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INVESTING FOR SUSTAINABILITY IMPACT

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EXECUTIVE SUMMARY

Long-term investors who overlook sustainability outcomes or systemic risks may be neglecting crucial factors that are essential for protecting the investments of their beneficiaries or clients.

For this reason, institutional investors are increasingly undertaking investing for sustainability impact (IFSI). This shift is driven by evolving investor practice, changes in policy and regulations, and a growing recognition of the systemic risks and opportunities associated with issues such as climate change, biodiversity loss, and human rights.

This guide introduces a four-part framework for investors to implement IFSI, drawing on the findings of the report, A Legal Framework for Impact.

The four parts are:

1. Determine the investor's intention, including beliefs, financial return goals, and how real-world sustainability impact contributes to and results from those beliefs and financial return goals.
2. Set real-world sustainability goals that align with intentions.
3. Take action through capital allocation, stewardship, and policy engagement, which are best used in combination.
4. Measure and report on progress.

In addition to the actions an investor might take, this guide considers the degree of influence of those actions, potential KPIs, and how to get started. For example, escalation in stewardship or real-economy policy engagement may be highly effective in pursuing sustainability goals.

Putting this framework into practice is not without its challenges.

Complex intermediation chains and misaligned incentives can hinder the achievement of goals. Corporate lobbying may conflict with investors' goals, and the long-term nature of sustainability outcomes can be hard to capture within traditional investment time horizons. This guide explores these challenges and provides insights into potential solutions.

Alongside this guide, we encourage the review of asset owner case studies, which we have published to demonstrate IFSI in practice.

INTRODUCTION

This report was created to provide guidance to PRI signatories – both asset owners and investment managers – on investing for sustainability impact.

Published in 2021, a Legal Framework for Impact (LFI) found that, in the jurisdictions analysed, investing for sustainability impact, which we abbreviate as IFSI, is consistent with fiduciary duties and, in many cases, required.

IFSI occurs when asset owners and/or their investment managers take action to pursue a sustainability impact goal.

To support the development of the legal analysis, the LFI report identified two approaches to IFSI. IFSI pursues a real-world sustainability goal, either to achieve financial goals and fulfil legal duties (instrumental IFSI), or in parallel to such objectives (ultimate ends IFSI). In more detail:

1. In instrumental IFSI, achieving the sustainability impact goal is 'instrumental' in realising the investor's financial return goals. This could include pursuing a sustainability goal intended to reduce a systemic risk or address the drivers of financially material, system-wide sustainability risks (or take advantage of a systemic opportunity) to help an investor achieve their financial objectives.
2. Ultimate ends IFSI is where achieving the sustainability impact goal is pursued as an end in itself, alongside the investor's financial return goals. This could include an investor's pursuit of a sustainability goal irrespective of its potential contribution to their financial goals.

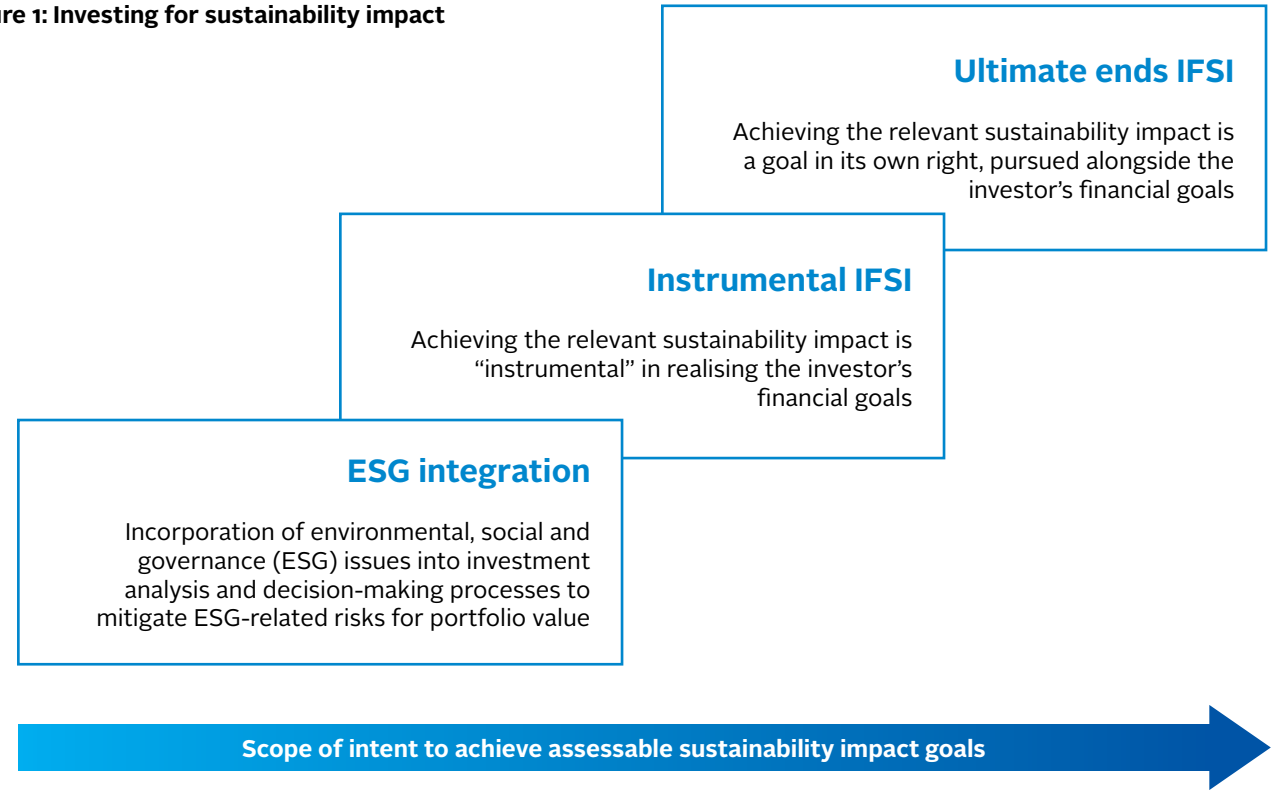
IFSI is related to but different from what is commonly termed 'ESG integration'. ESG integration is the practice of using sustainability data to inform investment decisions. That process may not involve the intent to have a positive impact. When it does, the intention to have an impact and the associated actions would be considered IFSI.

