Preparing for Impact:

Five Ideas to Maximize the Potential of Impact Investing

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While governments at every level – local, state, national – determine how to meet fundamental needs with constrained resources, impact investing continues to mature into a vehicle for innovative, socially oriented enterprises. The convergence of these two macro-level developments can create opportunities for stakeholders and communities. States, in general, and New Jersey, in particular, can harness impact investing's potential with policy decisions focused on fostering a climate hospitable to the burgeoning field.

Borrowing directly the Global Impact Investing Network's definition, "Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return." [1] This admittedly capacious description suits an asset class bound by fairly broad parameters, within which fit the more passive practice of negative screening along with more complex instruments, such as Pay-for-Success. An equally diverse assortment of participants – institutional investors, foundations, high-net-worth individuals, entrepreneurs, nonprofit organizations, governments – engage in a space canopied by a shared aspiration: to do well by doing good or to achieve a return with a "double-bottom line." As the U.S. National Advisory Board on Impact Investing states in its 2014 report, "It's a simple idea with profound implications." [2]

Impact investing can trace its origins to such informal endeavors as nineteenth-century anti-slavery economic activism and to more formal ventures as the 1977 Community Reinvestment Act. The modern iteration remains relatively fresh, with the Rockefeller Foundation first applying the term in 2007.[3] In 2009, Jessica Freireich and Katherine Fulton of the Monitor Institute posed, "The pressing question is whether impact investing will remain a small, disorganized, underleveraged niche for years or even decades to come – or whether leaders will come together to fulfill the industry's clear promise."[4]

In answer to that question, recent years have witnessed significant commitments to impact investing by major global players, such as the Ford Foundation, and by multinational and national bodies, notably with the G8 Social Impact Investment Forum in 2013 and with the U.S. National Advisory Board on Impact Investing in 2014, as well as its evolution into the U.S. Impact Investing Alliance. As for dimension, according to the *2016 Global Impact Investor Survey* prepared by J.P. Morgan Chase and the Global Impact Investing Network, respondents held $77.4 billion in impact-investing assets in 2015, having devoted $15.2 billion to 7,551 deals that year and projecting a 16-percent increase to $17.7 billion the following year.[5]

Impact investing has reached adolescence, continuously gaining strength and retaining enviable flexibility, able to bend in any number of worthwhile directions. Thoughtful government policies can help guide the industry toward mutually beneficial outcomes.

Regarding impact investing, David Wood writes, "It can't just be the market,"[6] while the U.S. National Advisory Board on Impact Investing affirms, "Government plays a vital role."[7] Quite simply, the social-financial hybrid character of impact investments leaves them uniquely dependent on the public sector's participation. Progress with impact investing appears most pronounced where the government has adopted a cooperative, supportive posture, aspiring to what Cathy Clark, Jed Emerson and Ben Thornley have termed "policy symbiosis."

A review of the federal policies that shaped the community-development landscape – the New Market Tax Credit, the Low-Income Investment Housing Tax Credit and the Community Development Financial Institution Fund – offers an instructive analogue.[8] To a somewhat lesser magnitude, the federal government has taken steps to nurture impact investing, issuing new regulations around Mission-Related Investments and the Employee Retirement Income Security Act in 2015, as well as Program-Related Investments in 2016.[9] Not equipped with the same regulatory apparatus, states nevertheless can put forth an agenda calibrated to their own governance capabilities.

New Jersey, in particular, stands as a prime candidate to capitalize on the rise of impact investing, due both to negative and positive factors. The state sits atop a shaky fiscal foundation, ranking 50th in the nation in PwC's State Financial Position Index.[10] At the same time, New Jersey confronts multiple social challenges, many of which mirror those already highlighted by impact investors in other locations. For example, according to the United Way of Northern New Jersey's ALICE study, 37 percent of the state's households struggle to afford basic necessities.[11] New Jersey also wrestles with one of the country's highest rates of long-term unemployment.[12] If any state should begin to map alternative avenues to solving problems, it is New Jersey.

