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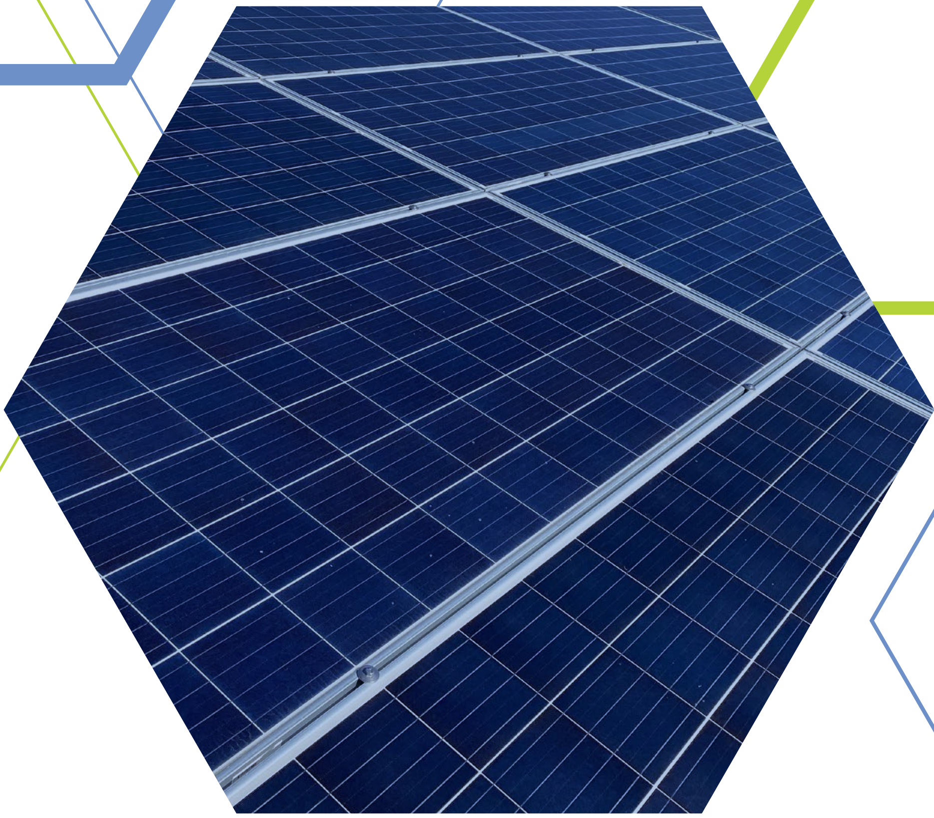

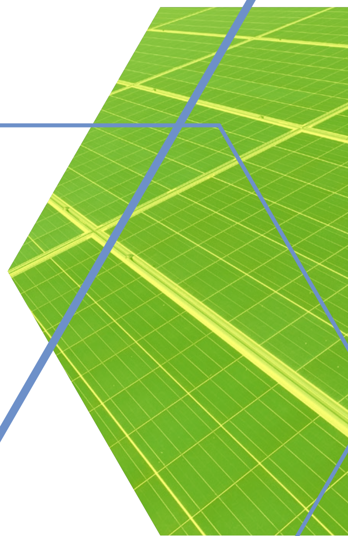

INVESTING WITH INTEGRITY

THE BENEFITS AND CHALLENGES OF INTEGRATING HIGH BUSINESS INTEGRITY STANDARDS IN IMPACT INVESTMENTS

Supported by: British International Investment

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EXECUTIVE SUMMARY

Impact investors play a critical role in international efforts to meet the United Nations Sustainable Development Goals (UN SDGs). Estimates of the volume of capital managed in this sector range from USD 500 billion to 2 trillion and the figure is growing[1]. These investors have ambitious goals to drive positive economic, environmental and social change (together 'development impact') through investment.

Investing with integrity is fundamental if impact investors are to meet these goals. Business integrity is central to fulfilling a development mandate, and should not only be a matter of compliance. Without this insight, the positive forms of impact that investors seek are in jeopardy.

> **Business integrity is central to fulfilling a development mandate, and should not only be a matter of compliance.**

Implementing high business integrity standards in practice presents some distinct challenges for this group of investors. For impact investors focussed on emerging and frontier markets (the primary audience for this publication), their development mandate means they typically have high inherent exposure to risks from corruption. Countries where investments can be most impactful – countries where there are high rates of poverty and unemployment – are often heavily afflicted by corruption. If other types of investors might walk away, impact investors are compelled to work in these markets to meet other development objectives.

While there is existing guidance on business integrity standards, this report is the first to explore in detail the realities of implementation in impact investing in emerging and frontier markets. It illustrates the challenges which arise and how impact investors can best respond.

This report makes five main recommendations which are expanded below. It calls on impact investors to:

1. **Conceptualise business integrity as central to their development mandate and not only as a compliance issue.**

2. **Adopt a proactive stance to detect and mitigate risk to become leaders on business integrity.**

3. **Improve coordination of their activities on business integrity and Environment, Social and Governance (ESG). This will strengthen risk management and provide a platform for realising development impact.**

4. **Ensure they are consistent on business integrity and recognise that an impact mandate means that high levels of transparency should be the norm.**

5. **Enhance levels of sectoral collaboration to raise standards and disseminate good practices.**

To research these issues Transparency International UK has consulted widely with stakeholders in the sector. We spoke to over 50 individuals, including professionals based in developed and developing markets working at impact investors, asset owners and investees. We reviewed over 100 existing articles and reports in a literature review and developed case studies to illustrate key points.

1 IFC, 'Growing Impact. New Insights into the Practice of Impact Investing' (2020).

What do we mean by impact investing?

We follow the Global Impact Investing Network (GIIN) definition of impact investments as **"investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return"**. However, we recognise this covers a broad group of investors, and there are ongoing debates around authenticity and credibility in this sector. We consequently look to the Impact Principles, a framework to improve rigour in impact measurement, when we think about the defining characteristics of an impact investor. The focus of this report is on impact investing in emerging and frontier countries. Many of the points raised will be relevant to impact investors in developed countries, where corruption is also a serious societal problem.

What do we mean by business integrity?

Business integrity encompasses a broad range of issues, including anti-corruption, anti-money laundering, sanctions controls, counter fraud measures and the assessment of associated reputational risks. The topic sits at the intersection of financial crime compliance and ESG. There are also overlaps between business integrity and corporate governance, another key priority for impact investors. At Transparency International we are principally concerned with approaches to mitigating corruption risk and this is the main focus of this report. We argue that corruption is a distinct issue needing specific attention. It has directly harmful societal consequences and also undermines other forms of impact.

What do we mean by ESG?

In this sector, Environmental, Social and Governance (ESG) is concerned both with risk mitigation and value creation. Investors seek to mitigate any adverse environmental and social impacts of investments, such as labour and human abuses, reinforcement of gender inequalities, and damage to the environment. The sound management of these issues can result in positive outcomes from an investment, such as improved labour standards, improved diversity and inclusion in business, and reduced greenhouse gas emissions. The International Finance Corporation's (IFC) Performance Standards on ESG are a benchmark widely applied by impact investors.

1 Impact investors should conceptualise business integrity as central to their development mandate and not only as a compliance issue.

This report explicitly seeks to reorientate the framing of business integrity to emphasise its intrinsic connections to the development impact investors seek. It is motivated by the observation that the extensive links between business integrity and other developmental impacts are only weakly recognised in practice and in existing guidance materials. Corruption as an issue is largely absent from leading ESG frameworks used by impact investors. Equally, while addressing corruption is a target of the SDGs, corruption barely features in debates around how impact investors can best measure the development impact of their investments.

This disconnection is evident in the ways impact investors approach business integrity. The topic is recognised across the sector as important but many impact investors too narrowly approach business integrity as a compliance threshold to be crossed. In this framing, business integrity matters because it helps the investor avoid negative reputational, financial, legal and regulatory consequences. These are important and tangible risks for impact investors. However, they should not be the only goal, nor the end goal, of business integrity risk management.

An alternative conceptualisation sees business integrity as an enabling factor for development impact. This requires deeper engagement with the relationship between corruption and development. While analysis of this relationship is increasingly sophisticated – corruption can sometimes coexist with economic growth in the short-term at least - the overall relationship is overwhelmingly negative. Many of the countries where impact investors look to deploy capital are entrapped in vicious cycles of corruption with harmful developmental consequences. Corruption deepens poverty and exacerbates inequalities. Its burden falls hardest on women and vulnerable groups.

Corruption is consequently not an issue impact investors can ignore. In this report we demonstrate how business integrity fundamentally shapes the development outcomes from investments. For each investment, high standards of business integrity:

- **Underpin financial sustainability:** impact investors aim to support financially sustainable businesses that generate employment, broader societal benefits, and return on their investment. Involvement in corruption threatens these gains. There is no question that firms working in contexts of systemic corruption face real dilemmas on how to respond to corrupt demands. Short-term gains from participating in corruption nonetheless often come at the cost of entrenching long-term problems at firm and societal level. In contrast, investors see a 'business integrity premium' where high standards translate into improved financial performance and return on investment.

- **Strengthen ESG risk management:** Managing business integrity issues is necessary if impact investors are to successfully mitigate environmental and social risks. Involvement in corruption can dramatically undercut carefully designed systems to limit negative environmental and social impacts of investments. Because the issues are tightly connected, impact investors cannot create value on ESG without equivalent attention to business integrity.

- **Prevent unintended harms:** if an investment offers the prospect of high development impact, this should not come at the expense of harms elsewhere. Impact investors should resist the idea of a trade-off in which tolerance of business integrity problems can be justified by otherwise positive impact. There is no denying this at times means making tough choices. Clear lines need to be drawn on the acceptability of issues around investments.

  This does not stop impact investors from working in difficult contexts and nor should it; withholding external capital may cause more harm. What it does absolutely demand is that higher exposure to business integrity issues is met with commensurate effort on risk mitigation. This will include not making investments in some circumstances. At other times, this will involve supporting an investee to strengthen business integrity risk management.

Impact investors also need to step up efforts to incorporate business integrity into the ways in which they measure their contributions to development impact. Business integrity can be thought of as a risk to impact and form of value creation.

Specific recommendations for impact investors are to:

- **1.1.** Set out publicly how business integrity connects to their business development and strategic impact objectives.
- **1.2.** Explicitly consider the implementation and maintenance of high business integrity standards as a form of positive impact from an investment.
- **1.3.** Assess whether business integrity problems could undermine or negate the intended positive outcomes from investments.
- **1.4.** Commission research, case studies and evaluations to develop the evidence base on the business integrity impacts of investments.
- **1.5.** Consider making select investments where a principal aim is to contribute to reducing corruption issues in a market.

2 Impact investors should be leaders in business integrity, adopting a proactive stance to detect and mitigate risk.

As some of the first movers in emerging and frontier markets, impact investors often set standards which others follow. Sometimes called the 'demonstration effect' of impact investing, this confers responsibility to demonstrate high standards of integrity can be maintained in difficult operating contexts.

Our research found pockets of good practice but overall many impact investors are not making the most of their position to proactively promote high business integrity standards. We also see common areas where standards should be improved. Key to this would be for impact investors to shift from a *reactive* stance on business integrity, responding to concerns when threats arise, to a *proactive* stance, actively looking to identify and mitigate risks.

For the majority of impact investors consulted, their position appears more reactive than proactive. This distinction becomes apparent throughout the investment cycle. Due diligence is central to the way impact investors operate. All the investors described generally thorough counterpart compliance and reputational checks on prospective investees. Only a minority however look beyond this to work with an investee to build understanding of the specific challenges and issues facing that business.

All the investors consulted similarly require investees to adopt basic, uniform business integrity controls. What is often lacking are efforts to combine internationally recognised good practice with local knowledge on what has worked in countering corruption. Investors also need to understand whether an investee genuinely has capacity and will to manage the business integrity risks it faces.

Investor attention to the issues can further diminish post-investment. Several impact investors privately acknowledged that portfolio monitoring on business integrity is an area of weakness. Some leading impact investors do not have sufficient staff to conduct adequate portfolio monitoring on business integrity.

With the right resourcing, impact investors can support investees to strengthen their approach to business integrity risk management. This should be seen as part of the key responsibilities for an impact investor if they are investing capital in high-risk markets.

Specific recommendations for impact investors are to:

- **2.1.** Incorporate business integrity into country and sectoral market assessments, examining the political and economic factors that influence levels and forms of risk. The information should be continually updated to reflect current market conditions and influence where and how investments are made.
- **2.2.** Strengthen pre-transactional due diligence by going beyond counterpart compliance due diligence to assess business integrity risks in the operating environment. Assessments should also cover the adequacy of risk management capacity and level of commitment to mitigating these risks.
- **2.3.** Strengthen portfolio monitoring by ensuring resources are in place to regularly engage with investees on business integrity risk management.
- **2.4.** Support investees in developing business integrity risk management systems.

3 Business integrity and ESG intersect in important ways. Impact investors can look to improve coordination of their activities in these areas to strengthen risk management and provide a platform for realising development impact.

One adverse outcome of framing business integrity as a compliance issue is that the topic can become disconnected from other activities connected to an impact investor's mandate. Across the lifecycle of an investment, business integrity and ESG intersect in important ways. There are additionally legal and professional trends that support the principle of closer working between functions.

Although these functions cover different topics, the aim should be to build, as one interviewee explained, "systems which strengthen and complement each other rather than being parallel and separate". The benefits include forming a more holistic understanding of an issue, its drivers, and the options available for mitigation.

This report demonstrates how these benefits can be achieved with analysis around the topics of gender and healthcare standards. Corruption is an enabling factor for different forms of abuse that could be present at an investee. Understanding the common roots of problems leads to complementary mitigating measures. The figure **(below)** illustrates priority responses where there is overlap between business integrity and ESG in terms of the types of measures impact investors can recommend to investees.

Specific recommendations for impact investors are to:

- **3.1.** Ensure that business integrity is not separated from work with investees on ESG. The issues should be coordinated from the beginning of the investment process and not as a final compliance check. Organisational structures need to support this mode of working.
- **3.2.** When implementing the IFC Performance Standards, explicitly consider whether business integrity issues could undermine the measures developed with investees.
- **3.3.** Review how certain risk mitigation tools could be better integrated or coordinated. These might include joint business integrity and ESG risk assessments, audits, and whistleblowing processes.

4 Impact investors should at all times ensure they are consistent on business integrity and recognise that their mandate means that high levels of transparency should be the norm.

Impact investors have broad-based accountability to different stakeholders (see Figure 1 below). This means that they should expect high levels of scrutiny on business integrity and be ahead of the game. Effort spent on developing standards is not always matched with effort on implementation. As one expert put it in interview: *"sometimes sight is lost on how investment codes are to be delivered. Investors need to ensure the mechanisms are in place to demonstrate they can live up to guidelines"*. Three areas where consistency could be improved are:

- **Transparency** is central to the accountability that impact investors have to their stakeholders. It also has a dual benefit in that it helps to strengthen business integrity systems by discouraging misconduct. Our review of the public materials released by a sample of impact investors shows that there is room for improvement. While some investors publish reasonable levels of detail about their approach to business integrity risk management, for many others the information available is much more limited. Some investors do not disclose the very basics, such as an anti-bribery and corruption policy.

- **Responding to concerns:** In high-risk contexts, it is likely that business integrity issues will occur. It is important that investors respond to concerns openly and in a consistent manner. This should be based around structured guidelines rather than approaching all decision-making on a case-by-case basis.

- **Investment structures:** Transactions structured through offshore financial centres present a problem of internal consistency on business integrity for impact investors. These structures are widely used in the sector to provide legal and financial security for investments. At the same time, they are a major loophole in the global financial system that enable financial crime with devastating developmental consequences.

  Impact investors conduct anti-money laundering (AML) checks to reduce the risk of their investment structures being directly implicated in financial crime. They also need to respond to the contradictions apparent in sustaining an investment model which is known to cause harm to the communities they serve. Impact investors need to continually review their use of these structures. They should further consider how they can be part of the solution to the problem, such as by publishing beneficial ownership information when it is otherwise lacking.

Specific recommendations for impact investors are to:

- **4.1.** Publish core information on their approach to managing business integrity risks, including but not limited to:
  - An overall assessment of the corruption risks the investor and its investee businesses face and how they respond;
  - Anti-bribery and corruption policies and procedures;
  - Requirements and expectations of investees on business integrity;
  - Information on investigations and complaints processes, including the status and outcomes of past investigations.
- **4.2.** Establish a clear public position on risk tolerance, including levels of business integrity risk that are unacceptable to the investor.
- **4.3.** Have set procedures and guidelines in place for responding to integrity incidents, with different scales of response up to and including divestment.
- **4.4.** Minimise the use of offshore jurisdictions in investment structures. Refuse to use corporate vehicles incorporated in offshore jurisdictions that do not meet the higher of Organisation for Economic Co-operation and Development (OECD) or local standards on releasing identity and beneficial ownership information.

