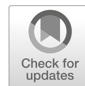
Impact Investment: The Real Issue Not Money or Innovation But Change Management



Arthur Wood

The Chinese expression from 1627 of Feng Menglong "宁為太平犬,莫做亂离人" (*nìngwéitàipíngquǎn, mòzuòluànlírén*), is usually translated as "Better to be a dog in a peaceful time, than to be a human in a chaotic period" and is generally shortened to what is known as the "Chinese Curse"—"May you live in interesting times".

It is hard to not have those words ringing in your ears after Brexit, posturing between China and Japan, the wholesale slaughter of families out to watch fireworks on July 14th on the Promenade des Anglais in Nice following on from the indiscriminate bloodbaths earlier this year at Brussels airport and on the streets of Paris—the policy response—as I type this a US presidential candidate suggesting that the US guarantee of NATO should be dropped and in the same breath suggesting the wholesale burning of civil liberties in Turkey is perfectly acceptable—suggesting moral bankruptcy and military impotence from the world's leading democracy.

What you may ask has this got to do with Impact Investing and ultimately does crisis = opportunity?—to invoke another misappropriated Chinese phrase.

To understand the question one has to understand the crisis in the context not just of the markets, or state and military power, but also as the Council of Foreign Relations noted the demographics of the Youth Bulge[1] or indeed as a Pincer of demographics. A youth bulge creating greater uncertainty in the developing world's—compounded by an ageing of populations in G7 (plus China).

Together this pincer of demographic problems is creating an inability to fund social causes in traditional grant and aid models in the developed world; which will in turn cannibalise funding in the developing world where the social problems will grow as youth populations age—as an academic Bradley Taylor noted in a recent

[1] http://www.cfr.org/world/effects-youth-bulge-civil-conflicts/p13093

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Royal Society Publication—***"The tectonic plates of population change are shifting . . . and the resultant analytical and policy earthquakes will remake the features of international politics in this century".***

Indeed that the ageing of populations in the developed world—which to a large extent are unfunded liabilities in both Health and Pensions, means that the social capital we can allocate from Government is at best limited. This is further compounded by a private sector social capital market currently dominated by a financing mechanism (The Foundation system) invented in 1903 that controls over $1 trillion of global assets—yet 98% of their core assets are unaligned with social mission. To make matters worse the system of grants/aid further incentivises a lack of collaboration and scale and this in the face of issues we all intuitively understand are systemic social issues.

This lack of scale and self imposed capital famine is a detriment not only to allowing the social sector to address these issues—but also to Government that outsources the solving of issues into a fragmented social market, which ironically is in part due to its own tax policy that incentivises the act of giving over the achievement of tangible social outcomes.

To the corporate sector (ignoring from one moment what could be called the FT/Guardian divide—ergo cultural mistrust on both sides) it has created a highly fragmented market lacking for the most part inscale—making risk and commercial assessment difficult.—This is reinforced by a bipolar tax code that reinforces a mind set of "for profit" morally bad—"not for profit" morally good which is not only conceptually wrong but reinforces in peoples mind the reputational and political risk

Critically for companies, they are now faced with issues traditionally that had been seen as social—such as water, waste management, climate, education or resilience—which threaten their bottom line specifically in their growth markets of the future.

The bottom line for all stakeholders is that the current paradigm is bankrupt—this is not because people don't care, or because of a lack of innovation, or perhaps most controversially of all, nor because there is not enough capital. To be cynical it may well be that the players in the current social capital market continue comfortably along—but in the context of demographic trends quite simply the financial framework relative to the social problems we all face both domestically and internationally will fail judged by the ability to mobilise capital to address them.

So if the current social capital market will fail—what are the trends and opportunities that one can note emerging and do we need to go beyond the current view of Impact Investing as a Venture Capital model towards thinking about broader systemic opportunities and hard wiring the social mission in a new Social Contract?

Indeed to be a tad controversial, enabled by the three drivers of all historical change in any market place—Technology, Finance and Legal frameworks—are we in danger because we add the word Social—encouraged by the bipolar language of a tax code (Not for profit and For Profit) and the vested interests of the status quo—of thinking that a social capital market is so unique and morally superior?

Or is the solution simply the application of existing capital, business models and commercial tools for social purpose but also hard wiring the social mission agenda and margin into a broader social contract in a win-win for all society's stakeholders?

What is clear about the status quo in the current social market place is that there is no more capital coming from Government whilst the current Private sector social capital market solution imposes a self inflicted capital famine on itself.

Key elements of its own core capital is the $1 trillion plus in the core funds of Global Foundations. One suspects it would be a surprise to most members of the general public that for the most part this capital is unaligned with their Social Missions, and by the time you look at "frictional" costs, there is a credible case—as will be noted later—that only 1–2% of that $1 trillion actually makes it to the front line in the myriad of social ventures annually—whilst the current banking sector in one product—asset management (and in my old bank we called it without a touch of irony—the Charity Team)—makes exactly the same margin on the management of the core funds of these same social entities.

The Demographic Pincers

The demographic challenge can perhaps be best seen pictorially. Attached below as Fig. 1 from the UN and Canadian Treasury is an indication of the ratio of people aged between 15 and 64 to those aged over 64 in the major economies. The case is compelling increased ageing populations related to a relative decline in the number of people in work—a declining tax base with increased unfunded liabilities.

