



**Law
Commission**
Reforming the law

Pension Funds and Social Investment



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Reforming the law

(Law Com No 374)

Pension Funds and Social Investment

Presented to Parliament pursuant to section 3(2) of the Law Commissions Act 1965

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The Law Commission

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Glossary

Active member: A member of a pension scheme who is currently contributing to and accruing benefits under that scheme.

Actuary: A professional who specialises in statistics and risk who gives advice on a pension scheme's assets and liabilities. They will predict movements in the scheme, such as deaths, retirements and withdrawals, and estimate the costs of providing the benefits due and accruing in the future.

Alternative asset classes: Assets which are not traditional equities (shares), bonds or cash. Examples include property, infrastructure, private equity, artwork and gold.

Annuity: A fixed sum of money paid to individuals each year upon retirement. This may be for an agreed period or for the rest of the individual's life. The amount of money paid will depend on the individual's total accumulated pension savings.

Asset manager: See "investment manager".

Automatic enrolment: Also known as "auto-enrolment". A legislative requirement introduced by the Pensions Act 2008 which requires all employers (beginning with the largest) to automatically enrol their qualifying employees into a qualifying pension scheme.

B Corp: B Corps are for-profit companies with social or environmental outcomes as part of their mission and which have been certified by B Lab, a non-profit organisation, on the basis of their social and environmental performance, accountability and transparency.

Charge cap: This is a legislative requirement found in the Occupation Pension Schemes (Charges and Governance) Regulations 2015 and the FCA's COBS chapter 19. It is a limit placed on the administrative charges which can be passed on to members of the default arrangement of an auto-enrolment qualifying scheme.

Chosen fund: Also known as a "self-selected fund" and a "self-select option". An investment fund offered by a pension scheme to which a member can choose to allocate their pension contributions. Examples include an ethical fund, a sharia fund, a high-risk fund and a low-risk fund.

Closed-ended fund: A fund which raises a fixed amount of capital for a defined period. Investors can buy units in the fund but they cannot sell (or redeem) their units back to the fund. Units in some closed-ended funds are traded on a secondary market (ie an exchange), where investors can buy or sell units in the fund.

COBS: Conduct of Business Sourcebook. The section of the FCA's Handbook that deals with business standards.

COLL: Collective Investment Schemes Sourcebook. The section of the FCA's Handbook that deals with collective investment schemes.

Collective investment scheme (CIS): A fund that several people contribute money into. A fund manager will invest the pooled money on their behalf in one or more types of asset, such as stocks, bonds or property. These may be regulated or unregulated. If regulated, they require FCA authorisation and are subject to restrictions in terms of their investment powers and how they are run.

Contract-based scheme: A pension scheme which is based on a contract between an individual and a pension provider and is regulated primarily by the FCA. These may be work-based or individual pensions. In work-based contract-based schemes, the employer appoints a pension provider, usually an insurance company, to administer their pension scheme. The employees enter into a contract directly with the pension provider, although the employer may make arrangements to collect and pay contributions. Contract-based schemes can only be defined contribution (DC) schemes.

Contributions: The money paid by members and employers into the pension scheme.

Custodian: An institution that is responsible for the safekeeping and administration of assets belonging to another. Custodians will often handle administrative arrangements such as collecting coupons and dividends.

Default fund: Also known as a “default arrangement”. The investment fund within an auto-enrolment scheme into which a member’s contributions are paid if they fail to select a chosen fund to invest in.

Defined benefit (DB) schemes: Also known as “final salary” schemes. A type of pension where the amount an employee receives on retirement is pre-determined, and is often calculated on the basis of the employee’s final salary and length of service. The amount received on retirement does not depend on the performance of the pension scheme’s investments.

Defined contribution (DC) schemes: Also known as “money purchase” schemes. A type of pension scheme where the amount received by a member on retirement will be calculated by reference to the contributions the member makes to the scheme and the investment return on those contributions. Each member’s income in retirement depends on how their contributions are invested. The member, not the employer, bears the investment risk.

Department for Work and Pensions (DWP): The government department responsible for welfare and pensions policy.

Financial Conduct Authority (FCA): The regulator of the financial services industry. It took over some of the functions of the now abolished Financial Services Authority (FSA). The FCA is responsible both for regulating the infrastructure of financial markets and standards of conduct. It also regulates contract-based schemes.

Financial Services Authority (FSA): A now defunct financial services regulator. Abolished in 2013 and replaced by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

Fixed income: Income generated from debt instruments, such as loans and bonds.

Fund manager: See “investment manager”.

Group personal pension: A contract-based scheme where employers make arrangements for a group of employees to take out pensions, but the employer has no ongoing responsibility for monitoring the performance of the scheme once it is in place. A group personal pension is characterised as a series of contracts between the individual members and the pension provider, who is typically a life insurance company. Group personal pensions are “workplace pension schemes”.

Illiquid: Assets or investments which are not easy to sell or exchange for cash quickly without incurring a loss.

Illiquidity: An inability to convert assets or investments into cash easily and quickly in order to meet short-term obligations.

Investment intermediary: An intermediary in the investment chain between an asset and the ultimate beneficiary of the investment in that asset. In a typical investment chain this includes investment managers, brokers and custodians.

Investment manager: Also known as a “fund manager” (for example, in pensions legislation) and an “asset manager”. An individual (or organisation) who carries out the day-to-day management of a pension scheme’s assets. The investment manager will act on the basis of instructions given to them by the pension scheme in the investment mandate.

Investment mandate: The agreement between an investment manager and their client outlining how the assets of the pension scheme are to be managed. The mandate may contain performance targets by reference to a benchmark, or may contain restrictions on which investments the investment manager can make.

Lifestyling: An investment strategy where the allocation of a member’s investments is adjusted depending on age and length of time to retirement. For example, as a member gets older, their investments are likely to be moved out of equities and into less volatile investments such as cash and bonds.

Liquid: Assets or investments which can be readily converted into cash. Examples include publicly listed shares and bonds.

Liquidity: The ease at which assets or investments can be converted into cash in order to meet short-term obligations.

Mark-to-market: The practice of valuing assets on the basis of their current market value, rather than the potential value they are expected to achieve.

Mark-to-model: The practice of determining the price of a portfolio by reference to financial models, rather than allowing the market to determine the price.

Master trust: A multi-employer trust-based scheme. Examples include NEST, The People’s Pension, Legal & General WorkSave Pension Mastertrust and Standard Life Master Trust Co Ltd.

Member: An individual who contributes or has contributed to a pension scheme.

National Employment Savings Trust (NEST): A government-sponsored defined contribution (DC) trust-based pension scheme. It is available to all employers to use for the purposes of auto-enrolment. Employers can use NEST as their only pension scheme or alongside other pension schemes. NEST is regulated by HM Revenue and Customs and The Pensions Regulator.

Negative screening: The practice of excluding certain investments from an investment strategy, such as tobacco companies or pesticide manufacturers.

Occupational pension scheme: A trust-based scheme set up by an employer to provide retirement benefits for its employees.

Open-ended fund: A fund where investors can buy units in the fund and sell them back to the fund on demand at their net asset value. This is a price based on the value of the fund's underlying assets which is calculated at the end of each trading day.

Passive investment: An approach to investment which typically involves replicating the investment performance of a specific market index such as the FTSE100, with the result that the assets in question move exactly in line with the chosen index. "Passive funds" are also known as an "index funds".

Pensions Infrastructure Platform (PiP): A platform that has been specifically developed to facilitate long term investment into UK infrastructure by pension schemes. It is made up of ten major defined benefit (DB) pension schemes and its aim is to invest in UK infrastructure. By the end of 2016, the fund had invested £100 million in renewable energy, including a portfolio of 31 wind turbine sites.

PERG: Perimeter Guidance Manual. The section of the FCA's Handbook that explains the circumstances in which authorisation is required or exemption is available. It also explains the activities that are regulated under the Financial Services and Markets Act 2000 and the exclusions which are available.

Permitted links: The list of approved assets found in COBS that an insurer engaged in unit-linked insurance business may link to, in order to determine the value of benefits due, under unit-linked contracts (for example, contract-based schemes).

Platform: Also known as an "investment platform". May refer both to a "platform" as a piece of technology, which allows pension scheme members to check their pension savings online, or to an intermediary (usually an insurer) who facilitates the purchase of investments. It also allows an investment manager to review holdings in different investments and to issue instructions to buy or sell assets, or move money into funds which are offered via the platform.

Positive screening: The practice of selecting investments based on what are considered to be desirable practices. For example, renewable energy supply.

Real estate investment trust (REIT): A company established to hold a property portfolio. A REIT owns real estate, which can include commercial property ranging from office blocks and apartments to hospitals, shopping centres and social housing.

Risk-adjusted returns: Returns adjusted to take account of risk exposure.

Shareholder engagement: An approach to investment which emphasises the importance of effective dialogue between investors and investee companies. Engagement may involve an exchange of views on issues such as strategy, performance, board membership and quality of management.

Shares: Also known as “equities”. This is the name for the individual units that measure the holder’s interest in and liability to a company. Shares may also be referred to as stock or equity of a company.

Social enterprise: A business with a social, charitable or community-based purpose, whose surpluses are principally reinvested for those purposes. They are subject to rules and restrictions as to their activities and use of profits.

Statement of investment principles (SIP): A statement required by the Occupational Pension Schemes (Investment) Regulations 2005 which sets out the investment strategy of an occupational pension scheme.

Stewardship: A philosophy which aims to promote the long term success of investments in such a way that protects and enhances the value that accrues to the ultimate beneficiary of an investment. It is usually discussed in the context of institutional investors. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration.

The Pensions Regulator (TPR): The statutory regulator of workplace pension schemes (including both trust-based and contract-based schemes). Its objectives are to protect the benefits of members of occupational pension schemes (and contract-based schemes where there is a direct payment arrangement), to promote and improve understanding of the good administration of workplace pension schemes and to maximise employers’ compliance with their duties under the Pensions Act 2008.

Trust-based scheme: A pension scheme established using a trust. The trustees are responsible for managing the scheme and for reviewing and monitoring investments.

UCITS: Undertakings for Collective Investment in Transferable Securities (otherwise known as UCITS compliant funds). These are funds which comply with an EU regulatory framework governing the operation of certain collective investment schemes.

Unit-linked fund: A fund which collects cash for investment from many people; in this context, through pension contributions. These contributions are treated as insurance premiums and in return the member receives units in the fund. The cash from contributions is then invested in a wide range of investments held by the unit-linked fund. Unit prices rise and fall, reflecting changes in the value of the fund’s underlying assets. These are units of account and the member receives no proprietary rights in the underlying assets of the fund.

Workplace pension scheme: A pension arranged through an employer. It can be either a trust-based pension scheme or a group personal pension scheme (which is a contract-based scheme). It can be a defined benefit (DB) scheme or a defined contribution (DC) scheme.

Table of Abbreviations

CIC	Community interest company
CIO	Charitable incorporated organisation
COBS	Conduct of Business Sourcebook
COLL	Collective Investment Schemes Sourcebook
CIS	Collective investment scheme
DB	Defined benefit
DC	Defined contribution
DWP	Department for Work and Pensions
ESG	Environmental, social and governance
FCA	Financial Conduct Authority
IGC	Independent governance committee
IORP	Institutions for Occupational Retirement Provision
NEST	National Employment Savings Trust
OECD	The Organisation for Economic Co-operation and Development
OFT	Office of Fair Trading
PiP	Pensions Infrastructure Platform
PLSA	Pensions and Lifetime Savings Association
PPI	Pensions Policy Institute
PRA	Prudential Regulation Authority
REIT	Real estate investment trust
SIP	Statement of investment principles
SRI	Socially responsible investment
TPR	The Pensions Regulator
UCITS	Undertakings for Collective Investment in Transferable Securities
UKSIF	The UK Sustainable Investment and Finance Association

Pension Funds and Social Investment

To the Right Honourable David Lidington MP, Lord Chancellor and Secretary of State for Justice

Chapter 1: Introduction

- 1.1 Workplace pensions are changing rapidly. Traditional defined benefit (DB) schemes are being replaced with defined contribution (DC) schemes, where each member's income in retirement depends on how their contributions are invested. Furthermore, employees are no longer required to make a positive choice to join a workplace pension to save towards retirement. Instead, employees are automatically enrolled into a workplace pension and must take action if they wish to opt out. The vast majority are placed in "default funds" where investment decisions are made by those administering/managing the scheme rather than the individual.
- 1.2 The assets in DC schemes are expected to increase sixfold by 2030 to £1.68 trillion, a sum equivalent to 15% of the current net wealth of the UK. These changes raise questions about how the new pension assets are to be invested and, in particular, whether at least a proportion could be invested for the wider social good.

TERMS OF REFERENCE

- 1.3 On 3 November 2016, the Minister for Civil Society, Rob Wilson MP, asked the Law Commission to look at how far pension funds may or should consider issues of social impact when making investment decisions. Our full terms of reference were:
 - (1) 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:
 - (a) Defined contribution default funds;
 - (b) Defined contribution chosen funds; and
 - (c) Defined benefit schemes.
 - (2) To provide an accessible account of the law governing the forms which may be used by social enterprises.
 - (3) To consider whether there are legal or regulatory barriers to using pension funds for social impact (including investment in social enterprises); and
 - (4) If appropriate, to set out options for reform.

THE LAW COMMISSION'S PREVIOUS WORK ON FIDUCIARY DUTIES

- 1.4 This project builds on our 2014 report, *Fiduciary Duties of Investment Intermediaries*¹ and accompanying guidance,² which considered when pension trustees can take environmental and social factors into account when making investment decisions.
- 1.5 The guidance clarified that pension trustees should take into account factors which are financially material to the performance of an investment, balancing returns against risks. This includes risks to the long-term sustainability of a company's performance. We said these risks may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. For ease of reference, we set out the guidance at Appendix 1 of this report.
- 1.6 We found that, although financial return should be trustees' predominant concern, the law is sufficiently flexible to allow other, subordinate, concerns to be taken into account in some circumstances. The law permits pension trustees to make investment decisions that are based on non-financial factors (such as environmental and social concerns), provided that:
 - (1) they have good reason to think that scheme members share the concern; and
 - (2) there is no risk of significant financial detriment to the fund.

THIS PROJECT

- 1.7 In this report we apply our 2014 guidance to the current pensions landscape.
- 1.8 Our terms of reference ask us to provide an accessible account of the law relating to pensions and social investment and also to consider whether any legal or regulatory barriers exist in this area. We are asked to set out options for reform, but only if appropriate given the scope of the review we have been asked to carry out. We are not asked to make recommendations on major policy issues relating to pensions and social investment, such as whether pension funds should be encouraged to invest for social impact in the first place.
- 1.9 We have not identified any legal or regulatory barriers to social investment by pension schemes. The barriers that we did identify were, in most cases, structural and behavioural barriers within the pensions industry – but it would not be appropriate for us, as a law reform body, to make recommendations in these areas. Accordingly the greater part of this document comprises advice to Government under section 3(1)(e) of the Law Commissions Act 1965.

¹ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350. Available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

² Guidance from the Law Commission, *Pension trustee's duties when setting an investment strategy: "Is it always about the money?"* (2014). Available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

- 1.10 We set out options for reform where we have identified steps which could be taken by others to address these barriers. We make some recommendations where we have identified that the law could be improved so as to reduce the impact of these barriers. These recommendations build on our 2014 work and have been updated in light of the current pensions landscape.

Call for evidence

- 1.11 The emphasis on applying existing guidance to new circumstances has made this an unusual project for the Law Commission. Rather than publish a detailed consultation paper with proposals for reform, we conducted a call for evidence and had detailed discussions with stakeholders.
- 1.12 We published our call for evidence on 7 November 2016 and asked for responses by 15 December. We were particularly keen to understand the context in which pension funds make investment decisions and, in particular, the challenges they face. We also asked consultees whether there were legal or regulatory barriers to pension funds investing in social investments. We received 30 responses from a wide range of stakeholders, a compilation of which can be found on our website.³ These responses discussed the issues in some depth. We have drawn on them extensively in this report.
- 1.13 We have also had further face-to-face meetings with 20 stakeholders and a roundtable with stakeholders. In Appendix 2 we list those who responded to our call for evidence and those we met or corresponded with in the course of this project.

THIS REPORT

Chapter 2: What is social investment?

- 1.14 Chapter 2 discusses the nature of social investment, or investing for social impact. Consultees provided a range of approaches to defining social investment, including a focus on the investor's motives, an emphasis on investments with a measureable social impact, a focus on the underlying investment, socially responsible investment and investment in efficient financial systems.
- 1.15 We describe these different approaches and then discuss what social investment means for the purposes of this report and its focus on pension savers. Our interpretation of social investment focuses on investment which addresses societal challenges while continuing to generate competitive financial returns. We acknowledge that pension savers may choose to make investments with a social impact which offer below market returns. However, we conclude that this is not necessarily suitable for all pension savers, and this kind of investment is therefore not the focus of this report.
- 1.16 In our call for evidence we asked for examples of social investments which pension funds could or should be making. Overwhelmingly, consultees mentioned property and infrastructure projects such as social housing, green energy and sustainable transport initiatives as investment opportunities with a genuine potential to both do good and do well. Consultees also mentioned investments in charities and other social

³ Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

enterprises. Chapter 2 briefly introduces these two broad examples. We consider these in more detail in Chapters 7 and 8.

Chapter 3: The current pensions landscape

- 1.17 Chapter 3 provides an outline of the current pension landscape. It introduces the concept of the “workplace” pension, being a pension arranged through an employer. It then sets out the two main types of workplace pension from the saver’s perspective. The first is the defined benefit (DB) scheme, where the employer guarantees the saver a certain income on retirement. The second is the defined contribution (DC) scheme, where the saver’s income on retirement depends on the performance of the pension fund investments.
- 1.18 We then describe the surge in workplace pensions seen since the introduction of auto-enrolment in 2013, and the significant shift from DB to DC schemes. We identify how much the pension landscape has changed since our 2014 report, *Fiduciary Duties of Investment Intermediaries*.⁴ It is expected that this move from DB to DC schemes will continue due to the comparatively higher costs to employers of offering DB rather than DC schemes. The majority of DC scheme members are invested in the default arrangements provided by their scheme rather than making an active decision to invest their pension savings into specific funds and their investments.
- 1.19 We explain that there is considerable homogeneity in the way that DC schemes are currently invested. The great majority of funds are in listed equities (that is, shares on traded markets). Less than 5% of invested funds are in alternative asset classes, such as property or private equity. This proportion in alternative asset classes is low compared with DB schemes or with pension schemes in other countries, such as Australia.

Chapter 4: Law and regulation of pensions

- 1.20 In Chapter 4 we identify a further distinction between different types of pension schemes, which is concerned with legal forms and does not impact the saver’s return in the way that the DB scheme / DC scheme distinction does. This is the distinction between pensions which are set up through a trust structure, and those which are based on contract.
- 1.21 Trust-based and contract-based schemes are governed by different sources of law and there are differences in relation to how investment decisions are made and reviewed. However, the outcome for pension savers should be the same. It is important for the reader to understand the legal and regulatory differences in order to understand why our options for reform and recommendations are framed as they are.
- 1.22 We provide a brief outline of the law and regulation applying to investment decisions made by trust-based and contract-based schemes.

⁴ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350. Available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

Chapter 5: Considering the social impact of pension investments – financial and non-financial factors

- 1.23 Our terms of reference ask us to provide an accessible account of the law governing how far pension fund investment policy may or should consider issues of social impact. In Chapter 5 we discuss how far pension trustees can or should consider financial factors and non-financial factors when making investment decisions, including the social impact of their investments. We draw on our 2014 guidance for pension trustees and apply it to the current pensions landscape.
- 1.24 These principles apply to both DB and DC schemes. They also apply to all investments, including equities, bonds and property.
- 1.25 If trustees make an investment, they must consider the risks of that investment. This may include the extent to which a project's negative social or environmental impact could affect its long term sustainability and financial returns.
- 1.26 In some limited circumstances, the trustees of a scheme may go further than this. They may favour investments with a positive impact or avoid investments with a negative impact. However, trustees would need good reason to think that their members held the values underlying the concern. In any event, the decision should not risk significant financial detriment. Investment by a default fund should not provide a significantly lower return than one available elsewhere.
- 1.27 Some scheme members may decide independently to put their pension savings into a chosen fund with an investment strategy which makes investments based on non-financial factors. For example, a chosen fund may exclude certain investments like tobacco or munitions. Pensions scheme decision makers will need to take such investment strategies into account when making investment decisions relating to those chosen funds.

Chapter 6: Considering the social impact of pension investments – recommendations

- 1.28 Although the law enables pension trustees to take account of issues of social impact in certain circumstances, we have been told that the law continues to be misunderstood.
- 1.29 In practice, trustees of trust-based pension schemes structure their decision-making around the statement of investment principles, produced by trustees to meet the requirements of the Pensions Act 1995 and Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations). In this chapter we look at the current regulations on how a statement of investment principles should address financial and non-financial factors and stewardship. We draw on our work in 2014 to make recommendations for amendments to the Investment Regulations which would require trustees to explicitly consider their policies in relation to financial and non-financial factors and stewardship. This will help trustees structure their decision-making in this area, both to control for long term risk, and to respond to members' ethical and other concerns.
- 1.30 We then consider contract-based schemes, which should, as far as possible, be subject to equivalent provisions and result in the same outcomes for pension savers. The rules for contract-based schemes are found in COBS (the Conduct of Business

Sourcebook), which is the section of the FCA's Handbook that deals with business standards.

- 1.31 Unlike trust-based schemes, there is no requirement for contract-based schemes to produce a statement of investment principles. However, each provider must have an independent governance committee which carries out an oversight role over workplace schemes operated by that provider, assessing the value for money for policyholders and how the provider has considered the policyholders' interests more generally. We make recommendations for amendments to COBS to require independent governance committees to report on the provider's policies in relation to financial and non-financial factors and stewardship.
- 1.32 The Pensions Regulator (TPR) guidance for trustees includes the Law Commission test set out in our 2014 guidance for taking into account non-financial factors in investment decisions. By contrast, there is no FCA guidance aimed at contract-based schemes to assist them as to how to consider financial and non-financial factors when they are making investment decisions. This chapter contains a recommendation that the FCA should issue guidance aimed at contract-based pension providers on financial and non-financial factors. This should follow the guidance given by TPR in its Guide to investment governance.

Chapter 7: Investment in social enterprises

- 1.33 Our terms of reference ask us to consider whether there are legal or regulatory barriers to using pension funds for social impact (including investment in social enterprises). They also ask us to provide an accessible account of the law governing the forms which may be used by social enterprises.
- 1.34 We provide a fuller account of the law in a background paper which looks in detail at each of the legal forms a social enterprise may take.⁵ In Chapter 7 we explain how the legal form a social enterprise takes can affect its ability to attract investment. We look at the following characteristics:
- (1) incorporation and separate legal personality;
 - (2) ability to provide returns to investors via interest and grant security for debt financing; and
 - (3) ability to provide returns to investors via dividends.
- 1.35 The wide range of possible legal forms provides choice and flexibility for organisations to choose the form most appropriate for them. Some legal forms are more or less restrictive in relation to an enterprise's ability to provide returns to investors, and this may well be appropriate where providing returns to investors is not the primary aim of the enterprise.
- 1.36 We do not propose that all restrictions should be lifted as the different legal forms serve different and useful purposes. We suggest options for reform where we have identified unnecessary barriers to investment in social enterprises.

⁵ See Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

Chapter 8: Investment in property and infrastructure

- 1.37 In response to our call for evidence, consultees identified property and infrastructure investments as providing a social impact as well as a financial return. Property and infrastructure therefore emerged early on as the area with the greatest potential to provide opportunities for social investment which were appropriate for pension schemes.
- 1.38 In Chapter 8 we consider the link between social investment and property and infrastructure. We also look at pension fund investment in property and infrastructure, including comparisons with other jurisdictions.
- 1.39 Traditionally, commercial property was an important asset class for DB schemes, however, DC schemes have been less likely to invest in property and asset classes other than equities (shares). In this chapter we focus on barriers to investment in property and infrastructure by DC schemes. This is in recognition of the significance of DC schemes in the current pensions landscape as compared with DB schemes.
- 1.40 We have not identified any legal or regulatory barriers to investment in infrastructure. We suggest options for reform which seek to address structural and behavioural barriers.

Chapter 9: Engagement and social investment

- 1.41 By “engagement”, we mean the extent to which members are interested in their pensions. Engagement levels are low: pension decisions are viewed as complex, unpleasant, boring, time consuming and something to be put off indefinitely. Although many schemes offer savers a choice of funds other than the default option, few people take these up. In Chapter 9 we draw on principles of behavioural economics to understand why this is.
- 1.42 Polling evidence suggests that savers are interested in making investments for social impact, but this is not translated into pension scheme members choosing to invest in specialist funds which offer ethical investments.
- 1.43 We consider the suggestion that savers should be offered the option of a “social investment” pension, which invests around 10% of funds for social impact. We also consider whether a “social investment” label for certain investments could be accredited by an independent organisation and whether impact reporting could be used to increase engagement and social investment.
- 1.44 We suggest options for reform where we have identified that the Government or industry could take steps to harness pension savers’ interest in social investment in order to increase levels of engagement and social investment.

Chapter 10: Recommendations and options for reform

- 1.45 In Chapter 10 we provide a consolidated list of the recommendations we make, and options for reform we have identified, in earlier chapters.

GEOGRAPHICAL SCOPE

- 1.46 This project is focused on the law of England and Wales. However, many of the issues we discuss apply equally to Scotland, including auto-enrolment, FCA rules, pension legislation and TPR guidance.
- 1.47 For our 2014 report we worked closely with the Scottish Law Commission to identify similarities and differences between the two jurisdictions. Our guidance on financial and non-financial factors applies equally to Scotland, as will the changes we propose to the statement of investment principles. The Scottish Law Commission, have reviewed this document in draft form. This report does not apply to Northern Ireland.

ACKNOWLEDGEMENTS

- 1.48 We would like to thank all those who responded to our consultation and those who we met with or corresponded with in this project. The responses we have received have been invaluable in understanding the context of pension investment and the challenges currently facing the industry. We are particularly grateful to the University of Birmingham for organising a roundtable on 10 January 2017, which allowed an open discussion of the issues.
- 1.49 We would also like to thank the officials from various Government departments and regulators who have given us their time to discuss this project.

THE TEAM WORKING ON THE PROJECT

- 1.50 The following members of the commercial and common law team have contributed to this report at various stages: Tamara Goriely (head of policy); Laura Burgoyne (team manager); Teresa Trepak (team lawyer); and Lucinda Cunningham (research assistant).

Chapter 2: What is social investment?

- 2.1 Social investment has been described as “a broad concept”,⁶ which “has meant different things to different people at different times”.⁷ Here we start by outlining various approaches to defining social investment. Most definitions of social investment involve a mix of financial and non-financial motives, and we consider the spectrum covered by this mix. We also look at the breadth of strategies used in socially responsible investing and the importance of stewardship in this context.
- 2.2 Often consultees found it easier to give examples of social investment than to define it. In this chapter we introduce the two main examples that consultees identified as providing opportunities for social investment: infrastructure and property; and charities and social enterprises. We were told that investments in infrastructure in particular have the ability to provide financial returns for retirement as well as having a social impact. Although we are aware of the differing interpretations, in this report we use “social investment” and “investing for social impact” interchangeably.

APPROACHES TO SOCIAL INVESTMENT

- 2.3 We start by looking at the various ways that social investment may be defined. We group these into five main approaches: motives of the investor; measurable social impact; a focus on the underlying investment; socially responsible investment; and investment in efficient financial systems.

Motives of the investor

- 2.4 Social investment defined by reference to the investor’s motives focuses on there being mixed motives, namely “to do well and to do good at the same time”. Big Society Capital told us that social investment is “the use of repayable finance to achieve a social as well as a financial return”.⁸ It is different from a purely financially motivated investment, because both the investor and the user of the capital intend to make a positive social impact. It is also different from a decision to give money to a particular cause. As the Financial Conduct Authority (FCA) put it:

⁶ Financial Conduct Authority, *Feedback Statement FS16/11, Call for Input: Regulatory Barriers to Social Investments* (October 2016), para 1.4. Available at <https://www.fca.org.uk/publication/feedback/fs16-11.pdf>.

⁷ Dan Gregory – Common Capital, *Angels in the Architecture: building the infrastructure of social investment* (2013), p 12. Available at https://www.bigsocietycapital.com/sites/default/files/pdf/Angels%20in%20the%20Architecture%20%281%29_0.pdf.

⁸ For further discussion see, Big Society Capital, *Social Investment Insights* (March 2016). Available at http://www.bigsocietycapital.com/sites/default/files/attachments/The%20size%20of%20and%20composition%20of%20social%20investment%20in%20the%20the%20UK_3.pdf.

Social investment is different from charitable giving or making a donation as there is an expectation that capital may be returned and some financial gain could be made.⁹

- 2.5 Most definitions of social investment involve a mix of financial and non-financial motives. However, even this encompasses a broad spectrum of approaches and strategies. In their initial paper on social pension funds, the Social Market Foundation and Big Society Capital explained:

Social investment is not an asset class – it is better thought of as a spectrum, which captures many classes of financial assets, including low-risk investments such as infrastructure, where patient capital is needed, through to social impact bonds and much riskier equity-like investments into social enterprises.¹⁰

- 2.6 Bates Wells & Braithwaite agreed:

There is a large spectrum of investing which could be deemed “social”, ranging from social investment in the narrow sense such as community members investing in a renewable energy project in their community, and investment in charities, to other types of investment with broad social impact, such as investment in infrastructure.

