ACCELERATING IMPACT INVESTING INITIATIVE AI3

Unleashing the Power of Pensions:

Expanding Economically Targeted Investments by U.S. Pension Funds

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A research brief by Enterprise Community Partners and InSight at Pacific Community Ventures, collaborating partners on the Accelerating Impact Investing Initiative (AI3).

Enterprise

INSIGHT AT PACIFIC COMMUNITY VENTURES

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Enterprise

Enterprise works with partners nationwide to build opportunity, creating and advocating for affordable homes in thriving communities linked to jobs, good schools, health care and transportation. Enterprise's Public Policy team, based in Washington, D.C. brings valued relationships with key policy leaders, as well as deep expertise in tax policy, CRA, and other areas of housing and community development finance policy.

Initiative for Responsible Investment

The Initiative for Responsible Investment at the Hauser Institute for Civil Society at Harvard University is an applied research center that focuses on fundamental issues and theories around the social utility of finance. Through research and ongoing dialogue, the IRI looks at opportunities across asset classes, issue areas, and investor types to engage private sector investment around environmental and social goals, risks and opportunities.

InSight at Pacific Community Ventures

PCV InSight is the impact investing research and consulting practice at Pacific Community Ventures. PCV InSight provides information and analysis to investors and policymakers with the goal of driving capital to underserved markets. PCV InSight's work has provided the basis for national and international policy initiatives, including the U.S. National Advisory Board, White House Impact Economy Forum, and the Social Impact Investment Taskforce.

We welcome your feedback and comments. Please direct them to: ai3@pcvmail.org

INTRODUCTION

Over the past decade, the global market for impact investing—investments made with the intention to generate measurable social and environmental impact alongside a financial return—has grown in both scale and prominence.[2] In the U.S., profit-seeking investors are working with public and private partners to address some of the most pressing issues facing low-income communities, from poor health and education outcomes to a lack of quality, affordable housing. However, some of the country's largest institutional investors—including many U.S.-based pension funds, which combine for nearly $18 trillion in investment assets—have been reluctant to pursue impact investments.[3] According to one survey from Deloitte, as of 2013 only 6 percent of the country's pension funds had made an impact investment, but 64 percent expected to make an impact investment in the future.[4]

Pension fund participation in impact investing is strongly influenced by public policy, in part because pension funds are governed by rules and norms that can limit their ability to invest in new or innovative investment vehicles. Just under half of pension fund assets in the U.S. are in plans governed by the Employment and Retirement Securities Act of 1974 (ERISA), a federal law that requires pension funds to be managed "for the exclusive purpose of providing benefits to participants and their beneficiaries."[5] The remaining assets are in religiously-affiliated plans or public plans for state and municipal employees—including teachers, police officers, firefighters and civil servants—which are not directly governed by ERISA. Most public pension funds are regulated at the state and local level, but it's worth noting that many states have chosen to adopt some version of the federal ERISA standards.

Historically, most pension fund managers have only considered the financial interests of the fund, with a particular focus on diversification, liquidity, risk and return. However, some fund managers—especially those managing public and religiously-affiliated pensions—have concluded that they can further support their beneficiaries by investing a portion of the pension's resources into so-called "economically targeted investments" (ETIs), impact investments that seek certain social goals while maintaining risk and return characteristics that are comparable to more traditional investment opportunities.[6]

In October 2015, the U.S. Department of Labor (DOL), which oversees the implementation of ERISA, released new guidance on ETIs for ERISA-governed pension plans. The guidance clarifies that pension fund fiduciaries "may consider collateral goals as tie-breakers when choosing between investment alternatives that are otherwise equal with respect to return and risk over the appropriate time horizon."[7] With this guidance, the DOL has opened the door for more managers of ERISA-governed pension funds to consider the social and environmental impact of their investments without fear that this may jeopardize their fiduciary duty.[8]

This brief offers a few models of how pension funds have used ETIs to achieve measurable social impact while fulfilling the fund manager's fiduciary duty. It also points to opportunities for further policy changes that could make ETIs more attractive and amenable to pension fund fiduciaries.

