2014, <http://www.rbf.org/content/divestment-statement>.

⁸⁸ DivestInvest, 2015.

PRODUCTS WITH ESTABLISHED RETURN EXPECTATIONS AND CLEAR IMPACT OBJECTIVES

Building and designing products that meet existing risk-adjusted return requirements of mainstream investors and that align with traditional financial instruments also will make social finance more accessible to investors. The steady growth of negative screening as a common entry point to social finance for mainstream investors highlights the value of strategies that are relatively easy to understand and implement, engage investors in decision-making, and incur relatively low transaction costs.

The high demand for green bonds is another example of a product with well-defined return expectations. A green (or climate) bond is structured like a traditional bond and provides investors with market-rate returns while using proceeds to advance climate change mitigation or adaptation projects. Green bonds are commoditized and easy to compare through credit ratings.

In addition to building more products with strong and well-defined return expectations, *issuers, fund managers, and other intermediaries* should seek to clarify products' impact objectives and performance. Although green bonds are intended to have positive environmental and/or climate benefits, more work is needed to ensure consistent classification of bonds as meeting "green criteria" so investors can identify those that meet their requirements. Some progress is being made through the voluntary guidelines set out in the Green Bond Principles, which were launched by 13 commercial and investment banks in 2014. The Green Bond Principles have since been updated through a consultative process involving close to 130 members and observers, and they now include a comprehensive, high-level definition and an updated list of categories of eligible projects.⁸⁹

Asset owners can work closely with managers and other product developers to codesign products that meet their needs. As highlighted in the case study below, this codesign process was integral to the creation of the first green bonds by the World Bank. One way investors can support the creation of more investable financing vehicles and instruments is by using a call for proposals that explicitly mentions social and environmental impact criteria. In late 2014, the French pension scheme ERAFP awarded an active U.S. dollar SRI bond mandate to AXA Investment Managers, with a view to invest around €400 million over three years. This was done through a call for tenders in April of that year.⁹⁰

Investors can also engage in partnerships with various stakeholders and institutions in order to design innovative products that cater to the risk and return profiles of the institutions involved. This can be done through blended finance, which often involves leveraging development finance and/or philanthropic funds to attract private capital. For example, the JPMorgan Chase Foundation provided US\$2.5 million in grants as part of the first loss tranche of the California FreshWorks Fund Term Debt Facility, which is composed of sub-debt (provided in part by the Calvert Foundation) and senior debt. The loss reserves will absorb losses resulting from a loan default or transactions.⁹¹ Other examples of blended finance structures and public-private partnerships are described on page 47 of this report.

⁸⁹ Green Bond Principles, 2015.

⁹⁰ Fixsen, 2014.

⁹¹ GIIN, 2013.

CASE STUDY

World Bank Green Bonds

The World Bank developed the first green bonds in 2008 in response to demand from Scandinavian pension funds and Skandinaviska Enskilda Banken AB (SEB) for fixed-income instruments that address environmental issues. Scandinavian pension funds (such as AP2, AP3, Gamla Livförsäkringsbolaget, and SEB Trygg Liv) and the corporate bank SEB, which served as the lead manager and underwriter, worked closely with the World Bank to create green bonds as part of the World Bank's "Strategic Framework for Development and Climate Change" initiative to encourage public-private partnerships.⁹²

Today, the World Bank's green bond issuance has grown to more than US\$8 billion through more than 80 transactions in 18 currencies. These bonds support more than 67 eligible projects, including renewable energy and energy-efficiency projects.

Now, the green bond market is worth more than US\$60 billion and includes diverse issuer groups such as corporations, energy companies, multilateral development banks, municipalities, and government agencies.

Indexes also seek to make social finance more accessible by providing portfolio managers with best-in-class performance for stock selection. For example, the Dow Jones Sustainability Indexes use a best-in-class approach that includes companies that outperform industry peers across various ESG metrics.⁹³ SRI index funds, such as the Calvert Social Index Fund, are simplifying engagement options and have the added benefit of reducing management costs. The Calvert Social Index Fund showed a return of 13.75 percent for 2014, versus 13.69 percent for the S&P 500 over the same time period, according to Morningstar.⁹⁴

Asset owners can provide input into the criteria and parameters for company selection and rankings in indexes, which can support improved alignment of products with investor needs. In September 2014, MSCI created its MSCI Global Low Carbon Leaders Index (which comprises companies with lower carbon exposure) at the request of, and with insights from, the Fourth Swedish National Pension Fund AP4, Fonds de Réserve pour les Retraites, and Amundi.⁹⁵

⁹² World Bank Green Bond Program, 2008.

⁹³ Sandor and Flatz, 2002.

⁹⁴ Post, 2015.

⁹⁵ MSCI, 2014.

Other emerging developments to help connect investors to investment opportunities include *social stock* exchanges such as London's Social Stock Exchange and Asia's Impact Investing Exchange (IIX). Both seek to facilitate the purchase of stocks and bonds in companies with financial and social returns, and they can help reduce transaction costs by providing investors with due diligence and ease of comparability, thus increasing the accessibility of impact investments.⁹⁶

“

If [I] have to go in to talk to a mainstream portfolio manager and convince him that he should be paying attention to these factors, I have to be able to point to concrete examples of where these factors have influenced financial performance/stock performance.

”

—Vice President of a global investment bank interviewed

GREATER SOCIAL FINANCE EXPERTISE AND KNOWLEDGE

Many of the problems related to accessibility are rooted in the lack of social finance knowledge and expertise within the investment community, particularly among *advisors and managers* who act as important gatekeepers in presenting investment opportunities to investors. In a survey of more than 1,000 financial advisors, 42 percent cited the lack of access to quality research and information or lack of comfort advising clients as reasons for not recommending social finance strategies to clients.⁹⁷

Better education and training to integrate social finance into investment decisions is necessary to help *asset managers, advisors, and intermediaries* communicate the options and benefits of social finance more clearly, and in ways that resonate with investors. This was reiterated by one of our focus group participants, who said, “On the intermediation side, there is even a bigger lack of services: Not enough skilled and affordable third parties that can help the mainstream investor make sense of all of this.” This includes shifting recruitment requirements, internal training programs, and internal incentives and rewards programs to support capacity-building.

Asset owners can encourage advisors and fund managers to deepen their expertise and skills, such as by making social and environmental impact a part of formal contractual agreements and managers' performance evaluations. A RobecoSAM analysis of more than 80 asset-owner UNPRI reports revealed that less than 40 percent of the asset owners used ESG criteria as a formal component in their

⁹⁶ Wilson, 2015.

