The Tiresia Handbook in Management for Sustainability and Impact

Chapter 7

Finance for Sustainability and Impact

Finance for Sustainability and Impact

1. Why Finance for Impact? The need for new financial models

The global financial crisis started in August 2007, has brought to a re-evaluation and re-conceptualisation of the theories concerning financial innovation processes (Khraisha and Arthur, 2018) and has increased interest in innovative financing (Sandor et al., 2009). The excessive expansion of the financial sector in the economy led large companies and institutions to concentrate more and more on financial speculation, and less on the production of goods (Palmerio, 2009), and on the consequences of their daily operations on society and environment. The crisis led to the collapse of the financial sector and discussions on the responsibility and irresponsibility of the financial services industry have been enormously fuelled by the role it played during the crisis (Muniesa and Lenglet, 2013). Since then, there has been a need to reform the financial system to make it more innovative, democratic, and inclusive (Kim and Hann, 2019).

The global financial crisis highlighted the need to rediscover a more human and equitable dimension of economic and financial systems, after decades of inadequate market discipline (Chapra, 2014), as well as for financial models able to allocate funds to its most productive use (Schoenmaker, 2017).

This is one of the reasons why novel financial models have grown in size and importance, as an attempt to "provide much needed capital to individuals and businesses" (Collins et al., 2013). As a result, innovative, decentralised, and disruptive forms of financial intermediation are emerging.

Another relevant challenge of recent years concerns the access to finance by individuals and companies (Kim and Hann, 2019). Regarding the advancement of new financial models, the need for greater inclusion of people and small businesses that would not normally have the characteristics to access financial services is vital. (Collins et al., 2013; Zhang et al., 2016).

The market has started to realise how shareholder wealth maximization is no longer a valid guide to the creation of sustainable wealth (Fatemi and Fooladi, 2013). A paradigm shift has become more than necessary and, consequently, various models of sustainable finance have emerged. As a matter of fact, one of the main changes we have witnessed in recent years is the penetration of moral and ethical considerations into financial mechanisms, and thus attention to environmental, social and governance (ESG) aspects. This vision differs from traditional finance, which focuses solely on financial return and risk (Schoenmaker, 2017).

Besides the bottom-up market-based influences on the financial system, a top-down institutions-based force is additionally fostering the adoption of sustainable finance solutions. As the spread of environmental, social and governance aspects generated positive feedbacks from the markets and customers, the jump on the sustainability bandwagon required more strict regulations and boundaries that avoid potentially misleading behaviour (e.g., green washing and social washing). For these reasons, countries started to cooperate for a more regulated financial system especially with respect to the disclosure of sustainability and impact.

Accordingly, this bidirectional motion has caused a cultural shift. As people realised that financial instruments are not neutral and the way financial resources are allocated can change the world, policymakers are working to define the boundaries that preserve the integrity of such actions that use finance to change the world. Given the unpredictable, fast, and complex nature of social impact in our hyperconnected society, ex-post control, mitigation and absorption of social impact are no longer viable options. The best way to generate a positive impact is to endogenize impact and sustainability in innovation processes, in entrepreneurial models, financial instruments and policies. The Impact priority become a more and more important point and a not negotiable one, a situation that is making sustainability and impact cross cutting the whole financial system.

These emerging approaches in the financial sector are presented and discussed in this chapter. We identify four main categories of new financial models (Errore: sorgente del riferimento non trovata).

Disintermediation	Long-term risk protection	Value alignment	Solving social and environmental problems
Alternative finance	Responsible finance	Islamic finance	Microfinance
		Sustainable investing	Impact Finance

Figure 1: New models in finance

Disintermediation

Disintermediation refers to those financial models that bypass the need for the intermediation of financial institutions and rely on direct interaction and exchange between individuals without the need for "orthodox institutions" (ex. Banks) (Collins et al., 2013). Disintermediation is the result of increasing competition from other financial institutions different from banks as well as technological development. While financial sector organisations have acted as intermediaries in the financial system by providing an invaluable service to clients, their functions are now increasingly supplanted by new technology-driven business models. For instance, in the banking sector, online lending platforms allow individuals and businesses to lend and borrow between each other. Here we can find alternative finance that can operate through different types of financial instruments whose socio–economic foundation is built upon financial disintermediation.

Long-term risk protection

Holding long-term investments requires understanding, identifying and managing long-term financial risks and opportunities related to them. Investment institutions, in their asset allocation, portfolio construction and risk management processes and decisions, regularly and rigorously assess whether their investments are resilient and can be sustained indefinitely. Nowadays, it is widely acknowledged that Environmental, Social and Governance (ESG) considerations can impact long term risks and opportunities in financial markets. Under this section we will outline, under the label of Responsible finance, the integration of ESG criteria into financial analysis to protect a portfolio from operational or reputational risk. ESG investing considers a broader set of metrics to measure a company's risks which also assess how environmental, social and governance risk factors affect its performance, both positively and negatively.

Value alignment

Value-driven investing represent investments whose goals in defining the allocation strategy is to allocate financial resources to sectors and/or companies that can contribute to sustainable development at the same time ensure that the financial return is in line with market return standards.

This can happen in different ways:

- Faith-based investing, which involves putting money in activities compliant with the investor's religious values. One example that will be discussed is Islamic finance.

- Sustainable investing, which involves actively removing or choosing investments based on specific social or environmental guidelines.

Solving social and environmental problems

An ever-increasing number of mainstream investors are showing interest in allocating capital in a way that can contribute to addressing a wide array of societal issues. Under this section, we will outline the two models of impact finance and microfinance.
Differently from value driven investment and from mere philanthropy, impact finance is the purposeful allocation of financial resources to initiatives that can deliver measurable societal impact (social and environmental) alongside financial return in undercapitalized area (Geobey and Weber, 2013; Weber, 2016; Carè and Wendt, 2018). Microfinance has the specific objective of making the financial system more inclusive by providing loans and insurance products tailored for those clients usually excluded from the traditional financial system.

1.1. Regulatory frameworks for finance and sustainable development

Before diving into the various financial models in greater depth, we would like to take a closer look at the regulatory framework that affects the financial sector, specifically for the approaches that claim to incorporate sustainability and impact into their practice. Indeed, we could reinterpret the new financial models that look at long-term risk protection, value alignment and solving social and environmental problems from an ESG (Environment, Social and Governance) perspective.

The regulatory reforms are crucial in shaping the way for the transformation towards "sustainable development" and driving the financial sector towards "sustainable finance" practices. Indeed, the most well-known regulatory frameworks regarding sustainable development are the Paris Agreement of climate change and the UN 2030 Agenda for Sustainable Development, where the European Union has committed to three ambitious climate and energy targets by 2030 that will lead to sustainability in economies:

(i) Minimum 40% cut in greenhouse gas emissions compared to 1990 levels;
(ii) At least a 27% share of renewables in final energy consumption;
(iii) At least 30% energy savings compared with the business-as-usual scenario.

However, reaching these ambitious goals requires public policies to be rebuilt based also on green financial legislation (Cigu et al., 2020). For instance, it has been estimated that annual investments of €180 billion are needed to achieve the EU's targets for energy and climate policy. The European financial sector, contributing 160 percent of the European Union (EU) GDP according to the European Commission (2019), is at the centre of the current EU regulatory debate on how to support the transition to a low-carbon, more resource-efficient and sustainable economy (Ahlström and Monciardini, 2021).

Consequently, the European national regulatory system is assigning an increasingly central role to the generation of social and environmental value in the way of doing business and finance. The European Union (EU) is defining an ecosystem of binding standards in the field of Environment, Social and Governance (ESG) that will impose increasingly extensive compliance, disclosure, and measurement obligations on finance players.

To date, sustainability can be a "compliance choice" for its own sake, or a "strategic choice" to generate long-term value that impacts the mission, governance, organisation, and products, with a twofold benefit:

- Improving one's market positioning;
- Anticipating compliance obligations by integrating social and environmental value generation into business strategy.

Non-Financial Reporting Directive (NFRD - EU Directive 2014/95)

The EU Directive 2014/95 requires large companies to disclose **non-financial information** to provide investors and other stakeholders with a **more complete picture of the development, performance, and impact of their business**. The directive applies to large companies and groups with more than 500 employees, and they are required to provide an analysis of their business model, policies, results, key risks, and performance indicators, including information on the following aspects:

- Environmental information;
- Social and employee-related aspects;
- Respect for human rights;
- Fight against active and passive corruption.

If companies do not have a policy in one of the above areas, the non-financial statement must explain the reason for this, following the comply or explain principle.

