EXECUTIVE SUMMARY

Impact at Scale

POLICY INNOVATION FOR INSTITUTIONAL INVESTMENT WITH SOCIAL AND ENVIRONMENTAL BENEFIT

INSIGHT AT PACIFIC COMMUNITY VENTURES
& THE INITIATIVE FOR RESPONSIBLE INVESTMENT
AT HARVARD UNIVERSITY

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About InSight at Pacific Community Ventures

InSight is the thought leadership and advisory practice at Pacific Community Ventures, a U.S. Community Development Financial Institution and nonprofit organization. InSight provides research on community development and impact investing to clients including The Rockefeller Foundation, Annie E. Casey Foundation and The California Endowment. InSight also evaluates the social and economic performance of more than $1 billion of targeted private equity investments by pension funds including the $230 billion California Public Employees Retirement System (CalPERS), investment managers including Hamilton Lane, and foundations including the Northwest Area Foundation, and $18 billion invested by CalPERS in California across asset classes. For more information on InSight's work see www.pacificcommunityventures.org/insight.

About the Initiative for Responsible Investment at Harvard University

The Initiative for Responsible Investment (IRI), a project of the Hauser Center for Nonprofit Organizations at Harvard University, promotes the development of the theory and practice of responsible investment through research, dialogue, and action. The IRI encourages the development of responsible investment theory and practice across asset classes, builds communities of practice around innovative responsible investment strategies, and catalyzes new opportunities and concepts in responsible investment. For more on the IRI's work see www.hausercenter.org/iri.

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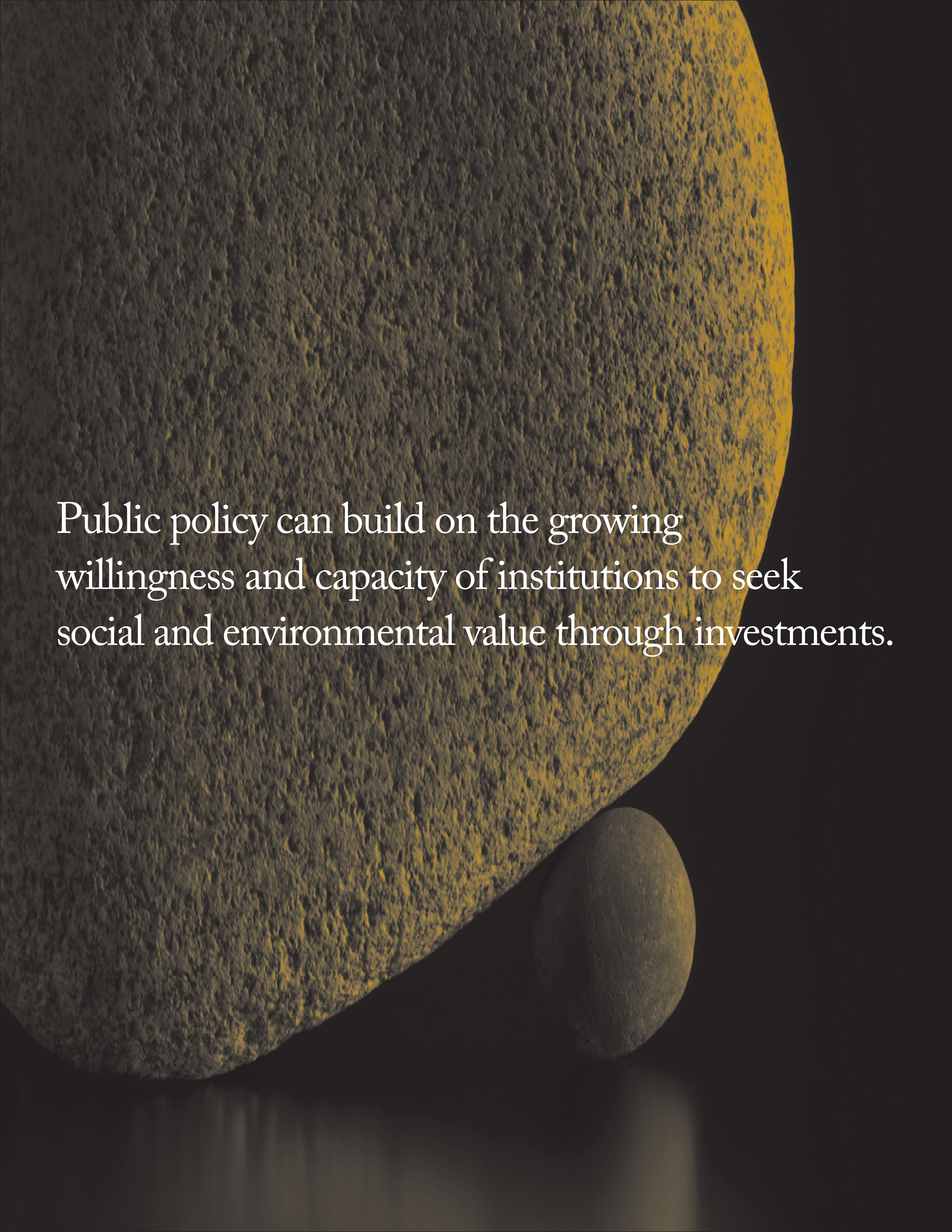
PREFACE

