



ESG

Demystifying Impact Investing



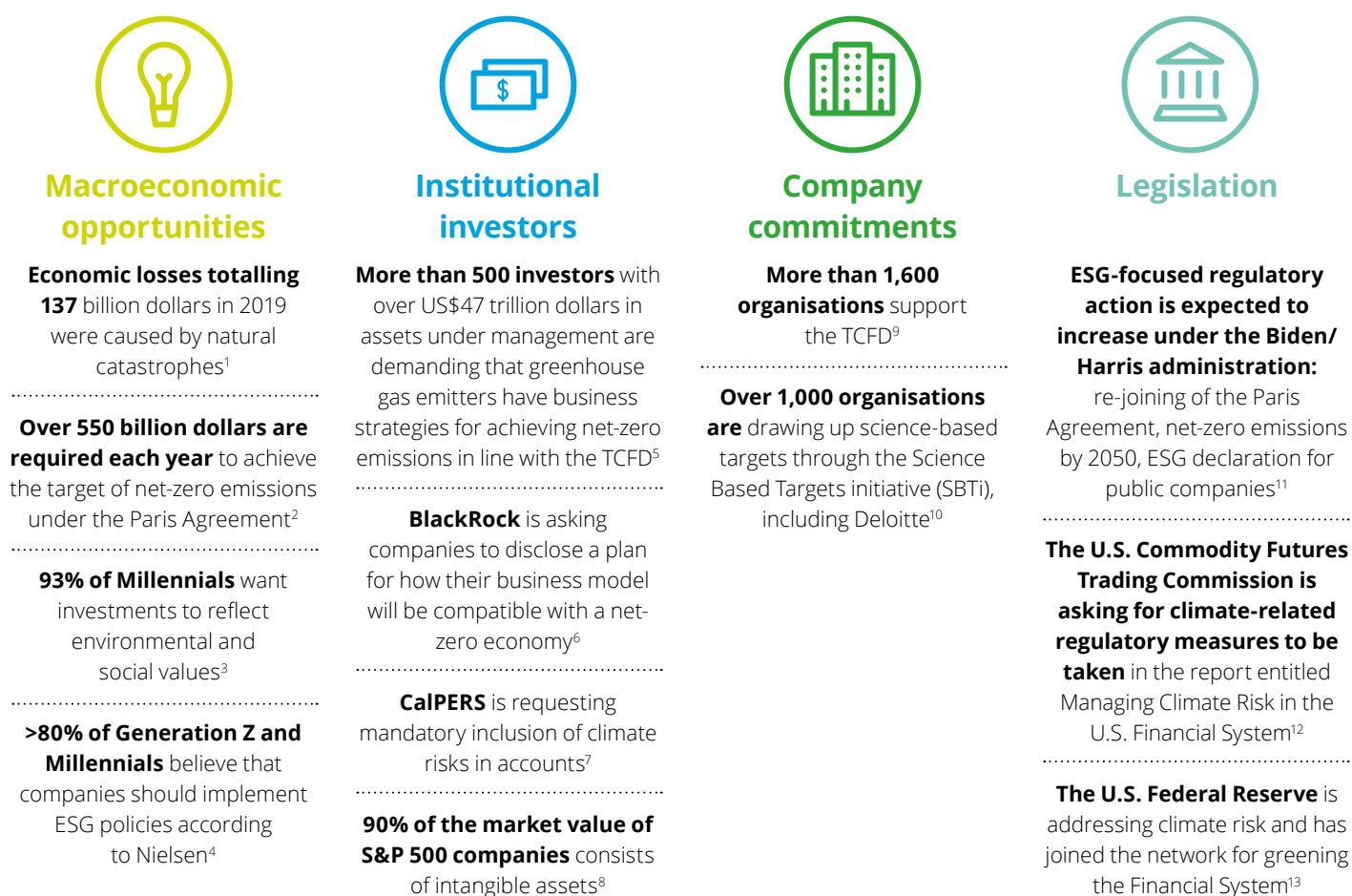
ESG investing is
here to stay as a
new benchmark
in investing.

Introduction: the current situation with regard to Environmental, Social and Governance (ESG) investing

ESG-focused investing is no longer a “niche” market for specialist or green investors. The graphic below shows that ESG investing is here to stay as a new benchmark in investing. The four key factors (the macroeconomy, investors, companies and regulators) are all heading in the same direction.

Figure 1.

ESG: current trends among the main market players



1. Lucia Bevere and Michael Gloor, Swiss Re Institute. Sigma 2/2020. Natural catastrophes in times of economic accumulation and climate change.
 2. International Energy Agency, 2019 World Energy Outlook. Huffington Post, April 2017.
 3. Huffington Post, April 2017.
 4. Nielsen, “Global consumers seek companies that care about environmental issues”, 11 September 2018.
 5. Ceres, “Climate Action 100+”, 14 September 2020.
 6. Larry Fink, “2021 Letter to CEOs”,
 7. Financial Times, 15 August 2020.

8. Standard and Poor’s. Annual Report. 2020.
 9. Task Force on Climate-related Financial Disclosures, 25 February 2021.
 10. U.S. Securities and Exchange Commission, Modernization of Regulation S-K Items 101, 103 and 105, 9 November 2020.
 11. President Biden’s Climate Plan, 27 January 2021.
 12. CFTC Commissioner Rostin Behnam, Managing Climate Risk in the U.S. Financial System, 2020.
 13. Board of Governors of the Federal Reserve System, “Federal Reserve Board announces it has formally joined the NGFS as a member” Press release. 15 December 2020.

Impact investing

Impact investing is an investment “philosophy” which, as a subgroup of ESG investing, also addresses social and environmental issues. We will highlight the characteristics of impact investing further down in this “Point of View”. It should not be considered as a different asset class separate from the “traditional” world of investing but rather as a methodology which also applies a socio-environmental lens. Perhaps the term “impactful investing” would be a more appropriate classification. Impact investing is not a “trendy” product but rather, on the contrary, is becoming increasingly relevant in the current context as a result of aggressive environmental damage, and the social and health crisis, further exacerbated by the effects of the COVID-19 pandemic.