EU Sustainable Finance Disclosure Regulation (SFDR - EU Regulation 2019/2088)

On 27 November 2019 the EU Parliament and Council adopted Regulation 2019/2088 "on sustainability-related disclosures in the financial services sector" ("SFDR"), in an attempt to regulate the world of ESG investments by establishing common rules on the reporting of so-called sustainability risks in managers' portfolios. The innovative goal of this Regulation is the emersion of environmental impacts and the social value generated by the financial sector, mainstreaming ESG disclosure and upgrading this practice from voluntary initiative of a few innovators to a precise obligation of the general market.
SFDR Regulation aims to reduce information asymmetries towards investors on the integration of sustainability risks, adverse sustainability impacts, sustainable investment objectives, and environmental or social characteristics promoted by the financial market participants.
The first important step taken by the EU through the SFDR is about definitions. Besides specifying what is meant by Sustainability Factors ("environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters") and, more specifically, Sustainable Investment[1] and Sustainability Risk[2], the Regulation provides a clear framework concerning what financial market participants shall put in place in terms of disclosure and reporting practices.

To be noted, the regulation identifies various levels of disclosure processes and practices, depending on the extent to which financial products are based on the achievement of ESG objectives. **Article 7** poses the entry level, mandatory aspects for sustainability disclosures, asking to providing explanations of whether and, if so,

1 *"an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities"*
2 *"an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment"*

how a financial product considers principal adverse impacts on sustainability factors. The key connection between disclosure and measurement for each financial product referred to **article 8** and **article 9** "(a) a description of the environmental or social characteristics or the sustainable investment objective; (b) information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product". Besides these main indications, financial actors are required to internalize the meaning of ESG criteria with a strategic approach that needs to connect claims with measurement approaches. For these reasons, the ESG criteria are becoming the basis through which financial actors position themselves in the industry.

Taxonomy of environmentally friendly activities (EU Reg. 2020/852)

In June 2020, the European Parliament approved the text of the regulation on the taxonomy of environmentally friendly activities: it represents a classification shared by the EU on economic activities that can be considered environmentally sustainable. The objective of the taxonomy is to accompany the choices of investors and companies in view of the transition towards economic growth without negative impacts on the environment and, in particular, on the climate.

The taxonomy identifies six environmental and climate objectives:

1. Mitigation of climate change;
2. Adaptation to climate change;
3. Sustainable use and protection of water and marine resources;
4. Transition towards a circular economy, including waste reduction and recycling;
5. Pollution prevention and control;
6. Protection of biodiversity and the health of eco-systems.

In addition, an activity, to be recognised as eco-friendly, must meet the following criteria:

1. Positively contribute to at least one of the six environmental objectives;
2. Not produce negative impacts on any other objective;
3. Be carried out in compliance with minimum social guarantees (e.g., those provided for in OECD guidelines and UN documents).

Matching the regulatory framework with innovative financial models

In a process that matches regulatory framework impositions for the sustainable development and market-based orientations, financial models tackling sustainability issues deploy different strategies involving ESG criteria. Although ESG acronym clearly reminds to the environment, social and governance dimensions, especially in the financial markets ESG can take different interpretations depending on the extent to which the financial actors enact sustainability. Accordingly, we identified three main perspectives along which ESG criteria can be enacted by financial actors: i) ESG risks; ii) ESG performance; iii) ESG value.

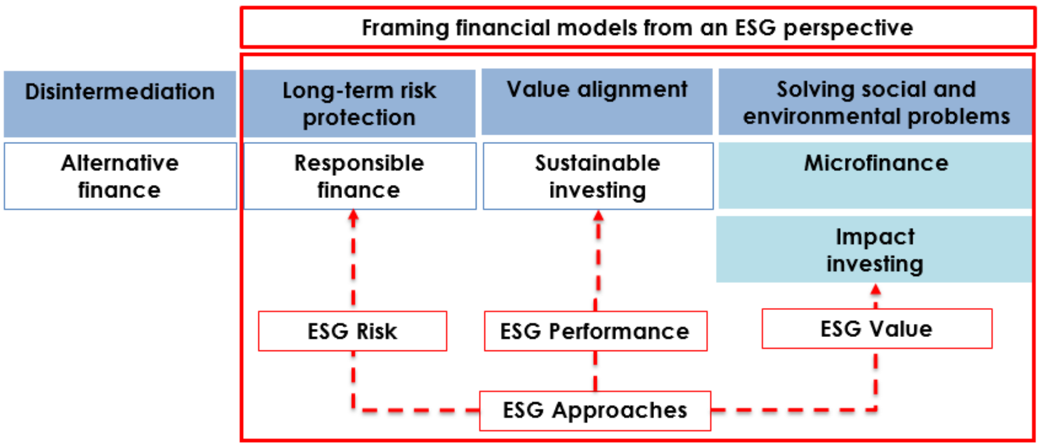


Figure 2: Framing financial models from an ESG perspective

ESG Risks identifies a way of enacting sustainability actions presenting the lowest levels of centrality of the social impact. Accordingly, actors taking this position use ESG criteria to control for potentially negative evaluations of certain investment opportunities. As certain ESG issues can affect the rewards of financial products, actors want to consider ESG criteria to ensure the financial returns proposed to capital owners. ESG Performance identifies an approach that considers ex-ante defined sustainability criteria driving the selection of eligible investment opportunities. This is an allocation strategy that aims at aligning precise values, norms, and criteria to the achievement of financial returns of investment opportunities. Finally, ESG Value requires an interpretation of the ESG criteria that aims at ex-ante defining impact objective alongside financial returns for an investment opportunity (Geobey and Weber, 2013; Weber, 2016; Carè and Wendt, 2018). Conversely, actors positioning in the ESG Performance are required to present the characteristics for which they select investment only certain investment opportunities, avoiding anticipating ex-ante impact objectives. Differently from ESG Performance, ESG Value requiring highest ESG performances to be associated to the generation of positive impacts on ex-ante defined overarching societal objectives.

2. Alternative Finance

Alternative finance is an umbrella term that covers a range of very different models that aim to overcome the intermediation role of a financial institution (disintermediation), so that the funders and the fundraisers are directly connect (Allen et al., 2012). Thus, these financial models bypass rely on direct interaction and exchange between individuals without the need for orthodox institutions (Collins et al., 2013). Alternative finance solutions link individuals who have extra funds to those who need them, working outside the conventional financial system (Baeck et al., 2014; Zhang et al., 2016). Itis thus characterised by absence of lengthy application forms, low documentation, almost no collateral and/or minimum credit score requirements, high approval rates, and fast funding, even for cash flow and asset finance needs. Overall, alternative finance aims to give "individuals more control over their money as well as new outlets to invest or donate it" (Nesta, 2014).

Figure 2 provides many examples of alternative finance models that can be sum up in three groups: people lending money to each other or to businesses; people donating to community projects; and businesses trading their invoices (Nesta, 2014).

	Alternative Finance Model	Definition
Investment-based Models	Marketplace/P2P Consumer Lending	Individuals or institutional funders provide a loan to a consumer borrower.
	Balance Sheet Consumer Lending	The platform entity provides a loan directly to a consumer borrower.
	Marketplace/P2P Business Lending	Individuals or institutional funders provide a loan to a business borrower.
	Balance Sheet Business Lending	The platform entity provides a loan directly to a business borrower.
	Marketplace/P2P Property Lending	Individuals or institutional funders provide a loan secured against a property to a consumer or business borrower.
	Real Estate Crowdfunding	Individuals or institutional funders provide equity or subordinated-debt financing for real estate.
	Equity-based Crowdfunding	Individuals or institutional funders purchase equity issued by a company.
	Other	We include two additional categories, which are not presented individually due to small sample size. They are Revenue-sharing/Profit-Sharing[3], and Debt-based Securities/Debentures.[4]
Non-investment-based models	Reward-based Crowdfunding	Backers provide funding to individuals, projects or companies in exchange for non-monetary rewards or products.
	Donation-based Crowdfunding	Donors provide funding to individuals, projects or companies based on philanthropic or civic motivations with no expectation of monetary or material return.

Figure 3 - A Taxonomy of Alternative Finance Models (Source: Ziegler et al. 2018)

The alternative finance market is relatively diverse, we will focus here on tree specific models: crowdfunding peer-to-peer lending and balance sheet lending.

2.1 Crowdfunding

Crowdfunding is a novel method for funding a variety of new projects, allowing founders to request funding from many individuals, the "crowd", often in return for future products or equity. This is usually done via or with the help of the Internet. Individual projects and businesses are financed with small contributions from a large number of individuals, "allowing innovators, entrepreneurs and business owners to utilise their networks to raise capital." (De Buysere et al., 2012)

In 2021, the global crowdfunding market was valued at 12.27 billion U.S. dollars and was forecast to double by 2027, growing at compound annual growth rate (CAGR) of 11 percent.[3] Over the years, a better regulatory environment and a greater professionalization of insiders have allowed a strong but healthy growth in the sector. In fact, from 2015 to 2020 the sector has recorded promising results both in terms of capital raised and number of supporters and investors who first approached aimed at this digital financing tool. From 2015 to 2020 the crowdfunding platforms in Italy raised a total of € 778,813,773[2].

