Meeting the challenge of impact investing: How can contracting practices secure social impact without sacrificing performance?

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Abstract

Responsible investors face a unique contracting challenge: ensuring that investments generate a preferred combination of financial performance and social impact when the entrepreneur or manager's effort is unobservable. At the heart of this challenge is a multi-task principal-agent problem. If financial and social objectives are in a "trade-off" for the entrepreneur, economic contracting theory suggests that the use of a financial investment contract can lead the entrepreneur to pay less attention to the social outcomes of the project than the investor desires. This trade-off between high financial performance and non-zero effort toward impact should strike a chord for responsible investors. Empirical SRI literature has found ESG funds sometimes, but not always, outperform (Renneboog et al. 2008). Among the "impact investor" subset, an "impact-first" to "finance-first" spectrum orders investors by objective he/she is least willing to sacrifice (Joy et al. 2011, 11). There is a need to (1) establish conditions under which a contract with incentives for financial performance could induce an entrepreneur to allocate excessive resources toward revenue-generating activities and away from impact, and to (2) define solutions that enable better financial performance through incentives without sacrificing social, environmental, and economic impact. This paper takes on the task, drawing on theory from multitask contracting literature and evidence gathered through structured, in-depth interviews with 16 responsible ("impact") investors who make direct debt, quasi-equity or equity investments with specific social impact objectives into for-profit businesses or social enterprises around the world.

My analysis is comprised of five chapters. After a brief introduction, Chapter 2 introduces a multitask model, explaining its ability to capture the impact investing environment and identifying the source of the problematic trade-off. Chapter 3 examines three approaches to achieving a desirable balance of financial and social objectives under a financial incentives contract, sourced from multitask theory: the "production technology" approach, the "performance measures" approach, and the "relational contracting" approach. I present each approach in consistent notation, identifying the mechanisms enabling optimal effort allocation and interpreting the intuition for impact investors. Chapter 4 illustrates how a sample of impact investors secure positive impact and pursue financial performance, in practice. Due to the nascent state of multitask contracting theory for investors and the void of public data on impact investment contracts and performance, my analysis is indicative rather than conclusive. Nevertheless, theory and evidence together point to certain paths that impact investors can follow to achieve high financial performance and desired attention to impact. Chapter 5 provides conclusions and policy and research recommendations. In particular, I suggest how contracting tools can be improved, point out opportunities for impact investors to improve strategy by building analysis tools and conducting internal policy reviews, and explain the advancements necessary to bring multi-task theory up to the challenge of impact investing.

For responsible investors and the narrower class of impact investors, this paper enhances knowledge of best to engage with the managers of an investment in order to improve the likelihood of long-term social impact and financial success. Firstly, I provide a theoretical framework for improving the social responsibility of investees by evaluating and modifying business models, improving performance measurement, designing appropriate investment contracts, and engaging post-financing through monitoring and in some cases, investment restructuring or enforcement. Secondly, I source empirical evidence on a set of impact investor's investing procedures, performance measurement systems and contract design in order to illustrate successful active investment strategies in practice. These results are most relevant for responsible investors such as private equity, venture capital, investment banks, and development finance institutions. Within academia, this paper fits most closely within a subset of multitask contracting literature on actors balancing financial and a environmental tasks. This paper also contributes to the theory underpinning empirical SRI literature by demonstrating how the contracting practices of financiers can affect corporate social and financial performance.