LEGAL FRAMEWORK FOR IMPACT: SUMMARY REPORT

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INTRODUCTION

On Tuesday 25 June, the PRI hosted a policy conference: ‘Investing for sustainability impacts and advancing the UK transition’. During the first half of the event the PRI, the Generation Foundation and UNEP FI launched the summary report Long-term value creation in a changing world which concludes the implementation stage of the Legal Framework for Impact (LFI) programme. This briefing is a synopsis of the speeches and panel discussions about the summary report.

HISTORY OF A LEGAL FRAMEWORK FOR IMPACT

The morning began with Grace Eddy, Director of the Generation Foundation, providing an overview of the project’s history beginning back in 2005 with the initial “Freshfields’ report”. This legal analysis, commissioned by UNEP FI, showed that ESG integration was not a violation of fiduciary duty, rather the opposite - failure to consider material factors is itself a failure of fiduciary duty. Ten years later the partnership between the Generation Foundation, PRI and UNEP FI began with the Fiduciary Duty in the 21st century project. This multi-year programme aimed to identify and address policy and market barriers to ESG integration.

During its lifespan over 400 sustainable policy instruments were implemented worldwide, some of which drew from the project’s research. However, despite this success, it became clear that the integration of material ESG factors in investment decisions is not sufficient to drive the economic system change needed to achieve the Sustainable Development Goals (SDGs) and the Paris Agreement target. A shift in thought process was required: from “how do investors manage the effect of ESG risks/opportunities on their portfolios?” to also “how can investors ensure portfolios have positive impacts in the world?”.

The Legal Framework for Impact Report, authored by Freshfields Bruckhaus Derringer, explored across 11 jurisdictions how far current legal frameworks require or permit investors to pursue positive sustainability impact goals in their investment activities. The report found that mainstream investors are generally required to consider whether climate change and other sustainability factors could affect their financial goals and are permitted and in many cases required to pursue positive sustainability outcomes.. The address ended with a reminder that “legal analysis alone is not sufficient, NGOs, investors and policymakers need to work together to make change happen.”

DESIGNING AN INVESTMENT PRODUCT TO ADDRESS SYSTEMIC RISK

The keynote address from Clara Barby, Senior Partner at Just Climate, started by emphasising that all investors should feel empowered to set goals and take action to pursue positive sustainability impacts through asset allocation, stewardship and policy advocacy. The specialist investor has applied the design principles laid out by LFI: to have a rationale, set objectives, and take actions (all of which underpinned by measurement). They shared several lessons learnt undertaking this process.

Firstly, in pursuing decarbonisation, Just Climate’s investment team conducts research to understand not only potential for highest GHG emissions abatement but also the potential unintended consequences for other sustainability issues. For example, some approaches to decarbonisation, such as biomass solutions, may risk land use change and competition with food security. This analysis requires multi-disciplinary investment teams with wider skill-sets than typical asset managers. This requires multi-disciplinary teams with wider skill sets than typical asset managers.

Furthermore, having a sustainability impact lens has enabled Just Climate to identify new opportunities, across all asset classes. Businesses with the highest positive climate impact have huge growth potential especially with the right market and policy tailwinds.

THE LEGAL FRAMEWORK FOR IMPACT FINDINGS

David Rouch, Partner at Freshfields, presented the key findings of the 2021 report, A Legal Framework for Impact, which demonstrates how legal duties can permit or require investors to take steps to bring about positive sustainability outcomes, focusing specifically on the threat that sustainability factors pose for the future resilience of economic systems. It is important to look at both the 'black letter' of the rules and the circumstances in which they are being applied to understand what an investor is permitted or required to do. From that perspective, areas of challenge currently facing investors include:

- the need to make business and investment decisions by reference to things 'as they are' (for example, where the market is not pricing in a net zero outcome that is optimal for the investor) while concurrently pursuing a world as it needs to be. There comes a point at which the two come into conflict and, in practice, things as they are can tend to win out;
- the need to build everyone's confidence in connecting individual actions with the project of tackling core sustainability challenges which requires high levels of society-wide engagement, including from the multitude of individual operators. No individual operator can move the dial on systemic risks or generate measurable benefit for the relevant operator so, at first blush they may assume they cannot act; and
- the need further to strengthen the enabling framework for those seeking to bring about positive sustainability outcomes, such as the availability of the information, methodologies and frameworks they need to take action. There is already plenty for investors to be working with, and there are limits to how far radical uncertainties can be reduced, but still more is needed.

LFI SUMMARY REPORT: LONG TERM VALUE CREATION IN A CHANGING WORLD

Sustainability outcomes are highly relevant for most investors, because economic prosperity and investment returns ultimately depend on the healthy functioning of natural and social systems, especially over the long term. This raises the question "how can investors play their full role in seizing opportunities, mitigating risk and safeguarding financial returns through the pursuit of sustainability goals?". PRI provided an overview of the LFI summary report which highlights current examples of how its signatories are doing this by stewarding goal-oriented funds. More extensive case studies can also be found on the PRI's website.

Regulators and policymakers are increasing efforts to incentivise behaviour change, implementing enabling measures for investors to monitor and disclose sustainability outcomes, mitigate sustainability risks, and contribute to sustainability goals. However, despite the increasing range and depth of enabling policies, real and perceived barriers still exist meaning established investment practice is not evolving fast enough. Policy recommendations in this summary report, including to continue to clarify legal duties where necessary, aim to facilitate and accelerate investor action.

PRACTICAL STEPS TO INVEST FOR SUSTAINABILITY IMPACT

The first panel featured two case studies of funds implementing sustainability impact goals into their practices. Speakers from Brunel Pension Partnership, NOW: Pensions and Canbury Insights shared practical steps such as engaging managers on alignment with objectives, continually monitoring and modifying objectives to ensure transparency, and highlighting the importance of policy engagement. It was also discussed how important the LFI report has been in shifting mindsets around investing for sustainability impact as historically Brunel and NOW: Pensions have faced resistance due to conservative legal interpretations.

The session began with a presentation on how Brunel is actioning their portfolio-level sustainability goal to align 100% of AUM with net zero by 2050. A detailed case study can be found here. Brunel has taken a systemic approach to look at investment risk and opportunities and map seven priorities, such as addressing climate change, with relevant SDGs. For each priority, Brunel has set targets against 5 pillars (policy, products, portfolios, positive impact, and persuasion) and uses these targets to assess all their products. Throughout this process Brunel measures and evidences outcomes by using frameworks such as the Transition Pathway Initiative (noting that there are still challenges with measuring where real world solutions will have positive impact).

NOW: Pensions then presented their work towards their portfolio-level sustainability goal to close the gender pay gap and gender pensions gap which is one of the Trustee's three sustainable themes (the others being climate and living wage). There is a detailed case study on PRI's website. NOW: Pensions shared the policy recommendations used in their engagement with the UK government for fairer UK pensions, and the steps taken to ensure higher quality engagement with investee companies. The latter process involved engaging with their third-party managers to determine how aligned their beliefs are and how managers have engaged with investee companies and voted at AGMs. The results showed there was inconsistency of engagement with the Trustees' investment beliefs/themes and engagement framework. In order to better align Trustee beliefs and themes with the stewardship of assets has led NOW: Pensions to bring the management of their equity portfolio in-house. The in-house investment manager now votes and engages with investee companies in-line with the Trustee's beliefs and priorities including gender equality.

Canbury explained the four-part framework for Investing for Sustainability Impact (IFSI), derived from the LFI report. This approach begins with determining intention, where investors establish their rationale and consider systemic risks and opportunities. Next, investors set specific, time-bound sustainability goals aligned with their intention. The third step involves taking action through various means such as strategic asset allocation, stewardship activities, and policy engagement. Finally, investors measure and communicate progress towards their goals, using appropriate metrics or narratives. Canbury emphasised the importance of aligning actions with stated intentions and considering the degree of influence of different actions.