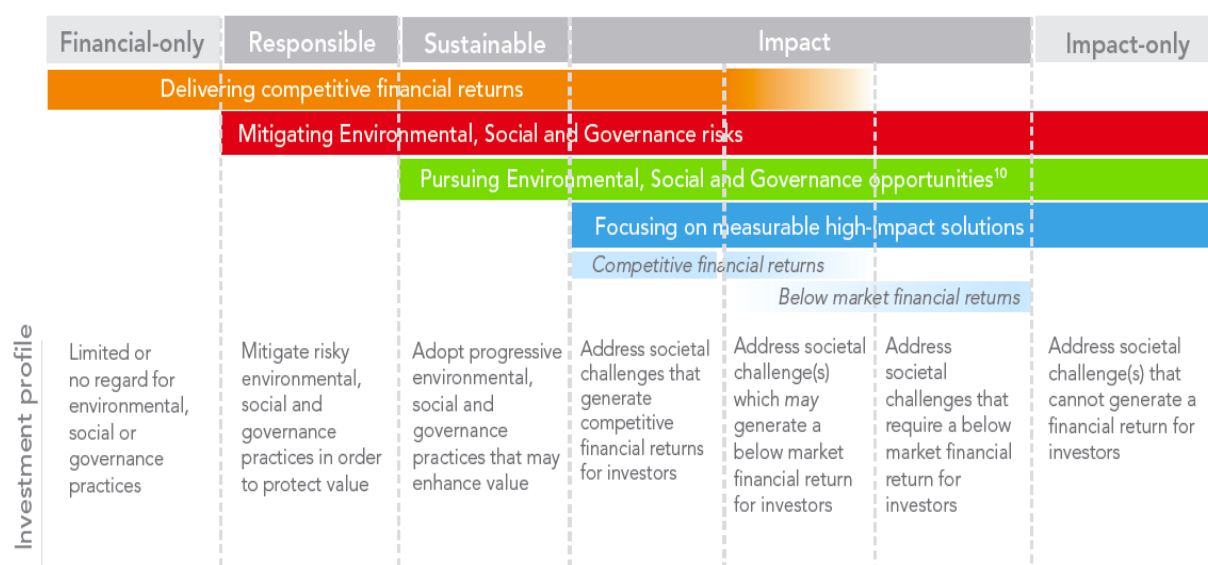
- 2.7 Legal & General Investment Management (LGIM) emphasised the need to move away from the message that investment risk and social motivations sit at opposite ends of the spectrum and the idea that one must be chosen at the expense of the other.

- 2.8 Several consultees referenced the work done by Bridges Ventures (Bridges Fund Management), demonstrated at Figure 1 below. On the left of this spectrum are investments made for purely financial reasons; on the right are transactions motivated purely by altruism, such as charitable giving. Between the two extremes are a range of mixed motives.

⁹ Financial Conduct Authority, *Feedback Statement FS16/11, Call for Input: Regulatory Barriers to Social Investments* (October 2016), paras 1.4 and 1.5. Available at <https://www.fca.org.uk/publication/feedback/fs16-11.pdf>.

¹⁰ Social Market Foundation and Big Society Capital, *Good Pensions: Introducing social pension funds to the UK* (2015), p 6. Available at <http://www.smf.co.uk/wp-content/uploads/2015/09/Social-Market-FoundationSMF-BSC-030915-Good-Pensions-Introducing-social-pension-funds-to-the-UK-FINAL.pdf>.

Figure 1: Spectrum of capital



Source: Social impact investment taskforce, *Allocating for Impact* (September 2014), p 7, adapting Bridges Ventures, *Spectrum of Capital*.

2.9 We find this spectrum to be a useful way of showing the variety of approaches. At one end, social investment includes an approach in which investors consider and take steps to mitigate poor environmental, social and governance practices inherent in an investment, but only to provide an improved risk-adjusted return.¹¹ Social investment at the other end of the spectrum might include a semi-charitable approach, in which financial return is sacrificed for other objectives.

Measurable social impact

2.10 Other commentators have looked for more objective indicators of social impact to define social investment. There have therefore been various initiatives to develop ways to measure the positive impact of an investment on society and the environment.¹² Schroder Investment Management Ltd explained that:

The term “impact investing” was coined in 2007 and is defined by the Global Impact Investing Network (GIIN) as: “investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return”.

2.11 A form of social impact measuring has been used in Government-issued “social impact bonds” as a means of delivering returns to investors. For example, the social impact bond at Peterborough prison used investors’ money to run a service aimed at

¹¹ Risk-adjusted returns are returns adjusted to take account of risk exposure. A high risk-adjusted return is a high return with comparatively low levels of risk.

¹² See Social Impact Investment Taskforce, *Measuring Impact Working Group Paper* (September 2014). Available at <http://www.socialimpactinvestment.org/reports/Measuring%20Impact%20WG%20paper%20FINAL.pdf>; and GECES Sub-Group on Impact Measurement, *Proposed Approaches to Social Impact Measurement in European Commission legislation* (June 2014). Available at http://ec.europa.eu/internal_market/social_business/docs/expert-group/social_impact/140605-sub-group-report_en.pdf.

reducing reoffending. Returns to investors were based on whether or not the project lowered the rate at which prisoners reoffended, rather than the cost of the project or the number of people working on the project.¹³

- 2.12 Some consultees noted the United Nations (UN) Sustainable Development Goals, which seek to measure social impact.¹⁴ There are 17 goals ranging from eradicating poverty to building resilient infrastructure and ensuring access to affordable, reliable, sustainable and modern energy for all.¹⁵ These have been designed to apply to individuals, governments and the private sector.

A focus on the underlying investment

- 2.13 A third approach to defining social investment focuses on the nature of the underlying investment. Dan Gregory explains that, for some:

the focus is often on encouraging investment in under-invested communities, personal lending to people that traditional banks would not lend to, small loans for self-employed people and very small businesses, loans to help local businesses, and loans to charities, community organisations and social enterprises.¹⁶

- 2.14 In the UK, much of the interest in social investment has been on providing finance for charities, community interest companies or community benefit societies.¹⁷ In their response to our call for evidence, Bates Wells & Braithwaite urged us to take a wide view of the sorts of businesses which might be included. For example, social investment could include investment in for-profit organisations which also have an explicit mission to make a positive social or environmental impact. They noted that:

It is important that the range of opportunities in the social investment market is fully recognised. This could include investment in mission-led profit organisations, and other businesses which aim to make a positive impact on the community and environment. The B Corp movement is an example of mission-led business.¹⁸

¹³ Cabinet Office, *Guidance on social impact bonds* (November 2012). Available at <https://www.gov.uk/guidance/social-impact-bonds>.

¹⁴ *United Nations Sustainable Development Goals* (2015). Available at <http://www.un.org/sustainabledevelopment/sustainable-development-goals/>.

¹⁵ *United Nations Sustainable Development Goals* (2015), goals 1, 7 and 9.

¹⁶ Dan Gregory – Common Capital, *Angels in the Architecture: building the infrastructure of social investment* (September 2013), p 12. Available at https://www.bigsocietycapital.com/sites/default/files/pdf/Angels%20in%20the%20Architecture%20%281%29_0.pdf.

¹⁷ For further information about these legal forms for social enterprise, see Chapter 7 and; Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

¹⁸ Mission-led businesses are profit-driven businesses that make a commitment to social impact as part of their mission. B Corps are for-profit companies with social or environmental outcomes as part of their mission and which have been certified by B Lab, a non-profit organisation, on the basis of their social and environmental performance, accountability and transparency.

Socially responsible investment (SRI)

2.15 Several consultees argued that the definition of social investment should include all forms of “socially responsible investment”. SRI Services wrote to say that they interpreted social investment as “any investment that considers ethical, social or environmental issues to a significant extent”.

2.16 Similarly, Vigeo Eiris, in response to our call for evidence, wrote:

We are concerned that the narrower focus on ‘social investment’ does not take into account the potential breadth of strategies, issues and risks that pension funds can address through ‘responsible investment’.

2.17 They went on to explain:

At Vigeo Eiris we tend to use ‘responsible investment’ as an umbrella term that captures a broad range of investment strategies (positive screening, negative screening, integration, engagement, thematic etc) that consider environmental, social and governance factors in investment decision-making. To a large extent various terms can be used interchangeably and the term ‘responsible investment’ can encompass them all.

2.18 LGIM highlighted the need for an umbrella approach to considering “responsible investment” and the variety of investment strategies that this can encompass. These include stewardship and corporate governance, environmental, social and governance (ESG) integration, screening, and investments with a measurable social impact, as well as a combination of each. LGIM outlined the importance of differentiating between the motivations for, and potential outcomes of, the different approaches in terms of risk, return, social impact and ethical persuasion.

2.19 The Pensions and Lifetime Savings Association (PLSA) emphasised that ESG factors can play a role even where investment is driven by financial rather than ethical or social concerns.¹⁹

2.20 Several consultees used the term “ethical investment”, which we think falls within socially responsible investment and which we understand to mean strategies such as negative and positive screening. An example of negative screening is where a pension scheme avoids investing in companies whose operations are judged as “unacceptable” by certain standards; for instance, a company which manufactures tobacco products, causes damage to the environment, or is involved in the manufacture of weapons and arms. An example of positive screening is where an active choice is made to invest in companies which are considered to be “socially responsible” because, for instance, they have a positive approach to workers’ rights and the environment.²⁰

¹⁹ Pensions and Lifetime Savings Association (PLSA), *Environmental, social and corporate governance (ESG): Made simple guide* (May 2016), p 3.

²⁰ An example of such a socially responsible company might be a supermarket chain which operates in a socially responsible way, for instance by being carbon neutral or promoting fair policies around employee pay. This is usually distinct from a “social enterprise” which often incorporates these values as part of its core business model.

Investment in efficient financial systems

2.21 A final school of thought on the matter of defining social investment argues that if investment markets worked as they should work, they would create wealth for future generations, and thus deliver a social good. Social good should flow naturally from any given investment and should be seen as part of the purpose of investment generally. Professor Kay describes this function of investment in the following terms:

A central function of financial markets is to direct money from savers to businesses, home owners and governments. They in turn use those savings to build, own and operate houses, shops, offices, warehouses and factories, to buy plant and machinery, and to develop the nation's infrastructure and civil works, its roads, bridges, electricity and telephone cables, pipelines and sewers. Or so it should be.

Each generation inherits a stock of assets from the one that preceded it. Each generation makes use of that stock and sees it depreciate. Each generation adds to it, and passes an augmented capital stock onto the generations that follow. An effective financial system aids businesses, households and governments to achieve these objectives – and enables them to leave behind a better country than the one they found. Or so it should be.²¹

2.22 Professor Kay argues that the two key functions of the financial system are “search and stewardship”:

Search is the pursuit of new investment opportunities, stewardship is the management of long-term capital assets that have already been created.²²

2.23 Three problems can prevent financial markets from using members' savings to create wealth in this way. First, an undue emphasis on short-term “casino” trading may mean that one person's gains are at another's expense. Secondly, if too much investment is poured into too few assets, it can create asset bubbles, followed by crashes. Thirdly, a failure of stewardship could leave senior managers pursuing their own short-term interests rather than the long-term interest of the company.

The importance of stewardship in investment

2.24 Stewardship is the activity of investors engaging with the underlying investment in order to promote its long term success. Pension savers invest via their pension scheme therefore it is up to the people managing the scheme to exercise stewardship.

2.25 Stewardship was identified by consultees as a key way in which investors (in this context, pension schemes and their members) can promote the long term success of companies. Consultees also noted a key link between investing in a socially responsible way and promoting stewardship. As highlighted above, consultees suggested that stewardship could be integrated as part of an umbrella approach to sustainable and responsible investment. Stewardship is relevant to social investment because it is a means by which pension schemes can have a social impact through their investments. For example, a scheme can use its stewardship powers to influence

²¹ John Kay, *Other People's Money: masters of the universe or servants of the people* (2015), ch 5.

²² John Kay, *Other People's Money: masters of the universe or servants of the people* (2015), ch 5.

a company or project in which it has invested to implement more environmentally friendly policies.

2.26 Where pension schemes have invested in equities (shares), they can exercise stewardship using voting rights linked to those equities to vote at shareholder meetings where key decisions about the company are made, for example, pay awards to directors and senior managers. Voting rights are the most well-known stewardship power. However, the UK Stewardship Code, published by the Financial Reporting Council (FRC), explains that “stewardship is more than just voting”:

Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration.²³

2.27 ShareAction agreed that stewardship is more than just voting rights. They suggested that less formal methods of stewardship should also be used to address ethical and/or social concerns of pension savers, such as engagement in purposeful dialogue with companies on the matters identified above, as well as on issues that are the immediate subject of votes at general meetings. This could include objecting to certain environmental practices of an infrastructure project, or even threatening to withdraw investment because of it.

2.28 Such informal methods of engagement with the underlying investee can have a positive impact. ShareAction said that this approach, based on “voice” rather than “exit” could be used to address ethical concerns of investors. Exit in this context means disinvesting from the particular investment because of social or ethical concerns, or concerns about the long-term sustainability of the investment. By using their voice, the investor has the opportunity to exercise stewardship and open a dialogue with the investee in order to address those concerns directly and encourage them to take mitigating steps which could have a positive social impact and prevent disinvestment.

2.29 The UK Stewardship Code encourages all institutional investors (including pension schemes) to disclose publicly how they will discharge their “stewardship responsibilities”.²⁴ In addition, the FCA requires investment managers to disclose clearly the nature of their commitment to the Code. Where there is no commitment to the Code, the firm must explain its alternative investment strategy.²⁵ However, there is no duty on pension trustees and managers to undertake stewardship activities, or even to consider whether they should undertake these activities.

2.30 In our 2014 report we concluded that it is clearly in the interests of pension funds as a whole to do all they can to promote the long-term success of the companies in which they invest. We thought that pension trustees should be encouraged to consider whether and how to engage with companies to promote their long-term success,

²³ The Financial Reporting Council, *The UK Stewardship Code* (September 2012), p 1. Available at <https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>.

²⁴ The Financial Reporting Council, *The UK Stewardship Code* (September 2012), p 4.

²⁵ FCA Conduct of Business Sourcebook (COBS) 2.2.3 R.

either directly or through their investment managers. We make a recommendation relating to stewardship in Chapter 6.²⁶

SOCIAL INVESTMENT FOR THE PURPOSES OF THIS REPORT

- 2.31 Our terms of reference ask us to consider how far pension fund investment policy may or should consider issues of social impact. We think social impact or social investment goes beyond simply protecting risk-adjusted returns by guarding against the financial risks created by poor ESG factors of an investment. For example, socially responsible investment takes into account ESG factors and although it can sometimes have a social impact, it does not always. Consultees drew our attention to several “SRI funds” that currently exist in the market for DC schemes and which can provide market returns.²⁷ We do not consider that there are currently any legal or regulatory barriers to pension schemes choosing to invest in such funds. For these reasons, socially responsible investment as such is not a focus of this report.
- 2.32 We think that the reference to “social impact” in our terms of reference involves investment which incorporates some non-financial element into the decision making, alongside a desire for good risk-adjusted returns.
- 2.33 In some contexts, social investment could involve sacrificing returns for social good. We think that, generally speaking, the central purpose of a pension has to be to make money for retirement. Investment made by pension schemes should therefore be chosen to generate competitive financial returns. We do not think that it would be right for pension schemes to make a clear and significant sacrifice in returns unless expressly authorised by a pension saver. In this report social investment does not include investments which involve a significant element of charitable giving or which involve a significant sacrifice of competitive market returns.

TWO BROAD EXAMPLES OF SOCIAL INVESTMENTS

- 2.34 In response to our call to evidence, consultees provided a range of definitions and suggested a variety of approaches to social investment (as set out above). However, when we asked for examples of potential social investments which pension funds could or should be making, there was greater consensus. Consultees identified two broad examples of social investment: investment in infrastructure and property; and investment in charities and social enterprises.

Investment in infrastructure and property

- 2.35 Overwhelmingly, consultees mentioned potential investment in infrastructure and property, particularly social housing. For example, Big Society Capital drew attention to £67 billion of investment opportunities, of which £59 billion (88%) involved social housing. This included “supported housing for people with disabilities, affordable housing for those on low incomes, elderly care and specialised housing for people experiencing homelessness”. Other infrastructure projects included green energy

²⁶ See paras 6.25 to 6.49.

²⁷ For example, SRI Services provided a long list of SRI funds, including the Aviva Alliance Trust Sustainable Futures Managed Pension Fund, the BMO (F&C) Responsible Global Equity fund, and the Kames Ethical Equity Pension Fund.

(including solar and wind energy); sewers (such the Thames Tideway Tunnel); and sustainable transport initiatives. It was also suggested that as well as preventing climate change, the UK should be mitigating its effects, for example through better flood defences. While not all property or infrastructure projects will constitute social investment, there are clear examples such as social housing and green energy projects which would fit this description. Other projects may be more controversial – for example, a new runway at Heathrow would generate employment, but has an environmental impact which for some people would certainly rule it out of the “social investment” category.

- 2.36 In Chapter 8 we look at investments in property and infrastructure in more detail and consider how such investments have the ability to provide financial returns as well as social impact. We also explore whether there are any barriers to pension schemes investing in property and infrastructure.

Investment in charities and social enterprises

- 2.37 The other main example of social investment mentioned was investment in charities and other social enterprises. We discuss the legal regulation of these various forms of social enterprise in a background paper, published alongside this report.²⁸
- 2.38 Some potential infrastructure investments are conducted through social enterprises. Examples include investments into social housing providers and loans to universities to build new facilities. These may well offer opportunities for pension investment.
- 2.39 However, most social enterprises are small and do not provide the scale necessary for pension investment. Many social enterprises seek small loans from charitable trusts or from altruistic individuals, but often will not provide the scale necessary for pension investment.
- 2.40 Some social enterprises are able to provide market returns for low-risk investments. However, they may be subject to full or partial “asset locks”. As we discuss in Chapter 7, asset locks require some or all of the profits of the organisation to be used for charitable purposes or for the benefit of the community. This curbs the ability of social enterprises to provide returns which mirror those for venture capital. The normal model for venture capital is to invest in a large portfolio of relatively risky ventures. The investor knows that many will fail, but hopes that the few ventures which succeed will compensate for the failures by providing high levels of equity returns. Not all social enterprises can pay profits to equity investors in this way.
- 2.41 This means that social enterprises may offer some suitable low-risk investments to pension funds – particularly in physical assets. However, they may be less likely to be able to offer the high-risk, high-return investments of venture capital.
- 2.42 In Chapter 7, we explore whether the law puts any unnecessary barriers in the way of social enterprises borrowing money and receiving investment.

²⁸ Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

CONCLUSION

- 2.43 Social investment generally refers to investment made with mixed motives – that is, a desire for financial returns and social benefit at the same time. It covers a broad spectrum. At one end, any consideration of environmental, social or governance factors may be primarily financial. The aim is to control long-term risks, so as to provide better risk-adjusted returns. At the other end of the spectrum, the desire to “do good” may be more important than the desire to “do well”.
- 2.44 In this report, we focus on the mid-range of the spectrum where financial and non-financial factors combine. Social investment for the purposes of this report is investment which addresses societal challenges while continuing to generate competitive market returns.

Chapter 3: The current pensions landscape

- 3.1 In this chapter we introduce the concept of the “workplace” pension and the two main types of workplace pensions from a saver’s perspective: defined benefit (DB) schemes and defined contribution (DC) schemes. We then describe the surge in workplace pensions seen since the introduction of auto-enrolment in 2013, and the significant shift from DB to DC schemes. We also note that the majority of DC scheme members are invested in their scheme’s default arrangements rather than a fund they have actively chosen to invest in.
- 3.2 We consider the way that DC schemes are currently invested and note that there is considerable homogeneity between schemes. The great majority of funds are in listed equities (that is, shares on traded markets). We end with a brief account of the new pension freedoms.

AUTO-ENROLMENT AND WORKPLACE PENSION SCHEMES

- 3.3 In this report we are concerned with workplace pensions which employers use for the purposes of automatic enrolment (also known as “auto-enrolment”).

Auto-enrolment

- 3.4 In 2005, the Pensions Commission made a ground-breaking recommendation, based on the insights of behavioural economics.²⁹ This was to “harness the power of inertia” to increase pensions savings. Employers should be required to enrol employees into a low cost pension savings scheme: contributions would be automatically deducted from wages unless the employee made a positive decision to opt out.
- 3.5 This led to auto-enrolment, which is a new legislative requirement introduced by the Pensions Act 2008 which requires all employers to automatically enrol their qualifying employees into a qualifying pension scheme.
- 3.6 Auto-enrolment is being phased in from October 2012 to October 2018. Auto-enrolment started with large and medium employers, and is now being extended to small employers. Employers are required to enrol all employees between the ages of 22 and state pension age into a pension scheme if they earn over the threshold (currently £10,000 a year).³⁰ Employees have the right to opt out, but they must make a positive decision to do so.
- 3.7 At present, the minimum contribution is 2% of band earnings (that is, earnings of over £5,876 up to a maximum limit of £45,000 in 2017/2018).³¹ Of this, 1% must come from

²⁹ Pensions Commission, *A New Pensions Settlement for the 21st Century* (2005).

³⁰ Pensions Act 2008, s 3(1).

³¹ Pensions Act 2008, s 13(1). For details of previous thresholds, see The Pensions Regulator, *Automatic enrolment earnings thresholds*. Available at <http://www.thepensionsregulator.gov.uk/automatic-enrolment-earnings-threshold.aspx>. For an analysis of the current threshold see Department for Work and Pensions, *Automatic Enrolment: Review of the earnings trigger and qualifying earnings band for 2017/18*. Available at

the employer. From 6 April 2019 onwards, when auto-enrolment phasing is complete, the total minimum contribution will increase to 8% of employee band earnings, of which at least 3% must come from the employer.³²

Workplace pension schemes

- 3.8 A workplace pension is a pension arranged through an employer. There are two types of workplace pension scheme: defined benefit (DB) schemes and defined contribution (DC) schemes. DB schemes provide their members with a fixed level of income, often expressed as a percentage of their final or average salary. By contrast, in a DC scheme, each member's income in retirement depends on the performance of the investments bought with the contributions they and their employer have made. The member, not the employer, bears the risk that investments will not perform well.
- 3.9 This report is concerned with workplace pensions which employers use for the purposes of auto-enrolment. It does not relate to any state pension paid for by national insurance contributions, local authority or civil service pensions or private pensions which employees and the self-employed have arranged independently.

THE PENSIONS LANDSCAPE PRIOR TO 2013

- 3.10 The last few years have seen a revolution in UK workplace pensions. It may be helpful to start with the position in 2012, when pension membership was lower than at any point since the 1950s. Fewer than half of all employees (47%) were members of a workplace pension.³³ Figure 2 below contrasts membership in the public and private sector. It shows that the decline was particularly marked in the private sector. In 1967, 8.1 million private sector employees were members of a pension scheme. By 2012, this had reduced to 2.7 million.³⁴

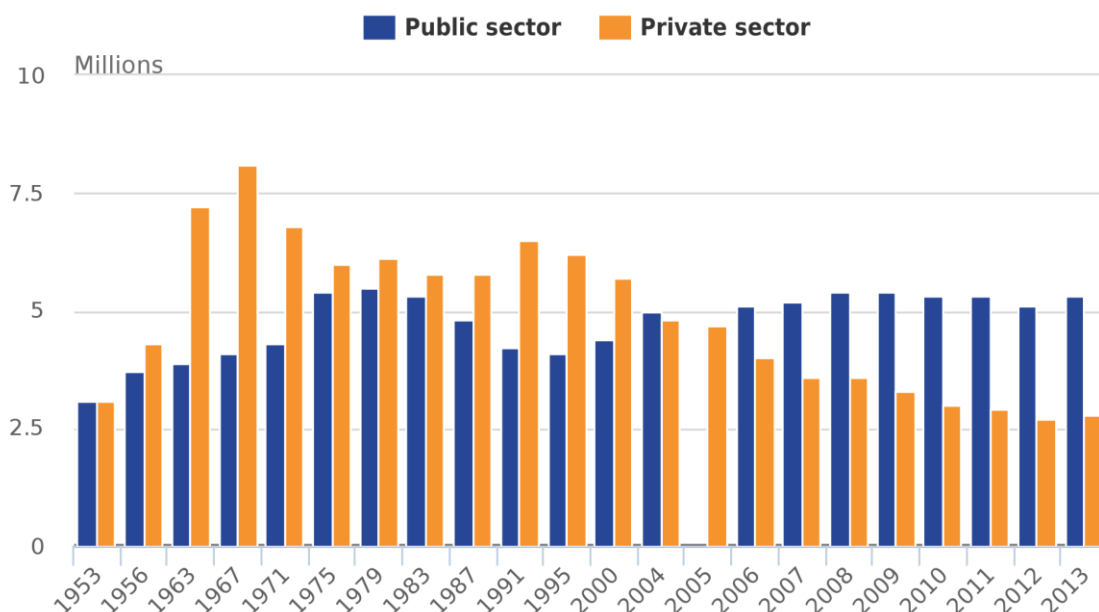
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/576423/review-of-ae-earnings-trigger-2017-2018.pdf.

³² Pensions Act 2008, s 20(1). See <http://www.thepensionsregulator.gov.uk/doc-library/increases-in-minimum-contributions-automatic-enrolment.aspx>; Department for Work and Pensions, Automatic Enrolment Evaluation Report (2016), p 19. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/576227/automatic-enrolment-evaluation-report-2016.pdf.

³³ Office for National Statistics, Pension Trends (2014), ch 7. Available at <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/compendium/pensiontrends/2014-11-28/chapter7pensionschememembership2014edition>.

³⁴ Office for National Statistics, *Pension Trends* (2014), ch 7. Available at <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/compendium/pensiontrends/2014-11-28/chapter7pensionschememembership2014edition>.

Figure 2: Active members of trust-based workplace pension schemes:³⁵ by type of scheme, 1953 to 2013



Source: Office for National Statistics, *Pension Trends* (2014).

3.11 This reduction of pension provision reflected the steady decline of private sector DB schemes. Rising life expectancy and low investment returns significantly increased the cost to employers of offering these schemes.³⁶ Faced with rising deficits, most employers closed their DB schemes to new members.³⁷ By 2016, many schemes no longer allowed further contributions from existing members.

THE PENSIONS LANDSCAPE SINCE THE INTRODUCTION OF AUTO-ENROLMENT

The effect on scheme membership

3.12 Auto-enrolment has led to a dramatic increase in pension scheme membership. By February 2017, 7.5 million new people had been brought into a pension scheme via auto-enrolment.³⁸ According to the 2015 survey of employers' pension provision, before implementing auto-enrolment only two thirds of employers offered pensions and only one third of their workforce participated. After auto-enrolment, 93% of these employers offered provision, and 66% of the workforce participated.³⁹

³⁵ Trust-based schemes are discussed below in chapter 4.

³⁶ It is estimated that every one-year increase in life expectancy adds about £12 billion to the aggregate pension liabilities of FTSE 100 companies. See *The Economist*, "Running to stand still" (5 August 2006).

³⁷ In 2012, only 13% of private sector DB schemes remained open to new entrants; The National Association of Pension Funds (NAPF), *Annual Survey 2013* (December 2013), p 6.

³⁸ The Pensions Regulator, *Declaration of compliance report* (February 2017), p 2.

³⁹ Department for Work and Pensions, *Employers' Pension Provision Survey* (2015), p 19.

- 3.13 The Department for Work and Pensions (DWP) estimates that, when fully implemented, auto-enrolment will affect 9 million employees: either bringing them into a pension scheme for the first time, or increasing the level of contributions to their pension.⁴⁰ These new members are largely in the private sector – which is the focus of this report.
- 3.14 Inertia works: fewer than one in ten (9%) of employees had opted out of a pension scheme within the first month.⁴¹ A further 4% had contributed originally, but then ceased active membership.⁴² An active member is a member of a pension scheme who is currently contributing to and accruing benefits under that scheme. The remaining unenrolled employees are mainly part-time workers earning less than £10,000 a year. Although these part-time workers may opt in if they wish, only 5% had done so.⁴³
- 3.15 The greatest increases were for younger workers (particularly for those aged between 22 and 29) and for lower paid workers (particularly those earning between £10,000 and £20,000).⁴⁴

The rise of DC schemes

- 3.16 DC schemes have now overtaken DB schemes as the primary form of workplace pension in the UK. Membership of DC schemes has increased rapidly. Meanwhile, active membership of private sector DB pension schemes has continued to decline, but more slowly.⁴⁵
- 3.17 Auto-enrolment “qualifying schemes” can be set up as DB or DC schemes. Our focus in this report is primarily on DC schemes due to their growing membership. As Figure 3 shows, there has been a fall in active membership of DB schemes, which has been linked to the rising costs of providing these pensions. In contrast, there has been a rise in DC scheme membership, which is likely to be as a result of auto-enrolment. Active membership of private sector DC schemes had remained around 1.0 million between 2008 and 2012 but rose to 3.2 million in 2014 and 3.9 million in 2015, following the roll-out of auto-enrolment. Active membership of private sector DB schemes was 3.7 million in 2005 and declined steadily to 1.6 million in 2013. It remained constant at around this level between 2013 and 2015.⁴⁶

⁴⁰ Department for Work and Pensions, *Automatic Enrolment Evaluation Report* (November 2015), p 3.