⁹⁷ Rockefeller Foundation et al., 2012. The survey specifically referred to “sustainable investing” rather than social finance. In this case, we use the terms interchangeably.

evaluations of managers' performance.⁹⁸ The 2014 UNPRI "Annual Progress Report" noted that the majority of asset owners surveyed are still daunted by the perceived complexity of formalizing manager expectations in contracts. When it came to external manager agreements and fund-formation contracts, fewer than half of the asset owners surveyed said they incorporated considerations such as reporting on agreed ESG issues and management influence of ESG issues in investment monitoring.⁹⁹

There also is a need for *asset owners* to strengthen their own internal capacities and knowledge of social finance. Zurich Insurance Group has designated a group of "responsible investment champions" to serve as conduits for communicating strategy to asset management and investment teams. These champions also share ideas and feedback with the centralized responsible investment team. They are well-versed in traditional investment analysis and portfolio management, but they also gain new expertise in ESG through exposure to the responsible investment team. The champions also have individual objectives aligned with responsible investment targets.¹⁰⁰

Universities and research institutions also play an important role in developing the knowledge and skills of current and future talent. For example, the Case Foundation's "Guide to Impact Investing"¹⁰¹ and US SIF's education programs are strengthening the talent pipeline through courses, training programs, and business plan competitions. Nearly all of the top business schools now offer some form of social finance courses. Saïd Business School's Oxford Impact Investing Program, now in its third year, was one of the first executive-education programs on impact investing.¹⁰² The Wharton School of Business cofounded the MBA Impact Investing Network and Training Program with Bridges Ventures, which provides students from 11 business schools with theoretical and hands-on experience with the impact investment process.¹⁰³ Organizations are also developing practical resources for investors and policymakers to speak the same language and ensure that policy incentives promote the uptake of social finance. For example, BlackRock, the world's largest asset manager, has partnered with Ceres to publish an investor guide on corporate engagement. This guide includes case studies and best practices for engaging with companies and policymakers on sustainability issues.

Measurement

Social finance measurement—of both financial and impact performance—is also necessary to grow the field. It captures and codifies investment value, and helps establish the track record necessary to give investors the confidence that their investments will deliver on both social and financial expectations.

This includes strengthening the quality, standardization, and availability of financial, social, and environmental performance. In addition, there is a need to strengthen approaches and commitments to integrating this data into valuation and risk measurement.

Standardizing metrics and strengthening the availability of good-quality data will require a collective effort by the investment community and key intermediaries (including research, analysts, indexes, raters, and

⁹⁸ Churet, 2014.

⁹⁹ UNPRI, 2014.

¹⁰⁰ WEF, 2014.

¹⁰¹ Greene, 2014.

¹⁰² Oxford Impact Investing Program, <http://www.sbs.ox.ac.uk/programmes/execed/iip>.

¹⁰³ Wharton Social Impact Initiative, <http://socialimpact.wharton.upenn.edu/projects/impact-investing/>.

aggregators), asset managers, and investee companies. Policymakers also play a role by mandating ESG disclosures, making data accessible, and creating measurement tools and frameworks.

DEVELOPMENT AND ADOPTION OF STANDARDIZED NONFINANCIAL METRICS

Standardizing nonfinancial metrics and reporting across investment products is an important part of helping the investment community communicate. It is important in ensuring that capital is deployed efficiently by multiple sources, based on lessons learned and credible, comparable data. For mission-driven organizations or values-driven investors, impact measurement also confirms that investments achieved their desired goals.¹⁰⁴

However, measurement of social and environmental performance can be costly and complicated in light of the many interpretations of impact and the typically long timeframes between the investment and the realization of impact. In addition, data quality and availability remain a hurdle for many countries and companies. Much of the ESG data is not audited, making it difficult for investors to feel confident in the data's credibility. The rigor of financial-performance measurement for social finance also must be improved. This is particularly true in cases where de-risking mechanisms are used, calling the credibility of the financial returns into question.

Over the past decade, there have been significant advances in the standardization of nonfinancial metrics and reporting mechanisms. The Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), Impact Reporting and Investment Standards (IRIS), Global Impact Investing Rating System (GIIRS),¹⁰⁵ and B Impact Rating System all have played an integral role in this. (See the case study that follows.) GIIRS, for example, is a system for assessing the social and environmental impact of developed- and emerging-market companies and funds with a ratings and analytics approach analogous to Morningstar investment rankings and Capital IQ financial analytics.¹⁰⁶ *Intermediaries* can work alongside *government and standards-setting bodies* to strengthen these taxonomies and support the uptake of standardized and comparable metrics.

Data providers and *research and rating agencies* are also critically important to strengthen the quality and availability of data on ESG performance. For example, Morningstar recently announced that it will attach impact scores to all mutual funds and exchange-traded funds. The scores will be based on data from Sustainalytics, which applies scores ranging from 0 to 100, based on a company's perceived ESG impact. A higher score is considered more ESG-friendly.¹⁰⁷

Alongside these changes, *investee companies* also need to strengthen the quality and quantity of data available to these firms. *Government* can help by mandating disclosure on ESG risks and performance. For example, the U.S. Securities and Exchange Commission's (SEC's) mandated climate-risk disclosure has helped strengthen the quality and availability of data on greenhouse gas emissions. Investee companies should also adopt standardized reporting frameworks (see more on page 40) and strengthen

¹⁰⁴ Narain et al., 2012.

¹⁰⁵ GIIRS was developed by B Lab, the U.S.-based organization behind the B Corp certification. GIIRS uses IRIS metrics, in conjunction with additional criteria, to rate companies and funds.

¹⁰⁶ Richardson, 2012.

¹⁰⁷ *InvestmentNews*, 2015.

their measurement capabilities internally. Mandating disclosures on board diversity and on CEO pay are also important efforts to provide more and better quality data.¹⁰⁸

Lastly, *investors* play an important role in advocating for improvements. *Asset owners* can use their leverage with other actors in the investment community to encourage better measurement. This demand from investors was one of the critical reasons why Morningstar joined other research firms like Bloomberg in providing ESG impact scores alongside other data.¹⁰⁹ The role of investors in demanding ESG performance data is particularly important to ensure that the data align with investors' values and decision criteria.

CASE STUDY

The B Impact Ratings System

The B Impact Ratings System, a tool to measure a company's social and environmental impact, comprises the "B Impact Assessment" and the "B Impact Report." The "B Impact Assessment" is a free, web-based tool with 60 to 200 questions divided into five impact areas that provide a holistic view of a company's business. The "B Impact Report" is the simple, one-page report that a company receives after completing the assessment. Oversight of the B Impact Ratings System is the responsibility of B Lab's Standards Advisory Council, an independent committee of nine members. The B Impact Ratings System is used to both certify B Corporations and generate GIIRS ratings.¹¹⁰

INTEGRATION OF SOCIAL AND ENVIRONMENTAL IMPACT INTO VALUATION AND PRICING OF RISK

Despite the investment community's growing interest in social finance and awareness of the impact of major global trends on business and investment performance, the integration of ESG risks and performance into valuation processes is far from standard practice.¹¹¹

To ensure measurement is used proactively in investment decision-making, *service providers* and *asset managers* need to integrate it into existing tools and platforms for portfolio analysis. One emerging example is Bloomberg's "ESG Valuation Tool," which enables users to apply a financial methodology to assess the impact of ESG factors on a company's earnings before interest and tax (EBIT) performance, as well as on share price. Bloomberg's portfolio-analysis tools also allow investors to customize models using metrics that are most meaningful to them, and the tools allow them to assess the ESG performance of underlying holdings.¹¹²

A number of *asset managers* are advancing their research capabilities to provide investors with a more holistic picture of risk and valuation. Morgan Stanley's Sustainable and Responsible research team has

¹⁰⁸ Carter, 2015.

