SoFi 101: Understanding social finance

Christian Petroske  
*Singapore Management University, cpetroske@smu.edu.sg*

Florian Parzhuber  
*Singapore Management University, fparzhuber.2013@smu.edu.sg*

Haneol Jeong  
haneolj@wharton.upenn.edu

John Kinsella  
jkin@sas.upenn.edu

Maaya Murakami  
maayam@sas.upenn.edu

*See next page for additional authors*

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SoFi 101
Understanding Social Finance

What is social finance? Rachel Kalbfleisch of the International Development Research Centre (IDRC) defines it as a collection of approaches to managing money that create value for society or the environment, often while producing a financial return, while the MaRS Centre for Impact Investing calls it “an approach to managing money to solve societal challenges”. In other words, social finance is a movement that covers various ways of using finance—via socially responsible investments, micro-loans, community investments, and so on—to achieve a social or environmental impact.

Who is involved in this process? While charities, socially driven businesses and governments all work towards creating positive social change, those who finance them are the ones facilitating the creation of social and environmental value (hereafter “social value”). These funders are thus considered to be practising social finance.

So Who Needs Social Finance?
The recipients of social finance span charities, non-profit organisations and various kinds of social enterprises. In this section, we will discuss their role in the spectrum of social finance.

purely social returns

1. Charity
   A charity is a non-profit-making organisation set up exclusively to achieve a social or environmental mission. It relies solely on donations and/or grants, which often come with strings attached, e.g. funding cycles and reporting requirements.

2. Revenue-Generating Not-for-Profit
   This label refers to any non-profit-making organisation, dedicated to a social or environmental cause, that generates income by selling products and services. It includes businesses that make typically up to 75 per cent of their income through commercial activities, with the rest covered by grants and donations.

3. Revenue-Generating Social Enterprise
   Also dedicated to creating social or environmental value, a revenue-generating social enterprise typically makes over 75 per cent of its income from commercial activity. Many are able to break even through commerce, but all surplus is reinvested to help the organisation achieve its mission. Thus, they come in many organisational forms, from non-profits, to LLCs, to worker-owned cooperatives, to a hybrid of two or more.

4. Social Purpose Business
   Organisations in this category are set up like traditional private or public businesses, but are driven by a social or environmental mission. They have shareholders and distribute profit, but see business growth as a means to create their intended social impact.

5. Socially Responsible Business
   This is a traditional business entity that also makes conscious efforts to benefit society at large through various means, including targeted CSR programmes, staff initiatives and supply chain management. Operations of socially responsible businesses may not have social impact as their first priority, but they cause few negative externalities in the long run.

6. What Doesn’t Count as a Recipient of Social Finance?

   Commercial Business that Gives Profits to Charity
   Into this category fall many of the world’s businesses, which pursue profit maximisation but also contribute a fraction of profits to charity. Daily operations are not tied to any social cause, so investment into these companies does not fall under “social finance”. However, they may be considered social financiers themselves.

purely financial returns

It’s Complicated: Other Things Also Called “Social Finance”

Social Impact Bonds
Social impact bonds (SIBs), also known as “Pay for Success” financing, are perhaps the most confusing form of social finance. For one, they aren’t really bonds, but complex contracts that are used to pay for large social impact projects. They essentially work like this: investors invest their cash in a social project and evaluate its results. These results are then tallied based on how much money they save the government—for instance, by reducing prison recidivism, the state doesn’t need to pay for as many prisoners as it would’ve had to without the programme. Once the project is completed, the government pays out a portion of the savings to the investors who originally put up the money. Often, these savings are so large that the investors can make returns at or above market rates.

Microfinance
Championed by Nobel laureate Muhammad Yunus, founder of Grameen Bank, microfinance is a way of providing financial services to the working poor at low interest rates so as to increase their incomes and improve their livelihoods. Originally only referring to loans, microfinance has expanded to encompass other services like savings and insurance. Large banks don’t typically provide loans to the poor because they consider it too risky. If they or others do, it’s usually at astronomical interest rates. Microfinance brings interest rates down and often pairs loans with financial literacy training.

Social Finance Explained Further
This section covers the relationship between risk, financial returns and social impact; touches briefly on the tricky issue of impact measurement; presents an around-the-world glance at social finance initiatives carried out in various countries; and identifies some of the biggest players in the field of social finance.