⁴¹ Department for Work and Pensions, *Automatic Enrolment Evaluation Report* (November 2015), p 52.

⁴² Department for Work and Pensions, *Automatic Enrolment Evaluation Report* (November 2015), p 53.

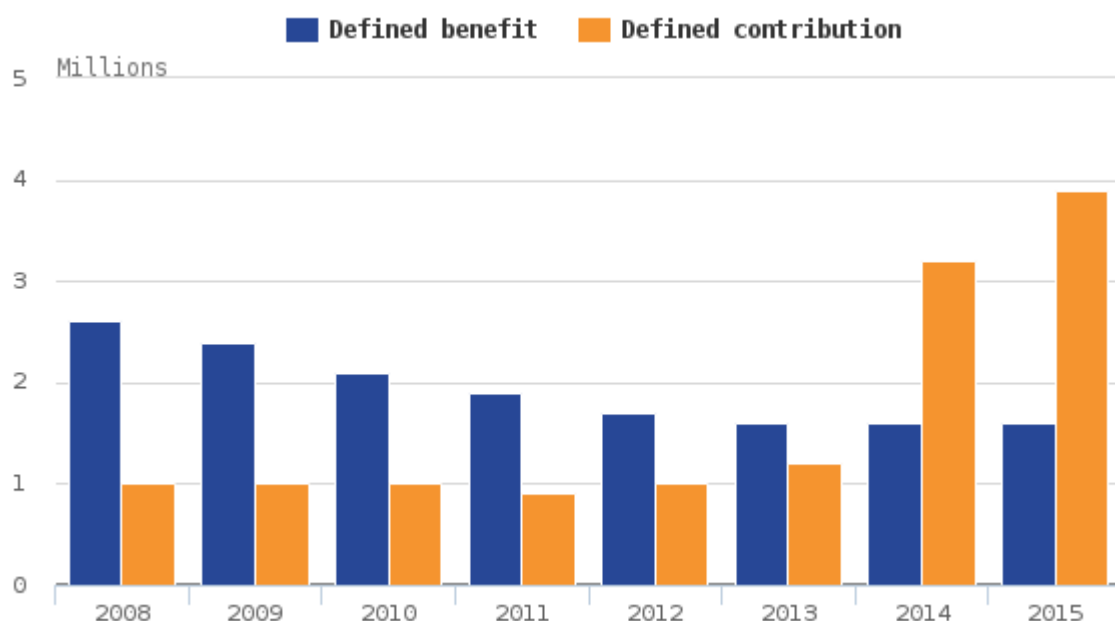
⁴³ Department for Work and Pensions, *Automatic Enrolment Evaluation Report* (November 2015), p 54.

⁴⁴ Department for Work and Pensions, *Automatic Enrolment Evaluation Report* (November 2015), pp 51 and 53.

⁴⁵ Pensions Policy Institute, *The Future Book: unravelling workplace pensions* (2016) p 8; Pensions Policy Institute, *The changing landscape of pension schemes in the private section in the UK* (2012), p 1.

⁴⁶ Office for National Statistics, *Occupational Pension Schemes Survey UK: 2015 (September 2016)*, ch 7.

Figure 3: Active membership of occupational pension schemes by sector, 2008 to 2015



Source: Office for National Statistics, *Occupational Pension Schemes Survey, UK: 2015* (September 2016), figure 2.

3.18 Traditionally, the volume of assets held in DC schemes has been low, when compared to DB schemes. In 2012, only £279 billion was held in DC schemes, compared to £1,063 billion in DB schemes. This is set to change. The Pensions Institute estimates that assets in DC schemes will increase sixfold by 2030, to £1,680 billion, and overtake the assets of DB schemes.⁴⁷

3.19 This is a substantial sum, equivalent to 15% of the current net wealth of the UK.⁴⁸ The way that this money is invested will have a major impact, both on the old age of the current generation of workers, and on the wealth created for future generations.

THE PENSIONS LANDSCAPE SINCE OUR 2014 REPORT

3.20 The trends described above were identified in our 2014 report. In the years since that report these have continued to apply. In particular, active DB scheme membership has fallen while active DC scheme membership has increased.

⁴⁷ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in Defined Contribution Pension Schemes* (October 2013), p 12. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

⁴⁸ Office for National Statistics, *UK National Balance Sheet 2016 estimates* (August 2016). Available at <https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/bulletins/nationalbalancesheet/2016estimates>.

DEFAULT ARRANGEMENTS AND CHOSEN FUNDS

- 3.21 Under section 17(2)(b) of the Pensions Act 2008, schemes used by employers for the purposes of auto-enrolment must not require employees who are enrolled to express a choice, or provide information, in order to remain active members of the scheme. In DB schemes, pension savers are not given a choice of investment funds and strategies. However, this is not the case for DC scheme members. The effect of the new legislation is that employees are not required to make a choice about the fund into which their contributions may be invested. All auto-enrolment schemes must therefore have a default fund which employees' contributions are paid into if they fail to make an active choice of fund.
- 3.22 The Pensions Institute commented that in 2012, around 80% of members were in the default fund.⁴⁹ Since auto-enrolment, the proportion of members in default funds is now much higher: over 90%. Half of master trusts report that 99% of members are invested in the default fund.⁵⁰
- 3.23 As well as a default fund, schemes can offer pension savers a selection of funds which they can choose to invest in. These are known as "chosen funds" in this report. Chosen funds may focus on investment in certain assets or markets, for example, property or equities listed on recognised stock exchanges in certain jurisdictions. Alternatively, chosen funds may focus on a particular investment strategy or approach. Schemes typically offer up to five choices, often including an ethical fund,⁵¹ a sharia fund,⁵² a high-risk fund and a low-risk fund.⁵³

WHAT ASSET CLASSES DO DC SCHEMES INVEST IN?

- 3.24 The majority of all DC pension investment is in listed equities. As members near retirement, schemes apply "de-risking" or "lifestyle" strategies. In other words, funds are moved from equities to less volatile corporate bonds and gilts.
- 3.25 We are grateful to Spence Johnson for the data shown below, on the breakdown of assets in DC pension investment for 2015.⁵⁴

⁴⁹ See Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 19. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

⁵⁰ Pensions Policy Institute, *The Future Book: unravelling workplace pensions* (2016), p 22.

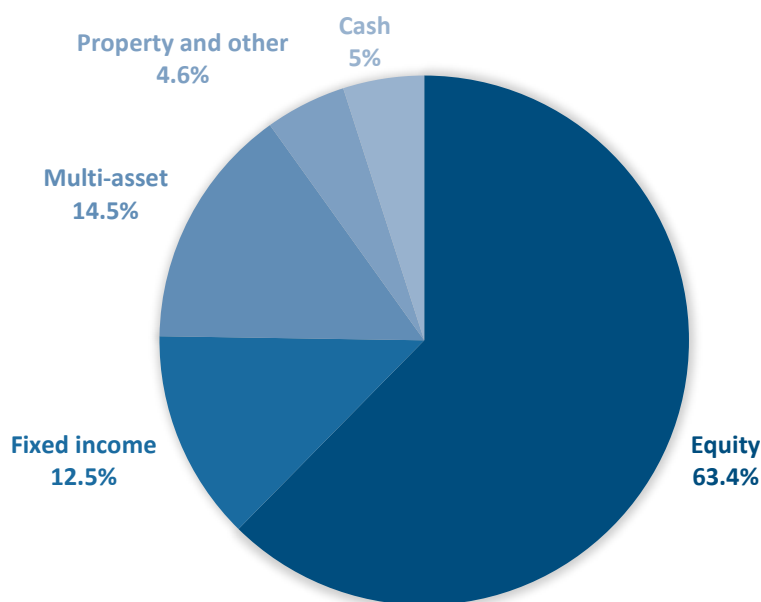
⁵¹ An ethical fund is a chosen fund which uses strategies such as positive and negative screening to create an ethical investment policy. For example an ethical fund might avoid investing in companies which manufacture tobacco products, cause damage to the environment, or are involved in the manufacture of weapons and arms (negative screening). They may instead choose to invest in companies which have a positive approach to human rights, workers' rights and the environment in order to guard against financial risks created by poor ESG factors (positive screening). However, there is no one approach in the industry as to what constitutes an ethical fund.

⁵² A sharia fund is a chosen fund which invests in accordance with Islamic law and excludes investments that conflict with Muslim values for example investments in companies involved in producing alcohol or pork related products; or financial services that operate on interest payments.

⁵³ The Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 22. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

⁵⁴ Spence Johnson – Market Intelligence 2016: *UK Defined Contribution, Looking beyond the passive approach* (2016), p 90.

Figure 4: DC scheme investment by asset class



Source: Spence Johnson, *Market Intelligence 2016: UK Defined Contribution, Looking beyond the passive approach* (2016), p 90.

3.26 “Fixed income”, in figure 4 above, means income generated from debt instruments, such as bonds. The “multi-asset” funds shown in figure 4 above are typically funds which combine equities and fixed income. Many are “target date” funds, designed to provide a suitable blend of shares and bonds for those who intend to retire at a particular time.

3.27 Most equity investment is now in passive funds, tracking an index, or some variation of an index.⁵⁵ Spence Johnson data shows that out of £193 billion in equity funds, only 30% is actively managed. The strong trend towards passive funds reflects the need to keep charges low, in the light of the charge cap and other market pressures. It is also informed by increasing evidence that active management⁵⁶ not only costs more but does not reliably outperform the market. As the FCA put it in their 2016 market report:

Overall, our evidence suggests that actively managed investments do not outperform their benchmark after costs. Funds which are available to retail investors underperform their benchmarks after costs – while products available to pension schemes and other institutional investors achieve returns that are not significantly above the benchmark.⁵⁷

⁵⁵ These variations are often referred to as “smart beta”. Typically, the strategy is to adjust the index towards undervalued stocks, by taking some account of the fundamentals of a company.

⁵⁶ The management of assets (eg equities, gilts) in which the skill of the fund manager is used to select particular stocks at particular times, with the aim of achieving higher than average growth for the assets in question.

⁵⁷ Financial Conduct Authority, *Asset Management Market Study Interim Report* (November 2016), para 1.25.

3.28 One feature of the data in figure 4 is how little DC scheme money is invested in property, or in asset classes other than equity, bonds and cash, such as private equity or commodities (4.6%). This proportion is low compared with the traditional approach of DB schemes, and low compared with pension schemes in other countries, such as Australia.

THE PENSION FREEDOMS

3.29 A DC pension is said to “accumulate” during the member’s working life, as contributions are made and invested, and to “decumulate” as the member draws on their savings to provide an income in retirement.

3.30 Until recently, individuals were required to use the “pension pot” that they had built up during the accumulation phase to purchase an annuity by the time they turned 75.⁵⁸ By taking the pension pot and reinvesting it in corporate bonds and gilts, annuity providers promise to pay an individual a guaranteed income for life. The view of the government of the day was that annuities were the most efficient way of guaranteeing individuals a constant income regardless of how long they lived, reducing their possible future need for income-related support.⁵⁹

3.31 In 2011, the government removed the requirement to annuitise at 75.⁶⁰ However, alternative options were limited. Whilst everyone was able to take 25% of their pension pot as a tax-free lump sum, only individuals with pension savings under £18,000 a year, or a guaranteed income in retirement of over £20,000 a year, had full flexibility over the rest of their pension pot. Otherwise, individuals were limited to “capped drawdown”, where they could either withdraw a pension of up to 150% of the value of an equivalent annuity per year, or withdraw the full pension pot subject to a 55% tax charge.

3.32 Since April 2015, individuals have had more choice about how they access their pensions. Under the new system, those over 55 are allowed to withdraw any amount of their pension at the marginal tax rate.⁶¹ Effectively, older people have six options: leaving the pension pot untouched; purchasing an annuity; drawing down their pension pot to provide an income; taking cash in chunks; cashing in the whole pot in one go; or mixing any of these options. The government has set up a free advice service, Pension Wise, to help them make choices that reflect their needs.⁶²

3.33 It is too early to evaluate the effect of these changes, though it is clear that annuity sales have decreased. Research into how savers had exercised their choices over the first six months found that people had been slow to act on these freedoms. Among those who had acted, drawdown was the most popular option.⁶³ The DC Investment

⁵⁸ The principle of mandatory annuitisation was first introduced by the Finance Act 1921, s 32. The requirement to annuitise by 75 was introduced by the Finance Act 1976, s 30.

⁵⁹ Department for Work and Pensions, *Modernising Annuities: A Consultative Document* (February 2002), p 5.

⁶⁰ Finance Act 2011, s 65; sch 16.

⁶¹ This will rise to 57 in 2028.

⁶² *Pension Wise* <https://www.pensionwise.gov.uk/>.

⁶³ Pensions and Lifetime Savings Association, *Pension Freedoms: no more normal* (January 2016).

Forum, evaluating experience from overseas, highlighted a global move away from annuities and towards drawdown products. However, retirees had a tendency to underestimate their longevity and overestimate investment growth. They may therefore drawdown their pension too quickly.⁶⁴

- 3.34 Some consultees pointed out that investment horizons have become longer. It is now possible that a 25 year old currently investing in a DC fund will still have the money invested in the fund in 60 years' time, when they are 85. Without the need to annuitise on a set date, funds may also be able to cope with more volatility.
- 3.35 However, as the DC Investment Forum put it, "successful drawdown will require retirees to manage a dwindling resource in a complex and volatile environment".⁶⁵

CONCLUSION

- 3.36 In this report we are concerned with workplace pensions which employers use for the purposes of automatic enrolment. Auto-enrolment has led to rapid increases in DC pension membership. DWP estimates that auto-enrolment will affect 9 million employees: either bringing them into a pension scheme for the first time, or increasing the level of contributions to their pension.⁶⁶ Contributions are projected to increase substantially so that by 2030 DC pension schemes will account for £1.68 trillion of assets. Our focus in this report is primarily on DC schemes due to their growing membership.
- 3.37 The system works through inertia. Most people do not make an active choice to be in a scheme. They do not decide how much to save, and they do not choose how their savings should be invested. The great majority of savers, over 90%, are in the default fund.
- 3.38 So far, the emphasis has been to funnel money into investments quickly and cheaply. Most money is invested in listed equities, generally using passive funds. For older workers, money is then transferred to lower risk bonds. As we discuss in Chapter 8, very little money is invested in "alternative asset classes" such as property and infrastructure.

⁶⁴ DC Investment Forum, *Global Comparison of DC Plan Investment Design* (2015), p 22.

⁶⁵ DC Investment Forum, *Global Comparison of DC Plan Investment Design* (2015), p 4.

⁶⁶ Department for Work and Pensions, *Automatic Enrolment Evaluation Report* (November 2015), p 3.

Chapter 4: Law and regulation of pensions

- 4.1 In Chapter 3 we explained that workplace pensions may either be defined benefit (DB) schemes, where the employer guarantees a particular level of income on retirement, or defined contribution (DC) schemes, where the employee takes the risk of the pension fund investments not performing well. Whether a pension scheme is DB or DC may have an impact on the saver's income on retirement.
- 4.2 In this chapter, we look at a further distinction which applies to DC schemes. This does not make a difference to the financial worth of a saver's pension, but it does affect the law and regulatory regime which applies to it. This is the legal structure by which a DC scheme is set up: either through a trust, or under contract. Although different rules apply, the Department for Work and Pensions (DWP), which sets the rules for trust-based schemes, and the Financial Conduct Authority (FCA), which regulates contract-based schemes, have emphasised that the outcome for pension savers is intended to be the same whether a DC scheme is "trust-based" or "contract-based". DB schemes are set up as trust-based schemes. DC schemes may be set up as trust-based or contract-based schemes. It is important to understand how the two regimes work for DC schemes in order to understand the recommendations and some of the options for reform in this report.
- 4.3 We then provide a brief outline of the law and regulation applying to investment decisions made by pension schemes, considering the different regimes for trust-based and contract-based schemes.

TRUST-BASED SCHEMES

- 4.4 DB and DC schemes can be set up as trust-based schemes. In trust-based schemes, a trust is set up and all the members of the pension fund are its beneficiaries. Trustees are appointed and are responsible for managing the scheme and for reviewing and monitoring investments. In practice, trustees appoint an investment manager who is responsible for day-to-day investment decisions. Trust-based schemes are sometimes referred to as occupational pension schemes.
- 4.5 An employer providing a workplace trust-based scheme can set up its own trust or use a "master trust". Master trusts are multi-employer trust-based pension schemes, which a pension provider manages under a single account. There is one legal trust and, therefore, one trustee board.⁶⁷
- 4.6 Much of the recent growth has been in master trusts. An important development was the creation of the National Employment Savings Trust (NEST), set up by the Government in 2008 to ensure that all employers have access to a low-cost scheme.⁶⁸ Other new providers have also been set up as master trusts. Some have roots in the

⁶⁷ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014), p 10.

⁶⁸ The legislation establishing NEST is contained in the Pensions Act 2008, Pt 1 ch 5 and orders and regulations issued under this Act.

trust-based pension market. For example, The People's Pension is run by a not-for-profit organisation with a background in supplying employee benefits to the construction industry. Others have been established by insurance companies.⁶⁹ It is rare for employers to set up new single employer trust-based schemes. The Pensions Policy Institute reports that out of 6.1 million workers automatically enrolled by 31 March 2016, almost half (49%) were enrolled into master trust schemes.⁷⁰ NEST was particularly popular among smaller employers.⁷¹

- 4.7 Trust-based schemes are subject to multiple sources of law. The starting point is the trust deed, to ascertain what powers it provides to the pension trustees. Generally, trust deeds will provide broad powers. The second source of law is pensions legislation, which imposes additional rules over and above those in the trust deed. Trustees are also subject to various “judge-made” duties; particularly the duties connected to the exercise of a power, duties of care and fiduciary duties. Trust-based schemes are regulated by The Pensions Regulator (TPR).
- 4.8 Any investment manager appointed by trustees must be authorised by the Financial Conduct Authority (FCA) and is subject to FCA rules. The trustees will only need to be authorised by the FCA if involved in the day-to-day management of the assets.

CONTRACT-BASED SCHEMES

- 4.9 Alternatively, DC schemes may be set up by means of a contract between an individual and a contract-based pension provider, typically an insurer. These are known as contract-based schemes.
- 4.10 There are two main types of contract-based schemes:
- (1) **Individual personal pensions:** here an individual enters into a pension directly with a pension provider, without any employer involvement. This is common, for example, amongst the self-employed. Individual personal pensions are not workplace pensions; and
 - (2) **Group personal pensions:** here employers make arrangements for a group of employees to take out pensions, but the employer has no ongoing responsibility for monitoring the performance of the scheme once it is in place. A group personal pension is characterised as a series of contracts between the individual members and the pension provider, who is typically a life insurance company. Group personal pensions are workplace pensions.
- 4.11 In a contract-based pension scheme, there are no trustees. Instead, where the pension is a workplace pension, the employer selects one or more insurance companies to offer pensions to its employees. It will use a financial adviser to help it select a provider based on a range of factors, including fund range, cost and service quality. Each employee will then enter into a contract with the insurance company. The insurance company in turn agrees a mandate with an investment manager who will select investments according to that mandate. Ongoing monitoring of investments

⁶⁹ Examples include Legal & General, Standard Life and Zurich.

⁷⁰ Pensions Policy Institute, *The Future Book: unravelling workplace pensions* (2016), p 17.

⁷¹ Department for Work and Pensions, *Employers' Pension Provision Survey 2015*, p 46.

is carried out by independent governance committees (IGCs) which assess the ongoing value for money of the scheme for pension policyholders. IGCs are discussed in more detail below.

- 4.12 Contract-based schemes are subject to a legal regime based on FCA rules and contract law, including the protections given to consumers under unfair contract terms legislation.⁷² Investment managers must be authorised by the FCA and are subject to FCA rules. Judge-made duties under trust law and certain pensions legislation do not apply to contract-based pensions.
- 4.13 Providers are subject to extensive regulation by the FCA. TPR has less regulatory oversight of contract-based schemes, though all workplace contract-based schemes must register with TPR, which oversees payments by employers into the scheme.

EFFECT OF TWO CO-EXISTING REGIMES

- 4.14 Trust-based and contract-based schemes are governed by different sources of law and there are differences in relation to how investment decisions are made and reviewed. However, the DWP and FCA have clearly stated that although the sources of law are different, they intend that the outcome for pension savers is and will continue to be the same.

INVESTMENT DECISIONS IN TRUST-BASED SCHEMES

- 4.15 The investment decisions of pension trustees are governed by the Pensions Act 1995, the Pensions Act 2004 and the various regulations made under these Acts. These are expanded by codes of practice issued by The Pensions Regulator (TPR).⁷³ TPR also issues guidance to explain the statutes, regulations and codes of practice in specific areas. Effectively, therefore, there are four levels to pension legislation: statutes, regulations, codes of practice and guidance.
- 4.16 We start with a brief introduction to trustees' investment powers, together with the duties to delegate, to obtain proper advice, and to prepare a statement of investment principles.
- 4.17 These rules apply to DB and DC schemes. We note where specific rules apply to default arrangements in DC schemes.

The investment power

- 4.18 Section 34 of the Pensions Act 1995 provides scheme trustees with a wide investment power. However, this power is in fact heavily constrained. It is subject to the provisions of the trust deed, as well as relevant case law. Importantly, this power is

⁷² For the current law, see Part 2 of the Consumer Rights Act 2015. Previously, the law was set out in the Unfair Terms in Consumer Contracts Regulations 1999.

⁷³ Under the Pensions Act 2004 s 90(5), a court must take a TPR code into account if it appears relevant to a question in the proceedings. For the purposes of this report, the most important is Code of Practice No 13, "Governance and administration of occupational trust-based schemes providing money purchase benefits" (July 2016). Available at <http://www.thepensionsregulator.gov.uk/docs/code-13.pdf>.

also constrained by the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations).⁷⁴ Regulation 4 requires that:

- (1) investment of the scheme assets is in the best interests of members and beneficiaries;⁷⁵
- (2) the power of investment is exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”;⁷⁶
- (3) assets held to cover the scheme’s technical provisions are invested in a manner “appropriate to the nature and duration of the expected future retirement benefits payable under the scheme”;⁷⁷
- (4) scheme assets consist predominantly of investments admitted to trading on regulated markets.⁷⁸ Other investments must be kept at a prudent level;⁷⁹
- (5) scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole”;⁸⁰ and
- (6) investment in derivative instruments may only be made in so far as they contribute to a reduction of risks or facilitate efficient portfolio management.⁸¹

4.19 Regulation 4 is in broad terms: trustees are required to balance the liquidity⁸² of the portfolio against its quality and profitability. Although most scheme assets must be traded on regulated markets, “a prudent level” of assets need not be. As we discuss in Chapter 8, this would potentially allow a small percentage of the fund to be invested in infrastructure.

4.20 Technically, regulation 4 does not apply to schemes with fewer than 100 members. Trustees of small schemes have a more limited duty to have regard to the diversification of investments insofar as appropriate to the circumstances of the scheme.⁸³ However, in our 2014 report we reached the conclusion that many

⁷⁴ SI 2005 No 3378.

⁷⁵ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(2).

⁷⁶ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(3).

⁷⁷ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(4). A scheme's “technical provisions” means the amount required, on an actuarial calculation, to make provision for the scheme's liabilities: Pensions Act 2004, s 222(2).

⁷⁸ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(5).

⁷⁹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(6).

⁸⁰ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(7).

⁸¹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(8). Derivative instruments are defined as including any of the instruments listed in paras (4) to (10), section C, Annex 1 to the Markets in Financial Instruments Directive 2004/39/EC, Official Journal L145 of 30 April 2004, p 1.

⁸² Liquidity is the ease at which assets or investments can be converted into cash in order to meet short-term obligations.

⁸³ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 7(2).

elements of regulation 4 effectively apply to all schemes, large and small, as a result of trust law.⁸⁴

Delegation

- 4.21 Section 34(2) of the Pensions Act 1995 provides that trustees may delegate decisions about investments to an investment manager. In practice, trustees must appoint a manager, either internal or external, to take “day-to-day” decisions relating to the management of investments.⁸⁵ Such a manager requires FCA authorisation.⁸⁶ While some trustees are authorised, the vast majority are not, and must use an external manager.
- 4.22 There is no definition in law of what constitutes a “day-to-day” decision. However, FCA guidance provides that such decisions will include:
- (1) decisions to buy, sell or hold particular securities or contractually based investments such as an investment manager would be expected to make in their everyday management of a client's portfolio; and
 - (2) recommendations made to investment managers, on a regular basis, with a force amounting to direction relating to individual securities or contractually based investments.⁸⁷
- 4.23 The effect of this guidance is that trustees will usually be restricted to making “strategic” decisions. These include decisions about the formulation of a general asset allocation policy and the appointment of investment managers.⁸⁸ In broad terms, the decision to allocate a specified proportion to infrastructure, for example, would be a strategic decision for trustees. Decisions about specific projects would be for the investment manager.
- 4.24 Although trustees may delegate certain tasks and decisions, they need to retain effective control, give direction and intervene when problems are identified. It is the trustees’ role to determine the overall investment objectives.⁸⁹ Trustees are also required to establish and operate adequate internal controls to ensure the scheme is administered according to the scheme rules and the law.⁹⁰

⁸⁴ For a discussion of this issue, and the reasons why the Government excluded small schemes from the Investment Regulations, see *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, paras 4.8 to 4.10.

⁸⁵ Pensions Act 1995, s 47(2).

⁸⁶ Managing investments belonging to another by way of business, in circumstances involving the exercise of discretion, is a regulated activity: see *Financial Services and Markets Act 2000*, s 22 and sch 2, para 6; *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001* SI 2001 No 544, art 37.

⁸⁷ *Financial Conduct Authority Handbook* PERG 10.3, Q9.

⁸⁸ *Financial Conduct Authority Handbook* PERG 10.3, Q8.

⁸⁹ The Pensions Regulator, *Guide to investment governance* (July 2016), pp 4 to 5.

⁹⁰ *Pensions Act 2004*, s 249A(1); The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 37.

Proper advice

- 4.25 Under section 36(3) of the Pensions Act 1995, trustees must obtain and consider “proper advice” as to whether an investment is satisfactory. For existing investments, trustees should obtain advice periodically, when it is “desirable”.⁹¹
- 4.26 Section 36(6) states that “proper advice” means advice from someone authorised under the Financial Services and Market Act 2000, or the advice:
- of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of trust schemes.
- 4.27 Under section 36(7), trustees will not be taken to have fulfilled their duty to obtain and consider “proper advice” unless the advice was given or confirmed in writing. Failure to comply with the advice requirements exposes trustees to civil penalties.⁹²

Statement of investment principles (SIP)

- 4.28 A statement of investment principles is a written statement of the principles governing decisions about investments for the purposes of the scheme”.⁹³ Under section 35(1) of the Pensions Act 1995, trustees “must secure” that a SIP is “prepared and maintained”, and that it is reviewed and if necessary, revised. This requirement does not apply for schemes with fewer than 100 members.⁹⁴
- 4.29 The Investment Regulations provide further detail about the content of a SIP. Under regulation 2(3), the SIP must include a statement of the trustees’ policy on a range of issues, including the balance between different kinds of investments, risk, and the realisation of investments.
- 4.30 Two issues are particularly relevant to this report. The SIP must include a statement of the trustees’ policy on:
- (1) the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;⁹⁵ and
 - (2) the exercise of the rights (including voting rights) attaching to investments.⁹⁶
- 4.31 As well as preparing a SIP for the whole scheme, under regulation 2A, trustees are required to prepare a SIP governing decisions about investments for the purposes of their scheme’s default arrangement.⁹⁷ This requirement applies to DC schemes and applies regardless of the size of the scheme. The SIP must describe the scheme’s

⁹¹ Pensions Act 1995, s 36(4).

⁹² Pensions Act 1995, s 36(8).

⁹³ Pensions Act 1995, s 35(2).

⁹⁴ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 6(1)(a).

⁹⁵ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(3)(b)(vi).

⁹⁶ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(3)(c).

⁹⁷ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2A.

“default strategy”.⁹⁸ This must include the trustees’ policy on social, environmental and ethical considerations, as outlined in paragraph 4.30(1), above.⁹⁹ However, it does not need to include their policy on voting rights, outlined in paragraph 4.30(2) above. We discuss these requirements in more detail in Chapter 6.

4.32 TPR suggests that trustees may include additional information in their SIP. For example:

details about the factors or assumptions relating to member characteristics that [trustees] have taken into account when setting investment objectives and strategy.¹⁰⁰

4.33 Trustees must review the SIP prepared under regulation 2(3) “at least every three years” and “without delay after any significant change in investment policy”. Failure to do so exposes the trustees to civil penalties.¹⁰¹ Similar review requirements apply to the SIP relating to the default strategy prepared under regulation 2A.¹⁰² Trustees must provide their members with a copy of the SIP on request.¹⁰³

INVESTMENT DECISIONS IN CONTRACT-BASED SCHEMES

4.34 The following only applies to DC schemes set up as contract-based schemes. DB schemes are not set up as contract-based schemes.

