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Financial innovation and the poor

A place in society

Sep 25th 2009 | NEW YORK
From The Economist print edition

You might suppose that financial innovation had done enough damage. But bankers, investors and philanthropists believe it can help the world's poor

Acumen Fund

MANY nodded when Lord Turner, the City of London's chief regulator, said recently that the financial industry had grown "beyond its socially useful size". The idea that devices such as collateralised debt obligations and credit-default swaps have been a blessing, not least by allowing the less well-off to buy houses, is in tatters: lots of those new homeowners have lost their houses as well as their jobs. It is remarkable, then, that the crisis should have given fresh impetus to "social finance", a movement based on the belief that financial innovation can be used directly to help society's neediest people.

Two events this month should give believers in social finance a lift. On September 1st nearly 900 people, from institutional investors to social entrepreneurs, gathered in San Francisco for SoCap09, a conference dedicated to building "social capital markets". The event was abuzz with novel ideas such as a "social stock exchange" and "sustainable hedge funds".

And on September 25th, at the meeting of the Clinton Global Initiative in New York, the Global Impact Investing Network (GIIN) was due to be launched. This is, in effect, a commitment to create a new asset class—impact investing—yielding a financial return alongside a social or environmental benefit. The network's 20 or so members include big banks (Citigroup, Deutsche Bank, JPMorgan), philanthropic institutions (such as the Bill & Melinda Gates Foundation and the Rockefeller Foundation), the Acumen Fund, which invests charitable donations in firms supplying health care, clean water and so forth in Africa and India, and Generation Investment Management, a green-tinged fund manager co-founded by Al Gore.

GIIN and tonic

The GIIN's goal is to share information on what works and what does not, to agree on common language and measures of performance, and to lobby for helpful laws and regulations. The creation of just such an organisation was a priority set out earlier this year in a report by the Monitor Institute, the research arm of Monitor, a firm of management consultants. If this group succeeds, the report argued, within five to ten years impact investing could grow to $500 billion, around 1% of the world's total assets under management in 2008.

The rising interest in social finance is the product of several trends. First, the financial industry and its clients spy a way of making money and doing good at the same time. Many impact investments are in emerging economies, which are expected to grow faster than developed ones. They may be uncorrelated with other assets and thus offer diversification and reduced risk. Impact investments such as the Calvert Community Investment Note (a bond) have performed relatively well during the recent crisis, fuelling demand for them. Bankers also detect a chance to give their image a badly needed polish. Philanthropy plays a part too—especially, it seems, for super-rich investors.

Second, more people want to do well by doing good. Specialised intermediaries have sprung up, including several "social investment banks", such as Total Impact Advisors, which is supported by Calvert Foundation, a pioneer of impact investing, and Social Finance, recently founded in Britain. Social-enterprise clubs are now among the biggest student organisations in leading business schools.

Third, there is a growing demand for private capital and skills to be tapped to supply the basics of life and to get small businesses going. Government spending and philanthropy are not enough. Fourth, governments are providing encouragement. America's controversial Community Reinvestment Act stimulated investment in poor neighbourhoods (too much, critics say). The State Department is expected to give financial support for the GIIN's efforts to create useful measures of social impact. The British government has given tax breaks and introduced more helpful regulations for private investment in social projects, as recommended by the Social Investment Task Force it established in 2000. In the Netherlands legislation has encouraged green investing.

Social investing is not new. People have been practising it for years. Perhaps the commonest form has been to apply an ethical screen to a portfolio, filtering out the securities of tobacco firms, arms companies, casinos, big polluters and other sinners. The merits of this are disputed; it may do more to make investors feel good than to make companies do good. But according to the Monitor Institute, almost $7 trillion of assets are screened in some way.

The other main forms of social investment have been "community development" (especially low-cost housing), microfinance (loans and other financial services for the poor) and "clean" technology. Community investment grew at an annual rate of 22% in America in 2001-07, reaching $26 billion. It has been picking up in Europe, too. Microfinance has grown even faster. The total volume of microloans went up by 44% a year in 2001-06, to $25 billion. Clean-tech investment soared by 60% in 2007 alone, to $148 billion—although it has since slipped because of the financial crisis and because cheaper oil made alternative energy less alluring.

What is new is the interest of mainstream financial institutions and investors. Microfinance has been a particular inspiration to the GIIN set, because what was once a charitable activity has become, in some instances, a highly profitable business. More and more microfinance institutions are tapping conventional capital markets through securitisation, arranged by banks such as Citigroup, and even share offerings. Compartamos Banco, a Mexican microfinance firm that became a for-profit company after starting as a charity, had a hugely successful initial public offering in 2007. Sequoia Capital, a prominent Silicon Valley venture-capital firm, is likely to profit handsomely from its investment in SKS, an Indian microfinance company that is expected to float shares soon.

