Supply of Impact Capital: Pension Funds - The Next Frontier

By Christian Kingombe & Dario Moroni, 4IP Group, 29 October 2018.

INTRODUCTION

Sovereign wealth funds (SWFs) manage assets of over $6 trillion, and public-sector pension funds (PPFs) worldwide almost triple this figure, approximately $100 trillion in assets globally. With a long-term investment horizon, these funds play a growing role as investors in SDG sectors, particularly in infrastructure, renewable energy, public health and education (UNCTAD WIF, 2018). **Four in five European (83 per cent) institutional investors** said sustainable investing was becoming more important, against 74 per cent globally, according to a survey of 650 investors published in June 2018 by Schroders. Despite this, only a quarter of all the companies surveyed — which collectively manage $24tn in assets — said sustainability had a significant influence in investment decision-making.

Our resource paper addresses what role Pension Funds can play in promoting sustainable development through impact investment. It considers some relevant facts regarding impact capital dynamics and their developments. It shows examples on how investors in a number of countries are dealing with this recent phenomenon, combining and adapting traditional financial instruments to innovative and creative solutions. It refers to ways of having reliable measurements of the impact that financial assets have on social, environmental and governance structures.

The paper also highlights the effective and potential roles that Pension Funds and their stakeholders can play. In fact, pension funds' activities address cross-cutting issues such as, social justice dynamics, geographical socio-economical integrations, inter-generational clashes, as well as social impact dynamics linked to fast development of new technologies. Artificial Intelligence, for instance, Robotics, NBICs (Nanotechnologies, nanotechnologies, information-technologies and connectivity), are going to challenge traditional employment structures and therefore pension funds activities.

We will finally consider how can governments create a more conducive environment to encourage sustainable investment by institutional investors and maximize development benefits by looking at some recent inputs regarding legislation, by looking specifically at the Financing of Sustainable Growth initiative of the European Commission. Such measures are interesting as they can be seen as an innovative way of shaping and at the same time spurring this new field of capital supply.

This work is structured in 3 parts: Facts and issues of impact investments; Shift in thinking about supply of impact capital; and Future Developments and Action. Some final reflections regarding a way forward conclude this paper.

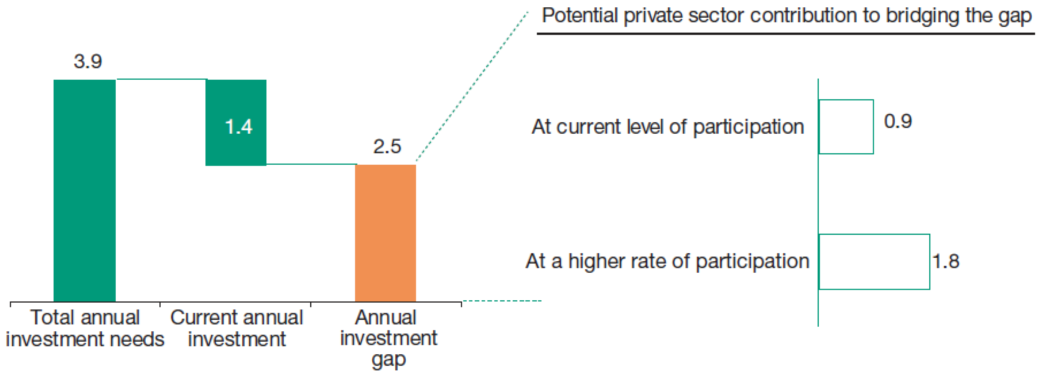
I FACTS AND ISSUES OF IMPACT INVESTMENTS

Some key facts and trends in impact investments

One of the key messages coming out of the UNCTAD World Investment Report (WIR) 2014 is that "**the SDGs** will have very significant resource implications across the developed and developing world. Global investment needs are in the order of $5 trillion to $7 trillion per year. Estimates for **investment needs in developing countries** alone range from $3.3 trillion to $4.5 trillion per year, mainly for basic infrastructure (roads, rail and ports; power stations; water and sanitation), food security (agriculture and rural development), climate change mitigation and adaptation, health, and education." According to UNCTAD(2014) "The SDGs will require a step-change in the levels of both public and private investment in all countries. At current levels of investment in SDG-relevant sectors, developing countries alone face **an annual gap of $2.5 trillion**. In developing countries, public finances are central to investment in SDGs. However, they cannot meet all SDG-implied resource demands. **The role of private sector investment** will be indispensable."

The participation of the private sector in investment in SDG-related sectors is still relatively too low. Only a fraction of the worldwide invested assets of banks, pension funds, insurers, foundations and endowments, as well as transnational corporations, is in SDG sectors. Bridging such a gap is a daunting task, but it is achievable. To address this annual financing gap the Global Steering Group for Impact Investing (GSGII) has since its Chicago Summit in July 2017 and its call to drive the impact investment sector to **Tipping Point by end of 2020**, been working full steam ahead, along with its partners and the broader global community. To achieve this vision **new financing models have been developed at multiple levels and in parallel to traditional markets** to fund, deliver and scale innovative solutions to social, environmental and economic challenges. This is because the public funds in many countries have become depleted and the social challenges have mounted.

