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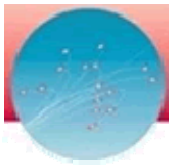


The Role of Institutional Investors in Social Finance

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The Role of Institutional Investors in Social Finance

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The Role of Institutional Investors in Social Finance

Dr. Tessa Hebb, Carleton Centre for Community Innovation
October 8th 2010

Executive Summary

This policy brief focuses on Canadian pension funds as a source of potential capital in for Canadian communities. It examines how other jurisdictions have approached this issue and looks for possible policy options that will encourage such investment.

There are three primary means of engaging Canadian institutional investors, particularly pension funds in impact investing for social finance. They can be encouraged, incentivized or compelled to take such action. Encouragement can range from clarifying fiduciary duty, requiring ESG disclosure, to reinforcing the need for a 'social license to operate' that large pension funds will require given their dominant role in the Canadian economy and tax exempt status.

With the exception of the US Community Reinvestment Act no other institutional investors throughout the world have been required through regulation to make mandatory community investments. Rather these investors have been encouraged and incentivized to make such investments.

I strongly recommend that the Task Force on Social Finance put forward policies that encourage and incentivize impact investing by institutional investors in Canada rather than compelling such action.

Barriers to Impact Investing in Social Finance

Our research suggests that Canadian institutional investors face four structural barriers to impact investing.

1. Lack of qualified intermediaries with expertise in impact investing
2. Lack of intermediaries with lengthy track records, assets under management and standard financial product that meets fiduciary and asset allocation needs
3. Lack of scale and standardization in impact investing opportunities
4. Investor reputation risk should the investment fail

Encouraging Impact Investing

Policies that encourage impact investing for institutional investors, particularly pension funds, must address restrictions either perceived or real that are imposed by fiduciary duty.

- The definition of fiduciary duty in existing and future legislation should be amended to include not only financial stewardship, but also economic, social and environmental considerations. To do this pension plan regulation should clarify that risk adjusted market-rate investments that also achieve an ancillary benefit for communities are permissible under fiduciary duty.
- Similarly to UK, France, Australia, Denmark and Germany, Canadian governments should require pension funds to make mandatory annual disclosure of the use of environmental, social and governance (ESG) factors in their investment decision making, detailing how they take ESG into consideration.
- Social license to operate can be reinforced by requiring pension fund disclosure on where their investment is taking place in Canadian communities.

Incentivizing Impact Investing

In addition to encouraging impact investing, governments' can also incentivize such investment by reducing the risks to investors involved in these transactions. Such incentives help community investments achieve the required market rates of return that pension funds and other institutional investors require.

- Governments can provide pools of patient capital to qualified intermediaries that enable them to offer guarantees and credit enhancements.
- Governments themselves can provide guarantees on investment and credit enhancements directly that incentivizes investment.
- Tax deductions and tax credits can provide additional incentives for community investment.
- Other tax structures such as flow-through share can also stimulate more investment in this sector.
- Municipal governments can provide land, re-zoning, and reductions in cost for real estate developers who provide social returns for the city. This can allow development that generates both positive social outcomes (such as affordable housing) and market rates of return.

The Role of Institutional Investors in Social Finance

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Canadian Context

This policy brief looks at ways to encourage, incentivize and compel Canadian institutional investors to adopt polices that result in direct and intentional impact investing in social finance. It focuses on Canadian pension funds as a source of potential capital in this market and examines how other jurisdictions have approached this issue.

Canadian institutional investors are comprised of banks and credit unions, pension funds, mutual funds, insurance companies, foundations and endowments[1]. Together these Canadian institutional investors represent assets of $4.7 trillion: with banks and credit unions assets at $2.9 trillion, trusteed pension funds with $811 billion; mutual funds at $611 billion, and insurance companies holdings of $500 billion (all figures as of 2009).