"If an asset owner or investment manager concludes, or on the available evidence ought to conclude, that one or more sustainability factors poses a material risk to its ability to achieve its financial investment objectives, it will generally have a legal obligation to consider what, if anything, it can do to mitigate that risk (using some or all of investment powers, stewardship, policy engagement or otherwise) and to act accordingly."

'A Legal Framework for Impact: sustainability impact in investor decision-making', Freshfields Bruckhaus Deringer, 2021 - p14[1]

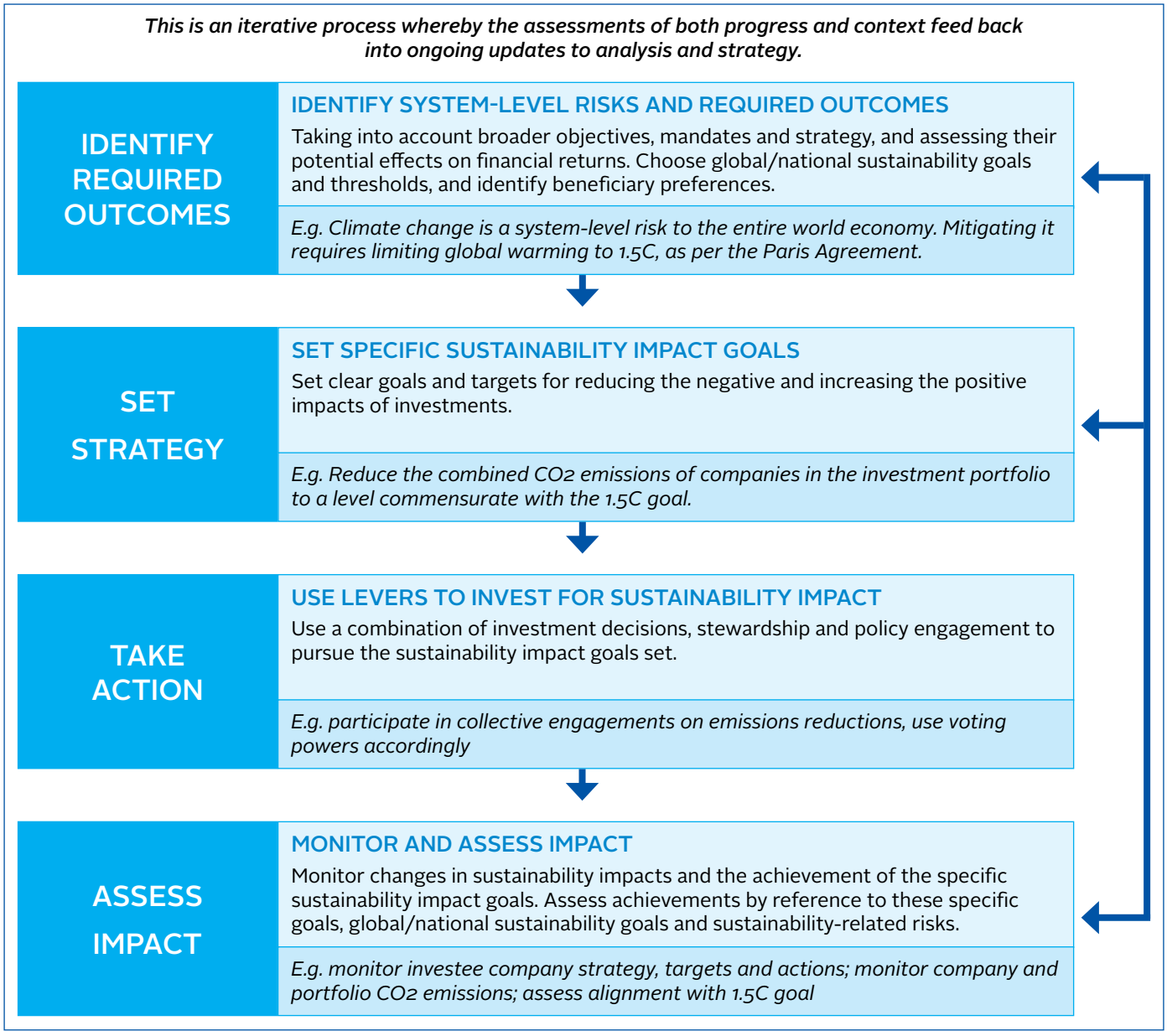
1 https://www.unpri.org/policy/a-legal-framework-for-impact/4519.article

Figure 1: Investing for sustainability impact



This guide does not replay the legal arguments set out in LFI. Rather, it provides guidance to investors on IFSI.

We recognise that IFSI is not market-friendly language.[2] We believe that it is best expressed through the actions involved. This report introduces four main steps, adapted from the insights found in the LFI report:



Because not all actions are equally influential, within the third step, 'Take action', we also encourage investors to consider 'influence' – the extent to which their actions influence progress towards the real-world sustainability goal.

Finally, we consider some of the challenges in implementing IFSI.

2 The legal researchers used the term as a conceptual framework to capture whether a specific set of behaviours was permitted or required. IFSI includes asset allocation, stewardship and policy advocacy.

BACKGROUND TO SUSTAINABILITY IMPACT

This section provides a detailed explanation of the concepts, how they are increasingly supported by regulation, their relation to double materiality, systemic risks and opportunities, impact investing, and where IFSI fits within investment processes.

IMPACT IN POLICY FRAMEWORKS

While IFSI may be relatively new to some investors, 'real-world' impact is increasingly a feature of both investment practice and policy frameworks, reinforcing LFI's findings.[3]

For example, dating back to March 2018, the European Commission, in its action plan on sustainable finance, said: 'The action plan on sustainable finance adopted by the European Commission has 3 main objectives:

- Reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth
- Manage financial risks stemming from climate change, environmental degradation, and social issues
- Foster transparency and long-termism in financial and economic activity.'[4]

All three of the European Commission's objectives are significant to IFSI, particularly the first, 'achieve sustainable and inclusive growth'. In the action plan, European policymakers are not only talking about sustainability as an input to investment decision-making but also as an outcome that investors pursue.

Similarly, the UK FCA, in its consultation paper for its Sustainability Disclosure Rules, CP22, said in October 2022:

- 'Consumers must be able to trust sustainable investment products. Consumers reasonably expect these products to contribute to positive environmental or social outcomes.'

