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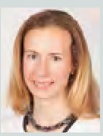
Aberdeen Standard Investments

CHAIR

BRUCE PORTEOUS
Global Head of Insurance Specialists, Aberdeen Standard Investments
Bruce develops ASI's global insurance proposition and business. Over his career with Standard Life Aberdeen, Bruce has gained experience in marketing, corporate finance and international business development, especially the early development of the Indian life insurance business HDFC Standard Life.

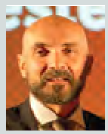
NALAKA DE SILVA
Head of Private Market Solutions, Aberdeen Standard Investments
Nalaka is the portfolio manager for ASI's flagship Global Private Markets Fund and the head of private markets solutions. He is responsible for developing and implementing strategies across the private markets spectrum. This includes investments across private equity, infrastructure, real estate, natural resources and private credit.

SWENJA SURMINSKI
Head of Adaptation Research, Grantham Research Institute on Climate Change and Environment
Swenja oversees research projects that investigate climate adaptation, risk management and resilience strategies through a mix of inter-disciplinary approaches. She has published widely on these topics, working closely with industry and policymakers.



EMILY PENN
Capital Initiatives and Investment Director, LV=
Emily has responsibility for capital & liquidity management, investment, ALM and unit pricing. Recent successes include execution of an innovative, award winning solution to reinsure a £1bn with-profits deferred annuity book, and the design and implementation of the revised strategic asset allocation for LV='s smooth managed fund range.

PRASUN MATHUR
Head of Private Assets, Aviva
Prasun joined Aviva in October 2016 where he is responsible for investing in private assets and delivering associated P&L for Aviva UK. In his current role, Prasun focuses on investing optimally across a variety of fixed income asset classes. This involves market entry analysis into new asset classes and asset allocation insights by identifying key risk drivers.



CORRADO PISTARINO
Chief Investment Officer, Foresters Friendly Society
Corrado has more than 20 years experience in capital markets. Previously to his current positions, he was head of insurance LDI at Aviva Investors, responsible for over £10bn of insurance funds and £30bn of derivatives exposure. His previous employers include the likes of Deutsche Bank, Dresden Kleinwort and ABN AMRO Ban.

IMPACT INVESTING TO BENEFIT SOCIETY AND THE ENVIRONMENT

OUR PANEL OF EXPERTS DISCUSS THE LATEST IMPACT INVESTING TRENDS IN PRIVATE MARKETS FOR INSURERS

CHAIR: By definition, impact investing refers to the investments made into companies, organisations and funds with the intention to generate a measurable, beneficial, social or environmental impact alongside a financial return. How do you and your organisation think about impact investing?

DE SILVA: We think of impact investing and ESG as a spectrum. In terms of framework, where financial return is being traded off for impact, we genuinely believe there is a part of that middle ground where sustainable investing or responsible investing can generate market returns as well as produce positive outcomes.

The framework that we use is based on the three ABC principles of our impact management project. This is firstly about avoiding harm at one end of the spectrum, so this could be negative screening or screening out investments from a procurement standpoint. Benefits to stakeholders is the second, which is around proactive ESG management – looking at environmental, social and governance issues that can be improved. The third is about contributions to the UN Sustainable Development Goals (SDGs). You can't invest directly in the SDGs, there's not an immediate overlap there, so we've broken down the 17 SDGs into key principles to deal with the issues. That allows us to have sectorial bets that we can put in place.

The major difference from an impact standpoint for us is the measurement point. What are the KPIs that you put in place? How are those outcomes measured over time? These things aren't delivered in 24 or 48 hours, so there's constant monitoring and management around that. We have a range of tools, some of them proprietary, that we've developed. Others are built on frameworks that are used in the marketplace. The Sustainable Accounting Standards Board essentially gives us a starting point from a materiality matrix perspective. The KPIs around impact are then measured because irrespective of your asset, they have intended or unintended consequences, and then positive or negative impacts. The question is measuring it.