Building and Preserving Affordable Rental Housing in New York

The New York City Retirement System (NYCRS) is comprised of the five major pension funds that serve the city's public employees, including municipal workers, police officers, firefighters, public school teachers and employees of the Board of Education. Together the five funds control more than $165 billion in assets, making NYCRS one of the largest sources of public pension investments in the country.[9]

As part of a broader strategy around ETIs, all NYCRS pension funds share a goal to invest at least two percent of their total assets into low- and moderate-income areas in the five boroughs of New York City and the surrounding areas. These targeted investments are made through a variety of asset classes, including fixed-income securities, private equity and real estate.[10]

As part of that effort, since the early 1980s NYCRS has operated the Public-Private Apartment Rehabilitation Program, which purchases loans for the renovation or construction of affordable rental housing throughout the city. Since the program's inception, NYCRS has invested $757 million to build or preserve nearly 30,000 homes that are affordable to low- and moderate-income New Yorkers.[11]

Here's how the program works. Say that a local developer wants to build an apartment building that is affordable to low- and moderate-income households, but first they need long-term, affordable financing to cover construction costs. NYCRS agrees to purchase a fixed-rate mortgage with a term of up to 30 years once construction is complete, as long as the loan is fully insured by the State of New York Mortgage Agency (SONYMA) or another entity to cover any risk of default. With a SONYMA commitment in hand, an approved lender with strong ties to the local community makes a short-term construction loan to the developer. When construction is complete, a mortgage lender converts the construction loan to permanent financing, which is then sold at par to NYCRS.

Research shows that investments through the Public-Private Apartment Rehabilitation Program are fully consistent with the fiduciary responsibilities of pension fund managers. According to a 2007 study, returns on NYCRS's affordable housing investments "consistently outperformed the established benchmark or industry standard."[12] As of the end of 2014, NYCRS's entire ETI portfolio yielded a 10-year net return of 6.3 percent, compared to a benchmark of 4.9 percent.[13] Since the loans are fully insured by SONYMA, these investments pose very little risk to the fund. It's also worth noting that SONYMA has experienced very low claim rates on these loans, indicating that the actual credit risk on the loans is limited.

Building on the initial success of the city's program, in 1991 New York State's Common Retirement Fund (NYSCRF)—which now controls more than $180 billion in total assets—launched its own version of the SONYMA partnership. Unlike the city program, NYSCRF partners with just one mortgage originator—the Community Preservation Corporation—and focuses primarily on smaller apartment buildings in upstate New York. As of July 2014, the state program had purchased 440 mortgages worth more than $665 million, which helped create roughly 17,000 affordable homes across the state.[14] According to a recent analysis from the state comptroller's office, this portfolio of affordable mortgages delivered an average return of six percent, which is "consistent with the long-term fixed income investment market."[15] Due in part to this strong track record, last year NYSCRF made an additional three-year, $200 million commitment to the partnership.[16]

A significant portion of units financed through the NYCRS and NYSCRF initiatives are "naturally affordable," meaning they do not require additional subsidy. It's worth noting, however, that long-term, fixed-rate financing is not enough on its own to build housing that's affordable to the lowest-income people in New York City and other parts of the state. For deeply affordable units, often additional subsidy—such as Low-Income Housing Tax Credits or Section 8 rental assistance—is required to offset the cost of land, construction and ongoing operating expenses. However, according to researchers at New York University's Furman Center for Real Estate and Urban Policy, "the ability to lock-in an interest rate even before construction begins…increases the predictability of the project's finances" and streamlines the process of getting a project done.[17]

Investing in Underserved Markets and Communities in California

The California Public Employees' Retirement System (CalPERS) is the largest state pension fund in the U.S., with roughly $300 billion in investment assets.[18] Since 1992 CalPERS has explicitly targeted investment in the State of California.[19] CalPERS describes its focus on in-state investment as follows:

"CalPERS is committed to investing in California and seeks competitive risk-adjusted returns while contributing to the well-being of the state, its localities, and residents…Our investments in California are a direct result of the strength and diversity of California's economy and the quality of its companies, properties, and other investment opportunities relative to comparable financial opportunities."[20]

