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THE IMPACT INVESTING MARKET

Bringing together supply and demand for sustainable and social investment products

The field of impact investing, alongside other sustainable investment approaches on the global markets, has attracted increasing attention in recent decades. Even though growth in this segment has recently been consistently positive, there are supply-side barriers that stand in the way of further consolidation on the capital markets.

DEFINITION AND EMERGENCE OF IMPACT INVESTING

The type of investments that today are covered by the term impact investing originated in the second half of the 20th century and can be traced back to several different movements. The concept of Socially Responsible Investing (SRI), i.e., investing in companies that pursue social or ecological goals and adopt corresponding responsibility, emerged in a similar period to the concept of microfinancing[1]. Socially responsible investments (SRI) and microfinancing - i.e., the granting of small loans, usually to entrepreneurs in emerging countries, with the aim of having a positive impact on economic development - are forms of investments that can be regarded as early forms of impact investing. The interaction of two aspects within the investments is crucial. The generation of a financial return goes hand in hand with a positive sustainable or social impact through the provision of liquidity.

Other fields that have similarities to impact investing are ethical investment[2], in which investors invest in companies that meet defined standards in areas such as environmental protection or ethical labor operations, or, most notably, the currently popular ESG investing. Following the turn of the millennium, the term "impact investing" began to establish itself on the markets as a form of investment whose definition includes the anchoring of social or ecological objectives in addition to the generation of a financial return. With the increasing popularity of this investment type in recent years, the emergence of corresponding international associations and societies has also grown significantly. The Global Impact Investing Network (GIIN), a non-profit organization for the promotion and support of the investment field, has thus contributed to the development of best practices and the creation of frameworks for the operational area[3]. Over time, other aspects such as poverty reduction, education and health improvements have been added to corresponding investments. The main

Figure 1 – Classification of Impact Investing

[1] Renneboog et al., 2008

[2] Forbes, 2023

[3] The Rockefeller Foundation, 2023

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reason for this is the development of the investment preferences of investors in impact investing, which will be discussed below.

OVERVIEW OF IMPACT INVESTING

In addition to traditional investment segments, impact investing is a fairly new way of allocating capital from various investor groups on the financial markets. It combines the field of philanthropy and adds the element of capital investment, where generating a positive return is a key objective. The convergence of both aspects is based on changing preferences of various private and institutional investors. For them, embedding sustainability and socially responsible corporate action is becoming increasingly important.

"We are observing strong demand in the market for - transparency regarding - impact investing products, yet our clients are struggling to clearly define impact and therefore have difficulties offering suitable assets."

Marco Meyer
Director
Head of Sustainability@Banking
Germany

REQUIREMENTS FOR ELIGIBLE ASSETS

In order to qualify as an investment or asset in this field, financial products must meet specific criteria. Impact investing products in projects or shares of companies are often aligned with the Sustainable Development Goals (SDGs) of the United Nations[4]. Possible investments that demonstrate a direct connection to the SDGs include the development of infrastructure solutions in areas such as water supply or waste recycling, developments in renewable energy markets, or the creation of housing in disadvantaged regions. The development of frameworks that provide a clear definition and distinction from other financial products, as well as the implementation of quantitative sustainable and social objectives, is therefore essential for such investments. In addition to achieving a financial return, the presence of measurable positive effects is an essential criterion. The quantification of positive sustainable effects within metrics such as subsequent CO2 savings or an improvement in the level of education must be documented and defined in the investment conditions[5].