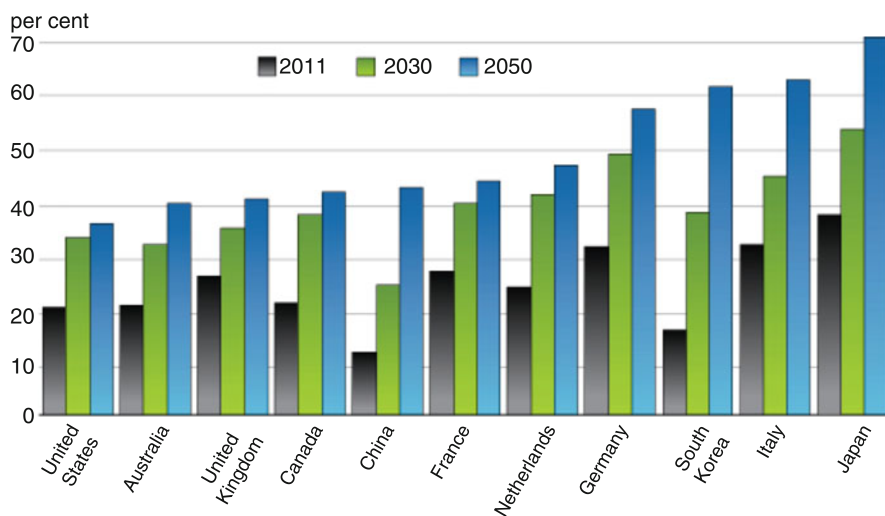

Fig. 1 Ratio of populations—15–64 age group to over 64 years of age. Source: UN/Canadian Treasury

In some senses the welfare reforms of the mid twentieth century are victims of their own success—with increasing elderly populations as folk have lived longer—longevity and better health is in itself good—the policy failure has been in the unwillingness to create funding for these future liabilities. These are now substantive. In the best case scenario of the G7 countries—the US, the US unfunded pension liabilities out to 2050 are estimated to be $3–$9 trillion dollars with pessimists noting that health liabilities may be ten times that figure.

It is worth noting in the EU context (where Italy and Germany are amongst the worse demographic profiles) that this was also enshrined/ignored in the Maastricht agreement—and indeed the current EU prognosis assumes higher levels of productivity that may be at askance with an increasingly elderly population.

In Asia, historically post war seen as the dynamic engine of growth of the more mature economies, Japan has the worse demographic profile of any major economy—with one caustic observer noting there are "no more nippers for the nips". China has substantive problems as the one child policy comes home to roost and South Korea is in equally challenging straits.

The bottom line is that the domestic budget strains will in all probability constrain the amount available for international aid development—and as the response to the migration crisis (allowed under OECD rules) is cannibalising existing aid budgets—this is already happening. As will be noted later, the cuts made by the Swedes, Danes and Dutch in the last year are symptomatic—indeed the proposed realignment of UK aid on key issues suggested recently by the UK PM—Mrs. May—at the UN is also a clear marker of this risk to traditional aid budgets.

To give you a longer term perspective as to why this is a critical policy consideration; if you look at the UK—which is one of the better positioned countries—here one notes that before these demographic strains hit the interest on the current national debt with interest rates at a 160 year low is 50% of the annual budget of the NHS. As the Office of National Statistics noted in a report in 2013 by the Intergenerational Foundation total UK pension liabilities are already £7.1 trillion of which about £5 trillion are currently unfunded.[2]

This also notes that some of the suppositions implicit in the assumptions made by the EU as to longevity, productivity and discount rate, and assumed economic growth rate may be overly optimistic. . . .

The Canadian Treasury figures on the Ratio of Elderly seem to confirm this. Again looking at the Canadian Treasury figures presented in Fig. 2 one can see the extent of the historical trend (applicable to all G7 countries) and given health and pensions are usually about 50% of Government expenditure—you can see how the trend will impact Governments priorities as these liabilities climb over the next 15 years.

To round off the toxic mix of public finance is quantitative easing which to quote Goldman Sachs (and George Osborne as I write) is creating asset inflation making the rich richer and creating greater inequality. In 2008 it was estimated that 60 million

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[2]http://www.if.org.uk/archives/2031/ons-reveals-full-uk-pension-liabilities

PLUS IN WESTERN WORLD TAX BASE DECLINES NOW WITH DEMOGRAPHIC RATIO – ERGO PROBLEM BECOMES STRUCTURAL NOT CYCLICAL

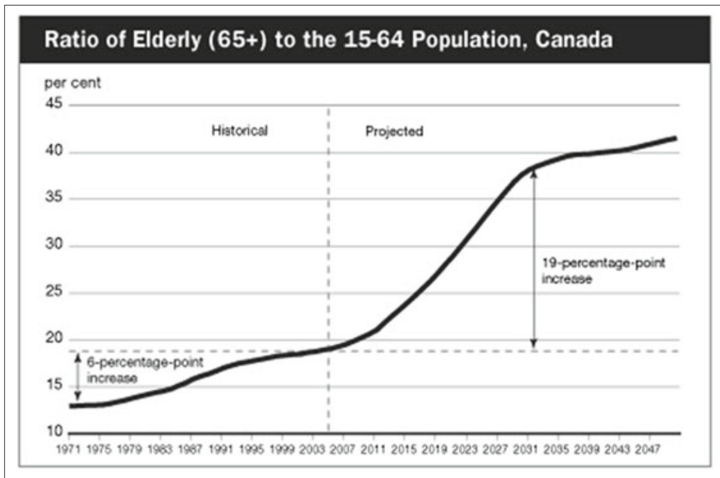

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Fig. 2 Ratio of Elderly compared to the population. Sources: Historical Values from Statistics Canada: Projections from the 21st Actuarial Report on the Canada Pension Plan

people owned more than the bottom 3.5 billion people—last year Oxfam noted that the top 62 people now owned more than the bottom 3.5 billion.

https://www.oxfam.org/en/pressroom/pressreleases/2016-01-18/62-people-own-same-half-world-reveals-oxfam-davos-report

Even to conservative observers one cannot but help note the comment by the Victorian Conservative Prime Minister Benjamin Disraeli—"When the Cottages are not happy—the Palace is not safe"—and some would argue Trump, Sanders, Le Pen and Brexit are a political reaction to the negative impacts of globalisation made worse by the policy reaction to the 2007 crisis; which through quantitative easing has created asset inflation rather than retail inflation.

In the developing world with the youth bulge shown in Fig. 3, we are faced if not addressed with increased economic migration and/or increased political unrest/ radicalisation.