There are examples of financial regulators considering real-world impact in many other countries, which can be found in the PRI's Regulation Database.[5]

DOUBLE MATERIALITY, DUAL OBJECTIVES, AND 'INSIDE OUT'

Interpretations of double materiality may vary depending on geography and investment strategy.

For example:

- The European Commission introduces the terms 'outside in' and 'inside out' when discussing double materiality. The 'inside out' framework considers the external impacts a company's operations have on the environment and society.
- The Impact Management Project (IMP) refers to single, systemic, and double materiality. Single materiality focuses on the financial impacts of environmental and social issues on an organisation. Systemic materiality considers the broader system-level effects. Double materiality combines these perspectives, evaluating both the financial implications for the organisation and its broader societal and environmental impacts.

When introducing impact, some consider this double materiality, where investors pursue two objectives: a financial objective and a real-world impact objective. However, IFSI may not always constitute double materiality.

This is particularly true for instrumental IFSI, which may be better understood as aligned to 'single materiality'. Though the terms are used differently by various groups, single materiality is generally used in pursuit of financial objectives. Instrumental IFSI is when an investor pursues a sustainability outcome in order to meet a financial objective, i.e. to manage the 'outside in'.

In this case, while the investor looks through the investment to the real world (inside out) and considers how capital allocation, stewardship, and policy engagement may contribute to their intentions and goals, the primary aim of pursuing the sustainability outcome is to achieve financial objectives.

That said, single materiality, double materiality, inside-out, and outside-in perspectives are interpreted in different ways, across different contexts, and are often not explicitly defined in law, and so we suggest applying them with caution.

3 Real-world here refers to something that happens in the real economy, relating to the environment and society and often linked to corporate activity.
4 https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52018DC0097
5 https://www.unpri.org/policy/global-policy/regulation-database

SYSTEMIC AND SYSTEMATIC RISKS AND OPPORTUNITIES

Often, the route to a real-world sustainability impact is through addressing systemic risk and/or systematic risk, particularly in jurisdictions where sustainable finance policy is still in development or has less political support.

- Systemic risk is the risk of a breakdown of an entire system, rather than the failure of individual parts, due to the interconnectedness and interdependencies of the system.
- Systematic risk (interchangeable with 'market risk' or 'market-wide risk') refers to risks transmitted through financial markets and economies that affect aggregate outcomes, such as broad market returns. Because systematic risk occurs at a scale greater than a single company, sector, or geography, it cannot be hedged or mitigated through diversification.

Climate change is an example of a systemic risk because its widespread and severe impacts can disrupt and destabilise interconnected ecological, social, and economic systems. Investors (both asset owners and asset managers acting on their behalf) with diverse portfolios spanning multiple industries and asset classes may consider themselves universal owners. As such, they have a unique role to play in addressing systemic risks like climate change.

Each individual company maximising shareholder value may not necessarily lead to the best financial outcome for an investor's overall portfolio over the time horizon of the investment. For example, if one company is doing something that maximises its own value but is detrimental to other companies in an investor's portfolio, or the economy as a whole, it may be in the investor's interest to take action.

If this detrimental action was related to, for example, high greenhouse gas (GHG) emissions that exacerbate the financial risks from climate change, the investor might pursue a real-world climate goal, like decarbonisation, to reduce systemic risks and meet their financial goal.

While, in some cases, this may seem at odds with directors' duties (the duties of the company directors), a misalignment between an investor's duties and a company's directors' duties – at least in the short-term – may suggest a market failure. In response, the investor's action could be policy engagement, rather than (or as well as) company engagement. For additional insights on the interplay between investors' fiduciary duties and company directors' duties, we recommend reviewing the materials prepared by The Shareholder Commons.[6]

IMPACT INVESTING

IFSI is much broader than what would traditionally be classed as impact investing. It involves a perspective and set of practices that extend beyond impact investing.

Impact investing is the intention to generate a positive, measurable social and/or environmental impact alongside a financial return.[7] It generally involves using specialist funds to direct capital towards activities with specific sustainability goals, with a credible expectation that the investor will play a contributory or catalytic role in generating an improvement.

IFSI describes a wider category of investment approaches that can be applied to broader portfolios, with an emphasis on a range of actions an investor can take, such as capital allocation, stewardship, and policy engagement.

That is not to say, however, that impact investment is not relevant – it is. Impact investment has been integral in paving the way by creating the tools and best practices for setting and pursuing impact goals and measuring progress against them.

6 https://theshareholdercommons.com/

7 CFA, PRI, and GSIA (2003) Definitions for Responsible Investment Approaches

WHERE IFSI FITS WITHIN INVESTMENT PROCESSES

IFSI doesn't apply to just one part of an investor's portfolio. It applies across investment processes and asset classes, enabling investors to better align their strategies (and the available levers) with the pursuit of sustainability outcomes.

ESG integration is the process of identifying and integrating the material risks and opportunities associated with an investment into its risk and return profile. For example, the use of emissions curves to determine how a company might perform under different climate scenarios to establish its likely long-term profitability.

IFSI does not negate the need to assess a company's material ESG risks and opportunities. The LFI report elaborates on ESG integration, stating that, where investors are able to do so, their duties are to take action to address risks and opportunities. The report explains how investors should be assessing risks and opportunities, reporting on them, and taking actions to address them.

Investors should take the following steps:

- Conduct analysis of sustainability-related risks and opportunities (including systemic risks and opportunities) that could affect investment processes. Reports such as the World Economic Forum's Global Risks Report[8] or the PRI's work on sustainability issues[9] serve as useful starting points for this assessment.
- Recognise the obligation to act upon risks and opportunities. This obligation stems from the investor duties to consider sustainability factors relevant to their investment objectives.
- Identify the sustainability-related risks and opportunities that investors can influence through their investment decisions and activities, including capital allocation, stewardship, and policy engagement.
- Evaluate the feasibility of taking action on risks and opportunities, considering factors such as resource availability, expertise, and potential impact. Prioritise those deemed most reasonable and impactful for the investor to address.

In addition to addressing systemic risks and opportunities, investors may also pursue sustainability impact goals that align with their 'ultimate ends' objectives. These objectives may be determined by factors such as:

- Client demands and preferences for sustainability outcomes.
- Country-level requirements, such as anti-money laundering (AML) guidance or restrictions on investments in controversial weapons.
- Specific regulatory requirements, such as the sustainability objectives mandated for pension funds.

