Social Finance at Scale: Creating Value for Investors

BNY MELLON | Invested

Social Finance

— investments that generate financial returns and include positive social and environmental impact.

BNY Mellon has been helping apply capital to social change for more than 225 years. It began with a loan to a fledgling government undertaking a large social experiment: The United States of America and democracy. We continue to think about the potential for investments to enable positive change today. The size and complexity of current environmental, social, and governance issues facing the global economy have motivated us to assess the market structure in order to address these issues, highlight some of the challenges to greater and more effective deployment of capital, and propose ways to address those challenges. We seek to answer: why hasn't social finance caught on in the past and what is needed to extend and broaden the recent growth?

Investments we make today can influence the extent to which future generations will be able to live within the boundaries of our resources and social systems. At BNY Mellon, we're focused on the role that investors play as a source of capital to address economic, social, and environmental problems. However, portfolios need to serve financial goals. Social finance — investments that generate financial returns and include positive social and environmental impact — should offer investors an opportunity to protect and grow their financial assets in the face of a shifting global landscape, as well as to support solutions to some of the world's toughest problems. Investment professionals in social finance are familiar with a number of global challenges and associated statistics, as are most mainstream investors[1], but it is worth noting their diversity and size. Here we reiterate the importance of global social, economic, and financial trends, define our social finance universe, and present attributes of attractive social finance products.

We then identify challenges and barriers to realizing social finance at scale, and propose five categories of actions to overcome these challenges going forward. Results stem from our own insights, sponsored research conducted by Business for Social Responsibility (BSR), and conversations with dozens of mainstream and social finance investors. Of the five action categories to address challenges to scale, four address barriers that appear to be preventing more capital from being allocated to social finance: **accessibility**, **measurement**, **transparency**, and **systemic change**. We believe the fifth category, **collaboration**, will be a key ingredient to the overall success of growing social finance. Within these five categories, we distinguish 12 specific recommended actions that are especially applicable to large, broad financial services firms such as BNY Mellon. We are addressing many of these actions in our product areas and within other activities at BNY Mellon today.

The cumulative global cost of climate-change related impacts on the environment, health, and food security will reach

US$2-4 trillion

by 2030.[2]

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) FACTORS: RESHAPING THE GLOBAL INVESTMENT LANDSCAPE

Large global environmental and social shifts have rapidly gained recognition as factors that present significant risks and opportunities, particularly as we face the threat of global instability. These shifts are part of what is addressed by the ESG risk analysis used by many professional investors.

Deployment of low-carbon technologies, including renewables, nuclear, and carbon capture and storage could lead to an additional investment opportunity of

US$4.7 trillion[6]

By 2050, the world population is expected to grow by more than 30 percent, with the majority of this growth happening in urban areas in the developing world. The resulting 9.5 billion people will face added challenges in an already resource constrained world.[3]

Without further financing, the gap is likely to grow. Funding will be required to meet growing needs related to issues like climate change and rapid population growth, for example in areas including low-carbon technologies and consumer industries. Notably, the annual global investment needed in developing countries in key sectors related to the proposed UN Sustainable Development Goals is estimated to range from US$3.3 trillion to US$4.5 trillion. Current investment in these sectors is around US$1.4 trillion, leaving an investment gap of between US$1.9 and US$3.1 trillion per year.[4] Industry-wide, greater effort is needed to motivate the investment community and engage clients.[5]

Ignoring risks presented by the shifting global landscape has implications for investors' long-term returns. Natural resource constraints, global health threats, social instability, and demographic changes are already presenting business leaders with challenges, and are shaping decisions that will affect future business success and investment performance. These realities have been recognized and have resulted in policy shifts, for example, in some large US and non-US public investment funds.[7,8]

