The Impact Investing Institute's response to the Department for Work and Pensions' consultation: Consideration of social risks and opportunities by occupational pension schemes

16 June 2021

ABOUT US

The Impact Investing Institute was launched in 2019 with a simple mission: to accelerate the growth and improve the effectiveness of the impact investing market in the UK and internationally. Our vision is for lives to improve, as more people choose to use their savings and investments to help solve social and environmental challenges, while seeking a financial return. We want to see more capital contributing to the well-being of people and the planet – as set out in the United Nation's Sustainable Development Goals.

We are an independent, non-profit organisation, which brought together two influential initiatives: the government's Taskforce for Growing a Culture of Social Impact Investing in the UK and the UK National Advisory Board on Impact Investing. We are part of the GSG – the Global Steering Group on Impact Investing - network.

WHAT WE DO

Our Theory of Change describes how we plan to achieve change in the short-, medium- and long-term. We run a series of research, education and advocacy programmes designed to bring about the market conditions to enable impact investing to flourish.

We want to make it easier for pension schemes to invest with impact which is consistent with their purpose and support them in reducing negative impacts and risks to the environment and society such as carbon emissions, biodiversity loss, poor governance and inequality that arise from their portfolios. We work with them to make it easier to allocate for impact in the following ways:

- Our *Fiduciary duty – the legal context* paper, written by five City law firms and reviewed by the Association of Pension Lawyers, counters the misconception that investing for social and/or environmental impact is incompatible with pension scheme fiduciary duty.
- We have also developed four guiding Impact Investing Principles for Pensions that give an accessible, practical insight into the opportunity presented by impact investing and provide pension scheme trustees with concrete steps to take to Invest with Impact.
- In partnership with Pensions for Purpose, we run the Adopters Forum – a member forum of pension scheme, investment consultants and fiduciary managers that have committed to the Impact Investing Principles for Pensions. Members advance the principles, share best practice and together lead the way for more pension schemes to invest with positive social and environmental impact.
- We are also continually developing an evidence base of impact investments suitable for pension schemes. This includes the investment cases for 'place based impact investments' like clean energy and social housing. Our Place-Based Impact Investing (PBII) Project explores how a place-based approach, already favoured by public and social investors, can be extended to private investors, in particular Local Government Pension Schemes. We recently published a series of case studies on opportunities for impact investments in emerging markets that are suitable for pension schemes.

impact investing institute

OUR KEY RECOMMENDATIONS

In response to DWP's consultation seeking evidence on the social element of ESG investing, we would make two key recommendations:

1. UK pension scheme trustees should be provided with a framework to aid them in understanding social factors and how they can be included in their ESG policies. We agree that these factors may present potential risks to pension scheme investments - but would emphasise that they also can present robust investment opportunities. The disciplined and intentional investment process introduced by impact investing - with a focus on specified outcomes, measurement and reporting - will improve the way pension schemes integrate ESG into their portfolios. We invite the Department for Work and Pensions to **support our** Impact Investing Principles for Pensions **and encourage their adoption by all pension schemes**. The principles were designed in extensive consultation across the pension sector. They provide clear and practical guidelines for how pension schemes can better understand social factors and integrate the consideration of impactful social factors into their investment and stewardship activities.

2. UK regulation and supervisory practices should reflect an equal emphasis on environmental and social factors. To underline the importance of social factors, the government should **establish a Social Technical Advisory Group to advise on a 'social taxonomy'**, to complement the work of the Green Taxonomy Advisory Group to develop a 'green taxonomy'. This would ensure that future developments in corporate reporting and other financial regulation to integrate sustainability-related matters include, and give equal weighting to, wider environmental and social factors alongside climate-related impacts. The Institute would be pleased to contribute to this work.

HOW WE WILL APPROACH THIS RESPONSE

We contextualise these recommendations in our response below. As we are not a pension scheme, our response pulls out key themes of the consultation that we feel the Institute is best placed to comment on. We have identified these themes as 1) The importance of 'S' factors 2) Impact 3) Stewardship.

We also directly answer question 8, "What opportunities are there for trustees to invest, directly or indirectly, in companies solving social issues in developing or emerging markets? How attractive are these investments?" in section 4) of this response.

We thank you for this timely consultation. As previously noted, we are particularly interested as pension schemes are a significant focus of our work programme on impact investing. In addition to our written response, we would welcome the opportunity to meet with DWP representatives to flesh out our responses and share ideas and discuss overlapping areas of interest.

OUR RESPONSE

1. Importance of 'S' factors

We strongly welcome the consultation's foresight in recognising the increasing importance of 'S' factors for investing. Our fiduciary duty legal paper explains that 'prudence' is not a set concept. It has changed and continues to change over time, in line with societal norms and knowledge. For example, investing in stocks and shares was considered imprudent until the mid-20th century. A way of thinking about what it means to act prudently in the face of systemic risk and uncertainty is to adopt a 'transitional mindset', considering systemic and forward-looking risks as the transition to a net-zero economy which also addresses social issues such diversity and inclusion, workforce protections, and health and wellbeing will require a massive reallocation of capital.