Institutional investors have a fiduciary relationship to the capital they manage. Their fiduciary duty is prescribed by law and requires prudence in investment decision making. With the exception of foundations and endowments, institutional investors are not able to sacrifice returns from investment for social goals. The direct result of their fiduciary duty means that these investors must seek risk adjusted market-rate returns on their investment. But these investors, particularly pension funds, are able to achieve ancillary or corollary benefits from their investment in addition to risk-adjusted market rates of return (as described under US pension fund law ERISA). Positive impacts for communities such as affordable housing, expansion of economic activity, and community development are examples of ancillary benefits that can be targeted by institutional investors.

While the size of Canadian institutional investors' holdings is large, currently very few of these assets have been deliberately invested to achieve both financial return and ancillary benefits for Canadian communities. The Social Investment Organization estimates the amount of Canadian institutional investors' assets in responsible investing broadly to be $609 billion[2] with $1.4 billion currently invested in community development. Community loan funds in Canada while small have increased from $58.7M in 2006 to $103.3M in 2008.

There continues to be limited examples of Canadian institutional investors engaged in social finance. One example is the British Columbian real estate company Concert Properties that uses 100% union construction and building maintenance. A consortium of twenty-seven pension funds in British Columbia invested in Concert Properties that provides affordable housing as well as a range of other positive community impacts. Shareholder equity of Concert Properties

[1] We will not examine foundations and endowments in this policy brief as a separate policy brief has been developed for the task force on this topic.

[2] Responsible investing is taking environmental, social and governance (ESG) factors into consideration in investment decision making.

is estimated at over $800 million and returns on investment have been at market rates. Another example of Canadian institutional investment in social finance is the Public Service Alliance of Canada (PSAC) staff pension fund that made an unprecedented $2 million investment in affordable housing in Ottawa in 2006. Five years after establishing a responsible investment policy and indicating a desire to invest in affordable housing, the pension fund was able to find a way to fulfill its fiduciary duty and target investment for community benefit. This investment was made through Alterna Credit Union and utilized a fixed income Guaranteed Investment Certificate for the pension fund investor that generated a market rate of return at minimal risk.

Among financial institutions, Canadian credit unions have been most active in community investment. The Mouvement Desjardin in Quebec has several programs in this area including the Capital regional et coopérative Desjardins (CRCD). This $500 million venture capital fund was created in 2001 by the Desjardins Movement with the help of a provincial tax credit. Individual investors can invest up to $3,500 a year in shares with a 50% tax credit. Shares must be kept for a minimum of seven years. CRCD has the mission to provide capital, expertise and access to networks for businesses and cooperatives in all Québec's regions. VanCity is another key figure in impact investing for social finance. It is Canada's largest credit union, with $14.5 billion in assets, more than 400,000 members throughout British Columbia. In addition to grants, VanCity has developed a number of financial products, programs, and partnerships to meet the needs of the community and non-profit sector and support new areas of the economy such as social and environmental enterprises. Other credit unions across Canada also provide important access to capital for community development. These programs often take the form of micro-loan funds offered by the credit union, sometimes in partnership with local community loan funds.

Within the mutual fund industry, Socially Responsible Investment (SRI) recognizes community investment as one of its four pillars. In Canada only two SRI funds, Acuity Fund and Meritas Fund, offer a community investment component to their unit holders. Meritas Fund pledges to invest 2% of its assets in community investments. As of 2004, Meritas had invested over $500,000 through community loan funds, development banks and credit unions.

Increasingly in Canada we are seeing innovative impact investing financial intermediaries that seek institutional investment. A number of deals have been innovative in devising structures to leverage private, public and foundation money. The Great Bear Rainforest Fund is a $120 million funding package for conservation management and ecologically sustainable business ventures in First Nation territories in the Great Bear Rainforest. This public-private-philanthropic partnership was structured to allow private funds ($60 million) to flow to a conservation endowment fund, while using public funds ($60 million) for investments in

ecologically-sustainable business ventures within First Nations' territories or communities. In March 2009, the $50 million CAPE Fund was launched by former Canadian Prime Minister Paul Martin to provide equity and quasi-equity investment in the range of $1 million and $7.5 million to Aboriginal businesses. The Fund includes investors from private and philanthropic sectors, including strong representation from Canada's largest financial and mining companies.