A growing number of investors are trying to repeat the microfinanciers' success, but in equity rather than loans. One example is IGNIA, an investment firm founded in 2007 by Alvaro Rodriguez Arregui, a former chairman of Accion, a non-profit network of microfinance institutions that did nicely from its stake in Compartamos Banco, and Michael Chu, formerly of Kohlberg, Kravis & Roberts, a blue-chip private-equity firm. IGNIA is raising a $75m fund, which it plans to invest in for-profit businesses in areas such as basic health care (it has already backed Primedic, a Mexican clinic chain), organic food, housing, water purification and energy. Another example is GroFin, which invests mostly in African small businesses. It was incubated by the philanthropic arm of Royal Dutch Shell, a giant oil company, but has since turned commercial. In 2008 it established its biggest fund by far, which had $170m at final closing.

Acumen Fund

Tapping social finance

A more innovative idea, perhaps, is the "social impact bond", the brainchild of Social Finance. The idea is to attract private capital into solving a deep-rooted problem that is soaking up public money. Take, for example, reoffending by released prisoners, which costs the British government millions of pounds a year. A social-impact bond could raise money to pay for the expansion of organisations with the expertise to reduce reoffending rates. The more money the organisations save the government, the higher the return the bond would pay investors. This goes beyond a standard public-private partnership, which is expected to provide the same service as the state, but more cheaply. The social-impact bond would reward better social outcomes and not merely cut costs.

Social Finance thinks that the social-impact bond could be tried out in several public services. Besides being used to tackle reoffending, it could reduce the need for children to be put in residential care, or improve community-based health care, easing the strain on hospitals. The key is to measure performance clearly, so that contracts can be enforced. "With government budgets increasingly tight, this could be a major innovation," says Sir Ronald Cohen, who made his money in private equity before chairing the Social Investment Task Force as well as the commission, backed by charities, that proposed the creation of Social Finance.

Similar ideas are getting attention around the world. Notably, several efforts are under way to replicate an international finance facility for immunisation known as the GAVI bond. This was created in 2006 to allow the Global Alliance for Vaccines and Immunisation, a partnership of public and private sectors, to borrow against government promises of future aid to fund vaccination programmes. So far it has raised more than $2 billion. The World Sanitation Financing Facility has been created to devise financial structures to enlist private investment in seven areas from public toilets to fertiliser production.

The financial industry may be providing the rocket science, but the backing of rich philanthropists is an essential source of fuel. The Rockefeller Foundation has been the principal force behind the creation of the GIIN. Meanwhile, the Gates Foundation, a keen supporter of the GIIN, has begun an experiment in using financial innovation to generate extra investment in its favoured causes. The foundation has created a $400m facility to see if various innovations can entice considerably larger sums (two to five times as much) from governments and private investors to help the organisations to which it gives grants. These innovations do not count as conventional gifts or as loans. They are contingent liabilities against the foundation's balance-sheet, which in effect cost nothing except in some worst cases.

One idea is to provide a guarantee to charter schools issuing bonds, helping other investors overcome what may be excessive risk aversion. Or the foundation might provide insurance against the non-payment of aid promised by a donor, so that a government will know that, one way or another, the money will come. It is also looking for innovative ways to encourage private-equity and venture-capital investments in, say, infrastructure projects in countries where it is making grants.

The foundation hopes this will encourage other providers of capital to overcome their fears and put their money at risk. Alex Friedman, its chief financial officer, says: "We want to show the private capital markets that there is money in this, that it is a sustainable business." The new approach will "let the foundation operate almost like a merchant bank for the poor", a model it believes can be widely imitated.

Whether this idea and the GIIN initiative will succeed remains to be seen. Measuring social impact, for instance, is difficult but necessary. Some investors have naive expectations of the sorts of risks and financial returns of investing in, say, small and medium enterprises in developing countries, says Shari Berenbach, the chief executive of Calvert Foundation—though she sees potential in impact investing.

Sir Ronald is optimistic. “This reminds me of private equity in the early 1980s, just before it started to grow,” he says. It was only when the disparate private-equity firms got together and formed a network that things really took off, not least because they began to standardise and speak with one voice to regulators about what the industry needed to thrive. He hopes the same will now be true of impact investing. As a participant in the GIIN puts it, the real test will be “whether people put their money where their mouth is. Will you see deals done together?”