At first glance, one might ask what link exists between the capital market or finance and the environment, social inequality and global warming. In fact, they are very closely related: the capital market and investments are pre-eminently

a source of funding and a pursuit of profitability, generally associated with current issues: where there are unmet needs there are investment opportunities. In this sense, investors analyse trends (key variables of economies) to determine where to invest their money and, at the same time, evaluate whether they are indeed trends or actually paradigm shifts.

At Deloitte, we are convinced that we are witnessing a paradigm shift in finance: the need to evaluate not only financial returns but also investment goals. Today these two variables are closely intertwined, given that a growing number of actors in both the capital market and society now demand it. Companies need to carefully consider their environmental policies and working conditions if they want consumers – who are becoming increasingly discerning and are very much aligned with the priorities of Millennials – to continue consuming and requesting their products and/or services. Therefore, as part of their investment strategy, asset managers should consider

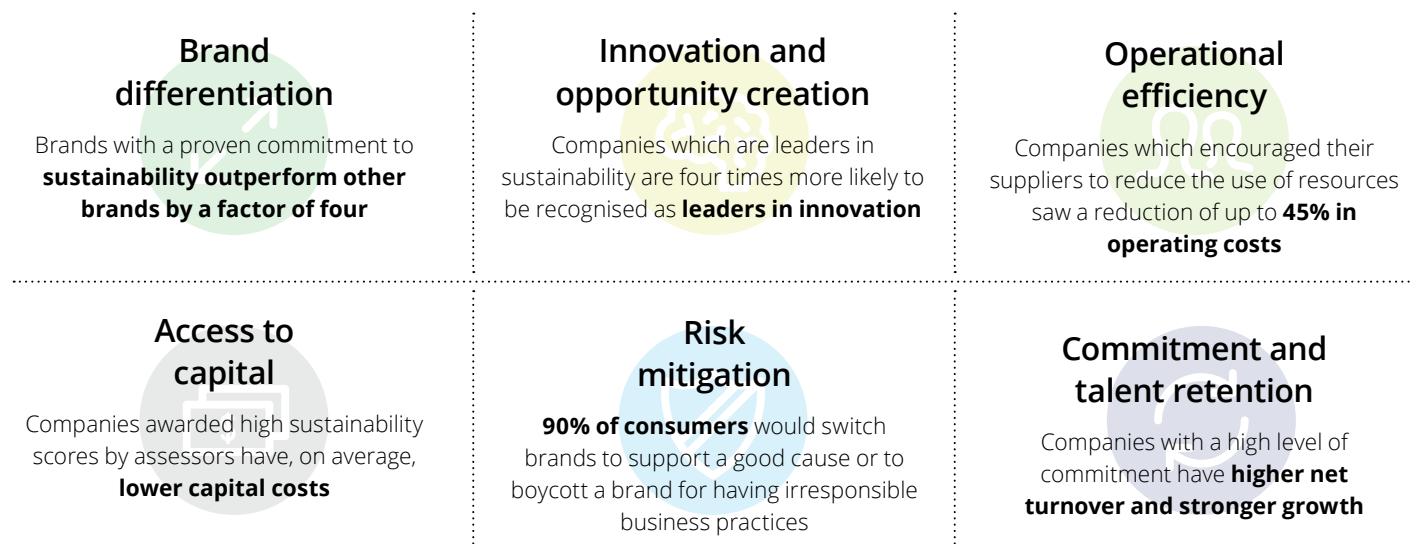
projects which help to resolve issues that are currently affecting society, such as climate change, gender inequality, racism and poverty, if they wish to continue receiving investors’ trust and money.

As such, impact investing is quite simply the result of two forces which appeared to be opposing forces but nowadays go hand in hand: the pursuit of profitability and purpose, whereby the possibility of the existence of a correlation and the extent of the correlation between the two have been demystified over the years.

Indeed, these two variables are what leads to the development of an industry, of a country, or of a region like Latin America, and of an integrated and globalised world. Our publication entitled “Deloitte Insights: Measuring the Value of Social Capital” summarises the tangible benefits that a commitment to sustainability creates for companies.

Figure 2.

Material impact of a commitment to sustainability

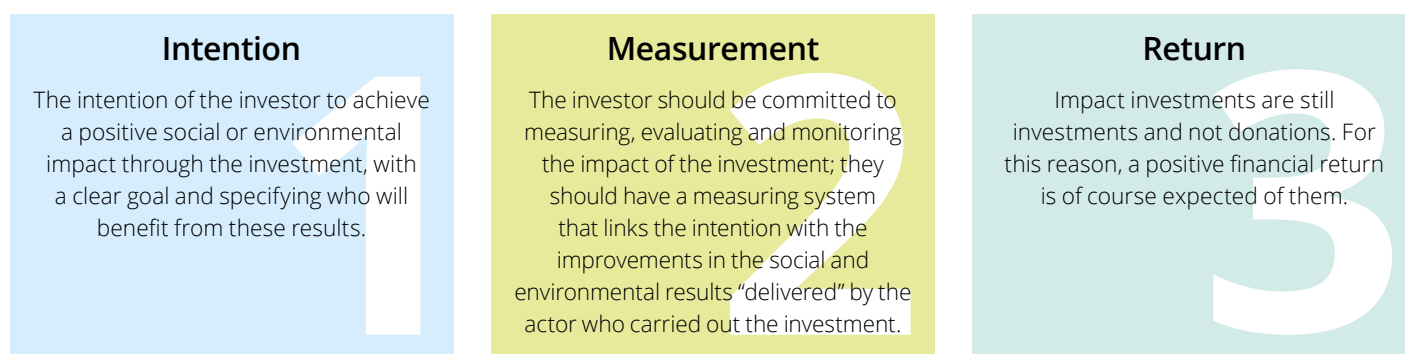


Getting started

There are different ways of adopting this investment philosophy depending on your specific role (individual, investor, company or government). The main objective for everyone should be to look for investments (in projects or companies) that generate added value, can be measured and offer a financial return that roughly correlates with the risk being taken.

