impact investing institute

Impact investing by pension funds
Fiduciary duty – the legal context

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Contents

This paper has been produced by Bates Wells, Herbert Smith Freehills, Norton Rose Fulbright, Sackers and Travers Smith, in order to provide a description and overview of the law and its application to impact investing in practice. It is not intended to be comprehensive or exhaustive and nothing stated in this document should be treated as an authoritative statement of the law. Trustees will need to consider obtaining legal and investment advice in the context of their own specific circumstances.

Executive summary

Investing with purpose

As with all fiduciary powers, investment powers are to be exercised by trustees for the purpose for which they are provided. In a pension fund context this means that they are to be exercised to serve the purpose of the pension fund – to provide retirement benefits for its members. This basic duty is supplemented by additional investment duties set out in legislation.

This paper will focus on trust-based occupational pension schemes and as such will focus on the duties of trustees when making investment decisions, including both those set out in statute and the pension fund's trust deed and rules.

Investment decisions require consideration of a wide range of financial factors. Conventionally such factors might include, for example, matching assets against liabilities as part of a diversified portfolio or making allocations to specific asset classes to hedge against risk. *However, it is becoming increasingly apparent that the wider social and environmental impacts of the investments in a fund's portfolio ("impact factors") may also be financially material to a pension fund's investments over time.* Pension funds, due to their long-term horizons, are uniquely affected by long-term risks.

Understanding impact investment

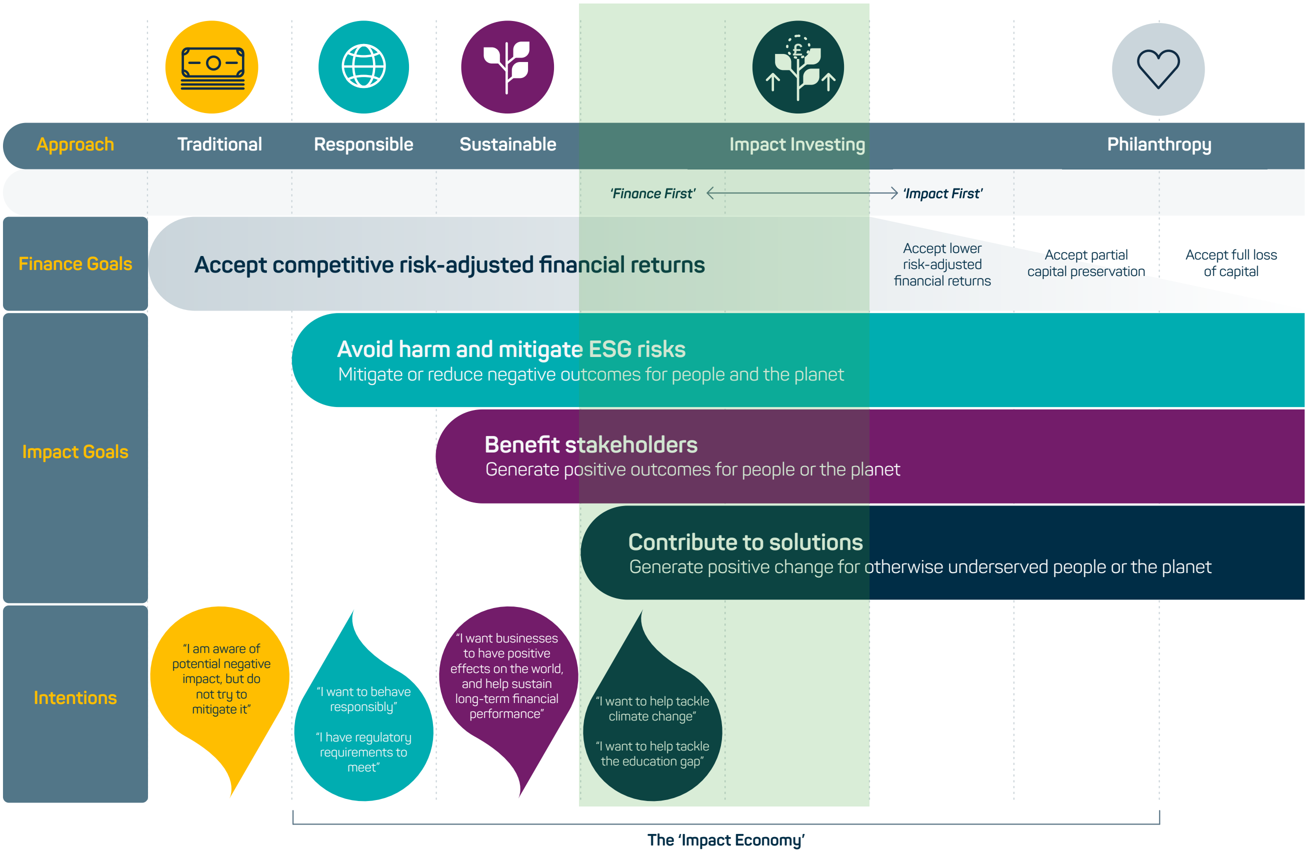
Impact investing refers to investments *"made with the intention to generate positive, measurable social and environmental impact alongside a financial return."*[1] Understood in this sense, impact investment might currently be seen by some trustees as a relatively new or niche form of investment activity, albeit one growing quickly in scale and significance. Yet all investments are in enterprises that have impacts in the real world. On this broader view, 'impact' might be understood as a *"change in outcome (positive or negative) caused directly or indirectly, wholly or partially, intended or unintended"*.[2] This focus on 'outcomes' differs from traditional ESG analysis, which tends to be more focused on how an organisation seeks to avoid harm, mitigate risk and manage its reputation.

