

SUSTAINABLE INVESTMENT

- IMPACT IN ASIA



FOREWORD



“There is a growing awareness and appetite for sustainable investment within the global investor community, and this positive momentum is expected to continue.

The sustainable investing canvas is very broad, however, and there are features that are still not clearly drawn. This book, “Sustainable Investment - Impact in Asia,” looks at the principal routes taken for sustainable investing, while providing guidance to investors.

It traces the evolution of sustainable investment in its many forms from philanthropic causes through more targeted forms such as ESG (environmental, social and governance) investing to Impact Investing.

The book examines the United Nations Sustainable Development Goals (SDGs) as a driver of significant transformation in the arena of sustainable investment and also how private capital can complement government funds in financing the Goals. It provides an analysis of the different forms of sustainable investment, the principal players involved in ,and presents what is on its way to becoming an investment “revolution”.

The book’s focus is Asia however some of the lessons learned and conclusions drawn are of universal validity. It looks at the role of government as well as of investors in facilitating and financing sustainable investment, and it showcases success stories of sustainable investment from various parts of Asia.”

Marcos Athias Neto
Director, Finance Sector Hub
United Nations Development Program (UNDP)



“Being a ‘future maker’, we leverage our investments and influence with companies and governments to advocate for a low-carbon, environmentally sustainable and inclusive economy.”

Jane Ambachtsheer
Global Head of Sustainability
BNP Paribas Asset Management



“It is high time we move from complaining about the shortfalls of liberal market capitalism to acting on our convictions. Sustainable investing is a real solution. Whether you’re a professional money manager, or self-directed investor, read this book to learn how you can raise your target return and live up to the convictions of your better self.”

Jesper Koll
CEO of US Asset Manager WisdomTree Japan;
Former Head of Japan Equity Research at JPMorgan Securities Japan; and
Former Chief Economist at Merrill Lynch, Japan





“The issue of sustainability of the environment is of critical importance.

The unnecessary environmental situation of causing disruption to millions of families, business operations and wildlife is not acceptable.

Financial culpability needs to be strengthened. I would personally like to see the Listing Rules of Stock Exchanges to look at sanctions against those directors and management who have directly or indirectly engaged in the policy of flouting environmental laws. The health of current and future generations cannot be marginalised and held hostage due to the weak standards in any sector .”

Datuk Shireen Ann Zaharah Muhiudeen
Chairman
Bursa Malaysia



“With the recognition that all capital has impact and managing that impact with intentionality is the new goal of a growing number of asset owners, Sustainable Finance will play a central role in supporting our common effort to direct capital to support our attainment of the Sustainable Development Goals. A growing body of literature informs our work today and Lee Hock’s contribution is a welcome addition to that library of practice.”

Jed Emerson
The Purpose of Capital:
Elements of Impact, Financial Flows and Natural Being



“The emergence of investment science has contributed to the rapid development of global financial market in the last century thanks to the contribution of modern portfolio theory, stock valuation theory, option pricing model, capital asset pricing model and ETF indexing management, etc. These theoretical constructs have benefited policy makers, regulators and asset owners in terms of financial innovation and risk management, which also interlace the cornerstones of the behavioural aspect of global financial market.

Sustainable Investment has built on the paradigm shift of redefining purpose of capital from pure economic motive to co-creating financial reward and societal betterment, the foundation of social impact investing and the merits of ESG investing in conventional capital market place.

‘Leaving no one behind’ with achieving 17 Sustainable Development Goals by 2030, requires the collective efforts to enhance the theoretical construct of capital market for social value creation as well as the best practice of business, finance and technology as a force for good. The collaboration between AAM and UNDP SDG Innovative Finance together with the contributors of this publication serves as phenomenal milestone for Sustainable and Impact Investing.”

Dr. Ilex Lam
Chairman, iSDG Capital Partner Group
Co-founder, SDG Institute of Impact Finance (SDGIIF)



SUSTAINABLE INVESTMENT - IMPACT IN ASIA

Written primarily by Anthony Rowley,
with contributions from other writers.
Chapters 2 and 9 were contributed by Kirthisri Rajatha Wijeweera.

This book is printed on recycled paper 

Published by Asia-Pacific Media Ltd, Hong Kong

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INTRODUCTION

Sustainable investment is on its way from being a philanthropic or “niche” activity to becoming “big business” – very big business in fact, involving multiple trillions of dollars – for financial institutions, business firms and individual investors. It is at the same time helping to reshape the global financial system, bolstering the image of capitalism and even contributing to saving Planet Earth.

By some definitions, the total stock of sustainable investment is already measured in trillions of dollars. Most of this, however, is in what is called “negative exclusionary” forms of investment by those who are anxious to avoid “doing harm” by investing in what they see as socially undesirable activities such as armaments or tobacco production or gambling. More “positive” investment by those who wish actively to “do good” is much smaller but is growing fast – and that is where the future lies.

Rather confusingly, the term sustainable investments is subject to various different definitions which all come under the umbrella of sustainability: “responsible, ethical, green or thematic” investment being just a few. But two principal forms – “ESG” (environment, social and governance) investing and “Impact” investing – seem certain to dominate the field from here on, as ideas about what constitutes sustainable investing become crystalised and clarified.

Sustainable investment is defined by the US-based BlackRock group (one of the world’s leading asset managers) as being investment which “combines traditional investing with sustainability-related insights, in an effort to reduce risk and to enhance long-term returns.” BlackRock further subdivides sustainable investment into four main components (which are further examined in Chapter 1 of this book):

- > ESG Investing, which involves evaluating companies based on their environmental, social and governance business practices to identify risks and opportunities.
- > Thematic Investing, which focuses on “particular environmental, social or governance issues.”
- > Impact Investing, which “seeks to achieve a measurable sustainable outcome alongside a financial return.”
- > Screened Investing, which “eliminates exposures to companies or sectors that pose certain risks or violate an investor’s values.”

Sustainable investment is, as BlackRock says, “no longer a niche area; it is going mainstream.” According to the Global Sustainable Investment Alliance, a loose group of institutions dedicated to sustainability. “Sustainable investments have grown by a quarter globally to \$23 trillion over the last two years to around one-quarter of professionally managed assets,” the GSIA said in 2019. As noted, however, this figure is based upon a very broad definition of what constitutes sustainable investment.

This book seeks to identify key underlying trends and chronicles progress in making investment more sustainable for the longer term – financially and socially. It identifies some of the key challenges and opportunities and looks at how the investment landscape is likely to develop as social goals assume increasing importance in the overall deployment of funds.

Sustainable investment has taken hold chiefly in Europe and North America but is gaining traction in Asia too, Japan and China especially. Japan’s Government Pension Investment Fund is pursuing an innovative venture with the World Bank to make sustainable investment accessible to fixed-income investors in addition to the equity investors who dominate the asset class whilst China has established a leading position in “Green” financing.

So far, sustainable portfolio investment has overwhelmingly taken the form of equity securities, but fixed-income forms of sustainable investment are rapidly gaining popularity, as this book makes clear. Global sustainable debt issuance came in close to \$235 billion in the first eight months of 2019 (with green bonds accounting for over half of that) and the total is expected to exceed \$350 billion for the whole year, according to the Institute of International Finance (IIF).

Also, while official organisations (such as the International Finance Corporation for example) have tended to dominate sustainable investment, private financial institutions such as pension funds and life assurance companies, as well as private equity firms and others are becoming increasingly active investors.

Retail investors too are becoming more involved, especially via so-called exchange traded funds or ETFs. ESG-dedicated bond ETFs attracted some \$3.7 billion during the first eight months of this year – according to the IIF. “Solid returns on ESG bonds relative to investment-grade (IG) peers have also contributed to the appeal of ESG debt products.”

ESG, which aims to steer corporate activity in sustainable directions is the most widely practised form of sustainable investment. It incorporates environmental, social, and governance issues into analysis, selection and management of investments. The “E” covers climate change, carbon emissions, pollution, resource efficiency and

biodiversity; the “S”, human rights, labour standards, health and safety, diversity policies and development of human capital; and the “G”, corporate governance, corruption, rule of law, institutional strength and transparency.

IMPACT INVESTING – FROM (RELATIVELY) “PASSIVE” TO “ACTIVE”

Impact investing goes further and requires investments to have a measurable social impact. Critically, it also assures the investor of a financial return, which means that social goals can be achieved along with fulfilling financial fiduciary obligations. This is particularly important for institutional investors such as pension funds that generally are unable to sacrifice financial returns for wider social obligations.

Impact investing grew out of philanthropy, where private benefactors contracted with beneficiaries or intermediaries to produce measurable social results from their equity investments. Impact Base, a global online directory of impact investing vehicles, lists sustainable trade financing, provision of low-income housing plus provision of clean energy and clean water as typical examples of impact investing at present. A more high-profile example of impact investing is in the Tesla electric car enterprise, where a number of US impact funds are invested.

The impact investing universe appears poised to expand dramatically from here on, however, as the United Nations seeks to fund its ambitious Sustainable Development Goals or SDGs on the one hand, and on the other, where institutional and individual investors (as well as official development institutions) seek to secure measurable social impact in addition to financial returns on their investments.

Because of its insistence on the need to achieve measurable social impact, impact investing is seen as being well suited to guide private savings into achieving social targets across a broad spectrum. This is vital if the UN targets are to be met, as collectively they could require \$2-3 trillion of private investment annually plus similar amounts of official funding.

As the Global Impact Investing Network (GIIN) puts it: “Impact investing challenges the view that social and environmental issues should be addressed only by philanthropic donations and government aid and that market investments should focus exclusively on financial returns. It has the potential to reshape the role of capital in society, demonstrating that social and economic progress can be made alongside financial returns.”

According to GIIN, impact investments are investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both

emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.

Impact investors include fund managers, development finance institutions, diversified financial institutions and banks, private foundations, pension funds and insurance companies, family offices and non-governmental organisations (NGOs), among others. Investments are not defined by their membership in an asset class but by the approach of the investor. They may be made into the full range of public and private assets, as long as the investor contributes to achieving impact.

Impact investing and ESG can together be seen as part of a sustainable investment “revolution”, which is essential if critical climate and environmental goals are to be achieved and threats to social instability avoided. The revolution will present huge challenges to global finances but also big opportunities for financial institutions to benefit from the changes involved.

SUSTAINABLE INVESTMENT – COSTS AND OPPORTUNITIES

The costs of transitioning to a sustainable, lower-carbon environment in line with SDGs was estimated by one Bank of England (BoE) official as up to \$90 trillion by way of new investment between now and 2030, equal to around one year of global GDP. Costs involved in writing off “stranded” assets (such as fossil fuel plants) alone could be up to \$4 trillion.

Many of these costs will be borne by corporate balance sheets or those of financial institutions. But while the costs will be very large the shift offers “substantial opportunities for the financial sector to develop new products and services to mainstream green finance,” as the BoE official put it.

So how big is the sustainable investment universe? Data are approximate but the International Finance Corporation (part of the World Bank Group) estimates that there is some \$280 trillion of private financial assets available in the world, of which \$80 trillion is managed by financial institutions that have signed up for the UN-supported Principles for Responsible Investment which seek to promote ESG principles.

This is a baseline figure of investors who are “committed to doing no harm” by their investments. Around one quarter of this (\$22 trillion) is in the hands of institutions that are “committed to doing good” by observing ESG standards which are directed across the entire spectrum of corporate investing.

By contrast, the impact investing market is still small relative to other forms of sustainable investment, at around \$1 trillion according to the IFC. But the World

Bank-related organisation believes impact investing is set to grow dramatically in coming years and that its size could grow to around one tenth of global financial assets or more than \$25 trillion over time.

The main focus of ESG investing has been on equity markets. In recent years, however, according to a joint report by the International Finance Corporation and Japan's Government Pension Investment Fund, ESG has spread increasingly to other asset classes, in particular fixed income, given that bonds constitute a substantial percentage of institutional investors' assets.

Different methods for applying ESG are being adopted by fixed-income investors: from purchasing 'labelled' (green, social, and/or sustainable) bonds and setting up or investing in ESG/SRI (Socially Responsible Investment) funds; to following ESG indices; to hiring ESG active managers; to incorporating and embedding ESG across the whole investment process.

The IFC reported in September 2019 that there had been a recent "surge" in sustainable debt issuance, taking it to record levels. Interest in sustainability-oriented financial products has never been stronger, with global issuance surpassing \$234 billion in the first eight months of 2019. Green bond issuance was particularly robust, amounting to over \$129 billion or some 60% higher than in the same period in 2018.



THE BROAD LANDSCAPE OF SUSTAINABLE INVESTMENT

An accelerating flow of private funds into various forms of “sustainable” investment, and those which have a positive impact on society and the environment, is evidence that capitalism is capable of going beyond the simple pursuit of profit. Sustainable investment has evolved over recent decades from being a form of philanthropy to becoming more of a science, as strategies have emerged to encourage good corporate governance with regard to environmental and social responsibility. More recently, private investment has begun to play a part in supporting officially-mandated development goals – again illustrating the flexibility of market systems. Critically, sustainable investment (and most specifically, “impact investment”) practices now recognise the need to make, according to The Global Impact Investing Network (GIIN), a “measurable contribution to the achievement of social and environmental goals, alongside a financial return.”

This marks an important step forward in the evolution of the sustainable investment spectrum. While philanthropic donations and aid from multilateral financial institutions have contributed greatly to achieving social and environmental goals, the resources of financial markets – equity markets in particular – have not generally been available for such purposes. Impact investment has the potential to become a key element of sustainable investment by virtue of the fact that its aims are aligned closely with those of the government sector, where resources are insufficient to meet sustainable targets such as those identified by the United Nations (UN).

This book provides an overview of the development of sustainable investment in its various forms but with particular reference to ESG (Environmental, Social and Governance) investing and to Impact Investing. It highlights the importance of the UN Sustainable Development Goals (SDGs) as markers of key areas into which sustainable investment needs to be directed.

The Introductory chapter examines the dimensions of the sustainable investment challenge, while Chapter 1 chronicles progress in making investment more sustainable for the longer term – both financially and socially. It also identifies some of the challenges and opportunities involved for investors, and looks at how the investment landscape is likely to develop as social and environmental goals assume increasing importance in the overall deployment of funds. An analysis is offered too of where the required resources might come from as SDGs and investment vehicles evolve at an increasing pace.

Chapter 2 examines the critical role that governments are playing - and will need to play increasingly in the future - in promoting sustainable investment and in helping to ensure that sufficient projects are available on the “demand side” to satisfy the appetite of sustainable investors in general and of Impact Investors in particular.

Chapter 3 offers a broad guide to the principal instruments that are available for sustainable forms of investment, while Chapter 4 reviews some of the key “players” and organisations that have developed to cater for the needs of various classes of sustainable investment. Chapter 5 looks at the impact that the evolution of sustainable investment is likely to have on the financial system as a whole, and why the system itself needs to adapt to the needs to sustainability.

Chapter 6 examines the role of Japan as an Asian leader in sustainable investment and looks at innovations by two principal Japanese asset management companies in the area of sustainable investment, as well as the role played by one leading private equity group in helping develop the concept of sustainable investment in a Japanese context. Chapter 7 looks at the developing Green Bond market with particular reference to sustainability issues and incentives in Asia and beyond, while Chapter 8 examines the development of Blended Social Finance in China. Chapter 9 focuses on Sri Lanka’s experience with Impact Investing, leading on to Chapter 10 which examines the development of Impact Investing in Asia with particular reference to Southeast and South Asia. Chapter 11 argues that corporate boards need to take the concept of sustainable investment fully “on board.” The concluding chapter suggests that while sustainable investment remains something of a “work in progress” in Asia and elsewhere, progress to date has been impressive and that investor interest should drive even more rapid progress in the future.

The need for sustainable investment applies in advanced and developing (or “emerging”) economies. Investment in both cases needs to focus on projects and forms of economic activity that are sustainable from an environmental and social point of view if wellbeing is to be maintained and improved. In the case of emerging

economies, finance also needs to be directed toward development ends, and this is the area where the challenge to sustainable investment is greatest. In this regard, there is a strong need to marshal private funds behind the UN SDGs if these are to be achieved in full and on time.

The International Finance Corporation (IFC) (part of the World Bank Group) estimates that there is some \$280 trillion of private financial assets available in the world, of which around \$80 trillion is managed by financial institutions that have signed up for the UN-supported Principles for Responsible Investment (PRI), which seek to promote sustainable investment. That is a baseline figure of investors who (in the words of one IFC official) are “committed to doing no harm” by their investments. Around one quarter of this (\$22 trillion) is in the hands of institutions that are “committed to doing good” by observing the ESG standards in their investment. So-called “impact investing” goes a stage further and requires that investments have a “measurable impact” (as well as producing a financial return). The impact investing market is still quite small relative to other forms of sustainable investment, at around \$1 trillion according to the IFC, but this World Bank arm believes that impact investment could grow to nearer \$25 trillion over time.

Sustainable investment philosophy and practice has so far taken hold chiefly in Europe and North America, but is rapidly gaining acceptance in Asia also, in Japan and China especially. Japan’s Government Pension Investment Fund (GPIF), for example, is pursuing an innovative joint initiative with the World Bank Group to render sustainable investment more accessible to fixed-income investors, in addition to the equity investors who currently dominate this asset class. China, meanwhile, has established a leading position in the so-called “Green” financing movement.

Avoid and advance
Sustainable investing styles

	Avoid	Advance		
	Screened	ESG	Thematic	Impact
Objective	Remove specific companies/industries associated with objectionable activities	Invest in companies based on ESG scores/ rating systems	Focus on particular E, S or G issues	Target specific non-financial outcomes along with financial returns
Key considerations	Definition of and financial impact of screens	ESG data sources; active risk taken	Broad versus specific exposures	Report on progress toward outcomes
Examples	Screening out producers of weapons, fossil fuels and/or tobacco	Optimized ESG benchmarks; active strategies overweighting strong ESG performers	Environmental focus (low carbon or renewable energy); social focus (diversity)	Specific green bond or renewable power mandates

Sources: BlackRock Investment Institute and BlackRock Sustainable Investing, December 2018.

With its huge surplus of savings over investment and consumption, Asia represents a major potential source of sustainable investment capital. But in Asia, as elsewhere, if the billions of dollars currently flowing into what are seen as socially desirable (or in some cases essential) forms of investment are to become the trillions needed to accomplish official development goals, then conduits for channeling such investment will need to be better developed. For example, the amount of assets under management (AUM) under impact investing is estimated to be only around 1% of those managed under somewhat looser ESG principles, which do not require a measurable contribution to social goals.

There is no shortage of resources in the global financial system to enable larger sums of money to be channeled into economic and social development goals and into sustainable investment generally. Furthermore, there is a growing willingness on the part of institutional and individual investors to reorient their priorities in order to achieve such goals. However, at present the chief agencies practising sustainable investment (in terms of investment value) are multilateral development institutions and private equity firms that have the resources to select and monitor large-scale investments. Public equity and bond market financing play a significantly smaller role.

This balance needs to change if the huge amounts of savings held by institutional investors, such as pension funds and insurance companies, are to flow more liberally into financing the SDGs set by the UN in 2016. Private savings are helping to promote environmental and social sustainability through investment in individual companies that pursue appropriate policies, but there is arguably a need for more purpose-built vehicles to channel funds from institutional and retail investors into identified development goals.

Increasingly, the drive to promote sustainable investment is being viewed as the combined responsibility of financial fiduciaries (banks as well as asset holders and managers), corporate sector management, governments and regulatory agencies. BlackRock group chief executive Larry Fink made headlines in a 2018 message to CEOs, in which he suggested that society expects companies to serve a social purpose, and that it is a firm's fiduciary duty to encourage this by engaging with asset managers over those goals and the firm's longer term prospects.

Progress is being made in bringing what is still in some ways the rather fuzzy universe of sustainable investment into sharper focus. The final report of the UN Environment Inquiry into the Design of a Sustainable Financial System published in April 2018 noted that “huge progress on reforming the global financial system

over the last four years has started to deliver desperately needed financing for sustainability and setting up the next wave of action. Reform of the global financial system has gathered pace as banks, investors and regulators realise they must step up – not only to protect people and the planet, but their bottom lines also.”

The UN report cautioned, however, that current financial flows are still nowhere near enough to deliver the trillions of dollars needed each year to finance the UN SDGs and the Paris Agreement on Climate Change. As the Institute of International Finance (IIF), a trade body of the world’s biggest banks and other financial institutions headquartered in Washington, has put it: “There is a clear and urgent imperative to scale up and mainstream sustainable finance.”

No form of investment is truly sustainable of course, unless the physical and financial environment in which it takes place is also sustainable for the longer term. This realisation is increasingly influencing government, corporate and capital market behaviour as concerns rise over everything from climate change and environmental degradation to social income inequalities and the threats these pose to future stability.

The term “Sustainable Investing” (SI) lends itself to many interpretations and has assumed a variety of forms, including “Responsible Investing” or RI, and “Socially Responsible Investing” or SRI (which are often used interchangeably in capital markets), and “Thematic Investing” among others. Other classifications include “Green Investing” and “Social, Ethical and Religious” investing. The two most widely accepted forms of sustainable investment, however, are “ESG Investing”, and “Impact Investing” which, as noted, aims to promote measurable social objectives along with achieving acceptable financial returns.

One area of sustainable finance that has experienced dramatic growth in recent years is investing in publicly listed corporations based on ESG factors. In the United States, total AUM under ESG strategies have grown almost four-fold in eight years, from around \$3 trillion in 2010 to \$11.6 trillion in 2018, representing \$1 out of every \$4 currently invested with professional asset managers. According to BlackRock, the world’s largest asset manager, the global market for ESG exchange-traded funds (ETFs) alone is expected to expand from \$25 billion to more than \$400 billion within a decade.

Amid warnings from policymakers to firms that fail to adapt to climate change, the financial services industry and the broader corporate sector are pursuing a raft of measures in response to the looming climate crisis, the Washington-based IIF commented in August 2019.

While pockets of resistance remain – with some still viewing ESG considerations

as a niche set of issues – the shift in mindset has been striking in recent years. This change is partly in response to strong demand for ESG investments – reflected in exponential growth in the universe of ESG financial products, which are increasingly mainstream.” As a consequence, the global corporate sector is rapidly integrating sustainable finance into governance, strategy, and risk management frameworks as they seek to manage climate-related risks and opportunities.”

Some estimates suggest that flows of private portfolio investment into sustainable investment already amount to trillions of dollars. “Global sustainable investment assets have reached \$30.7 trillion,” the Global Sustainable Investment Alliance (GSIA) reported in April 2019. However, this is a liberal definition of what constitutes active sustainable investment. Just under two thirds (\$20 trillion) of the \$30.7 trillion total investment was in enterprises selected by what are known as “negative exclusionary screening” methods – meaning that the enterprises concerned are not engaged in “undesirable” activities such as oil extraction, coal mining, weapons manufacture, or tobacco and alcohol production and gambling, rather than in pursuing activities judged to be desirable from a social, environmental and governance perspective.

By this broad definition, sustainable investment commands a sizeable share of professionally managed assets in each region of the world, ranging from 18% in Japan to 63% in Australia and New Zealand, according to the GSIA. Again, under this definition, Europe accounts for the largest pool of sustainable investment, with \$14.1 trillion in AUM, followed by the United States with \$12.0 trillion. Using inclusive screening techniques that rank investments by their positive contribution to social and environmental goals, the amounts of money flowing into sustainable investment are more modest at around \$10 trillion.

The apparent discrepancy in figures relating to sustainable investment reflects in part the fact that defining such investment is far from being an exact science (that and the fact that many different organisations seek to measure sustainable investment). The IFC data referred to at the outset in this chapter provide perhaps one of the most consistent among the different pictures, especially with regard to impact investing (which the IFC claims to have been practising continuously for the 60 years of its existence). What is undisputed is the fact that sustainable investment in its various forms is continuing to grow in a way that suggests it will become a dominant part of the overall investment spectrum over time.

EVOLUTION OF SUSTAINABLE INVESTING

Sustainable investment in its various forms has quite a long history, which can be

traced back to the 1960s and even earlier when socially responsible investment (SRI) emerged as (to quote the IFC) a “set of asset management strategies, in part to meet demand from religious institutions with large endowments.” What has been achieved since then reflects in part enlightened self-interest on the part of a global investment community which is coming to realise that if growth, development and quality of life are to be sustained and improved, investment must be directed into sustainable economic activity. It accepts that “business as usual” is no longer an option, and that capitalism cannot survive unless it widens its social horizons.

Over the past ten years, people have “pivoted to more proactive approaches” in the words of one executive of Partners Group, a leading private equity firm headquartered in Switzerland. Nowadays “it is not just about screening out companies, but it is more about improving the practices of companies. This is where you have this next step which is about ‘ESG integration,’ or evaluating companies, not merely by their financial metrics but also on certain environmental or social metrics.”

ESG INVESTING

A landmark development in codifying the elements of sustainable investment came in 2004 when former UN Secretary General Kofi Annan wrote to chief executives at 50 of the world’s leading financial institutions, inviting them to join a Global Compact that would require the integration of ESG factors into capital markets and investment practices.

The Global Compact required signatory financial institutions to accept a degree of responsibility for all three elements of ESG. Investors should evaluate companies using ESG criteria, as a framework to screen investments or to assess risks in investment decision-making. Environmental factors determine a company’s stewardship of environment and focus on waste and pollution, resource depletion, greenhouse gas emissions, deforestation, and climate change. Social factors look at how a company treats people, and focuses on employee relations and diversity, working conditions, local communities, health and safety, and conflict. Governance factors take into account corporate policies and how a company is governed. They focus on tax strategy, executive remuneration, donations and political lobbying, corruption and bribery, and board diversity and structure.

Since 2004, rating agencies such as S&P Dow Jones Indices have taken a lead in producing stock indices that are aligned with ESG selection guidelines, allowing institutional investors and fund managers to buy into a basket of stocks in companies that have been pre-screened for their ESG factor compatibility. The S&P 500

ESG Index for example is a slimmed-down version of the standard S&P 500 index containing more than 300 of the stocks in that standard index. At the same time that S&P introduced this index in April 2019, it announced a new “scoring system to determine ESG-compliant stocks (as calculated by SAM, a unit of Robeco SAM which specialises in providing ESG data, ratings and benchmarking).”

The S&P Dow Jones ESG Index splits sustainability into two categories: ESG, and green or low carbon. The ESG framework of investing tends to capture more factors, while green is more focused. Environmental factors include waste management, water management, environmental resource use, environmental disclosure, environmental impact, and reduction of pollution and emissions. Social factors include stakeholder analysis, workplace mentality, human rights, diversity community relationships, corporate citizenship, and philanthropy. Governance factors include board structure, management compensation, stakeholder impact, stakeholder rights, and the relationship between management and stakeholders.

Such screening and scoring systems are expected to aid the adoption of ESG strategies. The huge growth of “passive investment” strategies in recent years, especially in Exchange Traded Funds or ETFs, along with a growing consciousness among retail investors of environmental and social concerns, implies a rapid rise in demand for ESG-compliant investments. As one S&P executive put it, “the retail market in particular is developing rapidly to meet growing ESG and ‘impact investment’ demands, and that is exemplified by the growth of ETFs in the United States. There is a huge amount of attraction for the retail market to get involved, and our role as an index provider is to supply the market with a range of solutions to decide that objective.” UBS Asset Management has announced plans to launch a new ETF based on the S&P ESG index.

Kofi Annan’s call for increased consciousness among investors of ESG factors was followed in 2005 by the adoption of the UN PRI drawn up by the UN Environment Programme and the UN Global Compact as a framework for improving the analysis of ESG issues. By 2018, the PRI agreement had attracted 2,100 signatories, representing \$80 trillion of AUM. These six “PRI” are described as a “voluntary and aspirational” set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. “Signatories have agreed that while finance fuels the global economy, investment decision making does not sufficiently reflect environmental, social and corporate governance considerations or the tenets of sustainable development.”

Specifically, the signatories to the PRI undertook to incorporate ESG issues

into investment analysis and decision making, to become “active owners,” and to incorporate ESG issues into ownership policies and practices. They agreed to seek appropriate disclosure on ESG issues by the entities in which they invest, to promote acceptance and implementation of ESG, to jointly enhance effectiveness in implementing the Principles, and to report on their activities and progress.

Even so, implementing ESG remains a challenge, as acknowledged, for example in a report by BlackRock in February 2019. “The industry faces a lot of questions about what ESG integration means in practice for asset owners, asset managers and insurers,” the report said. “There is no one standard definition or approach. Some define ESG integration as adding ESG metrics to investment analysis. Others claim ESG integration occurs at the strategy levels. The breadth of industry definitions is stoking confusion.”

Even so, the support now for socially sustainable investment and for good governance evidenced by such instruments as the PRI marks a dramatic shift from the prevailing ethos in the 1970s when Nobel prize-winning economist and doyen of the Chicago School of Economics Milton Friedman argued that concern for social responsibility can adversely affect a company’s financial performance. He claimed that the valuation of a company or asset should be based almost entirely on the financial “bottom line,” and not on issues of social responsibility. Friedman was, however, an advocate of making money “ethically”, and in that sense of good corporate governance. He also argued that companies pay taxes (in the process of maximising shareholder wealth) and that governments should take care of society.

The Friedmanite view was in effect refuted in August 2019 when the US Business Roundtable, one of the biggest and most influential business groups in America, abandoned what the *Financial Times* called the “shareholder primacy” creed that has long underpinned capitalism, and placed shareholders among five categories of stakeholders alongside customers, employees, suppliers and communities in a new “statement of purpose.”

The Global Financial Crisis of 2008-09 helped to bring about a recognition of the need for more sustainable financial systems, as well as for investment in companies and projects that are sustainable from an environmental and social perspective. As one official of the UNPRI expressed it: “Some of the advances in the financial market really came about after the Global Financial Crisis, when a lot of the people just thought there had to be a better way to invest because what we are doing is not working.”

Yet even in 2018, when the UN published the results of its inquiry into the need

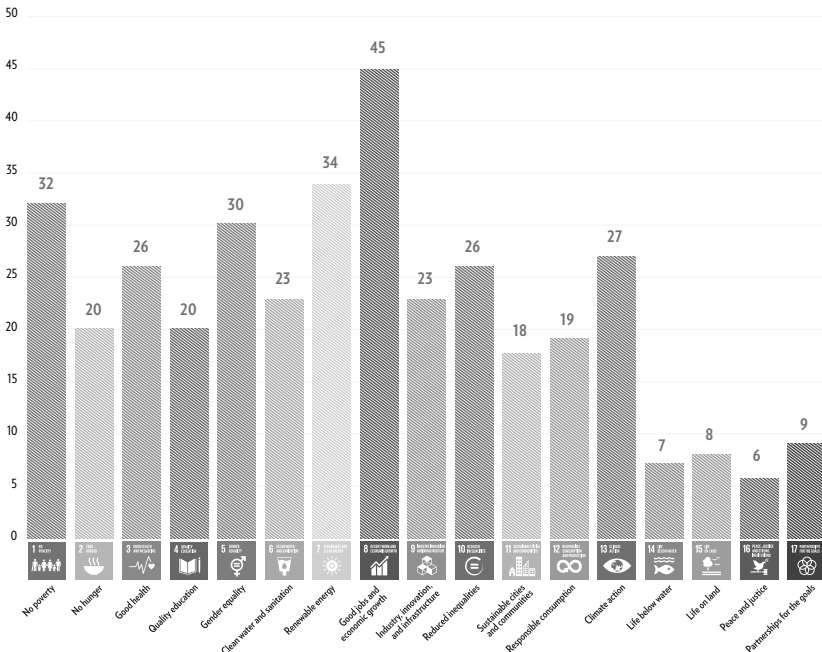
for a desirable financial system, it noted that at the start of inquiry four years earlier “most of the initiatives now underway to accelerate sustainable finance, whether by central banks, pension funds, credit rating agencies or insurance companies would have been unthinkable.” This, it suggested, “should us give us confidence that we can achieve alignment of the financial system with sustainable development.”

ADVENT OF THE UN SDGs

The responsibilities facing financial markets and corporate entities with regard to sustainable investment were brought into sharper focus in 2016 with the promulgation of the UN SDGs. At that time, UN members agreed on specific areas into which investment needed to flow if economic welfare and social stability were to be maintained, and improved, if environmental degradation was to be halted. These targets were enshrined in 17 goals with the broad aim of ending poverty, ensuring prosperity and protecting the planet. They represented, in the words of the UN Development Programme (UNDP) a “universal call to action to end poverty, protect the planet, and ensure that all people enjoy peace and prosperity.” The goals built on the successes of the earlier [UN] Millennium Development Goals (MDGs), but

SDGS TO WHICH IMPACT INVESTORS TRACK THEIR PERFORMANCE

n=55; respondents could select multiple options. Number of respondents selecting each option shown above each bar.



