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Position Paper

Impact Investing in Alternative Investments

Why private market investments are particularly suited for impact-generating investments

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1. INTRODUCTION

Since 2018, the European Union's Sustainable Finance agenda has introduced numerous new regulations and directives for both financial market participants and corporates, like the Sustainable Finance Disclosure Regulation (SFDR), the EU Taxonomy framework, and the Corporate Sustainability Reporting Directive (CSRD). One goal of the EU Sustainable Finance agenda is to reorient capital flows towards sustainable investments (European Commission, 2018). The European Commission estimates that achieving the 2040 and 2050 climate targets will cost approximatively €1.53 trillion annually between 2031-2050 (European Commission, 2024a).

However, critics have concerns regarding the complexity and lack of clarity of the regulations. As an example, a recent EU consultation shows that 84% of respondents do not consider the SFDR disclosures to be sufficiently useful and a majority (52%) agrees that the SFDR has not succeeded in directing capital towards sustainable or transitional investments (European Commission, 2024b). In parallel, discussions about impact investments that pursue social or environmental impacts alongside financial returns have increased, moving it out of a niche and specialized market (GIIN, 2024c). Numerous definitions, guidelines and frameworks have been developed by both practitioners and academia (OECD, 2020), but challenges remain, particularly regarding fragmented measurement frameworks and a lack of regulatory guidance (GIIN, 2023a).

Against this backdrop, the Bundesverband Alternative Investments e.V. (BAI) and the Bundesinitiative Impact Investing e.V. (BIII) set up a working group on impact investments in alternative investments at the beginning of 2024. The field of alternative investments includes what is often referred to as "non-traditional" or private market asset classes including investments in infrastructure, private equity, private debt, real estate, hedge funds or commodities as well as many other specialties such as aircraft, ship financing, or crypto assets.[1] Alternative investments offer the necessary tools and resources to fulfil the dual requirement of financial return and sustainable impact and thus can make a significant contribution to solving global sustainability challenges and to transforming the economy by successfully implementing impact investing strategies. Due to their direct influence on assets, e.g. through operational control, or through their direct financing in less efficient capital markets, alternative investments are well equipped to *generate* impact, especially compared to public market investments.

Given the challenges and uncertainties in implementing both impact investments and the EU Sustainable Finance legal framework, the goal of the working group is to provide the necessary conceptual clarity and implementation guidance for impact investments in private markets. The working group's outputs should support practitioners to implement impact investments, and thereby help to mainstream this practice in alternative investments. In a first step, this position paper develops important

1. See for a categorization and examples BAI Homepage

conceptual foundations and compares impact investments with the SFDR's concept of sustainable investments, providing clarity on important differences but also similarities. The working group aims to build upon these foundations, providing guidance through case studies and concrete examples for infrastructure, private equity, and microfinance. The working group is also interested in producing deep dives into specific topics in the future to provide guidance to asset owners and managers on how to implement impact investments.

The paper is structured as follows: Chapter 2 introduces the most important concepts to support a common understanding of key terms. Chapter 3 summarizes the core characteristics of impact investments. The goal is not to provide yet another definition of impact investments, but rather to focus on synthesising existing definitions. Chapter 4 analyses existing definitions of impact products, building upon current discussions about classifying sustainability-related financial products in the context of the SFDR review. Based on this analysis, it proposes categories for impact products for further discussion. Chapter 5 concludes and describes specific topics where additional work is needed to provide guidance for successfully implementing impact investments.

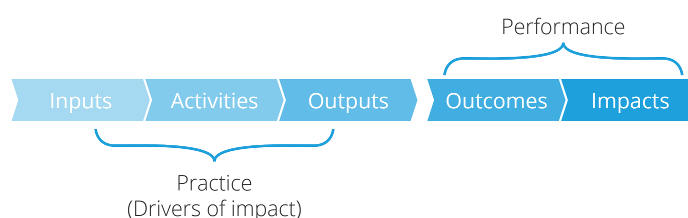
2. KEY CONCEPTS

To support a common understanding for key terms, this chapter introduces the most important concepts which form the basis of impact investment strategies in a European regulatory and market context.

2.1. IMPACT PATHWAY

One key aspect of impact investment is the impact pathway, often also referred to as theory of change (ToC) or impact thesis (IMP, 2024c). The impact pathway describes the different steps necessary to create impact, from inputs through activities to outputs, outcomes and impacts (see Figure 1. For definitions of all terms, see the glossary.).

Figure 1: The Impact Pathway



Source: *IMP (2024d)*

Inputs, activities and outputs are the drivers of outcomes and impacts, leading to positive and/or negative effects on people and the natural environment (IMP, 2024c). There are, however, different understandings of the terms "outcomes" (see Chapter 2.3.) and "impacts". One common perspective understands impacts as normative goals that refer to long-term changes on the level of society or the natural environment. The focus of this perspective is on the normative desirability of certain impacts, like achieving the goal of climate change mitigation. Another perspective defines impacts as short-, medium- and long-term changes with a focus on their concrete measurability (European Commission, 2023a). Both perspectives are important for impact investments. Since this paper has the goal to clarify the conceptual foundations for impact investments in alternative investments with a view to the European regulatory and market context, it will focus on the second perspective, which is in line with current definitions of impact in the EU Sustainable Finance Framework.

2.2. IMPACT

Up until recently, the EU Sustainable Finance framework did not explicitly define the term impact, even though it is of central importance for impact investments. The European Sustainability Reporting Standards (ESRS) introduced a legal definition for impacts:

> *"The effect the undertaking has or could have on the environment and people, including effects on their human rights, connected with its own operations and upstream and downstream* ***value chain****, including through its products and services, as well as through its* ***business relationships****. The* ***impacts*** *can be actual or potential, negative or positive, intended or unintended, and reversible or irreversible. They can arise over the short-, medium-, or long-term.* ***Impacts*** *indicate the undertaking's contribution, negative or positive, to sustainable development." (European Commission, 2023a, p. 269).*[2]

This definition is in line with the definition provided by the Impact Management Platform[3], a global collaboration between major providers of sustainability standards and guidance, whose goal is to mainstream the practice of impact management (IMP, 2024b). The ESRS's definition of impacts is also in line with definitions from academia.[4]

