The third age looms – Why impact will shape the next generation of sustainable finance

Although one of the most touted investment trends, impact investing remains plagued by misconceptions and regulatory confusion. We look back over the three eras of sustainable investing and argue impact will unlock a new ambition for progressive finance

Like the different geological ages of earth, sustainable investing has continually developed in cycles, each shaped by another dominant concept. This is the thesis developed by a team of researchers led by renowned academics including University of Oxford professor Robert Eccles, University College Dublin professor Andreas Hoepner and German university professors Timo Busch and Christian Klein. From the early stages of socially responsible investing in 'Sustainable Finance 1.0' to the rise of ESG in 'Finance 2.0' to the current 'Sustainable Finance 3.0' in which impact can take a leading role, each of the cycles has been shaped by potent concepts. Since elements of these earlier frameworks are still deployed today, it is salient to consider their roots and goals to judge their relevance within an increasingly intense global debate on the proper role of sustainable investment.

Sustainable Finance 1.0: The age of exclusion

In the early days of sustainable investing, the main concern was to avoid backing harmful activities. For centuries, religious edicts played a central role, from the ban on interest rates to prohibiting investments in gambling, alcohol and tobacco. Over the past 50 years, these precepts have been joined by political objectives, most notably with boycotts against the apartheid regime in South Africa and, more recently, by environmental considerations.

Initially, charitable investors and religious funds took the role of aligning these ancient techniques with modern investment strategies, soon to be followed by fiduciary investors like pension funds and insurers operating with blacklists of undesirable economic activities. The key term for this concept was "responsible investing" or, with a focus on societal and human well-being, "socially responsible investing" (SRI), though such terms are often used inconsistently. In short, the focus of Sustainable Finance 1.0 was to avoid backing undesirable economic activities with fiduciary money. Supporters did not generally aim to change or stop these activities, although extensive boycotts and exclusions by a large number of investors may have similar effects.

Sustainable Finance 2.0: The rise of ESG

The next age of sustainable finance coined the now ubiquitous tag ESG, encompassing a vast range of environmental, social and governance issues. Environmental aspects include impact on climate change, decline in biodiversity or use of water resources. Key social factors cover the treatment of human and employee rights, as well as diversity and inclusion. Good corporate governance focuses on more traditional topics such as board appointments, control mechanisms and proper tax payment, though often views them through the lens of good corporate citizenship rather than serving earlier notions of unalloyed shareholder capitalism. Although there is a general understanding on the main aspects of ESG, there is no legally binding definition of what it encompasses, though parts of the EU regulatory framework relate to aspects of ESG. Examples are the definition of sustainability factors in the EU Sustainable Finance Disclosure Regulation (SFDR) and certain of EFRAG's reporting standards under development for the recasting of non-financial reporting within the draft EU Corporate Sustainability Reporting Directive.

ESG data – The central currency

Sustainable Finance 2.0 is characterised by the shift of ESG from a focus on prohibition to a far broader and interconnected range of concepts and goals. Yet this evolution brings a central challenge to sustainable finance: the hunt for available, reliable ESG data. To evaluate an investment according to ESG factors requires far more data than a simple exclusion based on the business model or location of the investee company. As such, Sustainable Finance 2.0 is closely linked to the rise of ESG data providers and ESG rating companies such as ISS ESG, MSCI and Sustainalytics.


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ESG – A tool to handle risk

While Sustainable Finance 1.0 focused on avoiding the promotion of ethically, politically or environmentally undesirable activities, the multidimensional view of ESG enables a better assessment of the sustainability risks associated with the financing of such activities. The EU's SFDR defines sustainability risks as environmental, social or governance events or conditions that, if they occur, could cause an actual or potential material negative impact on the investment's value. Hence, sustainability is a sub-category of financial risks.

Sustainability risks can arise either from the fact the financed business activity will not be economically successful long term because it is socially undesirable (for example, coal-fired power plants) or because it will suffer damage from expected developments (for example, factories in flood areas). Reputation and associated sales, as well as potential claims by regulators or private litigants, also contribute to sustainability risks.