Seen in this light, all pension funds are (and have always been) impact investors – the question is, what kind of impact investments are they making?

1 GIIN (Global Impact Investing Network), https://thegiin.org/impact-investing.
2 Impact Management Project, https://impactmanagementproject.com/impact-management/impact-management-norms/

Trustees may find it helpful to consider impact investment in the context of the "Spectrum of Capital". Typically, impact investments which are attractive for a pension fund trustee would fall within the light green shaded area ('accept competitive risk adjusted financial returns').

The Spectrum of Capital



Source: Bridges Fund Management and Impact Management Project.

Financially material impact factors

Increasingly, investment professionals are aware of risks to financial returns that arise from weaknesses in companies' approach to our environment, social responsibility and governance (ESG risks). 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.

However, there is also opportunity in a changing, and challenged, world. 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 fund'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 fund, many impact factors can fall into this category and so can contribute to positive portfolio outcomes for the pension fund. 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 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[3], child labour, or modern slavery in a company's workforce or supply chain[4]) 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.

Of course, as with any investment decision, considering impact factors must be consistent with the Trustee's legal duties and support the objectives of their investment portfolio. That support 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.

Trustees with fiduciary duties in the UK and throughout the world are finding competitive investments across a range of sectors and asset classes that provide capital growth, income or diversification as well as a positive impact. Hence, there can be sound financial reasons for making impact investments. They can both contribute to the sustainability and resilience of people and planet and increase prospects for long-term capital growth and performance over time.

The duty to act prudently and risk management

In a situation where society as a whole is generating negative impacts which present systemic risks to the broader economy[5] in the form of carbon emissions, biodiversity loss, poor governance and inequality, many trustees will properly wish to consider what actions they can take, as prudent investors, to mitigate such risks to their portfolio. Considering impact factors as part of a fund's portfolio investment and engagement activities (collectively with other investors and otherwise) can form a key part of a prudent response to mitigate these investment risks.

The prudent trustee may also wish to consider how the investment portfolio as a whole is resilient to other known challenges facing society, such as the transition towards a lower carbon economy.

The coordinated international policy response we are beginning to see to the climate and ecological emergency brings this issue into sharp relief. It means that trustees should have a 'transitional mindset' to manage the various associated transition risks and opportunities.

3 See Economic analysis by BNP Paribas Asset Management, pg9 below.
4 See Industry analysis by Société Générale, pg14 below.
5 For example, there is a considerable body of academic analysis on the economic impacts of climate change, including the landmark Stern Review for the UK Government (2006).

Conclusion

The world is changing – with new challenges relating to people and the planet. Thus, new risks and opportunities must be considered by trustees when balancing risk and return in investing their pension funds' assets. Trustees may therefore consider it prudent to adopt investment strategies which reduce financial risk arising from negative impacts in the portfolio and to search for positive impacts which provide financial opportunity, for example, as part of the need for a sustainable energy transition.

In short, where there are sound financial reasons for making impact investments as part of a wider investment strategy, trustees should have the power to do so. In particular, there may be circumstances where such impact investments contribute positively to asset diversification, lower overall volatility, reduce the effect of negative externalities, and increase the future-fitness, resilience and prospects for long-term capital growth and performance of the fund over time.

The legal context – in a little more detail

PART I - Introduction to the legal framework

The focus of this paper

This paper focuses on “impact factors” to the extent that such factors are considered by trustees to be financially material to a pension scheme as an investor and so to have a meaningful bearing on the financial performance of its portfolio. “Impact factors” can be defined as the wider social and environmental impacts of the investments in a fund’s portfolio.

In considering the extent to which impact factors can be taken into account by trustees, this paper focuses on trust-based occupational pensions schemes, for which it is necessary to apply the relevant pensions legislation and trust law. This paper does not specifically consider local government pension schemes, which are governed by specific statutory powers and duties.

This report does not consider in any detail the extent to which trustees may wish to consider impact factors which are solely “non-financial” in nature from an investor perspective. In its report on the Fiduciary duties of Investment Intermediaries (2014), the Law Commission considered the extent to which so-called “non-financial factors,” might be taken into account by trustees making investment decisions. Among other things the Law Commission concluded that:

- “purely ethical” concerns, designed to show moral disapproval of activities, may be taken into account if two conditions are satisfied. Firstly, the trustees must have good reason to think that scheme members would share the ethical/moral view. Secondly, they should anticipate that the decision will not result in significant financial detriment to the scheme.
- “quality of life factors” (that is, factors relating to beneficiaries’ quality of life now and in the future) may also be taken into account when choosing between two equally beneficial investments. However, improving quality of life must remain a subordinate objective: there must still be good reason to think that members would welcome the lifestyle benefit, and the “quality of life” objective should not be pursued to the extent that a risk of financial detriment to the scheme is created.[6]

There are, however, a number of legal nuances and practical considerations which arise from the Law Commission’s views on “non-financial factors”, meaning that where trustees wish to make an investment decision based on “non-financial” factors, they should take legal advice. The Pensions Regulator also provides further guidance on this.[7]

In many cases however, it will not be necessary for trustees to concern themselves with a “non-financial” justification for making an impact investment, since a financially positive case can frequently be made for impact investing. Where trustees are able to base an investment decision on financial factors, the fact that there may be non-financial benefits from the investment need not be a factor in the legal decision.