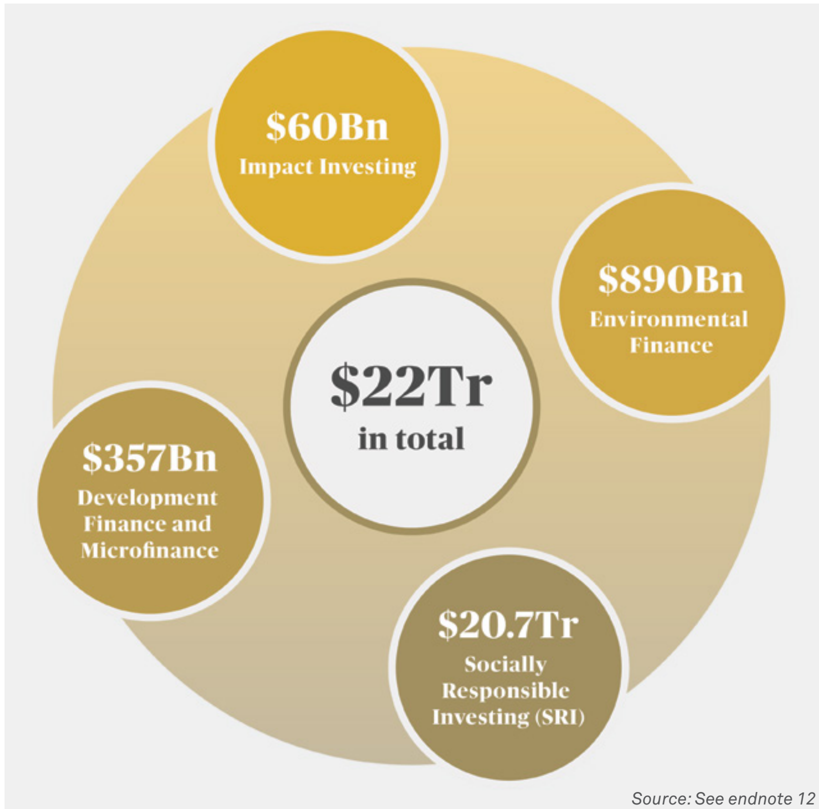
SOCIAL FINANCE: A US$22 TRILLION MARKET

A growing number of investors recognize the importance of these global movements as it relates to their investment decisions and are adjusting their investment management strategies accordingly. In the United States alone, the total value of professionally managed assets integrating socially responsible investing (SRI) considerations expanded to nearly US$7 trillion at the start of 2014, from just under US$4 trillion at the start of 2012.[9]

BNY Mellon defines social finance more broadly than what is traditionally considered SRI. For us, social finance refers to any investment activity that generates financial returns and includes social or environmental impact.[10] Across asset classes, it encompasses diverse investment strategies and products that deliver a range of risk-adjusted returns, align with different investor motivations and goals, and differ in terms of how explicitly or intentionally they strive for positive social and environmental outcomes. We here define, and will continue to track, an industry-wide, global asset pool that currently stands at $22 trillion[11] — a number which we believe will grow as investors intentionally direct capital to social finance. Reflecting the diverse capabilities of BNY Mellon, this asset pool includes four primary strategies: SRI, environmental finance, development finance and microfinance, and impact investing, as illustrated in the global social finance market size figure.[12]

Framing social finance holistically — combining multiple strategies together under a broader social finance objective — is helpful from two perspectives. For investors,

GLOBAL SOCIAL FINANCE MARKET SIZE



it provides visibility on where capital is most needed and on opportunities for further deployment. For providers, especially broad financial service firms, it provides an arena where we can encourage expertise to grow social finance throughout the life cycle of securities from origination to investment to custody.

CREATING SHORT-TERM BENEFITS AND LONG-TERM VALUE FOR INVESTORS

The industry has made significant progress creating attractive social finance products. Here we reiterate key attributes that end users seem to be seeking. We believe social finance products can succeed at scale when they:

- **Offer attractive risk-adjusted returns.** There is more evidence than ever before that investors can achieve attractive returns *and* drive positive societal change. Some research shows that companies that are considered leaders in ESG performance enjoy lower cost of capital and strong stock performance.[13]
- **Incorporate ESG related risks.** Social finance offers another way to evaluate and incorporate risk. Companies that include social and environmental impact as part of business decision-making can be better equipped to manage short- and long-term risks stemming from a variety of stresses and systemic shocks including climate change, government policy shifts, commodity price volatility, and political instability, to name a few.[14]

70%
of the global population will be concentrated in
24
of the world's poorest countries over the next 40 years.[16]

- **Meet growing investor demand for social and environmental impact.** Demand is growing for social finance products, thanks in part to interest among clients and beneficiaries in aligning investment decisions with their values. For millennials and women — two growing investor demographics — the desire for positive impact is particularly strong.[15]
- **Protect and generate long-term value.** Social finance can guide investors towards opportunities to support the long-term viability of the economy. With a quickly growing global population, 70 percent of which will be concentrated in 24 of the world's poorest countries over the next 40 years[16], rising demand for food and resources, climate change effects, and other global shifts may change the current investment landscape, including the way we think about value creation and preservation.

