Department for Digital, Culture, Media & Sport

Department for Work & Pensions

Pension funds and social investment: the Government's final response

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

June 2018

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Joint Ministerial Foreword

Pension schemes are some of the biggest and most influential investors in the UK. Their role in safeguarding the future of their members through growing and securing their retirement savings is well understood. But for too long, the role of pension schemes in responding to the long-term needs of our economy, our society and our environment has been little considered or misunderstood. Pension investment is not just about mitigating risk and maximising investment returns, but also about creating opportunities.

We know that 'responsible' investing can improve long-term returns for savers. Companies which have a strategy for dealing with climate change, uphold fair employment standards, and have strong and transparent governance structures should have a greater chance of succeeding and producing better investment returns in the long-term.

That is why the Law Commission recommended action to clarify and strengthen the law in this area in its 2017 report on pension funds and social investment. We are pleased to announce that the Government intends to take its recommendations forward. Through the Department for Work and Pensions' *Consultation on clarifying and strengthening trustees' investment duties*, we set out how we propose to update the law to require pension scheme trustees to consider the impacts on their investments from a changing environment, corporate governance and social trends. Alongside this, trustees will be expected to have a policy on how they take account of members' views, such as on social impact, when investing their savings. And we propose to clarify regulations to strengthen trustees' stewardship duties, as the owners of the firms in which they invest.

We also welcome the fact that the Financial Conduct Authority (FCA) is announcing its intention to take forward – and build upon – the Law Commission's recommended policy changes, by consulting on a range of rule changes in relation to Independent Governance Committees (IGCs).

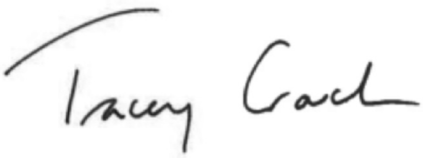
Social impact investment seeks to have a positive impact as well as generate a financial return. As the Prime Minister recently said, "The challenge now is for industry to unlock the capital to boost [social] impact investment even further, finding solutions to some of the burning injustices we face as a society, and helping make sure the country works for everyone."[1]

We should also not forget the savers who are the ultimate beneficiaries of pension investment – the people whose money is being invested, ideally in a way that supports the sort of world they want to live in. We know that an increasing number of people want to reflect their values in the things they choose to buy, the places they live and visit, and the jobs they do. People care about the impact that their choices have on our environment and humankind. Pension scheme members should therefore be able to see how their money is being put to work, and to make their views heard.

We recognise the challenge that remains to bring responsible, and specifically social impact, investing into the ‘mainstream’. We will therefore continue to consider, at Ministerial level, what more can be done to increase consideration of the wider impacts of pension investments – environmental and social, as well as financial. We will focus on ensuring that current work is capitalised upon; on identifying and, where appropriate, proposing the removal of longer-term behavioural and legislative barriers; and on improving investor consideration and communication of impact issues.

We thank the Law Commission, the FCA and The Pensions Regulator (TPR) in responding to the challenge thus far and we look forward to continuing to work with the financial services industry and regulators in growing the positive impact of pensions in the UK.

Guy Opperman MP
Minister for Pensions and Financial Inclusion



Tracey Crouch MP
Minister for Sport and Civil Society

Introduction

Saving for a better future

If asked, "What world do you want to retire into and pass on to future generations?", most would surely opt for one that is more environmentally sustainable, fair and free. The way in which money is invested has a direct impact on these factors. Therefore shouldn't people's pensions be invested *now* in a way that helps to shape positively the world of their retirement?

An increasing body of evidence shows that not only is this possible, but it can improve long-term investment returns[2]. Investors are recognising the materiality of certain environmental, social and governance (ESG) factors – such as how firms are acting to limit the risk of climate change, how well they treat their employees, and whether pay awards are justifiable. Moreover, investing in the building blocks of our communities – from affordable housing and sports facilities, to bridges and renewable technology – can offer stable, long-term returns. Therefore, when we talk about 'responsible investing', we can mean the dual responsibility of growing people's savings whilst acting as stewards of our environment and citizens.

Responding to a new generation of savers

Thanks to automatic enrolment, the majority of employees in the UK are now saving into a pension[3]. 10 million more are newly saving or saving more into a private pension than 5 years ago. By 2020, it is estimated they will be saving £20bn a year more[4]. Many of these people are millennials, and their pension could be the largest savings pot they build in their lifetime. Millennials are also the generation most concerned with environmental and social responsibility. Research shows that 86% say they are interested in socially responsible investing[5], and 55% want their pension invested in organisations that reflect their social and environmental views[6].

