The Impact Investing Institute's response to the Department for Work and Pensions Consultation: Climate and investment reporting: setting expectations and empowering savers

6th January 2022

1. 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 (SDGs).

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, which brings together leaders from finance, business, and philanthropy to solve some of the world's most pressing social and environmental challenges.

2. 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. We seek to support schemes in making investments which create opportunities to generate positive, measurable environmental and social impact alongside a competitive risk-adjusted return. "Impact is defined as a change in outcome – positive or negative." We believe that a key element of positive impact is "additionality" – this is the concept that takes impact investing beyond "just" ESG. It asks that this type of investment makes more of a difference than a business-as-usual approach. A "true" impact investor must be additive in some way – they have to show that their investment makes more happen than would through using traditional investment approaches.

We work with pension schemes to make it easier to allocate for impact in the following ways:

1. We have developed a pension schemes fiduciary duty legal context paper in November 2020, written by five City law firms and reviewed by the Association of Pension Lawyers, which counters the misconception that investing for social and/or environmental impact is incompatible with pension scheme fiduciary duty. Please see paragraph 4.2 for more detail on this paper.

2. We have also developed four guiding Impact Investing Good Governance Principles for Pensions (see our comments on stewardship below). These 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 at every stage in the investment chain.

3. In partnership with Pensions for Purpose, we run the Impact Investing Adopter Forum, a member forum of pension schemes, 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.

4. 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', including 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 have recently published a series of case studies on opportunities for impact investments in emerging markets that are suitable for pension schemes.

5. Finally, the Impact Investing Institute’s Learning Hub is designed to help professionals and individuals learn more about impact investing to meet personal interests or support work with clients or on behalf of beneficiaries.

3. KEY RECOMMENDATIONS

We welcome the Department for Work and Pensions' (DWP) Consultation on climate and investment reporting (the Consultation), which introduces important and valuable new ways for pension schemes to invest lawfully, responsibly and with impact. The Impact Investing Institute is committed to encouraging better approaches and to removing barriers to impact investment. This means investing in a way to create opportunities for positive impact, as well as a focus on managing risk. To this end, we make the following recommendations:

3.1 Fiduciary Duty

We believe that fiduciary duty is still a live issue. There is still confusion amongst some UK pension scheme trustees as to what they are permitted and required to do. This contributes to a risk-averse investment culture which in turn limits impact investing. As noted above, in 2020 we commissioned a pension schemes fiduciary duty legal context paper and, from this, developed four guiding Impact Investing Good Governance Principles for Pensions. As a simple first step, we encourage the DWP to consider supporting more widespread awareness-raising about this important piece of work, together with our Good Governance Principles and the Impact Investing Adopters Forum.

There will be additional action needed to address fiduciary duty which may include guidance or legislation. In particular, in our view, the Law Commission's two stage non-financial factor test, first formulated in 2014, is no longer fit for purpose.[1]

Chancellor Rishi Sunak has noted that around 70% of the UK public want their money to go towards making a positive difference to people and planet,[2] and the Consultation itself states that "it is now well established that the majority of scheme members care about climate change and the impact it will have on their savings, environment and wider society." If this is correct, this traditional formulation of the fiduciary duty, with its implied narrow focus on benefits to individuals, must now be ripe for reconsideration.

The most straightforward resolution to the inadequacy of the Law Commission's two stage non-financial factor test, and an acknowledgement of the weight of public sentiment, is for DWP to issue explicit guidance to the effect that pension fund trustees, in selecting scheme investments, must consider the impact of those investments on society and the environment.

3.2 Universal Ownership

We note the DWP's discussion of the concept of "universal ownership" in relation to Stewardship and Voting (at p. 9). However, we recommend that the core logic of universal ownership, that a portfolio is impacted by larger dynamics in society and the economy, be recognised not only in stewardship and voting but throughout the investment process, including governance, risk management and investment selection.

3.3 Just Transition

We applaud the introduction of climate reporting requirements for pension schemes based on Task Force on Climate-Related Financial Disclosures (TCFD) but believe that additional reporting should be added to this baseline, reflecting the importance of a Just Transition and the interrelationship between environmental and social factors. The Just Transition is developed more fully in the reports of the G7 Impact Taskforce (ITF), an independent, industry-led effort backed by the UK Government as part of the UK presidency of the G7 in 2021. The Impact Investing Institute led one of the two workstreams of the Impact Taskforce, the "Instruments and Policies to Scale Impact Investment" Workstream. This was complemented by a second workstream on "Impact Reporting, Integrity and Transparency" led by the Global Steering Group for Impact Investing (GSG), of which we are a member. Specific recommendations of the ITF bearing on this Consultation are discussed at paragraph 4.4 below.

