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# Comparing two analytical framings of Impact



The focus of the Quality Assurance framing of impact investing outlined in the previous note "Impact Investing needs a neutral decision-making framework" is to provide investors with an operational framework which provides guidance on how to design non-financial goals and how to select the combination of strategies that will be the most helpful in achieving these goals.

As described in the previous note, the Quality Assurance framework is based on three ideas:

- All non-financial goals can be described and designed in terms of the management of some combination of exposures, risks, outputs and outcomes.
- At the present time we can identify eight strategies which are used to manage exposures, risks, outputs and outcomes. Any goal can be implemented using a combination of one or more of these eight strategies. Each of these eight strategies is independent from the others in terms of the data required to implement it, the reporting required on results and the valid impact claims that can be made by an actor using the strategy.
- Because the eight strategies are independent of each other they are a suitable basis for a Quality Assurance framework. A Quality Assurance framework for impact investing is created by arranging the eight strategies in ascending order of operational intensity. By operational intensity it is meant the time, resources and effort required to implement the strategy.

The Quality Assurance framework:

- Guides actors in designing non-financial goals.
- Guides actors in the selection of the combination of strategies best suited to help them achieve their goals.
- Enables an observer to understand the valid impact claims an actor is able to make by observing the combination of the eight strategies that the actor is using.
- Establishes a clear definition of impact washing. Impact washing is making claims that go beyond the claims that are supported by the combination of the strategies being used.

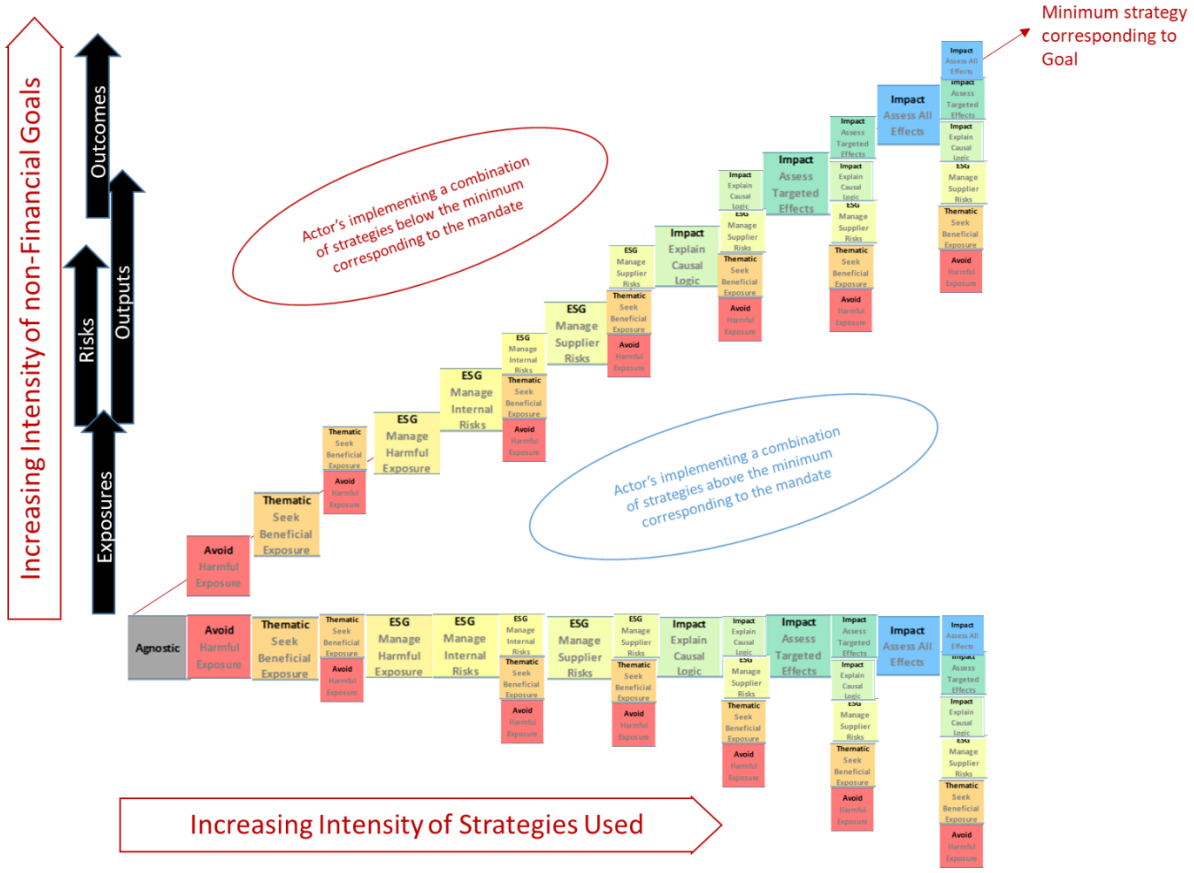
The functionality of the Quality Assurance framework is illustrated by Figure 1, in which the four building blocks of exposures, risks, outputs and outcomes are placed on the y-axis and the eight strategies (individually and in combination) are on the x-axis.

