



Finance for good

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Financial institutions are crucial to the smooth functioning of our society. Continue reading to find out the 4 ways that a society can benefit from finance.



'Financial innovations can have positive impact on how well the financial sector can benefit and serve society'

The financial sector provides us with deposit, payment, savings, investment and insurance services. That is helpful if you want to buy a house, pay for a world trip or save for your pension. Financial institutions provide individuals or enterprises with credit or capital, in this process creating trust for individuals and organizations to work together, taking on and spreading risks, allowing individuals and businesses to coordinate their actions across time and space. In this way, productive activities are developed, such as new medications, technological innovations and sustainable energy sources, increasing individual and collective wellbeing in our society. However, as we have noticed in the past years, the financial sector can also destabilize economies and increase inequality through speculative activity and excessive risk-taking, and it can create conflicts and pollute environments in search of high financial returns.

The big financial challenge for the current and next generation finance professionals is not how to run a discounted cash flow model (a.k.a. technical stuff). Your task is to take finance a step further: learn to understand the impact of your investments on the world, and integrate this knowledge into your financing decisions. We call this impact investing - the deliberate allocation of capital into initiatives that lead to a better society.

Traditionally, financial institutions focus on maximising financial return when making investment, and are even kept to this objective by fiduciary duty (Amalric 2006). This leads to financial institutions investing in activities that lead to negative externalities such as environmental damage or are unbeneficial to the wellbeing of individuals, such as unhealthy or addictive foods. Furthermore, they fail to make investments that could be impactful but have inadequate expected financial returns.

Financial innovations can have positive impacts on how well the financial sector can benefit and serve society. The challenge of the coming generations is to do exactly this. Finance should benefit society (Shiller, 2013). So how can you make this difference?

4 ways to go:

1: Impact investing

At the core of financial institutions is a decision-making process by which capital is allocated. By including social and ecological decision criteria in this capital allocation decision, non-impactful investment can be excluded, which leaves more capital to be allocated towards impactful activities. Based on our joint experience in the field of impact evaluation and the financial sector, we identified three general conditions that should be met by an investment to classify as an impact investment: (1) it should be directed towards productive activity or the financing of trade, connected to an end-user (non-speculative); (2) it should have a positive impact on the individual wellbeing of consumers (3) investments should have a non-negative effect on common goods, goods from which it is difficult to exclude others, like public goods, and which are subtractive, like private goods (Ostrom 2010). Engaging in impact investing means working with mainstream financial institutions to redirect their portfolios towards activities that adhere to these three conditions.

2: Pricing the commons.

Establish effective regulated markets which create an incentive to prevent externalities through a price tag, such as CO² or sulphur dioxide emissions markets. This strategy incorporates the direct or opportunity cost of sustaining common goods into the price of products and services and ask companies and consumers to pay for this cost. It thus aims to make measurable what was not measured, beforehand, and change the 'bottom line' (MacKenzie, 2009). This can work in the case of equivalent, measurable units that need prevention on large scale and can be accounted for, but has not yet offered a solution for less generalizable types of impact.

3: Social Impact Bonds

What if a product or service can improve the wellbeing of individuals, but these individuals have no purchasing power available?

Traditionally, this is the domain of government spending (i.e., welfare payments). Here, additional private sector financing can potentially make the investment more impactful. The Social Impact Bond, makes use of a private investment that is made to reach a social goal, such as higher levels of youth employment through a mentoring programme. If the investment achieve the intended result (i.e. a higher level of employment), the government pays a financial return to the private financier. Government spending only occurs when results are achieved, saving unnecessary costs while obtaining impact for society. The risk of the investment - and part of the return - is shifted to private investors. Individual wellbeing of the youth improves: they generate their own income, the government saves costs due to lower unemployment benefit payments. These types of investments solve or prevent problems instead of collectively paying for unsolved problems (high unemployment). Also, it adds an incentive to measure impact to improve social policies. How many Social Impact Bonds will you bring to the market?

4: Community Finance

Collective goals, such as infrastructure or biodiversity are often funded by the government. However, the government often lacks funds or political attention to potential improvements in collective wellbeing, and are not always able to identify and execute the most impactful investments. Through community finance, the financial sector is able to facilitate impactful investments that individuals, mainstream finance and governments cannot do alone. Crowdfunding is the main example of this type of innovation where financing is provided by bringing together a network or community. It refers to efforts by entrepreneurial individuals and groups - cultural, social, and for-profit - to fund their projects online by drawing on relatively small contributions from a relatively large number of individuals in exchange for financial and/or in-kind return (Mollick, 2014). Crowdfunding works without the standardization needed for carbon markets: returns can be adapted to the target investor community per project, ranging from equity, debt, in-kind (i.e. solar lamps, theatre ticket), warm glow and a feeling of 'belonging' to a community. The public nature of the investment process (when identity of investors is known) might increase the willingness of some individuals to cooperate around some collective good if they see others have 'cooperated' (Vollan & Ostrom, 2010). However, it can also facilitate herding and unwise investment. More knowledge is needed to understand and develop these markets to their full potential impact - will that be your job?

The challenge to take up

There is plenty of work to do. We suggest three main directions for progress. First, continue to develop financial innovation that increases and improves credit and capital allocation to create impactful results. Our suggestions (impact investing, externality trading, SIB's and community finance) are only a starting point. There are more financial innovations out there such as complementary currencies and even more to be developed. All these innovations need maturing, scaling and improving.

Second, we need well-organised learning loops for optimizing impact. Money has a natural learning loop (if our aim to get a

certain financial return, we know ex post if we succeeded or not). If we want to improve the impact of our investments, we need to know which investments, ex post, actually turned out to really be impact investments, and why. Building, sharing and applying impact knowledge through evaluations and research, will make investments more impactful.

Finally, in order to build a better society and serve this goal from the financial sector, we need vision and wisdom. The term 'impact' means nothing without concrete and well thought-through objectives that will help build a better, and a long-term, robust society.

So do you have a vision, the need to improve the world, are you results-oriented, creative, and not afraid of technical details? Look no further - please get going. <



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