3.4 Stewardship, Voting and Engagement

Finally, we support the Consultation's renewed focus on effective stewardship and voting by pension schemes, chiefly through disclosures in Statements of Investment Principles

[1] In 2014 the Law Commission explained that the primary concern of trustees must be to generate risk adjusted returns. However, the law is flexible enough to accommodate other, non-financial concerns in some circumstances. For trustees to take account of non-financial factors when setting investment strategies and making investment decisions, they should apply two tests, taken from the case law: (1) trustees should have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund. See the Law Commission Pension Funds and Social Investment No.374 at p.38.

[2] Chancellor sets new standards for environmental reporting to weed out greenwashing and support transition to a greener financial system - GOV.UK (www.gov.uk)

and Implementation Statements. Stewardship and voting are essential impact investing tools, and one means of achieving additionality. We suggest that trustees be asked to provide more specific disclosure on the activities they are carrying out and the reasons why those activities (and not more, or different, activities) have been chosen to be carried out in members' best interests.

We also recommend that the guidance provides equal or greater emphasis on engagement alongside voting. Engagement is arguably the more flexible, responsible, and value-adding approach to stewardship – particularly by providing additionality. We believe the engagement section could be enhanced with more practical suggestions and examples of good practice as discussed below.

4. OUR RESPONSE

4.1 Our approach

As we are not a pension scheme, our response pulls out key themes from the Consultation that we feel the Impact Investing Institute is best placed to comment on under four main headings:

1. Thematic issue: fiduciary duty
2. “Universal Ownership” concept: investment selection and Stewardship
3. Climate reporting: TCFD baseline and social elements reflecting the importance of a “Just Transition "
4. "Additionality": Stewardship, voting and engagement

In addition to our written response, we would welcome the opportunity to meet with DWP representatives to flesh out our responses, share ideas and discuss overlapping areas of interest.

4.2 Thematic issue: fiduciary duty

As we see it, one of the underlying policy objectives of the Consultation is to encourage more specific and concrete action among pension schemes in relation to climate change, stewardship, and engagement. We support this, and the Government’s wider objective of making it easier for pension schemes to invest in opportunities with positive impact factors that deliver competitive risk-adjusted financial returns.

However, we caution that in our experience, the trustee fiduciary duty currently remains a live issue which is likely to continue to interfere with these objectives. We have worked with five leading City law firms to produce *Impact Investing by Pension Funds – Fiduciary Duty: The Legal Context* (see box below for more details). Despite the conclusions of this report and the guidance it provides, subsequent engagements suggest to us significant ongoing concern about misconceptions and misapplications of the fiduciary duty, with the result that sustainable investment practices are not being effectively cultivated.

These concerns include:

1. That, in practice, the financial materiality test often results in responsible investment considerations being given low priority. The financial materiality test allows trustees to identify a financially material environmental, social, and governance (ESG) or impact factor, but resolve that other financially material factors in the decision take priority if the trustee considers those factors to be more persuasive. As long as the final decision is neither imprudent, irrational or perverse (which are difficult to establish), it is not legally challengeable.

2. Ongoing uncertainty about the two stage non-financial factors test. Examples include uncertainty about whether the "significant financial detriment" aspect – particularly in relation to quality-of-life factors – is correct in law, and about whether and how trustees can achieve adequate comfort that the concern would be shared by their members (particularly in large schemes with many thousands of members).

Fiduciary duty and our legal paper

The current generally accepted industry view, which the DWP approach is based on, follows the Law Commission's 2014 and 2017 reports. This roots climate, social and other ESG considerations within trustee discretionary investment decision-making. In short:

- ESG considerations can and should be taken into account when investing where they are financially material.

- Non-financial factors (which may include environmental or social impacts and member views) can be taken into account where the trustee has good reason to think members would share the concern and the decision does not involve a risk of significant financial detriment to the fund.