The line at 45 degrees indicates the point at which actors are using the exact combination of strategies required to achieve their goals. Points to the left of the line indicate that an actor is using fewer of the strategies than is required to achieve its stated goals and so needs to either implement the full set of required strategies or revise its goals and reduce its claims. Points to the right of the line indicate an actor is using more of the strategies than is required to achieve its goals and is in a position to make larger claims than those stated in its goals.

As an actor improves its impact practice and is positioned further along the 45 degree line, the actor is traveling in a direction in which:

- Confidence that it will achieve its goals increases.
- Ability to target larger impactful effects increases.
- Confidence that the results it achieves are replicable increases.
- Confidence that its actions will not have unintended consequences increases.

*Figure 1 Using the Quality Assurance framework to match Goals with Strategies to create more certainty of achieving goals, achieve larger goals, be more confident of ability to replicate results and be more confident of avoiding unintended consequences*



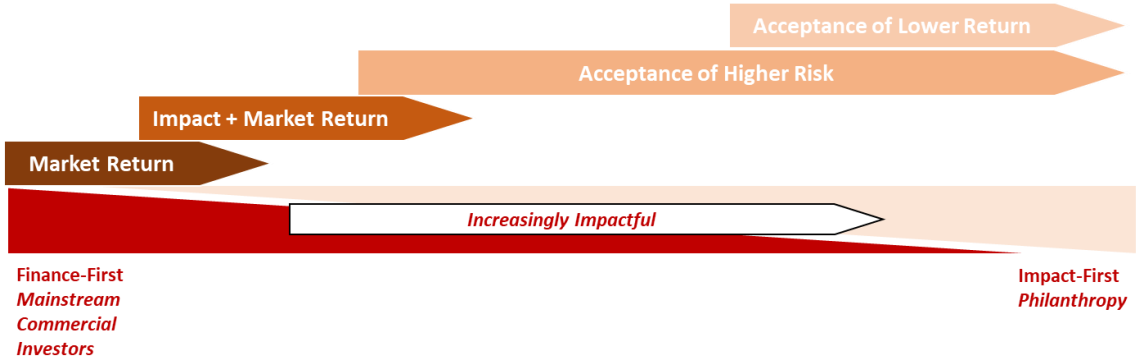

Operationally, the fact that as an actor's practice progresses along the 45 degree line the ability of the actor to design and achieve larger goals with greater confidence increases is a very useful attribute as it places the design and achievement of non-financial goals on a similar structured footing to the design and achievement of financial goals.

## Comparing the Quality Assurance framework with the Trade-off framework

The Quality Assurance framework can be compared to another framework, the 'Finance-first vs Impact-first Trade-off" framework (illustrated in Figure 2) which to date has been widely used to frame the discussion of impact. The Trade-off framework does not consider the building blocks of exposures, risks, outputs and outcomes from which goals are constructed nor the strategies which can be used to achieve goals. Rather, the Trade-off framework is organized in terms of the mandates of different types of actor.