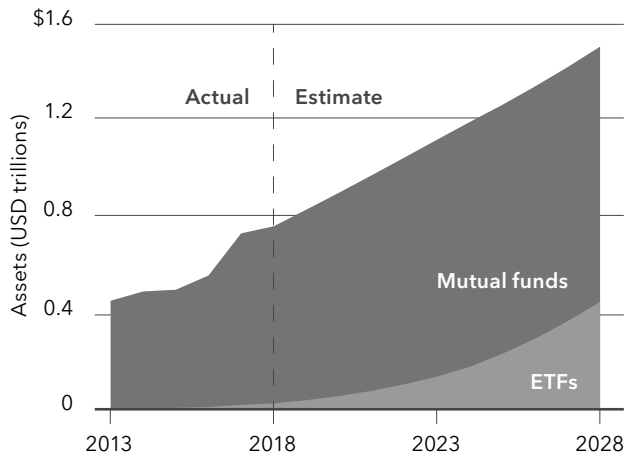
Source: GIIN

were widened to include new areas, such as climate change, economic inequality, innovation, sustainable consumption, peace and justice. The broader theme of the SDGs is “leaving no one behind.” Unlike the MDGs, which applied only to developing countries, the SDGs apply to all countries.

Achieving such lofty aims through the provision of “public goods,” such as infrastructure, health and welfare services, education and environmental protection is usually considered to be the business of governments rather than private investors. The UN has suggested, however, that governments will be unable to supply more than around one half of the \$5 trillion of annual spending that it is estimated the SDGs will require in the period up to 2030. This means that if the goals are to be met, the other half of the required financial resources (some \$2.5 trillion annually) must come chiefly from private capital markets and donors. The projected shortfall in governments’ ability to fund the cost of the SDGs in full reflects in part the fact that (according to the Brookings Institute) in 2018 only five OECD countries met the commitment to deliver 0.7% of gross national income in aid. If all high-income countries made good on this pledge it would add around \$200 billion to development finance. This in turn would help greatly to finance gaps in the ability of

Sustainable swell

Assets of sustainable mutual funds and ETFs, 2013–2028



There's no guarantee that forward-looking estimates will come to pass.

Sources: BlackRock, with data from Broadridge/Simfund, June 2018. Notes: The chart shows the total assets under management in ESG mutual funds (MFs) and ETFs globally. The 2019 to 2028 figures are based on BlackRock estimates, assuming a 5% annual growth rate in the underlying markets. Other assumptions: MF asset growth starts at 5% in 2019 and declines by 0.5% annually through 2022, then at a zero-to-0.5% rate annually thereafter. ETF asset growth starts at 45% and decreases by 5% annually through 2022, with a zero-to-3% pace thereafter.

those countries in greatest need to fund their SDG targets.

How to attract the required sums into investments capable of yielding an acceptable financial return while also serving wider social objectives is a critical challenge. Its dimensions were identified by another arm of the UN – the UN Conference on Trade and Development (UNCTAD) – in its World Investment Report of 2014. This set out a plan for promoting private sector contributions to the SDGs by means of investment in sustainable development, and concern for good corporate governance.

The SDGs, this report said, would have “significant resource implications across the developed and developing world. Achieving the goals would require a “step-change in both public and private investment.” Only a fraction of the worldwide invested assets of banks, pension funds, insurers, foundations and endowments, as well as transnational corporations, are in SDG sectors, and even less in developing countries, it noted, while adding that business decisions “are driven by calculations of economic risks and returns often ignoring broader social and environmental impacts.”

There has been a significant shift in investment attitudes since that report appeared, but while there is now greater consciousness of the need for investment to be sustainable, this has yet to translate fully into the adoption of specific goals for private investment, or the creation of mechanisms and vehicles that will allow this to happen. SDG-related investment is “still in its infancy,” in the words of a joint report by the World Bank Group and Japan’s GPIF in April 2018. The UN SDGs, as this report observed, “were not primarily made for investors but achievement of the Goals recognises the necessary contribution of all, including the private sector and [private] investors.”

In the end, the SDGs are “geared toward governments,” as one industry executive put it. These are “government-level targets,” which raises the question of how do investors and companies put themselves in a position to contribute to official goals? A limited number of investment vehicles aimed at channeling private investment into the SDG targets have appeared since 2016, one being the Partners Group “PG Life” fund, which focuses specifically on the SDGs. It has a “dual mandate to achieve competitive risk-adjusted financial returns alongside measurable, positive social and environmental impact.” The fund focuses especially on those SDGs related to healthcare, education and clean energy. Partners Group claims to use rigorous checks to ensure that the fund’s investments “deliver meaningful environmental and social impact returns.”

IMPACT INVESTING – A ‘WITH PROFITS’ APPROACH TO SUSTAINABLE INVESTING

A wider linkage between officially identified development goals and private capital has emerged with the growth of impact investing, which seeks to combine social and environmental benefits with a measurable financial return. This should help institutional investors and investment managers to meet financial fiduciary obligations while also paying heed to wider social obligations. There are hopes that impact investing will serve alongside public finance as a means to finance the UN SDGs. Impact investing could appeal to a wide range of investors by virtue of its emphasis on financial as well as social returns, and is sometimes known as “double bottom line” investing because of these twin objectives.

Impact investment is a term that is used for an expanding segment of the investment universe. The original use of impact investing was by those who focused on the impact of a specific investment. “For instance, they put money into a project with certain environmental or social goals,” as one industry practitioner put it. “Now increasingly the term is also associated with investors who put their money into all kind of things and who want to explore what the impact of those investments are, maybe not as a primary goal but as a secondary goal beyond the financial returns. Depending on which of these objectives they focus on, there are very different kinds of methodology or approaches under the umbrella of impact investment.”

It is probably unreasonable to expect absolute definitional precision in an area such as impact investing which is still relatively new and where “impact” is subject to interpretational differences. The “Operating Principles for Impact Investing” published by the IFC do, however, go some way towards providing an accepted framework in which impact investors can operate.

Impact investing, according to one IFC official, is “gaining support because on the one hand you have more and more investors who see that these types of environmental and social issues do have effects in the financial performance of companies and therefore need to be accounted for. On the other hand, you have a growing segment of investors who are saying that these issues have importance in their own right, regardless of whether they have an impact on financial returns. This is especially the case for young, private wealth owners. They are people who inherit money and place emphasis on sustainability. They are big. You have individuals, pension funds and foundations who are increasingly saying we need to align how we invest our capital with our foundation goals. Until recently, foundations were investing their capital without regard to these issues.”

At present, the main impact investing markets are in North America and Northern Europe where impact investing or “II” is used to finance projects such as affordable housing, renewable energy and others that encourage financial and social inclusion. Some of the biggest investors in US electric vehicle manufacturer Tesla are impact investors who see the development of electric cars as being good for the climate. However, the chief future growth potential for impact investing is perceived to be in developing and emerging economies, where it can be used as a means to help achieve the SDGs.

The term impact investing originated in 2007 when a group of investors met at the Rockefeller Foundation’s Bellagio Centre on Lake Como in Italy to discuss new forms of investment to achieve social or environmental impact. Since then, the size of the impact investing market has grown to just over \$500 billion according to a survey of 1,300 impact investors published in April 2019 by the GIIN, a non-profit organisation of professional investors. These included asset managers, foundations, banks, development finance institutions, family offices, pension funds, insurance companies and others. The size of the market is subject to varying interpretations however, according to how it is measured.

Impact investments target a range of returns from below-market to market rate, depending upon investors’ strategic goals. The impact investing market, according to the GIIN, “provides capital to address the world’s most pressing challenges in sectors such as renewable energy, conservation, sustainable agriculture, affordable and accessible basic services including housing, healthcare and education. It is applicable to many asset classes including private equity and venture capital, debt, and fixed income securities.”

According to the GIIN, growing numbers of investors are incorporating impact investments into their portfolios and many are adopting the SDGs and other widely recognised goals such as those in the COP21 on climate change as a reference point to illustrate the relationship between their investments and impact goals. Not all investors are able to switch the emphasis of their portfolios to impact investing, however. Japan’s GPIF (the biggest in Japan and in the world), for example, says that its mandate does not allow it to become involved in corporate management to the degree that impact investing would involve. The GPIF does, however, require investment managers who are given mandates to manage its portfolios to adhere to ESG principles.

The IFC has emerged as a key player in promoting impact investing and its own portfolio investments in the developing world over the past 60 years. Returns on the

IFC portfolio over its lifetime have been comparable with commercial returns, it is claimed. The European Investment Bank, along with some 25 other development finance institutions (including the IFC), are major players in the impact investing market. According to the IFC, governments now hold some \$3.8 trillion of impact investment via the private investment portfolios of their development finance institutions.

Public institutions are nevertheless dominant players in the world of impact investing and, some argue, are best able to exercise the function of monitoring the impact of the enterprises they invest in. Yet institutions, individually or collectively, do not have the financial wherewithal to fund the aims of the UN SDGs, whereas private institutional investors and households collectively control much larger financial resources. These resources, argues the IFC, could provide within a period of seven years the financial resources (some \$21 trillion) needed to fund the cost of achieving the SDGs in developing economies as a whole.

THE PRINCIPLES FOR IMPACT MANAGEMENT

Getting impact investing accepted and adopted beyond the realm of official institutions is proving to be a challenge. Despite the increased number of product launches claiming to be impact investments, there is, as the IFC for one acknowledges, no common discipline for how to manage investments for impact and the systems needed to support this.

The Impact Management Project (IMP), a forum for building global consensus on how to measure and manage impact, was launched in 2016 and now convenes a Practitioner Community of over 2,000 organisations ranging from leading institutional investors to aid agencies, to debate and seek consensus on technical topics and to share best practices. It also facilitates the IMP Structured Network – which according to the IMP website, is “an unprecedented collaboration of organisations that, through their specific and complementary expertise, are coordinating efforts to provide complete standards for impact measurement and management.”

The IFC, meanwhile, together with a group of other associations has developed a set of draft Operating Principles for Impact Management. The objective, as stated on the initiative’s website, is to “establish a common discipline and market consensus around the management of investments for impact and help shape and develop this nascent market.” The principles facilitate this process by “creating clarity and consistency about what constitutes impact investment, so as to bolster confidence in the market. They draw upon the experience of leading development finance

institutions in emerging markets in order to achieve strong development impact and financial returns.”

The 60 organisations adopting the Principles today collectively hold at least \$350 billion in assets invested for impact, which they commit to manage in accordance with the Principles. The IFC estimates that investor appetite for impact investment could eventually amount to close on \$25 trillion. This includes \$5 trillion in private markets involving private equity, non-sovereign debt, and venture capital, and as much as \$20 trillion in publicly traded stocks and bonds.

As of today, however, estimates put the size of the impact investment market at around \$1 trillion. By any measure, it is still small in absolute terms, and relative to the total size of global financial assets and capital flows it is minute. According to the IFC, some \$270 trillion of financial assets (equal to more than three times annual global GDP) are held by financial institutions and households around the world and are potentially available for investment. If just 10% of this amount were to be channeled into investments focused on improving social and environmental outcomes, that would go a long way toward providing the funding necessary to achieve the SDGs.

As of now the key point “is that the financial services industry is not yet providing impact investing opportunities at sufficient scale to meet investor appetite,” as one IFC official put it. “Most investors want to put their money into funds or other wholesale structures, not into individual companies. There are various impact investment and SDG funds being launched to meet the needs of institutional investors who can make use of co-financing platforms offered by the IFC and other Development Finance Institutions and which enable them to invest at scale. But the size of the sustainable investment universe in general and of the impact investing segment in particular needs to grow.”

Of the estimated \$240 trillion of global assets held by savers and investors, around one third or \$80 trillion is managed by institutions that have signed up for the UN PRI, according to the IFC. But most of this is in relatively passive or “do no harm” (in terms of social and environmental impact) types of investment. Only around \$20 trillion is in more active ESG-integrated types of investment. A much smaller proportion still is in impact investment, but increasing interest in this type of investment with its promise of financial (as well as social) returns promises to attract far bigger volumes in future, especially in emerging markets. Currently, institutional investors as a whole have only around 5% of their global portfolios in emerging markets, according to the IFC, which claims that financial returns on its

own emerging market impact investments over the space of six decades have been comparable with commercial returns.

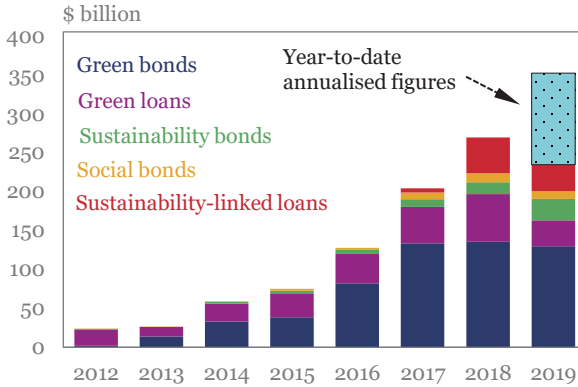
SUSTAINABLE INVESTMENT AND THE FIXED-INCOME UNIVERSE

Issuance of green bonds (defined as fixed income securities that raise capital in support of projects or activities with specific climate or environmental sustainability purposes) has jumped in recent years, rising (according to Bloomberg/World Bank data) from around \$10 billion in 2003 to over \$160 billion in 2017. The bulk of such issues has been made by government and municipal agencies (more than one third), followed by business corporations and banks and then energy and utility companies. As of 2017, China was by far the biggest single issuer of green bonds at around \$32 billion, followed by France at \$20 billion and then by a series of mainly European countries. Overall demand for green bonds continues to outstrip supply.

Yet while the green bond movement has attracted much interest as a means of achieving sustainable investment, by far the majority of such investment is in the form of equity investment rather than fixed income investment. The green bond market is still tiny as a proportion – around 0.5% or \$450 billion – of the \$90 trillion in outstanding value of all bonds globally, according to the World Bank Group, while other types of “labelled” bonds, such as Social Bonds and SDG Bonds, represent an even smaller proportion of the value of the global bond market. All this remains very small too in relation to estimates that put the size of equity and equity type instruments in sustainable investments as a whole at something over \$30 trillion.

Joint research by the World Bank and Japan’s GPIF concluded that “incorporating ESG into fixed income investing should be part of overall credit risk analysis and should contribute to more stable financial returns.” ESG investing, as the study notes, is “increasingly becoming part of the mainstream investment process for fixed income investors as opposed to the specialist segregated activity often confined to green bonds.” Leading investors are viewing ESG not only as an aspect of risk and return but also merging ESG and impact investing. This includes measuring the impact of their portfolios on targeted environmental and social outcomes and beyond, such as using the SDGs.

Even so, fixed income investors face particular challenges in building sustainable investment portfolios. The joint report acknowledged, “There are still no standard definitions of ESG, especially in the social area.” Though improving and coming from increasingly varied sources, data is still wanting, particularly in emerging markets.

Sustainable debt issuance boom in 2019

Source: Bloomberg, Bloomberg NEF, IIF

The report also cited issues such as the limited choice of fixed income ESG indices compared to the equity space, plus a dearth of specifically ESG-focused products.

There is ongoing discussion, meanwhile, about the definition of green bonds with “issuers increasingly stretching the boundaries of what qualifies as green or social investing,” to quote the World Bank/GPIF report. There are concerns about “greenwashing”, whereby the proceeds of so-called green bond issues are used only peripherally for such environmental purposes. Related to this is the difficulty on the part of investors and also issuers in some cases in monitoring green activities. The market is still “immature and relatively small”, in the words of the report, although it is perceived as having great potential for growth, given the dimensions of climate change and other environmental challenges.

ROLE OF OFFICIAL AGENCIES IN SUSTAINABLE INVESTMENT

Central banks and financial regulators are increasingly seeing the sustainable investment sphere as being part of their regulatory responsibility. “More and more of them are saying that this is within our mandate,” according to Alex Barkawi, founder and director of the Council on Economic Policies (CEP), an economic policy think tank. Sustainability in the environmental and social sense is linked inextricably to financial stability which is at the centre of the central banking remit. In addition, under so called quantitative and monetary easing policies, central banks are injecting huge sums of money into purchases of financial assets such as stocks and bonds (as well as infrastructure and other alternative assets) and are thus in a position to exercise indirect influence on sustainable investment choices. The Governor of the

Bank of England, Mark Carney, is thinking about including climate-related stress tests under the stress testing of banks in the future.

Securities and market regulators will also be intimately involved with sustainable investment issues, and in June 2019 the International Organization of Securities Commissions (IOSCO) published a report in which the 34 global securities regulators set out recommendations for the development of sustainable finance in emerging markets and the role of securities regulators. The report prescribed conditions for “creating an ecosystem that facilitates sustainable finance, such as an appropriate regulatory framework and market infrastructure, reporting and disclosure requirements, governance and investor protection guidelines and mechanisms to address the needs and requirements of institutional investors.”

BANKS AND SUSTAINABLE INVESTMENT

European banks in particular are acknowledged to be among the leaders in promoting sustainable investment in its different forms. The European Banking Federation (EBF), which represents 32 banking associations and 3,500 banks that together finance around 80% of the economy in Europe, has declared that “the financial sector needs to throw its full weight behind the fight against climate change.” This is a challenge, but also an exceptional opportunity. In the next few years, Europe’s banks and financial institutions have a chance to drive global developments in sustainable finance. By moving to an economy based around low-carbon technology and resource-efficiency, [they] can boost job creation, productivity, and the well-being of our people,” the EBF has declared.

European banks claim to be at the forefront of the transition to a low-carbon economy, as well as supporting the UN SDGs. Through individual and collective action in international and regional fora, they claim to have shown “visionary leadership in tackling the urgent and paramount challenge of climate change.” They see banking activities as being “critical for transitioning to a low-carbon economy” and to achieving other social objectives by virtue of being lenders to companies and households, issuers of bonds in their own name (which generates sources of financing for lending to companies and households), underwriters of corporate bonds, financial advisors and asset managers.

SUSTAINABLE INVESTMENT – THE VIEW FROM THE BOARDROOM

Sustainable investing cannot be said to have truly taken root unless and until the concept has been fully accepted in corporate boardrooms, and until it becomes clear

that directors are taking a lead in creating sustainable strategies or whether they need to be nudged or pushed in that direction.

A growing number of companies are integrating ESG factors into their business strategies and “there are some exceptional companies that are actually ahead of the curve when it comes to the development of sustainability,” one official at the UN PRI headquarters in London noted. But “most boards are [still] thinking about their financial obligations to shareholders and the returns. They need to think about their shareholders but [also about] other stakeholders. They need to think about their employees, the community that they work in, and about society more broadly.”

There are increasing numbers of people now at the corporate CEO level who understand the “vision, purpose and mission values of sustainable investment,” an executive of private equity specialist Partners Group suggests. Impact investing, with its emphasis on achieving measurable social (as well as financial) return on investment, promises to focus the minds of company directors and managers on critical aspects of ESG investment, although one official at the IFC suggests that impact investing will not so much change corporate behaviour as change patterns of investment according to the perceived commitment of companies to social, environmental and governance factors.

ROLE OF GOVERNMENT IN PROMOTING SUSTAINABLE INVESTMENTS

The rapidly growing focus on sustainable investment (SI) the world over, and particularly in the Asia Pacific region, requires greater collaboration and partnership with governments to build effective institutions and foundations. Governments have a prima facie reason to encourage sustainable investment, as it helps mobilise additional funds for addressing social issues and meeting SDGs that government alone cannot fund or manage. When private sector investments are mobilised into addressing sustainability challenges, it brings with it the disciplines of innovation, analytical rigour and implementation that could see solutions beyond the usual vantage point of government. General public policies, however, to a great extent influence the success, or not, of SI initiatives¹. Government influences SI in a myriad of ways – through regulation and facilitation, and the provision of fiscal incentives, to support development of a sustainable investment ecosystem which can develop, enforce and implement standards for impact measurement, and recognise impact achievers. This chapter explores these factors in detail and provides a framework for governments to systematically foster impact and sustainable investment in their countries through targeted measures and interventions.

REGULATION, FACILITATION AND HIGH LEVEL POLICY SUPPORT

Government regulation to promote impact-related investments largely looks to achieve two objectives: (i) to prepare a conducive environment for private funds to be channelled into impact-generating investments; and (ii) to specify the necessary boundaries to those activities. The Governments can also play a strong facilitation role – particularly relevant in underdeveloped markets – to promulgate sustainable investment and enhance awareness of it.

¹ Particularly the impact aspects.

The earliest and widely discussed examples of direct government-led regulations and directives to enforce impact focused investments came from the US. The US Community Reinvestment Act (CRA) of 1977 was passed to restrict banking discrimination in low- to moderate-income areas. In 2015, a landmark directive issued by the US Department of Labor reaffirmed the previous proviso (1994) that private pension plans subject to the Employment Retirement Income Security Act of 1974 (ERISA) could take social factors into account when making investments, as long as returns were not compromised². Moreover, in September 2015, the United States Inland Revenue Service (IRS) issued new guidance for foundations' mission-related investments. Under the old rules, foundations were concerned that they would suffer tax penalties for making impact investments, especially those that produced returns below-market rates. However, under the guidance issued, foundations were free to undertake impact investments – with no tax penalties – even if investments yielded below-par returns, on the condition that those investments had close tie-in with the foundation's missions.

Since 2015, the Chinese government has adopted a number of measures to encourage the country's transition towards a green economy. First, it launched guidelines for setting up a Green Financial System – laying out the road map for China's green transition and establishing a regulatory framework. This was followed by the setting up of Green Finance pilot zones in China, and the opening up of the country's green bond market.

There are several examples in the Asia Pacific region which have government-mandated credit 'quotas' for priority and selected sectors by banks and financial institutions (referred to as 'directed lending'). The Reserve Bank of India (RBI) stipulates that 40% of credit allocation for both domestic and foreign commercial banks should be targeted towards what it calls Priority Sector Lending (PSL) – covering agriculture, MSMEs (micro-, small- and medium-sized enterprises), education, housing, social infrastructure and renewable energy. The Bank of Bhutan (BOB) has adopted a similar stance for direct lending to cottage and small industries (CSI), which is seen as a priority sector. The State Bank of Pakistan and the Central Bank of Sri Lanka have enforced similar policies. There are several arguments for and against state-enforced directed credit, including whether it actually meets objectives and has the desired impact. In many countries, directed lending has helped financial inclusion and reduced the reliance of the vulnerable and needy on informal credit.

²This was somewhat undermined by a regulation in 2008 that made investors think twice about impact investments.

Whilst it has helped to reduce poverty, the flipside has been that directed lending in some cases has led to the pile-up of delinquent assets in the banking system, undermining financial sector stability.

Governments also have a role in advocating and promoting policy in relation to impact investment. In many countries – particularly in the Asia Pacific region – the understanding of impact investing is rather weak, and government-led impact investing network could provide a backbone for effective policy formulation and enhanced awareness. In 2013, the UK government took initiatives to establish a social impact investment task force for social investments and place it in the G8 agenda. The GSG initiatives to set up National Advisory Boards (NABs) for impact investments started in 2015, and recently the UNDP began work to establish National Networks for SDG Financing (NNSF). While the former does not insist on government leadership and ownership, the latter does, as it is more targeted towards a wider framework for SDG financing and is not limited to impact investment (as in the case of NABs).

FISCAL INCENTIVES

This could be thought of as the most potent support that government could provide to promote impact investment. Fiscal incentives could take myriad forms, such as tax concessions for sustainable investments and investment funds, direct government investments in impact funds (or similar) and underwriting investments through provision of first-loss reserve buffers and guarantees. Many such fiscal incentives have been used in countries in the past, and other more innovative means are likely to evolve in the future.

Tax concessions usually take the form of tax credits (also known as tax expenditure) which provide allowances for impact targeted investments. Examples of government tax incentives for impact investment are manifold: the US government Low-Income Housing Tax Credit (LIHTC), instituted in 1986, was perhaps one of the earliest examples that helped to channel private sector investment into affordable housing. The Solar Investment Tax Credit (SITC) introduced in 2006 was a significant federal fiscal policy measure introduced to spur growth of solar (renewable) energy in the US. This was instrumental in instigating a wide expansion in solar power energy generation in the country³. More recent examples from the Asia Pacific region include initiatives in Shenzhen in southern China, where the

³ A production tax credit (PTC) introduced in 2014 provides similar support for the generation of wind energy.

government has established a range of incentives for fund managers to launch impact-oriented funds (including providing concessional capital for their funds), and in Hong Kong and Singapore, where the governments provide incentives for the issuance of green bonds by absorbing the cost to issuers associated with bond certification. In Thailand, the government offers tax incentives for investing in government-certified social enterprises.

Tax concessions, however, do raise a number of questions. Firstly, on targeting – and the question of whether investments in sectors would have happened anyway if there were no fiscal incentives, and whether means of support into areas such as affordable housing and clean energy could have been performed better directly by the government. In the modern context of fiscal dynamics, government would like to see some element of ‘payoff’ from providing fiscal incentives or tax expenditures. The most obvious case of this payoff is when incentives results in successful firms and enterprises that augment the tax base of the country. However, this case is never easy, and requires an appraisal of inter-temporal tax expenditure recovery.

There are several examples of direct government investments in impact funds, or funds controlled by the government investing in impact projects. The move in 2015 by Japan’s Government Pension Investment Fund (GPIF) – the world’s largest pension fund – to make direct investments into impact projects is a particular example. Also covered in the chapter is the case of the Bank of Japan⁴ undertaking investments into Exchange Traded Funds (ETFs) focused on ESG investments. Similar examples are also found in the government-backed sovereign wealth funds of Khazanah (Malaysia) and Temasek (Singapore) – among the global leaders in ESG investing – and Australia’s government-backed Social Enterprise Development and Investment Fund (SEDIF) which commenced investing in 2011.

Further support for SI could be provided through government procurement systems – particularly procurement of general consumables that could be sourced from social entrepreneurs/socially responsible firms, providing these with a ready market, and thus encouraging investments into those sectors. Public procurement amounts to an average of 13% of GDP in OECD countries, and up to 30% in developing countries⁵. Shifting that spending towards more sustainable goods and services produced by socially responsible businesses can help drive markets in the direction of sustainability and innovation. Through sustainable procurement practices, governments can lead by example and deliver key policy objectives.

⁴The central bank of Japan.

⁵ 2015 data IMF, World Bank and OECD.

Several governments worldwide and international agencies have already taken up this task. In the UK, the Social Value Act requires that public services procurement consider social impact factors rather than simply focussing on price. In 2016, The United Nations Environmental Programme (UNEP) drafted its sustainable public procurement implementation guidelines. The UNEP, in conjunction with the Swiss government, subsequently developed the Capacity Building for Sustainable Public Procurement project in developing countries. Seven countries piloted this initiative: Chile, Colombia, Costa Rica, Lebanon, Mauritius, Tunisia and Uruguay. Since then, many other countries have adopted this new approach, with differing objectives and focus. In Brazil, the project's focus was on recycled paper; in France, toner cartridges for laser printers (for the French Ministry of Education); Hong Kong aimed to improve traffic management with LED traffic light retrofits; Italy piloted an organic food scheme for schoolchildren; and in the United States, there was a push for the sustainable transportation of waste.

DEMAND SIDE INTERVENTIONS TO SUPPORT DEVELOPMENT OF THE ECOSYSTEM

Perhaps one of the most overlooked aspect of government support for SI from the demand side is the support it could provide to develop the sustainable development ecosystem. There are several examples of government support for incubators and accelerators. The New Zealand government-backed Callaghan Innovation is perhaps one of the best known. In 2019, Canada's Federal Government launched a scheme for incubators and accelerators in the Quebec region, while the Australian federal government also extends similar support. In the UK, the Government's Investment and Contract Readiness Fund (ICRF) supports social ventures to build their capacity to be able to receive investment and bid for public service contracts.

In the start-up ecosystem, ideas usually spring up spontaneously, but only a few survive into incubation and beyond. Governments can show leadership by signalling interest and inspiring confidence among people, particularly the young, to innovate and develop new ideas. Governments could provide support for innovation and idea generation through suitable schemes and programmes. The incubation stage is often regarded as the riskiest stage of the start-up life cycle. During this stage, start-ups are often faced with high business risk, with a high global failure rate of around 90%. This essentially means that the enterprises are unable to obtain leverage, or any other form

⁶ In traditional financing literature it is stated that incubation stage could only afford FFF financing: contributions from friends, families and fools!

of risk capital, and can only receive grants⁶. The lack of suitable grant financing in any economy could be viewed as a ‘market failure’, and one which only governments can address. That is, by being an entity capable of providing sizeable grant support to start-ups in the incubation stage, the government fills a gap which the private sector may not be in a position to undertake because of the risk involved. Of course, such budgetary support through grants would need to be administered effectively. One of the more robust means of doing this could be to administer this through existing incubator/accelerator houses in the country with target rates for ‘successful’ incubation/acceleration. If the global failure rate is as much as 90%, an asking or ‘hurdle rate’ of 40% successes may be feasible and likely to recover costs for the government when successful entrepreneurs become part of the permanent tax base of the country⁷. Budgetary support could also ensure a continuous supply of grant support to the pipeline of entrepreneurs coming onstream annually, which normally may not be delivered by the private sector, while strong performance alignment (for incubators) means that if the targets (or hurdle rates) are not met, incubators would be ineligible for successive rounds for financing. The scheme could also potentially create a more efficient network of incubators/accelerators in a country – with inefficient ones being phased out and newer more robust and innovative incubators (that could make effective use of the scheme) emerging, which will underpin a vital institutional base for impact investments in any country.

IMPLMENTING STANDARDS, ENCOURAGING RESEARCH AND RECOGNISING ACHIEVERS

Adequate standards for impact measurement and monitoring (IMM) are now an integral part of impact investment, and address a long-felt need in the industry. While many impact measurement platforms have emerged, there appears to be some convergence to the platform advocated by the global Impact Management Project (IMP). Government intervention on this front could support the adoption of IMM in countries, and bring opportunities for standards to be tailor-made for the specific needs of the country. With the launch of the first indigenous social impact funds in Sri Lanka, the UNDP in conjunction with the IMP has developed an IMM standard which was used to pre-screen the first social entrepreneurs under the country’s Social Enterprise Fund. Further work in this area is being pursued in Bangladesh and in Indonesia, with support from the respective governments.

⁷ A few ‘back of the envelope’ calculations for several countries based on average SME Earnings Before Tax (EBT) together with applicable corporate tax rates (CIT) and assumptions on growth (IMF) gives a cost recovery period of 7-15 years for the government.

Sustainable investment is fast growing globally, and its effectiveness can only be measured by concerted research into the area. The government may also have a role to play in fostering research into SI in countries leveraging on existing research and higher education institutions under its control, and providing funding for such activities. China has a government-supported research programme looking into opportunities related to social impact bonds (SIBs). A similar scheme is also in place in Japan.

Governments could also play a role in recognising and awarding outstanding practices for impact-related investments and achievements they have made. These could be aligned with country-specific factors: for example, how far the investments have gone in addressing existing SDG gaps or crucial social priorities of countries. When governments acknowledge and recognise impact investment, it gives out a strong signal underlining its importance.

AUSTRALIA CASE STUDY

Australia became a member of G8 Social Impact Investment Task force in 2013 and established the Australian Advisory Board for Impact Investment (AAB) in 2014. Impact Investing Australia (IIA) an independent non-profit organisation was established in 2014 to fill a void in providing dedicated leadership, facilitation and capacity building for impact investment in Australia. It was largely instrumental in executing the AAB strategy during the early formative years.

Recent experience of Australia demonstrates several facets of government involvement – particularly in the areas of high level policy support, provision of fiscal incentives, ecosystem development and other measures.

I. High level policy support for impact investments: In 2017 the Australian Government⁸ issued its Social Impact Investing Principles which articulated consideration of: (i) government as a market enabler; (ii) value for money considerations; (iii) outcomes-based measurement and evaluation measures; (iv) fair consideration of risk and return profiles; (v) outcomes that align with the Australian Government’s policy priorities and (vi) outcomes co-designed with a broad range of stakeholders when considering social investments. In the state of New South Wales, a policy for social impact investment was issued earlier in 2015, which was followed by the setting up of an office for Social Impact Investments that greatly contributed to SII development in the state by

⁸Treasury, Australian Government

creating an institutional mechanism to develop and implement policies, as well as catalyse investments. New South Wales was the first Australian state to issue a social impact bond. Among other states, Victoria also has made progress in setting up a policy framework for promoting social impact investments.

II. Pipeline development: As in many other countries in the Asia Pacific region, Australia also has a relatively weak *pipeline* of investment-ready social projects. Existing social impact funds in Australia have seen a deployment rate of just 50%, giving considerable scope to extend activities provided there is a more robust pipeline. Pipeline development support has been in existence in Australia for several years, supported by institutions such as IIA and National Australia Bank (NAB). The Federal package for 2017-18 (see below) further supplemented these by including A\$8 million⁹ (\$5.4 million) for capacity strengthening pipeline development.