The geo political question this poses is this: Are these developing countries the markets of the future where 70% of corporate growth will come from; or an increasing source of political instability in the developing world; reflected amongst other things in increased economic migration to the North? The danger is that a vicious cycle arises if migration results in cuts to projects, which then result in funding cuts to initiatives that address the causes of the migration

The problems of climate, environmental degradation, food and WASH (water, sanitation and hygiene) compound a negative feedback loop, and as Kofi

Demographics – Growing youth bulge in developing world – economic opportunity but social problems getting worse

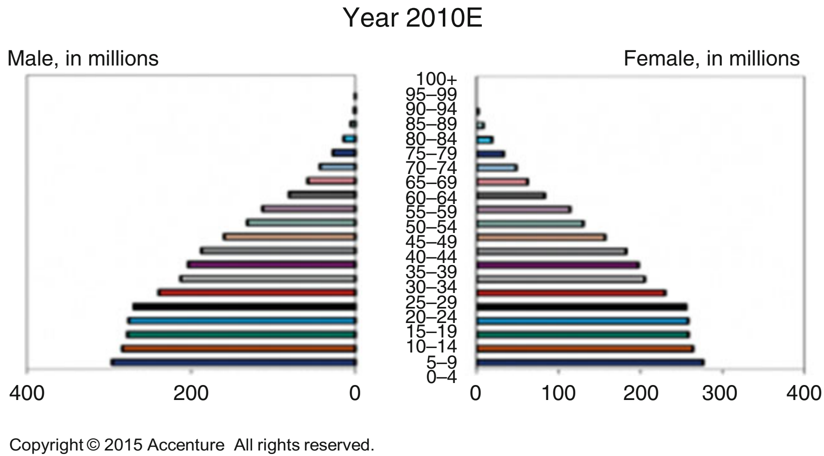

Fig. 3 Demographics—Growing youth bulge in developing world—Figures taken from Accenture

Annan—the former UN secretary general—noted, the problem is leveraged by the effect of social media to Youth that makes transparent the income inequalities in the world.

Indeed the logical reaction by youth which we are now seeing is a large scale economic migration to the north for the better life as we are now witnessing on the borders of Europe. In this year alone one to two million people this year will seek entry to Europe.

Add to this a frustration and envy reflecting itself in a perverted philosophical turning of local values towards extreme Islamic fundamentalism exploited by some players and is at odds with Western values. The result is the bloodshed in the Arab world, and the resulting indiscriminate violence historically seen on the streets of New York, London, Madrid and this year in Paris, Nice and Brussels and Munich. As noted earlier, the two demographic trends have now combined this year to directly impact on aid budgets with OECD rules allowing the domestic migration issue to be funded from aid budgets—with Denmark, Finland Holland and Sweden all cannibalising and cutting aid budgets to fund the domestic migration issues. Even the British who have committed to maintaining the 0.7% of GNP on Development have seen a restructuring of how they look at traditional aid funding with DFID funding dropping to around 75% of this 0.7% commitment—the increased share now taken by the MOD and the Foreign Office—this would appear to reflect a clearer realisation of the use of soft and hard power in pursuit of British interest. Perhaps the clearest indicator on the soft power side was the reversal of the BBC

Foreign Aid is Hitting a Plateau

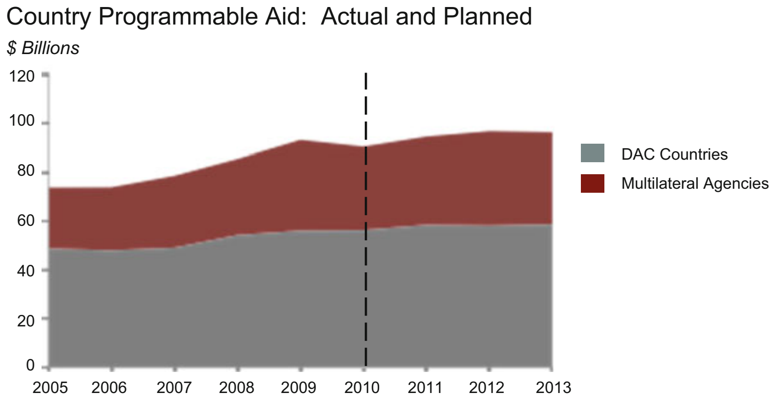

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Fig. 4 Country programmable aid. Source: OECD

World Service cuts last year—which to put in context were about the cost of one to two Eurofighters—and the increased funding for MI6. Yet in Impact Investment despite the rhetoric DFID since 2012 has commmited just 0.23% of its budget to Impact Investment.

Foreign Aid is hitting a lateau. This fact is illustrated in Fig. 4 as multinationals alone cannot take the full burden. Equally in the US as one of my former CEOs was keen on noting, “It does not take the brains of an Archbishop” to realise that should there be a President Trump, US aid budgets may also be slashed—the brute reality is that at best aid budgets are flat (as can be seen below). The traditional Breton Wood agencies are now looking nervously over their shoulders to their traditional sources of funding and beginning to think how else they may raise funds in pursuit of their missions.

The above analysis of course also ignores the fragmentation of the existing agencies where high levels of duplication and fragmentation occur—as but one example (and they are legion) in WASH there are an estimated 30 UN Agencies engaged: many with decisions taken at the regional level—negotiating with about 30 governments who again have about two or three agencies a piece. The “net net” effect is that in the UN system **alone** you have upwards of 50 entities negotiating with 50 plus agencies in a fragmented un-coordinated manner—and in the absence of incentives to collaborate or metrics to draw them together—they often see each others as competitors for limited and declining pools of grant/aid capital.

If one wants to see the issue most graphically and shockingly, it is perhaps demonstrated in the response to international disasters—where the issues of lack of collaboration and scale are crystallised. But it is symptomatic of the sector as a whole where incentives to collaboration and scale are completely misaligned and distorted by the Grant and aid model—as in the recent response to the Ebola crisis—too slow to mobilise, at the outset limited collaboration and slow to act, then after the

Despite Headlines - i - Flat in real terms; ii – Social orgs grow 40% in ten years; iii- Fragmented and only 5% to Intl Projects ; iv - Under this paradigm $41 trillion of US inheritance = Only $50bn pa of new money...