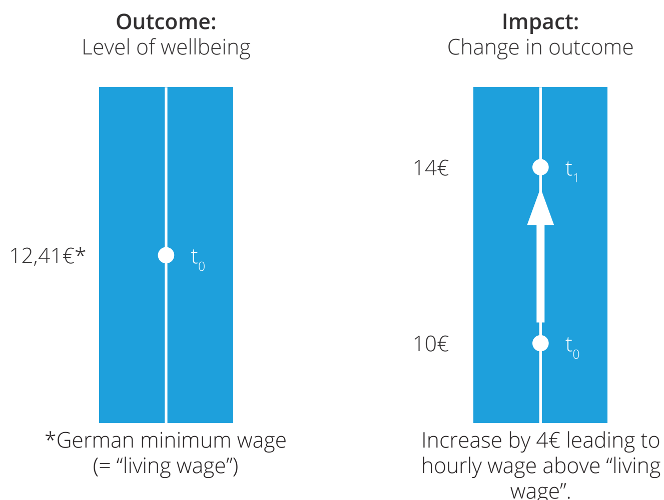
While this definition is helpful, it does not distinguish between the impact generated by investees or assets (company impact) and the impact generated by the asset owners or asset managers (investor impact).[5] Kölbel et al. (2020) provided important definitions of both terms, stating that company impact is the "change that a company's activities achieve in a social or environmental parameter", while investor impact is the "change that investor activity achieves in company impact" (p. 3).[6] This distinction was adopted in several definitions of impact investments (BIII, 2023; DVFA, 2023, SpainNAB, 2023). The European Securities and Markets Authority (ESMA) argued in a recent report that not being clear about the type of impact targeted can lead to "misleading fund impact claims" (ESMA, 2023, p. 41).[7] For the purposes of this paper, we will use the ESRS's definition of impact, while also distinguishing between "company impact" and "investor impact" to be transparent about the different sources of impact and reduce the risk of creating misleading impact claims.

2.3. OUTCOME

The impact pathway (see Figure 1 above) shows why the term "outcome" is of central importance to impact investments. The ESRS do use the term, but they do not explicitly define its meaning in Annex II Table 2 (European Commission, 2023a).[8] To have conceptual clarity and to be in line with global standards for impact management, the working group uses IMP's definition of outcome as "the level of well-being experienced by people or condition of the natural environment that results from the actions of the organisation, as well as from external factors" (IMP, 2024a). To implement impact investments with the necessary clarity, it is important to be explicit about the difference between outcome and impact. Figure 2 helps showing that this understanding of outcomes refers to a *level of well-being* at a specific point in time, while impacts refer to *changes in outcomes* caused by specific activities (of investees or investors, i.e. company or investor impact).

2. The definitions for the bolded terms can be found in the ESRS's Annex II, Table 2 (European Commission, 2023a).
3. The IMP defines impact(s) as "The effect(s) of organisations' actions on people and the natural environment" (IMP, 2024a).
4. Kölbel et al. define impact as „change in a specific social or environmental parameter that is caused by an activity." (2020, p. 3).
5. We will use the term "investors" to collectively refer to both asset owners and asset managers.
6. Instead of "investor impact", some use the term "investor contribution". We use both terms interchangeably. We also use the terms "company impact", "investee impact" and "asset impact" interchangeably.
7. ESMA distinguishes "buying impact", i.e. investing in companies with positive impact without a positive influence of the investor (investor impact), and "creating impact", i.e. improving the impact of underlying assets or investees as an investor (ESMA, 2023, p. 41). From ESMA's point of view, both are equally viable strategies in the context of SFDR.
8. For example, the ESRS refer to outcomes in the application requirements of ESRS 1, when describing how to assess the usefulness of metrics for inclusion in entity-specific disclosures: "a) its chosen performance metrics provide insight into: […] how effective its practices are in reducing negative outcomes and/or increasing positive outcomes for people and the environment (for impacts);" (European Commission, 2023a, p. 24).

Figure 2: Difference between outcome and impact (example hourly wage)



Source: *adopted from IMP (2024e)*

A second understanding of outcomes described by the IMP defines outcomes as „a change or event resulting from organisations' activities and outputs, providing a causal link between the activities/outputs and their impact(s) on people and/or the natural environment" (IMP, 2024a). From this perspective, outcomes and impacts are very close in meaning, both referring to changes on people or the natural environment caused by inputs, activities or outputs. To be in line with the ESRS's definition of impact provided in Chapter 2.2. and to clearly differentiate impacts from outcomes, this paper is using the understanding of outcomes as *levels of well-being* caused by inputs, activities or outputs, instead of *changes* caused by inputs, activities or outputs.

3. COMMON CORE CHARACTERISTICS OF IMPACT INVESTMENTS

After clarifying the key concepts, this chapter analyses the core characteristics of impact investments based on an analysis of existing definitions in the market. The resulting definition provides conceptual clarity and helps comparing impact investments with the notion of sustainable investments in the SFDR in Chapter 5.

The analysis of existing definitions of impact investments shows that there are five core characteristics of impact investments (see Figure 3 and Table 1). First, all analysed definitions argue that impact investments need the clear objective or **intentionality** to generate positive social or environmental impacts (GIIN, 2024b). This is considered key to distinguish impact investments from other forms of sustainability-related investment approaches (FIR, France Invest, 2021). Having clear intentionality entails establishing a theory of change or impact thesis (BIII, 2023; IFD, 2021).

Second, the integration of **impact measurement and management (IMM)** into the investment process is a characteristic common to most analysed definitions of impact investments. This usually refers to measuring and managing impact from sourcing to exit, using the impact information to improve investment decision-making and real-world impact (GIIN, 2024a; BIII, 2023). IMM usually entails setting clear impact targets before investing based on qualitative or quantitative indicators, and monitoring and managing impact performance compared to these targets during the holding period and at exit, promoting sustained impacts and using impact performance data to improve future decision-making and processes. The Operating Principles for Impact Management (OPIM, 2024) are increasingly used by investors as a best-practice framework for impact management. Due to challenges in measuring impacts directly, impact investors often utilise indicators of outputs or intermediate outcomes as proxies for impacts (IMP, 2024d).

Third, **positive asset impact** is also a characteristic common to all analysed definitions of impact investments. Impact investments are usually expected to create positive

social or environmental impacts, while mitigating negative impacts (GIIN, 2024b). Some definitions specify this requirement referring to *significant* positive impacts (BIII, 2023; SpainNAB, 2023). Others also add the requirement of creating significant *net* positive impact (BIII, 2023).

The fourth characteristic shared by impact investment definitions is creating **positive investor impact**. Some definitions are clearer in differentiating between asset and investor impact than others. GIIN's definition, for example, is not explicitly using this differentiation (GIIN, 2024a). In its guidance for impact in listed equities, however, GIIN is clearly referring to investor contribution (GIIN, 2023b). Others, like Impact Europe or BIII, make explicit use of it (Impact Europe, 2024; BIII, 2023). Some definitions also differentiate impact investments based on whether they have investor impact or not (BIII, 2023; FNG, 2023; Impact Europe, 2024). Several definitions also use the term "additionality" instead of investor impact or investor contribution.

