Managing on Impact

Financial Arena discussion paper, October 2023

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1. Introduction

Actors in financial markets are facing challenging issues. Banks, insurance companies, portfolio managers and pension funds, further referred to as the financial sector, are expected to generate returns on investments in the financial markets for their shareholders, depositors, policy holders and for future pensions. At the same time, they are in a position to shape and direct the actual economy with the capital entrusted to them. And herein lies a dilemma.

In a world in need of transformation, there is an increasingly explicit expectation that capital will be deployed to mitigate risks and to take advantage of opportunities. Trends such as the climate transition, deglobalisation, an ageing population, migration, transition to a (more) circular economy, the digital revolution and the loss of biodiversity only manifest themselves over a longer period of time. However, traditionally, actors in the financial sector mainly work with short- to medium-term horizons for assessing financial risks and returns and for making intended investments.

Their dilemma is that the traditional risk and return framework does not cater for factoring in the effects of long-term systemic risks and transitions. The nature, scope and complexity of these issues is such that their effects cannot be (sufficiently) taken into account in the current way of working, which is primarily a two-dimensional framework of risk and return. For too long, the emphasis was on risk reduction in combination with returns-driven thinking at the expense of ecological and social capital. However, the financial claim on social and ecological capital is growing, while the social and ecological foundation is diminishing. The aim of the transition is to reverse this trend: resulting in a financial system that grows rather than depletes social and natural capital.

The financial sector must also go through a transition so that the impact of the capital deployed is fully taken into account when making decisions about what the financial sector finances. But how can we get out of the groove of return and risk reduction and move away from historical development and standard models that mainly look back, yet do not offer an adequate response to the transition questions posed by the imminent systemic changes required? How can we ensure that impact takes centre stage?

The aim of this discussion paper is to raise awareness of the transition required in the Dutch financial sector and how this transition can be initiated, ideally using the recommendations and acting together to accelerate the transition. Chapter 2 features a theoretical framework describing the implications of moving from a two-dimensional framework of risk and return towards an holistic framework based on risk, return and impact. Here, impact means the positive and negative influence of capital on the real economy and the world as a whole.

Chapter 3 starts with an internationally accepted definition of impact financing. Using this definition and the theoretical framework explained in the previous chapter, we outline what it would take for actors in financial markets to create a holistic

framework. It requires changes to both the 'what' and the 'how' in the organisation. Chapter 3 concludes by examining what the financial sector requires from its external environment for the transition to a new way of working.

Chapter 4 outlines some of the dilemmas arising from the required transition, draws conclusions and suggests follow-up actions.

2. Theoretical framework

Traditional financing pursues financial value, aiming to optimise the balance between risk and return. This is a two-dimensional framework. In the first step of sustainable financing, the ESG risks are taken into account (financial materiality). The additional step of impact financing takes the external impact into account as well (impact materiality). The aim of three-dimensional financing is to encourage the transition to a sustainable economy within social and planetary boundaries (Burckart and Lydenberg, 2021). Figure 1 depicts this goal, with financial institutions steering for integrated value (IV), which combines financial value (FV), ecological value (EV) and social value (SV).

