About

The 2° Investing Initiative (2DII) is an international, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals.

Working globally with offices in Paris and New York, 2DII coordinates some of the world's largest research projects on climate metrics in financial markets. In order to ensure our independence and the intellectual integrity of our work, we have a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, regulators, policymakers, universities and NGOs.

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Annex 3: Advising impact-oriented clients

Avoiding confusion about the motivation of impact-oriented clients

What impact is

(1) When clients express in a suitability questionnaire a will to "have a clear positive impact on the society and/or the environment with their investments", they signify they aim at achieving a positive "investor impact".

(2) By definition, impact is a change in an outcome caused by someone or something. An impact can be positive or negative, intended or unintended. In the case of impact-oriented clients, the targeted impact is undoubtedly positive and intentional.

(3) Impact is measured in relation to various social or environmental goals. Impact themes are as diverse as impact investors.

(4) Impact is about final outcomes and not about intermediary stages that connect economic activities to real-life outcomes. It is widely accepted to differentiate between concepts of "outputs," "outcomes", and "impacts" of economic activities. "Outputs" are the direct products (in the form of goods and services) of the economic activities. "Outcomes" indicate the positive changes to the social or environmental system generated by the economic activities. Finally, "impact" refers to the portion of the total outcome generated by the economic activities that occurs "above and beyond what would have happened" without the economic activities. Frequently, this requires the development of a counterfactual scenario.

Distinguishing investor impact from investee impact

(5) An impact analysis can be performed for any economic agent, including investors and investees. When applied to investees (companies, governments, etc.), impact becomes investee impact and is the additional outcome to the world caused by the investee compared to a counterfactual (and hypothetical) scenario when the investee would not operate.

(6) Similarly, investor impact is the additional outcome to the world caused by the investor compared to a counterfactual scenario when the investor would not invest. There is a positive investor impact only when his/her investments causally improve outcomes in the theme(s) he/she targets.

(7) Following the distinction between investor impact and investee impact, researchers have advocated for distinguishing between impact-aligned investments (i.e., investments in positive-impact companies that do nothing significant to grow that impact) and impact-generating investments[1]. Only the latter are suitable for impact-motivated clients.

[1] Busch et al. (2021), "Impact investments: a call for (re)orientation", *SN Business and Economics*.

How clients can achieve impact

(8) Investors have several opportunities to generate a positive impact in the real economy through their investing (and lending) activities. They can i) enable “green” companies to grow faster, ii) encourage “brown” enterprises to improve their sustainability performances, and/or iii) influence other investors in their investment decision-making processes[2]. The first two channels are direct and imply improving the impact of investees while the last channel is indirect.

(9) Research has widely documented impact mechanisms available for investors. In particular, the Impact Management Project (IMP) developed a taxonomy of the different investors’ strategies to effectively generate an impact. The taxonomy includes four main investor impact mechanisms, namely (i) signalling that impact matters, (ii) grow new or undersupplied markets, iii) provide flexible capital and iv) engage actively with investees and other relevant stakeholders[3].

(10) The four impact mechanisms can be explained:

- **Signalling that impact matters:** investors can send market and non-market signals that they are committed to impact. Market signals through investments and divestments based on sustainable screening contribute to change the conditions to access capital in financial markets for companies. Investors can also send signals that do not directly affect financial markets but may influence stakeholders through stigmatization (publicly stating opposition to certain companies or industries), endorsement or benchmarking (passively applying benchmark portfolios of companies with the highest sustainability performance);
- **Grow new or undersupplied capital markets:** investors can make a difference by enabling the growth of impactful companies whose growth is constrained by limited access to external financing;
- **Provide flexible capital:** investors can also help impactful companies by offering beneficial financing, for instance by accepting below-market returns, taking subordinated debt or equity or agreeing on custom-made exit terms;
- **Engage actively:** investors may use their privileged position to influence the companies they are invested in through different means (voting at shareholder meetings, dialoguing with management, asking for board seats, etc.).

Which financial products can deliver impact

Various investor contributions

(11) All the above mechanisms should not be considered as equal. A comprehensive review by Heeb and Kölbel (2020)[4] shows that among the four impact mechanisms, signalling is the one whose capability to create positive change in the real economy is the least supported by empirical evidence. The support for signalling comes from mere narratives or theoretical models, while, in contrast, other mechanisms are backed by real-life observations.

(12) They should neither be considered as exclusive. Indeed, it is possible to combine them. The IMP has listed various combinations of impact mechanisms that can be actioned by an investor. They distinguished and ranked 6 combinations, from the least to the most effective. The figure displays those 6 investor contribution categories according to the IMP.

