21 December 2016

Tamara Goriely
Law Commission
1st Floor, Tower
52 Queen Anne's Gate
London SW1H 9AG

Dear Ms Goriely,

I am writing in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association in relation to the recent Law Commission call for evidence on pension funds and social investment. We appreciate you taking the time to meet us and a selection of our members to discuss our views in addition to our written evidence.

The UK Sustainable Investment and Finance Association (UKSIF) is the membership network for sustainable and responsible financial services in the UK. We act as the voice of the SRI sector and promote long-term investment aimed at sustainable economic development, enhancing quality of life and safeguarding the environment. Our members include many of the UK's largest pension funds, banks, insurance firms and asset managers, all of whom are committed to long-term sustainable economic growth.

<u>Question 1</u>

What are the barriers to pension funds investing:

(a) In infrastructure generally?

Increasingly, infrastructure investment has become an attractive proposition to pension schemes, enabling them to diversify their portfolio and match long-term liabilities. There are a variety of obstacles to pension schemes making these investments, however. One UKSIF member described infrastructure as an appealing asset class provided exposure was "cheap and relatively easy" but went on to say that since this is rarely the case, most defined-contribution (DC) schemes would be better suited to core, central asset classes such as equities, fixed income and property. As with defined-benefit (DB) schemes, often only the biggest funds are able to invest.

A lack of experience in infrastructure investment on trustee boards may also represent a significant obstacle, and one which may be compounded by the small size of some funds. Even where there is some exposure, it is often so small that schemes simply cannot justify creating an internal capability to invest directly or develop internal resources. Difficulties for pension schemes investing in infrastructure were confirmed by UKSIF members at a meeting with MPs in 2015 at which they made clear it was easier to invest in infrastructure assets in Australia than it was in the UK. To illustrate the contrast between regimes, UK pension scheme exposure to infrastructure currently stands at around 1%, compared to the situation for funds in Australia which has 8-15% of funds invested in infrastructure assets.[1] The Pensions Infrastructure Platform, set up to address this and other issues has been slower than anticipated at raising funds and has yet to meet its £2bn target. If successful, however, it will allow member schemes to achieve the benefits of scale which characterise the asset class.

[1] http://researchbriefings.files.parliament.uk/documents/SN06594/SN06594.pdf

Infrastructure is an inherently illiquid asset class which presents its own problems, particularly in the DC space. This is chiefly due to daily liquidity and daily pricing practices on assets in the fund. This "daily dealing" means DB funds are in a far better position to invest in infrastructure and prevents many DC schemes from investing in the many available funds already in the market. To overcome this problem, some infrastructure funds have started to be "wrapped" in more liquid funds to provide both liquidity and a daily price, however this again tends to be the preserve only of larger schemes. DC schemes are in theory well placed to earn the illiquidity premium generated by such assets given their long-term time horizons: there is no reason why a saver in her early 20s would require even infrequent access to her assets. The position has been described by one UKSIF member as a "nonsense".

The DC Investment Forum (DCIF) made clear that there is no regulatory requirement for daily dealing and that it was instead a result of the evolution of the DC market. In particular it has developed as a market norm for platforms which require daily priced funds to meet the consequences of members switching, retiring and dying on different dates. DC schemes were designed to be flexible savings vehicles to allow these members to easily and regularly transfer in and out of funds. However these needs have evolved since the rules on daily dealing were established and will continue to do so due to automatic enrolment. DC members are currently at a significant disadvantage since they are denied the benefits of diversification and the illiquidity premium received by DB members. The focus should now be to encourage long-term default investment options for DC members, including by investing in more illiquid assets.[2] This is an area the Law Commission should investigate further.

(b) In socially significant infrastructure?

Provided returns are satisfactory we see no further barriers to DC pension funds investing in socially significant infrastructure, subject to the above.

(c) In other forms of social investments?