III. Fiscal Incentives through the government procurement system: In 2018, the Victoria state government announced a social procurement framework which is expected to promote social and sustainable procurement and help invigorate investments into the sectors. Several other states, notably Queensland and New South Wales have also developed procurement strategies that not only target local businesses, but also social enterprises. **Outcomes contracting:** One of the more noticeable areas of government involvement in impact investment in Australia has been on the issuance of impact bonds and the role of outcome funders. As previously noted the state government of New South Wales was Australia’s earliest mover in terms of commissioning the country’s first SIBs – the first to restore children in out-of-home care back to their families and the other to prevent entry into out-of-home care. Since then, further investments valued at over A\$200 million supporting various social causes have also been undertaken by the NSW government. The state governments of Queensland and Victoria have also undertaken SIBs, many of them targeting the issue of homelessness.

IV. The Federal Government 2017-18 SII support package: The Australian Federal government in its budget for the Fiscal Year 2017-18 promulgated an A\$30 million package, spread over ten years, to promote impact investment in Australia. Furthermore, as part of the 2019-20 Budget, the Australian Government announced its intention to establish a taskforce (the Taskforce)

⁹ Over a four-year period.

in the Department of the Prime Minister and Cabinet to examine the Commonwealth's role in the social impact investment (SII) market. The Federal package for 2017-18 was intended to test out the concept of SII to uplift and improve housing and welfare facilities for people, particularly young people. The programme consisted of several components: (a) Pilot SII initiatives worth A\$10.2 million over ten years (starting 2017-18) to improve housing and welfare outcomes for young people facing the risk of homelessness; and (ii) A\$20.2 million over ten years (from 2017-18) to support development of the SII market focused on areas other than homelessness. The latter component comprised A\$8 million over four years to establish a SII Readiness Fund that will help organisations build capacity to develop projects for SII; and A\$12.2 million support for states and territories to trial further SII initiatives, and provide a platform for data/information sharing and improved impact measurement.

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3

PRINCIPAL INSTRUMENTS OF SUSTAINABLE INVESTING

There are numerous approaches to sustainable investing, ranging from philanthropic donations and official aid to more market-based methods, but the two principal routes taken now by public and private investors are ESG (environmental, social and governance) investing and impact investing. Of the two, ESG at present accounts for far more assets under management than impact investing, but the latter could hold out most promise for active investor participation in shaping social and governance policies into the future.

As the Global Impact Investing Network (GIIN), described as the “largest global convening of leaders in the impact investment industry”, puts it: “Impact investing challenges the long-held view that social and environmental issues should be addressed only by philanthropic donations and government aid, and that market

Private Investors Have Three Key Opportunities for Impact Investment, Which Span Public and Private Markets



*Total fundraising from 2008–18 by private investment funds with verifiable intent for, and measurement of, impact. These funds operate only in private markets: private debt and equity, real estate, infrastructure, and natural resources such as timber. Their fundraising is equivalent to AUM under the assumption that it takes 10 years to return capital to investors.

**Value for year-end 2015.

***Value of all green and social bonds outstanding as of year-end 2018. This includes sovereign issuance.

Source: Preqin, EMPEA, ImpactBase, ImpactAsset50, Symbiotics, IRIS, B-Analytics, Gresh, HIPS0, 2016–17 DFI mobilization reports, and DFI annual reports. GSIA. PwC. ICMA. Bloomberg. Thompson Reuters.

Note: There may be double counting between these two groups, to the extent that DFIs are limited partners in, or guarantors of, private investment funds

investments should focus exclusively on financial returns. Instead, impact investing has the potential to reshape the role of capital in society, demonstrating that significant social and economic progress can be made alongside financial returns.”

There is a key – and sometimes overlooked – distinction between ESG and impact investing. While ESG seeks to guide investment generally into improving corporate behaviour with regard to environmental, social and governance issues, impact investing provides a link or channel between private investment and achieving official development targets. It requires investors to “measure” the impact that their investments have on environmental, social and governance issues of the kind enshrined in the UN Sustainable Development Goals (SDGs). As the International Finance Corporation (IFC) puts it, “a growing number of investors are incorporating impact investments into portfolios. Many are adopting the SDGs and other goals as a reference point to illustrate the relationship between their investments and impact.” In this sense impact investing can be seen as the active counterpart to more passive ESG investments.

In money terms, the amount of broadly defined “sustainable investment” represented by impact investment is still relatively small. At more than a quarter of global assets under management, investments made in accordance with ESG principles account for an estimated 100 times the AUM held in the impact investing market – and ESG investments are growing by some 17% per year.

Estimates of the size of the different segments of the sustainable investment market often differ according to source and to how these segments are defined. The IFC, for one, acknowledges that it can be “challenging demarcating impact investing from certain other types of sustainable investment.” But the data do at least provide an order of magnitude.

According to the Global Sustainable Investment Alliance (GSIA) (which describes itself as a “collaboration of membership-based sustainable investment organisations from around the world”), the biggest single category of sustainable investment is that which is known as “negative/exclusionary screening”, where investors seek to ‘do no harm’ by avoiding investment in socially and environmentally detrimental areas. The GSIA puts the size of this segment of the sustainable investment universe at near \$20 trillion, while a further \$18 trillion is accounted for by “ESG integration”-type investments where investors seek actively to “do good”.

The GIIN, meanwhile, has estimated the size of the global impact investing market at a much more modest \$502 billion (as of April 2019). The New York-based organisation said in its 2019 annual report that this figure represented “the most

SDG integration throughout the investment process

Sourcing and due diligence

Partners Group selects deals for impact evaluation for PG LIFE that directly contribute to one or more SDG targets through their core business activities and that meet the strategy's requirements for financial risk and return. The PG LIFE Impact Committee assesses deal flow on a weekly basis to identify potential investments meeting the following minimum impact criteria:

- A clear link between the company/asset's core product or service and at least one SDG target;
- More than half of company/asset revenue supports at least one SDG target; and/or the company has significant market share;
- The company/asset has no ESG controversies and does not significantly detract from any SDG target.

Partners Group then works with a third-party impact assessment provider. First, deals in the pipeline are assessed for impact against the SDGs, beginning with a logic model that sequences how each company or asset creates impact, both positive and negative. Next, each investment is scored on a five-point scale using PG LIFE's SDG target rating based on the Impact Management Project's five dimensions of impact.¹⁴ Finally, relevant impact metrics are identified based on the created logic model, GRI's Business Reporting on the SDGs,¹⁵ and the GIIN's IRIS metrics.¹⁶

Investment selection and structuring

After the due diligence process, the five-member Impact Committee reviews and votes—on a scale from one to four—to decide whether an investment can be included in PG LIFE. Two criteria are required: (1) the five scores must average 2.7 or more; and (2) no more than one of the five scores can be two or below.

Investment management

Within the first hundred days after investment, Partners Group's PG LIFE team presents the company/asset management team with the proposed impact goals and metrics, along with risks identified during due diligence. During this time, the PG LIFE team works with the management team to agree on impact metrics, address how to manage risks, and establish systems to collect impact data. The third-party impact assessment provider collects and analyzes impact data annually, which PG LIFE then reports to its investors.

¹⁴ The Impact Management Project's five dimensions of impact are What, How Much, Who, Contribution, and Risk. For more information, see <http://www.impactmanagementproject.com/understand-impact/>.

¹⁵ Business Reporting on the SDGs is an Action Platform to accelerate corporate reporting against the Global Goals established by GRI and the United Nations Global Compact. For more information, see <https://www.globalreporting.org/information/SDGs/Pages/Reporting-on-the-SDGs.aspx>.

¹⁶ IRIS is the GIIN's catalog of generally accepted performance metrics. For more information, see <https://iris.thegiin.org/>.

comprehensive study to date [based on] the most rigorous analysis and estimate of the size of the impact investing market.” It reflected a “collation of data on more than 1,300 impact investors around the world” such as asset managers, foundations, banks, development finance institutions, family offices, pension funds, insurance companies, and others.

Such sums pale into relative insignificance alongside the several trillion dollars a year that the United Nations has estimated will be required by way of private sector

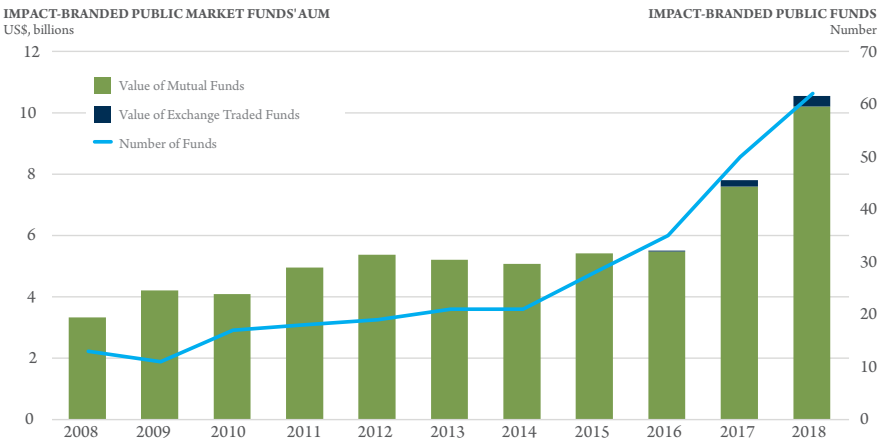
investments to close the funding gap between likely government sector contributions and the actual amounts needed to finance the UN SDGs between now and 2030. Even the IFC calculation that the total size of the impact investing market currently stands at around \$1 trillion implies that the contribution of impact investing to the SDGs (and to sustainable investing in general) might be only modest.

However, the IFC also believes that, in the light of its growing appeal to official, institutional and individual investors anxious to see their money make a measurable contribution to economic and social development, impact investing will in time come to represent a much larger segment of the global sustainable investment market.

In a report published in February 2019, the IFC suggested that “the [impact investing] market holds great potential. We estimate that investor appetite for impact investing is as high as \$26 trillion — \$21 trillion in publicly traded stocks and bonds, and \$5 trillion in private markets involving private equity, non-sovereign private debt, and venture capital. Turning this appetite into actual investments will depend on the creation of investment opportunities and investment vehicles that enable investors to pursue impact and financial returns in ways that are sustainable.”

The Washington-based IFC acknowledged that “the lack of clear boundaries between impact investing and other forms of sustainable and value-aligned investing makes it difficult to say for sure exactly how large the impact investing market is at present.” We know that [private impact funds] currently total around \$71 billion. Larger amounts are invested by development finance institutions (including over

The Number of Publicly Traded Funds with “Impact” in Their Name Has Grown Substantially



Sources: Bloomberg and Thomson Reuters.

Note: Includes all funds identified in the two sources with the word “impact” in the name.

\$700 billion by those following harmonised measurement metrics), and in green and social bonds (over \$400 billion outstanding). In addition, a share of the \$8 trillion dedicated to activist investing in public markets may be managed for impact.”

This “lack of clear boundaries and the thus far limited role of privately managed funds is not unusual for a market under development,” the IFC suggested. “What is important going forward is that investors should be able to clearly identify opportunities to invest for impact, and that those opportunities can expand over time to enable larger amounts of capital to be put to work.”

The IFC, which has decades of experience in nurturing capital market development, is confident that “it is possible to mobilise like-minded investors to collaborate in ways that can change the landscape of investing. We did so in 2003 when we helped international banks establish the Equator Principles, which have become the most tested and applied global benchmark for sustainable project finance in emerging markets. We also worked to develop guidelines and procedures for the green bond market as a member of the Green Bond Principles Executive Committee. The principles were established five years ago to promote market discipline and transparency. Since then, annual issuance of green bonds has grown from around \$10 billion in 2013 to \$183 billion in 2018.”

Some have likened the likely future development of sustainable investment in general and of impact investing in particular to the evolution of emerging stock and bond markets after the 1980s, when it moved from the sidelines of global portfolio investment into a more mainstream position.

As noted above, an estimated one quarter or so of global financial assets are at present managed in accordance with ESG principles, and these account for more than 100 times the assets under management of the impact investing market. But at least some ESG assets follow impact investing principles and, as the IFC has noted, “impact investments that generate a measurable social impact alongside a financial return are increasing in popularity, with no signs of [this accelerating trend] slowing down.”

WHAT IS IMPACT INVESTING?

In its February 2019 report, the IFC defined impact investing as “investments made in companies or organisations with the intent to contribute measurable positive social or environmental impact, alongside a financial return.” Impact investments, it noted, “are not defined by their membership in an asset class with common risk and return characteristics, but rather by the approach of the investor. In principle,

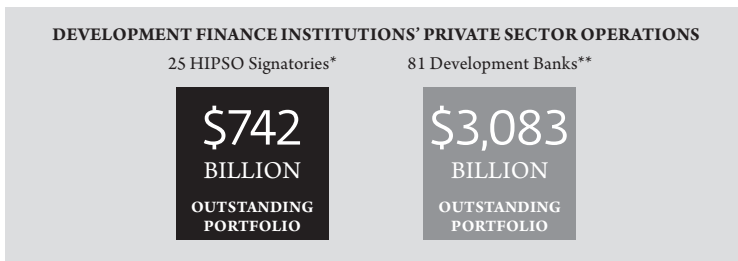
investments may be made into the full range of public and private assets, as long as by doing so the investor contributes to achieving impact.”

Specifically, the IFC suggested, the definition of impact investing encompasses three observable attributes that can distinguish this form of investment from other segments of sustainable investing:

- > **Intent:** The investor articulates an intent to achieve a social or environmental goal by identifying outcomes that will be pursued through the investment and specifying who will benefit from these outcomes.
- > **Contribution:** The investor follows a credible narrative, or thesis, which describes how the investment contributes to achievement of the intended goal – that is, how the actions of the impact investor will help achieve the goal. In this case, contribution is considered at the level of the impact investor, and can take financial or non-financial forms.
- > **Measurement:** The investor has a system of measurement in place linking intent and contribution to the improvement in social and environmental outcomes delivered by the enterprise into which the investment has been made.

The GIIN notes, meanwhile, that “impact investors have diverse financial return expectations. Some intentionally invest for below-market-rate returns, in line with their strategic objectives. Others pursue market-competitive and market-beating returns, sometimes required by fiduciary responsibility. Most investors surveyed

Governments, Through Development Finance Institutions, Are Major Impact Investors



*Values for 2017. DFI include 12 multilateral development banks (MDBs) and 13 bilateral DFIs, all of which are signatories to a memorandum of understanding regarding the Harmonized Indicators for Private Sector Operations (HIPSO). The committed portfolio includes: non-treasury investment portfolios of loans, equity investments, and debt securities to non-sovereign entities (\$455 billion); an estimate of the stock of thirdparty investment that has been directly mobilized by DFIs over five years (\$255 billion); and gross exposure to guarantees to non-sovereign entities (\$32 billion). In general, DFIs only expect to pay claims on a small fraction of their gross exposure to guarantees or risk insurance. For MIGA, gross guarantee exposure does not include guarantees against the non-honoring of financial obligations by sovereigns, sub-sovereigns, or state-owned enterprises. Within this pool, the largest institution by far is the European Investment Bank (EIB), which has approximately \$515 billion in outstanding portfolio, or 69 percent of the total, split between \$322 billion in non-sovereign portfolio investments, \$183 billion in estimated direct mobilization; and \$10 billion in off balance sheet contingent liabilities and guarantees.

**Includes 12 multilateral development banks and 69 national development banks with charters or mission statements describing intent to contribute to social or environmental impact alongside financial return. Given limited data on the share of portfolio allocated to treasury, sovereign and non-sovereign operations, the outstanding portfolio of these institutions is estimated at 50 percent of total assets.

Source: HIPSO, 2016–17 DFI mobilization reports, and DFI annual reports.

in the GIIN's 2019 Annual Impact Investor Survey pursue competitive, market-rate returns.[They] also report that portfolio performance overwhelmingly meets or exceeds investor expectations for both social and environmental impact and financial return, in investments spanning emerging markets, developed markets, and the market as a whole."

Impact investment, the GIIN adds, "has attracted a wide variety of investors, both individual and institutional." Among these, it lists fund managers, development finance institutions, diversified financial institutions and banks, private foundations, pension funds and insurance companies, family offices, individual investors, NGOs (non-governmental organisations), religious institutions, and others.

Governments are also major impact investors via official Development Finance Institutions or DFIs. These DFIs include 12 multilateral development banks (MDBs) and 13 bilateral DFIs, all of which are signatories to a memorandum of understanding regarding the Harmonised Indicators for Private Sector Operations (HIPSO). The part of their portfolios committed to various kinds of impact investment includes non-treasury investment portfolios of loans, equity investments and debt securities to non-sovereign entities totalling \$455 billion.

"While some investors have been making impact investments for decades, recently there has emerged a new collaborative international effort to accelerate the development of a high-functioning market that supports impact investing," says the GIIN." This market is still relatively new [but] investors are optimistic overall about its development and expect increased scale and efficiency in the future. Impact investors generally recognise broad progress across key indicators of market growth."

CLEANING UP 'IMPACT WASHING'

A note of caution over the quality of certain types of claimed impact investing was introduced in a report by private equity specialists Partners Group in a report for the Impact Management Project (which seeks to build a global consensus on how to measure and manage impact investment). "More and more managers are developing impact strategies and the competition for impact capital will increase," observed Adam Helzer, an executive of the group. "Therefore, impact asset owners and managers must be brave enough to share impact failures and the lessons learned."

If the impact investing industry "can only tell good stories it is surely not thinking critically or holistically about company impacts," Helzer asserted. This "ultimately will edge the industry toward a mass form of 'impact washing.' By sharing what

does not have as much of a positive impact as expected, or have a negative impact, managers can prevent other organisations from making mistakes and from wasting precious resources,” he added.

Helzer’s comments reflect a growing debate in the investment industry over whether some asset managers engage in impact in order to attract investors, while making investments that do not meaningfully address environmental, social, or governance (ESG) issues. Partly with this in mind the IFC announced in April 2019 a new framework of nine principles designed to bring greater transparency, comparability and rigour to the impact investing market.

A coalition of 60 leading global asset managers and institutional investors has signed up to new standards, which are designed to accelerate the growth of impact investment. These firms collectively manage at least \$350 billion in assets invested for impact. They include, among others, UBS, Amundi, Axa Investment Managers, BNP Paribas, Credit Suisse, as well as insurers including Prudential Financial and Zurich. The European Bank for Reconstruction and Development and the Development Bank of Latin America are also among the high-profile signatories to the accord.

Despite the increased interest in and number of product launches claiming to be impact investments, “there is no common discipline for how to manage investments for impact and the systems needed to support this,” the IFC said at the time the principles were launched. This, it suggested, “has created complexity and confusion for investors, as well as a lack of clear distinction between impact investing and other forms of responsible investing.” The objective of the operating principles is “to establish a common discipline and market consensus around the management of investments for impact and help shape and develop this nascent market.”

The nine principles include the following:

- > Define strategic impact objective(s), consistent with the investment strategy.
- > Manage strategic impact on a portfolio basis.
- > Establish the Manager’s contribution to the achievement of impact.
- > Assess the expected impact of each investment, based on a systematic approach.
- > Assess, address, monitor, and manage potential negative impacts of each investment.
- > Monitor the progress of each investment in achieving impact against expectations and respond appropriately.
- > Conduct exits considering the effect on sustained impact.
- > Review, document, and improve decisions and processes based on the achievement of impact and lessons learned.

- > Publicly disclose alignment with the Principles and provide regular independent verification of the alignment.

These principles, the IFC emphasises, “may be implemented through different impact management systems and are designed to be fit for purpose for a wide range of institutions and funds. Also, a variety of tools, approaches, and measurement frameworks may be used to implement the Principles. The Principles do not prescribe which impacts should be targeted, or how impacts should be measured and reported. They also complement other industry initiatives, such as IRIS, and green/social bond principles, which seek convergence towards common approaches to impact measurement and reporting.”

EXAMPLES OF IMPACT INVESTING IN ASIA AND ELSEWHERE

In Southeast Asia, according to a report by the GIIN (one of a series on impact investing’s progress in different regions of the world), investors have primarily deployed impact investment capital to sectors that promote financial inclusion, expand access to basic services, and create livelihoods as well as financial services, energy and manufacturing. Together, these three sectors account for 82% of total capital deployed in the region and 63% of total deals. Development Finance Institutions (DFIs) in Southeast Asia have traditionally invested in sectors that create large-scale employment opportunities and support countries’ national development priorities. DFIs also invest in private impact investment funds in order to drive impact in more targeted areas, such as poverty alleviation, job creation, or women’s empowerment.

In India, most impact capital has been deployed in the manufacturing, financial services and energy (both renewable and non-renewable) sectors, and a sizeable number of deals have been in other sectors such as education and healthcare. Funds are shifting toward a less opportunistic and more hypothesis-driven approach to selection; in this new approach, these funds start with the identification of a problem in a given sector, then identify a potential solution and subsequently seek organisations that contribute to this solution.

In Pakistan, energy, financial services (microfinance institutions, or MFIs, and others), and manufacturing have been the most attractive sectors to date. Impact investors see high potential in businesses serving the large domestic consumer base. Angel investors on the periphery of impact investing are particularly drawn to ICT-related investment targets.

In Bangladesh, most impact capital has been deployed in growing sectors such

as ICT, energy and manufacturing, particularly as many investors target job creation as their main impact objective and see these sectors as having the best potential to meet this core goal.

In Sri Lanka, microfinance and other financial services have drawn the bulk of impact capital. Tourism and hospitality have been attractive to investors as well. There is a growing interest in investment in balance of payment-focused enterprises in the ICT, energy, health and technology sectors.

In Nepal, transportation and tourism have drawn the largest proportion of impact capital to date – these sectors are attractive because they can absorb large ticket-size investments. Looking forward, impact investors “are excited” about opportunities in hydropower and tourism, which have been growing and are expected to continue to do so. In Myanmar, to date, most impact capital has been deployed in real estate due to a dearth of investible assets.

Outside of Asia, Impact Base, a global online directory of impact vehicles (which is supported by the GIIN) offers what it says are key illustrative examples of impact investment funds.

SUSTAINABLE TRADE FINANCING

A UK-based \$65 million fund invests in sustainable trade and targets high-impact, sub-market rate returns for investors. The fund has provided more than \$200 million in loans to 300 small and growing businesses in across Latin American and Asia, with borrower repayment rates surpassing 98%. The fund has invested in Fair Trade and an organic-certified coffee cooperative located in Ecuador. The cooperative’s 300 active members are smallholder farmers who cultivate shade-grown coffee. The trade finance loan allowed the cooperative to cover operating costs and invest in new processing equipment. Additional revenue gained from Fair Trade coffee sales are used to sponsor projects in reforestation, education and community-based health clinics in the community where smallholder farmers live.

LOW-INCOME HOUSING

A private equity fund based in Brazil closed with \$75 million in assets. Investments target market-rate financial returns and social benefits to rural communities in South America. The fund’s investors include large financial institutions, private family offices, development organisations and large-scale foundations. The fund has made an investment of \$4 million to a provider of affordable homes designed for low-income families in rural settings. More than 10,000 homes have been constructed

in three South American countries, focusing particularly in areas affected by natural disaster.

CLEAN ENERGY ACCESS

A 150 million euro (\$165 million) European private equity fund invests between 2-10 million euros in companies that provide clean electricity to rural communities in developing countries with limited access to energy. The fund targets competitive private equity returns, and has made five investments in Asia and Africa. The fund made a 2 million euro equity investment in a company that provides solar energy for lighting and refrigeration in rural Indian households, schools and hospitals that have limited access to the main electricity grid. Enabled by this investment, the company has installed more than 40,000 systems and currently offsets 25,000 tons of carbon dioxide emissions.

CLEAN DRINKING WATER

An India-based impact investing fund manager started investing in microfinance institutions more than ten years ago. After delivering 14% returns to investors, the fund manager decided to raise a second fund to target businesses across a broader set of sectors, including renewable energy, agriculture, health and education. The fund provides risk capital and support to early stage ventures with investments averaging \$50,000. The second fund invested in a company that sets up water purification plants in rural villages. The plants are owned by the local community and operated by the installation company, which sells the purified water to the village at affordable rates. The installation company also trains local entrepreneurs to develop businesses that deliver water to neighbouring villages.

ESG (ENVIRONMENTAL, SOCIAL AND GOVERNANCE) TYPE INVESTING

Though sometimes considered synonymous with Socially Responsible Investing (SRI), ESG is a separate and important class of investing. It involves the integration of environmental, social and governance factors into the fundamental investment process. Using an ESG framework, investors can select companies in which to invest knowing that they are contributing to environmental, social and governance improvement which also benefits the health of corporate sector and capital market development. For example, factors such as environmental friendliness are considered likely to add to the longevity of a company. Firms that follow high quality environmental, social and governance standards are more likely to outperform their

ESG integration

Traditional	Negative screening / SRI	Responsible investment / ESG integration	Impact investing		Philanthropy
			Market-rate	Concessionary	
Limited or no focus on ESG factors	Excluding investments based on harmful products, services or practices	Focus on creating and protecting value through consideration of ESG factors	Focus on one or a cluster of issue areas, where social or environmental need creates a commercial growth opportunity for market-rate returns	Focus on one or a cluster of issue areas, where social or environmental need requires some financial trade-off	Focus on one or a cluster of issue areas, where social or environmental need requires 100% financial trade-off

peers over the long term.

This often runs counter to popular perceptions. According to “Environmental, Social and Governance Issues in Investing: A Guide for Investment Professionals” published by the Chartered Financial Analysts Institute, “there is a lingering misperception that ESG considerations adversely affect financial performance.” Yet, to the contrary, the guide asserts that “systematically considering ESG issues will likely lead to more complete investment analyses and better-informed investment decisions.” The report lists some examples of why this is so.

Environmental risks created by business activities have actual or potential negative impact on air, land, water, ecosystems and human health. Company environmental activities considered relevant for ESG investing include managing resources and preventing pollution, reducing emissions and climate impact, and executing environmental reporting or disclosure. Environmental positive outcomes include avoiding or minimising environmental liabilities, lowering costs and increasing profitability through energy and other efficiencies, and reducing regulatory, litigation and reputational risk.

Social risks, the report suggested, refer to the impact that companies can have on society. They are addressed by company social activities such as promoting health and safety, encouraging labour-management relations, protecting human rights and focusing on product integrity. Social positive outcomes include increasing productivity and morale, reducing turnover and absenteeism, and improving brand loyalty.

Governance risks concern the way companies are run. These address areas such as corporate brand independence and diversity, corporate risk management and excessive executive compensation, through company governance activities such as increasing diversity and accountability of the board, protecting shareholders and their rights, and reporting and disclosing information. Governance positive

outcomes include aligning interests of shareowners and management, and avoiding unpleasant financial surprises.

Many investors are interested not only in the financial outcomes of their investments but also in the impact these can have on promoting global issues such as climate action. This applies in particular to so-called “millennials” (born between the beginning of the 1980s and the start of the 21st century). Various studies have suggested that millennials are more likely to trust a company or purchase its products when the company has a reputation for being socially or environmentally responsible. Half of those surveyed are more likely to turn down a product or service from a company perceived to be socially or environmentally irresponsible.

More precisely, ESG investing looks at “extra-financial” variables or factors. Responsible investors evaluate companies using ESG criteria as a framework to screen investments or to assess risks in investment decision-making. Environmental factors determine a company’s stewardship of the environment and focus on waste and pollution, resource depletion, greenhouse gas emissions, deforestation, and climate change. Social factors look at how a company treats people and focuses on employee relations and diversity, working conditions, local communities, health and safety, and conflict. Governance factors take a look at corporate policies and how a company is governed. They focus on tax strategy, executive remuneration, donations and political lobbying, corruption and bribery, and board diversity and structure.

As noted, ESG investing can take various forms. The S&P Dow Jones Index splits sustainability into two categories: ESG and green or low carbon. The ESG framework of investing tends to capture more factors, while green is more focused. Environmental factors include waste management, water management, environmental resource use,

Avoid and advance
Sustainable investing styles


	Avoid	Advance		
	Screened	ESG	Thematic	Impact
Objective	Remove specific companies/industries associated with objectionable activities	Invest in companies based on ESG scores/ rating systems	Focus on particular E, S or G issues	Target specific non-financial outcomes along with financial returns
Key considerations	Definition of and financial impact of screens	ESG data sources; active risk taken	Broad versus specific exposures	Report on progress toward outcomes
Examples	Screening out producers of weapons, fossil fuels and/or tobacco	Optimized ESG benchmarks; active strategies overweighting strong ESG performers	Environmental focus (low carbon or renewable energy); social focus (diversity)	Specific green bond or renewable power mandates


Sources: BlackRock Investment Institute and BlackRock Sustainable Investing, December 2018.


environmental disclosure, environmental impact, and reduction of pollution and emissions. Social factors include stakeholder analysis, workplace mentality, human rights, diversity community relationships, corporate citizenship and philanthropy. Governance factors include board structure, management compensation, stakeholder impact, stakeholder rights, and the relationship between management and stakeholders.


Core characteristics of impact investing

The practice of impact investing is further defined by the following four core characteristics:

 **INTENTIONALITY** An investor's intention to have a positive social or environmental impact through investments is essential to impact investing.

 **RANGE OF RETURN EXPECTATIONS AND ASSET CLASSES** Impact investments target financial returns that range from below market (sometimes called concessionary) to risk-adjusted market rate, and can be made across asset classes, including but not limited to cash equivalents, fixed income, venture capital, and private equity.

 **INVESTMENT WITH RETURN EXPECTATIONS** Impact investments are expected to generate a financial return on capital or, at minimum, a return of capital.

 **IMPACT MEASUREMENT AND MANAGEMENT** A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance and progress of underlying investments, ensuring transparency and accountability while informing the practice of impact investing and building the field.

PRINCIPAL PARTICIPANTS IN THE SUSTAINABLE INVESTMENT ARENA

In the same way that the term sustainable investment is the subject of many different definitions, so multiple different organisations have sprung up in recent years with the aim of promoting various forms of sustainable investment. This is often rather confusing for those anxious to understand and participate in investment that contributes to society, the environment and good governance, in addition to offering a financial return. This chapter offers a brief outline of some of the more salient developments in sustainable investing, the players involved and the terminology employed. It is presented as a reference guide, drawn from numerous sources, rather than as a comprehensive narrative on how the sustainable investment movement has evolved.

SUSTAINABLE FINANCE/INVESTMENT – A MATTER OF DEFINITION

Increasing numbers of people agree that sustainable investment is desirable or essential if economic and social development is to be maintained, and the environment protected. But definitions of what constitutes sustainable investment have evolved over recent decades and continue to do so, making the objective something of a moving target. Definitions are, however, being narrowed down and refined, which offers hope of faster progress in achieving better social, economic and environmental outcomes. Sustainable finance, as defined by the European Commission (it was chiefly Europe that pioneered the practice) means “the application of finance to investments taking into account environmental, social and governance considerations.” Sustainable finance or investment, according to this definition, “includes a strong green finance component that aims to support economic growth while reducing pressures on the environment by addressing green-house gas emissions and tackling pollution, minimising waste and improving efficiency in the use of natural resources.” The EU

definition also encompasses “increasing awareness of risks which may have an impact on the sustainability of the financial system and] it accepts “the need for financial and corporate actors to mitigate risks through appropriate governance.”

There are various sub-groups within the term sustainable investing itself. These include (among others) Impact Investing, Socially Responsible Investing (SRI), ESG (Environmental, Social and Governance) Investing and Values-Based Investing. One school of thought argues that most of these forms of investing fit under the umbrella term of Socially Responsible Investing.

Socially Responsible Investing began nearly 50 years ago when some investors employed “negative screening” methods to exclude investments in companies dealing in arms, tobacco, gambling and other activities judged to be undesirable. Investing in such securities was seen to be supporting morally bad or socially irresponsible businesses.

The basic philosophy was that capital should be employed only for morally good purposes. This view was criticised, however, for being overly narrow, thus creating an impediment to optimal investment.

The number and range of policy measures created to advance sustainable finance has increased quite sharply in recent years. According to a report published in 2018 by the United Nations, by the end of 2013 a total of 139 policy and regulatory measures were in place across 44 jurisdictions. Four years later, the number of measures had risen to 300 in 54 jurisdictions, with a substantial number of these initiatives having system-wide coverage.

ESG: A POPULAR YARDSTICK FOR MEASURING SUSTAINABLE INVESTMENT

ESG (Environmental, Social and Governance) investing maintains that companies following high quality environmental, social and governance standards are more likely to outperform in the long run. The *Financial Times Lexicon* defines ESG as “a generic term used by investors to evaluate corporations and to determine the future financial performance of companies.” ESG ethical and corporate governance issues include managing a company’s carbon footprint and ensuring that there are systems in place to ensure accountability. These factors are incorporated into both investment decisions and risk management processes. Other definitions note that ESG investing looks at “extra-financial” variables or factors.

Responsible investors evaluate companies using ESG criteria as a framework to screen investments or to assess risks in investment decision-making. Environmental

factors determine a company's stewardship of environment, and focus on waste and pollution, resource depletion, greenhouse gas emissions, deforestation and climate change. Social factors look at how a company treats people, and focuses on employee relations and diversity, working conditions, local communities, health and safety and conflict.