Risky Business?
From the investor’s perspective, risk is defined in terms of how difficult it will be to get one’s money back, with interest, from an investment. The less “risky” and the higher the return, the more investors can be convinced to put up more of their funds. The impact investor, or social financier, looks to achieve positive social value, and often considers the level of social impact that their investment might yield. Different investors use different financial tools, depending on their appetite for risks, financial returns and social impact. The following illustration shows the various levels of financial return and social impact associated with different forms of social finance.
Market-Rate Returns?
Is it possible to achieve both social and financial returns simultaneously? A new analysis conducted by the Cambridge Associates Impact Investing Benchmark, in association with the Global Impact Investing Network (GIIN), shows that the answer is yes: “market rates of return are achievable through impact investing”, states GIIN CEO Amit Bouri. In this study, the benchmark compared normal venture capital and private equity funds to funds that have both financial and social impact objectives. Overall, the analysis found an internal rate of return (IRR) of 6.9 per cent for impact funds, as compared to 8.1 per cent for non-impact funds—“within spitting distance”, as classified by one commentator. However, breaking down the data reveals an even more compelling story. For instance, impact investing funds in emerging markets posted returns of 9.1 per cent; impact investing funds that were smaller (under US$100 million) saw 9.5 per cent returns; and smaller impact investing funds focused on the US returned a whopping 13.1 per cent. This robust data shows that investors who seek social impact do not have to sacrifice profits, and might even be able to outperform the market in some cases.

Measure for Measure
Almost everyone [with good intentions] hopes to achieve positive social impact. According to Mark Florman, Robyn Klingler-Vidra and Martim Jacinto Facada, “The notion of the social impact of business has become so mainstream that government at the highest levels—including G8 leaders and even the Pope—advocate the creation of institutions to give greater attention to driving social impact”. However, one of the most difficult challenges facing social finance revolves around the question: how do we measure social impact?

There are, in fact, many ways to measure it, but the crucial question concerns how to consolidate these many methods under one impact measurement and evaluation system. At present, the impact measurement field is quite chaotic: each institution or region typically has its own assessment criteria for impact, and creates its own metrics. Though in recent decades the Global Impact Investing Network (GIIN) and Social Value UK (formerly the SROI Network) have made efforts to consolidate their metrics, there has not been a single governing authority to establish an official and centralised system of impact measurement and evaluation.

There are, in fact, many ways to measure it [social impact], but the crucial question concerns how to consolidate these many methods under one impact measurement and evaluation system.

Triple Bottom Line (People, Planet, Profit)
The triple bottom line is one way to think about what an organisation’s relationship to its impact should be. The triple bottom line consists of three Ps: people, planet and profit. Organisations that take this approach are understood to prioritise social, environmental and financial impact equally in order to take into account the full costs of operating their business.
Founded in 2006, d.light aims to bring solar lighting and power systems to developing countries not only through producing and selling solar products, but also through innovative financial products. To date, d.light has sold over 10 million solar products across more than 60 countries, and improved the lives of some 50 million people. A growing portion of d.light’s sales come through its pay-as-you-go system, which allows customers to combine top-up cards, microloans, savings groups, employer sponsorship, cash and mobile money to make d.light’s solar products radically affordable.

The UK was one of the earliest countries to recognise social enterprises as a separate business entity. They designate social enterprises, legally, as “Community Interest Companies”. Since 2005, more than 12,000 companies have registered as CICs. These are subjected to asset locks, dividend caps and interest caps to ensure that their assets are used for the benefit of society. Being a hybrid form, CICs can get funding from private philanthropy, public funding and venture philanthropy firms such as UnLtd, which supports social entrepreneurs through challenge grant awards, advice and networking opportunities.

Two government departments in the Western Cape of South Africa have committed 25 million rand (US$1.62 million) for three social impact bonds (SIBs) designed to improve maternal and early childhood outcomes. This is the first time a middle-income country has committed to a pay-for-success scheme—to date, no low-income country has done so.

Working across India, Dasra combines research, organisational capacity-building and philanthropic networks in its mission to bring 800 million Indians out of poverty. They report to have strengthened the growth plans of over 200 successful non-profits and enabled over US$11 million in funding to social businesses and non-profits in India. Dasra actively works to bridge the gap between social entrepreneurs and philanthropists by providing research, support, and a platform for both.

