Fostering Impact Investment in Developing Countries

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Abstract--**The paper will present the development of impact investment as an industry and then specifically focus on the ways of fostering such a financial instrument in developing countries. Similar to the venture capital firms supporting innovation in high technology firms, impact investment firms are spurring social innovation in a vast variety of countries. Such a financial instrument might have high potential in developing countries that are facing with many social and environmental problems besides economic ones. Based on the experiences in advanced countries, we will attempt to compare the conditions of advanced and developing countries in terms of building and running impact investment industry. As impact investment is a unique financial institution, we will highlight how developing countries can learn from the experience of advanced countries and develop their own impact investment industry in order to foster their social innovation capability.**

I. INTRODUCTION

A substantial amount of studies and literature has been produced on the subjects of innovation financing and the development of new technology-based ventures [1]. However, many of the earlier studies relate to the US conditions and to some degree to European context, which often differ quite considerable if compared to developing country conditions. The similar trend emerges for the social innovation financing and the rise of impact investment in the US [2,3].

A new social finance type is taking place in recent years with various names, such as philanthrocapitalism [4]; natural capitalism; social capital; social venture capital; venture philanthropy [5]; blended value returns [6]; social enterprise and so on [7]. In fact, 'social investment'/ 'impact investment' acts as an umbrella term covering a number of distinct but related developments in resource strategies for social and environmental projects and organizations.

Impact investment is already having a positive effect globally in catalyzing new markets and encouraging entrepreneurship and innovation for the benefit of society. Impact investors are demonstrating that it is possible to design initiatives that deliver not only a financial return but mainly have a positive impact. They are expanding ways of working that intentionally benefit society in ways that neither grant making nor capital markets can achieve alone. Examples range from the arts to aged care, community development, education, employment, health, environmental management, sustainable agriculture, renewable energy, and social housing.

The US impact investment has enabled fast growing social enterprises to raise funds to finance their fast growth [3]. In addition to the social funds given by investment companies, the US government has engaged both directly in the early stages of seed financing for social ventures, and through different institutional support mechanisms that cover individual institutions and regulations. Many European countries have tried to learn from, or imitate, the success of the US financing system. In the beginning of the 2000s, the European impact investment started to increase; there are influential associations dealing with impact investment issues such as European Sustainable Investment Forum and European Venture Philanthropy Association, both established in 2004.

In developing countries, the lack of capital is still a problem not only for innovative social enterprises but also for for-profit companies [8]. In this paper we want to summarize the international developments and indicate the new institutional forms that might be helpful for policy makers in developing countries. By analyzing the recent developments in advanced countries, we aim to highlight three important dimensions:

(1) Actors in the market
(2) Innovative financial mechanisms for social innovation, special emphasis on impact investors
(3) Policy suggestions for developing countries.

II. FINANCING SOCIAL INNOVATION

A. Actors

Financing of social innovation requires both supply side and demand side actors. In addition, there are also financial intermediaries that attempt to bridge the demand and supply side actors. The social investment intermediary agencies have emerged, offering a range of specialized client services, mainly to potential investors. These services include generic and tailored information on social investment opportunities, advice and full investment management. They range from the umbrella bodies, accountants, lawyers, to fundraising consultants. This paper focuses mainly on supply and demand side actors.

Supply side actors consist of investors of all types, including government and individuals, trustees of foundations and superannuation funds that target to manage assets and capital for more than financial performance alone [9]. Impact investing rejects the notion that it is always a choice between 'doing good' and 'doing well' and focuses on areas where it is possible to achieve financial return and generate positive outcomes for society [10].

The financial actors represent a service industry, which should supply not only capital but also competence;

'competent capital' is what distinguishes this part of the capital market from other parts, such as banks [11]. Impact investors help to channel savings in the economy into investments in social enterprises. These savings can be of different sorts, for instance accumulated within private pension funds or within publicly run pension schemes. The growth in the value of the investments is influenced by the competence of the financial firm, not only in selecting firms to invest in but also in helping the firm to develop. The skills involved are not only general management skills, but also industry and technology specific competence including the ability to connect the firm to a larger network of actors. Without access to competence, technical and industrial, competent capital cannot be formed.

Demand side actors include a spectrum of social purpose organizational models from those that generate their own earned income to those that are entirely reliant on grant funding or voluntary resources [12]. Social entrepreneurs recognize what has been termed 'blended value' [6] in which social and economic value creation are intrinsically linked within all action.

B. An Innovative Financial Mechanism: Impact Investment

The financial instruments might be generally classified under the following scheme on the basis of the goal of each investment; the two extremes being financial goals versus social and environmental impact only (see Fig.1).