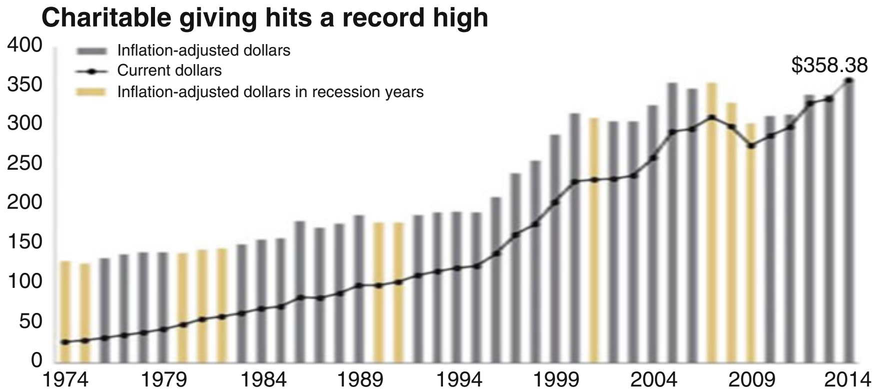

Fig. 5 Charitable giving—Figures taken from Giving USA 2015. Source: Giving USA Foundation, Giving USA 2015

crisis continued spending on the Ebola problem out of kilter with the health challenges of the effected countries.

Or as another example, the Centre for Global Development noted after the Haiti crisis drawing on the reports of the UN Special Envoy—"*Official bilateral and multilateral donors pledged $13bn and… 50 percent of these disbursed. Private donations are estimated at $3 billion (together the equivalent of Haiti's GNP). Where has all the money gone? Three years after the quake, we do not really know how the money was spent, how many Haitians were reached, or whether the desired outcomes were achieved.*"

It goes on—"*We found that about 94 percent of humanitarian funding went to donors' own civilian and military entities, UN agencies, international NGOs and private contractors. In addition, 36 percent of recovery grants went to international NGOs and private contractors. Yet this is where the trail goes cold… it is almost impossible to track the money further to identify the final recipients and the outcomes of projects.*"

This is the reality of a market defined by the pursuit of Inputs—ergo spending the 0.7% and Outputs—bilateral funding process of programmes rather than by the achievement of tangible auditable systemic social Outcomes.

So if the public sector solution if as some would argue is inefficient and fragmented, difficult to reform and unlikely to grow given structural deficits—is the Private sector solution of donations and Foundation grants any better?

When looking at Fig. 5 below the answer when matched against the challenges the sector and society face is unfortunately also an emphatic No.

Despite headlines announcing this year that giving in the US was at an all time high. Indeed supporters of the status quo would point to the demographic backdrop and note given the ageing of populations that this will mean the largest transfer of wealth in Human History—with an estimated $41 trillion being transferred in the US between generations according to the Boston College research[3] (between now and 2050)—so why worry?

The headlines speak to record highs and indeed the market may grow comfortably for the Foundation status quo—but as an efficient capital capable of addressing the issues that imperil us all or even the moral imperatives of our age—the answer must also be a resounding No—given the market and the size of the challenges.

The headline figure for giving in the US last year was $358.38 billion announced as a record high but as the chart above notes; that figure in real terms has more or less been flat for 10 years—meanwhile the number of 501c3 (registered philanthropic entities under this US tax code) has increased by 40% in the same time period. Around 70% of the giving is accounted for by domestic Education and Religion and Human Services, around $275bn is accounted for by generous but fragmented Individual giving and around $50 billion from foundations—the amount allocated to International causes is about 5% of the total spend. Non Foundation giving is virtually by definition fragmented.

Of what could be called the strategic giving of the US Foundations of around $50 billion—this is based off an asset base (core funds) of the US Foundations of around $750 billion. US Foundations must make a minimum allocation primarily grants of 5% of their value every year to maintain their tax status.

Of that $750 billion only however around 2% of those core funds are actually aligned with social mission of which again only about 2% of that figure is in Social Finance products—the vast majority of those funds primarily being in US housing bond structures So the amount of their core capital aligned with Social Mission is very low—resulting in one leading commentator referring to Foundations as Asset management organisations that give 5% away a year for a tax break.

Or to phrase differently and in perspective—TOTAL US Foundation core funds are roughly equivalent to the annual expenditure of the US defence budget—the amount given away in primarily grants (95% of the 5% they have to give away) being about the same as the proposed cost of just the USAF B21 Stealth bomber program of about $45 billion.

The annual give away amount invested in for profit Social Equity from the core funds of Foundations is probably equivalent to 5% of the cost of one B2-1 Bomber. This is of course compounded by high fragmentation and even the Gates Foundation annual grant making is roughly what the Pentagon spends in 36 hours.

Indeed as the Director of the CIA John Brenan noted in a speech in November 2015—"In many developing societies, growing pessimism about the prospects for economic advancement is fuelling instability. Regions with burgeoning youth

[3]http://givingusa.org/giving-usa-2015-press-release-giving-usa-americans-donated-an-estimated-358-38-billion-to-charity-in-2014-highest-total-in-reports-60-year-history/

populations, such as the Arab world, have been unable to achieve the growth needed to reduce high unemployment rates. Perceptions of growing inequality have resulted in more assertive street politics and populism. At the same time, slower growth has left these nations with fewer resources to devote to economic, humanitarian, and peacekeeping assistance to address these challenges. . .Mankind's relationship with the natural world is aggravating these problems and is a potential source of crisis itself."[4]

Now as a former defence analyst I believe the first duty of the state is to protect its citizens, but one has to ask fundamental questions about the use of soft and hard power to achieve that objective when as a society in the Cold War we could mobilise 5% of GNP to ensure against the possible destruction of New York or London in 13 min—and yet in a Warming Peace cannot mobilise a fraction of those assets to address the probable loss of many major coastal conurbations from climate instability in a range of states by the middle of this century and the resultant political turbulence—when my kids are my age.

Now in all this I have probably also sounded like a former banker specialising in creating new financial products which indeed I was for much of my career—but after over 10 years in the social sector I have learnt that we "tell stories"—so if you will permit me perhaps I can illustrate the above with one of my own experiences. For part of my time in the Social sector I focused on the Sanitation issue—which resulted in publishing with Dr. Guy Hutton of the World Bank probably the first UN report on Impact Investing and the move to Outcome models—using Sanitation as a case study.[5]

As a result of this ongoing work back in 2010, I was invited by the Ecuadorian Government and the Lindblat/National Geographic to the Galapagos Islands for a meeting on board the Endeavour to discuss the sustainability of the Galapagos. My flight was kindly funded by the CEO of Ryanair, and it was a gathering of the great and good. It is of course hard to turn such opportunities down. On a personal level, a distant relation of mine Sir Joseph Banks had been the Scientist on the original Endeavour (Captain Cooks first voyage). At a practical level I considered it an opportunity to structure a financial opportunity—after all for Private Bankers—and in brand terms, courtesy of Charles Darwin, who has not heard of the Galapagos Islands—and its criticality to Conservation? Indeed they are small islands, and I expected the issues would be well known and that the community actors must know each other well.