CalPERS began its in-state investing efforts with real estate investments in urban markets, and later expanded its in-state investments to include private equity investments. In 2000, CalPERS began exploring the possibility of making private equity investments in California's underserved capital markets as a way of identifying attractive opportunities that may have been bypassed or not reviewed by other sources of investment capital.[21] In 2001, following extensive due diligence and board approval CalPERS established the California Initiative, a $1 billion ETI that invests private equity in "traditionally underserved markets, primarily, but not exclusively in California."[22]

The California Initiative's primary objective is to generate attractive financial returns that meet or exceed industry benchmarks with additional goals of creating jobs and promoting economic opportunity in California. The initiative has sought to achieve these objectives through investing in private companies that:

- Traditionally have had limited access to institutional equity capital;
- Employ workers living in economically disadvantaged areas; and
- Provide employment opportunities to women and minority entrepreneurs and managers.

Since inception, 531 private companies have received investment through the California Initiative, and CalPERS continues to have active investments in 161 companies.[23]

The California Initiative has invested across a variety of industries, including information technology, consumer discretionary products and services, industrials, health care and energy. Companies receiving investment have tended to be larger and more mature, with the majority employing 100 workers or more.

CalPERS has shared the results of the California Initiative for ten consecutive years through publication of the *CalPERS California Initiative Report*.[24] The most recent findings are detailed in the following tables.

California Initiative Social Impact (6/30/14)[1]	
Net employment growth since investment	35%
Percentage of companies located in areas traditionally underserved by institutional capital	36%
Percentage of employees classified as low- to moderate-income	48%
Percentage of dollars invested in companies that have at least one woman officer	32%
Percentage of dollars invested in companies that have at least one minority officer	38%

[1]Results are based on analysis of active investments in California Initiative companies as described in the 2014 CalPERS California Initiative Report

California Initiative Financial Performance (9/30/14)[1]				
Phase	Vintage Year	Capital Committed	Net IRR[2]	Net Multiple[2]
Phase I[3]	2001	$480 million	13.5%	1.8x
Phase II (GSIF)[4]	2006	$560 million	8.4%	1.4x

[1] As reported at the 6/15/15 Investment Committee meeting: https://www.calpers.ca.gov/docs/board-agendas/201506/invest/item08b-00.pdf

[2] The Net amounts are returns on invested capital.

[3] Phase I - $480 million to nine private equity funds and one fund of funds

[4] Phase II - $560 million to a fund of funds investment vehicle, known as the Golden State Investment Fund (GSIF)

In addition to private equity investment targeted to California, in 2011 the CalPERS Board of Administration approved the allocation of $800 million to the California Infrastructure Program. The program focuses on investments into the state's transportation, energy, water and telecommunications infrastructure that have the potential to benefit local economic development and provide essential community services.[25] For the CalPERS Infrastructure Program and all of CalPERS in-state investments, the primary goal is to generate risk-adjusted financial returns, with a secondary goal of supporting economic development and environmental sustainability in the state.

OTHER EXAMPLES OF ETIS BY PUBLIC PENSION FUNDS[26]

• **Colorado**: Under state law, the Public Employees' Retirement Association of Colorado gives preference to investments in the state of Colorado, so long as the investment is "consistent with sound investment policy."[27]

• **Florida**: The Florida State Board of Administration created the Florida Growth Fund in 2009 to allocate up to 1.5 percent of its total investment assets in technology and growth companies with a significant presence in the state. As of June 2014, the fund had invested $382 million in 27 companies across the state and 24 private equity funds.[28]

• **Hawaii**: As part of its private equity investment portfolio, the Hawaii Employees' Retirement System oversees the Hawaii Targeted Investment Program (HiTIP), which targets long-term alternative investment opportunities in emerging growth businesses in traded sector industries, with an emphasis in the greater-Hawaii geographic region.[29]

• **Louisiana**: In 2003, the Board of Trustees of the Teachers Retirement System of Louisiana approved a pilot program for investing in venture capital, emerging businesses, and money managers focused on Louisiana.[30]

• **Massachusetts**: The Massachusetts Pension Reserves Investment Management Board (MassPRIM) system has a goal of investing two percent of its portfolio into ETIs. For example, since 2007 the fund has been a significant investor in the AFL-CIO's Housing Investment Trust, a mutual fund that invests in the development of affordable housing and other community assets.[31]