5 Levels of sectoral collaboration on these issues should be significantly enhanced to raise standards and disseminate good practices.

In many areas such as ESG, the impact investing sector has shown itself to be innovative and a standard setter. There is an opportunity for impact investors to take up this role on business integrity, enhancing collaboration to find solutions to common challenges.

Unlike for ESG, there is no common unified framework on business integrity for impact investors, nor consistency in the language and terminology used. This can create some problems. There can be mixed messaging from different impact investors to investees on the importance of business integrity. Conflicting business integrity requirements can also lead to a high administrative burden on investees.

Given the sector encompasses firms of varying sizes and mandates, there is no single model of business integrity risk management. There would be benefits however from harmonisation around core standards to which all impact investors can subscribe. Promoting collective action on business integrity in key markets would further enable impact investors to multiply their impact.

Specific recommendations for impact investors are to:

- **5.1.** Develop a global set of harmonised standards covering, at minimum, common expectations on business integrity for investees and investee reporting standards to investors.
- **5.2.** Convene regular industry forums and working groups to share learnings on approaches to managing business integrity risks.
- **5.3.** Incubate and support collective action initiatives in markets in which multiple impact investors and investees are operating.

Oversight by asset owners

Asset owners have an important role in promoting high standards and ensuring accountability on business integrity in the sector. This group of stakeholders includes government funders of Development Finance Institutions (DFIs) at one level, and then various investors in impact funds including DFIs, institutional investors and foundations. We heard some examples of asset owners demanding high standards and following-up to ensure these are implemented in practice. In other cases, it was apparent from discussions that asset owners are passive on business integrity. They are content that basic measures are in place and then react to specific events. This is insufficient. Asset owners should equally look to use their influence to ensure the highest standards are upheld.

Specific recommendations for asset owners are to:

1. Set the highest expectations for impact investors on business integrity and provide the resourcing to ensure these commitments can be met in practice.
2. Proactively engage with impact investors to review whether they are meeting business integrity commitments in practice.
3. Have set procedures and guidelines in place for responding to integrity incidents involving impact investors, with different scales of response up to and including divestment.

Figure 1: Key stakeholders in the sector

INTRODUCTION

What is impact investing?

It is important to outline what we mean by impact investing, how it differs from other forms of investment, and recognise there are ongoing debates around investor credibility in this sector. One of the most widely used definitions of impact investing is promoted by The Global Impact Investing Network (GIIN), an industry group. It defines impact investments as:

> **"Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return"[2].**

Two important elements of this definition are:

- **Intentionality:** impact investors purposefully pursue positive impact through their investments. It is core to their investment thesis that an investment should generate both financial return and positive social and environmental impact. This differentiates impact investors from mainstream investors where social and environmental impact may be one outcome but not necessarily an explicit goal of investment. It also differentiates these investors from grant-making, where there is usually no expectation of financial return.

- **Measurement:** impact investors should proactively seek to understand the social and environmental performance of their investments. This requires commitment to generating evidence to be used for the complex task of impact measurement. It also implies high levels of transparency and accountability to the various stakeholders affected by an investment.

One critique of the GIIN definition is that it is too broad. It covers such a range of asset classes, investor types, themes and return expectations that "it is hard to identify what is an impact investment and what is not"[3]. While impact investors might once be said to have operated at the margins of the financial system[4], many of the values they espouse have also become more integrated into mainstream investment. This is apparent from the wide dissemination of the United Nations Principles for Responsible Investment (UNPRI), which encourage investors to integrate Environmental, Social and Governance (ESG) into their work. These principles count 4,902 signatories as at March 2022[5].

The rise of impact investing has not been without controversy. The phenomenon of "impact washing" is cited as the top concern of investors in the GIIN's 2020 annual survey[6]. This is "when a company or fund makes impact-focused claims in bad faith without truly having any demonstrable positive social or environmental impact"[7]. High profile allegations of impact washing have shown the sector that impact credentials have to be earned and not taken at face value[8].

An important step in this direction was the launch in April 2019 of the Impact Principles, a process originally convened by the International Finance Corporation (IFC). As at May 2022, this group included 150 investors with USD 451.7 billion in covered assets[9]. The Impact Principles represent a common framework for integrating impact considerations into the lifecycle of an investment **(see Section 1.4)**. They operationalise and reinforce the two key elements of the GIIN definition highlighted above on intentionality and measurement.

We recognise there is overlap between impact investing and other terms such as "ESG investing" and "socially responsible investing" but use the Impact Principles as a guiding frame for this report.

2 GIIN, 'What You Need to Know about Impact Investing' (accessed 13 May 2022).
3 Brian Trelstad, 'Impact Investing: A Brief History' (2016) *Capitalism and Society, Vol 11, Issue 2.*
4 Harry Hummels 'Impact investments' in Veronica Vecchi, Luciano Balbo, Manuela Brusoni and Stefano Caselli (eds), *Principles and Practice of Impact Investing. A Catalytic Revolution* (Routledge 2016).
5 UNPRI, 'Signatories' (accessed 13 May 2022).
6 GIIN, 'Annual Investor Survey 2020' (2020).
7 Peter O'Flynn and Grace Lyn Higdon, 'Is Participatory Impact Investing the Antidote to "Impact Washing"?', (Institute of Development Studies, 19 September 2019).
8 Cam Simpson and Saijel Kishan, 'How BlackRock Made ESG the Hottest Ticket on Wall Street' Bloomberg (London, 31 December 2021).
9 Operating Principles for Impact Management, 'Signatories and Reporting' (accessed 13 May 2022).

Who is the intended audience for this publication?

Impact investments are made in developed and developing countries. In this publication, we focus on impact investing in emerging and frontier markets, as this is where corruption risks typically run the highest. The United Nations Sustainable Development Goals (UN SDGs) 2021 Report estimates that bribery is at least five times more likely in low-income than high-income countries[10]. This does not detract from the fact that corruption problems are also present in developed countries. This is a sector that illustrates well that corruption and the responses to it are transnational in nature. International investors can facilitate and exacerbate domestic corruption issues. They can equally disseminate high business integrity standards with benefits across countries.

Our primary intended audience is impact investors for whom the pursuit of development impact in emerging and frontier markets is an explicit objective of their strategy. This might be for their investment activities as a whole or through a dedicated impact fund. The findings and recommendations primarily relate to the organisations making and managing impact investments ('impact investors'). These constitute a mix of investor types, including private equity firms, Development Finance Institutions (DFIs) and foundations. The findings will be relevant to various individuals at these firms including compliance and business integrity teams, ESG and impact specialists, and investment professionals.

There are additionally several other groups of stakeholders for whom this research is highly relevant. These are:

- The investors in asset management firms, including banks, family offices, sovereign wealth funds, large 'fund of funds' investors, and institutional investors such as pension and mutual funds. As the providers of capital in the sector, they are highly influential.
- The businesses that receive capital from investors (referred to in this report as 'investees'), their employees, and their connected customers, suppliers and contractors. They are direct and indirect beneficiaries of impact investing.
- The host communities of investees affected by their operations.
- The home governments and regulators of impact investors, which are responsible for supervising conduct. They may also be providers of capital as owners of DFIs or investors in asset managers, which brings responsibility to uphold standards and accountability to their own public.

Many of the findings will also have wider applicability to investors and businesses working in emerging and frontier markets, even if development impact is not an explicit goal of their work. Figure 1 illustrates key stakeholders in the sector and the terms used in this report.

Figure 1: Key sector stakeholders

10 United Nations, 'The Sustainable Development Goals Report 2021' (2021).

What types of investments are made?

Impact investors mainly use private debt and equity financial products to support investees. Data produced by the GIIN illustrates that for emerging market-focused impact investors, investments in public equities are rarely a priority[11]. Impact investors tend to invest in earlier stage businesses, where there is likely to be stronger evidence that their capital can bring additional value. DFIs sit at different levels within this system which means they have amplified influence in the sector. They are both providers of capital to impact investors, who manage funds on their behalf, and make direct investments.

Financial products have a bearing on investor strategies on business integrity. Equity and debt products can bring varying levels of influence, control and engagement with investee businesses.

Their development mandate leads impact investors to certain sectors. Taking GIIN survey data, **Figure 2** shows the distribution of capital across sectors for emerging market-focussed impact investors[12].

Figure 3 shows the regional geographic allocations of all impact investors[13]. We excluded North America and Western Europe from the figure as investments in these regions are not the focus of this report.

Figure 2: Allocations of capital by sector

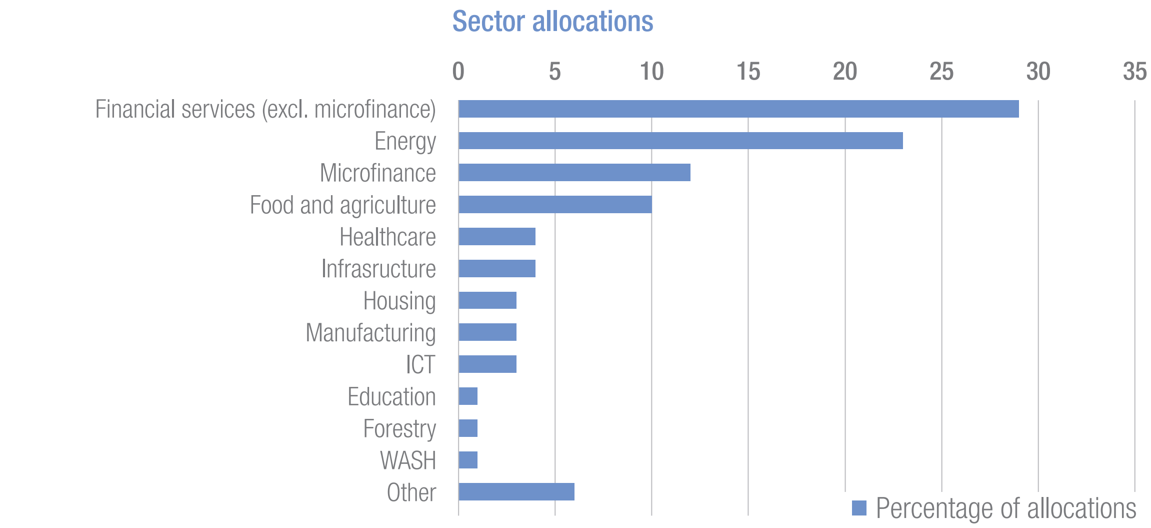
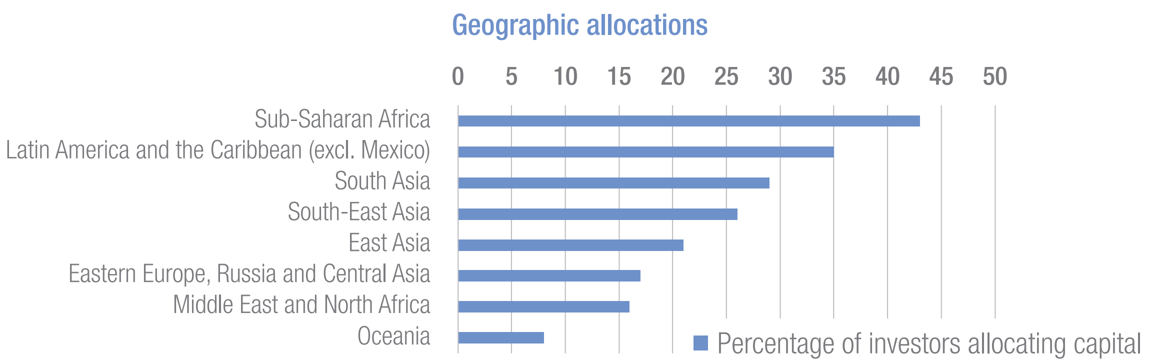


Figure 3: Allocations of capital by geography

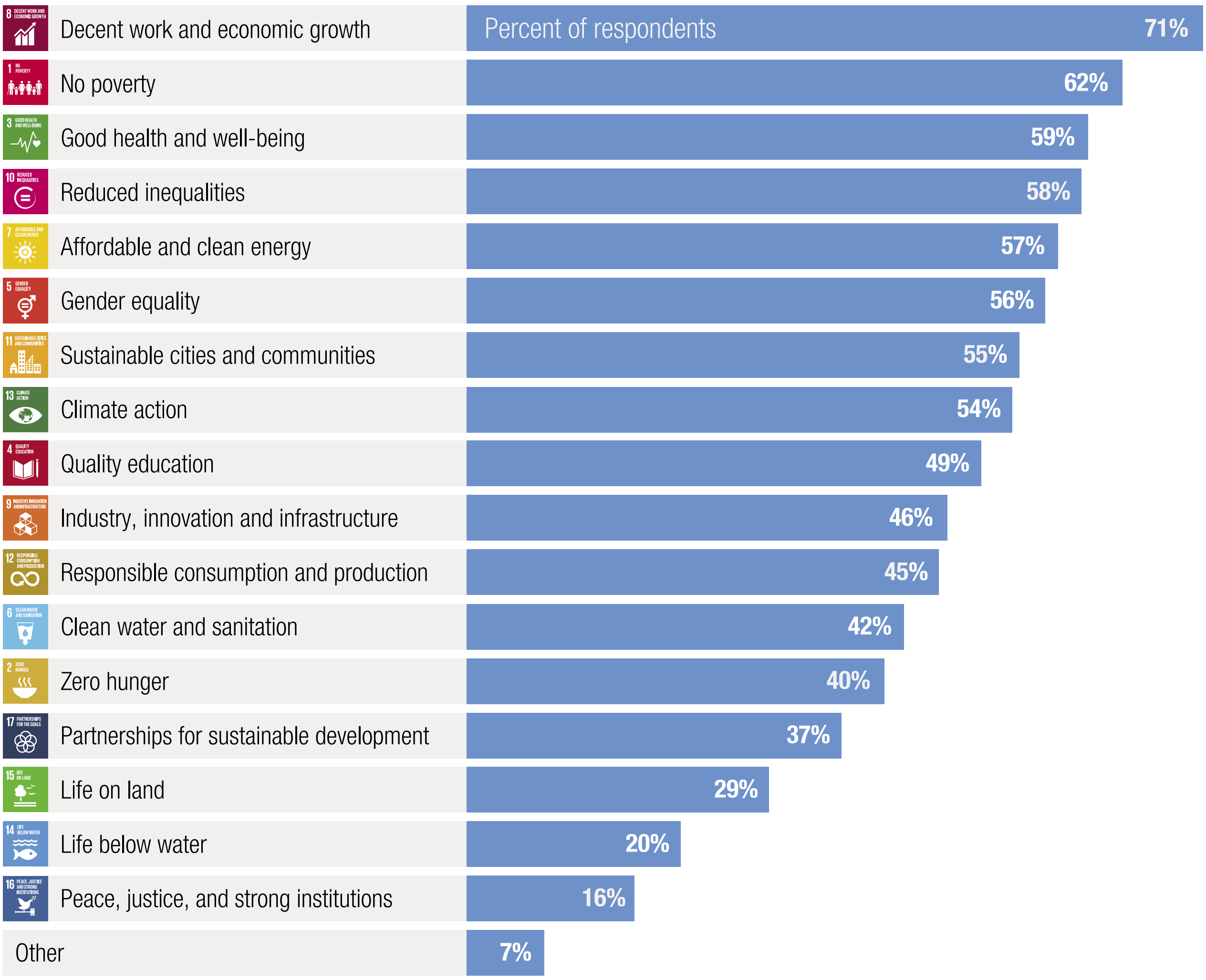


11 GIIN, 'Annual Investor Survey 2020' (2020).
12 GIIN, 'Annual Investor Survey 2020' (2020).
13 GIIN, 'Annual Investor Survey 2020' (2020).

These types of investors pursue diverse developmental objectives. **Figure 4** shows the SDGs to which all impact investors most commonly seek to align their investments[14].

The focus on SGD-8, 'Decent work and economic growth', reflects the emphasis on investing in businesses which can be major drivers of employment, economic growth and increased tax revenue. Impact measurement seeks to capture these impacts and has become increasingly sophisticated to cover diverse forms of impact. These can include climate indicators and the mobilisation of external capital (see **Section 1.4**)[15]. As shown in **Figure 4**, SDG 16, 'Peace, justice and strong institutions', which includes targets related to bribery and corruption, is the SDG theme which is the least directly targeted by impact investors.

Figure 4: SDG themes targeted by impact investors



n = 294; respondents could select multiple answer options.