A true double- or triple-bottom-line investor, UBERIS invests in early-stage social businesses that seek impact and financial sustainability. For instance, one of their investees, Coco Khmer, creates fair trade coconut-based skincare products while providing economic empowerment for marginalised Cambodians. When Coco Khmer was breaking even but needed capital in order to grow, UBERIS provided early capital in the form of a convertible loan, and paved the way for future investment and Coco Khmer’s continued growth.
### Biggest Social Financiers

<table>
<thead>
<tr>
<th>#</th>
<th>Name</th>
<th>Financial Resources (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>International Finance Corporation</td>
<td>45.3</td>
</tr>
<tr>
<td>2</td>
<td>Inter-American Development Bank Group</td>
<td>14.0</td>
</tr>
<tr>
<td>3</td>
<td>Enterprise Community Partners</td>
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<td>4</td>
<td>Morgan Stanley Institute for Sustainable Investing</td>
<td>10.6</td>
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<tr>
<td>5</td>
<td>Netherlands Development Finance Company</td>
<td>8.4</td>
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<tr>
<td>6</td>
<td>National Community Investment Fund</td>
<td>5.8</td>
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<tr>
<td>7</td>
<td>Responsibility Investments AG</td>
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<td>8</td>
<td>Capricorn Investment Group</td>
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<td>9</td>
<td>Goldman Sachs Urban Investment Group</td>
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<td>10</td>
<td>Triodos Investment Management</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Adapted from Christa Hangl, “A Literature Review about the Landscape of Social Finance”, Table 1, 77–92.

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**THE INTERNATIONAL FINANCE CORPORATION**

Founded in 1956, the International Finance Corporation (IFC) is the private investment branch of the World Bank. Over US$45 billion in investments from the IFC go towards loans and venture capital. In turn, most of its funding comes from issuing triple-A rated bonds in several different capital markets. Most of its bonds are of the traditional variety, marking investments that lack an exceptional focus on social impact. However, certain innovative themed bonds such as Green Bonds, Banking on Women Bonds, and Local Currency Bonds also allow investors to target causes and communities they want to support. The reach and financial power of the organisation is impressive: a Google search for “IFC” will typically yield headlines such as “IFC plans to invest $75 million in Glenmark Pharmaceuticals”; “IFC to invest $15 million in Vietnamese animal feed firm Anova’s Bond”; or “IFC to invest $20 million in Abraaj Group”. The IFC example foregrounds the complexity of drawing hard-and-fast boundaries around the field of social finance. Even though many of the IFC’s investments are in private-sector businesses and multinational corporations (i.e. investments that are not particularly “social”), its ultimate mission is a social one: to create jobs and seed economic growth in order to advance development.

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**CROWDFUNDING**

Othmar M. Lehner defines crowdfunding as the act of “tapping a large dispersed audience, dubbed as ‘the crowd’, for small sums of money to fund a project or a venture” and one that is “typically empowered by the social media communication over the Internet, through for example embracing user-generated content as guides for investors.”

The idea of funding a project through small contributions from a large audience is not new. However, due to its informal and democratic nature, crowdfunding has become more widespread in recent years. As its investors generally care more about social rather than financial returns, crowdfunding seems an appropriate tool for social entrepreneurs to raise capital. The emergence of online platforms, such as Kickstarter, Indiegogo and GoFundMe, has aided social enterprises in raising both awareness and capital for their ideas. Typically, out of the plethora of initiatives, only a selected number of crowdfunding projects receive adequate funding and see their ideas turned into reality. Open Source Ecology is one particular social enterprise that used crowdfunding for its Global Village Construction Set (GVCS). Aimed to bring affordable industrial machines to rural communities around the world, the company has, to date, raised over US$60,000 for its GVCS project.

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Industrial machines featured in Open Source Ecology’s GVCS, taken from the company’s website.
Conclusion: Looking Ahead

Going forward, social finance faces a broad set of opportunities and challenges. Ellie Howard of Cicero Group suggests that “in time, social finance will become inherent to the practice of investing in line with the progression to a conscious economy”, but that “the sector first needs to establish itself”. In other words, what is now somewhat of a fringe concept—investing to achieve measurable social impact—will eventually become inextricable from “plain-old” normal investing. When that happens, we’ll have an economy that includes social impact in its core calculus; that incorporates more of the full costs and benefits of doing business; and that is more “conscious” of the impacts it has. Howard goes on to call for “the creation of a platform to not only attract the investment, but also the brightest minds and expertise for the sector to flourish”. The table below presents a summary of the prospects and obstacles facing social finance, and its potential to thrive.