Governance factors take a look at corporate policies and how a company is governed. They focus on tax strategy, executive remuneration, donations and political lobbying, corruption and bribery, and board diversity and structure.

ESG investing can take various forms. The S&P Dow Jones Index for example divides sustainability into two categories: ESG and green or low carbon. The ESG framework of investing tends to capture more factors, while green is more focused. Environmental factors include waste management, water management, environmental resource use, environmental disclosure, environmental impact, and reduction of pollution and emissions. Social factors include stakeholder analysis, workplace mentality, human rights, diversity community relationships, corporate citizenship, and philanthropy. Governance factors include board structure, management compensation, stakeholder impact, stakeholder rights and the relationship between management and stakeholders.

POLICING THE APPLICATION OF ESG AND OTHER SUSTAINABLE INVESTMENT PRINCIPLES

The United Nations has played a key role in promoting sustainable investment in general and of ESG standards in particular. The Principles for Responsible Investment Initiative (PRI) was established in 2005 by the UN Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact, as a framework for improving analysis of ESG issues in the investment process and to aid companies in the exercise of responsible ownership. This came after former UN Secretary General Kofi Annan wrote to some 50 CEOs of major financial institutions in 2004, inviting them to participate in a joint initiative under the auspices of the UN Global Compact and with the support of the International Finance Corporation (IFC).

In 2005, the United Nations Environment Programme Finance Initiative also commissioned a report from the international law firm Freshfields Bruckhaus Deringer on the interpretation of the law with respect to investors and ESG issues. The Freshfields report concluded that not only was it permissible for investment companies to integrate ESG issues into investment analysis, but it was arguably part of their fiduciary duty to do so. In 2014, the Law Commission (England and Wales)

confirmed that there was no bar on pension trustees and others from taking account of ESG factors when making investment decisions.

THE UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT

The London-headquartered “PRI” (as it is usually known) describes itself as “the world’s leading proponent of responsible investment.” It “works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions.” The organisation is funded primarily via the annual membership fee payable by all signatories. As of April 2019, there were more than 2,350 signatories of the Principles for Responsible Investment representing institutional investors from around the world – predominantly in Europe followed by North America then at some distance by Asia, Oceania, Latin America and Africa. Collectively, these signatories had more than \$80 trillion of assets under management (AUM).

The PRI has produced six Principles for Responsible Investment – a “voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice.”

Under these principles, signatories agree to:

- > Incorporate ESG issues into investment analysis and decision-making processes.
- > Be active owners and incorporate ESG issues into ownership policies and practices.
- > Seek appropriate disclosure on ESG issues by the entities in which [they] invest.
- > Promote acceptance and implementation of the Principles within the investment industry.
- > Work together to enhance effectiveness in implementing the Principles.
- > Report on activities and progress towards implementing the Principles.

These principles, according to the PRI, were “developed by investors, for investors” and the intention is that in implementing them, signatories contribute to developing a more sustainable global financial system. The PRI has committed itself to “evaluating the effectiveness and improving the content of the Principles over time”, and to supporting the development of ESG-related tools, metrics and analysis. The PRI is implementing minimum disclosure requirements for signatories, and failure to meet these by 2020 will result in the ‘delisting’ of a signatory.

THE UN SUSTAINABLE DEVELOPMENT GOALS – GOALPOSTS FOR DEVELOPMENT

The Sustainable Development Goals or SDGs (otherwise known as the Global Goals) which came into effect in 2016 take the concept of sustainable investment from the general to the particular. Going beyond encouraging portfolio investors to direct funds toward objectives that aid the environment, society and governance (as in ESG investing) the SDGs define specific areas for economic and social development so that investment may be directed into focused and optimal channels.

The goals represent (in the words of the United Nations) a “universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity”. Together they comprise 169 development “targets” within the 17 goals and “build on the successes of the UN Millennium Development Goals, while including new areas such as climate change, economic inequality, innovation, sustainable consumption, peace and justice, among other priorities. The SDGs are designed to guide UNDP policy and funding until the year 2030, when they will be reviewed.”

FROM GOAL SETTING TO GOAL SCORING – THE ROLE OF IMPACT INVESTING

The SDGs are essentially “government-level” targets but by common consensus governments alone are not going to be able to produce the financial wherewithal to meet these targets. The United Nations estimates that \$5-7 trillion is needed annually between now and 2030 to achieve the goals, but only around one half of this can realistically be provided by the public sector and thus the remainder must come from the private sector if the targets are to be met. But since there is no direct conduit for directing private funds into the SDGs on a meaningful scale, means have to be found to quantify the impact of existing forms of investment on the Sustainable Development Goals so that progress in achieving them can be measured and the quantum of investment boosted where necessary.

Impact investing provides a means to do this (although the term impact investing began to achieve popular currency a decade or more before the SDGs appeared. The term (like most aspects of sustainable investing) lends itself to different definitions but the International Finance Corporation, a pioneer in impact investing, defines it to mean “investments made in companies or organisations with intent to contribute measurable positive social or environmental impact, alongside a financial return. Impact investments are not defined by their membership in an asset class with common risk or return characteristics but rather by the approach of the investor.

Investments may be made into the full range of public and private assets as long as by doing so the investor contributes to achieving impact.”

THE GLOBAL IMPACT INVESTING NETWORK

The Global Impact Investing Network (GIIN) is a non-profit organisation dedicated to increasing the scale and effectiveness of impact investing around the world. According to the GIIN, the amount of impact investment assets under management globally doubled from \$114 billion to \$228 billion between 2017 and 2018.

The GIIN issued a series of case studies in 2016 about the role of impact investing in achieving the UN Sustainable Development Goals. These studies profiled how impact investors were mapping their existing portfolios and impact themes to the SDGs. The GIIN has since found that more impact investors are aligning their portfolios to the global goals and are utilising them as a framework for measuring the effectiveness of their impact investing activities. The GIIN’s 2018 Annual Impact Investor Survey revealed that more than half of impact investors surveyed reported tracking some or all of their impact performance against the SDGs, showcasing the potential for impact investing to catalyse progress towards the goals.

In the view of the GIIN, it is important for impact investors to align existing assets to the global goals; however, there is not enough new capital being channeled into solutions. “As such, it is critical that investors go beyond alignment to the global goals and instead, raise and direct new capital towards progress against the SDGs,” the GIIN argues.

OPERATING PRINCIPLES FOR IMPACT MANAGEMENT

The International Finance Corporation has estimated the “appetite for impact investment” at as much as \$26 trillion. This includes \$5 trillion in private markets, involving private equity, non-sovereign debt and venture capital, and as much as \$21 trillion in publicly-traded stocks and bonds. To fulfil this potential, the IFC argues that “impact investing needs to offer investors a transparent basis on which they can invest their money, in order to achieve positive measurable outcomes for society as well as adequate financial returns.”

In order to aid this process, the IFC launched (in April 2019) the Operating Principles for Impact Management with the aim of “creating clarity and consistency about what constitutes managing impact investments, so as to bolster confidence in the market.” The Principles draw on the experience of leading development finance institutions including the IFC itself and the European Bank for Reconstruction

and Development (EBRD), in investing in emerging markets to achieve strong development impact and financial returns. The 60 organisations that have so far adopted the Principles collectively hold at least \$350 billion in assets invested for impact, which they commit to manage in accordance with the Principles.

“Despite the increased interest in and number of product launches claiming to be impact investments, there is no common discipline for how to manage investments for impact and the systems needed to support this,” the IFC said. “This has created complexity and confusion for investors, as well as a lack of clear distinction between impact investing and other forms of responsible investing.” To address this challenge, the IFC, in consultation with a core group of external stakeholders – impact asset managers, asset owners and industry associations – developed a draft entitled Operating Principles for Impact Management. The objective is to establish a common discipline and market consensus around the management of investments for impact and help shape and develop this nascent market.

The Operating Principles “integrate impact considerations into all phases of the investment life cycle: strategy, origination and structuring, portfolio management, exit, and independent verification. Critically, they call for annual disclosure as to how signatories implement the Principles, including independent verification, which will provide credibility to their adoption.” The Principles are “part of a broader trend to harmonise private sector efforts to drive positive social and environment outcomes.” The Principles complement the Impact Management Project’s framework for analysing impact. The Principles are also a follow on from the Equator Principles, a risk management framework for determining, assessing and managing environmental and social risks in project finance, which were formally launched in 2003 and are periodically updated.

THE IMPACT MANAGEMENT PROJECT

The Impact Management Forum (IMP) is “a forum for building global consensus on how to measure and manage impact.” It convenes a “Practitioner Community of over 2,000 organisations to debate and find consensus on technical topics, as well as to share best practices.” The IMP is in the process of “coordinating efforts to provide complete standards for impact measurement and management.”

It is building consensus around standards in three areas:

- > Processes for managing impact (practice)
- > Frameworks and indicators for measuring and reporting impact (performance)
- > Rating and valuation for comparing impact (benchmarking)

THE EQUATOR PRINCIPLES

The Equator Principles are a risk management framework adopted by financial institutions for determining, assessing and managing environmental and social risk in project finance. This is primarily intended to provide a minimum standard for due diligence to support responsible risk decision-making. As of March 2017, 92 financial institutions in 37 countries had officially adopted the Equator Principles, covering the majority of international Project Finance debt in emerging and developed markets.

Equator Principles Financial Institutions (EPFIs) commit to not providing loans to projects where the borrower will not or is unable to comply with their respective social and environmental policies and procedures.

The Equator Principles, formally launched in Washington in June 2003, were based on existing environmental and social policy frameworks established by the International Finance Corporation. These standards have subsequently been periodically updated into what is commonly known as the International Finance Corporation Performance Standards on social and environmental sustainability and the World Bank Group Environmental, Health and Safety Guidelines.

THE GLOBAL SUSTAINABLE INVESTMENT ALLIANCE

The Global Sustainable Investment Alliance (GSIA) is a collection of sustainable investment organisations from around the world whose mission is to deepen the impact and visibility of sustainable investment at the global level. Its vision is a world where sustainable investment is integrated into financial systems and the entire investment chain and where all regions of the world have coverage by vigorous membership-based institutions that represent and advance the sustainable investment community.

The Alliance publishes a biennial Global Sustainable Investment Review, the April 2019 edition of which showed that global sustainable investment assets reached \$30.7 trillion at the start of 2018, a 34% increase from 2016. The Review brings together results from regional market studies by the sustainable investment forums of Europe, the United States, Japan, Canada, and Australia and New Zealand. It also includes data on the African sustainable investing market in cooperation with the African Investing for Impact Barometer, and highlights from several countries in North, Central and South America provided by the Principles for Responsible Investment.

GLOBAL STEERING GROUP

The Global Steering Group (GSG) describes itself as “an independent global steering group catalysing impact investment and entrepreneurship to benefit people and the planet. The GSG was established in August 2015 as the successor to and incorporating the work of the Social Impact Investment Taskforce established under the UK’s presidency of the G8. The GSG currently has 19 member countries plus the EU, as well as active observers from leading network organisations. Chaired by venture capitalist and philanthropist Sir Ronald Cohen, the GSG brings together leaders from the worlds of finance, business and philanthropy.

It was founded “with the aim that measurable impact is embraced as a deliberate driver in every investment and business decision affecting people and the planet. Its mission is to harness the energy behind impact investment to spark an impact movement around the world.”

With Impact Investment representing 1% of capital allocated globally, just a small increase could unlock billions more to benefit people and the planet, the GSG argues. “There is a paradigm shift occurring across the world towards a future where a positive and measurable combination of risk, return and impact drives investment and the allocation of capital. Something fundamental is changing and the catalyst has been impact investing.”

“There is no longer a trade-off between ‘doing good’ and ‘doing well’. Impact investing brings together private and public capital with social entrepreneurship and not-for-profit organisations to drive huge social change to benefit the people and the planet, while delivering financial returns.”

THE ASIA SUSTAINABLE FINANCE INITIATIVE

The Asia Sustainable Finance Initiative (ASFI) is a multi-stakeholder forum that aims to harness and amplify the power of the finance sector to create resilient economies that deliver on the Sustainable Development Goals (SDGs) and the Paris Agreement. This will ensure that economic and social development is achieved while preserving the natural capital on which all societies depend, and support the urgent transition to sustainable food, energy, transport and infrastructure systems.

Based in Singapore, ASFI brings together industry, academic, and science-based resources to support financial institutions in implementing Environmental, Social, and Governance (ESG) best practices. As Singapore is a conduit for financial flows into Asia, the lending and investment decisions taken by financial institutions based

here will have a significant impact on the region’s contribution to a 1.5-degree world and its climate resilience.

THE UNEP FI ASIA PACIFIC WORKING GROUP

The Asia Pacific Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI) provides a platform for all UNEP FI members based in the Asia Pacific region to exchange ideas and best practices, and address region-specific sustainability priorities and needs in the financial sector. The Group serves to provide an Asian perspective to UNEP FI’s overall work programme. The Task Force also acts as a disseminator and promoter of UNEP FI’s work in the Asia-Pacific Region, in the form of training workshops, webinars, conferences and tools, etc., to promote the adoption of best sustainability practice at all levels of financial institution operations in the Asia Pacific region. Within the Working Group, there are three country-based sub-groups: the Australasia Group, the Japan Group and the Korea Group.

UN ENVIRONMENT INQUIRY INTO THE DESIGN OF A SUSTAINABLE FINANCIAL SYSTEM

The final report of the UN Environment Inquiry was published in April 2018 and found that there the “huge progress on reforming the global financial system over the last four years has started to deliver desperately-needed financing for sustainability and set up the next wave of action.” The report cautioned, however, that “current financial flows are still nowhere near enough to deliver the trillions of dollars needed each year to finance the Sustainable Development Goals and the Paris Agreement [on climate change].”

The Inquiry worked with policymakers, international organisations, financial institutions and civil society to help put sustainable finance at the heart of the development debate. Its final report, *Making Waves: Aligning the Financial System with Sustainable Development*, finds that sustainability is now becoming part of routine practice within financial institutions and regulatory bodies. The Inquiry focused on the rules of the game governing financial and capital markets. It worked in more than 20 countries, from Argentina to the United Kingdom, both to evaluate progress towards a sustainable financial system and help deliver national roadmaps.

It looked at a wide range of issues impacting the ability of the financial system to serve sustainable development, including delivering the first assessment on green tagging in Europe’s banking sector, publishing the first analysis of how digital finance

could support sustainable development, and identifying the key steps that need to be taken to align insurance with the Sustainable Development Goals.

The Inquiry also worked to encourage international cooperation across issues and platforms, including the G7, G20 and V20, establishing the Sustainable Digital Finance Alliance with China's Ant Financial Services and building a network of 20 financial centres sharing experiences to promote green and sustainable finance.

COUNCIL ON ECONOMIC POLICIES, ZURICH

The Council on Economic Policies (CEP) focuses on the role of central banks and financial regulators in the sustainable investment movement. More and more of these official institutions are coming to accept that such issues are within their mandate as regulators. Financial stability is one of their objectives and issues such as climate risk are increasingly seen as a risk for financial stability. The CEP's focus is on fiscal, monetary and trade policy and how sustainability is related to such areas and what the role of central banks should be in this regard. As such, it seeks to answer questions such as when central banks inject funds into the financial system, to what extent should they take into account sustainability criteria and whether, for example, banks need to undergo climate-related stress tests.

IOSCO ON SUSTAINABLE FINANCE AND EMERGING MARKETS

The International Organisation of Securities Commissions (IOSCO) in 2019 published a report on sustainable finance in emerging markets and the role of securities regulators, which provided ten recommendations for emerging market member jurisdictions to consider when issuing regulations or guidance regarding sustainable financial instruments.

The recommendations include requirements for reporting and disclosure of material ESG-specific risks, aimed at enhancing transparency.

IOSCO is the leading international policy forum for securities regulators, and is recognised as the global standard-setter for securities regulation. The organisation's membership regulates more than 95% of the world's securities markets in more than 115 jurisdictions. Members are typically primary securities and/or futures regulators in a national jurisdiction, or the main financial regulator from each country.

The report explored the trends and challenges that influence the development of sustainable finance in emerging capital markets. It also provides an overview of the initiatives that regulators, stock exchanges, policy makers and others key stakeholders in emerging markets have undertaken in this area. The report identifies

the prerequisites for creating an ecosystem that facilitates sustainable finance, such as an appropriate regulatory framework and fit-for-purpose market infrastructure, reporting and disclosure requirements, governance, and investor protection guidelines and mechanisms to address the needs and requirements of institutional investors.



SUSTAINABLE INVESTMENT AND A SUSTAINABLE FINANCIAL SYSTEM

The connection between sustainable investing and central banks or other financial regulatory bodies may not be immediately obvious, but it is a critical one, especially where the link between climate change and the health of the world's financial institutions is concerned. Sustainable investment is synonymous with the sustainability of the financial system, which in turn is dependent upon the sustainability practices of the corporate sector.

The costs of transitioning to a sustainable, lower-carbon environment and economy, in line with the UN Sustainable Development Goals, was estimated by one Bank of England official in early 2019 as being up to \$90 trillion by way of new investment between now and 2030 – equal to around one year of global GDP. Costs involved in writing off “stranded” assets (such as fossil fuel plants) alone could be up to \$4 trillion. Many such costs will be borne by corporate balance sheets or those of financial institutions, with obvious adverse implications for the financial system.

Central banks and monetary authorities are directly responsible for the health of financial institutions which could be impacted adversely in myriad ways by the need to ensure that investments in future economic growth and development are made in a sustainable manner. The effects of climate change could ramify throughout the banking and other financial sectors as climate risks translate into credit risks.

Some argue that the viability of the financial system itself could be at stake, unless it recognises and adapts to the implications of climate change. On the other hand, while the costs of transitioning to a more sustainable environment are likely to amount to trillions of dollars, the transition will also present “substantial opportunities for the financial sector to develop new products and services to mainstream green finance,” as the BoE official put it.

Alarmed by the implications of what these issues could imply for the future of

the financial system if left unaddressed, some 35 of the world’s leading central banks have begun calling attention to potential systemic risks and have set in motion moves to address them. And some central bankers are beginning to sound their own quite strident alerts.

Bank of England governor Mark Carney, for example, warned in a speech at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London in June 2019 that adapting to climate change “will require a massive reallocation of capital, creating unprecedented risks and opportunities.” Firms that do adapt “will be rewarded handsomely,” he suggested while adding bluntly that “those that fail to adapt will cease to exist.”

Or, as Sarah Breenen, Executive Director for International Banks Supervision at the BoE, put it in an address to the Official Monetary & Financial Institutions Forum in London in April, the world may be facing a “climate Minsky moment where asset prices adjust quickly, with negative feedback loops to growth.” That, she said, “underlines why the financial system needs an early and orderly transition” to climate change.

The situation was well summed up too by Pierre Monnin, a fellow with the Council on Economic Policies (CEP) in Zurich, in a discussion note published in December 2018. In this, he noted that “climate change and the transition to a low-carbon economy to mitigate it engender significant economic costs. These costs are ultimately borne by households and firms, affecting their cash flows and wealth, which are key determinants of their credit-worthiness. Climate-related costs are thus a source of credit risk.”

An accurate assessment of credit risks (including climate credit risk), he said, “is key for creditors, such as banks and bondholders. If they underestimate this risk, they will be exposed to unexpected and potentially large financial losses. Such losses, if large and simultaneous, can become systemic and generate financial instability.” An accurate assessment of such risk is also important for central banks, Monnin suggested. Tools and methodologies to assess climate financial risks are at an early stage, but cause for concern is growing as techniques are refined, he added.

The Bank of England has played a leading role in pursuing sustainability issues. Early in 2019, the Bank became the first regulator in the world to publish supervisory expectations that “set out how the banks and insurance companies we regulate need to develop an enhanced approach to managing the financial risks from climate change.” The Bank also plans to “stress test” the UK financial system for climate change adaptability.

The BoE is by no means alone, however, in expressing and acting upon concerns about the link between sustainable investment and financial system sustainability. The European Central Bank (ECB), according to its president Mario Draghi, is paying “close attention to public debate on the risks emanating from climate change, both for economic and financial stability and for society at large.”

The ECB favours “drawing up guidelines for credit rating agencies to disclose if and how environmental, social and governance (ESG) factors enter their credit ratings,” Draghi said. This “will contribute to achieving a higher level of transparency regarding sustainability, [and] allow the Eurosystem and other rating users to gain a deeper understanding of credit ratings and to investigate potential shortcomings. The ECB has already taken steps to incorporate ESG factors into its non-monetary-policy portfolios.”

The central banks of Finland, France and the Netherlands, among others, have meanwhile begun integrating ESG criteria into the management of their non-monetary policy portfolios. The Austrian National Bank commissioned research to assess climate-related financial risks across its entire balance sheet while the People’s Bank of China (PBoC) included green bonds with an AA rating and high-quality green loans as collateral into its medium-term loan facility.

And, as Rostin Benham, a commissioner of the US Commodity Futures Trading Commission has noted, “among the many lessons learned from the 2008 financial crisis, the interconnectedness of our global financial system is one, if not the single, most important.” As such, “all risk analysis, including risk derived from climate change, must include a holistic examination of the systemic relationships throughout our financial markets,” said Benham.

Leaders of the G20 group of advanced and emerging economies have also recognised the need for financial institutions to adopt a more active stance on various aspects of sustainable financing. In 2016 they highlighted the critical role that the financial sector must play in addressing such issues with the launch of the G20 Green Finance Study Group (later renamed the G20 Sustainable Finance Study Group), which called for clearer policy signals and frameworks for green investments.

BEYOND CLIMATE CHANGE

The concerns of central banks and other financial regulatory agencies relating to sustainable investing go beyond the issue of climate change – highly important though that is. In a joint paper presented in March 2019 Alexander Barkawi (of the council on Economic Policies) and José Siaba Serrate (from the Argentine Council

for International Relations) set out some of the wider dimensions of central bank concern.

Central banks, they noted, “play a vital role for sustainable prosperity. With price and financial stability at the core of their mandates, they provide key pillars for macroeconomic development. As lenders of last resort, micro-prudential supervisors and macro-prudential regulators, they fulfil key tasks for functioning financial markets. And with oversight of payment as well as clearing and settlement systems they are essential for an integrated world economy.”

The instruments central banks have at their disposal to meet these objectives are closely interlinked with a broad range of policy goals, the authors suggested. Among these they listed “environmental risks inherent to central banks’ asset purchases and collateral frameworks. Understanding these linkages and ensuring alignment between central bank policies and the broader goal of inclusive and sustainable growth is critical”, they added.

In addition, many central banks, they authors noted, have already made important steps in this direction but they also called upon the G20 group of leading advanced and emerging economies to formally endorse the momentum provided by the efforts of central banks. The G20 should encourage these central banks and their peers to “move further in assessing, reporting and engaging on the broader effects of their policies, and thus ensure policy coherence within the G20 agenda.” Climate risks, added Barkawi, are currently not adequately reflected in credit risk analysis.

THE NETWORK OF CENTRAL BANKS FOR GREENING THE FINANCIAL SYSTEM (NGFS)

The most important joint initiative so far in linking sustainable investment to the sustainability of the financial system has been the formation in December 2017 of the Network of Central Banks and Supervisors for Greening the Financial System, representing central banks and financial regulators from across five continents of the world. The NGFS is described as a “coalition of the willing.” It is a “voluntary, consensus-based forum whose purpose is to share best practices to contribute to the development of climate and environment-related risk management in the financial sector and mobilise mainstream finance to support the transition toward a sustainable economy.”

The NGFS has a significant number of members, including the following: Den Nederlandsche Bank Finansinspektionen, Monetary Authority of Singapore,

Reserve Bank of Australia, Oesterreichische Nationalbank, Bank of Canada/Banque du Canada, Superintendencia Financiera De Colombia, Danmarks Nationalbank, Suomen Pankki Bank of Greece, Magyar Nemzeti Bank, Central Bank of Ireland, Banca d'Italia Financial Services Agency, Banque Centrale du Luxembourg, Bank Negara Malaysia, Reserve Bank of New Zealand, Norges Bank/Finanstilsynet, Banco de Portugal, Banco de España, Sveriges Riksbank, Bank of Thailand, Banque Nationale de Belgique/Nationale Bank van België, Bank of England, People's Bank of China, Banque de France/ACPR, Deutsche Bundesbank, BaFin Bank Al-Maghrib, and Banco de México.

In their first progress report published at the end of 2018, NGFS members highlighted the fact that that environmental risks are a source of financial risk – and that it is within the mandates of central banks to ensure the financial system is resilient to these risks.

They also warned that such environmental risks are not sufficiently accounted for in financial markets and called for central banks to “lead by example” by reflecting environmental risks in their activities. Climate or environment-related criteria are not yet sufficiently accounted for in internal credit assessments or in credit agencies’ models which many central banks rely on for their operations, the NGFS said.

In a foreword to the report, Frank Elderson, Chairman of the Network, underlined the risks that climate change poses not just for society and the global economy but for the financial system also. “We collectively face the effects of climate change, as it reaches beyond economies, borders, cultures and languages” he noted. “In 2017, air pollution was a cause of almost five million deaths worldwide while 62 million people in 2018 were affected by natural hazards, with two million needing to move elsewhere due to climate events.”

“A transition to a green and low-carbon economy is not a niche [measure] nor is it a ‘nice [thing] to have’ for the happy few. It is crucial for our own survival. There is no alternative. Therefore, we need to come together and take action. Climate-related risks are a source of financial risk and it therefore falls squarely within the mandates of central banks and supervisors to ensure the financial system is resilient to these risks.”

RISKS AND REWARDS

How do climate risks translate into credit risks, which then impact the financial system? Pierre Monnin of the Council on Economic Policies described the linkages in a discussion note dated December 2018. Climate change, he noted, engenders

significant economic costs. The most obvious ones are the damages caused by extreme weather events such as storms or floods. Disruptions in supply chains, higher prices following shortages due to droughts or lower labour productivity in extreme heat periods are further examples.

“The transition to a low-carbon economy, which is necessary to mitigate these physical costs, also comes with a price. Investments in low-carbon technologies must be made. Carbon prices will reduce margins and existing polluting productive assets must [therefore] be written-off. Transition costs will be substantial and such costs are ultimately borne by households and firms.” These costs “translate in higher expenses and lower revenues. They can also trigger significant assets revaluation and impact household and [corporate] wealth. Cash flows and asset wealth are key determinants of household and corporate financial soundness and thus of ability to service debt. Reduced cash flows and lower asset values erode creditworthiness and thus become a source of credit risk – a climate credit risk.”

“An accurate assessment of credit risks, including climate credit risk, is key for creditors, such as banks and bond-holders,” Monnin argued. “If they underestimate this risk, creditors are exposed to unexpected and potentially large financial losses. Such losses, if large and simultaneous, can become systemic and generate financial instability. An accurate assessment of credit risk is also important for central banks. One fundamental principle of central banking is that, when providing liquidity to financial markets, central banks must require low-risk assets as collateral. If central banks underestimate risks by overlooking climate-related credit risk, they might breach this rule, by accepting assets as collateral that do not meet these stringent risk standards.”

Currently, he argued, “financial markets do not adequately reflect climate risks.” Monnin’s warning in this regard echoed a similar one from the NGFS, which has stressed the fact that “climate or environment-related criteria are not yet sufficiently accounted for in internal credit assessments or in credit agency models.” Climate credit risk is thus “significantly underestimated in current credit risk analysis.” This, as Monnin suggested can have serious consequences. It exposes creditors to potentially large losses and it could result in central banks accepting collateral of inadequate credit quality.

What’s more, as Monnin pointed out, “if credit prices do not adequately reflect climate credit risk, they send signals and incentives to investors that lead to a misallocation of capital and drive investments away from an environmentally sustainable path. These signals and incentives are amplified by monetary policy

operations, if central banks also fail to adequately take account of climate credit risk in their monetary policy operations.”

One reason why current credit markets do not reflect climate credit risk, Monnin argued, is that “costs are not captured by the asset valuation models market participants use – in particular because these models are calibrated on past data, which give poor or no indication on future climate costs. Assessing climate risks requires forward-looking scenarios that are based on complex cause-and-effect linkages and data that has not been observed in the past. Such models are at their infancy, but already offer meaningful insights. Enhancing and mainstreaming them is a critical next step for financial markets to safeguard current risk standards.”

There have been fewer attempts to quantify the risks to financial stability posed by dealing with climate change than is the case for assessing the economic fallout of that change – financial value at risk could be up to 17% on the mean average temperature rise. If potential financial losses are insured, more frequent and severe weather events will affect insurance firms directly through higher claims, and their customers indirectly via higher premiums. If losses are uninsured, the burden falls on households, companies and ultimately government budgets.

A change in the debt repayment capacity of borrowers or a fall in collateral values can increase credit risks for banks and other lenders, Monnin observed. A change in lenders’ projected earnings would also be reflected in financial markets, adversely impacting investors and asset owners. “Feedback loops between the financial system and the macroeconomy could further exacerbate these impacts and risks. For example, damage to assets serving as collateral could create losses that prompt banks to restrict their lending in certain regions, reducing the financing available for reconstruction in affected areas. At the same time, these losses weaken household wealth and could in turn reduce consumption.”

“The transition to a low-carbon economy can also significantly affect the value of households’ and firms’ assets: potential re-pricing of stranded fossil fuel assets is a case in point. Changes in real estate valuation due for example to stricter energy efficiency standards provide a further illustration. Changes in asset valuations affect both the capital as well as the collateral that underpin credit and thus add a further channel through which climate risks are a source of credit risk.”

There will, as the Bank of England’s Sarah Breeden says, be “winners and losers” in dealing with the financial and investment impacts of climate change. “Studies have focused on the impact from the transition on the financial system through ‘stranded assets’ that turn out to be worth less than expected, probably zero in the case of

unburnable carbon. The estimated losses are large – \$1 to 4 trillion when considering fossil fuels alone, or up to \$20 trillion looking at a broader range of sectors.”

As she has observed, “even at the bottom ends of these ranges, losses represent a material share of global financial assets.” Measuring these future risks from climate change to the economy and to the financial system is a complex task. A myriad possible climate pathway – with different physical and transitional effects – need to be translated into economic outcomes and financial risks looking ahead over many decades. To simplify that challenge, we need to focus not on what will happen but what might happen. To support that goal, we might well need to develop new standards and classifications to identify which economic activities contribute to the transition to a low-carbon economy.

6

JAPAN AS AN ASIAN LEADER IN SUSTAINABLE INVESTMENT

Asia ranks low on most counts in terms of sustainable investment awareness and achievement compared to the United States and Europe. Led by Japan and China, however (on different grounds in each case), Asia is becoming more aware of the need to embrace sustainability. The gap between Asia and other regions meanwhile implies an opportunity for Asia to make a sizeable dent in the global sustainable investment deficit as it catches up with leaders elsewhere.

“Nowhere is the opportunity for sustainable finance greater than in Asia,” a joint report published in April 2019 by consultants FSG and funding network AVPN (supported by the Rockefeller Foundation) said. “But so far only a sliver of this opportunity has been realised.”

In terms of ESG investing, the most widely used yardstick for measuring how far environment, social and governance factors are taken into account in investments, Asia remains “far behind the US and Europe,” the report noted. It estimated the percentage of ESG investment in total assets under management in Asia at just 0.7% compared to 12.6% in Europe and 14.4% in the US. In Japan’s case, the ratio was also less than 1%.

Asia’s lagging position in terms of sustainable investment is likely to prove costly for the world’s fastest-growing and most populous region, unless determined efforts are made to remedy the situation. As the FSG-led report noted, “most Asian countries have achieved strong economic growth over a sustained period of time, and this has enabled large-scale improvements in living standards and reductions in poverty.” But by the same token, “this model of resource-intensive growth has created long-term risks to sustainability.”

Different approaches are being adopted in different parts of Asia to address the problem. Pollution and climate change rank high among the concerns of countries

such as China and India, both of which have experienced particularly high growth and industrialisation in recent decades. Both have also made considerable progress in recent years with the development of bond markets to finance green investments. In the case of Japan, which achieved industrial transformation much earlier, the approach towards improving investment sustainability has been broader and more holistic.

Japan accounts for no less than 83% of all ESG-type investment in Asia, but this dominant position is as much a reflection of the low overall incidence of ESG investment in Asia as it is of absolute ESG volumes in Japan. Japan's relatively strong position with regard to the adoption of ESG is also largely a result of government actions rather than private sector initiatives.

A report in May 2019 from the upper house of the Japanese parliament, or National Diet, argued that “the concept of sustainability is linked to the Japanese culture, which cherishes coexistence with nature and regeneration.” As such, the report suggested, Japan has the potential to “lead initiatives in the international community such as attaining some of the SDG goals” (a reference to the 17 Sustainable Development Goals identified by the United Nations in 2015). However, at the same time this report emphasised the need for a national programme of education and consensus-building in Japan in order to swing wider public support behind the concept of sustainable investment.