Provincial governments have also been able to creatively leverage policy tools towards stimulating social investment capital. La Fiducie du Chantier de l'économie sociale Trust (Fiducie) is an innovative structured finance product to meet the needs for long-term capital investment in social economy enterprises in Quebec. It is a $52.8 million patient capital (quasi-equity) fund that offers loans with a 15-year capital repayment moratorium to support social enterprise and real estate investments. Finance in the range of $50,000 and $1.5 million is offered for working capital requirements of social enterprises (including asset purchase), or to finance real estate acquisition or renovation. The three institutional investors – Fonds de solidarité (a labour-sponsored venture capital corporation), Fondaction (a labour-sponsored development fund) and the Government of Québec – received a debenture in exchange for their investment, in addition to a non-repayable government grant from Canada Economic Development.

In spite of these new and innovative investment products and intermediaries, impact investments made by institutional investors, particularly Canadian pension funds remain small and lag other jurisdictions such as the US and many European countries.

US Institutional Investors' Impact Investing

US institutions engaged in impact investing (also known as economically-targeted investment, community investment, community development finance, social entrepreneurship, and social finance) include vehicles that rely heavily on US federal government support: Community Investment Institutions (CIIs) and Community Development Financial Institutions (CDFIs). According to CommunityInvest.org estimates CIIs collectively hold over $25 billion in assets.

The US Community Reinvestment Act compels regulated financial institutions to invest in the communities in which they are chartered to conduct their business. As a result most US banks make deposits in CDFIs to obtain credits that meet their CRA obligations. As a result CDFIs are a robust and integral part of the US community development finance landscape.

The Community Reinvestment Act

The Community Reinvestment Act (CRA) is a US federal law enacted by the US Congress in 1977 to require regulated financial institutions to invest in the communities in which they are chartered to conduct their business. This act made credit available to low- and moderate-income neighbourhoods, where financial institutions were traditionally least willing to provide credit, but where financing was most needed for community building initiatives. These institutions are monitored by appropriate federal agencies to ensure safe, sound banking operations are maintained in fulfilling the credit needs of the local communities. The act also provided a mechanism for federal agencies to monitor banks for discriminatory lending practices.

Regulated financial institutions refers to federally insured depository institutions, which includes national banks, savings and loans (thrifts), and state-chartered commercial and savings banks, but does not include mortgage companies or investment banks. Nor does it include other institutional investors such as pension funds, insurance companies and mutual funds.

In light of the recent lending crisis in the United States, it has been suggested that the scope of the CRA should be expanded to include non-depository institutions, including securities companies, mortgage companies, insurance firms and investment banks.[3] Legislation to expand the lending requirements of the CRA to Wall Street, bank affiliates and other financial services companies was introduced in October 2010. According to the National Community Reinvestment Coalition (NCRC), this legislation is expected to promote small business lending and job creation for local economies in the United States without expenditure of tax dollars.[4] The bill is also expected to close loopholes and gaps in the law, improve enforcement and expand transparency and accountability.

Impact of the CRA

In a review of the literature, Taylor and Silver (2008) found that studies have shown that banks provide a significantly greater number of home loans in areas covered by CRA agreements than those that are not. For example, a study by Federal Reserve economists using the NCRC CRA database found that incentives provided by CRA encourage banks to seek out opportunities in previously under-served markets. Also, the Treasury Department reports that between 1993 and 1998, CRA-covered lenders increased home mortgage loans to low- and middle- income

[3] Taylor, J. & Silver, J. (2008). The Community Reinvestment Act at 30: Looking Back and Looking to the Future. *New York Law School Law Review*. 53 (203).