¹⁰⁹ *InvestmentNews*, 2015.

¹¹⁰ Foundation Center, 2015.

¹¹¹ Generation Investment Management, 2012.

¹¹² *Responsible Investor*, 2011.

developed a model for integrating exposure to sustainability themes into equity valuation. The model demonstrates how companies' earnings and revenues could be affected by this exposure. The model is intended to help investors understand the valuation scenarios for specific companies on an ongoing basis.¹¹³

Progress has been better for environmental and governance factors than for social factors. *Various research firms and data providers* have developed valuation tools that assess the economic impact of climate change and natural resource use, including the implications of stranded assets for investment portfolios.¹¹⁴ Bloomberg's "Carbon Risk Valuation Tool" helps companies and investors evaluate financial risk from exposure to high-carbon assets. It offers insight into company earnings if the oil or gas price deviates from the futures price, as a result of various carbon-constraint scenarios.¹¹⁵

TruCost, which provides data and insight on the economic consequences of natural capital dependency, has collaborated with Ecolab to create the "Water Risk Monetizer," a free, web-based tool that allows companies to put prices on respective water use, and quantify those prices in ways that reflect the true value in sustaining natural capital.¹¹⁶

Country and corporate governance are also increasingly incorporated into economic analysis. This has been driven in part by the growing interest in operating and investing in emerging markets that may have weaker governance structures. It is also driven by the recognition of how poor governance influenced the 2008 financial crisis.¹¹⁷

Investee companies should review broader valuation frameworks that consider the environmental and social value of a project and implications to the company's brand, business continuity, ability to attract employees, and license to operate.¹¹⁸ Some investee companies, such as PUMA and Dow Chemical, are incorporating natural capital into financial accounting.¹¹⁹

On the social side, some effort has been made to incorporate factors like diversity, human rights, relationship with local communities, and employee engagement into assessments of management quality. There has also been an effort to integrate factors like commitment to product safety, responsible marketing, and innovation into market-sizing and risk exposure. Early efforts are also being made to measure the financial value of social impacts by estimating the costs of a societal issue, such as the cost of taking care of unhealthy citizens or troubled youth, and then comparing these costs to the investment needed to achieve outcomes such as healthier populations or higher youth employment.¹²⁰

¹¹³ Morgan Stanley, 2014.

¹¹⁴ The Carbon Tracker Initiative defines stranded assets as fuel energy and generation resources which, at some time prior to the end of their economic life (as assumed at the investment decision point) are no longer able to earn an economic return, as a result of changes in the market and regulatory environment associated with the transition to a low-carbon economy. For more information please see <http://www.carbontracker.org/resources/>.

¹¹⁵ Bloomberg New Energy Finance, 2013.

¹¹⁶ Water Risk Monetizer, <https://tool.waterriskmonetizer.com/>.

¹¹⁷ UNPRI, 2015.

¹¹⁸ *Harvard Business Review*, 2014.

¹¹⁹ Puma Environmental Profit and Loss Account, <http://about.puma.com/en/sustainability/environment/environmental-profit-and-loss-account>.

¹²⁰ G8 Social Impact Investment Taskforce, "Measuring Impact," 2014.

Transparency

The well-known investor Peter Lynch famously advised investors to “know what you own, and know why you own it.” Relevant and credible information provides investors with the confidence necessary to allocate capital to social finance. Transparency and measurement are closely linked in many ways. For example, transparency without verifiable and relevant data through measurement can be meaningless or just window dressing.

Policymakers have proven to be critical enablers of transparency through mandated disclosure requirements. Increasingly, asset owners and beneficiaries are also helping drive more transparency through shareholder activism and engagement with investee companies and enterprises.

In addition to serving an important role in informing investment decisions, transparency helps investors build trust, learn from successes and failures, and promote best practices. Asset owners and managers can support this by offering insights and lessons learned within the integration of social finance into existing asset allocations.

DISCLOSURE OF SOCIAL AND ENVIRONMENTAL IMPACTS ON FINANCIAL PERFORMANCE AND IMPACTS ON SHAREHOLDERS

Multinational companies’ disclosure of social and environmental risks and opportunities is becoming more common. More than 5,000 companies responded to the CDP’s climate change questionnaire in 2014,¹²¹ compared to only 235 companies when the CDP sent out its first carbon-data request in 2003.¹²² This trend is partly due to the growing interest of institutional investors in understanding how climate change positively or negatively affects their investments. Today, the CDP issues requests for climate-risk disclosure on behalf of 822 institutional investors, which represents more than a third of the world’s invested capital (US\$95 trillion).¹²³ While this shows tremendous growth, transparency on some other material issues and impacts has not gained as much momentum. Only 500 publicly listed corporations reported water data to the CDP in 2014.¹²⁴

Investors can help promote transparency by advocating for mandated disclosures with governments, using their influence with investee companies, and supporting voluntary initiatives and coalitions that promote transparency. For example, coalitions such as the Investor Network on Climate Risk (highlighted below) and the Sustainable Stock Exchange (noted above) work to encourage mandated disclosure on environmental and social metrics from companies.

Some investors are using shareholder engagement to drive transparency on a range of issues, from executive compensation and board diversity to human rights in the supply chain. As of February 17, 2015, 433 social and environmental shareholder resolutions had been filed, outpacing the record 417 shareholder resolutions filed in 2014.¹²⁵ By June 30, 2015, 42 percent of the more than 900 shareholder proposals submitted focused on environmental and social topics. The top four categories were political spending/lobbying, climate change/sustainability, equal-employment opportunity/diversity, and

¹²¹ CDP Climate Change Program, <https://www.cdp.net/en-US/Programmes/Pages/CDP-Investors.aspx>.

¹²² Newell, 2010.

¹²³ CDP, *The Facts*.

¹²⁴ Freyman, 2015.

