SOCIAL IMPACT INVESTMENTS: WHICH PATH FOR THE EUROPEAN UNION?

ENGLISH VERSION OF THE ARTICLE:

INVERSIONES DE IMPACTO SOCIAL: ?QUE CAMINO PARA LA UNION EUROPEA?

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Social Impact investments (SIIs) are becoming a very heated topic in public agenda. Nevertheless, there is still a lot of confusion concerning the fundamental features of this emerging market. There's a lack of clear boundaries between categories: on one side, there's SIIs. On the other side, there's traditional finance and socially responsible investments (SRIs), which are somehow related to corporate social responsibility (CSR). This confusion emphasizes the need to clarify the real nature of social impact finance, the main business models it puts into practice, and the role SIIs can play in Europe.

How to Define Social Impact Investments?

In order to label an investment as "social impact", we have to test the existence of several variables[1]. The most evident feature is that SIIs generate a **social value**; nevertheless, this is not enough: many traditional investments can do so. What makes the difference between traditional finance and social impact finance is the **intentionality** to generate social impact; that is to say, the investment is planned with the main intention to generate social value. It is a "demand-driven" investment because it is inspired by the principal intention of meeting social needs, and not simply to turn a profit. This argument also distinguishes SIIs from SRIs: SIIs are, by definition, inspired by a proactive attitude towards social impact.

This being said, SIIs also aim at profit: the social value goes **alongside the financial return**. Again, this is not the whole story; what distinguishes SIIs from traditional investments is that the financial return is strictly connected to the social impact and somehow depends on the achievement of the

[1] For more details: http://socialimpactinvestment.org/

social goal: in practical terms, investors will receive financial return only if a “minimum level” of social impact has been achieved. This remuneration scheme, known as “**pay for success**” model, leads to the conclusion that the social impact must be measured and converted into financial metrics: SIIs need to aim at **measurable impacts**.

There is evidence that SIIs are different from SRIs also with the return expectation and risk-return profile: socially responsible investors expect a return that is near the market return, while impact investors are open to accept long-term return below the market rate and, according to this, they can be labelled as **patient investors**. As for the above, SIIs can be defined as “impact first”, while SRIs can be labeled as “financial first” investments.

In conclusion, it is possible to define social impact investments as those investments which aim for a social impact—one which is intentionally pursued and clearly measurable—alongside a financial return below the market rate and dependent on the achievement of the social goal.

How Social Impact Investments Work in Practice?

The theoretical framework pictured above has been put into practice, adopting several financial architectures: different schemes may incorporate a different mix of the features described, realizing different levels of “impact intensity”. In general terms, it is possible to state that three of the main features are always present in any impact investing financial structure: the social goal, the intentionality, and the financial return; these can be considered as the “minimum impact requirements”. Contrarily, the requirements of linking the financial return to the achievement of the social purpose – and, consequently, to the measurement of the social impact - as well as the condition of fixing a cap below the market rate to the investors return, are often missing in most of the SII structures. According to the above, it is possible to distinguish between a “pure SII” and a “hybrid SII”, where the first is characterized by the presence of all the features illustrated, while the second incorporates only the minimum requirements – the fundamental ones - to be labeled as “social impact”. What is certain is that, if the fundamental features are missing, we are out of the boundaries of the SII market.

The Most Common Financial Structures of Social Impact Investing

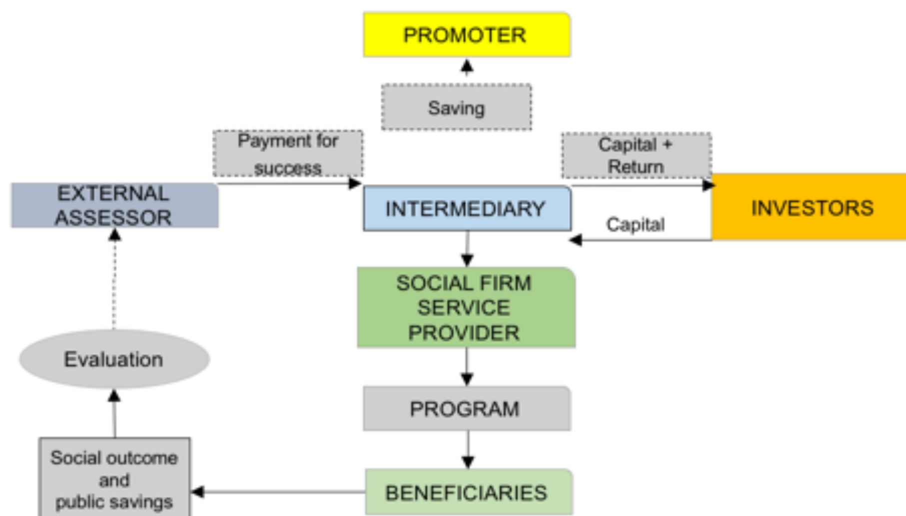
Even if new financial structures and instruments are being explored by the market, social impact investments have been financed mainly through Social Impact Bonds (SIBs) and Social Impact Funds (SIFs).