• **North Carolina**: The North Carolina Retirement System oversees a Private Equity Innovation Fund, which is authorized to commit up to $250 million over five years in investment opportunities with significant operations in the state.[32]

• **Oregon**: Under state law, the Oregon Investment Council is required to look first at Oregon-based opportunities when making venture capital investments. At any given time, the council must have at least $100 million in venture capital investments in Oregon, unless it is deemed imprudent to do so. [33]

• **Rhode Island**: The Rhode Island State Investment Commission Board allows for up to two percent of total pension resources under management—or roughly $135 million—to be dedicated to targeted investments that yield economic benefits to the state. Any ETI pursued through the initiative must produce returns commensurate with other non-targeted investments.[34]

• **Texas**: The Texas Growth Fund was created in 1988 by the state legislature to invest money from state public pension funds and endowments into companies with operations in Texas. Investors into the fund include the Employees' Retirement System of Texas, the Teacher Retirement System of Texas and the San Antonio Fire & Police Pension Fund.[35]

• **Washington** State: Since 2003, the Washington State Investment Board has directed its partners to report annually on their in-state investments as part of a broader ETI policy. As of 2014, the Board's portfolio included $1.6 billion in Washington-based equity, real estate and fixed-income investments, representing roughly 1.5 percent of its total portfolio.[36]

• **Wisconsin**: Since the 1960s, the State of Wisconsin Investment Board has operated the Wisconsin Private Debt Program, which offers senior and subordinated debt financing to companies with operations in the state. In an effort to avoid competing with banks, the program focuses on longer-term, fixed-rate loans to smaller-sized businesses. The board also offers a private equity program focused on Wisconsin-based businesses.[37]

• **Vermont**: The Vermont Pension Investments Committee considers ETI opportunities that support economic and community benefits within the state, provided that they are consistent with the committee's broader fiduciary obligations to the pension's members and beneficiaries.[38] As of 2014, the committee had committed more than $25 million to local investments.[39]

ALIGNING INVESTMENTS WITH MISSION AT THE UNITED METHODIST CHURCH

In addition to public pension funds, several nonprofit organizations with religious affiliations have pursued ETIs as a way to align their pension investments with their organizational missions.[40] Since 1990, the United Methodist Church and its independent fiduciary, Wespath, have operated the Positive Social Purpose Lending Program, which invests pension fund resources into loans for affordable housing and community development projects in disadvantaged communities.

To date the church has invested more than $855 million through the program, which has helped build or preserve nearly 50,000 affordable homes across the country, as well as several homeless shelters, health care centers and charter schools in low-income neighborhoods. According to Wespath, these investments have delivered an annualized rate of return of about 7.5 percent, which is roughly on par with the other real estate investments in its pension portfolio.[41]

The Positive Social Purpose Lending Program operates through seven approved intermediaries, which are mostly Community Development Financial Institutions (CDFIs) and other mission-based lenders. The intermediary performs due diligence on the project, agrees to service the loan and cover a certain percentage of the losses—typically the top 1-10 percent—and then sells it to Wespath, as long as it meets certain minimum requirements.[42]

Depending on the specific project, the loans can include a variety of credit enhancements and public subsidies, including guarantees from Fannie Mae and Freddie Mac, mortgage insurance from the Federal Housing Administration and equity from Low-Income Housing Tax Credits. The size, location and affordability of the property varies, but the bulk of the loans made through the program support smaller multifamily properties, with an average loan size of about $2 million.