[4] Bill to Expand CRA to Wall Street Introduced, available online [http://www.ncrc.org/index.php?option=com_content&view=article&id=621:bill-to-expand-cra-to-wall-street-introduced&catid=24:press-releases&Itemid=75]

borrowers by 39%, while the increase to middle- and upper-income borrowers in the same time period was only 17%. The Joint Center for Housing Studies at Harvard University estimates that without the CRA, 336,000 fewer home purchase loans would have been made to low- and middle-income borrowers and communities between 1993-2000. The Community Reinvestment Act has generated private sector (primarily banks) investment in community development equivalent to $1.7 trillion. It has been the most significant driver of banking involvement.

Taylor and Silver also compared the lending patterns of CRA-covered banks and non-CRA covered lending institutions. Based on data from NCRC's calculations of the HMDA data, the comparison indicates that banks make a slightly greater percentage of their loans to minorities and low- and middle- income borrowers than non-CRA covered mortgage companies and credit unions do.

While CRA is one of the few pieces of legislation that compels community investment requiring regulated financial institutions with deposit insurance to extend their lending, such regulation has not been extended to pension funds, mutual funds or the insurance industry (with the exception of Massachusetts[5]). Engagement of the later institutional investors has been encouraged and incentivized rather than mandated.

Community Deposit Financial Institutions (CDFIs)

A CDFI is a private, community-based organization that provides loans, investments, financial services and technical assistance to support community development of the area it is based in. CRA rules encourage mainstream financial institutions to invest capital directly into CDFIs by awarding CRA credit and potential cash rewards under the CDFI Fund's Bank Enterprise Award Program. CDFIs support the development of businesses and people, helping communities to build their credit and enable them to borrow from conventional lending institutions. Because CDFIs are active in specific communities, they are often able to identify the best opportunities for investment, and act as intermediaries between the banks and the community. The CDFI Fund of the US Treasury was established by in statute by the Riegle Community Development and Regulatory Improvement Act of 1994, and since its creation, has awarded $1.11 billion to community development organizations and financial institutions.

In addition to CRA, the US government offers a range of tax incentives to encourage community investment. The New Market Tax Credit (NMTC) is a federal tax credit offered by the Department of the Treasury (under its Community Development Financial Institutions Fund – CDFI Fund) to incentivize private investment in low-income communities. Under the program,

[5] In 1996, Massachusetts passed a law requiring Home Mortgage Disclosure Act (HMDA) disclosures on where property insurers do business and creating CRA-like financial incentives for insurers to write more policies in underserved neighbourhoods.

eligible investors receive 39 percent of the cost of their investment – an amount which can be claimed over a seven-year credit allowance period. CDFIs are able to package deals that incentivize a range of investors, using the New Market Tax Credit to gain maximum advantage.

Another investor incentive offered by CDFI Fund is the Bank Enterprise Award (BEA). The BEA program targets those institutions which are already involved in social entrepreneurship to incentivize them to further expand their financial services in low-income communities. BEA provides grants to financial organizations which increased their services from Baseline Period to the Assessment Period. To assist in overcoming financial barriers in Native communities in the United States, the CDFI Fund administers Native American CDFI Assistance (NACA) program. In the 2010 round of awards, $10.3 million was distributed to forty-five eligible Native organizations.

In the housing market, the government's Low Income Housing Tax Credit (LIHTC) provides roughly $8 billion annually to encourage investment in affordable housing. These efforts are further strengthened by the federally-issued Housing Authority Bonds – interest made on these bonds is exempt from income taxes.

Another financial innovation in this sector is the CARS rating system. It creates industry-wide standards for CDFI social impact and risk profiles, and creates a more transparent market for investors. In addition to direct investment, the strength of CDFIs has helped develop a secondary market in community loans. The Community Reinvestment Fund buys loans from the CDFIs in which they originate and bundles them into securities for purchase by large institutional investors. This gives the sector greater liquidity while offering a solid financial product to the market. This product was rated by Standard and Poors in 2007 which is important to institutional investors who are often mandated to invest only in institutional investment grade assets with third party credit ratings. It should be noted that although these securitized investments are similar to securities sold in the sub-prime mortgage market, the due diligence of CDFIs with their loan portfolios avoided the pit-falls of the subprime debacle. They have performed well during the current crisis.