From a private market standpoint, we've always had the view that to generate the highest degree of impact is when you're allocating capital directly to projects, or controlling management teams, or making decisions in terms of behaviour. We have the benefit of getting KPIs in place early and measuring them. Through that, building portfolios that have a lens of ESG and impact considerations is something we've been moving closer to. Clients are demanding more of that now as a norm in terms of reporting, and we're doing more in that space to work across that spectrum.

SURMINSKI: An area I currently see opportunities, but also challenges, is around climate resilience. Usually, you hear climate change and you think mitigation and reducing emissions. I think there is a lot of focus on impact investing in that context, but as we see climate change progressing, and as we also see our efforts to reduce emissions not necessarily hit targets, it is really important to consider climate resilience and dealing with climate impact as an investment area. Too often it is simply regarded as a cost, not as an investment that can generate many benefits now and in the future.

I'm working with the Zurich Flood Resilience Alliance, which is a big partnership with Zurich Insurance, non-governmental organisations (NGOs), and researchers, and we're looking at creating investment opportunities in resilience: we know that there is a strong economic case for climate resilience, for example when building new infrastructure or regenerating neighbourhoods. What is less clear is how to measure the resilience impact that my investment might have? How do you define or measure that? Our project looks at engaging communities, local governments and businesses in measuring the resilience impacts of investments, it's very much that question that impact investors are asking: how to know what matters on the ground, what impacts are being generated?

Another aspect is the work I'm doing with the UK government as part of the Third UK Climate Change Risk Assessment, where we're looking at climate risks and possible opportunities for businesses in the UK. There is clearly an expectation by government and by others in the real economy that investors will play a stronger role in dealing with climate -

and we are looking at how the market is picking up opportunities in terms of impact investment.

The last aspect that is relevant is the SDG context. As part of the Development Corridor Partnership we're working with several partners in the UK, China and Africa to explore how SDGs are being considered by public and private investors. In particular we look at the investment decision process - what role do SDGs play when appraising investment options, and how do we measure what happens on the ground? How can we prove that a particular investment which is supposed to deliver on two or three SDGs actually does the trick on the ground? There are many frameworks out there that can help investors, but I know that there is also confusion and lack of transparency.

PISTARINO: Terms like ESG, sustainability and impact investing are often used interchangeably. It is a fast developing area, and some confusion and overlaps are inevitable. There are established practices - think for instance of corporate engagements in public markets – that are closely associated with a particular investment discipline, and others that are still in their infancy and more difficult to categorise. Impact investing is an approach that has been championed by state agencies and development banks for a long period of time. Their scope of action is broader than what is usually understood falling under the remit of ESG criteria, including climate change, and it's better outlined by reference to the UN Sustainable Development Goals. It often includes operating within a framework that allows concessionary returns, especially when the objective function is to create positive externalities that cannot be immediately or entirely monetised. As private investors enter this space,

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from a taxonomy point of view the issue is how to identify with clarity those thematic approaches that are expected to generate a genuine positive impact. This will rest on the industry's ability to reach a consensus on the definition of "impact" and to agree on robust measurement and reporting frameworks. Yet, at a more fundamental level, we will have to identify segments that are truly investable in terms of return opportunities, as we discharge our fiduciary duty primarily towards our stakeholders.

PENN: We outsource our asset management, predominantly to one asset manager and prior to this year responsible investing has been handed off to them. It has been similar for a number of smaller mandates for specific assets in place as well.

With an increased focus both internally and externally on responsible investing we felt it was important to set out our own beliefs and expectations around responsible investing and so this year, we've taken an RI framework through governance. In this we set out our core belief that ESG factors must be considered in investment decisions as they have a material impact on performance and understanding the risk in any investment. Impact investing is a subset of the whole spectrum of responsible investing.

We haven't spent a huge amount of focus specifically on impact investing, even less so on impact investment within private market assets. We invest in some private debt assets, commercial real estate mortgages where we see ESG as a key component of understanding risk within that asset. However, we haven't looked to invest specifically in impact strategies within the commercial real estate sector.