Social Impact Bonds

SIBs are the most well-known financial structure of the social impact market; the way they work allows us to clearly understand the deep nature of impact finance. Also, because they usually incorporate all the features of “pure impact investing” (Figure 1).

Despite the name, a social impact bond is a “pay for success” financial structure which does not provide the issue of any bond and is based on the agreement between a promoter - usually a public authority or a Government – and an intermediary aimed at realizing a project with a social goal. When the promoter is a public entity, the project is usually connected with welfare state services traditionally financed by public expenditure. The intermediary plays the role of attracting potential investors. Sometimes it manages the project directly, or, more often, uses a social firm specialized in the field of the intervention (the so called “service provider”), which services the flow of funds. Investors provide the capital needed to fund the operational costs of the project and the financial costs related to the fees to be paid to the intermediary and the social firm; they will be repaid with a rate of return negotiated upfront with the promoter, but only if the social bond is successful. That is to say, only if the program has generated a minimum level of social impact.

Figure 1. The Structure of a SIB



A third-party assessor is usually in charge of estimating the success of the program, which includes measuring the social outcome generated and the correlated saving in public expenditure, which will

be shared between the promoter and the investors according to the conditions included in the signed agreement. It is, then, the saving in public expenditure, which arise from the social impact generated by the program, that allow the promoter to repay back investors. This is the reason why the economic rationality of the SIB can be identified in the ability of the social firm to realize the program and in the accuracy of the metrics utilized to measure, in financial terms, the social impact generated. To make it clear, a simplified example may result in some utility (Table 1). Let's assume that a National Government want to reduce recidivism implementing a project for convicted people with the aim of fostering their social inclusion once they have left prison.

Let's assume that: (i) the public cost per day of each prisoner is equal to 50 euro; (ii) our group of prisoners involved in the project is equal to 2.000; (iii) the actual reoffending rate is 50% (1000 people); (iv) the average time period prisoners spend in prison is 100 days per year. As for the above, the reoffending rate costs, in terms of public expenditure, account for EUR 5 million (1000 prisoners X 100 days X 50 euros). Let's suppose that the operational costs of the program amount to EUR 1 million, and that investors look for 10% interest rate on capital invested, as well as the promoter aims at 5% saving in public expenditure, while commissions and fees amount to EUR 150,000 in total.

Table 1 The Economics of SIBs

	N° OF PRISONERS	COST PER DAY	REOFFENDING RATE	N° OF DAYS	ANNUAL COST	GROSS SAVING
ACTUAL	2000	50	50%	100	5.000.000	
CASE 1	2000	50	25%	100	2.500.000	2.500.000
CASE 2	2000	50	10%	100	4.000.000	1.000.000
	OPERATIONAL COSTS	INTERST RATE TO INVESTORS	COMMISSION & FEES	PROMOTER SAVING	NET SAVING	
	1.000.000	10%	150.000	5%		
CASE 1	1.000.000	100.000	150.000	250.000	0	
		CAPITAL TO INVESTORS				
		1.000.000				

Now, let's assume that the social program would cut the reoffending rate in half (500 people): this will generate EUR 2.5 million of gross public savings (500 prisoners x 100 X 50 euros). The economic sustainability of the SIB is verified only if the operational costs of the program, plus the financial costs to repay the players involved in the scheme, are covered by the gross saving in public expenditure. In our example, EUR 2.5 million of gross saving is enough to repay back capital to investors, plus 10 % return, to cover flat fees to be paid to the other players and to leave the promoter with 250.000 euros of public saving (5% out of the 5 million). Should the program not be completely successful, lowering the reoffending rate by only 10%, the gross saving in public expenditure will amount to EUR 1 million, enough to repay only the operational costs.