However, the majority of pension savers have no engagement with their plan beyond paying in and, eventually, taking out[7]. There is a real opportunity to motivate young people to save more for their retirement by helping them to understand and make choices about how their savings are invested.

So could environmentally and socially responsible investing be a means of addressing this? Some certainly think so. Communications consultant Quietroom has released a short video to engage people in the 'amazing journey' of pension money – 'building stuff, creating jobs and doing good'[8]. Likewise, ShareAction has argued[9] that pension schemes could better connect with members by communicating the wider, non-financial, impact of their pension. In turn, this could encourage higher contributions – alongside more money into investments that benefit society.

Getting there

So the question for those managing, advising on, and regulating the pensions of future retirees is: how do we enable pension money to be invested in a way that delivers appropriate returns, aligns with members' values and supports a positive future world?

In 2016, the Government asked the Law Commission to help answer this question by looking at how far pension funds may, or should, consider issues of social impact when making investment decisions. In its response[10], the Law Commission reiterated that the 'primary purpose of the investment power given to trustees is to secure the best realistic return over the long term, given the need to control for risks'. It concluded that, provided social impact investments do not involve a significant sacrifice of financial returns, there are no regulatory barriers to making these types of investments.

However, the Law Commission did identify where regulation could be clearer and where certain structures and practices in the investment industry could be changed, in order to make it easer for pension schemes to invest for social impact. In particular, it clarified that some of the risks (and opportunities) that pension schemes *should* consider when making investment decisions relate to firms' environmental, social and governance (ESG) practices. It highlighted a lack of understanding among some trustees of the materiality of these risks – which are often conflated with purely ethical considerations – and clarified the circumstances under which pension schemes can consider and respond to members' concerns, such as about social impact. It concluded that the current regulations in these areas are misleading, and may in fact be playing a part in perpetuating the misunderstanding or lack of confidence among trustees about what they can do.

Hence, we welcomed the Law Commission's recommendations and are now taking action to address the causes of this regulatory confusion, as well as removing other barriers that prevent pension schemes from more easily investing in opportunities that have wider societal benefits.

These changes aim to create a virtuous circle, directing higher contributions to those schemes, service providers and firms that are bringing about positive economic, social and environmental change. Ultimately, our goal is to ensure that the regulatory framework supports a default investment approach that increases long term performance, supports stronger member engagement and drives up the positive social impact of pension scheme investment.

Context

It is worth noting some of the wider policy context within which this report sits. A number of initiatives have begun or progressed since the Government's interim response to the Law Commission (December 2017), including:

- **Implementation Taskforce**, **Growing a Culture of Social Impact Investing in the UK**[11] – an industry-led taskforce, commissioned by the Prime Minister in March 2018[12], to progress the recommendations in the report, *Growing a Culture of Social Impact Investing in the UK* (November 2017)[13]. Chaired by Elizabeth Corley (Vice Chair of Allianz Global Investors), the taskforce is working on generating a faster rate of innovation in the financial services industry to provide products that give savers and investors the opportunity to make a social impact. It will report on progress at the end of the year.

- **Government Response** to the advisory group on Growing a Culture of Social Impact Investing in the UK – an HM Government response to the advisory group's recommendations, outlining any policy work that is in progress or planned. The response reaffirms a strong commitment from the Government to partner with the taskforce and the wider financial services industry to bring social impact investing to the mainstream. The Government will provide a further short update on progress in winter 2018.
- **Green Finance Taskforce** – an independent taskforce, initiated by the Government in 2017, to look at how the UK could consolidate its position as a world-leading hub for green finance. Chaired by Sir Roger Gifford (former Lord Mayor of the City of London), the taskforce worked with over 140 organisations across the finance and energy sector. Its report, *Accelerating Green Finance*[14], provided a number of recommendations to the Government about policy changes needed to make green finance an integral part of the UK's financial system. The Law Commission's recommended policy changes were supported by the report.
- **Patient Capital: Pensions Investment Taskforce** – a working group of institutional investors, fund managers and regulators whose objective is to explore how to tackle continuing barriers holding back defined contribution pension savers from investing in patient capital and illiquid assets. The taskforce was initiated by HM Treasury at Autumn Budget 2017 as part of the Government's response to the *Patient Capital Review*[15].
- **Environmental Audit Committee Green Finance inquiry**[16] – exploring how investment in longer-term sustainable development can be incentivised across the economy. The committee's report, *Greening Finance: embedding sustainability in financial decision making*[17], published in June 2018, provided a number of recommendations to the Government about policy changes needed to make green finance an integral part of the UK's financial system. The Law Commission's recommended policy changes were supported by the report.
- **Pensions and Lifetime Savings Association (PLSA) guide: *Impact Investing Made Simple***[18] – a guide to explain the key aspects of impact investing, looking at a range of ESG strategies and the importance of impact investing as a driver of future growth.
- **Personal Finance Society (PFS) guide: *A Practical Guide to Social Impact Investing***[19] – an overview of the social impact investment market, recent government and regulatory activity, and how financial advisers might assimilate value based investing into their recommendations where appropriate, helping those investors with an interest in social impact investing to align their savings, pensions and investments with their personal values.