One important aspect is that we outsource a lot of our asset management. There's a powerful message in being able to go to your customers or stakeholders and say we're investing in XYZ and it's having this impact. However, when you're doing that via an outsourcing arrangement, it's much harder to do as well as articulate.

MATHUR: From our perspective, as Emily said, this belongs in the area of responsible investment approaches. We have an appetite to invest where impact can be demonstrated qualitatively and/or quantitively. The problem we face with impact investing is that, by definition, evidencing it requires you to measure social and environmental return. That is extremely hard. There may be some frameworks out there, but have they been tried and tested adequately enough for us to start relying on them to make investment decisions? This area has not trickled into our institutions in investment decision making adequately enough for us to have strong opinions.

We are pressing ahead with determining how we think about climate through our portfolio strategies, we've made some investments that we think can qualify for impact investing, but we can't quantify it right now.

PISTARINO: On this point, I think we could take the lead from DFI's, which have a firm presence in the impact investing space. There are at least three established frameworks that DFI's use for measuring impact: the target approach; the rating approach;

and the monetisation approach. There is plenty of literature describing pros and cons of each of these methodologies. These approaches can also be blended, leading to hybrid reporting frameworks. If this is the direction of travel, how do we compare between different managers?

MATHUR: When we think about selecting an asset manager, ESG and sustainability is a key criteria that we measure them on. It is one of our investment beliefs that we achieve value by factoring in ESG/sustainability. This trickles down to all our investment decision making, including our approach for selecting asset managers.

The challenge we have always faced on ESG and sustainability, is that every asset manager has a different approach. This is unhelpful because collective action that benefits society is best reliant on an "open source" assessment framework. I hope that ESG and sustainability frameworks will converge with time, and expect the national regulators to sponsor consistent approaches.

For now, we ask asset managers about the different tools they have at their disposal to do various ESG analyses. The more tools/approaches they have, the more flexible they can be to adopt our internal views. We always try to find asset managers who can incorporate our views through the tools they use.

PISTARINO: As a portfolio discipline, impact investment builds on the ESG approach, of which it represents a natural evolution towards a clearer output-controlled framework. Its determinants are explicitly expressed: a statement of intent; a convincing narrative on how a particular investment is designed to deliver on that intent; and a framework for tracking and verifying that intent over the whole life of that investment. It is

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a departure from "sustainability" claims that can be often unsubstantiated, or way too generic to be measurable. From what I can see in terms of engagement and awareness, we are at the very beginning of this evolutionary process, at least in the private sector, and certainly amongst investors.

CHAIR: What about the point we heard on the difficulty of selecting an asset manager in this particular space?

DE SILVA: From a range of clients, whether they are insurers or pension fund investors looking at the space, they need to have a view and then they need to interpret that view through the implementation method they use. From the principles that are out there, looking over the last 10 years, there's been a small club of foundations coming together at that end of the spectrum to try and broaden out the principles. The climate agenda has accelerated that and there's a lot of focus on transition and things like net-carbon zero.

When we're looking at financial outcomes that might reside from mainstream portfolios – this idea of ESG and the discipline around understanding its risks – the types of impact or outcome issues that are environmental or social are now much higher than those that are purely financial. Dealing with those issues has become a bit more of the mainstream.

Trying to boil this down into investment strategies that can tackle those things, alongside the risk and reward frameworks that insurers have, is very difficult as we have alluded to. The way we have tackled it is to try and address each of these on a standalone basis. Providing a framework, such as our ABC approach from the impact management project, and saying that if you want to map your portfolio you can put it within a framework, we can look at types of assets and how that implementation and measurement of those type of assets can give you confidence that it is meeting an outcome, but also provide the risk and reward characteristics within your portfolio.

The really hard thing when we talk about impact spaces is the social aspect. These types of issues are very difficult to wrap financial measures around. I think this is where impact investing requires a bit of a leap of faith.

SURMINSKI: I would challenge that ESG and its sub-categories have become mainstream. There is certainly much more happening in this space and the public discourse has changed, but is this mainstream? I think this relates to the ambition, the scope and how governmental regulation can play a bigger role in facilitating more ESG investment.