4.35 The investment decisions of contract-based pension scheme providers and investment managers engaged by them are governed by contract law and rules issued by the FCA which are found in COBS. The FCA has also issued policy statements when new rules have been introduced, in order to provide further context.¹⁰⁴ These policy statements are not updated and are not therefore intended to be used in the same way as TPR guidance, which is updated for trustees from time to time as new issues arise.

4.36 Under COBS, pension providers owe “fiduciary-like” duties to members, including to act honestly, fairly and professionally in accordance with the best interests of their clients.¹⁰⁵ They must also take reasonable care and skill in carrying out the services they have undertaken to provide under the terms of the contract. As set out above, the pension provider agrees a mandate with an investment manager. The investment manager’s powers of investment are set out in that mandate.

⁹⁸ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2A(1)(c); the “default strategy” are the aims and objectives of the trustees and their policies in a number of areas in respect of default arrangement investments.

⁹⁹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2A(1)(b).

¹⁰⁰ The Pensions Regulator, *Guide to communicating and reporting* (July 2016), p 18.

¹⁰¹ Pensions Act 1995, s 35(6).

¹⁰² Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2A(2).

¹⁰³ Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013, reg 13.

¹⁰⁴ For example, see Financial Conduct Authority, *Final rules for independent governance committees: policy statement PS15/3* (February 2015).

¹⁰⁵ FCA Conduct of Business Sourcebook (COBS) 2.1.1 R.

- 4.37 Unlike trust-based schemes, there is no requirement for contract-based schemes to produce a SIP. However, since April 2015, each provider of contract-based schemes must have an independent governance committee (IGC), which carries out an oversight role over the workplace pension schemes operated by that provider.¹⁰⁶
- 4.38 IGCs are responsible for assessing the ongoing value for money of the scheme for pension policyholders, including:
- (1) whether default investment strategies are designed in the interests of policyholders; and
 - (2) whether the firm regularly reviews the net performance of investment strategies to ensure alignment with the interests of policyholders.¹⁰⁷
- 4.39 The IGC must raise any concerns with the provider's governing body and escalate concerns further if the provider has not addressed these.¹⁰⁸ The Chair of the IGC must produce an annual report setting out, among other things, the IGC's opinion on the scheme's value for money and how the IGC has considered relevant policyholders' interests.¹⁰⁹ We discuss these requirements in more detail in Chapter 6.

CHOSEN FUNDS

- 4.40 The rules above apply equally to default funds and chosen funds. As discussed in Chapter 3, pension savers may choose to invest their money in a chosen fund with a specific investment strategy. Pension scheme decision makers will need to take such investment strategies into account when making investment decisions relating to those chosen funds.

CONCLUSION

- 4.41 This chapter has considered how investment decisions are made in trust-based and contract-based schemes.
- 4.42 In Chapters 5 and 6 we consider the extent to which the rules covering investment decisions require or allow a consideration of non-financial factors, including social impact, and suggest recommendations where these could be made clearer.

¹⁰⁶ FCA Conduct of Business Sourcebook (COBS) 19.5.1 R to 19.5.4 G. Smaller providers are permitted to establish a governance advisory arrangement instead of an IGC, which is subject to fewer requirements.

¹⁰⁷ FCA Conduct of Business Sourcebook (COBS) 19.5.2 R and 19.5.5(2)(a) and (b) R.

¹⁰⁸ FCA Conduct of Business Sourcebook (COBS) 19.5.5(3) R and 19.5.5(4) R.

¹⁰⁹ FCA Conduct of Business Sourcebook (COBS) 19.5.5(6).

Chapter 5: Considering the social impact of pension investments – financial and non-financial factors

- 5.1 This chapter focuses on two questions:
- (1) When *should* DB and DC pension schemes consider issues of social impact?
 - (2) When *may* DB and DC pension schemes consider issues of social impact?
- 5.2 We begin by setting out the 2014 Law Commission guidance for pension trustees of trust-based schemes, and apply that guidance to the current pensions landscape described in Chapter 3 in relation to trust-based schemes. This guidance applies to both DB and DC schemes. It also applies to all investments, including equities, bonds and property.
- 5.3 We consider the position in relation to contract-based schemes in Chapter 6.

TRUST-BASED SCHEMES: LAW COMMISSION GUIDANCE (2014)

- 5.4 In 2014, the Law Commission published its report, *Fiduciary Duties of Investment Intermediaries*.¹¹⁰ This looked at how far pension trustees may take account of factors such as social and environmental impact and ethical standards.
- 5.5 We also published guidance alongside our report, which was intended to assist trustees when they are making investment decisions. The report and guidance distinguish between financial and non-financial factors.¹¹¹ In particular, we set out how far trustees may (or must) consider interests beyond the maximisation of financial return, such as questions of environmental and social impact, and the ethical views of their beneficiaries. The 2014 Law Commission guidance is set out in full in Appendix 1 to this report.
- 5.6 The Pensions Regulator (TPR) includes the terms financial and non-financial factors in its guidance for trustees and refers trustees to our 2014 guidance.¹¹²
- 5.7 In response to our call for evidence on this further project, the UK Sustainable Investment and Finance Association (UKSIF) thought that the terms “financially material factors” and “non-financial factors” were particularly helpful in clarifying the law for trustees. We explain these terms in more detail below.

¹¹⁰ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350.

¹¹¹ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 6.22.

¹¹² The Pensions Regulator, *Guide to investment governance* (July 2016), p 8.

Financially material factors

- 5.8 In pensions, 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.¹¹³
- 5.9 Trustees must always take account of financially material factors when considering investments.
- 5.10 In our 2014 guidance we explained that trustees are required to balance financial returns against risk:
- This is not a question of maximising returns: risks matter just as much as returns. Not all risks can be quantified. They often involve questions of judgement, which must be assessed at the time of the decision, not in hindsight.¹¹⁴
- 5.11 For long-term investments, the risks will include risks to the long-term sustainability of a company's or project's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's or project's reputation arising from the way it treats its customers, suppliers or employees.
- 5.12 TPR has confirmed that trustees are expected to take account of exposure to long-term financial risks as part of their investment risk assessment. TPR guidance identifies examples of such long-term financial risks, including climate change, unsustainable business practices and unsound corporate governance.¹¹⁵
- 5.13 Trustees of DB and DC schemes should always take into account financially material factors. Some of these factors could be considered issues of social impact, for example, practices which impact upon the environment or policies which ensure employees have job security and are paid fairly. The examples given could impact upon the long-term sustainability of a company's or project's performance, which could in turn affect the financial returns of any investment in that company or project.

Non-financial factors

- 5.14 In 2014 we explained that the primary concern of trustees must be to generate risk-adjusted returns.¹¹⁶ However, the law is flexible enough to accommodate other, non-financial concerns in some circumstances.¹¹⁷

¹¹³ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, ch 5.

¹¹⁴ Guidance from the Law Commission, *Pension trustee's duties when setting an investment strategy: "Is it always about the money?"* (2014), para 1.15. Available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

¹¹⁵ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 97; The Pensions Regulator, *Guide to investment governance* (July 2016), p 8.

¹¹⁶ Risk-adjusted returns are returns adjusted to take account of risk exposure.

¹¹⁷ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, paras 6.100 to 6.101.

- 5.15 For trustees to take account of non-financial factors when setting investment strategies and making investment decisions, they should apply two tests, taken from the case law:¹¹⁸
- (1) trustees should have good reason to think that scheme members would share the concern; and
 - (2) the decision should not involve a risk of significant financial detriment to the fund.
- 5.16 Only if both tests are met can a non-financial factor be taken into account. Below we consider examples of non-financial factors, how these tests apply to chosen funds and default funds, and how trustees can apply these tests in practice.
- 5.17 Trustees may choose to make certain investments solely because of their financial returns. If so, then the trustees do not have to apply the two-stage test even if the investment has a social impact.

Examples of non-financial factors

- 5.18 In our 2014 report we gave some examples of possible non-financial factors, of which two are particularly relevant to this discussion: decisions aimed at improving members' quality of life, and decisions aimed at improving the UK economy.

Example 1: improving members' quality of life

- 5.19 "Quality of life" concerns might favour projects which create jobs, or improve transport, or the environment.
- 5.20 In 2014 we noted that some local authority pension funds invest in local infrastructure projects which they think have the potential to improve the local area.¹¹⁹ For example, Strathclyde Pension Fund puts a proportion of its investment into a New Opportunities Fund, which aims to create local jobs or benefits to the local community while delivering returns.¹²⁰
- 5.21 Other stakeholders have raised issues about the human cost of environmental degradation and climate change.¹²¹ A Freshfields Bruckhaus Deringer report commented:

Many people wonder what good an extra percent or three of patrimony are worth if the society in which they are to enjoy retirement and in which their descendants will live deteriorates. Quality of life and quality of the environment are worth something, even if, or particularly because, they are not reducible to financial percentages.¹²²

¹¹⁸ See in particular, *Cowan v Scargill* [1985] Ch 270; *Harries v Church Commissioners* [1992] 1 WLR 1241; and *Martin v City of Edinburgh District Council*, [1989] Pens LR 9, 1988 SLT 329.

¹¹⁹ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, para 6.42.

¹²⁰ The Smith Institute, *Local authority pension funds: investing for growth* (September 2012), p 18.

¹²¹ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, para 6.41.

¹²² Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (October 2005), p 3.

5.22 On the other hand, quality of life objectives are a subordinate investment objective. This is important to remember where trustees face pressure to invest in “the issue of the day”. As one commentator noted:

Schemes are being regarded, following the collapse of our banking framework, as the magic porridge pot out of which the money for the roads and railways we need can be found.¹²³

5.23 Furthermore, different members may hold different views on these issues. To take an obvious example, some may favour an airport because of its positive effect on jobs and economic growth, while others may oppose it because of its negative effects on the environment.

Example 2: Decisions aimed at improving the UK economy

5.24 How far may trustees favour investment in the UK because it would benefit the UK economy as a whole?

5.25 In 2014 we quoted UNISON, who argued that the performance of investment funds “is directly correlated to the overall performance of the British and world economy”.¹²⁴ Therefore, they said, trustees ought to consider the effect of their decisions on the economy as a whole. As Hawley and Williams put it:

... the time has come for institutional investors to explicitly recognize that economy-wide, macroeconomic issues heavily influence the returns they will earn on their investments.¹²⁵

5.26 In 2014 we said that, in some extreme circumstances, damage to the wider economy might be considered a financial factor, if it would impact on the scheme’s portfolio as a whole.¹²⁶ However, for an investment decision to be justified on financial grounds, the anticipated benefits to the portfolio should outweigh the likely costs to the portfolio. The financial benefit must not be “too remote and insubstantial”¹²⁷ and must accrue to the fund itself, and not to the general social good.

5.27 In practice, we said that it would be rare for a decision on one investment aimed at improving the UK economy to have a measurable impact on the portfolio.¹²⁸ Pension funds are not heavily invested in UK equities but have moved away from the UK to more international portfolios. The schemes we talked to told us that less than 10% of their holdings were in UK equities, so that their future returns depend more on the world economy than on the UK one.¹²⁹ We concluded that a general concern about the UK economy is more likely to be a non-financial factor rather than a financial one.

¹²³ R Ellison, “Pointing the finger” (July 2013) *Pensions World* 14, p 14.

¹²⁴ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 6.50.

¹²⁵ J Hawley and A Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (1st ed 2000), p 22.

¹²⁶ For further discussion see, *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 6.53.

¹²⁷ *Cowan v Scargill* [1985] Ch 270 at 292.

¹²⁸ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 6.54 to 6.56.

¹²⁹ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 6.54.

Default funds

5.28 Many schemes have taken the view that non-financial factors are irrelevant for default funds. Instead, if scheme members have ethical concerns, trustees should provide them with suitable chosen options, which they can choose to invest their money into. As TPR's Guide to investment governance puts it:

You may wish to offer members funds that take non-financial factors into account. These could include funds that select investments according to particular religious principles, or based on environmental or social principles.¹³⁰

5.29 However, not all schemes have taken this view. ShareAction provided the example of the DC default fund of the HSBC pension scheme, where the trustees have decided to screen out controversial weapons.

5.30 Several consultees thought that more focus should be put on non-financial factors within default schemes. As the Pensions and Lifetime Savings Association (PLSA) put it:

A focus on the standards of default funds in relation to their social/ethical impact might be more productive than trying to persuade savers to explore options beyond the default fund.

5.31 It is therefore important to clarify that trustees may make investment decisions for default funds based on non-financial factors, subject to meeting the two tests discussed in this chapter.¹³¹

5.32 TPR also recognises that there may be some interest in non-financial factors amongst default fund members. In its Guide to communicating and reporting, it states that it is best practice to include information about trustee policies relating to non-financial factors in the statement of investment principles (SIP) applying to a scheme's default arrangement.¹³²

Chosen funds

5.33 DC scheme members may voluntarily decide to put their pension savings into a chosen fund which makes investments based on non-financial factors. For example, a chosen fund may exclude certain investments like tobacco or munitions. Pensions scheme decision makers will need to take such investment strategies into account when making investment decisions relating to those chosen funds.

¹³⁰ The Pensions Regulator, *Guide to investment governance* (July 2016), p 8. Available at <http://www.thepensionsregulator.gov.uk/trustees/investment-management-in-your-dc-scheme.aspx>.

¹³¹ See paras 5.15 and from para 5.34 below.

¹³² The Pensions Regulator, *Guide to communicating and reporting* (July 2016), pp 18 to 19. Available at <http://www.thepensionsregulator.gov.uk/trustees/communicating-with-members-in-your-dc-scheme.aspx>.

Non-financial factors: the tests in practice

5.34 As set out above, two tests must be satisfied before trustees can take account of non-financial factors when setting investment strategies and making investment decisions:

- (1) trustees should have good reason to think that scheme members would share the concern; and
- (2) the decision should not involve a risk of significant financial detriment to the fund.

5.35 We consider each in turn.

Test 1: Trustees must have good reason to think that scheme members share the concern

5.36 Trustees may not impose their own ethical views on their beneficiaries. If trustees wish to take account of a non-financial factor, they must have good reason to think that scheme members share this concern.

5.37 In 2014, we said that scheme members must “share” the concern. During the course of this project, ShareAction asked us to clarify this. They asked whether by this we meant that members must share the concern with each other – or whether they must share it with the trustees.

5.38 We meant the former. The personal views of the trustees are irrelevant as they are required to act solely in the interests of the members. In *Martin v City of Edinburgh District Council*, Lord Murray recognised that it may not be possible for a fiduciary to “divest himself of all personal preferences, of all political beliefs, and of all moral, religious or other conscientiously held principles”.¹³³ Nevertheless, they must do their “best to exercise fair and impartial judgment” in the interests of the beneficiaries.¹³⁴

How should schemes find out members’ views?

5.39 In 2014, we explained that finding out members’ views does not necessarily require survey evidence. In some cases, trustees may be able to make assumptions. We gave an example of manufacturing cluster bombs.¹³⁵ The fact that this contravenes the Convention on Cluster Munitions may give trustees reason to think that most people would consider them to be wrong. When coupled with letters from members agreeing, and no letters disagreeing, we suggested that trustees would have good reason to think that they were acting on members’ concerns rather than their own.

5.40 In other cases, we think it may be necessary to consult members more formally. We do not think that there needs to be 100% agreement, which is usually unachievable. If a significant number (for example, the majority of members who engage) are opposed to an investment while the rest remain neutral, that may be enough. The more difficult question is where a significant number hold one view but a minority disagree strongly. We said that where the issue was clearly controversial, the courts would expect trustees to focus on financial factors, rather than becoming embroiled in

¹³³ [1989] Pens LR 9 at 33, [1988] SLT 329 at 334.

¹³⁴ *Martin v City of Edinburgh District Council* [1989] Pens LR 9 at 33.

¹³⁵ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, paras 6.64 to 6.65.

disagreements between the members on non-financial factors.¹³⁶ If the issue is not controversial, and there is good evidence of agreement from some people, we think that trustees may act on these views even if many people fail to engage.

- 5.41 Establishing members' views becomes more problematic where members are disengaged, as is particularly the case with default funds where it is often hard to obtain feedback from members. In Chapter 9 we discuss the fact that the majority of default fund members are likely to be disengaged. However, the law is not prescriptive about how members' views are obtained. As we discuss below, TPR suggests a variety of methods.

TPR guidance on finding out members' views

- 5.42 In guidance aimed at DC scheme trustees, TPR notes that having an understanding of members is "key, particularly in gauging member views to inform the design of investment strategies and the assessment of value for members".¹³⁷ Trustees should choose methods of engagement that are "appropriate and proportionate according to the size of the scheme and available resources".¹³⁸ By law, trustees of master trusts are required to make arrangements to encourage members of the scheme to make their views known on matters relating to the scheme.¹³⁹
- 5.43 However, trustees are given considerable flexibility about what the arrangements might be. TPR's Guide to communicating and reporting offers a variety of methods which could be used by all trust-based schemes. It suggests that trustees could tap into existing knowledge about members, from (for example) member-nominated trustees, employers or union representatives. Member surveys could use existing portals or free online tools, while other possibilities include speaking events, member annual general meetings or focus groups.¹⁴⁰
- 5.44 We return to the issue of obtaining member views in Chapter 9.

Test 2: The decision should not risk significant financial detriment

- 5.45 In *Harries v Church Commissioners*,¹⁴¹ Sir Donald Nicholls VC stressed that the purpose of investment was to generate money. Other factors could be accommodated, but only "so long as the trustees are satisfied that course would not involve a risk of significant financial detriment".¹⁴² Trustees must seek professional advice on the issue.¹⁴³

¹³⁶ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, paras 6.64 to 6.65.

¹³⁷ The Pensions Regulator, *Guide to communicating and reporting* (July 2016), p 4. Available at <http://www.thepensionsregulator.gov.uk/trustees/communicating-with-members-in-your-dc-scheme.aspx>.

¹³⁸ The Pensions Regulator, *Guide to communicating and reporting* (July 2016), p 4.

¹³⁹ Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI No 1715), reg 29.

¹⁴⁰ The Pensions Regulator, *Guide to communicating and reporting* (July 2016), p 4.

¹⁴¹ [1992] 1 WLR 1241.

¹⁴² [1992] 1 WLR 1241, at 1247.

¹⁴³ *Martin v City of Edinburgh District Council* [1989] Pens LR 9 at [24], [32], 1988 SLT 329, pp 331 to 332, 334.

5.46 In 2014, we said that the test should not be applied in a narrow way. The requirement is that trustees should not incur the risk of significant financial detriment to the scheme, not that they should avoid theoretical detriment according to a precise mathematical model. However, it would not be acceptable for pension trustees to invest default fund contributions for a risk-adjusted return that is significantly less than one available elsewhere.

Can trustees turn a blind eye to non-financial factors?

5.47 In 2014, we concluded that trustees *may* take account of non-financial factors but are not obliged to do so. In its response to this project, ShareAction was generally supportive of the tests we set out, but questioned whether it was right that trustees could simply refuse to consider non-financial factors. They asked whether trustees were required to give reasons for doing so and, if so, what would constitute a good reason.

5.48 ShareAction pointed out that trustees' power to take non-financial factors into account was a fiduciary power based on members' best interests and therefore argued that trustees are under an obligation to consider periodically whether or not to exercise it. If this was the case, a trustee could not simply turn a blind eye to members' best interests, purely because those interests were non-financial.

5.49 We accept that trustees must not "fetter" or restrict their discretion by deciding how they will or will not exercise a power in the future.¹⁴⁴ A "fetter" is wrong because it obliges the trustees to exercise their discretion "in a specified manner to be decided by considerations other than his own conscientious judgment *at the time* as to what is best in the interests of those for whom he is trustee".¹⁴⁵

5.50 Therefore, trustees cannot simply refuse to take account of non-financial factors in all circumstances, however serious the potential harm to scheme members. To give a hypothetical example, suppose that a DC scheme catering largely for construction workers invested in a construction project with a particularly poor safety record. The scheme could not simply refuse to consider the risk of injury caused to its members by its investment.

5.51 However, such extreme circumstances would be rare. Generally, the courts are reluctant to intervene, and allow trustees a very wide margin in deciding what circumstances are relevant and irrelevant. As the Supreme Court has put it:

It is not enough to show that the trustees' deliberations have fallen short of the highest possible standards, or that the court would, on a surrender of discretion by the trustees, have acted in a different way.¹⁴⁶

¹⁴⁴ *Snell's Equity* (32nd ed 2010), para 10-016.

¹⁴⁵ *Osborne v Amalgamated Society of Railway Servants* [1909] 1 Ch 163 at 187, Fletcher Moulton LJ (emphasis added).

¹⁴⁶ *Pitt v Holt* [2013] UKSC 26 at [73].

Reasons for failing to take account of non-financial factors

- 5.52 ShareAction also asked whether scheme trustees who decide not to take non-financial considerations into account are obliged to disclose their reasons to their beneficiaries, either on their own initiative or upon request. And, if so, what would constitute a good reason for trustees to decide not to exercise their power?
- 5.53 The courts have found that pension scheme members are not passive objects of “bounty”,¹⁴⁷ which “must influence the attitude of the courts towards the obligations of trustees”.¹⁴⁸ So in an extreme case the courts may be sympathetic to members’ requests for reasons.
- 5.54 However, trustees would usually find it easy to justify a focus on financial factors by reference to the purpose of the trust, which is to invest savings for a financial return. As we said in 2014, “trustees should assume that their members will judge the success of the investment policy by the size of the pension they receive on retirement”.¹⁴⁹ To this end, it is particularly important to keep charges low, and “trustee boards will not wish to deflect focus from factors that more directly influence financial growth”.¹⁵⁰ All these are good reasons for looking only at financial factors.

CONTRACT-BASED SCHEMES

- 5.55 Our 2014 report and guidance was focused on trustees. In Chapter 6 we consider whether more guidance is needed for contract-based schemes.

CONCLUSION

- 5.56 If trustees make an investment, they must consider the financial risks to that investment. In the case of equities, this may include risks arising from unsustainable business practices and unsound corporate governance.
- 5.57 In some limited circumstances, the trustees may go further than this. They may favour investments with a positive impact or avoid investments with a negative impact. Trustees are permitted to do this for default funds as well as other funds. However, trustees would need good reason to think that the membership held values justifying this concern. They would need to bear in mind that many values are contested, and that tensions exist between different conceptions of the social good.
- 5.58 Furthermore, the decision should not in any event risk significant financial detriment. Investment in a default fund should not provide a significantly lower risk-adjusted return than one available elsewhere.

¹⁴⁷ *Imperial Group Pension Trust v Imperial Tobacco* [1991] 1 WLR 589 at 597.

¹⁴⁸ D Pollard, *The Law of Pension Trusts* (1st ed 2013), para 2.13.

¹⁴⁹ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 5.38.

¹⁵⁰ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 6.80, quoting the National Association of Pension Funds (now renamed as the PLSA).

- 5.59 In 2014 we concluded that the law provided an appropriate balance between financial and non-financial factors and did not require substantive change for trust-based schemes. However, we recommended changes to the Investment Regulations about how trustees were required to state their policy on these issues. We discuss these recommendations in Chapter 6.
- 5.60 In Chapter 6 we also consider whether more guidance is needed for contract-based schemes.

Chapter 6: Considering the social impact of pension investments – recommendations

- 6.1 In Chapter 5 we set out the law on how far pension trustees may or should take into account issues of social impact. We do not think that the law in this area needs substantive change. However, we have been told that it continues to be misunderstood. Consultees pointed to confusion over terms such as “ethics” and “ESG” (environmental, social and governance). This confusion was thought to be a major barrier to trustees’ consideration of social impact.
- 6.2 In practice, trustees structure their decision-making around the statement of investment principles (SIP), which they must review at least every three years. In practice, therefore, the SIP is an important document, which influences how trustees reach decisions. The regulations governing SIPs are particularly confusing in the way they deal with financial and non-financial factors. We have concluded that there is a need for reform. As we have already consulted on this issue as part of our 2014 report, we are able to make specific recommendations.
- 6.3 In this chapter we look at the current regulations on how a SIP should address financial and non-financial factors, and make recommendations for reform. We then consider contract-based schemes, which should, as far as possible, be subject to equivalent provisions. We recommend broadly equivalent changes for contract-based schemes.

TRUST-BASED SCHEMES: STATEMENT OF INVESTMENT PRINCIPLES

Financial and non-financial factors

- 6.4 In Chapter 4 we explained that defined benefit (DB) and defined contribution (DC) scheme pension trustees must prepare a SIP and review it at least every three years. The content of the SIP is governed by the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations).¹⁵¹ Regulation 2(3)(b)(vi) requires a SIP to include a statement of the trustees’ policy on:
- the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.
- 6.5 A new regulation 2A(1)(b) was introduced in April 2015 which expanded the SIP requirements. Trustees of DC schemes must now provide the same information in a SIP prepared specifically for a scheme’s default arrangements.
- 6.6 These provisions do not grant trustees any powers to take particular factors into account. That is governed by case law, discussed in Chapter 5. However, the SIP has proved to be important, because it structures the way that trustees consider social impact when deciding their investment principles. In 2014 we recommended reforms

¹⁵¹ SI 2005 No 3378.

to the SIP requirements. Here we discuss our previous recommendation and state why we think that change is still needed.

Confusion over “social, environmental or ethical considerations”

6.7 In 2014, we were told that regulation 2(3)(b)(vi) was particularly confusing. This is because the reference to ethical considerations alongside social and environmental considerations conflates financial and non-financial factors. One way of controlling for risks over the long term is to consider “environmental, social and governance” (ESG) factors. Therefore “social and environmental” considerations are usually financial factors. This is very different from specifically “ethical” considerations, such as a decision to disinvest in an industry to show ethical disapproval. As we put it in 2014:

Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor.¹⁵²

6.8 In response to our 2013 consultation paper,¹⁵³ many stakeholders asked for a change to regulation 2(3)(b)(vi) to distinguish more clearly between financial and non-financial factors and to clarify thinking in this area. For example, the National Association of Pension Funds (now the Pensions and Lifetime Savings Association (PLSA)) said:

We think there is merit therefore in considering amending the SIP requirements to focus more on those activities in relation to ESG factors and stewardship, separating these activities from the discussion of ethical considerations.

6.9 NEST Corporation¹⁵⁴ also thought that the current provision was unhelpful:

We suspect that a lot of the confusion comes from the lack of understanding or clarity as to what ESG means and a conflation between ESG and ethical factors.

Our 2014 recommendation

6.10 In 2014 we recommended that regulation 2(3)(b)(vi) should be amended to distinguish more clearly between financial and non-financial factors.¹⁵⁵ In relation to financial factors, we thought that trustees should state their policy on how they evaluate risks to a company’s long-term sustainability (including risks relating to governance or to the firm’s environment or social impact). As a separate issue, in relation to non-financial factors, trustees should consider their policy on responding to beneficiaries’ ethical and other concerns.

¹⁵² Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, paras 7.79 to 7.85.

¹⁵³ Fiduciary Duties of Investment Intermediaries (2013) Law Commission Consultation Paper No 215 (CP 215).

¹⁵⁴ NEST Corporation is the trustee that runs the NEST scheme.

¹⁵⁵ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, para 7.94.

DWP consultation

6.11 The Department for Work and Pensions (DWP) consulted on our 2014 recommendation in February 2015¹⁵⁶ and published its response in November 2015.¹⁵⁷ The response noted that “many responses were supportive of the thinking behind the proposal” because:

amending the regulations in this way could help move assessment of long-term risks up the agenda and further clarify that pension trustees should take ESG considerations into account if they believe they may be financially material to the performance of their investments. Respondents felt that changes could also clarify that investment decisions can take into account nonfinancial factors, providing there is good reason to believe there is member interest in doing so, and that there is no risk of significant detriment to the fund.¹⁵⁸

6.12 However, DWP reported that “there was no consensus on how this might best be done, or how precisely these different factors should be defined in the regulations”. They also noted that The Pensions Regulator (TPR) was updating its DC code of practice and supporting guidance to incorporate the Law Commission’s findings. In November 2015, DWP decided not to change the Investment Regulations at that time, on the ground that “this is an area where guidance can be more effective than regulatory change”.¹⁵⁹

IORP II – The New Pensions Directive

6.13 This issue is now subject to a new European Union directive on “IORP”, which stands for “institutions for occupational retirement provision”. The original IORP Directive dates from 2003. It has now been replaced by IORP II, which came into force in January 2017.¹⁶⁰ EU Member States have until 13 January 2019 to incorporate the Directive into national legislation. The IORP II Directive will (absent any contrary agreement) require to be implemented before the expiry of the two year period, as

¹⁵⁶ Department for Work and Pensions, *Consultation on changes to the Investment Regulations following the Law Commission’s report ‘Fiduciary Duties of Investment Intermediaries’* (February 2015). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/407937/Condoc_27_02_15_to_DWP.pdf.

¹⁵⁷ Department for Work and Pensions, *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations Public consultation and Government response* (November 2015). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476447/reducing-regulatory-burdens-and-misc-regs-nov-2015-consultation.pdf.