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[2] Kölbel et al., (2020), “Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact”, *Organization and Environment.*

[3] Impact Management Project (2019), *Investor contribution in public and private markets*

[4] Heeb and Kölbel (2020), *The Investor’s Guide to Impact*, CSP Center for Sustainable Finance & Private Wealth.

Figure 1: IMP's investor contribution categories

	INVESTOR'S CONTRIBUTION
1	Signal that impact matters + Engage actively + Grow new/undersupplied capital markets + Provide flexible capital
2	Signal that impact matters + Engage actively + Grow new/undersupplied capital markets + Provide flexible capital
3	Signal that impact matters + Engage actively + Grow new/undersupplied capital markets + Provide flexible capital
4	Signal that impact matters + Engage actively + Grow new/undersupplied capital markets + Provide flexible capital
5	Signal that impact matters + Engage actively + Grow new/undersupplied capital markets + Provide flexible capital
6	Signal that impact matters + Engage actively + Grow new/undersupplied capital markets + Provide flexible capital

Achieving impact in various asset classes

(13) Researchers have highlighted that the impact potential of investments in public (bond or equity) markets is limited in comparison to investments in private markets[5]. By nature, investments in public markets cannot achieve the highest investor contributions as they cannot address new/undersupplied markets (since they target large companies) nor propose flexible capital (compared to market terms). They are restricted to do, at best, signalling and shareholder engagement.

Achieving impact through sustainable strategies

(14) In practice, sustainable financial products are not designed to conform to any of the specified impact mechanisms or combinations. They instead apply various typical sustainable strategies.

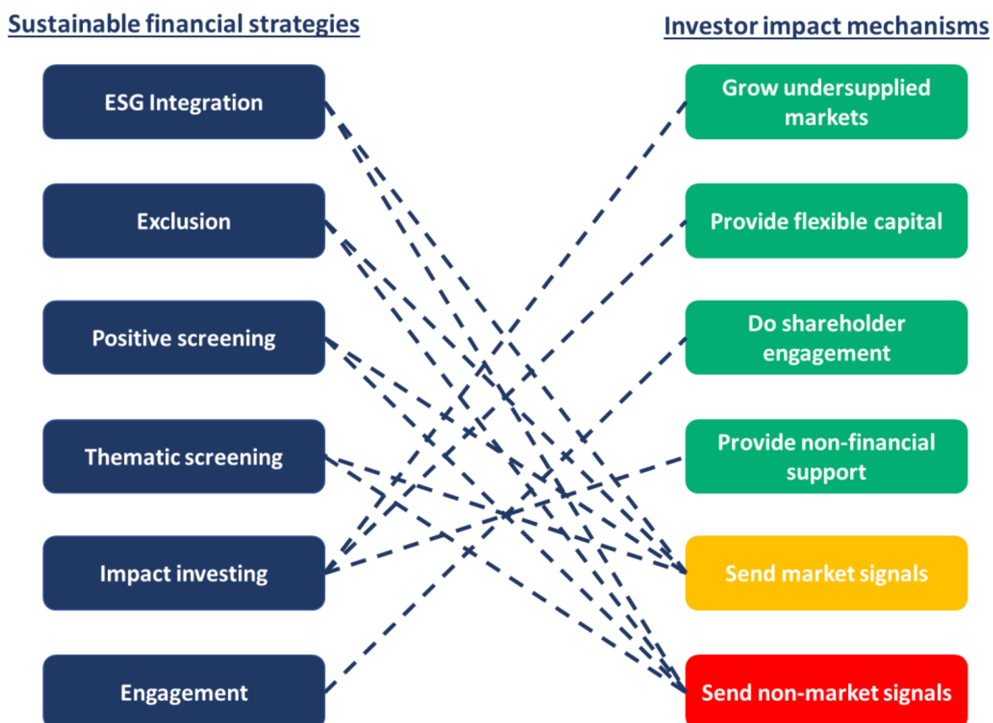
[5] Caldecott et al. (2022), *Sustainable Finance and Transmission Mechanisms to the Real Economy*, Oxford Sustainable Finance Group.

(15) For instance, the Global Sustainable Investment Alliance in its biannual Global Sustainable Investment Review considers seven sustainable common strategies and provides estimates of total assets managed using the strategies. These strategies are:

1. NEGATIVE/EXCLUSIONARY SCREENING: the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria;
2. POSITIVE/BEST-IN-CLASS SCREENING: investment in sectors, companies or projects selected for positive ESG performance relative to industry peers;
3. NORMS-BASED SCREENING: screening of investments against minimum standards of business practice based on international norms, such as those issued by the OECD, ILO, UN and UNICEF;
4. ESG INTEGRATION: the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis;
5. SUSTAINABILITY THEMED INVESTING: investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture);
6. IMPACT/COMMUNITY INVESTING: targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose;
7. CORPORATE ENGAGEMENT AND SHAREHOLDER ACTION: the use of shareholder power to influence corporate behaviour, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

(16) By nature, those strategies may action some of the previously described impact mechanisms more or less intensively. Figure 2 shows which impact mechanisms are intensively actioned by the different strategies. They can also lever other mechanisms in a more minor way.