Note: 'Other' target SDG-aligned impact themes include affordable housing, technology and innovation, small and medium-enterprise development, racial equity, and cross-cutting themes such as job creation, focus on stakeholders with disabilities gender equality and environmental conservation. Some respondents also noted that they do not proactively target SDG-aligned impact themes. Source: GIIN, 2020 Annual Impact Investor Survey

14 GIIN, 'Annual Investor Survey 2020' (2020).

15 GIIN, 'The State of Impact Measurement and Management Practice' (2020).

What do we mean by business integrity?

Business integrity sits at the intersection of financial crime compliance and ESG. It covers a broader range of issues including:

- Anti-bribery and corruption
- Anti-money laundering and counter-terrorist financing
- Compliance with international sanctions regimes
- Counter fraud measures
- Other associated regulatory and reputational risks
- Tax evasion

> **Transparency International** defines corruption as the abuse of entrusted power for private gain. In the impact investing sector, this covers wide categories of misconduct by individuals at both investment firms and investees. Some of the forms of corruption most relevant to this discussion include bribery, conflicts of interest, embezzlement, influence peddling, kickbacks on contracts and deals, laundering of the proceeds of corruption, nepotism, the revolving door and unethical lobbying practices.

In this report we are principally concerned with investor and company approaches to mitigating corruption risks. This is Transparency International's core organisational priority and area of expertise. We sometimes refer to the other issues listed at relevant points, but they are not the primary focus of this report.

While traditionally anti-corruption is regarded as a compliance matter, a major aim of this report is to showcase how the topic also connects to other aspects of an impact investor's mandate. There is substantial overlap between work on business integrity, corporate governance and ESG. **Figure 5** below illustrates how these topics connect at the level of an individual investee[16].

Business integrity builds on the roots of firm corporate governance and alongside ESG risk management enables development impact. Without properly attending to business integrity, the potential of an investment can be dramatically undercut.

Many different terms for 'business integrity' are used in the sector and several interviewees expressed frustration that there is no common language. For some impact investors, corporate governance is the focal point of their engagement with investees. Corporate governance and business integrity are terms that are often used interchangeably but there are important distinctions (see **Text Box 1**).

Figure 5: Business integrity interconnections

16 This figure draws substantially on prior work by the Dutch DFI: FMO, 'The FMO ESG Toolkit for PE Funds' (2021).

TEXT BOX 1: CORPORATE GOVERNANCE AND BUSINESS INTEGRITY: POINTS OF OVERLAP AND DIFFERENCE

Following the definition applied in the Corporate Governance Development Framework[17], an initiative supported by 33 DFIs, 'corporate governance' refers to 'structures and processes for the direction and control of companies'[18]. The IFC's methodology for assessing corporate governance covers six areas: commitment to ESG (leadership and culture); structure and functioning of the board of directors; the control environment; disclosure and transparency; treatment of minority shareholders; and governance of stakeholder engagement[19].

These six areas provide a foundation for business integrity. There is overlap with widely adopted anti-corruption frameworks, in particular the emphasis on board responsibility and leadership. It is difficult to envisage a firm upholding high anti-corruption standards without such a foundation. One expert said that this would be like *"putting anti-corruption controls into a vacuum"*.

Corporate governance as described in the Corporate Governance Development Framework is not however *sufficient* for maintaining high business integrity standards. Corruption is a common and harmful enough issue that it needs direct attention. Managing the issues additionally requires a more comprehensive understanding of a firm's external risk than set out in corporate governance frameworks. Key elements of recognised anti-corruption standards, such as risk assessment, third party risk management, functional responsibility for anti-corruption, incentives management, and training on corruption risks, are not emphasised in the corporate governance frameworks widely used by impact investors[20].

Three impact investors consulted, each with extensive experience working on corporate governance, said they had recently brought in staff with business integrity expertise. This was because they felt the topic was not sufficiently covered by their existing work. An ESG lead at one of these investors commented that *"the impacts of corruption are different from weak corporate governance. It needs to be handled in a particular way with a particular lens. This is not just about internal controls"*. There are also steps being taken for corporate governance to be more outward-looking. However, it is important to stress that consequences of corruption go far beyond impacts to the firm.

What is distinct about managing business integrity in the impact investing sector?

All investors need to abide by high standards of business integrity but there are certain circumstances created by impact investing which merit dedicated discussion. The basis of our analysis is that their mandate to create development impact means impact investors have both:

i) High inherent exposure to risks from corruption and related forms of financial crime which must be appropriately managed.

and

ii) Responsibility to use their influence to promote high standards of business integrity in their investment portfolio and the business environments in which they work.

Geographic and sectoral risk profile

Impact investors targeting emerging and frontier markets frequently work in countries that are heavily afflicted by corruption. This is because the countries where investments can be most impactful – countries where there are high rates of poverty, unemployment and

17 IFC, 'Corporate Governance Development Framework' (2011).

18 IFC, 'Why Corporate Governance?' (accessed 13 May 2022).

19 IFC. 'IFC Corporate Governance Methodology' (accessed 13 May 2022).

20 The definitions document currently available on the Corporate Governance Development Framework website dates from 2010 and states that corporate governance may reinforce but does not include business ethics, political governance, anti-corruption and AML (accessed 13 May 2022). From public materials, the extent to which these topics are now covered in current corporate governance methodologies is not clear.

significant barriers to development, such as inadequate infrastructure – are also those that experience widely prevalent and harmful forms of corruption. Corruption is both a cause and a symptom of political and market failures in these countries. While other investors might simply look elsewhere, impact investors need to consider opportunities in these countries if they are to fulfil their mandate.

Several smaller asset managers consulted during our research moderate their risk exposure within this overall context. For instance, they choose to limit their investments to companies that have fewer interactions with governments. However, for investors with larger portfolios concerned with tackling systemic development issues, elevated exposure to corruption risk is inherent to their work.

Sectors prioritised by impact investors such as infrastructure, renewable energy, finance and healthcare are also sectors where corruption can present significant risks. Within these sectors there can be long-established, problematic patterns of corrupt behaviour. Learning to understand and mitigate corruption is consequently a reality impact investors working in emerging and frontier markets need to confront.

Investee relationships

There are certain dynamics around the investor-investee relationship that are relatively distinct to this sector. Investors commonly work closely with management teams and play a more active role than only providing capital. One advantage this brings is that impact investors quickly become attuned to problems because of their proximity to investees. This knowledge can be usefully employed by investors in managing business integrity issues across a portfolio. On the other hand, proximity brings responsibility and, as one impact investor commented, means *"investors have limited excuses when things go wrong"*.

Responsibilities are more blurred in certain investment structures used in the sector. This is particularly true of fund of fund approaches, when impact investors entrust an investment manager to manage capital on their behalf.

The types of investees impact investors support can further increase their risk exposure. Impact investors often consider investments in companies that are at an earlier stage of growth and maturity. Helping promising businesses grow is part of how impact investors demonstrate their contribution to impact. This is the value they bring to a business beyond a mainstream investor, which can be a justification for providing finance at a rate that may be less competitive than the market.

In many cases, although by no means all, this means impact investors work with businesses that have weaker corporate governance (see **Text Box 1**). They may also have less familiarity with international standards on business integrity. Working to improve governance at the business can be part of the investment case but brings with it the uncertainties of a business in transition. In addition, in certain countries the pool of viable investee businesses may be very limited with some carrying legacy issues related to integrity.

Broad-based accountability

The level of accountability to a broad range of stakeholders is another distinguishing aspect of impact investing. There are important ongoing debates in the investment community as a whole to redefine social responsibility in investment, and ensure accountability not only to shareholders but to all stakeholders[21]. Lines of accountability are however especially direct for impact investors.

To begin, a large proportion of the funds used for impact investing is public money. DFIs in particular have government shareholders and are providers of capital to other investors. Privately-owned investors are often managing public funds. This means impact investors are scrutinised to ensure they are providing 'value for money' and funds are not lost or misused. Impact investors are also highly accountable to the communities affected by the investment. Meeting stakeholder expectations necessitates extensive consultation and public reporting beyond what might be expected for a mainstream investor.

Several interviewees emphasised the importance of the 'demonstration effect' of impact investing. In operating in challenging settings and assuming higher risk, impact investors want to show others that these investments are financially viable and can be executed to high standards. A major goal is to attract and pave the way for external capital from other sources. Business integrity is fundamental to the demonstration effect. If standards are high, this can have a positive multiplier effect, influencing other companies and investors who might follow a similar

21 As an example: BSR, 'Redefining Sustainable Business. Management for a Rapidly Changing World' (2018).

path. If impact investors get this wrong, the effects on show will be negative. This may deter others with harmful developmental consequences.

Methodology

This project began in September 2021 and ended in June 2022. We used five main questions to guide the research:

- How can we best conceptualise the links between business integrity and impact investing outcomes?
- What are the links between business integrity and other ESG risks and opportunities?
- What are the main strengths and weaknesses in how impact investors currently approach business integrity?
- What examples are there of emerging best practice on integrating business integrity into impact investing approaches?
- What are the obstacles to raising business integrity standards in the sector?

We followed a qualitative methodology as data constraints precluded quantitative examination of these questions. We began with desk-based literature research, reviewing over 100 articles, policies and reports of relevance published by impact investors, academics, civil society organisations (CSO), international organisations, media outlets and industry bodies. Key reference materials are included at the end of this report.

This review found that the existing literature specifically discussing business integrity and impact investing is limited and dispersed. While many existing materials provide context on related themes, only a small number (<10) blogs and short media articles directly addressed our research questions. Existing commentary largely focuses on the compliance aspects of business integrity. There is limited exploration of any positive relationship between business integrity and impact outcomes. There is equally a shortage of practical guidance that addresses the unique challenges of managing business integrity issues in an impact investing context.

To explore these issues further we held interviews with different types of impact investors, investee businesses, and relevant experts from academia, civil society and the private sector. We constructed a sample of interviewees to capture diverse perspectives from different stakeholders in the sector. **Table 1** below shows the distribution of interviewees consulted.

The individuals worked in various professional functions including investment, business integrity, compliance, ESG, corporate governance and impact assessment roles. 56% of those interviewed were men and 44% were women.

28% of respondents were based in non-OECD countries, although many others had lived and worked in emerging and frontier markets. The imbalance reflects the fact that many of the largest impact investors, the main audience for this publication, have their headquarters in OECD countries. We targeted these investors because they have the potential to shape standards across the sector as a whole. While we believe we have captured different perspectives, we would have liked to have had more inputs from investees in emerging and frontier markets. This is a limitation noted below.

The interviews followed a semi-structured approach around the five research questions listed. To protect the anonymity of participants, any insights or quotes derived from those sessions are not directly attributed. Through the interviews we also developed case studies to help shed further light on practice and provide learnings

Table 1: Distribution of interviewees

Organisation type	Number of people consulted
Investees	7
Development finance institutes	16
External experts (academics, CSOs, consultants)	11
Private asset managers and owners	18
Total:	**52**

for other investors. These are placed throughout this report but the investors and businesses involved are anonymised.

Limitations

There are several limitations to emphasise concerning the research:

- This report should not be read as a detailed implementation guide for impact investing. It rather critically assesses current practice and provides supporting examples.
- While we have tried to capture a diverse and representative group of perspectives, this is a large sector and we could not reach all stakeholders in the time available. There was an imbalance in interview respondents toward individuals based in OECD countries.
- A challenge identified was the lack of data on business integrity management systems at investors and investees, which might have been used to corroborate findings.
- This report outlines but cannot comprehensively address several areas where further research and tools are needed. These areas include further integrating business integrity into impact measurement and harmonising standards in the sector.

1. CONCEPTUALISING THE LINKS BETWEEN BUSINESS INTEGRITY AND IMPACT

The investors consulted would agree that business integrity matters but conceptualise the topic in different ways. The starting point is usually the investment organisation itself: business integrity is about safeguarding the organisation from various risks that, if mismanaged, threaten the sustainability of the institution. This goes hand in hand with meeting core regulatory compliance requirements common to all investors. Impact investors need to be especially mindful of avoiding integrity incidents as they can threaten their social licence to operate with stakeholders.

There is then a broader outward-looking framing, which sees business integrity as intrinsically connected to the development impact investors seek. Both are important but we spend more time in the sections which follow on this second perspective. This alternative framing is under-emphasised in the existing literature but fundamentally distinguishes the impact investor from the mainstream investor. We also draw out some of the dilemmas which positioning business integrity alongside development impact creates for investors.

1.1 Institutional risk

The risks to investors from integrity issues are commonly grouped into the following main types:

- **Reputational:** integrity issues can damage the standing of an investor in the eyes of various stakeholders. They may bring adverse media coverage as well as criticism from civil society in the investor's home jurisdiction and in the countries in which they invest.

- **Financial:** integrity issues can lead to significant financial losses. Investors can be defrauded by investees, sometimes by large amounts given the size of investments. Investees embroiled in corruption issues may also see operations obstructed, suspended or shut-down with knock-on financial consequences for the investor.

- **Legal:** investors can be drawn into lengthy and expensive legal processes to seek redress for losses and damages suffered as a result of integrity issues.

- **Regulatory:** the majority of impact investors are regulated entities. They have obligations to ensure the capital they handle derives from legitimate sources. Failure to meet anti-money laundering (AML) regulations can result in financial penalties and suspension of licences. Investors are also subject to anti-bribery legislation with extra-territorial reach, notably the US Foreign Corrupt Practices Act (FCPA) and UK Bribery Act.

These risks are equally relevant to mainstream investors. The issues can however be especially damaging in the impact investing sector because the fallout harms large numbers of businesses, employees and dependent communities in emerging and frontier markets. Integrity incidents contradict investor claims to be a force for positive change. As one integrity lead at an impact investor surmised:

> **"If we get involved with the wrong project, our credibility is shot, which could affect our ability to get involved in other impact investments and lose the confidence of our investors".**

There are various public cases involving impact investors which demonstrate these are not abstract risks. The Abraaj scandal is a recent case which has shaken the sector. Abraaj was a Dubai-based private equity firm which touted its impact credentials and raised capital from many prominent funders. In 2018, journalists at the *Wall Street Journal* published an investigation suggesting massive fraud orchestrated by the firm's founder, Arif Naqvi. He is accused of embezzling up to $385 million in funds[22]. At time of publication (June 2022), Naqvi had been indicted in the US on charges of fraud with prosecutors reportedly also examining allegations of his involvement in bribery in Pakistan[23].

22 The full background to the case is outlined in a book published by the Wall Street Journalists who broke the story. Simon Clark and Will Louch, *The Key Man: The True Story of How the Global Elite Was Duped by a Capitalist Fairy Tale* (Penguin Business 2021).

23 Simon Clark and Will Louch, 'U.S. Investigating Whether Private-Equity Chief Bribed Pakistani Politicians' *Wall Street Journal* (New York, 24 October 2019).

At different times, other leading impact investors have been the focus of adverse press due to links to business integrity issues[24]. These types of cases illustrate weaknesses in investor approaches, some of which remain and which we return to in **Section 2**. They have also spurred improvements that we similarly note.

Existing guidance for investors makes the business case principally in these terms; business integrity is essential to avoid these forms of institutional harm[25]. This reinforces a trend for investors to treat business integrity exclusively as a compliance matter.

Some respondents nonetheless questioned how critical these institutional risks are as a driver of behaviour. The threat of regulatory action for all types of investors is low in most countries. As noted, the business model of impact investors rests on being able to show impacts above and beyond financial return. They are therefore pushed towards a wider set of institutional risks than mainstream investors to meet these objectives. This supports the perspective that additional motivations for high business integrity standards are needed.

1.2 The relationship between corruption and development

Impact investors and companies concerned with promoting economic growth and prosperity should consider how their work fits within a bigger picture of the relationship between corruption and development. Leading international development agencies recognise corruption as a development priority[26]. Substantially reducing corruption and bribery in all their forms, as well as reducing illicit financial flows, are also targets of the UN SDGs[27]. The relationship is complex however and what this means for impact investors needs elaboration.

Economists have long explored the relationship between corruption and development and on the surface the connections are straightforward: corruption is widely believed to have adverse development effects[28]. Cross-country data shows that the correlation between country scores on the UN Human Development Index – a measure of key dimensions of development such as health, education and gross national income per capita – and perceived levels of corruption is "one of the most robust relationships to have emerged out of corruption research"[29]. Academics have also looked closely at the relationship between corruption and economic growth. Many have argued that corruption depresses growth, although some report more variable outcomes in the short term at least[30].

Economists offer different explanations as to why an overall negative relationship between corruption and development is likely. Some see corruption as deterring responsible investors and creating inefficiencies in the market, adding costs for businesses forced to spend time on less productive activities like dealing with bureaucratic red tape[31]. This is not the only school of thought and the idea that corruption might instead 'grease the wheels' of the economy (i.e. help firms ease through bureaucracy) has received substantial attention[32].