The process of identifying and prioritising these 'ultimate ends' objectives should follow a similar approach. Once a set of objectives, along with associated rationales, has been established, investors should follow the process for implementing IFSI, as outlined below.

BOX 1: EXAMPLES OF REAL-WORLD SUSTAINABILITY IMPACT LINKED TO FINANCIAL VALUATION IMPLICATIONS ('INSTRUMENTAL IFSI')

- **Reducing CO2:** Investing in companies actively reducing CO2 emissions can mitigate physical risks, such as changing weather patterns. Reducing these GHG emissions could also reduce the portfolio impact of regulatory and transition risks.[10]
- **Preserving Forest Cover:** Investments that prevent deforestation can contribute to biodiversity, climate stability, and ecosystem services, thereby reducing physical and reputational risks and attracting consumers and investors focused on sustainability.
- **Increasing the Recycling and Reuse Rate:** High rates of recycling and reuse indicate operational efficiency and resilience, reducing resource costs and exposure to raw material price volatility, thereby enhancing financial performance.
- **Improving Healthcare Access:** Investments that improve healthcare access can lead to healthier communities, enhancing workforce productivity and consumer markets and reducing healthcare costs, thereby contributing to stable and sustainable economic growth.
- **Fair Labour Practices:** Adhering to fair labour practices, such as providing living wages, can benefit society by improving social stability and cohesion.

8 https://www.weforum.org/publications/global-risks-report-2024/
9 https://www.unpri.org/sustainability-issues
10 See the Inevitable Policy Response for further analysis.

BOX 2: ASSOCIATED TERMINOLOGY

- **Goal/Objective:** These are aspirational outcomes that individuals or groups aim to achieve. Goals tend to be broad, general intentions, while objectives are more precise, measurable steps to achieve these goals.
- **Commitment:** This indicates a pledge or promise towards achieving a specific goal or objective, often within the context of formal agreements or collaborative efforts.
- **Target:** Targets are specific and quantifiable, designed to measure progress towards achieving a goal or objective within a specified time frame.
- **Systemic Risk:** Refers to the risk posed by the breakdown of an entire system, rather than the failure of individual parts, due to the interconnectedness and interdependencies of the system.
- **Systematic Risk:** Systematic risk (interchangeable with 'market risk' or 'market-wide risk') refers to risks transmitted through financial markets and economies that affect aggregate outcomes, such as broad market returns. Because systematic risk occurs at a scale greater than a single company, sector, or geography, it cannot be hedged or mitigated through diversification.
- **Sustainability Outcomes:** Refers to the positive or negative effects of an activity, whether intentional or not. In this context, sustainability outcomes are those resulting from investor activity.
- **Sustainability Impacts:** Refers to measurable changes in sustainability outcomes that an investor has some causal role in, whether intentional or not. (Outcomes and impacts tend to be used interchangeably.)

A FOUR-PART FRAMEWORK FOR INVESTING FOR SUSTAINABILITY IMPACT

DETERMINE INTENTION

First, the investor should establish their intention or rationale. This includes the investor's beliefs, financial return goals, and how real-world sustainability impact contributes to and results from those beliefs and financial return goals.

The investor should consider systemic risks and opportunities relevant to financial return goals, and the risks and opportunities over which the investor has influence. In addition – relevant to ultimate ends IFSI – the investor may consider sustainability outcomes in their own right, for example, based on their relevance to client or beneficiary preferences.

Examples:

- Take action to address non-diversifiable portfolio-level risks (such as climate change).
- Minimise costs associated with negative environmental impact, such as regulatory penalties.
- Respond to consumer and regulatory pressure on sustainability issues.
- Contribute to societal resilience and stability.

The intention should be disclosed, as well as the systemic risks and opportunities considered, but action should be excluded where the investor has determined that it is not possible to influence.

SET GOAL

Having established an intention, the investor should set a sustainability goal (or goals) that support it. Sustainability goals are best when they are time-bound and specific.

Examples:

- Reduce GHG emissions in the real world, aiming for net-zero emissions by a specified date.
- Address the causes of forest loss and promote sustainable land use practices.
- Minimise waste through the reuse, recycling, and reduction of resources.
- Expand access to healthcare, promote physical and mental health, and enhance overall quality of life.
- Address human rights abuses and uphold and promote human rights standards.

TAKE ACTION

The actions or processes undertaken by the investor to achieve the goal.

Examples:

- Strategic asset allocation to achieve the sustainability goal.
- Manager selection, appointment and monitoring to work with managers that invest consistent with the goal.
- Stewardship to change company behaviour.
- Policy engagement to address policy barriers.
- Direct investments in solutions.
- Exclusion of investments that conflict with the sustainability goal (coupled with a belief that this may affect the license to operate or alter the cost of capital for the divested companies or sectors).

Actions and influence are covered in more detail below.

MEASURE PROGRESS

While measuring the quality and quantity of sustainability actions – such as capital allocation, stewardship, or policy engagement – is relatively nascent, this does not negate its relevance to investment processes. IFSI is about investors' contributions to societal goals, either motivated by portfolio financial goals (instrumental IFSI) or parallel motivations (ultimate ends IFSI). Assessing progress and communicating it to stakeholders is crucial, but investors should not restrict their actions to those that are easily measurable. Often, particularly when involving policy change and collaborative stewardship, investor contributions to such large goals will be measured at the broader economy level, where precision may be neither possible nor desirable. Instead, the use of narratives to describe efforts and progress may be most useful.[11]

In other circumstances, like when an investor allocates capital to solutions or engages in targeted stewardship efforts, more precise measurement may be possible. Examples of these more precise metrics might include:

- CO_2 Reduction: This metric, measured in tonnes of CO_2 equivalent reduced or avoided, assesses the effectiveness of decarbonisation efforts. Example frameworks and guidance include Partnership for Carbon Accounting Financials (PCAF), the World Business Council for Sustainability Development (WBCSD), and the Net Zero Investment Framework (NZIF).

11 See the UK Financial Markets Law Committee (FMLC) paper on investor contribution to climate goals and the section on metrics: https://fmlc.org/wp-content/uploads/2024/02/Paper-Pension-Fund-Trustees-and-Fiduciary-Duties-Decision-making-in-the-context-of-Sustainability-and-the-subject-of-Climate-Change-6-February-2024.pdf.

