



Department for
Digital, Culture
Media & Sport



Department
for Work &
Pensions

Pension funds and social investment: the government's interim response

The government's interim response to the Law
Commission report: *Pension Funds and Social
Investment (Law Comm No 374)*

December 2017

Contents

Foreword	2
Background	3
Introduction to the government response	5
The Law Commission’s recommendations and government’s interim response	9
Annex 1: Illustrative examples of the possible impacts of regulatory change	25

Foreword

This government has set itself the ambition of building a shared society that works for everyone. This requires harnessing the potential of finance as a force for good, with capital directed towards investments that build a stronger society. Consumers are increasingly attaching social values to their earning and spending habits. It is against this backdrop that the rise of social impact investing has such potential – supporting people to invest in line with their values.

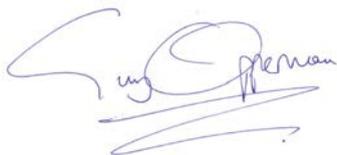
Pension schemes represent one of the biggest pools of opportunity to grow social impact investment. Meeting schemes' central purpose of maximising retirement savings and investing for positive social change should go hand-in-hand. Given the increasing size of the pension market, if trustees choose to make even modest allocations to investments that generate both a social and financial return, the effect could be transformative.

We would therefore like to thank the Law Commission for its review, and welcome its recommendations. We are encouraged by its finding that there are not substantive regulatory barriers to making social impact investments. Most of the barriers are in fact structural and behavioural, such as the need for clearer legislation and guidance on certain issues, or industry collaboration on engaging consumers.

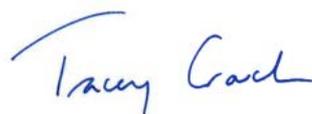
This initial response provides government's first view of the Law Commission's recommendations and areas in which we are considering taking action. It includes plans to clarify legislation around consideration of broader long-term financial risks, and pension schemes' ability to consider members' non-financial or ethical concerns. Together these will make it easier for trustees of pension schemes to invest members' savings in assets that can "do good", as well as delivering market returns.

We hope that these changes will open up the funds sitting in pension schemes to wider opportunities that genuinely reflect and mirror the beliefs and principles of those people saving for their future retirement.

This response also includes the views of a range of partners inside and outside government to whom the Law Commission addressed certain recommendations. We are grateful for all their work on the matter so far and will provide our full response in summer 2018.



Guy Opperman MP
Minister for Pensions and Financial
Inclusion



Tracey Crouch MP
Minister for Sport and Civil Society

Background

1. On 3 November 2016, the then Minister for Civil Society, Rob Wilson MP, asked the Law Commission on behalf of government to look at how far pension funds may or should consider issues of social impact when making investment decisions. The full terms of reference were:
 - To provide an accessible account of the law governing how far pension fund investment policy may or should consider issues of social impact, looking at:
 - Defined contribution default funds;
 - Defined contribution chosen funds; and
 - Defined benefit schemes.
 - To provide an accessible account of the law governing the forms which may be used by social enterprises.
 - To consider whether there are legal or regulatory barriers to using pension funds for social impact (including investment in social enterprises); and
 - If appropriate, to set out options for reform.
2. On 23 June 2017, the Law Commission published their report, *Pension Funds and Social Investment*¹. The report draws upon responses to their call for evidence (7 November - 15 December 2016) as well as face-to-face meetings and a roundtable with stakeholders. In summary, the Law Commission's key conclusions were as follows:
 - Whether and how pension funds should consider social impact is dependent on the nature of the social investment and the expected returns. Generally speaking, the central purpose of a pension has to be to make money for retirement. Although individual savers may choose to make investments that have a social impact and involve a clear and significant sacrifices in returns, this is not necessarily suitable for all pension savers. The Law Commission outlines two tests to be met before trustees may choose to make a social impact investment that involves some financial sacrifice: first, the trustees should have good reason to think that scheme members would share the concern, and second, the decision should not involve a risk of significant financial detriment to the fund.
 - Where social investments do not involve a significant sacrifice of competitive risk adjusted returns, the barriers that the Law Commission identified were, in most cases, structural and behavioural rather than legal or regulatory.

¹ <https://www.lawcom.gov.uk/project/pension-funds-and-social-investment/>

- Given this, it was not appropriate for the Law Commission, as a law reform body, to make recommendations in these areas.
3. The Law Commission has nevertheless made some recommendations to government where it has identified that the law could be improved so as to reduce the impact of these barriers. These recommendations were previously identified in its 2014 report, *Fiduciary Duties of Investment Intermediaries*², and have been updated in light of the current pensions landscape.
 4. The Law Commission also set out options for reform where it identified steps which could be taken by others to address these barriers.
 5. The Law Commission recommended that:
 - For trust-based pensions, the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations) should be amended in the following ways:
 - The reference to ‘social, environmental or ethical considerations’ should be amended to ensure that it accurately reflects the distinction between financial factors and non-financial factors.
 - There should be a requirement that the statement of investment principles (SIP) produced by trustees should state trustees’ policy (if any) on stewardship.
 - For contract-based pensions, the Financial Conduct Authority (FCA) should require schemes’ Independent Governance Committees to report on a firm’s policies in relation to:
 - evaluating the long-term risks of an investment, including relating to corporate governance or environmental or social impact;
 - considering members’ ethical and other concerns; and
 - stewardship.
 - The FCA should issue guidance for contract-based pension providers on financial and non-financial factors, to follow the guidance for trust-based schemes given by The Pensions Regulator.
 6. The Law Commission also suggested ‘options for reform’ in the following three areas:
 - investment in social enterprises (such as charities and community interest companies);
 - investment in property and infrastructure; and
 - encouraging savers to engage more actively with their pensions.