There are four models of crowdfunding:

- Equity crowdfunding, which addresses early-stage unlisted company (a company that is not listed on a stock market) in exchange for shares in that company. The crowdfunding platforms allow the project to collect financing shares, even small ones, from a large number of subjects.
- Donation crowdfunding or donation-based crowdfunding in which the crowd donates to project with a social purpose or a charity, without expecting the funds to be returned.
- Rewards-based crowdfunding, in which individuals donate to a project or business with the expectation of receiving a non-financial reward in return, such as goods or services at a later stage (e.g., a unique service or a new product, pre-selling). This form of crowdfunding allows companies to launch with orders already on the books and cash-flow secured (a major issue for new businesses) and gathers an audience before a product launch.
- Real Estate crowdfunding in which fintech logic are applied to capital collection for Real Estate investments and the capital raised is used to purchase, develop, or refurbish a Real Estate asset with the aim of subsequent use or transaction.

➢ Examples of crowdfunding platforms are Kickstarter at a global level and Lita.co in Italy.

2.2 Peer-to-peer lending

Peer-to-peer (P2P) lending (sometimes called crowdlending) is a direct alternative to a bank loan with the difference that, instead of borrowing from a single source, companies can borrow directly from tens, sometimes hundreds, of individuals who are willing to lend. Crowdlenders often bid for loans by offering an interest rate at which they would lend. Borrowers then accept loan offers at the lowest interest rate. Internet-based platforms are used to match lenders with borrowers. Due diligence is carried out for each loan request, as crowdfunding platforms have a duty to protect both businesses and investor interests. Platforms normally require financial accounts and a trading track record.

➢ Examples of P2P lending are Lending Club at a global level, and Smartika in Italy.

2.3 Balance sheet lending

Also referred to as portfolio lending, balance sheet lending involves a monetary loan in which the original lender retains the debt throughout the life cycle of the loan. In balance sheet lending (also called portfolio

3 Global Crowdfunding Market Size, Status and Forecast 2020-2027

lending), the platform provides a loan directly to a consumer (Balance sheet consumer lending) or business (Balance sheet business lending) borrower. The main difference between traditional P2P lending and balance sheet lending is how the risk is structured if a loan goes bad. In P2P lending, the platform does not lend to the borrower but merely link borrowers with investors between who the loan agreement is made. Conversely, in balance sheet lending the P2P platform (or another type of balance sheet lender) assumes the risk, becoming directly liable for any losses. Balance sheet lending can take many different forms, but the common trait is that the platform provides loans on their own risk.

3. Responsible Finance

Responsible finance is defined as the explicit and systematic inclusion of ESG issues in investment analysis. with the objective of lowering risk and, thus, generating returns better return. Many investors have turned to ESG factors as another way to spot and attempt to avoid risk in an individual company or sector.

The literature already approached ESG from risk perspective, evidencing that a proper management of the ESG levers lead to insurance-like protection with respect to the obtaining of financial returns (Godfrey 2005; Godfrey Merrill and Hansen 2009; Koh, Qian, and Wang 2013). From a financial actor standpoint, previous studies approached ESG risks through negative screening and exclusionary dynamics (Aslaksen and Synnestvedt 2003; Haigh and Hazelton 2004): the literature refers here to absolute exclusion, when potential investment opportunities do not fulfil certain standards for ethical performances.

To this regard, the evaluation is based on the narrative reported by third party information, such as UN reports, in which entire industries are rejected – such as the weapons, or tobacco. Accordingly, ESG risks may follow a product-based exclusion. However, process-based exclusion may occur too: use of plastics in the supply chain, child labour dynamics, of labour unions may be excluded as well. Scholars evidenced the ESG risks of investments also in terms of the ethical approaches of finance (Haigh and Hazelton 2004): often used interchangeably with socially responsible investments (Hellsten and Mallin 2006), ethical approaches attempt to provide control for exogenous factors with respect to stakeholders' values, making economic returns going hand in hand with moral and responsible conducts. Accordingly, these approaches lead to "healthier" returns for investments, avoiding opportunities that the relevant audience dislikes for their inadequate moral.

For these reasons, ESG criteria are considered in terms of potential risks that may generate on the financial component. From this perspective, asset managers adopt ESG criteria with a passive approach, aiming at avoiding risks for the financial returns more than seeking ESG value besides economic value, mainly disclosing statements of conducts, or aligning with specific moral and ethical principles.

Certain principles of the UN PRI criteria fit this framework. The UN PRI criteria are high-level guidelines that aim at defining an overall vision for investment approaches that consider ESG principles also from a risk mitigation perspective.

Principle 1	We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2	We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3	We will seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4	We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5	We will work together to enhance our effectiveness in implementing the Principles.
Principle 6	We will each report on our activities and progress towards implementing the Principles

Table 1: UN PRI principles

For example, financial actors' signatories of UN PRI criteria should incorporate the ESG issues in investment analysis and decisions – Principle 1 –, so that in practices, the management of such issues are reflected in the exclusion of certain sectors, companies or practices based on specific sustainability criteria – e.g., tobacco industry, weapons – from an investment fund or portfolio, and should be considered in the ownership policies and procedure too – Principle 2. To comply with this position, investors often develop and disclose a risk matrix in which they represent a dashboard of combinations involving a list of industries, sectors and context whose potential ESG risks may damage the long term protection of the financial returns of investments, avoiding harm more than generating impact.

This means that this approach adds one more criterion in a multifactor analysis. For instance, if an asset manager receives money, he/she aims at investing it and making as financially profitable as possible. The ratio used to invest the money is based on a set of criteria (e.g., how good is the company, what is the financial performance, the risk of the financial structure, etc.). In a responsible investing approach, he/she also considers the company compliance or performance on social, environmental and governance issues. The difference of the other that are going to be described in the following section is that here the purpose of including social, environmental and governance analysis is functional to make the portfolio as performing as possible in financial terms by spotting potential risks that might affect the performance and thus lower the value of the company in the portfolio.

For these reasons, the responsible approach is the weakest in terms of contribution to sustainable development because the main purpose guiding the investment allocation strategy is still financial return, not the creation of a positive impact.

However, up to now, there is no strong empirical evidence that the performance of ESG integration in terms of returns is strongly higher than other investments. Even when there is evidence of a positive impact of ESG integration on returns, the causal link is debatable, i.e., we do not know if a company is good because it is compliant with ESG or vice versa.

The responsible finance approach manly leverages on the use of ESG indices. An index is a set of securities designed to represent a particular market or strategy. ESG indexes are distinguished from traditional broad market indexes by the introduction of ESG criteria into security selection.

The primary uses for indices are:

- performance benchmarks
- the basis for passive investment funds such as ETFs
- investment policy benchmarks for large asset owners such as pension funds.
- define universes that meet specific ESG criteria for use by asset managers, and standards for ESG characteristics to compare with the underlying market.

The construction of ESG indices uses ESG scoring and rating of the performance of the companies developed by rating agencies, specialized data providers and data aggregators. How scoring and rating are generated is more deeply addressed in the Chapter on impact management and measurement.

In a nutshell, because is not the primary scope of this Chapter, ESG is built through two main steps: constituent selection; constituent weighting. The first step is identification of a parent index, which defines the universe of companies from which the constituents of the ESG index are selected. Next, screens may be applied to remove companies from the parent index universe. Many — but not all — ESG indexes use exclusionary screens such as tobacco, firearms, or fossil fuels to avoid particular kinds of companies. Then, constituents are selected from the remaining pool of companies based on criteria designed to achieve ESG exposure. Once constituents have been selected, they are weighted according to index rules. There are several weighting options: market capitalization, equal, and tilting. The most common approach is market capitalization weighting, which assigns weights to constituents in proportion to their market capitalization.

Figure 3 illustrates some examples of indices that emerged over time.

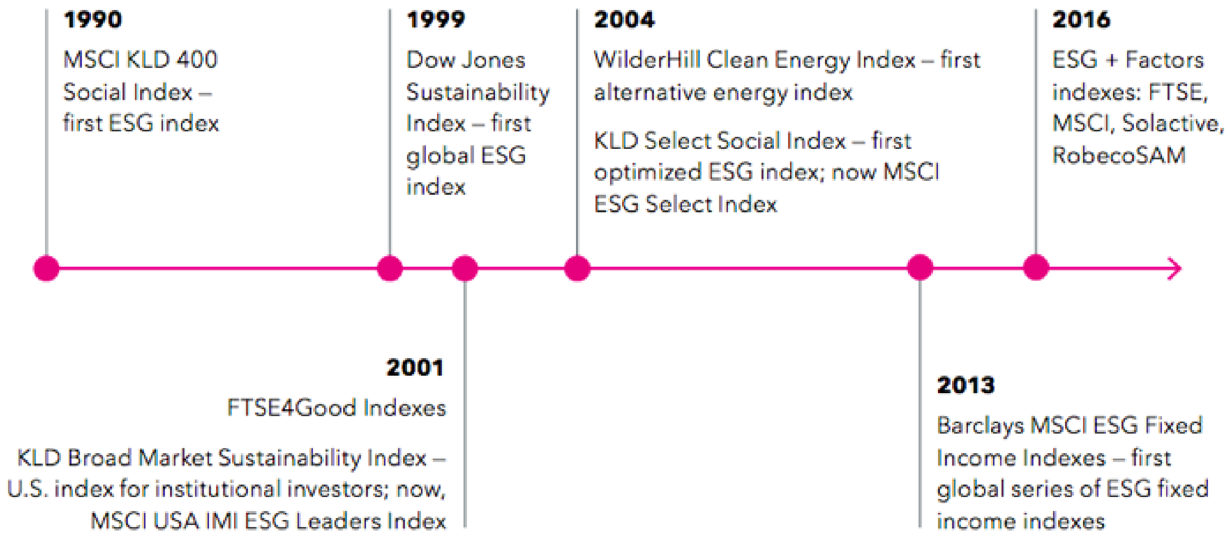


Figure 3 - An Evolution in ESG Indexing (Source: Blackrock)

➢ Example: The MSCI Extended ESG Focus Indexes are designed to maximize exposure to companies with high ESG ratings while exhibiting risk and return characteristics like those of the underlying market.