EXISTING CHALLENGES TO SCALE

While social finance is gaining traction among many mainstream investors, there have been, and remain, challenges to unlocking its full potential:

- **Insufficient supply of scalable products that offer attractive risk-adjusted returns creates a bottleneck.** Despite positive signs of growth, there is a dearth of products that meet the investor risk and return requirements. Some social finance products have longer durations and maturities leading to higher risk, and limited or no liquidity, especially among impact investments.[17]
- **Nascent and unclear value propositions hinder action.** Non-traditional language, multiple terms and definitions, and unclear value propositions have deterred some investors from exploring social finance.[18]
- **Limited track record, underdeveloped infrastructure, and weak enabling environments contribute to real and perceived risks.** As a new field, track records are still developing as are the benchmarks, metrics, and rating systems that enable investors to assess opportunities against standardized criteria.[19] Additionally, emerging markets present new opportunities for investors, while inherently weak regulatory systems that fail to address these volatilities present more challenges.
- **Current incentives don't prioritize long-term impact or measurement of long-term social and environmental performance.** Incentive structures and benchmarks that asset owners use for evaluating asset managers are heavily weighted toward short-term and quarterly performance. This fails to take into account the longer time frames over which social and environmental impacts may play out.

BUILDING THE FRAMEWORK FOR CONDITIONS FOR SCALE

Translating growing investor interest in social finance into significant capital allocation will require fundamental changes to the current system. This includes not only improving products to meet investor goals and performance expectations, but also strengthening the enabling environment, including the infrastructure, skills, and incentives that shape business decisions. This requires a collective effort by all members of the investment community to overcome key challenges and facilitate increased participation.

Investors themselves have an important role to play. Levers at their disposal include: investing their capital, engaging policymakers, seeking technical expertise to use best practices, and piloting new innovations. We propose five conditions that are necessary to allow investors and intermediaries to work together to bring social finance to scale. We elaborate on these with 12 specific actions, and we will look to support implementation of these conditions alongside other actors including policy makers, intermediaries, and issuers.

ACCESSIBILITY Aligning expectations to create attractive investment products	• Facilitate asset allocation with multiple social finance products which meet different risk tolerances, return expectations, and liquidity requirements • Create products with well-defined return expectations and clear impact objectives • Deepen social finance expertise and knowledge in investment teams and among client advisors
MEASUREMENT Building track records, frameworks, and presentation standards necessary to generate investor confidence	• Develop and adopt standardized nonfinancial metrics • Integrate social and environmental impact into valuation and risk measurement
TRANSPARENCY Institutionalizing sharing of information among investors and stakeholders as best practices to promote efficient use of capital	• Drive consistent and material disclosure of social and environmental impacts on financial performance, as well as the effect on stakeholders • Increase awareness and promote learning by sharing best practices regarding the integration of social finance into portfolios
SYSTEMIC CHANGE Creating incentives that shift thinking about value creation and support good governance and positive policy frameworks	• Work towards acceptance of assessment of ESG risks and opportunities as part of fiduciary duty • Work towards alignment of internal and external incentives with long-term value • Encourage good governance and positive policy that can respond to and support broader uptake of social finance
COLLABORATION Pursuing innovation and risk mitigation by leveraging expertise through partnerships	• Encourage partnership among stakeholders and product innovation to control ESG risk in asset portfolios • Provide guidance and technical assistance to issuers in order to strengthen the pipeline of investable social finance-oriented securities

THE PATH FORWARD FOR BNY MELLON

Our goal is to enable investor capital to advance social finance. By harnessing expertise from across our firm, our capabilities in SRI and ESG integration and our knowledge of market infrastructure will facilitate and encourage increased use of social finance products.