When investing in companies, it must therefore be ensured that their business activities generate appropriate positive effects[6]. One way of combining the SDGs with assets that meet the requirements for impact investments is to issue funds that comply with the sustainability requirements set out in Article 9 of the Disclosure Regulation[7]. A respective real estate fund can create a direct link to the SDGs "7 - Cheap and clean energy", "9 - Industry, innovation and infrastructure", "11 - Sustainable cities and communities" and "13 - Climate action" by embedding

[4] Global Impact Investing Network, 2018
[5] Global Impact Investing Network, 2019
[6] Tessa Hebb, 2013
[7] IntReal, 2022

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environmental objectives in the areas of own energy production or CO2 savings[8]. In the German impact investing market, the focus of respective investments in 2020 was on the SDGs 7 (reference to this in 51.3% of all assets), 13 (51.3%) and 3 ("Health and well-being", 50%). A mere 3.9% of the investors surveyed stated that the SDGs were not considered in their impact strategy[9]. The impact investing market can therefore be a key driver in achieving the SDGs by 2030, provided that sufficient capital is allocated in this area to contribute to them.

RELEVANCE FOR THE CAPITAL MARKETS

Since its emergence, the field of impact investing has grown significantly in size as well as in scope. The publications of various institutions and organizations on market dimensioning still vary in terms of the respective asset-under-management (AuM) values. This is often based on different classifications of the assessment basis. For example, listed assets are in some cases included or excluded from the estimates.

According to the GIIN, the global impact investing market volume can be estimated at USD 1,164 billion for 2022[10]. This

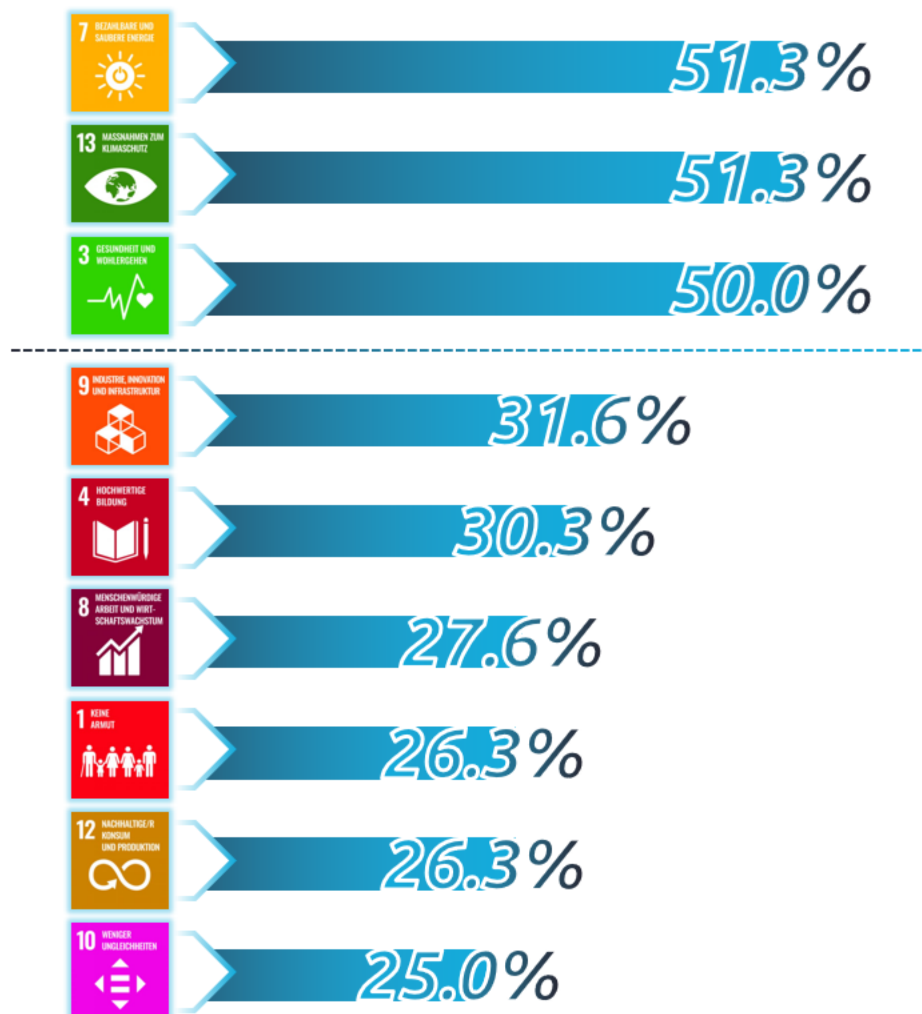

Figure 2 – Visualization of SDGs according to their consideration – Bundesinitiative Impact Investing, 2022