Figure 1: main impact mechanisms activated by sustainable financial strategies

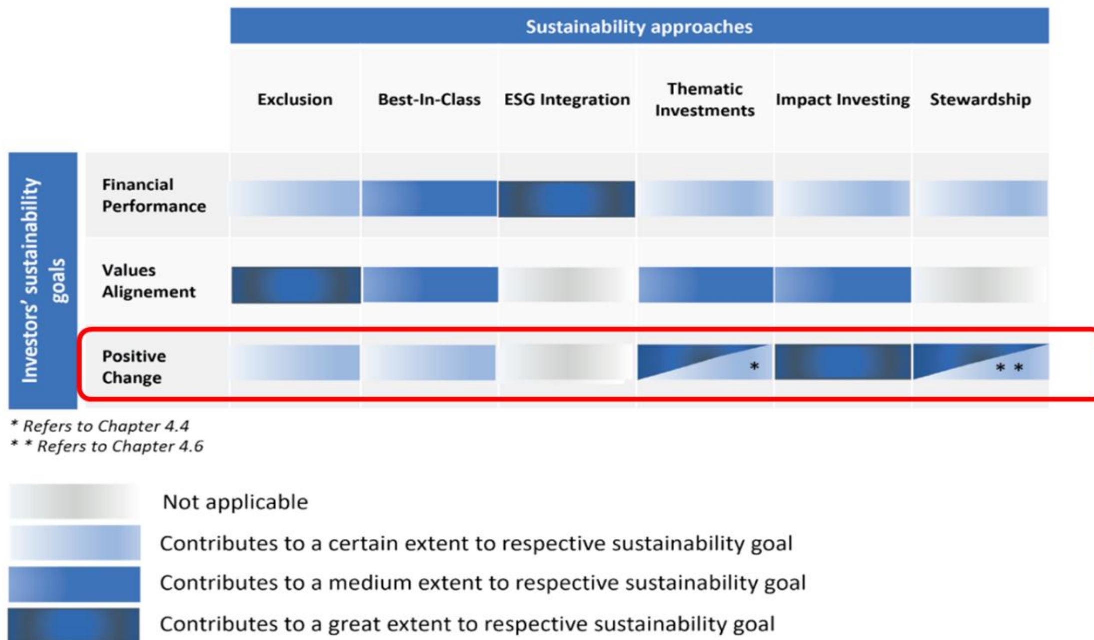


(17) Looking at the figure 2, one can easily note that most of the mainstream sustainable financial strategies (excluding engagement and impact investing) only action impact mechanisms that are only weakly supported by academic evidence, namely market- and non-market signalling.

(18) As such, the capacity of those sustainable strategies to deliver impact has been considered to be poor by researchers. For instance, in a paper about greenwashing in sustainable finance, the Swiss Asset Management Association (2021)[6] concluded that products using ESG integration, exclusion or positive screening were contributing to a minor extent or not at all to the impact goal of some retail investors, unlike stewardship (engagement) or impact investing products[7].

(19) Regarding thematic investing, they varied their conclusions based on the asset class in which the strategy is implemented. They consider the potential of thematic investing to deliver impact to be minor in public markets but more significant in private markets, where private equity or private debt investors can encourage young companies with sustainable solutions to grow by providing fresh capital. Said differently, in private markets thematic investment often grows undersupplied markets aside of sending market and non-market signals.

Figure 2: matching matrix between sustainable strategies and investor sustainability goals



Source: Swiss AMA (2021)

How impact interacts with return

(20) Research has not yet clarified the relationship between investor impact and financial returns. Nevertheless a few pieces can be brought to illuminate the relationship.

[6] Swiss Asset Management Association (2021), *How to Avoid the Greenwashing Trap.*
[7] Exclusion or positive screening can deliver real-world effects only if multiple conditions are met. First they require similar and simultaneous actions of a large number of investors to significantly affect market prices. Second, the market price change needs to trigger the expected behaviors by targeted companies' managers, which is not straightforward. Therefore, those strategies imply a high impact risk (i.e., the risk of not delivering impact).

(21) According to surveys of impact investors, a minority of concessional impact investors (i.e., who accept below market returns for achieving positive impact) coexist with a majority of non-concessional ones[8].

(22) According to financial theory, asset returns do not reflect impact but risk. Consequently, there should be no obvious relationship between impact and financial returns at least if impact is not related to risk. But impact may become related to (transition) risk when the legislator starts reflecting on imposing taxes on negative externalities (like carbon emissions).