Figure 1. Estimated annual investment needs and potential private sector contribution (Trillions of dollars)

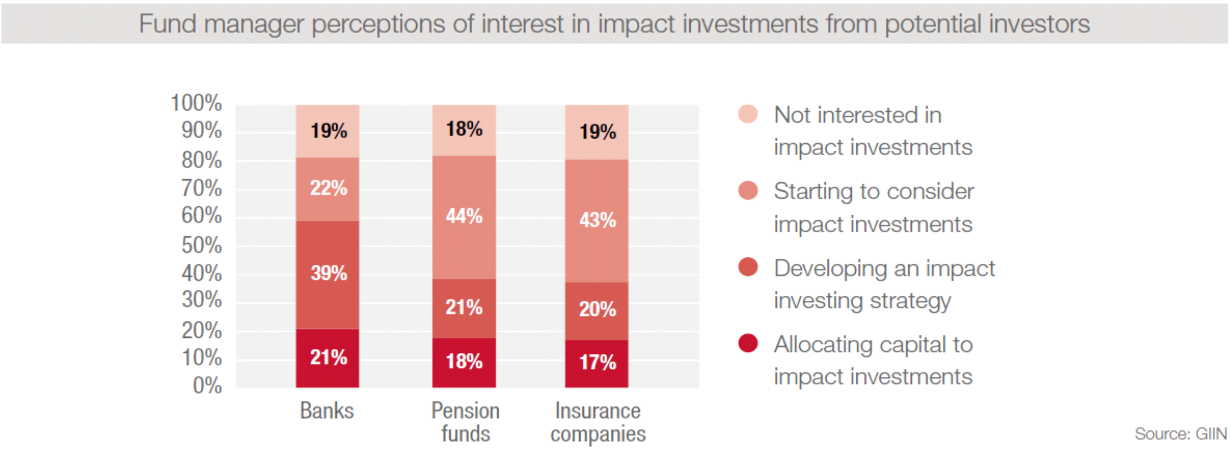


Source: UNCTAD, WIR, 2014:xxvii.

Let us consider for instance **Social Impact Investment, -** the provision of finance with the explicit expectation, and measurement, of a ***social*** as well as ***financial*** return, which is considered key to solving these challenges because it: Spurs social **innovation;** Increases **accountability** (measurement of social outcomes); and enables **sustainability** of organizations addressing SDGs. Already, a **growing range of social investment instruments** have been developed, all with a different financial/social return profile (Karen E. Wilson, 2018).

Currently, a **mix of investors** are engaging in social impact investing, including foundations, angel investors, venture philanthropists, and social venture funds. When only five years ago more than **76% of the global assets under management (AUM)** were controlled by mainstream investors such as insurance companies, mutual funds and **pension funds** (TheCityUk, 2013).

Attracting **mainstream investors** is a crucial factor for the impact industry to grow to its full potential (Drexler, Noble, & Bryce, 2013; Freireich & Fulton, 2009). Mainstream investors get involved in the market when they can implement impact investments in their portfolios without compromising on the return or when they can compose competitive total impact portfolios (NA Pouw, 2015).
Figure 1



We believe that **institutional investors** have an important role to play and that they can become impact investors. Pension Funds and Insurance Fund are increasingly becoming interested in Impact Investing as more investors focused on Environmental, Social and Governance (ESG) factors (see Figure 1).

The arrival in 2013 of several new institutional investors marked a milestone for the impact investment market. These investors' arrival also indicated that some of **the barriers to entry for investors** –such as market awareness, investment opportunities and risk perceptions –had already begun to ease five years ago. As an example of this, in October 2013, AXA Group, one of the largest insurance and asset management groups globally, initiated the Group's **"Impact Investment" project**, which aimed to allocate capital to organizations that address **key societal challenges** in the areas of environmental (e.g. climate change), life (e.g. health & longevity), or socio-economic (e.g. poverty) risks. The Group initially committed EUR 150mm to this initiative and considered various investment opportunities that demonstrate positive social and/or environmental impact. The social and environmental impacts of these investments was **measured and reported** to stakeholders regularly.

And today **100 Financial Institutions** are allocating 5-10% of their investment portfolio into Impact Investing assets. However, already in June 2017 the Global Head of Philanthropic advisory of UBS, said that **major financial institutions** are failing to meet demand for impact investment platforms from philanthropists and private foundations. A lot of demand doesn't get translated into action. The need to measure social impact, on top of ensuring financial returns, requires a high level of active management and supervision. And as funding levels in impact investing typically are small compared to conventional wholesale banking transactions, banks that are set-up for big products are shying away from impact investing operations that might tie up resources but make barely a mark on multi-trillion-dollar balance sheets.

Consequently, a breakdown of **the GIIN latest 2018 Impact Investor Survey** showed that out of the 225 respondents investing USD 35.5 billion into 11,136 deals during 2017, the largest category was Fund managers for profit (105 executed 7857 deals in 2017), followed by Fund Managers non-for-profit (30 executed 701 deals in 2017), and Foundations (30 executed 221 deals in 2017), whereas 9 responding Pension Funds / Insurance Company only carried out 155 deals in 2017.

UNCTAD conversations with Pension Funds have recently found in connection with the recent WIF2018 that they would like to invest in SDG sectors, but they can't identify these projects. More and more Pension Fund boards have decided to allocate a certain percentage for sustainability investment and they have also felt the pressure from their own shareholders to invest (see below), but they still need bankable pipeline projects.

From the latest GSGII Impact Summit in Delhi we learned that **50 of the Fortune 500 companies** are measuring their impacts. More companies than ever are using the profit motive to help the planet and tackle social problems. Fortune.com (Change the World) 2018 list the best of them with the help of its partners at the Shared Value Initiative, through which they have identified dozens of companies that are tackling public health, environmental, economic, or other societal challenges as part of their everyday operations.

Lack of data and complexity of impact assessment

Getting reliable measurements – need reliable data to know where we are going and to persuade going to the right place. The GIIN has found amongst existing **30 Pension Funds** that ESG investing and measurement are going in the right directions. These include e.g. Japan's Government Pension Fund the world biggest State investor and the way it spends its staggering $1.3 trillion can roil global markets. Combining the explicit search for positive environmental and social returns with financial returns constitutes an important quality leap that blurs the lines between responsible investment and impact investing.