6 The Law Commission wrote that the decision “should not involve a risk of significant financial detriment to the fund”. The recent Supreme Court decision on the case of R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government endorsed a test requiring that the decision should not involve “significant risk of financial detriment”.
7 See Pensions Regulator Guidance for DB Schemes and DC Schemes

The law - a permissive legal framework

The law with respect to pension schemes comes from a variety of different sources. In the interests of brevity, the paper seeks to summarise the way these legal sources and principles interact in relation to trustee fiduciary duties as they relate to the investment of pension fund assets.

It is important to note that the law is generally permissive in terms of the investments trustees can make, although the precise rules which apply to pension schemes will depend on the legal rules of the schemes and the type of arrangement in question – defined benefit (DB) or defined contribution (DC), default fund or specialist fund.

Pension trustees will be aware that they have additional statutory duties in relation to investment, which include being required to disclose their investment policies under the **Pensions Act 1995** and the **Occupational Pension Schemes (Investment) Regulations 2005** and, from October 2020, being required to report on the implementation of those policies under the **Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013**. Further changes in relation to climate change are anticipated under the Pension Schemes Bill. These statutory duties are beyond the scope of this paper, however, and trustees should take specialist advice on the application of those regulations to their particular scheme.

PART II - What are impact factors?

"ABC" categorisation of impact investing

We have described "impact investing" as referring to investments *made with the intention to generate positive, measurable social and environmental impact alongside a financial return*."

The Impact Management Project has developed a helpful "ABC" categorisation of impact investing, which trustees may find useful when seeking to identify financially material impact factors:

- **A.** Act to avoid harm – investors can choose enterprises that act to avoid harm to their stakeholders, for example decreasing their carbon footprint or paying an appropriate wage;
- **B.** Benefit stakeholders – investors may favour enterprises that actively benefit stakeholders, for example proactively upskilling their employees or selling products that support good health or educational outcomes;
- **C.** Contribute to solutions – investors may invest in enterprises that are using their full capabilities to contribute to solutions to pressing social or environmental problems, such as enabling an otherwise underserved population to achieve good health or educational outcomes or hiring and upskilling individuals who were formerly long-term unemployed.

Case study:
Impact investment funds that 'contribute to solutions'

An increasing range of impact investment funds are coming to the market. These focus on delivering both long-term economic value and measurable societal impact.

One particular specialist private market investor in the UK with such an offering has raised £1bn since their launch in 2002 and saw a 44% 2-year EBITDA CAGR in their growth portfolio in 2018/2019. Their property fund has a ten-year track record and delivered financial returns of 12-15% net IRR alongside positive social and environmental outcomes by focusing investments on three main areas:

- Emerging sectors with strong macro fundamentals and/or a clear supply/ demand imbalance
- Underserved locations with clear economic growth or regeneration potential
- Neglected or misplaced assets with clear potential for future value-growth

Therefore, although funds such as these are managed on the basis of positive social, environmental or other sustainability goals, this is not designed to come at the expense of returns.

Economic analysis: research by BNP Paribas Asset Management (2019), Wells, Wires and Wheels: EROCI and the Tough Road Ahead for Oil[8]

One example of how impact factors may drive risk is in the oil sector, which has obvious environmental impacts relative to other forms of energy.

This white paper from BNP Paribas Asset Management contends that "the oil industry has never before in its history faced the kind of threat that renewable electricity in tandem with electric vehicles poses to its business model", and concludes: "the economics of oil for gasoline and diesel vehicles versus wind- and solar-powered EVs [electric vehicles] are now in relentless and irreversible decline, with far-reaching implications for both policymakers and the oil majors. If all of this sounds far-fetched, then the speed with which the competitive landscape of the European utility industry has been reshaped over the last decade by the rollout of wind and solar power – and the billions of euros of fossil-fuel generation assets that this has stranded – should be a flashing red light on the oil industry's dashboard."

Impact factors in the future

However, it is important to emphasise that whilst some impact factors will also be financially material to investors and should therefore be considered by pension trustees, other impact factors may not currently be seen as financially material (or relevant to financial performance). They may, however, become relevant in the future.

For example, whether a company pays taxes may increasingly be recognised as an issue that affects the value of a company (i.e. is financially material) as well as being a driver of justice and global equality by enabling governments to provide quality public services and promote economic development (i.e. is an impact factor).[9]

Ultimately it is for trustees, taking advice where necessary and considering investment opportunities on a case by case basis, to decide whether one or more impact factors may be financially material to performance or risk as part of their investment strategy, assessed over the appropriate time horizon for the scheme.

8 https://docfinder.bnpparibas-am.com/api/files/1094E5B9-2FAA-47A3-805D-EF65EAD09A7F
9 https://www.globalreporting.org/standards/standards-development/topic-standard-project-for-tax/

PART III - What are the legal sources applicable to trustees?

