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Institutional impact investing: practice and policy

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This article examines how public policy can and does play a role in enabling impact investing by U.S. institutional asset owners. We outline how government often plays a key role as underwriter, co-investor, regulator, procurer of goods and services, or provider of subsidies and technical assistance, thus enabling intentional investment for social and environmental benefits by asset owners. The article focuses on how policy intersects with the specific legal requirements and a distinct investment culture that often constrain the ability of institutions 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. Careful coordination between policymakers and institutional investors will be essential in building private investment markets that deliver positive social impact. We concentrate on more narrowly construed impact investment policies. Examples include geographically targeted economic development, and energy-efficient real estate investments.

Keywords: impact investing; responsible investing; institutional investors; economically targeted investing

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Introduction

Impact investment is investment with the intent to create measurable social or environmental benefits in addition to financial return. Such investment has received increasing attention in recent years including that of policymakers drawn by the promise of leveraging private capital to support public purpose and by the opportunity to make better use of scarce resources.

The focus of this article is impact investing by U.S institutional asset owners such as pension funds, endowments, and insurers, and the role of policy in supporting these activities. Institutional asset owners are an especially important category of current and prospective impact investors, even if they are not familiar or self-identify with the term 'impact investing'. With total assets of over $20 trillion in the United States, these anchor investors play a fundamental role in the domestic U.S. and world capital markets.

For the purposes of this article, we focus exclusively on the field of impact investing – that is, investing that intentionally seeks targeted positive social impact as well as financial returns – at the expense of a broader discussion of responsible investment; environmental, social, and governance (ESG) analysis; and the social value of markets. Although we thereby sacrifice the chance to discuss the systemic nature of financial market impacts, we hope this narrower focus sheds light on an emerging field that has drawn increased interest.

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We focus on institutional asset owners as a class of investors for several reasons. First, large asset owners are potential sources for significant sums of investment capital and therefore might be seen as agents who can bring impact investing to scale in developing track records and deals. Second, the entry of large asset owners into the impact investing market can, apart from their own investment, catalyse other investment by legitimizing the field for asset managers, service providers, and other investors. Third, institutional asset owners share legal requirements and a distinct investment culture that govern their service to beneficiaries. Finally, U.S. pension funds and endowments have a specific history with a variety of impact-related investment strategies from which the impact investment community can learn. These strategies fall under various labels such as responsible investment, mission investment, social investment, sustainable or green investment, or economically targeted investment (ETI).

We have chosen the additional geographic focus on U.S.-based institutional asset owners for the purposes of our policy analysis. While there are varying levels and types of policies that affects their participation – local, state, regional, national, and international – these asset owners are governed by a set of regulations most of which are specific to the U.S. context. Operating within this context makes them distinct from other asset owners internationally and other investors domestically, though the lessons learnt from engaging U.S. investors apply to many areas around the globe.

This article progresses in the following manner. In the first section, we discuss the special challenges that institutional asset owners present to advocates of impact investing, including the specific legal requirements and distinct investment culture that shape their ability to invest with social or environmental benefit in mind. 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.

In the second section, we highlight the current approaches to impact investing by institutional asset owners. In particular, we point to two practices that have shaped institutional investor participation in impact investing:

- Efforts to link long-term financial returns to positive social and environmental performance that mitigates risk and identifies opportunities often not reflected in short-term investment analysis; and
- Discrete targeting of ancillary social and environmental benefits within the context of investment products that otherwise resemble one another.

The range of institutional investment practices that emerge targeting economic development, underserved communities, job creation, and environmental sustainability are essentially linked to public policies.

In the third section, we examine the policy environment that either supports or dissuades impact investing by institutions. The policy lens can help public officials, advocates, investors, and other stakeholders identify potential interventions that balance the needs of institutional asset owners that include scale, comparability, and comfort, while ensuring the delivery of social and environmental benefits.

In the final section, we offer three modes of linking policy to impact investing for policymakers, advocates, and investors to consider as they determine whether policy interventions can help catalyse private investment that supports public purpose and meets the needs of institutional asset owners.

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The institutional investor context

Understanding how institutional asset owners approach their investment decisions taking into consideration both real and perceived obstacles, is important for developing appropriate strategies for engagement on impact investing, particularly in policy discussions.

We provide a review of the legal environment and current interpretations of fiduciary duty, and draw a general picture of the conventional investment methods of institutions and their relationship to third-party service providers.

Institutional asset owners are, by definition, entrusted to manage funds on behalf of their beneficiaries including public and private pension funds and plan sponsors responsible for supporting current and future retirees; insurance companies for obligations to their policyholders; and endowments for the purposes specified by donors.

The concept binds together a set of 'standards of care' that make up fiduciary duty. Relevant here are the Duty of Care, where fiduciaries are required to subordinate their own interests to those of the beneficiaries of their fund; the Duty of Prudence, that requires fiduciaries to invest in a manner consistent with 'sound' investment decision-making; the Duty of Loyalty, that states fiduciaries must consider only the interests of fund beneficiaries when making decisions; and the Duty of Impartiality, that requires fiduciaries to take into account all fund beneficiaries, present and future, while making investment decisions.

These standards of care have evolved over time. Originally, fiduciaries were obliged to invest in the safest of investment products, and forbidden from investing in riskier investments such as public equities. The Modern Prudent Investor Rule, which informs current legal interpretation of fiduciary duty, highlights changes from this traditional model, by emphasizing the diversification and performance of whole portfolios.

Fiduciary duty requires large institutional asset owners to balance the twin goals of capital preservation and accumulation, although current interpretations of fiduciary duty generally define long-term sustainable wealth in exclusively financial terms. It does not expressly forbid impact investing by asset owners, though it does prohibit subordination of financial performance to social objectives. To the extent that certain social and environmental risk factors affect long-term investment performance, fiduciaries may be obliged to consider these factors in the decision-making process (Sethi 2005).