In addition to its Positive Social Purpose Lending Program, the United Methodist Church recently announced that it would incorporate certain environmental and social standards into the management of its entire $21 billion pension fund.[43]

OTHER EXAMPLES OF ETIS BY RELIGIOUSLY-AFFILIATED PENSION FUNDS

• **Church Pension Group**: The Church Pension Group manages the pension resources of members of the clergy and other employees of the Episcopal Church. The pension fund has incorporated social and environmental standards in its investment decisions since the 1970s, and starting in 2001 fund managers began to seek out investments that "offer fully competitive returns while also providing important social benefits." One example is the Wastewater Opportunity Fund, a $20 million fund that focuses on developing and expanding the use of anaerobic digesters, which transform organic waste into renewable, sustainable energy.[44]

• **Everence Financial**: Everence Financial was founded in 1945 by the Menonite Church, and now works with individuals, organizations and congregations that wish to integrate their investments with their faith and mission. The firm urges its clients to allocate a portion of their investment resources toward the Everence OneWorld Community Investments Program, which invests in projects that support faith-based community development projects in the U.S. and seek to eliminate poverty through international microfinance.[45]

• **Mercy Investment Services**: Mercy Investment Services is the asset management program for the Sisters of Mercy and its ministries. In addition to embracing certain socially responsible investment standards, Mercy Investment Services manages a community investing program begun in 1995, known as Mercy Partnership Fund, which consists of debt and equity investments that benefit the economically poor—especially women and children—who are unserved through traditional financial sources.[46]

UNLEASHING PRIVATE PENSIONS: OPPORTUNITIES FOR REGULATORY REFORM

While many public and religiously-affiliated pension funds have some flexibility to pursue ETIs, private pension funds have historically faced regulatory barriers to these sorts of investments. As mentioned above, most private pensions are governed by the Employment and Retirement Securities Act of 1974 (ERISA), which requires funds to be managed "for the exclusive purpose of providing benefits to participants and their beneficiaries."[47] In 1994, the U.S. Department of Labor, which oversees the implementation of ERISA, issued an interpretation of the law stating that ETIs would not violate fiduciary duties as long as they provided the same rate of return at the same level of risk as comparable investments.[48] However, a reinterpretation issued in 2008—known as the "rigid rule"—stated that ETIs should be rare and, when considered, documented through a written analysis showing they were "economically indistinguishable" from more traditional investments. The 2008 guidance also included a number of examples of investments that violated its new interpretation, including a hypothetical bond to finance affordable housing for people in the pension fund's local community.

To be sure, the 2008 guidance has not stopped all managers of private pension funds from pursuing ETIs and other socially responsible investments. However, the guidance is considered to have had a chilling effect on ETIs, as some pension fund managers view ETI compliance requirements as overly burdensome and time-consuming.[49]

In an effort to encourage more impact investments by private pension funds, in October 2015 the Department of Labor issued new guidance that rescinded the 2008 "rigid rule" and reverted to the language of the 1994 guidance. The new guidance states that "fiduciaries may consider collateral goals as tie-breakers when choosing between investment alternatives that are otherwise equal with respect to return and risk over the appropriate time horizon." It also clarifies that "environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment," and thus these issues "are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."[50] This action has broad support throughout the impact investing community, and the new guidance is consistent with the recommendations of the U.S. National Advisory Board on Impact Investing.[51]

There are further actions policymakers can take to encourage more impact investments by private pension funds. Another step would be to institute new disclosure rules that better align U.S. fiduciary regulations with those of other developed countries. For example, a number of countries have rules that mandate disclosure on environmental, social, and governance issues by pension funds. In Australia, pension funds must disclose "the extent to which labor standards or environmental, social or ethical considerations are taken into account in the selection, retention or realization of the investment."[52] In the United Kingdom, a fund's Statement of Investment Principles should include the extent to which managers "take account of social, environmental or ethical considerations when taking investment decisions."[53] In the U.S., the Securities and Exchange Commission mandates certain disclosures on investments by U.S.-listed companies and mutual funds, but there is no such mandate for pension funds.[54]

ACCELERATING IMPACT INVESTING THROUGH PUBLIC POLICY

In 2013, Enterprise Community Partners, Pacific Community Ventures and the Initiative for Responsible Investment co-founded the Accelerating Impact Investing Initiative (AI3), one of the first groups dedicated to policy topics related to impact investing in the U.S. Since then, the AI3 has helped spark a national conversation about the federal government's role in expanding and improving the market for impact investments.