Trust-based occupational pension schemes

As previously stated, this report focuses on trust-based occupational pension schemes and applicable pensions legislation and trust law. This paper does not specifically address local government pension schemes, which are operated by administering authorities on the basis of specific statutory powers and duties, rather than pensions legislation and trust law. However, many of the principles applying in a fiduciary context will be similar. Contract-based schemes are subject to different legal principles and regulations and are also out of scope.

In a trust-based occupational pension scheme, investment decisions are made by trustees exercising the powers given to them by statute (with some exceptions) and in the relevant governing documentation: the pension fund's trust deed and rules.

Overriding legislation and case-law then apply some limitations and principles as to how those broad investment powers may be exercised by pension schemes in specific cases.

In practice, trustees will also likely delegate many decisions about investments to an investment manager in accordance with legislation, with trustee attention being focused more strategically on decisions about asset allocation policy and the appointment and oversight of investment managers under mandates most suitable to the trustees' aims. Fiduciary duties should be considered in the context of those decisions.

Trust deed and rules

Trustees may only invest a pension fund's assets in accordance with the powers given to them under the scheme's trust deed and rules. Such powers are usually drawn very broadly and typically allow trustees to invest in most types of investment, including impact investments (as defined above). However, trustees should always take advice on the specific parameters of their scheme.

Legislation

General legislative requirements
The **Pensions Act 1995** and the **Occupational Pension Schemes (Investment) Regulations 2005** are the primary sources of legislation in respect of trust-based occupational pension schemes. There are only limited exemptions where this legislation does not apply.

The legislation contains some general requirements, for example that trustee investment powers should be exercised in a manner "calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole" and "appropriate to the nature and duration of the expected future retirement benefits payable under the scheme". Scheme assets must also be invested predominantly in regulated markets (although a prudent level of investment outside such markets is permissible) and should be properly diversified avoiding excessive risk concentration. Trustees must take proper written advice from an appropriately authorised investment adviser before investing in any manner.

The legislation also requires trustees to prepare a Statement of Investment Principles' (SIP), which must now include details of how financially material considerations (including ESG factors and climate change) and, potentially, non-financial matters, are taken into account in the scheme's investment approach.

Requirement to act in the 'best interests' of members

The legislation also states that pension fund assets must be invested in the 'best interests' of members and beneficiaries and, in the case of a conflict of interest, in the sole interest of members and beneficiaries. The sponsoring employer is not a beneficiary for this purpose. Members "best interests" are not given a comprehensive definition in the legislation, and this has been a source of much legal debate (see 'Case law and fiduciary duties' below). In view of the Law Commission's findings, it is suggested that consideration of members' "best interests" can involve considering impact factors where financially material to the pension scheme's investments.

Nature of the legislation

Thus, save for restrictions on employer-related loans and investments, and some broad principles regarding matters such as derivatives, the legislation is not prescriptive as to what a trustee may invest in. Consequently, impact investment is permissible under the legislation, as long as trustees have taken the correct steps and properly considered the relevant criteria.

Case law and "fiduciary duties"

Most of the principles applying to how trustees may exercise their investment powers derive from fiduciary and trust law principles.

In the past some commentators may have described trustees' investment duties as being about "maximising returns". This probably derives from attempts to summarise in shorthand the legal principles established by some of the leading court judgments on trustee investment duties (dating from the 1980s and 1990s).

However, a closer examination of the case law (by the Law Commission and many others) shows that "maximising returns" is usually not the most appropriate view, especially when considered over the long term, balanced against the need to control risks, and taking account of the scheme's wider circumstances, for example its maturity (for DB benefits) or members' individual investment journeys and decumulation decisions (DC benefits). Trustees must exercise their investment discretion in the context and circumstances of the pension scheme and in light of all relevant information available to them at the time. Ultimately, they are responsible for providing benefits for fund members and other beneficiaries – investing for which may include consideration of a wide range of factors such as the appropriate diversification of trust assets, the time horizon of investments and matching assets to liabilities or cashflows, as well as managing risk in the trust's investment portfolio.

Part IV – Trustees' core duties when making investment decisions

Summary of duties

Trustees should always consider taking advice on their legal duties in the context of specific exercises of investment powers, but may wish to think in terms of three core duties when making investment decisions:

1. Exercise investment powers for their proper purpose
2. Take account of relevant financial factors
3. Act in accordance with the "prudent person principle"

1. Exercise investment powers for their proper purpose

Background

Pension scheme trustees must exercise their investment powers for the purposes for which they were given, namely for the provision of benefits to the members of the pension scheme.

Trustees should invest in the service of the scheme's purpose and in the best interests of the pension scheme's beneficiaries, taking care not to let their own personal interests influence their decisions.

Pension schemes may either be DB, where the employer guarantees a particular level of income on retirement irrespective of the funding position of the scheme or performance of the assets, or DC, where the employee takes the risk of the pension fund investments not performing well.

Application to DB and DC Schemes

For DB schemes, the trustee duty is to invest the scheme's assets appropriately for the purpose of enabling the scheme's promised benefits to be paid.

