Making an impact: the regulatory merits of impact investing

April 2018

In the latest column for Compliance Matters by experts from Guernsey's legal sector, Collas Crill Group Partner Wayne Atkinson discusses the merits of 'impact investing' from a regulatory point of view.

Those of you working with investments will doubtless have heard the word "impact" with increasing frequency over the past year or two. There is an increasing focus amongst investors on making investments with a positive social impact, investments which not only offer a profitable return but also come with the added bonus of good ethical returns; due to their sustainability, environmentally positive nature or the way in which they drive social change and well-being.

Prior to "impact" catching on, *green*, *clean*, *social* and e*thical investments* were all badges worn with pride.

A 2017 survey conducted by the Global Impact Investing Network (GIIN), an impact investment trade body, revealed cumulative impact investment of US$22.1 billion in 2016 by roughly 200 self-identified impact investors spread across nearly 8,000 investments focused on positive impact.

Those same 200 investors predicted that number increasing to $25.9 billion this year and those were simply the respondents to the survey. Anecdotally, the trend upwards is expected to be much, much sharper. GIIN considers an impact investment to be one "made into companies, organizations, and funds with the intention to generate a measurable, beneficial social or environmental impact alongside a financial return."

It's not easy being green

As noted economic commentator Kermit the Frog once taught us however it is not easy being green. In a world where investments are differentiated in the market place by virtue of a badge such as impact or green it is inevitable that many people will want to wear that badge, some with less virtue than others.

In the same way that many marketers are floating even the most tenuous of tech credentials, greenwashing and the equivalent behaviour in the social investment space are real issues for investors. To put things very bluntly one man's social housing provider may be another man's slum landlord.

If an investor lost money because monies they put into an investment fund were invested in a way other than that suggested by disclosure they'd expect to have a claim and probably also expect that fund's regulator to take action.

Investors who invest into impact investments would no doubt feel similarly aggrieved if their monies were invested into less ethical investments but a claim to have had one's ethics infringed by a breach of investment policy is far harder to define than one based around identifiable financial loss. So there is growing demand in some circles for some form of a "stick" (with which non-impactful impact managers may be hit) to balance out the economic "carrot" being dangled by investors looking for impact opportunities.

Social impact

In terms of measuring the effective impact of purely charitable actions, economists and statisticians are increasingly able to measure and compare organisation's impacts. Websites such as GiveWell are now able to offer comparisons of various charities and provide you with an assessment of where you would get the most "bang for your buck". But those are charities. In the impact investment sector investors are factoring in a couple of things, return on investment and social impact.

In circumstances where an investment manager is required to put a certain proportion of a portfolio towards impact, green or ethical investments it's natural he or she will want to put it towards those offering the greatest return. They may or may not also offer the greatest social return but surely to fit in that spot they should at the very least offer a de minimis level of impact? Is it even possible to define and quantify an investment's impact? If so should we regulate funds that wear such a badge to ensure they meet their lofty goals?

If we can identify minimum requirements, the obvious next question would be who should determine whether an investment meets this de minimis level; is this a matter for self-certification or external audit? Following that what happens if an investment fails to meet expectations in impact terms ether because a project doesn't meet expectations or because an external issue causes the investment to change?

Regulatory restrictions

In the funds space there are an ever growing number of funds and promoters claiming some form of impact and a number of national and international regulators have considered whether to regulate such entities specifically. Funds have always been categorised in a number of different ways. Some of those categorisations come from portfolio composition and investment restrictions meeting very specific standards, for example the UCITS requirements. Others come from certification by a recognised expert whose expertise is recognised by target investors; for example Shariah law scholars.

Regulatory restrictions on portfolio composition are problematic particularly in such a nuanced area. The regulator can rarely keep up with the marketplace and regulators have lots of other jobs to do besides assess investments' social impact.