However what shocked me when I arrived at the event was the following, and at the risk of not telling a good story I will bullet point it:

- This was the first meeting between the key stakeholders—Central and local government; The tour operators; the NGO community; and the local community

[4]http://www.cnsnews.com/news/article/cnsnewscom-staff/cia-director-cites-impact-climate-change-deeper-cause-global

[5]http://www.unescap.org/sites/default/files/Development%20Financing%20for%20Tangible%20Results-A%20Paradigm%20Shift%20to%20Impact%20Investing%20and%20Outcome%20Models.pdf

- Although they must have lived cheek by jowl—the major NGO players had limited understanding of what the other NGO players were doing and their strategy
- There was no universal metric for what environmental success or degradation looked like
- A local politician was shipping in folk (10,000 plus) to the Islands to secure his own political position, and what was worse is the housing that had been provided for them had no Sanitation facilities—hence their sewage was being directly deposited into the sea
- Impressive plans were presented—with a focus on what happens in 10 and 30 years—when I asked what would happen in a 3 and 5 year time frame there was a deadly silence
- Equally I asked how they intended to pay for it and was told the Government of Ecuador would pay, followed by another deadly silence.
- Subsequent experience in trying to inject innovative solutions has met resistance/ lack of a framework for innovative ideas to be implemented

Now to be fair since then the Galapagos has now been removed from a World Heritage site at risk list—despite ICUN's recommendation that it not be—but unfortunately the above scenario will be all too familiar to many players in many areas of Philanthropic endeavour.

A fragmented sector, starved of capital, with incentives misaligned, lack of collaboration and incentives on bilateral rather than systemic interventions.

Under the current paradigm, there is clearly an issue of mobilisation of capital—however when you also view the current social funding paradigm and analyse it in the same way a bank would identify the cash flows, opportunities and assess risks, you find a capital market that is not of a required scope to address the issues we all face, and also one that is highly inefficient.

The chart below in Fig. 6 indicates the money flows from the $1 trillion in assets currently under the control of global foundations

As we noted the Government sector is unlikely to grow in funding, and structurally is highly fragmented, but equally the Private sector solution is in much the same bind.

This also tells the social sector that they need to ensure that they do not lump the Finance sector into one broad category called "Bankers"—but instead understand that different elements of the capital market players will be driven by differing objectives—indeed as we will argue later, the focus on just applying a Venture Capital methodology to Impact Investing risks sub optimising the returns and imposes risks to society, the social sector and indeed to the banking sector itself.

What is also clear from this chart is that Impact Investing is a two edged sword for Asset managers—potentially cannibalising a $10–20 billion income flow for the banks in traditional Foundation and Asset management structures—yet an opportunity as Assets Under Management (AUMs) since Impact portfolios are growing at about 17%.

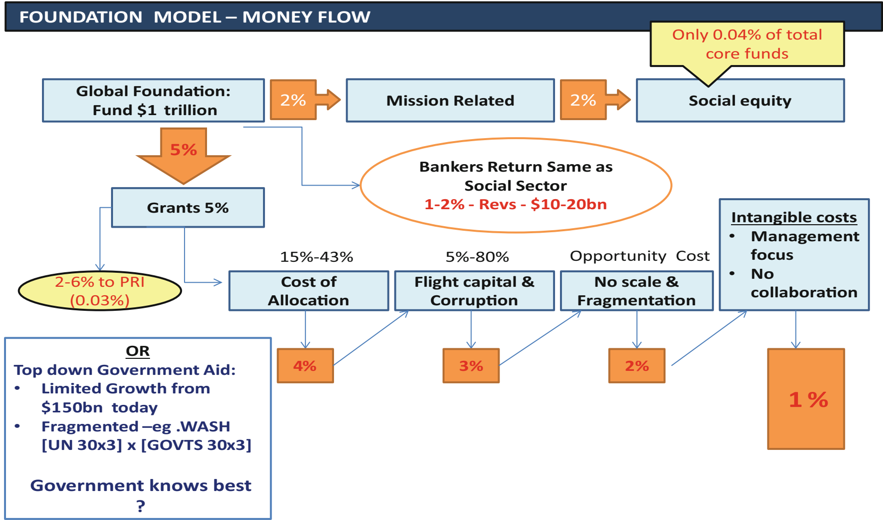

Fig. 6 Foundations models money flow

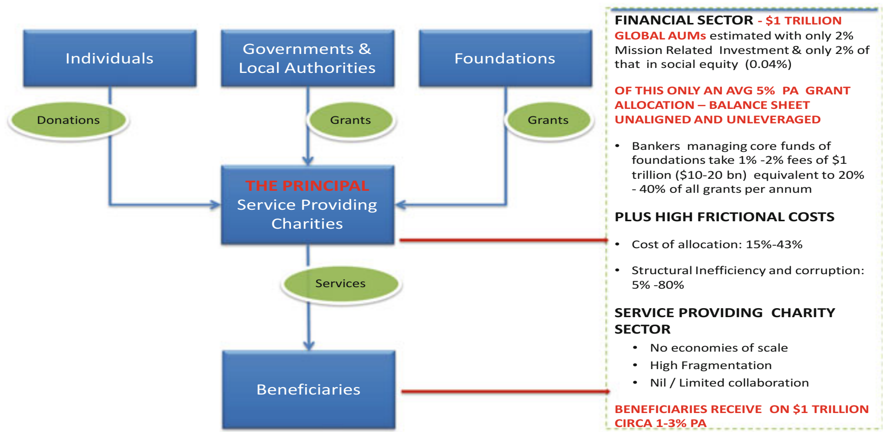

Fig. 7 Investment model today

Let's perhaps look at this same chart not from a cash flow perspective but from an organisational perspective in Fig. 7.