Fortunately, the state can claim inherent strengths with respect to impact investing. New Jersey owns a vibrant philanthropic community, with the tenth-highest number of foundations in the nation (2,856), entities that held $24 billion in total assets (ninth in the nation) and distributed $3.9 billion annually (fourth in the nation) as recently as 2014.[13] Additionally, Prudential – one of the state's most prominent corporate partners – has distinguished itself as an international leader in impact investing, having pledged to construct a $1-billion portfolio by 2020.[14]

With an awareness of natural advantages and with an eye toward policy symbiosis, New Jersey can advance an agenda to actualize impact investing's promise to deliver results creatively and cooperatively. To this end, the state can proceed with the following five ideas, which in no way argue for being exhaustive or beyond revision:

- ✓ appoint a council to author and advise on statewide strategy;
- ✓ establish a catalytic first-loss fund;
- ✓ introduce a tax credit for impact investments;
- ✓ enact Pay-for-Success legislation; and
- ✓ aggregate and publish relevant data.

✔ Appoint a Council to Author and Advise on Statewide Strategy

As has occurred nationally and internationally, New Jersey can legitimize and prioritize impact investing by empowering a collection of proponents and collaborators to elevate the sector in the state. Formed by the Governor and stationed within the New Jersey Economic Development Authority, the council's composition of volunteer members would reflect the diversity of impact investing, with representatives from government, business, nonprofits and foundations. Initially charged with authoring a statewide strategy within an immediate timeframe, such as six months, the group would transition into an enduring operation, lending expertise to the management of New Jersey's impact-investing policy portfolio.

As Antony Bugg-Levine writes, by "offering coordination to a highly fragmented market," a government-sponsored body would delineate the social and environmental concerns on which New Jersey would concentrate, identify existing impediments and recommend modifications favorable to the industry's growth.[15] This approach echoes the advice of the U.S. National Advisory Board on Impact Investing, which calls for a "third party to develop a public framework" within which to assess and enhance continuously the regulations, policies and incentives influencing the impact-investing market.[16]

New Jersey already houses a model within its own borders. The Strong Healthy Communities Initiative (SHCI), formed in 2011 with backing from the Prudential Foundation, focuses on improving systematically the quality of life of Newark's children. Led by participants from the business, government, philanthropic and nonprofit communities, SCHI works to introduce innovative, market-oriented solutions to historically intractable issues in the city's neighborhoods.

Extending elements of the SHCI to a state-level council would position New Jersey to – in the words of Katie Grace, John Griffith and Brenna McCallick – announce the "legitimacy of impact investing as a financial tool for the creation of social and environmental good – one that enjoys the support of the highest-level officials and private sector leaders – and that such activity has a powerful role to play in national agenda setting."[17]

✔ Establish a Catalytic First-Loss Fund

However valuable a government's efforts to bolster impact investing through regulations and technical assistance, the risk-return analysis ultimately governs most transactions.[18] By not only acknowledging this reality, but also by mitigating the risk through the provision of catalytic first-loss capital (CFLC) – by "putting the first dollar on the table"[19] – the public sector can facilitate further investment in social ventures.

As a credit enhancement, CFLC functions as a loan or security below those held by other investors. If a default should occur, senior debt holders would receive repayment before the return of the CFLC, thereby improving the risk-return relationship for the capital markets. In this respect, CFLC succeeds as leverage, a smaller sum of public dollars strategically deployed to attract larger amounts of private financing.

Several instances demonstrate the effectiveness of CFLC. In one case, the California Endowment, J.P. Morgan Chase Foundation and the U.S. Treasury's Community Development Financial Institutions Fund committed $7.5 million in first-loss grants to California Freshworks Fund, a financing intermediary to expand the availability of healthy food options to underserved locales in the state. The first-loss contribution spurred the investment of an additional $125 million, including $100 million from commercial capital investors.[20]

Of course, the employment of CFLC can raise concerns, such as the injection of a moral hazard or a distortion into the market; however, structuring agreements with clear expectations, investment limits and high degrees of transparency could preempt a number of questions.[21]

New Jersey can stimulate impact-investing deal flow through the establishment of a catalytic first-loss fund, initially in an amount of $5 million per year, with the option to enlarge the total up to $50 million based on execution and demand. Housed within the New Jersey Economic Development Authority, the fund would support projects that clear recognized benchmarks, while maintaining the ability to blend its dollars with those from foundations or other qualified partners, all toward the end of boosting the viability of socially purposed initiatives among conventional financiers.