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. Our report shows that many such impact factors are financially material now, and that others (such as payment of taxes) may well become so in the future.

Even for highly motivated trustee boards, these issues mean the fiduciary duty is not working actively to foster impact investment. For less motivated schemes, it can even provide cover for inaction. In both cases, the result is that unsustainable investment practices are not being effectively discouraged at present.

The Impact Investing Institute is committed to encouraging better approaches, and to removing barriers to more responsible investment. Our report is an innovative piece of legal and economic analysis, and as a simple step we would encourage the DWP to consider supporting more widespread awareness-raising about this important piece of work, together with our Principles and Impact Investing Adopters Forum.

We believe that additional action will ultimately be needed to address the ongoing problems with the fiduciary duty. Chancellor Rishi Sunak has noted that around 70% of the UK public want their money to go towards making a positive difference to people and planet,[3] and the Consultation itself states that "it is now well established that the majority of pension scheme members care about climate change and the impact it will have on their savings, the environment and wider society".

As noted above, the Law Commission formulation of the fiduciary duty, with its implied narrow focus on benefits to individuals, is now out of date. We invite DWP to issue explicit guidance to the effect that pension fund trustees, in selecting scheme investments, must consider the impact of those investments on society and the environment. Such a step would capture the predominate social preference for considering societal impact as a trustee obligation and remove the uncertainty around gauging member views.

Furthermore, as one of the outcomes of the Impact Investing Institute's programme at COP26, we are working with the University of Glasgow and a group of market participants including the Impact Investing Institute to reappraise the fiduciary duty and explore how the challenges might be overcome or reframed. We would very much welcome the Government's engagement with this work.

We believe all of these suggested steps will materially contribute towards greater and faster greening of the pension scheme investment ecosystem in line with the Government's policy ambitions.

4.3 Universal Ownership

The core idea of universal ownership is that large institutional asset owners, of necessity, construct highly diversified, long-term portfolios that reflect the entire investment market, and by extension the entire economy. As a result, returns on their portfolios are impacted by negative externalities, i.e., negative impacts on society (e.g., pollution) created by companies whose costs are absorbed by the economy, not by the company generating them. In the environmental area, these costs can re-enter the portfolio as insurance premiums, taxes, increased health costs and the costs generated by climate-related

[3] Chancellor sets new standards for environmental reporting to weed out greenwashing and support transition to a greener financial system - GOV.UK (www.gov.uk)

pressures and disasters. In the social area, these costs can re-emerge as higher social spending, depressed economic activity and political instability.

Large institutional asset owners that are indexed to the market, and thereby constrained to owning companies generating negative externalities, can contribute to influencing those companies positively through their voting and stewardship activity. If the asset owners' efforts are successful, the overall portfolio will benefit from the reduction in negative impact (or creation of positive impact) on the macro economy. For an indexed investor, the most important determinant of long-term portfolio returns is in fact the health of society and the economy, which then feeds into the financial markets.

We therefore welcome the Consultation 's mention of universal ownership as a potential consideration by trustees in approaching stewardship and voting, as we believe that active ownership can be effective, especially in coordination with other asset owners and managers.

However, we believe that the core logic of universal ownership, that a portfolio is impacted by larger dynamics in society and the economy, should be recognised throughout the investment process, including governance, risk management and investment selection. This would therefore apply to pension portfolios that are not indexed (and not necessarily large), but rather making active investment selections. For example, a pension fund might compare two investments that have equivalent financial prospects but have opposing impacts on society and/or the environment. In a conventional approach, either investment would be appropriate. In consideration of universal ownership however, the enterprise making a more positive contribution to society and/or the environment would more likely improve the prospects for the portfolio's other investments, and therefore would be the more appropriate choice.

4.4 Climate change, TCFD and Just Transition

The 2021 TCFD regulations provide a ground-breaking policy platform for pension schemes to engage with, and better address, their climate-related risks, and opportunities.

We welcome the Consultation proposals to introduce a mandatory Paris-based portfolio alignment metric, and to require a total of four climate metrics, rather than three, on pension scheme portfolios. We are enthusiastic that this new baseline will increase focus on the journey towards Net Zero within pension scheme investment strategies. However, we believe that there is a need to focus not only on climate but also reflect the importance of a Just Transition, and the interrelationship between environmental and social factors.