The last common characteristic is that impact investments seek a financial return on capital "that can range from below market rate to risk-adjusted market rate." (GIIN, 2024a, p. 1). The amount and type of financial return will be defined by the investor based on its own considerations and requirements, including fiduciary duties, where applicable. This distinguishes impact investments from pure philanthropy.[9]

Busch et al. (2021) introduced the terms "impact-aligned investments", for investments without investor impact, and "impact-generating investments" for investments with investor impact. ESMA uses "buying impact" (i.e. getting exposure to impactful companies via the investment, which is similar to "impact-aligned") and "creating impact" (i.e. creating impact via the investment, e.g. by financing the transition or supplying new capital for sustainable solutions, which is similar to "impact-generating"), arguing that clear disclosure about the type of impact fund strategy is essential in preventing misleading impact claims (ESMA, 2023). The distinction is also adopted by others, for example the BIII (BIII, 2023). Alternative investments which are typically made via private markets are especially well equipped to *generate* impact compared to public market investments due to their direct influence on assets, e.g. through operational control, or through their direct financing in less efficient capital markets. This is why this position paper focuses on impact-generating investments, capitalising on alternative investments' potential to create positive impacts through their investments made via private markets.

Figure 3: Common core characteristics of impact-aligned and -generating investments

#	Impact-aligned investments	Impact-generating investments
1	Intentionality	Intentionality
2	Impact management and measurement	Impact management and measurement
3	Significant, net positive asset impact	Significant, net positive asset impact
4	-	Significant, net positive investor impact
5	Financial return	Financial return

Especially relevant for alternative investments and focus of this position paper.

9. We note that targeting financial returns may not in all cases be suitable to distinguish between philanthropy and impact investing since some philanthropic strategies also include a certain amount of financial returns.

Table 1: Overview of the analysis of existing definitions of impact investments

Dimensions	GIIN (2024b)	Impact Europe (2024)	BIII (2023)	FNG (2023)	IFD[10] (2021)	SpainNAB (2023)	DVFA (2023)
Intentionality	✓	✓	✓	✓	✓	✓	✓
Investment process	IMM	IMM	IMM	Impact Channels & Measurability	IMM	IMM	Impact Channels & Measurability
Asset impact	Positive asset impact	Positive investee additionality ("C" impacts)	Significant, net positive asset impact	Significant positive asset impact	Net[11] positive Impact (Investor & asset)	Investee additionality	Net positive company impact
Investor impact	Positive investor contribution[12]	Positive investor additionality	Significant, net positive investor impact	Significant positive investor impact	Additionality	Investor additio-nality	Positive investor impact

10. Formerly Finance for Tomorrow.
11. The IFD adopts FIR's and France Invest's definition of Impact Finance and describes additionality as one key characteristic. In the definition of additionality, they also refer to net positive asset impact: „Additionality: considered as the specific and direct action or contribution of the investor enabling the company receiving the investment or the funded project to increase the net positive impact generated by its activities." (IFD, 2021, p. 18). FIR, France Invest and the IFD also discuss existing methodological challenges in netting asset impacts (FIR, France Invest, 2021, IFD, 2021).
12. This is not part of the official definition of impact investments, but explained in GIIN's guidance on impact in listed equities, where investor contri-bution is also explained in the context of private markets (GIIN, 2023b).

4. IMPACT PRODUCTS

In recent months discussions on classifying different types of sustainability-related financial products have increased, especially due to the EU Commission's review of the SFDR. Parallel developments like the introduction of a labelling regime by the Financial Conduct Authority (FCA) in the UK also sparked debate. Analysed definitions of impact investments often do not clearly distinguish between the investment and the portfolio level, which is why a clear distinction between impact investments (investment level) and impact products (portfolio level) is often missing.

This chapter shows the results of an analysis of current proposals for defining impact *products* from regulatory authorities and different associations. In a second step, we utilize the results of the analysis and combine them with the core characteristics of impact investments to arrive at a classification of impact products. This classification for different types of impact products is a proposal on how to provide conceptual clarity about key categories and characteristics of impact products. It is also providing input for current discussions on categorising sustainability-related products in the context of the SFDR review.

4.1. ANALYSIS OF EXISTING PROPOSALS

The analysis of existing proposals shows that they can be structured based on the core characteristics of impact-generating investments. Many approaches include the objective or the intentionality to generate positive impacts. The FCA's Sustainability Impact label for example requires the „aim to achieve a pre-defined positive, measurable, impact in relation to an environmental and/or social outcome" (FCA, 2023, p. 107). Other examples include the sustainable impact and the transition product categories of the Dutch financial markets authority (AFM) or Impact Europe's proposal for an impact category for financial products (AFM, 2023; Impact Europe, 2023).

Most analysed approaches describe different ways how investors can generate impact (capital allocation and/or stewardship) when specifying the impact-oriented investment process. Some use the terms additionality, or financial and non-financial additionality to describe the different investor impact mechanisms (AFM, 2023). Most of the proposals also specify a threshold at portfolio level that the products need to qualify for the category or label. These thresholds usually refer to the share of a specific type of investment that impact products need to invest in. For products with impact-related terms in their name, the ESMA fund name guidelines for example require that "investments [...] are made with the objective to generate a positive and measurable social or environmental impact alongside a financial return." (ESMA, 2024a, p. 9). The AFM, for example, proposes that transition products are required to invest a minimum of 80% of AuM according to its sustainability strategy, which includes investments in "companies that are not yet sustainable (but plan to become so)" (AFM, 2023, p. 5). Some of the proposals add a requirement to ensure that the investments do not cause significant harm to sustainable investment objectives and/or sustainability factors (DNSH) as well. The majority of the proposals argue that there needs to be some form of investor impact, either through capital allocation (i.e. financial additionality) or stewardship. Some proposals are also specifying criteria for the governance of impact products. While the FCA is generally speaking about appropriate resources, governance and organisational arrangements, Impact Europe is more specific, for example introducing impact-linked carried interest as one criterion.

Table 2: Overview of the analysis of existing impact product definitions and related proposals

Dimensions	SFDR consultation (EU Commission 2023b)	ESMA fund name guidelines (2024)		AFM (2023)		FCA: Sustainability Impact (2023)	SEC: ESG Impact (2022)	FIR/France Invest (2021)	Impact Europe (2024)
		"transition"-related terms	"impact"-related terms	Sustainable impact product	Transition product				
Intentionality	?	?	✓	✓	✓	✓	✓	✓	✓
Investment process & Threshold	Capital allocation	? 80%	? 80%	Capital allocation 80%	Capital allocation & Stewardship 80%	Capital allocation & Stewardship 70%	?	Capital allocation & Stewardship 100%	Capital allocation & Stewardship 70% & 30%[13]
Asset impact	Positive asset impact	Transition investments[14]	Positive asset impact	Positive asset impact & DNSH	Transition investment[15]	Positive asset impact[16]	Positive asset impact	Positive asset impact	Positive investee additionality ("C" impacts) & DNSH
Investor impact	?	?	?	Financial additionality[17]	Additionality[18]	Positive investor contribution	?	Additionality	Positive investor additionality
Governance	?	?	?	?	?	Appropriate governance to support delivery of sustainability objective	?	Appropriate Governance to implement impact strategy (roles & resources)	Impact-linked carried interest & audits

4.2. TYPES OF IMPACT PRODUCTS

Inspired by the visualisation provided by AFM (AFM, 2023) and based on the common core characteristics of impact-generating investments defined in Chapter 3, we can distinguish four types of impact products (see Figure 4). Based on the common core characteristics of impact investments, all four types of impact products require intentionality and IMM processes.