Recent work on fiduciary duty and responsible investment has emphasized the importance that ESG factors can play in portfolios with long-term time horizons. Issues such as climate change that pose substantial long-term risks have received special attention.

For example, the UN Environmental Programme Finance Initiative's Freshfields' report found that, given existing regulations and case law, investors can take ESG considerations into account so long as they are 'motivated by proper purposes and do not adversely affect the financial performance of the entire portfolio' (Freshfields Bruckhaus Deringer 2005). The UNEP-FI issued a follow-on report in 2009, which provided new legal developments and practical and legal guidance for incorporating ESG considerations into investment practice (UNEP FI 2009). An October 2008 FSG Social Impact Advisors report lays out similar legal background for mission investing by foundations in the U.S. (Stetson and Kramer 2008; Hawley et al. 2011). These publications reflect a general understanding of fiduciary duty as a concept changing over time in concert with investment practice and changes in society broadly.

Investment conventions are as important as legal determination in shaping how institutional asset owners approach impact investing. In large part, institutional asset owners currently draw from a set of beliefs about market efficiency and the benefits of portfolio diversification associated with Modern Portfolio Theory (MPT) (Lydenberg 2009). In brief, MPT offers a model of portfolio management that emphasizes diversification across asset classes. The MPT approach assumes that

investors are rational, markets efficiently price assets, and a close relationship exists between an investment's risk and its return.

In part, thanks to MPT, large asset owners hold funds in multiple asset classes, not only in fixed income and public equities, but also in venture capital, private equity, real estate, commodities, hedge funds, and infrastructure. Diversification and MPT's risk management theories have encouraged product development in alternative sectors like private equity and increased the range of investment managers and other services available to impact investors (Bernstein 1993).

At the same time, diversification in line with MPT has encouraged funds to benchmark the performance of these portfolios with conventional, asset class-specific measures that compare investment risk and return performance. Benchmarks have become important tools for asset owners to assess the performance of consultants and fund managers who work for them, and have in the aggregate defined what market performance means for all investors.

We highlight three points here with regard to impact investing. First, we suggest that performance measurement in terms of risk and return, as measured by MPT-driven understandings of market efficiency, encourages assessment of investment opportunities on a limited number of indicators, which may constrain the incorporation of impact investing into investment decision-making. Second, though the expansion of investment opportunities across asset classes may help investors engage in impact investing, asset class-specific benchmarking has also helped develop relatively strong conventional preferences for standardized opportunities at the expense of idiosyncratic or innovative product approaches. Third, critics have argued that many of these benchmarks encourage short-term performance at the expense of long-term returns by providing short-term measures of success and by serving as the basis for incentive-based remuneration for asset managers (Woolley 2010). Social and environmental performance may not fully register on these short-term measures.

Best practice by public pension funds and other asset owners in integrating impact investment into their investment policies has generally involved a focus on the due diligence process and by emphasizing investment selection based on financial performance.[1] One important point about both responsible and mission investing: to date, practitioners who engage in these practices have tended to adopt conventional asset allocation policies and benchmarks for performance measurement, even as they have explicitly or implicitly criticized the ideas that underpin those strategies and benchmarks.

Finally, the management of funds is delegated to either external investment advisors or investment intermediaries, or, at larger funds, to a mix of external advisors and internal fund staff. Asset owner trustees determine investment strategies, which are then executed by others. This intersection of stakeholders involved in fund management is more complicated than a simple model of strategy setting and execution would suggest. Practically speaking, implementation means translating investment policies, including them in Requests for Proposals to service providers, and building systems that measure performance.

The agency issues involved in governing complex service provider relationships are vital to determining how investment performance is achieved, managed, and evaluated. To the extent that those incentives disfavour the consideration of social benefit, the asset owner institutional structure will hinder the uptake of impact investing (Youngdahl and Wood 2011).

Institutional asset owner impact investing practices

We can think about impact investments by institutional asset owners in two ways: as portfolio-level strategies and as asset class-specific applications of those strategies. Portfolio-level strategies, such as economically targeted investing (ETI) by pension funds and most sophisticated mission investing strategies by foundations, tend to involve multiple asset classes and investment

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vehicles. The application of those strategies, in keeping with the broader asset allocation strategies of asset owners, is largely within particular asset classes such as infrastructure or fixed income.

The presence of investments with impact in an asset owner's portfolio does not necessarily reflect an impact investment strategy. Most investments by institutional asset owners are made through fund intermediaries. While an institutional investor may not explicitly support a particular impact objective, we consider investment in an intermediary that is clearly committed to delivering measurable social and environmental benefits in addition to financial returns, to be an impact investment.

ESG integration portfolio strategies

Explicit impact investing strategies and broad impact objectives sit at the portfolio level. They may or may not be contained in explicit investment policy statements or fund strategy documents. These strategies may have a variety of different names – ESG integration, ETI, and mission investing – but they centre on seeking out investments with a particular type of impact throughout the portfolio.

Advocates argue that the integration of ESG information into investment decision making can enhance long-term investment performance by more closely linking investment strategies to macro trends such as climate change, resource scarcity, urbanization, demographic shifts, and polarization of wealth. Such trends are likely to affect risk and return over time. The implication is that the conventions of short-term benchmarking and agency issues among owners, managers, and consultants have inhibited the pricing of externalities. ESG integration offers a potential platform for impact investing to the extent that this integration focuses on positive social and environmental returns. The preamble to the UN PRI highlights the link between ESG integration and the potential for positive impact returns by asserting that 'applying these principles may better align investors with broader objectives of society' (PRI 2006). In practice, however, signatories to the UN PRI have focused their efforts on identifying high-performing companies for public equity stock selection, engaging publicly held companies on their ESG practices, and building systems for applying ESG analysis across asset classes. Climate risk and corporate governance have been central focuses, though a number of emerging efforts are focused on the role that social issues like human rights, worker relations, and community engagement may play in investment decisions.