✔ Introduce a Tax Credit for Impact Investments

Governments can alter tax policy to encourage investment in selected issues and geographies, a practice not without critics.[22] Over the years, federal departments and agencies have disseminated tax incentives to seed the community-development terrain. For example, the New Markets Tax Credit has sparked $31 billion of investment and $118 billion of economic activity in low-income areas since 2000.[23]

The U.S. National Advisory Board on Impact Investing's 2014 report suggests a number of federal tax adjustments "to influence greater participation in the impact investment field,"[24] such as classifying impact-related write-offs as charitable deductions. In this vein, a state can tilt tax policy in favor of impact investing, such as by lowering rates for impact enterprises or reducing the capital gains tax for certain investments.

As an initial stride, New Jersey can introduce an impact investing tax credit similar in scope and structure to the Angel Investor Tax Credit, which provides a 10-percent credit – up to $500,000 – against the corporation business tax or gross income tax for an investment in an emerging technology business. Just as the Angel Investor Tax Credit seeks to funnel capital to industries recognized as consequential to the state's economic future, e.g., biotechnology, renewable energy, etc., a tax credit for impact investments could steer capital toward firms registered as benefit corporations – or "B Corps" – businesses pursuing environmental or social missions in concert with their for-profit interests.

A tool complementary to other efforts in the social sphere, a tax credit for impact investment could act to reroute capital otherwise slated for traditional destinations by offering an incentive familiar to the investor community. An analysis conducted for the City of London in 2013 concludes tax relief for investors would feed an "unmet appetite to invest for social purpose" and would send a "signal that social investment can be a suitable element of an investment portfolio."[25]

✔ Enact Pay-for-Success Legislation

The Pay-for-Success (PFS) model – or social impact bond (SIB) – is a dynamic impact-investing instrument, a transactional, public-private collaboration aimed at accessing capital, encouraging innovation, dispersing risk and prioritizing outcomes. According to the design, a government entity interfaces with private investors to provide up-front funding to a third party to implement a program geared toward the achievement of a specific social goal, such as reducing recidivism or assisting the homeless. The agreement among the parties contains clear metrics, which, if met and validated by an independent agency during the established term, result not only in demonstrable progress, but also in cost savings. Based on a calculation of the financial and social value associated with the outcome, the investors derive a return: however, should the initiative fall short of projections, the investors do not receive payment.

Theoretically, PFS transactions hold appeal as mediums through which public bodies can accomplish desired objectives with limited budgets and without absorbing the full force of the risk. Moreover, the contractual, data-driven conditions impose strict accountability measures on the undertaking.

The attractiveness of PFS has spawned interest and action in domestic and international locales. Following the first SIB in 2010 – the recidivism-reduction plan at Peterborough Prison in the United Kingdom – 11 nations have launched 43 SIBs with an aggregate investment surpassing $215 million.[26] In the United States, several states have pursued PFS in such areas as early childhood development, foster care and housing,[27] with the activity ranging from the fully executed Adolescent Behavioral Learning Experience program at Rikers Island in New York to the authorization to study further the concept in Maine.[28]

Of course, the momentum behind PFS should not distract from legitimate risks. Foremost, the Rikers Island attempt failed to hit its targets.[29] General uncertainty also shadows a marketplace without standardized templates and a robust record of success.[30] To dwell too heavily on such points threatens to overlook the very nature of investing, even in a traditional sense, in which capital allocation occurs without the guarantee of a return. Moreover, even without necessarily fulfilling quantitative ambitions, PFS does permit policy experimentation without taxpayer exposure and can promote ancillary social enhancements, including service integration[31] and preventive intervention.[32]

