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Defining an Ecosystem for Social Finance

Nicholas Roose
Kanishk Bishnoi¹²

The ecosystem that supports the social finance represents an impressive confluence of actors and institutions. Collectively, these support the industry through sourcing, facilitating, securitizing, intermediating, structuring, and promoting investments. In the realm of impact investment - where deals are smaller in size and have higher overhead costs as a percentage of financial returns - for impact investments to succeed, they cannot rely exclusively on indiscriminate market forces, but in fact may require financial and other support functions to launch. As defined the ecosystem referenced here represents a broad variety of financial institutions, private research and consulting organizations, and investors, each with distinct functions, investment mandates, funding sources, liquidity requirements, time horizons, and liability structures. Most importantly, each actor operating in this space has a different approach to balancing and managing the risks, financial returns, and social returns of an impact investment. Together they form part of the microstructure of the market of social finance,

¹ Mr. Roose is a MIB candidate at the Fletcher School, Tufts University.

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serving various information, certification, monitoring, risk management, financial, and intermediary functions.

Our objective here is to provide an introductory overview of the social finance ecosystem across a broad institutional and functional spectrum. In doing so, we attempt not only to define discrete entities, but also to establish linkages between and among the components of the system.

Global Banks

Global banks have been attracted to social finance for some time. However, their overall engagement has been to some degree muted. Among global banks we identify two discrete categories of actors: those who invest their own capital into impact investment-related activities and those that provide informational and other services. Deutsche Bank, for example, offers a case direct bank investment. Deutsche Bank created its first microfinance investment fund over 10 years ago. Similarly, Citigroup has supported the microfinance industry through its Citi Microfinance business unit. More recently, through its \$350 million partnership with OPIC to develop new distribution models to access micro entrepreneurs in developing markets, it has participated in investments by providing guarantees.³

Global banks are a key source for product structuring and so provide various banking and intermediary services to social finance structures, including microfinance. J.P. Morgan Social Finance and Morgan Stanley's Global Sustainable Finance, as discrete business units, support the industry through thought leadership and investment services to clients, the former in collaboration of other members of the GIIN's Investors' Council.

³ <https://www.db.com/usa/content/en/1077.html>, <http://www.opic.gov/press-releases/2012/citi-opic-and-bank-andara-support-rapid-growth-microfinance-sector-indonesia-185>

Multilateral Institutions

Multilateral institutions, as international organizations, support dimensions of a social finance agenda. For example, specifically related to sustainable development, activities can range from promoting financial or commercial activities, social progress such as human rights, or agencies that are focused solely on development. More specifically, from a finance perspective, the International Finance Corporation (IFC), as a member of the World Bank Group, is the world's largest multilateral source of debt and equity financing for private sector projects. It is owned collectively by its 172 member countries and retains considerable flexibility to access deep capital pools. Similarly, the Multilateral Investment Guarantee Agency (MIGA), a member of the World Bank Group, is an international financial institution that offers political risk insurance guarantees.

Multilateral organizations, such as the IFC, can serve several functions, including originator/sponsor. However, and importantly, they can bring maximum value as a co-investor, providing not only capital, but also certification value for other investors by validating the quality of a transaction, the level of due diligence undertaken, and the institutionalization of the monitoring to be expected. In addition they represent a potential stable source of follow-on financing.

Development Finance Institutions

Development finance institutions, particularly those from developed economies, are a source of credit and risk capital in the form of higher risk loans, equity positions, and risk guarantee instruments to private sector investments in developing countries.⁴ The purpose of DFIs is to catalyze investment in countries, regions, and sectors where the market has failed to

⁴ Dirk Willem te Velde, et al. 2007. Use of subsidies by Development Finance Institutions in the infrastructure sector, ODI Project Briefings Issue 2, December 2007.

reach sufficiently. DFIs aim to help the private sector implement investment plans and especially seek to invest in countries where there is restricted access to domestic and foreign capital markets. Specific examples include OPIC, IDB, ADB, and KfW.

With further reference to the KfW banking group of Germany, this institution covers over 90% of its borrowing needs in the capital markets, mainly through bonds that are guaranteed by the federal government. This allows it to raise funds at advantageous rates. Together with its exemption from corporate taxes, resulting from its legal status as a public agency, and an equity based provided by public shareholders, KfW is able to offer loans for purposes prescribed by the KfW law at rates lower than those available from commercial banks. Typically, KfW does not lend directly to enterprises or individuals, but it provides commercial banks with liquidity at low rates and long maturities, including through instruments that facilitate risk transfer risk (e.g. securitization).

Asset Owners/Managers

Asset owners, particularly pension funds, represent sources of capital for social finance projects, albeit to date much of this investment has been targeted to established impact funds and microfinance. Interestingly, moving beyond this paradigm, Storebrand, a Dutch pension, has recently invested in a rural agricultural finance fund.