Other US Institutional Investors

CDFIs are not the only intermediaries able to attract institutional capital to community investment in the U.S. Many mutual funds, pension funds, and foundations actively invest in their communities. In 2002 the Social Investment Forum (a trade association for socially responsible investors, similar to the Social Investment Organization in Canada) launched its "1% or More in Community Change" Campaign in order to direct 1% of its members' assets under management to community investment. The result was an increase in community investment on the part of Forum members from US$800 million to $3.2 billion. . Between 2001 and 2003,

assets for community investment mutual funds grew by 11 percent. Its goal is $25 billion for this sector of the economy.

The US has much broader engagement by institutional investors in what is termed 'emerging domestic markets', 'underserved capital markets', or economically targeted investments (ETIs). These investors are most often public sector pension funds, though there are also examples of insurance companies in the US such as Prudential engaging in these types of investments. Targeted investments are aimed at low and moderate income (LMI) areas and include affordable housing as a primary objective. In many cases investment vehicles partner with community level non-profit organizations in order to deliver the range of community impacts sought by the pension fund investors. Pension funds (such as CalPERS, CalSTRS, NYCERS, New York Common, Rhode Island, New Jersey, Vermont, Connecticut and MassPRIM) have invested more than $12 billion in social finance. The size of this market has expanded rapidly. What started as a niche market has increased its asset value by almost one-third, since 2005.

A leader in such targeted investing is CalPERS, the largest pension fund in the US. The goal for this fund is to invest 2% of its portfolio (currently valued at $200 billion) in California's underserved capital markets. It has allocated approximately $4 billion to thirteen real estate and twelve private equity partners who deliver this mandate (Hebb, 2005). Several of its investment partners are non-profit hybrid vehicles where income generated from these investments both generates a return for CalPERS and a return to the umbrella organization. Two such examples are Bridge Housing (a non-profit housing corporation) and Pacific Community Ventures (a private equity arm of non-profit group) both of whom have received considerable investment from CalPERS.

Other products used by pension funds and other institutional investors include fixed income products that are key to providing affordable housing and draw on Fannie Mae and Freddie Mac guaranteed mortgage-backed securities in order to access this capital. New York City Retirement System is a good example of this type of economically targeted investment, as is New York Stare Common and Massachusetts PRIM.

In the US large, sophisticated intermediaries with long track records and top quartile performance are able to attract market-rate targeted institutional investors including insurance companies, banks, and pension funds. These intermediaries tend to be very diverse in style, scale, structure, asset class, and targets. They bring expertise in what is termed under-served capital markets or emerging domestic markets. US Intermediaries that have received large institutional investments include:

- Bank of America Capital Access Fund: a fund-of-funds that enables large investments to be diversified across the sector.
- AFL-CIO Housing and Building Investment Trusts, that manages over $3 billion in assets.
- small innovative groups as Pacific Community Ventures (a not-for-profit California based intermediary), and Access Capital Strategies (now owned by Royal Bank of Canada through Voyageur Capital).

What they and others have in common is an ability to accept institutional investment and place it in community development, in order to generate both revitalization (as opposed to gentrification) and market rates of return [6] .

Another US pension fund manager making significant community investment is the $400 billion TIAA-CREF. After learning that its clients had an interest in both financial returns and socially responsible investing, this fund developed a number of SRI investment products. One is a $20 million dollar investment in Shorebank, one of the leading community banks in the U.S.