Unlike several other states, New Jersey has yet to institute a statewide PFS mechanism, although both chambers of the legislature approved a pilot program in 2014 (S2710/A3289) and again in 2015 (S452/A2771), only for a gubernatorial veto to halt the measure on each occasion. The New Jersey Social Innovation Act would establish a five-year, $15-million loan program to reduce public health costs by attracting private investment to preventive care. Managed by the New Jersey Economic Development Authority and aided by a newly formed body – the New Jersey Social Innovation Study Commission – the "social innovation loan fund" would issue guarantees to qualified nonprofit and for-profit enterprises to execute according to clearly articulated metrics for health services, including how the interventions would result in savings for the state. The New Jersey Economic Development Authority, which could pledge up to 100-percent of a loan under a cap of $3 million each year, would solicit grants from philanthropic and private sources to capitalize the fund.

The state can build on the recent approval of the New Jersey Social Innovation Act by advancing similar legislation to activate PFS for the delivery of human and social services, while simultaneously outlining a bold vision. An updated proposal could preserve from the previous versions those features that account for a number of the associated taxpayer risks, specifically the designation as a pilot program, annual thresholds and the installation of an oversight component that underscores "economic feasibility" in arriving at decisions. At the same time, New Jersey can set the target of igniting $100 million in overall PFS activity within the five-year period of the enabling legislation. Such a construct would erect a state platform on which actors interested in social-financial engagement could begin to work, the possible benefits of which appear to outdistance the costs.

✔ Aggregate and Publish Relevant Data

Data are one of government's most valuable resources. Public bodies continuously collect facts and figures on the effectiveness of services and the status of the population. A state, like New Jersey, can augment its value proposition to impact investors by making high-quality, up-to-date, relevant information readily available.[33]

Traditional investors operate in an environment where financial and operational performance indicators drive decisions. Impact investing invariably adds complexity to an evaluation, introducing socially oriented considerations to a standard calculus. An investor must weigh elements that fall outside the columns and borders of a balance sheet. To replicate aspects comparable to those in private markets, state government can avail its accumulated statistical knowledge to "help identify both where there are gaps in services and where there is effective demand for investment," according to David Wood and Katie Grace.[34]

By developing a database that draws evidence from departments and agencies, New Jersey can lower the barriers that might deter a transaction, publishing estimates of the associated costs and savings earned through interventions, per the U.S. National Advisory Board on Impact Investing.[35] Over time, the state could analyze the information with its sights on the evolving discipline of social impact assessment, rendering statistics not only more accessible, but also more useful.

The database eventually could serve to lift impact investing in New Jersey to a more comprehensive and sophisticated plane, one on which the various participants would operate with universally accepted regulations, measurements and reporting systems.

NOTES

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[16] U.S. National Advisory Board on Impact Investing, 25.

[17] Grace, Griffith and McCallick, 6.

[18] Wood.

[19] U.S. National Advisory Board on Impact Investing, 6.

[20] Amit Bouri and Abhilash Mudaliar, "Catalytic First-Loss Capital" (New York, NY: Global Impact Investing Network, 2013).

[21] *Ibid.*

[22] Bruce Bartlett, "Spending Through The Tax Code," *Forbes*, May 28, 2010.

[23] Ronald Phillips, "Impact Investing and Community Development," *Maine Policy Review* 25.1 (2016): 63-71.

[24] U.S National Advisory Board on Impact Investing, 35.

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[27] *Ibid.*

[28] National Conference of State Legislatures, "Social Impact Bonds" (Washington, DC: NCSL, 2016).

[29] Jim Parsons, Chris Weiss, and Qing Wei, "Impact Evaluation of the Adolescent Behavioral Learning Experience (ABLE) Program" (New York, NY: Vera Institute of Justice, 2016).

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[35] U.S. National Advisory Board on Impact Investing.