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Impact investing: a promising niche solution?

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Impact investing: a promising niche solution?

Bonn, 16 June 2014. Two weeks after the International Labour Organization (ILO) warned against further social spending cutbacks in European countries in its World Social Protection Report 2014/2015 a group of politicians and experts from the fields of business, academia and finance is meeting in London to discuss ways of further developing the international market for social impact investments. "Impact investing" is a new form of investment that can be seen as a supplement to traditional market financing for commercial purposes on the one hand and to grants or donations for social purposes – by the state, private foundations or donors – on the other.

From 19-20 June 2014 the Social Impact Investing Task Force, formed last year by the G8, together with its national advisory boards and working groups is set to work on recommendations for its report, which is planned for September. The date for the publication of this report is the day before the beginning of the 69th session of the United Nations General Assembly, during the course of which new development goals for the period following 2015 are to be resolved – certainly no coincidence. The task force and the national advisory boards have thus far focused primarily on the development of the social impact investing markets in the G7 countries and should now broaden that focus to include developing countries and the potential for financing ecological projects. However, the question is whether impact investors actually have an interest in this.

Impact investing finances social services delivery

Impact investing utilises a market-style system of incentives to mobilise private funding for investments with a predominantly social purpose. The most important prerequisite for these risky investments – in addition to the expected return – is that they are made in charitable organisations, projects and "social enterprises" with the specific intention of making a measurable social and/or ecological contribution. But how is it possible to achieve a return from "social" projects that have thus far been financed largely from state funding?

Social Impact Bonds (SIBs) represent a promising instrument in the field of impact investing. These bonds can be used to finance preventive measures in a broad range of sectors. The investment model is based on a performance-related contract in which investors put up the money required to secure the financing of not-for-profit projects. Repayment of the capital, including a bonus, is via the state – however, only where the social or ecological return actually exceeds the effect that would have been achieved in any case. Failure results in the total loss of the invested capital.

Initial successful SIB models, such as the Peterborough SIB in the United Kingdom – which aims to reduce re-offending among former prisoners – nourish hopes that impact investing can be a promising complementary approach to the state financing of social services delivery in industrialised countries.

Impact investing can do more…

The task force and its advisory boards should now increasingly shift their focus towards developing countries and ecological challenges. On the one hand, it could be possible to use the experience (both positive and negative) gained in performance-based approaches to development co-operation to further develop the use of impact bonds in industrialised countries. On the other hand, the funding requirements for social and ecological challenges, especially of those related to climate change, are particularly high in developing countries. The increased mobilisation of philanthropic investment capital could represent a key contribution to the mix of capital flows that are relevant for development.

In the area of "green" investments in particular the development of the impact investing market could play a decisive role: alongside the donor countries, impact investors are a second, key investor group, willing to take higher risks in exchange for a socio-ecological return. By investing in suitable financing instruments such as structured funds, in which investors put their money into different tranches depending on the amount of risk they are willing to accept, impact investors could help to mobilise urgently-needed capital from private, risk-averse investors (such as pension funds).

The potential of impact investing lies above all with philanthropists in search of an investment form offering sustainable effects instead of merely donating. In order to fully utilise this potential the backers of impact investment should actively seek interaction with the communities that are engaged in the financing of development and ecological sustainability.

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