The Indices:

- exclude companies in the tobacco, civilian firearms and controversial weapons sectors, and companies that have very severe ESG controversies;

- utilize optimization to maximize portfolio-level ESG scores while limiting predicted tracking error relative to the parent index. The optimization process overweighs companies with higher MSCI ESG ratings and underweights companies with lower MSCI ESG ratings, within a tracking error budget.

4. Islamic finance

Islamic finance[4] can be considered an example of faith-based investing and an alternative to the conventional financial system, having the capacity to offer new opportunities through standardized financial products with prudent regulations and supervisory arrangements. Indeed, the major features of Islamic finance (i.e., asset-backing, the bans on uncertainty and interest or usury, and risk and profit sharing), seem to provide a more resilient financial system.

Islamic financial industry has values very close to forms of cooperative finance or finance for good. The Islamic laws (Shariah) prohibit from paying or receiving interest or any other financial transactions that promises a guaranteed return. To be compliant with the Islamic law, indeed, in the Islamic Finance all parties of a financial transaction share the risk, and no one gets a predetermined return, and it supports only morally acceptable investments that yield fair legitimate profits and economic social ''added-value''. Therefore, it results to be also coherent with a principle of social justice and financial inclusion.

More specifically, major principles of Islamic law that are applicable to finance and that differ from conventional finance are (Alam 2009):

- Ban on Interest (Riba): in conventional forms of finance, a distinction is made between acceptable interest and usurious interest (i.e., excessive rates of interest). In contrast, under Islamic law, any level of interest is usurious and is prohibited. Some question how lenders can profit from financial transactions under Islamic law. Take for instance, in a real estate setting, shariah-compliant financing takes the form of leasing, as opposed to loans. Instead of borrowing money, the bank obtains the property and leases it to the shariah-compliant investor, who pays rent instead of interest.
- Ban on Uncertainty (Gharar): uncertainty in contractual terms and conditions is not allowed unless all of the terms and conditions of the risks are clearly understood by all parties of a financial transaction. This condition may help eliminate most of the speculative transactions which involve excessive uncertainty.
- Risk-sharing and Profit-sharing: Parties involved in a financial transaction must share both the associated risks and profits. Earnings from profits or returns from assets are permitted if the business risks are shared by the lender and the borrower. This will help ensure that the seller (or lessor) also shares a part of the risks to be able to get a share of the returns. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risks.
- Ethical Investments that enhance society: investment in industries that are prohibited by the Qur'an, such as alcohol, pornography, gambling, and pork-based products, are discouraged.
- Asset-backing: each financial transaction must be tied to a "tangible, identifiable underlying asset." The debt cannot be sold, and thus the risk associated with it cannot be transferred to someone else;

4 For further information see: Muhamed Zulkhibri (2016) Financial inclusion, financial inclusion policy and Islamic finance, Macroeconomics and Finance in Emerging Market Economies, 9:3, 303-320, DOI: 10.1080/17520843.2016.1173716
Zaher, T. S., & Kabir Hassan, M. (2001). A comparative literature survey of Islamic finance and banking. *Financial Markets, Institutions & Instruments*,*10*(4), 155-199.

it must be borne by the creditor himself. According to this condition a transaction must be a genuine trade transaction, and the fact that the creditor cannot transfer the risk to someone else by selling off the debt, will also help eliminate speculative and derivative transactions, as well as prevent the debt from rising far above the size of the real economy.

Currently, Islamic finance represents a small but growing segment of the global finance industry. A number of Middle Eastern banks conduct business in compliance with the religious laws of Islam, and the national banking systems of Iran, Sudan, and Pakistan are founded on Islamic law. Overall, there are more than 500 Islamic financial institutions in more than 70 countries, which administer estimated assets of more than 2 trillion USD.[5] Conventional western deposit and lending instruments often do not conform to Islamic finance tenets.

- Examples: KT Bank (Germany/Eurozone); Ethical & Islamic Crowdfunding platforms and systems in Singapore, Malesia, and Indonesia by Ethis Ventures; Adab Solutions (a global cryptocurrency platform for both Muslims and the world at large).

5. Sustainable finance

Sustainable Investing refers to the application of sustainable development principles to financial investments. The proactive approach to considering ESG aspects includes investments in sectors, companies, or projects with a positive ESG performance compared to sector peers; this translates into a proactive orientation towards investments in activities specifically related to sustainability (e.g., social housing, clean energy, green technologies, or sustainable agriculture). However, ESG Performance approaches involve measuring social and/or environmental impact at the output level, i.e., identifying value within a scale without any particular standardisation and with no active engagement of the financial institution.

Differently from what reported for ESG Risks, there is a positive screening approach for which the investments in selected sectors – for instance, target companies or projects – should obtain a higher overall performance under sustainability criteria than their peers to be considered eligible; in alternative, investment opportunities may be selected depending on norm-based screening, for example considering only those ventures that possess prosocial certifications – e.g., B Corps, Organic.

Despite certain scholars beware of the lack of standardization and transparency about ESG (Consolandi et al. 2020), they are increasing played a strategic and relevant role in the financial sphere. Academic literature in management and finance investigated the implications for firms evidencing particularly high performances on ESG criteria; for example, scholars evidenced that several financial actors extract financial values out of portfolios presenting higher ESG performances than peers do with average ESG performances (Flammer 2013; Cheng et al. 2014). Investment solutions presenting higher ESG performances than peers are deemed to have more chances to generate better financial returns.

Accordingly, these types of approaches are in line with the shade of blended value finance that proactively considers and build on ESG measurements to identify investment opportunities from which extracting financial returns. For these reasons, asset managers adopt mechanisms of performance measurement on ESG criteria. There are over 1000 examples of ESG ratings, indices, and managerial dashboard available to assess whether and how organizations assess ESG criteria. Among those most adopted, the GIIRS Ratings help asset managers to assess their portfolio's contributions to sustainability to deliver a comprehensive audit portfolio's performance on workers, governance, customers, communities, and the environment. They rely on the

5 https://www.kt-bank.de/en/islamic-banking/background/

questionnaire proposed by the B Impact Assessment to measure the sustainability performance of investment funds. This tool allows a comparison of performance against 13000 investees of overall 90 funds. In alternative, we can find the Global Reporting Initiative (GRI). Using the GRI Guidelines, organizations disclose their most critical impacts, whether positive or negative, on the environment, society, and the economy. The GRI generates reliable, relevant, and standardized information to evaluate opportunities and risks, and to enable a more informed decision-making process, both within the company and among its stakeholders. The GRI is designed to be universally applicable to all organizations of all types and sectors, large and small, around the world.

These types of ESG approaches help financial products to navigate investment opportunities with specific characteristics and requirements, distinguishing them from business-as-usual opportunities for their relevant ESG aptitude, and thus offering a proactive interpretation to sustainability practices. These investment criteria may not only use tools to exclude contexts that potentially harm the society and the environment but adopt metrics and performance measurements to identify investment opportunities that strategically consider relevant ESG performances. In sustainable investing, issues related to sustainable development (sometimes broader that ESG criteria) are the drivers of the investors decisions and they are both integrated in the scouting and selection phase and then in the due diligence. Still sustainable investors aim to reach a market rate financial return, but the inclusion of sustainability issues is not merely functional. Sustainable investors can include sustainability in their decision on resource allocation using different strategies:

- Positive/best-in-class screening: investment in sectors, companies or projects selected for positive ESG performance relative to industry peers;
- Norms-based screening: screening of investments against minimum standards of business practice based on international norms
- ESG integration: the systematic and explicit inclusion by investment managers of sustainability criteria into the allocation strategy, investment decision and into the different stages of the investment process;
- Sustainability Themed Investing: investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture).

To explore further the strategy of Sustainability Theme Investing, we provide here some examples of approaches and financial instruments: climate finance, mission-related investments, Social, Green and Sustainability bonds, and Social stock exchange.

5.1 Climate Finance

Climate finance refers to local, national, or transnational financing that seeks to support mitigation and adaptation actions that address climate change. It is possible to distinguish between:

- Mitigation finance that aims to reduce greenhouse gas (GHG) emissions, or to remove GHGs already in the atmosphere or ocean, to slow warming and stabilize the climate in the long term.
- Adaptation finance that focuses on improving preparation and reducing climate-related risk and damage, for both human and natural systems, as short-term climate impacts will continue to exert economic, social, and environmental costs even if appropriate mitigation actions are taken.