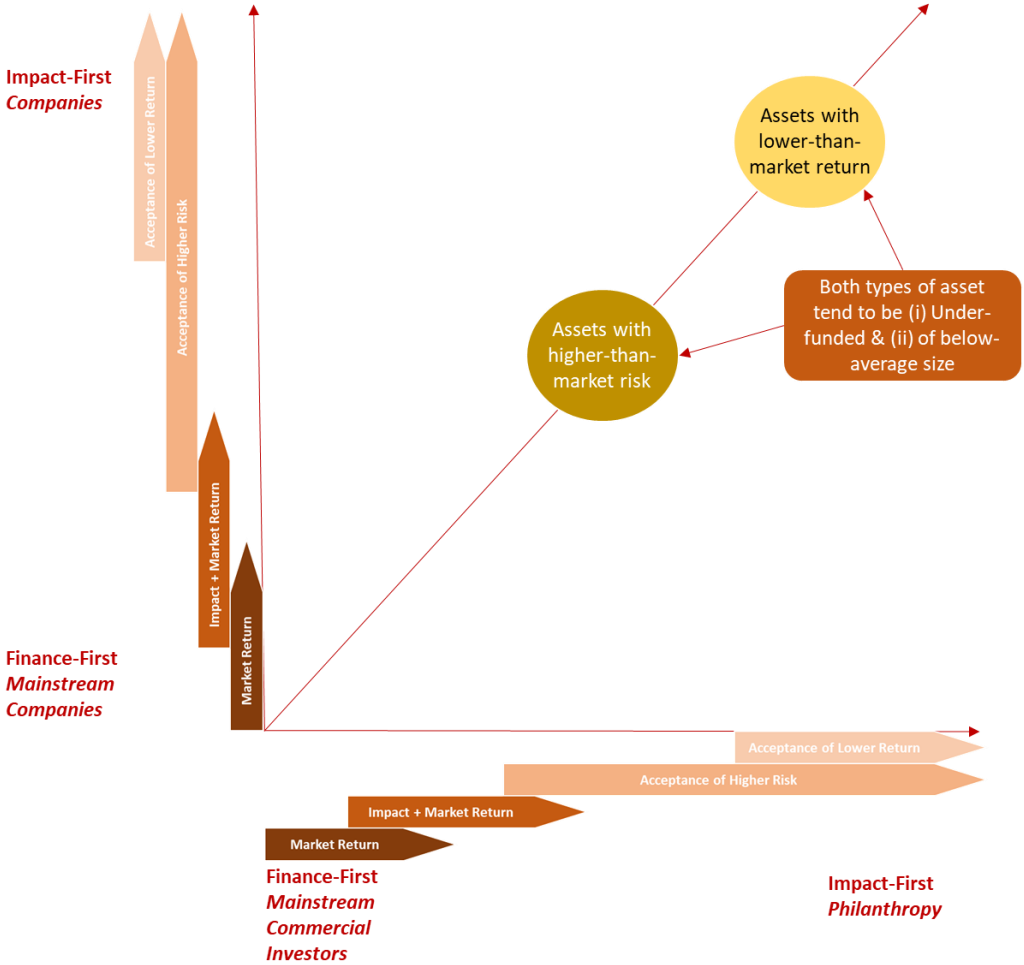
In the Trade-off framework the impactfulness of a mandate is thought of in terms of the extent to which the mandate focuses on supplying capital to assets which have difficulty obtaining funding. In this framing mainstream commercial investors have the least impactful mandates and philanthropies have the most impactful mandates.

*Figure 2 Finance-First vs Impact-First Trade-off framing of Impact*




The functionality of the Trade-off framework is illustrated in Figure 3 in which the y-axis is based on the mandates of companies and the x-axis is based on the mandates of investors. Because it is based on mandates, the Trade-off framework directs capital to the types of assets supported by DFIs, NGOs and philanthropy, that is assets whose risk is or is perceived to be above-market (for example, start-ups, unproven business models) and/or whose return is below-market (for example, activities which have

*Figure 3 Using the Trade-off framework to re-direct capital to under-funded assets*



difficulty scaling on a commercial basis). Both types of asset tend to be smaller than average, start-ups because they have not yet had time to grow and businesses which have difficulty scaling commercially because they have difficulty scaling. Both types of asset tend to have difficulty raising capital and, as such, represent the need to close funding gaps in order to meet social and environmental goals.