Over the past few years, a growing number of investors have sought to deploy capital in investments designed to generate social and/or environmental benefit as well as provide a financial return. The sources and uses of this capital vary widely, as do the participants in this emerging impact investing industry. However, the largest pools of capital, namely institutional asset owners, are often absent from conversations among self-identified "impact investors." Institutional investors and the over $20 trillion in assets they control have the potential to play an important role in addressing the problems of our time.

Institutional investors are governed by rules and norms that can impede their participation in new or innovative investment vehicles; and institutional participation in impact investment markets is invariably tied to those public policies that shape and promote investment opportunities. Policy and regulation – while in and of themselves not a silver bullet – can play an important role in unlocking more institutional investment capital for greater social and environmental impact.

This report combines several elements that we believe must be part of a discussion about the role of public policy in unlocking institutional investment for impact. This includes an exploration and analysis of the unique opportunities and constraints faced by U.S. fiduciary investors, including relevant regulations. We also examine the different roles that policy can play in accelerating the development of impact investing practices and products. And finally – and most informatively – we offer insight and case studies about the current practices of institutional asset owners and service providers. In bringing these elements together, InSight and IRI have provided a framework for analysis that will stimulate important and productive dialogue among investors, policymakers, advocates, and other stakeholders. We look forward to your participation in that dialogue.

Margot Brandenburg, Associate Director, The Rockefeller Foundation
Justina Lai, Associate, The Rockefeller Foundation



Public policy can build on the growing willingness and capacity of institutions to seek social and environmental value through investments.

1. EXECUTIVE SUMMARY

Impact Investment – investment with the intent to create measurable social or environmental benefit in addition to financial return - has received increasing attention in recent years. This includes interest from policymakers drawn by both the promise of leveraging private capital to support public purpose and the opportunity to make better use of scarce resources to support important social benefits.

Institutional asset owners – such as pension funds, endowments, and insurers – are an especially important category of current and prospective impact investor, even if they are not familiar or self-identify with the term "impact investing." With total assets of over $20 trillion, these anchor investors play a fundamental role in the domestic U.S. and world capital markets. For advocates of impact investing, engagement of institutional asset owners is one key to growing markets that create measurable social and environmental benefits. Institutional asset owners can also help legitimize the field for asset management intermediaries, consultants, lawyers, and other service providers.

But institutional asset owners face specific legal requirements and a distinct investment culture that often constrain their ability to invest with impact. These barriers must be taken into account for the institutional role in impact investing to grow beyond the current limited activity, and careful coordination between policymakers and institutional investors will be essential in building private investment markets that deliver positive social impact.

The Culture and Practice of Institutional Asset Owners

When making investments, institutional asset owners follow the conventions of fiduciary duty and portfolio management, as well as the institutional structures that design and implement investment strategies. Such conventions include diversified portfolios, standardized forms of investment that exist at scale, benchmarks that determine how the broader market evaluates products, and, especially in recent years, relatively short time horizons for evaluating investment performance.

In practice, institutional asset owners share a similar approach to impact investing, acknowledging that all investments – whether impact is a consideration or not – meet the legal requirements, due diligence processes, and standard asset class specific benchmarks for expected financial risk and return. These investments are also typically consistent with the services and product offerings supplied to the institution by its third-party advisors.

Environmental and social targets are rarely acknowledged explicitly as part of the institutional investment framework. From the perspective

The U.S. Market for Institutional Asset Owners

Institutional asset owners are the largest investors in the world, with over $20 trillion in funds under management. The group includes private and public pension funds, private and college endowments, and insurance companies. All of these investors are entrusted to invest capital on behalf of beneficiaries, whether they be current and future retirees, donors and the public more broadly, or current and prospective recipients of claims and annuities.