² <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

Introduction to the government response

Context

1. The phased introduction of automatic enrolment means that Defined Contribution (DC) pension schemes are expected to grow six-fold, to £1.7trn by 2030 - equivalent to 15% of the current net wealth of the UK. With the momentum behind greater consideration of long-term financially material risks, this represents a significant pool of capital that might benefit from taking into account social impact alongside financial returns.
2. Government notes that, since instructing the Law Commission, the market has tended to adopt slightly different terminology to refer to the activity described as 'social investment.' Per Option for reform no.9, the terminology relating to social investment is not yet standardised – as a fast-developing, relatively new market, the concepts and their definitions are evolving. The Law Commission's examination of the meaning of social investment and the 'spectrum' of risk / return upon which investments can lie is helpful. However, at the current time, the term 'social *impact* investment' is generally used to reflect the breadth of (per the Law Commission definition) 'investment which addresses societal challenges while continuing to generate competitive market returns'. The term 'social investment' is used to refer to the more restricted activity of investing solely in registered social sector organisations (RSSOs), whose capital structure or distributions are specifically determined by regulation.
3. The Law Commission report sits within a broad Government agenda to enable more money to flow into investments that create positive social outcomes. For example, recent activity includes:
 - **The Government Advisory Group on Growing a Culture of Social Impact Investment ('Social Impact Advisory Group')** - an independent financial services industry group initiated by government in 2016 through joint sponsorship by the Department for Digital, Culture, Media and Sport (DCMS) and the Treasury (HMT). The Group has also commented favourably on the Law Commission's recommendations for government.³
 - **The Rise of Impact - report by the UK National Advisory Board on Impact Investing (the 'NAB')**⁴ - published in October 2017, it included a number of recommendations relating to changes to pension schemes that would 'empower

³ See report, *Growing a Culture of Social Impact Investing in the UK*, available at

<https://www.gov.uk/government/publications/growing-a-culture-of-social-impact-investing-in-the-uk>

⁴<https://static1.squarespace.com/static/5739e96207eaa0bc960fcf52/t/59e9b572b7411c0d793bd466/1508488629602/NAB+Report+FINAL.pdf>

savers to invest in line with their values’.

4. The Law Commission report is also highly relevant to ongoing activity around the consideration of long-term financially material risks by pension schemes and investee firms. This includes:
 - **The Pension Regulator’s guidance on investment by Defined Contribution schemes (in July 2014)⁵ and Defined Benefit schemes (in March 2017)⁶** - these clarified that trustees are required to take into account factors that are financially material to investment performance, including environmental, social and governance (ESG) factors or ethical issues.
 - **Institutions for Occupational Retirement Provision (IORP) Directive⁷** - this Directive was recast and adopted in December 2016. When transposed, it will require affected pension schemes to consider and report on their approach to environmental, social and governance factors and risks.
 - **Shareholder Rights Directive⁸** - these requirements were recast and were adopted in June 2017. If implemented in the UK, they will require affected pension schemes to develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy, or provide a clear and reasoned explanation why they do not.
 - **Taskforce on Climate-Related Financial Disclosures⁹** - established by the Financial Stability Board, they published their final recommendations in June 2017, which call for consistent and comparable voluntary disclosures on climate-related risks, across sectors and jurisdictions.
 - **A European High-Level Expert Group on Sustainable Finance** - this group considers the scale and dimensions of the challenges and opportunities that sustainable finance presents and recommends a comprehensive programme of reforms to the EU financial policy framework, including a clear prioritisation and sequencing. It published its interim report in July 2017¹⁰.
5. Government welcomes the Law Commission’s explanation that incorporating social impact into investment decision-making can deliver competitive risk adjusted returns, where that is the investment objective. The Social Impact Advisory Group report also notes that ‘social impact investing is increasingly recognised as a commercial opportunity that has driven the growth of profitable business lines.’¹¹ Mainstream financial services firms are responding to evidence of unmet demand from individual investors by increasing their offering of social impact products as well as integrating

⁵ <http://www.thepensionsregulator.gov.uk/trustees/investment-management-in-your-dc-scheme.aspx>

⁶ <http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx>

⁷ <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32016L2341-2016/2341>

⁸ <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32017L0828-2017/828>

⁹ <http://www.fsb.org/2017/06/recommendations-of-the-task-force-on-climate-related-financial-disclosures-2/>

¹⁰ https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf

¹¹ As before, ref.4

environmental, social, governance and social impact concerns into their core business.