A comparison of Figures 1 and 3 indicates that the logic of the Quality Assurance framework and the logic of the Trade-off framework are very different and lead to very different courses of action. The Quality Assurance framework focuses on guiding actors to design and implement goals which are consistent with their mandates, and to achieve larger impactful effects with increasing certainty and confidence in being able to replicate results. The Trade-off framework focuses on guiding actors to modify their mandates in ways which increase support to assets which have difficulty obtaining funding.

## Which framework is the correct one through which to analyze impact investing?

The analysis of impact investing is sufficiently complex and diverse that both frameworks are required to develop a broad and comprehensive approach. Each framework plays a different role.

We can identify the role played by each framework by drawing a picture of the larger context in five steps.

1. Begin by deciding that our objective is to achieve the SDGs, which requires very large amounts of capital to be directed towards positively impactful assets and directed away from negatively impactful assets.

2. Because of the need for large amounts of capital, achieving the SDGs requires the participation of institutional investors as they allocate capital at the required scale. DFIs, NGOs and philanthropic entities allocate nothing like the quantum of capital required to achieve the SDGs.

3. As achieving the SDGs requires the participation of institutional investors, the first question to address is how to achieve the *voluntary* participation of institutional investors in impact investing. Four steps are necessary to *enable* the voluntary engagement of institutional investors ('enable' implies they are able to engage, but does not guarantee that their engagement is sufficient).

- The ultimate owners of the capital allocated by institutional investors must require the inclusion of impact criteria into the management of their assets. To voluntarily engage with impact, the request needs to come from their clients. Institutional investors will only act under the direction of their clients or the direction of the law/regulations. Fortunately at the present time demand from the ultimate owners of capital to include impact criteria in the management of their capital is significant and growing.
  If client demand for impact was insignificant the next step would be to consider legal/regulatory options. However, with client demand in place and growing the next step is to identify the actions necessary to enable institutional investors to respond fully and efficiently to client demand for the inclusion of impact.
- The first action to enable institutional investors to respond is to identify and remove any legal or regulatory impediments to integrating impact criteria into capital allocation decisions. For example, revise the definition of fiduciary duty.

This requires a response from policy makers & regulators to (i) ensure the definition of fiduciary duty is sufficiently flexible to enable the consideration of both financial and non-financial goals and (ii) require long term pools of capital to consider long term risks to the quality of life of their members.

- The second action required to enable institutional investors to respond to client demand for the inclusion of impact is to provide a framework which enables investors to establish non-financial goals in parallel with financial goals. Such a framework needs to enable investors to set quantitative goals, understand the confidence level in achieving these goals and understand the ability to replicate results. That is, it needs to place non-financial goals on the same analytically robust footing as financial goals.
  The **Quality Assurance framework** meets this need by enabling investors to (i) specify their goals in terms of exposures, risks, outputs and outcomes and (ii) identify the strategies best suited to achieving the specified goals (with their associated data needs, reporting requirements and valid impact claims).
- The third action required to enable institutional investors to voluntarily incorporate impact into capital allocation decisions is to ensure that investors have the non-financial data required to establish, manage and report on their non-financial goals. Before investors can use the Quality Assurance framework efficiently, without miss-allocating capital to incorrectly described assets, the data required by each of the eight strategies needs to be available. Providing this data places non-financial goals on the same footing as financial goals. The lack of adequate data on the non-financial characteristics of assets is a major issue at present.
  Ensuring the availability of the non-financial data required by investors for the efficient allocation of capital requires action from policy makers, regulators and standard-setting bodies to require the disclosure of non-financial information.