More directly relevant at the project level are asset managers that specialize in impact models. Barriers to entry in this segment of the asset management industry are high owing to the dual requirements of a demonstrated track record and experience. Across managers there is considerable variability with respect to asset class, geographic focus, fund impact objectives, investment style/stage, fundraising status, committed capital, and minimum investment size. Typically such funds raise money from investors such as foundations and high net worth

individuals, then select investee companies based on discrete criteria related to both financial return and social impact. Critically, post investment, managers monitor activity and report performance to their clients. Major impact asset managers include Acumen Fund, Calvert Foundation, Root Capital, Big Society, Bridge Ventures, Accion International, IGNIA, LeapFrog Investments, MicroVest, Pearl Capital Partners, and Sarona Asset Management

Wealth Advisors

Wealth advisors and private banks serve an intermediary role in assisting increasing numbers of private investors and family offices interested in forms of socially responsible or impactful investing to access the market. Advisors provide informational services and assist clients to get exposure to funds in developed sectors of the industry, including microfinance and clean energy solutions, as well as to funds in emerging sectors such as affordable housing in developing markets. Advisors engage with fund managers and provide screening and due diligence to facilitate placement to meet both the financial and social return objectives of their clients.

Networks

With the expansion of the impact investing and SRI, a critical segment of the ecosystem has evolved to serve an outward, industry-facing function to share information, promote activities through conventions, provide research and thought-leadership, and engage in fundraising. Due to the early-stage of this industry, and in absence of robust infrastructure for deal sourcing, conferences in particular represent an important opportunity to network, uncover quality

investment opportunities, and create contacts for (informal or formal) collaborations on due diligence process⁵

Networks usually have representation from actors throughout the ecosystem. The Global Impact Investing Network or GIIN, which was founded from commitments made at the 2009 Clinton Global Initiative, is one such network with members ranging from impact funds (both for-profit and non-profit), private foundations such as the Rockefeller Foundation, and financial institutions such as J.P. Morgan. The networks in particular engage in a variety of informational role, including research, publication, and development of methodologies to measure social returns.

In addition, several impact investment “marketplaces” have developed with the aim of connecting the actors operating in the ecosystem for the purpose of sourcing and catalyzing new debt and equity investment capital. Some networks furthermore provide a platform or database of venture listings, funds, service providers and impact investment deals that permit investors to source high impact opportunities, collaborate on investment screening, and perform.

Foundations

Among the most important providers of “patient” investment capital are foundations. Because they may be constrained by certain fiduciary mandates from direct investing, they often ‘invest’ in impact investment projects via a program-related investment (PRI)⁶. Foundation capital is frequently deployed to fund research or in parallel with conventional investment capital investment to finance technical assistance. Prominent examples of active foundation investors

⁵ “A Portfolio Approach to Impact Investment” October 1, 2012, JPMorgan & Chase, Global Social Science Finance Research, pp. 17

⁶ A program-related investment is an investment made by a US-based foundation that qualifies as a charitable expense under the tax code, allowing the foundation to include the investment as part of the 5% of assets it must distribute philanthropically each year.

include The Bill and Melinda Gates Foundation, Calvert Foundation, The Esmée Fairbairn Foundation, The F. B. Heron Foundation, The Lundin Foundation, The Rockefeller Foundation, Shell Foundation, and Kellogg Foundation.

Social Entrepreneurs

The social enterprises are often the ultimate recipient of the impact investment. Social entrepreneurs apply business solutions to affect social change and can operate in dozens of sectors. Among those sectors most able to demonstrate financial sustainability as businesses include agriculture, healthcare, water and waste management, energy solutions, and financial services. Much like private equity or venture capital, investors in early stage social enterprise investing engage in considerable due diligence, much of which is directed at entrepreneur. Acumen Fund investee companies - A to Z Textile Mills and Life Spring – are specific examples.

NGOs

Non-governmental organizations (NGOs) include a broad set of non-governmental actors that are legally constituted and operate independently from any sovereign government. With respect specifically to sustainable development NGOs play a pivotal role in the identification of needs and the formulation of products, projects, or services to address those needs. In many cases NGOs may exist solely to develop solutions to those needs. NGOs are driven by a strong social mission that defines their work rather than explicitly by a profit motive.

Ratings Services

The Global Impact Investing Rating System (GIIRS) seeks to rate and categorize impact investors through a proprietary rating system, focused on companies making investments in

either debt or equity. GIIRS measures companies' and funds' social and environmental performance in the impact areas of governance, workers, community, environment, suppliers, and consumers. GIIRS functions as a certification agent – akin to Moody's or S&P - of the impact investing industry. It was created through B Labs, and relies on B Impact Rating Systems.

Local Government

Local governments are often key stakeholders in development project. The approval of the local authorities is often a nonnegotiable prerequisite to having any project “green lighted.” Often powerful locally, and in particular when dealing with international consortia of development actors, the local officials provide necessary approvals and can facilitate project execution and implementation.

Citizenry

Lastly, an informed and enlightened citizenry have strong influence in shaping the public dialogue with regard social finance. The practice of placing investments with both social and financial returns has received increasing interest and resulted in a host of new ventures launched, funds raised, networks created, and capital deployed. Public awareness of impact investing plays an important role in shaping the reception and image it receives in the broader development finance community.