¹²⁵ Proxy Preview, <http://www.proxypreview.org/>.

labor/human rights.¹²⁶ In early 2015, a coalition of UK pension funds worth £267 billion (about US\$391 billion) called on fund managers to improve reporting on the social impact of their investments as a way to gain a better understanding of how such issues affect short- and long-term risk and performance.¹²⁷

In addition to investor engagement and voluntary reporting efforts such as the CDP and the GRI, *governments* can institute mandatory disclosure and reporting requirements to drive more consistent and material disclosure of social and environmental considerations. In 2011, South Africa became the first country to mandate integrated reporting. This requires all companies listed on the Johannesburg Stock Exchange to produce a single report combining information on the company's financial performance with information on its nonfinancial performance.¹²⁸

CASE STUDY

Investor Network on Climate Risk

Founded in 2003, the Investor Network on Climate Risk (INCR) is a coalition of more than 100 institutional investors representing about US\$13 trillion in assets. The group is dedicated to mitigating climate risks and capitalizing on low-carbon investment opportunities. INCR members spearheaded successful petitions to the U.S. SEC and to the Canadian securities regulators to issue formal guidance requiring companies to disclose material climate change risks and opportunities.

INCR members also support new and emerging disclosure frameworks to ensure investors receive the information they need. This includes input into the integrated reporting standard, working closely with the International Integrated Reporting Council and the Climate Disclosure Standards Board, which aim to advance greater global standardization of climate-related disclosure in mainstream corporate disclosure.¹²⁹

There has also been a movement for more transparency in impact investing. The growth of B Corporations, a new class of corporations dedicated to positive social and environmental impacts, has been instrumental in this.¹³⁰ B Analytics,¹³¹ launched in 2013 by the nonprofit B Lab, is a customizable platform for benchmarking, measuring, and reporting on impact. B Lab also hosts the world's largest database of verified social and environmental performance data for private companies (as of September 2015 the database comprised more than 1,00 companies.)¹³²

¹²⁶ Ernst & Young, 2015.

¹²⁷ Williams, 2015.

¹²⁸ Eccles, 2011.

¹²⁹ CERES, 2015.

¹³⁰ B Corp, <http://benefitcorp.net/>.

¹³¹ Note that this is driven by GIIRS, discussed above.

¹³² B Analytics, <http://b-analytics.net/giirs-ratings/>.

SHARING OF BEST PRACTICES AROUND THE INTEGRATION OF SOCIAL FINANCE INTO PORTFOLIOS

Creating a culture of information-sharing throughout the investment community is an important way to identify best practices and help investors make informed decisions about social finance within their asset allocation. Asset owners and managers can support transparency by sharing lessons learned and using their convening power, research capabilities, and leverage with managers and advisors.

Growing numbers of managers and advisors are starting to notice the demand for transparency, including more information on their ESG methodologies and approaches. The European SRI Transparency Code, launched in May 2008, aims to increase the accountability and clarity of SRI practices for European investors. The principle driving the code is that asset-manager signatories should be open and honest, and they should disclose accurate, adequate, and timely information to help stakeholders understand the policies and practices of a given SRI fund. As of December 2013, more than 500 funds (of 884 SRI funds) had adopted the code. A number of national European SRI labels or trade associations have made the use of the code mandatory.¹³³

Transparency by investors themselves on how they have integrated social finance into financial deals and structures also is important to promote learning and best practice. This is especially important with issues regarding exposure to ESG risks. The UNPRI principle 6 explicitly calls on asset owners and managers to report and communicate the integration of ESG factors into investment practices. Many pension funds and foundations are also clarifying the role of ESG factors in formal investment policies. *Asset managers and intermediaries* can also assist investors by disseminating information regarding the implementation of social finance strategies.

Asset-owner beneficiaries, particularly, pensioners, are starting to demand more transparency on investment practices. The Asset Owners Disclosure Project (AODP) advocates for more proactive disclosure by asset owners on portfolio climate-risk exposure and asset allocation. Only 2 percent of asset owners responded directly to a 2014 AODP survey on climate-risk disclosure, but when contacted by beneficiaries, 34 percent of funds disclosed information.¹³⁴ As beneficiaries become more aware of the importance of ESG factors, it is likely such demands for transparency will grow. By proactively disclosing pertinent information as part of the reporting process, asset owners have an opportunity to connect better to their customers and strengthen their reputation with key stakeholders. To date, AODP covers the climate performance of more than 500 asset owners representing US\$40 trillion in assets. According to AODP, in 2015, just nine funds gained a positive AAA rating, which is given to those that engage in divestment, shareholder activism, and hedging. On the other hand, 232 funds were given an X-rating—the designation for funds that they are not engaging in any material activity related to the management of climate risk.¹³⁵

Various investors are leading a number of additional efforts to promote transparency and best practices in impact investing, with many foundations taking the lead. KL Felicitas Foundation, along with Sonen Capital, an impact investment firm, partnered to publish the first-of-its-kind analysis of the financial returns of the foundation's portfolio-wide approach to impact investing. The report showed that impact investments can compete with, and at times outperform, traditional asset-allocation strategies, while simultaneously

¹³³ European SRI Transparency Code, <http://www.eurosif.org/transparency-code/introduction/>.

¹³⁴ Scott, 2014.

¹³⁵ Asset Owners Disclosure Project, 2015.

pursuing meaningful and measurable social and environmental impacts.¹³⁶ For a number of years, the Rockefeller Foundation also has been convening investors and intermediaries with varying experience in impact investing to share lessons and identify opportunities to strengthen the market.

Systemic Change

For mainstream investors to embrace social finance, it will not be enough to focus solely on creating new products and improving the market infrastructure. If the system continues to reward short-term profit maximization and ignore the real and perceived risks and opportunities presented by social and environmental trends, investors will find it difficult to allocate capital to social finance.

There is a need for a cultural shift to reorient the investment community toward long-term value creation and the underlying ESG factors that support sustainable economic growth. Asset owners and managers can help shift mindsets and priorities by changing incentive structures and advocating for better regulatory and policy frameworks. This requires strong support from many other actors, particularly policymakers.

INTEGRATION OF ESG ASSESSMENT TO FIDUCIARY DUTY THROUGH DIALOGUE, POLICY AND DUE DILIGENCE

Narrow interpretations of fiduciary duty that exclude relevant ESG factors have deterred many institutional investors from engaging in social finance.¹³⁷ This can be attributed, in large part, to the misperception that social finance does not yield adequate returns and that ESG factors are not relevant to trustees' obligations to maximize returns. UNPRI explains that the obligation to maximize returns with respect to fiduciary duty is interpreted by many investors to mean short-term returns. As a result, the integration of ESG factors (which encourage a longer-term view of value, asset protection, and return) is often overlooked.¹³⁸

More investors are starting to question many of the prevailing theories and practices that could jeopardize the long-term viability of institutional investments.¹³⁹ This has been aided by research conducted by the United Nations Environment Programme Finance Initiative (UNEP FI) and others on whether institutional investors such as pension funds and insurance companies are legally permitted to integrate ESG issues into investment decision-making and ownership practices. A UNEP FI study concluded that investors should be permitted and sometimes required to take such factors into account to predict financial performance more reliably.¹⁴⁰

Asset owners and managers can engage in dialogue with *policymakers* to help clarify the definition and interpretation of fiduciary duty through legal changes where necessary, and they can educate others on the importance of ESG factors and impact on long-term value protection and generation. In the United States, for example, efforts are underway to clarify the Employee Retirement Income Security Act rules and guidelines for pension funds in order to facilitate recognition that ESG factors can be material to the

¹³⁶ Lai, 2013.