There are flaws with that perspective. "Corruption may solve a short-term problem, but it hardwires in longer-term ones" by encouraging officials to abuse their positions, including by creating even more overly complex rules[33]. Other evidence shows that firms succumbing to corruption often become more vulnerable to be further extorted in the future rather than seeing

24 For examples see Parliamentary and Health Service Ombudsman, 'Handling Allegations of Corruption. A Report by the Parliamentary and Health Service Ombudsman on an Investigation into a Complaint about the Department for International Development' (25 February 2014); Sean O'Neill, 'Shamed banker's £1.5m flat seized after bribery trial' *The Times* (London, 29 April 2016); Sarah Chayes, Carnegie Endowment for International Peace, 'When Corruption is the Operating System. The Case of Honduras' (2017).

25 UNPRI, 'Engaging on Anti-Bribery and Corruption. A Guide for Investors and Companies' (2016); Organisation for Economic Co-operation and Development (OECD), 'Corporate Anti-Corruption Compliance Drivers, Mechanisms and Ideas for Change' (2020).

26 For example, USAID has recently announced plans to integrate anti-corruption across all development sectors, including climate change and pandemic recovery; the World Bank revamped its approach to corruption from 2016 as confirmed in a 2018 Update on World Bank Commitments following the UK Anti-Corruption Summit in May 2016 and 2019 Policy Paper; and DFID/ FCDO has been working on the topic since the late 1990s.

27 United Nations, 'Sustainable Development Goal 16' (accessed 13 May 2022).

28 For an overview of literature on this relationship see Dan Hough, *Analysing Corruption* (Agenda Publishing 2017).

29 Susan Rose-Ackerman and Bonnie Palifka, *Corruption and Government: Causes, Consequences and Reform, Second Edition* (Cambridge University Press 2016).

30 For a key early contribution to the debate which was later critiqued see Paolo Mauro, 'Corruption and Growth' (1995) Quarterly Journal of Economics, Vol. 110 (3). A challenge for all cross-country comparison is the reliability of the underlying data, especially measurement of corruption. See also TI, 'The Impact of Corruption on Growth and Inequality' (2014).

31 Susan Rose-Ackerman and Bonnie Palifka, *Corruption and Government: Causes, Consequences and Reform, Second Edition* (Cambridge University Press 2016). Hasan Faruq and David T.Yi 'Corruption, Bureaucracy and Firm Productivity in Africa' (2013) Review of Development Economics, Vol.17 (1).

32 Nathaniel Leff, 'Economic Development Through Bureaucratic Corruption' (1964) *American Behavioural Scientist*, Vol.8, (3).

33 Dan Hough, *Analysing Corruption* (Agenda Publishing 2017).

corruption solve their problems[34]. Many experts refer to a 'corruption trap' in which countries are drawn into vicious cycles in which "corruption breeds corruption" and harms to the economy and society increase[35].

A key lesson also to emerge from recent research is that the effects of corruption on development vary according to corruption type and context[36]. The SOAS-ACE research programme has published influential research that shows how four types of corruption have varying consequences for private sector development. The types of corruption are: corruption driven by market restrictions, policy-distorting corruption, political corruption and predatory corruption[37]. Researchers have explored how these dynamics play out and the options for reform in a variety of sectors in Bangladesh, Nigeria and Tanzania[38].

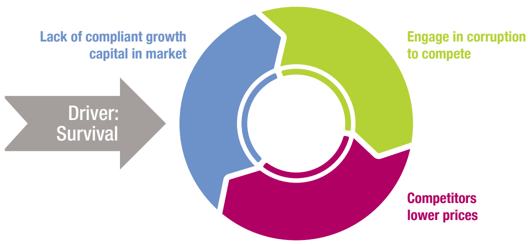
Companies can be victims and perpetrators of these types of corruption. Certain sectors where valuable rents are on offer, most notoriously natural resources, are often a locus for political corruption. In many emerging and fragile markets, the payment of small bribes (sometimes referred to as petty corruption) is a societal norm.

This has high impact on companies, hindering day-to-day operations and everything from moving goods to hiring staff. It presents real dilemmas on how to respond, particularly for small and medium enterprises (SMEs), which may have less influence to deflect corrupt demands. Corruption is also typically gendered, with women excluded from male dominated business groups and unable to access opportunities[39]. Conversely, influential businesses which take a stand against corruption can help to shift these dynamics in a more positive direction.

Existing analysis generally under-recognises the potential of impact investors and investees to change corruption dynamics in positive and negative ways. Tim Gocher has theorised how vicious circles of corruption can be spun in a different direction by 'compliant capital'. External investment can shift cost-benefit calculations for firms when the benefits of being compliant (accessing external capital through compliance with anti-bribery laws) outweigh potential benefits from corruption. The effect is illustrated in the diagrams below and, as Gocher notes, "in the real world, foreign businesses and fund managers observe these effects across frontier markets, and at larger scales"[40].

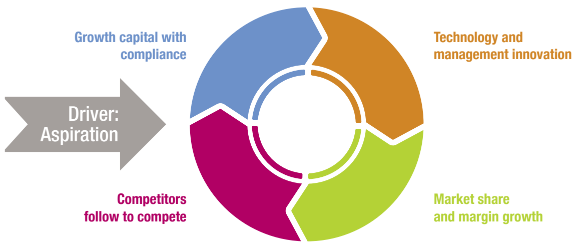
Figure 6: Vicious and virtuous cycles of capital

Vicious cycle of corruption



Systemically corrupt, competitive market

Virtuous cycle of compliant capital



Enter compliant capital

34 Matthew Jenkins, U4, 'The Relationship Between Business Integrity and Commercial Success' (2017).

35 Susan Rose-Ackerman and Bonnie Palifka, *Corruption and Government: Causes, Consequences and Reform, Second Edition* (Cambridge University Press 2016); Raymond Fisman and Miriam Golden, Corruption: What Everyone Needs to Know (Oxford University Press 2017).

36 Yuen Ang in particular has used the paradox of China, where corruption co-exists with high rates of economic growth, to show how a particular form of corruption 'access money' can act like a steroid to stimulate growth but also cause "serious side effects". Yuen Ang. *China's Gilded Age. The Paradox of Economic Boom and Vast Corruption.* (Cambridge University Press 2020).

37 Market-restricted related corruption concerns corruption driven by unnecessary red tape and regulation; policy-distorting corruption relates to socially useful policies wherein corruption distorts their implementation with harmful consequences; political corruption refers to informal patron-client relationships and the distribution of rents; and predatory corruption involves coercion to extract rents.

38 https://ace.soas.ac.uk/ (accessed 13 May 2022).

39 See for example this study on gendered corruption affecting female businesswomen in Malawi. Cosimo Stahl, 'Gendered corruption. Initial insights into sextortion and double bribery affecting female businesswomen in Malawi' (Basel Institute on Governance, June 2021).

40 Tim Gocher, 'Can Investing in Frontier Markets Tackle Corruption?' (London Business School, 31 October 2017).

Whether impact investors providing compliant capital are able to push markets to such a tipping point will depend on the balance between compliant and non-compliant forms of capital. Gocher and Jayalakshmy Rama at the University of Nottingham are conducting further research to test this model in the Nepalese banking sector (forthcoming).

Whatever the specific nuances, the evidence on corruption's effects on development clearly shows that investors need to fully understand the context in which they are investing. In line with their development mandate, they further need to look for opportunities to work with companies motivated to change harmful practices.

In **Sections 2 and 3** we collate further practical ideas on how investors can make positive contributions on business integrity. Below we explore how business integrity shapes the development outcomes from investments by:

- Underpinning financial sustainability
- Strengthening ESG risk management
- Preventing unintended harms

1.3 Business integrity and investment outcomes

1.3.1 Financial sustainability

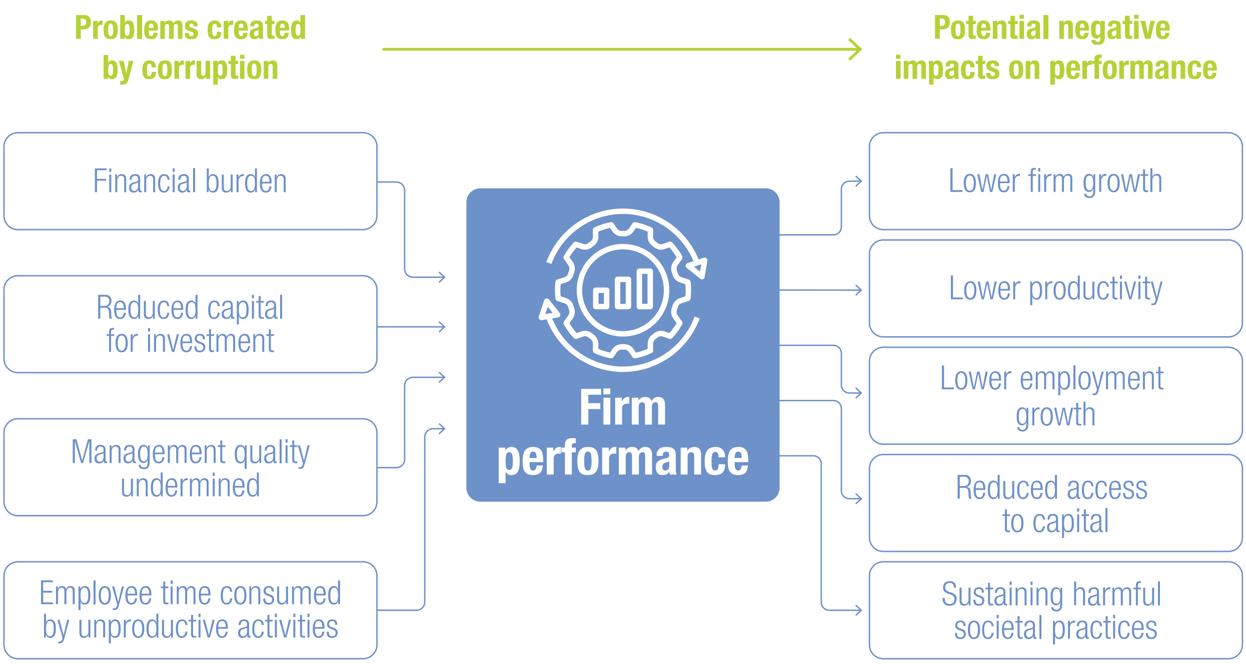
For impact investors it is critical to understand how business integrity affects the financial returns from investments. As one partner at an impact investor emphasised:

> **"When you talk to people with an investment mindset, they understand business integrity but what they want to see is how it links to profitability and returns. It is all well and good being best in class in governance but our investors need to also see profitability".**

Financial sustainability is moreover what underpins the development contributions of investments.

Overall, emerging evidence indicates that business integrity and improved financial performance correlate, while engagement in corruption will ultimately have a

Figure 7: Effects of corruption on firm performance



negative impact on a firm's financial performance[41]. Nonetheless, the relationship is not always what might be expected, and again context matters.

Various studies have highlighted a range of direct and indirect costs of corruption on firms which are illustrated in **Figure 7**[42].

It is important to recognise in spite of this that research does not always point in the same direction. Effects differ depending on firm characteristics and market conditions.

A 2021 analysis supported by the European Bank for Reconstruction and Development (EBRD) covering 88,000 firms across 141 countries shows that these questions defy simple answers[43]. For firms working in high-corruption settings it finds an initial positive relationship between informal payments and growth. Firms refusing to pay bribes can be excluded from growth opportunities; they simply find it difficult to get operations off the ground. Conversely, once firms make such payments, the relationship goes into reverse. Firms that pay bribes grow more slowly.

Key to understanding this dynamic is that corruption is not a one-off transaction but an evolving relationship:

> **"Corruption begets corruption; firms with a propensity to pay bribes not only find themselves spending more time and money dealing with the bureaucracy, but also suffering from the indirect costs such as lower productivity, slower growth, employee theft and more expensive access to capital"[44].**

Several studies support the idea of corruption effectively entrapping firms over time[45]. As providers of patient, long-term capital, impact investors are better positioned to help investees weather demands and build a more sustainable business model.

The other side to this debate – the financial benefits that higher business integrity can bring – has received less attention in existing literature. One key study of relevance on this question was published in 2018 by the IFC[46]. It examined the correlation between corporate governance and firm financial performance in emerging markets. This was based on data from 61 of its portfolio businesses. The study found that firms that improved their corporate governance during the investment period achieved a 20% higher return on equity (ROE) and return on invested capital (ROIC). There was also positive relationship between corporate governance and lower environmental and social risk at these investees.

Corporate governance and business integrity are complementary but not interchangeable terms (see **Text Box 1**). An important finding from the study was certain measures associated with controlling corruption had the highest correlations with financial performance, notably:

- Having a dedicated internal audit function with its own charter or terms of reference;
- Following internationally recognized standards on internal controls;
- Having financial statements audited by a recognized independent auditing firm;
- Having a written code of ethics/conduct;
- Having a board that has an audit committee.

While experts working in this area intuitively see a positive relationship, much more research is needed on the impact of business integrity programmes on commercial performance. Other studies on management quality and intangible benefits of integrity suggest business integrity

41 For an overview of existing literature see Matthew Jenkins, U4, 'The Relationship Between Business Integrity and Commercial Success' (2017).

42 On the financial burden of corruption see James Anderson and Cheryl Gray, World Bank, 'Anticorruption in Transition 3. Who is Succeeding… and Why?' (2006); on productivity see John McArthur and Francis Teal, 'Corruption and Firm Performance in Africa' (2002) Economics Series Working Papers WPS/2002–10; on effects on growth see Raymond Fisman, Sergei Guriev, Carolin Ioramashvili and Alexander Plekhanov, 'Corruption and Firm Growth: Evidence from around the World' (2021) EBRD, Working Paper No.255; on employment generation see Mohammad Amin and Soh Yew Chong, 'Does Corruption Hurt Employment Growth of Financially Constrained Firms More?' (2020) World Bank, Policy Research Working Paper; No. 9286; and on access to credit see Shusen Qi, 'Will Money Talk? Firm Bribery and Credit Access' (2016) EBRD Working Paper No. 194.

43 Raymond Fisman et al. 'Corruption and Firm Growth: Evidence from around the World' (2021) EBRD Working Paper No.255

44 Matthew Jenkins, U4, 'The Relationship Between Business Integrity and Commercial Success' (2017).

45 Daniel Kaufmann and Shang-Jin Wei, 'Does 'Grease Money' Speed Up the Wheels of Commerce?' (2000) IMF Working Paper, WP/00/64.

46 IFC, 'Governance and Performance in Emerging Markets. Empirical Study on the Link Between Performance and Corporate Governance of IFC Investment Clients' (2018).

can be part of an overall firm culture that drives strong financial performance[47]. However, the evidence is limited, especially for developing countries. This is a gap impact investors should help to fill with improved data collection (see **Section 1.4**).

Comments made by both investors and investees in interviews show how experts see financial value in business integrity in their day-to-day work. One impact investor said for example:

> **"When our anti-corruption efforts filter down to investees, we put a seal of approval which make these companies more attractive to other lenders and investors. It reduces the cost of capital for them".**

Others gave examples of equity investments where business integrity had supported exits, through either a public listing or private sale. Having strong standards in place helped to speed up the sales process. In the eyes of buyers, it also provided assurance around firm professionalism and control of finances. One ESG lead at an impact investor explained how this plays out in favour of a seller in a sales process, saying that high business integrity standards:

> **"Increase the pool of potential buyers for a business, which ratchets up competition. What you then see are that cash flows are valued very differently in a competitive process. There is a halo effect around governance and integrity which brings in buyers with access to cheap cost of capital. Compare this to a business with unresolved issues, where you might be scratching around for a buyer of last resort. The value of the business is viewed completely differently".**

This led several investors to refer to a 'premium' for business integrity and ESG more broadly that is recognised by the market. Others interviewed saw close correlations in debt portfolios between business integrity and firm credit risk.

1.3.2 Strengthening ESG risk management

We have already positioned business integrity and ESG as parallel risk management activities that provide a platform for realising development impact (see **Figure 5**). Here we argue that managing business integrity is a prerequisite to effective ESG risk management.

We illustrate this point in **Text Box 2** below by looking more closely at renewable energy investments. Investment in affordable and clean energy is a key strategic goal for many impact investors[48]. Assiduous ESG management is needed for these types of investment both to avoid any harm and to achieve development impact. This impact is often measured in terms of electricity generated in GWh along with broader economic benefits that stem from clean energy supply, such as job creation, local firm growth and tax payments.

47 Nicholas Bloom et al., 'Adding a Piece to the Productivity Puzzle: Management Practice' (Vox EU, 17 May 2017); Alan Barlow, *Profiting from Integrity. How CEOs Can Deliver Superior Profitability and be Relevant to Society.* (Routledge 2017).