The market of SIBs is still at an emerging stage and statistics suffer from a lack of affordable data. Nevertheless, several institutions have started implementing local or worldwide data bases, which can offer a vision at a glance. The first famous example of an EU social bond is the Peterborough Social Bond, launched in U.K. in 2010, which aimed at reducing reconviction rates at Peterborough prison. Now, several other SIBs have been launched in Europe and beyond. According to INSTGLIO[2], there are 76 SIBs active worldwide, while 35 more have been announced, but have not yet been implemented. Excluding a few exceptions (among which, the project of "water conservation" in Costa Rica, the "workplace absenteeism" program in Finland, and "cocoa and coffee production" in Peru), it is possible to distinguish four macro categories of SIBs according to their social goal/sector: (i) job creation and social inclusion (recidivism, work force development); (ii) health care; (iii) education; (iv) vulnerable people (homeless, refugees). The U.K. and U.S.A. markets are the most advanced ones; U.K. can be labeled as the leader of SIBs worldwide, with almost 36 social bonds already launched. In Europe, the Netherlands, with 7 SIBs - mostly dedicated to job creation - can be considered the second biggest player. France, moreover, is planning to launch several social bonds in 2017: one aims for the improvement of the procedures for child custody, a second supports families in a state of fragility, and a third SIB will hope to increase school attendance for children born in disadvantaged conditions. Italy also is developing a feasibility study for an SIB devoted to reduce recidivism.

Social Impact Funds

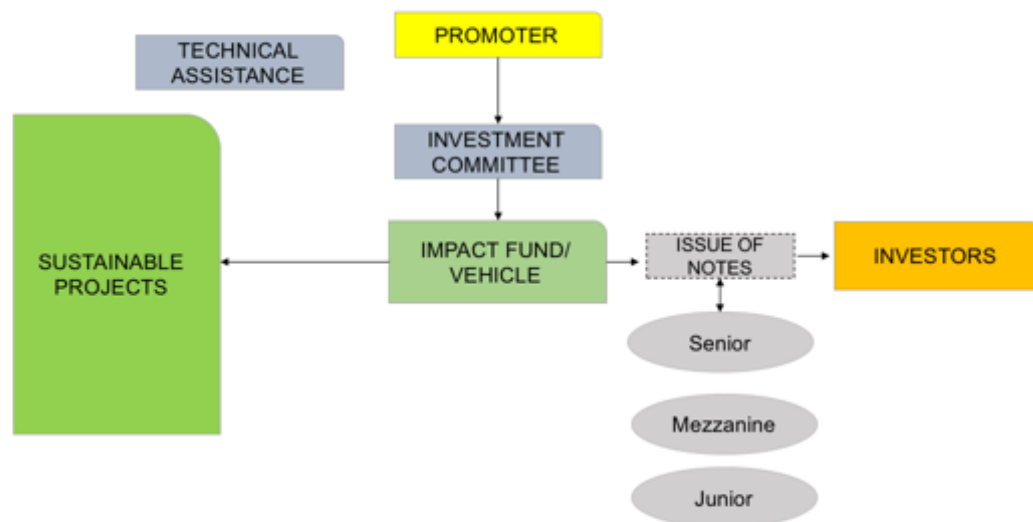
The largest funding for social impact investments comes from investment funds set up with an impact-oriented goal. These funds do not differ from traditional ones in terms of financial structure: they are labeled as "impact funds" because of the "impact-oriented approach". The typical structure of a social impact fund (SIF) requires a vehicle issuing notes to investors and channeling the funds raised on the market to finance a basket of projects identified by the promoter and the Investment Committee (Figure 2).

According to the Global Impact Investing Network (GIIN) annual survey[3], in 2016, the impact funds market managed nearly USD 114 billion - 40% of which refers to US and Canadian markets, and only 14% to Western Europe (21 funds) – invested mainly in the housing, energy and microfinance sectors. As for the purpose, 50% of the money aims both at social and environmental goals, while

[2] See: http://www.instiglio.org/en/sibs-worldwide/
[3] https://thegiin.org/

40% is purely social-impact, and only 9% can be defined as environmental. Funds raise capital mainly by family offices (100%), foundations (84%), banks, pension funds and insurance firms (58%), while few funds attract resources by retail customers (31%), religious institutions (19%) or sovereign wealth fund (7%).