The Impact Investment Institute is doing extensive work in relation to a Just Transition, including:

1. In collaboration with the Green Finance Institute and the London School of Economics' Grantham Research Institute, developing a Green+ Gilt with well-defined social and economic benefits and related reporting. The Green+ Gilt gained the support of 40 leading asset owners and managers, as well as organisations such

as the CBI, TheCityUK and the Association for Financial Markets in Europe. Together, these investors represent more than £10 trillion in assets.

2. This focus on a Just Transition is developed more fully in the reports of the G7 Impact Taskforce, an independent, industry-led effort backed by the UK Government as part of the UK presidency of the G7 in 2021. The Impact Investing Institute led one of the two workstreams of the Impact Taskforce, namely the "Instruments and Policies to Scale Impact Investment" Workstream. This was complemented by a second workstream on "Impact Reporting, Integrity and Transparency" led by the Global Steering Group for Impact Investing (GSG) of which we are a member. The Taskforce's recommendations include:

    - Mandatory accounting for impact by businesses and investors to harmonise standards, recognising the central role of transparency and integrity in changing behaviour and driving investment flows.
    - Support for the efforts of the International Financial Reporting Standards Foundation's International Sustainability Standards Board (IFRS-ISSB) to create a global reporting "baseline" on impact related to enterprise value.
    - Mobilise institutional capital from the full range of private and quasi-public institutional actors, in pursuit of positive impact and advancing the SDGs by increasing the use of proven instruments and tools that can address real barriers for private capital participation and encouraging more private sector capital to flow to emerging markets.
    - Break down silos between climate-first and social-first strategies and transactions and strengthen the participation of local Community Voice to advance a Just Transition.

We believe that this emphasis on a Just Transition and the interrelationship between the E and the S is essential. 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.

In this context, pension schemes and other asset owners can contribute to the Just Transition by measuring and reporting on the social implications of their climate-related investing alongside investment risk and opportunity (for example, by assessing alignment with relevant wider UN SDGs as well as Net Zero). We urge the DWP, over the medium-term, to expand the reporting regime to cover the social impacts and opportunities arising in connection with climate-related investing. 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 and climate impact.

We believe that, as well as contributing to a Just Transition, wider sustainability impact reporting would be entirely consistent with both the DWP's call for evidence on social factors in pension scheme investing (please see our response to that call for evidence), and with the Government's stated plan for pension schemes to report on sustainability impacts of their investments under upcoming Sustainability Disclosure Requirements (SDR).

Finally, on metrics, specifically the additional climate change metric, we would encourage the DWP to give trustees a much clearer steer towards choosing the optional 'exposure to risks' and 'alignment toward opportunities' metrics under paragraph 173 of the revised guidance, as opposed to the other options. The 'alignment with opportunities' metric, in particular, will encourage a focus on investing for measurable positive impact.

We believe this is a simple short-term step which will help with achieving the policy intention. Climate-related investment risks and opportunities are highly correlated with social and environmental outcomes, and although the regulations already contain a general duty for pension schemes to identify and manage climate-related risks and opportunities, in practice trustees need methodological tools to help them make informed decisions. A firmer nudge towards adopting these exposure/alignment metrics will act as a valuable catalyst for the pensions industry to develop and use these tools.

We would also encourage a more joined-up approach across the different pieces of guidance that covers how to identify and respond to climate risks and opportunities. The draft climate metrics guidance currently refers to the TCFD examples of key categories of commonly accepted risk and opportunities – effectively, taxonomies. Our perspective is that active stewardship through voting and engagement can be of equal or greater value than taxonomies when identifying and managing climate risks and opportunities. We would therefore suggest that the DWP expands the content of the climate governance and reporting guidance to make a stronger link to the concept of stewardship when explaining how trustees might approach governance and management of climate risks and opportunities. We would also suggest cross-referring more specifically, within the climate guidance, to the new stewardship guidance to make these links even clearer.

4.5 Stewardship and engagement

The Consultation proposes a renewed focus on effective stewardship, voting and engagement by pension schemes, chiefly through disclosures in Statements of Investment Principles and Implementation Statements. We support this. Stewardship, voting, and engagement are key to an important tenet of Impact Investing – "additionality". Through engagement, investors (either directly or through delegated agents) can engage with investees to improve corporate performance on social and environmental impact factors. Thus, stewardship and engagement can:

1. form a key part of a prudent response to managing financial risk to pension portfolios; and
2. create additionalities which ultimately further benefit both investors and investees.

