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8 January 2018

Dear Elizabeth

Thank you for your letter dated 9 November 2017.

I read the Advisory Group report with interest and I welcome the steps you are taking to encourage the financial services industry to contribute to the development of a stable framework for impact investing in the UK. I was also pleased to note that the Advisory Group will continue in some capacity to drive the necessary changes forward.

As I am sure you will be aware, the FCA published a Call for Input on regulatory barriers to Social Investments[1] in December 2015 to explore whether any rules or policies may be hindering investment for social purposes. Based on the responses received and roundtables we organised with the social investment community, we concluded that regulation does not prevent the social investment market from developing; rather, it could ensure the development of strong practices which in turn lead to investor confidence. We published a Feedback Statement summarising our findings in October 2016.[2]

I have addressed below each of the points in raised in your letter.

A shared understanding of the social impact concept

The report notes that stakeholders have encountered differing levels of understanding of what impact or social investing is and were provided a number of definitions in their engagement with the FCA. You have asked us for a commitment to continue to engage in the process of creating a consistent understanding of the topic.

In our Feedback Statement[3], we defined social investing as "a broad concept, which at its heart combines the idea that an investment can have a social impact as well as some form of financial return".

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1 https://www.fca.org.uk/publication/call-for-input/social-investments-call-for-input.pdf
2 https://www.fca.org.uk/publication/feedback/fs16-11.pdf
3 *ibidem*

This remains our understanding of social impact; it is not product specific and we would expect communications with investors as to the expected degree of social return alongside any potential financial returns to be clear, fair and not misleading as, indeed, we would with any other type of investment.

Of course, any developing sector will see new terms and concepts arise and we support the work of the Advisory Group in seeking to set out and maintain a current terminology within the social impact space. As regulators, it is important for us to remain aware of these developments and we would be pleased to continue our engagement in this work.

Law Commission recommendations on social investment and pension funds

The recent Law Commission report into pension funds and social investments has confirmed the view expressed in our Feedback Statement that barriers are primarily structural and behavioural rather than regulatory.

It has also made a number of recommendations to the FCA, for example in relation to the role of Independent Governance Committees ('IGCs') or in regards to guidance for contract-based pension providers on financial and non-financial factors. In your letter, you encourage us to implement the recommendations relevant to us.

We see the report as consistent with a number of other pieces of work we are undertaking. For example, we are already considering the role and focus of IGCs across a number of pension products we regulate. We will consider what form of rule changes may be appropriate to address the Law Commission's proposals around requiring IGCs to report on firms' policies in relation to evaluating risks to an investment in the long term, including risks relating to sustainability and to consider members' ethical concerns. We are also considering the proposal for IGCs to report on a firm's policy on stewardship as part of our work on the revised Shareholder Rights Directive and we will consider whether to include explicit additional guidance on financial and non-financial factors for firms operating workplace personal pension schemes.

We will consider our final response to all these recommendations for inclusion in the Government's final response but are, similarly to the Advisory Group, supportive of the objectives of this report. In the meantime, you can read our contribution to the Government's interim response to the Law Commission's proposals here: https://www.gov.uk/government/publications/pension-funds-and-social-investment-interim-response

Illiquid assets

You have noted that the current perception of FCA liquidity requirements can be to the detriment of long-term investment because they may preclude the use of long-term and less liquid assets. You also suggest that both the regulatory framework and industry have a role to play in promoting the willingness of investors to engage meaningfully with long term investments where these are suitable and offer better returns for equal security.

It is important to note, as described in our Discussion Paper on Illiquid assets and open-ended investment funds,[4] that the FCA's rules do not require daily pricing and both authorised investment funds and workplace pension schemes using unit-linked structures are already able to manage some element of illiquid investment within their funds.

[4] https://www.fca.org.uk/publication/discussion/dp17-01.pdf

However, we will consider further whether any changes are necessary to our existing rules and guidance on permitted links in response to your concerns. We will also take account of your response to our discussion paper as we consider what further steps we may need to consider within this space.

You will note that this paper already considers the point you raised in your response to us about the role of advisers and platforms and the requirements they set onto managers.

It is worth noting too that, in recent times, we have seen the emergence of investment trusts that have an impact investing mandate as well as a number of charity bonds and traditional open-ended funds. This demonstrates there is space, within the regulatory framework, for investment products with a social angle. We will continue to engage actively on these proposals as participants reach out to the FCA.

To provide further support to firms, we have recently set up an Asset Management Authorisations Hub with the aim to provide support to new asset managers from start-up, through to authorisation and into the early stages of supervision. This platform is open to all new asset managers and I would encourage new managers who wish to consider impact investing in their fund strategies to engage with the Hub.

Suitability

I have also noted your concern that advisers may be unclear on how to take account of non-financial goals when making recommendations. Our Feedback Statement on regulatory barriers to social investments directly addresses this point but, alongside our broader work on suitability, we will consider further opportunities to reiterate that clients' objectives will be individual and should be explored and considered by advisers, regardless of whether they are financial or non-financial goals.

The new MIFID II rules on product governance which require a robust and responsible distribution framework for products should further assist in this endeavour.

I nevertheless remain cautious about the idea of creating further guidance or examples of good or bad practice. Beyond the additional standards to MIFID II that we would be setting when firms provide advice, the effect of such guidance may be to artificially restrict firms' appetite to explore the boundaries of a budding sector where there has so far been no regulatory reason to do so.

However, we will work with the Financial Ombudsman Service where it seeks to provide clarity about it will approach any complaints about social investments, and especially in respect of non-financial losses.

Innovate's role

A flexible regulatory framework is not enough for financial practices to become mainstream; these practices must also be based on sound foundations and have the confidence of market players. On that basis, it came as no surprise to me that your report mentions that 52% of respondents said difficulty in measuring social outcomes limited their willingness to invest in impact investments.

The lack of consistent valuation of non-financial outcomes had already been identified as a key impediment to the development of a social investment sector in our own work and I therefore strongly support your goals of developing better reporting of these outcomes.

You have noted the role of the FCA's Innovate in supporting the growth of the social impact investing market and suggested the financial services industry should work with the FCA to identify how to facilitate the issuance of new instruments and bonds to bring further choice and diversity to the market place.

I can confirm the FCA in general, and Innovate in particular, remains open to truly innovative businesses. I would be happy for the Group to promote Innovate to firms as they seek to develop better reporting of non-financial outcomes or consider the type of financial instruments that should be available to investors.

Conclusion

We will continue to engage with the Advisory Group and the social impact investment industry as it further develops its work within the impact investing space. In the meantime, I would be pleased to discuss this further with you directly.

With very best wishes for the New Year.

Yours

Andrew

Andrew Bailey
Chief Executive

CC: Caroline Wayman, Financial Ombudsman Services