6. Government also recognises the Law Commission's advice that regulatory clarity would help remind trustees that they should take account of all relevant financially material factors, whether these are 'traditionally' financial or related to broader risks or opportunities, such as environmental, social and governance issues.
7. The 'ecosystem' around social impact investing is still developing but it is government's aspiration to see this market operating at scale. The expertise that lies outside government - in charities, social enterprises, SMEs, pension schemes and big business - is integral to delivering solutions for the social challenges in the UK. Enabling and partnering with these different actors will help to deliver a country that works for everyone.

Summary interim response

8. For the most part, the Law Commission's recommended policy changes and reforms lie with the relevant regulatory authority or with the industry itself. In these cases, government is working with the relevant parties as they consider the recommendations. Where one of these parties has provided a response, it has been included below.
9. Government has liaised closely with the FCA in preparing this interim response, since a number of the Law Commission's proposals are addressed to the FCA. The FCA regulates workplace personal pension schemes, which are defined contribution, largely contract based and typically provided by insurance firms. The FCA welcomes the Law Commission's report, which it sees as consistent with a number of other pieces of work it is undertaking, and is considering the Law Commission's proposals.
10. The Law Commission's report also presents some opportunities for government action:
 - On the policy changes (Recommendations 1 and 2): Government welcomes the recommended changes to the Investment Regulations and is minded to make the proposed changes, subject to consultation with stakeholders on the most effective approach to delivering the desired outcome of the recommendations.
 - On the Options for reform (nos 1, 3, 6, 7, 8, 9, 10, 11): government is pleased to report that certain recommendations are addressed by initiatives already underway. Other recommendations involve or impact a number of government and external stakeholders and work is ongoing to determine the appropriate response.

11. The Department for Digital, Culture, Media and Sport and the Department for Work and Pensions will continue to work together and with key stakeholders, within government and externally, to provide a full response to the Law Commission's report in summer 2018.

The Law Commission's recommendations and government's interim response

Policy changes

Financial and non-financial factors

Recommendation 1

Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005 should be amended to require trustees to state their policies in relation to:

- (1) evaluating risks to an investment in the long term, including risks relating to sustainability arising from corporate governance or from environmental or social impact; and
- (2) considering and responding to members' ethical and other concerns.

12. Government will consult on this recommendation in full.
13. It is minded to make the proposed change, by requiring that the Statement of Investment Principles must include trustees' policy on evaluating long term risks, and any policy on consideration of members' non-financial concerns. On the latter policy, government supports the Law Commission's view that trustees should consider members' ethical and other concerns, and may respond by acting on them where they have good reason to think members share the concern and it does not involve a risk of significant financial detriment.
14. Government plans to engage with stakeholders to identify approaches which are likely to be most effective in delivering the right level of evaluation and consideration, and to aim to consult on policy and regulations during 2018. Subject to the outcome of that consultation, legislation will be brought forward for Parliamentary approval at the earliest reasonable opportunity.
15. There is evidence that trustees are not aware either of the ability to take into account non-financially material matters, or the requirement to take into account

environmental, social and governance risks where there are financially material concerns. Research by the law firm Sackers¹² found that:

[Trustees] also consider ESG (Environmental, Social and Corporate Governance factors) and external governance reviews to be low priorities. Some participants were not sure what ESG meant... Some see ESG as a distraction or potentially detrimental to achieving the scheme's goals.

16. A survey by Professional Pensions¹³ found that more than half of respondents do not take ESG factors into account when making or advising on investment decisions, or think of climate change as a financially material risk to their investments or those of their clients.
17. Examples of the benefits that might follow from this legislative change and that in Recommendation 2, below, are included in Annex A.
18. It is also not intended that these measures will give any support to campaign groups for boycotts of certain countries or divestment from certain assets. Trustees have primacy in investment decisions, and their prime focus is to deliver a return to members. The Law Commission's advice is clear.
19. Where the concerns are not financially material – for example, primarily ethical - trustees are only permitted to take these concerns into account when there is a broad consensus, and they are never required to.

In cases where the issue is clearly controversial, the courts would expect trustees to focus on financial factors rather than becoming embroiled in disagreements between the members... trustees may consider the views of the beneficiaries when making their investment decisions, but there is no legal requirement for them to do so¹⁴.

Recommendation 2

1) Regulation 2(3)(c) of the Occupational Pension Schemes (Investment) Regulations 2005 should be amended to require the Statement of Investment Principles (SIP) to state trustees' policy (if any) on stewardship. Stewardship would include the exercise of formal rights (such as voting) and more informal methods of

¹² Effective Governance – the Art of Balance (2017). Sackers/Winmark. -

<https://www.sackers.com/publication/effective-governance-the-art-of-balance/>

¹³ <https://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry>

¹⁴ "Is it always about the money?": Pension trustees' duties when setting an investment strategy - Guidance from the Law Commission

engagement.

2) This requirement should apply to both the SIP prepared under regulation 2 and regulation 2A.