Socially Responsible Investment (SRI) is an investment process that integrates social, environmental, and ethical considerations into investment [13]. As such, it differs from conventional investments in two ways. First, socially responsible investors apply a set of investment screens to select or exclude assets based on non-financial criteria, in addition to financial criteria. Second, those investors often engage in shareholder activism to foster Corporate Social Responsibility strategies in the firms they own. Over the last decade, the SRI market has kept expanding, reaching in 2010 about 3,070 billion US dollars in the US, representing 12.2 % of assets under management and 3,800 billion Euro in Europe in 2010 [14]. SRI markets are also expanding in Canada, Australia, and Asia.

The SRI category includes: investment approaches that incorporate ESG issues into fund management. SRI includes the following four categories of investments [14]:

1) Sustainable investing: Investment approach that integrates long-term environmental, social, and governance (ESG) criteria into investment and ownership decision-making with the objective of generating superior risk-adjusted financial returns. These extra-financial criteria are used alongside traditional financial criteria such as cash flow and price-to-earnings ratios.
2) Responsible investing: Investment approach that integrates consideration of ESG issues into investment decision-making and ownership practices, and thereby improving long-term returns to beneficiaries.
3) Ethical investing: An investment philosophy guided by moral values, ethical codes or religious beliefs. Investment decisions include non-economic criteria.
4) Impact investing: Investment approach that aims to proactively create positive social and environmental impact against an acceptable risk-adjusted financial return. This requires the management of social and environmental performance (in addition to financial risk and return).

Impact investments are investments made into companies, organizations and funds with the intention to generate social and environmental impact in addition to a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below

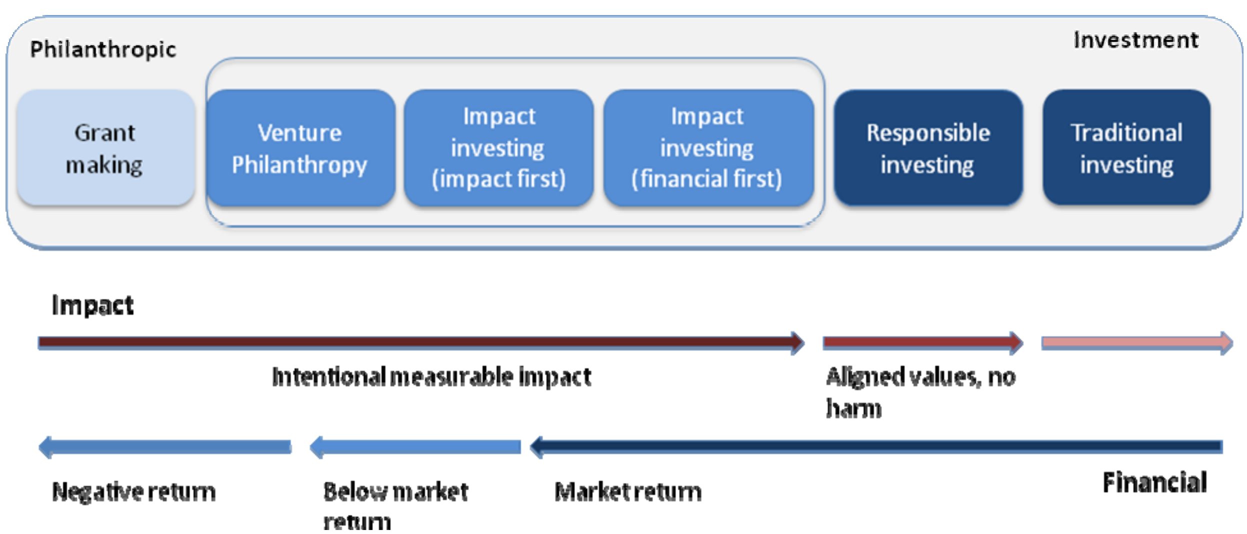

Figure 1. The Range of Investment Types

market-to-market rate, depending upon the circumstances. Investments are often project-specific, and distinct from philanthropy, as the investor retains ownership of the asset and expects a positive financial return. Microfinance, community investing (local development banks, credit unions, loan funds) and social business/entrepreneurship funds are typical examples of impact investment types [14]. As an ecosystem, the actors operating in impact investment market include [15, 9, 3]:

1) Development finance institution (such as European Bank for Reconstruction and Development)
2) Private foundations (such as Omidyar Nework in the US)
3) Large-scale financial institutions (such as JP Morgan, Prudential)
4) Private wealth managers (such as Capricorn Investment Group)
5) Commercial banks (such as Tridos Bank in Europe)
6) Pension funds and insurance organizations (such as PGGM in Holland)
7) Boutique investment funds (such as responsAbility in Switzerland)
8) Companies (such as Danone's collaboration with Grameen Bank in Bangladesh)
9) Community development finance institutions (such as rural-focused Southern Bancorp)
10) high-net-worth individuals

The Eurosif [14] study indicates that the total size of impact investment as grants, loans, equity is equivalent of 8.75 billion Euro, a small part of the total SRI. Another study, GIIN and J.P. Morgan, captures data on over 2,200 private transactions totaling over 4 billion US dollars of impact investment [2]. Clearly there is no agreement on the size of the impact investment market. However, whatever the exact size, it is clear that it is already large enough to make a difference for social innovations in many countries.

