Impact Investing: Towards a Credible Sustainable Investment Strategy.

Author

Dr Katarzyna Wilk, Swiss Impact Lead GmbH

Abstract

The paradigm shift towards impact investing is upon the finance sector. Impacting investing with the goal to generate significant positive socio-environmental outcomes is becoming mainstream. It goes beyond simply a declaration that an investment meets ESG criteria, and requires credible justification backed with properly performed assessments. Although approaches to quantifying positive socio-environmental impacts vary, depending on objectives and scope, a credible impact assessment should include: materiality analysis, definition of objectives with related targets and metrics, monitoring and reporting. In order to bring transparency and credibility to impact investing, it is essential to ensure that analytical procedures are verifiable and replicable, while data analysis is done carefully with existent data shortcomings in mind. Regardless of the presence of methodological and data challenges, impact investing is a significant step towards a more credible strategy in sustainable investing.

Contact

Swiss Impact Lead GmbH, Zurich, Switzerland

Email: contact@swissimpactlead.com

Date written

July 15, 2021

The paradigm shift towards impact investing is upon the finance sector. Impacting investing, as being linked to UN SDGs with the goal to generate significant positive socio-environmental outcomes, is becoming mainstream. In 2020, this strategy experienced the highest growth rate among all sustainable investment approaches, reflected in an annual increase of 70%, says the Swiss Sustainable Finance's investment study. Alongside, over 20 impact-related market standards are in preparation, including recently launched Principles for Responsible Banking, signed by 230 signatories representing 40% of the banking industry. At the same time 60 global investors agreed to adopt the Operating Principles for Impact Management — a new market standard.

Impact investing currently comes in various forms of capital and approaches, and pertains to all asset classes, including SDG bonds and SDG-aligned funds. The definition of impact investing has also broadened recently — with exogenous trends such as climate change, resource scarcity and population growth, affecting investment markets, impact investing is becoming an effective tool to mitigate those risks both globally and regionally. Nowadays, investors can choose to allocate capital and expect positive impacts in emerging or underdeveloped regions, but also in developed economies. The top five impact investment topics of asset managers include: water, environment, microfinance, energy, housing and community development, according to the latest Swiss Sustainable Finance's market study.

Methodological Challenges

As much as impact investing presents an unprecedented opportunity for investors and, at the same time, for sustainable development globally, it uncovers multiple challenges. Among them there is the lack of transparency, stemming from no clear rules for impact-related disclosure and assessments; the lack of accountability as a result of insufficient monitoring of financial intermediaries and companies related to non-financial returns; and the lack of coherence, stemming from an absence of clear policy incentives and fragmented regulations. All above, leads to suboptimal allocation of assets and, at times, to SDG impact washing, undermining credibility of the sustainable finance market, as OECD Framework for SDG Aligned Finance points out.

Another challenge is related to available ESG data, in particular the process of operationalisation of ESG company-level data into SDGs. Initially, SDGs were not meant to serve as a guideline for investors and corporate performance evaluation; they were defined at the global level, focusing rather vaguely on interdependencies between countries and global sustainable development. As far as intuitively we may assume that ESG and SDGs are linked, the magnitude and type of linkages is blurred and vary, while casualty is unclear — these interdependencies are being likely mediated by external and contextual factors, all which need to be taken into account, while performing analysis. Given the above, impact assessment requires rigorous analytical procedures.

Moreover, unlike ESG investing, impact investing requires measuring a change in induced impacts over time. Alternatively, making predictions as to expected future changes in impacts. This requires access to comparative ESG data collected in multiple points of time. Comparability across time is only possible when the process of data collection and operationalisation are executed properly and follow science-based methodology. With the prevalent lack of standardisation of ESG data and data collected only on an annual basis, impact assessment requires additional procedures, including combined qualitative and quantitative comparative analysis, requiring advanced analytical skills.

Impact Assessment

There are multiple approaches and frameworks available to quantify positive socio-environmental impacts generated by investments, including: IRIS (Impact Reporting and Investment Standards), GIIRS Rating (Global Impact Investing Rating System), or SASB Standards. However, there is no consensus on how to measure contribution of investments to specific SDGs and their targets. Assessing companies' contributions as well as analysing how investments and portfolios affect SDGs, remains in most cases a manual process.

Asset managers face dozens or hundreds companies included in portfolios to review. This means that an assessment is not only a lengthy process but can be biased, due to diversified research and analytical skills of asset managers or analysts. Given that, offering advice and providing investors with a proof of SDG-alignment as well as comparing SDG-aligned funds against each other remains challenging. All above may lead to confusion in investment decision-making and contribute to both market distortions and possible impact washing instances. An impact washing problem can be overcome by additional verification of SDG-alignment against investment criteria and science-based constraints.

As shown, approaches to quantifying positive socio-environmental impacts vary, depending on objectives and scope. However, a credible impact assessment should include: materiality analysis, definition of objectives with related targets and metrics, monitoring of performance, and reporting. Measuring an investment impact on SDGs, on the other hand, should cover: an assessment of investments alignment to specific SDGs goals and targets, an assessment of how they affect a corporate performance over time as well as overall outcomes/impacts.

Regardless of the presence of methodological and data quality related challenges, impact investing is a significant step towards a more credible strategy in sustainable investing. It goes beyond simply a declaration that an investment meets ESG criteria, and requires credible justification backed with properly performed assessments. In order to bring transparency and credibility to impact investing, it is essential to ensure that analytical procedures are verifiable and replicable, while data analysis is done carefully with existent data shortcomings in mind.

References

Swiss Sustainable Finance 2020 Investment Market Study 2020 available at: https://www.sustainablefinance.ch/upload/cms/user/2020_06_08_SSF_Swiss_Sustainable_Investment_Market_Study_2020_E_final_Screen.pdf

Principles for Responsible Banking, https://www.unepfi.org/banking/bankingprinciples/

Operating Principles for Impact Management, https://www.impactprinciples.org