Figure 2. The Structure of a SIF



With respect to SIBs, impact funds are generally characterized by the “minimum impact requirements”; recent studies have tested the intensity of the impact attitude of impact funds finding that very few funds are compliant with the SII definition provided by the OECD, which is very much consistent with the “pure impact” approach[4].

The need to attract investors and to scale the invested portfolio has resulted in a “less pure” impact investing approach, compared to SIBs. In particular, the majority of impact funds issue different classes of notes in order to meet investors with different risk-return appetite; nevertheless, they offer financial return at or above the market rate. Besides, in order to meet investors preferences, they generally do not link the financial return to the achievement of the social goal – which is measured mostly for communication and funding reasons. According to GIIN, the majority of

[4] See: Chiappini (2017). *Social Impact Funds. Definition, Assessment and Performance.* Palgrave Macmillan London. Available at: https://www.palgrave.com/de/book/9783319552590

investors (66%) ask for market rate of return; of the 34% who target a return below the market rate – mostly investing in “junior notes” - 18% aim at return below but closer to the market rate, while only 16% aim for mere capital preservation.

Why Foster Social Impact Investments in Europe?

Europe is facing a dramatic economic phase characterized, among other things, by the need to urgently foster sustainable growth. The sustainability of a new growth cycle must be based on investments and structural reforms, which would not only increase production and income, but would also facilitate wealth distribution and social inclusion. In practical terms, these goals ask E.U. Governments to face two clear challenges: (i) to fund investments, specifically, more of those with a social impact; (ii) to fund investments without compromising the compliance with the fiscal compact requirements and, more generally, a sound budgetary policy.

Impact finance may become an important tool to foster a sustainable growth in Europe: it is specifically tailored to finance social impact projects; it is based on a public-private partnership which allows Governments to not increase public expenditure while fostering investments. In the “Guide to Social Innovation” of 2013, the Commission outlines, step by step, what the Governments should do to take the role of market building for inclusive financial markets; in 2015, the G8 Taskforce on Social Impact Investments published a set of policy recommendations useful for building a social impact investment market. Nonetheless, very few policy makers in European countries have really understood the potential of social impact finance in solving the short-circuit between growth and fiscal compact constraints, and only the U.K. is carrying out concrete policies in favor of social impact finance.

In order to foster the SII market, recommendations are not enough; primarily, we need to increase financial education among policy makers, managers, and investors. This would facilitate actions at three levels: regulatory, operational, and government.

From the regulatory point of view, it is worth creating an environment that is friendlier to impact finance; under this perspective, prudential regulation should ask for less stringent capital requirements for those intermediaries willing to enter the SII market. As for fiscal policy, traditional tax incentives are always at odds with budget constraints; in the case of SIIs, it would be possible to link the incentive to the achievement of social goals: in such a case, we would deal with “compensatory fiscal policy”.

When it comes to recommendations concerning operational tools, it is evident that the main issue is the need to catalyze increased funding for this market. The use of public funds as leverage for private investments needs a more transparent accountability of the welfare state costs. A public agenda which refers to a selected list of social projects should be launched at the national level. It should be associated with information regarding actual public expenditure and potential saving pursued by the Government, in the wake of what has already been done by the United Kingdom. This can also be a model at European level where "Government Social Bonds", with social impact project as underlying assets, could be issued. These bonds could be exempted by the fiscal compact and become an eligible asset class in the monetary policy operations - or even acquired by the European Central Bank. Maybe they could even, somehow, be seen as a pilot test for the Euro Union Bond.

Finally, for the governance of the market, there is a clear need for greater coordination and greater dialogue among the European Financial Authorities and the European Commission. Additionally, there is a need to have a stronger representation of alternative stakeholders, socially oriented, by the Financial Authorities, with the idea of putting the SIIs to the forefront of policy makers' and regulators' attention.

SIIs can play a crucial role in financing a new age of Europe, where financial parameters would be associated with qualitative ones and both would contribute to foster inclusive growth and well-being of European citizens. It's also a challenge to demonstrate that finance "…goes beyond numbers and techniques and leads to visions and solutions inspired by a careful approach to value creation, distribution of wealth, financial and social inclusion, in short: the economics of wellness"[5].

[5] https://www.goodinfinance.com/en/about-the-blog/