### OPPORTUNITIES

- Population growth in emerging countries
- Innovative technologies that
  - allow for global reach
  - increase collaboration
  - reduce transaction costs
- More collaborative efforts between businesses, charities and governments
- Increased professionalism from impact investors
- New investment tools
- Growing legislative support
- Academic support (professional programmes, incubators and competitions)
- High payback rates for micro-loans
- Positive mindset shifts and generational changes

### CHALLENGES

- Returns from social instruments are on average lower than those of traditional instruments (for now)
- Insufficient education about and training in social finance
- Social enterprises still largely seen as charities
- Fragmented social enterprise market due to varied agendas of organisations
- Lack of available quantitative data
- Lack of standards for measuring social impact
- Too little readily available funding
- More regulations that potentially curb the investment
- More collaborative efforts between businesses, charities and governments
- Increased professionalism from impact investors
- New investment tools
- Growing legislative support
- Academic support (professional programmes, incubators and competitions)
- High payback rates for micro-loans
- Positive mindset shifts and generational changes

Now that we’ve examined the kinds of organisations that receive social finance, discussed the financial tools used, cited examples from around the world, and highlighted some exciting opportunities ahead, we hope this “SoFi 101” has covered some important ground, albeit not exhaustively, on the topic of social finance. Maybe the next time someone asks, “What is social finance anyway?”, this article can be a place to start.

All opinions expressed in this article, unless otherwise stated, are those of the authors. Any errors or omissions are the authors’ own.

### Notes

4. Ibid.
13. CIC Association, “What is a CIC?”. http://www.cicassociation.org.uk/about/what-is-a-cic


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17  Ibid.


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Christian Petroske is an Assistant Manager at the Lien Centre for Social Innovation. He drives forward a diverse range of projects, including the Centre’s research, capacity-building, partnerships, events, and is Contributing Editor for Social Space. Before joining the Centre, Christian helped Year Up build data-based feedback loops into its core decision-making as Sales Operations and Market Research Fellow while participating in a selective, applied management training programme through New Sector Alliance’s Residency in Social Enterprise. Christian holds a BA in Sociology with Honours from Brown University, where he chaired the state’s biggest social enterprise conference, worked with two start-ups and founded one, conducted both applied and academic research, and wrote an award-winning Honours thesis on feedback and power in social finance. He can be reached at cpetroske@smu.edu.sg

Florian Parzhuber is a senior at the Singapore Management University (SMU) where he majors both in Finance and Operations Management. Presently a Data & Operations Associate at the Lien Centre for Social Innovation, he has previously conducted research on water access in Laos (specifically the regional water-management along the Mekong River), social entrepreneurship in the Philippines, as well as the social entrepreneurial landscape around the globe. His research interests include water and sanitation systems across different continents, financial inclusion, as well as the future outlook of crowdfunding. He can be reached at fparzhuber.2013@smu.edu.sg

Florian Parzhuber

Originally from Seoul, South Korea, Haneol Jeong is a student at the Wharton School of the University of Pennsylvania, and a member of the Joseph Wharton scholars program. He was a Summer Research Associate at the Lien Centre for Social Innovation, during which time he conducted independent research project on increasing energy access in Southeast Asia through investment in social enterprises. He can be reached at haneolj@wharton.upenn.edu

Haneol Jeong

Mitchell Laferriere was a Summer Research Associate at the Lien Centre for Social Innovation. During this time, he studied theory, strategy and developmental curriculum for the teaching of impact investing to university students. His primary research interests cover impact investing, sustainable finance, social entrepreneurship and social innovation. He is currently based in Manhattan, New York, where he attends the Gabelli Business School at Fordham University. He can be reached at mlaferriere1@fordham.edu

Mitchell Laferriere

John Kinsella is a sophomore at the University of Pennsylvania. Originally from Houston, Texas, he earned an Eagle Scout award and received the Princeton Prize Certificate in Racial Relations. He was a Summer Research Associate at the Lien Centre for Social Innovation, during which time he conducted independent research on interdisciplinary solutions to issues facing the world. He can be reached at jkin@sas.upenn.edu

John Kinsella

Remi Cordelle is a rising sophomore at the University of Pennsylvania, where he majors in Economics and Computer Science. Formerly a Summer Research Associate at the Lien Centre for Social Innovation, Remi conducted research on income inequality. His areas of interest include social mobility in emerging economies; financial inclusion in Southeast Asia; financial literacy in marginalised communities; social enterprises in Indonesia; microfinance in developed and emerging economies; and leadership in social finance. He can be reached at remicor@sas.upenn.edu

Remi Cordelle

Maaya Murakami, formerly a Summer Research Associate at the Lien Centre for Social Innovation, is a senior at the University of Pennsylvania, where she majors in International Relations and Economics. Born in Japan but raised in the Netherlands and Germany, Maaya’s research interests include ASEAN’s strengthening of social protection measures in its member states, and its challenges and implications; social entrepreneurship in Cambodia; and Germany’s dominance in the management of the European economic crisis. She can be reached at manyam@sas.upenn.edu

Maaya Murakami

Laferriere