C. Investment Types

The sector of impact investment has recently taken off as a viable industry. While a few years ago, there were only a few reports on impact investing such as those by the Monitor Institute and Bridges Ventures, recently there have been many reports about the industry [9, 14]. But more importantly, there are already around 200 globally registered impact investment firms [16]. In addition, several global initiatives have emerged to help drive the transition towards sustainable investing. These initiatives include the UN Principles for Responsible Investment (PRI), the Global Reporting Initiative (GRI), the Prince of Wales' Accounting for Sustainability Project, and the Carbon Disclosure Project. The PRI especially has raised awareness among large institutional investors: at the end of 2012 more than 1071 investors had signed the Principles, representing approximately 32 trillion US dollars in assets under management.

The types of impact investment fall into one of the seven groups [9, 12, 15]: grants, venture philanthropy, debts, credit unions, social investment funds, stock markets and microfinance.

1) Grants

A number of associations such as ASHOKA, Bridgespan, the FB Heron Foundation, the Social Investment Task Force and the EVCA offer grants to social entrepreneurs for social purposes. In the US, there are special legal codes to form foundations with Mission-Related Investment or Program-Related Investment. These involves trusts investing their finance or income in social businesses which are able to return an acceptable or close-to-market rate and whose work fits in with their mission or their program.

2) Venture Philanthropy

New philanthropists such as Venture Philanthropy Partners, Impetus, New Philanthropy Capital, Geneva Global, and Ark are bringing new investment cultures and tools to philanthropy, particularly from venture capital models, including:

- A highly engaged model of funding and business support
- Flexible long-term investment, sometimes repayable
- Active seeking out of investees with growth prospects, either social or economic
- Assessment of achievement by output indicators
- Regular monitoring to targets
- Assessment by financial sustainability and funds

3) Debt

A debt market for small-scale low-cost loans for individuals and organizations in deprived communities has become well established.

4) Credit unions

Although credit unions are not new, their role in the social investment landscape has expanded over the last decade. For example, there are now almost 800 credit unions in the UK, with assets worth £900 million. Many have focused on low-income communities.

5) Social investment funds and quasi-equity

The European Venture Philanthropy Association (EVPA) [17] reports that the total investments made by venture philanthropy organizations in the EU reached 1 billion Euro of financial and non-financial support since the beginning of their operations, with eight organizations contributing 64% of total venture philanthropy investments.

6) Stock markets

A number of social enterprises are already listed on alternative indexes such as AIM, for small and medium sized enterprises, and the embryonic share market Ethex, founded by Triodos, for unlisted equity offerings with individual investors operating through a matched bargain process run through a designated broker. Other alternative listings include the FTSE4GOOD, which measures the performance of companies that meet SRI standards.

7) Microfinance

The first microfinance institutions were founded in the 1970s and they have become mainstream in the mid-2000s. Its success has been characterized by initiatives that built critical elements of the infrastructure to attract a broader set of actors and capital to the table. Internet has increased its fast development in recent years in the form of peer-to-peer format where individuals loan small amount of finance to social entrepreneurs. During the period of 2006-9, the total peer-to-peer lending reached to 179 million US dollars at the global level.

III POLICY SUGGESTIONS

The financing in social innovation has started to attract international comparisons. The Rockefeller report [18] summarizes some of the most critical policy suggestions on the basis of the experiences of 13 advanced countries.