Figure 3.

The 3 main features of impact investing



Source: created internally.

Intention is closely related with the **Sustainable Development Goals (SDGs)** developed by the United Nations in 2015 with the aim of describing and quantifying the social and environmental needs to be addressed in the next 15 years. The 17 goals to be achieved by the year 2030 include, amongst others, No Poverty, Quality Education, Clean Water and Sanitation for all, Affordable and Clean Energy, Reduced Inequalities, and Climate Action.¹⁴

Measurement is a fundamental requirement in impact investing, given that simply having the intention will not ensure that the impact will be achieved. In fact, there is a concept known as “green washing”, which is used to describe the actions of a company that creates a false impression or provides misleading information about its practices and its positive impact on the environment so as to benefit its corporate image. In order to create a formal impact measurement framework and prevent “green washing”

(or “rainbow washing” when related to certain other SDGs), the institutions seeking to ensure the existence of impacts have in particular focused, in recent years, on developing methods and systems of measurement required in the impact investing process. One of the most widely used systems is **IRIS+**, a system for “quantifying” impacts, developed by the **Global Impact Investing Network (GIIN)**, which impact investors can use to measure, manage and optimise their impact. At the same time, management and operational frameworks have been created, such as the **Operating Principles for Impact Management**, developed by a group of investors (individuals), asset managers and financial institutions to describe the essential characteristics of managing investments for any individual or institution that wishes to carry out impact investing and therefore avoid green washing behaviours due to a lack of information or absence of a formal operational framework.

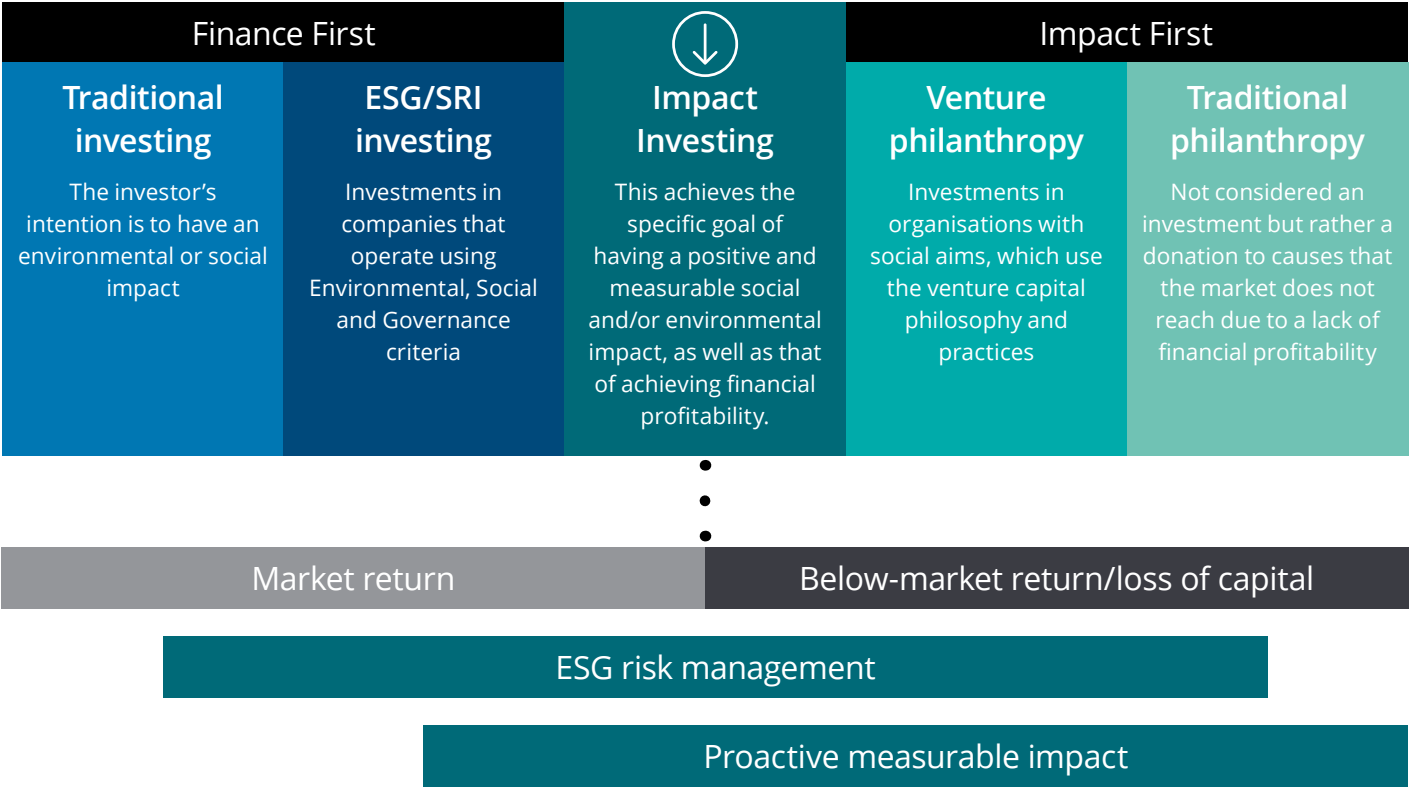
Financial return is one of the main areas of debate surrounding impact investing. Some question whether it can have a return comparable with traditional investments, given that, because it has a social intention, it was originally associated with philanthropy. This has been demystified over time, as several studies have proven that impact investments can offer a financial return equal to or even greater than that of traditional investments and even be more resilient in negative circumstances, such as the current COVID-19 pandemic.