¹³⁷ Urwin, 2009.

¹³⁸ UNPRI, 2015.

¹³⁹ UNEP FI, 2009.

¹⁴⁰ Freshfields Bruckhaus Deringer, 2005.

fulfillment of fiduciary duty.¹⁴¹ Increasingly, pension funds such as CalPERS or the Ontario Municipal Employees Retirement System (OMERS) are recognizing the importance of ESG factors in their investments.¹⁴²

In France, pension funds are required by law to give each employee the choice of including impact investments in his or her pension savings through “*fonds d’investissement solidaires dits 90/10*,” or 90/10 solidarity investment funds that invest 90 percent according to SRI principles and the remaining 10 percent in unlisted “solidarity-designed organizations.”¹⁴³ As of 2013, these funds had €3.7 billion (US\$3.95 billion) under management.¹⁴⁴

ALIGNMENT OF INTERNAL AND EXTERNAL INCENTIVES WITH LONG-TERM VALUE

Since the 2008 financial crisis, numerous business and government leaders have criticized the short-termism pervasive in the capital markets. This has caused investors to overlook key risks and opportunities pertaining to ESG factors that affect the long-term health of the economy and sustainable value creation.¹⁴⁵ A survey of 1,000 board members and C-suite executives found that 63 percent felt the pressure to deliver short-term returns had increased over the past five years. Of the individuals polled, 86 percent believed that taking a long-term perspective would increase financial returns.¹⁴⁶

Quarterly reporting, employee-incentive structures that reward short-term performance, and investment strategies that are solely focused on tracking against benchmark indexes promulgate this short-termism. *All actors in the investment community* can help shift mindsets to prioritize long-term value. An investigation of the numerous ways investors can promote the cultural and structural changes needed for this shift are beyond the scope of this paper, but emerging research and examples highlight the importance of investor leadership and employee and manager incentives.

The Canada Pension Plan Investment Board and McKinsey & Co. have been leading one promising effort. These organizations have initiated a campaign to educate corporate directors and shareholders on the merits of longer-term investment strategies.¹⁴⁷ With the support of investment professionals from firms such as BlackRock and PGGM, the team set up an initiative called “Focusing Capital on the Long Term” to develop practical structures, metrics, and approaches for longer-term behaviors in the investment and business worlds. The subsequent “Long-Term Portfolio Guide,” published in early 2015, offers five key recommendations for improving long-term outcomes of portfolios.¹⁴⁸

Another essential part of shifting focus to the long-term is ensuring that *asset owners, managers, and advisors* implement the right incentives for employees, managers, and investee companies that take into account drivers of long-term value. This helps hold people and companies accountable for decisions over

¹⁴¹ Smith, 2010.

¹⁴² Ellsworth and Spaulding, 2013.

¹⁴³ Impact Investing Policy Collaborative, 2015.

¹⁴⁴ G8 Social Impact Investment Taskforce, “Impact Investment: The Invisible Heart of Markets,” 2014.

¹⁴⁵ Zuckerman, 2015.

¹⁴⁶ Barton and Wiseman, 2014.

¹⁴⁷ Ibid.

¹⁴⁸ Focusing Capital on the Long Term, 2015.

the long term.¹⁴⁹ This could include changes to practices like quarterly reporting requirements, employee bonuses and rewards, and policies such as the capital gains tax.¹⁵⁰

It could also include evaluating companies on long-term performance measures around operational excellence, including return on equity and return on invested capital.¹⁵¹ In 2015, Larry Fink, the CEO of BlackRock, the world's largest asset manager, sent a letter to the chief executives of the 500 largest publicly listed U.S. companies, urging them to embrace a long-term approach to creating value for shareholders or risk losing the firm's support.¹⁵² Active ownership is also becoming a significant investment strategy that uses shareholder rights to engage with companies on their long-term business strategies in order to improve the long-term value of a company.¹⁵³

Some *investee companies* are taking a proactive stance. Some companies, like L'Oréal, are sending signals to their shareholders that they are committed to long-term performance by rewarding shareholders for holding their stock for more than two years.¹⁵⁴ They are using a form of loyalty shares that seeks to attract long-term investors with patient capital.

Unilever stopped providing quarterly reports shortly after CEO Paul Polman took over the company leadership in 2009. He argued that if "we focus the company on improving the lives of the world's citizens and coming up with genuine sustainable solutions, we are more in sync with consumers and society, and ultimately this will result in good shareholder returns".¹⁵⁵ This long-term view has helped the company embed social and environmental outcomes in its mission, corporate practices, and product development, while providing sustainable returns for shareholders.¹⁵⁶ Unilever has achieved significant growth in returns over the past five years, with 79 percent total shareholder returns, which includes both the increase in share price and dividends.¹⁵⁷

Certain *asset owners*, particularly pension funds, are playing a more direct role in shifting mindsets. As investors that are inherently interested in the long-term, pension funds are increasingly integrating ESG factors into investment strategies as a way to generate and protect value over the long term. The leading French public pension fund, the Fonds de Réserve pour les Retraites; as well as CalPERS, the largest U.S. pension plan; and Latin America's largest pension plan, the Brazilian fund PREVI, have all committed to considering ESG issues in their investment processes.¹⁵⁸

¹⁴⁹ Generation Investment Management, 2012.

¹⁵⁰ Brooksbank, 2015.

¹⁵¹ Focusing Capital on the Long-Term, 2015.

¹⁵² Reuters, 2015.

¹⁵³ KPMG, 2015.

¹⁵⁴ L'Oréal, *Shareholder and Social Responsibility Recognized*, <http://www.loreal.com/who-we-are/awards-recognitions/shareholder-and-social-responsibility-recognized.aspx>.

¹⁵⁵ Guardian Sustainable Business, 2012.

¹⁵⁶ Unilever Annual Report 2014, http://www.unilever.com/images/Strategic_Report_AR14_tcm13-407587.pdf.

¹⁵⁷ Ibid.

¹⁵⁸ Staub-Bisang, 2013.

Unfortunately, these positive signs remain shining examples rather than mainstream practices. There is a need for more members of the investment community to view short-term performance and long-term value creation as mutually reinforcing.

GOOD GOVERNANCE AND POLICY SIGNALS THAT CAN SUPPORT BROADER UPTAKE OF SOCIAL FINANCE

Governments play a critical role in creating an attractive regulatory environment for investors to allocate assets to social finance. In addition to ensuring good governance, governments influence business and investment decisions through taxes, subsidies, and other policy incentives.