They differ, however, in terms of their asset and investor impact. The horizontal axis differentiates the social or environmental outcomes that the assets are generating at the point of the investment between harmful and sustainable. Assets with currently harmful social or environmental outcomes can generate positive impact by transitioning towards generating sustainable outcomes (e.g. replacing fossil fuel-based heat generation by renewable energy-based heat generation in real estate assets).[19] Assets creating sustainable outcomes can generate impact by helping to replace unsustainable alternatives, like investing in solar parks that help decommission coal-based power plants.

The vertical axis describes whether an impact product is having investor impact through capital allocation, stewardship, or some other mechanism. Investors can positively influence assets with currently harmful or sustainable outcomes. In alternative investments via private markets, investors can, depending on their stake in the assets, for example use their influence over the assets to implement a transition strategy to help assets create

13. The 70% threshold refers to the „C-asset class" and the 30% thresholds refers to the „B-asset class" (Impact Europe, 2023, p. 4), following the ABC-Framework developed by the Impact Management Project (IMP) and now administered by Impact Frontiers (Impact Frontiers, 2024a).
14. Defined as „investments [...] are on a clear and measurable path to social or environmental transition." (ESMA, 2024, p. 56).
15. Defined as (1) investee companies that fulfil the exclusions criteria referred to in Article 12(1)(a)-(c) of Commission Delegated Regulation (EU) 2020/1818 as prescribed in ESMA's final report on guidelines on funds' names using ESG or sustainability-related terms (ESMA, 2024) and (2) investee companies having a credible transition plan following the CSRD standard (AFM, 2023).
16. In addition, the FCA specifies that „The product must not invest in any assets that conflict with its sustainability objective." (FCA, 2023, p. 103).
17. Through financing underserved sustainable sectors or markets.
18. Through active management (engagement), requiring an engagement strategy.
19. Assets or economic activities that are always significantly harmful would need to be decommissioned, since they currently have no technological possibility to transition away from creating harmful social or environmental outcomes (EU PSF, 2022, p. 24). See also Chapter 5.

sustainable instead of harmful social or environmental outcomes. Alternative investment investors can also help finance economic activities that already create sustainable outcomes, like financing new renewable power generation projects, increasing their share in the overall electricity supply.

In combination, the two dimensions of (1) assets' social/environmental outcomes and (2) investor impact, lead to four different types of impact products:

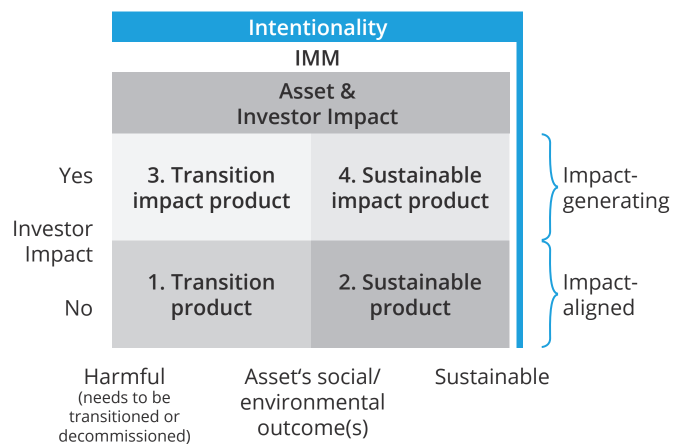
1. **Transition Products:**[20] These products invest in assets that are transitioning from creating harmful to creating sustainable outcomes. While transition products have impact intentionality and IMM processes in place, they are not able to provide plausible evidence for investor impact (impact-aligned). An example for a transition product could be a fund investing in listed equities of large companies that implement credible transition plans without actively influencing the implementation of such plans.

2. **Sustainable Products:** These products invest in assets that are creating sustainable outcomes. Like transition products they have impact intentionality and IMM processes in place, but they are not able to provide plausible evidence for investor impact (impact-aligned). An example for a sustainable product could be a fund investing in green bonds in the context of secondaries (i.e. where the related projects have already been financed and built).

3. **Transition Impact Products:** These products invest in assets that are transitioning from creating harmful to creating sustainable outcomes. They have impact intentionality and IMM processes in place and can provide plausible evidence for investor impact (impact-generating). Examples for a transition impact product could be a fund providing private debt financing to companies which decarbonise their manufacturing processes or a real estate fund replacing fossil-fuel based heating with renewable-based heating in buildings.

4. **Sustainable Impact Products:** These products invest in assets that are creating sustainable outcomes. They also have impact intentionality and IMM processes in place, and they can provide plausible evidence for investor impact (impact-generating). An example for a sustainable impact product could be a fund investing via private equity in photovoltaic energy generation facilities which replace fossil fuel-based energy generation.

Figure 4: Four types of impact products



Source: *adopted from AFM (2023)*

This overview and classification for different types of impact products is one way to provide conceptual clarity about key categories and characteristics of impact products. It is also providing input for current discussions on categorising sustainability-related products in the context of the SFDR review.

20. We note that for the purposes of this paper, „transition investments" is broader than the definition suggested by ESMA which is limited to environmental objectives linked to the implementation of the Green Deal (ESMA, 2024b, p. 7).

4.3. INVESTOR IMPACT AT PRODUCT LEVEL

Figure 4 shows that impact products with no investor impact can be referred to as "impact-aligned", while impact products with investor impact can be described as "impact-generating", based on whether a product has investor impact. To specify different investor impacts, investors should refer to existing norms and research (Impact Frontiers, 2023a; Heeb, Kölbel, 2020). According to academic research, the investor contribution mechanisms of capital allocation and stewardship are the most effective ones (Kölbel et al., 2020). Impact Frontiers (2024b) and Heeb & Kölbel (2020) specify these mechanisms further, which can be applied to both private and public market investments:

1. Grow new/undersupplied capital markets
2. Provide flexible capital
3. Engage actively
4. Signal that impact matters (market signals & non-market signals).

Investors that want to implement impact-generating investments should specify the types of investor impacts they aim for in their theory of change. They should also provide plausible evidence that their activities have had a positive impact on the invested assets. In their online curriculum, Impact Frontiers provides one way to think about measuring investor impact (i.e. investor contribution) (Impact Frontiers, 2024c). They also updated definitions of investor contribution mechanisms with a focus on private markets (Impact Frontiers, 2023a) and provide both a template with which to start measuring investor contribution (Impact Frontiers, 2023b) as well as a set of indicators for the same purpose (Impact Frontiers, 2023c).