14. For more information, visit <https://www.undp.org/sustainable-development-goals.html>.

Difference between impact investing and other types of investment

Taking into account the ultimate goal, there is a wide spectrum of different types of investment, depending on the priority which these give to financial profitability vs social and/or environmental “profitability” (impact), as described in Figure 4.

Figure 4.
Spectrum of investments



Source: Adapted from Impact Investing is Catching Fire, Forbes (2018).

At one end of the spectrum, we have investments that prioritise profitability over impact. Amongst these, we find traditional investments as well as investments considered sustainable or responsible (investments in companies that are guided by ESG – Environmental, Social and Governance — policies and Sustainable Development policies) that operate under a framework of intention, but the actions are difficult to measure or quantify, meaning that they are not considered impact investments in their own right.

At the other end of the spectrum, we have investments that prioritise impact over profitability and that are mostly (venture and traditional) philanthropic investments. As profitability is not prioritised here, they are normally projects with below-market returns, which may even include donations or grants.

In the middle are impact investments, which incorporate profitability and impact in equal measure. These are *investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return*¹⁵.

15. Formal definition of impact investments by the Global Impact Investing Network (GIIN).

In which sectors can impact investing be carried out?

Impact investing can be carried out across any type of industry or sector for the simple reason that it is an investment concept and not a niche: the main focus is the purpose for which the funds are used, and practically all industries can be linked to a social or environmental purpose.

Figure 5.

Main sectors in which impact investing occurs



Education

Examples: increasing quality and quantity of education, promoting inclusive education models, reducing the cost of education



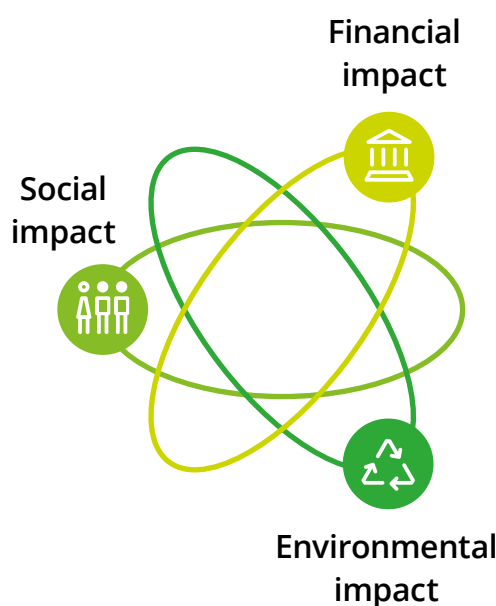
Health

Examples: developing health centres, health technology, suppliers of sanitary equipment, pharmaceutical industry



Agriculture

Examples: funding for production and processing, reducing disparities between urban and rural sectors, developing sustainable agriculture, mitigating soil damage



Diversity and inclusion

Examples: microcredits (microloans), loans for women, citizens of poor regions and SMEs, Islamic finance, amongst others



Environment

Examples: developing renewable energy or energy efficiency projects, waste management facilities, constructing sustainable infrastructure, marine or forest conservation projects



Infrastructure

Examples: developing innovative technology, telecommunications, transport, affordable water and housing projects



Source: Created internally.

Impact investing can be carried out across any type of industry or sector for the simple reason that it is an investment concept and not a niche.

Case study **Bancamía, Colombia**

In 2010, the International Finance Corporation (IFC) invested US\$10 million in preferred shares in the microfinance bank Bancamía S.A. (Bancamía), which specialises in providing microcredits (microloans) to rural micro-entrepreneurs and female entrepreneurs with limited resources. In 2010, Bancamía had a portfolio of around 300,000 clients in 369 Colombian municipalities (including those with limited resources).

More than 20 years after its founding, the Colombian Women's World Corporation (CMMC) and the Medellín Women's World Corporation (CMMM) (the founders of Bancamía) began the process of finding a strategic partner to transform Bancamía, which at that time was a non-governmental organisation (NGO), into a bank. The strategy conceived by the founders was based on the fact that, as a regulated institution (a bank), Bancamía would be able to expand its product portfolio. In 2007, the BBVA Microfinance Foundation became a Bancamía shareholder, and the institution thus became a bank. That was the year in which the IFC subscribed to the preferred shares in Bancamía, and the bank became the third largest Colombian institution in terms of microcredits (after Banco Agrario, a publicly owned bank, and Banco Caja Social).

By participating in the project, the IFC was able to: (i) form an alliance with a key player in the Colombian microfinance market; (ii) strengthen the bank's capital so as to lay the foundations for developing and further expanding the bank's portfolio; (iii) provide technical consulting and risk management services in the fledgling bank; and (iv) promote the growth of microfinance to micro-entrepreneurs with limited resources that operate in border regions in Colombia.

The IFC's investment took place as part of the strategic collaboration agreement entered into between the IFC and the BBVA Microfinance Foundation, majority shareholder of Bancamía, to promote joint investments in microfinance entities, with the aim of promoting the consolidation and future of the sector in Latin America. It is important to note that micro-enterprises in Colombia employ 51% of the Colombian population and account for 95% of all of the country's companies.

As for the measurable benefits from the impact, it is estimated that the project has contributed to the bank tripling its portfolio of clients (from 300,000 in 2010 to 913,977 in 2016 – 48% of these work in rural areas and 55% are female entrepreneurs). Furthermore, during the investment period, the portfolio of microcredits increased by 124%, reaching US\$381 million. It is also worth noting that Bancamía reported that 42% of its clients with limited resources managed to get out of poverty after the third year of the loan provided by the bank. Lastly, the bank has estimated that during the IFC investment period, its clients' sales increased by an average of 19% (IFC, 2020).