Good governance is of particular concern for investments in emerging and frontier markets, a rapidly growing destination for the majority of development finance and impact investing deals, and the site of tremendous opportunities for mainstream investors. Poor rule of law creates unstable investment destinations for a multitude of investors, and poor security, increased corruption, and immature criminal-justice systems (among other issues) serve as a deterrent to institutional investors with low risk appetites.

A robust regulatory system can assist in mitigating risk exposure by codifying fair business practices, establishing channels for recourse against illegitimate activities, and enhancing incentives for investors through stabilized regulatory protection. Regulations involving taxes, enforcement disclosures of corporate payments to both foreign and domestic governments, ease of investment entry, and well-developed operational conditions can improve the investment attractiveness of countries. In addition, changes to policies and regulations limiting foreign ownership can channel greater capital flows from foreign investors. Overall, regulation designed to enable greater public-private partnerships can encourage foreign investments that have social and environmental objectives.¹⁵⁹

While governance is primarily the role of governments and international bodies such as the UN and the World Bank, investors can encourage some of these more positive reforms. For example, to inform the UN's SDGs goal-setting process, the UN Foundation has convened a community of experts, including some key investors, to help elevate measurable and actionable indicators focused on the rule of law, as part of SDG goal 16. This goal aims to “promote peaceful and inclusive societies for sustainable development; provide access to justice for all; and build effective, accountable, and inclusive institutions at all levels.”¹⁶⁰ The engagement of private-sector representatives as experts, including BNY Mellon's participation in the Third International Conference on Financing for Development,¹⁶¹ helps ensure that the indicators developed reflect private-sector knowledge in the drivers of business, investment, and economic growth in developing countries.

Investors can also encourage *policymakers* to implement policy incentives that encourage capital allocation to social finance and remove subsidy programs that deter investors from shifting capital away from investments that may pose negative social and environmental risks. This could include dialogue on changes to current energy-subsidy practices. Currently, fossil fuel companies receive US\$550 billion in subsidies each year, versus the US\$120 billion that go to renewables such as wind, solar, and biofuels on

¹⁵⁹ UNCTAD, 2014

¹⁶⁰ United Nations, Open Working Group Proposal for the Sustainable Development Goals, <https://sustainabledevelopment.un.org/content/documents/1579SDGs%20Proposal.pdf>.

¹⁶¹ For more information, see <https://www.bnymellon.com/us/en/newsroom/news/expert-voices/insights-from-financing-for-development-financial-services-sector-views-on-sustainable-development.jsp>.

an annual basis.¹⁶² Subsidies can help improve competitiveness and reduce project costs, which, in turn, can translate into discounted cash flow and better rates of return.

Collaboration

Financing solutions to the most intractable social and environmental problems will require partnerships that draw on the risk tolerance, expertise, and innovative thinking of various partners. While cross-sector collaboration is an essential ingredient in building all of the conditions for scale, it is particularly important for addressing the actual and perceived risks that mainstream investors face in deploying capital to new and, in many cases, untested strategies and products. This is often the case for strategies such as impact investing or development finance, which lack a strong track record and where many of the opportunities are found in countries with underdeveloped investment ecosystems. For instance, gaps in the ability for small and medium enterprises to receive capital and use it efficiently increase risk to investors.

Collaboration is also critically important to strengthening the investment pipeline. Lending business and technical expertise to issuers, enterprises, and other key actors can help improve the ability of smaller enterprises to absorb capital and meet performance expectations, and for issuers to create investable vehicles.

“

Attracting investors with high risk-adjusted return expectations to good projects is not sustainable. Rather, we need a buffer zone built by collaboration.

— Executive Director of a venture philanthropic organization, Hong Kong focus

group participant

”

PARTNERSHIPS TO DE-RISK INVESTMENTS AND ACCELERATE PRODUCT INNOVATION AND TESTING

The development and testing of new business ideas and investment products and vehicles will help social finance grow to meet investors' diverse needs. This desire for innovation has led to new collaborations that engage investors with different motivations and performance expectations. For instance, some of them are willing to take higher risks and accept below-market returns to leverage the mainstream private-sector capital needed to scale these transactions.

Many *mission-driven investors*, including foundations, are willing to absorb some investment risk through guarantees, convertible grants, and quasi-equity, which will attract more risk-averse mainstream

¹⁶² Morales, 2014.

investors. *Governments and development finance institutions* also are critical innovators in using instruments and tools to take on additional risk to support these partnerships. These institutions are supporting innovation in social finance, recognizing that the cost of developing and deploying new financial vehicles is a barrier to attract investors.

Some of the tools include credit enhancements, bonds, first-loss guarantees, reinsurance, advance-market commitments, long-term currency swaps, and others. SIDA and USAID have strong track records of offering guarantees for high-risk commercial ventures, protecting a percentage of investor losses and enticing more capital to enter these transactions.¹⁶³ One such collaboration is the Global Microfinance Consortium I, through which USAID and the UK Department for International Development (DFID) share first-loss risk with Deutsche Bank in order to leverage capital from investors that have a lower risk tolerance. This consortium is an innovative investment vehicle that has been able to channel capital to 41 microfinance institutions in 24 countries.¹⁶⁴ The Global Health Investment Fund is another example of a blended structure that has attracted mainstream investors (see case study below).

More recently, the Sustainable Development Investment Partnership was launched to mobilize US\$100 billion in private financing over five years for infrastructure projects in developing countries using development assistance to reduce risk. The founding members include several governments, leading banks, foundations, and development finance institutions.¹⁶⁵

There are a number of other innovative instruments within social finance that draw on the capital and expertise of various parties. For example, pooled vehicles reduce transaction costs of individual deals by combining capital from various sources and channeling it to smaller investment opportunities through fund managers. Impact bonds, or pay-for-success contracts, are another innovative product through which investors are paid a return by the government or development institutions if pre-agreed social outcomes are achieved.¹⁶⁶

The Rockefeller Foundation has played a catalytic role in impact investing, and now through its Zero Gap program, the foundation works to “develop new financing mechanisms to mobilize large pools of private capital, identifying and supporting innovations that have the potential to create outsized impact.”¹⁶⁷ Another example is the Morgan Stanley Sustainable Investing Challenge, in which the Morgan Stanley Institute for Sustainable Investing, INSEAD, and Northwestern University's Kellogg School of Management organize a competition for students designed to develop investment vehicles that seek positive environmental or social impact and competitive financial returns.¹⁶⁸ Despite the willingness of stakeholders to collaborate, and the significant potential it has for bringing social finance to scale, too few investors have embraced “social finance R&D.”

¹⁶³ Devfin Advisors and SIDA, 2014.

¹⁶⁴ Pacific Community Ventures. Case Study: Deutsche Bank Global Commercial Microfinance Consortium 1, 2013.

¹⁶⁵ World Economic Forum, 2015.

¹⁶⁶ U.S. National Advisory Board on Impact Investing, 2014.

¹⁶⁷ Rockefeller Foundation Innovative Finance, <https://www.rockefellerfoundation.org/our-work/initiatives/innovative-finance/>.