5. COMPARING IMPACT INVESTMENTS AND SUSTAINABLE INVESTMENTS PURSUANT TO SFDR 2(17)

This section compares the core characteristics of impact investments and products with SFDR's definition of sustainable investments set out in Art. 2 no. 17 SFDR. The comparison shows how investors need to go beyond sustainable investments as defined by the SFDR to implement impact-generating investments. The comparison also shows how key concepts of sustainable investment in the SFDR, "contribution" and "do no significant harm", can be specified by referring to the EU Taxonomy and CSRD. The result is high level, conceptual guidance on how to implement impact generating investments in the context of the current EU Sustainable Finance framework, helping investors to make sense of both.

5.1. INTENTIONALITY VS. SUSTAINABLE INVESTMENT OBJECTIVE

One of the core characteristics of impact-generating investments is the intentionality of the investor to achieve positive social or environmental impacts. This aspect is not fully reflected under the SFDR at the investor level. At the investment level, the SFDR defines sustainable investments as investments in economic activities that (1) positively contribute to an environmental or social objective, (2) that do not significantly harm any social or environmental objectives (DNSH), provided that (3) investee companies follow good governance practices (European Commission, 2020).

At the level of financial products, the SFDR introduced disclosure requirements differentiating between Article 8 and Article 9 products. Financial products that *promote* environmental or social characteristics are expected to disclose under Article 8, while products with the *objective* of sustainable investments disclose under Article 9. The EU Commission also clarified that Article 9 products are expected to only invest in sustainable investments, except for investments for certain purposes like liquidity or hedging (ESAs, 2024b). Beyond that, the EU Commission clarified that both Articles 8 and 9 are neutral in terms of product design (ESAs, 2024b). Consequently, the SFDR does not require Article 8 products to have sustainability- or impact-related objectives. For Article 9 products, their sustainable investment objective should be to make sustainable investments. In other words, this objective refers to whether an *investment* contributes to an environmental or social objective (i.e. limited to asset, company or investee impact). Investors who want to implement impact generating investments, therefore, need to go beyond the requirements for sustainable investments and Article 9 products and clearly state how (1) their investment leads to positive impacts (= investor impact) and (2) how they aim to achieve this impact, including a theory of change or impact thesis.

5.2. IMPACT MEASUREMENT AND MANAGEMENT (IMM)

Impact measurement and management is another core characteristic of impact generating investments missing from the SFDR. SFDR's definition of sustainable investments does not prescribe to have a dedicated IMM process. Although both Article 8 and Article 9 products require the use of "sustainability indicators" to measure the attainment

of the sustainable investment objective or the promotion of environmental or social characteristics, there is no further specification how these indicators should be chosen, measured and managed, since both products are neutral in terms of product design (ESAs, 2024b). In particular, the SFDR does not require a direct link between the sustainability indicator and the positive impact generated by the investment. The indicators for principal adverse impacts of investment decisions on sustainability factors (PAI) provide some kind of standardised impact measurement and can be used to actively manage (i.e. reduce) PAI of investments but are limited to negative impacts. Consequently, asset managers would need to go beyond the SFDR and set up IMM processes to implement impact-generating investments, for example following established standards like the Operating Principles for Impact Management (OPIM).

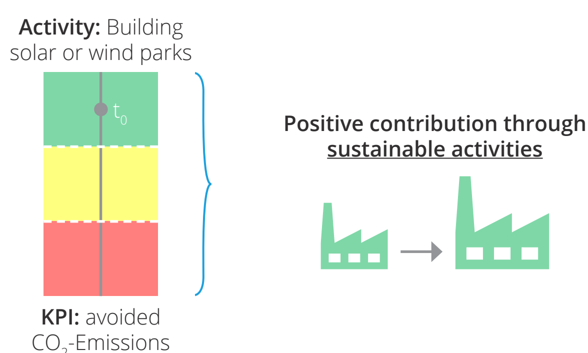
5.3. POSITIVE ASSET IMPACT

Another core characteristic of impact-generating investments is the positive impact of the invested assets, i.e. the ideal result of its intentionality and IMM. For impact-generating investments, positive asset impact refers to increasing positive and reducing negative impacts. The SFDR is not explicitly defining "impact" but refers to "contribution" and "DNSH" when defining the characteristics for sustainable investments. The concrete meaning of "contribution" and "DNSH" is not specified in detail by the SFDR (ESAs, 2024a, 2024b) and, therefore, less specific compared to impact-generating investments. Consequently, we argue that both concepts should be specified if investors want to implement impact-generating investments. To do that, investors can refer to other aspects of the EU Sustainable Finance framework as well as to the core characteristics of impact-generating investments and impact products. This way, investors can implement impact-generating investments while being in line with important concepts from the EU Taxonomy and the ESRS.

Contribution

Based on the EU Taxonomy and the ESRS, we can distinguish two types of positive contribution. First, economic activities can contribute positively to sustainability objectives *by already performing sustainably, i.e. creating sustainable outcomes*. The EU Taxonomy, for example, provides concrete technical screening criteria and thresholds to define the levels of performance necessary for economic activities to be considered environmentally sustainable.[21] Thresholds are key to determine which level of performance can be considered sustainable, as shown by both the EU Taxonomy and the EU Platform on Sustainable Finance (EU PSF, 2022; European Commission, 2021). Economic activities that create sustainable outcomes can contribute positively to sustainability objectives if they are maintained or grow, enabling the replacement of economic activities that are not sustainable (e.g. replacing power production through coal with power production through renewable energy). As a consequence, one strategy for impact-generating investments to contribute positively to sustainability objectives is to *help grow or maintain sustainable economic activities* (Figure 5; Heeb, Kölbel, 2020). Figure 6 shows how this strategy can be illustrated in an impact pathway. The EU Taxonomy framework provides a set of economic activities that qualify for this strategy, defining which economic activities substantially contribute to environmental objectives based on thresholds. As the EU Taxonomy is currently limited to certain sectors, investors that wish to implement impact-generating investments need to do their own analysis of economic activities and their impact pathways for activities not covered by the EU Taxonomy, including selecting thresholds where possible (e.g. when they implement sustainable investments following the SFDR).[22]

