"Impact Investing": Theory, Meet Practice

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The loud buzz of excitement about Impact Investing is cause for concern, but not only because the enthusiasm is ahead of the practice. The practice of so-called "impact investing" lacks clarity of purpose, definition, and results. The often-referenced J.P. Morgan research report, "Impact Investments: An Emerging Asset Class," suggests that the potential market for "impact investing" is "vast."[2] I disagree.

As defined and practiced today, "impact investing" is infinite; it is unbounded, requiring only self-determined good intent to qualify (see Table 1). By that standard, Angelo Mozilo, the failed former Countrywide mortgage mogul, and any number of predatory lenders, qualify as impact investors–many believed they were giving underserved people access to the American dream.[3]

"Impact investing" advocates acknowledge that they are selling more sizzle than steak. To my surprise, most seem pleased about that. But the sizzle has also attracted unwanted attention: more than one "impact investing" champion told me they are concerned about investment managers who are appropriating this new brand category in name only to re-package otherwise standard investments to high net worth investors. This may be a case of making a deal with the devil in the details.

It turns out that the "impact investing" brand is easy to appropriate because its best intentions are not rooted in anything in particular. The parameters of "impact investing" practice are up for grabs and seem likely to go to the highest bidder. As the saying goes, in theory there is no difference between theory and practice, but in practice there is. It is easy to get excited about a promise, but it is unwise, at best, to act on that excitement without a clear sense of what happens when theory meets practice.

The tension between the idea of "impact investing" and its current practice has created a dilemma not only for those who choose to align with it but also for those entities–notably community development financial institutions (CDFIs), their partners, and the people they serve–that "impact investing" advocates have decided to associate with.

1 This commentary is based on comments at the "Advancing Social Impact Investments Through Measurement: New Capital for Community Development" conference held by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of San Francisco, March 21, 2011, in Washington, DC. Sam Coggeshall provided research assistance on this commentary.

2 J.P. Morgan Global Research, "Impact Investments: An Emerging Asset Class" (New York: J.P. Morgan Global Research, November 29, 2010).

3 Not all, however. In 2006 or 2007, on a flight from Los Angeles to Philadelphia, I sat next to a Countrywide executive, who was returning from a corporate strategy session. Countrywide's strategy, he explained, to my horror, was to "make a lot of money off of poor people."

Table 1. What Isn't Impact Investing?

This table, based on examples given in the still-sparse literature describing "impact investing," is meant as a tool to draw a circle around the idea–to help figure out what is "in" the circle and what is not. Taken together, the table seems to suggest that it is all but impossible to exclude anything from "impact investing" as long as the investor's intent is to create a positive impact.

Yield	Impacts	Investees	Investors	Intermediation	Outcomes
Profit-maximizing	Green Real Estate	For-profit	Individuals	Foundations	Jobs
Profitable but not profit-maximizing	Green businesses (innovation, production, distribution)	Nonprofit	Private Financial & Other For-profit Institutions	CDFIs	Improved Social Program Outcomes
Marginally profitable	Education (early care, charter schools, etc.)	B Corps	Philanthropic Institutions	Banks	Education
Breakeven	Affordable housing	Community Investment Cos.	Governments	MFIs	Environmental Sustainability
Philanthropy (100% loss)	Women & minority owned businesses	Government		Investment Banks	Economic Opportunity & Equality of Opportunity
	Social services	Micro-finance Institutions		Social Investment Funds	New Social Enterprise Business Models
	Social Enterprises			None	New investors & investment opportunities
	Other	International & Domestic			Other

I am concerned about the path that "impact investing" is taking because it poses a risk for CDFIs that, in my view, outweighs potential benefits. Because the small body of "impact investing" literature[4] relies primarily on CDFI examples to credential the theory, "impact investing" practice rests heavily on the track record of CDFI lending and investing. If "impact investing" stumbles, falls, or fails outright, it could compromise or damage the hard-earned standing, credibility, and brand that CDFIs have built over 30 years of disciplined work. The further "impact investing's" reputation gets ahead of actual practice, and the longer it stays there, the greater the risk to CDFIs. This does a disservice to CDFIs for three reasons.

First, the unbounded definition of "impact investing" complicates the comparison of assets or impacts.[5] The international emphasis of "impact investing" is also different than CDFIs' domestic focus. So far, the metrics that "impact investing" advocates are developing to measure the practice emphasize breadth over depth. This is important because what gets measured gets done and thus tends to shape the course of future practice. By contrast, the data set on CDFIs[6] is decades deep and tightly defined.[7]

Second, "impact investing" is positioned primarily for investors who want self-defined impact. In contrast, CDFIs work primarily to benefit low-income, low-wealth, and other disadvantaged people–measured by results–and they ask investors to make concessions to that end.

Third, and most significantly for CDFIs, supporters of "impact investing" have publically minimized CDFIs as poor examples of the future of "impact investing" because they believe there are multiple higher-yield investments. Why make a concession when you can have your cake and eat it, too?