Summary of the Government's Final Response

1. This is the Government's final response to the Law Commission's report, *Pension Funds and Social Investment*, published in June 2017, and follows the Government's interim response, published in December 2017[20]. (For full background information to the Law Commission's report, see Appendix A.)

2. In the Government's interim response, we welcomed the Law Commission's explanation that investments which seek to deliver a broader positive impact upon society can also deliver competitive risk-adjusted returns, and that incorporating social impact considerations into investment decision making can be in the best interest of members. We also recognised the Law Commission's advice that trustees could benefit from regulatory clarity around relevant financially material considerations, including environmental, social and governance (ESG) factors, as well as stewardship responsibilities.

Recommended Policy Changes

3. A year on from the Law Commission's report, we are pleased to announce the launch of our *Consultation on clarifying and strengthening trustees' investment duties*[21]. This consultation responds to the Law Commission recommended Policy Changes 1 and 2, proposing changes to regulation to require that trustees update their Statement of Investment Principles (SIP) to set out:

   - how they take account of financially material considerations, including (but not limited to) those arising from ESG considerations, including climate change;
   - their policies in relation to the stewardship of the investments, including engagement with investee firms and the exercise of the voting rights associated with the investment;
   - a separate statement on how they will take account of members' views (including, but not limited to, views on ethical, social impact, and present and future quality of life matters) in relation to the matters covered in the SIP.

4. We believe that these proposed regulatory changes will help dispel trustee confusion, and give institutional investors the confidence to begin or increase the allocation of capital to investment opportunities such as unlisted firms, green finance and social impact investment.

5. The consultation also proposes additional measures concerning SIPs that we believe will strengthen them for use as real, effective and regularly-reviewed guides to investment strategy and not as generic 'box-ticking' documents.

6. The Government has liaised closely with the Financial Conduct Authority (FCA) in preparing this final 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 (DC), largely contract-based and typically provided by insurance firms.

7. Under the FCA's rules, each provider of workplace personal pension schemes must establish and maintain an Independent Governance Committee (IGC), which must act independently and solely on behalf of scheme members in assessing value for money. IGCs have a similar role to trustee boards and are a key part of a range of protections the FCA introduced to ensure that these schemes deliver value for money for members in accumulation.

8. The FCA welcomes the Law Commission's report, which it sees as consistent with a number of other pieces of work it is undertaking. The FCA supports recommended Policy Changes 3, 4 and 5, which propose rule changes for IGCs and related guidance for firms, and proposes to take them forward. The FCA is also considering other possible extensions to the remit of IGCs and intends to consult on a single package of rule changes in the first quarter of 2019.

Recommended Options for Reform

9. The recommended Options for Reform lie variably with the Government, regulators and industry. Where a relevant authority has provided a response, it has been included verbatim in this report.

Investment in social enterprises (Options 1, 2 and 3)

- Option for reform 1: As stated in our interim response, the Government is not minded to consider creating a new register of security interests that can be used by Charitable Incorporated Organisations (CIOs) at this time.
- Option for reform 2: The Department for Business, Energy and the Industrial Strategy (BEIS) and the Office of the Regulator of Community Interest Companies are in discussion with a view to conducting a light-touch review of the dividend cap later in the year to re-test whether the existing balance remains appropriate.
- Option for reform 3: The Government will engage with registered societies and community interest companies to explore ways in which greater regularity clarity might be achieved by non-legislative measures. We will also keep under review the possibility of legislative options in future.