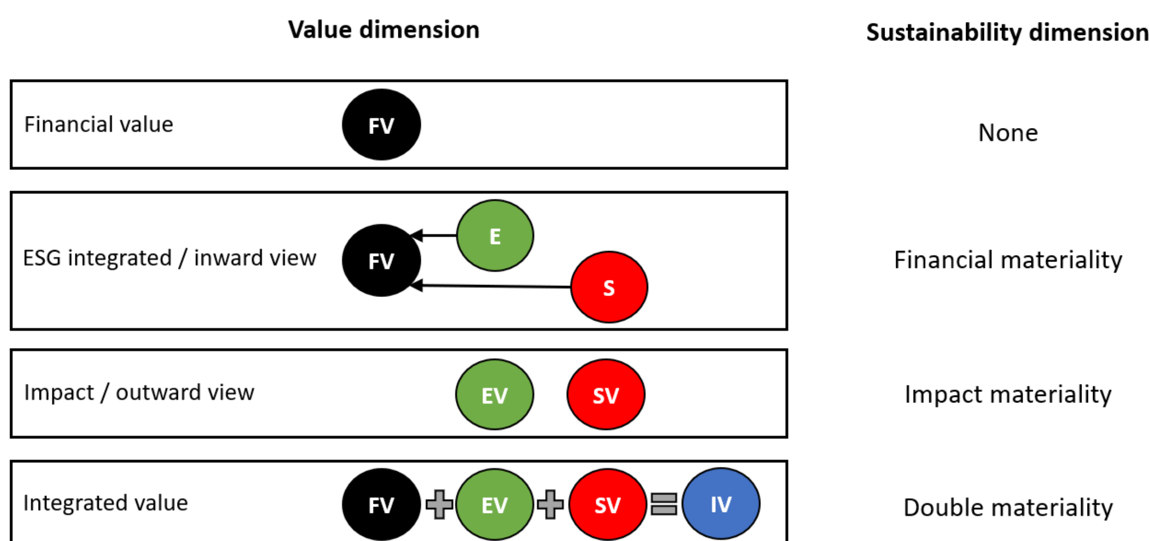

Figure 1: Value and sustainability. Source: Schoenmaker and Schramade (2023)

A. The current framework

The traditional financing framework considers the trade-off between risk and return on an investment or loan portfolio. Risks are measured by looking back: for market risk to historical price volatility; for credit risk to trends in economic growth, interest rates and inflation. This statistical approach assumes that the past is a good predictor for the future (the business-as-usual scenario). In this model, impact is just an add-on (an external factor), which occurs either independently of the maximised return or at its expense ('sustainability costs money'). Impact does not represent a value that is considered when making a financing decision. In this model, negative impact in the form of ESG risk is part of risk management. Limiting the tracking error (deviation from the market index) is a significant risk instrument for investors.

B. A new framework: integrated value optimisation

There are three parts to the integrated value optimisation framework.

ESG risk integration/looking inwards: Ecological and/or social impact is considered a predictor of future risks (transition scenario): negative impact leads to higher risks

(e.g. stranded assets) and positive impact to future-proof business models. This is a dynamic approach in which the impact is internalised, for example through regulations and/or taxes, technological changes; consumer, employee and NGO preferences; or social pressure. Sooner or later, impact is taken built into the price and therefore becomes an endogenous factor.

There is empirical evidence that negative impact is (increasingly) being included in prices in the form of a risk premium (Bolton and Kacperczyk, 2023; Huij, Laurs, Stork and Zwinkels, 2023). Because impact and risk have a negative relationship, expectations for return go down when the impact is positive and go up when the impact is negative. The risk premium then forms the compensation for the transition risk incurred.[1] The lower discount rate for positive impact then leads to a higher financial value, and vice versa. Ecological and social impact therefore work their way into the financial value. Here, the sustainability dimension is the financial materiality.

Impact/looking outwards: Ecological and social impact represent a value and can be measured by multiplying realised quantities actually achieved by a shadow price, which is based on social foundations and planetary boundaries: see Box 1. The measurement is a way of monitoring progress made towards transition goals where the materiality principle is leading. Here, the sustainability dimension is the impact materiality.

Social (S) and ecological (E) factors are expressed in their own units Q (for example, life years saved by medical treatment or carbon emissions from fossil fuel consumption), multiplied by their respective shadow price P, derived from welfare economics. For example, the shadow price for a single life year: €108,000 and the shadow price per 1 ton CO_2 equivalent is €204 (IEF, 2022). The annual value flows (calculated as Q x P) can also be discounted using the discounted cash flow model as the financial cash flow.

The shadow price, derived from welfare economics, is based on the social foundations and planetary boundaries (IEF, 2022; Schoenmaker and Schramade 2023). In this way, financial institutions can guide the transition to sustainable social and ecological systems (Burckart and Lydenberg, 2021).

The financial, ecological and social value are combined to form the integrated value (Schoenmaker and Schramade 2023). Even though the short-term relationship between impact value and financial value may not yet be evident due to the onset and speed of transitions, the long-term perspective is clearer: companies that create integrated value are future-proof, while companies with large externalities are unlikely to survive the transition. Here, the sustainability dimension is the double materiality (financial + impact). The aim is to bring about systemic change – and transition to a sustainable economy (Burckart and Lydenberg, 2021). The key risk in this approach is that the transition does not actually take place and the social and ecological risks manifest themselves. Besides being a goal in itself, a liveable world is also a precondition for achieving future financial returns.

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[1] Not all impacts can be factored into prices immediately (Lo, 2017). When impacts are initially factored in, they may lead to a higher return, after which the expected return decreases.