These considerations fit easily into existing risk concepts and general market understanding. It is therefore unsurprising that the consideration of sustainability risks is now standard practice worldwide. In the EU, for example, it has become a legal requirement for financial products under the SFDR and for investments by insurance companies and pension funds.

ESG – Criticism grows

Recently, however, the ESG ethos has been subject to increasingly harsh criticism. It has been noted that available data is often unreliable and valuations are frequently not comparable due to lack of uniform standards. Moreover, market participants claim that risks resulting from ESG aspects are often not as significant as claimed. Others note that the Ukraine war and energy crisis should lead to a reassessment of the ESG balance of activities such as arms production and fossil fuels. Technical arguments, meanwhile, relate to the multidimensionality of ESG, which is claimed to lead to arbitrary ESG assessments, as any business activity can score positively on certain aspects of ESG while negatively impacting others. A famous example is the exclusion of electric mobility pioneer Tesla from S&P Global's sustainability indices because of alleged disregard for workers' rights, while major fossil fuel companies remained in the grouping.

Probably the most significant criticism, however, relates to the inefficiency of deploying ESG criteria to measure an investment's achievement of non-financial goals. While multidimensional ESG screenings are well suited to filtering out harmful investments and gauging financial risks resulting from ESG aspects, they do not assess the impact of investment on specific sustainability objectives. On one hand, ESG techniques do not measure the impact achieved during the investment. On the other, many investments included in traditional ESG products such as listed shares, ETFs or certificates are not designed to positively change the real economy at all. A sufficiently capitalised company should be relatively indifferent to whether an investor purchases its shares. If an investor tracks a sustainable index by purchasing certificates from a bank, money only flows to the bank, but not into the companies included in the index.

Sustainable Finance 3.0 – Time for impact

The limitations of previous iterations of sustainable finance have fueled the demand for next-generation models explicitly geared to driving substantive results rather than reshuffling capital allocations. Crucially scientists believe this approach should be characterised by the measurable impact of investments. Probably the best-known definition of impact investing is provided by the Global Impact Investing Network (GIIN): "Impact investments are investments made with the intention of achieving a positive measurable social and environmental impact in addition to a financial return." According to the International Finance Corporation (IFC), a development bank, impact investing aims to contribute to the achievement of measurable positive social and environmental impact.

Impact investing – The three foundations

1. Pursuit of environmental and social objectives

Firstly, an investment strategy must pursue defined environmental or social objectives in addition to financial return. These non-financial goals should be at least on equal footing with financial targets. Many impact investing strategies make reference to the United Nations Sustainable Development Goals (UN SDG) as a starting point to define environmental and social objectives.

Impact investing was originally developed for investors acting on charitable or other ethical motives. Hence, it is unsurprising that the concept focuses on objectives as a key differentiator to "traditional" investing. However, with the popularity of impact investing as a playbook for financially motivated investors it becomes increasingly difficult to rely only on motivation or objectives. For example, if an investor finances a start-up with the aim of making it the leading provider of carbon capture and storage solutions, this indisputably leads to a positive contribution to climate goals (see no. 2 below). To assess the future success of the start-up's business model, the investor will use typical impact metrics such as "CO2 emissions avoided" (see no. 3 below). Should it matter in this situation whether the investor primarily pursued economic objectives or also had climate change mitigation in mind? The scientific community takes a pragmatic view. As long as the positive impact is not an unintended consequence, the investor's main motivation should not matter.

2. Positive contribution to an environmental or social objective

The investment must make a positive contribution to achieving environmental or social objectives. Unlike Sustainable Finance 1.0 and 2.0 the main focus is not on the investment avoiding harm or sustainability risks impacting value, but on driving substantive change.