Investment in property and infrastructure (Options 4, 5, 6, 7 and 8).

- Option for reform 4: The Pensions Regulator will consider further guidance to make clear how trustees should promptly realise investments from funds with longer dealing cycles. It is also going to provide further guidance on how trustees' investment strategies can include assets with long-term investment horizons in a diverse portfolio.

- Option for Reform 5: The FCA is taking forward further work in relation to the permitted links rules, in light of its involvement in HM Treasury's Patient Capital Pensions Investment Taskforce, and continuing work following HM Treasury's Patient Capital Review[22].
- Option for Reform 6: On defined contribution (DC) schemes, the Government has implemented regulatory[23] changes to simplify the current rules on bulk transferring members between schemes without their consent. We also published guidance in April[24] of this year to support the regulations, and to assist trustees in interpreting their statutory duties. On defined benefit (DB) schemes, the Government set out its position towards consolidation in the White Paper, *Protecting Defined Benefit Pension Schemes*[25], published in March 2018. Towards the end of 2018 we will consult with the pensions industry and stakeholders on the design of a legislative framework and authorisation regime applicable to all forms of commercial DB scheme consolidation.
- Option for Reform 7: As stated in our interim response, the Government has no immediate plans to bring forward legislation requiring that pension schemes should consider whether they are disadvantaging members by not consolidating.
- Option for Reform 8: As stated in our interim response, the impact of the charge cap on asset class diversity will be taken into account as part of the 2020 review of the level and breadth of the charge cap.

Engagement and social investment (Options 9, 10 and 11)

- Option for Reform 9 & 10: The Government is working on a number of projects to improve visibility of businesses' social and environmental responsibility, focussing on how they frame and communicate this more strongly. We continue to work in close partnership with the industry-led taskforce on Growing a Culture of Social Impact Investing in the UK, which is taking forward a number of actions to improve standards, definitions and reporting of social impact investing.
- Option for Reform 11: The Government has given careful consideration to whether pension schemes should be required to ask their members periodically for their views on social investment and non-financial factors. However, we have concluded that any legislative changes are inappropriate at the present time.

Conclusion

10. Government departments will continue to consider, at ministerial level, what more can be done to increase consideration of the wider impacts of investments – environmental and social, as well as financial. We will focus on ensuring that current work is capitalised upon; on identifying and, where appropriate, proposing the removal of longer-term behavioural and legislative barriers; and on improving investor consideration and communication of impact issues.

Appendices

Appendix A: Background to the Law Commission's report on pensions and social impact investment

The Law Commission's recommendations and the Government's final 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.

1. In its interim response in December 2017, the Government confirmed its intention to consult on this recommendation in full, and stated that it was minded to make the proposed change. That remains the case.

2. Accordingly, alongside this final response to the Law Commission's report, the Government has published a consultation[26] on policy proposals and a draft instrument, the Occupational Pension Schemes (Investment and Disclosure) Amendment Regulations.

3. This amends the Occupational Pension Schemes (Investment) Regulations 2005 to require trustees of schemes with 100 or more members to:

   - state their policies in relation to financially material considerations, including but not limited to environmental, social and governance (ESG) considerations (including climate change); and
   - state the extent to which the views held by members of the scheme (including, but not limited to, views on ethical, social impact and present and future quality of life matters) are taken into account.

4. It also requires defined contribution (DC) schemes with fewer than 100 members to set out their policy as regards financially material considerations in relation to their default arrangement/s.

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 engagement.

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

5. In its interim response, the Government indicated that it would consult on the proposal.

6. At the time, it indicated that it was minded to make the change to the SIP (under regulation 2), but not to the default strategy (under regulation 2A). Informal engagement with a range of stakeholders has supported the view that extending stewardship requirements to DC schemes with fewer than 100 members would be disproportionate. Members of DC schemes with 99 or fewer members account for only 1% of the overall DC scheme membership. Requiring them to report on stewardship would both be burdensome and have relatively little effect. This is due to the very limited power such schemes have to bargain or negotiate with investment managers over voting and engagement practices.

7. Therefore alongside the Government's final response, the published consultation and draft regulations propose to require only schemes with 100 or more members to set out their policy on:

   - the exercise of the rights (including voting rights) attaching to the investments; and
   - undertaking engagement activities, including how and when trustees monitor and engage with: the firms in which they invest; people who manage the investments on their behalf; and fellow investors.