The breakdown of institutional assets in the U.S. is roughly as follows:

INVESTOR TYPE	ASSETS	SOURCE
Pension funds	$15.3 trillion	Towers Watson[6]
Insurance companies	$6.1 trillion	International Financial Services London[7]
College/university endowments	$400 billion	Responsible Endowments Coalition[8]
Private foundations	$590 billion	Foundation Center[9]
TOTAL	**$22.4 trillion**	

Though impact investments remain a relatively small component of the overall institutional market, there are numerous examples of asset owners that invest with explicit social benefit. Areas of focus mentioned in the policies of some asset owners include:

- Assisting the regional economy;
- Promoting economic wellbeing of the state, its localities, and its residents;
- Creating jobs and promoting economic opportunity;
- Providing capital in areas inadequately served by the market;
- Revitalizing neighborhoods; and
- Fostering environmental sustainability.

Those foundations that engage in mission or impact investing often have very specific social or environmental focuses, which are based on their institutionally defined mission.

of institutional asset owners, impact investing — as an emerging field of investments with occasionally unconventional goals or value propositions — may look idiosyncratic, too small, or too new.

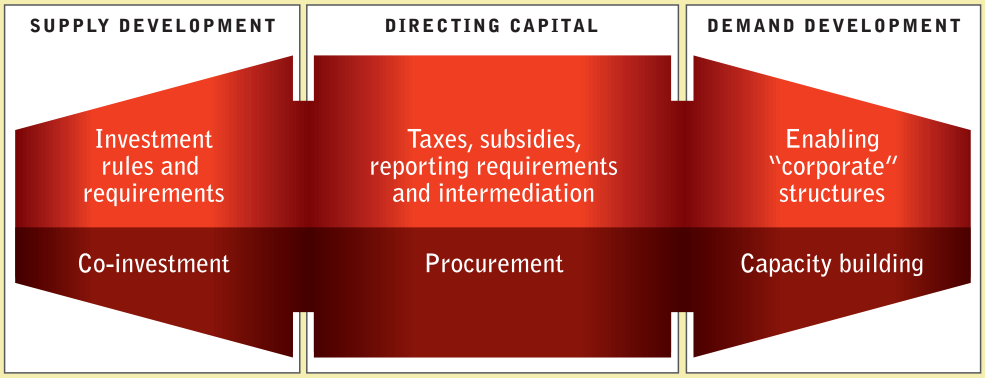
At the same time, an existing track record of institutional investment with explicit non-financial intent can offer policymakers a history on which to draw. Various terminologies are used to describe these activities, from "responsible investment" and "Environmental, Social, and Governance (ESG) integration" to "economically targeted investing."

We can point to two practices in particular that have shaped institutional investor participation in impact investing:

- Discrete targeting of ancillary social and environmental benefits within the context of investment products that otherwise resemble one another; and
- The incorporation of ESG analysis on the belief that long-term financial performance is linked to positive social and environmental performance that mitigates risk and identifies opportunities often not reflected in short term investment analysis.

The range of institutional investment practices that target economic development, underserved communities, job creation, and environmental sustainability – often driven by public policies – offers a substantial base on which to build impact investing policy engagement.

POLICY FRAMEWORK



A Policy Lens on Institutional Impact Investment

The public policy lens can provide a useful tool for examining institutional impact investing as the availability of capital from asset owners is closely tied to the public policy environment. For example, interpretations of fiduciary duty, defined by policy, can constrain investment by limiting real or perceived opportunities. But public policy can also encourage investment by supporting, for instance, tax credits that leverage private capital for investment in underserved communities or by creating investment opportunities that subsidize business enterprises delivering defined social benefits.

Our initial work on the role of government in impact investing, *Impact Investing: A Framework for Policy Design and Analysis,* described policy as intervening in three places: the supply of capital for impact investing; the demand for impact investing capital and availability of investment opportunities; and in directing existing capital toward investments with social benefit.

We can view these policies through a framework that identifies where government intervenes to shape investment outcomes.

- **ON THE SUPPLY SIDE,** policies can direct how institutional asset owners can or should invest capital, setting the regulatory framework that governs investment decisions. Policies may also create co-investment opportunities that lend government credibility and security to impact investment.
- Policies that **DIRECT CAPITAL** operate at the product or transaction level (i.e. at the "point of sale"), influencing markets primarily through incentives like tax credits and subsidies for industries and sectors that meet specific impact goals. Impact areas can include affordable housing, energy efficiency, transit-oriented development, urban or rural regeneration, health and wellness, and education. Other policies may mandate performance floors, like green building regulations or inclusionary zoning laws for affordable housing. Still others provide a related procurement preference. Policies that mandate transparency and reporting requirements are also included here.
- **ON THE DEMAND SIDE,** policies can boost investment opportunities through the development of sound, investable companies, projects, and intermediaries. These policies can help develop or grow impact-related industries through technical assistance, pilot projects or other supporting efforts. They can make existing investment products more financially attractive through credit guarantees. Or they may help identify institutions that create social benefits through certification systems. These policies also help to communicate the existence and suitability of impact investing opportunities.