Some forms of finance have dual benefits and target both mitigation and adaptation outcomes.

The Global Financial Markets Association (GFMA) and Boston Consulting Group's (BCG) estimated in the report "Climate Finance Markets and the Real Economy" the current market for climate finance to be approximately $600 billion. Climate finance market has to grow to the $3–5 trillion+ of investment per year to achieve the ambitions set out in the Paris Agreement.

5.2 Mission-related investment

Mission-related investments are investments made by foundations and other mission-driven organizations to address their philanthropic goals. They are market-rate investments which are part of a foundation's endowment and have a positive social impact while contributing to the foundation's long-term financial stability and growth. This approach helps large philanthropic institutions to align their endowment preservation with programmatic objectives based on the social mission.

5.3 Green, Social, Sustainability and Sustainability-linked bonds

Green Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects.

All designated Green Projects should provide clear environmental benefits, which will be assessed and, where feasible, quantified by the issuer. The Green Bond Principles (GBP) are voluntary process guidelines that recommend transparency and disclosure and promote integrity in the development of the Green Bond market by clarifying the approach for issuance of a Green Bond. The GBP are intended for broad use by the market: they provide issuers with guidance on the key components involved in launching a credible Green Bond; they aid investors by promoting availability of information necessary to evaluate the environmental impact of their Green Bond investments; and they assist underwriters by moving the market towards expected disclosures that will facilitate transactions. The GBP explicitly recognize several broad categories of eligibility for Green Projects, which contribute to environmental objectives such as: climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation, and pollution prevention and control.
The issuer of a Green Bond should clearly communicate to investors: the environmental sustainability objectives; the process by which the issuer determines how the projects fit within the eligible Green Projects categories identified above; the related eligibility criteria, including, if applicable, exclusion criteria or any other process applied to identify and manage potentially material environmental and social risks associated with the projects.
Issuers are encouraged to position this information within the context of the issuer's overarching objectives, strategy, policy and/or processes relating to environmental sustainability. Issuers are also encouraged to disclose any green standards or certifications referenced in project selection.

EU Green Bond Standard

The EU has recently approved the establishment of a standard for this type of financial product. In the case of green bonds, a widely used bond-type financial instrument to provide environmental and/or climate benefits, the EU launched the Green Bond Standard (GBS) in 2020. Closely linked to the Taxonomy of Environmentally Friendly Assets (EU Reg. 2020/852), it is however strictly voluntary, to be used in case financial institutions want to designate their Green Bonds as aligned with the taxonomy.

The Green Bond Standard (GBS) is designed to ensure transparency at the financial product level.

It consists of four steps:

1. Align the GBS green criteria green criteria against the taxonomy;
2. Publish a Green Bond Framework containing information aligned to the taxonomy and the relevant methodology used;
3. Publish an Allocation and Impact report;
4. Involve an accredited external certifier for disclosure reporting.

Social Bonds are use of proceeds bonds that raise funds for new and existing projects with positive social outcomes. Social bonds are securities issued by non-social sector (charity or regulated social enterprise) issuers with the aim of delivering or generating social impact or broader social benefit unrelated to the financing of regulated charities and social enterprises. This could include issuance whose proceeds are ring-fenced for a particular project or investment area which is deemed to be socially impactful or securitised upon a pool of social assets.
The Social Bond Principles (SBP) promote integrity in the Social Bond market through guidelines that recommend transparency, disclosure, and reporting. Social Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible Social Projects. Its categories can include Affordable basic infrastructure, access to essential services, affordable housing, employment generation, and programs designed to prevent and/or alleviate unemployment stemming from socioeconomic crises, including through the potential effect of SME financing and microfinance; food security and sustainable food systems, socioeconomic advancement, and empowerment.

Sustainability Bonds (SB) are any type of bond in which the proceeds are exclusively used to finance or re-finance a combination of both Green and Social Projects. They emerge from the idea that that certain Social Projects may also have environmental co-benefits, and that certain Green Projects may have social co-benefits. The classification of a use of proceeds bond should be determined by the issuer based on its primary objectives for the underlying projects.
The reference framework that disciplines SB is the Sustainability Bonds Principles (SBP) proposed by the International Capital Market Association (ICMA). They are voluntary process guidelines that recommend transparency and disclosure and promote integrity in the development of the SB market by clarifying the approach for issuance of a SB. The SBP are intended for broad use by the market: they provide issuers with guidance on the key components involved in launching a credible SB; they aid investors by promoting availability of information necessary to evaluate the environmental impact of their Green Bond investments; and they assist underwriters by moving the market towards expected disclosures that will facilitate transactions. The principles clearly provide guidelines on the type of projects the proceeds of the bonds can be used for; the process for project evaluation and selection; management of proceeds; and reporting.
The Sustainable Bond market has shown impressive growth in recent years; however, 350 billion US-Dollar market is by far not enough to address the global sustainability challenges and provide the capital at scale

urgently needed for the necessary transformation. Compared to 100 trillion US-Dollar global fixed income market the sustainability bond market is still a small but shiny light.
Recently a new type of sustainability bond has been introduced which has a clear implication in terms of measurement of social impact. Sustainability-Linked Bonds are bond instruments for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ESG objectives. In that sense, issuers are thereby committing explicitly (including in the bond documentation) to future improvements in sustainability outcome(s) within a predefined timeline.

5.4 Social stocks exchange

Social stock exchanges are regulated markets with public information and transaction services related to equity and debt instruments that generate financial returns along with positive social and/or environmental impact. Basically, a Social Stocks Exchange is a trading platform where an investor can come to buy shares in a social enterprise just as a profit-oriented investor would go to the traditional stock market.

- Examples of Social Stock Exchanges across the world are the London Social Stock Exchange, the Impact Investment Exchange Asia in Singapore, the SVX platform in Canada, the Kenya Social Investment Exchange (KSIX) and the Sasix in South Africa.

This category includes those approaches that aims at generating impact from ESG criteria, meaning investments made with the primary intention of extracting value from ESG criteria for an enlarged set of stakeholders in the long-term, alongside a financial return.

In this case, the measurement of intentional and unintentional social and/or environmental outcomes achieved through the financial activity is a fundamental and intrinsic part of the initiative itself. For this reason, it is necessary to structure an impact measurement process that starts with an ex-ante definition of the investment social and/or environmental objectives and involves an analysis of the activities carried out, ending with an assessment of the long-term impacts (which are observable after several years), also considering any externalities produced (i.e., unintended results).

6. Microfinance

In 1976, Muhammad Yunus (Nobel Peace Prize Winner 2006) noticed that small amounts of loans could make a big impact on the poor peoples' lives. Grameen Bank ("Bank of the Villages", in Bangla) was founded in 1983 and it was supported by the central bank of Bangladesh. When Yunus saw ladies in Rural India with the potential to start an entrepreneurial activity, instead of giving them subsidies or grants to allow them to access food and house for their family, he gave them a small loan and helped them to become small entrepreneurs.

Microfinance is the provision of small loans (typically less than $100) to low-income clients who traditionally lack access to banking because they do not qualify for the banking system, i.e., people who have no collateral or credit history). Therefore, microfinance emerged as a solution addressing those living in poverty in developing economies, yet it has spread to developed economies where entrepreneurs also find micro loans difficult to secure.

In its reference model mainly used in developing countries, instead of using collateral to gain credit, loans are secured against the honour of a peer group: if one person fails to make their payments, others in the lending circle will be denied future credit. This arrangement proves to outperformed almost all other forms of development lending because the loan is very small and it is received in a community where people feel a big obligation to repay the loan, it is less risky than other traditional lending.

Moreover, microfinance provides other benefits, on the top of the loan, to those people in need. Indeed, access to loans can open up numerous opportunities such as starting a business, improving housing conditions, or purchasing an asset and opportunity for education and community development.

The industry has been growing rapidly, in 2018 there were $114 billion at work in microfinance loans.[6]

Nowadays, microfinance has become a specific financial product that is used not only in the developing countries. Therefore, microcredit has been defined by the European Commission as a loan under € 25,000 to support the development of self-employment and microenterprises. The problem that often arises in developed countries is that when banks are providing loans to risky people, they tend to cover the risk with a very high price for the loan. As a result, if the general interest rate for a loan with a guarantee is 5-6%, they use a 10-11-12% interest rates for microloans with no guarantee.

- Examples: Kiva (global); PerMicro (Italy).

7. Impact finance

The context in which financial instruments extract value from ESG criteria is impact finance. Impact finance adopts a social impact investing approach, and refers to the deployment of financial resources primarily for social and environmental returns, as well as in some cases, a financial return (Nicholls, 2014). This approach explicitly aims to orient resources toward solutions to social or environmental challenges. The emergence of impact finance was boosted by two main factors

1) The scepticism about the long-term sustainability and impact of traditional charitable models paired with the increased dissatisfaction with gaps and inefficiency in public services funding.