8. The matters on which trustees might engage are quoted in the draft instrument as including its (an investee company's) performance, strategy, risks, social and environmental impact and corporate governance. As with recommendation 1, we welcome views from trustees, providers, civil society groups, members and other stakeholders in response to this consultation.

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)

9. The FCA recognises the growing interest in the role of financial regulators and the wider financial services sector in responding to sustainability risks, including climate change and the long term harm it can cause. Alongside the Government and industry, the FCA has an important role to play in tackling these challenges.

10. IGCs were introduced in 2015 to provide independent oversight of workplace personal pension schemes. IGCs have a role similar to trustee boards and are a key part of a range of protections the FCA introduced to ensure that these schemes deliver value for money for members in accumulation.

11. Under the FCA's rules, each provider of workplace personal pension schemes must establish and maintain an IGC, which must act independently and solely on behalf of scheme members in assessing value for money. IGCs must raise any concerns they may have with the governing bodies of providers (typically the Board) and providers must respond to these concerns. IGCs may escalate their concerns to the FCA.

12. IGCs must already produce an annual report that includes their opinion on the value for money of their provider's schemes and how the IGC has considered scheme member interests. IGCs are increasingly reporting on how their firms incorporate environmental, social and governance (ESG) factors in investment decision making.

13. The FCA agrees that mandating such reporting in its rules could promote greater transparency across providers and would enable IGCs, employers and interested members of pension schemes to engage better with providers on these issues. This may increase competition between providers to design and monitor investment strategies incorporating ESG factors and protect consumers from potentially unsuitable investments. The FCA notes that the European Commission Action Plan on Financing Sustainable Growth, published in March 2018, has as an objective the management of financial risks stemming from climate change, environmental degradation and social issues[27].

14. At the same time, the FCA recognises the risk that providers could be driven towards making ethical or social impact investments that are unsuitable for members. The FCA agrees with the Law Commission's finding that, generally speaking, the primary purpose of pension scheme investments is to secure the best realistic return for members, given the need to control for risks. Members invested in default investment strategies in particular rely on providers to deliver good financial outcomes. The FCA also agrees that understanding the shared concerns of members is important.

15. The FCA considers that financially material ESG risks, including climate change risks, should be incorporated into investment decision making. But providers should also incorporate other equally important risks, such as interest rate, inflation, liquidity, concentration, exchange rate, political and counterparty risks. In addition, ESG considerations, including climate change, may represent investment opportunities as well as risks.

16. With that in mind, the FCA will consult on a broader rule change to that proposed by the Law Commission, to the effect that IGCs must report on their firm's policy on evaluating financially material considerations, including but not limited to ESG considerations, including climate change. The FCA will also consult on a rule change requiring IGCs to report on their firm's policy on how they take member concerns into account.

17. The FCA has wider work underway which may also result in changes to the remit of IGCs. As part of its Retirement Outcomes Review, the FCA is considering whether retirement income products bought with pension savings should be brought within the remit of IGCs. The FCA's *Non-Workplace Pensions* discussion paper[28], published in February 2018, also asked for views on enhancing oversight arrangements for non-workplace pensions. The FCA anticipates reaching conclusions in these areas by the first quarter of 2019.

18. Rather than consulting piecemeal, the FCA intends to take forward these measures together, by consulting on a single package of rule changes in the first quarter of 2019. The FCA considers this more efficient and cost effective, as well as removing the risk that changes made to address the Law Commission's recommendations need to be revised subsequently to ensure consistency with the wider work outlined above.

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 FCA

19. The FCA has considered the Law Commission's proposal in the context of its work on the European Commission's revised Shareholder Rights Directive (SRD2), which is due to be implemented by 10 June 2019, as well as the wider work outlined above. If SRD2 is implemented in the UK, it would impose general 'comply or explain' requirements on life insurance firms (insurers) to disclose publicly 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.

20. This requirement would make it more likely that insurers would have a stewardship policy on which IGCs could report. However, some self-invested personal pension (SIPP) operators are also providers of workplace personal pension schemes and may not be subject to SRD2.

21. The FCA considers that a broad requirement that IGCs must report on their firm's policy (if any) on stewardship, as proposed by the Law Commission, would promote transparency and encourage providers to engage with fund managers and investee companies on these issues. Such a requirement would protect consumers from the risks of poor stewardship and may increase competition between providers on stewardship, as well as enhancing market integrity. The FCA does not see the need to wait for SRD2 to introduce such a requirement.