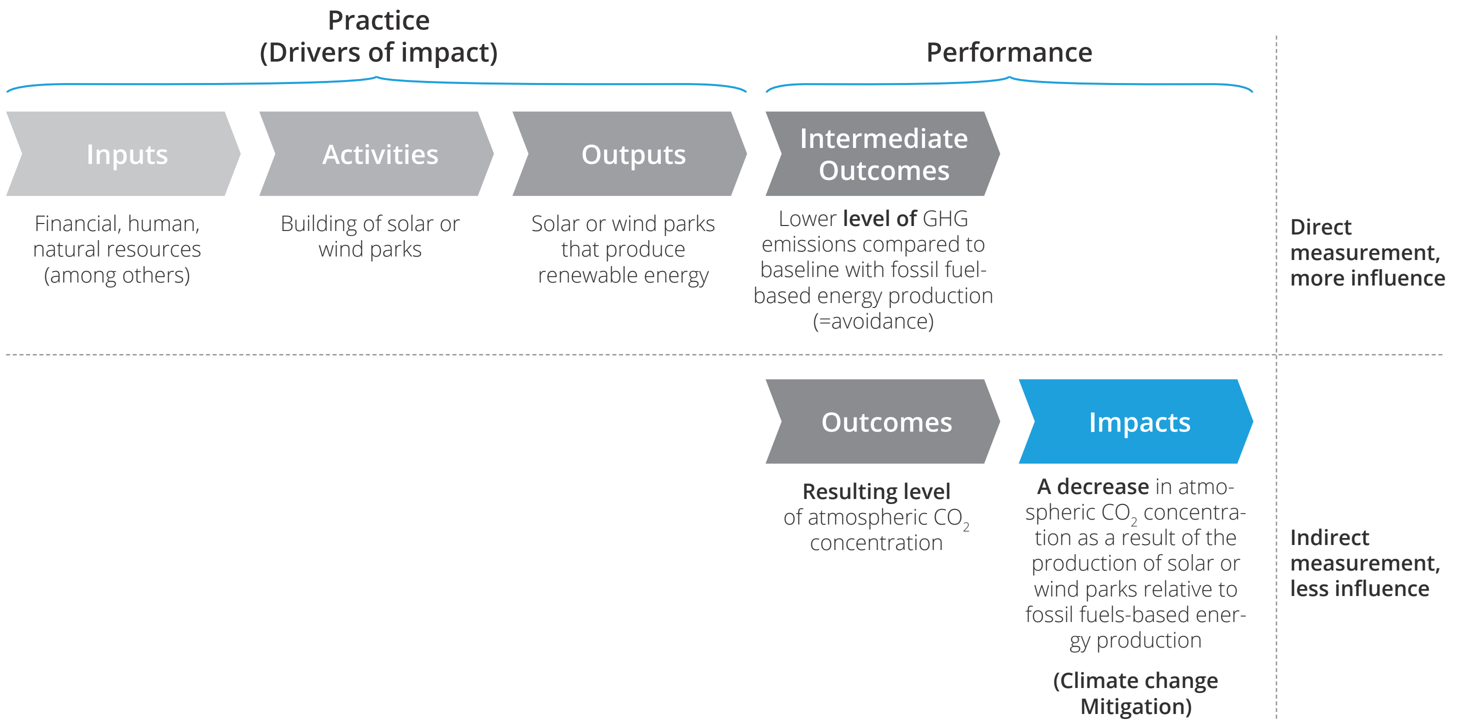
Figure 5: Strategy 1: Help to grow or maintain sustainable economic activities



Source: *own illustration; adopted from Heeb and Kölbel (2020)*

21. The EU Platform on Sustainable Finance (EU PSF) provided some insights into how this understanding of positive contribution can differentiate several levels of performance (substantial contribution, intermediate performance, significant harm) (EU PSF, 2022, p. 49).
22. Setting thresholds to determine the materiality of (positive and negative) impacts is also required under CSRD, following the ESRS. ESRS 1, paragraph 42 says that "The undertaking shall apply the criteria set under sections 3.4 and 3.5 in this Standard, using appropriate quantitative and/or qualitative thresholds. Appropriate thresholds are necessary to determine which impacts, risks and opportunities are identified and addressed by the undertaking as material and to determine which sustainability matters are material for reporting purposes." (European Commission, 2023a). As a consequence, investors subject to CSRD will need to think more generally about setting thresholds for material positive impacts of their investments. The outcome of this exercise in the context of the CSRD materiality assessment could also be utiliszed for implementing impact generating investments.

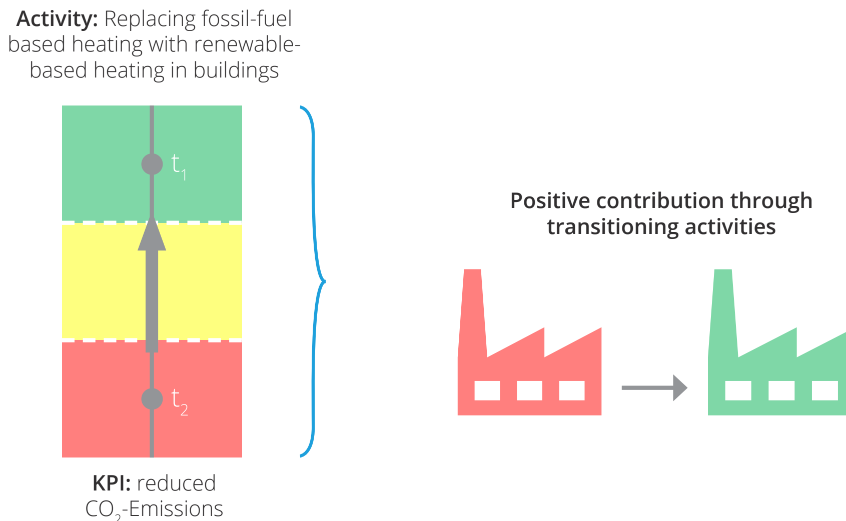
Figure 6: Strategy 1 as an impact pathway