“An increasing number of large companies and local governments [in Japan] have come to recognise the SDGs compared with the previous [UN] Millennium Development Goals,” the report noted. Even so, it added, the official goals “are not sufficiently known among small and medium sized enterprises and the general public.”

The House of Councillors consequently called for a programme of national education involving the general public, educational institutions, private companies, the media and local governments, to raise awareness of the need for sustainability. It also urged the Japanese parliament itself to initiate discussion on adopting the UN Sustainable Development Goals as a “national strategy.”

Progress towards achieving somewhat looser forms of sustainable investment has been under way for some years in Japan's private sector. In 2014, the Japanese Financial Services Authority (FSA) published a Corporate Stewardship Code encouraging boards of directors to include long-term sustainability considerations among their other fiduciary duties. Initiatives taken by prime minister Shinzo Abe's administration to encourage higher standards of corporate governance in Japan have

also helped lay the foundations for corporate and financial market sustainability, with the result that ESG investments in Japan grew from virtually zero in 2014 (when the Stewardship Code was published) to just under \$120 billion in 2016.






ROLE OF JAPAN’S GOVERNMENT PENSION INVESTMENT FUND

An important milestone, one that is helping to change the face of the sustainable investment landscape generally in Japan and of the ESG movement in particular, came in 2015 when the Government Pension Investment Fund (GPIF) began a series of initiatives aimed at boosting its own financial returns and aiding the Japanese sustainable investment movement in general. The significance lies in the fact that the GPIF is Japan’s (and indeed the world’s) biggest pension fund and asset owner, with some 170 trillion yen (\$1.56 trillion) of assets under management.

The GPIF has adopted a twin strategy to incorporate ESG factors into its equity investments in Japan. The first prong of the strategy involves passively investing across the spectrum of Japanese equities, while at the same time engaging directly with certain investee companies as a means of encouraging wider adoption of sustainability practices in their core business. The second prong involves investing in funds that track several ESG indices. So far, the GPIF has invested around 2.3 trillion yen through the second approach, and aims to expand this to around 10% of its Japanese equity portfolio.



List of ESG Indices GPIF Selected

	 FTSE Blossom Japan Index	 MSCI Japan ESG Select Leaders Index	 MSCI Japan Empowering Women Index (WIN)	 S&P/JPX Carbon Efficient Index	 S&P Global Ex-Japan Large Mid Carbon Efficient Index
Concept	<ul style="list-style-type: none"> FTSE's ESG index series. Utilize the globally established FTSE4Good Japan Index ESG rating methodology. integrated index by screening constituents with high ESG rating, and industry neutral weighting. 	<ul style="list-style-type: none"> Integrated index constituted by MSCI's ESG research. Reflect various ESG risks comprehensively into the market portfolio. Include stocks with relatively high ESG rating among industry. 	<ul style="list-style-type: none"> Calculate gender diversity scores based on various information disclosed under the Act on Promotion of Women's Participation and Advancement in the Workplace". Constitute index by including companies with the high score from each industry. The first index to select stocks from various perspectives in this field. 	<ul style="list-style-type: none"> Based on carbon data provided by Trucost, one of the pioneers of environmental research companies, S&P Dow Jones Indices, a leading independent provider, develops the index methodology. The indices are designed to increase index weights of the companies within the industry which have low Carbon to Revenue Footprints (annual greenhouse gas (GHG) emissions divided by annual revenues) and actively disclose information of carbon emissions. 	
Subject	Domestic equities	Domestic equities	Domestic equities	Domestic equities	Foreign equities
Universe	FTSE JAPAN INDEX [509 stocks]	Market cap top 500 in MSCI Japan IMI	Market cap top 500 in MSCI Japan IMI	TOPIX [2,103 stocks]	S&P Global Large Mid Index(ex JP) [2,584 stocks]
# of Constituents	149	252	208	1,694	2,162
AUM	526.6 billion JPY	622.9 billion JPY	388.4 billion JPY	1.2 trillion JPY in total	

Note: Data of three indices from the left is as of the end of March 2018. data for two indices from the right is as of the end of August, 2018.

“Ninety per cent of our equity holdings are passively managed, tracking the [Tokyo Stock Exchange’s] TOPIX index, and other indices and we have shareholdings in more than 5,000 companies”, (more than 2,000 domestic stocks and nearly 3,000 overseas equities), one GPIF official notes. “Half of our investment is fixed-income bonds and the other half is equity. We own a part of the whole capital market and that is why, by incentivising our portfolio companies to pay attention to ESG factors, we can create more sustainable corporate value for the longer term.”

The GPIF’s domestic equity investments comprise nearly 6% of Japan’s total stock market capitalisation and so it needs to ensure that markets grow in a sustainable manner in order to mitigate risks to its own assets. Aside from that, the GPIF also expects to see capital appreciation from its domestic ESG investments as it believes that stock prices do not yet fully reflect the ESG performance of companies. As an “early ESG investor” in Japan, the GPIF expects to benefit significantly from share price appreciation once other shareholders incorporate the value of ESG performance into their investments, as was the case in other markets such as the UK and the US, the FSG report suggested.

The GPIF has meanwhile become a signatory of the UN Principles for Responsible Investment (UNPRI) and it has selected three ESG indices into which investments can be directed by fund managers who manage money on behalf of the government fund. This is aimed at encouraging companies to be proactive in addressing ESG issues and disclosing information. The GPIF tracks the three indices, which have a portfolio value equal to around 3% of the fund’s total equity portfolio. These three indices cover all aspects (environmental, social and governance) aspects of ESG and the GPIF also tracks two additional indices – the FTSE Blossom Japan Index and the MSCI Japan ESG Select Leaders Index.

“We began to invest in ESG indices in 2017 and now we have invested around 3 trillion yen in five indices. Everything is via asset managers but we selected these indices,” a GPIF spokesperson said. “When we award passive mandates we say, ‘please follow these indices.’ The indices measure the level of ESG achievement by each company according to disclosed information. In the case of active investment, the aim is to beat these benchmarks in terms of financial return but the basic investment strategy is overwhelmingly passive.” The GPIF also requests asset managers to engage with their portfolio companies on ESG issues.

There is potential for GPIF involvement in ESG investment to grow significantly in the future, given the massive size of its overall assets under management. In the meantime, the lead given by the GPIF in promoting sustainable investment

is particularly important in a country such as Japan where, as one executive at the Tokyo regional headquarters of a leading US insurance company put it, “we tend to pay a lot of attention to what the government wants to do.”

The government in this case comprises not only institutions such as the GPIF but also the official Financial Services Authority (FSA) and various government ministries. Now that Japanese government officials have (as the same executive put it) “shaken hands with their foreign counterparts” on the need to promote sustainable investment, the Japanese private sector is likely to fall in line behind government leaders.

The GPIF is thus at the forefront of Japanese sustainable investment initiatives. As the FSG-led report referred to above phrased it, “the GPIF has adopted a collaborative approach [in order] to share learning and to drive change toward sustainable investing globally and in Japan. In addition to its investment activities it collaborates with other asset owners, institutional investors, ESG evaluation agencies and with the World Bank to create knowledge promotion and cross learning.”

The example being set by the GPIF in promoting sustainable investment does not stop short in Japan. The Japanese pension fund has also co-founded the Global Asset Owners Forum together with two other leading international pension funds – the California Public Employees Retirement System (CalPERS) and the California State Teachers’ Retirement System – as a platform for asset owners to share learning. As the world’s largest financial asset owner, the GPIF’s actions could encourage other asset owners and institutional investors in the Asia region to adopt a more long-term view of investment,” the FSG report suggested.

For all its proactive approach toward ESG issues, the GPIF is obliged to recognise and respect certain constraints on its activities. While the pension giant is becoming an increasingly important presence in ESG investing, the GPIF is not an impact investor. As a “pay as you go” system, the GPIF is required to earn financial returns on its investments in order to reduce the financial burden on future generations of pension fund contributors (whose numbers are diminishing relative to the number of pensioners in Japan’s rapidly ageing society).

This legal requirement for the GPIF to earn financial returns means that it is not able to make impact investments, which can involve sacrificing part of the financial return on investment in favour of social or other non-financial priorities. “We do not use the term Impact Investment,” one GPIF official put it. The GPIF is also prohibited from taking an active role in company management with regard to policy

issues. But the fund is nevertheless having an impact on sustainable investment in other ways.

Promoting stock indices is “one of our methods to incentivise portfolio companies to pay more attention to ESG”, as one fund official noted. The GPIF also requests its asset managers to engage with their portfolio companies in terms of ESG issues, and it has changed its method of asset manager evaluation so as to incentivise them to engage more with the companies the fund invests in.

JAPAN POST INSURANCE JOINS THE SUSTAINABILITY DRIVE

Japan Post Insurance, part of the formerly state-owned but now partially privatised Japan Post group, intends to triple the proportion of ESG investments in its domestic stock portfolio to around 100 billion yen over the next two to three years. At the same time, the company (which is Japan’s biggest life insurer with total assets of some 75 trillion yen) proposes to adopt a more radical approach toward ESG investment than do many of its peers.

While many ESG investors have focused on “somewhat superficial [ESG] criteria such as the percentage of female managers a company employs, the average amount of paid leave taken by staff, or on a company’s carbon emission levels, Japan Post Insurance plans instead to identify companies which it believes have the technological capability to help deal with global ESG issues and to meet the United Nations Sustainable Development Goals,” chief investment officer of Japan Post Insurance Atsushi Tachibana told Reuters in March 2019.

According to Tachibana, Japan Post Insurance (known in Japanese as “Kampo”) will examine the extent to which companies’ exposure to businesses or products that will contribute to solving ESG challenges are driving their growth. This, he notes, “is not something that you can find in their public disclosure. [So,] we try to get an estimate through the 300 to 400 meetings and factory visits our analysts have with companies annually.”

Consequently, the ten biggest holdings in Japan Post Insurance’s ESG- focused growth stock fund reflect this active selection strategy, and include companies that specialise in recycling and energy-saving technologies. They do not include giant Japanese firms such as Toyota Motor Corporation, Sony Corporation or KDDI Corporation, which are all constituent stocks with heavy weightings in indices such as the MSCI Japan ESG Select Leaders index or the FTSE Blossom Japan index.

Since its launch in April 2018, the returns on Kampo’s ESG growth stock fund have exceeded those on the Tokyo Stock Exchange benchmark TOPIX Index by 2.5

percentage points and also beaten those on the MSCI and FT Blossom indices. Japan Post Insurance has been increasing its investment in risk assets since it was partially privatised in 2015. The value of its (mainly passively managed) stock portfolio currently stands at around 2.1 trillion yen and Kampo aims to double the actively managed portion of the portfolio to around 400 billion yen in the near future.

THE BANK OF JAPAN – ANOTHER PLAYER IN SUSTAINABLE INVESTMENT

The Bank of Japan (BoJ) has also become a player in promoting sustainable investment in Japan via its monetary policy. The Japanese central bank has begun to engage in ESG investing through investments in an ESG Exchange Traded Fund (ETF). This tracks the MSCI Empowering Women Index, which is comprised of companies with relatively high levels of participation by women in their workforce.

The BoJ has the potential to become a much bigger ESG investor in the future. It now owns more than three quarters of the nearly 40 trillion yen of total Japanese ETFs in issue. The BoJ is said to be the only consistent buyer of stock on the Tokyo market in recent times, and is seen to step into the market whenever a significant drop in share prices threatens.

The BoJ has committed itself to continued monetary easing until such time as its 2% annual inflation target it achieved, through various means including expanding the size of its balance sheet by means of asset purchases. This suggests that, if anything, purchases of ETFs by the Japanese central bank are likely to expand further rather than contracting in the foreseeable future, which in turn implies further BoJ involvement in sustainable forms of investment. The European Central Bank too has hinted that it could become more involved in new forms of asset purchase as part of its monetary easing policy.

SOCIAL IMPACT BONDS AND FIXED INCOME INVESTMENT IN JAPAN

Beyond the realm of equity investment in Japan by giants such as the GPIF, Japan Post Insurance and the BoJ, the issue of wider exposure to sustainable investment by fixed-income investors is looming larger nowadays. So-called Social Impact Bonds or SIBs are gaining popularity among investors as a means not only to alleviate pressure on public finances but also to open sustainable investment to fixed-income investors.

SIBs are a fairly recent innovation (pioneered in Britain) and are issued by governments, official agencies and others who are pursuing positive social outcomes in particular sectors. The market is comprised of “outcome payers” (who identify

needs and offer to pay for specific social outcomes), service providers such as business firms, NGOs and others (who provide the particular service involved), and investors (who provide finance).

SIBs can be a force for innovation, it is argued by promoters of this form of investment. By encouraging innovation by the business sector and private investment funds they also work as a trigger for innovation in public services by providing resources for testing new approaches. Private SIB investors bear risk by covering the costs of projects that fail to achieve expected outcomes. The model encourages the public sector to design and implement innovative services that can be developed by the business sector.

In Japan, the main focus of SIB programmes has been healthcare. The first batch was launched in three municipalities in 2017 and 2018 based on the themes of diabetes prevention and cancer screening. The Japan International Cooperation Agency (JICA), a principal arm of Japan’s overseas aid administration, has been another active issuer of SIBs.

Green bonds issued by a variety of Japanese and international entities ranging from the Tokyo Metropolitan Government to British and French water and electricity utilities have also become popular fare among Japanese institutional investors. As one executive at life insurance company Aflac Japan put it, SIBs and green bonds offer an opportunity for fixed-income investors such as his own company to participate in forms of sustainable investment without having to focus on “total returns” to the extent that equity investors such as the GPIF do.

The GPIF, along with the World Bank Group, has meanwhile been examining ways to widen the spectrum of investments available to sustainable investors. This joint initiative aims at finding ways to incorporate ESG criteria into investment decisions across various asset classes.

A report published by the two organisations in 2019 said that, “ultimately the goal is to direct more capital into sustainable investments and to leverage the private sector to achieve the scale of investment needed to meet the [UN] Sustainable Development Goals (SDGs).” The GPIF is anxious that fixed-interest investment should play a key role alongside equity investment in furthering ESG objectives and attaining the SDG targets.”

GROWING ESG CONSCIOUSNESS IN JAPAN

ESG investment consciousness is growing slowly but surely among investment managers and institutions in Japan. As Junko Nakagawa, the first female President

and CEO of Nomura Asset Management in Tokyo puts it, “ESG has conceptually become a ‘must have’ product” among asset owners and asset managers in Japan.

“We encourage dialogue with the companies we invest in to promote a good cycle in the investment chain.” Increasingly, she notes, Japanese companies are seeking to disclose non-financial information (such as on their compliance with ESG criteria) by means of their own reporting. It is very helpful, Nakagawa adds, for investment managers, asset managers and portfolio managers to learn about the activities of corporations in these areas.

She acknowledges the lead given by the GPIF in stimulating ESG consciousness within the investment and corporate sectors of Japan. Among other institutions that are taking a lead is Japan’s biggest life assurance company Dai-ichi Life, which is promoting impact investment as well as ESG principles in its approach to sustainability.

The Tokyo Metropolitan Government has meanwhile begun granting an annual prize to financial institutions which “provide and develop innovative products and services that meet Tokyo citizens’ needs and challenges, as well as financial institutions who work to promote ESG investments.” Tokyo residents have their needs and opinions regarding ESG investments, and these have been incorporated into award categories “based on social issues with a high level of awareness among various ESG fields.”

Japan has also become a leading supporter of the Task Force on Climate-Related Financial Disclosures (TCFD) set up in 2015 by the Financial Stability Board (FSB) to develop voluntary, consistent climate-related financial risk disclosures for use by companies, banks, and investors in providing information to stakeholders. This consortium had its Japanese launch in May 2019 with the Ministry of Economy, Trade and Industry (METI), the Financial Services Agency (FSA) and the Ministry of the Environment (MOE) serving as observers. With 164 company members the Japanese organisation has become the world’s biggest TCFD-supporting consortium.

In setting up the TCFD at the request of Group of 20 (G20) financial leaders, the Financial Stability Board (an international organisation that monitors global financial systems) argued that “increasing the amount of reliable information on financial institutions’ exposure to climate-related risks and opportunities will strengthen the stability of the financial system, contribute to greater understanding of climate risks, and facilitate financing the transition to a more stable and sustainable economy.”

In its second annual report, the Task Force reported that it had reviewed reports for more than 1,100 companies from 142 countries in eight industries over a three-

year period. In addition, it conducted a survey on companies' efforts to implement the TCFD recommendations as well as users' views on the usefulness of climate-related financial disclosures for decision-making. The Task Force found some of the results of its review encouraging, but at the same time registered concern that not enough companies globally are disclosing decision-useful climate-related financial information.

ASSET MANAGEMENT ONE – A JAPANESE PIONEER IN IMPACT INVESTING

Japanese institutional investors are becoming increasingly aware of the importance of impact investing, which aims to contribute to solving societal issues and problems in addition to having an expected earnings growth. Conventional investing can also have a positive impact on society; however, impact investing is targeted investment specifically aimed at addressing societal and environmental issues and differs greatly from conventional investing in this regard.

The size of the impact investing market in Japan is currently around 829 billion yen (\$7.653 billion), according to 2018 Global Sustainable Investment Review (GSIR). However, Junichiro Yano, a fund manager at Asset Management One Co., Ltd., one of the largest asset managers in Japan, expects the market to grow eventually to 3-4 trillion yen. If so-called “thematic” investing is included, then the size of the market has already reached 2 trillion yen.

There is an important distinction between impact and “thematic” investing, as Yano observes, “while impact investing requires investment managers to measure the actual impact each company has on society, thematic investment does not.”

Thematic investing has been growing faster than impact investing in Japan but this is expected to change as increasing numbers of institutional and other investors become interested in assessing what impact their investment is having on society, and what contribution it is making to the UN Sustainable Development Goals.

According to the GSIR, the penetration of sustainable investment in terms of proportion in Japan is considerably less than that in Europe. Sustainable investment has significant room for growth, and impact investment especially is expected to increase very rapidly.

In these circumstances, it is becoming more important for Japanese asset managers to consider how to incorporate their activities that contribute to the sustainable development of society into their investment analysis and strategies. Asset Management One aims to help solve societal issues through investing in and influencing companies to make positive impacts towards a better quality of life.

“By doing so, we work together to build a virtuous circle along the

investment chain for the sustainable development of society”, Nobutaka Aoki, CIO of Asset Management One, explained. As such, their ultimate goal is to preserve and enhance the long-term value of the assets entrusted to them by their clients and beneficiaries, while at the same time contributing to the environment, the economy and society.

In order to realise their goal, Asset Management One has adopted a novel proactive approach toward impact investing in Japan. This strategy enables them to construct a high-conviction equity portfolio while generating stable returns. Identifying companies able to address societal issues through their core business is a focal point of their stock-picking.

What criteria are they using when they select stocks? “There are three points to consider for investment,” said Yano. Firstly, Asset Management One identifies the critical societal issues. For instance, climate change is a serious societal issue; however, the exact details of which region and country has suffered most from climate change, or how vulnerable societies as a whole are to it, are still unclear. Deep research is needed to truly understand the critical societal issues. Asset Management One conducts research through their top-down approach. Secondly, through a complementary bottom-up approach, they identify companies that have solutions for each societal issue. To be selected under the impact investing strategy, a company needs to have a distinct business model which can deliver sustainable earnings growth through a business offering effective solutions for certain social issues. Lastly, as this is an impact investing strategy, Asset Management One determines whether the company’s impact can be measured.

For example, Asset Management One’s impact investing strategy identifies and invests in companies with significant business opportunities in achieving the CO2 emissions reduction goals required by the Paris Agreement. Asset Management One has initiated idea generation and sought out business models which could assist with solving this issue. Their analysis of companies which have competitive advantages through renewable energy or energy-saving allowed them to identify a Japanese home appliance maker able to reduce CO2 emissions. This company has a strong competitive edge in highly efficient inverter air conditioners and has achieved a reduction of CO2 emissions of 54 million tonnes a year, equal to the annual emissions of approximately 15.5 million households. “As global warming is set to continue, we can expect an

increase in demand for air conditioners in developing countries as the income levels continue to grow,” Yano pointed out.

Even excluding climate change, there are still other outstanding societal issues such as tackling inequality and poverty, or healthcare for the elderly, and the world incontestably needs to address these societal and environmental issues and problems together. Governments tackle societal, economic, personal, physical and environmental issues together, which emphasises the all-encompassing nature of sustainable development. However, governments alone do not have the resources or capabilities to tackle all of these growing problems.

In these circumstances, the private sector as well as the public sector is expected to provide positive solutions. Impact investing is one of the solutions that asset managers can help deliver. At present, however, most impact investing strategies invest predominantly in private equity. This limits the number of investors who can benefit from such strategies, given the relatively low liquidity and capacity of private equity opportunities. Asset Management One’s impact investing strategy overcomes these issues. As the strategy invests in listed equities, it can accept greater investment from investors who wish to contribute to solving societal issues through their asset allocation decisions. “Our impact investing strategy has been well received among investors. We believe Asset Management One can be a leading company in the impact investing field in Japan”, concluded Aoki.

SUMITOMO MITSUI TRUST ASSET MANAGEMENT: JAPANESE MEGA FIRM LEADS THE WAY

When Sumitomo Mitsui Trust Asset Management Company (SuMiTRUST AM) launched a Social Responsibility Investment (SRI) fund back in 2003 it was something of a “fashion statement,” as executive chairman David Semaya acknowledges. Nowadays, such investment involves a closer commitment between asset managers and the companies they invest in, as SuMiTRUST AM is demonstrating.

The firm, which has around \$600 billion of assets under management and is a pioneer in Japanese equity investing, is planning to launch one of the country’s first impact investment funds, which will offer impact investing opportunities in Japan to overseas investors as well as those in Japan. The fund will comprise initially of some 30 stocks.

These initial stocks are chosen with a three-year investment horizon and, while they are all Japanese companies, the spread of international activity is wide. The 30 companies were selected from 100 that were judged as suitable to meet the impact criteria among some 3,000 listed stocks in Japan.

The Social Responsibility Investing which SuMiTRUST AM embraced in 2003 involved “social, green and ethical” investing, and was aimed at combining financial returns with doing social and environmental good. These aims have since expanded to require measurable social impact from investments.

When SuMiTRUST AM launched its original SRI fund, “there was a lot of talk around the world” about sustainable investment, says Semaya, but now there is real action. “Rubber is hitting the road. I think everyone would agree that the growth of sustainable investing and impact investing is undeniable.”

Because of its requirement for investors to measure the impact achieved by their involvement with companies, impact investment takes things a stage beyond SRI and even beyond ESG investing, which is already firmly established as an asset class in Japan.

Here too SuMiTRUST AM has been a leader. The firm is one of the first global and Japanese signatories to the UN Principles for Responsible Investment since in May 2006, a group of leading international investors who support the adoption of ESG principles and their integration into investment strategies. SuMiTRUST AM has participated also in various other ESG related bodies.

“As we have enhanced our ESG research, it is quite natural for us to extend into impact investing, and we are confident that we have the know-how to do so,” says Yuji Shiomi, Head of Equity Investment Unit at SuMiTRUST AM. “We are quite sure that the need for impact investing among institutional investors has risen and will continue to rise going forward.”

Semaya is among those who see a need to categorise these different forms of “sustainable” investment more clearly. “The issue for all of us is how to come up with the same nomenclature or taxonomy,” he suggests. “How do we talk about the same issues and questions with the same language?”

Such issues aside, however, there is no doubting the growing enthusiasm in Japan and elsewhere for sustainable investment. “The traction is there” both in the public and private equity space, and with a wide range of institutional investors from sovereign wealth funds to pension funds, says Semaya.

“Every major asset manager is thinking about ESG specifically,” he adds, while noting the lead given in this regard by the Japan Government Pension Investment Fund (GPIF), which has launched several indices based on ESG principles. Among Japanese corporations too, the intention to seek social return has become stronger.

SuMiTRUST AM too is demonstrating leadership in Japan by venturing into the impact investing space. This is evolutionary rather than revolutionary because ESG investing (in which the firm is involved through its existing funds) also requires engagement with corporate management on non-financial policies.

But the pace of evolution from relatively passive involvement by investors in corporate policy to more active involvement is gaining momentum. Semaya cites especially attitudes toward the environment and climate change which have become hot topics among investors in Japan and elsewhere.

“The challenge around the question of the environment as it affects asset managers and asset owners is, do we have a determined, yet gradual engagement approach, or do we just exclude [from investment] companies right from the start,” if their activities are seen to be adversely impacting the environment, Semaya posits.

SuMiTRUST AM’s view, he says, is that “we would like to proactively engage with companies to encourage a pathway going forward,” rather than avoid investing in such companies because of their perceived policy

shortcomings in respect of environmental and other corporate policies.

Debate in Europe favours exclusion of corporate sinners from the outset, but Semaya's attitude is more flexible. "Rather than exclude from the beginning, let's engage with management and over time we can make a decision whether we will need to exclude or not. This will take a little bit more time."

The step from the engagement-oriented approach via ESG to impact investing is a relatively short one and SuMiTRUST AM is close to taking it. "We believe there is quite a bit of interest [in], if not outright demand for, an impact-oriented fund," observes Semaya.

The Sumitomo Mitsui Trust Group as a whole (which includes its trust banking arm) is not only committed to impact investment, but also to the UN Sustainable Development Goals, or the "SDG space," as Semaya puts it. "This is an important goal for us," he says. Many Japanese companies have provided globally competitive solutions that contribute to achieving the SDGs and more will emerge, he says.

The new Impact Fund (which is currently in the phase of seed capital investing and yet to be publicly named or traded) will include a number of the 17 SDG areas identified by the United Nations in 2015. The SDGs serve as a type of lens to help identify suitable companies for the impact fund.

"We invest in companies which can provide better social or environmental solutions for the world, and such companies will [also] achieve better financial returns," says Shiomi, while noting that SuMiTRUST AM has around 20 Japanese equity analysts on its staff and 15 stewardship officers to cater for ESG activities.

They use the SDGs as a means to help identify companies to invest in. They provide, he says, a "global common language" that allow for "smooth communication" with investors, investee companies and others.

While the 17 SDGs (which comprise 169 specialised areas) are governmental rather than private sector targets, they identify areas such as climate action, affordable and clean energy, clean water, industrial innovation and gender equality that also lend themselves to impact and ESG investments.

More specifically, SuMiTRUST AM uses a "Qualitative Assessment Framework" or MBIS® system (an acronym for Management, Business Franchise, Industry and Strategy) to identify companies with potential for high growth alongside ESG criteria.

For the impact fund, it has selected a “portfolio of Japanese companies judged to have the most potential impact long term, combining both positive financial returns and positive social impact.” This involves engagement with companies and annual impact reporting based on “meaningful measurement.”

The impact investment fund portfolio ranges from large to medium and smaller companies (although not start-up situations) with activities split between Japan and overseas.

The fund aims at a long-term engagement with portfolio members, but allows for portfolio changes when the “MBIS® downgrades below the investment criteria, no longer meets the impact criteria [or] a higher impact alpha idea is identified elsewhere.” This allows flexibility of risk capital deployment.

THE PARTNERS GROUP EXPERIENCE IN JAPAN

One of the pioneers of the sustainable investment movement in Japan is Shunsuke Tanahashi, general manager for Japan and senior vice president at the Tokyo representative office of Swiss-based private investment firm Partners Group. Tanahashi has been instrumental in building bridges between private equity groups such as his own, which tend to be dominant players in sustainable investment, and institutional investment managers who also constitute an important force by virtue of their collective size.

He began promoting the cause of ESG investment in Japan as early as 2005, one year before the UN Principles for Responsible Investment (which are now being widely adopted in Japan) were promulgated. Tanahashi met James Gifford, the founding executive director of the UNPRI, during a visit by Gifford to Japan. Convinced by Gifford’s “sincerity” about the cause of sustainable investment, Tanahashi (who was at that time on secondment from Mitsubishi Trust as chief research officer in a think tank of the GPIF) set about trying to convince the mammoth pension schemes of the merits of ESG investment. But he was informed (politely but firmly) that the idea was “too early for Japan.”

Tanahashi refused to be deterred, however, and then became a member of what was initially a one-man expert group within the UNPRI with the objective of promoting the principles in Japan. The principles progressively caught on and when Gifford revisited Japan in 2010 Tanahashi had become head of his own private equity company and had decided that the time had come to promote ESG in a bigger way in Japan.

“My firm was the first [Japanese] signatory in the private equity industry,” he recalls. “I had the idea to expand this idea to the private equity industry generally in Japan.” Tanahashi subsequently established a private equity working group on ESG in Japan and there are now some 65 members of this group which operates under the aegis of the UNPRI. One of its functions is to provide a forum where investment managers who have a minority stake in many listed equities – and thus little influence individually on corporate policy and ESG – can exchange ideas and plan strategies so that their collective influence is coordinated and strengthened.

This is known as collective engagement or “shudan” in Japanese. As Tanahashi notes, investment managers have little way of measuring ESG

compliance by multiple individual companies in which they have small stakes, whereas private equity groups, by virtue of their closer engagement with individual firms, can exercise more influence in helping the ESG movement to progress.

Tanahashi is convinced that sustainable investment in its various forms is destined to expand significantly in Japan in the future. The principle accords with the basic philosophy of “mottenai” or “don’t waste anything” (such as energy for example) among Japanese people, he suggests. (Others argue too that sustainable investment is in line with the Buddhist or even Confucian beliefs held in Japan, and with the respect for nature inherent within the Shinto religion). The challenge as Tanahashi sees it is to heighten consciousness among Japanese investment managers of the importance of sustainable investment and how to implement it.

The problem, as he puts it, is that “there is a kind of wall” between many managers at institutional investment firms who invest in minority shareholdings across a wide range of stocks and the world of business. This barrier does not exist or at least not to the same extent, within private equity firms which, as Tanahashi notes are able to despatch managers with “deep experience” of a particular industry to ensure that investors’ targets are met – something that institutional investors in general cannot do.

This one area where the UN Principles for Responsible Investment can help to close the knowledge and implementation gap among investment managers. As he notes, “insurance companies and pension funds along with asset managers (in Japan as elsewhere) are taking a broader view of social considerations.” Pension fund managers, he says only half-jokingly, reason that “there is little point in producing a good pension for retirement age if the climate has gone wild” by then.

Impact investing in Japan is still “much smaller than its potential,” says Tanahashi because of the necessity to achieve measurable financial as well social returns on investment. Partners Group, however, like the International Finance Corporation (IFC), claims that the returns on its investment through the group’s “PG Life Fund” have been comparable with returns on commercial investments.

THE DEVELOPING GREEN BOND MARKET: ISSUES AND INCENTIVES

As a founding signatory of the Principles for Responsible Investment (PRI) in 2006 and a member of the Institutional Investors Group on Climate Change (IIGCC) since 2003, BNP Paribas Asset Management (BNPP AM) is among the first movers in green bond investing. In December 2015, the firm became a founding signatory to the Paris Green Bonds Statement.

BNPP AM launched its first dedicated green bond fund in 2017 with an initial total assets under management (AUM) of 100 million euros (\$110 million). As of end September 2019, the fund now has a total AUM of 394 million euros, typifying the “multiplication of interest to go into this format,” according to Felipe Gordillo, Senior ESG analyst at BNPP AM. This is only one instance of what he terms the “absolutely remarkable” groundswell of issuance and interest in green bonds – which, however, is still falling short of what is needed “to finance the transition to a low carbon economy.”

Green bond issuance in 2018, which Gordillo terms an “incredible year,” amounted to more than \$170 billion. Looking forward to end 2019, he expects an even higher total of around \$200 billion for the year. If the current pace of issuance of around \$200 billion per year is sustained over the coming five years, the present total global stock of green bonds c.2018 of around \$0.5 trillion will rise to around \$1.5 trillion at the end of that five-year period. Naturally, this is a positive development, but Gordillo compares this to the total current volume of fixed-income securities worldwide – around \$100 trillion. “You realise that we still have a small amount in the global bond market,” he notes, “just 1.5%.”

While there is impressive growth in green bonds issuance, we are still less than 2% of annual global bond issuance, and we are only 1/5 of what's needed per year to finance the transition to a Paris Agreement outcome.

The Climate Bonds Initiative (CBI) has released an estimate that green bond issuance needs to reach around \$1 trillion per annum to successfully finance a low-carbon economy. Yet actual issuance in the green bond space is still “less than 2%” of annual global bond issuance, as Gordillo’s colleague Xuan Sheng Ou Yong, a Green Bonds & ESG Analyst at BNPP AM in Asia, points out. Obviously, there is plenty of room for growth – which will be needed if green bond issuance is to achieve the fivefold increase needed to hit the CBI target. The issue then is how to structure the green bond market to facilitate issuance, and ensure that global appetite for green assets is met with solid and verifiable products.