In a DC scheme, the purpose is still to provide members with retirement benefits. However, the benefit structure of the scheme means that, in order to achieve that purpose, the trustee has to provide appropriate investments for members to access in order that they may have an opportunity to develop a "pot" of money to be used at retirement (to buy an annuity / to draw down / from which to take a lump sum). Consequently, there are two key aspects to the proper exercise of investment powers in relation to DC arrangements:

- To establish a default fund appropriate for members who do not (or do not wish to) make a choice about their investments, keeping this under review and updating it as necessary. Trustees should consider the needs of the scheme's members, and how these might change in the future (see Chapter 4 of the Pension Regulator's DC Code: Designing investment arrangements (including default arrangements) - Understanding your membership).
- To provide a choice of other investment arrangements appropriate for those members who do not wish to invest in the default arrangement. Again, these "self-select" options should be kept under review.

In practice, the different structures of DB and DC schemes (as outlined above), as well as how circumstances differ between pension schemes and members, will dictate the investment approaches trustees choose to take in order to achieve the purpose of their pension fund.

For example, mature DB schemes may tend to adopt defensive investment strategies designed to closely correspond to liabilities (so as not to over burden the sponsor covenant), whilst DC schemes may focus to a greater extent on return seeking assets while members remain a long period from retirement.

2. Take account of relevant financial factors

Background

In July 2014, the Law Commission published a report drawing a clear distinction between trustees' ability to take "financial factors" and "non-financial factors" into account in their investment decision making. It concluded that financial factors may always be taken into account by trustees (and should be considered where material).[10]

Financial factors typically include the need to balance income against capital, manage liquidity and volatility, and diversify and manage risk, including systemic, forward-looking and transitional risks. They may also include "impact factors" which themselves have a financial impact on investment performance or risk, or which provide a financial opportunity.

Relevant impact considerations may include:

- **Mitigating financial risk - negative impacts**
- **Seeking financial opportunities - positive impacts**
- **Application of financial factors across different investment objectives**

Mitigating financial risk – negative impacts: Trustees should consider whether any given investment approach is expected to provide the best realistic return over the long term, "with due regard to the need to control for risks"[11], alongside other relevant financial factors. As part of this analysis, consideration should be given to whether any proposed investment approach removes or mitigates any insufficiently rewarded risks or any risks that do not need to be taken in order to meet investment objectives.

Negative impacts upon society or the environment which arise as a result of a company's core business, products and services are often seen as a source of financial, legal, regulatory and policy risks. These can threaten the sustainability of the returns which investors can expect over the long term unless the enterprise has taken steps to address them. For example, the fashion retailer Boohoo had £1.5bn wiped off its share price in two days in July 2020 amid growing investor concern over practices within its supply chain.[12] Looking for ways to manage these negative impacts might therefore be a legitimate financial risk mitigation strategy which trustees could adopt and pursue within their investment portfolio.

10 Non-financial factors such as members' views on purely ethical questions or religious beliefs may also be capable of being taken into account in certain circumstances but trustees must satisfy themselves that certain further legal tests are met – which are generally outside the scope of this paper.
11 Law Commission, Pension Funds and Social Investment (2017), pg.37
12 https://amp.theguardian.com/business/2020/aug/28/revealed-auditors-raised-minimum-wage-red-flags-at-boohoo-factories

Industry analysis: research by Société Générale (2020)[13]

Recent research conducted by Société Générale found that in two thirds of "high ESG controversy" cases a company's stock experienced "sustained underperformance," trailing the global index by an average of 12% over the course of the following 2 years.

The firm defined a "controversy" as "when a company's activity has unintended and/ or undesired negative environmental and/ or social effects on stakeholders, with corresponding reputational risk," adding that it was the "extreme ESG downside risk, with at times a massively negative impact on company share prices."

The firm based its analysis on 80 past ESG controversies, dating back to 2005 and spanning regions and sectors. In addition to underperforming the MSCI World Index by 12% on average, the stocks typically lagged their regional sector by 4%. Société Générale noted that a stock's drop can contribute significantly to the performance of its regional sector, which is why the underperformance relative to the global benchmark was more extreme.

Seeking financial opportunities – positive impacts:

An increasing number of investors see greater opportunity for sustainable financial returns in economic sectors which create positive impacts. According to this logic, given the need to make a sustainable energy and low carbon transition and address the social challenges facing humanity (articulated by the Sustainable Development Goals (SDGs)), there is likely to be outsized demand over time for companies whose businesses are aligned with these broader societal goals. An increasing range of impact investment funds are coming to the market that are managed on the basis of positive social, environmental or other sustainability goals as well as expectations of competitive financial return.[14]

Aligning investments with positive impacts on the environment and people may also be seen as a good long-term investment strategy. An example of this can be seen by tracking the share price of energy companies – companies with strong renewables businesses have the potential for strong performance as we transition to a lower carbon economy, while those which remain committed to more traditional sources of energy are more at risk.

13 Stevens, Pippa. 2020. "Stock Performance Study Shows Companies Should Take Environmental and Social Factors Seriously." CNBC, Feb 7. https://www.cnbc.com/2020/02/07/esg-high-controversy-events-can-cost-stocks.html

14 See case study, pg8 above

Academic analysis:
extract from the article, Where ESG Fails, by Michael, Porter, George Serafeim and Mark Kramer, Harvard Business School[15]

"Beyond improving the performance of individual companies, social and environmental factors can also change the nature of competition in entire industries, with profound effects on shareholder returns…

Consider the power generation industry: twenty years ago, government regulation set electricity prices and conferred regional monopolies. The cost of building new multibillion-dollar power plants created high barriers to entry. There were no substitute sources of energy, and customers had no choice of suppliers… Now, however, many markets have been deregulated. European governments have imposed descending limits on use of the fossil fuels on which most major power plants depend. Solar and wind technologies have reached price parity, enabling distributed generation with very low barriers to entry. Most European utility companies and their investors missed these major shifts as they ignored changing societal factors in their investment analyses. The result was the destruction of €500 billion ($551 billion today) in economic value.