Impact Investing in the UK and Continental Europe

The United Kingdom is trying to emulate many of the activities in community finance underway in the United States and has made significant headway in this area particularly in recent years. The British government's Social Economy Unit is working on a number of programs that encourage private actors to invest in social economy enterprises. They have developed a number of instruments including tax credits, government policy and CDFIs. In the UK Community Development Finance Institutions are independent financial institutions that provide capital and support to individuals or organizations to develop and create wealth in disadvantaged communities or under-served markets. UK CDFIs have provided lent a record £113m in 2009, up 50% from the previous year. The value of CDFI loan applications rose to £360m in 2009 (from £160m in 2008). The CDFI loan portfolio stands at £394m. Banks have overtaken the regional development agencies as the main source of funds for on-lending for CDFIs. by 2009

CDFIs had helped to create or sustain over 96,000 jobs and had loaned and leveraged nearly £1 billion (£964 million) into the UK's most disadvantaged communities. (all figures from the 2009 Inside Out: The State of Community Development). The Community Development Finance Association (CDFA) has a number of core funders including, the UK Department of Trade and Industry, Barclays Bank, NatWest, and Royal Bank of Scotland.

[6] The results of a four year study by Tessa Hebb and Lisa Hagerman on US Pension Fund Investment in Urban Revitalization can be found at http://urban.ouce.ox.ac.uk/index.php.

Another example is the Local Investment Fund (LIF) established in 1995 by the Office of the Deputy Prime Minister, Business in the Community and the private sector, led by the UK bank NatWest, with the aim of overcoming the funding gap often experienced by social enterprise. The Local Investment Fund is a national organization that makes loans of between £25,000 and £250,000 to projects and organizations across England. LIF is establishing Regional Community Loan Funds in each of the English regions. These regional funds focus on the local communities in each region, with the aim of building a close connection between the funds, the clients and the sponsors. The regional funds make loans of between £15,000 and £100,000. Between 1995 and 2006 the Local Investment Fund has offered 102 loans totalling in excess of £6 million and leveraged almost £40 million into community regeneration. The LIF is funded by government, local business and the private sector of which NatWest the largest investor.

UK credit unions and co-operative banks are beginning to play a key role in access to capital for social economy enterprises. There are a number of specialized loan funds designed for co-operatives in the UK. These include Co-operative Action, a foundation established to serve the development of new and existing co-operative and mutual enterprises. By end of 2003 Co-operative Action had awarded £1 million in grants and £347,000 in loans. It is funded by the Co-operative Group, Co-operative Financial Services, United Co-operatives, and several smaller local co-operative.

Industrial Common Ownership Finance (ICOF) provides loan finance for co-operatives, employee owned businesses and social enterprises. It raises money primarily by public share issue, and lends it for social purpose and collective benefit. It also manages loan funds for several other organizations providing co-operative and community finance. Loans from £ 5,000 to £ 50,000 are normally available, however they are able to lend up to £ 250,000. Loans to new businesses are usually part of a larger financial package and not normally more than 50 percent of that package.

The UK's Charity Bank is a nonprofit bank that serves the needs of the charity and voluntary sector. Its mission is to change perceptions of how personal wealth can provide finance for the benefit of society rather than just for the profit of business or self-interest. For a number of years Charity Bank ran a loan fund called "Investors in Society" which between 1996 and 2001 made 167 loans valued at of over £8m. In May 2002 it converted to a bank and as Charity Bank it now takes deposits from the public, while continuing to provide affordable loans to the charitable and social enterprise sector. While a significant proportion of Charity Bank's loan funds are committed to supporting building purchase or renovation, a growing percentage is being used for child care and educational facilities, and environmental enhancements or to address disability issues, as well as for working capital or to underpin fund-raising initiatives. Triodos Bank is an ethical bank that invests in SEEs in positive social, environmental and cultural

change including SEEs. Its income is generated from deposits and it has an asset base of £100m.

Just as we find in Canada, there is only limited capital available from other financial institutions in the UK targeted to social finance. High Street banks are beginning to invest in UK CDFIs (Barclays, Halifax) and think about community investment outside traditional SME (Royal Bank of Scotland). SRI mutual funds encourage community investment, but do not have specialized community investment funds nor a campaign comparable to the US 1% for the Community.