Our *Reporting of Environmental, Social and Economic Outcomes* paper, response to the International Financial Reporting Standards (IFRS) Foundation's consultation on sustainability reporting, and response to the Financial Reporting Council's (FRC) consultation on the future of corporate reporting all outline why sustainable reporting should give stronger consideration to broader, interrelated environmental and sustainability impact factors, especially companies' social impact, alongside climate. This is encapsulated by the UN's Sustainable Development Goals, which show that environmental, social and governance factors are not only of equal importance but are often inextricably linked. Furthermore, a growing body of research is rendering visible links between broader environmental and social impacts: COVID-19, in particular, has shone a light on the social consequences of biodiversity loss. It is for this reason that we make the recommendation above to establish a Social Technical Advisory Group to advise on a 'social taxonomy', to which the Institute could contribute, to complement the work of the Green Taxonomy Advisory Group to develop a 'green taxonomy'.

Investor interest in social factors is growing rapidly, partly due to COVID-19. Bonds with a social theme - whether labelled social bonds, sustainability bonds or Covid-Response bonds – grew sevenfold to £104bn in 2020. Issuance of sustainability bonds - which allow issuers to use proceeds for both green and social projects – rose 81% to £49bn.[1] These figures reflect the 2020 Edelman Trust Barometer Special Report: Institutional Investors, in which 88% of respondents agreed that companies that prioritise Environmental, Social and Governance (ESG) initiatives represent better opportunities for long-term returns than companies that do not. Most crucially, 'social' ranked as the most important ESG element – up from third place in 2019.

In response to this demand, we launched our Green+ Gilt proposal in collaboration with the Green Finance Institute and the London School of Economics' Grantham Research Institute, which emphasised the potential of a green sovereign bond with well-defined social and economic benefits. We welcomed the Chancellor's announcement of a series of sovereign green bonds last year and confirmation in the March 2021 Budget that these will include reporting on social co-benefits. We are pleased to continue to be engaging both with the market and with Treasury and the Debt Management Office to support the effective implementation of the bonds, with a particular focus on providing an actionable schedule of social co-benefits, starting with jobs and skills, to deliver on the net zero agenda while levelling up across the country.

The consultation rightly identifies the wide range of types and sources of 'S' factors. In our recent IFRS Foundation and FRC consultation responses, we recommended increased convergence around sustainability reporting, which the UK government should support. Supply chains are global; investors and capital flows are global; urgent challenges such as climate change or pandemics can only be tackled globally. Global standards can effectively counter the

[1] Figures converted from $ via XE Currency Converter on 03/06/2021

risks of regional solutions not meeting the needs of cross-border capital flows and multinational expertise, as well as the risks of gaps in participation by some countries. While the consultation cites 'S' factor sources, such as the Principles for Responsible Investment and the Sustainability Accounting Standards Board, this list is not exhaustive. Scheme trustees and advisers may also wish to consider the Global Reporting Initiative (GRI) Standards, the world's most widely used standards for sustainability reporting, to take account of social factors.

2. Impact

We welcome the inclusion of impact investing as a means of taking into account social factors. However, we challenge the classification of impact as '*non-financial*'. The use of the terms '*financial*' and '*non-financial*' is unhelpful in this consultation and does not align with terminology used both in the UK and in wider, global discussions about sustainability reporting. The recent FRC consultation on corporate reporting referred to certain '*non-financial*' information that has a clear impact on enterprise value creation and the "sustainability of the business model over the longer term". It explicitly acknowledged that "the term non-financial reporting when used in this context is often considered a misnomer as it could affect financial performance."

Our fiduciary duty legal paper outlines that investment professionals are increasingly aware of risks to financial returns that arise from weaknesses in companies' approach to our environment, social responsibility and governance. Those risks must be considered in relation to the time horizon of the pension portfolios, which can be measured in decades. Many companies, for example, now have a significant risk exposure to the transition to a low-carbon economy. Social issues, including diversity and inclusion, workforce protections, and health and wellbeing can also impact the long-term success of an investee company.

Fiduciary duty and a growing body of regulation therefore compel trustees to consider the implications of exposure to ESG risks in their schemes' portfolios. Trustees must invest in the best financial interests of their pension scheme's members but, in so doing, they are entitled to consider investments that contribute to solutions to the challenges the world faces – in other words, that have an impact, by generating positive change for people or the planet. Whilst trustees must remain focused on what is financially material to their own pension scheme, many impact factors can fall into this category and so can contribute to positive portfolio outcomes for the pension scheme. It can be helpful for trustees to consider the extent to which investing in enterprises which avoid harm can mitigate financial risk, while favouring enterprises that have a positive impact - and actively benefit people and planet and contribute to solutions – may provide opportunities for financial outperformance over the long term.