The policy lens can help public officials, advocates, investors and other stakeholders identify potential interventions that balance the needs of institutional asset owners – for scale, comparability, and comfort – while ensuring the delivery of social and environmental benefits.

MODEL FOR POLICY ENGAGEMENT

POLICY STRATEGY	POLICY PROBLEM	USER FOCUS	EXAMPLES
ENABLING	Markets of interest are small and unconventional	INVESTORS	> Credit guarantees > Safe harbor provision
INTEGRATIVE	Asset owners have limited capacity for or limited interest in impact investing	INTERMEDIARIES	> Performance standards > Tax credits
DEVELOPMENTAL	No functioning market for impacts of interests	INFRASTRUCTURE	> R&D > Technical assistance > Convening

A Model for Policy Engagement

Our research suggests that it may be useful to think of three key strategies for using policy to catalyze institutional impact investment:

- **ENABLING:** By making impact markets investable, policy can help deliver the impact objectives institutional asset owners care most about. Enabling policies primarily address the challenge of small, untested, or unconventional markets where the impacts are of interest to institutions. These policies focus primarily on investors themselves and would establish guarantees to reduce risk in unconventional markets or fiduciary safe harbor provisions that assure investment decisions are legally defensible;
- **INTEGRATIVE:** By adding an impact element to traditional markets, policy can expand the universe of impact investments suitable for institutional asset owners. Integrative policies primarily address the challenge of insufficient opportunities for investors to deploy capital for ancillary social and/or environmental benefit, or simply a lack of interest or capacity on the part of investors. Integrative policies target established intermediaries and would provide performance standards mandating social and environmental criteria, like green building standards, or tax credits to bolster the risk/return characteristics of investments; and
- **DEVELOPMENTAL:** By developing market ideas and infrastructure, policy can build a pipeline of future impact investing opportunities for institutional asset owners. A developmental strategy is needed when markets are undeveloped or non-existent but impacts might be of interest moving forward. Developmental policies generally target the underlying infrastructure of nascent markets through support for research, technical assistance for prospective investees and their service providers, and convening key stakeholders to facilitate knowledge sharing.

As with all government interventions in impact investing, a balance must be struck between a policy's fidelity to an explicit public purpose and the risk that the intervention does more harm than good. To serve the public interest, government must ensure the policy is well targeted, transparent, and implemented efficiently at the appropriate scale and for the right duration.

Policies should also be designed not to reduce effective private investment or become subject to regulatory capture. In preparing to reform policy, government should ensure these questions are answered by engaging key stakeholders in the process and coordinating with other policies and agencies of interest.

Current practice and an evolving understanding of long-term value creation demonstrate a growing willingness and capacity on the part of institutional asset owners to seek social and environmental value through investments. Public policy can build on this practice to support institutional impact investing at scale.

The Way Forward

As with all government interventions in impact investing, a balance must be struck between a policy's fidelity to an explicit public purpose and the risk that the intervention does more harm than good. To serve the public interest, government must ensure the policy is well targeted, transparent, and implemented efficiently at the appropriate scale and for the right duration.

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Policymakers and advocates should keep several points in mind as they work with asset owners around impact investing.

- Institutional asset owners have a set of shared characteristics – from overlapping fiduciary duties to an investment culture shaped by portfolio strategies and service providers – that should be considered when making effective policy. To understand how to mobilize institutional capital, policies should account for issues like fiduciary duty, the prevalence of asset class benchmarking, and the delegation of investment strategies to consultants and fund managers.
- A number of institutional asset owners already engage in impact investments, but often by other names such as responsible investment or economically targeted investment. The impact investment community can build on this history and these practices.
- As a starting point for policy development, policymakers might focus on the social and environmental impacts institutional asset owners and their beneficiaries already care most about. If these impacts serve a public purpose and can be realized in capital markets, a strong case can be made for policy that addresses the legal and market barriers that suppress this activity.
- Applying the policy framework to U.S. institutional investors reveals a breadth of activity in investing for social and environmental benefit and a potentially expansive approach to engagement strategies and policy tools for government to build more robust and sustainable impact investing markets.
- To most effectively engage institutional asset owners, policymakers should consider the various points of leverage they have in the investment ecosystem. Targeting policies to asset owners themselves can support engaged institutions; building social impact into intermediaries expands the range of investments that create social impact; and developing market infrastructure for impact investing can help make both investors and fund managers more capable of entering the market.

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