Comparing Figs. 6 and 7 we can realize that the model of intermediation has not changes fundamentally.

The Growth of Impact Investing

When Dr. Max Martin (then head of Global Philanthropy at UBS) and myself (then Global Head of Ashoka Social Financial Services) wrote Market Based Solutions to Philanthropy[6] in 2005—before the phrase Impact Investing was coined 3 years later by the Rockefeller Foundation—we noted the structural inefficiency of the sector and the opportunity to engage capital markets for Social Good.

The last 10 years have seen a transformation of interest in the sector, with a growth in VC models of about 17% a year to circa $65 billion. This has been driven by a number of factors:

1. A need by Western Governments to consider how they engage capital markets for social good for both domestic and international purpose
2. In International development—the issue being brought to ahead by the migration crisis—and with aid budgets being cut
3. The corporate sector looking to the growth in the developing markets and moving beyond Corporate Social Responsibility and grants to how social impact investing approaches may impact their whole value chain from brand, cost of capital, marketing, product innovation and competitive profile
4. Bankers seeing an opportunity to apply their skills profitably as the margins/ stickiness on the traditional products declines
5. With funding drying up from traditional sources—the existing agencies looking to Impact Investing tools
6. A different view from the Millennially on Impact Investing and how to manage social issues
7. Cyclical Attractiveness of the Emerging Markets and low interest rates
8. The growth of Social Entrepreneurship and Impact Investing models filling the gap of a retrenching government
9. Increased openness to look at new models—reflected also in Technology, Financial and Legal innovation
10. Government focus on the issue as recognised by the G8 Report on Impact Investing

So Impact Investing Is Growing: But Have We Gone Down One Financial Path to the Exclusion of Other Opportunities—And Does This Hold Risks?

The support of the British Government culminating in the G8 Social Impact Investment Forum in June 2013 has been a high point of the development of the impact market—and is to be lauded. It aimed to catalyse the development of the global

[6] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=980097

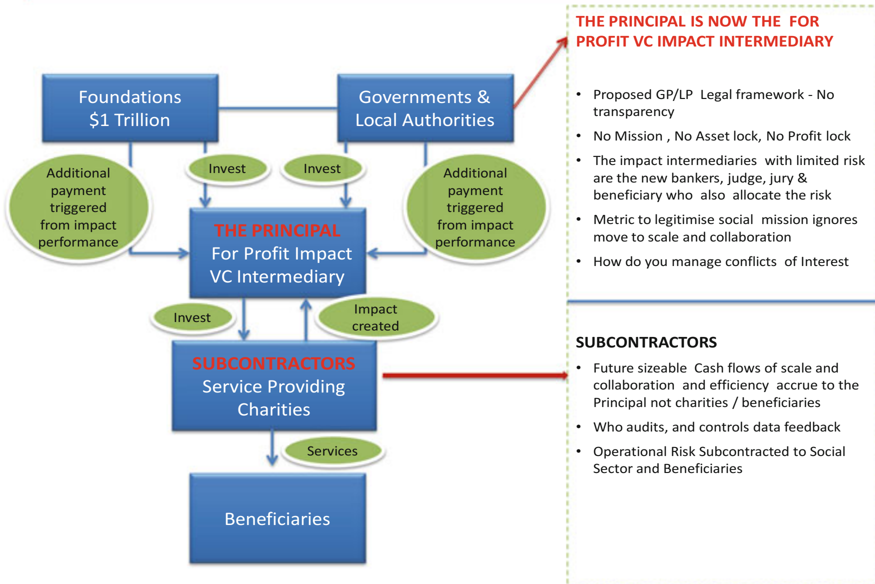

Fig. 8 Impact investing—New model as proposed by the G8 Impact Report

social impact investment market and has brought both key players and credibility into the market. In the UK, post Brexit and Cameron's departure, it remains to be seen how this will play out—but the reallocation of the Department of Civil Society out of the Cabinet office to the Ministry for Media, Sports and Culture is not a positive sign—as is the change of strategy for Big Society Capital from the creation and support of a deeper and diverse dynamic competive impact interrmediary sector to the support of current fiancial instiutions and paradigms.

The result of the UK G8 process was to frame Impact Investing in a Venture capital paradigm sas shown in Fig. 8—now there are clearly examples of great Venture Capital Impact Investing and notable success stories and it is a critical and important element in the development of the market.

However, the focus on an individual financial approach potentially threatens an ability to blinker the deployment of other financial solutions and approaches and throws up clear governance issues when applied to other financial tools.

The process is legitimised by reference to a social metric—the social sector is of course content that a definition of social value is being applied to financial judgements made by bankers. The thinking is that subsidy should be applied to the social metric—that is fine as far as it goes and one can see the logic if looked through a pure bilateral Venture Capital model.

When this thinking is applied to other financial innovations—such as the Social Impact Bond (which is not a Bond but actually fits directly under the SEC definition of a Structured product) the issue becomes more complex.—Unlike most financial models in the social sector which focus on funding innovation—these vehicles are

specifically designed to create outcome models—and create and capture the value of Collaboration and Economies of scale—which along with Innovation are the drivers of capitalism.

The problem under the proposed model is that you then have a governmental subsidy applied and justified by reference to a social metric that measures the current level of inefficiency—but indeed the impact across a range of issues.

That leaves on the table the value of collaboration and economies of scale (plus Asset management). Under this model, the subsidy is paid directly to an Impact Intermediary. It is worth noting that in nearly all cases these are for profit entities or have no mission lock—ergo their controlling shareholdings are held by a foundation as a Mission related Investment—and can of course be quite legitimately sold to maximise the economic return to the Foundation.

Furthermore, these impact entities subcontract the collaboration roles to the social players. The intrinsic danger of such a structure is that it places a for profit entity at the heart of the transaction, which given their for profit nature will be tempted to structure any deal so that they get the upside of collaboration and scale—and to sub contract the risk to the social sector players The key question is who is the principal and how is the social mission hardwired.