48 As examples, the British International Investment 2022-26 strategy requires 30% of new commitments to be made in climate finance. In its Green Economy Transition plan the EBRD aims to increase green financing to more than 50% of its annual business volume by 2025; and the IFC has a commitment to increase climate-related investments to 35% of its own commitments by 2025.

TEXT BOX 2: Business integrity and outcomes from renewable energy investments

Through our research we examined four case examples of renewable energy investments. These comprised a mix of solar and wind investments in emerging and frontier markets. They were developed through discussions with investors and investees.

Corruption risks arise frequently throughout the investment cycle for these forms of projects from origination to construction, and then the operation of assets. Key points of intersection with ESG risk management are apparent in:

- **Construction standards:** the effects of corruption may comprise the quality of construction work. One interviewee described a common problem of investee owners receiving 'rebates' from Engineering Procurement and Construction (EPC) contractors. This is essentially a kickback for selecting a nominated contractor. It is a concerning practice at multiple levels. These are funds lost which could have been invested in the project, or others. It bypasses legitimate (and therefore meritocratic) contracting processes, and suggests the contractor may be willing to cut corners, which could show in the quality of built work.

- **Health and safety:** in a similar vein, firms engaging in corruption are less likely to abide by occupational health and safety standards. Bribes paid to workplace inspectors can avoid scrutiny, thereby undermining measures put in place to protect workers.

- **Community relations:** the management of integrity issues can affect relationships with local communities. One interviewee said they had experienced a wind farm being shut down by community protests. Following investigation, they established that the protests were driven by disgruntlement over corruption in local contract awards. To resolve these issues, the business fell back on the integrity of their procurement procedures, but not before incurring tens of thousands of US dollars in costs.

  Conversely, research on climate adaptation projects in Bangladesh has shown dual benefits when influential community members buy-in to project monitoring[49]. These include both lower corruption and higher project quality.

- **Environmental protections:** renewable energy projects must respect environmental safeguards, typically in areas such as water management, land usage, and protection of wildlife. The experts consulted outlined how this brings regular contact with government authorities, and in some instances requests for bribe payments. Unscrupulous actors may engage in bribery to avoid key requirements, with serious risks for the environmental footprint of the project.

- **Taxation:** In all four cases, interviewees cited corrupt requests from tax authorities as one of the main areas of risk. Arbitrary tax demands serving as a cover for corruption can threaten the sustainability of a project, whereas fair payment of tax is part of a firm's societal contribution. One interviewee described how a consistent and clear position of non-payment of bribes, combined with being able to point to the business integrity standards pushed by impact investors, helped in resisting the requests. In time, this also led to more predictable relations with the tax authorities.

49 Mushtaq Khan et al., 'Win-Win: Designing Dual-Use in Climate Projects for Effective Anti-Corruption in Bangladesh' (2022) Climate and Development.

The cases show how challenging the issues can be but also the role impact investors can have in reinforcing business strategies premised on integrity. When faced with these problems, corruption might have brought a short-term operational pay-off. The unanimous perspective of these respondents was that this would only have worsened the problem. It would have also been at the cost of undermining ESG risk management. We expand further on the interconnections between business integrity and ESG in **Section 3**.

1.3.3 Preventing unintended harms

Pressure to achieve ever-greater development impact can lead to tensions with an investor's position on business integrity. This issue came up frequently in interview discussions. One integrity lead at a large DFI had concerns around trying to reconcile high capital deployment objectives while maintaining integrity standards. Another questioned how much upfront discussion there is in the sector around potential conflicts, asking for instance whether commitment to climate investing meant "*green at all costs*".

There may be scenarios where investments offer the prospect of high development impact but this could come at the expense of harms related to business integrity. The fictional examples in **Table 2** show the types of dilemmas which can occur and the associated harms.

Table 2: Developmental harms

Example	Scenario	Potential harms
1	The investor has an opportunity to acquire and expand a wind farm, significantly increasing power generation in a country with low electrification rates. The wind farm is owned by a former Minister for Energy. He used his position to obtain licences and early government funding for the project.	The investment represents a pay-off for an individual who has profited from corruption. It perpetuates and encourages elite level political corruption. This form of corruption is a major driver of dysfunction in the sector and a root cause of low electrification rates.
2	Investment in a financial institution would allow the investor to support a lending scheme for SMEs owned and/or managed by women. This is in a market where access to credit for these businesses is limited. The financial institution however has weak anti-money laundering (AML) controls and has previously been fined by regulators for failing to prevent money laundering by organised crime groups.	The financial institution supports groups that drive high crime rates. Their exploitative practices fall hardest on the most vulnerable in society. Women suffer disproportionately more than men. Financial services allow these groups to profit from crime and escalate their activities.
3	There is a chance to invest in a pharmaceutical chain which is expanding access to medicines in hard to reach areas in a low-income country. The business regularly pays small bribes to import its products and transport medicines.	The business is contributing to a systematic societal problem. It can afford to pay small bribes but others cannot. Smaller importers are unable to grow due to the high cost and time penalties in importing and transporting goods.

These types of scenarios occur relatively frequently and present very real dilemmas for impact investors. There can be numerous nuances that influence whether an investor decides to make an investment in cases such as these.

There is no denying that at times this means having to make tough choices. Impact investors should nonetheless resist the idea of a trade-off in which tolerance of business integrity problems can be justified by otherwise positive impact. This is because of the central role that corruption plays in locking countries in under-development, as set out in **Section 1.2**.

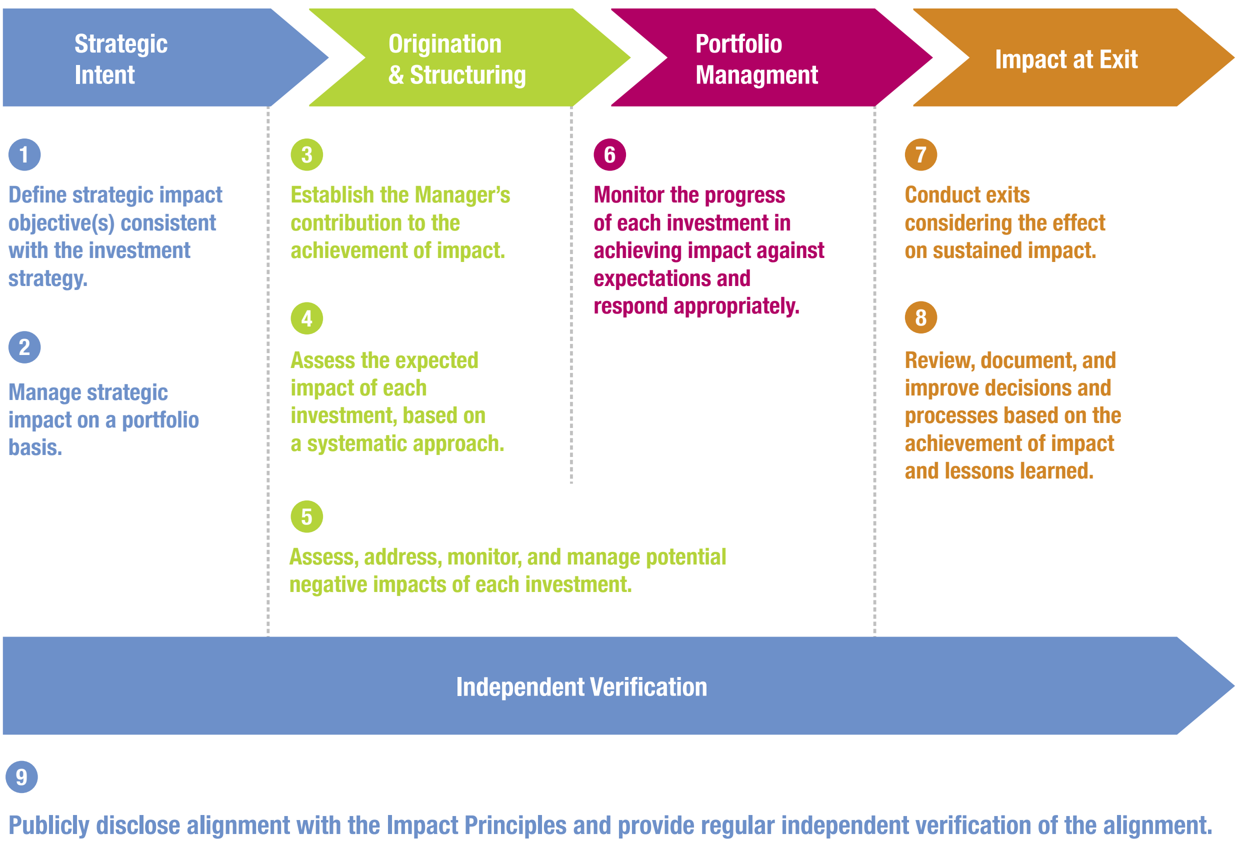
The logical conclusion to this analysis is not that impact investors should stop making investments in countries heavily affected by corruption. There will certainly be specific investments that should not be made. Setting out and abiding by clear lines on the acceptability of issues is furthermore a fundamental responsibility of investing in emerging and frontier markets. What these challenges absolutely demand is that higher exposure to risk is met with proactive efforts to integrate business integrity into investment approaches. In **Section 2** we look at how impact investors are currently approaching this task, what works well, and what can be improved.

1.4 Measuring business integrity impact

1.4.1. Overview

A defining characteristic of an impact investor is commitment to measuring the impact of their work but this task is challenging[50]. An assessment of impact management undertaken in 2021 by the impact verification firm, BlueMark, found standards varied by impact investor type. The report concluded that the majority of investors still have "work to do to deliver on their good intentions"[51].

Figure 8: The Operating Principles for Impact Measurement



50 For an overview see materials produced by the Impact Measurement Project (accessed 13 May 2022); GIIN, 'The State of Impact Measurement and Management Practice, Second Edition' (2021); Ivy So and Alina Staskevicius, Harvard Business School, 'Measuring the "Impact" in Impact Investing' (2015).

51 BlueMark. 'Making the Mark. The Benchmark for Impact Investing Practice' (2021).

Concerns noted in the introduction around “impact washing” and the credibility of widely used ESG metrics have led to initiatives promoting greater rigour in impact measurement[52]. Notably the Operating Principles for Impact Management require independent verification of impact results. The principles also encourage investors to consider impact through the whole lifecycle of an investment, as shown in **Figure 8** below.

In our discussions there was considerable interest in considering how business integrity might connect to impact measurement. This has not as yet translated into impact investors integrating business integrity into measurement activity in practice. We are aware of only one impact investor, Swedfund, which tracks investee improvements on business integrity. It reports publicly against ‘the proportion of investments that have implemented an anti-corruption management system’[53]. One other DFI indicated in interview that they incorporate risk analysis as part of discussions on the expected impact of each investment (Step 4 in **Figure 8**).

Part of the reason for this situation relates to some of the inherent difficulties around measuring business integrity and efforts to reduce corruption. By their nature, these are not issues which are easily observed. It can also be difficult to clearly attribute investor contributions to any changes which can be established.

One major barrier to better measurement is that the majority of the impact investors consulted do not systematically collect data on business integrity standards across their portfolio. Verification of any data provided appears to be rare. The data which is available also tends to be driven by regulatory requirements. It therefore focuses narrowly on issues such as fraud losses and complaints figures rather than measuring positive dimensions of business integrity.

Better data collection would be a necessary first step to integrating business integrity into impact measurement. The experts consulted offered ideas on how this might be achieved which we have organised into two groups: *corruption as a risk to impact and business integrity as value-creation*. Experts were also cautious that any proposals should add genuine value and not create either an administrative burden, nor drive perverse incentives around measurement.

1.4.1 Corruption as a risk to impact

In certain circumstances corruption issues can constitute a risk to the predicated impact of an investment. Taking the renewable energy investments discussed in **Section 1.3.2.**, corruption may have significant operational consequences such as delays and shutdowns, with negative outcomes for the impact sought by the investor. In an extreme event, a major integrity incident resulting in reputational, legal or regulatory harms can threaten the viability of an investment and therefore the impact sought. Consideration of business integrity is consequently relevant to Steps 4 and 5 of the Operating Principles for Impact Management (see **Figure 8**).

Estimating risk and the potential implications for impact is challenging. Metrics may point in opposing directions. For instance, in the short-term, firms upholding high business integrity standards may see adverse consequences, with time needed for positives benefits to show in measurement. In other situations certain common metrics used as part of impact measurement may be misleading. As an example, metrics used to assess healthcare investments include the number of procedures and/or surgeries performed[54]. These can be distorted if professionals are incentivised through corruption to over-treat patients (see **Section 3.5.**).

This requires serious engagement with the complexity of measurement but there is not necessarily widespread willingness across the sector to do so. As one expert commented:

> **“I would say there is this real tension between impact managers wanting to show all the good things they’re doing, and wanting to know what the core messages are, and what is the essence of what they have done. There isn’t the same readiness to recognise the complexity of change management and risk”.**

Impact investors concerned about rigour in impact measurement should conduct a pre-investment assessment of whether business integrity could undermine the expected impact of an investment. They should then track how this plays out and report on how issues may have affected the impact claims made.

52 Michel Posner, ‘ESG Investing Needs More Rigorous Standards to Evaluate Corporate Conduct’ (Forbes, 1 February 2022).

53 Swedfund, ‘Integrated Annual Report 2020’, p.67

54 GIIN, ‘Impact Measurement in the Healthcare Sector’ (2017).

1.4.3 Business integrity as value-creation

Contributing to improved governance and integrity at an investee can be part of the value created through an investment. Part of the explanation why the topic often does not feature in investor stories of impact may be something of an image problem. One expert commented that business integrity:

> **"Needs a significant re-brand to show it is coming from a development perspective... this is about improving standards which have real effects on everyday life. Corruption is an issue which is a serious concern for ordinary people".**

Similarly, an expert on impact measurement commented:

> **"The sector wants to generate uplifting stories which interest people, like lifting people out of poverty... [but] there is an assumption that business integrity is something investors should automatically have under control, instead of a story of transformation".**

The comments underscore the need to socialise the idea across the sector that business integrity is not limited to financial crime compliance.

To address this gap, impact investors need to improve data collection on business integrity.

This might begin with more detailed information collection on outcomes at firm level. TI-UK's report *Make it Count* for example summarises current and emerging trends on how firms can better understand the effectiveness of their anti-corruption programmes[55].

However, the challenge goes beyond data collection. The sector needs to be able to set out convincing narratives on how business integrity connects to the wider goals of impact investing. These are not stories that can be told exclusively in numeric terms. One investor expressed concern that exclusively quantifying change might mean that less tangible benefits of business integrity are deprioritised.

Evaluations of specific investments can be used to tell stories of change and improvement on business integrity. These efforts should be concentrated on investments where corruption issues have the most tangible effects. Presently, as impact investors are not necessarily seeking these forms of impact, these are benefits that might only be picked up unintentionally.

In certain circumstances, impact investors might also look to make investments in firms where there is credible potential to reduce corruption. This could be one of the aims of an investment rather than a secondary outcome. Certain types of business, such as e-payment and mobile technology firms, could be leading candidates. There is also evidence to suggest that the modernisation of infrastructure critical to trade flows, such as ports, can have significant effects in reducing corruption[56]. One expert said they would like to see impact investors:

> **"Pick out good examples of investments which can be used as a nudge, helping shift the dial on corruption. Investors could do more scene-mapping, scanning countries for ideas that don't only generate commercial return but can also have governance benefits".**

Text Boxes 3 and 4 are examples that show positive impacts of business integrity.

55 TI-UK, 'Make It Count' (2021).

56 Sandra Sequeira and Simeon Djankov, 'On the Waterfront: an Empirical Study of Corruption in Ports' (2008).

TEXT BOX 3: THE INTEGRITY IMPACT OF DIGITAL PAYMENTS

One tangible example of business integrity impact is a pan-African digital payments company, Cellulant, which has received funding from impact investors. Research cited by the Harvard Business Review showed how the firm worked with the Nigeria Ministry of Agriculture to re-design a 'corruption-plagued' seed and fertilizer subsidy scheme. Whereas previously fertilizer and seeds were distributed by government representatives, the firm's mobile application allowed farmers to pick up subsidised goods directly from merchants using e-vouchers. Under the previous scheme, an estimated 89% of funds were lost to mismanagement and corruption. The technology overhauled the system and led to 90% of support reaching farmers as the intended beneficiaries. In comparison to other seasons, the technology played a part in participating farmers earning an additional $99 annually by improving maize yields[57].