Among the more prominent venues for interest in environmental markets has been engagement with corporations and public policy via investor groups such as the Investor Network on Climate Risk. This research and advocacy group highlights both the risks of climate change to long-term investment returns and opportunities to improve corporate governance and public policies that address that risk (Investor Network on Climate Risk 2012). The recent report 'Climate Change Scenarios – Implications for Strategic Asset Allocation', released by Mercer Investment Consulting in conjunction with the Carbon Trust and the International Finance Corporation, concludes that investors can better manage climate risk by increasing asset allocations to real assets and sustainable investments (Guyatt 2011).

Some asset owners already directly engage with fund managers on climate risk. For instance, the North Carolina Department of State Treasurer conducted a survey in 2010–2011 of its real estate fund managers to determine how they manage climate risk in their holdings to better assess the state pension fund's exposure to long-term risk.

The State of California has begun to make investments with an eye toward climate change. Recently, the state invested $700 million in World Bank green bonds that will fund reforestation, alternative energy, and water purification projects. In announcing the second, $400 million tranche of investment from the state's Pooled Money Investment Account, State Treasurer Bill Lockyer emphasized the dual benefits of return and 'climate risk mitigation' (Lifsher 2011).

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Economically targeted investing

The practice of ETI dates back to the 1980s and is most commonly associated with public pension funds. ETIs have additional, place-based economic benefits besides the financial return accruing to the fund. By design, ETIs are a double-bottom line investment strategy that targets financial return as well as economic growth in areas related to beneficiaries. ETIs take many shapes and forms from targeted private equity or loan programmes, which require intermediaries to invest all or a portion of assets in operating businesses within a predetermined geographic area, to targeted real estate and infrastructure investments.

The Florida Growth Fund offers a prototypical example of ETI investing in the U.S. In May 2008, the Florida State Legislature passed the Senate Bill 2310[2], allowing the Florida State Board of Administration (SBA)[3] to invest up to 1.5% of the $130 billion Florida Retirement System in businesses domiciled in Florida in technology and other growth sectors. For the Legislature, investments by Florida pension funds in technology and other growing industries presented the 'potential to generate high-growth and high-wage jobs that would economically benefit the state' (Florida State Senate 2008). The law was designed to mirror ETI policies for state pension funds in New York, Massachusetts, Ohio, Texas, and California. The Fund is managed by Hamilton Lane, an investment manager that has developed a subspecialty in managing ETI accounts, and deploys capital both through private equity fund intermediaries and direct co-investments.

The ETI policy adopted by the Washington State Investment Board in July 2006 provides additional insight into the way many institutions structure targeted investing within the context of fiduciary duty and portfolio strategy:

- The Board will consider for investment only those ETIs that are commensurate on a risk-adjusted financial basis to alternatively available investments;
- The decision to invest in an ETI in consideration of its collateral benefits shall be made only after the opportunity is deemed acceptable exclusively on its economic investment merits;
- The collateral benefits of an ETI shall not be considered part of the return of the investment, nor a part of risk reduction;
- ETIs shall be made in accordance with the Board's approved asset allocation policies and included within existing asset categories, and shall conform to all laws, policies, and procedures governing the Board; and
- ETIs shall receive the proper level of due diligence and evaluation consistent with all other investment opportunities evaluated of similar type or classification (Washington State Investment Board 2006).

Following the 2008 financial crisis, a renewed interest emerged in new forms of ETIs and the expansion of existing practices. In Massachusetts, for example, the state legislature approved $25–$50 million in additional allocation for investments in banks and financial institutions making small business loans in-state, adding to MassPRIM's nearly $300 million in existing ETI outlays in fixed income and venture capital (The General Court of Massachusetts 2010).

More recently, CalPERS announced in September 2011 that it had earmarked up to $800 million for investments in California infrastructure over the next three years in transportation, energy, natural resources, utilities, water, communications and other social support services, adding another asset class to its ETI policy (CalPERS 2011).

Additionally, a number of funds have preferential 'emerging domestic manager' programmes, which seek out and invest in funds with minority and women investment professionals and owners. The impact of these investments is not measured by their results, but in the placement of the funds, with the intent of developing a diverse supply of investment intermediaries.

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Mission investing

A number of U.S. foundations that engage in mission investing have developed portfolio-wide strategies for targeting social impact that is explicitly tied to their organizational mission. For instance, the F.B. Heron Foundation sets clear criteria for the types of positive social impact sought, in this case, the development of wealth creation strategies for underserved communities. It then seeks out investments that help achieve these goals across a range of asset classes and risk/return profiles.[4] The Meyer Memorial Trust has adopted a mission investing strategy to further its goals of positive social impact in the state of Oregon and Clark County, Washington – that includes investments in the region that create positive social impact beyond the foundation's immediate issue-specific and geographic focus.[5]

The market-rate investments of these foundations have ranged from fixed-income products that target-specific regions or communities, to urban regeneration and green building funds in real estate, to public equities investments that favour corporate engagement on ESG issues. Both foundations work with their in-house investment staff and external consultants to benchmark their market-rate mission investments in a manner consistent with any other asset in their portfolio, in a process suitable for the range of institutional asset owners.[6]

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Specific applications by asset class

Institutional asset owners typically apply their investment strategies within the constraints of asset allocation decisions and risk/return profiles that define their portfolios. They target impact investment strategies within asset classes, and typically use conventional asset class benchmarks and tools to make their decisions about investability.