- Forest Cover Preservation: Quantified in hectares, this metric evaluates the success of initiatives aimed at preventing deforestation and promoting sustainable land use.
- Recycling and Reuse Rate: This metric measures the percentage of materials recycled or reused within a company's operations, reflecting circular economy practices.
- Access to Healthcare: Number of individuals gaining access to healthcare services due to an investment, indicating improvements in health and well-being.
- Fair Labour Practices: Assessed through audits and compliance rates with international labour standards, this metric evaluates adherence to human rights within supply chains.

Instead of treating sustainability impacts as an unintentional by-product of their activities, IFSI involves intention, as well as actions or processes designed to contribute to measurable changes in sustainability impacts in line with the investor's stated objectives. Put simply, investors should do what they say, and say what they do.

Investors should, and increasingly do, articulate in their investment beliefs and policies, why they consider sustainability impact relevant, how they perceive its effects on achieving their financial objectives, and how they integrate sustainability impact into their investment strategy and decision-making.

Investors can use a variety of tools to influence sustainability impacts. As set out in the LFI report, the three key levers – best used in combination rather than in isolation – are capital allocation, stewardship, and policy engagement. By utilising these levers, investors can drive measurable changes in the behaviour of investee companies and in the broader systems in which both companies and investors operate (e.g. through reforms to government policies and regulatory standards).

Investors should not only document their reasons, objectives, and actions, but also assess progress towards their goals. They should seek to determine whether their actions are having the intended effect on sustainability outcomes and, if finance is the motivation, on their financial objectives.

Taken together, the processes that enable an investor to develop a coherent IFSI strategy culminate in a theory of change, which helps the investor communicate and understand their impact goals, activities, and results.

ACTIONS, INFLUENCE, AND GETTING STARTED

Some actions have more influence in achieving the goal than others. Considering the actions listed above, the following framework assesses the level of influence, provides potential KPIs, and offers guidance on getting started.

1. CAPITAL ALLOCATION

A. STRATEGIC ASSET ALLOCATION

Explanation: Allocating to asset classes that contribute to sustainability impact.

Degree of Influence: Medium; directly shapes the portfolio towards investments that support the goal.

Mechanism for Impact: This could, for example, mean that solutions would have a lower cost of capital; economic activities working against the goal would have a higher cost of capital, potentially affecting the licence to operate.

Potential KPIs: Real-world metrics related to the goal, perhaps based on the geography of the investor, the percentage of assets in sectors contributing to the goal, and the growth of those assets over time.

Getting Started: This could involve analysing the sustainability impact of various asset classes and individual securities and adjusting allocations based on their alignment with the sustainability goal.

For example, an investor might choose to overweight asset classes or sectors that contribute to the sustainability goal, such as renewable energy or green bonds, whilst underweighting or excluding those that work against the goal or have high exposure to sustainability risks.

Investors could also set specific sustainability targets or objectives for their portfolios and use these as a guide for strategic asset allocation over time. This could involve establishing a target to achieve a certain percentage of investments in companies or projects that contribute to the goal. For further, analysis, we recommend reviewing the materials prepared by the Impact Management Project (IMP).

B. DIRECT INVESTMENTS IN SOLUTIONS

Explanation: Investing in companies or assets with products that directly achieve the goal, such as renewable energy or emission-reduction technology.

Degree of Influence: High

Mechanism for Impact: This could, for example, involve directing capital towards economic activities that contribute to decarbonisation solutions.

Potential KPIs: Percentage of AUM invested in solutions. This could be specific, such as MW capacity of renewable energy funded.

Potential Actions: Similar to strategic asset allocation, investors could directly allocate capital to companies or assets that provide solutions for achieving the sustainability goal.

C. EXCLUDING INVESTMENTS

Explanation: Avoiding investment in sectors or companies that work against the goal.

Degree of Influence: Variable.

Mechanism for Impact: This could divert capital from polluting activities and signal market disapproval.

Potential KPIs: The percentage of the investment universe excluded, based on sectors or companies that are contrary to the goal, could serve as a KPI to measure excluded companies' activities, and/or portfolio alignment metrics.

Getting Started: On its own, excluding investments is unlikely to be sufficient to achieve a sustainability outcome. However, for some investors, it may be a necessary escalation point when other actions, such as engagement, have been unsuccessful. An investor's influence in particular markets, asset classes, or with certain investees, is a crucial consideration in determining the effectiveness of exclusions or divestment within a strategy. Another consideration is what will happen to these investments after they are sold. Public disclosure and the rationale for divestment are important and increase the degree of influence. Some argue that divestment in debt is a particularly effective mechanism for incentivising decarbonisation.[12]

D. MANAGER SELECTION, APPOINTMENT, AND MONITORING

Explanation: Selecting, appointing, and monitoring managers based on their actions that support (or undermine) sustainability impact.

Degree of Influence: Medium to high.

Mechanism for Impact: Investment managers are motivated to develop products and services to meet client demand. Asset owners could use selection as a key tool to incentivise innovation in financial product development.

12 Andreas Hoepner, for example, encourages divesting from debt and engaging in equities.

Potential KPIs: A scoring framework for selected managers, including their actions, with a focus on real-world impact and contribution to the goal.

Getting Started: This could involve selecting and appointing managers with expertise in achieving the sustainability goal, such as a fund that invests in companies decommissioning high-pollution energy assets. Additionally, it includes assessing managers' sustainability policies, their track records in integrating sustainability outcomes into investment decisions, and how their engagement and voting activities align with the sustainability goal. An asset owner might ask managers how they manage systemic risks and opportunities and whether they are well-positioned to pursue impact that will support the asset owner's goals.

Investors can also set specific sustainability outcome expectations or targets for their managers, such as requiring a minimum level of engagement with companies on sustainability issues, joining collaborative engagement initiatives such as Climate Action 100+, and overall alignment with the goal.

2. STEWARDSHIP

Although the following stewardship elements can be considered separately, they are most effective when integrated into the investment strategy, with clear, time-bound objectives that escalate from engagement to voting, and potentially to divestment.

A. ENGAGEMENT

Explanation: Engaging with companies to change behaviours (either individually or in collaboration with other investors).

Degree of Influence: Variable.

Mechanism for Impact: This can be high if focused on driving change in products, operations, or governance, undertaken at a senior level.

