How India can boost social impact investing

The Securities and Exchange Board of India's report moves the conversation on the social sector ahead, but does not recognize the tensions and fails to suggest adequate checks and balances. **(Photo: iStock)**

The market regulator has announced its intent to create a stock exchange for the social sector. Will it work?

- Sebi's recommendations speak less about the functioning of the SSE and more about creating an ecosystem for the flow of funds from the for-profit investment world. This may not be adequate

BENGALURU : A stock exchange is meant to create an ecosystem for trading investment instruments. The participants in the exchange make profits (or losses) by betting on a particular investment in the hope of it providing a better return. It is an important institution in the for-profit world providing feedback on how firms are perceived on their capacity to generate returns.

Now, India has announced its intent to bring this well-established, market-based concept to the nascent world of social impact investing. In the previous Union budget, finance minister Nirmala Sitharaman proposed the idea of setting up a social stock exchange (SSE). This was followed up by the Securities and Exchange Board of India (Sebi), which set up a working group to look into the idea. That report has now been put up in the public domain and has been available for feedback and comments. With the time for submitting feedback having been extended twice, the current deadline is 15 August.

In this backdrop, it may be important to take a deeper look at the idea and the issues around the idea. As of 2017, McKinsey estimated that the cumulative investments in the social sector (impact investments) stood at $5.2 billion. This is an emerging area, where funds operating on market principles are possibly crowding out the old-fashioned grants for projects of social intervention.

The prevailing system of stock exchanges, rating agencies, analysts and the ecosystem around the markets measure and interpret primarily one thing—the returns generated on investments. Is this idea worth replicating in the social world? Can it be replicated where 'purpose' is ahead of profits?

Both commercial and social enterprises require a scarce resource: Capital. While the commercial enterprise promises a unifocal reward of generating returns on capital, the returns that a social enterprise promises are necessarily social, working towards greater equity, and a more just and sustainable world. How can we apply the principles of a market to enterprises that are supposed to correct the failure of the market system and deal with problems created by markets, which tend to promote and rely on self-interested behaviour?

The idea of creating a market has a natural, instinctive appeal but carries a paradox. The strongest supporters of markets agree that markets have contributed towards economic inequality, environmental degradation, the weakening of communities and, as the current pandemic reminds us, fragile public systems—the root causes of many of the challenging social problems we encounter. So, with these limitations, can we bring market instruments judiciously to tackle social problems; identify and support organisations that negotiate the tensions of generating profits, especially when 'purpose' is placed at a higher pedestal?

Distinguishing social firms

India is not the first country to be experimenting with the idea of an SSE. Attempts have been made in Brazil (BOVESPA), Canada, Portugal, Singapore, South Africa (SASIX) and the United Kingdom. While the idea is much extolled, there is surprisingly little information on how it has actually worked. From what is available publicly, the privately-run Impact Investment Exchange (Asia) (IIX), based out of Singapore, is a “crowdfunding platform" which has issued debt under a series called Women’s Livelihood Bonds.

Likewise, the Oxford-based Ethex, run by a small non-profit organisation, has been described as a “model for understanding that social stock exchanges are feasible with the will of philanthropy, for a limited segment offering limited services and certainly not going as far as being regulated like a traditional stock exchange."

Empirically, the idea of SSE has failed or at best functioned in ways not different from existing platforms and that too at small scale. This does not foreclose a possibility of future success but points to the need for more critical thinking.

Defining social enterprises is tricky, but regulations rest on definitions, measurements, compliance and verification. Structuring an enterprise on the market system and adding a label “social" on top does not suffice. We need a sharper distinction. The signals and commitments under a distinct regulatory oversight allow the enterprises an entry in sensitive domains and the ability to avail tax benefits.

For instance, the not-for-profit organisations (NPOs) are legally prevented from distributing any “residual earnings" to contributors of capital. In voluntarily tying their hands up, they signal their commitment to their purpose over promoters’ financial interest. In the case of a social business—a concept being popularised by Bangladeshi social entrepreneur Muhammad Yunus—the signalling is in the form of the promoters not taking anything out of the enterprise beyond the nominal value of investments and a one-time premium of 20% without consideration of the time value of money.

Cooperatives the world over move away from the primacy of capital towards “patronage" or usage of the critical service. The capital is rewarded on a pre-contracted basis and is not treated as resources that gets residues. This is similar to interest payment on debt instruments.

The Community Interest Companies (CIC) in the UK similarly set a limit on the share of profits that can be redistributed to shareholders, hardcoding a balance between competing interests.

The most significant intervention in trying to create a distinct ecosystem for differentiated enterprises is by B Labs which is working on a new form of incorporation as a Benefit Corporation (B-Corp). This experiment creates an elaborate system of incorporation and certification of a B-Corp. Several states in the US have passed the B-Corp law and provide tax benefits.

There is a legislative and regulatory framework defining a B-Corp, an architecture for measuring performance and certification. Even as this system evolves, there are problems. The pre-defined B-Corps migrate and list as regular enterprises and give up their certification. The initial commitments made to the purpose are not valid any longer and raise questions about mission drift.