Since social investments also tend to be illiquid, the issues around daily dealing will apply. The Law Commission's 2014 report into fiduciary duties was helpful in clarifying that the law permits pension scheme trustees to take non-financial factors into account providing they have good reason to think members would share that view and that there is no risk of significant financial detriment to the fund. The report recommended the use of the terms *financially material factors* and *non-financial factors* rather than *ESG* and *ethical* to help clarify the law for trustees. We do not think this language has permeated the sector yet, and in part this was due to the failure of DWP to make the recommended changes to the Investment Regulations in 2015. We have also expressed our concern to you that the Law Commission's own language has not been used in this follow-up consultation.

Another obstacle is the scale of the universe of investible assets. UKSIF member feedback was that one way around this may be to broaden the definition of what a social investment is. Social Investment has its roots in the charitable space and the market has developed to cater for those investors; currently the market has neither the size nor demand to match the need of pension schemes. Big Society Capital has identified three potential groups of high impact assets that a social investment fund may be able to invest in:[3]

- Social investments (traditionally smaller investment sizes)
- Larger investments into the social sector (large organisations with defined social purpose)

[2] DC Investment Forum, *Mind the Gap: The case for a relaxation of daily dealing requirements for DC pension funds*, 2013

[3] http://www.bigsocietycapital.com/sites/default/files/Social%20pensions_Technical%20paper_Oct16.pdf

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- Investments for broader public purpose (by organisations not within social sector, but intending to deliver a social impact, such as public institutions)

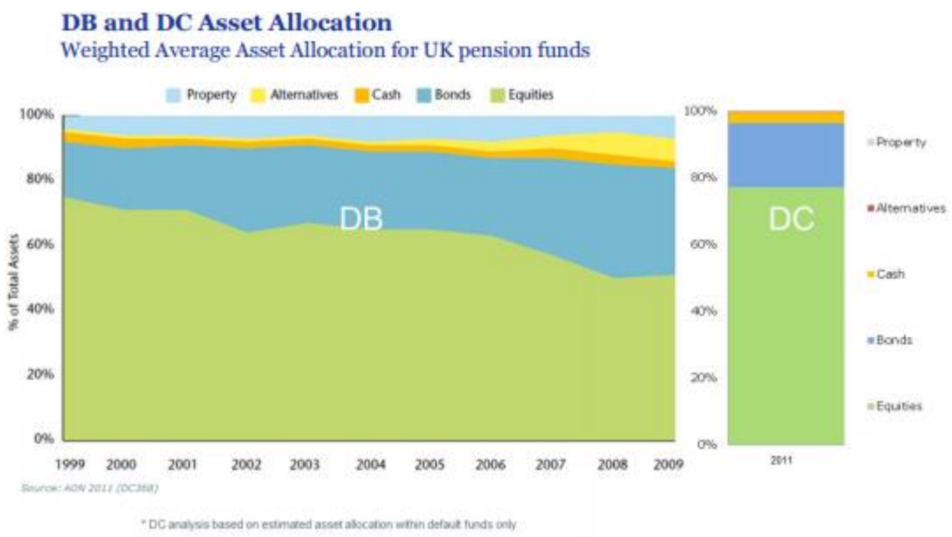
If the definition is to be broadened, it will be essential for the focus to remain on the social aspect of those broader opportunities. For investors this will mean a requirement for information on social outputs to be available to members of the fund which may in itself help drive engagement and further saving.

Question 2

Do any of those barriers relate to issues of law and regulation?

We have already discussed in some detail the issues surrounding daily dealing and highlighted that this is having a definite impact despite not being a regulatory issue. The failure of DWP to implement the Law Commission's recommended changes to the Investment Regulations has prolonged the confusion for some trustees over their fiduciary duties. We hope the recent change to the investment guidance for trustees by TPR will in part address this, and also the transposition of IORPs2 into UK law.