PROGRESS ON THE LFI POLICY RECOMMENDATIONS

The second panel discussion focused on how current policies are supporting investors to pursue sustainability impact and what more can be done to address ongoing barriers. A diverse range of perspectives were provided with panellists from the European Insurance and Occupational Pensions Authority (EIOPA), Impact Investing Institute (III) Board, and International Financial Reporting Standards (IFRS), enabling a global view as well as a deep dive into UK and EU policy frameworks.

The discussion started with an overview of the policy framework in the UK. Despite some recent changes such as the implementation of the Sustainability Disclosure Requirements (SDR), the Transition Plan Taskforce (TPT) and guidance from the Financial Markets and Law Committee

(FMLC) there is still a need for either permissive or prescriptive rules from the government to ensure a more enabling environment, particularly for undertaking collaborative action. Panellists focused in on the 2024 FMLC paper which clarifies current law and confirms that pension schemes should consider sustainability issues as financial factors. The paper is clear that if trustees take a decision properly, they should not fear liability as there are a range of appropriate decisions that can be taken. Investment decisions operate within the wider financial system, therefore a long-term view is particularly important as issues that aren't immediately financial can become so. The discussion also touched on how the review of the UK Stewardship Code is an excellent opportunity to embed stewardship and engagement as part of everyday investment decisions, as well as increase the motivation to engage policymakers as part of stewardship practice.

The EU context for pension funds was also provided. It was described how double materiality has been embedded in the EU framework, yet there is still a need to increase beneficiaries' understanding of sustainability. It was also pointed out that more can be done in relation to stewardship to ensure that preferences are integrated, and pensions funds are improving their engagement. Although the EU does not currently have a stewardship code there are rules related to stewardship such as the SFDR due diligence statement that requires disclosure on the negative impacts, as well as corporate reporting requirements which help pension funds track whether their engagements are working. The panel also went through how the policy work by EIOPA relates to the overall objective of the EU Green Deal. There has been a lot done to incentivise more sustainable choices by investors particularly by facilitating more comparable data. Many rules have been established that should support system change, but capacity building is needed for supervisory authorities as well as investors to enable effective implementation.

Finally, effective and consistent corporate sustainability reporting is a key policy tool to enable investors to account for ESG risks but also understand and manage sustainability outcomes. The LFI summary report recommends that policymakers develop comprehensive sustainability disclosures which IFRS has helped to enable, most recently with the Inaugural Jurisdictional Guide for the adoption or other use of ISSB Standards and their commitment to deliver further harmonisation of the sustainability disclosure landscape the day before the event. The guide showcases a range of approaches that jurisdictions can take to adopt or apply ISSB standards. Investors can also use it to engage with policymakers. ISSB is also collaborating with IOSCO in developing economies on capacity building, and training regulators to ensure they have the skills to implement ISSB in their jurisdictions. Some of these jurisdictions are already adopting the standards such as Nigeria. Overall, more than 20 jurisdictions have started to adopt ISSB covering more than 55% of world GDP.

FINAL THOUGHTS

Sustainable investing is rapidly evolving as a result of the efforts across the economy to respond to the systemic sustainability challenges we all face. Policymakers have responded by implementing legislation and guidance to encourage responsible practices, while investors are increasingly aligning their portfolios with positive environmental and social outcomes alongside their financial objectives. During this event it was clear that attendees have moved on from asking the question of **whether** they have to do this to thinking about **how** they can make it happen. However, there is still more work to be done to embed investing for sustainability impact as the established best practice for investors. The PRI, the Generation Foundation and UNEP FI will continue to engage with both investors and policymakers to encourage faster and more comprehensive uptake of investment approaches that address sustainability outcomes.