It is highly arguable whether or not a financial services regulator has, or should have, the expertise necessary to assess the social benefits of a micro-finance company in Africa for example. That is a job best left elsewhere with specialists. Of course in transferring responsibility for confirming an investment's nature to an external professional monitor, the question then becomes one of "who monitors the monitor"?

The London Stock Exchange's answer

One area where we have seen an attempt to mandate an investment's impact in this way is the London Stock Exchange's bond market. LSE has launched a number of what might be called impact segments, offering issuers a flexible range of market models for "Green bonds". In the LSE model, green bonds have the same regulatory status as equivalent “non-green” bonds .

However to get their green bonds admitted to the LSE’s dedicated green bond segments, issuers are required to provide a relevant “second opinion” document that certifies the nature of the bonds.

LSE does not mandate who the certification provider but does set minimum criteria that the third party green bond certifier should meet in order for the instruments to be included in the relevant London Stock Exchange green bond segment. The admission criteria LSE use are aligned with Green Bond Principles developed by the International Capital Market Association. Third party reviewers are required to be:

- Independent of the entity issuing the bond, its directors, senior management and advisers
- Remunerated in a way that prevents any conflicts of interests arising as a result of the fee structure
- An entity specialising in assessing the framework of the bonds' environmental objectives, with sufficient financial and market-specific expertise to perform a comprehensive assessment of the use of proceeds (with expertise demonstrable through either industry body affiliations or past experience)

This model has proved popular in the market place and at the end of November 2017, the total number of green bonds listed on the London Stock Exchange Group's markets was 59, with US$20.2 billion equivalent raised. LSE also offers Social Bond and Charitable Bond frameworks as well, again working with ICMA.

Impact ratings

One issue that does remain however is that the relatively non-prescriptive requirements mean there may still be considerable variance between the greenness of various offerings so what someone who wants to be dark green rather than light green do, run their own comparators of bond and certifier credentials? As mentioned earlier, the Green marketplace focussing as it does on a single issue (or framework of issues), is likely to be an easier space to quantify than the broader concept of "impact" in any event.

B Lab, a US non-profit organisation has attempted to address this issue of whether funds have a suitable impact not by setting a de minimis set of standards but by building a rating system; GIIRS, which creates "a holistic picture of [a] fund and portfolio companies' impact" which can allow comparison and benchmarking against other funds and be used to verify funds' claims of a social mission – it is, as one user described it, "a standardized way to compare apples to apples across different impact areas."

It may be that in future, in addition to being certified as "green", "social" or "impact" by an independent arbiter, a rating system like this is applied to almost all investments in much the same way many investments now get an S&P or Moody's rating and the marketplace takes it from there. Perhaps these ratings would in and of themselves do away with the need for a differentiation with the market simply recognising that funds and their portfolios reach a certain threshold on GIIRS or a similar system should be categorised within an impact sector – an ethical AAA rating if you will.

What does this all mean?

Whilst the current state of play is somewhat frustrating with varying standards and definitions in play for the layman, it would appear that the marketplace itself is regulating what is or isn't impact through demand. In essence this is a question of credibility in just the same way as a broader financial track record is. Whilst I have no doubt that financial services regulators in various parts of the world may attempt to create "an impact fund product", I would hope that this is modelled in a similar fashion to the LSE Green Bond model with relatively simple clearly designed requirements for an independent certifier to meet.

An excessive overlay (too much stick, not enough carrot) beyond that may well cramp the marketplace's innovative nature and delay or reduce the delivery of capital to projects that can use it for globally positive purposes. Hopefully the various bodies involved will continue to make progress in this field and a global standard of some kind can be worked toward; perhaps the GIIN will be just the tonic the world's financial markets need.

For more information please contact:

Wayne Atkinson

Partner // Guernsey

t:+44 (0) 1481 734225 // e:wayne.atkinson@collascrill.com

WE ARE OFFSHORE LAW

BVI | Cayman | Guernsey | Jersey | London