Utilities that have adopted a shared-value approach, such as €70 billion Italian energy company Enel, have uncovered major opportunities to profit from renewable energy, already the source of more than half of Enel's power and generating higher profit margins than older thermal-power plants. The company is also expanding innovation to drive new sources of revenue by providing high-speed internet connectivity, electric-vehicle fleets, and energy management software. By adapting to social and environmental pressures on industry structure, Enel has found new sources of revenue that many of its competitors have missed."

Application of financial factors across different investment objectives:

Investment objectives are unlikely to be the same throughout a large investment portfolio. Different parts of an investment portfolio may have different objectives and trustees may have different strategies at different times.

The trustees' objectives in relation to the particular strategy will dictate what is financially relevant to the selection of an appropriate investment to deliver on that strategy. In DB schemes this might be anything from outperforming an index ('seeking alpha'), hedging against a risk such as changes in the rate of interest or providing a cashflow to match the scheme's pensioner payroll.

These different investment objectives will lead to different asset allocations over time and the impact factors that are most relevant and financially material to the objectives and allocation may therefore change accordingly.

Importantly, in terms of diversification, trustees may also believe that certain impact investments have the potential to improve the diversification of the portfolio due to a low correlation with mainstream markets – and wish to take advantage of this as part of a larger investment strategy.[16]

15 https://www.institutionalinvestor.com/article/b1hm5ghqtxj9s7/Where-ESG-Fails
16 The economic case for this has been examined in other jurisdictions: see for example 'Impact Investing in the Context of a Diversified Porfolio' (2016): https://www.pensionsforpurpose.com/brightlight-impact-investing-in-diversified-portfolio.pdf

3. Act in accordance with the "prudent person principle"

There is a long-established principle that trustee investment powers must be exercised with the "care, skill and diligence" a prudent person would exercise, not just when dealing with their own investments, but when dealing with investments for someone else for whom they feel "morally bound to provide".[17]

Prudence will always be context specific. This means that prudent trustees must be sensitive to the factual context in which investments will be made. The risks which trustees must consider include:

- **Transition risk**
- **Systemic and forward-looking risks**

Transition risk:

(a) Background

Now more than ever, this means being aware of systemic and existential risks to the financial system, the economy and humanity as a whole and considering how to respond, with a view to achieving the purpose of the pension scheme by managing the risks in its investment portfolio. The coordinated international policy response we are beginning to see to the climate and ecological emergency brings this issue into sharp relief.

17 Re Whiteley (1896) 33 Ch D 347 at 355

18 The Paris Agreement (2015) made clear the imperative of a just transition: that the negative repercussions from climate policies are minimised, and that positive social impacts for workers and communities are maximised. "Importantly for investors, the just transition is the smart thing to do as it reduces systemic risk, enhances human capital and strengthens their societal licence to operate." https://www.oecd.org/environment/cc/g20-climate/collapsecontents/Just-Transition-Centre-report-just-transition.pdf

(b) Duty to act prudently

The duty to act prudently in this context will require that trustees understand the role of particular investee companies and projects in contributing positively towards a sustainable and just transition.[18] Considering impact factors as part of a fund's portfolio investment and engagement activities (collectively with other investors and otherwise) can form a key part of a prudent response to manage financial risk to pension portfolios, given the changes in law, policy and practice which are expected increasingly to affect business and investment performance in what is a rapidly changing landscape.

(c) Transitional mindset

Trustees should have a "transitional mindset" to manage the various associated transition risks and opportunities. There are a number of reasons for adopting a "transitional mindset" in pension fund investment:

- Any investor's failure to effectively manage the transition towards a carbon neutral economy may place the capital value of their existing investment portfolios at risk, especially in the event of the future devaluation of carbon -intensive and other assets in the wake of sudden public policy responses, which seem increasingly likely. It may be prudent for pension funds to develop and implement "transition plans" over time, designed to support a transition within the investment portfolio which tracks the potential impacts of the Paris Accord, for example, and any subsequent political agreements of equivalent gravity.
- The transition towards a carbon-neutral economy presents significant structural opportunities for capital growth in the case of investments in sectors and businesses which stand to gain from such a transition.