I share the challenge – this isn't about a lack of tools or standards for investors, in fact there are probably too many that people are using in a different way. There is a myriad out there all serving different purposes that have been designed in different contexts. There needs to be a degree of harmonisation, standards and also transparency about what actually goes on. It's harder than just coming up with numbers that can track performance. Talking about co-benefits can help. If you say an investment serves different purposes – of course you want to make a profit but you also want to achieve X, Y and Z – one way of doing it is by focusing on co-benefits and measuring those. That takes a little bit away of the impact, which is such a loaded term, because there's a level of interpretation and judgement in it. I think this could be a way of providing a bit more clarity.

PISTARINO: Are we not playing a linguistic trick here? By referring to co-benefits are we not ducking the issue of what impact investing really is? Wouldn't we be faced with the same set of questions, irrespective of the terminology we choose to adopt?

> You need engagement with those who are experiencing change or are implementing it, including local communities, businesses or civil society

SURMINSKI: There is a question about the narrative. I've noticed that people tend to be more comfortable looking through a cost-benefit lens. That could be through building different types of infrastructure, or in terms of a deprived area having more jobs. Recognising co-benefits and co-costs is a way of getting more clarity about what happens through your investment, but uses a language and the tools that people might be more familiar with because a cost-benefit analysis is often more common, and people might offer more trust when they see these numbers. With impact, you are looking at what you eventually want to achieve on the ground, and the outcome of achieving change. For that you need engagement with those who are experiencing change or are implementing it, including local communities, businesses or civil society.

PENN: Asset manager selection is one of the key drivers that made us feel we needed to develop our own framework for responsible investing. We now have a clearly articulated set of views so that when we speak to asset managers with a view of engaging them, we know what to measure them against, and therefore we can see the degree of overlap offered versus our intentions and aspirations. Also, it helps us look at our current asset managers and see where they are on that framework versus where we want them to be, and work with them to get them up to that level in the areas we invest.

There's a high degree of overlap between the comment about ESG being mainstream. My personal view is that every asset manager and the industry is talking about ESG, but the crux of the question is whether they are truly integrating it from the top to the bottom within the firm, and within the portfolios they're managing. There's quite a big distinction between the firms that are really driving that culture from the top, where it is being embedded throughout the organisation, and others where it is not. Until you start to see ESG factors being considered in all investment decisions, I don't think you can really have confidence it is integrated across the portfolios as a whole.

CHAIR: That's really interesting that you say it seems to be pretty transparent if there is no ESG substance behind an asset manager, you can spot it quite quickly. Is that correct?

PENN: Certainly. If you are having detailed conversations with asset managers as to how a particular fund has performed or why they've made an investment decision, you can start to see where ESG factors are being considered as part of that investment decision, or whether they're not. In our experience it is within these conversations with portfolio managers that we really see how they're investing and considering ESG.

MATHUR: From a governance perspective, the investment decision making process for the asset manager must require the originator/credit analyst to perform an ESG analysis and escalate issues to an ESG team where necessary. Further, voting rights for ESG teams in investment committees gives us more confidence on how strongly integrated ESG is within the asset manager's DNA.

PENN: I totally agree with that. We see best practice where the ESG research team are integrated into the wider research team, so in decision making you're getting a view from a more traditional analyst and then an ESG analyst, to form the wider decision making process.

DE SILVA: It also depends on your investment activity as well. Manager selection is one thing, but I think there is also an extra level down you can go to, in terms of the operational managements of some of these assets, that are interesting to see how they're being dealt with.

> Impact will ultimately become mainstream in the future in the same way that ESG has started to get that dialogue

I don't quite believe it's mainstream. I think there's a lot of rhetoric but when you look at all the investment activity that goes on, you can still ask whether it's something that is becoming more mainstream. I think this journey is only at the infancy of getting all asset management businesses to get fully integrated, and I think others are further than some in delivering that. Impact will ultimately become mainstream in the future in the same way that ESG has started to get that dialogue. The end marketplace is becoming more aware of these issues, and asset managers have to be in a position to provide transparency and explain their frameworks.