¹⁵⁸ Department for Work and Pensions, *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations Public consultation and Government response* (November 2015), para 14.

¹⁵⁹ Department for Work and Pensions, *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations Public consultation and Government response* (November 2015), para 23.

¹⁶⁰ Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs). Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.354.01.0037.01.ENG&toc=OJ:L:2016:354:TOC.

provided for in article 50 of the Treaty on European Union, from the date of the United Kingdom's notice pursuant to article 50 given on 29 March 2017.

6.14 Among the many changes introduced by IORP II, there is a new obligation on Member States to allow occupational retirement institutions to take into account the “potential long-term impact of investment decisions on environmental, social and governance factors”.

6.15 The preamble to the Directive states:

It is essential that IORPs improve their risk management while taking into account the aim of having an equitable spread of risks and benefits between generations in occupational retirement provision, so that potential vulnerabilities in relation to the sustainability of pension schemes can be properly understood and discussed with the relevant competent authorities. IORPs should, as part of their risk management system, produce a risk assessment for their activities relating to pensions. That risk assessment should also be made available to the competent authorities and should, where relevant, include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets').¹⁶¹

Environmental, social and governance factors, as referred to in the United Nations-supported Principles for Responsible Investment, are important for the investment policy and risk management systems of IORPs. Member States should require IORPs to explicitly disclose where such factors are considered in investment decisions and how they form part of their risk management system.¹⁶²

6.16 Article 19(1)(b) of the Directive then requires that:

within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors.

Financial and non-financial factors: conclusion

6.17 As discussed in Chapter 5, schemes are already allowed to take account of the potential long-term impact on investments caused by ESG factors. However, we think more needs to be done to require IORPs “to explicitly disclose where such factors are considered in investment decisions”. We therefore adhere to our 2014 recommendation with updates as described below.

6.18 We recommend an explicit requirement on trustees in regulation 2(3)(b)(vi) to state their policy on how they evaluate risks to long-term sustainability of investments (including risks relating to environment, social or governance factors). Our 2014 recommendation referred to the sustainability of a company and this has been expanded to “investment” to reflect that equities are not the only investment available

¹⁶¹ Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), para 57. Available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.354.01.0037.01.ENG&toc=OJ:L:2016:354:TOC.

¹⁶² Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), para 58.

to pension schemes. We also recommend a requirement for trustees in regulation 2(3)(b)(vi) to state their policy on responding to beneficiaries' concerns.

- 6.19 Since making our recommendation in 2014, the legal requirements relating to SIPs have been expanded. Trustees are now also required to provide the same information about "social, environmental or ethical considerations" in a SIP prepared specifically for their scheme's default arrangements.¹⁶³ The concerns raised and the recommendation we made in 2014 apply equally to these expanded SIP requirements. As we said in Chapter 5, it is important to clarify that trustees may make investment decisions for default funds based on non-financial factors, subject to meeting the two tests discussed in that chapter.
- 6.20 In some ways, our recommended change may appear small and technical. However, we think it is important in practice, because the SIP requirements structure the way that pension trustees approach their investment duties. We hope that by separating financial and non-financial factors in the Investment Regulations, we will help trustees structure their decision-making in this area, both to control for long term risk, and to respond to beneficiaries' ethical and other concerns.
- 6.21 Details of the trustees' policies in these areas will also be made available to members via the SIP. We hope that this will focus the minds of trustees as to what members value and also encourage members to consider these issues and put pressure on trustees to reconsider their policies where appropriate.
- 6.22 Any changes to SIP requirements should cover SIPs prepared under regulations 2 and 2A of the Investment Regulations. Under regulation 2A(1)(b), the matters mentioned in regulation 2(3)(b) also apply in respect of the default arrangements. Therefore, a change to regulation 2(3)(b) will apply to a SIP prepared for a scheme, including in relation to the default arrangements.
- 6.23 Where trustees have no policies in these areas, we would expect this to be stated in the SIP.

Recommendation 1.

- 6.24 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.

¹⁶³ The Occupational Pension Schemes (Charges and Governance) Regulations 2015 amended the SIP requirements in the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations). The expanded SIP requirements are set out in regulation 2A of the Investment Regulations.

Stewardship

- 6.25 We also think that pension trustees should be encouraged to consider whether and how they will exercise stewardship. By stewardship, we mean how trustees will promote an investment's long-term success, through monitoring, engagement or voting, either directly or through their investment managers. In this context, an investment could be equities (shares) in a company, but it could also be investment in an alternative asset class, for example in relation to an infrastructure project. We introduced the concept of stewardship in Chapter 2.¹⁶⁴
- 6.26 We begin by looking at the role of stewardship in equity markets. To function well, equity markets require a chain of accountability. Directors need to be accountable to professional investor shareholders, such as pension trustees and insurance companies. In turn, professional investor shareholders should be accountable to the ultimate beneficiaries whose money has been invested, such as pension savers. Without this accountability, professional investor shareholders may neglect their stewardship function and corporate governance role. And without stewardship from professional investor shareholders, senior managers may be tempted to act in their own interests rather than the company's interest. At the extreme, senior managers could take value out of the company by, for example, awarding themselves excessive pay or making short-term decisions which are detrimental in the long term.¹⁶⁵
- 6.27 Professor Eva Micheler explains that intermediation of shareholdings goes some way to explain weaknesses in the chain of accountability.¹⁶⁶ Intermediation is the process by which shares or other investments are held for the benefit of pension savers through pension trustees.
- 6.28 This level of intermediation has been referred to as "separation of ownership from ownership".¹⁶⁷ This phenomenon happens at several levels. Shares are frequently held for the benefit of pension savers through investment vehicles which act as asset owners – such as trust-based schemes. Those overseeing these vehicles, for example pension trustees, employ fund managers to take investment decisions for them. Pension savers bear the risk of those investment decisions but are removed from the decision-making and direct monitoring of those investments (something an "owner" would normally participate in). Intermediation will also exist in relation to other investments, not just equities, wherever a pension saver is removed from the decision-making and direct monitoring of those investments.
- 6.29 Intermediation therefore complicates the process of engagement and stewardship. It makes it more difficult for members to exercise voting rights or to engage more informally with underlying companies or projects. The pension saver, as the ultimate beneficiary, may well have a greater interest than the pension fund in active

¹⁶⁴ See paras 2.24 to 2.30.

¹⁶⁵ For further discussion, see J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012).

¹⁶⁶ Eva Micheler, "Facilitating investor engagement and stewardship" (2013) *European Business Organization Review* 30, pp 39 to 40.

¹⁶⁷ Usha Rodrigues, "Corporate Governance in an Age of Separation of Ownership from Ownership" (2010-2011), 95 *Minnesota Law Review*, p 1822. Available at: http://digitalcommons.law.uga.edu/cgi/viewcontent.cgi?article=1741&context=fac_artchop.

stewardship but stands behind a chain of intermediaries and is therefore less able to exercise a stewardship role.

- 6.30 The perceived lack of customer demand for such stewardship by pension trustees has resulted in narrow mandates for asset managers which do not, as standard, include stewardship.¹⁶⁸ In particular, the Financial Reporting Council pointed out that:

One barrier frequently raised by pension funds is competing priorities. Corporate engagement inevitably slips down the agenda... and busy trustees are not always equipped to hold their asset managers to account. It is important to remember that pension funds themselves do not necessarily need to be directly involved in engagement and that this task falls more naturally to their asset managers in many cases.

The critical point is getting the mandate right and in recognising that the different roles played by different players depending on where they are in the investment chain.¹⁶⁹

- 6.31 Even small amounts of pressure from pension savers can ensure that trustees are reminded of the importance of voting rights and more informal engagement with underlying companies or investments. They can then either exercise their stewardship powers or put pressure on investment managers to exercise stewardship powers, where they manage the investments on a day-to-day basis.

Our 2014 recommendation

- 6.32 At present, regulation 2(3)(c) of the Investment Regulations requires a SIP to include a statement of the trustees' policy (if any) "in relation to the exercise of the rights (including voting rights) attaching to the investments".
- 6.33 We think this is too narrow. As the Stewardship Code explains, "stewardship is more than just voting" and includes other forms of engagement.
- 6.34 In 2014, we recommended that the government should review whether the Investment Regulations should be amended to require trustees to state their policy (if any) on stewardship.
- 6.35 DWP also consulted on this recommendation. It reported that responses on this were mixed:

Most expressed support for promoting stewardship activity, reflecting the fact that many pension schemes already sign up to the Stewardship Code, or indicate that their investment managers are signatories on their behalf. There was, however no consensus about whether it would be proportionate or effective to explicitly require pension schemes to report on their use of the Code in their SIP.

¹⁶⁸ Eva Micheler, "Facilitating investor engagement and stewardship" (2013) *European Business Organization Review* 30, pp 40 to 41.

¹⁶⁹ Financial Reporting Council, *Developments in Corporate Governance* (2011), p 27. Available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2011-The-impa.pdf>.

6.36 Again, DWP decided not to implement the recommendation.

Stewardship: conclusion

6.37 Stewardship remains an important tool for pension schemes, especially in the context of socially responsible investment. We therefore adhere to our 2014 recommendation with updates as described below. We recommend that the Investment Regulations should be amended to require the SIP to contain a statement of trustees' policy (if any) on stewardship. This would include the exercise of formal rights, such as voting at general meetings where the pension scheme owns equities (shares) in a company. It could also include more informal methods of engagement such as regular meetings with project decision-making boards or company directors and objecting to certain environmental practices of an infrastructure project. In extreme cases it could include threatening to withdraw investment altogether.

6.38 Since making our recommendation in 2014, the legal requirements relating to SIPs have been expanded so that trustees are required to produce a SIP specifically for a scheme's default arrangement. However, the SIP requirements for default arrangements do not include the requirement in regulation 2(3)(c), that trustees should state their policy (if any) in relation to the exercise of rights. We have expanded our 2014 recommendation and recommend that trustees are also required to state their policy on stewardship in relation to their scheme's default arrangements.

Recommendation 2.

6.39 We recommend that:

- (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.

CONTRACT-BASED SCHEMES

6.40 In our 2014 report we said:

Given that trust-based and contract-based default funds perform the same function, we think that the law should seek to achieve similar outcomes. Both regulators have said that they have similar expectations for scheme quality and member outcomes.¹⁷⁰

6.41 Below we make recommendations for contract-based schemes to ensure this broad equivalence. We also recommend that that our guidance on financial and non-financial factors for trustees should be applied to contract-based schemes in a broadly equivalent way.

Reporting requirements for contract-based schemes

6.42 Unlike trustees, contract-based pension providers are not required to prepare a SIP. As we explain in Chapter 4, the main public document for contract-based providers is the independent governance committee (IGC) annual report.¹⁷¹ IGCs are required to act in the interest of policyholders. Their main function is to assess value for money, but the content of the annual report goes further than this. For example, it includes how the IGC has considered policyholders' interests more generally. It must also set out the arrangements the pension provider has put in place to ensure that the views of policyholders are directly represented to the IGC.

6.43 Like the SIP, the duties on IGCs to report annually have the effect of structuring the questions they ask the firm. We believe that by asking questions about financial and non-financial factors and stewardship, this will help focus the mind of the firm to consider these issues and so will indirectly affect the firm's investment strategies. Therefore we consider that a change to the annual reporting requirements in COBS rule 19.5 would help structure thinking in this area. It would also provide a method of achieving a similar outcome for contract-based and trust-based schemes.

6.44 As we say for trust-based schemes above, where a firm providing contract-based pensions does not have policies in these areas, we would expect this to be reported by the IGC.

6.45 Under the preamble to IORP II, member states should require institutions for occupational retirement provision to explicitly disclose how ESG factors are considered in investment decisions. The Government has previously stated that personal pension schemes, including group personal pensions, are not within the scope of the original IORP Directive.¹⁷² However, DWP and FCA have clearly stated

¹⁷⁰ Law Commission, *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 8.54; Financial Conduct Authority and The Pensions Regulator, *Guide to the regulation of workplace defined contribution pensions* (March 2014), p 2. See also Department for Work and Pensions, *Better workplace pensions: Further measures for savers* (2014) Cm 8840, p 5.

¹⁷¹ FCA Conduct of Business Sourcebook (COBS) 19.5.5(6).

¹⁷² Department for Work and Pensions, *Implementing the European Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision: Government Response to Consultation*, paras 2.1 to 2.3.

that, although the sources of law are different for contract- and trust-based schemes, they intend that the outcome for pension savers is, and will continue to be, the same.

- 6.46 In order to ensure similar outcomes for members of contract-based and trust-based schemes, we consider that information about how ESG factors may be taken into account for contract-based schemes should be in the public domain, so that it is available to scheme members and to regulators.

Recommendation 3.

- 6.47 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.
- 6.48 This requirement should apply to policies reflected in investment strategies including default investment strategies.

Recommendation 4.

- 6.49 COBS 19.5 should be amended to require IGCs to report on the firm's policy (if any) on stewardship.
- 6.50 This requirement should apply to the policy reflected in investment strategies including default investment strategies.

FCA guidance on financial and non-financial factors

- 6.51 Our 2014 report was focussed on trustees and therefore our guidance does not apply to contract-based schemes.
- 6.52 Contract-based schemes are regulated by the Financial Conduct Authority (FCA), so TPR guidance does not apply to them. The FCA issued a policy statement to support its introduction of IGCs. The statement touched upon how IGCs should consider members' views on ethical and social investments to assist them in their oversight role:

A theme for our policy statement is that IGC members should not assume that they know what scheme members need and want. In this context, we would emphasise the importance of assessing member views on ESG [environmental, social and governance] factors and on the availability and use in the default of ethical and long-term social investments, while at the same time considering the risks and potential impact on pension outcomes.¹⁷³

¹⁷³ Financial Conduct Authority, *Final rules for independent governance committees: policy statement PS15/3* (February 2015), para 4.25.

- 6.53 However, we are not aware of any guidance issued by the FCA which provides detailed direction for contract-based schemes.
- 6.54 FCA and TPR guidance is not the same in relation to financial and non-financial factors. TPR guidance for trustees includes the two Law Commission tests which can be applied by trustees when taking into account non-financial factors.¹⁷⁴ By contrast, there is no FCA guidance aimed at contract-based schemes to assist them as to how to consider financial and non-financial factors when they are making investment decisions.

Recommendation 5.

- 6.55 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 to investment governance.

¹⁷⁴ The Pensions Regulator, *Guide to investment governance* (July 2016), p 8.

Chapter 7: Investment in social enterprises

- 7.1 In response to our call for evidence, consultees identified investment in charities and social enterprises as a form of social investment.
- 7.2 Our terms of reference asked us to consider whether there are legal or regulatory barriers to using pension funds for social impact (including investment in social enterprises). They also asked us to provide an accessible account of the law governing the legal forms which may be used by social enterprises.
- 7.3 In this chapter we begin by explaining what a social enterprise is for the purposes of this report. We go on to briefly consider the different legal forms a social enterprise can take. This report is accompanied by a background paper which looks in more detail at each of the legal forms.¹⁷⁵
- 7.4 We also consider how investors may be able to invest in social enterprises and explain how the characteristics of different legal forms can affect their ability to attract investment. We note that some social enterprises may not be a natural fit for those seeking to invest for financial returns. This is because they are subject to restrictions in relation to their use of assets which can affect their ability to provide returns to investors. Many social enterprises will also not provide the scale of returns necessary to make them attractive to pension schemes.
- 7.5 Finally, we identify the possible barriers to investment in different social enterprises. The wide range of possible legal forms provides choice and flexibility for organisations to choose the most appropriate form for them and their social purpose.¹⁷⁶ Restrictions on the use of assets may restrict a social enterprise's ability to provide returns to investors, but this may well be appropriate where providing financial returns to investors is not the primary purpose of the enterprise. We do not suggest that all restrictions should be lifted as the different legal forms serve different and useful purposes. However, social enterprises may benefit from access to investment where this can provide them with additional funding. We therefore suggest options for reform where we have identified unnecessary barriers to investment in social enterprises by pension schemes.

WHAT IS A SOCIAL ENTERPRISE?

- 7.6 In this report, we use the phrase “social enterprise” to mean a business with a social, charitable or community-based purpose, whose surpluses are principally reinvested for those purposes. They are subject to rules and restrictions as to their activities and use of profits. Examples include charities, community benefit societies and community

¹⁷⁵ See Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

¹⁷⁶ The different legal forms available to social enterprises have different regulatory requirements in relation to the purposes or objectives they must / are allowed to pursue. These are mentioned briefly in paras 7.7 to 7.24 and in more detail in Law Commission, *Background paper: Legal forms for social enterprise* (June 2017).

interest companies which have been set up for a particular social purpose and which have restrictions on the use of their assets (including any profits) for that purpose.

- 7.7 A social enterprise is distinct from a commercial business which has been set up solely to serve its shareholders.

Contrast with companies limited by shares

- 7.8 In Chapter 3 we noted that the majority of DC scheme investment is in listed equities (shares in companies which are listed on a recognised stock exchange). Companies limited by shares do have the potential to have social impact. For example, a “mission-led business”¹⁷⁷ is a commercial business set up to make a profit and, provide returns to shareholders while also fulfilling a social mission or purpose. These companies are distinct from social enterprises: they have been set up to make a profit to provide returns to shareholders rather than to reinvest in their social, charitable or community based purpose.
- 7.9 An example might be a company whose social mission is to improve the quality of life of those living with dementia by providing specialist training to care home staff. Other examples include a renewable energy company which has a social mission to help tackle climate change or a green printing business committed to reducing environmental damage by only using waterless printing technology.
- 7.10 We have not identified any legal or regulatory barriers to investing in companies limited by shares, including where these are mission-led businesses, and therefore do not make any recommendations or suggest options for reform in relation to such organisations. However, by including companies limited by shares in the discussion in this chapter and in the background paper,¹⁷⁸ we are able to contrast investment in social enterprises with investment in traditional companies.

LEGAL FORMS OF SOCIAL ENTERPRISES

- 7.11 Social enterprises can take a wide variety of legal forms, providing choice and flexibility. For example, a social enterprise may wish to ensure that all its assets (including profits) are used only for its social purpose. It can do this by adopting a legal form which includes a full restriction on the use of its assets. Alternatively, if a social enterprise wishes to be able to provide some returns to investors, it can adopt a legal form which permits the issue of shares and the payment of dividends.
- 7.12 However, the range of possible structures can also create complexity, as each legal form is subject to different legal rules. Below we briefly describe the different legal forms to provide context for the options for reform proposed later in this chapter. Appendix 3 also sets out a quick reference table summarising the key characteristics

¹⁷⁷ There is no legal definition of a “mission-led business”; this is a term used in the government-commissioned Independent Advisory Panel Report, *Mission-Led Business: On a Mission in the UK Economy* (2016). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/574694/Advisory_Panel_Report_-_Mission-led_Business.pdf.

¹⁷⁸ Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

of the different legal forms. The background paper provides a more detailed account of the legal rules which apply to different legal forms of social enterprise.¹⁷⁹

Unincorporated associations

7.13 An unincorporated association is a group of two or more people with a common, non-business purpose.¹⁸⁰ Unincorporated associations are set up by contract and governed by rules agreed by the members of the association. The unincorporated association does not have separate legal personality from its members and cannot issue shares. This legal form is therefore only suitable for small community groups and charities.

Trusts

7.14 In a trust arrangement, individuals (known as trustees) manage assets for the benefit and on behalf of others (known as beneficiaries).¹⁸¹ The powers of trustees to manage those assets is usually set out in a trust deed and is also governed by separate legislation and case law.¹⁸² A trust does not have a separate legal personality from its trustees and it cannot issue shares.¹⁸³ In a charitable trust trustees manage the assets of the charity for its charitable purpose.

Charitable incorporated organisations (CIOs)

7.15 A CIO is a new form of incorporated charity introduced as an alternative to a limited company.¹⁸⁴ It has separate legal personality from its members, but unlike a company it cannot issue shares. It cannot apply assets, profits or surplus for any other purpose than its specified charitable purpose. It is regulated by the Charity Commission but not by Companies House.

¹⁷⁹ Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

¹⁸⁰ There is no statutory definition for an unincorporated association, but a number of definitions appear in the case law. The most well-known definition comes from Lawton LJ in *Conservative and Unionist Central Office v Burrell* [1982] WLR 522, who defined the entity as: “two or more persons bound together for one or more common purposes, not being business purposes, by mutual undertakings each having mutual duties and obligations, in an organisation which has rules which identify in whom control of it and its funds rests and on what terms and which can be joined or left at will”.

¹⁸¹ *Lewin on Trusts* (19th ed 2015), paras 1-001 to 1-010.

¹⁸² *Lewin on Trusts* (19th ed 2015), para 36-120.

¹⁸³ *Lewin on Trusts* (19th ed 2015), paras 21-010 to 21-012.

¹⁸⁴ The Charities Act 2006 first introduced the CIO legal form, and the statutory provisions now appear in the consolidated Charities Act 2011. However, the CIO status only became available to charities in England and Wales on 4 March 2013 after the enactment of the Charitable Incorporated Organisations (General) Regulations 2012.

Community interest companies (CICs)

- 7.16 The CIC is a relatively new form of company, introduced in 2005.¹⁸⁵ The sector is growing rapidly: in 2015-16, 2,727 new CICs were established, a growth of 12% compared with the previous year.¹⁸⁶
- 7.17 CICs were designed to provide a legal form for non-charitable social enterprises which aim to benefit the community or which are established with a social purpose, rather than solely to serve shareholders. A CIC cannot be a charity.¹⁸⁷
- 7.18 A CIC has separate legal personality from its members. It can be limited by shares or by guarantee. CICs can issue shares, but dividends are subject to a cap of 35% of profits,¹⁸⁸ as we discuss in more detail below. CICs are regulated by the Office of the Regulator of Community Interest Companies.

Companies limited by guarantee

- 7.19 A company can be limited by shares or by guarantee.¹⁸⁹ A company has a separate legal personality from its shareholders¹⁹⁰ or members, and their liability is limited to the value of the shares they hold, or the guarantee they have given.¹⁹¹
- 7.20 Historically, companies limited by guarantee could issue shares, but it is no longer possible to register such companies.¹⁹² We are concerned in this chapter with companies limited by guarantee without a share capital.
- 7.21 This form is less likely to be used by a normal trading business as profits cannot be distributed to members by way of a dividend,¹⁹³ as they can in a company limited by shares. Members will usually be involved in the company due to their commitment to the company's objectives, rather than for financial returns.

¹⁸⁵ See the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the Community Interest Company Regulations 2005.

¹⁸⁶ Regulator of Community Interest Companies Annual Report 2015/2016 (2016), p 18. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/538040/cic-16-3-community-interest-companies-annual-report-2015-2016.pdf.

¹⁸⁷ Companies (Audit, Investigations and Community Enterprise) Act 2004, s 35.

¹⁸⁸ Community Interest Company Regulations 2005, s 22(1). See Office of the Regulator of Community Interest Companies, *Chapter 6: The Asset Lock* (May 2016), p 7. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524154/14-1089-community-interest-companies-chapter-6-the-asset-lock.pdf.

¹⁸⁹ Companies Act 2006, ss 3 and 5.

¹⁹⁰ *Salomon v A Salomon & Co Ltd* [1896] UKHL 1; *Adams v Cape Industries plc* [1990], Ch 433.

¹⁹¹ Companies Act 2006, ss 3(2) and 3(3).

¹⁹² Companies Act 2006, ss 3 and 5.

¹⁹³ Companies Act 2006, s 37.

7.22 Companies limited by guarantee must register and file annual reports and returns with Companies House.¹⁹⁴ If the company is also a charity, it must also file annual reports and returns with the Charity Commission.¹⁹⁵

Registered societies (co-operative society or community benefit society)

7.23 Co-operative societies and community benefit societies (collectively known as “registered societies”) are membership organisations whose members hold shares in the society. Registered societies have separate legal personality from their members.¹⁹⁶

7.24 A community benefit society must carry on an industry, business or trade that is conducted for the benefit of the community.¹⁹⁷ A co-operative society is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.¹⁹⁸

7.25 The following are examples of social enterprises which could take the form of a registered society:

- (1) housing associations and social housing providers;
- (2) community energy societies. For example, groups for collective purchasing of heating oil, purchasing and installing of solar panels and collective switching of electricity or gas suppliers; and
- (3) community stores, cafes and pubs.

INVESTMENT IN SOCIAL ENTERPRISES

7.26 In response to our call for evidence, consultees identified investment in charities and social enterprises as a form of social investment. However, some stakeholders we have spoken to in the course of this project have pointed out that social enterprises may not be a natural fit for those seeking to invest for financial returns. This is, in part, because the legal forms of social enterprises are subject to restrictions in relation to their use of assets. These can affect their ability to provide returns to investors.

7.27 Also, most social enterprises are small. For example, the estimated average turnover of a community interest company is less than £50,000.¹⁹⁹ Out of over 166,000

¹⁹⁴ Companies Act 2006, ch 4.

¹⁹⁵ Charities Act 2011, ch 4.

¹⁹⁶ Co-operative and Community Benefit Societies Act 2014, s 3(3).

¹⁹⁷ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 31. Available at <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>.

¹⁹⁸ This is a definition used by the Financial Conduct Authority in their role as the registering authority for registered societies. See Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 27. Available at <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>.

¹⁹⁹ NCVO, *Analysis of financial data on charities and social companies* (April 2016). Available at https://www.ncvo.org.uk/images/documents/policy_and_research/funding/investment-within-the-social-sector-2016-data-analysis-final.pdf.

charities registered with the Charity Commission for England and Wales at 31 December 2016, only 11,000 had an income of more than £500,000.²⁰⁰ Many social enterprises will therefore not provide the scale of returns to investors necessary to make them attractive to pension schemes.

- 7.28 In this chapter we consider investment in social enterprises generally, whether by pension schemes or other investors.
- 7.29 Depending on the legal form of the social enterprise, an investor may be able to get a financial return from a social enterprise in the following ways:
- (1) where the social enterprise can issue shares, by purchasing shares, and receiving dividends or interest on share capital, or selling the shares for a profit; or
 - (2) by providing debt financing to the social enterprise and receiving interest. This could be achieved by acting as lender on a secured or unsecured basis.
- 7.30 Different legal rules apply to different legal forms of social enterprises. Below we consider the relevance of different characteristics in relation to an enterprise's ability to attract and provide returns to investors. Appendix 3 sets out a quick reference table of the different characteristics for each legal form mentioned in this chapter.

Incorporation and separate legal personality

- 7.31 Most of the legal forms social enterprises can take are incorporated and provide a legal personality which is separate from its members.²⁰¹ This allows the social enterprise to enter into contracts and borrow money in its own name.
- 7.32 As explained above, unincorporated associations and trusts do not have separate legal personality from their members or trustees. As a result, such forms cannot enter into contracts or borrow money in their own name. Individual members or trustees would have to enter into contracts and borrow money in their personal capacity. This would result in them being personally liable for any obligations and debts under those contracts. While investors would be able to lend to individuals in this way, they may be less willing to lend large amounts. Equally, the individuals involved may not want to take on personal liability on behalf of the social enterprise.
- 7.33 Although the lack of separate legal personality could make it harder for a social enterprise to attract investment, there can be benefits to using these forms. The unincorporated association form is useful for small community groups which have no need to attract investment because it is the easiest, quickest and cheapest way for a group to establish itself. Trusts are also a unique legal form which are used in various situations, not just in the context of social enterprises. If a social enterprise wants to have separate legal personality, it has the option to incorporate using a different legal form.

²⁰⁰ Charity Commission, Recent charity register statistics (31 December 2016). Available at <https://www.gov.uk/government/publications/charity-register-statistics/recent-charity-register-statistics-charity-commission>.

²⁰¹ By way of comparison, companies limited by shares are incorporated and have separate legal personality from their members

Ability to pay interest on debt financing and grant security

- 7.34 Social enterprises with separate legal personality can enter into unsecured loans depending on their rules. They can also pay interest on these.
- 7.35 In particular, CICs, like other limited companies, may enter into loans which require them to pay a rate of interest which is linked to the performance of the company. This is known as “performance related interest”. For CICs, such interest payments are subject to a cap of 20%.²⁰²
- 7.36 Commercial lenders will generally wish to obtain security for their loan and may require it to be secured against the social enterprise’s assets. This will ensure that on insolvency of the social enterprise, the lender will be paid in preference to general creditors. Where a social enterprise is restricted in its ability to provide security it may be limited in the amount of finance it can raise via a loan. This in turn affects its ability to provide returns to investors as interest on debt finance. We therefore consider below how far social enterprises can grant fixed and floating charges.
- 7.37 Members of unincorporated associations can grant security over their own assets as security for a loan taken out in their own name. However, as discussed above, they may be reluctant to do so given that they will be personally liable for loan repayments. In trust arrangements, trustees can grant security over the trust assets they hold on behalf of beneficiaries; however, they are still personally liable for loan repayments and therefore may be similarly reluctant to take on this personal liability.
- 7.38 CICs, companies limited by guarantee, registered societies and companies limited by shares all have the ability to give fixed or floating charges over their assets.
- 7.39 Charges granted by companies, including CICs, must be registered with Companies House and can be inspected online. Fixed and floating charges on assets of registered societies can be registered with the Financial Conduct Authority (FCA) and inspected online by searching the FCA Mutual Societies Register. Security granted over land by individuals or social enterprises will be registered at HM Land Registry.
- 7.40 The position of CIOs is more problematic. A CIO can, in theory, give fixed and floating charges. However, in practice this is difficult as, unlike Companies House and the FCA, the Charity Commission does not keep a register of charges. As we discuss below, it has been argued that lenders are not prepared to provide secured finance to CIOs because they cannot easily access information about existing charges. As a result, lenders may be wary of CIOs, given their relative unfamiliarity and the limited transparency of existing charges compared with other legal forms.