This constitutes for instance, what Novethic qualifies as **a "sustainable investment" strategies**. These strategies, which aim at investing in sustainability solutions, have a strong impact on investment portfolios, which differ significantly from mainstream benchmarks. These approaches are mainly being pursued by **northern European pension funds**, which hope to apply them to a growing part of their portfolios, including listed equities. These investors are primarily motivated by their desire to align with their beneficiaries' expectations regarding the contribution of their investments to a sustainable economy.

The Dutch asset manager PGGM, which is a pioneer in structuring its impact approach, illustrates this issue. PGGM has already committed €11bn to «investments in solutions» in four fields: environment, water, food, and health. For each subject, PGGM invests in companies whose activities are assessed as providing sustainable solutions, and measures their performance in light of several key indicators. These companies include, among others, providers of energy efficiency solutions, companies that specialise in water treatment, pharmaceutical groups (Sanofi, Novartis, etc.), fertiliser and pesticide manufacturers (BASF, Monsanto, Dow Chemical, Phosagro), and food businesses (Wilmar, Unilever, etc.).

This kind of portfolio reflects convictions that can be diametrically opposed to those of traditional impact investors. For instance, PGGM considers that chemical pesticides and fertilisers help improve crop yields, and therefore food security. **The more natural approach for social impact investment** would be to fund organic and local food systems, in order to foster alternative models to large monocultures dependent on chemical inputs. **The rating agency Oekom Research**, meanwhile, believes that the large-scale use of chemical pesticides goes against SDG 15 (protect and promote a sustainable use of terrestrial ecosystems) and SDG 2 (end hunger, achieve food security and improved nutrition and promote sustainable agriculture).

PGGM, « Investing in solutions »

Area of Focus	Euros Invested (millions)	Impact in 2015
Climate and Environment	€3,860 (**€820** in 2016)	**3.8** **million MWh** of renewable energy produced **4.0** million tonnes of CO_2 avoided
Water	€867 (**€451** in 2016)	**38** **million m³** of water saved **65 millions m³** of wastewater treated
Health	€2,800 (**€629** in 2016)	**111,000** **tonnes/hectare** improvement in return **640 million litres** of milk produced in developing countries
Other	€3,690 (**€893** in 2016)	**530,000** people provided with access to good healthcare

Some recent developments

Social impact and environment impact was one movement brought together 2 years ago. Integrated thinking – a more holistic view on what was happening in markets and particular companies – is needed. **The next 5 years** will be the most important – where we must significantly address the SDGs – or otherwise we will not make them. Hence, the urgency makes it critical to think about how to scale impact investment market. The **good news** is that Sustainable Finance today constitutes one third of Global Capital Markets.

This leads to the following key questions:

- How to make this the rule rather than the exception, to **change how investors view their assets**, beyond just making more money.
- How to provide the leadership for others to follow.

In other words, there is a need to shift practices and thinking about these issues.

In March 2018 GIIN came up with a Road map for the future of impact Investing *"Reshaping Financial Markets"* including a perspective building a world **where all investors take into account ESG** by designing **the tools and resources** that support the incorporation of impact into the routine analysis, allocation, and deal-making activities of investors.

But central is to accomplish a **shift in thinking** – change the way people view the role of capital by changing the paradigm that governs investment **behaviour and expectations** about the responsibility of finance in society via asset owner leadership and updated finance theory.

The new approach is not just a trade-off – since there is a lot of value in understanding what investors are doing. The best in class performing assets and companies are also creating the best impact. Top performing fund – should therefore take account of ESG in a much deeper way.

II SHIFT IN THINKING ABOUT SUPPLY OF IMPACT CAPITAL

Pension Funds & Insurance Companies: The Next Frontier

Pension – defined as contribution plan/benefit plan – should enable the beneficiaries/pensioners to decide – **towards impact oriented options** – those who owns pension plans have a desire to see capital used in a constructive way. Thus, the question is how do pension funds navigate their **fiduciary obligation** to deliver financial return to the best interest of its members. On a proportional basis the largest stakes are placed on Impact Funds.

Is it the role of the Institutional Investors?

In **the US** – given the existing CFA curriculum – or the human nature due to the limited amount of time the fund managers have to beat the market, therefore what is going on outside this market makes it more difficult to get promoted from analyst to project manager. However, **there doesn't have to be a trade-off between risk and return**. There is plenty of education and story-telling that could be drawn on. Asset owners do have a role to play – in determining that it fits within their agenda within the Pension Plan. Therefore, leadership is critical and people will need to take risk. We should therefore instead frame it as education and framing, rather than the traditional persuasion campaign which the asset managers used to fight.

Decision to move into impact motivated by what?

The Fiduciary responsibility – leads to a sense of thinking about everything as **risk-return trade-offs**. Impact Investing projects are usually smaller than what the pension fund managers normally would invest in, which is minimum 100 Million US-dollars.[1] Turning attention towards to smaller ticket sizes instead implies more work. Such as paying the overhead associated with this kind of work. The underlying investment – is getting better return than larger asset, but it is out of scale. The Pension fund would need to pay for the overhead investing in both team and pipeline. The challenge has been largely internal: The fund manager would need to go straight to the board of directors to do this kind of work in order to justify the extra work and costs.

Christian Super case

***Christian Super** is a faith-oriented pension fund which achieves investment returns through investing ethically, benefiting the community, the environment and the world. Their investments reflect contributors' values. That's why they invest in corporations that demonstrate sound ethical practices, signified by honesty, integrity and accountability informed by faith good for the planet. The drive came from heritage and the branding. The combination of board and executive – believe that faith should inform the way we invest. How it looks like constructing their portfolio. At the board and CEO level it is not incongruous to incorporate a stronger impact lens.*

Now that market has matured in Australia they are starting to see **much larger funds** moving in this direction as good corporate citizens, but also moving because there is market, millennials with superannuation, but interested if money can do some good things. It is pure commercial market forces driving the question of the why, thereby changing the conversation from a moral imperative to market imperative.