- Thinking about transitional issues may help trustees identify and manage other forms of positive and negative impacts which the trustees consider to be financially material, such as forms of impact which contribute towards or undermine the achievement of the Sustainable Development Goals. It might be possible to identify financial opportunities arising from the transition towards more sustainable development across a range of different sectors and businesses, such as:

Investment thesis	Example investments	SDG
Products and services which contribute to a net zero carbon economy and other environmental objectives	• Renewable energy • Waste treatment and recycling • Forestry	✓ SDG 7 – Affordable clean energy ✓ SDG 12 – Responsible production and consumption ✓ SDG 13 – Climate action
Businesses which are diverse and inclusive by nature or design and provide workers with decent employment, economic opportunities and working conditions	• Locally based SME financing • PLCs with leading environmental, social and governance practices	✓ SDG 5 – Gender Equality ✓ SDG 8 – Decent Work and Economic Growth ✓ SDG 10 – Reduced Inequalities
Infrastructure which meets the needs of lower income and vulnerable people	• Social housing • Supported living • Care homes	✓ SDG 1 – No poverty ✓ SDG 11 – Sustainable cities and communities
Technologies which increase agricultural output or provide improved food supply	• AgTech – such as smart irrigation and biowaste • Farming equipment	✓ SDG 2 – Zero Hunger
Foods and other products which improve health and nutrition	• Health food enterprises • Sustainable fisheries	✓ SDG 3 – Good Health and Well-being
Digital and other technologies which increase literacy, language skills, financial inclusion and education	• Education technology ('ed tech')	✓ SDG 4 –Quality Education

- By contrast, recent experiences have shown that companies which fail to address concerns over human rights and decent work conditions within either their own activities or their supply chains can suffer a significant negative reputational impact with a knock-on effect on financial performance and prospects.[19]
- Transitional thinking might include identifying other forms of negative impact generated by portfolio investments which threaten financial value, such as products or services with addictive qualities, or which are detrimental to health or wellbeing, or have other material adverse social consequences which will be met with policy responses. In the same vein, research is producing evidence that investments which are generating positive impacts upon wider society, such as by promoting decent work, or which advance education or improve health, may be more resilient and future-fit and able to benefit from the shift towards more sustainable development.

19 See Industry analysis by Société Générale, pg14 above

Academic analysis:

SSRN paper titled, Corporate Sustainability: First Evidence on Materiality (last revised 2017), by Mozaffar Khan, Causeway Capital Management, LLC; George Serafeim, Harvard Business School; and Aaron Yoon, Northwestern University[20]

This research demonstrated that, when companies focused their sustainability efforts primarily on material social and environmental factors, they significantly outperformed the market, with alpha of 3 to 6 percent annually. They also outperformed peer companies that concentrated sustainability efforts on non-material factors. This approach is the first solid evidence that when social and environmental factors are considered from a business perspective, rather than a purely social perspective, they can influence shareholder returns.

Systemic and forward-looking risks:

(a) Background

By its very nature, data on many environmental and social issues, particularly climate risks (and related financial opportunities), will not be easily found and may not be available from historical records. Trustees may therefore need to find new data sources to address new forward-looking risks. These new data sources are continuing to develop, particularly as organisations increasingly disclose and report on key issues and risks using frameworks such as the recommendations of the Taskforce on Climate-related Financial Disclosure (TCFD) and the Sustainability Accounting Standards Board (SASB).

Nevertheless, some challenges remain. A recent survey of pension trustees[21] found that a lack of information on social impact investment risk and returns was one of the key reasons why investors might not be investing in positive impact investments - and many positive impact investments do not have the three years of demonstrable returns considered the minimum by many trustees and institutional investors. In this context, trustees should consider likely future scenarios, how these may impact their investments and what a prudent course of action might be as part of their scheme's forward-looking risk management framework.

(b) Regulatory developments

There is a growing regulatory expectation that pension trustees should report on how they consider and respond to climate-related risks in particular. There are already legal requirements to adopt and disclose trustee investment policies on financially material considerations (including ESG and climate change), non-financial factors and stewardship. Legal requirements to provide additional details around stewardship, asset manager arrangements and implementation of investment policies, and to strengthen governance and internal controls, are being phased in during 2020 and 2021. The Pension Schemes Bill currently before Parliament will, if it comes into force, bring in a further new framework requiring Trustees to have an effective system of governance around climate risk and to make additional climate risk disclosures. The TCFD recommendations are now frequently suggested as a framework that pension trustees might adopt and new regulations under the Pension Schemes Bill may indeed require Trustees to perform TCFD reporting. A key element of this requires that trustees should consider how resilient the scheme's strategies are to a range of climate related scenarios, including transition to a lower-carbon economy consistent with a high probability of a temperature rise of less than 2°C.

20 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912
21 Social Impact Investment and Pensions Survey, Allenbridge (2017)

PART V – Further considerations for DB Schemes

Trustees of DB schemes have successfully invested in infrastructure (and socially significant infrastructure) for many years. Provided such investments are made within the trustees' fiduciary duties and the wider legal framework set out above, there are no particular legal barriers to the making of such investments with a sustainability or impact theme as part of the strategy.

Case study:

Environment Agency Pension Fund[22]

Although Local Government pension schemes are generally outside the scope of this report because of the specific law and guidance that applies to them, in 2014 the Law Commission did draw analogies between the role of authorities administering Local Government Pension Schemes and the role of occupational pension scheme trustees in relation to investment, and there are some relevant practical examples of innovation in relation to impact investment in public sector pension funds.

One such example is the approach taken by the Environment Agency Pension Fund (EAPF) to investing in clean technologies and infrastructure. This involved the EAPF engaging with asset managers to develop portfolios, beginning with specific target allocations to clean technology and real asset mandates including sustainable and low-carbon real estate, renewable energy, forestry and agriculture. The approach was subsequently expanded and included the creation of a "total opportunities portfolio" (TOP) that allowed the EAPF to invest directly into funds in order to reduce costs and have better control and visibility into underlying investments.