[8] Umweltbank, 2022
[9] Bundesinitiative Impact Investing, 2022
[10] Global Impact Investing Network, 2022

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calculation is based on AuM values reported as of year-end 2021. Many international research institutions assume that the market will continue to grow at a high, usually almost double-digit, rate. According to GIIN calculations, the AuM volume in the impact investing sector grew by an average of around 18% year-over-year between 2017 and 2022[11]. Allied Market Research forecasts that the global impact investing market will have a volume of USD 6,000 billion in 2031 with an average annual growth rate of 9.5%[12].

Through the close connection between investment products in impact investing and the SDGs, it is possible to derive the economic sectors in which significant amounts of investments flow. A major part of the liquidity is allocated to products that incorporate targets and metrics for measuring a positive impact on climate protection, fair working conditions, gender equality and fair and sustainable energy[13].

In the past, the conception of international standards and the creation of frameworks, which have significantly expanded the scope of application and coverage of the market, have set the course for the establishment on the capital markets. Furthermore, the introduction of corresponding sustainable and social disclosure obligations has likewise created a need to invest in ESG-related products. One example of this is the SFDR disclosure regulation, according to which asset managers must provide information on the implementation of sustainability considerations in their products. Investment funds in accordance with Article 8 or, as previously mentioned, Article 9 must comply with defined criteria in order to be labeled as such[14]. For providers, this establishes a precise framework and scope for action and at the same time creates the need to offer appropriate assets through a disclosure obligation.

Embedding requirements for the expansion of sustainable business activities within regulations creates pressure to invest more in such assets. The signaling effect that high values of sustainable investments have in an institution's own disclosure is one reason for this. As a financial intermediary, a banking institution can, for example, increase its quota in sustainability KPIs which must be reported, such as the Green Asset Ratio (GAR) due to be disclosed from 2024, by granting loans to corresponding funds. Further positive effects include the improvement of companies' own ESG ratings or their inclusion in ESG indices[15]. As a direct consequence, the increase in the regulatory frameworks in recent years has led to a significant improvement in the maturity of impact investing.

Due to the opportunity to invest in a wide variety of projects and industries, the group of investors in the impact investing market is a highly heterogeneous group as well, as explained below.

DEEP DIVE INTO INVESTOR LANDSCAPE

Both individual and institutional investors are investing in the market. These include asset managers, private foundations, family offices and financial institutions that invest in underdeveloped regions[16]. As these are players who have different motivations for their investments, they may also have significantly diverged preferences in respect of their optimal investment objects.

[11] Global Impact Investing Network, 2023
[12] Allied Market Research, 2023
[13] Global Impact Investing Network, 2023
[14] Morningstar, 2023
[15] Ehlers et al., 2022
[16] Islam and Scott, 2021

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This applies in particular to the group of individual investors, in whose entirety the most diverse investment motivations in the areas of ESG are reflected. For companies providing impact investments, this poses the challenge of diversifying their product portfolio and meeting a wide range of expectations. Equally relevant is the large amount of regulatory framework and data requirements that must be observed and incorporated in the offering due to the broad investor landscape. In the context of investments with a sustainable or social purpose, the traceability of the use of funds and the linking of the respective projects to defined guidelines play a major role.

Especially in recent years, the supply on the market has not been able to keep up with the enormous demand for impact investing products. In the following, we will highlight reasons for this, provide recommendations for overcoming them and discuss how Capgemini Invent can support financial institutions with its expertise and approaches in this field.

INTERNAL AND EXTERNAL CHALLENGES

The issues that the sell side has in meeting the high demand in the market are diverse and can be divided according to their internal and external origin. Internal factors include conflicts of interest within the supplying organizations that prevent an expansion of supply. External obstacles are caused by market conditions or the institutions operating in the market.