(23) Some impact strategies are costly by nature, either in the form of increased implementation costs (engagement) or overpaid asset purchases (signalling)

(24) But impact strategies may also lead to positive financial performance as observed for successful ESG engagement campaigns[9] when it changes the market perception of the engaged company. In a similar vein, price signalling can turn beneficial for impact-motivated investors if their purchases are followed by purchases of trend-following investors.

(25) Finally, it can be added that even if it may not be necessary to be concessional to have a positive investor impact, all things equal investor impact is mechanically enhanced when the strategy superimposes the provision of concessionary capital on top of other impact mechanisms.

Impact-oriented financial products do not report… impact

Missing impact information

(26) So far, 2DII's internal desk research shows that most (if not all) impact-oriented financial products do not assess their investor impact.[10] At best, they assess and communicate about real-life outcomes of their investees. On some occasions, those investee outcomes are assessed and communicated vs targets.

(27) Impact-oriented financial products systematically neglect two crucial dimensions of impact assessment. First, they abstain from isolating the portion of the total outcome generated by their investees that occurs "above and beyond what would have happened" without the investees' actions. Whether done quantitatively or qualitatively, this would require the development of a counterfactual scenario that they do not provide. Second, they do not make the walk to the final step of impact evaluation in the financial context, which is about evaluating the investor impact by segregating the portion of investees' impact that could be attributed to the investors' actions through the financial product. Here again, this would require the development of a counterfactual scenario that is missing.

The looming risk of impact-washing[11]

(28) Several years ago, the Rockefeller Foundation warned that if a certain level of rigor in impact measurement is not established across the industry, the label "impact investing" runs the risk of becoming diluted and used merely as a marketing tool.[12]

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[8] GIIN (2020), *Annual Impact Investor Survey*.
[9] Barko et al. (2021), "Shareholder Engagement on Environmental, Social, and Governance Performance", *Journal of Business Ethics*; Bauer et al. (2022), "Private Shareholder Engagements on Material ESG Issues", *Working paper*.
[10] 2DII (2021), Sustainable finance and market integrity: promise only what you can deliver
[11] Regarding the prevention of impact washing in marketing claims, 2DII is currently leading, together with ADEME, and under Finance ClimAct project , a French working group producing a guide on environmental impact claims in the finance sector. 2DII is also leading a European working group under Level EEI project to improve the regulatory framework related to greenwashing (including impact washing).
[12] Reisman, J. and Olazabal, V.(2016), *Situating the Next Generation of Impact Measurement and Evaluation for Impact Investing*, The Rockefeller Foundation.

(29) Impact investing without a serious impact evaluation, is it still impact investing? Or is it another version of feel-good sustainable finance products that help investors (superficially) align their savings with their stated values? Alongside the International Finance Corporation[13], in absence of credible information about achieved impact, we are tempted to call such investments value-aligned too and consider them as misleading by default. Indeed, research (not yet published) by 2DII shows that when asked to say what an "Impact Fund" should be in order not to mislead investors, 15% of European retail investors say it should only display the intention to have impact, 25% it should display the intention and implement relevant actions, 42% it should display intention and adequate actions and positive achieved outcomes. The most common answer integrates the provision of information about investor impact.

(30) Despite the importance attributed to measurement within impact investing, researchers pointed out an "impact paradox" in the field, which is characterized by the lack of attention and agreement on accepted evaluative approaches[14].

(31) This has led to an ironic situation within the impact investing industry: the premise of 'doing good' has led to increasing claims of social impact by investors, and yet measuring impact has been a low priority for many impact-oriented product manufacturers.

(32) Even if past achieved impact would not ensure future impact, the absence of measurement of investor impact by impact-oriented financial products prevents the impact-motivated client to have access to an additional piece of information (alongside the description of the impact strategy and actions deployed by the product) that could increase trust in the ability of the product to deliver the targeted impact.

[13] IFC (2019), *Creating Impact - The Promise of Impact Investing.*

[14] Caseau & Grolleau (2020), Impact Investing: Killing Two Birds with One Stone?, *Financiaal Analysts Journal*; Kah and Akenroye (2020), "Evaluation of social impact measurement tools and techniques: a systematic review of the literature", *Social Enterprise Journal.*

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The Finance ClimAct project contributes to the implementation of France's National Low Carbon Strategy and the European Union's Sustainable Finance Action Plan. It aims to develop tools, methods and new knowledge that will enable (1) savers to integrate environmental objectives into their investment choices, and (2) financial institutions and their supervisors to integrate climate issues into their decision-making processes and align financial flows with energy and climate objectives.

Finance ClimAct is a first-of-its-kind program with a total budget of €18 million and €10 million in funding from the European Commission.

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