Some impact factors (such as carbon emissions, child labour, or modern slavery in a company's workforce or supply chain) may well be financially material now and should therefore be considered by pension trustees. Other impact factors may not currently be seen as financially material (or relevant to financial performance) but may become relevant in the future, such as payment of taxes. For example, the fashion retailer Boohoo's enterprise value fell by 23% following revelations that one of its suppliers failed to pay its employees the minimum wage. We therefore support the GRI's commitment to dynamic materiality – including sustainability disclosures material to enterprise value as well as to global public interest – because a rapidly evolving economic landscape means that what appears financially immaterial today can quickly prove to be business-critical tomorrow.

Of course, as with any investment decision, considering impact factors must be consistent with Trustees' legal duties and support the objectives of their investment portfolio. That objective may be a competitive return, but may also be mitigation of risk through diversification, provision of income, reduced volatility, or a number of other features that contribute to an efficient portfolio, and which can be delivered by impact investments.

We also challenge the assertion that impact is a "sub-set of assets/investments". Impact investment is not an asset class, but rather a lens that can be applied to all asset classes and investment approaches. Impact investing itself can have a wide range of financial goals from "finance first" competitive risk-adjusted financial returns to "impact first" approaches that can be concessionary. Investors are also finding sound investments across a range of sectors and asset classes that provide capital growth, income or diversification as well as a positive impact (detailed in Section 4)).

3. Stewardship

We agree with the importance of stewardship in managing social risks and opportunities - particularly in the public markets. Through engagement, investors (directly or through delegated agents) can engage with companies to improve performance on ESG issues. This extends impact investing beyond the financing of beneficial products and services, to the improvement of corporate behaviour and achievement of impact goals.

As we lay out in Principle Three of our Impact Investing Principles for Pensions, pension schemes should continue to engage with third-party providers, particularly investment consultants and fiduciary managers, to keep informed of key issues and developing asset owner views or positions on stewardship issues for particular sectors, assets or investments, especially where relevant to the scheme's stewardship guidelines. Schemes should undertake active, supportive monitoring of investment managers' stewardship activities throughout the year based on detailed reporting.

We welcome the development and adoption of tools such as shareholder resolutions, which are beginning to change the landscape of shareholder stewardship. There are also opportunities to engage collectively on key impact issues with like-minded investors through organisations such as ShareAction and the Investor Forum. Products such as Tumelo facilitate communication of investment priorities and engagement activities to members.

We support both of HM Treasury's Asset Management Taskforce's recommendations for the Department for Work and Pensions (numbered 15 and 16), which seek to raise the standard of stewardship across the sector, supported by a dedicated council of UK pension schemes.

4. Opportunities

We agree with the consultation's assessment that there are misunderstandings about the availability and viability of incorporating financially material social factors in the investment process, and we work to address these misunderstandings.

Our work on place-based impact investment, including a recent white paper on Scaling Up Institutional Investment for Place-Based Impact, highlights the financial viability of investments across social housing, clean energy, infrastructure, regeneration, SME finance that have a positive impact on communities and deliver above-average risk/returns. The paper also builds a sound evidence base for place-based impact investments, delivers a framework for place-based impact investing measurement, management and reporting and provides a critical review of existing institutional asset management models.

Our research into the viability of social housing suggests the sub-sector's attributes particularly justify its inclusion in a diversified portfolio that seeks to achieve strong and stable risk-adjusted returns.

To challenge the myth that investing in developing, emerging and frontier markets is not suitable for pension schemes, we developed a set of case studies of impact investments in such markets made by institutional investors including pension schemes. The case studies provide concrete examples of impact investments that meet the specific needs of UK institutional investors and cover multiple asset classes, themes and geographies, including emerging and frontier markets in Africa, Asia and other global regions. The research shows that significant and measurable impact can be achieved while delivering a risk-adjusted financial return that is suitable for pension schemes.

Impact investing opportunities in emerging and frontier markets are becoming more innovative and sophisticated to attract more capital from pension schemes. Asset managers and intermediaries are developing innovative solutions to address the most common concerns of institutional investors, for example around currency, liquidity or ticket sizes, that may prevent them from investing in emerging and frontier markets. The role of development finance institutions and public investors – such as the UK's CDC or the Foreign, Commonwealth and Development Office MOBILIST programme - is particularly important in mobilising such investment and should be supported and expanded as part of future policy changes.

We support the government's efforts to make it easier for pension schemes to invest in opportunities with financially material social factors that deliver competitive risk-adjusted financial returns. We will continue to generate information for pensions schemes and their trustees on attractive investments and products that meet these criteria.