¹⁶⁸ Sustainable Investing Challenge, <http://sustainableinvestingchallenge.org/about/>.

CASE STUDY

Global Health Investment Fund

The Global Health Investment Fund (GHIF) provides financing to advance the development of drugs, vaccines, diagnostics, and other interventions against diseases that burden low-income countries disproportionately. The fund was developed by the Bill & Melinda Gates Foundation, Lion's Head Global Partners, and JPMorgan Chase & Co. The Bill & Melinda Gates Foundation, together with SIDA of Sweden, provides GHIF investors with loss protection of up to 60 percent of the fund's capital, via a guarantee. The first loss up to 20 percent of invested capital is fully covered, with investors covering 50 percent of any subsequent losses. Repayment is achieved via a combination of milestones and royalties. The fund was able to raise US\$108.9 million, which is above the original target of US\$80 million.

GHIF demonstrates how innovative structures can lead to new collaborations between private foundations, development agencies, individual investors, and the business community to address major global challenges. Funders include the IFC, Axa Investment Managers, Storebrand, and several pharmaceutical companies, among others.¹⁶⁹

GUIDANCE AND TECHNICAL ASSISTANCE TO STRENGTHEN THE PIPELINE OF INVESTMENT OPPORTUNITIES

Collaboration also is essential for strengthening the investment pipeline, particularly investment readiness for recipients of capital and the key intermediaries that help strengthen deal flow and execute transactions. A Monitor Deloitte study conducted over 16 months across nine countries in sub-Saharan Africa found that among 439 impact enterprises, only 32 percent were commercially viable with the potential to achieve scale.¹⁷⁰ Many of the enterprises in this study struggle to attract the right management talent and face other challenges, including poor market and physical infrastructure, inefficient regulation and business protection, and volatile production.

Various mechanisms and partnerships can be used to build a stronger pipeline of investment-ready ventures, including technical-assistance programs, accelerator platforms, early- and seed-stage funding programs, entrepreneurship-development training, and mentorship programs.¹⁷¹ While development agencies, local governments, and foundations traditionally have played an important role in strengthening enterprises, more mainstream financial institutions are also helping bridge the gap to reach scale.

USAID's Partnering to Accelerate Entrepreneurship Initiative (PACE) launched its first six partnerships in 2014, which aim to catalyze private-sector investments in early-stage impact enterprises. Together with JPMorgan Chase & Co and the Rockefeller Foundation, PACE supports the Shujog Assistance for Capacity-Building and Technical Services, which provides tailored technical assistance to nearly 100 social enterprises in Asia, unlocking up to US\$50 million in follow-on investments in five focus sectors.¹⁷²

¹⁶⁹ Global Health Investment Fund, 2015.

¹⁷⁰ Kubzansky, 2011.

¹⁷¹ Huppe and Silva, 2013.

¹⁷² USAID's Partnering to Accelerate Entrepreneurship (PACE) Initiative, <http://www.usaid.gov/PACE>.

Many large financial institutions, particularly banks, are providing capital, technical expertise, and mentoring services to strengthen small businesses and social enterprises. For client-facing institutions, these programs help reach underserved populations with the potential to be future clients. UBS' Elevating Entrepreneurs Small Business Mentoring Program connects established small business owners with a UBS financial advisor and a UBS-affiliated small business owner who has achieved success.¹⁷³ Over six months, this mentorship team helps address the entrepreneur's specific needs. UBS and Deutsche Bank are both supporters of Be! Fund, India's first nonprofit risk-capital fund, which invests in low-income youth to start sustainable enterprises.¹⁷⁴

In recent years, *venture capital and private equity investors* have also injected significant capital in emerging markets, providing new funding, as well as bringing new skills and strategic capabilities to investee companies. Those investing in SMEs, in particular, play a catalytic role in leveraging additional capital, increasing risk-management capabilities, and nurturing good businesses. There is a recognition of the opportunities to focus on well-priced and impactful sectors such as education, healthcare, affordable housing, clean energy, and enabling technologies.¹⁷⁵

The Rockefeller Foundation and Monitor Deloitte define "impact accelerators" as intermediary organizations working to scale impact enterprises. These organizations represent a promising platform to overcome the lack of supply of investable impact enterprises. Through capacity-building to improve business models, direct resource provision, or access to networks, impact accelerators can play an important role in building an investable social finance pipeline.¹⁷⁶

¹⁷³ UBS Elevating Entrepreneurs Program, <http://www.ubs.com/microsites/ee/en/mentoring.html>.

¹⁷⁴ Be! Fund India, <http://befundindia.com/index.html>.

¹⁷⁵ Berla, Jed Emerson, and Gerhard Pries, 2012.

¹⁷⁶ ET Jackson & Associates, 2015.

Charting the Path Forward

The investments made today will determine whether future generations will be able to live within the boundaries of our natural resources and social systems. In the face of massive demographic shifts, these investments also will ensure that the economy continues to grow and deliver value for investors. We believe the future of finance will take into account the risks and opportunities of social and environmental trends and will harness the power of capital markets to drive positive change.

Earlier in 2015, finance ministers met in Addis Ababa, Ethiopia, for the Third International Conference on Financing for Development, where they confirmed the urgency and ambition needed to meet the needs of a rapidly growing world population in an increasingly resource-constrained world. For the first time at such a high level, the action plan emerging from the conference recognized that development realistically cannot be financed if the private sector does not play its part. Climate change, women's empowerment, inclusive growth, and other major social and environmental trends are now at the top of global policy agendas and they are increasingly strategic priorities for business. There is now an opportunity and a need for the investment community to help mobilize the private financial flows needed to finance a sustainable future, while unlocking new opportunities for investors.

Social finance offers investors an opportunity to protect and create value in the face of significant changes. It also gives investors a chance to seek solutions to some of the world's toughest problems. Not only can investors use the power of their capital to drive positive change, they can strengthen the system that catalyzes change for others.

For BSR, social finance is critically important in advancing our mission to catalyze and engage business to advance solutions on social and environmental challenges. Finance is a key enabler of progress, and thus it is a priority for BSR to work with the investment community to strengthen the signals for companies to advance sustainability solutions and channel resources toward more positive impact.

Going forward, BSR plans to draw on our network of corporate members, philanthropic and academic partners, and policymakers to identify opportunities to strengthen the ecosystem to unlock the full potential of social finance. This effort will include building and strengthening collaborations, conducting research, expanding advisory capabilities, and implementing new projects under our dual themes of Business in a Climate-Constrained World and Business Leadership for an Inclusive Economy. Drawing on our extensive experience working with leading financial institutions, BSR invites asset managers and others to engage with us to dismantle the barriers to driving more capital toward social finance, spur innovation in products and services, and collaborate with key stakeholders to advance best practices.

As highlighted in this report, there is a need for all actors in the investment community to help build the conditions for mainstream investors to bring social finance to scale. Below are some recommendations for various stakeholders to play a part in building these conditions.

