The Financial Inclusion Centre

Financial markets that work for society

Making a return or making an impact?

A new approach to defining social impact and sustainable finance and identifying impact washing

Mick McAteer John Lappin

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Summary report

It is hard to avoid the terms impact and sustainability in the world of finance nowadays. The financial sector constantly tells us it is no longer just about making profits or generating returns for owners and investors; it says it wants to make a positive social impact, too.

The financial sector claims that private finance[1] can be deployed more to: tackle social harms and enhance social good; invest in core infrastructure and levelling up so easing pressure on public finances; and improve standards of corporate behaviours on social issues such as diversity and inclusion, human rights, fair wages, ethnicity and gender pay gaps. Politicians champion a greater role for private finance in meeting social and public policy goals.

This report challenges the claims about social impact and examines whether making an impact is indeed given the same priority as making financial returns. The report concludes that it is far too easy for financial institutions to impact wash their activities. It is too easy for conventional return-prioritising finance to masquerade as social impact or sustainable finance.

We argue for a more robust approach to distinguish between finance that: prioritises making a measurable positive social impact; socially sustainable finance which makes a positive impact while making financial returns; socially neutral finance which at least does no harm; and finance that continues to cause social harm. We propose a set of six tests to enable that distinction.

Defining social sector assets, social impact and sustainable finance

Social impact or sustainable finance incorporates sustainable development goals (SDGs).[2] It is the S in ESG[3] and, along with environmental issues, it is referred to as 'people and planet'. Yet these constructs do not properly convey the extent to which finance has redefined its role in the economy and society and, in doing so, created new opportunities to generate financial returns while bolstering corporate reputations.

A whole new category of monetizable *social sector assets* has emerged because of the growing interest in ESG related concepts, and the financialisation of the economy and society. The state (central and local) is limiting its role in funding affordable housing, health, social care, specialist education, and other public services. Private finance seeks to fill that gap and also play a bigger role in funding core public infrastructure, regeneration and 'levelling up'. Financial sector trade bodies have successfully lobbied for financial deregulation[4] and pushed for corporate welfare[5] to make this social sector asset class even more commercially attractive.

Note that we do not comment on political decisions on public spending. That is outside the remit of our work. However, we do highlight the consequences of using private finance to fund policy goals.

[1] This incorporates insurers, pension funds, banks, asset managers, private equity and so on – any provider of finance, or intermediary that influences the allocation of finance to companies, projects, and so on ventures (the assets).
[2] Take Action for the Sustainable Development Goals - United Nations Sustainable Development
[3] Environmental, social, governance
[4] The Solvency UK 'reforms' are undoubtedly a weakening on prudential rules for insurers. The main insurance lobby group, the ABI, welcomed these reforms claiming this would allow it to invest in levelling up, social infrastructure, and the green transition Solvency II reform welcomed by insurance and long-term savings industry | ABI Phoenix urges solvency reforms to unleash £50bn for UK economy (ft.com)
[5] Corporate welfare includes states or other non-market actors 'de-risking' financial commitments or providing financial incentives.

For this analysis, we use a broad definition of social asset finance that incorporates: finance claiming to influence corporate behaviours on social issues; finance linked to SDGs; development, catalytic, and blended finance; finance deployed to tackle social harms such as poverty, exclusion, lack of affordable housing, and ill-health; and private sector funding of public policy goals such as building core infrastructure, regional development, and levelling up.

Social impact washing

If the history of finance tells us anything, it is that 'harm follows the money'. We are concerned that, as the wider sustainable finance market grows, opportunities for impact washing have also grown. Yet, impact washing does not receive the same degree of scrutiny as its 'twin', greenwashing.

Social impact washing includes financial institutions: making misleading claims about the contribution made to social policy or sustainability goals; seeking reputational reward for just doing what is acceptable on social issues rather than going beyond expectations; and rebranding conventional return-seeking finance as social impact or sustainable finance.

For return-prioritising financial institutions, the social sector is just another asset class to be considered during the investment decision process. The primary goal is to generate market returns and/or obtain corporate welfare to protect commercial interests. It is no different to investing in, say, the construction, technology, or pharmaceutical sectors to generate financial returns for investors and shareholders.

This is not a criticism. Financial institutions are not charities. They exist to make returns for investors and shareholders. The difference with social impact washing is that financial institutions can obtain a double benefit – generating market returns (sometimes underwritten by corporate welfare) and obtaining a reputational and marketing benefit and further commercial advantage for doing so.

Impact washing can happen because conventional return-seeking finance can masquerade as social impact or sustainable finance; the supposed benefits of deploying private finance to meet social and public policy goals have not been properly scrutinised; and the standards used to assess financial institutions' influence on corporate behaviours are not robust and are inconsistently applied.