It is, however, debated how narrowly positive contribution should be judged. Is it sufficient the investment makes a contribution at all or is it necessary to demonstrate the activity could not have been carried out without investment? This additional criterion is a particular issue for investing activities with strong economic drivers for which other financiers would likely have stepped in if the investment had not been provided. However, it is very difficult in practice to prove something would not have happened, hence the "additionality" criterion if applied strictly may lead to unreasonably high hurdles.

Source: SDG Use Guidelines (retrieved on 29 August 2022)

In many approaches, the positive contribution must be balanced by ensuring the investment does not cause significant harm to other sustainability objectives. The use of photovoltaic modules produced by forced labour may contribute to climate change mitigation while causing significant harm to people and human rights. Filtering out such unwanted effects is a robust use case for ESG screenings developed in Sustainable Finance 2.0.

3. Measurement and monitoring positive contribution

The positive contribution to an environmental or social objective must be measurable and credibly monitored during the investment using appropriate metrics. Guidance on such procedures is available from free resources on investment platforms such as the Impact Management Platform or the Impact Frontiers network, both of which drew on global co-operation between specialised investors.

Yet selecting metrics and obtaining the data to monitor them remains the Achilles' heel of many impact processes. Industry standards such as the IRIS Catalog of Metrics developed by GIIN contain a wide range of metrics with varying levels of detail and impact content. Referencing to the UN SDG per se does not yet create any real economy impact and strategies based on the UN SDG vary substantially in ambition. For example, virtually any successful business that treats employees in a reasonable manner could contribute to UN SDG 8 (decent work and economic growth).

The corresponding IRIS metric, namely "Jobs Created at Directly Supported/Financed Enterprises" (PI3687), is often used in development finance to measure impact, but makes little sense for judging the impact of investments in developed countries with high levels of prosperity. Asset managers specialising in impact therefore use a mix of metrics tailored to the asset class and location of the investment. Against this backdrop, investors are advised to take a closer look at impact ratings and assessments made available by ESG rating companies and data providers and to scrutinise their assessment processes.

Finally, merely defining the metrics and sourcing the data is not enough: if non-financial objectives are unmet, the investor must address this by suitable measures. These can include a variety of measures from engagement and support of the investee company to divestment.

Techniques and strategies – An expanding menu

Differentiating between the ages of sustainable finance is challenging because strategies from all three eras coexist in financial markets and it is often unclear how to allocate or prioritise them. "Sustainable" as a catch-all term can be used for any of the techniques. "ESG-aligned" is a reference to Sustainable Finance 2.0, but also often used to refer to sustainable investments, ie, investments with an impact objective. The term "impact" rarely provides distinction as a legally-binding definition. As an example, in a recent study Hamburg university professor Timo Busch analysed global retail products marketed as "impact" funds, with sobering results: only 19% of the 185 surveyed funds achieved a demonstrable impact with their investments while another 15% were found to invest in companies with a positive environmental or social impact.

It is, therefore, unsurprising "impact washing" is gaining traction as a subcategory of the well-known phenomenon of over-selling sustainability claims dubbed "greenwashing". In its recent guidance on sustainability risks and disclosures, the European Securities and Markets Authority explicitly addressed impact washing and recommended funds only be marketed as "impact investing" if they target a positive, measurable social and environmental outcome in addition to financial returns.

EU regulation – Lacking definition

Although impact considerations have clearly influenced parts of the comprehensive EU legislative package on sustainable finance, the regulation itself does little to clarify the terminology. For example, the definition of sustainable investment in Article 2 No. 17 SFDR features techniques from all three ages of sustainable finance. A sustainable investment must be made in an economic activity that contributes to achieving an environmental or social objective. Under technical provisions implementing SFDR (SFDR RTS) which will be effective from 2023, asset managers must disclose the indicators used to measure the achievement of the targeted objective. Both elements are linked to impact methodology and can be attributed to Sustainable Finance 3.0. Moreover, sustainable investments must be screened to ensure they do not significantly harm other environmental or social objectives using a variety of ESG indicators, which is more in line with Sustainable Finance 2.0. Finally, companies violating good corporate governance, for example, by tax evasion, are ineligible for sustainable investment. Such exclusions stem from Sustainable Finance 1.0.