*If looking through this **commercial investment lens** – the investment committee of Christian Super is mandated to have 12% of total funds invested in pure impact. Finance first (commercial rate of return aligned with rest of portfolio) – how to construct a measurement methodology that can scale well. They observe what can do and in turn cap on what can sit purely in the portfolio, e.g. direct lending providing social affordable housing – which generates social impact return.*

Impact part serves true commercial – generating financial return – core business commercial mandate, investing in this way, hedging the risk in other parts of the portfolio serving the members interest. In Christian Super an internal investment team – spun out an **impact investing advisory group** providing services to other pension funds, why they have the ability to catalyse and mobilize movement of other capital funds

Canada

In Canada the local pension plans – are more active in their provinces investing locally. The role of the Government is to protect their ability to do so, while retaining their primacy as fiduciaries. The more local the easier it is to understand what they are trying to do. It is more difficult with the big

[1] Projects and funds have to have an "institutional size" and should be scalable.

plans, which needs every tool available. **The local pension plan** are therefore the key players in Canada. They are also notorious about doing things properly, and therefore they go slower, since they want to get things right. When recognizing where things are going, they will be starting small but eventually get bigger.

The success of Canadian pension plans is in a big part due to the large allocation to equity thereby taking more risk around the world than many other pension plans. They are risk aware and welcome risk taking as long as they can diversify the funds. Many pension funds are leveraged – need more risk than can get otherwise.

Membership Pressure on Pension Funds

In the first case of its kind, Mark McVeigh a 23 year old pension fund member in **Australia** is taking his fund **the Retail Employees Superannuation Trust (REST)** to the Federal Court of Australia over a lack of information on what he knew about the impact of climate change on his investment. He is being supported by lawyers at Environmental Justice Australia. This case is being brought in Australia but the principles which underpin it are the same in **the UK** and we may well see similar cases in this country in the near future, as well as other countries such as in **Switzerland** where a referendum succeeds if at least 50,000 valid signatures have been deposited at the Federal Chancellery.

British pension funds are thus coming under renewed pressure to consider the ESG impact of their holdings as policymakers and consumers demand a bigger focus on sustainability. In September 2018, the UK's Department for Work and Pensions shone a spotlight on the subject when it introduced **new regulations for pension funds**. Under the rules, which are due to come into place from October 2019, trustees who disregard the long-term financial risks or opportunities from ESG will have to justify why this does not hurt their investment returns.

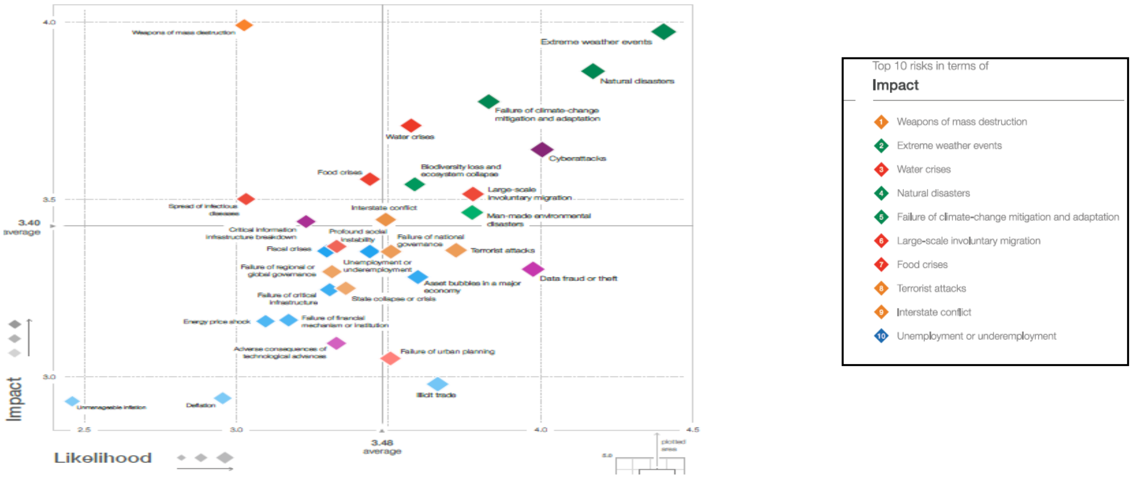
Janice Turner, founding co-chair of the **Association of Member Nominated Trustees, a trade body for pension fund representatives**, described the new regulations as a "huge step forward for the ESG agenda"."In order to become more responsible investors, it's important that pension trustees are able to take a more active asset ownership role."

Carola van Lamoen, head of active ownership at **Robeco**, an asset manager, says **the added scrutiny from policymakers** would help "steer laggards" across the pension industry and encourage them to pay greater attention to responsible investing. "We consider the involvement of policymakers a logical step as ESG risks are material and relevant — and not all pension schemes are moving at the same pace," she says.

Defined contribution pension schemes in the UK invested much less in ESG than their peers in other countries because they were unclear on whether they were permitted to do so, according to findings last year by **the Law Commission**, a body that makes recommendations on legal reform. Some schemes were deterred by **a perceived conflict with their fiduciary duty to maximise returns**. The commission stated that the barriers to social investing by pension funds were "structural and behavioural rather than legal or regulatory". Announcing the new rules introducing the **requirements for pension funds to report annually** on their progress in including climate change and sustainability in their investment decision-making, Esther McVey, the work and pensions secretary, said the changes came on **the back of growing interest from younger savers**, arguing it was important there was transparency about investment decisions made on their behalf.