We are delighted that the Consultation suggests that trustees may wish to consider whether the concept of universal ownership should inform their approach to stewardship and voting. As noted above, we endorse this view and would recommend that:

1. this commentary is specifically added to the stewardship guidance, instead of sitting within the Consultation paper only.

2. the separate guidance on setting investment policies within the Statement of Investment Principles and on climate change governance and reporting should also both be updated to encourage trustees to consider universal ownership in the context of investment selection.

The indicative lists of stewardship priorities in paragraphs 25 and 32 of the draft guidance make specific reference to impactful environmental and social financially material factors such as biodiversity, modern slavery, diversity and inclusion and workforce interests. To these, we would recommend adding further examples of potential priorities such as place-based impact investing, health and wellbeing, and housing and education, noting that pension schemes can, of course, adopt different stewardship priorities for different asset classes or sectors.

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 and small and medium-sized enterprises (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.

We would also like to highlight the following as points of detail for further thought:

1. **Best interests.** Paragraphs 16 and 19 of the stewardship guidance encourage trustees to explain "how their stewardship activities are in scheme members' and beneficiaries' best interests". We believe the intention of the guidance is to require trustees to explain the specific activities they are carrying out and the reasons why those activities (and not more, or different, activities) have been chosen to be carried out on the basis that they are in members' best interests. If that is correct, we believe the guidance must set out more specifically the level of detail the DWP expects pension schemes to provide in the explanation of how the best interests of members are being advanced by the stewardship and engagement activities the scheme is implementing. It seems to us that the current draft guidance could be taken literally and satisfied by giving short and generic statements about the general benefits of stewardship which provide no real explanation of why trustees are satisfied their own particular stewardship activities are the right ones for 'their' members.

2. **Engagement beyond voting.** The draft guidance has a significant section on stewardship through voting rights and collecting voting data. It is very positive that the guidance gives a clear example of an effective voting policy at paragraph 44. We believe that calling on pension funds to adopt more specific, focussed, and actionable investment policies is essential for delivering effective change against the backdrop of the current law and regulation[4]. However, the guidance provides comparatively less commentary on engagement, which is arguably the more flexible, responsible, and value-adding approach to stewardship – particularly by providing additionality. We believe the engagement section of the guidance should be expanded to include more practical suggestions and examples of good practice. For example, there are opportunities to engage collectively on key impact issues with like-minded investors and organisations (which could be added to the list of collaborative initiatives in paragraph 37); and products such as Tumelo which facilitate communication of investment priorities and engagement activities to members could also be mentioned (including generally without naming providers).

In addition to the sources already mentioned in the Consultation, as previously noted, the Impact Investing Institute has published a set of Good Governance Principles for Pension Trustees. These provide a framework for pension schemes looking to address social, economic, and environmental impacts of investments. The principles were developed in Consultation with the pensions industry and are designed as a simple guide to support existing pension fund processes, rather than create a new governance burden. The Good Governance Principles encourage pension schemes to:

1. set impactful objectives within their investment policies that help deliver the pension scheme's purpose.
2. appoint consultants and managers with impact integrity.
3. manage and review progress against objectives.
4. use their voices to make change by formulating and applying stewardship, engagement and voting guidelines.

There are clear alignments with the recommendations in the Consultation here, but each Principle is also accompanied by a set of specific and focussed recommended actions. We commend the Good Governance Principles and would be delighted to meet with you to discuss them further. They have been welcomed in many areas of the industry as a straightforward and practical tool to advance responsible and impactful investing.

We remain committed to assisting the Government and the pensions industry in making it easier for pension schemes to invest in opportunities with positive impact factors and

[4] For more on this, see the PLSA webinar 'ESG from policies to practice', delivered by one of our supporter organisations, the law firm Travers Smith, at the PLSA ESG Conference 2021: https://www.traverssmith.com/knowledge/knowledge-container/esg-from-policies-to-practice-pensions-and-lifetime-savings-association-plsa-esg-conference-2021/

deliver competitive risk-adjusted financial returns. We will continue to provide inputs, tools and thought leadership to help drive practical, effective progress and we welcome the Government's ongoing focus and commitment in this area.