The dangers of such an approach can be seen in the earlier attached chart:

In the G8 process, this approach was legitimised in the side report of the G8 Impact report on Mission alignment.[7]

This on a close reading (on p13/14) indicates that it is not necessary to have an asset, mission or profit lock. The implication being that you will be potentially more heavily regulated giving your money away in a Foundation at a guaranteed negative 100% return, than participating in a for profit social venture vehicle—intuitively flawed and open up the whole impact sector to potential crticism from the left. The key point here to reflect is that this is a fundamental issue if public private subsidies are in play.

Furthermore the report—despite claiming to be a comprehensive overview of the legislation in Impact Investing—ignored the Program Related Investment code in the US—legislation originally passed by Congress in 1968—and on the Statute books for over 50 years; indeed with a wide body of case law that defines exactly the terms on which a Foundation can apply/invest with and in a for profit investment with social purpose, ***i.e. there is a body of law that already defines how a foundation (and a corporate working with a Foundation) can participate in Impact Investment*** in multilayered structures.

These structures are often in classic philanthropic thinking confused with B Corps—where the social mission is hard wired at a bilateral level. In these

[7]http://www.socialimpactinvestment.org/reports/Mission%20Alignment%20WG%20paper%20FINAL.pdf

multilayered structures it is proposed the social mission is hardwired and indeed regulated by the IRS.

Furthermore in parallel with the development of the Social Impact Bond—a legal project was instigated from 2006 in both the US and the UK to ensure that there was a legal framework which mirrored the financial development of a SIB—ergo a financial structure that creates a multistakeholder collaboration needs a mirroring legal structure.

The proposal to simplify this for Foundations/Investors was created by the Former head of the Exempt Unit of the IRS (the US philanthropic regulator) by integrating the PRI rules into an LLC/LLP[8]*—called an L3C—(which to declare an interest I was involved from its conception at the Aspen Instiute in 2006) and was actually adopted in the following years by 11 US jurisdictions before being for the most part integrated into the 2012/2016 revisions of the IRS PRI code.

The logic of the L3C (and the mirror structure called the SELLP in the UK) logic can be seen in the videos below by probably the two leading lawyers in Impact Investment—UK and US—Mark Owens and the late Stephen Lloyd.

https://www.youtube.com/watch?v=FDNGFEjR_Ac—Interview with Marc Owens—Former Head of Exempt Unit IRS (25 years with IRS, ten as its head)

https://www.youtube.com/watch?v=jU0BUu8TevE—Interview with the late Stephen Lloyd—Advisor of Lord Hodgson on UK charity reform.

The bottom line is that when public private subsidies are in play, in governance terms the metrics framework cannot be separated from the regulatory and legal framework.

Secondly the danger of applying a single financial paradigm to everything in Impact Investment, is that it creates frameworks that although may provide the Venture capitalists the opportunity to apply their skills to the privatisation of the government balance sheet—may well result in the social sector getting a lower return. There are higher levels of risk—and in a worst case scenario—may create a political backlash that will tarnish Impact Investment more broadly—and impact on a range of solutions that can and need to be applied to social need.

The attached article in the New York Times[9] in a deal structured by Goldman Sachs highlights these concerns—I am making no judgement on this specific structure—but at a political level it all too easy to see how this can create scepticism.

None of this is to deny that there are very good Impact Investing VC solutions that should, can and have been applied by exceptionally committed folk to achieve substantive social good—but that as the sole model to be universally applied as THE model to Impact Investing risks ignoring or distorting other financial models—and raises concerns in Governance terms specifically when one places for profit

[8] *As an aside an LLP/LLC (effectively the same concept should not be confused with a LP (Limited Partnership structure) which is often used by Venture Capital entities and is notoriously un-transparent and can quite often define the power relationship to the benefit of the VC entity*

[9] http://www.nytimes.com/2015/11/04/business/dealbook/did-goldman-make-the-grade.html?_r=0

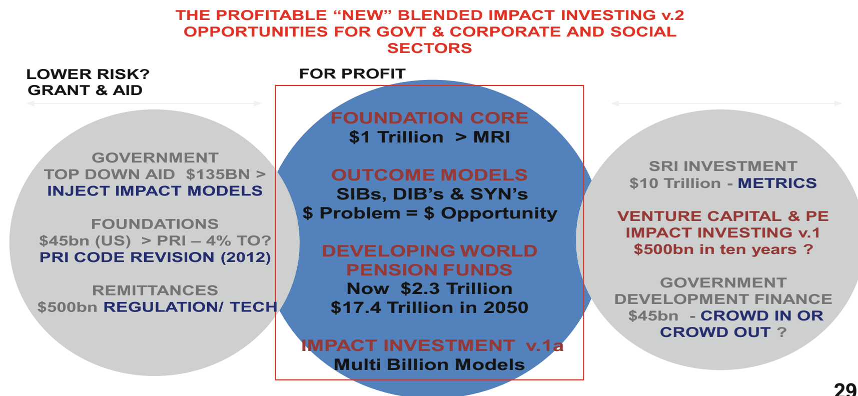

Fig. 9 The mission middle—The new blended impact investing. Sources: TIA, Hudson Institute, McKinsey, AMF, WHO, WSP

intermediaries or social intermediaries without mission lock as judge jury and beneficiary of such structures.

In the same way the sector rejected the argument that Impact Investing was a single asset class—the sector should be wary of arguments about single bilateral metric structures which will be used to justify subsidy—and as ever in all financial services we need to ask what is the governance structure—qui custodiet ipsos custodes—who Guards the Guardians

Indeed a reading of history will tell you the same dynamic was played out colourfully—in the early years of the Foundation world (allocation of capital at negative 100%) resulting eventually in the demand for a framework that hard wired the social mission by a regulatory framework—one wonders why we do not see the same necessity for modern day Impact Investment with multiple returns?

This is surely ultimately in the interest of all stakeholders—Government, Social Sector and indeed corporate and banking interests.

So What Are the Other Solutions in Impact Investment

As a rookie in Finance in the early 1980s with Merrill Lynch, I remember fondly my New York training manager—he was an American smoother than extra pressed virgin olive oil and whose email in later years I recall was Bigdog—on our first day of training I recall the three phrases he drilled into us—(1) KISS—keep it simple

Table 1 Impact investments taken from the JP Morgan 2013 Impact Report

The PE / Venture Capital Opportunity

- JP Morgan estimates that a total of between US$400.6 billion and $987 billion could be invested over the next ten years in " impact investment " to fund the capital needs of the BoP. …**but 40% Growth ??**
- Sub-sectors include urban housing, clean water for rural communities, maternal health, primary education and microfinance.