2) The requests from markets and institutions to evolve the ESG criteria from an aseptic measure of performance typical of responsible and sustainable investing, to a central condition for the selection of investment opportunities.

In this scenario, the role of impact finance emerged as that of a new financial model able to pursue higher effectiveness at societal level in capital allocation by leveraging decentralized mechanisms. This is linked particularly to the ability of social ventures to develop innovative solutions to neglected societal problems.

6

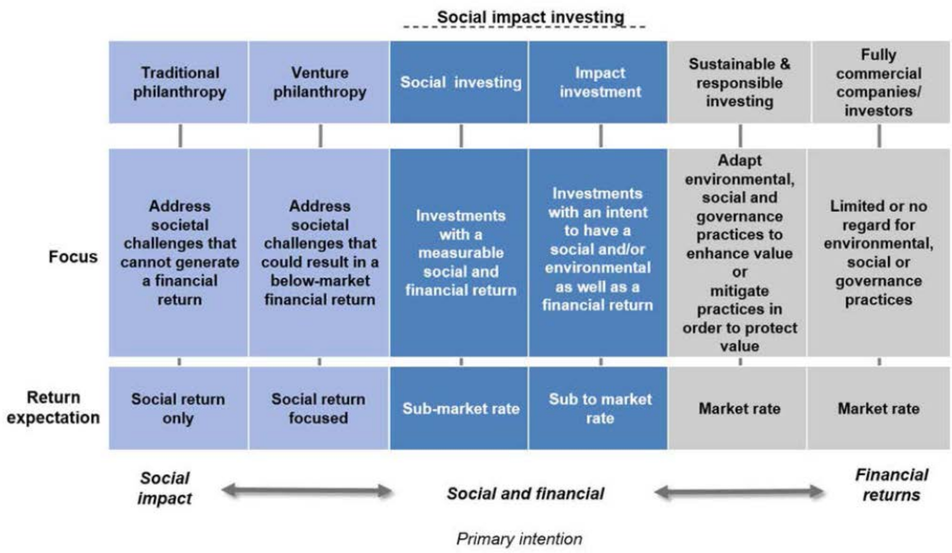


Figure 4: The finance spectrum

7.1 Definition, key characteristics, and rationale

Impact finance is defined as the purposeful allocation of financial resources to initiatives that can deliver measurable societal impact (social and environmental) alongside financial return in the undercapitalized area.

The pillars that help to distinguish impact finance from all the other approaches are:

- *Intentionality*: the social impact is targeted intentionally, and the investment is explicitly made to achieve a positive benefit for the society. This means an explicit statement "ex-ante" and a proactive search of initiatives pursuing a social goal. The social impact is not an incidental side effect. (Addis et al. 2013; Brown and Swersky, 2012)
- *Measurability*: The social impact must be measurable and measured in a quantitatively and/or qualitatively way. The social goals, indeed, should be defined in an ex-ante phase and measured thanks to estimation, and verified ex-post the effective and efficient achievement of those impacts. (O'Donohoe et al., 2010; Wood et al., 2012)
- *Additionality*: The impact investments are done in undercapitalized areas, where the activities would have been excluded by any other investors and thus not implemented. (So and Staskevicius, 2015)

Impact finance is well identified by the principle of additionality since it is not intended to substitute other financial sources such as traditional philanthropy or public funding that have historically supported social sector's initiatives, but to complement them. Impact finance, thus, operates in those areas or sectors that are not considered in charge of the public sector or the public sector has not enough funding to intervene; or in those undercapitalized areas because they are not attractive for traditional investors. In this sense, impact finance has the role to target neglected areas of social services and thus complementing sources of funding traditionally devoted to providing services to the society. Rather, this approach seeks novel forms of funding and various combinations of risk and return to achieve social aims.

In more operative terms, impact finance adds a third criteria, on the top of risk and return, in the investment strategy: social impact as shown. This means that impact investor must also consider the impact return and the impact risk, on the top of the financial ones, and should try to optimize all together.

According to Hornsby and Blumberg (2013), to select investments the investor should look at four different parameters: financial return, financial risk, impact return and impact risk. Financial returns in impact investments may be above, equal to, or below market rates with a minimum of capital preservation (Grabenwarter and Liechtenstein, 2011; Evenett and Richter 2011; Best and Harji 2013; Hochstadter and Scheck, 2015).

Impact return refers to how much social and environmental outcomes for society are fulfilled thanks to investment actions (Emerson and Freundlich, 2012; Reeder and Colantonio, 2013). It is important to articulate at the outset the desired impact according to the context of the investment field chosen (Brandstetter and Lehner, 2015). Here, the problem for impact investors is the lack of methodologies for measuring it that have become the market standards (Grabenwarter, 2013; Saltuk et al., 2013). In impact finance, the impact appraisal should be carried out at the pre-investment stage and post-investment stage,

Likely, the definition and calculation of impact risk have been only marginally investigated by scholars and practitioners (Brandstetter and Lehner, 2015; Fullwiler, 2016). The most diffuse definitions of impact risk consider it as:

- the risk of not generating the intended and stated social impact due to unpredictable events;
- the risk of not generating the level of social impact targeted/promised, so a measure of the certainty that an organization will deliver on its proposed impact;
- the risk of generating negative impact;
- the inability of properly measured/assessed the social return/social impact that leads to a lack of evidence;
- the probability of mission drift by the investor and the investees from social mission or financial mission.

The use of financial products for impact investing purposes involves the application of a Theory of Change (ToC) for investment opportunities. A Theory of Chance (ToC) describes how and why an investment opportunity is supposed to lead to a desired result - environmental and / or social (Ebrahim and Rangan,2014). Often a ToC is defined as the connection between activities and results (outputs, outcomes, and impacts). The measurement of social impact through a ToC approach defines the social and / or environmental problem that a financial product aims to solve, and the context in which it is supposed to be enacted. Thus, the identification of a precise impact objectives makes the ToC suitable for funds to operate in these contexts.

Within this framework, the SDG Impact Standards are a set of practices that help companies and investors aligning their activities with the SDGs, facilitating the mobilization of resources towards the generation of outcomes and impacts on the SDGs and implementing ToC to identify the impact targets. The standards provide a common language and best practices that can guide the achievement of social and / or environmental impacts from the screening of activities to their monitoring over time and to the exit strategies. The SDG Impact Standards also consider a predetermined set of KPIs to be applied to investment opportunities as impact targets to be achieved, linked to specific SDGs to contribute for.

In addition, the Impact Management Program (IMP) is a coherent recipient for the application of ToC approaches. The IMP has defined five dimensions through which evaluating the impact: What, Who, How Much, Contribution, Risk. In relation to these dimensions, a set of categories has been defined to allow companies and investors – mostly private investment funds – to set impact targets and evaluate performances.

These categories are building blocks that can be used by an organization to frame their impact picture or as a checklist to ensure they cover any elements essential to managing impact.

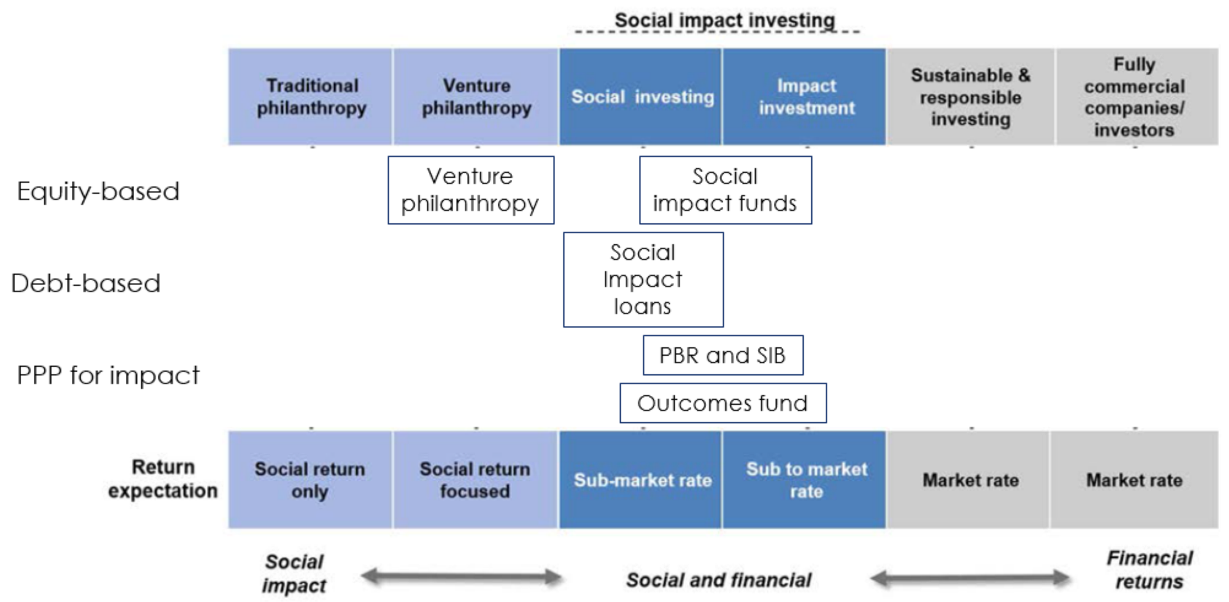
7.2. Instruments

Impact finance instruments can be clustered into three main groups: equity-based, debt-based, Public-Private Partnership.