Yet CDFIs are performing well and hold significant promise for the people and places they serve. CDFIs specialize in managing risk in distressed markets, an expertise that has

4 See J. P. Morgan Global Research, "Impact Investments"; Rockefeller Foundation, "Harnessing the Power of Impact Investing" (New York: Rockefeller Foundation, 2011), available at www.rockefellerfoundation.org/what-we-do/current-work/harnessing-power-impact-investing/; Rockefeller Foundation, "When is an Investment an Impact Investment?" Impact Investment News Brief #2 (New York: Rockefeller Foundation, June 2010), available at www.rockefellerfoundation.org/news/publications/when-investment-impact-investment; Monitor Institute, "Investing for Social and Environmental Impact," (San Francisco: Monitor Institute, January, 2009); Insight at Pacific Community Ventures and the Initiative for Responsible Investment at Harvard University, "Impact Investing: A Framework for Policy Design and Analysis," January 2011(with support from the Rockefeller Foundation).

5 The robust global microfinance marketplace might align better with "impact investing" but others are in better position to judge that.

6 CDFIs are private0sector financial institutions that share at least two defining characteristics: (1) they are dedicated to benefitting low-income, low-wealth, and other disadvantaged people and places; (2) they are profitable but not profit-maximizing.

7 For insured depository CDFIs—banks and credit unions—the data are deeper, extremely well defined, and hundreds of data points wide. For CDFI loan funds, the data set that is starting to emerge from the CDFI Assessment and Ratings System™ (CARS™) promises new, deeper opportunities for understanding, definition, and practical applications.

been both tested and proven since the financial downturn started in 2008.[8] As stewards of more than $30 billion of predominantly private investments, CDFIs hold themselves to rigorous standards based on data derived from practice–data that are increasingly public and used by investors, policymakers, and practitioners. No segment of the domestic financial services sector has performed more soundly during the Great Recession than U.S. CDFIs.

For these and other reasons, CDFIs are taking on expanded roles in partnership with mainstream financial institutions and government to maximize the flow of responsible, affordable financing in distressed markets. This work may not sizzle but, in the words of Federal Reserve Chairman Ben Bernanke, "providing responsible credit for individuals and small businesses through community development financial institutions can stimulate economic activity that generates local tax revenues."[9]

With so much riding on their work in urban, rural, and Native markets, CDFIs cannot sit quietly on the sidelines while "impact investing" leans on CDFI performance as it finds its way.

About 25 years ago, a young CDFI grew concerned about a younger CDFI in a neighboring state--in large part because they shared investors, including Orders of Women Religious. "If they screw up," the slightly older CDFI's Executive Director explained, "the nuns are going to pull their investments from both of us." Shared risk suggests, at best, mutual accountability. For the time being, at least, "impact investing" is gambling with someone else's assets: CDFIs'. In this way, it is putting low-income, low-wealth, and other disadvantaged communities at risk.

"Impact investing" poses at least two clear risks to CDFIs. First, guilt by association: if the rush toward it is, at worst, a bubble, the inevitable contraction would likely harm CDFIs, their partners, and the communities they serve. Second, opportunity costs: in a rush to embrace "impact investing," investors, policymakers, and practitioners are already forgoing other, more immediately important opportunities. An "impact investing"-led push for a federal program supporting the Social Impact Bond, for instance, muddied the waters in Washington around the CDFI Bond Program created by Congress in 2010.[10] The CDFI Bond Program has the potential to leverage $3 billion in government-backed, long-term debt for CDFIs to finance charter schools, affordable housing, small businesses, and other assets. The CDFI Bond Program is likely to transform how capital flows to benefit low-income, low-wealth, and other disadvantaged people and places.

For their own sake and for others', "impact investing" practitioners need to establish and

8 The "CDFI Market Conditions Survey," a quarterly data analysis of CDFI challenges and opportunities, tracked a surge in portfolio at risk (PAR) and net charge-offs in late 2008. In hindsight, this rise reflected sound, conservative accounting. Both PAR and charge-offs have declined slowly but steadily since.

9 "Community Development in Challenging Times," speech at the Federal Reserve System's Community Affairs Research Conference, Arlington, Virginia, April 29, 2011.

10 To date, there is a single Social Impact Bond transaction in a single place addressing a single issue. Yet impact investing advocates are pushing the White House and Congress for a substantial federal investment in the idea. That, for many decades, is how bad government programs got started. If the Peterborough Prison experiment (the UK test for the Social Impact Bond) is successful—and we won't know for many years—it should be viewed as a single experiment, not an established practice.

consistently enforce a definition, standards, and data protocols that make clear what "impact investing" is and what it is not. A good place to start is to categorize the growing number of self-described "impact investments" as being either "in" or "out." That would give others a basis for judgment. A second priority is to build a sound information infrastructure based on real practice, rather than on theory. The recent arrival of new leadership at the Global Impact Investing Network (GIIN) opens a window to demonstrate commitment to these, and perhaps other, ways of re-framing the field.

So far, the effort to ensure there is a foundation under "impact investing" is lagging behind the promotional bandwagon. Unless practice is used to inform theory, decades of good work done to attract capital to opportunities that benefit society both directly and indirectly, may go to waste. It's possible that "impact investing" is stretching the bounds of social capital–financial innovation at its best. That is its promise, but as yet it is a promise without proof, a theory in search of a practice.

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