The Sebi attempt

In the Indian context, the Sebi working group report on SSE has created a buzz. Ideally, the SSE should standardize information, create a better ecosystem and bring in more funds into the social sector. The report offers NPOs and for-profit enterprises (FPEs) a platform to list themselves as social enterprises in a “market" that promotes social impact. The potential benefits include access to financial instruments and tax incentives.

The report moves the conversation on the social sector ahead, but does not recognize the tensions and fails to suggest adequate checks and balances. The SSE conceived by the report is more a registry than an exchange. The details for a constructive engagement are absent, leaving the role of Sebi itself ambiguous. For instance, the report advises against the “immediate creation of a regulator for social enterprises, for social reporting, or for social auditors"(p.24). Other regulatory dimensions are vague, creating regulatory arbitrage and legitimising profiteering in social sectors. This platform need not create the next “unicorn" but should facilitate long-term sticky investments that create social and public value.

The report highlights that every enterprise has an impact—positive or negative. Do we need a separate dispensation for organisations creating a positive social impact but delivering market-level returns and could be in the mainstream? We believe no, and certainly not tax benefits.

Organisations that merit special dispensation for targeted investments are the ones that work for a cause and are unable to provide returns; where investors are happy with the “cause". How do we identify and distinguish organisations committed to a social purpose without financially rewarding those who may try to gain from just the label? In not defining the distinguishing behaviour or signalling of “social" in a social enterprise, Sebi’s attempt leaves much ambiguity. The unwillingness of the working group to define a social enterprise is problematic. We need to start with an unambiguous hard code and be responsive to innovations rather than relying on hard-to-interpret voluntary declarations.

The report suggests verified and certified information sharing as per a proposed framework without any tests on long-term measures of their commitment to the social sector, suggesting that any organisation willing to bear the costs of meeting reporting requirements could be a self-declared social enterprise. Usually, enterprises working on large social problems and difficult sectors are already stressed for resources, constantly measured, and penalised for having non-programmatic expenses by their funders. This framework adds more to the (non-programmatic) compliance costs. While the report suggests providing funds to assist in capacity building, it is unclear how the organisations will be selected.

Looking ahead

Clear Distinction between NPO and FPEs: The objectives and instruments available to NPOs and FPEs are very different and so are current governing standards. It would serve the interests of both forms of organisations and their supporters to keep them in separate exchanges, with different reporting standards. We do not need the threat of implicit (and unfair) comparisons. In fact, the FPEs may as well be listed on the main stock exchanges as an independent category.

Measuring Practices, Setting Standards: Experience shows that even while desirable, the measurement of social impact is horribly expensive and notoriously difficult. The report hopes that this can be resolved by developing the social ecosystem in India. If this were true, countries with better ecosystems would have resolved this, but they have not. Besides issues of measurement, issues of values need to be resolved in assessing social impact. For instance, Ducks Unlimited claims “$235+ million in total revenues and conservation of more than 14.5 million acres in North America since its inception in 1937", but the twist in the tale is that the organization’s primary supporters are duck hunters.

What might work are measures aligned with the values that the SSE promotes but also reflective of the organisation’s operations, internal processes, practices and governance structures. These could include ownership patterns, caps on the share of profits distributed, remuneration ratios and rules for decision making. In addition, some oversight on investors themselves on these measures would help keep the impatient ones out. For these measures to have teeth, standards will have to be specified. If organisations are expected to report on “compensation ratio of highest-paid and lowest-paid employee", then specifying a standard to be adhered would help organisations signal their values and commitment.

Avoiding Conflict of Interest: The potential beneficiaries from the creation of an SSE also include intermediaries that will get into the business of verification and certification. While marketising the field is about signalling efficiency, specialised certification adds significant costs. The gains of marketising may get nullified by the cost of certification. Be that as it may, we need to identify professionals who understand the social sector well enough to certify and not reduce it to a site of profit mining. The report talks about minimum reporting standards suggesting “if the SE is an FPE, it must have received funding from any one or more of the impact investors who are members of the Impact Investors Council" (p.49) to be eligible for listing. Investors getting the power of listing is not good and this should be de-mutualised.

Seeking inspiration outside the for-profit world: The significant challenges faced during the covid has highlighted that while there is a lot of expertise as well as fearless commitment in the private sector, aligning the interests of private hospitals, schools and the pharma industry to larger public interests is a complex and daunting task. Unfortunately, the language, idiom, instruments and instrumentalities in the design of the SSE comes primarily from the for-profit world. A bulk of the recommendations consequently speak less to the functioning of the SSE and more to creating an ecosystem for the flow of funds from the for-profit investment world to the social enterprise world. The report describes the Indian social sector as “early in its development", ignoring the significant contributions of organisations like Amul and Aravind Eye Care that have been internationally cited as leading examples of social enterprises.

The omissions suggest the need for a more diverse and representative group to engage with local and global experiences of Social Business, B-Corps, Community Investment Companies, cooperatives and farmer producer organisations, and beyond the for-profit sector. We do hope it would help the SSE realise its aspiration of becoming an instrument for transformative change in the social sector.

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