Sector	Potential invested capital required USD bn	Potential profit opportunity USD bn
Housing: Affordable urban housing	$214-$786	$177-$648
Water: Clean water for rural communities	$5.4-$13	$2.9-$7
Health: Maternal Health	$0.4-$2	$0.1-$1
Education: Primary Education	$4.8-$10	$2.6-$11
Financial Services: Microfinance	$176	Not measured

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stupid; (2) Whenever faced with a complaining client—make sure you say “I am so happy you mentioned it”; and (3) Follow the money.

The first I must admit I regularly fail, the second I wish I used more with my wife, and the third I will attempt to do for this market. So let’s follow the money.

Compiled below in Fig. 9 is an outline of the different sources of capital—it does not claim to be exhaustive—it is probably “more roughly right than precisely wrong”—but hopefully gives you a feel of the capital that can (and should) be aligned in the social capital market.

These are of course the current potential sources of social capital—which are noted in the traditional silos of for profit and not for profit—a perhaps interesting question is also where we shed our beliefs that there is a direct negative correlation between economic and social good and that we cannot create structure where different players take different economic social return.

If you can—and I suggest you do—this means you must ask the question how can this social capital be used to leverage further for profit capital into this market—reinforcing the point that this not about a shortage of capital, but how we leverage that capital for social and economic return.

As can be seen from Fig. 8 the traditional view of Impact Investment is the PE/VC model (v.1 on the chart) and attached below in Table 1 is the social breakdown of the $500bn that was identified by JP Morgan and Monitor as to the financial opportunity.

This is the market that people traditionally consider Impact Investing which is currently growing at 17% pa—although this is not the 40% that was originally implied given the 10 year target—but it is a growth rate clearly much higher than the essentially flat growth in standard investment portfolios—hence the growing interest by main stream asset managers. Though one cannot but think that there is

green washing going on with some funds designated now as Impact whereas before they would have been say developing equity markets.

There have clearly been other major drivers recently in the market with the growth of the Green Bond market to nearly $100 billion in 7 years indicating that where we package Social Investment in a consistent way that the market understands, that a market for social capital can grow very fast.

Or the disinvestment from the coal and dirty oil by main stream investors driven for the most part by the work of Mark Campanale at Carbon Tracker[10] (picked up by Mark Carney—the UK Governor of the Bank of England) which termed the concept of "Stranded assets"—the concept notes the cost of the externalities of the coal and oil industry (6% rise in global temperatures if it is all consumed)—which means the stock valuations driven by an analysis of the value of their reserves of many dirty polluters are effectively "Stranded assets"—ergo they have no financial value if 3% of global warming (as the head of the World Bank notes), "is catastrophic" for the global economy.

This analysis has resulted in the last 18 months in wide spread disinvestment in dirty energy companies and a reduction in the cost of capital for clean energy companies and much higher returns for them.

There is a broader issue in here that it raises some interesting questions as to how externalities to society should be priced to create the same impact on other social issues.

If you look at the centre of the image you will note a number of large scale markets of social capital—I will not go into in this article about realigning the current sources of capital—and the opportunity is large—but look namely at the large scale opportunities in what is often called the Blended finance space:

1. Asset Reallocation of existing Foundation funds

   (a) As noted earlier the core Funds—the $1 trillion that sits on the balance sheets of global Foundations—moving up from the current 2% of asset allocation. This is referred to as Mission Related Investment—and organisations such as Heron and KL Felicitas have moved to 100%

   (b) Currently of the 5% that is given away—only about 3% of that 5% is in for profit instruments—the 97% is in Grants. This allocation to for profit vehicles with social impact is allowed to be done under a legal code called Program Related Investment

   The long term acid judgement on Foundations is not the programs they support in research into the Impact market—but the allocation of core programmatic funds to Impact—the clearest way of doing this is to look at the amount of MRI and PRI an institution does.

   To give an in idea of the impact 20% of core funds in MRI by 2020—a 3% annual change in asset allocation—would create a capital pool of about $125 billion that in turn could be leveraged three times—creating a capital pool of nearly $400 billion.

[10] http://www.carbontracker.org/about/

2. The ultimate implication of the Social Impact Bond model (and the DIB) is the move towards Multi-stakeholder Collaboration models and a model where Social Equity = Financial Equity—this potentially could create liquid tradable opportunities—where the achievement of a tangible auditable social outcome is a market opportunity—indeed reflects pari passu the structure of a normal capital market. When one notes that the WASH market alone has according to WHO/World Bank research around $650 billion in social externalities—indeed monetising just 10% of that market would be equivalent to the total size of the current annual grants of all US foundations.
3. Local Currency pension Funds—there is approximately $9 trillion in the local capital markets today in the developing markets in local currency—effectively unaligned with their own essential sustainable development—very often in just cash or local government bonds—how about South–South capital alignment ? Again to give a sense of the size developing market pension funds alone are estimated to be around $2 trillion—with the World Bank research indicating that this figure will rise to $17 trillion by 2050.
4. Other Impact Investment tools v.2—anyone with a cursory engagement with Impact Investing will know there is a huge range of tools that are now being developed from Infrastructure to Blended models to Intellectual Property models and beyond. When we first did this exercise nearly 7 years ago at Ashoka we identified nearly 50 Ashoka Fellow models and of course the market has exploded since this.

With the current players such as the Breton Woods institutions now facing cuts and asking how these models change their role as Intermediaries; and companies now asking the question of how these tools impact their whole value chain—you are seeing the development of what could be called value chain financing with models having a focus from Infrastructure to Manufacturing to Innovation to redefining the nature of the terms of trade. IP structures in Africa alone are measured in tens of billions. I could go on but you get the point looked at through this prism the challenge is not money or even innovation but change management—as we look around our world we intuitively we can feel the storm clouds gathering—the post war consensus is breaking down driven by demographic forces beyond our control—the challenge have we the will to change the way we deal with these issues?

As Cassius says in Shakespeare's Julius Caesar—"The Fault dear Brutus lies not amongst the stars but amongst ourselves".