One key barrier to social investment by pension schemes that has been highlighted to us by UKSIF members on several occasions is that it is very expensive to deliver given the 75bps cap on default funds. Although the cap does not apply to chosen funds, we have heard that it tends to apply in practice anyway. Given the tiny size of the majority of these funds, there would be little impact in boosting social investment unless default funds were targeted. In fact, we hear from members that the 75bps cap, despite being introduced to ensure trustees and fund managers act in the best interests of members, has forced more schemes to invest in cheap passive equity funds. This has meant less balanced portfolios in DC schemes which are dominated by equities. The 2013 DCIF report illustrates this point with an asset allocation comparison showing that DC schemes have much larger equity weightings than their DB counterparts and far less diversification overall.



Now whilst there are other relevant factors in that comparison, such as the age of the investors, it is significant that the DCIF feels able to argue that as much as 35bps of DC performance could be gained from illiquid investments, producing 5% larger pots. A 'focus on fees rather than value' has acted as an obstacle to DC schemes gaining access to the benefits of diversification.[4]

We have also heard from members that the recent update to permitted links rules has acted as an unexpected barrier to schemes using fund platforms. The result has been a regulatory inconsistency whereby we are informed DC trustees are classified as retail investors. The FSA increased protections for DC scheme members, which included a list of appropriate assets; the feedback we have received is that this has acted as an obstacle to innovation.[5] In its response to a public consultation it argued that there was not a 'pressing need or consumer demand' to expand their definition further. This approach has made it very difficult for a DC scheme using a fund platform to invest in e.g. an alternatives only pooled fund. We think given the Government's focus on social investment and our own polling which reflects significant consumer demand, this could be an opportunity to revisit the FCA's approach in this area.

Question 3

Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

A small fund has less flexibility to deal with the practical consequences of issues such as liquidity, daily pricing and permitted links.

Most DC money goes into default funds and the focus should therefore be on rules permitting default funds to do social investment. More generally, most DC schemes tend to be smaller in comparison to DB, but assets under management will continue to grow as more people are automatically enrolled. DWP statistics show that by 2018 there will be an extra 9 million savers due to automatic enrolment, while The Social Market Foundation estimates DC assets under management to grow to £600bn by 2030.[6]

We are not experts on the legal practicalities of scheme mergers, however it is our understanding that the most important consideration are a scheme's own rules. Most have relatively broad rules allowing them to transfer and receive, while for those which do not there is a relatively straight forward process of amending the scheme's rules. UKSIF member feedback is that in most cases, particularly where a merger may impact costs, actuarial sign off will be necessary. This is to show that the benefits to be received by members are on the whole no less favourable than those they are entitled to in the current scheme – for some schemes this may be a barrier.[7]

Question 4

We wish to hear from employers and pension providers about the ethical options currently on offer (whether positively or negatively screened).

(a) What ethical DC pension funds are available?

Key terms relating to sustainable and responsible investment are as crucial to understanding as they are difficult to define due to predetermined perceptions of investments and differing methodologies

[4] DC Investment Forum, *Mind the Gap: The case for a relaxation of daily dealing requirements for DC pension funds*, 2013
[5] FSA Feedback Statement FS12/2 available at https://www.fca.org.uk/publication/feedback/fs12-02.pdf
[6] Social Market Foundation and Big Society Capital, *Good Pensions: Introducing social pension funds to the UK*, 2015 available at http://www.smf.co.uk/wp-content/uploads/2015/09/Social-Market-FoundationSMF-BSC-030915-Good-Pensions-Introducing-social-pension-funds-to-the-UK-FINAL.pdf
[7] More information available at https://www.sackers.com/pension/merger-basics/

in "non-traditional funds". This is one reason the Law Commission in its 2014 report opted to recommend the use of *financially material factors* and *non-financial factors*.

In precise answer to your question, there is a large number of funds that are "ethical" and use the term in their names. A list of these funds are available at YourEthicalMoney.org and FundEcoMarket.co.uk.