Different asset classes (and the often wide variety of investments within asset and sub-asset classes) offer different opportunities and requirements for due diligence by investors and their consultants. Some examples of asset class-specific issues that institutional investors have targeted include[7]:

Cash and Cash Equivalents: Deposits and operating accounts in local financial institutions and community banks that target lending to underserved communities or groups.

Fixed Income: Government-issued and private securities that support sectors or projects related to low income and workforce housing, business development and job creation, infrastructure, education, health care, or the environment.

Public Equities: Corporate engagement strategies across a variety of ESG issues ranging from environmental performance, to executive compensation, to health, safety, and labour standards in corporate supply chains; stock selection strategies that target environmental and/or social outperformance, incorporating ESG research to anticipate the long-term effects on shareholder value.

Real Estate and other Real Assets: Urban regeneration in underserved communities, energy efficiency, and sustainable land management strategies for targeting acquisition of land, buildings, and new development.

Private Equity: funds that target investment in underserved communities; venture capital funds that focus on new technologies for renewable energy production or energy efficiency improvements or support for social enterprises.

There has been recent interest from asset owners in the (relatively undeveloped in the U.S.) field of private infrastructure investing, targeting economic development and environmental sustainability in the context of stable long-term financial returns.

The policy lens on institutional impact investing

In the context of impact investing, we can think of public policies as a set of tools used to catalyse private investment in impact areas and to ensure this activity delivers the social benefits it promises. A variety of policies can help achieve these two goals. For instance, policy can:

- Reinforce the validity of impact investing through interpretations of fiduciary duty;
- Set impact standards that private investors can target;
- Provide financial or reputational incentives for social benefit;
- Direct capital to invest with ancillary goals in mind;
- Set regulatory floors for acceptable social and environmental performance;
- Integrate performance standards in public investment and procurement policies;
- Provide support for the creation of new intermediaries and products;
- Create disclosure and transparency requirements on social impact issues; and
- Disseminate information on the social and financial performance of impact investments.

Successful public policies can channel capital toward investments with positive social impact, opening the door to engaged investors and increasing the impact of their investments. On the other hand, poorly designed or implemented policies may create barriers to investments with public benefit or reward investment activity that creates no additional or negative social outcomes.

Though relatively few polices in the United States have addressed impact investing by name, different types of policies have promoted targeted investment. Several state-based economically targeted programmes focus on job creation, infrastructure, or housing. Issue-based policies can mandate divestment from countries that policymakers find controversial, such as Sudan. IRS allowances for programme-related investments by foundations allow for below-market investments that create social benefit to count toward a foundation's 5% annual required payout (Pennsylvania House of Representatives 2010).

Other policies have targeted asset managers. The Community Reinvestment Act, for example, targets banks and mandates investment in underserved areas where banks operate. The Low-Income Housing Tax Credit has opened the door to investment in affordable housing, helping to build a market for public benefit in real estate. Policies such as Montana's Renewable Portfolio Standard help direct capital toward investments in renewable energy (Database of State Incentives for Renewables and Efficiency).

In some cases, successful interventions involve multiple policies to catalyse impact investment in sectors deemed of particular public value. For example, the Healthy Food Financing Initiative (a joint project of the U.S. Departments of Agriculture, Treasury, and Health and Human Services) includes a $400 million mix of tax credits, below-market rate loans, loan guarantees, and grants (including technical assistance). This mix of interventions is intended to support and encourage investment in a range of community development financial institutions (CDFIs), nonprofits, and businesses that are working to address the absence of healthy foods, so called 'food deserts,' in American communities (USDA and HHS 2010). These interventions are paired with educational efforts for potential consumers that help shape the market for healthy foods.

By applying a policy lens to institutional investors in the U.S., we offer a framework for thinking about the most useful policy tools to engage this community. These polices run the gamut from the rules governing market activity to direct government outlays that change the risk/return profiles of investments, to educational activities that reduce the transaction costs for finding and underwriting impact investment opportunities.

In our previous research, published in *Impact Investing: A Framework for Policy Design and Analysis* (2011), we describe policy as intervening in three places: the supply of capital for impact

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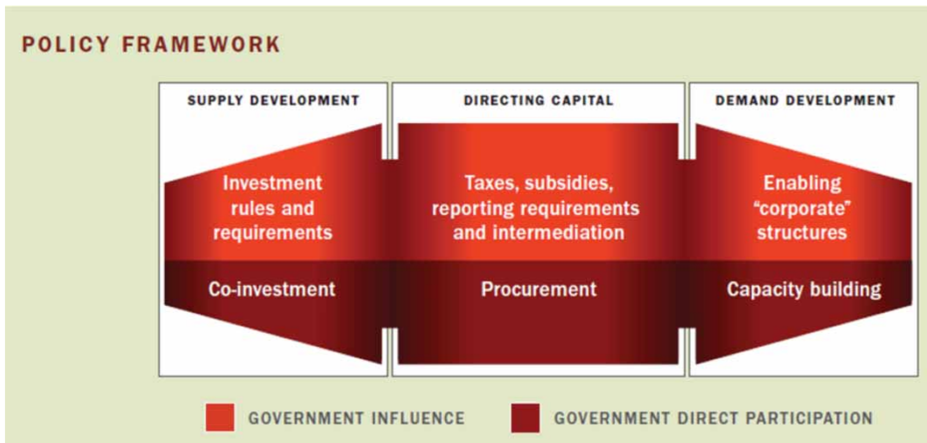

Figure 1. Policy framework for impact investing analysis.
Source: Thornley et al. (2011).

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investing; the demand for impact investing capital and availability of investment opportunities; and in directing existing capital toward investments with social benefits (Figure 1).