This approach focuses on the transition to a sustainable economy within planetary boundaries (climate neutrality and circularity) combined with social equity (just distribution). Impact financing uses the integrated value to guide system transitions to: a sustainable energy system; a circular economy with less raw material consumption; healthy food via regenerative agriculture; responsible working conditions in the chain; and equitable distribution.

Investors and financiers can calculate integrated value using a similar discounted cash flows model as is traditionally used (see Box 1), where social and ecological value are analysed at a different (lower) discount rate (Schoenmaker and Schramade 2023). The higher the positive ecological and social value, the lower the total cost of capital.

Box 1 Measuring social and ecological impact

Impact assessment and valuation follow a three-step approach (IEF, 2022):

1 Materiality: Identify which social and ecological factors are material;
2 Assessment: Quantify social and ecological factors in their own units (Q);
3 Valuation: Use shadow prices (P) to give each factor a monetary value.

3. What is impact and what does its holistic inclusion mean in the Dutch context?

This chapter aims to provide insight into what it means to transition from the current two-dimensional financial framework to a holistic framework. We endeavour to provide an initial sketch of a framework and the adjustments in thinking and acting which will be required within the organisation.

A. What is impact?

Impact refers to the social and ecological results achieved by the financial institution's clients (companies who attract financing and companies in which investments are made). The IFC uses the following definition:

Impact investing and lending is an approach that aims to contribute to the achievement of measured positive social and environmental impacts. It has emerged as a significant opportunity to mobilise capital into investments and loans that target measurable positive social, economic, or environmental impact alongside financial returns. A growing number of investors and banks are incorporating impact investments and loans into their portfolios. Many are adopting the SDGs and other goals as a reference point to illustrate the relationship between their investments/loans and impact.[2]

Relevant to our goal is that financial institutions make a conscious choice to invest in or to lend to organisations (private companies and public and semi-public institutions) that intend to generate a positive and measurable impact. This concerns all types of investments and loans: shares (public and private, including venture capital), credit, investment property, and infrastructure. The term 'impact' must be defined properly and should not be used flippantly.[3] As we indicated earlier, generating positive impact is a way of achieving sustainability transitions step by step. However, in practice, transitions usually progress in fits and starts (Loorbach, Frantzeskaki and Avelino, 2017).

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[2] See: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/principles

[3] An example: in its recent greenwashing progress report, ESMA encourages asset managers to clearly state what type of impact they are aiming for in their documentation. A distinction is made between 'buying impact' (impact via investee companies) and 'creating impact' (direct financing of transition activities). See also ESMA30-1668416927-2498 Progress Report on Greenwashing (europa.eu), p.41

B. What does the financial institution need internally to manage on impact?

To enable impact financing (investments and lending) the entire chain must focus on impact financing. Below we offer some concrete recommendations to help organisations make internal changes:

I. Adapt the primary operational processes

Adapt processes to incorporate holistic management on risk, return on investment, and impact. Processes to review include credit/investment process, customer acceptance, credit assessment and credit review.

A key starting point is to clearly define investment and credit principles so these form a good basis for a full assessment. The following three aspects may be considered:

- Assessment framework: Add impact to the assessment framework for risk and return. For example, by including a full long-term assessment in the investment decision making process in which the financial materiality and impact materiality are taken into account. Because harmful consequences of an economic activity cannot be passed on to people, society and the environment for an indefinite period. Sooner or later and in one way or another, these impacts will be factored in to the pricing.
- Management type: Define the preferred investment (and credit granting) methods. Traditionally, this is defined by choosing active or passive investing. This refers to passively following a broad market index or actively deviating from it. For impact investing, it is no longer sufficient to simply follow a broad market index. This also means that the traditional active and passive management strategies are no longer relevant. For example, depending on the investment category, the investment principles can specify a bottom-up buy-and-hold strategy or announce that a specific (non-market-wide) index is created that explicitly incorporates impact. And then the choice can be made to either follow this specific index exactly, or to deviate from it.
- Diversification: Investment principles often include the aim for optimal diversification, which implicitly assumes the largest possible spread. Therefore, for impact investments where investments are more concentrated because more conscious choices are made, ensure the investment principles state what ideal diversification means and include that a limited number of titles can still mean the portfolio has good diversification. At a certain point, adding extra titles will not really add to achieving adequate diversification.