TEXT BOX 4: DUAL BENEFITS OF OFF-GRID POWER

Impact investing can be part of the solution to structural issues of corruption in energy sectors. One interviewee involved in retail investments in Asia gave us an example of this. They explained how a food distribution business had installed rooftop solar panels at its warehouses. In addition to reducing the firm's energy costs and environmental footprint, a major benefit of the move was the end of corrupt requests to secure power supply from the state utility company.

Looking more broadly, the SOAS Anti-Corruption Evidence programme has proposed that off-grid power generation for Small and Medium Enterprises (SMEs) should be part of the response to systemic issues of corruption in the Nigerian power sector[58]. The efficiency of energy distribution and generation companies is heavily compromised in Nigeria meaning limited and unreliable power supply for businesses. One of the root causes is legacy corruption from the privatisation of the sector and subsequent under-investment by politically connected owners. SMEs are particularly badly affected by power shortages. They are pushed into corruption to secure informal supplies from the black market or engineers at distribution companies.

The research from SOAS proposes using natural gas to generate power for clusters of SMEs experiencing inadequate supply. This would diminish certain forms of corruption in the sector and increase power generation. As an illustration of the complexity of the issues and the challenge in understanding effects, there are also adverse consequences to consider from bypassing the national grid. This could include further under-investment in the grid with negative consequences for communities.

The research nonetheless shows the benefits of detailed analysis of the role corruption plays in a market and how this can pave the way to solutions. This has led to recommendations on an approach that could be complementary to longer-term structural reforms in the sector.

57 Tesfamicheal Wosson et al., 'Productivity and Welfare Benefits of Nigeria's E-Voucher-Based Input Subsidy Program' (2017) *World Development*, Vol. 97 cited in Chris Addy, Maya Chorengel, Mariah Collins and Michael Etzel, 'Calculating the Value of Impact Investing' (Harvard Business Review, January – February 2019).

58 Pallavi Roy, Kelechi C. Iwuamadi and Jibrin Ibrahim, 'Breaking the Cycle of Corruption in Nigeria's Electricity Sector: A Political Settlements Analysis' (2020) ACE Consortium, Working Paper no.20

KEY POINTS

- Business integrity is intrinsically connected to the development mandate of impact investing. In consequence, business integrity cannot be treated exclusively as a compliance issue but should be linked to an impact investor's broader objectives.
- Business integrity will shape whether an investment achieves development outcomes. It underpins financial sustainability, strengthens ESG risk management and prevents unintended harms.
- There are opportunities to better integrate business integrity into the measurement of development impact. Business integrity can relate directly to both risks to impact and value creation.

RECOMMENDATIONS

Impact investors should:

- 1.1. Set out publicly how business integrity connects to their business development and strategic impact objectives.
- 1.2. Explicitly consider the implementation and maintenance of high business integrity standards as a form of positive impact from an investment.
- 1.3. Assess whether business integrity problems could undermine or negate the intended positive outcomes from investments.
- 1.4. Commission research, case studies and evaluations to develop the evidence base on the business integrity impacts of investments.
- 1.5. Consider making select investments where a principal aim is to contribute to reducing corruption issues in a market.

2. MOVING FROM A REACTIVE TO A PROACTIVE STANCE ON BUSINESS INTEGRITY

Conceptualising business integrity as core to the development mandate of impact investing has implications for how the issues are managed day-to-day. To be leaders in this area, impact investors need to move beyond a reactive stance in which activities are principally limited to meeting compliance obligations. This section analyses current investor approaches and highlights where there are opportunities for impact investors to take a lead in advancing standards. In particular, we discuss the role impact investors can play in supporting investees with business integrity risk management.

2.1. Investment strategy

For impact investors, taking a proactive approach to business integrity should start with investment strategy. A range of stakeholders and factors typically shape an investor's strategy. This may have overarching goals related to development impact but can also represent a balancing act with expected rates of financial return. Many investors have an explicit sectoral or geographical focus, depending on the priorities of their funders. Thematic areas such as gender equality and climate change may cut across an investment strategy.

How business integrity connects to investment strategy presents a dilemma. High potential development impact often comes with a corresponding level of business integrity risk. A consequence is that it is difficult for business integrity risk to be a determinant of investment strategy. One investor commented:

> **"The more difficult the environment, the bigger role we think we can play... our instinct is always to find a solution to problems rather than leaving".**

Because of this conundrum, the majority of impact investors review business integrity issues almost exclusively on a transactional, case-by-case basis. The topic is not usually explicitly connected to strategy, either in terms of establishing the investor's risk appetite at organisational or market level, nor identifying areas where investors might make impactful contributions on business integrity. One expert surmised that *"it is rare for business integrity to have a seat at the strategic table"*. The expert added that *"even quite mature investors haven't had serious discussions about what the risk appetite is… it's hard to right-size compliance without this"*. High risk exposure is accepted but not necessarily analysed as part of firm strategy.

The inevitability of higher risk exposure should not preclude integration of business integrity into strategy. Smaller asset managers may have more flexibility. Two managers interviewed stated that it was an explicit part of their strategy to not invest in businesses with high dependency on government. This may not be an option for investors with larger footprints but other options are available.

At market level, one larger investor produces stakeholder maps for the most challenging countries. These identify sectors where the business interests of potentially problematic actors such as oligarchs and politically exposed persons (PEPs) are concentrated. The investor's country strategy stipulates that these sectors should be avoided due to the risk of exacerbating corruption issues (see **Text Box 5** for an example in Myanmar). Another investor is researching common forms of corruption in the main sectors it targets. The findings will influence the types of investments it makes as an organisation.

TEXT BOX 5: BUSINESS INTEGRITY MARKET MAPPING IN MYANMAR

Myanmar is an example of a country where there are high levels of business integrity risk but also pressing development challenges which have brought impact investors into the country. Business integrity concerns stem chiefly from decades of military rule in Myanmar which have a created a 'military-commercial complex' in which companies linked to the military control strategic sectors of the economy. This includes the minerals trade, ports and telecommunications[59]. Corruption underpins this system and international sanctions present an additional layer of risk for any investor.

From 2011 onwards, Myanmar began a transition towards greater civilian participation in politics, culminating in the election of Aung San Suu Kyi and the National League for Democracy in 2015. The democratic opening of the country led several impact investors to look at investment opportunities in Myanmar. On account of the high levels of risk, one impact investor followed a structured approach to determine sectors, regions and forms of activities where it was clearly not possible to invest without compromising business integrity standards.

Business integrity and compliance staff subsequently worked with investment officers and ESG professionals to identify viable investments outside of military spheres of control. When it came to reviewing specific investments, the investor developed a tripartite structure for reviewing military and political exposure. This was based on an assessment of ownership, personnel and contractual relationships. The investor developed a decision tree that clearly designated types of military and/or political exposure which were not acceptable.

In a challenging context, this structure clearly articulated the investor's risk tolerance on business integrity and was the basis of its investment strategy in that country. Insulating individual investments from military and/or political exposure has also served to protect the investor following changes in the political context. Shifts have included sustained criticism of Aung San Suu Kyi's human rights record, a military coup in 2021 and widespread civil unrest.

Practices such as these could be more widely adopted. All investors could be more transparent about the challenges on business integrity they face and how these influence their investment approach. This could include up-front commitments about types of risk an investor will not accept and identification of strategic opportunities to advance business integrity standards.

2.2. Organisational structures and resourcing

Organisational structures and resourcing are strong determinants on the extent to which an impact investor can be proactive on business integrity. Impact investors have different organisational structures influenced by their size, regulatory status and strategic priorities.

All the impact investors consulted have staff whose work involves meeting core compliance requirements. This typically includes developing internal investor policies and codes of conduct, managing training, conducting AML and sanctions checks, and responding to complaints. Other aspects of business integrity risk management are usually managed by investment officers, or in some cases, corporate governance or ESG officers. A small number of impact investors have established, or are in the process of setting up, dedicated business integrity teams.

This report does not endorse any one organisational model but argues that certain principles need to be respected. These are:

- **Scope of activities:** business integrity risk management involves a broader range of activities than the compliance requirements listed above. As outlined in the sections that follow, it will involve active risk assessment, due diligence, and portfolio management. Impact investors should see supporting investees to improve business integrity risk management as part of their role.

59 Michael Peel, 'Myanmar: The Military-Commercial Complex' *Financial Times* (London, 1 February 2017).

- **Resourcing:** it is not possible to raise business integrity standards without allocating adequate resources to the topic. Among the impact investors consulted, staffing levels suggest that firms are making available varying levels of resourcing. At some investors, the number of staff working on the topic is clearly insufficient relative to the size of their portfolio.

- **Expertise:** business integrity risk management requires a distinct skill set and the time available to fulfil the role. This encompasses familiarity with regulatory standards, best practice in risk management, understanding local market dynamics, and the ability to work effectively with investees. This is one of the reasons that some impact investors are establishing dedicated business integrity teams. Where other professionals pick up these tasks, they should be supported to develop expertise and also have sufficient time available.

- **Coordination:** this work needs to be closely coordinated with other ESG risk management activities. We discuss this in detail in Section 3.

- **Independence:** expanding the scope of business integrity activities is a novel approach. It involves staff working more closely with investment professionals and making recommendations on risk management to external parties. These activities are not easily organised within the established three lines of defence model of risk management[60]. Impact investors expanding the scope of their activities should be aware that conflicts can arise. Governance structures need to be in place to ensure investors make independent choices and continue to meet regulatory obligations.

For smaller investment managers with less internal capacity meeting these principles can be difficult. At the firms we consulted, a partner or senior manager typically holds responsibility for business integrity. Many smaller managers additionally outsource administrative aspects of fund compliance to a third-party service provider. This is an approach that can work but relies heavily on an independently-minded individual within the firm who can look beyond their commercial interests. Smaller firms should give serious consideration to hiring business integrity resource and/or upskilling ESG staff.

60 Typically at an asset manager, investment professionals form a first line of defence and are responsible for owning and managing risk; a compliance function forms a second line of defence to oversee risk management; and internal audit is a third line of defence providing independent assurance. Chartered Institute of Internal Auditors, 'IIA policy paper. Internal audit, risk and corporate governance – the three lines of defence model' (2015).

Table 3: Business integrity through the investment cycle

Stage	Activities
Pre-investment due diligence	• Reviewing a prospective investee's public profile for any indication of business integrity concerns, such as regulatory issues and allegations of involvement in corruption or other forms of financial crime;
	• Identifying and verifying the ultimate beneficial owners of the business;
	• Asking questions around the track record and reputation of the management and owners as concerns business integrity;
	• Assessing whether the owners and managers in the business have political exposure;
	• Analysing the integrity risks facing the investee and levels of commitment and capacity to manage these risks;
	• Screening the business for exposure to sanctions and other watchlists.
Portfolio monitoring	• Regular engagement with investees on business integrity to assess changes to their risk profile and the adequacy of controls;
	• Ongoing media and sanctions monitoring;
	• Periodic updates to due diligence and AML information;
	• Reviews of investee reporting on business integrity;
	• Proactive detection of potential issues.
Exit	• Anti-money laundering checks on the buyer of a business and their source of capital;
	• Reputational checks on the buyer and review of their track record on business integrity with similar businesses to gauge whether they share the same values and approach;
	• Review of the investee controls and whether they are appropriate for the investee's business plans post-exit.

2.3. Pre-investment due diligence

Much of the work impact investors undertake on business integrity is concentrated at the due diligence stage. While approaches vary depending on the financial product, due diligence is often a lengthy process to form a complete picture of a prospective investee.

A strength of impact investing approaches is that counterpart due diligence tends to be thorough. Impact investors have some advantages in that they generally have high levels of access to an investee. They can also draw on market knowledge and networks to aid their assessments. All of the impact investors interviewed conduct reputational due diligence on an investee, its owners and management. This is a review that extends beyond the collection of Know Your Customer (KYC) data for compliance purposes to review the track record of key counterparts on integrity. Several interviewees stressed the importance of conducting this work at the beginning of the process before momentum has built around a deal. Due diligence should also be tailored according to the geography and sector.

Some of the advantages impact investors have can also prove to be weaknesses. It is evident from our discussions that there has been an evolution for due diligence to become more formalised. One example is the high degrees of trust placed in an investor's own networks for assessing reputation.

As one expert commented, impact investors can become victims of "*group-think*" and "*lose their critical edge*" when an investee already has relationships in the sector. The Abraaj scandal mentioned in **Section 1.1** is arguably an example of that. Research published in 2017 by the Carnegie Endowment for International Peace in Honduras is another example. Here investment officers seemingly failed to recognise integrity issues because they had become too close to the investee[61].

The scope of due diligence is an area where there is disparity between impact investors and opportunities to be more proactive. Reputational due diligence is one critical step but to truly assess exposure to business integrity risks impact investors should understand the environment in which the investee is working. Working with an investee, the investor should assess the types of corruption risks facing that business and their drivers. The issues will be strongly shaped by the local political economy.

Investors will need to assess the implications for the investee, and crucially, whether they have the organisational structures, controls and culture in place to manage the corruption risks to which they are exposed. Our research indicates only a minority of impact investors invest substantive time and resources during due diligence to truly understand this second element.

2.4. Portfolio monitoring

Portfolio management looks very differently across the sector. Some large impact investors manage a global portfolio of hundreds of direct and indirect holdings. Other emerging market fund managers can have fewer than ten direct investments. Regardless of size, there are certain common tasks on monitoring which are set out in **Table 3**.

Portfolio monitoring should be risk-based. This requires nuanced management in the case of impact investors if their portfolios have an overall higher risk exposure and comprise multiple financial products (see **Section 2.1**). In interviews, several large impact investors privately acknowledged that portfolio management is the weakest area of their business integrity systems. If resources are stretched, then capacity tends to be pulled into due diligence processes to facilitate capital deployment. Investors recognising this weakness tended to have high growth plans; the implication being that capacity on monitoring has struggled to keep up.

Weaknesses in monitoring can leave investors vulnerable. Two business integrity leads spoke especially about the challenges associated with investing in embryonic businesses pursuing 'buy-and-build' strategies. This is where one investee is used as a platform to acquire others. There is considerable work in ensuring that the acquired businesses work to equivalent standards. One investor acknowledged they had significantly under-estimated the level of ongoing support required. This serves to show that business integrity risk management is an ongoing exercise which is not limited to upfront, pre-investment checks.

External experts similarly viewed ongoing monitoring as an area where impact investors could step up their activities. A civil society respondent said they "*wanted to see a change in mentality, more proactiveness, and not see investors waiting for something to happen*".

61 Sarah Chayes, Carnegie Endowment for International Peace. 'When Corruption is the Operating System. The Case of Honduras' (2017).

Some investors use technology for alert systems that can help an investor to respond quickly when problems arise. As yet, there is limited evidence of impact investors actively scanning for issues across a portfolio. Measures could include commissioning regular audits of high-risk businesses to assess the standards of controls. Monitoring changes in political dynamics in a market could also help investors anticipate changes in the risk profile for investees.

Proactive monitoring will also frequently entail supporting investees to develop capacity on business integrity, a topic we cover in **Section 2.5.** below.

2.5. Exit

Business integrity measures should carry through to the end of the relationship with an investee, whether this is the end of a loan agreement, sale to a private buyer or public listing. The priority at this stage is to ensure the sustainability of gains made on business integrity. The review should extend beyond regulator-required AML checks on buyers to also assess alignment on business integrity (see **Table 3**).

There is little an impact investor can do once a business is sold so ensuring a buyer shares a similar approach is fundamental to preserving gains. The majority of the impact investors consulted indicated they conduct AML checks. They do not necessarily undertake a broader review of a buyer's ethos on business integrity, nor the appropriateness of the investee's business integrity controls for any post-investment plans. Pressure around a sale can sometimes lead these issues to be overlooked. These steps are vital to protect the development impact of an investment.

2.6. Working with investees to raise standards

2.6.1. Overview

All the impact investors consulted place minimum contractual requirements on investees related to business integrity. These will include commitments on anti-bribery and other laws related to financial crime. Impact investors also typically require investees to adopt basic business integrity measures, such as having an anti-bribery and corruption policy and whistleblowing line.

Figure 9: TI-UK Global Anti-Bribery Guidance

Top Level Commitment
- Top level communication & culture
- Governance
- Collective action & other enabling factors

Risk Assessment & Planning
- Risk assessment
- What is bribery?

Policies & Procedures
- Financial controls
- Human resources controls

High Risk Areas
- Facilitation payments
- Gifts & hospitality
- Sponsorship, donations & community investment
- Conflicts of interest
- Political engagement

Managing Third Parties
- Managing third parties
- Contractors & suppliers

Communications & Training
- Communications & training

Monitor & Review
- Whistleblowing
- Monitoring & review

Reporting
- Reporting

There is then divergence in approaches. Only a minority of investors interviewed require and make available resources to support the establishment of more comprehensive business integrity management systems. There is no common framework currently, but approaches draw on existing guidance published by international organisations and civil society groups[62]. **Figure 9** illustrates core elements of TI-UK's Global Anti-Bribery Guidance that covers the priority areas. These need to be adapted and proportionate to the size and business model of the investee.