20. Government will consult on this recommendation.

Statement of investment principles (regulation 2)

21. The Government is minded to make the proposed change to the Statement of Investment Principles and require that the SIP should state the trustees' policy on stewardship. As with recommendation 1, government will engage with stakeholders to identify the most effective approach to deliver an impact and will aim to consult on policy and regulations during 2018. Legislation would follow, subject to the outcome of the consultation. Subject to the outcome of that consultation, legislation will be brought forward for Parliamentary approval at the earliest reasonable opportunity.
22. Government agrees that a focus on the exercise of voting rights alone by pension schemes is an unduly narrow view of the opportunities to influence investee firms and deliver better long-term returns for their members. Government recognises that the extent to which pension schemes are able to exercise voting rights and influence the firms in which they invest will depend on their assets and how they are expected to grow in future. The largest schemes may be able to exercise most or all of the voting rights attached to the schemes' assets and significant sway over the administration of investee firms. Smaller schemes with fewer assets may be limited to considering the stewardship policies and practices of investment managers when they appoint and replace firms. However most will have some opportunity to improve long-term member returns through their stewardship policy.

Default strategy (regulation 2A)

23. Government will consider further evidence and engage with stakeholders to determine whether it is appropriate to mandate trustees of Defined Contribution and Hybrid Defined Benefit (DB) / Defined Contribution (DC) schemes to state their policy in relation to stewardship as part of the default strategy. Schemes with fewer than 100 members are not required to produce a SIP under regulation 2 but must produce a default strategy in respect of default arrangements, under regulation 2A. Therefore, arguably, members of the smallest DC schemes may benefit from this legislative change.
24. However there are two difficulties with extending this change to include the default strategy. First, in modern - especially larger - DC schemes, the vast majority of assets are invested in the default arrangement, so this provision could be largely

duplicative. Second, the smallest DC schemes - whose members might benefit - will generally be the least equipped to engage with investee firms or to exercise the voting rights which come with the underlying equities, so this provision could be largely ineffective.

25. Although there are more than 33,000 DC schemes with fewer than 100 members, they account for less than 1.5% of the overall DC pension scheme membership, and this figure is in decline. The average assets under management in DC schemes with 12-99 members is only a little over £750K. Therefore government's initial view is that maintaining the requirement for DC and DB schemes with 100 or more members to report on their stewardship policy will capture the vast majority of pension assets and strikes the appropriate balance between member benefits and trustees burdens. However, government welcomes other views.
26. For the avoidance of doubt, it is not the government's view that there is any characteristic of a default arrangement which makes voting or stewardship less achievable. Even if passive funds, which are often found as constituents of defaults, are not able to divest from investee firms, they are as well equipped as actively-managed funds to engage and vote in order to benefit their investors. Furthermore, the line between market capitalisation-weighted 'pure' passive and fully active fund management is also blurring - 'smart beta' or 'factor' funds, which include engagement and voting as an aspect of their investment holdings, are also starting to emerge.

Recommendation 3

We recommend that COBS 19.5 should be amended to require IGCs to report on the firm's policies in relation to:

- 1) evaluating risks to an investment in the long term, including risks relating to sustainability arising from corporate governance or environmental or social impact; and
- 2) considering and responding to members' ethical and other concerns.

This requirement should apply to policies reflected in investment strategies including default investment strategies.

Response provided by the Financial Conduct Authority (FCA)

27. The FCA is already carrying out work which considers the role and focus of Independent Governance Committees (IGCs). This work is through a number of

workstreams in areas including non-workplace pensions, decumulation products bought with pension savings, and the governance of unit-linked and with-profits funds, which are often used by workplace pension schemes. Further details of these workstreams are outlined below:

- Non-workplace pensions: the FCA is carrying out initial discovery work to find out whether the non-workplace pensions market is sufficiently competitive to work effectively in consumers' interests.
- Decumulation and retirement outcomes: in July 2017, the FCA published its interim report on its Retirement Outcomes Review and intends to publish its final report in the first half of 2018. Alongside this report, it intends to propose a package of remedies to address emerging issues in this market. In its interim report, the FCA said that one option may be to extend the role of IGCs to ensure that decumulation products are appropriate and provide value for money.
- Remedies following the Asset Management Market Study (AMMS): In June 2017, the FCA consulted on implementing remedies following its AMMS. This work is considering the possible extension of the proposed governance remedies for authorised funds to other retail investment products, including unit-linked and with-profits products.

28. This work may lead to rule changes. In this context, the FCA is considering what form of rule changes may be appropriate to address the Law Commission's proposals. In the first half of 2018, the FCA will consider its final response to the Law Commission's proposals, for inclusion in the Government's final response.

The FCA's regulation of workplace personal pension schemes

29. The FCA already has rules in place requiring that firms, including insurers, must treat their customers fairly and must act honestly, fairly and professionally in accordance with the best interests of their customers.
30. In addition, following its consultation on 'Proposed Rules for Independent Governance Committees' in January 2015, the FCA introduced rules requiring that each individual firm operating one or more workplace personal pension scheme(s) must establish and maintain an IGC or a Governance Advisory Arrangement (GAA). Under FCA rules, GAAs are a proportionate alternative to IGCs for providers of smaller and less complex workplace personal pension schemes. References to IGCs in this response should be taken also to refer to GAAs.
31. Under FCA rules, the firm must place duties on its IGC:
- to act solely in the interests of scheme members, both individually and collectively, and
 - to assess the ongoing value for money of the workplace personal pension schemes that the firm operates.