INTERNAL TRADE-OFFS FOR FINANCIAL INSTITUTIONS

Banking institutions are profit-oriented companies and have always aimed to achieve the highest possible financial return for a given risk profile when offering investment products. In general, this has not changed; rather, in a competitive environment, banks are required to keep their profits high and their costs at a minimum. For banks, achieving financial targets in the assets they offer is therefore more important than a greater measurable

Figure 3 – Conflicting objectives between investors and banking institutions

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sustainable or social impact[17]. However, since in the field of impact investing such influences are preferred or at least equated with a higher financial return, there is a trade-off between the motivation of the buy side and the nature of the traditional sell side investment sector. If investment products do not simultaneously generate a financial return in line with the market and have a measurable impact that qualifies them as an impact investing product, a financial institution will always prefer to offer a product with higher returns.

Looking at the average returns of products on the impact investing market, it can be observed that these are below the average returns of products offered by financial intermediaries. A study by the University of California illustrates this. At 6.4%, the median return of the impact funds examined is one percentage point lower than that of non-impact funds (7.4%)[18]. Consequently, banks tend to offer only a limited amount of products that meet the classification criteria for impact investing. The reason for this is risk aversion with the intention of not jeopardizing the financial performance of the investment products offered by them. In the market, this could have negative consequences in the benchmarking compared to other competitors, which could result in the migration of certain investor groups. Products for which there is theoretically a demand in the impact investing market are therefore not included in the offer.

TRANSFORMATION OF THE PRODUCT PORTFOLIO

According to a recent study conducted by the GIIN, the majority (74%) of investors in impact investing likewise aim to generate a return in line with the market[19]. Even if this may be surprising regarding the aforementioned lower average return of corresponding products, an even larger proportion (80%) of the study stated that the financial performance of their impact investing strategy meets or even exceeds their own objectives. The statement that impact investing products are associated with lower returns than conventional investment products therefore does not appear to be valid universally. Of course, it is also important for banks to differentiate the characteristics and motivations for investing in impact investing from those of the market as a whole, as the objectives of investing are not the same.

However, there is an emerging trend that, like with other types of investment, impact investing is reaching a higher level of maturity due to a shift in the preferences of various investor groups and is therefore being perceived more strongly in the market. On the other hand, the motivations of traditional investors and those for whom a positive impact of their investments is the main priority are also converging. This can be seen, among other things, in the strong growth of the market volume in impact investing and the general objective of generating a conventional market return. The products offered also appear to at least satisfy the expectations of investors in this regard for the majority of investors, which is another indicator of greater market maturity.

This offers banking institutions the opportunity to create an offering that includes traditional investments but also addresses the growing market for sustainable and social investments. Establishing a separate product segment that includes appropriate products and flexibly responds to different investment

[17] Phillips and Johnson, 2019
[18] Penta, 2021
[19] Global Impact Investing Network, 2023

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preferences of the demand can realize huge potential. With the introduction of an ESG investment compass, for example, investors can be directly presented with products that have a measurable impact on a specific or various SDGs and the characteristics of the investments can be visualized, compared, and set in the context of traditional comparative investments. Last but not least, a distinctive sustainable offering and the accompanying sales volume has a number of advantages for the bank in the disclosure of different ESG KPIs or other regulatory indicators.

“The implementation of ESG or impact assets in the investment advisory process offers financial intermediaries the potential to access new customer markets.”

Carina Leidig
Director
Banking Transformation

THE EFFECT OF EXTERNAL REGULATORY REQUIREMENTS

The scope of sustainable or social financing and investment opportunities has multiplied in recent years, both in respect of assets and liabilities of financial institutions. Diverse product designs which relate to the SDGs or the six environmental goals in the EU taxonomy are playing an increasingly important role. At the same time, the financial sector is one of the most regulated economic sectors in the world[20]. In particular, the offering of sustainable and social products is subject to additional directives and frameworks that verify them as such, alongside conventional regulations. These include the ICMA's Green Bond Principles and the equivalent Green Loan Principles of the Loan Market Association (LMA). As in traditional finance, the aim of strong regulation is firstly to protect investors and secondly to prevent greenwashing and create transparency regarding the use of invested capital.