Pension funds must incorporate climate change risks and opportunities into their investment decision-making process to ensure the future savings of millions of people are protected. *"**Many pension fund members are concerned about climate change issues**. They, like all members, have a right to be kept informed about how their pension savings are invested. It is time pension funds are open about what actions they are taking to identify and manage climate-related financial risk so that members can hold their pension funds to account."* Thus, Pension funds have a big role to play in market building. Long-term performance evaluation of companies and implication of action are increasingly becoming material for **impact of evaluation**. Failing to do this introduces more risk. The Pension sector therefore has a critical role to play, especially since in the case of Australia nearly 3 Trillion US-dollars can be used to bridge capital and impact.

Figure 2: Risks: highest ***economical*** *risk = climate change*



Source: Global Risk Landscape, 2018 WEF reproduced by Antje Biber, FERI AG, September 2018, slide 4.

The Dutch pension funds' SDI taxonomy

APG and PGGM are the largest Pension Funds managers in the Netherlands (EUR650 Billion). These two **Dutch asset managers**, which manage the assets of the pension funds ABP and PFZW, have produced **a taxonomy for SDGs investing (SDI)**, which is «serving as the basis for an in-depth conversation between asset owners and their asset managers on how they can go further in **integrating SDGs into asset management**».

Source: Novethic. Investors in search of impacts. Strategies, innovations and challenges - July 2017.

Alecta Pension, Sweden

The Swedish Pension Fund Alexta has more than $90 Bn AUM. It is considered an active manager with fundamental analysis, which means that everything is done in-house. This is how it creates values for 2.5 million Swedish future pensioners. It carried out a survey to find out whether **responsible investment** is important to its customers. They found a clear positive reply from 75% of both corporations and private individuals, that they would like the fund to manage their money in a way that is responsible and creates sustainable development results. Despite its fiduciary duty the Swedish Pension Fund now needs to take this into consideration to cater for sustainable development and show responsible investment. The CEO believes that this can be done without abstaining from financial return by taking a 30 year down the road long-term view on how to invest. The Pension Fund management has realized that it need to think about **the risk concept** in a different way, in the sense that risk today might not be a risk 20-30 years down the road. Moreover, good return for customers needs to think about ESG factors. The arrival of SDG has been very helpful for the Pension Fund, since it provides a direction in operation, as well as a map towards the SDGs and a language to talk to customers with. It also provides **a tool to work internally with the cultural change** that this would require for the Fund / Portfolio managers as responsible investors. Pension funds as represented by this Swedish Pension Fund wants to do good. The just need to get the tools, so they can perform in way that is both meaningful and responsible.

90/10 Products

First of all, 90/10 products **hardly impact returns**. With 93% of assets being invested conventionally it is unlikely that French investors will even notice any "return" in this product. The current **market rate of interest is so low** anyway that even if impact returns were lower, one might hardly notice. Many observers also believe that the level of risk inherent in impact investing is lower and therefore risk-adjusted returns may be attractive.

The 90/10 funds represent a critical first step on the ladder for aspiring impact investors. It would be great to start higher up the ladder, but the key is really **to get people onto the first round**. From that point people can be "walked up" the ladder. As **the success of these products is demonstrated** it will then be easier to continue to bring new investors into impact investing and perhaps increase the percentage allocation into high impact enterprises.

A lot of institutional investors are seen as a framework to conceptualizing investment. They have made enormous progress, but there is still a lot to do. **The methodology** not only look at risk-return, but also impact – reduce the risk of overall portfolio to earn equivalent return, while some won't – finding more way to motivate allocating capital to more fragile cases. The current Portfolio model is not the solution – but instead we need to look at risk-return – by incorporating the impact dimention into this model (i.e. the 3-dimensional model).

The universal agreement of the UN SDGs created room for the private sector – to see a role for themselves and a great up-take among leading companies and investors. For the GIIN it is important to try to **focus contribution towards the SDGs for institutional investors.** A portfolio strategy should be chosen that is to align work with the SDGs, by answering the question how to contribute to more sustainable world by **bridging the massive financing gap.**

III FUTURE DEVELOPMENTS AND ACTIONS

An Urgent Call to action

We need to make a lot of progress fast, by **changing the rules of the game**, e.g. asset allocation is fundamental to how investors make their decisions. There is a need to shift their way of doing things. We need a new set of tools to allow capital to flow to most effective solutions.

Pension Funds do have a strong track record of financial return. However, we **need to be very clear on how institutional players plan** on this market and don't. Institutional Investors operating at scale – require the ability to write checks with a clear sense of return, track record and co-investing. While DFIs take capital where capital has not gone before, the institutional investors will only fit where there is more established track record and scale. We nonetheless need to take it to more dramatic scale of financing and impact, while remembering that **fiduciary Duty – shouldn't let moral judgment underline investment decision and affirmative ESG action**.

It is not just a moral decision but **a scientific decision** – e.g. how to deal with the carbon crisis by investing in Renewable Energy solutions. Taking part of the endowment and converting it into energy efficiency. It's about driving for impact that finds solution that help overall performance.

In other words, what is needed is **a redefinition of fiduciary duty** – representing the above mentioned long-term interests of the pensioners. Hence, we need to explore what those interests are – besides the money they have when retiring, but also the world they will retire into. We need to think about this as a movement to make sure that it is not just a role that wealthy managers play, but also the pensioners themselves in how to **reshape expectation for investment** – not just to maximize financial return, but also to redefine wealth.

The UK Climate Change Act

This section briefly looks at how climate change legislation is best structured to be effective. **The UK Climate Change Act** became law in November 2008 and is one of the earliest comprehensive framework laws on climate change globally. A recent Grantham Institute study finds that the experience of the UK's Climate Change Act since 2008 provides lessons for climate law-making that apply internationally.

The Climate Change Act has been instrumental in advancing climate action over the past decade: The introduction of the Act and its carbon budgets has helped to reduce emissions, particularly in the **power sector**, while the UK economy has continued to grow. In other words, the UK Climate Change Act 2008 clear commitment to reduce reliance on fossil fuel, today has led to the largest off-shore wind sector in the world through private capital coming in to fuel forward sustainable development by producing renewable energy for the consumer from a green source.