Ability to provide returns to shareholders

- 7.41 Unincorporated associations, trusts, CIOs and companies limited by guarantee do not issue shares. They therefore cannot provide returns to shareholders.

²⁰² Community Interest Company Regulations 2005, reg 22(1).

7.42 Registered societies and CICs can issue shares. However, they are subject to statutory restrictions on their ability to provide returns to shareholders. We consider these in turn below and contrast this with companies limited by shares.

Registered societies

7.43 Members of registered societies hold shares in those societies, but there are restrictions on any dividends they may pay to members. A community benefit society is prohibited from using its profits to pay dividends to shareholders.

7.44 Co-operative societies can use their profits to pay dividends to shareholders. However, the purpose of a co-operative society is not to make profits for the payment of interest, dividends or bonuses on money invested or lent to it.²⁰³ Guidance issued by the FCA, which is the registering authority for registered societies, explains that the benefit gained by members of co-operative societies comes from their participation in the business, rather than from financial returns.²⁰⁴ Any dividend paid to a shareholder should be in proportion to their participation in the co-operative, not based on the funds invested in shares.²⁰⁵

7.45 The ability of members of registered societies to sell their shares is limited. Guidance issued by the FCA explains that “a market in society shares allowing capital gains for members is normally inconsistent with registration as a society”.²⁰⁶

CICs

7.46 A CIC is subject to an asset lock. The asset lock is designed to ensure that the majority of assets and their proceeds are retained and applied exclusively for the benefit of the community.

7.47 A CIC limited by shares can issue shares and pay dividends to shareholders. It is also possible for a CIC to have an initial public offering (IPO) and become a public limited company, listed on a recognised stock exchange. This would increase the ability of investors to find buyers for their shares.

7.48 However, the payment of a dividend is subject to a dividend cap unless it is paid to another asset-locked body.²⁰⁷ With effect from 1 October 2014, a minimum of 65% of profits must be reinvested back into the company or used for the purpose it was set up

²⁰³ Co-operative and Community Benefit Societies Act 2014, ss 2(2) and 2(3).

²⁰⁴ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015). Available at <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>.

²⁰⁵ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 27. Available at <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>.

²⁰⁶ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 35. Available at <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>.

²⁰⁷ Community Interest Company Regulations 2005, reg 22(1).

to serve. This means that dividends are capped at a maximum of 35% of profits.²⁰⁸ An asset-locked body is another CIC, a charity or a community benefit society subject to a statutory asset lock; or a body established outside the UK that is equivalent to any of those.²⁰⁹

- 7.49 A CIC may be able to issue redeemable shares and therefore purchase its own shares. However, this too is subject to the asset lock and payments must be set at or below the paid up value of the shares, with no uplift for shareholders.²¹⁰
- 7.50 A CIC may distribute assets by reducing its share capital, but only by reducing that part of the value of shares which is not paid up, or by paying to members no more than the paid up value of their shares.²¹¹
- 7.51 Where assets remain after satisfaction of a CIC's liabilities on winding up, distribution to members is limited to the paid-up value of their shares.²¹²

Companies limited by shares

- 7.52 The Companies Act 2006 governs the ability of companies limited by shares to pay dividends to shareholders; they are not subject to any statutory requirement to have asset lock restrictions on to their ability to provide returns to shareholders.
- 7.53 It is possible for a company limited by shares to have an initial public offering (IPO) and become a public limited company, listed on a recognised stock exchange. This would increase the ability of investors to find buyers for their shares.
- 7.54 For businesses which want the flexibility to provide the maximum possible returns to shareholders, the company limited by shares form is likely to be the most appropriate.

POSSIBLE BARRIERS TO INVESTMENT IN SOCIAL ENTERPRISES

- 7.55 Above we identify a number of characteristics which may restrict the ability of a social enterprise to raise finance from investors. We do not propose that all restrictions should be lifted as different legal forms serve different and useful purposes.
- 7.56 We suggest options for reform below where we have identified possible unnecessary barriers to investment in social enterprises.

²⁰⁸ Community Interest Company Regulations 2005, s 22(1). See Office of the Regulator of Community Interest Companies, *Chapter 6: The Asset Lock* (May 2016), p 7. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524154/14-1089-community-interest-companies-chapter-6-the-asset-lock.pdf.

²⁰⁹ Community Interest Company Regulations 2005, reg 2.

²¹⁰ Community Interest Company Regulations 2005, reg 24.

²¹¹ Community Interest Company Regulations 2005, reg 25.

²¹² Community Interest Company Regulations 2005, reg 23.

Lack of a charges register for charitable incorporated organisations

Responses to Lord Hodgson's call for evidence on CIOs

- 7.57 In 2011, the government appointed Lord Hodgson to conduct a review of the Charities Act 2006. Respondents to Lord Hodgson's call for evidence were asked whether the lack of a register of charges discouraged them from using the CIO as the form for a new charity.
- 7.58 Several law firms, including Anthony Collins Solicitors LLP, Bates Wells & Braithwaite and Farrer & Co LLP responded to the call for evidence. They expressed concern that larger charities with significant assets could be deterred from adopting the CIO form if they were not able to access bank finance. Bates Wells & Braithwaite were of the view that CIOs are less likely to be able to access secured loan finance owing to the lack of a register of charges.
- 7.59 Most respondents agreed that small to medium sized new charities will not be deterred from using the CIO form, despite the lack of a register of charges. Respondents commented that such small and medium sized charities are unlikely to wish to enter into secured borrowing arrangements, other than land mortgages which will be registered at HM Land Registry.
- 7.60 The Baptist Union of Great Britain were concerned that the CIO would not be a suitable form for Baptist Churches. In particular, they had hoped that CIOs would be a suitable vehicle for local Baptist Churches to borrow money. They saw the lack of a register as a significant problem if banks and lenders are unwilling to lend to CIOs as a result.
- 7.61 Several accountancy firms mentioned that information on charges was available in the annual accounts of the CIO which are filed with the Charity Commission and are publicly available. However, it is not clear whether banks and lenders are or should be satisfied with annual accounts as evidence of security over assets of a CIO in the place of a register of charges.
- 7.62 Following consultation, Lord Hodgson concluded that it was not necessary for there to be a register of charges and said that there were no plans to provide a web-based searchable register of charges over the property of CIOs.²¹³ He acknowledged that the lack of a register meant that CIOs may not be an attractive legal form for charities that seek to raise funds through secured loans, but pointed out that larger charities could become charitable companies (such as companies limited by guarantee).²¹⁴

Option for reform

- 7.63 The CIO legal form provides an easily accessible structure, but the lack of a register of fixed and floating charges may restrict the ability of CIOs to take on secured loans. As

²¹³ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012), p 120. Available at <https://www.gov.uk/government/consultations/charities-act-2006-review>.

²¹⁴ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012), p 120. Available at <https://www.gov.uk/government/consultations/charities-act-2006-review>.

pointed out in Lord Hodgson's review of the Charities Act 2006, the lack of a register of charges means that the CIO may not be an attractive legal form for larger charities.

- 7.64 The Law Commission's recent report on Bills of Sale considered the ability of unincorporated businesses to grant mortgages on goods. While the focus of the report was on security granted by unincorporated businesses, the report did comment on problems in registering security interests more generally:

Registration of security interests in England and Wales is highly fragmented. Incorporated borrowers use Companies House; individuals and other unincorporated borrowers must use the High Court; and there are further specialist registries for, among other things, aircraft, ships and agricultural charges. The introduction of an electronic register of security interests could, depending on its scope, have the benefit of consolidating all these registries into one single registry that could be searched online.²¹⁵

- 7.65 The report identified several areas where the lack of an accessible register caused problems – for example, problems in the registration of general assignments of book debts granted by unincorporated businesses, and the lack of an electronic register of charges granted by unincorporated associations on works of art or some small ships.
- 7.66 It can be argued that none of these issues in isolation justifies the creation of a new register. However, collectively, there may be a case for a new register of security interests, possibly run by Companies House, for charges granted by CIOs which cannot be registered in the current company register. Registers of this type appear to work successfully in many common law jurisdictions, including Canada, Australia and New Zealand.

Option for reform 1.

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

Community interest company dividend cap

- 7.68 The CIC dividend cap²¹⁶ has been identified as a potential issue for certain investors. This raises the issue of whether the 35% limit on distributable profits should be increased. By way of comparison, a common legal form for social enterprise in France, called the société coopérative d'intérêt collectif (SCIC), is also subject to an

²¹⁵ Bills of Sale (Law Com No 369) 2016, para 6.52. Available at: http://www.lawcom.gov.uk/wp-content/uploads/2016/09/lc369_bills_of_sale.pdf.

²¹⁶ See para 7.48.

asset lock.²¹⁷ However, a SCIC can distribute up to 42.5% of its profits and must only re-invest 57.5% back into the enterprise.²¹⁸

7.69 Bates Wells & Braithwaite argue that the CIC dividend cap is more restrictive than it needs to be and that it should be set at 40% of distributable profits.²¹⁹ Big Society Capital argue that the CIC dividend cap should be 49%.²²⁰

7.70 Dividend caps have been the subject of two separate consultations by the Regulator of Community Interest Companies (the CIC Regulator), one in 2009 and one in 2013. In 2013 the CIC regulator received responses from a wide range of stakeholders, the majority of whom agreed that there should be a dividend cap in place to prevent dilution of the social purpose of CICs. The CIC regulator was of the opinion that the 35% dividend cap was set at the correct level to ensure a balance between encouraging investment and maintaining the integrity of the asset lock.²²¹ The CIC regulator did propose the removal of the dividend per share cap which existed at the time and this was removed on 1 October 2014.²²²

7.71 From responses to our call for evidence we note that there remains disagreement in the industry over the correct level of the cap. This is an issue which would benefit from further investigation and consultation now that the revised dividend cap arrangements introduced in 2014 have been in place for several years.

Option for reform 2.

7.72 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, consider whether it should be raised.

Differences between regulation of CICs and registered societies

7.73 The different forms of social enterprise are subject to different regulatory regimes and degrees of regulatory oversight. The difference is clearest between CICs and

²¹⁷ European Commission, *Social Enterprises and their Eco-systems: A European mapping report: Updated country report: France* (2016), pp 18 and 20.

²¹⁸ Loi n° 47-1775 du 10 septembre 1947 portant statut de la coopération, Articles 16 and 19; for further information see http://www.les-scic.coop/sites/fr/les-scic/FAQ/Resultats_et_reserves_impartageables.

²¹⁹ Bates Wells & Braithwaite, *Ten Reforms to Grow the Social Investment Market* (July 2012), p 20 to 21.

²²⁰ Big Society Capital, *Response to Social Investment Tax Relief Consultation* (2013) p 18. Available at: <https://www.bigsocietycapital.com/sites/default/files/pdf/BSC%20Response%20to%20SITR%20Consultation.pdf>.

²²¹ Department for Business, Innovation & Skills, *Changes to the dividend and interest caps for community interest companies: Response to the CIC consultation on the dividend and interest caps* (December 2013), paras 4.32 to 4.47. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264664/CIC-13-1333-community-interest-companies-response-on-the-cic-consultation.pdf.

²²² Department for Business, Innovation & Skills, *Changes to the dividend and interest caps for community interest companies: Response to the CIC consultation on the dividend and interest caps* (December 2013), para 4.45; Community Interest Company (Amendment) Regulations 2014 SI 2014 No. 2483.

registered societies (co-operative and community benefit societies). We consider these differences below and suggest an option for reform to bring the regulation of these forms together in a single regulator.

7.74 Although registered societies and CICs appear similar at first sight, they are subject to different regulatory oversight. A CIC is regulated by the CIC regulator, while the FCA is the registering authority for registered societies. The CIC regulator offers a “light touch” regime, while the FCA is more interventionist. We briefly set out these differences below.

CICs: the CIC regulator

7.75 The office of the CIC regulator is small, employing a team of six who work for a part-time regulator.²²³ They share an office and other facilities with Companies House.

7.76 The CIC regulator has powers of investigation and audit which it can use to obtain necessary evidence to decide whether enforcement powers should be used.²²⁴ It has wide ranging enforcement powers, including the power to appoint or remove directors, appoint a manager and order the transfer of shares in a CIC. It can also present a petition to the court for the winding up of a CIC where it believes that this is in the public interest.²²⁵ However, these enforcement powers are to be used only to the extent necessary to maintain confidence in CICs.²²⁶

7.77 In its annual report, the CIC regulator explicitly states that it adopts a “light touch” approach and uses its “powers of enforcement sparingly”.²²⁷ The regulator’s main concern is to ensure that a CIC continues to serve the community it was set up to benefit and that it is not operating in breach of the asset lock.²²⁸

7.78 The CIC regulator is responsible for investigating complaints. In 2015-2016, it received 53 complaints. The annual report states that “the majority [of these complaints] were resolved at the first point of contact.”²²⁹

Registered societies: the FCA

7.79 The FCA is the registering authority for registered societies. The FCA determines whether a society is complying with the Co-operative and Community Benefit Societies Act 2014. It does not regulate the business, financial stability or conduct of

²²³ The team comprises 3 executive officers, 1 administrative officer, 1 team manager, 1 deputy regulator and 1 part time regulator.

²²⁴ Companies (Audit, Investigations and Community Enterprise) Act 2004, ss 42 and 43 and sch 7.

²²⁵ Companies (Audit, Investigations and Community Enterprise) Act 2004, ss 44 to 52.

²²⁶ Companies (Audit, Investigations and Community Enterprise) Act 2004, s 41(1).

²²⁷ Regulator of Community Interest Companies Annual Report 2015-2016, p 16. Available at: <https://www.gov.uk/government/publications/cic-regulator-annual-report-2015-to-2016>.

²²⁸ Department for Business, Energy and Industrial Strategy, *Office of the Regulator of Community Interest Companies: Information and guidance notes* (May 2016), para 11.1.4. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605423/13-714-community-interest-companies-guidance-chapter-11-the-regulator.pdf.

²²⁹ Regulator of Community Interest Companies Annual Report 2015-2016, p 16. Available at: <https://www.gov.uk/government/publications/cic-regulator-annual-report-2015-to-2016>.

societies beyond this remit. Once registered, these societies are included in the FCA's Mutuals Public Register. At present, there are around 8,220 societies in the UK registered under the Co-operative and Community Benefit Societies Act 2014.²³⁰ This includes both co-operative societies and community benefit societies.

- 7.80 The FCA is more interventionist in its role than the CIC regulator. It has extensive powers. It may cancel or suspend a society's registration on several grounds.²³¹ It has the power to require societies to provide information or documents and may appoint an inspector to investigate the affairs of a society in certain circumstances.²³² These powers are backed up with the sanction of prosecution. For example, failure to submit a return by the due date is a criminal offence punishable by a fine of up to £1,000 per offence.²³³
- 7.81 The FCA makes use of these powers.²³⁴ The FCA maintains a list of prosecutions and cancellations, of which there are several each year. In 2015, the FCA cancelled the registration of seven registered societies for failure to submit annual returns/accounts on time and brought six prosecutions under the Co-operative and Community Benefit Societies Act 2014.²³⁵
- 7.82 In discussions, some consultees pointed out that being the registering authority for societies is not necessarily a close fit with the FCA's other duties.

The case for a single regulator

- 7.83 Given the similarities between CICs and registered societies, it has been suggested by several consultees that the registration and regulation of these legal forms should be brought together, concentrating policy, registration and legislative functions for social enterprises in a single regulator.
- 7.84 Bridges Impact+ have stated that "the current regulatory regime is not set up to effectively deal with social business", and recommended that a:

²³⁰ FCA Mutual Societies Register. Available at: <https://mutuals.fsa.gov.uk/Search.aspx>.

²³¹ These include: failure to meet the co-operative or community benefit society conditions; wilful breach of any other provision of the legislation; existing for an illegal purpose or ceasing to exist; membership falling below the minimum number; obtaining registration by fraud or mistake; request by the society to have its registration cancelled. See Co-operative and Community Benefit Societies Act 2014, s 5.

²³² Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 72. Available at https://www.uk.coop/sites/default/files/uploads/guidance_on_the_fcas_registration_under_the_ccbsa.pdf.

²³³ Financial Conduct Authority, *Guidance, Annual Returns and Accounts* (Sept 2016). Available at: <https://www.fca.org.uk/firms/annual-returns-accounts-mutual-societies>.

²³⁴ Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 74.

²³⁵ See list of cancellations and prosecutions available at <https://www.fca.org.uk/firms/annual-returns-accounts-mutual-societies/prosecutions-cancellations>.

new independent authority should be established within the Department [for] Business, Innovation and Skills (BIS – BEIS²³⁶ today) to coordinate, register, monitor and champion the non-charity forms of social business.²³⁷

7.85 In response to our call for evidence, both Bates Wells & Braithwaite and Big Society Capital argued in favour of combining the CIC regulator and relevant regulatory functions of the FCA into a new Social Economy Commission.

7.86 Bates Wells & Braithwaite argue that the lack of coordination between regulatory bodies leads to piecemeal policymaking in the social enterprise sector which fails to take account of the diversity and complexity of the social economy.²³⁸

7.87 In response to our call for evidence, Big Society Capital commented that:

The Social Economy Commission should be the registrar and regulator of community interest companies, co-operatives and community benefit societies. In time, the Social Economy Commission could also be given responsibility for the registration and regulation of Social Investment Vehicles and of Social Purpose Businesses or other social purpose organisations, if introduced. It would be a repository of deep and wide regulatory and policy knowledge with respect to the social economy as a whole.

7.88 Oversight by a single regulator could ensure a level playing field in relation to regulation, promote effective enforcement and minimise regulatory arbitrage, in which organisations choose their legal form on the basis of the most favourable regulatory regime in order to benefit from the least interventionist oversight. It would also allow for more integrated policymaking in this space.

Option for reform 3.

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

Financial promotion rules²³⁹

7.90 Consultees also drew our attention to inconsistencies in the way that the financial promotion rules apply to registered societies compared with CICs.

²³⁶ Department for Business, Energy and Industrial Strategy.

²³⁷ The Social Business Frontier, A report that investigates how to recognise and protect the social impact that business delivers in the UK (September 2014), p 19. Available at http://www.bigsocietycapital.com/sites/default/files/pdf/Social%20business%20frontier_final.pdf.

²³⁸ Bates Wells & Braithwaite, *Ten Reforms to Grow the Social Investment Market* (July 2012), pp 25 to 26.

²³⁹ Any reference to the financial promotion rules is a reference to the restriction in s 21 of the Financial Services and Markets Act 2000. A financial promotion is any communication that invites or induces someone to invest in a particular investment. There is a requirement that those promotions are “approved” by an FCA authorised person.

- 7.91 Registered societies can offer non-transferable shares or bonds to the public without the need for the financial promotion to be approved by an FCA authorised person.²⁴⁰ By contrast, CICs who wish to do the same are not able to and are subject to the financial promotion rules.
- 7.92 Furthermore, the financial promotion rules provide exemptions for certain types of investor (ie high net worth, sophisticated and investment professionals) but do not exempt social investors. Bates Wells & Braithwaite argue that the financial promotion rules can therefore make it difficult for charities and CICs to raise money from retail investors.²⁴¹
- 7.93 We note that the FCA considered these issues in their recent investigation into regulatory barriers to social investments. Following a call for evidence, the FCA published their findings in October 2016.²⁴²
- 7.94 The FCA were not persuaded that the current approach disproportionately impacted social enterprises or that the financial promotion rules constituted a barrier to social investment. They noted that, like any other investment, social investments carry risks, and that since the market for investments in social enterprises is still growing there is additional difficulty in valuing the investments. They concluded:

In these circumstances we do not believe that a relaxation of our financial promotion and suitability rules for social investment would be consistent with our consumer protection objectives.

CONCLUSION

- 7.95 In response to our call for evidence, consultees identified investment in charities and social enterprises as a form of social investment. However, such investment may not be a natural fit for pension schemes because it may not be able to provide sufficient scale or returns.
- 7.96 The wide range of possible legal forms of social enterprises provides choice and flexibility for organisations to choose the form most appropriate for them. The legal forms restrict the enterprise's activities and use of profits, which can affect their ability to provide returns to investors. We do not suggest that all restrictions should be lifted as the different legal forms serve different and useful purposes. However, we suggest options for reform where we have identified unnecessary barriers to investment in social enterprises by pension schemes.

²⁴⁰ Only registered societies can issue what are known as “withdrawable” shares. These may be “transferable” or “non-transferable”. Where they are non-transferable, the financial promotion rules do not apply. Withdrawable shares which are non-transferable are not ‘controlled investments’ or ‘specified investments’ under s 21 of the Financial Services and Markets Act 2000. Where the shares of a registered society become “transferable”, the financial promotion rules apply (Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, art 76(2)(b)). The position is the same in relation to bonds: The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, s 35(b).

²⁴¹ Bates Wells & Braithwaite, *Ten Reforms to Grow the Social Investment Market* (July 2012).

²⁴² Financial Conduct Authority, *Feedback Statement FS16/11: Call for Input Regulatory Barriers to Social Investment* (October 2016). Available at <https://www.fca.org.uk/publication/feedback/fs16-11.pdf>.

Chapter 8: Investment in property and infrastructure

- 8.1 In Chapter 2 we explained that we had identified infrastructure as an investment with the potential to provide financial returns as well as social impact. It encompasses a wide range of investment opportunities with differing social impacts including environmental, job creation, educational and economic social benefits. Infrastructure and property are closely linked, as investment in infrastructure projects will often involve investment or holdings in property, such as social housing, care homes and hospital facilities.
- 8.2 In this chapter, our focus is on the barriers to investment in infrastructure and property by defined contribution (DC) schemes. As set out in Chapter 3, since 2013, active membership of defined benefit (DB) schemes has fallen while active membership of DC schemes has risen; we therefore do not look at the barriers to investment by DB schemes in this chapter.
- 8.3 In this chapter we look at:
- (1) the potential to make social investments by investing in property and infrastructure;
 - (2) the benefits of investing in property and infrastructure for DC schemes;
 - (3) pension fund investments in property and infrastructure in other jurisdictions;
 - (4) the financial and non-financial factors pension schemes may take into account when deciding whether to invest in property and infrastructure; and
 - (5) the potential barriers to investment in property and infrastructure by DC schemes.
- 8.4 We have not identified any legal or regulatory barriers to DC investment in property and infrastructure. The barriers we have identified are structural and behavioural. We consider these below and suggest options for reform to address them as appropriate.

SOCIAL INVESTMENT IN PROPERTY AND INFRASTRUCTURE

- 8.5 As a type of investment, it is possible to identify property and infrastructure as investments which provide a social impact, as well as a financial return. Infrastructure therefore emerged early in discussions with stakeholders as the area with the greatest potential to provide opportunities for social investment which were appropriate for pension schemes.
- 8.6 Infrastructure is often associated with sustainable or socially responsible investing (SRI).²⁴³ Overwhelmingly, when giving examples of social investment in response to our call for evidence, consultees mentioned investment in infrastructure, particularly social housing. Other infrastructure projects mentioned by stakeholders were green

²⁴³ See paras 2.15 to 2.20 above and; G Inderst, *Pension Fund Investment in Infrastructure* (2009), *OECD Working Papers on Insurance and Private Pensions*, No. 32, OECD publishing, p 4.

energy projects (including solar and wind energy), sewers and sustainable transport initiatives.

- 8.7 In 2009, an OECD²⁴⁴ study noted that the idea of investing in infrastructure often strikes a chord with pension schemes, because it feels more “tangible” and “real” than complex financial products.²⁴⁵ Also, as the investment is made for the long term, there seems to be a natural fit with the long-term liabilities of many pension schemes. Furthermore:

For some people there is also a connotation to sustainable or socially responsible investing, which is an increasingly popular route chosen in particular by public and industry-wide pension plans.²⁴⁶

- 8.8 The paper noted that infrastructure could include many different sectors. On the economic side, it includes transport (such as toll roads, airports or railways), utilities (such as energy, water or sewerage) and communications (such as cable networks). On the social side, it might include schools, hospitals and prisons.

BENEFITS OF INVESTING IN INFRASTRUCTURE: FINANCIAL RETURNS AND SOCIAL IMPACT

- 8.9 Traditionally, in the UK, commercial property was an important asset class for DB schemes. The Pensions Institute comment that, in the 1980s, UK DB schemes held about 16% of assets directly in property and about another 8% in real estate funds.²⁴⁷ However, this has now reduced to around 6% to 7%, as DB schemes transfer their liabilities to insurance companies.
- 8.10 The Pensions Institute has highlighted the advantages of investing in property. Over the long term (from 1951 to 2012), property has provided returns which are less than equities but more than bonds. It can produce a stable income stream, and shows a low correlation with other assets, particularly fixed income.²⁴⁸ As the DC Investment Forum put it:

By holding asset classes that are less correlated to market returns investors can generate the same return as a portfolio of just stocks and bonds through a diversified portfolio with less risk.²⁴⁹

²⁴⁴ OECD stands for Organisation of Economic Co-operation and Development. It is an organisation which “promote[s] policies that will improve the economic and social well-being of people around the world” and its membership is made up of 35 countries. For further information see: <http://www.oecd.org/about/>.

²⁴⁵ G Inderst, “Pension Fund Investment in Infrastructure” (2009), *OECD Working Papers on Insurance and Private Pensions*, No. 32, OECD publishing, p 4.

²⁴⁶ G Inderst, “Pension Fund Investment in Infrastructure” (2009), *OECD Working Papers on Insurance and Private Pensions*, No. 32, OECD publishing, p 4.

²⁴⁷ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 39. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

²⁴⁸ Fixed income means income generated from debt instruments, such as bonds: Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 39.

²⁴⁹ DC Investment Forum, *Mind the Gap: The case for a relaxation of daily dealing requirements for DC Pension funds* (2013), p 5.

8.11 In 2009, when the National Employment Savings Trust (NEST) was being established, the Personal Accounts Delivery Authority (PADA) consulted widely on how DC funds should be invested. Nearly all respondents supported the use of alternative asset classes within the default funds.²⁵⁰ These asset classes included not only private equity and commodities but also infrastructure funds and property. The main reason was that these assets are not correlated with the performance of equities and bonds, so provide better risk-adjusted returns.²⁵¹ As the Pensions Management Institute put it:

Alternative asset classes do offer both greater investment performance and increased diversification. The scale of personal accounts mean that these could be added to the default fund. Provided that they are only used in moderation, then the approximate pricing and illiquidity²⁵² of these assets will not prove a problem.²⁵³

8.12 One study looked at the investment returns of 884 pension funds in North America, Europe, Australia and New Zealand from 1990 to 2009. It found that “larger pension funds are more likely to invest in real estate internally, have lower costs and higher net returns”. Smaller schemes tended to invest in funds, where “the additional investment layers significantly increase their costs and disproportionately reduce returns”.²⁵⁴

Opportunities for social impact

8.13 Infrastructure and property investments have the potential to address a number of different areas of social impact, for example: environmental impact, job creation and access to transport and housing.

8.14 There is also the potential for an investment to have more than one social impact. For example, a social housing construction programme will provide access to housing as well as job creation.

8.15 This makes infrastructure and property a good source of social investment opportunities for pension schemes which are seeking to make investments based on non-financial factors but which still generate market returns.

²⁵⁰ Personal Accounts Delivery Authority (PADA), *Building Personal Accounts: designing an investment approach – Key findings of the public consultation* (November 2009), p 63. Available at <https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/investment-consultation-response.PDF.pdf>.

²⁵¹ Risk-adjusted returns are returns adjusted to take account of risk exposure.

²⁵² Illiquidity refers to an inability to convert assets or investments into cash easily and quickly in order to meet short-term obligations.

²⁵³ The Pensions Management Institute’s response to Personal Accounts Delivery Authority (PADA) Consultation, *Building personal accounts: Designing an investment approach* (2009), para 4.2. Available at <https://www.pensions-pmi.org.uk/documents/building-personal-accounts-designing-an-investment-approach/pada-240709.pdf>.

²⁵⁴ A Andonov, P Eichholtz and N Kok, “Value Added from Money Managers in Private Markets? An examination of Pension Fund Investment in Real Estate” (2012) *Maastricht University*, cited in Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 47.