The assessment of environmentally-sustainable economic activities under the EU Taxonomy Regulation (Taxonomy) follows a similar approach. It requires a significant contribution to an environmental objective which must be established using the technical assessment criteria set out in the implementing regulations, clearly a case of impact. At the same time, these criteria also contain specifications for negative screening to avoid significant harm to other environmental objectives, a technique derived from ESG screening models in Sustainable Finance 2.0. Moreover, companies violating human or employee rights are ineligible under the Taxonomy (thanks to so-called "minimum safeguards"). Even the Taxonomy needs some exclusions drawn from Sustainable Finance 1.0.

Combining techniques in the right way

Such examples show techniques from the three ages of sustainable finance have the potential to coexist and enhance each other. Current confusion rests not with coexistence but rather techniques used for the wrong purpose or being improperly applied. For example, ESG ratings from Sustainable Finance 2.0 can reduce sustainability risks and determine whether an investment is overall doing more good than harm. However, ESG ratings perform poorly when it comes to measuring a positive contribution to a specific objective. The same reasoning applies to exclusions taken from Sustainable Finance 1.0. There is no better tool for avoiding financing of undesirable business activities, but exclusions cannot be used to achieve a positive impact. An investor expecting an ESG-aligned fund to deliver measurable environmental or social benefits will be as disappointed as a peer who believes exclusions will trigger any direct real world transformation.

Regulatory reluctance to embrace impact

The use of impact techniques requires a change of perspective from regulators as well as investors. EU agencies and national authorities can find it difficult to grasp the concept of impact. The SFDR RTS applicable from 2023 provides standardised metrics for ESG factors - the so-called Principal Adverse Impact (PAI) indicators. But, outside of the Taxonomy and CO2 emission reductions based on climate benchmark methodology, there is no similar guidance for environmental and social objectives under SFDR and the respective indicators. While this free space is helpful for the industry to shape new modes of investment, it requires in-depth assessments and individual decisions of regulators that still have to familiarise themselves with the emerging regulatory landscape. This explains initial reluctance reported from a number of EU countries to recognise sustainable investments outside of the Taxonomy. There may also be a tendency to over-emphasise ESG screening through the PAI metrics, thus cutting off investments due to an overly strict interpretation of what allegedly causes significant harm to other objectives.

More impact through transformation

Another barrier for impact is the wide misconception that a sustainable investment must make a positive environmental or social contribution from the outset, ie, at the time of acquisition. Thus, any positive contribution during the investment's term should be deemed irrelevant (with the exception of the CO2 reduction objective in Article 9 para. 3 SFDR). However, converting an unsustainable activity into a sustainable equivalent can have an even greater impact than financing an already sustainable activity. The Taxonomy's technical screening criteria reflects this concept, recognising planned future expenditures to convert into Taxonomy-compliant activities if they are based on a defined implementation plan with a limited time horizon. This transformative element is also included in the upcoming EU Green Bond Standard. A similar approach should apply under SFDR if investments are made in assets for which a pre-defined implementation plan matching the investment term sets out how to achieve a positive contribution to an environmental or social goal. However, regulators are still struggling to recognise such nuanced "manage-to-green" strategies for sustainable investments.

Sustainable Finance 3.0 – The outlook

All of this shows we are still at the age of impact's dawn and with it Sustainable Finance 3.0. The impact investing industry has produced proven methodologies and techniques on which investors can rely but these tools must evolve to play their role alongside exclusions and ESG considerations for the broader financial industry. The latter approach will not become extinct and can complement broader investment strategies. The most important development to support the evolution of impact will be a better understanding of the methodologies and uses of the techniques drawn from all three ages and a far greater global consensus on defined terms. As a starting point, it should be ensured that the impact label is used only for strategies and products that truly deliver non-financial results.