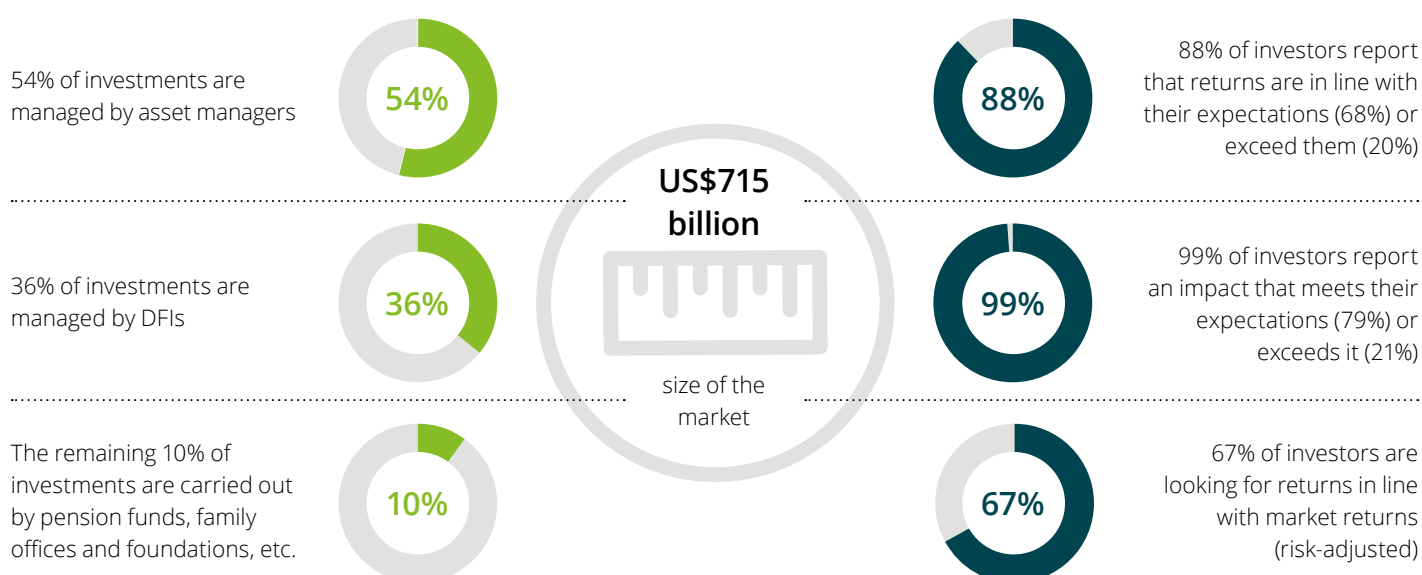


The size of the market and its actors

Based on its Annual Impact Investor Survey, the *Global Impact Investing Network (GIIN)* estimates that more than 1,720 organisations manage US\$715 billion in impact investment shares. Just over half are managed by asset managers (approximately 54% of the assets), around a third (36%) are managed by DFIs (development finance institutions such as the IFC, IDB Invest, CAF, etc.), and the rest (10%) are managed by pension funds, family offices and foundations, etc.

Figure 6.

The size of the market and its actors



Source: Produced internally, based on data provided by the Global Impact Investing Network (GIIN).

The actors in general (private investors, managers or borrowers) are beginning to internalise the importance of their individual and business decisions with regard to the impact on society and the environment. Statistics on environmental damage and the social crisis are alarming: if changes are not made today, the damage will be catastrophic which is why institutions, such as the United Nations, and key representatives of the financial market have begun to act. As a result of the paradigm shift and globalisation, we are seeing a gradual move away from an economy in which it was believed that the private sector should generate wealth and the public sector should be responsible for distributing it.

Nowadays, society understands that the private sector should take on a more active role, on the premise that the efficient and sustainable use of resources is effective not only for society but also for the long-term development of the private sector itself. Figure 7 shows the internalisation of impact investing in terms of investment goals.

Figure 7.

Impact investing in investment portfolios

54% consider sustainable investing to be fundamental to investment processes and the potential economic outcomes of investments

It is believed that in the next 5 years impact investments will represent on average 37% of the total portfolio (vs 18% currently)

Source: adapted from 2020 Global Sustainable Investing Survey, BlackRock (2019).



Instruments for carrying out impact investing

Impact investments, like any investments, can be achieved through different instruments. Despite this being a relatively new approach, the financial market has managed to adapt itself to the different needs and demands.

The main instruments which have been used by the various different actors in the impact investing market are essentially **bonds** (known as green, social or impact

bonds depending on the investment goal), **loans** (with the same classifications), equity investments (shares in companies that carry out impact practices), **mezzanine** investments ("custom-made" instruments that incorporate a debt component and a profit component according to the investment's performance), mobilisation of capital (a practice whereby financial institutions direct capital towards impact investing projects, which they would

otherwise not do), and **guarantees** (financial institutions guarantee certain investments and transactions that are considered risky so that investors feel "encouraged" to invest).

Figure 8.

Ways of carrying out impact investing



Source: Created internally.

Despite this being a relatively new approach, the financial market has managed to adapt itself to the different needs and demands.

Innovation: a key element in impact investing

Innovation stimulates fundamental changes in consumption and production systems, and allows for economic growth and improvements in human wellbeing without subjecting the environment to unsustainable stress. It is therefore the link between all the variables and players relating to the world of impact investing: through innovation it is possible to achieve intended purposes and attractive financial returns, link public policies with social behaviour and bring public and private actors together.

Figure 9.

Creating policies using the multiple benefits approach



Source: Adapted from the Global Resources Outlook 2019 (p.33), by the United Nations Environment Programme, 2019.

Innovation can be represented in different ways and is associated with three of the biggest issues of our time: global warming, the use of natural resources, and poverty. These issues are of course in turn all related, given that not only does environmental damage cause climate change but the latter is also closely linked with poverty on account of a lack of water, for example.

As such, we can say that innovation is the tangible way of creating the necessary changes in pursuit of sustainability. As for global warming and the use of natural resources, innovation is achieved by developing renewable energy sources, such as solar and wind energy, and means of transport that use electrical energy instead of gas.

