Global Impact Forum Blog

Considering the imperative for impact management

By Rachel Lewis

This blog reflects on the all-stakeholder event on impact integration at the September 2023 Global Impact Forum (GIF)

How to apply the theory of change to develop impact-led investment thinking and policies

Drawing on the *Impact Management Platform's* recent piece on The imperative for impact management and the upcoming Taskforce on Nature-related Financial Disclosure (TNFD) inclusion of double materiality, the session posed the question:

How should asset owners, their advisers & managers approach impact integration?

Charlotte O'Leary, CEO and David Brown, Director and Training Lead at *Pensions for Purpose* set the scene by establishing the need for 'systems thinking' in impact investment. They argued that idiosyncratic risk builds when stakeholders do not consider the interconnectivity of their impact. For example, rather than just prioritising individual areas such as the legal and reputational risk of an investment, stakeholders should equally consider system-wide risks such as water scarcity, climate change and biodiversity loss. Currently, there is a belief transition risk, regulatory cost and the toll of adjusting to a non-carbon world are reflected in pricing. However, physical long-term risks such as flooding and biodiversity loss are typically under-appreciated.

Does the legal environment support a systems-thinking approach?

To encourage systems thinking, David argued the need for better sustainability-related disclosures and reporting. He positioned environmental, social and governance (ESG) as the 'outside-in' perspective, and impact and double materiality as including the 'inside-out' view. As measures such as the Taskforce on Climate-related Financial Disclosure (TCFD), TNFD and non-financial reporting disclosures become more established, David argued incorporating both perspectives would lead to better company valuations.

At the moment, the legal environment does not sufficiently support asset owners in impact management. While section 172 of the Companies Act (2006) outlines a director's responsibility for profit, it remains vague on their responsibility for people and planet. The Better Business Act seeks to address this gap by proposing legislative change to the Act.

Equally, referencing a recent *Financial Times*' article, David claimed attitudes are shifting and there is belief in an up-and-coming, significant correction to asset values as physical risk becomes greater realised. Likewise, Charlotte argued pensions funds represent one of the best forms of democratised finance and, so, the potential for effective governance structure to deliver impact is possible.

Theory of change

David defined the 'theory of change' as a roadmap to reach a desired outcome. More technically, it is how a given intervention leads to a specific developmental change. He evidenced the need to incorporate the theory of change in impact investment using the example of reforestation. Planting trees in isolation addresses sustainable development goal (SDG) 13 but, without completing an outcome framework, it risks ignoring important complexities. For example, those involved could grow on viable carbon capture environments such as peatlands, in areas prone to droughts or not plant in areas presenting an opportunity to significantly improve biodiversity. Equally, stakeholders should consider whether the land is then used for future logging and other less obvious, long-term effects on biodiversity.

Trustee perspective

Helen Shay, Non-Executive Director at the *Universities Superannuation Scheme (USS)*, noted that the *USS* and *University of Exeter* recently collaborated on No time to lose. Helen argued how this report marks the start of a paradigm shift in climate change scenario analysis and provides a radical, innovative approach which integrates asset owner investment decisions with a more thorough understanding of physical and transition risks. It rejects the assumption climate change effects happen gradually. Instead, it highlights short-term ramifications accounting for specific tipping points such as Atlantic Meridional Overturning Circulation (AMOC) – an urgent climate reality for investors to face.

The report provides a framework over varied time horizons to assess the resilience of assets and portfolios. Specifically, *USS* used the framework to interrogate their 2050 net-zero trajectory and concluded the need to at least halve their carbon emissions by 2030. She also shared that climate tilt affects £5bn of *USS*-managed assets, making the imperative for impact management in this case clear. Equally, Helen raised the point all investments fare better in environments with stable societies and climates, which encourages stronger gross domestic product (GDP), less mass migration and fewer conflicts.

Working with others

Where financially beneficial, *USS* also aim to reduce their carbon exposure and increase engagement with investee companies. They intend to create investment outlooks informed by scenarios of climate change, accounting for risks and opportunities, and developing services to help economies decarbonise. For example, they have invested nearly £2bn in clean energy and implemented a £500mn sustainable growth mandate which targets privately owned businesses.

Policymaker involvement

In slight contrast to the Imperative for Impact Management report, Helen placed greater focus on government and regulatory involvement. She asserted the need for strong alignment between impact and fiduciary duty. It is crucial enterprises seek to guide policymakers and regulators on ESG and impact management. This influence would be pivotal to achieving meaningful progress at speed. However, political incentives, such as the recent *Mansion House* reforms, could place competing pressures on asset owners for impact-led approaches.

In the coming years, given the recent focus placed on pension fund investment power by Jeremy Hunt, Helen predicts fiduciary duty boundaries could be stretched and, potentially, legal challenges mounted. Trustees should resist attempts to use schemes as instruments of government policy and focus on their members' best interests. Responsible investment which accounts for system-wide risk, impact management, corporate governance and a good financial return can all be aligned.

Breakout room discussion

Moderators from sponsors *Aon*, *Tikehau Capital and Goldmann Sachs Asset Management*, in their discussion with delegates, evidenced organisations building sustainability risk management and ESG into their approaches, but rarely considering impact. They argued 'the mainstreaming of impact management' is necessary to secure sustainable environmental and social outcomes, and to optimise the market's capacity to manage risks and opportunities. There is a focus on sustainability-related risks without questioning contributions to rising inequalities and ecological overshoot – inadvertently contributing to tipping point scenarios.

Likewise, delegates highlighted the need for collaboration between policymakers and asset owners to set best practice. Creating a framework with intentionality and additionality which can be measured and reported independently is paramount to align stakeholder interests. Evolvable, evidence-based substantiation of delivering impact on a full-portfolio perspective is a challenge, but one which could encourage momentum across the industry.

Discussion also included the US situational context of assets being removed from organisations too overt in their sustainability-driven motivations. This has bled into international markets as asset managers avoid explicit impact goals, which European investors typically seek, to avoid damage in US markets. In response, Charlotte posited systems thinking as a solution; a long-term mindset could avoid short-term, political drivers. However, she corroborated the need to refocus fiduciary duty in view of impact integration.

Systems thinking in impact investment – risk builds when stakeholders do not consider the interconnectivity of their impact

Conclusion

Charlotte concluded the session saying 'linear ideas about linear economies' are ineffective as they assume an infinite supply of natural resources, and an inability to value the presence of feedback loops and interaction effects. Systems thinking allows for a better understanding of the circular economy, planetary boundaries and the limits of exponential growth.

Systems thinking further provides the opportunity to recalibrate the system to meet impact-based, desired outcomes. She argued impact needs to be built into business models, core purposes, services offered and business operations. Only by using a systems lens, for example, can it be addressed that pension funds are universal owners of assets and by being underinvested in private markets, where some of the greatest innovation in climate adaptation and technology takes place, stakeholders are undervaluing risks and missing opportunities presented by climate change. To meet climate-goals, it is integral to continue developing the awareness and core beliefs of decision-makers. Simultaneously, we can acknowledge the onus on individuals and organisations to support the evidence-base and demand sustainable solutions based on the needs of society and the environment.

Click to read the synopsis and watch the recording of the event.

- ***Rachel Lewis is Event Coordinator at Pensions for Purpose.***