The strategy was developed over time: it began in 2005 and included defining core investment beliefs around climate change and ESG factors. In 2010 the EAPF set itself a target of having 25% of the fund in clean or sustainable investments. By March 2017, 34% of the fund was invested in clean technology and sustainable investments.

The EAPF identifies the key successes of its approach to be:

- Financial performance, including substantial returns from particular clean investments.
- Reducing resources expended on sourcing investment opportunities: the EAPF's reputation as a responsible investment innovator in setting up TOP has helped it leverage a pipeline of direct approaches from cleantech and greentech funds.

22 https://www.pensionsforpurpose.com/environment-agency-pension-fund-case-study-updated-format.pdf

PART VI – Further considerations for DC Schemes

Default funds

Most DC schemes will operate a "default" fund for members who have not made an active choice where to invest their (and their employer's) contributions. Traditionally such funds have aimed to provide investment growth on those contributions, to providing a sum of money on a member's retirement, from which they draw down for a retirement income. A common approach was to invest for growth in the years furthest from retirement (when greater volatility can be tolerated) and gradually make the transition to more stable investments that expose a member's accumulated capital to less volatility as the member gets closer to retirement age.

Since the introduction of greater pension flexibilities in 2015, however, not all pension scheme members can be assumed to be investing for an "income" in retirement. Trustees must therefore consider the needs of their membership and determine what the purpose of the default fund is in relation to their particular scheme.

As noted above, once the objectives have been determined the trustees must select an appropriate investment fund or set up a separate account or a combination thereof to comprise the scheme's default fund. In making that selection the trustees may take account of any factor which is financially material to the objectives set.

Investments which meet relevant financial criteria as well as providing a positive impact can be included in a default fund strategy. An impact investment strategy which is geared to managing investment risk and exploiting investment opportunity would also be possible. However, other factors may be considered too, such as avoiding volatility at inopportune moments for the member and providing sufficient liquidity to meet member demands. Trustees may also want to consider how the use of impact investments within a default fund may improve member engagement.

Trustees of DC schemes must, as part of their statement of investment principles for their default fund, set out how their objectives and policies for the default fund investments are intended to ensure that assets are invested in the best interests of members and beneficiaries. Therefore, these criteria have to be considered when considering whether to include such an investment in a default fund.

Self-select funds

Although the trustees' legal duty will be focused on financially material factors in the default fund, when members make their own investment choices other factors may be considered. Some members may legitimately decide to sacrifice some income in old age for ethical concerns. Trustees may wish to accommodate these in the range of investment choices offered. Additionally, some members may have religious or philosophical beliefs which guide their views on the investment of their pension savings. Offering suitable investment choices to these groups will often have a financial as well as a non-financial basis to ensure that all members are able to save for their retirement.

Trustees should take time to consider the characteristics and needs of their scheme's membership and assess, with appropriate investment advice, the range of self-select funds available to them. It may well be perfectly appropriate for trustees to include funds for members to select which specifically take non-financial impact factors into account, even at the risk of financial detriment to the member where this is appropriate to member needs and there is demand for it. Trustees should not be open to legal challenge where a decision to include such self-select funds has been taken after reasoned, evidence-based advice and discussion, and the characteristics of the funds are communicated clearly to members.

Similarly, there is nothing in law to preclude pension trustees from offering socially significant infrastructure or other forms of impact investments within a range of investment choices for member chosen funds, even where those funds include some financial downside as a result of the particular investment objective pursued. Currently, these impact funds may not be as visible to members as they could be.

Trustees do, however, remain responsible for monitoring all investments offered to their members and ensuring that they remain appropriate to their members' needs. Trustee fiduciary duties include regularly reviewing the performance of chosen funds used by members against their performance objectives and industry benchmarks where available. If funds are not performing or cease to be appropriate to member needs, trustees should consider changing them.

PART VII – Conclusion

Impact investing may seem new or unfamiliar in the pensions context, but it is based on well-established legal principles.

Trustees must invest in accordance with their scheme's rules and legislation; and in line with their fiduciary duty to use their investment power to achieve the purpose of the pension scheme: providing beneficiaries with their benefits. *To this end, the economic analysis suggests that impact investment may reveal new or previously underappreciated risks in a scheme's portfolio.*

It may also help trustees identify new opportunities to remove risk or enhance or preserve value. In order to take a prudent investment decision based on all relevant factors, these are sensible issues for trustees to consider.

Where, based on evidence (and advice where necessary), trustees conclude that one or more impact factors is financially material to the risk or performance of their portfolio, the law permits the factors to be taken into account in investment decision-making. The range of impact investing options available to trustees on the investment markets is growing. The issues will play out differently in the DB and DC contexts. The scheme's wider circumstances and other financially material factors also remain highly relevant to the decision, so careful judgment is required. *However, within the contemporary legal framework, we conclude that trustees who reach an impact investing decision after following the legally correct decision-making process should feel confident that they have discharged their fiduciary duty.*

The Impact Investing Institute is an independent, non-profit organisation which aims to accelerate the growth and improve the effectiveness of the impact investing market. Our vision is for lives to improve, as more people choose to use their savings and investments to help solve social and environmental challenges, as well as seeking a financial return.

We drive change through education and awareness raising, providing useful tools and resources, and advocating for supportive policies.

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