COMPARISONS WITH OTHER JURISDICTIONS

- 8.16 As discussed in Chapter 3, based on data we have been given by Spence Johnson, less than 5% of UK DC pension investment is in property and asset classes other than equities, bonds and cash.²⁵⁵ This is low compared to the rest of the world.
- 8.17 Willis Towers Watson's Global Pension Assets Study 2017 shows that the use of alternatives to equities and bonds is growing, and at the end of 2016 stands at 24% globally.²⁵⁶ In Canada it is 20% and in the US it is 27%. The comparison with Australia is particularly pertinent, as the great majority of Australian pension assets are in DC funds (87%). Despite this, 21% of all Australian pension fund assets are in alternative asset classes.²⁵⁷ This includes property and infrastructure, as well as commodities and private equity.
- 8.18 Several consultees commented that Canadian, US, Australian and Dutch pension schemes are much more likely to invest in infrastructure than UK DC schemes. Bates Wells & Braithwaite contrasted the UK experience with infrastructure investment by:
- the Ontario Teachers' Pension Plan (which has, for example, invested directly in Birmingham and Bristol airports and HS1 in the UK) and CalPERS (the biggest US public pension fund which, for example, aims to invest 1% of its assets or approximately \$3bn in infrastructure and has recently invested in toll roads in the US).

Lessons from Australia

- 8.19 Most examples of infrastructure investment come from DB schemes. Australia is interesting because it shows that DC schemes can and do invest in infrastructure.²⁵⁸
- 8.20 Australian pension funds have pioneered infrastructure investment since the early 1990s. Columbia Threadneedle Investments told us:
- According to Industry Super Australia, industry super funds have around £12 billion directly invested in Australian airports, railway stations, electricity generators, gas pipelines, water treatment plants, roads, shopping centres, schools, aged care facilities, hospitals and courts.
- 8.21 A further OECD study finds that Australian pension funds have a high asset allocation to infrastructure. The study stressed "the importance of the size of the pension schemes for investment in illiquid assets".²⁵⁹ Large funds have an average allocation

²⁵⁵ Spence Johnson, *Market Intelligence 2016: UK Defined Contribution, Looking beyond the passive approach* (2016), p 90.

²⁵⁶ Willis Towers Watson, *Global Pensions Asset Study 2017*, p 5. Available at <https://www.willistowerswatson.com/en-PH/insights/2017/01/global-pensions-asset-study-2017>.

²⁵⁷ Willis Towers Watson, *Global Pensions Asset Study 2017*, p 7.

²⁵⁸ Willis Towers Watson, *Global Pensions Asset Study 2017*, p 5.

²⁵⁹ G Inderst and R Della Croce, "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada" (2013), *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 32, OECD Publishing, p 4. Illiquid: assets or investments which are not easy to sell or exchange for cash quickly without incurring a loss.

of roughly 8% to infrastructure in their default options.²⁶⁰ However, there is “little to no infrastructure investment activity by smaller funds”.²⁶¹

- 8.22 Before 2007, much of the investment in Australia was carried out through listed companies.²⁶²
- 8.23 More recently, Australian pension schemes have used open-ended unlisted funds²⁶³ at comparatively low cost.²⁶⁴ Although data is scarce, initial indications suggest that these unlisted funds have done well, with relatively “high risk-adjusted returns”²⁶⁵ and strong resilience in the recent market downturn.²⁶⁶
- 8.24 Although some pension schemes had taken on construction projects, most had “a preference for brownfield assets,²⁶⁷ seeking stable, often inflation-linked income streams, at moderate risk”.²⁶⁸ Infrastructure therefore has links with property. The study notes that the asset classes of unlisted property²⁶⁹ and infrastructure “tend to move together”.²⁷⁰
- 8.25 Finally, the study comments that there is increasing interest in “asset recycling”, whereby the public sector sells existing infrastructure assets to the private sector, and then uses the additional funds generated by the sale for new infrastructure. It suggests that this idea deserves attention in other countries.

²⁶⁰ Above, p 16.

²⁶¹ Above, p 4.

²⁶² Above, p 10.

²⁶³ A fund where investors can buy units in the fund and sell them back to the fund on demand at their net asset value. This is a price based on the value of the fund’s underlying assets which is calculated at the end of each trading day.

²⁶⁴ Above, p 40.

²⁶⁵ A high risk-adjusted return is a high return with comparatively low levels of risk.

²⁶⁶ G Inderst and R Della Croce, "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada" (2013), *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 32, OECD Publishing, p 10.

²⁶⁷ “Brownfield assets” are existing infrastructure or property in contrast to “greenfield assets” which are yet to be constructed.

²⁶⁸ G Inderst and R Della Croce, "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada" (2013), *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 32, OECD Publishing, p 39.

²⁶⁹ Unlisted property means property which is held by a company or a fund which is not listed on a stock exchange. This is distinct from property which is held by a real estate company listed on a stock exchange.

²⁷⁰ G Inderst and R Della Croce, "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada" (2013), *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 32, OECD Publishing, p 20.

The UK experience

- 8.26 In the UK, pension schemes have not traditionally invested in infrastructure. In 2011, the then Chancellor, George Osborne, challenged pension funds to raise £20 billion to invest in UK infrastructure. Following talks with the Treasury, ten major DB schemes came together to form the Pensions Infrastructure Platform (PiP) run by the National Association of Pension Funds (now renamed the Pensions and Lifetime Savings Association (PLSA)). Its aim was to invest in UK infrastructure.
- 8.27 The £20 billion target has been called unrealistic.²⁷¹ Instead, by 2015, PiP had funnelled around £1 billion through three externally managed funds. Investments included public private partnership (PPP) / private finance initiative (PFI) projects, solar power and £370 million for the Thames Tideway Tunnel, to upgrade London's sewerage system.
- 8.28 In April 2016, PiP launched its own fund using its own staff and obtained FCA authorisation. The fund is a closed-ended fund, over 25 years. It aims to provide above-inflation returns for relatively low-risk investments at low charges (a maximum of 0.5%). By the end of 2016, the fund had invested £100 million in renewable energy, including a portfolio of 31 wind turbine sites.
- 8.29 PiP's Chief Executive, Mike Weston, told us that the fund was looking for a range of small, relatively low-risk projects. He said it would be particularly interested in the sort of projects mentioned as examples of social investment, including social housing, student accommodation and care homes.
- 8.30 PiP was prepared to fund construction, where the risk was low (as in building homes) or where the Government was prepared to take steps to reduce risk for investors by offering a guarantee of returns. However, it would not fund novel or risky construction projects, such as nuclear power stations.
- 8.31 PiP is not the only channel for pension investment in infrastructure. Several large DB schemes make direct investments. For example a joint initiative between two local authority schemes has provided funds for wind farms and train fleets.²⁷²
- 8.32 Government policy is to consolidate local government pension schemes, which it hopes will encourage further investment in infrastructure. The Government's National Infrastructure Delivery Plan 2016 to 2021 states:
- The government has published guidance for pooling Local Government Pension Scheme Fund assets into British Wealth Funds, containing at least £25 billion of scheme assets each. The government has now received ambitious initial proposals to establish a small number of British Wealth Funds across the country. These will deliver annual savings of at least £200 to £300 million, and the government will work

²⁷¹ Investment and Pensions Europe, *Interview with Mike Weston* (January 2016). Available at <https://www.ipe.com/analysis/interview-mike-weston-pension-infrastructure-platform/10011291.article>.

²⁷² The venture is between Greater Manchester Pension Fund and the London Pensions Fund Authority. See joint press releases of 14 March 2016 (announcing £150 million for wind farms) and 5 October 2016 (announcing £45 million for train fleets).

with authorities to establish a new local government pension scheme platform to boost infrastructure investment.²⁷³

- 8.33 We have not found any examples of infrastructure investment by UK DC schemes. Nor have any DC schemes yet invested in PiP. In discussion, Mike Weston, cited the Australian example: there is no theoretical reason to prevent DC scheme investment in PiP. However, there are practical barriers, including the lack of liquidity.²⁷⁴ Liquidity can be built into a fund if necessary, but it comes at a price. Any open-ended infrastructure fund (which provides a high level of liquidity) is likely to exceed the 0.75% limit on administrative charges set by the charge cap applicable to default arrangements. We return to the issue of liquidity and the charge cap below.²⁷⁵

FINANCIAL AND NON-FINANCIAL FACTORS AND INVESTMENT IN PROPERTY AND INFRASTRUCTURE

- 8.34 We introduced the concept of financial and non-financial factors in Chapter 5. Below we consider financially material factors and non-financial factors which may be particularly relevant to investment in property and infrastructure.

Financially material factors

- 8.35 Pension schemes may choose to invest in certain property and infrastructure solely because of the financial returns they provide. If this is the case, then they do not have to apply the two tests described in Chapter 5. However, as described in that chapter, decision makers should take into account financially material factors when considering whether to make such an investment.
- 8.36 Discussions of infrastructure as a class can overlook “a very diverse reality”.²⁷⁶ Investment could be in such diverse projects as social housing, transport and green energy. There are huge differences in scale between, for example, a nuclear power plant or airport and a small social housing development.
- 8.37 When considering investments in infrastructure and property, pension schemes must consider whether such an investment is appropriate for their pension savers. This includes considering financially material factors which may be relevant to the long-term sustainability of an investment’s performance. Below we identify financially material factors which may apply to different infrastructure and property investments. This is not an exhaustive list which will always apply to each investment. Pension schemes should carry out their own assessment of each potential investment they are considering.

²⁷³ Infrastructure and Projects Authority, *National Infrastructure Delivery Plan 2016- 2021* (March 2016), para 1.43. See also Department for Communities and Local Government, *Local Government Pension Scheme: Investment Reform Criteria and Guidance* (November 2015).

²⁷⁴ Liquidity: ease at which assets or investments can be converted into cash to meet short-term obligations.

²⁷⁵ See paras 8.55 to 8.132 and paras 8.165 to 8.182.

²⁷⁶ G Inderst, "Pension Fund Investment in Infrastructure" (2009), *OECD Working Papers on Insurance and Private Pensions*, No. 32, OECD publishing, p 9.

- 8.38 The long-term risk profile of an infrastructure project should also be considered. The risks specific to different phases of a project may vary and the financially material factors relating to an investment may therefore change over time. For example, the risks at the initial construction phase of a property and infrastructure project may be different from those which could arise at later stages.
- 8.39 Political risks are a relevant consideration when investing in infrastructure. Inderst and Della Croce explain that:
- An essential factor in infrastructure investing, according to experts, is the stability of the Government's infrastructure, tax and other government policies and the stability of the regulatory environment, both at home and overseas.²⁷⁷
- 8.40 More bluntly, for our present purposes, any infrastructure project bears a risk that a current or future government will cancel, regulate or tax it, or in extreme circumstances, expropriate or nationalise it. In assessing such risks investors need to consider a range of factors, including the stability of the political system and the strength of the legal guarantee.
- 8.41 Investors may also need to assess the project's environmental and social impact, and the extent of any opposition to it. If there is the potential for detriment to a country's economy, the activity is likely to be regulated. For example, where certain infrastructure projects are natural resource intensive or polluting there is a risk that they may be more affected by taxes and restrictions aimed at reducing climate change. In those circumstances, it might be easier for investors to assess such risks at home rather than abroad. Other factors may also be at play. For example, a DC scheme may have more leverage against a potentially hostile government, if the government's own citizens would suffer the loss.

Non-financial factors

- 8.42 There is sometimes uncertainty about how far pension schemes may consider the social impact of infrastructure investments.
- 8.43 In response to our call for evidence, several consultees commented that pension trustees were often uncertain how to address social and environmental impacts, and that this made them shy away from the issue. As the Institute and Faculty of Actuaries put it:
- the legal provisions allowing trustees to consider longer-term and other factors are not well understood by trustees, or often by investment advisers.
- 8.44 In response to our call for evidence, Columbia Threadneedle Investments commented that, in addition to the barriers to investing in infrastructure generally:²⁷⁸
- there is a misconception that investing for a social good in some way inhibits the ability to also achieve a financial return for investors, which results in pension fund trustees shying away from investing in "socially significant" infrastructure

²⁷⁷ G Inderst and R Della Croce, "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada" (2013), *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 32, OECD Publishing, Paris, p 36.

²⁷⁸ We consider some potential barriers to investment in infrastructure from para 8.51 below.

opportunities. This is due in part to the lack of understanding and knowledge... combined with trustees' desire to carry out their fiduciary duties which require them to "act in good faith when entering into transactions and invest prudently" on behalf of scheme beneficiaries.

- 8.45 An OECD study noted that many Australian and Canadian pension funds have long-term investment and environmental, social and governance (ESG) policies, and that they use infrastructure as a core ingredient of these. On the other hand:

It is often less clear what the specific ESG investment process for infrastructure is, if any. Nor does this necessarily mean that all infrastructure investments are particularly environmentally friendly.²⁷⁹

- 8.46 Pension schemes may be motivated to invest in certain property and infrastructure projects by non-financial factors such as a desire to improve the environment or create jobs. Where pension schemes choose such investments for these reasons, they must apply the two tests explained in the 2014 Law Commission guidance, discussed further in Chapter 5.

Identifying non-financial factors relating to particular property and infrastructure investments

- 8.47 The first of the Law Commission's two tests is that, pension schemes must have good reason to think that scheme members share the non-financial concern behind the investment.

- 8.48 We have already identified that property and infrastructure investments can have a number of different social impacts. For example, environmental impacts, job creation and access to transport and housing. Where members share a concern about the environment, this could lend itself to, for example, investment in green energy projects and green public transport initiatives.

- 8.49 However, members may disagree about the social benefits of infrastructure investments. For example, in the case of investment in a new airport or power station, this may address some members' concerns relating to economic growth and job creation but may conflict with other members' views on environmental impact. As the Chancery Bar Association noted:

one member's "social" investment may not chime with another member's viewpoint; similarly, reasonable people can and do take very different views on infrastructure (e.g. HS2, Heathrow's Third Runway, nuclear vs green energy etc).

- 8.50 This could be a challenge for pension schemes. Assessing members' views is discussed in more detail in Chapter 9.

²⁷⁹ G Inderst and R Della Croce, "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada" (2013), *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 32, OECD Publishing, Paris, p 41. Available at <http://dx.doi.org/10.1787/5k43f5dv3mhf-en>.

POTENTIAL BARRIERS TO INVESTMENTS IN INFRASTRUCTURE

- 8.51 Infrastructure emerged early in this project as an area with the greatest potential to provide opportunities for social investment which were appropriate for pension schemes. However, we have observed that DC schemes are unlikely to invest in any physical assets, whether those assets are commercial property, social housing or infrastructure.
- 8.52 In our call for evidence, we asked consultees to identify the barriers to investing in infrastructure generally. We also asked whether any of the barriers to investment in infrastructure related to law and regulation.
- 8.53 We have not identified any legal or regulatory barriers to investment in infrastructure.
- 8.54 The barriers we have identified have been structural and behavioural. Below we consider the following potential barriers and some possible options for reform to address these as appropriate:
- (1) the demand for liquidity:
 - (a) the requirement for trust-based schemes to process transactions promptly;
 - (b) the permitted links rules;²⁸⁰
 - (2) scale and barriers to consolidation;
 - (3) charges and the charge cap; and
 - (4) “herding”.

THE DEMAND FOR LIQUIDITY

- 8.55 More than half of the responses we received identified a perceived need for liquidity as a barrier to investment in property and infrastructure. Consultees agreed that, in practice, many DC schemes were set up in a way that required daily pricing and daily dealing, and that this limited the range of investments open to them. The following comments sum up the problem:

The UK DC market currently has a relatively low allocation to alternative assets, to which we include infrastructure, against international peers... These do not sit well with the current practice in the UK of having daily liquidity and pricing on DC pots. [Schroder Investment Management Ltd]

For DC, the need for daily pricing and high levels of liquidity may also be making it more difficult for pension funds to invest in infrastructure. [USS]

- 8.56 Listed equities (shares) and bonds are liquid assets and led themselves to the practice of daily pricing and daily dealing. Their value can be ascertained at any time based on information from the stock exchange they are listed on and there is a market via these stock exchanges which allow them to be easily bought and sold at any time when the stock exchange is open. Property and infrastructure investments can be

²⁸⁰ Permitted links: The list of approved assets found in COBS that an insurer engaged in linked-long term insurance business may link to, in order to determine the value of benefits due, under unit-linked contracts.

structured in different ways, some of which do not lend themselves to daily pricing and daily dealing.

Ways in which pension funds can hold property

8.57 There are four main ways in which pension funds can hold property:

- (1) Direct holdings,²⁸¹ for example, where the pension fund buys an office block. Clearly this can only be done by larger funds. One consultee suggested that this might become feasible when the fund reached £40 billion.
- (2) Closed-ended funds,²⁸² set up for a pre-determined lifespan, usually with no provision for trading during that period. One example is the Cheyne Capital social property impact fund,²⁸³ which requires a capital commitment for five to seven years. It has attracted investment from some DB schemes, but no DC schemes.
- (3) Open-ended funds,²⁸⁴ which offer greater liquidity. Typically the portfolio will be valued once a month, though there may be more frequent “desktop updates” to account for acquisitions, dispositions and other portfolio events.²⁸⁵ These funds offer regular trading – some every day, others weekly, fortnightly or monthly, or with appropriate notice.²⁸⁶ However, open-ended property funds may close for trading if the demand for redemption by investors becomes too great. In July 2016, following the referendum on EU membership, several UK funds suspended dealing.²⁸⁷
- (4) Shares in listed companies which hold the investment, for example a real estate investment trust (REIT) which is a company established to hold a property portfolio.²⁸⁸ As the investor is buying shares in a company rather than property,

²⁸¹ A direct holding or investment is where the pension scheme holds the actual asset, such as shares or physical property and infrastructure. By contrast, an indirect holding or investment is where the pension scheme gains exposure to assets by investing in a collective investment vehicle, such as a closed- or open-ended fund.

²⁸² A closed-ended fund, also known as an investment trust, is a fund which raises a fixed amount of capital for a defined period. Investors can buy units in the fund but, unlike in open-ended funds, they cannot sell (or redeem) their units back to the fund. This avoids the fund having to sell assets in order to manage investor redemption requests. Units in some closed-ended funds are traded on a secondary market (ie an exchange), where investors can buy or sell units in the fund.

²⁸³ Cheyne Capital Management (UK) LLP, *Social Property Impact Fund*. Available at <https://www.cheynecapital.com/strategies/social-property/>.

²⁸⁴ An open-ended fund is a fund where investors can buy and sell units in the fund on demand at their net asset value (NAV). This is a price based on the value of the fund's underlying assets which is calculated at the end of each trading day. Open-ended funds usually maintain cash reserves in order to meet investor redemption requests.

²⁸⁵ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 50. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

²⁸⁶ Trading in this context refers to how often the fund deals in the underlying investments (eg securities) held by the fund.

²⁸⁷ See Financial Conduct Authority, *Illiquid assets and open-ended investment funds: DP17/1* (February 2017). Available at <https://www.fca.org.uk/publication/discussion/dp17-01.pdf>. This is discussed further at paras 8.124 to 8.127 above.

²⁸⁸ REITs were introduced in 2007 as a way for investors to gain exposure to the property market.

the investment is more liquid. The drawback is that share prices will be influenced by market sentiment as well as the performance of the underlying property. In the short term, REITs tend to perform more like equities than property, which could be said to lose some of the advantages of diversification.²⁸⁹

- 8.58 This list shows that it is possible to build liquidity into a property portfolio, but liquidity comes at a price. Open-ended funds, for example, need to hold balances of cash or other highly liquid assets to respond to redemption requests. This means that the fund cannot invest all of its money in illiquid assets as it may need to sell assets quickly in order to meet redemption requests. In addition, there are a number of intermediaries between the pension saver and the actual property in open-ended funds, including investment managers and pension scheme trustees. This intermediation will inevitably increase costs.

An industry practice rather than a regulatory requirement

- 8.59 Several consultees stressed that daily pricing was not a legal or regulatory requirement. As the Investment Association put it:

There is no regulatory requirement that dictates DC funds must have daily trading; instead it is the result of the evolution of the DC market and the operational systems put in place on the insurance platforms²⁹⁰ that are host to so many DC funds.

- 8.60 In 2013, the Pensions Institute drew a distinction between what DC schemes need and what they want. What they need are “assets to generate stable risk-adjusted returns in a diversified multi-asset portfolio”. But they want more than this. Many DC schemes are designed to look like a form of savings account, with daily pricing and daily trading, so that members can “transfer freely in and out of funds using up-to-date valuations”.²⁹¹

- 8.61 In 2012, Towers Watson (now Willis Towers Watson) asked whether the trend towards daily pricing and trading had gone too far. It commented:

There seems to be a perception in the market that DC funds have to be daily priced and traded. However regulations do not stipulate this. Indeed, less frequently priced and traded funds do exist.

Perhaps it is less a case of the market perception being that DC funds have to be daily priced and traded but rather a perception (and probably a reality) that non-daily priced/traded funds just would not get traction in the current market due to the general attitude of the various stakeholders: consultants, providers, administrators, trustees and members alike.²⁹²

²⁸⁹ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 46. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

²⁹⁰ For further information about platforms, see paras 8.78 to 8.80 below.

²⁹¹ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 41. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

²⁹² Towers Watson, *The DC trend towards daily pricing and trading* (2012), p 1.

8.62 Towers Watson expressed concern that this market perception effectively shut the door on asset classes such as infrastructure, which might provide more effective diversification and an additional source of investment return.

How much liquidity do DC schemes need?

8.63 Schemes are required to make payments in three circumstances. These are when their members:

- (1) reach pension age;
- (2) die; or
- (3) ask for a transfer to another scheme.

8.64 It is easy to foresee when members will reach pension age. Also, in a large enough scheme, it is relatively easy to rely on actuarial data to make provision to pay death benefits. The demand for transfers is less certain: for example, if a major employer closes, many former employees could ask for a transfer at the same time. However, many consultees thought that, as schemes became larger, it would be possible to manage the need to make payments while maintaining a substantial illiquid element in their portfolio of investments.

8.65 Many consultees argued that it was not necessary for all assets to be fully liquid on a daily basis. They thought that DC schemes should consider moving away from daily pricing and daily dealing:

It may be necessary to consider monthly liquidity, which could have the added benefit of making other alternative assets attractive for these schemes. [Schroder Investment Management Ltd]

8.66 Principles of Responsible Investment (PRI) saw the emphasis on daily dealing as encouraging a short-term approach to savings:

DC funds often offer same-day mark to market valuation.²⁹³ This reorients savers towards short term performance and imposes restrictions on investing in long-dated assets.

8.67 UKSIF thought that the current emphasis on daily dealing was irrational:

DC schemes are in theory well placed to earn the illiquidity premium generated by such assets given their long-term time horizons: there is no reason why a saver in her early 20s would require even infrequent access to her assets. The position has been described by one UKSIF member as a “nonsense”.

²⁹³ Mark-to-market: a valuation of assets on the basis of their current market value, rather than the potential value they are expected to achieve.

TRUST-BASED SCHEMES: REQUIREMENT TO PROCESS TRANSACTIONS PROMPTLY

- 8.68 Trustees of DC schemes are required to ensure that “core financial transactions” are processed “promptly and accurately”.²⁹⁴
- 8.69 “Core financial transaction” covers a wide range of different transactions. The definition not only includes payment “to or in respect of scheme members” (for example, on retirement or death) but also less crucial transactions such as:
- (1) Transfers of assets into and out of the scheme; and
 - (2) Transfers of assets between different investments in the scheme.²⁹⁵
- 8.70 Trustee boards often outsource administration to a third party or it is dealt with by the sponsoring employer directly. However, trustee boards retain responsibility for the quality of the scheme administration. The Pensions Regulator (TPR) expects trustee boards to receive regular and appropriate information from their administrators to allow them to monitor performance in accordance with their legal obligations.²⁹⁶
- 8.71 In its Guide to administration, TPR gives examples of situations in which delays prevent transactions being prompt, such as staff absence, unnecessary or time-consuming administrative steps and slow payment methods.²⁹⁷ It adds that procedures should be as “streamlined as they can be without increasing the risk of inaccuracy” and financial transactions should be processed “without delay once all the necessary tasks have been completed”.²⁹⁸

Member transfer requests

- 8.72 Above we considered the different calls on a DC scheme for payment.²⁹⁹ While payments on death or retirement are relatively predictable, requests for transfers out of the scheme may fluctuate, especially if a major employer makes redundancies.
- 8.73 The Association of Pension Lawyers explained:
- There is no legislation which requires members to be able to switch investment options on a daily basis. Similarly, there is no legislation which requires members to be able to demand access to their benefits with little or no notice.
- 8.74 Under section 99 of the Pension Schemes Act 1993, trustees of DC schemes have six months to implement a transfer request.³⁰⁰

²⁹⁴ Occupational Pension Schemes (Scheme Administration) Regulations 1996 SI 1996 No 1715, reg 24(1).

²⁹⁵ Occupational Pension Schemes (Scheme Administration) Regulations 1996 SI 1996 No 1715, reg 24(2).

²⁹⁶ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), paras 65 to 66.

²⁹⁷ The Pensions Regulator, *Guide to administration* (July 2016), p 12.

²⁹⁸ The Pensions Regulator, *Guide to administration* (July 2016), p 12.

²⁹⁹ See paras 8.63 to 8.67.

³⁰⁰ Pension Schemes Act 1993, s 99.

8.75 However, TPR has said that the six month timescale should be treated as an “absolute maximum” and should not be considered as equivalent to prompt.³⁰¹ In its Guide to administration, TPR stresses the importance of dealing with transfer requests promptly:

Members aged 55 and over may increasingly wish to transfer their savings to schemes that offer flexible options. Delays in the time taken to process a request to transfer can have a significant impact on a member’s funds at retirement, which is amplified the closer they are to an age where they may wish to access their benefits or transfer to an arrangement offering their preferred decumulation option.³⁰²

8.76 TPR also suggests that delays in payment may make members vulnerable if the value of an investment falls:

Members with DC benefits are highly vulnerable to market risks, and delays in processing financial transactions on their behalf can significantly affect their benefits.³⁰³

8.77 We accept that transfer delays may disadvantage members on a falling market (though equally they may benefit them on a rising one). However, we do not think this altogether precludes DC schemes from investing in more illiquid investments. Below we suggest as an option for reform that guidance should be issued about prompt payments and illiquid assets.

Pressure to use platforms to facilitate prompt processing

8.78 A platform, also known as an “investment platform”, can be both a piece of technology and an intermediary who facilitates the purchase of investments.

8.79 As a piece of technology, a platform allows pension scheme members to check their pension savings online and receive member communications. It also allows an investment manager to review holdings in different investments and to issue instructions to buy or sell assets, or move money into funds which are offered via the platform.

8.80 Trust-based schemes will often use a platform run by an insurer.³⁰⁴ Where an insurer acts as a platform for a trust-based scheme it is more than just a software provider. It is also an intermediary in the investment chain. The insurer is effectively making the investments. It will exercise its investment powers in line with the mandate agreed with trustees, which should reflect the statement of investment principles.³⁰⁵ The insurer can only make investments which comply with the FCA regulations on unit-linked funds.³⁰⁶

³⁰¹ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 75.

³⁰² The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), p 16.

³⁰³ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), p 12.

³⁰⁴ In 2013, the Pensions Institute identified about a dozen DC pension platform providers: see Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 45, footnote 48. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

³⁰⁵ The role of the statement of investment principles is discussed in more detail in Chapter 4.

³⁰⁶ We discuss these below at paras 8.92 to 8.98.

8.81 The Association of Pension Lawyers said that the focus on daily dealing was largely due to the fact that most DC schemes use the same platforms as retail investors, where daily dealing is generally expected. This allows members to make near instant changes to their investment choices and the quick processing of requests to transfer benefits. But it comes at a cost:

We wonder whether trustees give adequate consideration to the fact that demanding such high levels of liquidity means that they may be missing out on the premium an investor would expect to receive for investing in less liquid assets, such as infrastructure. [Association of Pension Lawyers]

8.82 There is no requirement in legislation for trustees to use platforms. However, TPR “expects trustee boards to consider using services and platforms that facilitate the prompt transfer of funds”.³⁰⁷ Related TPR guidance suggests that use of a platform could help to reduce the time it takes to process a transfer out of a scheme and into a different scheme. This is because it may minimise the time spent gathering and exchanging information with the receiving or transferring scheme. TPR’s Guide to administration suggests that:

To understand more about [platform] services and whether they would be suitable for your scheme, you may wish to refer to the marketing materials of the providers of these services... If your scheme does not make many transfers, or is very small or less resourced, it may not be suitable or financially feasible to invest in the use of such a platform, but it should be given due consideration.³⁰⁸

8.83 In the course of this project we were told that consumers increasingly expect to be able to manage their money online, immediately, and therefore expect the same from their pension scheme. TPR guidance specifically asks trustees to consider what members might expect:

Would they expect you to be taking advantage of latest technologies and processes (eg straight through processing), and if you are not, can you justify why not?³⁰⁹

³⁰⁷ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 73. Available at <https://www.pensions-institute.org/reports/ReturningtotheCore.pdf>.

³⁰⁸ The Pensions Regulator, *Guide to administration* (July 2016), p 17.

³⁰⁹ The Pensions Regulator, *Guide to administration* (July 2016), p 13. Available at <http://www.thepensionsregulator.gov.uk/docs/dc-administration-guide.pdf>.

Does the emphasis on prompt payment require daily dealing?

