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Climate and Money: Dealing with 'Impact Washing' and a Case for Climate Impact Bonds

Introduction

Climate change disrupts national economies and negatively impacts communities, with the poorest and most vulnerable people most affected. Responding to climate change requires collective action from the public and private sectors. But public sector finance can meet only a fraction of the trillions of dollars needed for climate mitigation and adaptation. More significant amounts of private sector finance are required. Any increase in finance may lead to a greater emphasis on impact investing and climate impact bonds, which could also raise the risk of 'impact washing'. These and other issues are briefly addressed in this summary of an IEU-produced chapter for the 2020 Global Handbook of Impact Investing.¹

Impact investing

One route for securing additional private sector resources is impact investing. Impact investing aims to generate positive, measurable social and environmental impact alongside a financial return. As one of the largest global climate funds and an operating entity of the financial mechanism of the United Nations Framework Convention on Climate Change, the Green Climate Fund (GCF) has an explicit private sector focus related to climate finance. The GCF is mandated to finance private sector climate change activities at the national, regional and international levels. It does this through flexible financial instruments such as grants, debt, equity and guarantees.

The challenge of mitigating impact washing

The impact investing industry is increasingly aware that public institutions face challenges when leveraging resources. Specifically, the measurement of impact in impact investing lacks rigour. This can lead to accountability and transparency gaps and

'impact washing' – the tendency of impact investments to claim social and environmental results not directly due to the investment.

Theory-based impact evaluations can combat impact washing by establishing logical impact pathways and considering results. Such evaluations require counterfactual frameworks, measurable metrics and evidence-based communication of impact. Such approaches can help measure the causal attributable impact of an investment. It can also help impact investing gather momentum by credibly measuring and reporting evidence-based impact and avoiding occurrences of impact washing.

Definition and measurement challenges

Central to making an impact investment is the investor's aim to seek environmental, social, and governance returns. Hence, in addition to evidence of their financial return, investors will often require proof that the investment achieved its social and environmental goals. Therefore, impact measurement plays a salient role in the industry precisely because, unlike financial returns, there is no objective numeraire to measure social, environmental or climate returns in the absence of rigorous measurement.

Impact investing is increasingly seen as able to unite a government or a multilateral organization's aim of realizing social goals and its capacity to bear risks with the private sector's ability to leverage resources, construct incentive-compatible contracts and manage returns on investment. This has led to a range of different terminologies and investment types, such as sustainable investing, ethical investing, and community development finance.

Social and environmental impact measurement

The recent growth in the impact investing industry has prompted discussions about social and

¹ The citation for the chapter discussed in this brief is: Jyotsna Puri, Aemal Khan and Solomon Asfaw (2020) "Climate and Money: Dealing with 'Impact Washing' and a Case for Climate Impact Bonds", *Global Handbook of Impact Investing: Solving Global Problems Via Smarter Capital Markets Towards A More Sustainable Society*, edited by Elsa De Morais Sarmiento and R. Paul Herman

environmental impact measurement. There is a widespread belief the industry has many measurement standards fraught with methodological and implementation difficulties. Still, while social impact measurement remains an ill-defined concept, it is broadly understood to refer to the quantified environmental, economic and social changes attributable to impact investments. Given this understanding, **social impact measurement must focus on a change caused by the investment.** The change would not have occurred in the investment's absence. Meanwhile, as noted earlier, **impact washing occurs when social and environmental impacts are incorrectly attributed to the investment.**

There are many reasons why measurement methods have not yet fully dealt with impact washing. The people who verify the impacts are often the same people issuing the bonds, creating an obvious conflict of interest. As a result, impact investing arbiters draw up "performance contracts" or "output contracts" that measure activities rather than actual social or development outcomes. This indicates a lack of communication and a common language between the impact investing sector and the evaluation community. Also, robust impact measurement is undermined by perverse incentives in the industry that "dumb down" or diminish what impact means and how it is tracked and measured.

Overall, this absence of credible measurement is due to a poor understanding of (i) what impact truly means, (ii) the cost of sophisticated measurement methods and (iii) investors' wariness of assessing hard-to-measure nonfinancial impacts. Ideally, measurement should be more than just assessing base and end lines. It should be about understanding what would have happened without the investment. This requires applying counterfactual methods, which include experimental and quasi-experimental methodologies.

Climate impact bonds

Climate impact bonds (CIBs), like impact investments, refer to investments with climate-related outcomes. Although CIBs use some of the

structural aspects found in impact investments, they are different. For example, rigorous measurement addresses the accountability gap seen in many impact investments. Also, CIBs can achieve scale as they guarantee the return of principal to investors and incentivize service providers to ensure greater success in securing impact outcomes and, thus, financial gains or savings.

Challenges

Investments that positively impact people and the planet have existed for decades and continue to scale up globally. Investments in microfinance, low-income housing, and green technology have become widespread. The future of social and environmental impact investment looks promising. Nevertheless, challenges remain. The first is the chasm of language and concepts between investors and practitioners who develop and apply impact instruments and evaluators or assessment professionals who design and implement measurement and reporting systems. Frameworks such as principles for responsible investing exist, but there is still a considerable accountability gap in measuring and reporting impact investments, including their transparency.

The second challenge is to identify a balance between the convergence of approaches and standards and continued innovation. Strong and credible impact measurement requires greater coordination and co-ownership between the impact investing sector and the measurement and evaluation community. Unfortunately, these two worlds seldom intersect. The collaboration will bridge the gulf between investing with impact and evaluating with rigour.

The third challenge concerns how genuinely organizations pursue robust impact measurement approaches to credibly inform social, environmental or climate objectives alongside financial returns. Unless there is a push to measure meaningful impacts, the impact investing industry will remain nascent. One way to encourage better impact measurement could be through closer collaboration with multilateral agencies, as they often can apply greater pressure and demand responsible investing.

