

**Certified Expert in ESG and Impact Investing**

# **Quality Assurance (QA) Framework for Managing ESG and Impact Investing**

The Quality Assurance framework presented in this write-up forms a central part of the [Certified Expert in ESG and Impact Investing](#) course at the Frankfurt School of Finance and Management.

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2. edition 06/2023

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Printed in Germany

# 1 Background

Environmental Social and Governance (ESG) and impact investing are attracting increasing attention, reflected in the accelerating volume of capital managed to sustainable criteria. Despite this rapidly increasing scale the discussion of ESG and impact investing remains surprisingly fragmented and lacking in precision as to the exact results that are expected to be achieved. This makes it difficult to integrate non-financial goals and financial goals into a single coherent investment framework that can be applied to total assets under management (AUM).

This fragmentation has two primary causes:

- A plethora of approaches to ESG and impact investing have been developed at different times, with different focuses, and have not yet been drawn together into a coherent discipline.
- In the case of impact investing, many approaches violate the basic logical separation between investors' mandates and the characteristics of individual assets which is a necessary part of portfolio theory.

The framework described below addresses these two problems.

- A structure which integrates the various approaches to ESG and impact investing into a logical and cohesive framework is created by:
  - Identifying the particular characteristics of an asset that are managed by each of the approaches to ESG and Impact. These characteristics are exposures, risks, outputs, and outcomes.
  - Describing eight discrete strategies that are used to manage each of exposures, risks, outputs, and outcomes.
  - Recognising that these eight strategies are independent of each other and so together form a quality assurance framework.
- The quality assurance framework is consistent with portfolio theory and, as such, enables the application of ESG and impact investing across an investor's entire assets under management (AUM), subject to the availability of the data required to implement the relevant combination of strategies. It is a neutral framework that can be used by all investors regardless of their mandate.

## 2 Developing the QA framework: Type of Goal Being Managed

As a *first step*, the QA framework looks at the four approaches to sustainable investing broadly defined – Socially Responsible Investing (SRI), Thematic Investing, ESG Investing and Impact Investing – and asks which characteristics of assets<sup>1</sup> are being managed by each of these approaches? The QA framework identifies that the characteristics being managed by the four approaches are exposures, risks, outputs, and outcomes.

Exposures, risks, outputs, and outcomes provide a precise way of describing non-financial goals and expressing expected non-financial results. Rather than talking in terms of SRI, Thematic, ESG and Impact, we can express our goals and describe our results with much greater precision if we frame the discussion in terms of exposures, risks, outputs, and outcomes.

Exposures, risks, outputs, and outcomes create a hierarchy in terms of both the significance of the contribution made towards achieving the Sustainable Development Goals (SDGs) and the operational intensity of the strategies required to achieve non-financial goals.

### 1. **Exposures**

Managing our exposure to assets does not make a direct contribution to achieving the SDGs as there is no direct increase in the quantity of beneficial outputs, reduction in the quantity of harmful outputs, or improvement in the experience of a community or an ecosystem. Managing exposures may make an indirect contribution to the SDGs if a large enough group of actors all manage the same exposures in a similar way, resulting in a reduction in the cost of capital for assets with positive characteristics and an increase in the cost of capital for assets with negative characteristics.

### 2. **Risks**

Actively managing non-financial risks contributes directly to achieving the SDGs by reducing the occurrence of negative events, for example industrial accidents or chemical spills. Active risk management may also indirectly contribute to achieving the

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<sup>1</sup> The term 'asset' is used as an overarching concept equivalent to 'funded entity', not asset class. An asset could be a private investment, an investment stake in a fund, a publicly listed security, a whole company, or a grant funded project, etc. The QA approach can be used in managing all these types of assets.

SDGs if a sufficient number of actors are aligned in placing a higher value on assets with good management of ESG risks, as this will lower the cost of capital for assets with good ESG risk management relative to assets with weak ESG risk management.

3. **Outputs**

By actively managing the creation of beneficial outputs an actor can contribute directly to achieving the SDGs by identifying and backing assets which are expected to create a particular quantity of beneficial outputs, for example one thousand additional lower-income children with access to education or twenty thousand fewer tons of carbon dioxide emitted. Managing the creation of beneficial outputs may also lead to an indirect contribution to achieving the SDGs if a sufficient number of actors are aligned in placing a higher value on assets which create a larger additional quantity of beneficial outputs and a lower value on assets which produce either few additional beneficial outputs or negative outputs.

4. **Outcomes**

By actively managing outcomes an actor contributes directly to achieving the SDGs (i) by ensuring that its actions will be experienced by the target population or ecology in the intended manner and (ii) by achieving a holistic understanding of the consequences of its actions and so improving its ability to ensure that its actions have net positive consequences. Managing outcomes may also lead to an indirect contribution to achieving the SDGs if a sufficient number of actors are aligned in being more willing to fund assets and activities whose effect on the target population or ecology is understood more exactly and with more certainty.