These technological innovations are already under way, but investors and companies need to double their efforts and commitment by greatly increasing the

production scale and constantly innovating processes to make them even more efficient. They should also be accompanied by public policies (such as tax incentives) to generate even stronger development.

Another key area in need of innovation is steel, cement and plastic production. In all three industries, the production process is usually expensive and complicated and there is still much more that needs to be done in terms of research and development work in order to make the products “green”. As a result, the stakes are even higher here: governments and investors should be prepared to invest in the face of increased risk, showing support for innovation focused on understanding how to transform these industries, in order to then make the changes to the production process. It is thus important that governments in rich countries first increase “research and development” budgets. Secondly, it will be the turn of impact investors (risk capital) to invest in

companies and start-ups able to come up with new ideas and solutions for these issues (Gates, 2021).

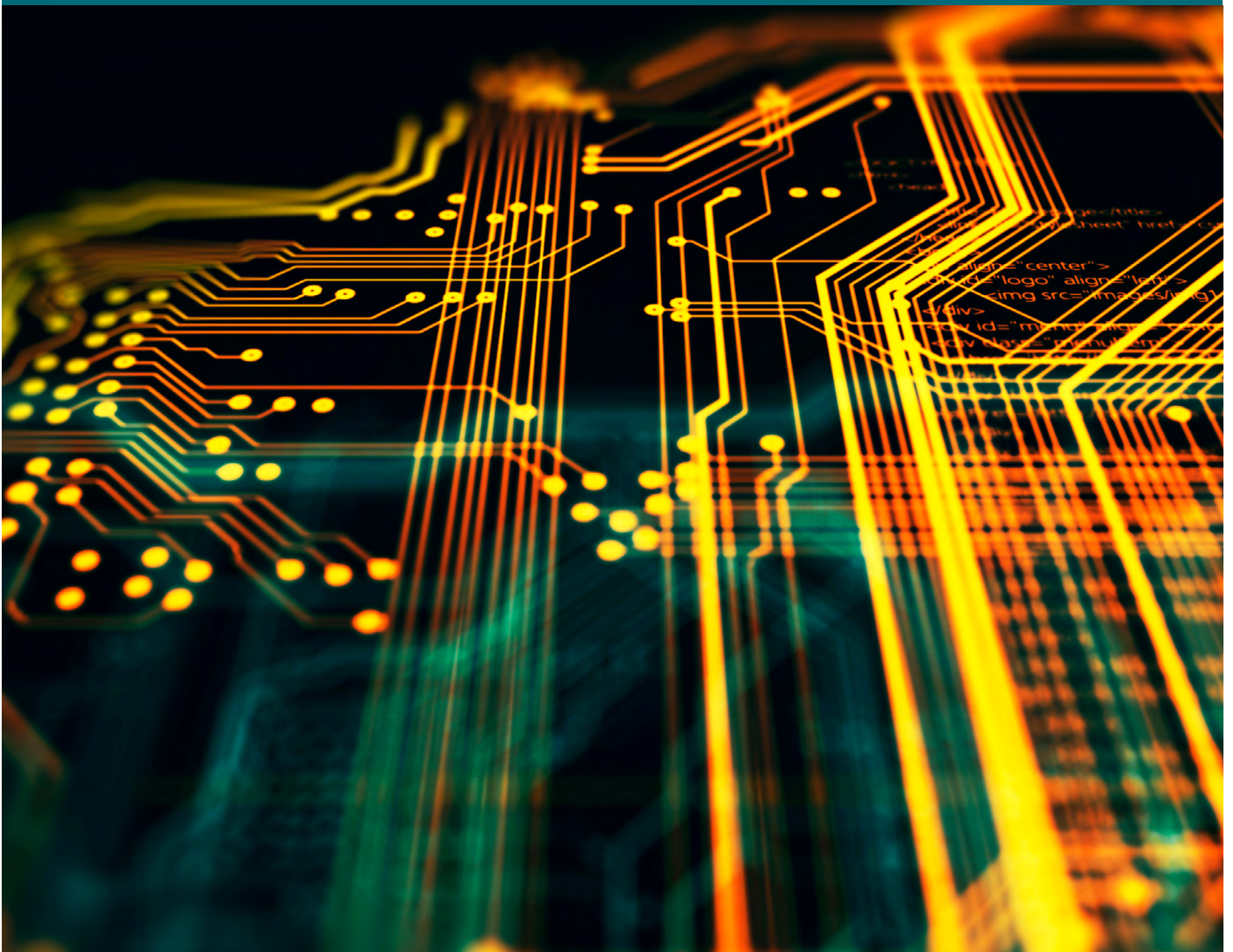
On the poverty side, innovation manifests itself in the development of technologies which allow the population to be financially included, as well as in improvements to infrastructure to help enable basic natural resources to reach “everyone”. This means people having access to drinking water, a health system, and the same financial system. Innovation is of vital importance in these areas for enabling society to develop.

Case study Internet Para Todos (Internet for All), Peru

The goal of Internet Para Todos (IpT) was to create a rural mobile infrastructure operator (RMIO) whose objective was to sustainably connect Peru's neglected and marginalised populations using an innovative Business to Business (B2B) model. IpT, a joint venture between Telefónica Perú, Facebook Connectivity, IDB Invest and Corporación Andina de Fomento (CAF), would create an overlay mobile broadband network via an existing voice network and a new broadband infrastructure.

The rationale behind the IpT model was that around 100 million people, i.e. 20% of Latin America's population, still do not have general access to mobile broadband and therefore the benefits offered by the digital economy. IpT's mission in Peru was to close this digital gap and connect rural communities all over Peru, allowing any mobile network operator to use the IpT 3G and 4G infrastructure to offer high-quality retail mobile communication services. IpT's success in Peru could pave the way for replicating this type of business model in other Latin American countries and across the Caribbean region.