22. The FCA will consult on a rule change, to similar effect to that proposed by the Law Commission, as part of the single package of proposed rule changes in the first quarter of 2019.

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 FCA

23. The Law Commission proposed 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.

24. The FCA considers that explicit guidance on financial and non-financial factors would be helpful to providers of workplace personal pension schemes, since its existing rules are high level. Such guidance would encourage providers to take account of ESG and climate change factors that are financially material. It would also encourage providers to consider social impact investment and member concerns in the right way.

25. The FCA will consult on guidance for providers, to similar effect to the guidance proposed by the Law Commission, as part of the package of proposed rule changes in the first quarter of 2019.

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).

26. For the reasons outlined in the interim response, the Government is not minded to consider creating a new register of security interests at this time.

27. The CIO was primarily designed for small charities and there remains insufficient demand to justify the cost of creating such a register of charges. The 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.

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 Office of the Regulator of Community Interest Companies (the CIC Regulator) and the Department for Business, Energy and the Industrial Strategy (BEIS)

28. The CIC Regulator needs to retain a balance between investor reward and community benefit. A wide-ranging consultation in 2013[29] concluded that the 35%/65% ratio fulfilled this purpose. BEIS and the CIC Regulator are in discussion with a view to conducting a light-touch review later in the year to re-test whether the existing balance remains appropriate.

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.

29. The Government recognises that the regulatory landscape for social investment is complex and can appear confusing. In recognition of the strength of feeling on this issue, the Government will engage with the sector to explore ways in which greater clarity might be achieved by non-legislative measures. We will also keep under review the possibility of legislative options in future. The Civil Society Strategy, due later this year, will also explore measures to support the social enterprise sector.

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)

30. As previously stated in the Government's interim response, TPR provides principles-based guidance with practical information, examples of approaches trustees could take and factors to consider. Whilst TPR considers that the Code of Practice and guides taken together currently reconcile the requirement to process transactions promptly with the benefits of holding some illiquid assets, it will consider further guidance to make clear how trustees should promptly realise investments from funds with longer dealing cycles so trustees are aware they can access a wide variety of investments to generate returns and value for members.

31. On 12 March 2018, TPR published a blog on its website about pension funds and illiquidity[30]. In this, it explained that trustees may have different reasons to want to gain exposure to assets with long-term investment horizons, such as venture capital, infrastructure and other illiquid assets – some of which might have a positive social impact in addition to offering strong investment returns. As part of its ongoing work to be clearer, as well as quicker and tougher, TPR is going to provide further guidance on how trustees' investment strategies can include these types of assets in a diverse portfolio. They are expecting to publish this before the end of the year.

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 FCA

32. 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.

33. Pension schemes provided by insurers generally invest in unit-linked funds. The permitted links rules restrict insurers to certain classes of assets when they contract to provide unit-linked benefits under long-term contracts of insurance. These rules permit some element of illiquid investment, subject to prescribed limits and an overall duty to ensure fair and accurate valuation of permitted links in determining policyholder benefits.

34. With regard to unit prices for illiquid assets, the FCA's rules do not require daily pricing. Under the Prudent Person Principle of the Prudential Regulatory Authority (PRA), 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.

35. The FCA is actively considering the potential for rule changes and/or guidance in relation to the permitted links rules in light of its involvement in HM Treasury's Pension Investment Taskforce and Patient Capital initiative. In the interim response to the Law Commission's report, the FCA said that it would consider changes in assessing the feedback to its discussion paper *Illiquid Assets and Open Ended Investment Funds*. While this discussion paper mentioned unit-linked funds, it did not focus specifically on them and there was little relevant feedback.

36. 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 measures proposed would need to be considered in conjunction with the PRA.

37. The FCA will progress this work in the second half of 2018.

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.

Defined contribution (DC) schemes

38. The Government carried out a consultation in October 2017 on policy and regulatory changes[31] to simplify the current rules on bulk transferring members between DC schemes without their consent. Responses were overwhelmingly in favour of the proposed policy changes, which would remove the time consuming and costly process of actuarial certification required by the existing regulations in favour of an approach more appropriate to DC schemes.

39. The new legislation[32], allowing transfers to authorised Master Trusts, and transfers between schemes sponsored by connected employers to take place without seeking individual member consent, came into force on 6 April 2018. It is expected to facilitate consolidation of DC schemes. Transfers which do not fall under one of these categories can take place without consent providing the trustees have taken independent advice on the proposed receiving scheme. Trustees are at all times expected to exercise their fiduciary duty to act in the best interests of the scheme beneficiaries.