Although the Act is technically consistent with the Paris Agreement, it will probably need **supplementing by 2020**, for instance by including a target for achieving 'net zero' emissions. New safeguards are needed to strengthen the ability to hold the government to account on the Climate Change Act according to the Gratham Institute publication.

European Commission Reform Approach

The UK government is not the only policymaker to look at ESG and investing. In December 2016, the European Commission established the **high-level Expert Group (HLEG) on Sustainable Finance**, led by DG FISMA. The HLEG's goals were the following:

- Set out the scale of the challenges and opportunities of sustainable finance;
- Propose recommendations to the European Commission for a comprehensive reform of the EU Financial policy framework, to better align it with EU and international sustainability policy objectives.

On March 2018, the European Commission adopted its strategy on sustainable with the following aims of its Action Plan on Financing Sustainable Growth:

- Reorient capital flows towards a more sustainable economy;
  - Europe has to close a yearly investment gaps of almost EUR180 billion to achieve EU climate and energy targets by 2030;
  - EU budget and the Investment Plan for Europe (EFSI) are already supporting climate-relevant and environmentally -friendly investments.
  - Need to mobilize finance from various sources and capital markets.
- Mainstream sustainability in risk management
  - Environmental and climate risks are currently not always adequately taken into account by the financial sector;
  - Social factors may also have concrete consequences for financial institutions including legal risks.
- Foster transparency and long-termism

    - Strengthening transparency through better disclosure;
    - Sustainability and long-termism go hand in hand (FERI, 2018).

In May 2018 the European Commission presented a package of measures as a follow-up to its action plan on **financing sustainable growth** (the feedback period 25 May – 23 August 2018 is now closed). The package includes **three mutually reinforcing proposals** aimed at:

- Establishing a unified EU classification system of sustainable economic activities (**'taxonomy'**);
    - Clarify investor duties to better embrace long-term horizons and sustainability preferences;
- **Improving disclosure requirements** on how institutional investors integrate environmental, social and governance (ESG) factors in their risk processes;
- Creating **a new category of benchmarks** which will help investors compare the carbon footprint of their investments. Thereby facilitating investments in sustainable projects and assets across the EU.
    - Empower retail investors via investment advice, minimum SRI standards and a new ecolabel;
    - Develop official European sustainability standards, starting with green bonds;
    - Establish Sustainable Infrastructure Europe to expand the pipeline of sustainable assets;
    - Update governance requirements so sustainability becomes part of 'fit and proper' tests;
    - Include sustainability in the mandate of the ESAs and extend the horizon of risk monitoring.

Regulation of the European Parliament and of the Council on **disclosures relating to sustainable investments and sustainability risks** is part of a broader Commission's initiative on sustainable development. It lays the **foundation for an EU framework** which puts **ESG considerations at the heart of the financial system** to help transform Europe's economy into a greener, more resilient and circular system. **ESG factors** should be considered when taking decisions on investments in order to make investments more sustainable.

This proposal and the legislative acts proposed alongside it aim to **integrate ESG considerations into the investment and advisory process** in a consistent manner across sectors. This should ensure that **financial market participants** — undertakings for collective investment in transferable securities (UCITS) management companies, alternative investment fund managers (AIFMs), insurance undertakings, **institutions for occupational retirement provision (IORPs)**, European venture capital fund (EuVECA) managers, European social entrepreneurship funds (EuSEF) managers and investment firms - that receive a mandate from their clients or beneficiaries to take investment decisions on their behalf would **integrate ESG into their internal processes** and inform their clients in this respect as requested by the above mentioned pension member of Australia.

Financial products, be they investment funds, life insurance or pension products, and portfolio management services are provided to pool investors' capital, and invest that capital collectively through a portfolio of financial instruments such as stock, bonds and other securities. While **existing rules** in Directive 2009/65/EC, Directive 2009/138/EC, Directive 2011/61/EU, Directive 2014/65/EU and Directive (EU) 2016/2341 require **institutional investors and asset managers** to act in the best interest of their clients and provide scope for integrating sustainability risks, **they do not systematically consider and integrate them** in a consistent way in their investment decisions and disclosure processes, determined by risks; regulatory framework; economic findings; and investment opportunities and performance.

Directive (EU) 2016/2341 represents a **first step towards a more concise disclosure framework in the financial services sector in relation to ESG factors**. Directive (EU) 2017/828 on long-term shareholder engagement increased the transparency obligations for institutional investors and asset managers by requiring them to **develop and disclose an engagement strategy** including a description of how they monitor investee companies on non-financial performance, social and environmental impact and corporate governance, and to **disclose on an annual basis how their engagement policy** has been implemented. Nevertheless, there is still **a lack of transparency** on how institutional investors, asset managers and financial advisors consider **sustainability risks in their investment decision-making or advisory processes**. As a result, their clients do not get the full information they need to inform their investment decisions or recommendations.

Unlike the other EU initiatives, this proposal focuses explicitly on financing aspects by the private sector. It is consistent with the **review of the European System of Financial Supervision** that provides for amendments to regulations establishing the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority so that the Authorities take account of risks related to environmental, social and governance factors when carrying out their tasks. In this way it ensures that **financial market activities are more consistent with sustainable objectives**.

Criticism of the EC's Effort to promote Sustainability amongst institutional investors

German and Austrian retirement providers are concerned that the European Commission's efforts to promote sustainability in the capital markets will end in additional regulation and costs for pension funds. Christian Böhm, managing director of the Austrian EUR4.4bn **APK pension fund** expressed that "what is happening at the moment is an attempt to shift some of this responsibility to institutional investors who will get the blame if a goal is not achieved." Böhm further warned of applying "superficial key figures" to identify sustainable companies without taking a closer look at the underlying operational business, for example.