According to scientific findings, regulations do have a positive impact on the demand for impact investing products by establishing definitions for terms that are difficult to specify, such as "sustainability" or "impact"[21]. A countervailing effect of increased regulatory requirements is the automatic restriction of impact investing offerings in the market through stricter standards for products that qualify as impact investments. Consequently, some assets that were previously offered as such and do not meet newly adopted standards are removed from the offer.

In addition to these immediate negative effects on supply, there are other adverse factors that hinder an expansion of supply. The establishment of additional regulatory requirements is usually perceived as a barrier by the issuing companies that prevents an expansion of supply[22]. Besides the conceptual aspect that extensive regulatory requirements entail, the gathering and processing of data is a factor that requires a great effort in terms of both time and money for companies. Collecting and reporting the required data ties up a lot of resources in organizations and creates barriers to market access for new potential

[20] BMWK - Sustainable Finance-Taxonomie, 2020
[21] Barber et al., 2019
[22] Phillips and Johnson, 2019

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providers[23]. The implementation of processes and data management solutions for various ESG aspects represents a further hurdle for businesses when offering impact investing products. Particularly in the emerging field of ESG, a large amount of the necessary data is not available (in standardized formats) or quantifiable.

Considering the motivation for introducing new regulatory frameworks to further establish sustainability as a factor in the market by creating a clear distinction, directives such as MiFID II, SFDR or the EU taxonomy are currently having opposing effects on supply in the market. The requirements from legislators do not yet appear to provide sufficient clarity or provide recommendations for current challenges.

"Although ESG-related regulations are intended to promote sustainable investments based on international standards, sell side investment firms can perceive them as barriers."

Manfred Miedl
Senior Manager
Sustainability@Banking

ADDRESSING AND OVERCOMING REGULATORY CHALLENGES

The large amount of guidelines creates a variety of sell side barriers in the field of impact investing. Established standards are primarily aimed at protecting the investing individuals or institutions as well as ensuring the use of funds and thus preventing greenwashing. However, the implementation of standards in associated areas can simultaneously have a positive effect on the supply of corresponding financial products. For example, the amendments to the Delegated Regulation to MiFID II as of August 2, 2022, requires companies offering investment products to ask their clients about their sustainability preferences when providing investment advice. The consideration of sustainability factors and the management of associated risks must equally be addressed. This will enable the integration of sustainability aspects to have a greater influence on investment decisions.

The strong emergence of new and extended disclosure requirements in relation to sustainable and social business practices and processes also requires the introduction of additional metrics for their quantification and measurability. The large amount of information that should and must be disclosed under the CSRD, for example, can represent an opportunity for impact investing to significantly expand its market volume and product range. Assets that qualify for impact investments can thus be analyzed as such directly, without the need to establish structures upfront that enable the measurement of impact, as the data is already available in the systems. Tools that have already been launched on the market can be used to measure impact, as well as the requirements of regulatory guidelines. After using their own metrics and indicators, investors in the German impact investing market state that they most frequently use the EU taxonomy (41.4%), the SDGs (39.7%) and the Principles