But in addition to an "ethical" approach these funds- and an increasing number of mainstream funds- will use additional techniques and approaches, the most common being sustainability themed, positive and negative screening, and best in class. Over time savers and investors have become less concerned about excluding certain sectors and more interested in the role of businesses in society and how they can help bring about positive social outcomes. This process has given rise to a wide spectrum of approaches with "ethical" being an important subset in terms of size and intellectual leadership. Purely "ethical" approaches are now probably a minority in a fast-growing sector characterised by the integration of financially material ESG factors. We consider funds practising responsible investment as likely to engage in ongoing active ownership with investee companies on these types of issues. This is becoming an increasingly mainstream approach to investment and an example is the NEST default fund which operates in this manner.

Both of the above approaches form part of sustainable and responsible investment, which could be summarised as any type of investment strategy that incorporates consideration of ESG factors, financially material or otherwise. Logically therefore, social investment may be included in this description. Further, if social investment can be structured appropriately and the return profile is suitable then it is no longer a "non-financial" factor or an "ethical" issue, but can form part of a risk diversification strategy and is therefore a financially material consideration. We are in favour of this direction of travel, but would again highlight the issues surrounding daily dealing and the 75bps cap.

(b) What proportion of people take them up?

Take up of ethical options has generally been low and NEST estimates enrolment into its ethical fund to be 1%. As we have mentioned, given the fact ESG is incorporated in its default fund, this figure may not be entirely revealing. Many people whose values might normally lead them to enrol in the ethical option may not choose to do so since these concerns may have already been catered for in the default fund. NEST also produces excellent communications for members including an annual report which details its responsible investment and stewardship activity.

According to the Investment Association ethical funds total £12.1billion and are 1.2% of the total. The IA tracks monthly sales and for the past two years or so the share of ethical fund sales has been appreciably higher at 3-4%. Further, polling commissioned for Good Money Week 2015 showed that 54% of people with investments want their pensions or savings to have some positive impact on the world beyond just making money.

Our view is that the appetite for responsible investment, which would include social investment, among UK savers is higher than it has been and is likely to grow further.

(c) What sort of returns do they provide?

Both responsible investment funds, i.e. those which integrate ESG factors and ethical funds can outperform more traditional, mainstream funds. Evidence is readily available that ESG considerations boost operational performance of companies as well as stock price as outlined in a report last year from an UKSIF member.[8] One clear example of this happening in practice is the FTSE4Good Index which has, for the past five years, outperformed both the FTSE All Share and the MSCI World indices, while over half of ethical equity funds have outperformed the FTSE All Share for the past 10 years.[9] In your work on fiduciary duty you also cited academic research which support the case for responsible investment.

<u>Question 5</u>

We seek views about how far these options meet the needs of savers.

(a) Would a greater range of options encourage greater engagement with pension saving?

UKSIF member feedback suggests there are three layers of offer by employers in a DC range: the default fund, where the majority of savers will be enrolled; a relatively small number of prompted extra funds, or chosen funds; and in some cases, the full range of funds offered by a DC platform. We have been told that while options are important in promoting greater engagement with pension saving, too many options can have the opposite effect.

Despite the risk that fund proliferation will affect engagement we do face the situation where as our polling shows some people want to create a positive social or environmental outcome and a return, and funds offering that are not offered. This is linked to the lack of financial literacy among the majority of savers. We think efforts to increase awareness more generally of the £1.5tn SRI market in the UK would be helpful. In our polling despite 54% wanting their investments to have a positive impact, 54% of people were unaware that sustainable and ethical products exist, which rises to 63% of millennials- the group most impacted by automatic enrolment.