Christian Wolf, head of asset management at **BVV**, the €28bn pension fund for the German banking sector, was also critical of the EU's approach. "What we do not need is legislation overtaking itself," he said. Wolf pointed out that pension funds had to implement **IORP II, the new EU pension fund directive**, by mid-January 2019. Schemes had until 2023 before a full assessment of implementation could be carried out. However, the Commission's proposals on sustainable finance brought additional pressure and less time, according to Wolf. " What pension funds need is long-term reliability of a regulatory framework and time to implement existing legislation," he said.

German pensions association aba has strongly rejected the European Commission's proposal to introduce new rules regarding pension funds' integration of environmental, social and corporate governance (ESG) criteria in investment decision-making. Aba recently said "the Commission's proposal misunderstood or ignored the nature of the EU's law on workplace pension funds – **the IORP II Directive** – and apparently also misunderstood the directive's existing ESG requirements." Aba further said in its position paper that "We therefore call for an adequate period of time for the member states and, above all, the [pension funds] concerned, first to implement the new rules of the IORP II Directive and then to gather experience before new rules are created."

ESG requirements in the IORP II Directive were mainly about disclosure and did not include a requirement to integrate ESG criteria into investment decisions, aba said. There was a requirement for pension funds to cover ESG risks within their risk management, but "this does not mean that IORPs generally have to include ESG criteria in their investment decisions".

While representatives of the pension fund industry have expressed that the Commission's efforts points "in the right direction" they are also wary of how various EU bodies and authorities might implement the proposals or translate them into additional regulations.

"It would be much more useful for **the DWP**, the asset manager that was recently spun off from Deutsche Bank, to focus on reminding pension funds that they should be taking a broad view on investment risk and reflecting on long-term factors as well as the short-term ones." **The AMNT** also questions the extent to which **the asset management industry** is willing to work with pension funds on the matter. It pointed out in September that there has been a reluctance among some fund managers to accept trustees' voting policies, such as the association's **Red Line Voting initiative**, which sets out standards on ESG issues.

While the asset management industry "don't think mandating consideration of ESG will suddenly make some trustees more sympathetic to the ESG agenda," it is similarly acknowledged that for those pension funds doing nothing, **the rule change** will be a wake-up call. "They will no longer be able to get away with the idea that their pension fund clients aren't interested in this and that they can push it to the margin."

The Next Steps

Notwithstanding these legitimate critical concerns, the next steps in The Commission's pursuit of sustainable finance measures as part of its efforts to deliver on climate change commitments are:

1. Q1 2019: Publish a report providing a first taxonomy, with focus on **climate change mitigation** activities;
2. Q2 2019: Publish a report extending it **to climate change adaptation** and **other environmental activities**
3. Q2 2019 prepare a **report on an EU green bond standard** building on current best practices
4. Q2 2019 specify the content of the **prospectus for green bond issuances,**
5. Q2 2019 **EU Ecolabel framework** for certain financial products (based on the EU taxonomy).[2]

According to **the EC Action Plan on Financing Sustainable Growth the Duties of asset managers, pension funds and insurance companies** are the following:

- Ensuring that **ESG factors and risks**
- if deemed material - are considered in **investment decision process** (internal processes such as governance and risk management),
- and there processes are **transparent** for end-clients (disclosure).

According to FERI(2018) several pieces of legislation will be concerned (including Solvency II, IORP II, UCITS, AIFMD and MIFID II).

WAY FORWARD

From Ethical investment to ESG investing marks a shift that is not just about avoiding harm but how to positively invest in the solution of ESG problems, which is motivating for many institutional investors. Thus, that conversation is moving up. The Fund managers need to spend time with CEO & CIO – to spur them to think about how they can put their capital at work for positive solutions. The capital is still not caught up to the interest, but a positive trend is clearly evident from the recent impact investing conferences attended by the 4IP Group in 2018. 4IP Group is ideally placed to help create the necessary awareness of these SDG investment opportunities. Through our involvement in **the GSGII Impact Revolution** we are also participating in the framing of the social impact investing market e.g. by creating an eco-system for cross-border impact investing awareness in the SADC region.

The Swiss Sustainable Finance association believes that the Swiss financial market has a great future if it can switch investment opportunities into sustainability, which is seen as its strategic objective. Unfortunately, the Swiss Pension Funds are not so dynamic. The Federal Act on Federal Pension Fund in Switzerland governs the organisation of the Swiss Federal Pension Fund (PUBLICA) and defines its tasks and competencies. According to Section 4 **Art. 15** Asset management and allocation of investment income: "The assets of all the employee pension funds affiliated to PUBLICA are invested in accordance with the risk management policy adopted by the Fund Commission."

[2] Source: FERI, 2018, slide 9.

In Switzerland more than 1,500 Pension Funds therefore have to achieve a market return in a way to obtain a market return, not defined, but the one used is in line with capital market rated indices. In this context the Pension Funds have to be pro-active if they want to do another objective by rewriting the pension investment.

Another problem is that most advisors of Pension Funds are **very passive investing** – every other solution is either more expensive or too risky. It is very difficult to get out of **the passive trap**. With low expense ratio, it is going to be difficult to come with active ESG solutions. The solution in **Switzerland** seem to be that if the citizens and members of the Swiss Pension Funds really care about climate change allegedly responsible for the longest Indian summer in memory, then the members can force the Pension Fund to care about climate change. While the pressure of the Pension Funds members currently is not very active, it takes as mentioned above only 50,000 citizens to require a referendum, which is the requirement in the Canton of Geneva. In that way the citizens could say to the Pension Funds what they will have to do. Thus, it's likely that the next steps in Switzerland will be through either a Public initiative or the Parliament to force the Pension Funds to implement new Pension Funds strategies.