In the table below the different types of instruments are related to a different type of target: Social ventures and Social Infrastructures.

Table 2 - Types of impact finance instruments

	Equity-based	Debt-based	Public-Private Partnership for impact
Social ventures	• Social impact fund • Venture philanthropy	• Social impact loan	• Payment by results • Social Impact Bonds • Outcome fund
Social infrastructures[7]	• Social impact fund	• Social impact loan	• Payment by results



7 Social infrastructure can be defined as the construction and maintenance of facilities that support social services. Types of social infrastructure include healthcare (hospitals), education (schools and universities), public facilities (community housing and prisons) and transportation (railways and roads). All of these structures serve as the backbone for communities and societies.

7.3.1 Equity-based

The term equity refers to an investment, in the form of risk capital, in companies and organizations with the aim of generating a measurable social impact together with a financial return. Social impact equity is substantially comparable to traditional equity investments. The return can be realized when the shares are sold. It is not repayable, and the capital provider has several benefits like voting rights even if it is more a risky approach. In general, the equity investment is made in the risk capital of unlisted companies with high development potential in terms of products or services, new technologies and new market concepts whose risky nature would be compensated, in traditional finance, by high returns. However, social impact equity typically has lower expectations of return or, more precisely, it provides a primary importance to supporting innovative solutions to social problems and, therefore, they are prone, given a certain level of risk, to forgive a part of the financial return to get the social return.

The main difference between the social impact equity and traditional equity investments are:

- the impact nature of the objectives pursued by the invested companies
- the type of agreements that define their governance structure within the invested companies.
- the so called “mission lock” obligations. They are legal constraints such as the obligation to reinvest a part of the profits of the investee company in other impact instruments or other strategies aimed at "blocking" the possibility that new shareholders of the company may take control and establish new lines of address.
- sometimes the remuneration of the investors is “capped” to some extent in accordance with the statute or law, as in the case of specific forms of social entrepreneurship.

Examples of equity-based instrument of impact finance are social impact funds and Venture Philanthropy.

Social Impact Funds are a ready-to-deploy pool of capital available to social enterprises through a professionally managed, diversified fund. Professionals who manage the Social Impact Fund aim to establish lasting relationships with their investees and implement a multi-stage selection process before investing in an organization. They typically evaluate the social entrepreneur, the business idea and the social goal and the financial return (Achleitner and Heister, 2009; Miller and Wesley, 2010).

First, they evaluate the company's social mission and found it to be a relevant predictive factor of efficiency. Enthusiasm for social change is considered an important trait because it is the source of the drive to achieve the enterprise's goals. Parameters which are often considered in the conventional business market are also evaluated, such as economic sustainability. Moreover, the passion of the social entrepreneur, its network, its reputation, and the management experience are considered relevant. The entrepreneurs' educational prestige as well as the performance measurement methodology, conceived as the ability to show results in a rigorous and accurate manner are important.

➢ Examples: SEFEA IMPACT, Oltre Venture, Phitrust.

Venture philanthropy is a new approach to grant making which uses the tools and criteria of traditional of venture funding. Venture Philanthropy (VP) is a high-engagement and long-term approach whereby an investor for impact supports a social purpose organisation to help it maximise its social impact (EVPA, 2004).

Investors for impact can be highly engaged grant-makers or social investors (e.g., foundations, social impact funds). They are willing to take risks that most other investors are not prepared to take to support innovative solutions.

Grossman and colleagues (2013) emphasize the approach to organizational building, and indeed venture philanthropists act as partners and in conjunction with financial support, they provide expertise and advice, focus on organizational development and on performance and impact assessment.

EVPA (2006) identifies the following as some of the key elements of venture philanthropy:

- High engagement: venture philanthropists have a close hands-on relationship with the social entrepreneurs and ventures they support, driving innovative and scalable models of social change. Some may take board places on these organisations, and all are far more intimately involved at strategic and operational levels than are traditional non-profit funders.
- Tailored financing: as in venture capital, venture philanthropists take an investment approach to determine the most appropriate financing for each organisation. Depending on their own missions and the ventures they choose to support, venture philanthropists can operate across the spectrum of investment returns. Some offer nonreturnable grants (and thus accept a purely social return), while others use loan, mezzanine, or quasi-equity finance (thus blending risk-adjusted financial and social returns).
- Multi-year support: venture philanthropists provide substantial and sustained financial support to a limited number of organisations. Support typically lasts at least three-to-five years, with an objective of helping the organisation to become financially self-sustaining by the end of the funding period.
- Non-financial support: in addition to financial support, venture philanthropists provide value-added services such as strategic planning, marketing and communications, executive coaching, human resource advice and access to other networks and potential funders.
- Organisational capacity-building: venture philanthropists focus on building the operational capacity and long-term viability of the organisations in their portfolios, rather than funding individual projects or programmes. They recognize the importance of funding core operating costs to help these organisations achieve greater social impact and operational efficiency.
- Performance measurement: venture philanthropy investment is performance based, placing emphasis on good business planning, measurable outcomes, achievement of milestones, and high levels of financial accountability and management competence.

7.3.2 Debt-based

Debt-based impact finance models are mainly provided for long-term projects with stable and predictable cash flows for a mature business model and stable cash flows. Social impact debt instruments consist of bonds or loans issued by a heterogeneous group of lenders and, as in traditional finance, assume that a company finances its business through borrowed capital. The money received must be repaid according to a series of rules that typically establish, for example, the duration of the investment period and the interest rate granted to the investor. Debt capital is repayable at the end of the period and the investee has to pay an interest payment in certain pre-defined time intervals. Compared to equity-based instruments, debt-based ones are safer models of capital provision with a lower-risk.

Fedele and Miniaci (2010) found that social impact organizations are more interested in these forms of financial models. Indeed, private debt seems to be particularly adequate to give rise to entrepreneurial growth programs, and, compared to equity instruments, it allows a greater degree of autonomy of companies.

One example of debt-based instrument is the Social Impact Loans.

Social banks provide loans to create a social and/or environmental benefits. All their products and services focus exclusively on creating and sustaining social value through financial products and services. It is an unsecured medium- or loan-long term aimed at companies that wish to finance a project that pursues a social goal intentional, positive, and measurable.

However, this type of instrument presents some open issues:

- credit scoring: it has not been developed until now a credit scoring tool that correlates the level of risk and social impact of potential clients.
- identification of social entrepreneurship: it is still difficult for social banking to identify potential social businesses to support through loans
- social impact measurement: banks are still not implementing standard impact measurement tools to assess the social impact of their client.

On September 2019 the UNEP Finance Initiative together with 30 international banks have launched the Principles for Responsible Banking. The principles, that have been signed from more than 170 institutions have the goals to align the financial operations of credit institutions to the SDGs framework and the Paris Agreement declarations. The six principles are coupled with a practical guide for their implementation and a four-year plan to be implemented from the signatories.

➢ Examples: Social Impact Banking, Triodos Bank, Big Society Capital.

7.3.3 Public-private partnership for impact

Public-private partnerships (PPP) for impact are financial instruments that entail a partnership between an agency of the government or a public administration and the private sector in the delivery of financial support and capital provision to a social initiative or to a social impact organization. We present here three types of these partnerships: Pay-by-results, Social Impact Bonds, Outcome funds.

Payment by results (PBR) is a new form of financing that makes payments contingent on the verification of results. Generally, it is a mechanism where all or part of the payment from the commissioning authority depends on the provider achieving outcomes specified by the commissioner. It is the founding principle of outcome-based bargaining, i.e., a public procurement management approach whereby the Public Administration commissions a private body to achieve specific objectives. The PBR principle establishes that the Public Administration is responsible for paying for the services provided only if the results have been achieved, to the extent and according to the conditions established at the time of the definition of the contract. Service providers therefore need to make an upfront investment, and some form of upfront payment or 'fee for service'. Providers are, to a greater or lesser extent, free to choose the interventions needed to secure the desired outcomes, and they are motivated to ensure successful performance. The deferral in payment generally is part of the attraction for commissioners but creates risk for providers who need to finance the upfront investment in the interim. There are reported instances of smaller welfare-to-work providers withdrawing from contracts due to this time lag between investment and payment. One approach to overcome this and to make the schemes more attractive to potential bidders, is to include a proportion of upfront payment that is not contingent on the achievement of a specified outcome.

Payment by results has three key elements:

- disbursements tied to the achievement of clearly specified results: payment for outcomes such as completion of education, rather than payment for inputs such as provision of textbooks;
- recipient discretion – the recipient has space to decide how results are achieved; and
- robust verification of results as the trigger for disbursement.