Potential KPIs: Changes to the company's product range.

Getting Started: Investors could engage in dialogue with companies to encourage them – or if necessary, require them – to take action on the sustainability goal.

This could involve discussing specific sustainability issues relevant to the company's sector, such as reducing GHG emissions, improving labour standards, or addressing human rights concerns in their supply chain.

B. VOTING

Explanation: Using voting rights to influence corporate behaviour and drive sustainability outcomes.

Degree of Influence: Medium, depending on the level of shareholding and the support of other investors.

Mechanism for Impact: This would include using votes to direct company activity.

Potential KPIs: Voting records, successful resolutions, changes in corporate policies or practices.

Getting Started: Investors could use their voting rights at annual general meetings (AGMs) to support resolutions that align with their sustainability goals and vote against those that do not. This could include voting for resolutions that require companies to disclose more information about their environmental and social impacts or voting against the re-election of directors who have failed to prioritise sustainability issues.

C. ESCALATION

Explanation: Taking further action when engagement and voting do not lead to the desired outcomes. This could include filing shareholder resolutions, voting against directors, direct engagement with consumers, speaking with the media, and potentially legal action.

Degree of Influence: High

Mechanism for Impact: Escalation activities (and even the threat of escalation activities) can put significant pressure on companies to change.

Potential KPIs: Successful outcomes from escalation activities, such as changes in corporate policies or practices.

Getting Started: If engagement and voting do not produce the desired changes, investors could escalate their stewardship activities. This could involve filing shareholder resolutions, voting off directors, publicly criticising companies through media campaigns, or collaborating with other investors to put pressure on companies. In extreme cases, investors may choose to pursue legal action and/or divest from companies that consistently fail to address sustainability concerns.

3. POLICY ENGAGEMENT

A. FINANCIAL POLICY ENGAGEMENT

Explanation: Engaging policymakers for policies that support the goal within the financial sector, such as TCFD reporting.

Degree of Influence: Variable

Mechanism for Impact: This can influence broader market practices and regulations.

Potential KPIs: Financial policies supported or passed, meetings with financial policymakers and regulators.

Getting Started: Investors could engage with financial policymakers by participating in consultations on sustainability-related financial regulations, supporting policies that require financial institutions to manage and disclose their climate-related risks and opportunities, encouraging the development of standardised metrics and reporting frameworks for assessing the sustainability performance of financial institutions and products, and advocating for policies that incentivise sustainable investing through tax incentives or subsidies for green bonds or other sustainable financial products, as well as due diligence disclosure requirements for companies.

B. REAL ECONOMY POLICY ENGAGEMENT

Explanation: Engaging policymakers for policies that support the goal in the real economy.

Degree of Influence: High

Mechanism for Impact: This can influence broader industry practices and regulations leading to change in the real economy. The degree of influence can be very high, though it is often difficult to attribute.

Potential KPIs: Real economy policies supported or passed, meetings with policymakers in relevant sectors.

Getting Started: Investors could engage with policymakers to advocate for policies and regulations that support sustainability in real economy sectors – such as energy, transportation, agriculture, and construction – by advocating for policies that put a price on carbon emissions or other negative externalities through carbon taxes or cap-and-trade systems; supporting regulations that set standards for energy efficiency, renewable energy, or other sustainability criteria in specific sectors; encouraging the development of infrastructure and technologies that enable the transition to a low-carbon, sustainable economy; participating in the development of industry-specific sustainability standards and certifications; and collaborating with other stakeholders to build support for sustainability policies and initiatives in real economy sectors.

IMPLEMENTATION CHALLENGES ... AND PRELIMINARY EXPLORATION OF SOLUTIONS

IFSI faces multiple and interconnected challenges. As a brief overview, this report does not seek to provide detailed solutions to these challenges. Rather, we list the challenges below and suggest actions investors can take.

We expect this area of practice to deepen and grow, and we hope it serves as a valuable starting point that contributes to ongoing efforts at PRI and beyond.

CHANGING POLICY FRAMEWORKS

Shifting regulations and policies can create uncertainty and volatility, making it difficult for investors to align long-term sustainability goals with changing legal requirements.

EXAMPLES

a. The European Union's evolving taxonomy for sustainable activities may require investors to adapt their strategies to comply with new classifications.
b. Changes in renewable energy subsidies or carbon pricing mechanisms can affect the viability of sustainable investments.

POSSIBLE ACTIONS

a. Engage with policymakers and regulators to provide input on the development of sustainability-related policies and advocate for a stable, long-term regulatory framework.
b. Diversify investments across regions and sectors to mitigate the impact of policy changes in specific regions.
c. Regularly review and adapt investment strategies to ensure alignment with the latest policy developments and developing policies while maintaining a focus on long-term sustainability goals.

HARD-TO-REACH GEOGRAPHIES SUBJECT TO POLITICAL RISK

Political instability and lack of infrastructure in certain regions can hinder sustainable investments, posing risks of disruption and loss and incurring higher fees. These regions are often where investors' actions can make the greatest contribution to their impact goals.

EXAMPLES

a. Investing in renewable energy projects in countries with unstable political environments may face delays, cancellations, or expropriation risks.
b. Weaker governance and limited transparency in some markets can make it difficult to assess and monitor the sustainability impact of investments.

POSSIBLE ACTIONS

a. Partner with local organisations, development finance institutions, or multilateral agencies to gain insights, mitigate risks, and access support in challenging geographies.
b. Conduct thorough due diligence and risk assessments to identify and manage potential political and operational risks.
c. Consider blended finance structures or risk-sharing mechanisms to attract private capital while reducing individual investor exposure.

BENCHMARKING LIMITATIONS

Mainstream benchmarks may limit allocations to sustainable investments subject to different risk–return characteristics and make it challenging to measure performance and impact.

EXAMPLES

a. Traditional market-cap weighted indices may underrepresent small-cap companies or emerging sectors with high sustainability impact potential.
b. Lack of standardised impact metrics and reporting frameworks can hinder comparability and benchmarking of sustainable investments.
c. Investments tend to be measured against benchmarks which themselves do not consider impact or price externalities. As a result, performance can be distorted in favour of inaction.