Source: *adopted from IMP (2024c)*

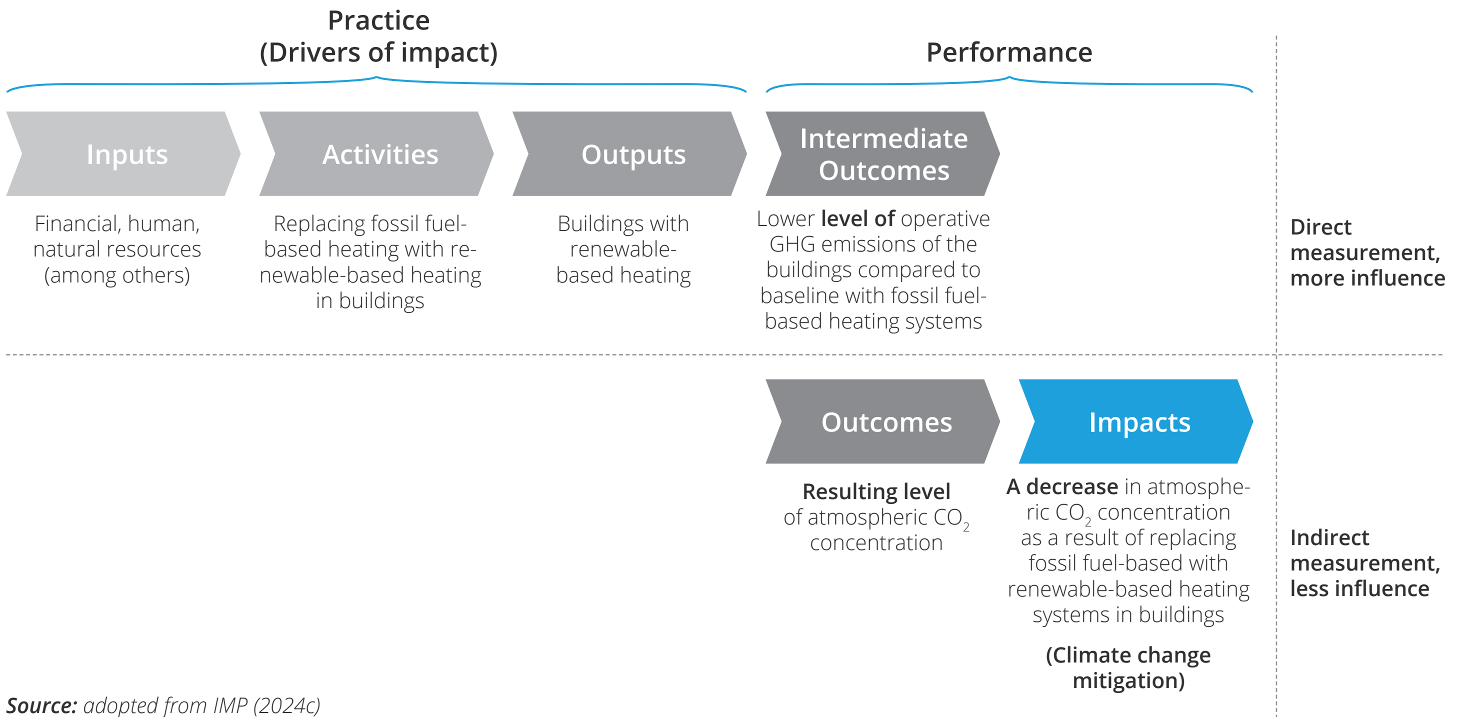
A second dimension of positive contribution can be based on the ESRS' definition of impact (see Chapter 2.1.). According to this definition, "Impacts indicate the undertaking's **contribution**, negative or positive, to sustainable development." (European Commission, 2023a, p. 269; emphasis added by the authors). As a consequence, a second strategy for impact-generating investments to contribute positively to sustainability objectives is to *help transitioning unsustainable economic activities and thereby improving social or environmental outcomes (Figure 7; Heeb, Kölbel, 2020)*. Figure 8 shows how this strategy can be illustrated in an impact pathway.

Figure 7: Strategy 2: Help to transition unsustainable economic activities



Source: *own illustration; adopted from Heeb and Kölbel (2020)*

Figure 8: Strategy 2 in an impact pathway



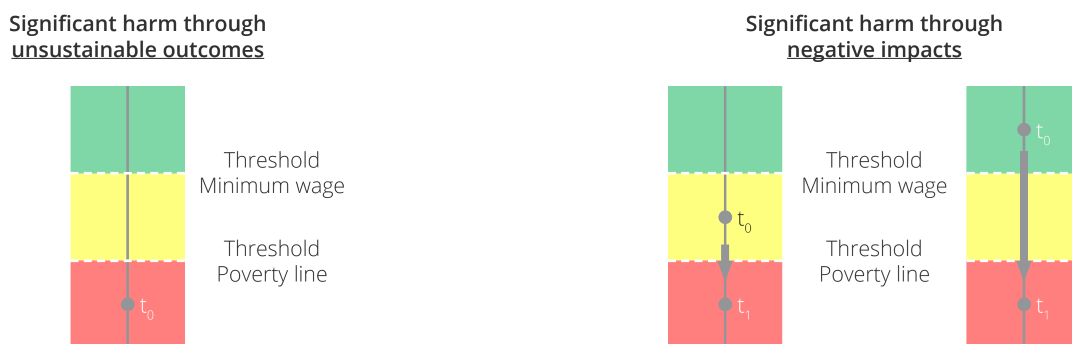
Source: *adopted from IMP (2024c)*

Do no significant harm (DNSH)

Following the core characteristics of impact-generating investments, positive asset impact includes mitigating negative impacts. In other words, managing the negative impacts of one's assets is part of implementing impact generating investments. The GIIN, for example, argues that impact investments should seek to "mitigate the negative consequences of [their] actions" (GIIN, 2024a, p. 2). The BIII is going further, requiring "net-positive" asset impact, stating that "the totality of all relevant, verifiable effects [...] if possible, does not contain any significant, insufficiently managed negative effects on external stakeholders or the environment." (BIII, 2023, p. 2).

Using the distinction between outcome and impacts for the negative results of an investment shows that there are different ways to significantly harm sustainability objectives (see Figure 9). First, economic activities can lead to unsustainable outcomes (e.g. investment in a company that pays wages below the poverty line). Second, economic activities can have negative impacts (= change in performance), either by deteriorating unsustainable outcomes even further (e.g. investment in a company paying low wages that leads to the company paying even lower wages) or changing sustainable outcomes to becoming unsustainable (e.g. investment in a company paying above minimum wages that leads to the company paying wages below the poverty line).

Figure 9: Types of doing significant harm to sustainability objectives:



Source: *own illustration*

For impact generating investments, there are different strategies for dealing with economic activities that do significant harm in one of these ways:

1. **Reduce (significant) harm:** Impact-generating investments can help to transition economic activities that lead to significantly harmful, unsustainable outcomes. This entails transitioning away from harmful performance levels to less harmful levels, i.e. what the EU Platform on Sustainable Finance describes as "intermediate performance" levels (EU PSF, 2022, p. 23).

2. **Decommission significantly harmful activities:** Impact-generating investments can help companies to decommission economic activities that are creating significantly harmful, unsustainable outcomes. This is necessary, for example, for activities that are by their nature or under current technological possibilities, unable to transition away from significantly harmful performance levels. Examples of this type of activities include "construction of new housing in extreme high-risk flood areas" or "Activities destroying ecosystems with high biodiversity value" (EU PSF, 2022, p. 24). Impact-generating investments can help companies to replace income generated by these activities, e.g. by financing the expansion of other business activities.

Products making impact-generating investments can exclude or exit from investments in significantly harmful economic activities. This does not immediately improve the negative impacts of the significantly harmful economic activities, but may have an effect if companies are no longer able to finance these activities. This might be an important lever, especially in less efficient capital markets.

Investors that want to implement impact-generating investments should specify in their theory of change which strategy or strategies they choose in dealing with economic activities that lead to significantly harmful outcomes or impacts. The EU Taxonomy already provides criteria to define what "significantly harmful" means. Investors that are implementing impact-generating investments and who are investing in economic activities covered by the EU Taxonomy can use the EU Taxonomy criteria as a measurement tool to determine significantly harmful outcomes or impacts when implementing one or more of the strategies explained above. Investors that want to do impact-generating investments but that are investing in economic activities not covered by the EU Taxonomy need to specify their own criteria on how to determine significant harm. The DNSH assessment for Article 9 products based on PAI indicators can be a starting point.