In June 2015, the AI3 team published a white paper that summarizes the initiative's first year of work, identifies the many ways that the government supports impact investing today and offers criteria for evaluating impact investing policies going forward.[55] In the coming year, the team will work to identify high-priority policy recommendations, build cross-sector coalitions around those recommendations and begin to engage key policymakers to usher in meaningful reforms. One of the team's top priorities for 2016 will be to work closely with pension fund managers, trustees, beneficiaries, asset managers, and government regulators to further investigate ETIs, starting with the creation of a national catalogue of ETIs and in-depth case studies of investments that deliver social impact and appropriate risk-adjusted financial returns.

Conclusion

Pension funds—both public and private—have a long history of pursuing ETIs while fulfilling their fiduciary duty to pension holders and beneficiaries. Through partnerships with government agencies at the federal, state and local levels, fund managers can ensure that these investments yield relatively low-risk, market rate returns—often exceeding the performance of relevant benchmarks—while delivering tangible assets to the local community.

Based on the examples discussed above, there are a few best practices to keep in mind for public and private pension funds looking to incorporate ETIs into their investment portfolios:

• **Start with a clear strategic focus and an achievable goal**. Several public pension systems—including those of the country's largest city and largest state—have set explicit targets for percentages of their total pension investments that go to financially responsible ETIs within a particular geographical area. Meanwhile, some religiously affiliated pension funds target specific underserved communities or sectors of the economy with a national scope. Whether the target is geographic, social or sectoral, it's clear that any ETI strategy should begin with a well-articulated focus and an achievable goal—say, a certain percent of all investment assets over a certain period of time. In most cases, the ETI goal is set by the pension system's board of trustees.

• **Like every other pension fund investment, ETIs must deliver appropriate risk-adjusted financial returns.** The primary goal of any pension fund must be to deliver benefits to its pension holders and beneficiaries. For ETIs and all pension fund investments the perceived risk, financial return and liquidity must be similar to other investment opportunities within the same asset class, irrespective of the societal benefits the investment may deliver. For this reason, the process for reviewing and underwriting a potential ETI should be identical to the process for all other investments in the fund manager's portfolio. A clear social benefit is no excuse for shoddy underwriting.

• **Some ETI initiatives might require outside subsidy or partnerships with government entities.** The NYCRS partnership described above is arguably the longest-standing success story in ETIs by a public pension fund. However, the partnership relies heavily on a 100 percent guarantee by the state mortgage insurance agency. Such a subsidy might be particularly important for newer investments with limited track records, but the need for subsidy should subside once an investment demonstrates a history of strong performance. When credit enhancement or another form of ongoing support is necessary for an ETI to be financially viable, the state or local government should consider creating a dedicated source of public funding. For example, in support of the NYCRS and NYSCRF partnerships described above, SONYMA receives a 25-basis-point surcharge on the state's mortgage recording tax, which generates about $180 million each year to capitalize the agency's mortgage insurance fund. Fund managers looking for a more modest level of affordability—say, workforce housing for families earning at or around the area median income—might be able to pursue these investments without credit enhancement or direct subsidies.

• **To maximize the impact of an ETI, consider partnering with a mission-driven nonprofit with connections to the local community.** Some pension funds decide to partner with a local community-based nonprofit to administer an ETI initiative. For example, Wespath partners with a small set of approved CDFIs to administer its Positive Social Lending Program, while NYSCRF has an exclusive agreement with one mission-driven lender, the Community Preservation Corporation. According to a 2006 study of ETI initiatives by Tessa Hebb, "social goals are best achieved by partnering with a local nonprofit organization whose purpose is to achieve social outcomes, rather than the pension fund becoming engaged in the delivery of social outcomes."[56]

When pursued carefully, ETIs have the potential to unleash a significant amount of new private investment into low- to moderate-income communities. For example, if just two percent of the assets in the country's public pensions and one percent of the assets in private pensions were dedicated to ETIs, it would bring $250-300 billion in private capital to the impact investing marketplace.

Of course, that level of new investment capital would require a significant expansion in the market infrastructure for impact investing, as well as a concerted effort to educate pension fund managers, their beneficiaries and other stakeholders. The Accelerating Impact Investing Initiative (AI3) looks forward to working with key stakeholders in the coming months to translate the Department of Labor's announcement into real investment opportunities and real social and environmental impact.

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