POSSIBLE ACTIONS

a. Engage with benchmark providers and industry initiatives to advocate for the inclusion of sustainability factors and impact metrics in mainstream indices.
b. Develop custom sustainability benchmarks or reference portfolios that better reflect the specific impact goals and criteria of the investment strategy.
c. Use a combination of quantitative and qualitative assessment methods to evaluate the performance and impact of sustainable investments.

PORTFOLIO COMPANY LOBBYING

Companies' lobbying against sustainability initiatives can conflict with investors' impact goals, affecting reputation and alignment with sustainability values.

EXAMPLES

a. A portfolio company in the energy sector may lobby against stricter emissions regulations, undermining investors' efforts to support the transition to a low-carbon economy.
b. A consumer goods company may oppose measures to reduce plastic packaging waste, conflicting with investors' goals to promote circular economy principles.

POSSIBLE ACTIONS

a. Engage with portfolio companies to understand their lobbying activities and advocate for alignment with sustainability objectives, using voting rights and direct dialogue to influence change.
b. Collaborate with other investors and stakeholders to collectively push for greater transparency and accountability in corporate lobbying practices.
c. Develop clear guidelines and expectations for portfolio companies' lobbying activities and consider divestment or exclusion for persistent misalignment with sustainability values.

INVESTING FOR SUSTAINABILITY IMPACT MAY INCUR HIGHER FEES

The additional research and due diligence required when investing for sustainability impact can lead to higher management fees, making allocations more challenging for asset owners subject to fee caps.

EXAMPLES

a. Conducting in-depth environmental and social impact assessments for each potential investment may require specialised expertise and resources, driving up costs.
b. Smaller-scale, high-impact investments in early-stage ventures or community projects may have higher transaction and monitoring costs compared to mainstream assets.
c. Stewardship and engagement, when done well, must be resourced.
d. Policy engagement and advocacy require expertise and resources to be effective.

POSSIBLE ACTIONS

a. Negotiate fee structures with asset managers that align incentives and reward long-term sustainability performance rather than focusing solely on short-term financial returns.
b. Collaborate with other asset owners to pool resources and share the costs of sustainability research and due diligence.
c. Advocate for regulatory changes or exemptions that allow for higher fee caps or separate budgets for sustainability-focused investments, recognising their additional costs and societal benefits.

COMPLEXITY OF THE INTERMEDIATION CHAIN

Multiple layers of intermediaries in the investment chain, as well as principal-agent issues and short-termism, can dilute the focus on sustainability impact.

EXAMPLES

a. Asset owners may rely on consultants, fund-of-funds, or multi-manager structures, each with their own incentives and priorities that may not fully align with sustainability goals.
b. Short-term performance pressures and high portfolio turnover at the asset manager level can hinder long-term stewardship and engagement efforts.

POSSIBLE ACTIONS

a. Simplify the investment chain where possible and establish clear sustainability expectations and accountability measures for each intermediary
b. Align incentives across the investment chain through fee structures, performance metrics, and reporting requirements that prioritise long-term sustainability impact.
c. Develop in-house sustainability expertise and capabilities to reduce reliance on external intermediaries and maintain direct control over impact objectives.

COST–BENEFIT ANALYSIS

Assessing the financial viability of achieving a sustainability goal can be complex, with long-term benefits sometimes overshadowed by immediate costs. Investors may lack the size and influence to achieve sustainability impact in their own right, requiring collaboration.

EXAMPLES

a. Retrofitting buildings for energy efficiency may have high up-front costs that take years to recoup through lower operating expenses, making it difficult to justify on short-term financial grounds.

b. Small-scale investors may struggle to influence large, multinational corporations to adopt more sustainable practices, as their individual stakes and voting power are limited.

c. While the costs are direct, the benefits are dispersed, so investors may struggle to communicate the cost/benefit to their stakeholders.

POSSIBLE ACTIONS

a. Develop robust frameworks and methodologies for assessing the long-term financial and societal value of sustainability initiatives, incorporating externalities and systemic risks.

b. Collaborate with other investors, asset owners, and stakeholders through initiatives like Climate Action 100+, Advance, or Spring[13] to amplify influence and share resources for sustainability engagement.

c. Engage with policymakers and regulators to advocate for incentives, subsidies, or regulations that can help shift the cost–benefit balance in favour of sustainable investments and practices. If the sustainability goal is not financially viable, this would suggest a market failure.

STEWARDSHIP BENEFITS MAY BE BEYOND THE TERM OF THE INVESTMENT MANDATE

The long-term nature of stewardship outcomes may not align with shorter investment time horizons, making it difficult to realise and attribute benefits within the mandate's term.

EXAMPLES

a. Engaging with a company to improve its labour practices or reduce its carbon footprint may take several years to yield tangible results, extending beyond the typical 3–5-year investment mandate.

b. The positive societal or environmental impact of a sustainable investment may only become apparent long after the investor has exited the position, making it challenging to capture and report on the outcomes.

POSSIBLE ACTIONS

a. Adopt a longer-term, multi-stakeholder perspective on stewardship and sustainability impact, recognising that the benefits may accrue over extended time horizons and to a broad range of stakeholders.

b. Incorporate sustainability objectives and stewardship expectations into investment mandate agreements, with provisions for ongoing monitoring and reporting even after the mandate term ends.

c. Collaborate with asset owners, beneficiaries, and other stakeholders to develop a shared understanding and appreciation of the long-term nature of sustainability impact, aligning incentives and reporting frameworks accordingly.

d. Establish mandates linked to longer-term sustainability, allowing asset managers to take a longer-term approach to engagements and benefit from those engagements.

e. Set interim targets or measurements (estimated or actual) that indicate progress against the goal, even if it is not fully realised within the investment time horizon.

13 https://www.unpri.org/investment-tools/stewardship/spring

SILOED RESPONSES TO SUSTAINABILITY CHALLENGES

There may be a fragmented and siloed approach to addressing systemic and systematic risks and opportunities across the investor.

EXAMPLES

a. An asset owner or investment manager sets high-level sustainability goals but fails to translate these objectives into specific investment mandates or stewardship policies, resulting in inconsistent implementation across different asset classes and investment teams.

b. An asset owner or investment manager does not fully integrate sustainability challenges into its core investment processes, leading to a disconnect between its intention and goal and investment decisions.

