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What Every Insurer Needs to Know About Impact Investing

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Impact investing is generally defined as investments in "companies, organizations and funds with the intention to generate social impact alongside a financial return" (Global Impact Investment Network). Insurers looking to make a difference in the lives of underserved populations but lacking the tools or competencies to launch micro-insurance initiatives may consider impact investing as an alternative way to participate in the financial upside of social impact. Micro-insurance itself could be considered an impact investment of sorts, but financial instruments such as social impact bonds (SIBs) present a potentially more convenient way for insurers to get their feet wet with impact, while still learning how to address the challenges of underserved populations domestically and abroad.

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A BRIEF PRIMER ON SOCIAL IMPACT BONDS

In an SIB, investors arrange with charities to fund services so as to achieve prespecified targets such as care for elderly with multiple chronic conditions, improving health of homeless youth, and so on. If these targets are achieved, the grantor (usually, a government) will repay principal as well as a healthy return to investors—but nothing if targets are not met. SIBs are not bonds in the traditional sense, they're "a hybrid instrument with some characteristics of a bond (e.g., an upper limit on returns) but also characteristics of equity with a return related to performance" (Social Finance 2014).[1] In many cases, a special purpose vehicle (SPV), or a subsidiary company, is established whose operations are used for the exclusive acquisition and financing of the service, and to receive investments and make outcome payments. The SPV can also issue contracts to service providers to deliver the intervention. As health and social care systems face the challenges of rising demand (due, for example, to an aging population) and severely constrained resources[2], social investors and financial intermediaries see the SIB sector as an area of growth and opportunities.

SOCIAL CONTEXT OF IMPACT INVESTING

An important factor to consider in evaluating impact investments such as SIBs is the social context in which they are borne. Examples include:

- **Economy.** The financial crises of 2008 substantially "reset" many existing economic and business models. Governments faced diminishing budgets and social problems were exacerbated.[3] Impact investing privatizes part of the welfare state during turbulent times.
- **Demography.** Ever-aging populations in developed countries create increased need for care of the elderly by the private sector. At the same time Millennials comprise an increasingly large share of the population that believes that their work should be for improving society and not just for money.[4] These attitudes were reflected in the recruitment stage of Big Society Capital which is a financial institution based on impact investing. The number of candidates and rejection rates suggested Big Society's roles were more in demand than ones at traditional investment banks.[5]
- **Polarity.** Oxfam showed that the top 1 percent own more than the remaining 99 percent.[6] We also have a historically high Gini coefficient, which is a metric for measuring economic inequality.[7] We are witnessing the development of differential modes of treatment of populations, where an emerging tendency is to assign different social destinies to individuals in line with their varying capacity to live up to the requirements of competitiveness and profitability. Taken to its extreme, this yields the model of a "dual" or "two-speed" society recently proposed by certain French ideologists[8]: the coexistence of hyper-competitive sectors obedient to the harshest requirements of economic rationality, and marginal activities that provide a refuge (e.g., SIBs and micro-insurance) for those unable to take part in the circuits of intensive exchange.

In one sense the dual society already exists in some markets in the form of negative externalities such as unemployment. Processes of disqualification and reclassification have traditionally been effects of the mechanisms of economic competition, underemployment, adaptation or non-adaptation to new jobs, etc. Attempts to reprogram these processes are often addressed to infrastructures rather than to people[9]—leaving their personnel to adjust as well they may, sometimes not particularly well,

to these "objective" exigencies. Impact investing embraces these challenges as opportunities.

BUSINESS MOTIVES

In the case of SIBs, if the desired social results are not achieved, investors lose all of their investment. More generally, challenges of mixing profit and social motives explicitly include:

- There are a number of parties involved in an impact investing initiative so agency problems can arise as well as high transaction cost.
- Social metrics are devilishly subjective and it is quite difficult to objectively assess whether performance metrics have been achieved or not.
- Initiating SIBs is a complex and time consuming task, potentially deterring would-be participants and demanding well-designed SIB contracts.
- Political risks such as a change of government, a change of policy, and overly bureaucratic processes affect an SIB, and can deter service providers and investors.