II. Conscious choice on where to invest or provide financing

For investors, this means working from a holistic framework, in which positive and negative impacts in the real world are taken into account alongside traditional criteria, which implies that more conscious choices will have to be made. After all, companies in the portfolio will no longer be selected solely for reducing idiosyncratic risk. This implies consciously building portfolios with potentially fewer entities. More thought must then be given to the knowledge required about the companies in the

portfolio, to assess all the relevant facets of risk, return and impact. For banking financiers this means applying the usual processes to determine with which customers they do or do not wish to do business, and thereby including what impact means and in which cases a customer will be eligible for financing, including the option to exclude customers if they do not meet the criteria. This can also be incorporated into revision processes, which currently mainly monitor credit risk. The baseline assumption here should not be 'what is in the benchmark or general financing market', but which companies make a positive contribution to the transitions. To conduct a sharper debate about the choices to be made, the companies can be roughly divided into three groups:

1. Companies making a positive impact;
2. Companies transitioning to making a positive impact;
3. Companies making a negative impact.

Companies in group 1 may be the subject of financing and/or investments. Companies in group 2 may also be the subject of financing and/or investments, as it is essential to help these companies make the desired transition. Engaging in effective discussions is part and parcel of this. A much more conscious choice will have to be made about whether or not to accept the negative impact of companies in group 3. Phasing out will be the logical consequence for investments and loans in the 'old economy', which cannot make the transition in the long term and therefore will become stranded assets. Some actors in the financial markets are already applying this classification, but the choices made within this structure will have to be much clearer. This requires greater focus on the longer-term consequences of the transitions mentioned above.

III. Ensure the right competencies and resources

The transition from the traditional conceptual framework in which positive and negative impacts on the actual economy are fully included, requires changes to the organisation. Many professionals in the Dutch financial sector were trained in the traditional theory (MPT, Markowitz, etc.) More attention is now being paid to including ESG factors and the number of training courses focusing on the role of sustainability in finance is increasing. However, we are a long way from fully integrating transition and systemic risks into our financial and economic thinking. The lack of clear definitions and data also plays a role.

Changing this situation starts with raising awareness among managers in the financial sector. It takes time and focus to expand knowledge and adapt conduct to gain the required competencies and resources. Mandatory training and setting different, more appropriate goals (KPIs) for employees to adjust conduct will help accelerate the changes required. In this regard, it is encouraging that an increasing number of benchmarks focus on impact, including the Paris Aligned Benchmarks.

IV. Reporting and measuring impact

Ultimately, it is the customers or companies in which investments are made and/or are financed who will make an impact. The financial sector makes its contribution by facilitating the financing and investment. Transparency regarding these inherently indirect impacts and the contribution made by the financial sector are part of this.

The impact of the financing and investment should be measured as clearly and uniformly as possible, to limit the reporting burden in the entire chain.[4] At the same time it is important not to wait for new standards and/or regulations and legislation, but to pioneer measuring and reporting on impact, and to be transparent and learn from the process.

The emphasis of impact reporting should shift from the short term to the longer term (5-, 7- and 10-year perspective) and for investments, reporting should be less focused on tracking errors compared to the benchmark. After all, relative risk measured from only a financial perspective does not give sufficient insight into risks in the real world. Thinking will need to shift from value-based and prosperity-based to future-proof, in line with the integrated value. Measuring impact should be done as holistically as possible (see Box 1), in standard units so comparison is possible and choices can be justified. Aligning with accepted (international) standards which encourage standardisation is a key catalyst.

C. What external enablers are needed to manage on impact?

Regulation: The regulator performs its mandated duties and as such contributes to the task of transition. It would be a political choice to change this, as the interaction with existing tasks is key. (Can the regulator still perform its original tasks just as effectively? In other words, should the regulatory authority's mandate be adjusted?)

Currently, it is the regulator's duty to ensure that all material risks are identified and managed. Investments must be made prudently, in the best interests of clients, policy holders and participants. In addition, the Dutch Central Bank (DNB) is responsible for maintaining financial stability. With this in mind, it can be argued that the regulator is already contributing to the transition in several ways:

- Financial risk: If the companies which are financed by parties are not future-proof, the parties are incurring financial risk. It is part of the regulator's mandate to expect institutions to be transparent about this risk, to manage it and take the risk-return trade-offs into account when making investment and credit decisions.
- Reputational risk: Funds must take their participants' preferences into account and participants increasingly indicate these preferences include ESG factors. In addition, funds must keep their promises and act consistently in accordance with the commitments made to participants. Reputational risk also plays a role for other financial institutions. With the financial sector's commitment to certain sustainability goals (such as the Dutch Climate Agreement), to a certain extent it has – and depending on the exact commitment – also committed itself to actively contributing to positive impact and the transition, rather than simply reducing negative impact. The regulator also has a role to play here given the risks involved.