32. In particular, IGCs must consider whether default investment strategies are designed and executed in the interests of scheme members. Oversight of the design and execution of default investment strategies is especially important, since the large majority of scheme members will be invested in their scheme's default investment strategy and most of these members will not have actively chosen to be in it. The FCA expects IGCs to consider the ongoing appropriateness of default investment strategies, taking account of the likely characteristics and needs of scheme members.
33. An IGC assesses value for money by weighing the quality of schemes against their cost, where the quality of a scheme includes the scheme's design and ongoing appropriateness for scheme members, bearing in mind that pension scheme investments are typically held for the long term. The IGC must raise any concerns about the value for money of the firm's schemes with the firm's governing body. Where the firm has not, in the IGC's opinion, addressed its concerns satisfactorily or at all, the IGC must escalate its concerns as appropriate, including to the FCA.
34. In addition, an IGC must report annually on (among other things) its opinion of the value for money delivered by its firm's relevant schemes; and on how it has considered the interests of the members of those schemes.

Recommendation 4

We also recommend that COBS 19.5 should be amended to require IGCs to report on the firm's policy (if any) on stewardship.

This requirement should apply to the policy reflected in investment strategies including default investment strategies.

Response provided by the Financial Conduct Authority (FCA)

35. The FCA is considering this proposal in the context of its work on the revised Shareholder Rights Directive, as well as the wider work outlined above. If the revised Shareholder Rights Directive is implemented in the UK, it would impose general requirements on life insurance firms to disclose publicly (or explain why they have not) their engagement policy, including how they monitor investee companies on (among other things) financial and non-financial performance and risk, social and environmental impact, and corporate governance.

Recommendation 5

We recommend that the Financial Conduct Authority should issue guidance for contract-based pension providers on financial and non-financial factors, to follow the guidance given by The Pensions Regulator in its Guide on investment governance.

Response provided by the Financial Conduct Authority (FCA)

36. The FCA agrees with the Law Commission that it is important to evaluate long term risks to an investment that is to be held for the long term, in particular when making investment decisions for default investment strategies and in the selection of “chosen funds” offered to members of defined contribution workplace pension schemes.
37. The FCA already expects firms operating workplace personal pension schemes, when they make investment decisions, to consider the appropriate risk/return balance for scheme members, taking account of financially material long term risks and opportunities, and taking account of the likely characteristics and needs of scheme members. This is consistent with the DWP’s *Guidance for offering a default option for defined contribution automatic enrolment pension schemes*, issued in May 2011.
38. The Law Commission proposes additional guidance on financial and non-financial factors for firms operating workplace personal pension schemes. In summary, when making investment decisions for such schemes:
 - Firms should take account of financially material risks, including financially material risks relating to ESG factors, and
 - Firms may take account of non-financial factors, including non-financial ESG factors, provided that (1) this does not risk significant financial detriment to scheme members, and (2) the firm has good reason to think that scheme members collectively share the concern.
39. The FCA will consider whether to include explicit additional guidance to similar effect in its Handbook.

Options for reform

Investment in social enterprises

Option for reform 1

Government should consider creating a new register of security interests which can be used by Charitable Incorporated Organisations (CIOs).

40. Government is not minded to consider creating a new register of security interests at this time.
41. Since its introduction in 2013 the CIO has proved a popular legal structure, particularly for small charities. Over 12,000 CIOs have been registered and it now represents over 30% of new charity registrations. When the CIO was introduced, it was decided not to include a register of charges on grounds of cost and value for taxpayers money. As the CIO was primarily designed for small charities, there were concerns that there would be insufficient demand to justify the cost of creating such a register of charges. Since the introduction of the CIO, government has not received representations in any volume from the charity sector advocating the introduction of a charges register.
42. Government accepts that for those charities that may have floating charges over their property, the company structure - with its access to an electronically searchable register of charges through Companies House - is likely to continue to be a more attractive option. This enables lenders and others proposing to do business with companies the ability to quickly and easily ascertain the financial risks of doing so. But for many small charities it may not be particularly relevant, hence the apparent popularity of the CIO structure. Where charities opt for the CIO structure and later decide that the company structure would be more appropriate, perhaps to benefit from the charges register, they still have the option of establishing a new charitable company with the same charitable purposes and resolving to transfer across the asset of the CIO.
43. Government would need to see evidence that the benefits of adopting an electronically searchable register of charges for CIOs would outweigh the likely costs of establishing and operating such a system. The value for money argument would need to be compelling given current budgetary constraints.

Option for reform 2

The Regulator of Community Interest Companies should consider reviewing the dividend cap to ensure that it is in the best interests of industry stakeholders and, in particular, whether it should be raised.

Response provided by the Regulator of Community Interest Companies and the Department for Business, Energy and the Industrial Strategy (BEIS)

44. The Regulator is, in conjunction with BEIS, considering when might be an appropriate point to conduct a further review of the aggregate dividend cap given the cap per share was abolished only as recently as 2014.

Option for reform 3

Government should consider whether the registration and regulation of registered societies and community interest companies should be overseen by a single regulator.

45. Relevant Government Departments are in active discussion over the implications of bringing CICs and some registered societies under the oversight of a single regulator.