The cost implications of these measures are relatively light. Investors will need to incur the additional cost of analyzing both financial and non-financial data. Companies will incur the cost of providing non-financial data. However, given the implications for return on capital on the one hand and the cost of capital on the other hand, it is not clear that this is a net cost to investors or to companies in aggregate. Rather, as the price of assets and the cost of capital alter in response to better information, the net cost will fall on those investors and companies who retain large exposures to negative-impact activities.

After the implementation of these four actions, investors' voluntary allocation of capital will become increasingly aligned with achieving the SDGs.

4. However, the improvements in the voluntary allocation of capital enabled by the three actions in step 3 may not be sufficient to achieve all the SDGs in the required time frame. For example:

(i) The voluntary reallocation of capital that occurs may not be sufficient to fully price externalities and so over-consumption of goods which create negative externalities and under-consumption of goods which create positive externalities may continue to an extent which threatens the achievement of the SDGs.

This situation requires a policy response, for example the taxation of negative externalities.

(ii) Some assets and activities may remain under-funded to an extent that achieving the SDGs is threatened. There will be different causes of this under-funding which are important to identify in order to select the best response. Examples of causes of under-funding are:

- Insufficient understanding of the importance of an asset or activity to achieving the SDGs. This situation requires the funding of research and dissemination of information to encourage investors to allocate capital to these assets.
- Inability of an activity to scale on a commercial basis, leading to expected financial returns that are less-than-market-rate. This situation requires the consideration of return-enhancements such as tax incentives and subsidies.
- The risk of an activity is, or is perceived to be, above the market level for the expected return. This situation requires the consideration of risk mitigation measures such as guarantees or preferential return structures.

There is a cost to these measures which falls on (i) companies creating negative externalities (the tax on negative externalities) and (ii) taxpayers, both individuals and companies (the cost of tax incentives, subsidies and risk mitigation).

5. It is possible that even after the measures in steps 3 and 4 have been taken the voluntary allocation of capital is insufficient to fund some assets which are of importance to achieving the SDGs. In this case further action may be required to direct capital towards assets which are necessary to achieve the SDGs. It may be necessary to consider regulatory direction of the mandates of investors to allocate capital to certain assets and, in this case, the logic of the **Trade-off framework** is relevant.

However to implement such a plan efficiently, to minimize the capital allocated to incorrectly described assets, the actions in step 3 need to be in place to ensure that the direction of capital is based on an adequate analytical framework and adequate information.

The efficient direction of this capital is particularly important as regulatory direction of mandates will necessarily reduce expected returns and/or increase expected risk and this will directly affect the ability of the population to provide for their long term financial security.

From the above discussion it can be seen that neither the Trade-off framework nor the Quality Assurance framework is wholly adequate to address the challenge of achieving the SDGs. Both frameworks are pieces of a larger whole.

The Quality Assurance framework addresses the need to increase the voluntary incorporation of impact goals into the allocation of capital. The Quality Assurance framework does not address the question: 'What if the voluntary incorporation of impact goals into the allocation of capital is insufficient to achieve the SDGs?'

The Trade-off framework is unable to contribute to solutions which increase the voluntary incorporation of impact goals into the allocation of capital. On its own, the Trade-off framework moves directly to suggesting that actors modify their mandates in order to finance assets which suffer from funding gaps. The Trade-off framework addresses a question which is not addressed by the Quality Assurance framework: 'What if (i) the voluntary incorporation of impact goals into the allocation of capital and (ii)

other policy measures such as taxing externalities and risk mitigation, are insufficient to achieve the SDGs?'

In terms of the sequencing of actions, there are reasons to think that steps 3 and 4 should be undertaken before step 5. That is, actions which (i) enable the voluntary engagement of institutional investors with impact, (ii) enable research and dissemination of information and (iii) identify needs for return-enhancements and risk-mitigation should be undertaken before the regulatory direction of investors mandates.

The primary reasons for this sequencing are (i) the risk of the inefficient miss-direction of capital to incorrectly described assets in the absence of an adequate analytical framework and adequate data on the non-financial characteristics of assets and (ii) the cost of the regulatory direction of mandates in terms of the risk to people's long term financial security and the narrower base of the population upon which this cost falls (individual savers rather than the broader taxpayer base including corporations).