More fundamentally, levels of pension engagement in the UK have been low for decades. One reason has been a general reliance on the state safety net and “guaranteed” DB pensions. The financial crisis resulted in a need to move away from this system, a further shrinking of the state and a transition to DC pensions whereby all investment risk lies with savers. Although efforts have been made to improve financial literacy, such as the introduction of the subject to the secondary school curriculum in 2014, not enough has been done. The introduction of automatic enrolment represents a move to bypass the lack of literacy and engagement amongst savers rather than address it. This was a short-term fix, and policy makers have yet to address the inadequacy of savings for retirement. A resulting drop in confidence levels of automatic enrolment could lead to increased opt-out rates and ultimately less capital with which to do social investment. It is absolutely critical to address the long-term problem of a lack of financial literacy and UKSIF members have been calling for efforts to boost financial education.[10] This would be hugely beneficial and far more effective at driving pension saving and engagement than an increase in the number of options for a generally financially-illiterate customer base.

We would urge consideration of the idea of regulation forcing the offering of a responsible default option. This would not boost the number of funds offered materially and would give some profile to the issues under consideration here.

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[8] Arabesque Partners and University of Oxford, *From the stockholder to the stakeholder*, 2015 http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11

[9] SALWAY, J. (5 November 2016), *Does it pay dividends to be an ethics man?*, The Scotsman Online http://www.scotsman.com/news/opinion/jeff-salway-does-it-pay-dividends-to-be-an-ethics-man-1-4278511

[10] For example Aviva’s Sustainable Capital Markets Union Manifesto, available at https://www.aviva.com/media/upload/SCMU_Manifesto.pdf

(b) In particular, would options seeking social impact as well as financial returns encourage engagement?

We think options which seek a social impact as well as a financial return would encourage engagement, but communication and reporting to scheme members on social outputs is crucial. Our polling for Good Money Week 2016 has shown that 47% of people with an investment would be interested in annual update on their social and environmental impact. This figure rises to 58% of people under the age of 35.

Question 6

We are also interested to hear about the returns available for social investment (intended to have a positive benefit):

(a) Are there sufficient investment opportunities to provide both social impact and market returns?

There are ample opportunities for savers wishing to invest in a product that has both a positive social or environmental impact and makes a return. There are various SRI and ethical funds on offer which can achieve this and it remains important that ‘social investment’ isn’t defined too narrowly. On investible assets that are specifically designed for social investment, we would point to recent research by Big Society Capital. It answers this question in detail and concludes that there are at least £67.4bn of social investment assets suitable for pension fund investment in the UK.[11]

(b) How far should savers be prevented or discouraged from sacrificing returns for social impact?

We do not accept the premise of this question. As UKSIF member feedback and the BSC report both make clear, social investment does not necessarily require a financial sacrifice and there are a number of social investments that target market rates. These are likely to be far more attractive to pension schemes which, unlike endowments for example, would find it harder to move away from benchmarks due to their liabilities. It may also be noteworthy that UKSIF polling showed that 60% of the public believes the financial sector can make high returns while investing ethically and responsibly. What is crucial to the growth of the market is to continue to gather information on the financial and social return profiles of these funds. For social investment we hear that there is a range of financial returns available, from a 95% payback to a 4% return. It is possible that trustees of schemes offering a social investment fund which is clearly below market rate or likely to result in a loss for savers might be considered by the courts to have failed in their fiduciary duty. This is why it is essential to both report on the fund’s performance as well as to have an evaluation framework for the social outcomes of the fund with clear information on how it helps to establish social change.

Question 7

In practical terms, how can financial advisers:

(a) best explore their clients’ social motivations?
(b) present social investment options in a way that is clear, fair and not misleading?

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[11] Big Society Capital, *Designing a social investment fund for UK pensions,* 2016 https://www.bigsocietycapital.com/sites/default/files/attachments/Designing%20a%20Social%20Investment%20Fund%20for%20UK%20pensions.pdf

Following discussion with the Law Commission we understand this question is not a priority and likely to receive less focus than other issues highlighted in the consultation paper. Nonetheless we highlight our response to the FCA on the regulatory barriers to social investment by retail clients which identifies a range of issues that must be addressed to help the market grow.[12] Further, polling commissioned for Good Money Week 2016 shows that 69% of people support a new law requiring financial advisors to ask customers if they would like to exclude specific sectors or companies.