If measures are not already in place, several impact investors use legally binding action plans to push changes pre- and post-investment. The extent to which impact investors proactively conduct verification of standards varies significantly depending on the resources they have available. Several impact investors appear to rely only on legal documents as a means of upholding standards. This is in itself not sufficient.

2.6.2. Challenges

Interviewees from both impact investors and investees cited various challenges which arise in supporting investees to develop capacity on business integrity, including:

- Geographic distance between investors and investees
- Levels of investee familiarity with international standards
- Levels of investor familiarity with the local context
- High turnover of staff making it harder to build trust and momentum
- Competing pressures on time and resources at both investees and investors
- Multiple, differing requirements from groups of investors
- Overload of requirements from investors

Notwithstanding these challenges, interviewees gave many examples of investments where investors had helped investees in realising standards on business integrity. One investment officer described a typical approach, saying:

> **"We invest in established businesses but they are often family-run and it can be an adjustment to put the right controls in place. They do not necessarily see the value in business integrity and ESG. There is a journey to go on but once they are on board, we see big changes and this impacts performance".**

Sometimes the hoped for changes do not materialise. Interviewees spoke about cases where management had resisted the implementation of controls or, more commonly, shown a lack of interest. **Text Box 6** provides a brief example.

TEXT BOX 6: CHALLENGES IN WORKING WITH INVESTEES ON BUSINESS INTEGRITY

An impact investor made an equity investment in a construction business. At the time of investment, the investor agreed an action plan incorporating anti-corruption measures. This was initially not implemented as the business lacked capacity to fulfil the commitments. Over the next two years, the business ran into financial issues and the relationship between the investor and investee deteriorated. Implementation of the plan became a negotiation point but was deprioritised in the face of pressing financial issues. The investor gradually reduced their shareholding and was unable to fully implement the plan.

A well-functioning business integrity risk management system is not something that can be externally imposed nor built overnight. One investor's view that business integrity is binary - *"it's something you either have or you don't"* – is not a comment with which we would agree. Firms can develop and maintain business integrity systems when the incentives align. This does not discount the possibility that issues will happen which are beyond an investor's control. However, many risks

62 TI-UK, 'Global anti-bribery guidance' (accessed 13 May 2022); OECD, 'Corporate Anti-Corruption Compliance Drivers, Mechanisms and Ideas for Change' (2020); Gemma Aiolfi, *Anti-Corruption Compliance. A Guide for Small and Mid-Sized Organizations* (Edward Edgar Publishing 2020). For examples of frameworks used by impact investors see BII, 'Policy on Responsible investing' (2022) and Swedfund, 'Anti-Corruption Management System' (2017).

can reasonably be mitigated, and much depends on the thoroughness of due diligence, monitoring and the strategy for raising standards.

2.6.3. Key priorities

We gathered views from interviewees on strategies to ensure capacity building on business integrity is a success. From these discussions we highlight three main priorities.

(1) Alignment from the outset

Upholding high standards is more likely if there is alignment from the outset between the investor and investee on the importance of business integrity. Investors need for example to understand whether an investee is prepared to properly resource controls over the long-term. They also need to understand whether an investee will be willing to make changes to established practices, which may sometimes entail commercial costs. There needs to be openness to discuss upfront what can be sensitive issues.

Several interviewees referred to what is essentially a window of opportunity in which working relationships are established on business integrity. One investee emphasised:

> **"Processes need to be in place as soon as possible because once time lapses the perceived importance lags proportionately. This needs to at the right level, at the top of the firm, and not given to a mid-level manager with no oversight".**

An investee similarly commented:

> **"The investor needs to ask 'how is this individual thinking about their optimisation for the project?' Do they want to see a ten, twenty year project which is sustainable? Or are they looking at ways they can game the system and make a lot of money upfront. This will tell you a lot about their attitude to business integrity".**

On the same theme, another investor focussed on the importance of a firm's business model, saying:

> **"There's a trend of just having anti-corruption contract clauses rather than trying to really engage with the investments, [to understand] what are the real risks, what does the management think about these and what are their ethics… A lot of investors don't spend enough effort trying to understand the manager's view on key issues, e.g., does the CEO think facilitation payments are ok? Focus on these operational aspects and whether you have a good partner".**

(2) Focus on organisational capacity and governance

Several interviewees believed that impact investors often under-recognise the importance of organisational capacity in business integrity. One expert consultant further explained:

> **"What is often missing is human capital. If the capacity is not there, you need to consider how it will be built and who will be the custodian of the frameworks you help build".**

The types of businesses targeted by impact investors may not have the resources to put in place dedicated business integrity officers and teams. In these circumstances, interviewees described how they seek to overcome the challenge of finding the right individual. They highlighted three key characteristics they look for:

- Seniority: responsibilities need to sit with an individual who has authority in the firm;
- Independently-minded: the individual needs to feel comfortable making decisions which may be contrary to prevailing attitudes in a firm;
- Personal capacity: they need to have the time to do the work.

TEXT BOX 7: LESSONS ON CAPACITY BUILDING AT A MICROFINANCE INSTITUTION IN ASIA

A capacity-building programme at a microfinance institute in Asia illustrates the importance of sustained organisational capacity. As a condition of investment, the investee agreed to undertake a review of business integrity risks. A consultant involved in the process described how the firm's overall risk profile was not exceptionally high but there were some vulnerabilities. These principally related to third parties, namely introducers, brokers and lawyers, used by the firm for purposes such as attracting and retaining investees, debt collection and resolving disputes in the courts. The firm identified the latter function as the highest area of risk due to systemic corruption in the country's judiciary.

This assessment prompted several counter-measures initially focussed on the firm's third party management system. The priority was a rationalisation exercise to map the number of third parties used by the firm to establish whether these were indeed needed. The firm then introduced a new code of conduct, contracts with anti-corruption clauses, and tightened rules on gifts and hospitality. It also engaged directly with select third parties on these rules according to a risk rating system. The firm planned future phases of work including re-examining the fee structures for third parties to disincentivise fraud and corruption.

The changes initially received a high level of impetus from a head of compliance at the firm, who led the programme with the support of the impact investor and an expert consultant. This was helped by the fact that the individual was widely respected in the firm. Unfortunately, the individual has recently moved to another employer. Skills and knowledge of compliance are in short supply in the market and the individual moved to a better-paid job. The result has been that the reform programme has stalled. There has since been more limited engagement from the investee, endangering the sustainability of these changes.

This describes an ideal person, who may not exist, meaning there should be a long-term plan to bring in resource. Some investors commented that they had been guilty of trying to do the work directly themselves but this created problems around ownership. One investor described a more sustainable approach in which members of compliance and risk teams take up periodic secondments at investees where they mentor counterparts.

(3) Combining international best practice with local knowledge

Relationships work best when international best practice is married with local knowledge. An investee will have a much more granular understanding of corruption dynamics locally and strategies that have worked in countering corruption. An investor can bring frameworks and tools that strengthen investee approaches. They can also bring lessons from across a portfolio on what has worked in similar circumstances. These ideas need to be sold in terms of the commercial benefits they bring to a business and not as an arbitrary, externally imposed standard.

KEY POINTS

- There are pockets of good practice in the sector but many impact investors could do more to proactively identify and address business integrity risks.
- Due diligence is often focussed on counterpart compliance and reputational checks. It should be more expansive to cover operating risks in the business environment and an investee's ability to mitigate these risks.
- Portfolio monitoring on business integrity is an area of weakness in the investment cycle. Resources are often drawn away from this area.
- Impact investors should see it as part of their role to support investees in developing capacity on business integrity. This can be part of their contribution to development impact.

RECOMMENDATIONS

Impact investors should:

- 2.1. Incorporate business integrity into country and sectoral market assessments, examining the political and economic factors which influence levels and forms of risk. The information should be continually updated to reflect current market conditions and influence where and how investments are made.
- 2.2. Strengthen pre-transactional due diligence by going beyond counterpart compliance due diligence to assess business integrity risks in the operating environment. Assessments should also cover the adequacy of risk management capacity and level of commitment to mitigating these risks.
- 2.3. Strengthen portfolio monitoring by ensuring resources are in place to regularly engage with investees on business integrity risk management.
- 2.4. Support investees in developing business integrity risk management systems.

3. IMPROVING COORDINATION OF BUSINESS INTEGRITY AND ESG

3.1. Why coordinate?

Business integrity risks and ESG risks often share common roots. One of the advantages in coordinating activities is that this can help an impact investor form a more holistic understanding of an issue, its drivers, and the options available for mitigation.

Labour intensive sectors like construction and manufacturing illustrate the interconnections well. Corruption is an enabling factor for the types of labour abuses which occur in these sectors. The US civil society organisation Verité for example has researched how corruption underpins international recruitment of migrant workers[63]. Demands for bribes are made at multiple stages of the recruitment chain, facilitating exploitative patterns of behaviour such as forced labour. Corruption at site level presents a direct threat to worker health and safety. This was shown tragically in 2013 at the collapse of the Rana Plaza garments factory in Dhaka, Bangladesh, resulting in over 1,100 deaths. This was an 'outcome of a corrupt system' in which local authorities acted negligently in enforcing building codes and labour laws[64].

Investee attitude to ESG matters is likely to be a strong indicator of alignment on business integrity and vice versa; firms paying bribes are likely to cut corners in other areas. Coordination of business integrity and ESG workstreams helps to reinforce the importance of both to an investee. It also reduces the burden on investees having to respond to multiple, sometimes overlapping, requests from investors.

There is additionally convergence in legislation that reinforces closer working between professionals in these areas. Unlike anti-bribery laws such as the US FCPA and UK Bribery Act, many ESG issues have historically been managed through voluntary principles and soft law[65]. This is changing with the introduction of mandatory due diligence laws in France and Germany, the Modern Slavery Act in the UK, and planned EU mandatory due diligence legislation on human rights and environmental impacts[66]. Campaigners are lobbying for anti-corruption to be incorporated into the EU legislation, expected in 2022[67]. Drafts of disclosure templates for the EU Sustainable Finance Disclosure Regulation (effective March 2021) include anti-corruption as a sustainability risk alongside other environmental and social indicators[68].

Impact investors should get ahead of these trends where coordination supports their development objectives. At the same time, it is important to recognise that there are issues where distinct skill sets and knowledge are required (see **Section 2.2.**). As an ESG specialist at an impact investor surmised, the overarching aim "*should always be to develop systems which strengthen each other rather than being parallel and separate*".

3.2. Current practice

Improving coordination of business integrity and ESG may require changes to the way many impact investors operate. The professionals interviewed had varying experiences on how much cross-functional collaboration happens in practice in impact investing.

Several experts, principally at DFIs, gave examples of close working between business integrity and/or compliance professionals and experts on ESG. As the latter typically look closely at the operational aspects of an investee's business, they help to flag business integrity concerns which others review. Some investors also create joint action plans for investees on business integrity and ESG (see **Section 4.1**).

63 Verité, 'An Exploratory Study on the Role of Corruption in International Labor Migration' (2016).
64 William Gomes, 'Reason and Responsibility: the Rana Plaza Collapse' (Open Democracy, 9 May 2013).
65 Rocio Paniagua and Bonnie Groves, 'Lessons from Past Approaches Towards Human Rights and Corruption Point to Pursuing Them Together in Future' (TI-UK, 13 July 2021).
66 Alison Taylor, 'Compliance Alert: Anti-Corruption and Human Rights Efforts Will Converge in 2020' (FCPA Blog, 3 January 2020).
67 Olivier de Schutter. Global Witness and TI-EU. 'The Prevention of Corruption as Part of Mandatory Due Diligence in EU Legislation' (2021).
68 Cleary Gottlieb, '2021 brings significant new ESG disclosure obligations for financial services firms' (5 January 2021).

Other individuals interviewed had experience of teams working in a more siloed manner. One common issue cited was that ESG functions are significantly more resourced; business integrity counterparts often struggle to keep up. Sometimes investors have developed separate due diligence workstreams which are hard to merge retrospectively[69]. The experience at smaller fund managers is different. Among the funds consulted, some had appointed an ESG officer to manage what can be increasingly complex requirements. Responsibility for business integrity usually remains with a senior partner with legal responsibilities.

Key standards applied in the impact investing sector moreover do not support coordination of these topics. Most importantly, there is no discussion of anti-corruption in the IFC Performance Standards, the leading ESG framework applied by impact investors, nor accompanying guidelines and procedures manuals[70].

3.3. What tools are available?

As they work with investees, business integrity and ESG professionals frequently employ the same types of risk mitigation strategies. Where there is a clear rationale for doing so, this work can be coordinated to reduce duplication of effort and improve the quality of measures.

The types of measures which overlap include:

- **Organisational culture:** assessing senior leadership commitment and incentive structures which could encourage unethical behaviour are foundations of business integrity and ESG.
- **Risk assessments:** conducting joint business integrity and ESG risk assessments that look closely at an investee's operations to identify potential vulnerabilities. Several investors use risk assessments as the basis for recommendations on controls but these are often separate exercises for different topics.
- **Supply chain management:** supply chains are commonly a weak point in maintaining operational standards. Business integrity and ESG risks can be managed through due diligence, contractual requirements and monitoring.
- **Audits:** auditors should have an explicit mandate to look for both ESG and business integrity issues. Social

69 On the separate of business integrity and human rights due diligence see for example Alison Taylor, 'Compliance Alert: Anti-Corruption and Human Rights Efforts Will Converge in 2020' (FCPA Blog, 3 January 2020).

70 IFC, 'Performance Standards on Social and Environmental Sustainability' (2012); IFC, 'Environmental and Social Review Procedures Manual' (2016).

audits are employed frequently but may not pick up other concerns if this is not an aim. Identifying these forms of issues likewise needs to be an explicit goal of financial audits. Audits can be used proactively to assess controls and not only as a response to problems.

- **Complaints and whistleblowing lines:** these should be open to employees and other stakeholders to raise different forms of concern. There should be lines of communication available at investees and to investors directly.
- **Stakeholder engagement:** investees should engage continuously with the communities affected by their operations. Concerns raised could relate to any form of issue, including corruption, and investees need to specifically look out for this issue.
- **Codes of conduct:** rather than having separate codes, core principles around employee ethical behaviour can be combined into a single document.

Experience of combining these types of tools is limited as yet. More research and sharing of lessons is needed to understand how well combined mechanisms work in practice. The following two sections look at some examples of coordinated work around the themes of gender and healthcare standards.

3.4. Illustrative example: connecting gender and corruption risk assessments

5 GENDER EQUALITY

Experience and research have shown definitively that corruption affects men and women differently. The harms from certain forms of corruption, such as informal payments for access to services, or the denial of services by people in power, fall disproportionately on women[71]. Other forms of corruption such as sextortion - the abuse of power to obtain a sexual benefit or advantage - are a driver and consequence of inequality between men and women[72].

These forms of corruption can be prevalent in sectors targeted by impact investors, such as education, finance and healthcare. One of the impact investors consulted has sought to understand how corruption connects to their wider work on gender and women's economic empowerment. They have initiated a pilot project in partnership with women's rights organisations to research linkages between gender-based violence, harassment and sextortion. This is incorporated in their risk assessment of investees. Emerging findings indicate that power imbalances at firms can provide opportunity for sextortion. This suggests potential joint responses, which include promoting women leadership and ownership at different levels in firms. Gender-sensitive whistleblower reporting systems are more likely to protect those harmed.

The SOAS-ACE consortium has also conducted research on the banking sector in Nigeria on these topics. It found corruption in lending at financial institutions exacerbates gender inequity in access to credit[73]. This limits expansion for women-owned SMEs. Policy options which follow from the research are to move the loan application process online to reduce rent-seeking by bank officials. Making more deliberate efforts to include male participants in gender equality training and sensitisation programmes is also an option proposed by the researchers.

There is limited evidence of impact investors looking to connect these themes in their work to date. More research is needed to assess how approaches can be effectively coordinated.

3.5. Illustrative example: referral fees and healthcare standards

3 GOOD HEALTH AND WELL-BEING

Impact investors support businesses in the healthcare sector with the aims of improving the accessibility, affordability and quality of services. An ESG priority is to support high standards of clinical governance at investees which emphasise patient rights and safety[74].

Corruption is a serious problem in the healthcare sector globally with adverse consequences for development[75].