Because of these, impact investing has not become prevalent and is limited to high net worth individuals and a few institutions aiming for corporate social responsibility.[10]

However, the benefits of impact investing are tantalizing. In the case of SIBs, the grantor only pays for programs that work. This result-oriented approach avoids the "black hole" where fetching funding potentially trumps addressing actual impact on ground realities of the target population. This benefit can potentially be felt to a gigantic magnitude if aid to developing countries becomes structured in this way. For example, aid is only provided when social objectives have been achieved instead of bolstering corrupt politicians and potentially making limited impact[11] to the target population. Early intervention on ineffective initiatives can potentially save huge amounts of human capital and prevent multitudes of social problems that can potentially arise in the future. The vigorous evaluation and transparency improves the rate of learning which is crucial for today's fast moving dynamic society, leading to more effective initiatives in the future.

PROPERTY AND CASUALTY AND IMPACT INVESTING

Impact investing presents challenges and opportunities in P&C insurance. Investment income has rock bottomed in recent years due to very low interest rates and insurance companies, among others, are actively seeking to diversify to alternative investments such as impact investing in pursuit of higher returns. However, specific challenges for P&C insurers include:

- **Loss of principal.** While in theory SIB is a hybrid equity, an SIB is practically more like an over-the-counter derivative which is not actively traded on any stock exchanges, cannot be transferred for capital gains, and risks loss of entire investment. This is not the same as beta investing of index tracking. While indices crash, they do not reach zero levels. SIBs hence can deliver alpha wounds if social objectives are not met.
- **Diversification.** CAT bonds have been successful in part because they are not correlated with economic performances and so deliver potent diversification benefits centered around natural catastrophes instead of the economy. Social problems, on the other hand, increase and worsen in times of global economic crises. When the economy is worsening and insurers need profits more direly, social problems can worsen and lead to collapse of performance metrics of SIBs.
- **Alternatives.** The main competition to SIBs is providing micro finance to the target population[12], which offers a potentially shorter return period. Another competitor is corporate social responsibility—which, for example, Allstate did by lending its data scientists to city of Chicago to check and improve food quality in restaurants in the city.[13]

P&C insurers may consider discussing their investment interests with financial institutions focused on impact investing. These institutions can help tailor investments with objectives of the company in mind and within constraints of impact investing. However, much more capital can be infused in impact investing from traditional private equity firms because they are more experienced in subjectivity, loss of all principal, lack of trading and other drawbacks that make SIB less friendly for consumer or commercial investments. Aside from investment banks and private equity firms, multinational insurers (systematically important insurers) and global reinsurers can potentially provide initiative and funding to launch a number of other SIBs. Reinsurers in particular have a reputation of being bearers of innovation[14] and it should not be any different for SIBs and impact investing.

The success in practice of SIBs as a tool for achieving better social outcomes in a cost-effective manner has yet to be fully validated. Specifically, SIBs have not been around for long enough to assess whether the results will justify the high expectations of their promoters. But enough has been learned about their complexities to inform those who are following the leading countries. For example, lessons drawn for the development of the SIB market in New Zealand[15] include: the importance of incorporating political risks into contractual arrangements; preventing political or bureaucratic risk aversion (the fear that a pilot SIB might fail or cause embarrassment) from unduly stifling delivery freedom; avoiding monitoring regimes that impose burdens on service providers that unduly impair their capacity to achieve performance targets; and ensuring that government laws and regulations do not unnecessarily inhibit the development of private initiatives to develop SIBs independently of government. As SIBs and other impact investment avenues evolve based on these lessons learned, they are likely to become an increasingly attractive investment option for investors, including insurers. ■

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ENDNOTES

1 Policy Innovation Research Unit (PIRU), Department of Health Services Research and Policy London School of Hygiene and Tropical Medicine, and *RAND Europe*: "An Evaluation of Social Impact Bonds in Health and Social Care."

2 Ibid. The demand for social investment in the U.K. has been estimated as likely to reach £1billion by 2016, a third of which is expected to be in the field of health and social care (Boston Consulting Group 2012).

3 Ibid.

4 *The Guardian*; Medeleine Evans; 21 March 2014: Shift in career values means millennials in finance jobs want more than money. Available at: *fortune.com/2015/09/30/america-wealth-inequality/*

5 Ibid.

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12 *Next Billion.com.* Manuel Bueno. "The Competitive Relationship Between Mainstream and Micro Finance Banks." Available at: *http://nextbillion.net/competition-between-mainstream-and-microfinance-banks/*

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