Investment in property and infrastructure

Option for reform 4

The Pensions Regulator should consider providing trustees with further guidance on how to reconcile the requirement to process transactions promptly with the benefits of holding some illiquid assets.

Response provided by The Pensions Regulator (TPR)

46. TPR provides principles-based guidance with practical information, examples of approaches trustees could take and factors to consider. These guides, and the Code of practice no 13 (Administration and governance of occupational trust-based

schemes providing money purchase benefits – the DC Code) with which they are to be read, balance the requirement for trustees to process core financial transactions promptly and accurately with holding illiquid assets.

47. This guidance is not prescriptive and trustees are expected to adopt an approach proportionate to their scheme's risk, complexity and size. TPR expects trustees to consider the investment governance guide when setting and revising their investment strategy, this is when they will be considering their asset allocation and diversification, including illiquid assets. This makes sense in the context of how schemes operate in practice.
48. The guide focuses trustees on liquidity in the context of risk and return for members. Under the heading 'Asset liquidity and dealing frequency', TPR notes specifically that 'most members will not have a need for immediate liquidity of their investments, and it may not always be beneficial for dealing to be carried out daily.' TPR's DC Code acknowledges that there are a number of variables which can influence what is considered to be prompt in reference to administration, including the timing of the investment cycle in a scheme.
49. The requirement for contributions to be invested at the next available dealing date, and within a maximum of five working days, does not mean that every fund used by trustees must have a minimum frequency of weekly dealing. Less frequently dealt assets may also make up part of the asset mix. The DC Code refers to both daily and less-than daily dealing cycles and is clearly permissive of either approach.
50. Whilst TPR considers that the Code and guides taken together currently reconcile the requirement to process transactions promptly with the benefits of holding some illiquid assets, it will further consider the option for reform in the context of its ongoing guidance review and in the light of its statutory objectives including to protect member benefits and promote good administration of pension schemes.

Option for reform 5

The Financial Conduct Authority should consider providing guidance about the permitted links rules and, in particular, guidance about how pension schemes can manage some element of illiquid investment within their funds and how they can produce unit prices for illiquid assets.

Response provided by the Financial Conduct Authority (FCA)

51. The primary purpose of the FCA's permitted links rules is to protect consumers from making investments (or, in the case of workplace pension schemes, being automatically enrolled into investments) that may not be appropriate for them.
52. The FCA's permitted links rules restrict insurers to certain classes of assets when they contract to provide unit-linked benefits under long-term contracts of insurance. The list of permitted assets derives originally from the 2002 EU Life Directive and was subsequently aligned with the UCITS Directive and Solvency II.
53. Workplace pension schemes using unit linked structures are already able to manage some element of illiquid investment within their funds for retail policyholders and beneficiaries, since the permitted links rules include the asset class "permitted land and property", which is further defined in the FCA Handbook Glossary.
54. The FCA has previously issued considerable material that includes available tools to manage illiquid assets, for example, its 2013 thematic review on the governance of unit-linked investments and its January 2017 discussion paper 'Illiquid Assets and Open Ended Investment Funds.'
55. With regard to unit prices for illiquid assets, the FCA's rules do not require daily pricing. Under the Prudent Person Principle (Article 132 of Solvency II, as incorporated into the Prudential Regulatory Authority (PRA) rulebook for assets covering linked long-term liabilities) the onus is on firms to match the value of assets to liabilities. This means that firms offering illiquid assets have to ensure that they have adequate systems and controls to value and price assets effectively. Within the rules there is flexibility as to how firms may achieve this, given the circumstances of each linked liability, and having regard to industry best practice.
56. Since the control and management of illiquid assets is a prudential as well as a conduct matter and is intrinsically linked to the capital management of a firm, and since insurance firms are dual regulated, any further measures proposed would need to be considered in conjunction with the PRA.
57. In assessing the feedback to its discussion paper 'Illiquid Assets and Open Ended Investment Funds' the FCA will consider any changes necessary to its existing rules and guidance on permitted links.

Option for reform 6

The Department for Work and Pensions should consider investigating whether the need for member consent is a barrier to consolidation of pension schemes and whether this could be removed.

58. Government agrees with this recommendation. There is already a process for consolidation without member consent in both DC and DB schemes.
59. However, evidence that government has received from stakeholders, both informally and via a Call for Evidence published in December 2016, suggests that the current process is both burdensome and ineffective for 'pure' DC schemes, i.e. those without guarantees. Government therefore published a consultation on policy and draft regulations in October 2017. That consultation has now closed and responses are being considered. Subject to Parliamentary timetables, government plans to lay regulations in March of next year to come into force in April 2018.
60. In relation to DB schemes, government sought views about the regulatory barriers to consolidation in its Green Paper, *Security and Sustainability in DB Pensions*¹⁵, published in February of this year. Through the consultation process a number of significant issues have been identified that would need to be overcome to enable and encourage greater consolidation to take place in DB schemes. Government will provide an update on its thinking and broad proposals in its White Paper, to be published in early 2018.

Option for reform 7

Government should consider whether a legal obligation should be introduced in England and Wales to require pension trustees to determine on an annual basis whether their members are disadvantaged, in comparison to members of other funds, due to insufficient numbers of members or pooled assets.