Across BNY Mellon business lines, our recommendations to bring social finance to scale are already guiding our own activities in product development, thought leadership, and partnerships. Company-wide product development is underway to meet clients' growing demand for engagement in the social finance field. We look to support capacity-building efforts by actively participating in knowledge-sharing opportunities, forming strategic partnerships, and creating leading research and thought leadership to help influence capital markets globally. We are working to promote education and dispel misinformation. In terms of products and services, we are:

- Developing **index-based strategies and products** that incorporate social finance metrics, providing tools for custody clients to **monitor social finance adherence** in their portfolios, and offering **ESG data and insights** to help global issuer clients gain insight into the approaches of investors and asset owners
- Supporting clients' ESG needs through **environmental finance products** including custody for green bonds, environmental trusts, and escrows
- Assessing demand across the spectrum of private clients for both **liquid and illiquid strategies** in social finance-oriented investments and filling product gaps
- Actively seeking prospective and current client input on **innovative impact strategies** that provide attractive returns and measurable impact
- Increasing assets under management adhering to the **United Nations Principles for Responsible Investment (UN PRI)** since 2011, with two of our investment boutiques serving as founding signatories of the UN PRI
- Leading the way on **engagement and disclosure** via some of our investment teams, and working towards **increased transparency**
- **Continuing education** across our investment teams and client advisors to increase competency in ESG investment issues
- **Engaging in research** with leading academics to provide guidance to issuers on social finance metrics
- **Joining and supporting multiple bodies** focused on standards and disclosure

At BNY Mellon, our efforts span securities origination, investment management and investment services, and demonstrate what an investment company can do in social finance.

To learn more about BNY Mellon's approach to Social Finance, visit: **www.bnymellon.com/socialfinance.**

[1] We use the term "mainstream investor" to refer to two primary groups of actors: Institutional investors and individual investors who are not primarily engaged in social finance. This typically includes insurance companies, high net-worth individuals, family offices, pension funds, foundations, endowments, mutual funds, hedge funds, private equity companies, venture capital firms, and financial institutions/banks.

[2] Mercer, "Climate Change Scenarios – Implications for Strategic Asset Allocation," 2011.

[3] United Nations Department of Economic and Social Affairs, "World Population Prospects: The 2012 Revision," 2013.

[4] United Nations Conference on Trade and Development, "World Investment Report," 2014.

[5] TIAA-CREFF Asset Management, "Socially responsible investing: Strong interest, low awareness of investment options," 2014.

[6] Global Commission on the Economy and Climate, "The New Climate Economy," 2014.

[7] Mercer, "Responsible Investment's next decade: Developing CalPERS Total Fund process for ESG integration," 2011.

[8] The Wall Street Journal, "Norway Oil Fund Would Exit Coal – Exposed Firms Under Deal in Parliament," 2015.

[9] USSIF, "Report on US Sustainable, Responsible and Impact Investing Trends 2014," 2014.

[10] Some stakeholders may refer to the definition and these strategies by different names and might consider including a different mix of strategies within the definition.

[11] Based on internal analysis of existing assets across SRI, environmental finance, development finance, microfinance, and impact investing as of 12/31/14.

[12] Based on data aggregated from JP Morgan and GIIN, "Eyes on the Horizon: The Impact Investor Survey," 2015; Global Sustainable Investment Alliance, "2014 Global Sustainable Investment Review," 2014; Climate Policy Initiative, "The Global Landscape of Climate Finance," 2014; Climate Bonds Initiative, "Bonds and Climate Change: The State of the Market in 2014", 2014; Bloomberg New Energy Finance, "Rebound in Clean Energy Investment in 2014 Beats Expectations," January 9th, 2015; OECD, "Statistics on research flows to developing countries," 2014; Mix Market, "Microfinance Institutions: Countries and Regions," aggregated March 2015.

[13] University of Oxford & Arabesque Partners, "From the Stockholder to the Stakeholder: How Sustainability can Drive Financial Outperformance," 2014.

[14] Hoepner, et al., "Does Pension Funds' Fiduciary Duty Prohibit the Integration of Environmental Responsibility Criteria in Investment Processes? A Realistic Prudent Investment Test," 2011.

[15] Morgan Stanley, "Sustainable Signals: The Individual Investor Perspective," 2015.

[16] University of Oxford, Oxford Martin School, "Now for the Long Term: The Report of the Oxford Martin Commission for Future Generations," 2013.

[17] Kubzansky, et al., Monitor Group, "Promise and Progress: Market-based solutions to poverty in Africa," 2011.

[18] Federal Reserve Bank of San Francisco, "Capital Markets for Scale, Proceedings from a Convening – Concluding Thoughts," 2012.

[19] JP Morgan and GIIN, "Impact Investments, an emerging asset class," 2010.

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