Asset Owners:

- » Work closely with managers and other product developers to codesign products that meet risk/return profiles and needs.
- » Develop asset-allocation strategies that employ various forms of social finance.
- » Strengthen internal expertise on social finance and incentivize managers to strengthen their expertise by integrating environmental and social impacts into formal contracts and performance evaluations.
- » Advocate for greater measurement and disclosure of environmental and social impacts by investee companies, including for ESG performance data.
- » Disclose performance of social finance investments and best practices to encourage information-sharing and to promote transparency.
- » Encourage good governance and incentives that promote a greater uptake of social finance such as renewable-energy subsidies.

Asset Managers:

- » Facilitate internal trainings and conduct research in order to better communicate options within social finance to investors.
- » Integrate social and environmental impacts into valuation and risk measurement to catalyze greater investment.
- » Collaborate with asset owners and others to codesign products.
- » Create appropriate incentives for employees to acquire social finance expertise and support investors in asset allocation across various strategies.

Intermediaries (Including Indexes, Rating Agencies, Research Firms, Fund Managers, and Service Providers):

- » Develop robust models for the measurement of investments' social and environmental impacts.
- » Support the standardization of ESG metrics and data used in measurement to build the evidence base and track record.
- » Clarify impact objectives and performance, and communicate the track record of investments, to attract greater investments within social finance.

- » Conduct and disseminate research to strengthen the evidence base.

Mission-Driven Organizations (Development Finance Institutions and Philanthropic Institutions):

- » Encourage innovative forms of financing, and test new products.
- » Provide catalytic first-loss capital in the form of guarantees or other instruments in order to reduce the risk/return profiles of innovative partnerships and to incentivize private investment.
- » Support research initiatives in order to improve knowledge and expertise.

While individual action is needed, collaboration is essential. Leveraging the combined resources and expertise of investors, governments, intermediaries, and mission-driven organizations can fuel innovation, mitigate risk, and build necessary skills and expertise. This research is intended to inform an ongoing dialogue among all actors who have a role to play in mobilizing more capital in pursuit of social and environmental progress. The scale and urgency of the challenges demand a collective effort and commitments by all actors to create a prosperous and sustainable future.

Appendix

Glossary of Terms

Development finance is financing that advances sustainable economic development in emerging and developing markets through the de-risking of investments to mobilize private-sector finance. This approach involves private and public investment flows, including official development assistance, investments from development finance institutions, and commercial investors. Typically, it includes long-term loans (between 10 and 25 years), equity investments, and credit-risk guarantees, as well as a number of innovative financing instruments, such as “blended” structured funds and results-based financing. These investments tend to be associated with higher risk, as they are in countries that may not have a sovereign credit rating. Through many cofinancing approaches, the risks associated with these investments can be reduced to attract mainstream investors. This definition draws on the mission statements and goals of a number of development finance institutions and multilateral banks, including the IFC, UK development finance institution CDC, and OPIC. It also is based on the Advocates for International Development’s “Development Finance Institutions” report.¹⁷⁷

Environmental finance comprises financial flows that contribute to low-carbon and climate-resilient economic growth, as well as the protection of ecological systems. This can include green bonds, renewable-energy investments, energy-efficiency investments, and green building investments, among other tools and products. The definition of environmental finance draws largely on definitions of climate finance used by actors such as the UN Development Programme.¹⁷⁸

Impact investing is investing in companies, organizations, and funds with the intention of generating social and environmental impacts as well as financial returns. Core characteristics of this investment strategy include the investor’s intention to create impact, return expectations (minimum return on capital), and measurement of environmental and social progress. This draws on the definition by the GIIN.¹⁷⁹

Socially responsible investing (SRI) integrates or considers ESG factors in investment decisions and portfolio management. This process may be referred to by other names, including responsible investing, sustainable investing, socially conscious investing, ethical investing, and ESG investing, among others. It encompasses screening approaches (negative and positive), ESG integration, and active ownership. This definition draws on the UNPRI definition of responsible investment.¹⁸⁰

¹⁷⁷ Advocates for International Development, 2015.

¹⁷⁸ UNDP, 2015. See also the Global Commission on the Economy and the Climate Policy Initiative.

¹⁷⁹ GIIN, 2015.

¹⁸⁰ UNPRI, 2015. See also US SIF and GSIA.

Research Methodology

Over the course of eight months, BSR investigated the current state of social finance, the drivers and motivations for mainstream investor engagement, and the barriers and conditions to achieve scale. Our research design drew upon a number of well-established research methods, including a comprehensive literature review to assess the latest research, analysis, and perspectives across social finance strategies. In addition, we conducted semistructured interviews and two focus groups, in Washington, D.C., and Hong Kong, to harvest lessons from leading thinkers in the field and to test our findings. We also drew upon BSR's deep knowledge and expertise of business and sustainability, as well as BNY Mellon's strong investment experience, financial knowledge, and analysis.

The draft report was sent for internal and external peer review. Reviewers were asked to assess the report on suitability for publication based on its likely success in informing and shaping opinion within the target audience, as well as its quality as a research product. The insights and recommendations from peer reviewers significantly enhanced the final product.

Semistructured interviews: Between September and November 2014, we conducted one-hour semistructured interviews with individuals representing a diverse range of institutions, geographies, and expertise across social finance strategies. The interview questions largely were focused on understanding existing terminology and definitions, exploring key trends in social finance, identifying key barriers to engaging mainstream investors, and seizing opportunities to achieve scale. We conducted a set of shorter interviews between December 2014 and February 2015 to fill gaps in the current research and test and validate some of the emerging findings, as well as our thesis.

Focus groups: BSR and BNY Mellon organized two focus groups to gather additional perspectives from key stakeholders in Washington, D.C., and Hong Kong. The Washington, D.C., focus group was held at the UN Foundation in early December 2014 and gathered experts from development finance institutions, government agencies, and financial intermediaries. The moderated discussion largely was focused on the value of building a common and holistic framework, and on exploring common barriers to scale across social finance strategies. The second focus group was held in Hong Kong in early February 2015 and gathered several experts from financial institutions, nonprofit organizations, and industry associations. The discussion focused on gathering insights on key trends and unique barriers to scaling social finance in Asia. It also provided an opportunity to test the five conditions of scale with key stakeholders. BSR facilitated both focus groups.

Comprehensive literature review: In addition, BSR conducted a comprehensive review of the latest literature across social finance strategies.

There were some limitations in the research, given the broad scope in terms of issues, strategies, and investor types covered. There are geographic biases, primarily toward the United States and Europe, largely due to the availability and quality of data available, as well as the geography of our own stakeholder network. While we have confidence in our conclusions and comfort in the evidence base used to craft this report, we nonetheless recognize that the views we drew upon represent a spectrum and subset of opinions from a broad and diverse landscape of stakeholders and expertise.

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Stakeholders Consulted

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