Pension funds in the UK and indeed across Europe are increasingly adopting responsible investing policies. As indicated above, these policies bring environmental, social and governance factors into investment decision-making. In 2000 the UK government required all pension funds to disclose on an annual if they were using these factors in their investment decisions, and if so in what way. The result was an immediate uptake of responsible investing by UK pension funds. In the first year after mandatory disclosure 70% of UK funds indicated they were using ESG factors in investment decisions. Similar impacts have occurred in Denmark, France, Germany, and Australia where ESG disclosure is mandatory. However, most funds apply ESG analysis to the public equity portions of their portfolio.

Unlike US pension funds, few UK or European funds have extended their responsible investing programs to target investment in social finance vehicles. The UK's Pensions Bill (2008) encourages UK pension schemes to consider such investments and makes it clear that there is nothing in law preventing trustees from considering social and moral criteria in their decisions. One exception on targeted investment (also called themed investments in Europe) is the Dutch pension funds that are heavily invested in micro-finance funds focused on developing countries.

Policy Options to Engage Canadian Institutional Investors in Social Finance

There are three primary means of engaging Canadian institutional investors, particularly pension funds in impact investing for social finance. They can be encouraged, incentivized or compelled to take such action. With the exception of the US Community Reinvestment Act that applies only to the banking sector in the US, no other institutional investors through out the world have been required through regulation to make mandatory community investments. Rather these investors have been encouraged and incentivized to make such investments***. I recommend that the Task Force on Social Finance put forward policies that encourage impact investing and incentivize such investment by institutional investors in Canada.***

Suggested Policy Options

Our research suggests that Canadian institutional investors face four structural barriers to impact investing. First, most institutional investors do not want to become experts in

community development. They therefore seek qualified intermediaries who can sell them a standard financial product that meets their fiduciary duty and their asset allocations. Second, these intermediaries must be able to stand behind their product either through a demonstrable expertise in the field (i.e., measurable in terms of their track record and assets under management) or through an implicit or explicit guarantee or credit enhancement on the investment. Third, these opportunities must be at a scale large enough to justify the time and resources that institutional investors must devote to the necessary due diligence. Finally, these investors are very conscious of their reputation in their communities. Consequently, the intermediary must insulate them from the potential risk associated with failed investments. The growth of this sector in Canada requires that we move beyond the few niche players and into mainstream capital markets, in order to meet these requirements and address these constraints.

The explicit or implicit investment guarantee or credit enhancement listed above speaks to the role government can and should play in social finance. The overview of U.S. models shows how critical government policies and programs are to the growth of this sector. Federal, provincial, and municipal governments all benefit from strong, healthy, and vibrant communities. Policies that encourage the flow of institutional investment into community development are necessary.

Encouraging Impact Investing

Governments have an important role to play in clarifying the fiduciary responsibilities of asset owners and managers. Many investors have interpreted fiduciary duty as one that focuses purely on financial gains and are concerned that considering ESG factors is in conflict with their responsibilities.

Policy Options:

- The definition of fiduciary duty in existing and future legislation should be amended to include not only financial stewardship, but also economic, social and environmental considerations. To do this pension plan regulation should clarify that risk adjusted market-rate investments that also achieve an ancillary benefit for communities are permissible under fiduciary duty.

- Similarly to UK, France, Australia, Denmark and Germany, Canadian governments should require pension funds to make mandatory annual disclosure of the use of environmental, social and governance (ESG) factors in their investment decision making, detailing how they take ESG into consideration.

- Social license to operate can be reinforced by requiring pension fund disclosure on where their investment is taking place in Canadian communities.

Many investors have interpreted fiduciary duty as one that focuses purely on financial gains and are concerned that considering ESG factors is in conflict with their responsibilities. The definition of fiduciary duty in existing and future legislation should be amended to include not only financial stewardship, but also economic, social and environmental considerations.