As an industry, we're going to be forced to explain where our capital is being allocated, the type of impact happening, and find a way to quantify that, so that allocators of capital can be confident. I think impact is still very niche but the ESG conversation is getting more attention. The environmental part of that is the most acute, where we're seeing environmental stress testing going on, and all the types of analysis of where returns are going. On the social side of things, we're trying to elevate the emphasis.

Have people seen moves to deal with societal issues that are more pervasive in the global economy and are these becoming more prevalent? Also the allocation of capital to those types of issues, I'm curious to see how people are thinking about those.

PISTARINO: If one thinks of ESG, the E element, usually focusing on climate change, tends to be predominant in the quest for new investment opportunities. To me, the area where impact investing can bring added focus is around the S of ESG. In a way, you don't need to create more interest around climate change by way of a new - certainly more advanced - investment discipline. The buzz is already there.

That said, I go back to my previous comment: will the industry be able to come up with investable propositions that target the S in ESG? One may argue that some infrastructure projects have in fact those attributes. Asset managers might succeed in developing increasingly creative solutions. As investors, blunt as it may sound, we have a duty to generate returns. Even in situations where fiduciary duty can be interpreted in a broader sense, and the notion of societal welfare can be a determinant behind portfolio decisions, returns are an inescapable constraint.

SURMINSKI: In the projects I've been engaged with, the S is usually in terms of job creation, looking at improved living conditions for people in a particular local area. The problem with that is scalability, because it is very context specific. As an example, in the Zurich Flood Resilience Alliance we are working in Indonesia with NGOs and local government to come up with an investment vehicle. The idea was

> Regulation will help force the issue, and I believe more onus should be placed on insurers to educate policyholders and shareholders alike on this subject

that this investment addresses several problems –bad water quality, regular flooding due to rivers clogged up with waste and lack of jobs in that area. The idea is to design a bond that funds interventions designed to address all three problems at the same time while also generating a profit. That is possible in a way on a very small scale, but for investors this is often too small-scale, this is a significant challenge.

PISTARINO: One of the principles of impact investing is about managing impact at a portfolio level. A small-size project is not necessarily unviable, if efficiencies of scale in the origination channel or in managing the assets can be found. Not to mention the improvement in risk diversification.

MATHUR: That is an interesting observation, that a lot of impact investing projects could be small scale, for the sake of argument let's say under $1m of an investment enabling or creating the impact. For us, the average ticket size is a multiple of that to make it worthwhile for us to invest. There is a bit of a disconnect here. We can't go about looking at every $500,000 investment in frontier markets. That would need a lot of feet on the ground and we don't have that.

DE SILVA: I think we are seeing a bit of movement on that front. Perhaps it's been driven over the last decade by the societal discourse around some of these issues. The larger private equity firms have launched impact arms, and I still think this idea of institutionalising the impact market needs a marketplace to happen. The UN have been pretty proactive around that in trying to solve some of these issues.

The interesting thing for asset managers is how to get the economics to work. DFIs have historically taken the first loss position to be able to provide an economic position for more mainstream capital to get the risk adjusted return they need. If there are groups that are willing to take that first loss position because there's an equity upside, or they are able to have a lower rate of return, that could allow for capital transition into more mainstream projects. You then have to solve the issue of procurement; how do you get the range of projects at the scale you need to deploy all that capital?

I still feel we don't have a capital transition mechanism yet because everyone is having this debate about the return they are receiving, what the risk is, and in private markets the difference between the highest performing asset and the lowest performing asset is really wide.

It needs a leap of faith from some large allocators to be able to say they're prepared in a lower returning and low inflation environment, who wouldn't be getting a lot of return from an economic point, to say they want to get more out of the S and G and potentially the E, and find a place in their portfolio to do it. Then you could get some momentum because the market will typically innovate around that. As soon as the market is made, you would have people coming to that marketplace and providing projects.

We've seen a little bit of that in micro financing. That's one area that seems to have been a mechanism to attract capital. If we can find other mechanisms, where do you think this kind of capital could come from, and what would its minimum constraints look like?