Question 9

a) Should social investment options be labelled or described in a standardised way?
b) Would this be possible given the range of funds which might be regarded by different groups, or in different contexts, as social investment?

Polling for Good Money Week 2016 also showed an overwhelming desire amongst the public for the introduction of a kitemark-style label. It showed that 63% of people backed a label to identify ethical or sustainable financial products, with 43% saying it would make them more likely to buy a financial product, a number which rose to 53% of 18-24 year olds. We hear from Eurosif that there is now demand from policy makers in the European Parliament and Commission for clear definitions on the different types of sustainable and responsible investments to enable them to better understand the concepts involved in e.g. the PRIIPs Directive and IORPS 2. Meanwhile, throughout Europe more countries are developing their own approaches to definitions and labels including in Belgium, France, Austria, Germany, Switzerland and Luxembourg. It is to be noted that these moves are from savers and from regulators.

Traditionally the SRI sector in the UK, typified by the UKSIF membership and composed of "providers", has tended to shy away from definitions and standards due to the potential to stifle innovation. We have taken soundings and still believe that there is no consensus support for a rigid definition of SRI investment styles at this moment. UKSIF members raised some practical considerations for the introduction of any such label, with sample comments saying that too "strict" a label might place such stringent requirements on funds that it would be almost impossible to achieve, whilst a "weak" definition might result in a 'race to the bottom' and box-ticking, whereby funds only meet the bare minimum requirements in order to maintain their possession of the label. In addition there is a widespread view that the UK should seek to align any definitions with international work. At the moment there is no consensus on what should be done, but a consciousness that the issue is "live".

As part of work examining how finance can support the Sustainable Development Goals, Aviva has made a public call for a general SRI kitemark-style label or standard for institutional investors.[13] This would assess how well fund managers integrate ESG issues into their investment analysis, engagement and AGM voting.

Feedback from UKSIF members that specialise in social investment has been to support a specific social investment standard (i.e. not a more general SRI standard), but with some provisos:

- The standard is clear that, unlike other approaches in the SRI sector, the primary activity of the investment is to deliver social value.

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[12] Available at http://uksif.org/wp-content/uploads/2016/03/UKSIF-response-to-FCA-regulatory-barriers-to-social-investment.pdf
[13] Aviva, *Money Talks: How finance can further the SDGs*, 2016, available at http://www.aviva.com/media/thought-leadership/money-talks-how-finance-can-further-sustainable-development-goal/

- The introduction of such a standard must include a clear reporting framework to evaluate and communicate the social impact of the fund.
- The fund is one part of the wider investment chain – there are many others which will be impacted i.e. asset owners, individual investors, fund managers, social enterprises and stakeholders. This must be the context in which any standard is framed.
- Innovation in social investment must not be stifled. A triennial review of the social investment sector following the introduction would be welcome to ensure the standard is flexible enough to encourage innovation – this cannot be a race to the bottom.

To be clear, we believe our members would support the introduction of a description in respect of social investment but that there is not currently a consensus as to the efficacy of that approach in responsible investment more widely.

Question 10

Is there a need to review the legal framework around social enterprises, to make it easier for such enterprises to borrow money and receive investment?

We are not expert enough to answer this question fully, however we do flag the impact Brexit will have on social enterprises if EU benefits which currently flow to the sector are not recycled, at least in part. Social enterprises in the UK will no longer have access to the benefits arising from e.g. the Social Business Initiative and we would welcome a review into the impact this, and other impacts following Brexit, will have on the sector and what steps the Government can take to mitigate any risks which result from it.

I hope our views are clear. If you have any questions or comments please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely,

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)