61. Government notes this option but does not intend to impose this legal duty at the present time.
62. It would not be proportionate to require pension schemes to carry out an assessment, which would be burdensome if it were to be robust, until work has

¹⁵ Available at <https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability>

concluded on reviewing - and where appropriate, removing - unnecessary barriers to consolidation. This activity is described above in the response to Option for reform 6.

63. In relation to DC schemes, government understands from stakeholders and from independent research that significant numbers of sponsors and trustees would like to consolidate if this were made easier from a regulatory perspective. Once measures to simplify DC pension scheme consolidation are complete, scheme numbers, costs and governance will continue to be monitored to inform a view on whether such a legal obligation is necessary.
64. In relation to DB, through the Green Paper consultation process government has been exploring changes which could help improve scheme governance and reduce costs. Any changes intended to be made in these areas will be set out in the upcoming White Paper.

Option for reform 8

The Department for Work and Pensions and Financial Conduct Authority should continue to monitor the charge cap as pension schemes make more direct investments in innovative ways in physical assets, such as property.

65. Government recently completed its examination of the cap that applies to member-borne charges for default funds in DC pension schemes used for automatic enrolment (AE). Government liaised closely with the FCA on this work.
66. The examination, which commenced in February this year, considered whether the cap should remain at its current level of 0.75 per cent of funds under management or be lowered further; and whether it should be expanded to include some or all transaction costs which are currently outside the cap. The examination fulfilled a public commitment made in 2015 by the then government to review the charge cap in 2017. After seeking a range of industry and consumer views and considering the findings of the recent Pension Charges Survey, government announced on 16 November that it believes that now is not the right time to change the level or scope of the cap.
67. Overall, the examination found that the cap is working broadly as intended, helping to drive down member-borne costs, whilst providing sufficient flexibility to allow asset diversity, including investment in property and, in future, infrastructure, as well some tailoring of services for members and employers.

68. Some providers indicated that they are already exploring the potential opportunities provided by social infrastructure investment, such as social housing, for members of their AE default funds.
69. Government remains committed to ensuring AE members are protected from unreasonable and unfair charges and recognises that there is ongoing concern amongst consumers, acknowledging that several of the reasons for maintenance of the current level of the cap are time-limited.
70. With this in mind, the level and scope of the charge cap will be revisited in 2020 to see whether a change is needed to protect members. This will also allow it to evaluate the effects of the next stage of AE and the new master trust and transaction costs regimes. In undertaking the 2020 review, government will, of course, consider potential impacts on investment choice and diversity.
71. The FCA proactively supervises the biggest firms operating workplace personal pension schemes and uses an event-driven approach for other firms, among other tools. If through its work the FCA becomes aware of issues relating to the charge cap, it will consider what action may be appropriate, liaising with Government as required.

Engagement and social investment

Option for reform 9

Government should encourage pension providers to work towards agreeing a set of terminology for social investments.

Option for reform 10

Government should encourage pension providers and pension industry stakeholders to work together to develop examples of good practice of impact reporting.

72. Government agrees with these recommendations and has undertaken work to begin to address them.
73. In 2016, government initiated the Advisory Group on Growing a Culture of Impact Investment ('Social Impact Advisory Group'), sponsored jointly by DCMS and HMT.

The group published their independent report in November 2017¹⁶, which included a number of recommendations for industry and government. The majority of recommendations address the broader investment market but are applicable to pension schemes; some relate specifically to pension schemes. They are structured around five key areas:

- Improve deal flow and the ability to invest at scale.
- Strengthen competence and confidence within the financial services industry.
- Develop better reporting of non-financial outcomes.
- Make it easier for people to invest.
- Maintain momentum and build cohesion across initiatives.

74. The Social Impact Advisory Group recognised the ‘confusion’ that exists around the meaning of ‘social impact investing’ and cites this as a barrier to the adoption of a generally agreed set of terminology. It presents what it deems a ‘workable standard definition that may be applied across a range of use cases’:

Social impact investment consists of investment in the share or loan capital of those companies and enterprises that measure and report their wider impact on society - and that hold themselves accountable for delivering and increasing this impact.

75. The Social Impact Advisory Group also recognised the lack of common standards for measuring social impact as a barrier to the growth of the social impact market. It sees the impact on: advisors, in their assessment of funds; investors, in understanding how funds can help them achieve their social and financial goals and; consumers, in being able to trust that financial institutions are making sound investments.
76. The Social Impact Advisory Group made a number of recommendations relating to the standardisation of terminology and improvement of impact reporting. Some are specific to government, while most are industry focussed but would benefit from government support. The government is broadly in agreement with these recommendations and will be providing a response in due course.

¹⁶ As before, ref. 4

Option for reform 11

Government should consider whether pension schemes should be required to ask their members periodically for their views on social investment and non-financial factors.