Worryingly, the Financial Conduct Authority (FCA) flagship sustainable investment label[6] is unlikely to hold financial institutions to account for impact washing[7] and could actually enable impact washing. The lack of robust standards and scrutiny applied to the market undermines the efforts of those financial institutions that do want to make a real difference and the integrity of the market generally.

The Six Tests

This report sets out six tests which can be used to evaluate the social impact of finance and challenge claims made by financial institutions. The tests can be used to rate individual social sector assets or to produce a composite rating of portfolios of assets including pension funds, insurance funds, investment funds, bank loan books and so on. The six tests cover:

Forgoing market returns – The first test we apply is: what is the primary purpose of committing finance to a company or venture[8] - making a market return or making an impact? Of course, it can be both. But, if generating a market return is a prerequisite before committing finance, we would argue

[6] Sustainability disclosure and labelling regime | FCA
[7] or greenwashing for that matter
[8] investing in, lending to, or insuring a company/ venture

this is not true social impact finance. Note that we would say that return-seeking finance could still be classified as ethical or socially sustainable if it drives the highest standards of corporate behaviour – see below. Or if the returns generated are then used for explicit social purposes – e.g. if a charitable foundation invests in listed companies to generate the assets for grant making. This test is set to identify the 'purest' social impact finance. There is a more general point here. Most finance can be said to be having an impact. For example, investment in technology or pharmaceutical companies undoubtedly has an impact on our lives. Yet we wouldn't classify this as *social* impact finance. So, we need to clearly delineate finance which has social impact as its primary goal and finance which treats social assets as just another financial asset from which to make returns.

The role of corporate welfare – Corporate welfare includes financial commitments being deregulated, 'de-risked', or incentivised by governments and others such as non-governmental organisations (NGOs). Corporate welfare is a transfer of *value* from the state or other non-market actors to financial institutions, investors, and shareholders. It is a transfer of *risk* from private sector financial institutions, investors, and shareholders to the state and other non-market actors. It is known as socialising the risks, privatising the rewards. Poorly designed financial models that generate market returns and involve corporate welfare are redolent of the controversial private finance initiative (PFI) and public private partnerships (PPP). We would argue that financial institutions that avail of corporate welfare should not brand that finance as social impact or sustainable. Again, in this case, the primary goal is protecting the commercial interests of financial institutions providing the finance, not social impact.

Standards of corporate behaviour – The term *social impact* suggests going beyond sustainability or ESG finance to have a significant, measurable impact on social goals. Yet, the current approach to ESG finance generally, and the Financial Conduct Authority (FCA) labelling regime (see below) allows financial institutions to gain a reputational advantage for just doing what society expects on social goals. For example, they may restrict their investments to companies that comply with acceptable standards on human rights, fair wages, and working conditions in supply chains. That may be welcome, but does it deserve special recognition? We would say special recognition should be reserved for investing in companies that, for example, have top quartile performance on social issues such as paying fair wages, ethnicity and gender pay gaps, diversity and inclusion in the workplace, supply chain behaviours, and human rights. Powerful financial institutions need to be held to higher standards on social impact. By way of analogy, with the Honours system ordinary citizens receive an OBE or CBE only if they go beyond what is expected by society, not for just doing the minimum expected.

The Do No Harm Principle – Social impact finance should follow the do no harm principle. That is, finance which produces a positive social impact in one area should not cause harm in another. Or finance which supports one social goal should not undermine another.

Social sector assets - Financing 'social sector' or 'inclusion' assets (e.g. social care, social housing, education, levelling up, and community lending) should not be automatically classified as social impact or sustainable finance unless the other conditions are met.

Development finance - Development finance, such as lending to or investing in Low or Middle Income Countries (LMICs) or deprived areas of UK should not be automatically classified as social impact unless the other conditions are met. For example, private finance which makes generating a market return or receipt of corporate welfare a prerequisite before committing that finance should not be considered social impact finance. The same approach should apply to 'catalytic' or 'blended' finance models.

Applying the tests

Existing ESG and sustainability ratings use a two-stage approach. First, the constituent assets are rated, which then allows for a composite rating of funds, portfolios, loan books, financial products, and financial institutions. We propose a similar structure. The difference is the input tests we propose to rate the constituent assets are more challenging. We think this would give a more objective assessment of the overall social impact performance of financial institutions.

Applying the tests, we propose that assets should be classified into four grades:

- **Focused Social Impact assets:** The highest-grade assets that pass all the relevant tests.[9]
- **Social-Sustainable assets:** Assets can generate a market return, but the company/venture passes the other tests relevant to its corporate activities and meets the highest standards of corporate behaviour[10] without relying on corporate welfare.
- **Social-Neutral assets:** Assets generate a market return but do no harm. Note that 'do no harm' in this instance means complying with a recognised *acceptable* standard on corporate social responsibility. This would not imply that financing these corporate assets is deemed to be having a *positive* social impact, it just does no harm.
- **Social-Negative assets:** Specific assets could also be evaluated to determine if they are causing or contributing to social harm. A clear example might be companies using suppliers that do not comply even with basic standards on human rights, fair pay, or employment rights. This would be the social equivalent of climate harming activities.