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 communicate the existence and suitability of impact investing opportunities.

Expanding the supply of impact investing capital

Policies that affect the supply of capital available for impact investing fall into two general categories. The first category includes regulations that mandate how institutional asset owners can or should invest capital; the second comprises co-investment opportunities in which public investment leverages private market participation (Table 1).

Rules and regulations that govern investments by institutional asset owners exist at national and state levels and vary by type of asset owner. These rules and regulations – both legislative and administrative – range from the vague to the specific, and they can change based on how they are interpreted, implemented, and overseen. They can mandate certain investment strategies, or, more

Table 1. Supply development.

Policy	Examples
Rules and regulations	Employee Retirement Income Security Act
Co-investment	Infrastructure Bank, SBA Impact Investment Fund

generally, constrain or allow for the incorporation of ancillary social benefits into the investment decision-making process.

Interpretations of fiduciary duty are a common focus for institutional asset owners and the legal and investment advisors who work for them, most notably through the Employee Retirement Income Security Act (ERISA), enacted in 1974 and regulated by the U.S. Department of Labor (DoL). ERISA established standards of conduct for pension plan fiduciaries. The act legally required fiduciaries to manage these plans to maximize financial return 'for the exclusive purpose of providing benefits to participants and their beneficiaries.[8]'

Although ERISA did not explicitly prohibit plan managers from considering additional factors beyond financial return, many shied away from such investments for fear of violating their fiduciary duties. In 1994, the Department reinterpreted ERISA hoping to encourage more targeted investment by institutional investors. It ruled that selecting an ETI would not violate fiduciary duties as long as the investment provided the same rate of return at the same level of risk to comparable investments available to the plan.[9] Economically targeted and other impact investments by pension plans increased after this point.

However, a change in administrations and political orientation led to a re-reinterpretation of ERISA by the DoL in 2008 that established the so-called 'rigid rule.' Investments with a secondary purpose other than financial return could be considered only if they were 'economically indistinguishable' from investments that satisfy primary obligations.[10] Anecdotal evidence from recent surveys suggests this reinterpretation of ERISA may have inhibited some plan managers from considering impact investments owing to uncertainty around the standard (Social Investment Forum Foundation 2009).

There are also laws and regulations that allow state pension funds to invest up to a certain percentage of assets in specific impact categories, such as in-state economic development or other social and environmental goals (Table 2).

Even the prospect of regulation can help develop impact investing markets. In California and New York, for instance, the life insurance industry has developed the California Organized Investor Network and the Life Insurance Council of New York to promote community investment in lieu of legislation such as the CRA. In Massachusetts, the Life Initiative was formed by the insurance industry for similar purposes through negotiations with the state over the insurance industry's tax burdens.

While certain regulations can help catalyse impact investing, many of these often have no clear mechanisms for enforcement. For instance, many state ETI mandates go unfulfilled with no penalty, limiting their effectiveness. Advocates must also consider whether new rules and regulations would create undue burdens that limit investment opportunities.

Co-investment

Co-investment opportunities, which involve investing private capital alongside public dollars, often take the shape of formal public–private partnerships, particularly at the scale necessary for institutional asset owner investment. By demonstrating government commitment, co-investment can reduce the real or perceived financial risk of the investment.

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Table 2. US state policies on ETI.

States and state pension systems Mandate, allow, or encourage ETIs	Discourage ETIs
State law	State law
Alaska	Kansas
Arizona	Nebraska
Arkansas	South Carolina
Colorado	South Dakota
Connecticut	
Florida	
Hawaii	
Iowa	
Kentucky	
Louisiana	
Massachusetts	
Michigan	
Missouri	
Montana	
New York	
North Carolina	
Ohio	
Oregon	
Rhode Island	
Wisconsin	
Board Investment Policy	Board Investment Policy
Retirement Systems of Alabama	Iowa Public Employees' Retirement System
California Public Employees' Retirement System	Maryland State Retirement and Pension System
California State Teachers' Retirement System	New Hampshire Retirement System
Connecticut State Employees' Retirement System	North Dakota Retirement and Investment Office
Hawaii Employees' Retirement System	Employees' Retirement System of Texas
Public Employees' Retirement System of Idaho	West Virginia Investment Management Board
Teachers Retirement System of Louisiana	Wyoming Retirement System
Massachusetts Pension Reserves Investment Management Board	
Missouri State Employees' Retirement System	
New York City Employees' Retirement System	
North Carolina Retirement System	
North Dakota Retirement and Investment Office	
Pennsylvania State Employees' Retirement System	
Rhode Island State Investment Commission	
Tennessee Consolidated Retirement System	
Vermont Pension Investments Committee	
Washington State Investment Board	
Wisconsin State Investment Board	

Government co-investment through a vehicle like an infrastructure bank can leverage private capital to expand available resources for creating public goods. The proposed U.S. National Infrastructure Bank would leverage $10 billion in public funding to attract long-term private capital for needed infrastructure investments in energy, transportation, and water at a 2:1 match. Proponents hope that the initiative will create quality jobs while developing necessary public infrastructure.[11]

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Two contemporary examples offer evidence of the effectiveness of co-investment by government. The Overseas Private Investment Corporation (OPIC) recently launched an impact investing financing initiative, which is providing $285 million to six impact investing funds in emerging markets. These investments will address impact areas such as job creation, health care, environmental protection and climate change, and are intended to leverage an additional $590 million in private investment.

In 2011, the federal Small Business Administration (SBA) established a five-year, $1 billion Impact Investment Initiative, co-investing public funds with institutional investors to promote small business growth in underserved communities. This initiative is intended to bring together public resources with private capital and engaged fund managers to provide funding for place-based or sector-specific impact investments. The SBA is repurposing a segment of its long-standing Small Business Investment Company programme to invest in and develop those funds that allocate at least half their investments to high-impact areas, such as low-to-moderate-income communities, clean energy, and education.