40. An increased emphasis on the fiduciary duty of trustees, and the need for independent advice on the suitability of the proposed receiving scheme should help protect members. Additionally, any members being transferred who benefitted from the charge cap will be able to take this protection with them into the receiving scheme.

41. DWP published guidance[33] in April of this year to support the regulations, and to assist trustees in interpreting their statutory duties.

42. By removing a cost and procedural barrier to consolidation, we expect this measure to allow the ongoing consolidation of DC schemes to continue and potentially accelerate.

Defined benefit (DB) schemes

43. The Government sets out its position towards DB consolidation in the White Paper *Protecting Defined Benefit Pension Schemes*[34], published in March. The White Paper sets out the advantages that DB consolidation can bring in reducing scheme costs per member, enabling more effective investment strategies and improving governance.

44. There are a number of ways DB schemes can consolidate and the Government is actively looking at what can be done to publicise the benefits and raise awareness of existing forms of consolidation. The industry is also considering new innovative models of consolidation where the sponsoring employer link is replaced by additional funding and capital investment from a commercial consolidator.

45. Towards the end of 2018 we will consult with the pensions industry and stakeholders on the design of a legislative framework and authorisation regime applicable to all forms of commercial DB scheme consolidation. We will work closely with the industry to design a framework which meets the needs of potential investors and operators, whilst also protecting members. We will also consult on proposals for a new accreditation regime which will apply to existing forms of consolidation so that members, trustees and sponsors can be confident that these vehicles meet or exceed a set of clearly defined standards.

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.

46. As stated in its interim response, the Government has no immediate plans to bring forward legislation requiring that pension schemes should consider whether they are disadvantaging members by not consolidating. We believe that now is not the right time for this measure.

47. For DC schemes, legislation has recently come into force to enable consolidation to continue more easily. The number of DC schemes has already fallen by more than 50%

in 8 years, and our expectation is that these recent regulatory changes will continue to facilitate pooling of assets without the imposition of a legal duty on schemes.

48. For DB schemes, the Government has recently announced that it intends to consult on a legislative framework and authorisation regime within which new forms of consolidation vehicles could operate. It will also consult on a new accreditation regime which could help build confidence and encourage greater consolidation to take place. The Government also plans to raise awareness of the benefits of consolidation to help prompt trustees and encourage them to consider whether consolidation would be beneficial under certain circumstances. The Government has no plans to mandate consolidation, which will remain for sponsoring employers and trustees to decide upon.

49. Nevertheless, the Government will continue to monitor closely how consolidation progresses over the next few years, including the effects on trustees' bargaining power with service providers, the range of assets to which schemes have access, and the effect on scheme efficiency and member outcomes. Further targeted or broad measures, whether supervisory or regulatory, will be considered, should this appear necessary.

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.

50. The Government has continued to see little evidence to suggest that the charge cap is a barrier to investment in physical assets such as property or infrastructure. DWP's charges survey[35], published in 2017, found that average charges in contract-based schemes were 0.54% and in trust-based schemes were below 0.50%, suggesting that there is significant headroom between the average level of charges and the 0.75% cap.

51. Rather, the potential barriers to such investment focus on perceived concerns around the application of permitted links, the use of platforms with a set-up based on daily trading, and a lack of appetite amongst trustees – the latter partly informed by concerns around appearing to increase charges. Occasional instances of difficulty with demonstrating charge cap compliance have also been raised. The Government will consider further whether any remedies are needed in this area.

52. Nevertheless, as previously stated, the impact of the cap on asset class diversity will be taken into account as part of the 2020 review of the level and breadth of the charge cap. The Government will liaise closely with the FCA on this work.

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.

53. In 2016 the Government asked Elizabeth Corley, Vice Chair of Allianz Global Investors, to chair an advisory group tasked with answering the question, 'How can the providers of savings, pensions and investments engage with individuals to enable them to support more easily the things they care about through their savings and investment choices?'. The advisory group's report[36], delivered in November 2017, set out a range of proposals to boost social impact investment by individuals. Whilst some of the recommendations were to the Government, many were directed at the institutional investors who often link individuals to the financial markets.