That said, the appetite for green bonds is there, among both institutional and retail investors. There is broad apparent demand for investment into green fixed-income assets, whether through individual bonds, dedicated green bond funds, or even ETFs based on green bond assets. Global demand for green bonds is now such that some form of ESG capability or green investment programme is practically a must-have for serious players in the asset management industry. Sheng reports anecdotally that practically all prime mandates now coming to market have “some form of consideration around ESG or green financing,” and an asset manager who cannot respond to these is liable to be excluded from the mandate. Nor is this just a matter for developed Western markets. The ASEAN green bond standard is based on the ICMA green bond principles, and – with the limited exception of China – “standards in Asia are very similar to those in Europe or the US,” Sheng notes. Even in the controversial area of China’s issuance of onshore green bonds for fossil fuel-related projects, the resulting bonds account for only a small share of total issuance, some 10-20% of the total, and are almost entirely made up of SOE-issued bonds. “The private market in China recognises that coal is out of the game,” Sheng adds, and Chinese issuers looking to tap international investors will align with international standards.

Still, green bond investors should pay attention to the credibility of the impact assessment in any green bond. In the case of BNPP AM’s own green bond fund, according to Gordillo, “a transparent process” allows selection of green bonds that can verifiably be shown to “really have an impact,” and exclusion of others that are less verifiable. This level of care is necessary because not all issuers coming to market are ready or able to structure a solid green bond, and the asset manager needs a process “to provide trust to the clients,” and allow them to explore the green bond space with reasonable confidence and security.

Impact reporting is a critical ingredient to reduce greenwashing in this market.

“Impact reporting”, as Gordillo notes, can be shared with clients to demonstrate “the amount of carbon that gets avoided” by investing into a specific bond, or other measurable impact. Defining impact investing by the three widely accepted concepts of additionality, intentionality and reporting (or measurability) has important implications for the green bond space, he adds. On additionality, the issuer should structure a bond issue to “increase the value of the green assets in their balance sheet,” and drive their business or operations towards greater sustainability. In intentionality, an issuer needs to set goals for their bond and measure progress towards those goals, to demonstrate “how is that bond helping them to become a more sustainable company.”

This definition avoids green bonds being used as pure greenwashing public relations exercises, and relates to the third principle of measurability, or impact reporting, which Gordillo describes as “essential,” the reason being “because at the end of the day, this is the only way to have proof” that a green bond really is having an impact. Unfortunately, despite welcome developments around the ICMA green bond principles and other initiatives, “today we don’t have a common protocol for impact reporting for green bond issuers,” Gordillo concedes.

Another new development in the green bond market, pushed by institutional investors, is greater engagement with issuers, and even sovereigns. “The green bond instrument allowed us to have this conversation with bond issuers that we wouldn’t have had three years ago,” Gordillo remarks, instancing discussions with the Indonesian and Dutch governments about their green bond issuance that helped “to understand what is their strategy when it comes to climate change, what are the actions they are taking, what is their progress, and also what are their constraints.”

Looking at the challenge financial markets face today in financing the transition to a low carbon world, measurability is perhaps not the most important factor in the potential growth of green bond investment, though: even more important, perhaps, are incentives.

Central banks and sovereign wealth funds must prefer green-labelled assets to non-green labelled assets, in order to unlock a systemic economic incentive for the market to really take off.

“We are now at a very critical moment for the green bond market,” Gordillo believes, and he links this to incentives for issuers. Solid financial incentives need to be put in place for the green bond market to really take off. Despite the evident demand among pension funds, SWFs and other major institutional investors, the immense fixed income appetite of central banks, whose balance sheets dwarf any other investor, is key to unlocking this potential, Gordillo maintains. “If you have a preference from a central bank to buy green, that will create a signal to bond investors that the issuers will see a tightening in primary markets, which will mean a lower cost of capital for companies, and that is the economic incentive that we want to see for this market to really scale up,” he concludes.

SUSTAINABILITY IN ASIA AND BEYOND

The environmental, social and governance (ESG) set of standards is often dubbed the predecessor of impact investing and sustainability in corporate and financial circles. Over the last decade, we have seen unparalleled progress on global efforts to address the world's biggest sustainability challenges, showcased by the launch of the Sustainable Development Goals (SDGs) and the Paris Climate Agreement in 2015. Both enjoy wide-ranging support from the world's largest investors, companies, civil society and numerous levels of government, including regions, states and cities.

The financial community, driven by prudential and long-term risk considerations as well as motives of public spirit, is also moving to address the pressing concerns of environmental and social responsibility.

As CEO Asia-Pacific at BNP Paribas Asset Management (BNPP AM), Ligia Torres is convinced that investing in a sustainable future is in the long-term financial interest of both the firm's clients and global economy. In fact, over the last two to three years, she has seen the accelerated adoption of ESG investing in Asia Pacific caused particularly by a greater push by leading institutions or governments in embracing these principles.

Sustainability considerations in an enterprise begin with the board, and this is where good governance can be a key influence from the start, Torres believes. This mindset is not only important from the classic impact consideration of achieving a positive good, but also from the longer-established perspective of doing no harm to your own business.

"When you are really engaged with sustainability issues, it is not just a question of maximising opportunities, you are also looking to identify and manage associated risks. The potential downside, from unmanaged sustainability risks can be material," she maintains. "As a company, we need to have a return on capital," she points out, "but that return can be impacted by lack of focus on sustainability issues."

For sustainability policies to work, and to integrate with good corporate governance, "it needs to be clear, and well communicated," says Torres, and supported by concrete actions at the board level. This is not just a matter of appointing non-executive directors, or greater board diversity. Rather, "you have to change the culture, behaviour and mindset of the company," she adds. Such changes need training, consultation, communication, active engagement,

and measurable objectives. It also, inevitably, affects how the company conducts business with others.

Financial companies are particularly well positioned in this respect, she continues, because they “have significant impact across different industries, different client segments,” and can “have an active engagement” with issuers to drive them towards more sustainable practices. This needs the company to change its own products and services, institute risk controls and filtering, while maintaining pro-active, positive interaction with other businesses.

“In asset management, it’s not just about exclusion, but also how you can engage and partner with issuers to help enhance their performance on key sustainability issues,” Torres maintains.

Corporate governance in Asia Pacific has also improved significantly over the past five years, in Torres’ experience. It also has remained, perhaps, the first priority among the original ESG troika in the region. In Japan, China, Malaysia, Singapore, Taiwan, and beyond, “there are new or revised corporate governance codes,” she notes, or other developments including revised listing rules, enhanced disclosure and increased transparency.

Despite all this positive momentum, “there is still a lot of room for improvement,” comments Torres. Related-party transactions remain an issue in some markets, as does the appointment of truly independent directors who are not simply friends of the management, but who can actually contribute to the running of a company. “It is a journey, and it’s going to take years,” she concedes, adding that changes to corporate culture, nor a simple direct transference of governance models from other regions would be truly effective solutions.

“You cannot transfer a system that is suited the Western world to markets in Asia,” notes Torres. Global best practice remains the standard to follow, but it needs to be adapted and implemented according to the local situation, and will not work on a one-size-fits-all basis. Asia is already a much more disparate and fragmented region than the West, and implementation of governance best practice consequently needs a lot more local fine-tuning.

In particular, Asia’s long tradition of family-owned businesses and corporate dynasties is often cited as an obstacle to good governance. “Sometimes, curiously enough, you could say the opposite,” points out Torres. A strong, trusted relationship with the owner of a family company can leave

an outside advisor with an effective channel to influence the running of that company.

All this comes down to the position of financial players in their various markets, and their position of trust and responsibility. Fiduciary responsibility to clients extends a long way, in Torres' view. A global financial group such as BNPP AM can have a "massive" impact on the communities it is based in.

"This also extends to the group's own business policies, risk exposures, and even the fiduciary duty to warn clients if they are going into areas unsuitable for them, and refuse to do business if we strongly believe that it's not going to be sustainable nor in their best interests," added Torres. On the positive side, financial groups have a huge "financial responsibility" to support sustainability. "If we can lend to projects that have true impact in the economy or even on the environmental or social side, it is super powerful."

BNP Paribas Asset Management has been, in many ways, a pioneer in these areas, as Torres is glad to point out. The firm was "one of the founding signatories of the Principles for Responsible Investment (PRI)," and moved rapidly to adopt and internalise the goals of the Paris COP 21 United Nations Climate Change Conference.

Put simply, such a monumental shift did not happen overnight. When she first arrived in Asia Pacific, she observed that most of the ESG-focused investing and asset management work were predominantly in Western markets, simply because the relevant data was more readily available.

"My conviction was that it was necessary to do it in a much more holistic manner," she states, bringing emerging markets into the sustainability perspective.

"To convince people, it needs to take time," she concedes, but adds that now 100% of the firm's staff are trained and educated on sustainable investment practices. "You need to have a very clear strategy and policy and it needs to be embedded in everything you do."

Fast forward to 2019, the firm did exactly that – launching its ambitious Global Sustainability Strategy in March 2019. The strategy sets out BNPP AM's plan for all of its assets to be managed with sustainable investment practices by 2020 – including ESG integration, stewardship, responsible business conduct and a thematic focus on 'the 3E's' (energy transition, environmental sustainability, equality and inclusive growth).

“This is much broader than our goal to expand ESG integration and sustainable investing across all investment strategies by 2020; it is about delivering long-term returns for investors via sustainable assets in alignment with the future economy,” Torres concludes.

TOWARDS CHINESE BLENDED SOCIAL FINANCE:

Opportunities for Social Impact Bonds, Impact Investment and Public-Private-Partnership for Ecotourism Development Cases in China

– Dr. Ilex Lam, Dr. Tat Lam, SDG Institute of Impact Finance (SDGIIF) –

Introduction

Sustainable tourism (or ecotourism) is a unique high-growth industry that spans worldwide markets, bridges the gap between developed and developing countries, and addresses a broad spectrum of problems and solutions articulated within the United Nations' 2030 Sustainable Development Goals (SDGs) to solve the world's most pressing issues. This chapter will mainly introduce impact investment cases in China, particularly in the industries of tourism and rural development, because we believe this industry on the one hand captures the most attention in both domestic and international mainstream capital markets with high financial scalability, while on the other hand severely lacks impact management frameworks and tools to optimise the mitigation of negative impacts and maximising positive ones that directly support the bottom line.

The chapter is written in two principal parts: the first contains an overview of our research and methodological development for impact investment in Asia for the tourism industry; the second focuses on the specific discussion about how impact investment models are modified and developed to match China's diverse socioeconomic contexts, reflected in three selected case studies.

THE SHIFT TOWARDS SUSTAINABLE TOURISM

Sustainable ecotourism inhabits the space of social development, environmental protection and rural development, all of which are driven by massive social and economic mandates; but due to the complexity of working in developing markets, supply is often unable to effectively connect with demand. In our effort to fully recognise and analyse such complex developing markets in a way that links international consumers with deep impact on marginalised and vulnerable

populations, and – perhaps more importantly – to realise how those populations may have a deep impact on international markets, our impact management research and analysis methodologies focus on the following principles:

1. **Creating Value with Local Communities** – The practice of ecotourism gains its commercial power from preserving and bolstering the health and vitality of developing communities and their environments, which requires building a resilient yet sensitive methodology for dialogue, consideration and value creation with local communities.
2. **Working across both Private and Public sectors** – The ecotourism industry thrives between commercial and government sectors to serve consumer markets. Impact investment funds can leverage this great potential to make investments that can form strong public-private-partnerships; influencing and informing social, economic and environmental policy and decision-making processes that can directly benefit vulnerable populations, environmental habitats and social enterprises; in ways where otherwise strictly corporate entities would have less influence and impact.
3. **Embracing Next-Generation Consumer Trends** – Last but not least, the projects are preparing to capture the major shifts in consumer demand as the buying power of younger generations increasingly prioritises sustainability and meaningful experiences with verifiable impacts that leave the world a better place than they found it. This entails not only shifting towards their proclivities for more sustainable investment and consumerism, but creating pathways that actively engage and bridge gaps in society, as well as deploying services on next-generation technologies such as mobile-enabled cloud computing and blockchain products and services towards non-exploitative, fair-trade, and ethical digital/data practices.

Tourism is quickly becoming one of the largest tertiary growth industries in the world. In 2012, there were more than one billion tourists globally and the number is projected to be 1.8 billion people by 2030¹, with a market size of nearly \$7 trillion annually. The tourism industry accounts for almost 10% of global GDP, 6% of global exports and employs over 277 million people². This size suggests the industry's significant potential contribution towards sustainable development where, “in 2013, tourists spent \$413 billion in developing countries – nearly three times the level of development assistance that year”³. Such figures represent a massive opportunity which impact investment funds can leverage to pioneer the sustainable tourism

industry by mobilising the global agenda into new capital markets, innovative blended finance strategies, and highly innovative and impactful projects with unique business models that produce high returns.

One of the most important trends in tourism is the shift in public preference towards sustainable tourism, products and services. The trend appears in people over 51, where almost half (48%) now consider sustainability to be an important factor in their travel decisions, and perhaps even more importantly, among people under 30 where sustainability options are important for over 90% when making travel decisions⁴, comprising nearly a quarter (23%) of the market, and an estimated \$400 billion in youth-driven sustainable tourism⁵. Millennials show more interest in the experience behind visiting foreign places, and seek to make a substantial and meaningful difference to where they go and with whom they visit, where “tourism is simply not a way to get away from life – it is a way to embrace life.”⁶ This represents a clear signal that the market is making a drastic shift away from the old model of destination-based leisure tourism towards experience-based impact tourism, challenging the next generation of tourism products and services to adopt sustainable practices or die.⁷

IMPACT RISK MANAGEMENT METHODOLOGIES

International and local investors are increasingly aware of risks and returns beyond financials. The research shows that not only does the financial risk and financial return of organisations need to be assessed, but also the impact risk and impact return that capture the extra-financial value, which can hugely influence reputation and therefore financial performance in the longer term, where trust and positive regard builds brand loyalty.⁸

Impact return is commonly measured through the social capital return on investment (such as the SROI framework), a principles-based method for measuring

¹ “World could see 1.8 billion tourists by 2030 – UN agency” UN News, December 27, 2017

<https://news.un.org/en/story/2017/12/640512-world-could-see-18-billion-tourists-2030-un-agency>

² Travel & Tourism World Economic Impact 2015, World Travel & Tourism Council; Tourism Highlights 2015, United Nations World Tourism Organisation

³ Towards More Effective Impact Measurement in the Tourism Sector, 2015, WBG Sustainable Tourism Global Solutions Group https://consultations.worldbank.org/Data/hub/files/consultation-template/towards-more-effective-impact-measurement-tourism-sector-openconsultationtemplate/phases/wbg_towards_more_effective_impact_measurement_in_the_tourism_sector_consultations.pdf

⁴ <https://www.travelpulse.com/news/tour-operators/millennials-are-the-most-socially-conscious-travel-demographic.html>

⁵ United Nations World Tourism Organisation and World Youth Student & Educational Travel Confederation (UNWTO and WYSE Travel Confederation) (2016), “Affiliate members global reports, volume thirteen – the power of youth travel”, UNWTO, Madrid.

⁶ <https://www.tts.com/blog/how-sustainable-tourism-is-impacting-the-travel-industry/>

⁷ United Nations World Tourism Organisation (2013), “Affiliate members global reports”, Volume thirteen – The Power of Youth Travel, UNWTO, Madrid

⁸ GIIN. (2017). Evidence on the Financial Performance of Impact Investments.

https://thegin.org/assets/2017_GIIN_FinancialPerformanceImpactInvestments_Web.pdf

social or environmental value that is largely not reflected in conventional financial accounting. Impact risk is the possibility that impact will be different than anticipated, as expected impact does not endure (drop-off risk), can be achieved with fewer resources (efficiency risk), is misunderstood or neglected by different stakeholders (stakeholder participation risk), is unsupported by high-quality data contributed by different stakeholders (evidence risk), or is disrupted by external factors (external risk), failure of execution (execution risk), destruction of project (endurance risk), or the failure to integrate impact into the business model (alignment risk). Last but not least, impact risks also include the likelihood that people and the planet experience unexpected positive or negative impact (unexpected impact risk)⁹.

Such assessment underlines that successful sustainable tourism investment mandates must adopt a blended finance model that invests in projects with different levels of financial and impact returns, as well as different typologies of financial risks and impact risks. Such multidimensional risk/return profiles help investors with different financial and impact appetites to participate more flexibly, while having a view into the nature of each project as it pertains to their interests and mandates. The following table describes the risk/return profile typologies:

Risk/Return Profile	Assessment
Financial Return / Financial Risk	How much money the investment will make versus the possibility that the organisation will lose money. This coefficient indicator is suited for traditional Profit-First Investors who seek financial returns regardless of Environmental, Social or Governance (ESG) factors.
Financial Return / Impact Risk	How much money the investment will make versus the likelihood that social or environmental impact will be different from expected. This coefficient indicator is suited for Socially Responsible Investors (SRI) with mandates that factor negative-screening based on impact risks.
Impact Return / Financial Risk	How much positive impact an investment will generate versus the possibility that the organisation will lose money. This coefficient indicator is suited for Impact-First Investors who take precedence of social and environmental considerations over financial return.
Impact Return / Impact Risk	How much social and/or environmental impact an investment will generate versus the likelihood that impact will be different from expected. This coefficient indicator is suited for Philanthropists, Venture Philanthropists and Public-Private Partnerships where financial returns can be disregarded in favour of positive social and environmental outcomes and solutions.

In the case studies, the research puts particular focus on *Hospitality Development and Cultural Heritage* projects that have higher financial return over different levels of financial and impact risks, and simultaneously invest in *Community-Building and Regenerative Development* projects that exhibit higher impact return over strategic

⁹ Impact Management Project. <https://impactmanagementproject.com/impact-management/what-is-impact/risk/#anchor2>

levels of financial and impact risk. These types of projects reveal approaches to risk management that create very innovative, early stage, high-impact return and high-impact risk projects that unblended models *cannot afford*.

In a typical investment, risk is generally limited to measuring the prospects of a venture against which it may suffer financial loss, or a complete failure, for which risk mitigation solutions must be deployed to manage such outcomes. As sustainable tourism is firstly a business-driven enterprise, and thereby requires typical risk management features, it also straddles social development, environmental protection, economic development and local governance, all of which have different financial and social consequences at risk, and thus need to be considered, designed and managed accordingly and resiliently, sometimes across multiple stakeholders.

IMPACT DUE DILIGENCE AND IMPACT MEASUREMENT

Working in developing regions on projects that affect social development requires knowing what kind of impact is made over time in order to report to key stakeholders, which may include governments, international NGOs, watchdog groups, community leaders, consumers and/or beneficiaries. Measuring impact is crucial to making sure projects are on the right track, allowing risk mitigation and opportunities for success. It is an active process, where its efficacy and success in informing the fund on how to support high impacts with high returns relies on the ability to monitor outcomes continually in a cost-effective manner across key stakeholders without adding to the stress of the system, but rather adding value to each node of the value chain as actionable and therefore monetisable insights. Just as important is the process of Impact Due Diligence, where the profile of the project and its target beneficiaries must show that it has the capacity to achieve its intended impacts as a function directly related to its financial return projections.

UNITED NATIONS SUSTAINABLE DEVELOPMENT GOALS

Key to forming government partnerships, unlocking social finance capital and making projects internationally interrelatable across portfolios, is mapping impacts into the United Nations Sustainable Development Goals (SDG) framework. Mapping related SDGs into impact mandate goal-setting and measurement methodologies allows participation in the international dialogue towards creating and mutually supporting more sustainable business practices, capital deployment and social development. In our investment mandate research, we primarily focused on the following SDGs in how they relate to sustainable ecotourism investment, entrepreneurship and innovation:

SDG 1 – No Poverty

Sustainable tourism development and its impact on communities can be linked with poverty reduction goals, promoting entrepreneurship and small businesses, and empowering less favored groups, particularly youths and women.

SDG 8 – Decent Work and Economic Growth

Decent work opportunities in tourism and policies that favour better diversification through tourism value chains can enhance positive socioeconomic impacts in communities.

SDG 12 – Responsible Consumption and Production

The tourism sector, when adopting sustainable consumption and production (SCP) modes, can accelerate the shift towards sustainability and positive economic, social and environmental outcomes, including but not limited to energy, water, waste, biodiversity and job creation.

SDG 17 – Partnerships for the Goals

Due to its cross-sectoral nature, tourism has the ability to strengthen private/public partnerships and engage multiple stakeholders – international, national, regional and local – to work together to achieve the SDGs and other common goals.

STANDARDISING IMPACT METRICS ACROSS PORTFOLIOS

In our research, we find that individual project operation and integration with the frontline greatly benefit from customised and specific project metrics to help monitor performance, while at the same time standardised portfolio metrics help support consistent and comparable impact analytics across investment portfolios. Both are necessary for managing overall health to maintain comparative competitiveness to other portfolios in its class as well as contributing towards global intelligence and knowledge-sharing of impact management for interrelated fields and industries. Therefore, we developed proprietary impact management methodologies to build impact management literacy at all levels of impact measurement, and to achieve consensus among all stakeholders. We have found that data collected for project metrics can be accumulated and aggregated to support the measurement and analysis of Portfolio Metrics across the following dimensions¹⁰:

1. Social Inclusiveness, Employment and Poverty Reduction: tracking job provision, inclusive growth, resilience of rural communities, revitalisation of urban areas, benefits to women, support to artisans and access to income via travel tech.

¹⁰ Tourism for Development. 20 Reasons Sustainable Tourism Counts for Development, 2017, World Bank Group.

2. Sustainable Economic Growth: monitoring GDP growth, increase in international trade, expansion of international investment, growth of infrastructure development, development of low-income economies.
3. Cultural Values, Diversity and Heritage: observing protection of cultural sites and conservation of intangible culture.
4. Mutual Understanding, Peace and Security: overseeing the prevalence of philanthropy, cultivation of intercultural understanding, and aids to post-conflict recovery.
5. Resource Efficiency, Environmental Protection and Climate Change: Keeping track of facilitation of environmental conservation, awareness building of climate change and promotion of the Blue Economy.

TRANSPARENCY COST AND COMPLEXITY

Measuring impact can become an expensive and time-consuming endeavour, without a one-size-fits-all solution. Depending on project scale, volume of data and the complexity of data collection, the budget for impact measurement may not be commensurate with required transparency mandates for the project. Before setting metrics to project investment mandates, sustainability funds undergo rigorous processes for selecting appropriate impact measurement systems that fit the scope, scale and financial realities of each of their projects, to make sure the process of transparency does not interfere with the core business mission and operations. Evaluation of cost-per-data-point should be considered and evaluated to fit the budgetary constraints of each project, considering the business purpose, duration and frequency of impact measurement, existing data infrastructure, data literacy and participation incentives of stakeholders, data sources available, data collection methodology and tools used, the depth and breadth of impact as well as data types and analytics required by the audience of impact and the appetite of the investors/stakeholders for higher/lower resolution visibility into project outcomes. Not only must the cost of data collection be considered, but also the cost and complexity of validating and ensuring quality, accuracy and reliability.

CASE STUDIES FOR IMPACT INVESTMENT IN CHINA

After studying several cases of impact investment and discovering unique phenomena of funds innovating financing models for developing contexts of social, economic and cultural factors, we find that the role of government and the public sector across all levels, both central or regional and more local levels of government, plays a

highly significant role in each case. On the one hand, the blended finance approach develops unique multi-layered investment strategies to maximise both financial and social return while risk-mitigating negative impacts and returns, where in China the inevitable public-private-partnership nature of social development projects is an ultimate stabiliser against the risk volatility of such mixed financial strategies in developing markets. The lessons from China echoes SDG 17 – ‘Partnership for the Goals’, because such dominant and decisive government leadership in China’s development finance market is able to create demand for rapid innovation in impact investing model design.

In the following section, we will discuss three unique cases in China of rural regional development, for tourism, agricultural or integrated development investment strategies, all of which engage with end-beneficiaries living in underserved communities. Key insights that stem from the evolution over the past 30 years in China’s developing markets include the following:

1. **The involvement of government units** – In the following cases, there is always a government entity partnering with the projects, either as investment partners that seek to share the socio-economic benefits, or as an outcome/ impact procurement entity that guides policy and civic practice towards mandated societal and economic improvements. Such mechanisms of public-private-partnership are not entirely for the institutional intent to share financial return, but rather to decentralise the burden and responsibility of social development requirements to private sectors, where the government cannot move fast enough to support such desired outcomes. Neoliberalism in China has indeed not been limited in its economic development ideology since the 1980s, but currently expands into the social development space. ‘Soft’ or social infrastructure becomes the new focus of public capital.
2. **Mixed Rural Development Strategies across Multiple Stakeholders** – China has very unique asset ownership and land-use-rights regulations in the rural space, including local residents, external investors, local governments and so on that have intricacies that need to be navigated for any deal, yet have created a myriad of strategies to accommodate or circumvent such complexity, where the influx of massive capital interests in conjunction with political mandates forces new innovations from legacy Communist and command-economy structures. At such a political, legal and governance tipping-point in rural development where once the majority of the country’s population and GDP production stemmed from its agrarian economies and

geographies, massive opportunities have bloomed overnight for inclusive economic growth models that can not only redefine sustainable economies and practices, but conversely also opens a door to systematic exploitation and unfair trade practices, against which such SDG-observant funds must find and deploy effective countermeasures.

3. **Ubiquitous development needs identification versus impact fatigue** – Social, economic and environmental problems are not difficult to identify in China’s rural space, nor is it difficult to mobilise the attention and action of numerous local Chinese and international organisations to deploy interventions. The difficulty is to define the executable root causes and continuous capacity-building of the local community. Too often have Western programme interventions landed like alien ships that make a sudden impact, but cannot sustain over time, or worse, have a negative impact, leaving local communities with impact fatigue after so many attempts at exogenous interventions. In this sense, an ‘impact exit’ in China’s context is not only about how to generate impact during the exit, but how to allow local stakeholders to carry forth the vision as integrated into or originating from within their own endogenous systems, needs and means. Our research reveals the need for specific capacity-building of local community digital literacy, impact literacy and financial literacy (to be discussed more in the following case studies).

Case 1: Social Impact Bond for anti-desertification and eco-tourism

The background story of this case has developed over several decades since the 1970s. In the western area of Inner Mongolia, desertification and additional compounding environmental issues were no doubt the root cause of many development problems, including causing farmers and herdsman in the surrounding regions to suffer through poverty. Thirty years ago, the Central Government of China launched policies to kickstart programmes to support anti-desertification efforts, businesses and practices. The model has recently broken through dramatically, receiving substantial attention both domestically across China, and internationally from the United Nations. The United Nations Environmental Programme (UNEP) recognised the project as an ‘eco-pioneer’ for both its outcomes and for its unique model, which advocates a tri-sectoral partnership, including government policy support, market-oriented participation of local residents, and new technologies and investment from ecology industries, marking the cornerstone of such success. New

social development and social finance concepts are layered into the model over three stages of the project, enabling multiplying factors to scale both the business and the impacts it progressively makes over time.

Stage 1: Responsible business

Elion Group (or Yili Jituan in Chinese) is an Inner Mongolian large-scale enterprise, with investments of \$5.82 billion since 1988, supporting business models that leverage local residents' skill sets towards the support of anti-desertification economies, including planting licorice and cistanche (a valuable Chinese medicinal herb) to fertilise desert soil, solar power station construction to increase income of local residents, etc.¹¹ There have been more than 100 anti-desertification and desert-friendly poverty alleviation technologies that Elion Group have invested in and/or invented over the last two decades. Responsible enterprises working together with government policy and local residents have successfully reduced poverty for over 100,000 households. Environmentally, the precipitation rate across the area has increased by four times annually. The fact that the project contributed 53% more plantation coverage in the same area compared to 30 years ago is considered one of the key factors in such big environmental change.

Stage 2: Internet technology, crowdsourcing and carbon credit procurement

Alipay's 'Ant Forest' takes the relay baton in the next stage of the anti-desertification race. Ant Forest is a charitable product launched by Alipay and Alibaba Foundation to encourage their users to participate in creating a greener life. There are in total 500 million users on Alipay, who planted 100 million trees in desert regions to cover almost 1,000 square kilometers, including Inner Mongolia.¹² Users earn their green credits through living greener lifestyles, and donate those credits towards virtual tree planting. Once the credit is enough, a real tree is planted through Ant Forest NGO partners in the area. This model spreads out the coverage of impact from local residents across China, which raises awareness to the general public. Carbon trading and carbon credits are concepts too abstract for the general public; however, Alipay Ant Forest gamifies the experience, leveraging their expertise in Internet product development, allowing massive participation from crowdsourcing. In this model, charity funds pay for tree planting activities once a credit is contributed by the users. It is very similar to outcome procurement or pay-for-success financial models.

¹¹ For Chinese information about Elion Group's work, please refer to <http://nm.people.com.cn/BIG5/196712/387882/>, and for the reporting about Elion's work, please refer to <http://www.chinadaily.com.cn/a/201808/06/W5Sb678ab7a3100d951b8c8b07.html>

¹² <https://medium.com/alipay-and-the-world/alipay-gallery-ant-forest-tree-planting-spring-2019-dc4e0578cc7c>

Stage 3 (Current): Social impact bond design

The current model and relationship between the local service provider company and Alipay Any Forest is stated as ‘service procurement’. In order to further push the model with more sophisticated social finance strategy to scale up the endeavour, the project is currently designing pay-for-success social impact bonds as a more mature impact investment strategy working in conjunction with local service providers. The premise of the design integrates the existing technological and agricultural anti-desertification solutions introduced in Stages 1 and 2, including the Internet-aid crowd-participation case brought by Alipay Ant Forest, and leveraging the recent maturation of the local social enterprises and related community stakeholders.

Project fact sheet

Project site: Malan Lake, Inner Mongolia Province, China

Project nature: Tree plantation and hospital development

Stage: A to A+ Round

Strategies: Social impact bond + donation + government outcome procurement fund

Investment return (social impact bond): 8-12% per year

Key impact: Anti-desertification, economic growth of local minority communities, job creation, sustainable consumerism

Company name: Springfield Ecology Ltd (SFE)

Exit Maturity: Principal repayment with interest, or exit when negative impact cannot be resolved



Picture taken in May 2012



Picture taken in May 2014



Picture taken in May 2012



Picture taken in May 2016



Picture taken in May 2012



Picture taken in May 2017

Before and after retreatment of anti-desertification strategies by SFE

Malan Lake Project is a regenerative ecotourism social enterprise founded by Springfield Ecology Ltd. (SFE), an environmental social enterprise and NGO. The project is located in the Tengger Desert, China's fourth largest desert, and focuses its efforts on working with locals and herders on anti-desertification, land restoration, reforestation activities, combined with environmental education programmes and entertainment facilities to engage visitors and tourists. In addition to government grants, venture philanthropy and public-private-partnership to reforest and remediate the land, the project will benefit from low-interest loans to scale its profit-making arm, in conjunction with an evergreen investment structure to safeguard impact achievement while the business becomes profitable.

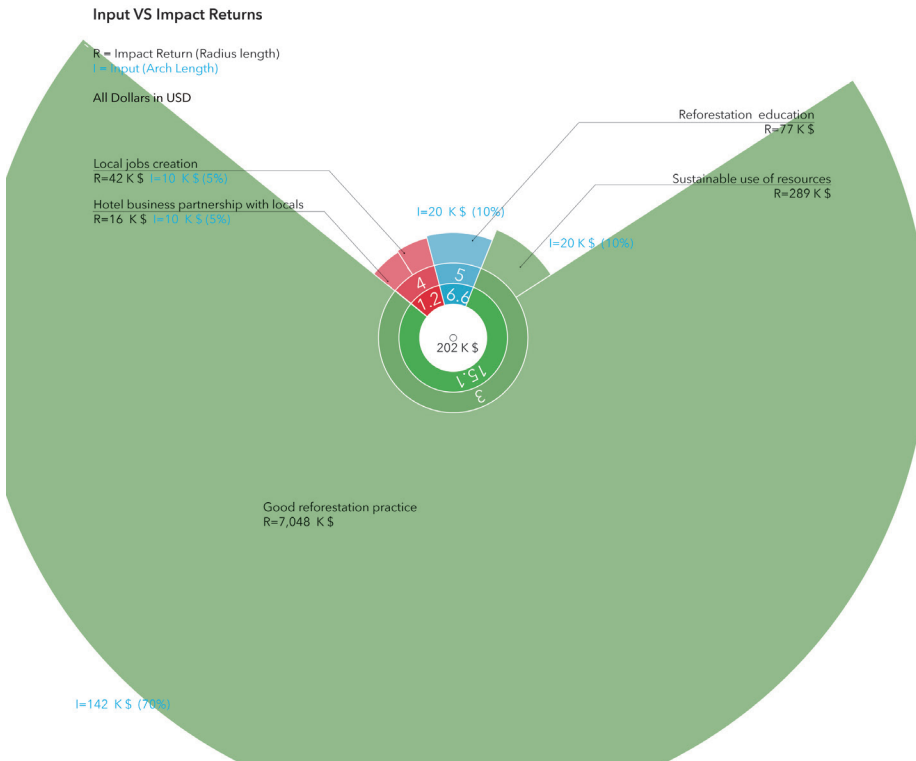
The SFE team has been conducting charitable work in this area over the last decade to plant trees in order to stop further desertification, deploying their own know-how and anti-desertification technologies. This was accomplished through constant exploratory work, where the team researched local knowledge for specific planting methodologies that reduce water consumption. Recently, the team has developed strategies to move business models away from pure charity towards promoting social entrepreneurship aiming to establish a social impact bond to collaborate with the government to work via public-private-partnerships with enterprises like Elion Group, technology platforms like Alipay Ant Forest, and impact investors both domestically and internationally.