5.4. POSITIVE INVESTOR IMPACT

Another weakness of the SFDR is that its definition of "sustainable investments" only refers to the asset or economic activity level, without considering investor impact or contribution. This is also true for the EU Taxonomy, which is not focusing on investor impact. The idea of investor impact is to some degree referred to in Article 4 of the SFDR which introduces transparency requirements regarding principal adverse impacts of investment decisions on sustainability factors (PAIs) at the level of financial market participants. Article 4 states that financial market participants could "consider adverse impacts of investment decisions" (European Commission, 2020, p. 6), referring to impacts of investment decisions, i.e. investor impact. But the PAI concept only refers to adverse impacts, not to positive investor impact and although they imply investor impact, the indicators used to measure PAIs only refer to the asset (= company/investee) impact.

As described in Chapter 4.3., investors that want to implement impact generating investments should specify the types of investor impacts they aim for in their theory of change. They should also provide plausible evidence that their activities have had a positive impact on the invested assets.

5.5. SUMMARY

Table 3 summarises the results of Chapter 5. Impact-generating investments go beyond sustainable investments as defined in the SFDR by stating a clear impact intentionality, implementing IMM processes and by providing evidence of asset *and* investor impact. They are similar in the sense that for both impact-generating and sustainable investments the economic activity invested in needs to positively contribute to sustainability objectives.

Within the current SFDR framework, impact-generating investments can clearly qualify as sustainable investments following SFDR 2(17), if they (1) contribute to sustainability objectives by helping to grow or maintain sustainable economic activities and (2) exclude significantly harmful

activities and do so in line with the regulatory requirements set out in the SFDR. The second dimension of positive contribution (helping to transition harmful economic activities) may be more difficult to qualify as sustainable investment under the SFDR. If the harm caused by these economic activities is significant and there are no clear actions taken by the company to reduce this harm or decommission the respective activity, the investment should not be considered to be "sustainable" in the sense of SFDR 2(17) since the EU Commission has clarified that the existence of "a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could for instance not be considered as sufficient." (ESAs, 2024b, p. 8).

Sustainable investments can only qualify as impact-generating investments if they go beyond current regulatory requirements and fulfill the core characteristics of impact-generating investments.

Table 3: Comparison of impact-generating investments and sustainable investments

Characteristics	Impact-Generating Investment	Sustainable Investment (SFDR 2(17))
Intentionality	✓	**Contribution to sustainability objective on asset level**
IMM	✓	**Measurement on asset level**
Positive asset impact	**Contribution to sustainability objective:** 1. Help to grow or maintain sustainable economic activities 2. Help to transition harmful economic activities **DNSH:** 1. Improve significant harm 2. Decommission significantly harmful activities 3. At portfolio level: exclude investments in significantly harmful activities	**Contribution to sustainability objective:** 1. Determined by financial market participant **DNSH:** 1. Reducing harm may be possible based on concrete actions 2. At portfolio level: exclude investments in significantly harmful activities.
Positive investor impact	✓	X

6. CONCLUSION

Alternative investments via private markets are especially well equipped to generate impact compared to public market investments due to their direct influence on assets, e.g. through operational control, or through their direct financing in less efficient capital markets. Consequently, they can make a significant contribution to solving global challenges by successfully implementing impact generating investments.

The working group on impact investments in alternative investments has the goal to help practitioners mainstream impact-generating investments. This position paper provides the necessary conceptual foundations. It clarifies important key concepts like impact, outcome, the impact pathway, impact-generating investments or impact products. It also compares impact-generating investments with sustainable investments as defined in the SFDR, showing how investors need to go beyond sustainable investments to implement impact-generating investments.

These conceptual foundations are, however, only the first step in providing guidance in order to help practitioners implement impact-generating investments in alternative investments. Further work is necessary to tackle open questions for concrete implementation. Some questions that came up during the discussions on this position paper include:

1. Intentionality:

a. Which actors need to have impact intentionality? Only the entity deciding on the investment? Or also the entity investing in the impact product which is not involved in the individual investment decision?

b. How should impacts be identified, including corresponding indicators to measure them? Based on a double materiality assessment?

2. IMM:

a. How does IMM look like for different asset classes, e.g. infrastructure investments, especially with reference to the different project phases of infrastructure investments?

b. How to deal with potential impacts that are not yet realised at the time of the investment?

3. Significant, net positive asset impact:

a. How can the "significance" of asset impact be determined?

b. How can positive and negative asset impacts be "netted"?

c. How can investors determine thresholds for determining the asset impact?

4. Positive investor impact:

a. How should investors determine their investor impact?

This position paper provides the necessary background to tackle these questions systematically, but answering them goes beyond the scope of this paper. The goal of the working group on impact investments in alternative investments is to discuss and provide answers to questions like this, providing guidance from practitioners where possible. Members of the working group for example founded a subgroup impact investment in infrastructure to provide insights into how IMM processes can be implemented for infrastructure investments with special focus on the project phases in infrastructure investments. BAI and BIII remain committed to provide the necessary opportunities to their members to discuss these questions to further achieve their goal of mainstreaming impact investments.

GLOSSARY

Term	Definition
Activities	“Everything that organisations do, including operations, the procurement of inputs, the sale and provision of products and/or services, as well as any supporting activities“ (IMP, 2024a).
Impact	ESRS: “The effect the undertaking has or could have on the environment and people, including effects on their human rights, connected with its own operations and upstream and down-stream value chain, including through its products and services, as well as through its business relationships. The impacts can be actual or potential, negative or positive, intended or unintended, and reversible or irreversible. They can arise over the short-, medium-, or long-term. Impacts indicate the undertaking’s contribution, negative or positive, to sustainable development.” (European Commission, 2023a, p. 269) IMP: “The effect(s) of organisations’ actions on people and the natural environment.“ (IMP, 2024a).
Impact pathway	“The sequence that links organisations’ actions with their effects on people and the natural environment.“ (IMP, 2024a).
Input	„The resources and relationships that organisations draw upon for their business activities, as well as the contextual elements that define their business activities“ (IMP, 2024a).
Investor contribution	“The contribution that the investor makes to enable enterprises (or intermediary investment managers) to achieve impact.“ (IMP, 2024a).
Outcome	Usage in this position paper: “The level of well-being experienced by people or condition of the natural environment that results from the actions of the organisation, as well as from external factors“ (IMP, 2024a). Additional meaning: “*A change or event* resulting from organisations’ activities and outputs, providing a causal link between the activities/outputs and their impact(s) on people and/or the natural environment“ (IMP, 2024a).
Output	“The direct result of organisations’ activities, including their products, services and any by-products.“ (IMP, 2024a).
Stewardship	“The use of influence by investors to protect and enhance overall long-term value, including the value of common economic, social and environmental assets, on which returns and client and beneficiary interests depend.“ (PRI, 2024)

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