Related to the demand side, the requirements for a healthy industry necessitate:

- Segmentation of investment opportunities
- New financial instruments that fit with multiple social and economic objectives, as well as qualities such as innovation, inclusion, growth potential and sustainable social change
- Increased performance transparency and information
- Exchange incentives such as underwriting or guarantees from third parties

Supply side requirements are given as:

- Greater financial literacy
- Financial options across all stages of the organizational lifecycle
- Legal contractual mechanisms to protect against mission drift and take-over
- Incentives to diversify funding and income base

The international studies also highlight the role of government as a crucial element in the development of impact investment market. The role of government might be listed under three categories [9, 12, 19]:

1) Supply development policies increase the amount of impact capital. Policies dealing with investment rules or requirements, and policies that provide co-investment, increase the supply of impact investing capital by mandating such investment or by enticing investors through risk-sharing with government.
2) Policies directing capital change the way existing investments are made in the capital markets, shifting more toward impact opportunities. Policies that direct existing capital change the perceived risk and return characteristics of impact investments by adjusting market prices and costs and improving transaction efficiency and market information. These include tax incentives for social investment and specialized investment funds.
3) Demand development policies increase the demand for impact capital. Policies that build demand include those that build institutional capacity, create enabling structures, and contribute generally to the development of impact investment-related projects and capital recipients. For example, government-supported training and infrastructure has rolled out across regional and local authorities, leading to numerous localized social enterprise growth strategies and funds.

For developing countries, we might expect to consider the abovementioned policy suggestions to hold and governments can be crucial factor in the establishment of the impact investment market. In addition, due to the underdeveloped institutional structures, there might be additional policy concerns for developing countries such as:

- Establishing standards and regulations, including more comparable quantitative information
- Building variety of deal flows, structured across a range of risk and return scenarios, as well as growth stages
- Transparency and accountability issues
- Transactional mechanisms, such as secondary markets, trading platforms and new intermediaries
- Creating role models

Developing countries needs new and innovative ways to finance efficient and effective social remedies [8]. Government and philanthropy, the traditional funders, can only achieve so much on their own. Lack of access to capital is a chronic problem in the not-for-profit sector yet alternative sources of capital remain largely untapped, often due to the inability of not-for-profit groups to build sufficiently clear opportunities. Thus, the concept of impact investing might offer solutions to this problem.

IV. CONCLUDING REMARKS

In this paper we have focused on the recent developments in the financing of innovative social ventures in the advanced countries. Financial constraints can often prevent a social enterprise from developing its business and expand the operations. The rapid growth of impact investment as a new investment approach in the financial sector brings new opportunities for social enterprises. This new financial tool might offer opportunity for developing countries as well. Even though, challenges will likely vary based on the investment practices, regulatory environment and culture of different geographies, the policy makers in developing countries need to be informed on the impact investment so that they could facilitate policies to establish and develop impact investment in their countries.

A financial system must support the start up and growth of social ventures and investors targeting social returns. It seems there are four key actors for the external financing of innovative social enterprises:

- Government
- Philanthropists and foundations
- Competent financial institutions and
- Competent social entrepreneurs.

The development in impact investment in advanced countries highlights the important role of government support and the public sector financing. Besides the supply of capital, government might contribute to a healthy development of other sorts of financial institutions in financing innovation.

Philanthropists and foundations play a unique and critical role in ensuring that impact investing moves from the margin into the mainstream [9, 20]. They fill the gap by supplying early-stage risk capital for the business model to scale. By doing so, philanthropists and foundations are leaders in helping to build capacity among impact enterprises. In addition, they can help to reduce due diligence costs for investors since they have information and experience on the social enterprises that can be helpful for investors who consider small sizes of investment as a hindrance for investment decisions.

The second actor of the impact investment ecosystem is a diverse set of competent financial institutions. Impact Investment Funds play a critical role in making it easier for institutional investors to allocate more capital to impact investments. The offerings in different forms such as grants or equity will bring diversity into the market and satisfy different needs of social enterprises. Financial institutions can add value to social enterprises in many ways, including increasing commercialization, supporting the fast growth of firm, linking firms with a wide range of networks of customers and suppliers, and supplying managerial support. That is why the entrepreneurial and high tech economic growth in the US is explained with the well functioning of the VC industry [1]. The same might arise with the rise of impact investment for social development [9, 20].

The third actor in the impact investment market is the competent social enterprises. Literature highlights the importance of readiness of social enterprises for outside investors. It is not at all self-evident that even if incentives and financial resources are available in abundance that social enterprises will benefit from it and utilize these financial resources. Social innovators need to have a capability/competence that will be enough to capture the existing offerings at the national and international markets. The accountability of social ventures can send the signal to investors and show the potential of their social value. That is why when social enterprises organize their operations effectively and understand the impact investment strategies of investors, they can shape their organizations and easily cooperate with their investors. The WEF report [9] recommends that: Impact enterprises are a central component to mainstreaming impact investing. Over time, as these organizations grow and their sectors expand, they will be better positioned for commercial capital.

We rather finish with the caution that impact investments are not cure for all and might not necessarily work for all countries. However, the rapid rise in the advanced economies show that it is a new financial instrument and it deserves attention for policy makers in all countries that demand best for their own citizens.

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