77. Government notes this option and will continue to consider it as part of other work reviewing the effectiveness of regulations. It will provide a full response next year.
78. Government agrees that it is good practice to gauge member views to inform the design of investment strategies and the assessment of value for members of DC schemes. This is reflected in guidance published by TPR.
79. However, government believes this can be done in a variety of ways, such as the use of other knowledge and data, and different member engagement methods. It is difficult for trustees to form conclusions from survey data that is typically based on low response rates from self-selecting members. One stage in the Law Commission's two-stage test for investment decisions based on non-financial factors is the requirement that trustees should have good reason to think that the scheme members would share the concern. A self-selecting survey would rarely provide this assurance.

Annex 1: Illustrative examples of the possible impacts of regulatory change

Illustrative examples of the possible trustee behaviour change that may follow from changes to the Occupational Pension Scheme (Investment) Regulations 2005, which are proposed by the Law Commission's recommendations for Government (Nos 1 and 2)

Trustee action	Without a regulatory change	With a regulatory change
<p>General – A new trustee joins the board and asks how long-term risk factors such as environmental, social and governance risks (ESG) are incorporated into the scheme's investment approach.</p> <p>While the scheme's Statement of Investment Principles state that they take a long-term approach to investing, the scheme's investment managers are left to implement this in practice.</p> <p>The scheme's investment managers are employed on three-year contracts and assessed on a quarterly basis, so they are incentivised to take a short-term approach to investment that is inconsistent with the scheme's long-term investment horizons.</p>	<p>The other trustees are sceptical about the significance of financially material risks such as ESG, or their ability to take them into account.</p> <p>Instead, they tend to see them as a distraction and potentially detrimental to achieving the scheme's goals, feeling that they have enough challenges to deal with without adding ESG to the mix of factors to take into consideration.</p> <p>The new trustee's concerns are not taken into account.</p> <p>Their investment managers continue to be assessed on a quarterly basis and take a short-term approach to investing.</p>	<p>The trustees have in place a clear policy around long-term financially material ESG risks, stewardship and members' ethical concerns.</p> <p>They are empowered to raise these issues with their investment managers when looking at their advice and to appoint managers based on the evidenced consideration of longer time horizons for investment decisions.</p>

Trustee action	Without a regulatory change	With a regulatory change
<p>Environmental – Trustees hear about the rollout of a water network which will connect individual UK firms’ pipelines that is due to begin construction.</p> <p>Changing rainfall patterns and greater occurrence of drought lead the scheme’s advisers to explain that stakes in the project may be underpriced, and likely to offer good returns in 5-10 years, but member funds will be tied up in the interim.</p>	<p>The trustees are not sure they can take into account the longer-term financial gains from the project to offset the illiquidity of the investment, and decide to access the water sector through shares in listed utilities.</p>	<p>The trustees consider the short-term risk to be worth the eventual long-term gains are sufficient to disregard the initial low returns. They divert a small percentage of the scheme’s funds into the new project.</p>
<p>Social – Trustees hear that a large retail company in which the scheme invests plans to become accredited with the Living Wage foundation and start paying the Living Wage.</p> <p>The company currently employs a large number of employees who are paid below the Living Wage so the increase to the cost of wages will be significant.</p>	<p>Trustees are concerned that the profitability of the company will be affected by the increased costs to wages.</p> <p>Although they have previously been impressed with the performance of the company, believing that they must maximise the pension fund’s returns in the short term, they feel members’ best interests require them to divest.</p>	<p>Trustees are already aware that companies that pay the Living Wage usually see financial benefits from:</p> <ul style="list-style-type: none"> - reduced staff turnover and absenteeism, and improved morale; and - enhanced reputation. <p>They anticipate that although short-term profits may be somewhat impacted by the company’s decision, their long-term investment approach allows them to hold the investment for the long-term and reap the eventual gains.</p>

Trustee action	Without a regulatory change	With a regulatory change
<p>Governance – The trustee of a large pension scheme discovers that the managing board of a company in which the scheme invests have been deploying dubious practices.</p> <p>For example, there are non-executive directors who are senior managers elsewhere in connected firms, and there are family members receiving salaries who do not have a clear role. There are suspicions that money could be going to the wrong places.</p>	<p>This does not constitute a reason to deliberately disinvest from the company. Returns continue steadily for the time being but the potential for these malpractices to cause a sudden fall remains high.</p>	<p>Trustees conclude that the governance issues at the firm constitute a sufficient long-term risk to cause them to disinvest, and members benefit when the concerns gain wider momentum and the firm’s price crashes.</p>
<p>Stewardship – The trustees of a large pension scheme consistently vote against re-appointment of auditors due to a concern about a conflict of interest.</p>	<p>The trustees do not appreciate that they can also meet their fiduciary duty by other forms of engagement, and divest from the company.</p>	<p>The trustees offer to meet the investee firm and raise their concern, and the issues they have are satisfactorily resolved whilst remaining invested.</p>
<p>Non-financial factors – The trustee of a scheme wants to invest in an affordable housing development in the sponsoring employer’s local area. An alternative investment is an overseas infrastructure investment opportunity, which offers slightly greater returns.</p>	<p>Trustees conclude that their fiduciary duty of undivided loyalty to members’ best interests mean they have to select the overseas investment.</p>	<p>After further consideration and engagement with members, trustees conclude that the broader financial benefits to members and their community from the housing being developed in their home area justifies a decision to invest in the affordable housing development.</p>