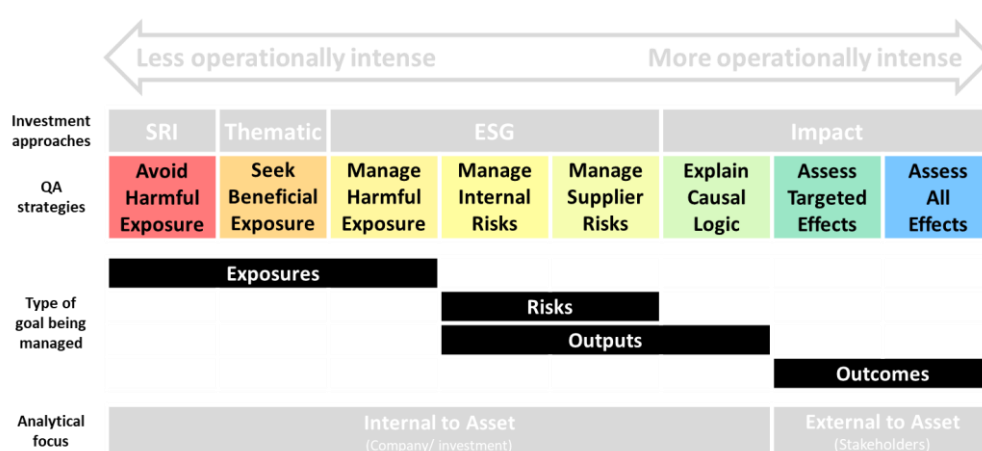
Managing exposures requires the least operationally intensive strategies to implement and results in only an indirect contribution to achieving the SDGs as to be effective it requires a large enough group of actors to all manage the same exposures in a similar way. At the other end of the scale, managing outcomes requires the most operationally intensive strategies to implement and results in confidence that our actions will be experienced by the target population or ecology in the intended manner and, by achieving a holistic understanding of the consequences of our actions, improves our ability to ensure that our actions have net positive consequences.

### 3 Eight strategies for managing the goals

The *second step* taken by the QA framework is to identify the strategies used to implement each of the four approaches and to establish exactly what combination of exposures, risks, outputs, and outcomes each strategy manages. Eight currently used strategies have been identified.

Putting the four approaches, the eight strategies and the four characteristics being managed together in one diagram creates the QA framework illustrated in Figure 1 below.

**Figure 1: Diagram of the Quality Assurance Framework**



The diagram of the QA framework makes it clear why a discussion of sustainable investing expressed in terms of SRI, Thematic, ESG and Impact is so lacking in clarity and precision. The imprecision arises both because (i) it is not generally well-understood which of the four characteristics is managed by each of the four approaches and (ii) ESG and impact correspond to the management of more than one characteristic. If we have adopted an SRI or a Thematic approach, then it is clear that we are managing exposures. However, if we have adopted an ESG approach we could be managing exposures, risks or outputs or some combination of all three. If we have adopted an Impact approach, we could be managing either outputs or outcomes or both.

Given the very different significance of the contribution to achieving the SDGs made by managing each of exposures, risks, outputs and outcomes, the imprecision involved in simply referring to 'SRI, Thematic, ESG and Impact' is a significant problem. The course examines each of the 8 strategies in detail.

## 4 Quality Assurance Framework

**Independence of strategies:** The *third step* in developing the QA framework is recognizing that the independence of the eight strategies makes it possible to develop a Quality Assurance (QA) Process. Each of the eight strategies is independent of the others, as each strategy requires a particular set of data to implement and the performance of distinct activities, achieves distinctly different results, and requires the reporting of particular information to track performance. This independence makes it possible to use the eight strategies to create a QA framework.

Once an investor has established the non-financial goals of its mandate, it can identify the combination of the eight strategies required to achieve those goals. Also, in the reverse process, one can observe the strategies being used by an investor and identify the ESG and Impact goals that the investor can validly claim to be pursuing.

This ability to match the actions undertaken to the possible valid non-financial goals creates an operationally precise definition of impact washing. An actor is impact washing if they are claiming to achieve goals which exceed those supported by the combination of the eight strategies they are using.

**Aligning financial and non-financial management:** The *fourth step* taken to develop the QA framework is to align the logic of the design and implementation of non-financial goals with the logic of the design and implementation of financial goals. The QA framework does this by framing the analysis of non-financial goals in terms of the significance of the contribution made to achieving the SDGs. Just as financial goals are framed in terms of maximizing returns subject to remaining within boundary conditions, e.g. the level of risk, non-financial goals are framed in terms of maximizing the significance of their contribution to achieving the SDGs subject to remaining within boundary conditions, e.g. a requirement for additionality or achieving financial goals.

Currently, most approaches to impact investment frame the analysis of impact in terms of the impact-intensity of the mandate of the investor. However, this framing provides no indication of the characteristics of any asset (exposures, risks, outputs, or outcomes) and so provides no information on the significance of any asset's contribution to achieving the SDGs.

We think that the QA Framework and strategies presented in the ESG and Impact Investing e-learning course establishes a clear relationship between the strategic choices of actors and the contribution made to achieving the SDGs.

We welcome a more detailed exchange with you during the course.

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