A large number of initiatives to increase community investment have been focused on the clarification of "fiduciary responsibilities" so that investment managers do not feel legally restricted to consider only financial returns. Several legal opinions have stressed the importance of considering ESG factors into investment decision-making. The UN's "Freshfields Report" of 2007 demonstrates that due to the effects that ESG factors can have on the financial value of an organization, it is clear that ESG considerations can and should be incorporated into decision-making. While not demanding ESG considerations must be taken into account, a number of jurisdictions (UK, Denmark, France, South Africa, Australia) require annual mandatory disclosure by pension funds of ESG consideration. Such mandatory disclosure has had a galvanizing effect on the sector, both thawing any perceived 'chill' that ESG considerations conflict with fiduciary duty and encouraging funds to take such action to remain consistent with their peers. Such legislation was proposed in Canada in 2001 but was not passed. Currently the UN Principles for Responsible Investing has over 800 signatories representing over $20 trillion of assets under management, who have committed to a set of responsible investing principles. Canadian signatories include some of Canada's largest pension funds.

Noteworthy initiatives on the clarification of "fiduciary responsibilities" include the US ERISA ruling on economically targeted investing and a subsequent ruling on socially responsible investing that allows pension funds to make these types of investments as long as they do not sacrifice financial returns to the fund. The UK's Pensions Bill (2008), also clarifies that there is nothing in law preventing trustees from considering social and moral criteria in their decisions. Manitoba reformed its pension legislation in 2005 to contain language on non-financial investment considerations, making it clear that such considerations do not constitute a breach of trust or contravene the Act.

As pension funds continue to grow and dominate our economy, their sheer size and impact in addition to the tax exempt status that such resources enjoy, begins to require a 'social license to operate' . This is particularly true of defined benefit pension plans with large assets under boards of trustee management. CalPERS, the largest defined benefit plan in the US came under attack by California Governor Arnold Schwarzenegger. When asked by the California State

Legislature to justify CalPERS role in the economy their response was "CalPERS cares about California in a way that Fidelity never will." They back up that statement through their market-rate targeted portfolio in California's underserved capital markets. By requiring disclosure on where investment is taking place in Canada, the social licence to operate is reinforced.

Incentivizing Impact Investing

In addition to encouraging impact investing, governments' can also incentivize such investment by reducing the risks involved in these transactions. Such incentives help community investments achieve the required market rates of return that pension funds and other institutional investors require.

Policy Options:

- Governments can provide pools of patient capital to qualified intermediaries that enable them to offer guarantees and credit enhancements.
- Governments themselves can provide guarantees on investment and credit enhancements directly that incentivizes investment.
- Tax deductions and credits can provide additional incentives for community investment.
- Other tax structures such as flow-through share can also stimulate more investment in this sector.
- Municipal governments can provide land, re-zoning, and reductions in cost for real estate developers who provide social returns for the city. This can allow development that generates both positive social outcomes (such as affordable housing) and market rates of return.

Governments can provide pools of patient capital that enable intermediaries to offer guarantees and credit enhancements. Additionally governments can provide guarantees on investment and credit enhancements directly that incentivizes investment. Tax deductions and credits (such as those offered in Nova Scotia, Manitoba, and now PEI) can provide additional incentives for community investment. Tax deductions and tax credits can provide additional incentives for community investment, as intermediaries can structure deals with a variety of tranches that provide tax credits to individuals and companies to whom these are of value. Utilizing this base of first loss capital intermediaries can structure subsequent tranches that meet the market-rate returns required by pension funds where the tax credit is not an incentive.

Other tax structures such as flow-through share can also stimulate more investment in this sector. Municipal governments can provide land, re-zoning, and reductions in cost for developers who provide social returns for the city.

The development of lower capital gains tax rates on investments in social enterprises would provide incentive to alternative assets to this market, rather than relying on grants. Providing full or partial tax-exemption status for social enterprises would give incentives for more organizations to take on this hybrid-structure that can produce ESG benefits and thereby, expands the pool of assets available to them for financing. A similar option would be to apply the UK's Community Interest Companies or US L3C model to Canada to help overcome the barrier faced by charities and non-profit organizations in their attempts to raise equity capital.