POSSIBLE ACTIONS

a. Develop a comprehensive, institution-wide sustainability strategy that articulates the organisation's purpose, values, and objectives, and provides a clear framework for IFSI across all investment activities.

b. Establish a robust governance structure that ensures sustainability beliefs are embedded into decision-making processes at all levels of the organisation – from the board and senior management to individual investment teams and operational functions.

c. Provide training and capacity-building initiatives to equip staff with the required knowledge and skills.

d. Align incentives and performance metrics with sustainability objectives to encourage a consistent focus on long-term value creation and systemic risk management across the organisation.

EXAMPLE TOOLS

Finally, we provide three examples of tools we believe are useful in implementing this in practice:

THE PRI'S STEWARDSHIP FOR SUSTAINABILITY EVALUATION TOOL[14]

The tool provides a framework designed to guide investors in evaluating and enhancing their stewardship activities towards achieving sustainability outcomes.

The tool is structured around a three-tiered approach that categorises stewardship practices into developing, intermediate, and advanced levels, enabling an assessment of how investment managers address sustainability issues such as climate change, human rights, and biodiversity.

- **Developing:** Initial steps towards integrating sustainability into stewardship, focusing on basic practices and awareness.
- **Intermediate:** Building on the foundational practices, this tier involves more active and strategic engagement with sustainability issues, including targeted engagement and policy advocacy.
- **Advanced:** At this level, stewardship practices are deeply integrated with sustainability goals, involving comprehensive strategies, leadership in collaborative initiatives, and significant influence on policy and industry standards for sustainability.

The framework sets out the importance of aligning stewardship strategies with global sustainability goals and provides a resource for asset owners to tailor their evaluations based on their specific sustainability priorities and investment beliefs.

Through this tool, PRI aims to facilitate a deeper engagement between asset owners and their investment managers, encouraging practices that contribute significantly to positive sustainability impacts.

GIIN'S HOLISTIC PORTFOLIO CONSTRUCTION WITH AN IMPACT LENS[15]

The report supports asset owners integrating impact considerations across their entire investment portfolio. The report establishes the rationale for a comprehensive approach that aligns financial returns with positive social and environmental outcomes, moving beyond traditional siloed investment strategies.

This includes a phased methodology to embed impact investing principles, urging asset owners to prioritise investments that not only secure financial gains but also contribute meaningfully to global challenges like climate change and social inequality.

The strategy encourages gradual integration, starting with the identification of impact goals aligned with financial objectives and progressively embedding these considerations into all aspects of portfolio construction and management.

This approach, GIIN argues, is crucial for asset owners to remain relevant and effective in a rapidly evolving global context, where beneficiaries increasingly demand investments that reflect their values and contribute to a sustainable future.

14 https://www.unpri.org/active-ownership-20/evaluating-managers-stewardship-for-sustainability/11697.article#Downloads

15 https://thegiin.org/publication/research/holistic-portfolio-construction-with-an-impact-lens-a-vital-approach-for-institutional-asset-owners-in-a-changing-world/

THE IMPACT MANAGEMENT PROJECT'S IMPACT MEASUREMENT FRAMEWORK[16]

The IMP provides a comprehensive framework for measuring, managing, and reporting the sustainability impact of investments, enabling investors to better understand and enhance their contributions to positive social and environmental outcomes.

The framework is built around five dimensions of impact, which collectively capture the key elements necessary for a holistic assessment of an investment's impact:

- **What:** The outcomes to which the enterprise is contributing and how important they are to stakeholders.
- **Who:** The stakeholders experiencing the outcome and how underserved they were prior to the enterprise's effect.
- **How much:** The degree of change experienced by stakeholders, including scale, depth, and duration.
- **Contribution:** The enterprise's contribution to the outcome, considering what would have happened anyway and the role of other actors.
- **Risk:** The likelihood that the impact will be different than expected, considering external and internal factors that could affect the outcome.

By assessing investments across these five dimensions, investors can develop a more nuanced understanding of their impact, identify areas for improvement, and make more informed decisions about how to allocate capital for maximum positive impact.

The IMP also provides guidance on integrating impact considerations throughout the investment process, from setting impact goals and targets to measuring and reporting on impact performance. This includes tools and resources for collecting and analysing impact data, as well as best practices for communicating impact results to stakeholders.

16 https://impactfrontiers.org/norms/five-dimensions-of-impact/

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ABOUT THE PROJECT

A Legal Framework for Impact is a flagship project of the Principles for Responsible Investment, the United Nations Environment Programme Finance Initiative and the Generation Foundation. The project is part of the Investment Leadership Programme, a joint initiative between the Principles for Responsible Investment and the United Nations Environment Programme Finance Initiative, created to accelerate collaboration among leading investors and boost action on achieving key global sustainability objectives. The project aims to identify and overcome the barriers to a financial system that is consistent with achieving the Sustainable Development Goals and limiting global warming to 1.5°C. Freshfields Bruckhaus Deringer were commissioned to produce a report on the extent to which legal frameworks in 11 jurisdictions enable investors to consider the sustainability impacts of their activities. The report provided the first comprehensive analysis of how far the law requires or permits investors to tackle sustainability challenges in discharging their duties – a practice called "investing for sustainability impact" or IFSI. The project is a multi-year work programme and is now focused on five key markets: Australia, Canada, Japan, the European Union and the UK.

ABOUT OUR PARTNERS

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. More information: www.unpri.org

The Generation Foundation is a UK registered charity and was established in 2004. The Generation Foundation uses strategic research, grant-making and advocacy to unlock the power of capital markets to drive a more sustainable economic system. It shares its vision with Generation Investment Management: a sustainable world in which prosperity is shared broadly in a society that achieves wellbeing for all, protects nature and preserves a habitable climate.

UNEP Finance Initiative (UNEP FI) brings together a large network of banks, insurers and investors that catalyses action across the financial system to deliver more sustainable global economies. For more than 30 years the initiative has been connecting the UN with financial institutions from around the world to shape the sustainable finance agenda. It has established the world's foremost sustainability frameworks that help the finance industry address global environmental, social and governance (ESG) challenges. Convened by a Geneva, Switzerland-based secretariat, more than 500 banks and insurers with assets exceeding US$100 trillion are independently implementing UNEP FI's Principles for Responsible Banking and Principles for Sustainable Insurance. Financial institutions work with UNEP FI on a voluntary basis and the initiative helps them to apply the industry frameworks and develop practical guidance and tools to position their businesses for the transition to a sustainable and inclusive economy. www.unepfi.org