A year after starting operations, at the end of 2020, IpT achieved its goal of connecting over 1.5 million Peruvians in remote coastal, mountainous and jungle regions so that they could access decent mobile Internet. A year after its operations were launched, IpT has now established itself as a rural mobile infrastructure operator in the country. Using a wholesale model, it offers all mobile operators on the market the opportunity to rent its telecommunication infrastructure so that they can offer their services and hence connect more Peruvians. IpT represents an opportunity to bring all Peruvians into the digital era, especially within the current context of the COVID-19 pandemic.



Impact investing in Latin America

In recent years, Latin America has become the world region with the third highest growth in impact investing – after the United States and Western Europe (GIIN, 2020). It is a region with a high level of creative and intellectual capital. And because it is still developing, there are a wide range of investment opportunities for those with an appetite for risk, such as venture capital and private equity funds.

As such, with regards to impact investing, Latin America represents a very interesting entrepreneurial and innovative ecosystem.

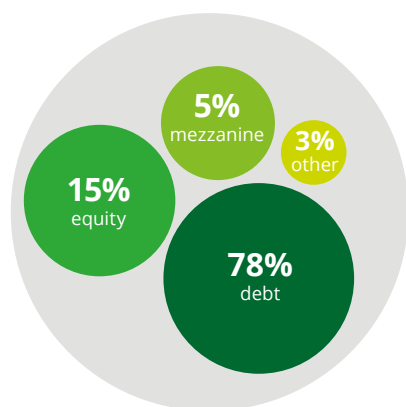
One clear example is the development of the fintech industry, a trend which has increased all over the world but which appears to be booming in Latin America due to the nature of the issues faced there.

Given that the impact investing market is still in its infancy in the region, investors tend to opt for more traditional investment alternatives and simpler instruments such as debt or equity instruments. Only 5% of the investments made between 2018 and 2019 involved mezzanine instruments (LAVCA, 2020), for example. Impact

investing with debt instruments accounted for 78% of total investments, while those made through capital investment accounted for 15%. This represents a major opportunity for exploring new types of investing and thus attracting even more investment.

Figure 10.

Most widely used instruments for impact investing in Latin America



With regards to impact investing, Latin America represents a very interesting entrepreneurial and innovative ecosystem.

Source: Created internally.

The sector to receive the largest amount of impact investing in recent years was Agriculture and Food, to the tune of US\$159 million and 253 projects, accounting for 32% of total investments made between 2018 and 2019 and 41% of the total number of projects carried out.

The Microfinance sector is the second sector of choice for impact investing in Latin America, accounting for 27% of investments, followed by Financial Services (excluding Microfinance), accounting for 11% of investments, and Education, accounting

for 3%.¹⁶ Latin America represents one of the world's most attractive hubs for developing impact investing: (i) despite being a developing region, it has a more sophisticated capital market (which is therefore better prepared for growth) than certain Asian or African countries; (ii) there is great capacity for innovation, specifically related to Agribusiness and Microfinance; and (iii) it is one of the regions with the greatest biodiversity in the world, favouring the development of renewable energy or other alternatives for producing sustainable energy.

Furthermore, agricultural production in Latin America is considerably higher than in other regions, which makes the region key to the development of investments that would increase global food production, meeting the main aim of SDG number 2: Zero Hunger.

Thus, despite it being one of the regions most affected by COVID-19, the expanses of Latin America are fertile ground for developing impact investing.

16. Information obtained at https://cdn.ymaws.com/www.andeglobal.org/resource/resmgr/2020_reports_/LatAm_Impact_Investing_ES.pdf

The COVID-19 pandemic as an accelerator of impact investing

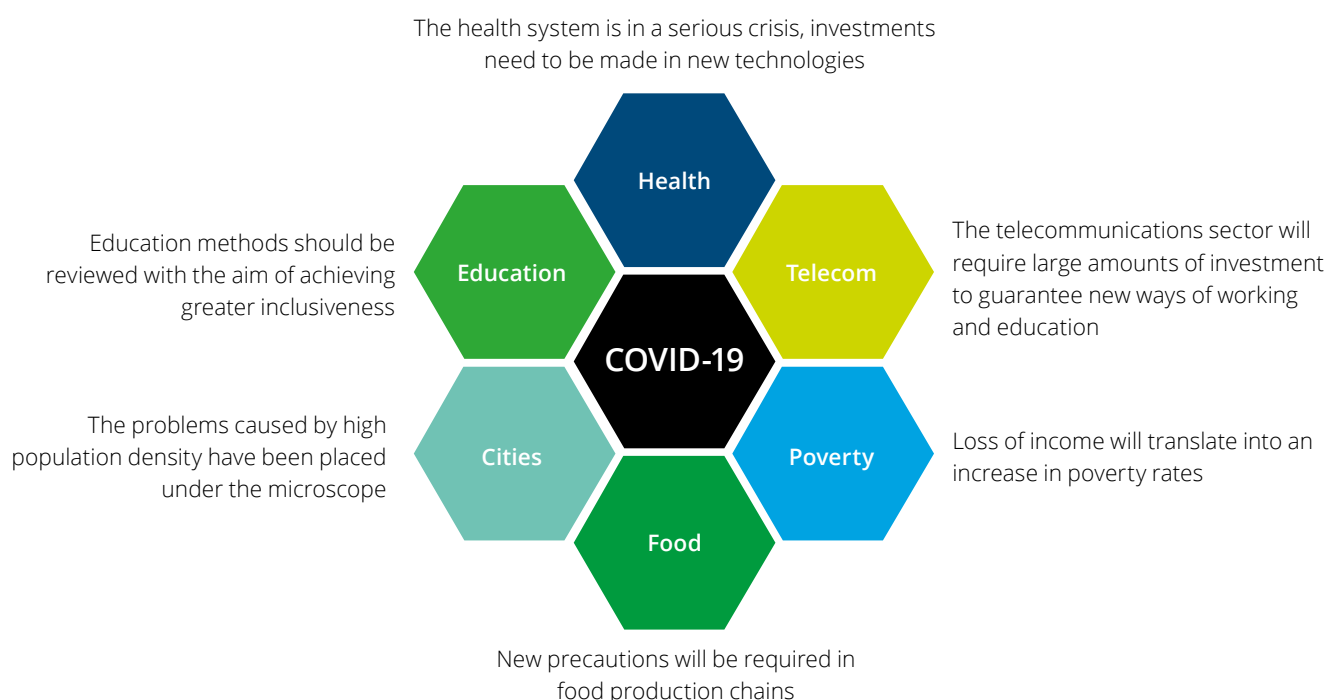
The COVID-19 pandemic has highlighted both the need to prioritise impact investing as an investment philosophy and the increasing desire of all stakeholders to develop businesses and policies which incorporate sustainability. The rapid spread of the virus has had grave health and economic consequences for most countries and their businesses and this is where impact investing has its main role.