In Social Impact Bond, a separate private investor pays for the activities of a social service provider thereby taking the financial responsibility for tackling a social issue (see the figure below). For the commissioner, it is a means to harness private resources through joint delivery, especially attractive in the contexts of constrained public budgets. From the investor's point of view, it is not only a contribution to a social cause, but also a financial opportunity. For social service provider, SIB provides up-front capital, shifting the financial risk onto the investor. A SIB intervention aims at improving the situation of the target group, resulting at the same time (if the intervention is successful) in government savings (e.g., unemployment benefits, if the target group is employed because of the intervention). An independent evaluator measures the target group outcomes periodically and reports on the SIBs progress and final results. The service provider can use the progress assessments to adapt and improve the intervention. Based on the SIBs final results, which are predefined in a contract signed by all stakeholders, the commissioner (government) pays part of its cost-savings to the investor, which should compensate for the upfront capital plus interest.

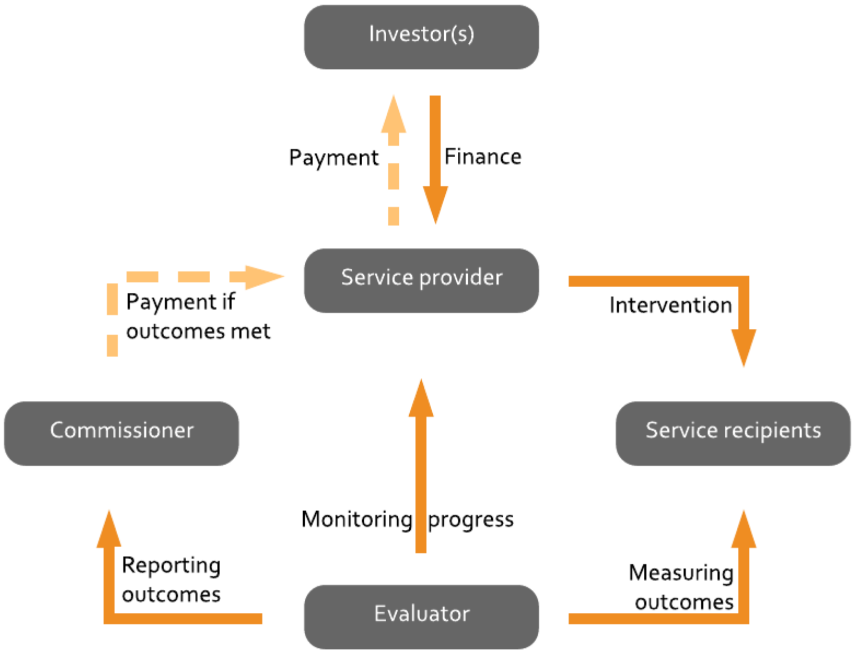


Figure 5 - Basic social impact bonds model

Private funding for SIBs can be issued in two main ways: through SIB funds and the individual SIBs. The main difference is that SIBs funds issue multiple contracts focusing on the same social issue, whereas individual SIBs release one payment contract at a time. Furthermore, individual SIBs take one of the following forms:

- In a direct SIB, a delivery contract is signed between the outcomes-payer and service provider. The service provider carries the risk if results are not achieved, as the investor is lending funds and is repaid first with the loan secured against the enterprise's assets.
- Intermediated SIBs also involve an intermediary to liaise between investors, service providers and the commissioner. Social Finance, a multinational NGO mentioned above, is one of the most notable actors in this role in a number of countries. In an intermediated SIB, the delivery contract is signed between the outcomes payer and an investor-owned special purpose vehicle (SPV), which contracts the service provider, supports the performance management process, and refines the financial model. The risk is shared within the SPV among investors and the repayment depends on the SIB's structure.
- Finally, a managed SIB is signed between the outcomes-payer and the prime contractor (usually an intermediary), who usually manages the entire process. The investors carry the risk but at the same time, they obtain gains if results are achieved or exceeded (OECD, 2016).

At least theoretically, SIBs offer opportunities to all the parties involved. The government shares the financial risk of resolving social issues to private investors. 'No cure no pay' ensures that governments only pay for proven results, which also clarifies the effectiveness of the intervention. Moreover, different government departments, agencies and arms can use this instrument to pool funds when interventions address issues that cut across different mandates, and to achieve outcomes of interest to more than one departmental sponsor. The instrument is not limited to annual budgets, so can be used for multi-year interventions, avoiding the need for repeated funding applications and decisions that also pose risk to intervention continuity (Marks and Weaver, 2017). Meanwhile, private investors get the chance to follow on their corporate social responsibility (CSR) and may obtain returns on social investments. Finally, the social service providers are offered a long-term investment that may be used to design, test and implement their innovative interventions on a larger scale – in other words, they are provided with better environment to scale-up.

Generally, SIB enthusiasts praise them for pulling together diverse actors and expertise from different domains, fostering cooperation and innovation, as well as promoting the culture of performance measurement. Therefore, this model is becoming increasingly popular across the world (see the figure below). For example, as of January 2020, Brookings Institution has mapped out a total of 176 impact bonds in 32 countries (Brookings, 2020)— marking around 24% increase in nine months (as in January Brookings found 134 SIBs in total (Global Economy and Development at Brookings, 2019)). Although most of them are in the UK, the US and generally high-income countries, the model is also emerging in the developing regions.

Nonetheless, SIBs are also often related in the literature to various risks, such as technical issues, considerable administrative burden and transactional costs (sometimes even overweighting the possible government savings), perverse incentives ("parking", "creaming", "cherry-picking", etc.). Other critics emphasise the ideological shifts, shrinking role of the public sector in social protection, and that SIBs reduce the central feature of social intervention of providing support to a by-product of investment and turning citizens into commodities (Roy, McHugh, & Sinclair, 2018).

During the Covid-19 crisis, social impact bonds gained momentum, due to a sudden increase in issuance driven by COVID-19. In April, $12.7 billion worth of social impact bonds were issued around the world, more than the total amount raised in 2019.

There is a specific family of impact bonds, which are the Development Impact Bonds (DIB), expressly created for the developing countries. The core characteristics of the DIB are:

- Financing is provided to support a development programme;
- Money is provided by a private investor who earns a return if the program is successful;
- The outcomes to be measured are agreed upon the outset and independently verified;
- The main objective is to solve a local problem with an innovative solution.

An outcome fund is a funding mechanism that allows the creation and support of many outcome-based contracts in parallel, under a common structure.

Outcomes funds' primary goal is to improve services and programs that address complex social issues by scaling up the contracting market based on outcomes. The aim of the Outcome Fund is to expand the use of outcome-based contracts to enable service providers to achieve social outcomes changes for particular target populations. They aim to contribute to more effective solutions for tackling complex social issues through greater collaboration and synergy between actors.

Outcomes funds may differ in many ways. However, we can highlight two key characteristics common to all Outcomes funds:

- Focus on outcomes – All Outcomes-fund share the desire to create better social outcomes. This indicates a transition of focus away from an activity-based approach and output-based approach to an outcome-based approach. This focus is linked to the creation of outcomes-based contracts for funding social projects.
- Welcome multiple outcomes-based contracts – Rather than funding and developing outcomes-based contracts one at a time, Outcomes-fund facilitate the funding and development of several of these projects, which sometimes could even be designed and/or implemented simultaneously. Even when the design/implementation of projects is sequential, the speed at which these projects are set up and launch could be significantly reduced by accessing standard procedures and design features.

Outcomes-fund vary considerably in their scale:

- the amount of money available for paying for outcomes;
- the number of outcomes-based contracts funded;
- the number of different actors contributing to the fund.
- The time frame allocated, population, policy theme and geography to be targeted also vary.

A simplified operational process for Outcomes fund follows four key stages:

1. Outcomes funding is designated – One or several actors (public, private and/or philanthropic) allocate capital to the operation of an Outcomes-fund. This is money that will be mainly used to pay for social outcomes, allowing funders to act as outcomes payers.
2. Call for outcomes-based project proposals – A partnership comprised by actors such as service provider(s), social investor(s) and/or intermediary(s) apply to the available funding with proposals for social projects based on outcomes.
3. Selection of successful projects – The fund selects proposals which become outcomes contracts to be implemented.

4. Payment conditional on measurable social outcomes – If social outcomes are achieved through the proposed service, contractors receive payment based on the specified outcome. To do so, a process of outcomes validation is set, based on administrative data or other evaluation methods. There are different approaches for defining the payment for outcomes achieved, such as the rate card approach, which provides a menu of highly specified outcomes each with specific maximum prices attached by the outcomes fund administrator.

Outcomes funds are not always able to achieve the outcomes targeted by the outcomes-based contracting projects. The achievement of outcomes relies on many factors linked to the local implementation context and the outcomes-based contracting market in each targeted geography and policy area. The capacity of local actors to administer Outcomes fund and to apply a flexible approach to learning may also affect the successful adoption of the approach. At present the evidence on the effectiveness of Outcomes fund themselves and of the contracts they fund is limited.

Examples: Impact Canada; French outcome-oriented focus on job integration, housing, and ecological transition; India Education Outcomes Fund.

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