[23] Bundesverband Investment und Asset Management e.V., 2023

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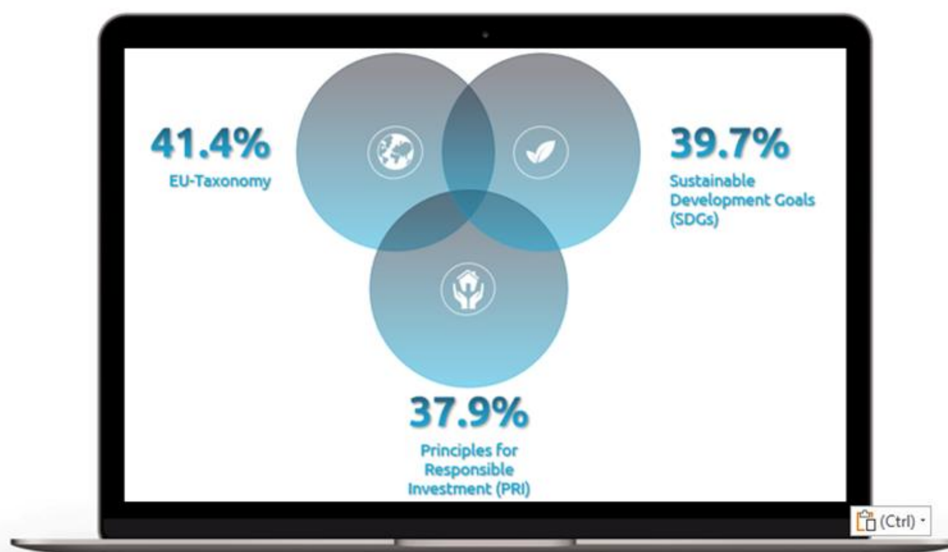

Figure 4 – Metrics used to measure impact – Bundesinitiative Impact Investing, 2022

for Responsible Investment (37.9%) for this purpose[24].

For the providers of such products, data management and the architecture of the related systems are a major challenge, in addition to stronger involvement in the investment process and a clear definition of when a financial asset is considered impact investing. If international supervisory authorities establish audit compliance criteria for the processes of data collection, formats and processing, providers and servicing companies are guided towards the implementation of a standard approach. This can significantly reduce the effort involved in data management and improve the database for the provision of appropriate products to enable them to offer diversified and data-based impact investing assets.

The process of data collection and subsequent processing is particularly challenging for organizations in the area of ESG data structures, as parts of the required data are publicly available or have to be purchased from specialist providers. This poses the challenge that part of the data has to be integrated incompletely and in varying formats into a system architecture that often does not meet these demands.

OUR APPROACH TO BOOST THE SUPPLY

As discussed, international standardization for various products and their reporting as well as notification systems will increase due to regulations and the associated disclosure obligations. Other obstacles to the expansion of the portfolio and greater flexibility for product diversification are currently internal trade-offs within financial institutions that align their offering with the market. Establishing structures to enable a broad product portfolio involves the process of data management and different methods of data utilization.

Capgemini Invent supports its clients along the way of building an integrated and automated ESG Product Master Data Supply Chain, which will aggregate external data with internal information from existing systems and visualize it making it readily available for all business functions and

[24] Bundesinitiative Impact Investing, 2022

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building a Sustainable Digital Enterprise of the future.

Together, we can help you implementing your Sustainable Investing function covering all impacted areas - from your investment advisory and portfolio management business processes to your sustainability related data management:

1. Sustainability data management: From data vendor selection to the data operationalization within your data architecture, management systems and the data warehouse

2. Improving your product offering: Leverage GenAI technology for hyper-personalized product and investor matching

3. Sustainability performance assessment: To measure the impact of your assets, we support you in establishing appropriate ESG KPIs and their implementation in your processes, dashboards and reporting formats

4. Know-Your-Customer: Expanding your suitability questionnaire to analyze and classify your customers according to their ESG preferences

5. Trainings and workshops: Getting your investment advisors and portfolio managers up to speed, enabling them to educate their own clients and to provide an improved ESG customer journey. This will initiate a valuable learning process for all people involved in investment decision making and for the investment managing company

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Capgemini Invent is an integral part of Capgemini, a global leader in partnering with companies to transform and manage their business by harnessing the power of technology. The Group is guided everyday by its purpose of unleashing human energy through technology for an inclusive and sustainable future. It is a responsible and diverse organization of nearly 350,000 team members in more than 50 countries. With its strong 55-year heritage and deep industry expertise, Capgemini is trusted by its clients to address the entire breadth of their business needs, from strategy and design to operations, fueled by the fast evolving and innovative world of cloud, data, AI, connectivity, software, digital engineering, and platforms. The Group reported in 2022 global revenues of €22 billion.

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