EXECUTIVE PERSPECTIVE: The role of banks in enhancing impact investing

By Mario Marconi, Head of Philanthropy & Values Based Investing at UBS | 4 November 2013

Large corporates do good through their Corporate Social Responsibility programs. However banks can go one step further by leveraging their core operations, investment and finance solutions, for doing good. Doing business and creating a positive impact on society are not mutually exclusive goals. Throughout history finance has played an important role in propelling social change, advancing living standards and creating good. Today the perception of finance is hampered and often associated with the opposite. But the Nobel prize winner Robert J. Shiller argues in his most recent book “Finance and the Good Society” that society can once again harness the power of finance for the greater good and says that “rather than condemning finance, we need to reclaim it for the common good”. I am also convinced that impact investing and social finance are the financial innovations of the 21st century which banks and the financial industry can drive and mainstream over the next decade.

WHY IMPACT INVESTING IS AN OPPORTUNITY

As many readers will know, impact investing aims to achieve a social objective next to a financial one. Yet, the question we find ourselves often confronted with is “why look for finance to devise social solutions?” For one, because philanthropic solutions are scarce, and secondly, because select areas of social intervention can be addressed more efficiently through market mechanisms (I am not making the case to substitute philanthropy through investing here. In light of scarce resources I am suggesting complementing philanthropy where it makes sense).

It may sound counterintuitive at first sight, but there is a strong commercial argument in favor of impact investing – just think about three secular trends that we are observing:

1) Emergence of low income consumers in developing and frontier markets

There is a pent-up demand of low-income consumers that so far are paying a “poverty premium” to access goods and services of inferior quality, as neither product designs, features, packaging, distribution nor pricing were designed for their needs in mind. According to the IFC, low income populations consume USD 5.2 trillion annually and this number is projected to grow.

2) Restructuring of the sustainable demand structure

We can see a clear shift from sustainability as a moral imperative to

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sustainability as an economic imperative and lifestyle, for example “Lifestyles of Health and Sustainability” consumers[1]. “LOHAS” consumers want their products to reflect their personal values and aspire to positively influence society with their purchases, be it food, fashion, real estate, or transportation. According to McKinsey & Company, consumers in the US have built their LOHAS market to over USD 300 billion, growing at more than ten percent per annum.

3) A growing expenditure gap

With high government debt levels leading to turmoil in Southern Europe, and political gridlock in the US, many governments in the developed world are turning to austerity, cutting expenditure on social projects. A recent study by Accenture and Oxford Economics projects the expenditure gap between expected demand for services and the ability to pay for them through to the year 2025, and the results are startling: for Germany it is USD 80 billion, for the UK, USD 170 billion and for the US, USD 940 billion.

These trends will continue independently of macroeconomic developments and they all represent significant commercial and social opportunities.

This offers an opportunity for private investors to fill the void. One example is a social impact bond – whereby private investors can launch programs intended to have a positive social impact. Provided the projects achieve positive social outcomes and public sector savings, investors then receive a return on their investment from the government.

INVESTOR BEHAVIOR & CHALLENGES

However these trends are only acknowledged by subject matter experts and by few insider investors. The vast majority of investors do not yet recognize these opportunities – and either are not familiar with the concept of impact investing or are at a stage of increased interest yet are still hesitant to invest. Therefore, while fundamentals are strong and interest is growing, impact investing has not yet taken off, growing at approximately 12.5% CAGR[2] from a relatively low basis (USD 8bn in 2012).

So, why is impact investing not being embraced wholeheartedly?

There are various reasons, many of which are typical to a burgeoning industry:

- Early stage ecosystems: Mainstream investors exist in a mature ecosystem, whereas the impact investor ecosystem is still evolving with comparatively few of the “necessary ingredients” (e.g., intellectual capital, venture capital, advisers, accelerators, successful companies, etc.)
- Subscale: Impact investment portfolios and deal sizes tend to be smaller than traditional investments. While smaller investment size can attract a wider pool of investors, it may represent an obstacle to larger investors with higher fixed costs.
- Fit with asset allocation framework: For impact investing to become a mainstream strategy, investments need to be able to be measured against the conventional criteria of the asset allocation framework, the central features of which are risk and return, volatility, liquidity, portfolio match, and exit timeline.
- Confusion with philanthropy: Nebulosity among investors prevails as to which category impact investing fits in. It is true that it has been pioneered by the foundation and philanthropy space; they kick-started and seed funded it, they provided first loss capital provisions to help the investment style off the ground. As a side effect of these jump start activities, there is still a perception that impact investing is an enhanced way of philanthropy.

THE ROLE OF FINANCE

What can finance do to overcome these challenges and mainstream it? Banks can contribute to the activation of more investors. This will not be done tomorrow and requires some stamina but it will pay off for investors (our clients), ourselves and the common good.

Banks have three core skills:

- Banks have the ability to structure financial products. There are two elements that are important here. For one, banks are (or should be) capable of seeing and understanding emerging demand. It is for this reason that they have a product development process that tries to translate emerging topics important to investors into offering solutions.
- Secondly, their ability to structure a financial product, which requires some upfront costs, allows for individually lower initiation, transaction and reporting costs and lowers the entry barriers .
- Furthermore, banks have a client base with different risk and interest preferences and they have sales people who can reach out to clients in a systematic and coordinated manner.

Hence the question, how can you leverage these three core strengths a bank possesses for the good as Nobel laureate Robert J. Shiller demands? We see a trilogy of solutions that must be applied, that can be subsumed as “ETS” – or “Educate”, provide “Transparency” and “Structure”.

Banks need to both educate themselves and investors and include impact investing into their advisory processes. This, of course, requires in-house capabilities and the ability to form an Impact Investing World View. Banks need to put the fundamentals presented in this article to practice and communicate them to their clients and the public. They need to create an advisory offering that will advise their client investors on how to approach their impact investing in a broader investment and portfolio approach.

Banks can and need to create transparency in a sector that looks chaotic to newcomers. Funds and investment opportunities are mushrooming, different organizations and interest groups call it theirs, disagree on definitions and purpose. Banks should enlighten investors, create frameworks and overviews that makes it easier to navigate in the “impact jungle”. At the same time banks should take an active position and help shape the public discourse – providing input as to what investors really need. UBS as well as other banks are investor council members of the Global Impact Investing Network; GIIN) and actively take part in the dialogue on how to make impact investing more accessible to investors.

Finally banks need to engineer and craft investment products. This is not cartesian science as in other more mature markets where you can guage the level of demand for what is needed. This is a market of predominantly latent demand, where it is difficult to assess demand and derive an exact list of product requirements. To embark on a product building route requires:

- A learning process
- Striking a meaningful balance between listening to what investors need and guiding them through unchartered territory.

CONCLUSION

Financial services are currently at an inflection point. There is an opportunity for them to design solutions which address societal challenges. These solutions will be larger in scale and smarter in design if they come from the bank’s core business as opposed being driven from a CSR perspective.

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[1]LOHAS Market,” ONELIFE MEDIA, 2013, http://www.effectpartners.com/onelifetour/the-lohas-market/.Winning the $30 Trillion Decathlon,” McKinsey & Company, accessed on May 1, 2013, http://www.mckinsey.com/features/30_trillion_decathlon; John Marshall Roberts, “LOHAS Consumers around the World,”

[2] From the Margins to Mainstream – WEF Report September 2013

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