As part of the World Bank Group's broader push to attract trillions of dollars in private capital to development projects, which they say is the only way of achieving the SDGs, The International Finance Corporation (IFC) has created in partnership with others in the sector **a list of "the 9 principles of impact investing"** unveiled it at this year's annual meeting of the World Bank and the International Monetary Fund in Indonesia. The IFC groups the principles into five categories: strategy, structure, portfolio management, exiting investments and verifying achievements. This would mirror the launch of the **IFC's Equator Principles** 15 years ago, which set out a way to assess environmental and social projects. The new IFC principles are based on how to exactly measure the impact – how to do that at portfolio level and then how impact has been achieved. In January 2019 ends the process of developing the principles, which according to O'Donohoe, who is also a board member of the Global Impact Investing Network, needs to become "even more collaborative." The The aim is to launch a final version of the Principles at the next World Bank and IMF meetings in spring 2019. Since the Principle are very generic in order to avoid green washing, where investments with little or no development impact are misclassified as impact investments, there needs to be an effort to measure impact, since finance intrinsically is obsessed with data.

In a statement, Andrew Kuper, CEO of LeapFrog Investments, described the principles as an "essential step forward in providing clear guidance to institutional investors" and said they could help address the issue of risk being "mispriced," which is currently preventing some from embracing impact investing.

As a matter for fact responding to a growing trend among asset owners to integrate sustainability and ESG considerations into their investment strategies and stewardship approach **FTSE Russell**, the global index, data and analytics provider, on 18th of October 2018 announced plans to launch **a climate and multi-factor index, the FTSE All-World Climate Balanced Comprehensive Factor Index** in November 2018. The fifth largest fund in the UK's Local Government Pension Scheme with £9 billion of assets under management, Merseyside Pension Fund (MPF), has selected the index to support the implementation of its Climate Risk Strategy within the Fund's listed equity portfolio. The objective of MPF's climate strategy is to align its Responsible Investment policy and activities with the goals of the 2015 Paris Agreement. As part of this, the Fund has considered options for capturing both the risks and opportunities arising from climate change.

We have clearly identified a need **to help Pension Funds becoming smarter investors**, by not just thinking about maximizing financial return of the portfolio, but similarly making sure to contribute to the creation of a world where retirees want to retire into. In the Pension Fund – with individual making choices, more will embrace the impact choice. To that effect 4IP Group has developed strategies and toolboxes as well as exchanged best practices to educate stakeholders along the investment chain. We thereby hope that our activities will lend support to the newly established UN Advisory Council for strategies and tool boxes to showcase bankable projects and understand the ESG requirements of PF and SWFs. This in turn should help to solve the problem of meeting capital supply with capital demand, exchange best practices and provide feedback in order to identify the failure to attract FDI into developing countries from Institutional Investors.

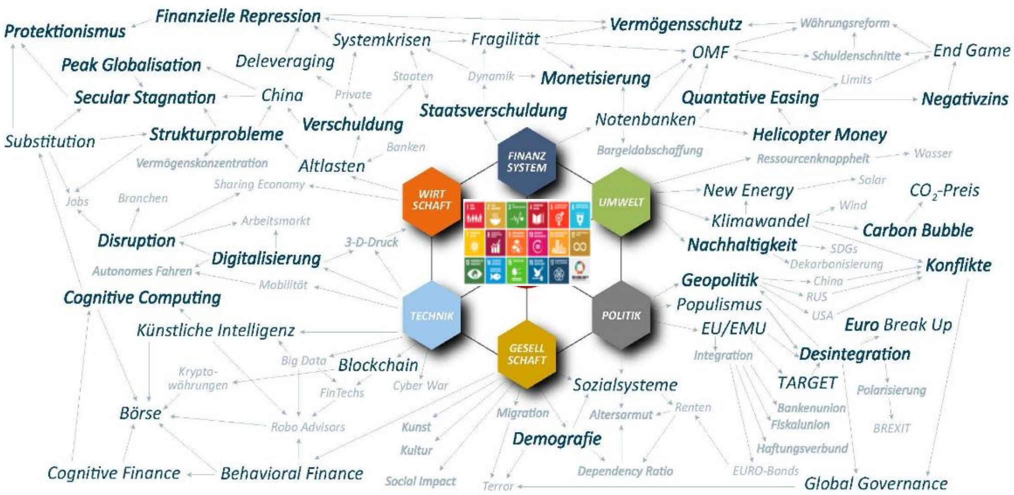
In conclusion, there is a need for big partners such as institutional investors in general and pension funds in particular – because they do bring capabilities and expertise allowing to go for big and complicated (SDG-related) challenges. We nevertheless believe that there is need for a team of committed and capable individuals bringing to the table a specific set of skills. 4IP Group possess this skillset and as part of our contribution to the forward-looking Impact Revolution are ready to use these skills to contribute to **the return-risk-impact paradigm shift** within the Swiss Sustainable Investing Market by proposing a systematic way in which Pension Funds can address the impact of their investment activities through the integration of sustainability criteria into their financial activities.

Annex 1: EC Action Plan on Financing Sustainable Growth

1. Establish an EU classification system for sustainability activities
2. Create standards and labels for Green financial products
3. Foster investment in sustainable projects
4. Incorporate sustainability in providing investment advice
5. Develop sustainability benchmarks
6. Better integrate sustainability in ratings and market research.
7. Clarify institutional investors' and asset managers' duties
8. Incorporate sustainability in prudential requirements.
9. Strengthening sustainability disclosure and accounting rule-making.
10. Foster sustainability corporate governance and attenuate short-termism in capital markets.

Source: FERI, 2018, slide 8.

Annex 2: The Real Drivers of Investment Scenarios



Source: FERI, 2018, slide 13.