SFE is already a service provider to Alipay Ant Forest. With their local operation knowledge and decade of experience, their efficiency is significantly better than Alipay Ant Forest mandated, and surpasses expectations from government mandates. The implications are that SFE can accomplish the same task with a lot less capital, so that extra capital can be reserved to develop other ventures, such as education, ecotourism and events facilities.

The central feature of the impact investment strategy for SFE as a social impact bond is to acknowledge and bank on its consistent track record for successful anti-desertification outcomes, as well as its lucrative in-place financing model with

Alipay Ant Finance. The goal of such new social finance mechanisms for SFE is to pilot a more scalable entrepreneurship model for small-medium-enterprise service providers related to anti-desertification efforts to grow, and to work closely with large-scale local responsible enterprises like Elion Group.

SDG	Portfolio Metrics		Project Metrics		Project Indicators
SDG 1.2	4	Social inclusiveness, poverty reduction	I	Local jobs creation	Jobs created for locals Salary per ppl
			i	Hotel business partnership with locals	No. of locals conducted business with hotel Additional income/yr to local from business with hotel
			f	Reforestation education	No. of farmers trained the reforestation No. of farmers adopted the reforestation practices No. of tourists engaged in reforestation Value of the training Value per practice Value per engagement
SDG 6.6	5	Sustainable economic growth	e	Good reforestation practice	Area of desert restored No. of tree planted Farm productivity of fruit tree Value per area of desert restored Value per tree planted Value per production
			q	Sustainable use of resources	Volume of water saved(Liter) Value per volume
SDG 15.1	3	Resource efficiency, environmental protection and climate change			



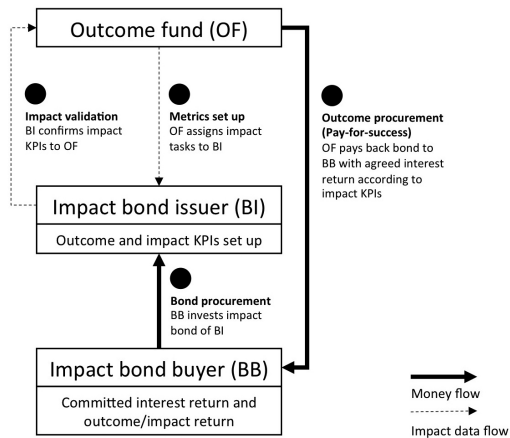
SDG Theory of Change table and return of impact for SFE project (Please refer to Appendix for key to the diagram)

Social impact bond basic structure

The design of the social impact bond typically involves a few components including an outcomes fund, bond issuers (usually the service provider) and bond buyers (impact investors). The outcome fund mandates the impact measurement metrics to trigger its pay-for-success criteria. The outcome fund managers focus largely on the impact due diligence of the bond product, where the conditional financing scheme (pay-for-success) is based on measurable impact. The bond issuer in this case is the tree planting company.

The service company obtains local know-how for executing the task, i.e. planting adaptive trees in the desert and guaranteeing a certain rate of survival across time. Because the payment is disbursed after such performance is achieved, the service provider requires an initial base-capitalisation to begin the work. The company then has the choice to issue either a corporate bond or a convertible loan note to initially receive funding with a promised return rate. In an American case of a Social Impact Bond with Goldman Sachs, the interest rate was dynamic and fluctuated between +25% and -25%, according to the integrated impact and financial performance of the project.

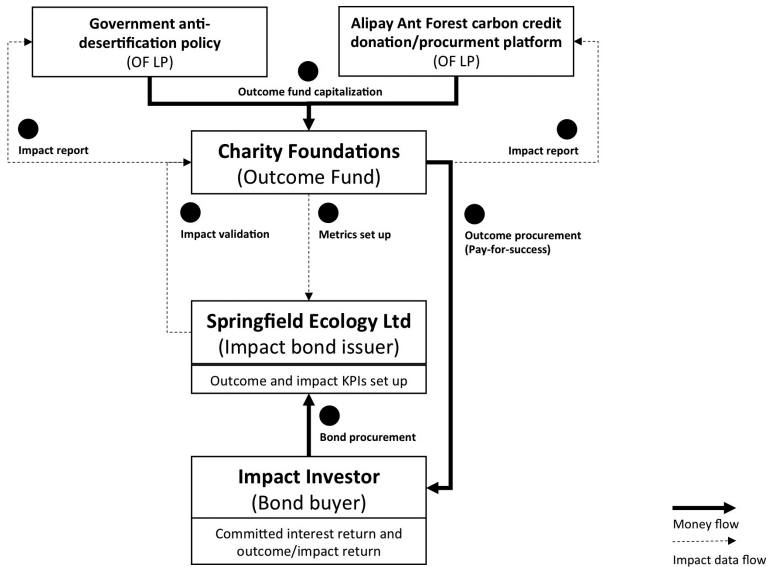
Bond buyers are usually impact investors, who are taking considerations on both impact risk and financial risk, but enjoy return on investment financially and socially. The impact investment fund manager plays a crucial role in impact due diligence which becomes the baseline from which the key payment criteria are established by a third party – the outcome fund. Impact fund managers need to understand and establish the framework that captures the impact generation processes and impact track records before investing and validating impacts post-investment. Moreover, impact fund managers also need to create strategies to mitigate potential impact risk, as those will jeopardise financial wellness. Lastly, impact fund managers need to participate in the decision-making about the reward mechanism (interest rate) and define impact risk tolerance criteria with the bond issuer.



Social impact bond structure

SFE Social Impact Bond Model

The success of the pay-for-success model is based on multiple stakeholders’ collaboration and vision alignment. The following is an introduction to the design of the social impact bond in this case.



SFE pay-for-success model design

Outcomes Fund – The role of the outcomes fund is taken by Alipay Ant Forest Charity Foundation. The ‘procurement’ of service becomes ‘payback’ for validated impact (number of trees planted). Therefore, the risk of procurement is lowered to the minimum, because it will only pay out once the agreed and defined impact is generated. The direct pay-to-impact also improves the transparency of expensing charitable money flow, and minimises management and transaction costs through multiple intermediaries. In an ideal situation, such transaction costs can be lowered to 0% – direct impact/outcome procurement. Further collaboration with government to capitalise the outcome fund is also being explored. Because the prescribed impact is trackable and auditable in the pay-for-success model, the government is able to bear zero risk while maximising efficiency for policy implementation. The management of an outcomes fund is rather simple, because it will mainly focus on setting up situation impact *Key Performance Indicators* (KPIs) with trackable, auditable and trustworthy data to fulfill the needs of government and/or individual donors of carbon credits (as part of the impact product design).

Bond Issuer – In this case, SFE is the service provider and bond issuer. In order to scale up its business as service provider, SFE requests further funding to receive more tasks (service contracts from Alipay Ant Forest and other impact service wholesalers) with zero deposit and full payment for success. SFE estimates the risk of achieving the tasks with their highly-tuned methodologies, which is reflected in the budget agreed by Alipay Ant Forest. SFE has begun the process of suggesting change in ‘success criteria’ according to their accrued knowledge. Once the ‘success criteria’ are agreed between the payback outcome fund and the execution bond issuer, it will become part of the new key conditions for the contract.

Bond Investor – Impact investment funds are able to support SFE to scale up its tree plantation business by collaborating with Alipay Ant Forest and other local partners. The structure of the bond can be a simple bond with interest and principal payback, or a convertible bond for the investor to have the option of enjoying long-term benefit sharing with the company. Impact due diligence, as mentioned previously, is very important because it mitigates the risk of default of the payback from the pay-for-success outcomes procurement fund. Moreover, financial due diligence is also needed to understand actual performance of the service provider company, and also its potential growth in the future.

Impact Data Flow – Such conditional finance vehicles such as Social Impact Bonds depend on a reliable flow of authentic and streamlined impact data. Transparency is the required mandate for all stakeholders into the progress and outcomes of the projects which they are financially bonded to support, where impact measurement data becomes the decisive factor for executing its financial transactions. SFE as the service provider is the claimant of outcomes and impacts (i.e. number of trees that survived), and a third party impact evaluator validates the claims. Alongside this digital breadcrumb trail, there will also be tools in place for a third party auditor of impact data. This impact flow should also flow back to individual carbon credit contributors (the tip of the impact value chain) with the aid of Internet infrastructure.

Case 2: Public-Private-Partnership for Inclusive Village Development

In order to improve quality-of-life standards in rural areas, both the government and private sector have attempted partnership finance models to tackle the very different land and rural asset ownership model. Idle rural assets, one-way rural-urban population movements, and a lack of public services exacerbate rural poverty and the economic divide between rural and urban China, which is experiencing more

social and development problems such as left-behind children and elderly, decreased productivity, rural flight and village abandonment. In 2010, the population of migrants from rural areas living in villages and remote areas in China reached 150 million. Within provinces, 58% of the migrant population are from villages, and between provinces, the figure is 85%.¹³ Through public-private-partnership we hope to explore more inclusive development models to solve these rural problems from their root cause.

The Returning-Diaspora Entrepreneurship Movement (2004 - now)

Rural entrepreneurship was advocated by the central government since the early 2000s in conjunction with the start-up and e-commerce boom in China. The returning-diaspora movement started since then, where the China Government advocated urban elites with international or big city experience to go back to their hometown for local development. Numerous village maker projects and “Youth Back to Hometown” programmes were supported by governments. Since 2004, with new communication tools, such as Alibaba and Taobao, business models have become more scalable and adaptable to the vast rural market in China (178 million rural Internet surfers). Internet technology provided logistic and information flow channels between rural and urban areas. Driven by emotional attachment and entrepreneurial opportunities, young entrepreneurs returned home to stimulate their respective untapped rural markets. It was found that the biggest markets are no longer Tier 1 and Tier 2 cities (1 and 2 trillion RMB/\$142 billion and \$284 billion markets respectively), but rather Tier 3 (3 trillion RMB/\$426 billion) and Tier 4 cities (3 trillion RMB/\$426 billion) as well as rural regions (Tier 5 cities and beyond = 4 trillion RMB/\$568 billion) with almost 260 million households untapped by commercial products.¹⁴

New Village Construction (2005 - now)

There are various programmes under this umbrella policy and some of them may be very familiar to the general public, such as the ‘beautiful village scheme’ (or Meili Xiangcun Jihua). Province and county governments allocate grants for villages to apply for infrastructural upgrade in the village. In 2005, the Central Government of China began its ‘New Village Construction’ campaign to bridge the gap between urban and rural areas. Instead of economic, cultural and social construction, many

¹³ China Statistic Year Book 2010.

¹⁴ Report of AC Nelson, 2014

real estate developers took the opportunity to develop real estate products with village organisations. Government also allocated funding to reconstruct new villages for local residents, in order to improve quality of life.

Precision Poverty Alleviation (2014 - now)

In China, ‘Precision Poverty Alleviation’ means very focused and targeted strategies on a personal scale through identifying impoverished individuals, customising poverty alleviation methods and monitoring towards evaluating microscale achievements. This is a reflection of the previous attempts being too expansive and not focused enough. Until 2013, there were 82,490,000 individuals suffering from poverty in China. Surprisingly this number did not change that much since the 1970s, when the Open and Reform Policy started to bring wealth to the urban population. The poverty standard in China is defined as individual annual income less than 2800 RMB (\$400). There were 14 regions, 592 counties and 128,000 villages with the majority of the population below that standard. The government goal is to eliminate all poverty problems in China by 2020 (next year will be a crucial year for political campaigns nationwide to prove their progress and effectiveness). China's government is preparing a huge amount of funding for poverty alleviation, through various channels. Until 2018, a total of 108.2 billion RMB (\$15.33 billion) was allocated towards poverty alleviation funds to support local projects and public-private-partnerships.

Impact Investment for returning diaspora, new village and poverty alleviation

This case touches all three important phenomena for rural development investments in China. The returning diaspora set up the vision and the heart, the new village construction opens up the door for government collaboration, and precision poverty alleviation aligns the vision between the public and private sectors.

Project fact sheet

Project site: Tangjiazhuang Village, Huangshan City, Anhui Province, China

Project nature: Tourism development

Total paid-in investment size: 50 million RMB / \$7 million

Stage: B Round (200 million RMB / \$28.3 million)

Strategies: Impact investment + Public-private-partnership

Investment return: 15%-25% (or market rate for hospitality industry)

Key impact: Local job creation, sustainable consumption, local infrastructural upgrade

Company name: Huangshan Yiju Tourism Development Investment Limited (YJT)

Exit Maturity: Likely M&A and IPO with impact exit strategies

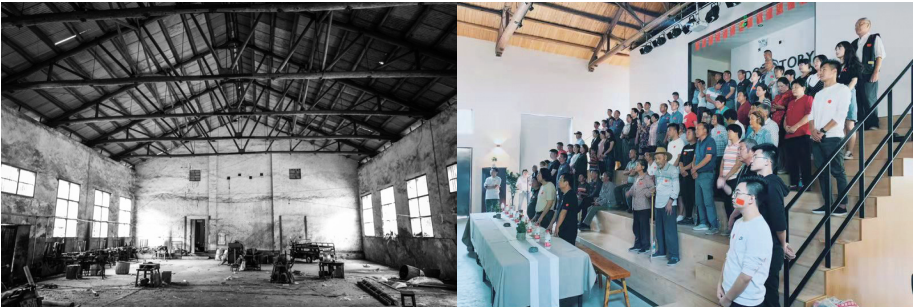


Tourism development of Tangjiazhuang Village, Huangshan City, Anhui Province

The project is invested by Huangshan Yiju Tourism Development Company (YJT) in Huangshan City, Anhui Province since 2015 by a few well educated returning diaspora youngsters to explore alternative, inclusive and sustainable rural development models in China. The Tangjiazhuang Village site is located next to the South Gate of Huangshan (Yellow Mountain) Scenic Region. This area is less developed compared to the other tourism clusters of Huangshan Scenic Region. There are five natural villages in the Tangjiazhuang Administrative Village, with around 300 households and natural resources including river, reservoir and forest. In the last five years, YJT has been working closely with local village governments and village individuals to design and develop plans for value creation.

The project aims to develop holistic tourism products using all resources in the village, for hospitality, touring, event organisation and company retreats. There are two strategies of fund allocation for two different types of asset with different ownership models. YJT is acquiring market-listed assets through auctions on the one hand and on the other collaborating with the local Administrative Village Government for those non-acquirable collectively owned assets. Among the existing total 50 million RMB (\$7 million) investment (first phase), around 25%

of investment capital (12.5 million RMB / \$1.7 million) is deployed to the latter strategy with a village level public-private-partnership model. The next stage is to scale the total capital injection to 200 million RMB (\$28.3 million) for phase 2 and 3. The overall strategy is blended with mainstream tourism development, equity investment to local companies and public-private-partnership, in order to maximise both profit and impact from different channels, also generating synergy for overall holistic development among investors, local enterprises, local village government and individual villagers.



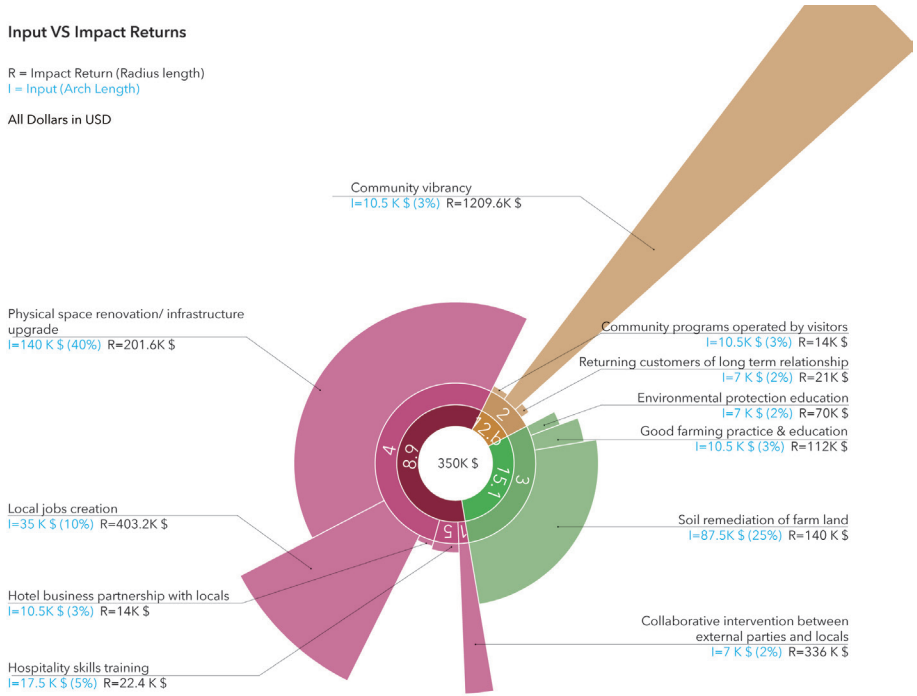
Reconstruction of Villager Congress Hall shared between villagers and tourists (Left: before and right: after)

SDG	Portfolio Metrics	Project Metrics	Project Indicators
SDG8.9	1 Cultural values, diversity and heritage	a Collaborative intervention between external parties and locals	No. of frequent activities run by external partners of the hotel Average income to locals from the activity
		5 Sustainable economic Growth	h Hospitality skills training No. of locals trained Value of the training
	4 Social inclusiveness, Poverty reduction	i Hotel business partnership with locals	No. of locals conducted business with hotel Additional income/yr to local from business with hotel
		l Local jobs creation	Jobs created for locals Salary per ppl
		m Physical space renovation/ infrastructure upgrade	Value/sq. meter of space upgraded
SDG12.b	2 Mutual understanding, peace and security	b Community programs operated by visitors	No. of locals joined capacity building programs Value of the training(program)
		c Community vibrancy	No. of public events in the village per year No. of locals joined the public event.
		o Returning customers of long term relationship	No. of returning customers Local expenditure per travel
		r Visitors/locals communication	No. of visitors acquiring/providing information from/to locals No. of locals acquiring/providing information from/to visitors Per info Per info
		d Environmental protection education	No. of farmers adopting environmental protecting practice Value per practice
SDG15.1	3 Resource efficiency, environmental protection and climate change	g Good farming practice & education	No. of farmers adopting good farming practice Area of farmland converted to good farming practice (mu) Value per practice
		p Soil remediation of farm land	Value of farm productivity in remediated land Area of land remediated
			Value of farmland restoration

Input VS Impact Returns

R = Impact Return (Radius length)
I = Input (Arch Length)

All Dollars in USD



SDG Theory of Change table and return of impact for YJT project (Please refer to Appendix for legends of the diagram)

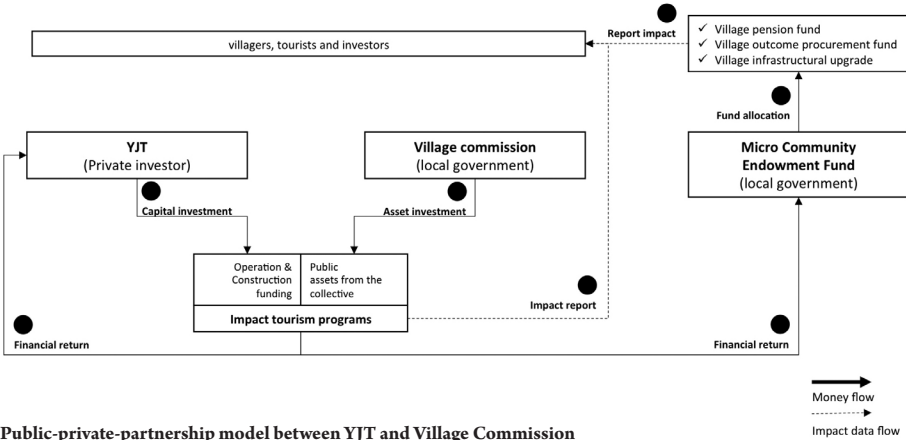
The pain-point and opportunity for Impact Investment in rural China

Rural assets in China are very valuable, but severely lacking sustainable or legal channels for development. Land resources are collectively owned by villagers and managed by collective government commissions. Other resources, such as forests and water bodies and village commissions are able to utilise these but lack the proper management capacity for sustainable development. Private sector businesses with enough management capacity cannot access those resources because of specific land ownership and transaction limitations. Therefore, public-private-partnership becomes a necessary solution to bridge those gaps. However, this does not inherently solve the problem of conducting development transparently, and nor does it establish a sustainable development criteria to guide such development.

The complex specificities of rural asset ownership, which lacks liquidity and legal channels, contribute to the poverty of the Chinese rural population. However, the recent exploration and progress made towards liquidising rural assets through cooperative laws and public-private-partnerships has opened up new possibilities. In this case, it is an apt example of how such partnerships can solve on the one

hand the holistic development of tourism and community on acquirable assets and non-acquirable assets in rural spaces, and on the other share positive social and environmental impacts with local communities and village collectives.

Village-scale Public-Private-Partnership



Public-private-partnership model between YJT and Village Commission

Public-private-partnerships are able to operate at the Central Government level with development banks and also at the level of village political administrative agencies in China with impact investors. In the YJT case, 25% of the investment fund (currently at 1,250,000 RMB / \$177,150) is allocated toward non-acquirable assets in the village for tourism development, in collaboration with the local village government – Tangjiazhuang Village Commission. The starting point of this collaboration was a young village chief promoted to this position and willing to try a new development model to alleviate poverty in the village. YJT and the Village Commission put funding and public assets together to establish a joint venture enabling the proliferation of more tourism commerce. All revenue for the Village Commission will go to a community endowment fund pool to support an elderly villager pension fund, village outcomes procurement and village infrastructural upgrades.

This programme is particularly interesting because of increased local awareness and because the initiative to create impact programmes from the earnings of the collaboration helps to support its success. In this sense, not only are the external investors able to leverage local assets towards more holistic development and transfer management knowledge to monetise local assets, but more importantly, all local villagers are able to participate towards such communal efforts and thereby

reap the benefits collectively and inclusively. Although the size of the pension fund is modest (a few hundred renminbi or tens of dollars per month) it is enough to attract the elderly to stay in the village. Village youth are able to run businesses locally, leveraging the newly strengthened tourism development.



Public building on collectively owned riverside in the village (Left: before and right: after)

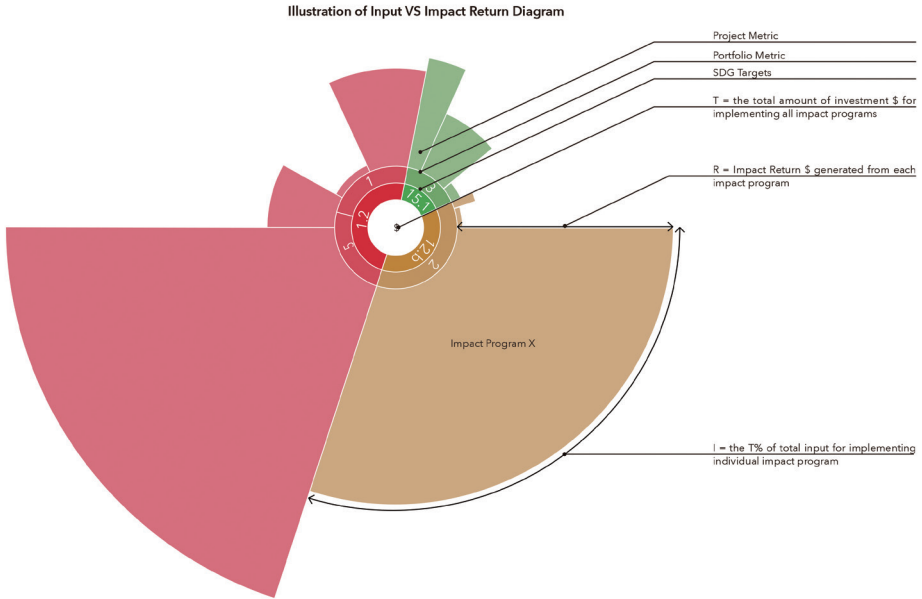
Concluding Notes

The authors would like to draw the conclusion towards the change in the role of impact measurement in impact investment. For both cases, the projects appeared specifically due to the macro sociopolitical context of China's development. The role of impact measurement changes from purely upward reporting towards multidimensional reporting due to networked data technologies and decentralisation of impact investment. Moreover, the authenticity, trackable and trustworthiness of impact data origins and impact data flow become extraordinarily important, because in both cases, such impact measurement data is important 'proof of impact' mechanisms that govern financial transactions, as exemplified in the pay-for-success case as well as the precision poverty alleviation policy projects. For future development, we would like to summarise the following three directions:

1. The impact metrics design can and should involve a broader and more inclusive range of stakeholders. Particularly in the social impact bond design with SEF and Alipay Ant Forest, the focus becomes how to make the metrics more flexible for the outcomes procurement fund, which establishes metrics for the overall impact strategy (which otherwise may not be specific enough for local execution), to assimilate and account for the knowledge of local social enterprises and even local residents.
2. Capacity-building social finance literacy with local partners should become a central strategy for establishing a better risk management threshold for both social and financial returns. One observation is that local partners may already be working on similar strategies to more advanced global social finance models; however, there is no local awareness of utilising or accessing existing tools that promote global industry standards. It is noted that building social finance literacy may require strong impact management intermediaries in different regions that have regional understanding of local politics, markets and culture.
3. Stakeholder participation should be intersectoral and financial vehicles should adopt a blended approach to improve economic development while giving space for much-needed social innovation. In both cases, there is a trend to link different stakeholders from mainstream industries, governments and local residents together. A blended finance approach is able to maximise stakeholders' mandates for both impact and financial returns. In the economic context of China, government leadership is quite strong and pushes national impact-driven mandates, providing stable and viable opportunities for integrating public capital, private capital, and even individual capital with both domestic and international partners.

Appendix (Impact Diagram Legend)

Theory of Change Table – to show how project impact is measured by project metrics, customised per project to meet individual goals set forth by each project, then how project metrics are grouped and aggregated into cross portfolio metrics, which reflect the goals set by the fund; and eventually how the portfolio metrics contribute towards SDG goals.



Input VS Impact Return Diagram – to visualise the total investment into the driving impact of each project and the impact return. Investors can see the total input into each project and how the capital being deployed to each impact programme and what kind of impact is generated that contributes to the portfolio impact goals and SDGs.

- Input = the total amount of investment for implementing all impact programmes in the project
- Arc = the % of total input for implementing individual impact programme
- Radius = Impact Return generated from each impact programme

Acknowledgements

This paper is mainly referring to impact management research work from SZC Holdings Limited and particularly gives credits to researchers, including Chris Gee, Jessica Cheung, Sandra Tai and Ting Zheng, for their contribution to basic materials and methodologies.

SRI LANKA'S EXPERIENCE WITH IMPACT INVESTMENT

Background

Following the end of a 30-year civil conflict, Sri Lanka was geared for rapid economic growth. Supported by postwar optimism, Sri Lanka saw strong growth performance, which, however, has moderated lately on the back of the ebbing peace dividend and the onset of adverse climate change patterns – floods followed by droughts. The country's potential growth has also declined on the back of more structural factors, such as the ageing population, low female labour force participation rate, high youth unemployment and relatively low absorption of new technology. There is wide acceptance that in order to gain a sustainable competitive advantage and orchestrate a 'game change' in Sri Lanka, the country needs to leapfrog, facilitated by entrepreneurship, innovation and technology.

While the country looks for sustainable competitive advantages through game-changing initiatives, it also has to confront the SDG challenge. Having achieved an overall compliance rate of just 64% as of 2018¹, the country under current trajectories is unlikely to reach the SDG goals. The financing gaps are particularly daunting – estimated at around 4% of GDP going forward – roughly equal to current government social expenditure². With a constrained fiscal situation and high public debt, the government needs to increasingly leverage on the private sector to meet the SDG financing challenge. Several innovative SDG financing approaches have been developed and suggested for Sri Lanka – including an innovative SDG Bond known as the SDG Programmatic Bond, as well as other SIBs and Green Bonds. Sri Lanka also launched its first social impact funds in 2018.

Sri Lanka Impact Funds

Impact investment and social entrepreneurship are relatively new to Sri Lanka and

¹ The government of Sri Lanka's social expenditure is around \$4-4½ billion per annum.

² SDG Dash Board Report 2018: Bertelsmann Stiftung and Global Sustainable Development Network, 2018

received a significant boost in 2015 when the Lanka Impact Investing Network (LIIN) was formed. Social entrepreneurship garnered attention recently due to LIIN's trademark television reality show “Ath Pavura”, launched in 2017 to identify potential impact projects and directly align impact investors with entrepreneurs. Currently, LIIN has a network of 14 high-net-worth individual (HNWI) impact investors who have undertaken investments amounting to LKR 70 million (\$385,000) spanning 68 projects under the Ath Pavura initiative. Ath Pavura became Sri Lanka's Best Business Programme on TV, rated by Lanka Market Research Bureau (LMRB), a leading research agency in Sri Lanka. Ath Pavura has funded ventures from nine different sectors, representing all nine provinces.

Considering the rather unique entrepreneur ecosystem that exists in the country due to the MSME constituents, and the challenges faced by MSMEs, the Lanka Impact Investing Network and Tempest PE Partners (a member of the Capital Alliance Group), in collaboration with UNDP, pioneered Sri Lanka's first social impact funds, the Social Enterprise Fund (SEF) and the Sri Lanka Impact Fund (SLIF).

The Social Enterprise Fund (SEF) of \$5 million provides funding and aligned support to commercially viable social enterprises in the micro and small enterprise segment, which require small-ticket investments between \$5,000-100,000. The SEF is essentially a growth stage fund, and will target social enterprises that have been successfully incubated and are looking to enter the acceleration phase of their life cycle.

The Sri Lanka Impact Fund (SLIF), a \$20 million growth-stage fund, provides long-term capital to support inclusive and responsible businesses that integrate and promote social and environmental impact as part of their business models. Funding will be provided to enterprises with larger financing requirements between \$1-4 million, looking to scale up and expand their businesses.

Impact Measurement and Management (IMM)

Impact Measurement and Management (IMM) is at the core of the SEF and SLIF funds, and underlies the impact screening platform for all investments made by the Funds. The IMM is supported by the UNDP. The framework has been developed from the global norms for good impact measurement and management practices. The IMM framework is aligned with the upcoming standards from UNDP SDG Impact, which will also be based on the consensus around impact facilitated by the Impact Management Project (IMP). The resulting framework forms part of the investment decision-making process.

Work ahead

While several promising initiatives have been made, the journey towards establishing a fully-fledged impact investment platform in Sri Lanka remains incomplete. Work still to be done includes:

1. **Establishing a strong incubator/accelerator backbone in the country.** Although startup incubators are surfacing in Sri Lanka, they lack consolidation and are limited in terms of their scope to carry out effective incubation support. Similarly, the accelerator network is also underdeveloped and remains highly fragmented. The notable existing accelerators in the country are mostly focused on tech startups, with very little interest in non-tech startups. Therefore, in order to foster entrepreneurship including social entrepreneurship, it is essential to establish a strong incubator and accelerator network in the country.
2. **Creating a conducive policy environment for fostering impact investment and entrepreneurship/social entrepreneurship and greater awareness.** Traditionally in Sri Lanka, entrepreneurship is seen as an inferior alternative to other career paths. Particularly, the understanding and appreciation of social entrepreneurship remains nascent despite the efforts of agencies such as LIIN, which have made considerable progress. It is important for the government to put impact investment and similar sustainable investments programmes at the core of its social programmes and see that as a means of achieving the SDGs – which aim to leave no one behind. While sustainable policies are very much part of government long-term national plans, there is not much appreciation of the needed investments. Specific schemes such as the SDG Programmatic Bonds (SPB) which hold much promise to address the country's long-standing social issues without aggravating the debt burden,³ as well as private-sector led schemes such as impact funds could serve the country's SDG financing agenda. The efforts could be underpinned by an integrated national financing framework (INFF) and driven by a national network for SDG financing (NNSF) – both led by the government.
3. **Developing a comprehensive financial system catering to different stages of the life cycle supporting entrepreneurs/social entrepreneurs.** Currently, Sri Lanka has an underdeveloped financial ecosystem for supporting entrepreneurs. With a heavy debt dependency culture (largely

³ And possibly leading to better public debt outcomes going into the future.

owing to the dominance of banks in the financial sector), entrepreneurs lack the diversity of financial instruments to take them through their entire life cycle, particularly grants (or seed money) at the incubation stage and a suitable mix of debt and equity at the acceleration stage. The country's stock market is thinly capitalised (compared to its regional peers), but with the establishment of a new SME board in 2018 there is now a viable platform for later (maturity) stage financing for start-ups. However, these need to be further augmented and strengthened to support entrepreneurs, and to have complementarity with institutional frameworks and policy frameworks.