In July 2011, the InvestMichigan! Mezzanine Fund became the first licensed fund under this initiative (U.S. Small Business Administration). The SBA is co-investing with Michigan Growth Capital Partners, an investment partnership of the State of Michigan Retirement Systems, Dow Chemical, and InvestAmerica. The $130 million fund comprises $80 million from the SBA, $35 million from Michigan Growth Capital Partners, and an additional $15 million from Dow, which is headquartered in Michigan.

Co-investments offer the potential for scale because public investment, like that of institutional asset owners, may favour big-ticket investments with longer time horizons.

However, many complications exist that can impede building well-crafted funds and deals. In addition, the potential for subsidizing unproductive activity or the perils of regulatory capture by private market participants are real investor concerns.

Directing capital to impact investments

Policies that direct capital often function largely at the product level by affecting the terms or price of a transaction at the 'point of sale'. As Table 3 indicates, these policies may do anything from subsidizing specific outcomes to employing government procurement to shape markets. Impact areas that have seen policy development for directing capital include affordable housing, energy efficiency, transit-oriented development, urban or rural regeneration, health and wellness, and education.

Tax credits and other subsidies can create incentives for specified social outcomes, and tend to focus on investment funds or deals in which institutional investors may participate. From the perspective of institutional asset owners, tax credits are often by definition indirect paths towards

Table 3. Directing capital.

Policy	Examples
Tax credits and subsidies	Low-Income Housing Tax Credit, New Markets Tax Credit, Healthy Food Financing Initiative, Build America Bonds
Rules that set social performance floors	Inclusionary zoning, climate change reporting requirements
Procurement	Green Building Requirements
Information Provision: Research and Transparency	Environmental and social reporting standards

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leveraging capital. For institutional asset owners that are themselves tax-exempt, tax credits hold little interest unless they can be used for leverage or risk mitigation in taxable deals or funds.

For example, the New Markets Tax Credits (NMTC) programme gives individuals and corporate investors tax credits against their federal income tax return in exchange for making equity investments in certified operating businesses and real estate projects in low-income communities (CDFI Fund). NMTC is a prominent component of many community investment real estate deals, and helps create impact investment opportunities for tax-exempt investors by subsidizing a particular element of social impact.

Tax credits can help make geographic markets, industries, or sectors more investable. However, as tax credits involve direct government outlays – primarily through foregone tax revenue – they may be politically unstable, especially in times of economic hardships. This instability may be of particular concern for institutional asset owners who invest with long-term time horizons. For instance, the existing public funding cycle for renewable energy production in the solar sector, which requires frequent Congressional reauthorization, has to some extent discouraged asset owner participation in the market because of political risk (Solar Energy Industries Association 2011).

At the same time, credits and other subsidies must be carefully targeted toward positive social impact, so as not to reward market activity that would be undertaken anyway or encourage rent-seeking among politically connected intermediaries. Policymakers must develop mechanisms to monitor implementation and enforcement, as institutional asset owners are unlikely to perform this function.

Rules that set social benefit performance floors

Policies that build social benefit into conventional business operations create a *de facto* impact investing market in which institutional asset owners participate. These policies have the advantage of leveraging greater sums of capital than those more narrowly targeted to individual investor participation.

Such rules and regulations are often associated with issues like fair labour standards. The Davis–Bacon Act of 1931, for instance, mandates the payment of prevailing wages to workers on public projects. Critics may argue that the act creates barriers to investment by raising labour costs on infrastructure and other investment; on the other hand, to the extent that quality job creation is seen as a positive social impact, setting a prevailing wage floor can be seen as an impact investing policy.

Efforts that operate on similar principles include mandates by local communities that new and existing buildings meet minimum environmental performance standards or inclusionary zoning laws that require a certain percentage of affordable housing in multi-family residential development.

The market for energy-efficient buildings has been boosted in the last decade thanks in large part to the development of the United States Green Building Council's Leadership in Energy Efficient Design (LEED) standards and, more recently, the incorporation of LEED standards into a number of municipal building regulations in many U.S. cities. For instance, San Francisco's Green Building Ordinance will require major commercial buildings (defined as those over 25,000 square feet and 75 feet tall) to achieve the relatively high level of LEED Gold certification. The same law mandates LEED-related performance evaluations for all buildings and renovations in the city (U.S. Green Building Council).

A number of federal agencies have also incorporated LEED standards into their building and leasing guidelines. Among the most notable is the early adoption by the General Services Administration (GSA) of LEED standards. The GSA is the largest civilian landlord in the U.S., and the

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incorporation of LEED standards into its procurement policies has sent an important market signal about the value of certification (U.S. General Services Administration).

The first inclusionary zoning policy in the U.S. was implemented in 1974 in Montgomery County, a large and affluent county in the Washington, DC, metro area. Montgomery County's Moderately Priced Dwelling Unit policy has produced over 10,600 affordable housing units. To address the financial ramifications for developers, who are obligated to include affordable housing, the County set up a density bonus that allowed the developer to build more housing units on a specified plot of land than local zoning regulations usually allow. For developers, this bonus effectively subsidizes the fixed costs of development, and together the performance floor and density bonus are designed to increase the total stock of affordable housing without unduly burdening real estate investments (Brown 2001).

Performance mandates or floors can play a significant role in driving market behavior. They can also catalyse the development of businesses that respond to demand for impact investing products like green building or affordable housing funds. Policymakers need to balance the private financial interests of investors and the risk of stifling market activity against the potential public goods that performance floors can create.