[4] One way is to relate impact to the global language of the SDGs (although this is not as simple as it sounds), the metrics of the Principle Adverse Impact indicators of the SFDR and/or EU taxonomy (under construction).

- Prudent person principle (PPP): When conducting its duties, the regulator must consider the interests and well-being of the participants or deposit holders. In the broader scope of impact investing and impact credit, this can be seen as the responsibility to not only consider the financial return on investment, but to also consider the world in which the participant or deposit holder ultimately lives.

Currently, the regulator does not apply explicit standards for allocating impact investments and impact loans. According to the regulator, the institution is responsible for justifying their strategic allocation policy based on the prudent person principle (PPP). However, the regulator does look at matters such as the concentration and expects more knowledge and capacity to be allocated to illiquid investments and loans, for example.

- Financial stability: Where financial regulation often focuses on managing or reducing the ESG risks of individual financial institutions, from a systemic perspective it is important to support sustainability solutions financing. The regulator may consider encouraging impact investments and impact loans as a way of reducing systemic risks. Accelerating the transition will decrease systemic risk (see chapter 2).

The following actions can be taken to tighten control:

1. Require investment funds and other financial institutions to use forward-looking risk indicators and scenario analyses rather than a risk indicator based on tracking errors.
2. Require financial institutions to draw up a transition plan.
3. Require financial institutions to include long-term results in their reports.
4. Clearly communicate to the sector that the regulator does not object to impact investments and impact loans.
5. Revise the opinion on concentration risk and illiquidity risk, within the prudent person principle.

Initially, the regulator can stimulate the sector by suggesting best practices (such as those mentioned in the Dutch Central Bank (DNB) guide to managing climate and environmental risks [Gids voor de beheersing van klimaat- en milieurisico's]). The regulator can also draw up FAQs to clearly specify the expectations.

- Policy: Policy uncertainty is a hindrance, yet the sector must continually seek clear direction from the policymaker. This in itself should not be a reason to postpone initiating work on the transition, because otherwise, transition uncertainty will only increase and replace policy uncertainty. However, the sector must insist that the policymaker provides consistent, long-term visionary policies.
- Education: The principle of ‘managing on impact’ should be embedded in education and training, and given a clearer position, so balancing out the current dominant risk-return thinking. Education and refresher courses will then transition from two-dimensional (risk-return) to three-dimensional (risk-return-impact) thinking and methods.

- Critical mass: It is very tempting to start (too) small: a few players start managing a small part of their portfolio on impact. However, in such a scenario, the transitions envisaged will simply not happen (Loorbach, 2022) because the grey companies will still be financed from other parts of their own portfolio and by other players in the financial system. The challenge is therefore to create momentum in which increasingly larger parts of the portfolio will be managed on impact and so encourage other financial players to follow suit. Visible leadership and publicity about the goals achieved on impact and transition will be key.

4. Conclusions

The purpose of this document is to raise awareness in the financial sector of the transition that the sector will inevitably make. To make the transition to a sustainable economy, the financial sector will have to change the way it works. Managing on integrated value will help accelerate the much needed (social and ecological) transitions and make investment and loan portfolios future-proof. Replacing the current two-dimensional risk-return framework with a three-dimensional risk-return-impact framework is crucial if managing on impact is to reach its full potential.

In the current two-dimensional approach, portfolio investment is equivalent to investing in a traditional benchmark and everything that deviates from this is labelled as risk. In Modern Portfolio Theory (MPT), properly diversified portfolios are constructed so they take systemic and transition risks into account (Lukomnik and Hawley, 2021). The same principle applies to financing, in which impact of customers as well as risk and return on investment are taken into consideration. In these three-dimensional frameworks, investors and financiers are pushing towards a transition from ecological, social and economic systems to a sustainable economy. Impact measures the steps from today's unsustainable economy to a future sustainable economy. A similar approach is possible in lending for banking financiers.

This discussion paper contains initial guidelines and principles for the financial sector to manage on impact. In a subsequent phase, these principles can be further elaborated to detail the actions so they become more tangible. The essence is that a group of financial institutions collectively starts managing on impact, to create momentum in the financial sector and eliminate the barrier of being the pioneer.

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