54. In March 2018, the Prime Minister commissioned Elizabeth Corley to lead an industry taskforce to take forward the recommendations[37]. This taskforce is focussed on generating a faster rate of innovation in the financial services industry to provide products that give savers and investors the opportunity to make a social impact. It will report on progress at the end of the year.

55. This month, the Government published its response to the advisory group's report[38]. Although we support the contention that much of the work to grow the impact investment market must come from industry itself, we reported on progress against a number of recommendations – both where the Government is primarily responsible for taking forward the work and where the Government has partnered to assist action.

56. The advisory group's report categorised its recommendations under five themes. *Theme 3: Develop better reporting of non-financial outcomes*, specifically addressed the need for a common set of standards and language through the social impact investment chain, as well as consistent and reliable reporting formats. In the Government's response to these recommendations, we outlined several projects that contribute towards these aspirations:

- A joint project between the Department for Digital, Culture, Media and Sport (DCMS) and the Department for Business, Energy and Industrial Strategy (BEIS) to explore how businesses are using the United Nations Sustainable Development Goals (SDGs) to frame their social and environmental responsibility and communicate this more strongly.
- Representation by BEIS at the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), which is considering ways to develop company reporting in accordance with the SDGs.
- A post-implementation review of the UK's transposition of the EU Directive on Disclosure of Non-Financial and Diversity Information, to include an evaluation of company reporting on social and environmental issues.
- Changes to the Companies Act requirements (Section 172), as part of the Government's Corporate Governance Reform package, that will improve businesses' reporting on their impacts on employees and other key stakeholders.
- Support for the World Benchmarking Alliance to publish league tables ranking company performance against the SDGs.
- Additionally, the Government supports initiatives such as the Global Impact Investing Network (GIIN) and the Impact Management Project, which work to improve impact measurement and management practices among investors and build market intelligence, such as through the GIIN's Annual Investor Survey.

57. *Theme 4: Making it easier to invest*, endorsed the recommendations of the Law Commission and suggested further actions – predominantly for the investment industry – that would increase education and awareness of social impact investment

products and improve consumer access. We are pleased to learn that the Investment Association (IA) has set up a Sustainable and Responsible Investment Committee that, amongst other initiatives, will take forward work around definitions and standards for impact investing, with a long-term view to improving visibility to end investors around social impact products. The IA is represented on the taskforce and is also collaborating with the Government on the above-mentioned projects on non-financial reporting.

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.

58. The Government has given further careful consideration to this option, but has concluded that any legislative changes would be inappropriate at the present time. This is because we agree with the Law Commission's view, set out in its 2014 report, that trustees are not compelled to take account of any non-financial member concerns, such as those related to ethics or quality of life.

59. The Law Commission gave further consideration to this point in its 2017 review and report, specifically, the question of whether trustees might be fettering their discretion by setting out in advance that they will not take member considerations into account in the future. However, the Law Commission once again concluded that, while trustees have the fiduciary power to take account of member concerns, they do not have a fiduciary duty to do so. Therefore, given that trustees have no obligation at any particular moment to take account of members' views, it would be inappropriate for the Government to consider requiring them to carry out member surveys.

60. Surveying members remains one possible way of identifying views, albeit an approach which comes with some hazards. The Law Commission has made clear that good evidence of agreement from some people will allow trustees to act on members' views, even if many people fail to engage. But in cases where a survey is undertaken and produces low numbers of responses, it will be difficult for trustees to assure themselves that they have the met the two-stage test which allows them to reflect members' preferences. There is also the danger that a focus on surveying members to establish views might blind trustees to the views they reasonably believe members hold, based on consideration of wider public opinion.

61. The consultation on *Clarifying and Strengthening Trustees' Investment Duties*, published alongside this response, proposes to require trustees to prepare a statement on how members' views are taken into account in developing an investment strategy each time they prepare or revise their Statement of Investment Principles (SIPs). It also proposes to require trustees of relevant schemes (those offering money purchase benefits, subject to a few exceptions – or more broadly, defined contribution schemes) to publish that statement. In line with the Law Commission's recommendations, this can include views which trustees have good reason to believe are held by the membership, as much as, if not potentially more than, those revealed by survey instruments.

Appendix A: Background

1. On 3 November 2016, the then Minister for Civil Society, Rob Wilson MP, asked the Law Commission on behalf of the 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 its report, *Pension Funds and Social Investment*[39]. The report draws upon responses to its 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.
   - 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 the 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*[40], 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; and
     - 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.

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