Credit guarantees

Credit guarantees and enhancements from the government help mitigate investor risk by ensuring a certain rate of return or by taking first loss positions. Credit enhancements can also mitigate concerns of newness or idiosyncrasy that some investors may have of certain impact investment products.

These are policies that target areas of investment which conventional market activity may disfavour, including SBA loan guarantees for small business development, USDA loan guarantees for rural community facilities development, and HHS guarantees for health-care facility construction. These three policies have all been used in conjunction with NMTCs projects to incent private investment.

Green bonds, like those issued by the World Bank, offer investors bonds that carry the World Bank credit rating and target alternative energy production and energy efficiency strategies in infrastructure and real estate investment. Institutional asset owners in the U.S., including the State of California, have invested in these green bonds as part of their broader climate strategies, and they offer useful lessons for policymakers.

Credit guarantees were also a critical element of the response to New York City's financial crisis in 1975, when Felix Rohatyn, an experienced banker at Lazard Frères, engineered a solution to the city's potential debt default that can serve as a useful paradigm of targeted investing. Mr. Rohatyn struck a deal among public officials, unions, and pension funds allowing the city to issue debt to meet its immediate cash flow needs. Pension funds purchased these bonds, in effect using their investment strategies to resuscitate the stumbling city economy. From the pension funds' perspective, the key to the deal was a public guarantee for the debt issued by the federal government.

This extreme case highlights some important implications for engaging institutional investors. The funds here had clear interest, in the service of their beneficiaries, in helping stabilize the financial environment that determined how they and their beneficiaries would thrive over time. Even so, the public policy intervention, which provided a guarantee for the debt, was necessary to make the deal work. Pension funds, despite their obvious interests, could not shoulder the uncertainty of the debt issuance alone given the volatile market conditions for municipal debt at the time (Rohatyn 2010). We should note that, for many, the case also serves as a cautionary tale, when the politics of reform allowed private interests to take control of public assets (Henwood 1998).

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Engagement strategies

While institutional asset owners have the potential, through their investments, for delivering social and environmental impacts at scale, for public policy to help achieve this goal, it must take into account the nature of asset owners as investors and, in the near term, overcome investor perceptions of impact investing as a new, idiosyncratic, or niche market.

The supply and directional approaches outlined herein are useful tools for locating and understanding the role of government in targeted investment markets. The framework can be applied across stakeholder groups, issue areas (like affordable housing or business finance in underserved markets), or geographies to better analyse the interplay of a broad range of policies and their effects.

The benefit of focusing on one class of practitioners in this research – institutional asset owners who sit squarely on the supply side of the continuum – is that it reveals more concrete strategies for investor engagement. These strategies focus policy on the specific challenges government can address for institutional asset owners and bring an important 'user-oriented' perspective (Figure 2).

Specifically, policymakers are faced with three overarching challenges when seeking to grow the activity of institutional asset owners in impact investing:

- Impact investment markets that are of interest to institutional asset owners may be unfamiliar, small, or unconventional in design;
- Most asset owners invest primarily through intermediaries – the asset owners themselves have limited control over the design of products and limited capacity to target impact; the intermediaries in whom they invest may themselves be skeptical or unlikely to pursue non-financial objectives; and
- Impact investing market infrastructure is underdeveloped, leaving fewer opportunities for investment.

Policies that respond to each of these challenges often share a similar user or target group: Investors, where an 'enabling' strategy is needed to provide flexibility and investability in target markets; established intermediaries, where an 'integrative' strategy can be used to

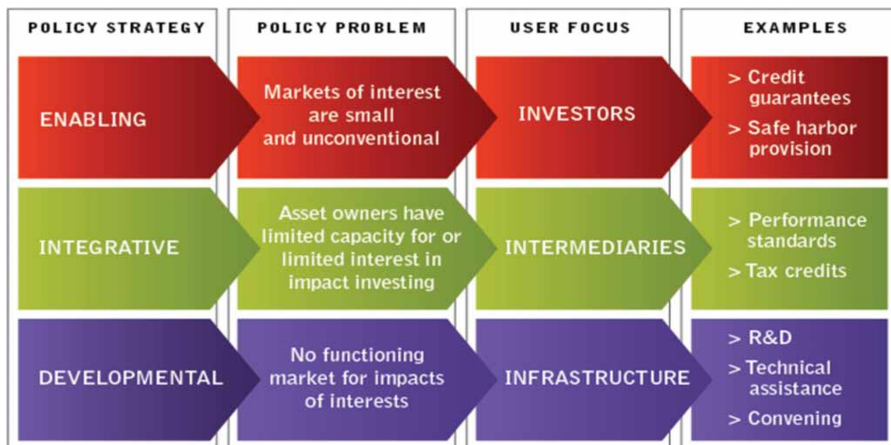

Figure 2. Engagement strategies for institutional investors.
Source: Wood, Thornley, and Grace (2012).

deliver impacts through traditional markets that achieve public purposes regardless of investor motivations; and market infrastructure and new or emerging intermediaries, where a 'developmental' strategy can be used to support nascent impact investing opportunities.

The enabling strategy: a focus on investors

Numerous institutional asset owners in the U.S. are interested in taking up impact investing or are actively integrating ESG analysis into their strategies in ways that may lead them to impact investing. But they report a number of barriers to turning theory into practice in the form of concrete impact investments. In interviews, they describe impact investments as unconventional, new, small, or policy dependent, all of which may increase perceived risk.

Policymakers can target such investors directly by implementing policies that reduce real or perceived risks, or that provide asset owners with additional legal flexibility to make impact investments more investable.