IMPACT INVESTING IN SOUTHEAST AND SOUTH ASIA – A PROMISED LAND

Asia might be described as the “land of opportunity” for impact investing. Southeast Asian economies are at different stages of development and offer investment opportunities across many different sectors, while South Asia similarly has significant potential because of the overall underdevelopment of this most populous region of the world.

Studies by the Global Impact Investing Network (GIIN) and others, based on a variety of cases in a score of different Asian economies and across numerous economic sectors, highlight these multiple opportunities. The countries covered range from giants like India to much smaller nations such as Brunei and Nepal.

Southeast Asia presents many socioeconomic and environmental challenges, including large and underserved populations, high poverty, and generally poor indicators of human development. Such challenges also represent opportunities, however, for those who wish their investment to have a measurable impact on social and economic development.

To date, much of the impact capital deployed in Southeast Asia has come from foreign investors, most of whom operate remotely or through local partners rather than having their own offices in the region, according to a report published in August 2018 by the GIIN and India’s Intellect Impact Investment Network.

Impact investing has yet to take hold as a concept among domestic investors, and this will likely continue to be the case given Asian investors’ general preference for making portfolio investments in overseas rather than local markets. If so, that will entail a continuing and possibly expanding demand for impact investing from overseas.

One reason why the investing canvas in Southeast Asia is so broad is that impact investments are applicable to myriad different economic, financial and

social situations, and the region displays such diversity in development. Impact investing opportunities range from those in agriculture and industry to the provision of affordable products and services, as well as housing, healthcare, education and energy.

Most of the economic growth that occurred during the so-called East Asian “Asian Miracle” period in the post-World War II decades (and then later in China and Southeast Asia) was driven by domestic investment and that from foreign multinational companies. Such private investment was focused mainly on the manufacturing sector, and not on social or economic development issues. Governments and multilateral agencies provided most social development-oriented investment and very high among the second group were Development Finance Institutions or DFIs. In fact, a dozen or so of these DFIs together account for over 90% of all impact capital invested so far in Southeast Asia.

DFIs are government-backed financial institutions that provide finance to the private sector for investments that promote development. The International Finance Corporation (IFC) is the largest DFI investor in Southeast Asia, and has contributed more than 65% of all capital deployed there by DFIs.

As of 2017, DFIs’ average deal size in Southeast Asia was around \$40 million, while the median was around \$8 million. DFIs have made investments across a wide range of deal sizes. Some 90% of the deals above \$100 million have been in the financial services or energy sector, with smaller deals across diverse sectors including ICT, manufacturing, agriculture, and water and sanitation.

The dominance of DFIs (in both Southeast and South Asia) also reflects the fact that such institutions are in many ways naturally suited to impact investing because of their ability to monitor and measure the impact of investments they make. Private sector financial institutions (and much more so in the case of retail investors) do not generally have equal resources in this regard.

Impact investing requires (as the GIIN studies note) that investors should have the intention to create positive social or environmental impact through their investments and that they should make a commitment to measure the social or environmental impact created by these investments. Impact investments are also required to yield a financial return.

In Southeast Asia, DFIs deployed a total of \$11.3 billion between 2007 and 2017, according to the GIIN. This was in eleven countries: Brunei, Cambodia, East Timor, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. In South Asia (Bangladesh, India, Myanmar, Nepal, Pakistan and Sri Lanka) the total

deployed by DFIs during this period was around \$7 billion – chiefly in India. These figures represent direct investments by DFIs. They also help to fund investments by private investment institutions, but such indirect investments are excluded in order to avoid double counting.

For perspective, the total of around \$20 billion that DFIs and private investors combined have invested in impact situations in Southeast and South Asia compares with the roughly \$1 trillion which the IFC estimates has been invested to date in impact projects in developed and developing countries around the world. And it pales alongside the annual flows of “trillions rather than billions” of dollars which the United Nations says needs to flow into impact and other sustainable forms of investment.

Yet, as various studies have shown, the potential to expand impact investment in Southeast Asia appears to be strong. “Impact investors, entrepreneurs and ecosystem enablers alike all express optimism about the Southeast Asian market because of its size, economic growth, and demographic trends,” according to one GIIN study published in partnership with Dalberg Global Development Advisors.

Likewise, in South Asia, research has revealed areas of opportunity such as the enormous potential market for affordable products and services to meet the needs of base of the pyramid populations. The studies also reveal a need for quality housing, healthcare, education, financial services and energy.

The most popular sectors for impact investment in Southeast Asia have been financial services, clean energy and ICT. The financial services sector has received the bulk of impact investment capital to date, and microfinance ventures account for more than 80% of it, while insurance and commercial banking sectors have also attracted capital.

Nearly one fifth of impact investing capital has meanwhile been deployed in clean energy (especially solar energy in the Philippines and Thailand), while ICT accounts for the next-largest volume of capital deployed with a concentration of activity in Singapore and Vietnam. Agriculture accounts for 15% of deals, with small and average sized deals ranging up to \$1 million.

NEED FOR MORE PRIVATE INVESTOR PARTICIPATION IN IMPACT INVESTING

Despite the dominant presence of official development finance institutions on the impact investing scene in Asia, participation by private investors is not insignificant relative to the total of such capital committed in Southeast and South Asia. Interest

in and opportunities for such investment continue to grow.

Private Impact Investors or PIIs encompass (in the GIIN definition) a range of investor types including fund managers, family offices, foundations, banks, pension funds and others that channel private capital into impact investments. Between 2007 and 2017, at least 60 different PIIs have invested \$904 million in 225 deals in Southeast Asia. At the same time, private investors have provided around \$1.3 billion of impact capital for impact projects in South Asia.

The overall environment for impact investment in Southeast Asia is improving – for private investors especially – as the region’s economies experience more diverse and broad-based economic and financial development. As the GIIN has noted: “Over the past decade, entrepreneurship has gained momentum across most of Southeast Asia, in part due to increased government support for private-sector growth, integration with the global economy, a rising consumer base and a young population.”

At the same time, strong flows of foreign direct investment into manufacturing and services industries have helped to create a more conducive environment for impact investment in Southeast Asia. Increasing urbanisation and technological advances have also helped reshape the region. “Government investments to develop infrastructure, improved educational facilities, technological advance and further social acceptance of entrepreneurship have helped develop new industries, with an increasing number of new enterprises entering sectors such as e-commerce, financial technology, hospitality and agro-processing,” the GIIN has noted.

Southeast Asia’s young population is another factor driving economic growth. According to United Nations calculations, by 2030 the median age in most Southeast Asian countries will be just 30 years, which is considerably lower than in other Asian nations, such as Japan or China. Many global companies are moving their manufacturing operations to Southeast Asia, taking advantage of the younger workforce.

Growing numbers of experienced PIIs are active in Southeast Asia across diversifying sectors as local ecosystems evolve and as support grows for social enterprises, says the GIIN. Demand for impact capital comes chiefly from startups and small and medium enterprises (SMEs) that are raising capital for the first time. The average “ticket” size of PII investors is around \$3.9 million while the median is around \$0.7 million.

Apart from the 11 Southeast Asian economies listed above, each of which has what the GIIN terms “comparatively mature impact investing ecosystems that have

garnered increasing interest from PIIIs,” private investors have also taken advantage of opportunities in Cambodia’s relatively open, dollarised economy to catalyse the country’s microfinance sector.

As a result, Cambodia has attracted nearly as much PII capital as Indonesia, the Philippines and Vietnam combined. Laos, Myanmar, Thailand, Malaysia, and East Timor have all attracted relatively less PII activity. Singapore and Brunei, as high-income countries with small populations, have sustained little PII activity to date. However, many regional enterprises that have received impact investment are headquartered in Singapore, as are many PIIIs that operate across the region.

As noted above, challenges remain in Southeast Asia, such as what the GIIN sees as a “limited focus on innovation and low financial literacy among entrepreneurs, a limited investee pipeline, concentration of seed-stage enterprises, and only a few records of exits – which may reflect limited transparency around exits, insufficient exit options and the nascent market’s limited track record.”

Most PIIIs that make equity investments in Southeast Asia seek market-rate returns, expecting to exit by selling to larger impact investors. As awareness of the concept of responsible investing grows, many formerly “impact-agnostic” investors are seeding impact-focused funds, or are beginning to consider social and environmental impact as part of their investment philosophies. Increased activity by such investors, who are potential buyers on the secondary market, is driving optimism regarding exits and somewhat galvanising the impact investing market.

Impact investors use a variety of often-customised impact measurement tools and reporting mechanisms for their investments in Southeast Asia. As the GIIN puts it, “vastly different country contexts and impact theses lead impact investors to take bespoke and fragmented approaches to impact measurement. Most investors use their own impact measurement frameworks, which may be based on globally accepted taxonomies, such as IRIS – the catalogue of generally accepted performance metrics managed by the GIIN.”

LACK OF AN INVESTABLE PIPELINE A PROBLEM IN SOUTHEAST ASIA

Given the nascent stage of social entrepreneurship in the Southeast Asia region, most investors have highlighted the lack of an investable pipeline as a key hurdle to deploying capital, according to the GIIN. In addition, interviewed equity investors perceived the region as having weak standards for corporate governance.

They also cite high costs of sourcing and due diligence leading to a “funding gap” in the early stage of impact projects. In most of the region, for-profit social

entrepreneurship is a relatively novel concept. Consequently, many social enterprises are at the seed and early stages, requiring small investments. However, only a few investors provide such investments. Instead, most prefer ticket sizes larger than \$1 million, because the relative costs of screening, due diligence and other pre-investment needs are very high for smaller investments.

Another problem is the limited local presence of impact investors. Many of them recognise the need for a local presence to ensure the success of projects but only a handful have local offices in their countries of operations. This, says the GIIN, “limits their operations in several ways. It increases the time required for decision making and due diligence; it increases the perceived risks associated with investing in the region, it adds to the time required to source deals and it limits investors’ ability to provide high-touch support to their investees.”

BRIEF PROFILE OF IMPACT INVESTING IN SOUTHEAST ASIA

Cambodia: The financial services sector – specifically microfinance – accounts for almost all PII impact deals and capital deployed in Cambodia. Other sectors (such as energy, agriculture and services) have received limited investment.

East Timor: All impact investments in East Timor have been in microfinance.

Indonesia: Agriculture and financial services have seen the highest number of deals. Workforce development, fisheries, education and healthcare are promising sectors, with a growing number of deals in recent years.

Laos: More than 8% of capital deployed and almost 60% of all deals in Laos have been in clean energy. The remainder has supported the tourism and financial services sectors.

Malaysia: Only consumer goods and financial services have received impact investment.

Myanmar: As in Cambodia, microfinance has received the most private impact investment in Myanmar (over 80% of capital deployed). Education, tourism and ICT have also received some investment.

Philippines: Clean energy and financial services have had the highest number of deals and greatest share of impact capital disbursed. Workforce development and agriculture are promising sectors, with many deals in recent years.

Singapore: The ICT sector is the single largest recipient of PII capital in Singapore, accounting for almost 80% of capital invested and 33% of deals. Healthcare and financial services have also attracted investment.

Thailand: Energy is the most-invested sector in Thailand both in terms of the

number of deals and capital deployed. Besides energy, the financial services sector has also attracted investment, primarily into insurance providers.

Vietnam: Most investment, both in terms of the number of deals and capital deployed, has flowed into the ICT sector, most commonly into healthcare and banking-related products. Although microfinance has attracted some investment the sector is largely government-controlled in Vietnam. Education and healthcare are up-and coming sectors.

Source: Global Impact Investing Network (GIIN) and Intelicap

SOUTH ASIA: FORTUNE FAVOURS THE BOLD IN IMPACT INVESTING

One of the least developed yet most populous regions in the world, South Asia is seen as having significant potential for impact investing. India is the largest and most active impact investing market in the region and after India, Pakistan and Bangladesh are the most active countries. Myanmar and Sri Lanka are two of the fastest-growing economies in the region and impact investors are showing strong interest in these two countries. Nepal, however, has seen relatively little impact investment as yet.

There are “clear areas of opportunity” in the future for impact investing in South Asia, the GIIN concluded in its study published in partnership with Dalberg Global Development Advisors and with support from the UK Government agency UK Aid. The report cited the “enormous potential market for affordable products and services to meet the needs of ‘base of the pyramid’ populations” as well as the need for improved access to quality housing, healthcare, education, financial services and energy in South Asia.

India is the largest and most active impact investing market in the region, and benefits from a broad range of investor and entrepreneur experience with impact investing, the study noted. Development finance institutions (DFIs) have deployed \$5 billion while other impact investors have deployed \$437 million (as of 2015) in South Asia. “There is still room for growth in several areas, such as the development and use of a wider range of instruments, gap filling in early-stage investing, and the development of strategic and consistent impact measurement practices.”

Behind India, Pakistan and Bangladesh have been the two most popular destinations for impact investors. Non-DFI impact investors have deployed \$162 million and \$121 million in Pakistan and Bangladesh, respectively. DFIs, for their part, have deployed \$1.8 billion and \$834 million respectively.

In Pakistan, while political instability and terrorism are major concerns for many foreign investors, the domestic business community remains largely undeterred

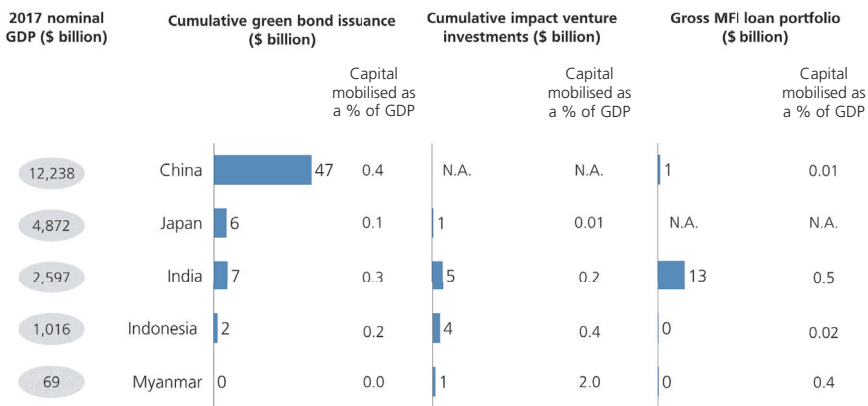
by these factors, according to the GIIN. “Rather, domestic investors and fund managers in Pakistan have demonstrated optimism about the industry, given the large domestic market, relatively favorable regulatory environment, strong history of entrepreneurial activity, and interest from some foreign providers of impact capital. In Bangladesh, market potential (based on GDP and large population), and a long-standing presence of development finance institutions (DFIs) are key facilitators of impact investment.”

Myanmar and Sri Lanka are two of the fastest-growing economies in the region, and impact investors considered in this study have shown a strong interest in these two countries. In Myanmar, while only \$12 million has been deployed to date, a further \$109 million has been committed by various investors for deployment in the next two to four years. Sri Lanka offers a “relatively favourable regulatory environment for investors.”

However, in both these countries, small overall market sizes and gaps in enterprise capacity pose challenges for investors.

In Nepal, despite strong macroeconomic growth trends and recent improvements in the investment climate, there has been relatively little impact investing activity (as well as little overall investing activity). Nevertheless, there has been some growth and impact investor interest in certain economic sectors such as hydropower and tourism.

CAPITAL MOBILISED THROUGH SUSTAINABLE FINANCE APPROACHES ACROSS DIFFERENT ASIAN ECONOMIES



Note: Green bond data for China, India, and Japan is as of March 2018, and for Indonesia it is as of April 2018; Venture impact investing data for India covers 2010-2016, for Indonesia it covers 2007-2017, and for Myanmar and Japan, the data is cumulative as of 2017; Gross MFI loan portfolio as of 2016.

Across the South Asia region as a whole, the majority of impact capital deployed by DFIs has been through debt instruments, while the majority of capital deployed by other impact investors has been through equity. DFIs prefer debt for several reasons, including a lower risk appetite (given that they are investing taxpayer money), a lower level of due diligence required as compared to making equity investments, and less active management of the investment when compared with equity investments.

There are many impact investment funds active across countries in the region. Most impact funds have a multi-geographic focus, including not just multiple countries in the region but a variety of countries worldwide. Bangladesh and India are the only countries with a handful (three or more) of country-specific impact funds with deployed capital. Overall, there are roughly 50 impact investment funds active in India, 11 in Sri Lanka, nine in Bangladesh and seven in Pakistan. These funds raise capital from a variety of sources, including DFIs, institutional investors (pension funds and insurance companies), family offices, high-net-worth individuals (HNWIs), commercial banks and foundations.

There are also several funds, banks, and family offices/HNWIs active in South Asia that are making investments on the periphery of impact investing – for instance, those who invest in enterprises providing goods, services, or employment to populations at the base of the economic pyramid (BoP), but without explicit impact intent. These include local wealthy families and individuals who often provide start-up financing, particularly to entrepreneurs within their family or social networks. Many local commercial banks, meanwhile, provide debt financing to SMEs (often mandated by policy) at the behest of DFIs.

BRIEF PROFILE OF IMPACT INVESTING IN SOUTH ASIA

India: Most impact capital has been deployed in the manufacturing, financial services and energy sectors, and in numerous other sectors such as education and healthcare.

Pakistan: Energy, financial services (microfinance institutions (MFIs) and others) and manufacturing have been the most attractive sectors to date. Impact investors see high potential in businesses serving the large domestic consumer base.

Bangladesh: Most impact capital has been deployed in growing sectors such as ICT, energy and manufacturing. Many investors target job creation as their main impact objective and see these sectors as having the best potential to meet this goal.

Sri Lanka: Microfinance and other financial services have drawn the bulk of impact capital. Tourism and hospitality have also been attractive to investors and there is

growing interest in investment in ‘Base of the Pyramid (BoP)’-focused enterprises in the ICT, energy, health and technology sectors.

Nepal: Transportation and tourism have drawn the largest proportion of impact capital to date – these sectors are attractive because they can absorb large ticket-size investments. For the future, impact investors are excited about opportunities in hydropower and tourism.

Myanmar: To date, most impact capital has been deployed in real estate owing to a dearth of investible opportunities in other sectors. There is strong interest among impact investors in financial inclusion investments.

Source: Global Impact Investing Network and Dalberg Global Development Advisors.



BOARDROOMS NEED TO TAKE SUSTAINABLE INVESTING FULLY ON BOARD

The image of capitalism has been tarnished from time to time by successive financial crises that have erupted at quite regular intervals, such as the global crisis of 2008. This image has been tainted in a rather different way too by a growing perception of greed-driven exploitation of the Earth's natural resources by companies intent on profit maximisation at the expense of almost everything else.

Yet “capitalists” are no longer simply the caricature “captains of industry” who were once easy to identify and to demonise. They are a vast and nebulous group of business and financial investors ranging from global institutions to individuals. All belong to an “investment community” that, directly or indirectly, channels capital into production and the use of resources.

By this analysis, most people are complicit to some extent nowadays in an unsustainable assault on natural resources, on the environment and on Planet Earth itself. By the same token, everyone has a vested interest in supporting sustainable investment if the world is to survive and prosper. This message is now beginning to sink in at various levels. It is being conveyed in different ways and by different people. It is being articulated by the development community (principally through the United Nations and by multilateral development institutions), and it is being promoted by the financial and investment community, as well as by the business community.

The messages have also been addressed directly to the boardroom, which is where turning sustainable investment theory into practice needs to happen. BlackRock group chief executive Larry Fink made headlines in a 2018 statement to corporate CEOs by suggesting that society expects companies to serve a social purpose, and that it is their fiduciary duty to engage with asset managers on corporate goals and long-term prospects.

A year later (in August 2019) the American Business Roundtable, which speaks on behalf of 180 US chief executives, issued a kind of mission statement urging Boards to substitute “stakeholder” primacy for shareholder primacy in the conduct of business. Jamie Dimon (chairman of the Business Roundtable and head of investment bank JP Morgan) pledged a “fundamental commitment to all stakeholders” in this regard.

Such statements would probably have been heresy to people like the late economics Nobel prizewinner Milton Friedman, whose Chicago School of Economics theory espoused free market capitalism and the virtually unfettered pursuit of corporate profit. But the more nuanced objectives championed by Fink and Dimon chime much more closely with the current gospel of sustainable investment.

DOUBLING UP ON THE BOTTOM LINE

Friedmanite preoccupation with bottom line financial results is coming to be seen as inadequate if it allows the social, physical and governance environment in which business corporations operate to deteriorate to the point where corporate profitability is automatically eroded. Environment, social and governance factors are becoming part of what accountants call the “cost of sales”.

The concept of impact investing in fact elevates the bottom line to new levels. Because it insists on a financial return on investment (commercial return generally, although less in some cases, depending upon investor preference) in addition to producing a measurable social impact, this form of investment is therefore known sometimes as “double bottom line” investing.

CONVERSION ON THE ROAD TO PERDITION – BOARDROOMS GO SUSTAINABLE

Acceptance of the need for sustainability is taking hold at boardroom as well as investor level, according to experts interviewed in the course of researching this book. For example, Adam Helzer in New York who is responsible for overseeing the integration of ESG factors into the investment process for Partners Group’s global investments, says there is a growing acceptance at management and CEO level that “you should be conscious of what your environmental impacts are.”

Or, as Fiona Reynolds, CEO of the UN Principles for Responsible Investment (PRI) in London, who has responsibility for the organisation’s global operations, commented: “What we found in our research is that companies which are ESG

invested, are well run, and well governed and continually effective. [So] they are going to be better companies and generally a better bet in the long term.” But, she adds, “the flipside of that is ‘is it okay to make money at any cost’, and I think the answer is no.”

Every investment we make “has an impact and is it okay that we make money by exploiting other people, particularly in the Third World?” she asks rhetorically. “Is it okay that we make money by polluting the environment? I think we are at a point where we are saying that is why the world is as it is. Climate change is becoming an emergency issue. We are seeing a lot of social issues with disruption around the world.”

“People feel the situation is due in a large part to the financial system – that it does not work for them. I think the role of the financial sector in this is vague and not really thought through enough considering its impact on peoples’ lives. Some of the advances in the financial market really came about after the Global Financial Crisis, when a lot of the people thought there just had to be a better way to invest because what we are doing is not working.”

How long before sustainable investment practices come to be regarded as a standard code of conduct in corporate boardrooms? Most experts seem to approach this question with cautious optimism. Mona Naqvi, Senior Director, Product Management for Environmental, Social, and Governance at S&P Dow Jones Indices in New York, believes that “it is one of those things where you arrive at an inflection point where there[is] a critical mass of companies that are interested in [ESG] and will be transparent and help to drive this pace, while the rest have to follow whether they like it or not.”

“The role that we in S&P are taking in creating more and more ESG benchmarks is a testament to the fact that it is something that has been mainstreaming, and one of the things we do as an index provider is to communicate and explain the methodology of our indices, not only for our investors who use them more as tracking tools, but also for the companies that use them to benchmark their own performance against their peers.”

Partners Group’s Helzer meanwhile sees few signs of boardroom resistance to adopting sustainable investment principles, though the responsibility of adopting such principles might appear daunting to some companies. “We have a pretty specific set of goals over a specific set of years, and this becomes another demand, another mandate, another priority that has to fight its way in the context of lots of other

priorities.” Corporate executives in general, he says, have no “principled opposition” to adopting sustainability principles, but they do not always see it as “moving the needle on profitability.”

Amar Bhattacharya, senior fellow at the Global Economy and Development Programme at the Brookings Institute in Washington, sees the corporate sector as likely to respond positively to inducements from financial markets to adopt sustainable investing. “Even in a world without climate change, we know that if environment, social and governance standards are poor it is very likely that investment will run into trouble,” he says. “By offering companies ESG and other sustainability ratings (which help their image and share price), financial markets can produce lures to improved corporate conduct.”

Neil Gregory, who has the rather unusual title of “Chief Thought Leadership Officer” at the International Finance Corporation (IFC) in Washington, and is an acknowledged expert in impact investing adopts a correspondingly more focused approach. The IFC (which claims to have been doing impact investing ever since the World Bank affiliate was launched some 60 years ago) directs investment only to companies where their impact can be measured, he notes.

“There has been an evolution in the impact investing market in the past ten years. Previously there was a lot of emphasis on trying to invest in social enterprises where the business owners also shared the objectives of the social impact. We have never taken that approach and we have always said we will invest in purely commercial enterprises. But we will pick enterprises where the success of the enterprise is aligned with having some positive environmental or social impact. We don’t want to invest in businesses where the social and environmental impacts are not relevant to the success of the business, and where we don’t have much confidence that the company is going to deliver.”

From Gregory’s point of view, impact investing is not so much about “changing corporate behaviour” as “directing investment into those companies that have objectives which are aligned with impact investing.” “I wouldn’t say [impact investing] is going to change corporate behaviour,” he says. “Rather, I would say it is going to change investing in corporates where we think their business model creates the kind of social, environmental and governance impact we want.”

CONCLUSION

SUSTAINABLE INVESTMENT – A WORK IN PROGRESS

Support for sustainable investment is fast gathering momentum as investors align their aims more closely with those of the global community in promoting sustainable social and economic development. As the Institute of International Finance in Washington has put it, “Green Is The New Gold” for climate change-conscious investors, while portfolio investors in general are becoming aware of the need to look beyond financial returns, and to encompass wider social and governance factors in their portfolio considerations. Financial industry leaders too are becoming mindful of the need to see business as a community of “stakeholders”, rather than just shareholders and managers.

All this provides grounds for optimism that the global financial system is capable of adapting (albeit at significant financial cost) to the demands of environmental and social sustainability. However, there is still more to be done by way of devising policies and identifiable vehicles that will allow much more of the world’s private savings to be channeled more easily into sustainable investments.

David Lipton, the then acting managing director of the International Monetary Fund (IMF), put the issue succinctly in a speech to the United Nations General Assembly in New York in September 2019, when he referred to the contribution needed from the private sector in order to achieve the UN Sustainable Development Goals (SDGs). Financial institutions, Lipton noted, “are already offering various forms of impact investing, green bonds and ‘ESG’ [environment, social and governance] fund products.” “But,” he added. “they could go further by launching a broader range of investment products that encourage corporations to align their business models with the SDGs.”

There is as yet no precise estimate as to how the cost of these SDGs is to be met between public and private sector contributions. A UN-ESCAP report in November 2018 suggested that the Asia Pacific region would need to invest an additional \$1-2 trillion per year in areas ranging from education and health to infrastructure and climate action between that time and 2030 – implying anything between \$12-24 trillion in total. Even if domestic official resources are boosted, that is likely to cover

“just one quarter” of estimated SDG [financing] needs, the report said. The need for very significant amounts of private or “blended” official and private finance can thus be seen to be very large.

Numerous conduits have emerged to facilitate the process of directing private finance into various forms of sustainable investment in order to meet the needs of the supply (investor) side and the requirements of the “demand” (investment) side. But the sometimes rather blurred distinctions between different categories of sustainable investment can render it difficult to identify sustainable investment options and to measure the impact of socially-oriented investment.

Part of the reason for this is the emergence of two basically different movements in promoting sustainable investment. One is the broad desire to improve corporate behaviour in terms of environment, social and governance (ESG), and policies as part of a general impetus toward achieving sustainability. The other is the advent of specific economic and social development targets, such as the United Nations Sustainable Development Goals or SDGs.

The fact that there should be teething troubles in creating an environment capable of supporting sustainable investment by the official, financial and corporate sectors (as well as by the community at large) is hardly surprising, given the enormity of the task involved. It calls for little short of a revolution in thinking by all parties involved.

Fundamental issues are involved. Economic development has traditionally taken place in the context of industrialisation, while finance (the so-called handmaiden of industry) has developed to assist business and to provide financial returns in the process. Sustainability has not been an end in itself in driving industrialisation or financial system development. Now it needs to become just that, if the massive resources of the private sector in market economies are to supplement official resources on the scale needed to reverse global warming, create a sustainable environment, reduce social and income inequalities, avoid social unrest, provide more equal opportunities, and ensure better governance of corporations and institutions.

Most of these tasks have traditionally been undertaken by governments using tax revenues (and debt) to finance development. But if they are now to become the province of the private sector using shareholder capital (and debt), then sufficient vehicles are going to be needed to enable the transition to take place. As the United Nations Conference on Trade and Development (UNCTAD) said in a report published in September 2019, “the world can meet the UN Sustainable Development

Goals by 2030 but only with the political will to change the rules of the international economic game. Policies must be adopted to scale-up the resources needed for a big investment push led by the public sector to put the global economy on a more sustainable and inclusive growth trajectory.”

While “led by the public sector,” this push (to achieve the SDGs) will need to be financed to around 50% by private investment, and what the investment community needs are clear-cut ways of making a contribution to sustainability. The road map is becoming better charted as time goes by, with ESG guidelines offering investors identifiable routes for channelling funds into different areas of sustainability. And the Principles for Responsible Investing (PRI), published under the broad aegis of the United Nations, provide detailed guidelines on how to interpret ESG in practice. Likewise, the Operating Principles for Impact Investment devised principally by the International Finance Corporation (IFC) are providing a road map for those investors who wish to take “active” investment to new levels.

However, just as ESG is still a relatively new idea for investors who have been accustomed to concerning themselves with individual companies and sectors, and who now find that they need to take environmental, social and governance factors into account, so impact investing is not yet established as a single or simple investment class. There are (as a joint study by Dalberg Global Development Advisors, the Global Impact Investing Network and the UK Department for International Development Impact Programme pointed out) various approaches to impact investing.

There is, to quote this study, still “a healthy ongoing debate on whether a particular investment should be treated as impact investment” – whether it is “impact investing” as such or “investing with impact.” This may sound like splitting hairs, but very many investments can be said (and seen) to have some impact, whereas bone fide impact investing sets out to achieve a precise and measurable impact.

More specifically, as the joint report pointed out, impact investment is made with the “intention to generate positive social and/or environmental impact.” Impact investors may, for example, seek to use investments to mitigate the negative effects of climate change and environmental degradation [or] to increase access to financial services, education, healthcare, affordable housing or quality employment by underserved populations. In other cases, investments may be made “where there is some intention to have social and/or environmental impact but this is assumed to occur as a by-produce and is not measured in any meaningful way.”

There is no doubt that demand for sustainable investments is growing fast among wider segments of the investment community – at institutional and individual level

– from the world’s biggest pension funds down to retail demand for exchange-traded funds linked to ESG and other types of sustainable investment. The “supply side” (being in this case investors) is eager to develop and expand sustainable investment. The “demand side” (being projects capable of absorbing impact investment at scale) is for now still somewhat less developed. The challenge for the official and financial communities is to develop sufficient numbers of (clearly identifiable) vehicles to absorb this potential investment.

Development finance institutions and private equity funds are already playing a major role in this regard, but their efforts and resources need to be supplemented fully by financial markets.

The case for combined efforts in directing funds into sustainable investment was well stated during the 2019 UN General Assembly meeting by the Secretary-General of UNCTAD, Mukhisa Kituyi.

“Everywhere, anxiety over the prospect of increasing economic insecurity is compounded by the impending threat of environmental breakdown,” he said. “The Intergovernmental Panel on Climate Change has recently raised the stakes by starting the clock on a climate meltdown; but a shortening time horizon is just part of a growing recognition of a wider and deeper ecological crisis.”

Efforts to address these challenges, as Kituyi noted, have aligned around a series of goals and targets which the international community agreed in 2015, to ensure an inclusive and sustainable future for all people and the planet. But as he also noted, “with little more than a decade left to achieve Agenda 2030, meeting these goals has already fallen behind schedule, and there is broad agreement that what is now required is a coordinated investment push on an unprecedented scale and across the entire global commons.”

ACKNOWLEDGEMENT

Asia Asset Management extends its sincere appreciation to the following institutions and organisations for their valuable contribution and support for the publication of this book:



The following individuals have also contributed to the contents of the book:

Dr. Ilex Lam and Dr. Tat Lam, SDG Institute of Impact Finance (SDGIIF);

Paul Mackintosh, Associate Editor (Europe) of Asia Asset Management;

Elizabeth Dooley, Contributing Editor of Asia Asset Management;

Anthony Rowley (main author), former Business Editor and International Finance Editor of the Far Eastern Economic Review, and Japan Correspondent of Asia Asset Management; and

Kirthisri Rajatha Wijeweera, Head of Research and Knowledge, UNDP SDG Innovative Finance, for his advice and guidance, and Nan Li Collins, Head of UNDP SDG Innovative Finance.

Book cover design: Alexander Ho