These names are not intended to be used for communication purposes. They convey different levels of intent and degrees of compliance with social goals. The tests can used to rate the financing of specific assets – for example, if an insurer invests in 'affordable' housing and claims to be making a social impact. Most finance is now 'pooled' so the tests can also be used to produce a composite or aggregate rating for: a financial institution's overall performance; collective or pooled finance such as pension, insurance, investment and private equity funds, and loan books; and financial products/funds aimed at retail consumers. Examples are included in the report.

The tests and ratings can be used by individuals, financial advisers, financial institutions, pension fund trustees, managers of charitable and endowment funds, NGOs and civil society,[11] and ratings agencies. The tests can also be used by civil society and media to challenge claims about social impact and sustainability.

There is much riding on the FCA's new sustainable label regime. It is the regulator's flagship intervention in the sustainable finance field. The FCA's labels conflate environmental and social goals. The regulator's approach relies far too much on self-regulation and disclosure. Firms will have too much leeway on defining investments as sustainable. The FCA is not going to approve the use of a label by an investment firm or require independent verification. Indeed, we fear the FCA's label regime will enable social impact washing and greenwashing.[12] The new regime will be difficult to

[9] For example, Test 6 which relates to development finance would not be relevant for investment in social sector assets which is covered by Test 6.
[10] For example, measured against the most robust standards developed by trades unions and NGOs on workers' rights in supply chains
[11] Those with important governance roles such as trustees can assess their own social impact performance as well as that of external investment managers.
[12] For a full explanation of the flaws in the FCA regime, see: Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre

enforce. The tests proposed here could enable civil society and the media challenge investment firms that use the FCA's sustainable investment labels to promote and market funds and hold the regulator to account.

We argue above the term *social impact* should be reserved for finance that is willing to accept a below market return. However, the FCA labels will be used by investment firms intending to generate market returns for clients who also want to take sustainability into account. To accommodate this, we propose that assets in portfolios which fall below the Social-Sustainable grade should not count towards the 70% threshold of qualifying assets that has to be met for a fund to use a label.[13]

These tests would set a higher bar for using the terms *social impact* or *sustainable* finance than is currently used in the market. The bar does not seem unreasonably high to us. To be clear, we are not saying that private finance which does not meet all the relevant tests is 'bad' finance. It will be for users to determine how strict they want to be when screening financial activities as the tests can also be aligned with users' own expectations of social impact and sustainability. However, we hope that these tests will provide a much more challenging process for screening financial activities that claim to be social impact or sustainable.

Policy recommendations

We also make a series of recommendations to embed higher standards and accountability into the social impact and wider sustainable finance market:

- The FCA and other regulators should have a clear strategy for combatting social impact washing separate from greenwashing. Social impact should have its own specific sustainability label.
- The asset minimum to attract an FCA social sustainability label should be the 80% threshold used in other major financial jurisdictions.
- Robust social impact standards should be rapidly rolled out to pensions and other financial activities not limited to investment funds.
- A comply or explain approach which relies on disclosure is not sufficient. The FCA should establish an approved list of independent social impact benchmarks. Firms should be required to choose from this approved list when making claims about social impact or sustainability.
- The FCA's labelling regime and the wider approach to sustainability assessment and reporting relies far too much on self-regulation by financial institutions. We urge civil society organisations to develop and agree a 'gold standard' for financial and corporate behaviours on social issues. Compliance with this gold standard should be independently verified.
- UK policymakers should develop a regime to allow evaluation of offshore and overseas funds given the international nature of finance based in the UK.
- UK policymakers should consult with civil society organisations and investors to develop a similar framework and tests for concepts such as development finance, catalytic and blended finance that are targeted overseas.

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[13] To use a sustainable label, 70% of the assets in a fund must meet a sustainability objective (environmental or social). The other 30% should not conflict with that objective.

About The Financial Inclusion Centre

The Financial Inclusion Centre (FIC) is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

Promoting system level change

Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

Ensuring households' core financial services needs are met

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform. We focus on households who are excluded from, face discrimination in, or are underserved by financial markets and services.

For further information please contact:

Mick McAteer
Co-Director
Financial Inclusion Centre
mick.mcateer@inclusioncentre.org.uk, or mickmcateer92@gmail.com

Financial Inclusion Centre
2nd Floor, 113-115 Fonthill Rd, London N4 3HH
www.inclusioncentre.org.uk
Non-profit organisation, Company limited by guarantee
Reg Office 19 Albion Road, London N16 9PG
Company no: 06272007, Vat No: 144925501