Such policies might include clear federal legal interpretations of fiduciary duty or safe harbour laws that confirm that impact investments, and the consideration of social and environmental benefits, are not barred by fiduciary duty. Such policies might reduce uncertainty for investors who occasionally report concern about fiduciary barriers to impact investing. State laws that allow for economically or environmentally targeted investment from public pension funds are another example. Policymaking at the state and local levels – where government best understands the appropriate fit between social and environmental impacts and the interests of fund beneficiaries – can open the door for institutional investors to consider double- or triple-bottom-line investments in underserved areas and communities. These policies have played important roles in catalysing specific impact investing markets. Loan guarantees from all levels of government that reduce risk for new or unfamiliar products can also catalyse the development of innovative markets, alternative energy production, or affordable housing.

The fundamental principle here is that the right policies can help shape idiosyncratic investments to match more closely the sorts of markets that institutional asset owners are already equipped to evaluate.

The integrative strategy: a focus on intermediaries

Many institutional asset owners report a relatively limited set of impact options that meet their investment criteria. More broadly, they may be skeptical of investments with social objectives, or they may have little interest or capacity to adopt impact investment strategies.

Policymakers can address this problem by identifying ways in which policies can build social impact into conventional investment vehicles. This approach can make the asset owners' intentions less relevant to the process of impact investing by making the social outcome something of a fait accompli.

In this strategy, established intermediaries are the focus because they play the critical role in bringing conventional investment opportunities to institutional asset owners. They will continue to do so until new, more impact-oriented intermediaries become 'institutional quality', with the requisite years of experience and performance track record.

For institutions with an interest in impact investing, an integrated strategy will expand the universe of investments with which to accomplish their objectives. For institutions with no interest in impact investing, the investments they are already making can be leveraged by government to achieve public purposes. Examples here include tax credits, labour and environmental standards, or mandates for investment by intermediaries in impact.

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The developmental strategy: a focus on market infrastructure

Beyond specific efforts to make impact investments investable, or to build social impact into investment markets, are policies that lay the groundwork for successful institutional investor engagement. Public policies can support a more robust market infrastructure in a number of ways to catalyse asset owner participation in impact investment.

By forging new relationships, creating additional data and evidence, supporting the development of products and platforms, and providing assistance to new intermediaries and other service providers, government can benefit institutional asset owners by building a pipeline of future, investable impact markets.

Such policies might include:

- Supporting high-impact enterprises. Technical assistance for small businesses in underserved communities is a prototypical example of policies that can help prepare high-impact enterprises to receive and leverage institutional capital.
- Incorporating social impact into public investment and purchasing strategies. This might mean incorporating labour or environmental standards into public procurement policies and the establishment of public–private partnerships. This form of direct public investment can build an impactful marketplace that extends to asset owners.
- Developing standards and support for systems of measurement. Though private investment may not be targeted in a particular case, establishing social impact criteria and measurements can play an important role in bringing standards and rigor to impact investment. Interagency collaborations like the Sustainable Communities Initiative (a joint programme of the Department of Housing and Urban Development, the U.S. Environmental Protection Agency, and the U.S. Department of Transportation) may play an important role in setting performance standards that will ideally inform better coordination of public investment in infrastructure, transit, and housing. Along a similar line, policies that recognize and support high-impact organizations, such as B-Corporations, can help normalize a vision for high social performance in the private sector.
- Convening multiple stakeholders. By bringing together public, private, and nonprofit stakeholders around specific social issues that could be addressed through private investment, government can bridge knowledge and cultural gaps and develop critical institutional relationships. For example, The Federal Reserve Bank of Boston has been collaborating with the Financial Innovations Roundtable at the University of New Hampshire on a series of initiatives and research activities around community development finance and the barriers to addressing financial needs in low-income communities (The Carsey Institute).

Developing the market for impact investment is a strategy that is likely to require some time to fully engage private market investors. Without such a strategy, however, policies that make impact markets investable or that build impact into particular investments will be more difficult to design, implement, and maintain.

Conclusion

In this article we describe institutional asset owner investment strategies that resemble impact investing as defined by those who self-identify in that field, even if the investors in question describe their own practice by other names such as responsible investment, mission-related investment, or ETI.

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While limited in number, the diversity of these strategies across institutional type, geography, and ancillary objective provide a solid foundation on which the impact investing community and policymakers can build when engaging with institutional asset owners.

However, the engagement must begin with an understanding of the shared characteristics of institutional asset owners – from overlapping fiduciary duties to an investment culture shaped by portfolio strategies and delegation to service providers.

As a starting point for policy development, policymakers might focus on the social and environmental impacts that 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 case can be made for policy that addresses the legal and market barriers that suppress this activity. The ETI policies in 20 U.S. states are illustrative.

There are many tools at the disposal of policymakers when interacting with 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 committed institutions; building social impact into intermediaries expands the range of investments that create social impact, regardless of asset owner motivations; 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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Notes

1. See, for instance, the work of Tessa Hebb, Lisa Hagerman, and Gordon Clark from the Oxford Pension and Worklife Program at http://urban.ouce.ox.ac.uk/research.php.
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4. The F.B Heron Foundation. *Mission-Related Investing.* www.fbheron.org/programs/investing.html
5. Meyer Memorial Trust. *Mission Related Investing*. www.mmt.org/node/901
6. For more on mission investing see www.moreformission.org
7. For illustrative examples see our report *Impact at Scale*.
8. 29 U.S.C. § 1104 : U.S. Code – Section 1104: Fiduciary Duties.
9. 29 C.F.R. § 2509.94-1. Economically Targeted Investments (Social Investing).
10. 29 C.F.R. § 2509.08-1. Supplemental guidance relating to fiduciary responsibility in considering economically targeted investments.
11. *H.R. 402- National Infrastructure Development Bank Act of 2011*. www.opencongress.org/bill/112-h402/show

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