MATHUR: The DFI space is interesting and something we have invested in the past. It offers access to investing in emerging/frontier markets with an investment grade counterparty via the DFI. The challenge we currently see in the DFI space is finding which DFIs are creditworthy and which aren't, and there are plenty of them out there. Strength of the DFI's governance, their balance-sheet, strength of the covenants with the shareholders are all standard ways by which you can rate and rank DFIs.

PENN: From LV's perspective, we don't have the scale or resources to put together an impact programme. It is something much further down the horizon for us. This is not to say we wouldn't go there but if we're looking at an impact fund for instance, and because we don't have a dedicated amount of capital to put aside for impact investing, it has to stack up on a risk-return basis versus any other asset class we're looking at.

Any new investment requires us to commit to resource to do the appropriate due diligence and governance. For a small firm, there's quite a big hurdle in terms of introducing any new asset class, let alone it being an impact investment.

CHAIR: You said at the start that LV= is having difficulty sourcing appropriate investments so how are you going to square that circle if you are not able to build the in-house expertise?

PENN: We have mandates out there in terms of the amount of commercial mortgages we want to originate per year, and we're not necessarily seeing the loans coming through to meet those mandates on a broad perspective. If we were to go a step further and say we want loans that are particularly targeted towards a specific social impact, I'm struggling to see where we'd be able to meet our business targets if we can't meet them with a much broader universe at the moment.

CHAIR: Are insurance companies feeling pressure to get more involved in impact investing? And is there pressure coming from policyholders, regulators or other peer insurance companies?

MATHUR: There isn't any more pressure than we have on climate change and ESG issues. Regulation will help force the issue, and I believe more onus should be placed on insurers to educate policyholders and shareholders alike on this subject.

Analysts now demand insurers to talk and disclose more about climate and ESG. Regulators are demanding us to do more scenario analysis, stress testing and reporting. Activist groups that probe us on anomalies in our investments and query us on very specific issues. Essentially, we see challenges from all stakeholders and that's why we find ourselves very keen on making progress.

SURMINSKI: Pressure from the outside is an issue, but I think there is also a huge strategic opportunity which is all about protecting your business model. I often start that conversation with where you see your business in 20 years. If you continue investing in risk creation, or continue harmful investments, you are basically reducing your own opportunities there. The challenge with insurers is that there is a much better understanding about future risk on the underwriting side than on the investment side. There is a disconnect in terms of sharing this knowledge.

> There is an opportunity to create instruments or mechanisms that can transition capital

PISTARINO: Another aspect worth considering is regulation. If anything, one may argue there is not enough pressure from regulators to steer the investment discipline towards achieving measurable impacts. I can see though why this is a difficult call.

The existing regulatory construct looks at risk over a one-year horizon, with both assets and liabilities priced at fair value. It is difficult to create exogenous incentives without tinkering too much with that framework. That same conundrum also emerges in respect of climate change, with the impact of both physical and transition risk on financial stability likely to manifest itself over a significant length of time, far beyond the 1-year survival horizon.

CHAIR: On climate I agree. There's been a lot of activity in the industry, but it's been a regulatory driver, and from Mark Carney in particular. In a way it's a bit disappointing that insurance companies and the financial services industry have not been more proactive.

DE SILVA: The pressure question is mounting and I think that's coming from a range of places. Institutionally, perhaps it's a bit more muted, but we're still seeing a shift. Regulation will come because of what's happened on the climate side, which will probably start permeating into the social and governance side. We're likely to see more scrutiny on asset managers to disclose and display that. I still feel from the insurance market standpoint, there is an opportunity to create instruments or mechanisms that can transition capital.

The insurance market has always been quite innovative in using structured finance products to create credit enhancement, to be able to match liabilities, to create things that have long duration. If they can innovate and use asset managers to implement, I think there will be a really interesting dialogue because that will move the agenda further forward. Getting insurers to start is probably the hardest part, and getting people to join the journey will take time, but being able to push that agenda forward is really important.