71 UNODC, 'The Time is Now. Addressing the Gender Dimensions of Corruption' (2020).
72 TI, 'Breaking the Silence around Sextortion. The Links Between Power, Sex and Corruption' (2020).
73 Brian Ezeonu and Kelly Krawczyk, 'Lending Corruption and Bank Loan Contracting: Implications for Gender Inequity and Inclusive Growth in West Africa' (2021) SOAS-ACE Briefing Paper 17.
74 IFC, 'Promoting standards in the private health sector. A self-assessment guide for health care organizations' (2015).
75 The World Health Organisation (WHO) has previously estimated that around 7% of healthcare expenditure is lost to corruption. For more background on corruption issues in the sector see TI-UK, 'The Ignored Pandemic' (2019).

A case study of an investment in a hospital chain in Asia illustrates how corruption risks need to be considered alongside ESG management. A coordinated response in this case helped to strengthen standards of patient care.

Prior to the investment the hospital chain regularly paid cash referral fees to general practitioners to refer patients to its facilities. This is a common problem in many markets[76]. While not always illegal, it is a harmful and corrupt practice because it incentivises profit-making over the duty of care health professionals have to patients. Due to the financial reward on offer, doctors can be incentivised to refer patients for unnecessary treatment, or to a facility that is not the most appropriate centre for care. As payments are often made in cash, this additionally creates opportunities for mismanagement and theft of funds.

At this business, the scale of the problem was significant: an estimated 8% of revenues were used for cash referrals. Following the investment, the investee and investor developed an action plan to reduce these payments. To replace the lost income for general practitioners, the hospital changed to an approach in which it paid eligible doctors to support post-operative care. This process was closely supervised, with the doctors participating in training schemes run by the hospital. Standards of care were also assessed by an audit and quality control team.

In this case, mitigating corruption issues was part of enhancing healthcare standards. The healthcare sector generally offers scope for improved coordination on business integrity and ESG. This includes themes such as the integrity of pharmaceutical supply chains and addressing informal payments for services. There are typically gendered variations to these problems with corruption impeding access to healthcare for women.

KEY POINTS

- The benefits of coordinating activities on business integrity and ESG include forming a more holistic understanding of issues and strengthening risk management processes.
- Key ESG standards do not adequately address corruption as a risk factor to implementation. At present, workstreams on business integrity and ESG are often separated.
- There are options available for coordinating joint working but there is limited experience to date of application. This report provides examples on gender and healthcare where impact investors have taken steps to improve coordination.

RECOMMENDATIONS

Impact investors should:

- 3.1. Ensure that business integrity is not separated from work with investees on ESG. The issues should be coordinated from the beginning of the investment process and not as a final compliance check. Organisational structures need to support this mode of working.
- 3.2. When implementing the IFC Performance Standards, explicitly consider whether business integrity issues could undermine the measures developed with investees.
- 3.3. Review how certain risk mitigation tools could be better integrated or coordinated. These might include joint business integrity and ESG risk assessments, audits, and whistleblowing processes.

76 See for example, David Berger, 'Corruption ruins the doctor-patient relationship in India' (2014), *BMJ*, 348.

4. INVESTOR CONSISTENCY ON BUSINESS INTEGRITY

An impact investing mandate entails high accountability to a broad range of stakeholders. Communities affected by investments in particular should be able to scrutinise whether impact investors are fully living up to their commitments on business integrity. In this section, we highlight three areas where we consider investor consistency between commitments and practice could be enhanced. These are levels of transparency on business integrity, responding to concerns, and investment structures.

4.1. Transparency

Transparency is central to the accountability impact investors have to the public and the stakeholders affected by their investments. It also has a dual benefit in that it helps strengthen an investor's business integrity systems by discouraging misconduct. Overall there is much room for improvement on the openness of business integrity risk management in the sector.

TI conducted a review of the public information made available by 20 prominent impact investors globally, including a mix of investor types. Around half of the impact investors reviewed publish some information on their business integrity practices. Some leading investors do not disclose basic information, such as their anti-bribery and corruption policy and business integrity requirements of investees. Most investors tend to provide very limited information on the management of business integrity in their portfolio and their engagement with investees. Public whistleblowing and complaints lines are an established feature but only a small number of impact investors make available case information. Only one investor publishes information on how business integrity relates to impact measurement. Gaps in information make it difficult for an outsider to understand how impact investors manage these issues.

Published information is not equivalent to actual practice and the findings are not necessarily a reflection of the approach impact investors take. However, transparency is part of demonstrating to external stakeholders that a firm takes these issues seriously. Past research by TI-UK shows there is a strong business case for corporate transparency on anti-corruption, which includes

What types of business integrity information should impact investors make publicly available?

Below is an illustrative, non-exhaustive list, of items most relevant to impact investors. A full list of transparency recommendations for businesses can also be found in the TI publication *Open Business*, which is cited below.

- An overview of their approach to managing business integrity, internally and in their portfolio, including an explanation of the investor's corruption risk assessment and how this informs anti-bribery and corruption risk management
- Anti-bribery and corruption policies
- Information on their beneficial ownership and organisational structure
- Requirements and expectations of investees on business integrity
- Tools and resources on business integrity which are a public good e.g. toolkits, sectoral risk assessments
- Details of whistleblowing and complaints channels
- Results from incident investigations and actions taken
- Assessment of how business integrity connects to investor impact claims

reputational benefits and building and maintaining consumer, investor, employee and business-to-business trust[77]. Transparency can further be used proactively as a business integrity mechanism. It sends clear messaging on the firm's ethics. It also deters actors who might engage in conduct that is inconsistent with this position.

4.2. Responding to concerns

Even at investees with sophisticated risk management systems, business integrity issues can still occur. It is important that investors respond to issues in consistent ways.

Two experts commented that historically this has been an area of weakness for impact investors. There are publicly available cases that illustrate this[78]. Investors should therefore work to structured guidelines rather than purely relying on ad hoc decisions. These could be based around a scale of response that increases in severity up to and including divestment. This applies not only to specific investments but also to major integrity incidents in a country that might affect groups of investors. Guidelines for international aid agencies organised through the OECD Anti-Corruption Task Team might provide a model in this regard[79].

Based on our review of public materials, this is an area where there are gaps in transparency (see above). Investors should not only make available whistleblowing and complaints lines. They should provide clear information regarding the process by which complaints are handled, the status of cases, and the outcomes.

Challenges stem from the fact that for certain financial products, particularly private equity investments, the options for impact investors to exit difficult partnerships are narrow. A ready buyer may not be available and the investor may need to remain engaged with the business. These scenarios underline the importance of clear public communication on the rationalisation for an impact investor's actions.

Multilateral development banks participate in cross-debarment schemes to prohibit transactions with companies implicated in business integrity issues, among other concerns[80]. The cross-debarment scheme is limited to multilateral development banks currently. This model might be extended to a wider group of impact investors as part of enhancing sectoral collaboration (see **Section 5**).

4.3. Investment structures

One domain where there is tension around investor consistency on business integrity is in the use of offshore financial centres in some investment structures. Impact investors have defended their use on the basis that these are needed to protect the financial and legal security of investments81. At the same time, secrecy requirements in offshore financial centres play a major role in laundering proceeds of corruption from the countries impact investors aim to serve[82].

This presents a problem of coherence for investors seeking to abide by high business integrity standards but also continuing to use structures which have proven to be obstacles to global efforts to tackle corruption. AML checks can help mitigate risk in the investment structures directly managed by impact investors. There is nonetheless a broader problem of being seen to endorse offshore business models which enable severely damaging forms of corruption.

There is not a simple policy response to this issue. Some investors only invest through jurisdictions which meet set criteria established by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes[83]. To manage corruption risks, the priority is to assess levels of compliance with criterion A1, 'ownership and identity information'. This assesses whether jurisdictions collect accurate and up-to-date identity and beneficial ownership information. Investors should minimise their use of jurisdictions which do not make corporate information publicly available[84]. They

77 TI-UK. 'Open Business: Principles and Guidance for Anti-Corruption Corporate Transparency' (2020).
78 Sarah Chayes, Carnegie Endowment for International Peace. 'When Corruption is the Operating System. The Case of Honduras' (2017).
79 OECD, 'OECD Recommendation of the Council for Development Cooperation Actors on Managing Risks of Corruption' (2016).
80 World Bank, 'Integrity Vice Presidency' (accessed 13 May 2022); Parliamentary and Health Service Ombudsman, 'Handling Allegations of Corruption. A Report by the Parliamentary and Health Service Ombudsman on an Investigation into a Complaint about the Department for International Development' (25 February 2014).
81 For an overview of the issues see Paddy Carter, Overseas Development Institute, 'Why Do Development Finance Institutions Use Offshore Finance Centres' (2017).
82 TI-UK, 'The Cost of Secrecy' (2018); International Consortium of Investigative Journalists, 'Offshore leaks database' (accessed 13 May 2022)
83 OECD, 'Global Forum on Transparency and Exchange of Information for Tax Purposes' (accessed 13 May 2022)
84 OECD, 'Exchange of Information on Request. Third edition' (2016).

should further not undermine countries which have made steps on beneficial ownership requirements by investing through jurisdictions with lower standards. This is a key part of the fight against transnational corruption.

As previously discussed in a paper published by the Overseas Development Institute, impact investors should also consider how they can be part of the solution to these issues[85]. This could include making beneficial ownership information for their investment portfolio publicly available in jurisdictions where transparency is lacking. This can help serve as bridge until jurisdictions release public beneficial ownership registers. It would help demonstrate investor commitment to integrity and transparency. Impact investors should also use their influence to advocate for higher transparency requirements in relevant jurisdictions.

KEY POINTS

- Transparency on business integrity risk management is relatively low in the sector. Some leading investors disclose minimal information on their approach to managing business integrity risks.
- Impact investors often respond on a purely case-by-case basis to integrity issues in an investment portfolio. Consistency of responses could be enhanced by working to structured guidelines.
- Certain investment structures through offshore financial centres can be clearly linked to developmental harms. There are legitimate purposes for using these structures in impact investing. However, their use conflicts with commitments to promote high standards of business integrity globally.

RECOMMENDATIONS

Impact investors should:

- 4.1. Publish core information on their approach to managing business integrity risks, including but not limited to:
    - An overall assessment of the corruption risks the investor and its investee businesses face and how they respond;
    - Anti-bribery and corruption policies and procedures;
    - Requirements and expectations of investees on business integrity;
    - Information on investigations and complaints processes, including the status and outcomes of past investigations.
- 4.2. Establish a clear public position on risk tolerance, including levels of business integrity risk which are unacceptable to the investor.
- 4.3. Have set procedures and guidelines in place for responding to integrity incidents, with different scales of response up to and including divestment.
- 4.4. Minimise the use of offshore jurisdictions in investment structures. Refuse to use corporate vehicles incorporated in offshore jurisdictions which do not meet the higher of OECD or local standards on releasing identity and beneficial ownership information.

85 Paddy Carter, Overseas Development Institute, 'Why Do Development Finance Institutions Use Offshore Finance Centres' (2017).

5. ENHANCING SECTORAL COLLABORATION FOR WIDER IMPACT

In many areas such as ESG, the impact investing sector has shown itself to be innovative and a standard setter. There is an opportunity for impact investors to take up this role on business integrity, enhancing collaboration to find solutions to common challenges.

Unlike for ESG, there is no common unified framework on business integrity for impact investors, nor consistency in the language and terminology used. This contributes to a number of challenges observed in the sector. For an impact investor looking to develop their approach there is no benchmark against which to assess their programme. For investees, there can also be mixed messaging on the importance of business integrity if only certain investors emphasise the topic. Some impact investors have different requirements, creating an increased administrative burden on investees dealing with multiple investors.

There are also no regular forums where impact investors convene to share lessons and discuss business integrity risk management. This is unusual in a sector where there is extensive collaboration on many parallel themes such as corporate governance, ESG and measurement of development impact.

We see three main areas where sectoral collaboration could be enhanced to bring wider benefits:

1. Harmonising standards
2. Sharing good practice
3. Initiating collective action at the local level

5.1. Harmonising standards

Given the sector encompasses firms of varying sizes and mandates, there is no single model of business integrity risk management. There would be benefits however from harmonisation around a core set of principles to which all impact investors can subscribe.

Lessons from work on ESG show the potential. In the impact investing sector, the IFC Performance Standards are widely embedded[86]. They are the recognised standard, providing a framework of action which is transparent for investors and investees. One ESG lead at an impact investor described how:

> **"Harmonisation on ESG has been one of the key things that holds us together. It stopped us asking different things of investees and created a level framework across investors".**

Other sectoral initiatives include the Operating Principles for Impact Measurement (see **Figure 8**) and the Corporate Governance Development Framework (see **Text Box 1**). The development of standards such as these does not come without challenge, especially when it comes to implementing any agreed principles. But the potential is there, and these frameworks have wide influence beyond the sector.

One investor took the view that harmonisation on standards in business integrity is more difficult because the issues are subjective. Impact investors also have legal obligations that enforce certain structures and ways of working. This certainly creates points of difference. In spite of this, this report has argued that to fulfil their development mandate impact investors should surpass legal obligations to engage more comprehensively with business integrity as a topic.

Some areas which present clear opportunities for harmonisation of approaches include:

- Baseline standards for investee business integrity systems
- Reporting requirements for investees
- Measurement of business integrity impact
- Levels of investor transparency on business integrity

86 IFC, 'Performance Standards on Social and Environmental Sustainability' (2012).

Notwithstanding what one expert labelled as some degree of 'standards fatigue', our research indicates there are a group of influential impact investors who would support greater harmonisation.

5.2. Sharing good practice

There is some collaboration on business integrity between groups of impact investors around individual transactions. There are not as yet regular forums where impact investors can share learnings and good practices. These are areas where firms can learn from each other and there would be clear benefits from sharing successful approaches.

We also identified a need to expand the range of guidance materials that speak to the specific circumstances facing impact investors and investees. Some impact investors have released materials and run relevant training courses[87]. These initiatives should be expanded. The IFC additionally runs a corporate governance advisory service for firms outside of its portfolio which may be candidates for future investment[88]. A similar approach might be adapted with specific attention to business integrity.

5.3. Initiating collective action at the local level

In **Section 1.2**, we described how impact investors can play a role in transforming corruption dynamics to improve the operating environment for businesses. Collective action is a key strategy by which this might be achieved. There are examples worldwide of businesses collaborating to advocate for reform and higher integrity in public processes[89]. Groups of investors with interests in multiple companies in the same market are well placed to galvanise joint initiatives. They can lend their voice and support to help initiate and sustain collective action. In response to points raised around gender and corruption (see **Section 3.4.** in particular), investors might prioritise support to business groups for female entrepreneurs.

In our research, we did not generally come across examples of impact investors playing an active role in collective action initiatives related to business integrity. One exception is the Danish DFI, the IFU, which encourages its portfolio businesses to participate in business associations to share corruption-related experiences. It has also previously provided training to support a business association in Ukraine[90].

KEY POINTS

- Levels of collaboration among impact investors on business integrity are low in comparison to other parallel activities, such as ESG.
- Impact investors are sometimes working to different standards on business integrity. This can create challenges for investees and there would be benefits in harmonising approaches.
- Impact investors are missing opportunities to support change on business integrity in the markets in which they work. There are multiple options available, including supporting collective action initiatives.

RECOMMENDATIONS

Impact investors should:

- 5.1. Develop a global set of harmonised standards covering, at a minimum, common expectations on business integrity for investees and investee reporting standards to investors.
- 5.2. Convene regular industry forums and working groups to share learnings on approaches to managing business integrity risks.
- 5.3. Incubate and support collective action initiatives in markets in which multiple impact investors and investees are operating.

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89 The Basle Institute on Governance is a leading actor on collective action. It maintains a searchable database of over 250 collective action initiatives on integrity and anti-corruption (accessed 13 May 2022).

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ACRONYMS

ABC: Anti-bribery and corruption

AML: Anti-money laundering

BII: British International Investment Plc

CPI: Corruption Perceptions Index

CSO: Civil society organisation

DEG: Deutsche Investitions- und Entwicklungsgesellschaft

DFI: Development Finance Institution

EBRD: European Bank for Reconstruction and Development

EPC: Engineering, procurement and construction

ESG: Environmental, Social and Governance

FCPA: Foreign Corrupt Practices Act

GIIN: Global Impact Investing Network

IFC: International Finance Corporation

IFU: Investeringsfonden for Udviklingslande

KYC: Know Your Customer

OECD: Organisation for Economic Co-operation and Development

PRI: Principles for Responsible Investment

PPA: Power purchase agreement

PSC: Person of/with significant control

ROE: Return on equity

ROI: Return on invested capital

SDGs: Sustainable Development Goals

TI: Transparency International

UN: United Nations

REFERENCE MATERIALS

Below are a selection of key source materials for further reading. This is not a comprehensive bibliography. Full references can be found throughout the text.

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