In many cases, this pandemic has taken different industries by surprise and changed the way in which virtually all sectors operate. It has, for example, pushed health systems to their limits and stretched the telecommunications sector, which is essential these days for personal and professional interconnectivity and above all for education. Within the new paradigm, activities that used to be carried out face-to-face will now be carried out virtually, meaning that large

amounts of investment will be required in the telecommunications sector in order to be able to provide an efficient service that can guarantee that activities such as virtual learning, online healthcare and remote working can continue to be carried out effectively. At the same time, new precautions will be required in the food preparation chain (in order to prevent possible infections) and the phenomenon of nearshoring will be given a boost.

Figure 11.

Impacts of COVID-19 on impact investing sectors



Source: Produced internally, based on data from the United Nations, the World Bank and the Inter-American Development Bank.

In this sense, the pandemic has revealed the need to direct private investment towards these new areas. The public sector has had to make a major and unexpected effort throughout 2020 to deal with the social crisis, worsened by the pandemic. This has highlighted the need to direct private investment towards this type of goal.

It is therefore highly likely that we will see an increase in public-private initiatives (governments participating with private investors and companies) to meet social and environmental needs that have long required attention and which, due to the pandemic, have become alarming issues.

Conclusions

The market often questions whether impact investing is simply a trend. Deloitte believes that impact investing is here to stay. It represents a profound paradigm shift and is increasingly becoming the norm, based on the following arguments:

1 Alignment of interests

Companies are undergoing a considerable cultural shift compared with 15 to 20 years ago. The role of the private sector has changed. It is no longer considered an ecosystem in which companies simply create value for their shareholders and employees but one where companies are now seen as playing the role of trustees within society. As part of this change, it is believed that companies should operate and create value within the limits permitted by society and the environment. Any firm which falls outside of this business model will not be sustainable in the long term. This new role that companies have as trustees is aligned with the key objectives of society and the public sector which represents it, and it is these aligned interests which will ensure a sustainable future for this new philosophy.

2 Consequences of a more globalised world

The pandemic has shown how a health crisis from just one country can create negative externalities in the rest of the world, even if these countries are not directly connected (through transport or business) to the country of origin. As such, it is clear that those industries and/or countries that cannot modernise or maintain minimum sustainability standards will be marginalised for fear that they may be the source of future environmental and/or health crises.

3 Sustainable growth of impact finance

Despite the fact that impact finance began as a mandate to be carried out by development institutions in accordance with their by-laws, the industry has clearly grown in the last few years thanks to the support of the private sector for this type of investment. Impact investing increased by 33% between 2015 and 2019 (GIIN, 2020), and continues to rise.

4 Inclusion of marginalised sectors

Impact investing can also act as a market catalyst. The ability to open up new markets by means of financial inclusion or to connect marginalised sectors allows for new actors and consumers to be incorporated into the current economic ecosystem. This provides a joint incentive between those who require services and are marginalised and those who are willing to receive such services.

5 Performance of impact investing

Various studies have shown that there can be a high degree of correlation between the financial return and the impact on development. Thus, the markets should gradually move towards more sustainable investment, given its overall effect on the sustainability of the planet. It has even been shown that funding for certain sectors that were originally cut off from the financial system (for example, gender lens investing and Islamic finance) has seen above-average performance with lower rates of late payments and greater resilience in adverse circumstances.

6 Specific use of funds

In financial terms, the specific use of funds in investing allows the implicit risk of the investment to be quantified (ring-fencing). The concept of ring-fencing is described as a barrier encircling, enclosing and separating different risks from the day-to-day business operations of a company. In this case, even though money is fungible, the fact that impact investing guarantees that certain funds are designated to a specific use allows the investor to have an additional tool for measuring the potential risk which they are facing.

7 New generations support the paradigm shift

New generations have emerged with a stronger social conscience than their parents. According to Morgan Stanley (2017), 93% of Millennials surveyed are interested in investments which seek to have a social impact, with a market-rate return. At the same time, there is consensus that impact investing can play an important role in the sustainable economy given that 75% of Millennials surveyed believe that investing can influence climate change and 84% of Millennials believe that impact investing has the power to lift people out of poverty. The generation after Millennials (Generation Z) also agrees with this initiative: 94% believe that companies should contribute to social and environmental shortfalls in the countries in which they live.

Impact investing is not an alternative to investment or a trend but an investment “philosophy” which seeks to find the socio-economic/environmental balance. This way of doing finance provides the most wide-ranging and sustainable way of supporting the growth of industry, countries and the global economy. At the same time, it enables investors to deepen their investment analysis and processes through the pursuit of profitability given that, in addition to what has been said above, we are in a world in which financial profitability is increasingly difficult to obtain. In this sense, the investment methodology in some way returns to the very essence of economics: closing the gap between supply and demand.

Finally, as we have covered in this Point of View, impact investing does not represent a niche investment or a different asset class but rather arises as the logical result of applying a social, environmental and diverse lens (previously often ignored) to financially profitable projects. The repeated use and continuous growth of this sustainable approach, which is increasingly based on common sense, will gradually convert impact investing into the benchmark for evaluating any type of investment project.

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