8.84 TPR's code of practice recognises that trust-based schemes may not operate a daily dealing cycle. It provides the following clarification:

Where a scheme operates a daily dealing cycle, we expect trustee boards to ensure that contributions to the scheme, including sums transferred into the scheme, are invested within a maximum of three working days following receipt of the contributions, and after completion of a reconciliation exercise. Where the dealing cycle is less frequent than daily, we expect investment to take place at the next available dealing date, and within a maximum of five working days, after completion of the reconciliation exercise.³¹⁰

8.85 TPR's Guide to investment governance also emphasises that the liquidity of assets must be balanced against the investment objectives:

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. You should think about the level of liquidity that your members need, eg in relation to likely transfers from the fund, and in that context, consider the liquidity constraints on certain fund structures. You should seek to balance the liquidity of assets against the investment objectives. Holding too high a proportion of liquid assets may impact the level of investment return, and limit opportunity for diversifying your portfolio of assets.³¹¹

8.86 We think the law around prompt payments is flexible enough to allow DC schemes to invest a small percentage of their portfolios in illiquid assets such as property and infrastructure.

Requirement to process transactions promptly: conclusion

8.87 We fully understand the need for DC schemes to pay promptly on a death, and to ensure money is available for those wishing to retire. However, when it comes to transfers between funds or between investments, the need to pay promptly should be balanced against the need to obtain the best possible returns.

8.88 We think that weekly or even monthly dealing should be seen as compatible with the requirement for prompt payment. Due to industry practice, trustees may feel under pressure to process payment requests immediately; therefore, any need to obtain the benefits of illiquid investments may seem less of a priority.

8.89 Most DC schemes use the same platforms as those used by retail investors, where daily dealing is generally expected. Law and regulation do not require full liquidity, daily dealing or daily pricing. However, some aspects of current TPR guidance may reinforce the industry practice of daily pricing and high levels of liquidity. For example, TPR guidance expects trustee boards to consider using services and platforms that facilitate the prompt transfer of funds.

³¹⁰ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 76. Available at <http://www.thepensionsregulator.gov.uk/docs/code-13.pdf>.

³¹¹ The Pensions Regulator, *Guide to investment governance* (July 2016), p 17.

8.90 On the other hand, TPR’s code of practice and guidance states that trustees should seek to balance the liquidity of assets against the investment objectives, and it does not state that daily dealing is a legal requirement. In light of industry practice, there is a case for providing trustees with further guidance on how to reconcile the requirement to process transactions promptly with the benefits of holding some illiquid assets.

Option for reform 4.

8.91 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.

PERMITTED LINKS RULES³¹²

8.92 Several consultees raised issues about the FCA’s rules on “permitted links”³¹³ and suggested that these rules imposed undue restrictions on the class of assets which DC schemes could hold.

8.93 Contract-based pension providers must be authorised as insurers.³¹⁴ In regulatory terms, the contract between the scheme member and the pension provider is characterised as a long-term contract of insurance.³¹⁵ These insurance policies offer investment in unit-linked funds.³¹⁶ Contributions paid by the member and the employer are treated as “premiums”, and in return the member receives “units” in the fund.³¹⁷ Unit prices rise and fall, reflecting changes in the value of the fund’s underlying assets.

8.94 Where the saver or scheme member is a natural person, unit-linked insurance contracts can only invest in a limited range of permitted assets.³¹⁸ These rules have been implemented in COBS, chapter 21, and are known as “permitted links”.³¹⁹

8.95 Additionally, under the Solvency II Directive, insurers are subject to capital requirements and prudential regulation which has been implemented by the Prudential

³¹² Permitted links: The list of approved assets found in COBS that an insurer engaged in linked-long term insurance business may link to, in order to determine the value of benefits due, under unit-linked contracts (for example, contract-based DC schemes).

³¹³ We explain the permitted links rules at paras 8.93 to 8.98 below.

³¹⁴ Financial Services and Markets Act 2000, ss 20 and 22.

³¹⁵ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, p 151.

³¹⁶ A unit-linked fund is a fund which collects cash for investment from many people; in this context through pension contributions. These contributions are treated as “premiums” and in return the member receives “units” in the fund. The cash from contributions is then invested in a wide range of investments held by the unit-linked fund.

³¹⁷ These are units of account and the member receives no proprietary rights in the underlying assets of the fund.

³¹⁸ Solvency II Directive 2009/138/EC, Official Journal L 335/1 of 17.12.2009, art 133.

³¹⁹ FCA Conduct of Business Sourcebook (COBS) 21.3.-1R.

Regulatory Authority (PRA) in the PRA Rulebook.³²⁰ The prudential regulatory regime seeks to ensure that insurers have sufficient assets to meet their insurance liabilities under unit-linked contracts.³²¹

- 8.96 Trust-based schemes are not required to comply with these rules unless they use a platform. As we discussed above,³²² where an insurer provides a platform it is more than just a computer provider. It is also an intermediary in the investment chain. The insurer is effectively making the investments and must comply with the FCA regulations on unit-linked funds, and with the PRA's rules.³²³ This means that the rules on permitted links are important to many DC schemes, both contract-based and trust-based.
- 8.97 The permitted links rules do not apply to DB schemes. The rules do however apply to DC schemes, because the investment risk is borne by the scheme member. The policy behind the permitted links regime is consumer protection. The aim is therefore to protect individuals, who bear the investment risk, from exposure to inappropriately risky assets.³²⁴
- 8.98 In its thematic review of the governance of unit-linked funds in 2013, the FCA noted:
- Where firms operated in the institutional market, they were more likely to invest in alternative, more exotic assets and legal structures, which can be more risky. Institutional customers such as pension trustees could be investing on behalf of underlying retail customers, so it remains important that protections are in place. Our review found that these firms needed to improve their assessment and decision-making processes for determining that such assets complied with our rules.³²⁵

Views of consultees

- 8.99 The UK Sustainable Investment and Finance Association (UKSIF) suggested that the list of appropriate assets contained in the permitted links rules has acted as an obstacle to innovation, including investments in alternative asset classes.
- 8.100 The Investment Association also expressed concern that “alternative asset classes are typically in other fund structures that would be prohibited by the permitted links rules”. LGIM commented that the rules “restrict the ability of pension funds to diversify investments into a broader range of asset classes”.
- 8.101 Big Society Capital asked for further clarification on how the rules worked. In response to our call for evidence, they noted that:

³²⁰ PRA Rulebook 2017, Part 4. Available at <http://www.prarulebook.co.uk/rulebook/Content/Part/212926/14-06-2017>.

³²¹ In particular, see the “prudent person principle” in the PRA Rulebook 2017, Part 4. Available at <http://www.prarulebook.co.uk/rulebook/Content/Part/212926/14-06-2017>.

³²² See paras 8.78 to 8.80.

³²³ Platform providers generally offer their own products and those of other providers.

³²⁴ Financial Services Authority, *Feedback Statement Solvency II and linked long-term insurance business* (June 2012), p 5. Available at: <https://www.fca.org.uk/publication/feedback/fs12-02.pdf>.

³²⁵ Financial Conduct Authority, *Thematic review 13/08: The governance of unit-linked funds* (October 2013), p 11. Available at: <https://www.fca.org.uk/publication/thematic-reviews/tr13-08.pdf>.

Any funds that include infrastructure, social infrastructure or social investments must be structured as “permitted links” to be offered on an insurance platform... This is a complex area of FCA regulation that warrants further clarification in the context of social investments.

8.102 Given the concerns expressed by consultees about these rules, we consider them below. Our conclusion is that the permitted links rules do not prevent property and infrastructure investment; nor do they mandate daily dealing or daily pricing. However, based on information provided in response to our call for evidence, we think that they are sometimes perceived as blocking certain investments.

Permitted links rules

8.103 The rules determine the types of investments that can be made by unit-linked funds. The list is contained in COBS 21.3.1 R and is derived from article 23 of the Life Directive.³²⁶ The rules require consideration of the economic effect of assets ahead of their legal form.

8.104 Rule 21.3.1 of COBS stipulates the types of property and indices to which insurers are allowed to link benefits. Property for these purposes includes approved and listed securities, unlisted securities, some permitted loans, cash, and interests in land and property. Commodities, wine and works of art are not permitted links.³²⁷

Permitted land and property

8.105 The permitted links rules allow investments in real property. Permitted land and property includes any interest in land (or any building situated on it). The rules allow real property to be owned directly or held indirectly through structures.³²⁸ For example, this permits investment in property through collective investment schemes³²⁹ and REITs.³³⁰ If held through structures such as units in a collective investment scheme, the rules require there should be no additional risks over and above a direct property holding.³³¹

³²⁶ Life Directive 2002/83/EC, Official Journal L 345/1 of 19.12.2002.

³²⁷ They may however be permitted within authorised collective investment schemes (CIS) and some non-UCITS retail schemes (NURS) allow limited investment in gold. FSA, *Permitted Links for Long Term Insurance Business Consultation Paper* (March 2007), p 19. FCA authorised CISs (including NURS) count as permitted investments under the permitted links rules.

³²⁸ See definition of “permitted land and property” in FCA Conduct of Business Sourcebook (COBS).

³²⁹ A collective investment scheme (CIS) is a fund that several people contribute money into. A fund manager will invest the pooled money on their behalf in one or more types of asset, such as stocks, bonds or property.

³³⁰ R SurrIDGE, N John and B Murphy, *Houseman’s Law of Life Assurance* (2016), p 153. A real estate investment trust (REIT) is a company that owns real estate, such as commercial property ranging from office blocks and apartments to hospitals, shopping centres and social housing.

³³¹ FCA Conduct of Business Sourcebook (COBS) 21.3.1(2)(d)(b)(ii) R.

8.106 However, interests in land and property cannot be highly leveraged. There is a “gearing” restriction that applies to property funds.³³² It provides that, to fall within the definition of “permitted land and property”, any interest in land must not be:

geared in excess of 10% of the gross asset value of the linked fund.³³³

8.107 This means that gearing, ie borrowing that is by the fund to purchase an interest in land or property, is limited to 10% of the overall gross value of assets comprising the fund.

Permitted unlisted securities

8.108 The permitted links rules used to provide that unlisted securities were only permitted if they were “readily realisable”. This requirement was removed in 2007 in favour of a more general requirement applicable to all asset types, discussed below.³³⁴ The FCA has said that this change would “lead to an increase in diversity and not necessarily to an increase in risk for policyholders”.³³⁵

8.109 The current position is that unlisted securities should be “realisable in the short term”.³³⁶ This is understood to require the security to be realisable in time for the insurer to meet its obligations to linked policyholders, such as transfers and paying out benefits under policies.³³⁷

8.110 The Financial Services Authority (now the FCA) in its policy statement³³⁸ noted that “such assets may rarely be realisable immediately”. It further stated that the requirement of short-term realisability can be met:

if a firm satisfies itself that it cannot reasonably foresee any circumstances in which it would need to realise the asset at a few days' notice, and would not be able to do so.³³⁹

8.111 This more liberal approach allows insurers the option to invest in unlisted securities provided that they can manage their liquidity requirements in other ways.

³³² Gearing refers to the proportion of debt and equity in the fund. It is essentially the use of borrowed capital (ie debt) to part-fund the purchase of property. It is also known as leveraging. The restriction means that, in relation to the purchase of an interest in land or property, the fund cannot borrow beyond 10% of the overall gross value of the assets in the fund.

³³³ FCA Conduct of Business Sourcebook (COBS) 21.3.1(2)(d)(c) R.

³³⁴ Financial Services Authority, *Policy Feedback Statement 07/17* (September 2007), p 6.

³³⁵ FSA, *Policy Feedback Statement 07/17* (September 2007), p 6.

³³⁶ FCA Conduct of Business Sourcebook (COBS) 21.3.1(2)(c) R.

³³⁷ R SurrIDGE, N John and B Murphy, *Houseman's Law of Life Assurance* (2016), p 152; also see PRA Rulebook 2017 Part 4. Available at <http://www.prarulebook.co.uk/rulebook/Content/Part/212926/04-01-2017>.

³³⁸ Financial Services Authority, *Policy Feedback Statement 07/17* (September 2007), p 8.

³³⁹ Financial Services Authority, *Policy Feedback Statement 07/17* (September 2007), p 8.

Valuation

8.112 Insurers must be able to track the value of a policy by tracking the underlying fund or funds selected. This means the insurer must have arrangements in place to calculate the value of a member's policy fairly and accurately.³⁴⁰ Insurers establish a "unit-price" by looking at the value of the underlying assets, minus any fees, charges and tax and plus any income such as dividends.

8.113 This does not require daily pricing. We think that the rules are broad enough to allow insurers to use "mark-to-model"³⁴¹ to produce a unit price,³⁴² though the point appears to cause some nervousness among insurers.

Third party collective investment scheme (CIS)

8.114 It has become common for unit-linked insurers to offer exposure to a third party CIS through their own unit-linked funds. An FCA authorised CIS is a permitted investment under the permitted links rules.³⁴³

8.115 These can be structured as UCITS or non-UCITS retail schemes (NURS).³⁴⁴ However, these types of funds are subject to their own investment restrictions, which may impose greater restraints than the permitted links rules.³⁴⁵

8.116 UCITS have a list of permitted assets and investment restrictions which are set out in the FCA Handbook,³⁴⁶ for example:

- (1) UCITS compliant funds may not invest directly in certain asset classes such as gold, commodities, property and hedge funds.³⁴⁷ However, UCITS can invest indirectly in property by purchasing shares in a listed real estate investment trust (REIT).³⁴⁸

³⁴⁰ FCA Conduct of Business Sourcebook (COBS) 21.2.1 R.

³⁴¹ Mark-to-model: the practice of determining the price of a portfolio by reference to financial models, rather than allowing the market to determine the price.

³⁴² The valuation of the social investment element of the French solidarity fund is priced using a mark-to-model formula. For further discussion, see N Keohane and S Rowell, *The Social Market Foundation, Good pensions: Introducing social pension funds to the UK* (2015), p 22. The Social Market Foundation argue that allowing mark-to-model pricing could overcome liquidity constraints within funds as well as provide assurance to trustees.

³⁴³ FCA Conduct of Business Sourcebook (COBS) 21.3.1(2)(g) R.

³⁴⁴ The acronym UCITS stands for Undertakings for Collective Investment in Transferable Securities. UCITS (otherwise known as UCITS compliant funds) are funds which comply with an EU regulatory framework governing the operation of certain collective investment schemes.

³⁴⁵ Investment Management Association, *Response to FCA Consultation* (February 2012), p 4. Available at: <http://www.theinvestmentassociation.org/assets/files/consultations/2012/20110214permittedlinks.pdf>.

³⁴⁶ FCA Collective Investment Sourcebook (COLL) 5.2 R.

³⁴⁷ FCA Collective Investment Sourcebook (COLL) 5.1.4 G.

³⁴⁸ A real estate investment trust (REIT) is a company that owns real estate, such as commercial property ranging from office blocks and apartments to hospitals, shopping centres and social housing.

- (2) UCITS compliant funds can invest up to 10% of their property in transferable securities and approved money-market instruments³⁴⁹ which are not listed on a regulated market.³⁵⁰ However, the relevant transferable securities and approved money-market instruments must still fulfil criteria relating to liquidity and valuation.³⁵¹ This rule does not permit investment in units or shares in unregulated CIS, such as hedge funds.³⁵²

8.117 A fundamental feature of UCITS are the mandatory redemption rights of investors. These require the fund to permit investors to redeem their shares (that is, sell them back to the fund).³⁵³ This means there must be sufficient liquidity at all times to meet redemption requests. In order to meet this liquidity requirement, the underlying investments must also be liquid.³⁵⁴ The need to ensure liquidity to meet demand for redemptions therefore prevents UCITS compliant funds from obtaining the full benefits of illiquid investments.³⁵⁵

8.118 In practice, many DC schemes invest in UCITS compliant funds and are nervous about using other possible structures, even when they are permitted to do so under FCA rules. UCITS do not permit direct investment in property and infrastructure, and require greater levels of liquidity.³⁵⁶ Based on information we have received during the course of this project, we believe that some schemes incorrectly think that the restriction on UCITS investing in property also applies to DC schemes more generally.

Ensuring sufficient liquidity

8.119 Insurers must ensure that their assets are sufficiently liquid to enable them to meet their liabilities, for example, paying policy benefits on maturity or transfers out.³⁵⁷

8.120 Article 260 of the Solvency II Delegated Regulation, when read alongside Article 44(2) of the Solvency II Directive, requires insurers to have an effective risk management system in place. This includes liquidity risk management. It requires insurers to take account of the short-term and long-term liquidity risk and the appropriateness of the composition of assets in terms of liquidity to meet obligations as they fall due.³⁵⁸ It also requires insurers to plan how to deal with changes in cashflows in and out.

³⁴⁹ Approved money-market instruments are short-term high liquidity debt instruments, which can be accurately determined at any given time (for further information see FCA Collective Investment Sourcebook (COLL) 5.2.7F R).

³⁵⁰ FCA Collective Investment Sourcebook (COLL) 5.2.8(4) R.

³⁵¹ FCA Collective Investment Sourcebook (COLL) 5.2.7A R, 5.2.7E R and 5.2.7F R.

³⁵² European Securities and Markets Authority (ESMA) published a formal opinion on 20 November 2012. Available at <https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-721.pdf>.

³⁵³ FCA Collective Investment Sourcebook (COLL) 6.2.16 R.

³⁵⁴ Carne Group, *UCITS Guide for Investment Managers* (August 2014), p 9. Available at www.carnegroup.com/wp-content/uploads/2014/08/UCITS-Guide-for-Investment-Managers-August-2014.pdf.

³⁵⁵ J Armour, D Awrey, P Davies, L Enriques, J Gordon, C Mayer, J Payne, *Principles of Financial Regulation* (2016). R Edelen, "Investor Flows and the Assessed Performance of Open-End Mutual Funds" (1999) 53 *Journal of Financial Economics* 439.

³⁵⁶ COLL 5.2 sets out the eligible assets that a UCITS may invest, which does not include direct investments in property.

³⁵⁷ PRA Rulebook 2017, Part 4. Available at <http://www.prarulebook.co.uk/rulebook/Content/Part/212926/14-06-2017>.

³⁵⁸ Solvency II Delegated Regulation, 2015/35, Official Journal L 12/1 of 17.1.2015, Article 260.

- 8.121 A “realisability” requirement applies to the fund as a whole. If firms need to dispose of investments to meet policy liabilities, the portfolio of assets that remains must continue to be able to meet policyholder benefits as they fall due.³⁵⁹ There is also a general requirement to carry out stress tests to estimate the amount of capital and liquidity resources needed to be able to meet liabilities as they fall due.³⁶⁰
- 8.122 Again, we can understand why the “realisability” requirement makes platform providers reluctant to include illiquid assets in their portfolios. However, DC schemes are highly unlikely to be called on to realise all their assets at a day’s notice. Willis Towers Watson (formerly Towers Watson) argue that having an illiquid element to a DC fund causes some administrative issues in managing demands for payment, but suggest these are not insuperable.³⁶¹
- 8.123 As part of its oversight role, a contract-based scheme’s independent governance committee (IGC) is required to assess the ongoing value for money for policyholders (that is, its members). This includes assessing whether core scheme financial transactions are processed promptly and accurately.³⁶² However, TPR’s code of practice and guidance does not apply to contract-based schemes. The FCA has not issued any separate guidance for IGCs in relation to how to assess value for money for policyholders or what it considers to be core financial transactions or prompt processing.

Lessons from the suspension of open-ended property funds in July 2016

- 8.124 As we mentioned above,³⁶³ several open-ended property funds suspended dealings in their funds following the referendum on EU membership. In February 2017, the FCA issued a discussion paper on the liquidity management issues raised by this experience.³⁶⁴ The FCA were particularly concerned that “first movers” may have been paid from the available cash, to the disadvantage of other investors.
- 8.125 The problems were mainly experienced by those funds which offered daily dealing. Those funds which offered monthly or quarterly dealing were able to maintain enough liquidity throughout the period to meet expected redemptions. After the event, the resulting market impact was limited, and all funds resumed trading within six months.
- 8.126 The paper noted that there was a “small ripple effect” on insurance companies with unit-linked funds, which had invested in property funds which had suspended trading. However, that effect was limited because “insurance companies have considerable flexibility to defer discretionary redemption requests from investors in unit-linked saving plans”.³⁶⁵

³⁵⁹ Financial Services Authority, *Policy Feedback Statement 07/17* (September 2007), p 6.

³⁶⁰ Solvency II Delegated Regulation, 2015/35, Official Journal L 12/1 of 17.1.2015, Article 259.

³⁶¹ Towers Watson, *The DC trend towards daily pricing and trading: has it gone too far?* (2013), p 2.

³⁶² FCA Conduct of Business Sourcebook (COBS) 19.5.5(2)(c) R.

³⁶³ See para 8.57.

³⁶⁴ Financial Conduct Authority, *Illiquid Assets and Open-ended Investment Funds: DP17/1* (2017). Available at <https://www.fca.org.uk/publications/discussion-papers/illiquid-assets-open-ended-investment-funds>.

³⁶⁵ Financial Conduct Authority, *Illiquid Assets and Open-ended Investment Funds: DP17/1*(2017), p 14.

8.127 As part of its discussion, the FCA explains what an insurer should do if it cannot realise assets needed to meet transfer requests:

When such a fund is suspended, unit-linked contracts can in turn suspend discretionary payments such as surrenders from life and transfers from pension contracts. The ability to do this depends on the wording on the insurance contract itself and it typically allows for up to a six-month suspension where the contract is offered to retail policyholders. Insurers must continue to meet all contractual payments – maturities, pensions coming into payment and pay-outs on death – regardless of whether the underlying assets are available in time to meet the payments. In these circumstances, the insurer must meet the payments from its own resources and may need to find the money from other capital sources.³⁶⁶

Permitted links rules: conclusion

8.128 Many commentators have pointed out that daily pricing and daily trading are not regulatory requirements. As Willis Towers Watson put it:

There seems to be a perception in the market that DC funds have to be daily priced and traded. However, regulations do not stipulate this. Indeed, less frequently priced and traded funds do exist.³⁶⁷

8.129 Our analysis of the permitted links rules has reached the same conclusion. DC schemes are not required to realise assets immediately. The obligation is a practical one: they should be able to realise assets in time to meet their obligations to members, to pay benefits on death or retirement, or comply with transfer requests within six months.³⁶⁸ This does not require the whole fund to be liquid at all times, and is compatible with some element of illiquid infrastructure investment.

8.130 We acknowledge that managing redemptions around illiquid assets may be challenging, but it is less challenging for pensions than in the context of open-ended funds. This is because transfer requests need only be paid within six months, and the illiquid component will be only a small proportion of the whole.

8.131 Given the uncertainties and worries about this issue, we think there is a need for guidance on this point which can be used by insurers managing pension scheme investments and also inform trustees.

Option for reform 5.

8.132 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.

³⁶⁶ Financial Conduct Authority, *Illiquid Assets and Open-ended Investment Funds: DP17/1* (2017), p 28.

³⁶⁷ Towers Watson, *The DC trend towards daily pricing and trading: has it gone too far?* (2013), p 1.

³⁶⁸ Pension Schemes Act 1993, s 99.

SCALE AND LEGAL BARRIERS TO CONSOLIDATION

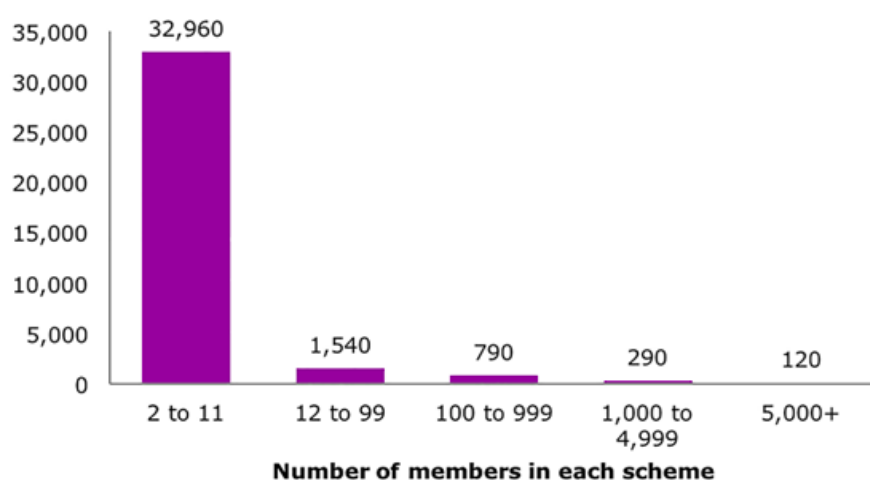
8.133 Consultees stressed that UK DC schemes do not have the size nor the scale to make investments in infrastructure. This was identified as a barrier by 18 out of 30 consultees who responded to our call for evidence. As Columbia Threadneedle Investments put it:

Scale is incredibly important for pension schemes.

8.134 The UK pensions market has been described as “the most fragmented” in Europe.³⁶⁹

8.135 In its 2016 market study of asset management, the FCA identified over 35,000 separate trust-based DC schemes, of which almost 33,000 had fewer than 11 members.³⁷⁰

Figure 5: Number of defined contribution trust-based pension schemes 2015-2016



Source: Financial Conduct Authority, *Asset Management Market Study Interim Report* (November 2016), p 19.

8.136 Some trust-based DC schemes are now closed, but 25,710 still have active members.³⁷¹

Why is scale important?

8.137 Many reports have highlighted problems with smaller schemes.³⁷² Consultees gave three reasons why scale is important for investment in infrastructure.

8.138 The first is that infrastructure often involves substantial minimum investments. The Pension and Lifetime Savings Association (PLSA) highlighted that only 120 schemes have over 5,000 members:

³⁶⁹ Spence Johnson, *Deeper Perspectives* (June 2015).

³⁷⁰ Financial Conduct Authority, *Asset Management Market Study Interim Report* (November 2016), p 19. Available at <https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>.

³⁷¹ This consists of 24,730 DC-only schemes, and 980 “hybrid” schemes, which have a DB element.

³⁷² See for example, Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014), para 7.26.

Therefore, many pension savers are invested in schemes that are unable to generate the resources – both in terms of finance and expertise – necessary to invest in infrastructure projects or specialist social investments.

8.139 PLSA mentioned the Pension Infrastructure Platform (PiP) as one way to pool expertise. It also commented:

Consolidation of smaller schemes into larger entities would also increase the feasibility of infrastructure and social investment projects for pension funds. Scale matters as there is an association between scale and investment performance in DB schemes that we think will hold for DC also once those schemes achieve sufficient scale. Access to alternative asset classes seems to be important in allowing larger schemes to achieve better returns.

8.140 B&CE Ltd, the parent company for the People's Pension, foresaw a greater emphasis on infrastructure once auto-enrolment was fully implemented:

The recent birth of the programme and the gradual rises in contribution levels mean that the assets under management are currently relatively small but will begin to rise significantly after 2019. Our ultimate aim is to mirror the activities of the large Canadian retirement funds but the cost of the in-house specialist staff required can only be justified once the assets under management are much larger.

8.141 Secondly, larger schemes can tolerate more illiquidity. As the Association of Pension Lawyers explain, it is easier for larger schemes to match incoming contributions with their outgoing obligations:

Large schemes may also have more scope to match cashflows in (from contributions and investment switches) and out (for investment switches, transfers and benefit payments) of particular investments so that any restriction on liquidity is unlikely to restrict member functionality in practice.

8.142 By matching cashflows, larger schemes do not need to resort to liquidating investments in order to meet short-term obligations, such as honouring benefit payments and member transfer requests. This means that larger schemes can tolerate a higher proportion of illiquidity in their investment portfolios.

8.143 Lastly, pension schemes also need scale to negotiate better fee structures:

Large pension funds get greater access to funds and are frequently able to negotiate better fee structures (as their allocations to particular funds will be greater). [USS Investment Management]

8.144 The FCA has also commented that smaller pension schemes may lack the resources, knowledge and bargaining strength to secure a good deal from asset managers. The FCA concluded that “it is likely that smaller pension schemes could achieve significant cost savings from consolidating their assets”.³⁷³

³⁷³ Financial Conduct Authority, *Asset Management Market Study Interim Report*, p 19. Available at <https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>.

8.145 Some consultees suggested that the problem of smaller schemes can be surmounted by using pooled funds which aggregate and invest money for a number of investors (for example, more than one pension scheme). However, as Pinsent Masons commented, even investing in pooled funds requires pension trustees to scale up their in-house resources, by ensuring that they have individuals with the relevant skills and experience to evaluate and monitor infrastructure offerings.

8.146 TPR has observed that larger schemes with more than 1,000 members are more likely to demonstrate the quality features that drive good member outcomes than small and medium sized schemes.³⁷⁴ Furthermore, the trustees of larger schemes are more likely to receive training, have greater access to advisers and spend more time on their duties.³⁷⁵ In its evidence to the Work and Pensions Select Committee, the National Association of Pension Funds said that:

It is our belief, supported by a considerable body of evidence both from the UK and internationally, that those smaller schemes tend to have weaker governance arrangements, and also tend to offer less value for money.³⁷⁶

Bulk transfers

8.147 Many consultees said more should be done to allow and encourage consolidation of trust-based schemes. We were told that unnecessary barriers to consolidation exist, particularly for bulk transfers.

8.148 Under the current legislation, a trust-based scheme may undertake what is known as a “bulk transfer” in order to merge schemes. This involves the transfer of assets and liabilities from one scheme known as the “transferring scheme” (usually a smaller scheme), to another known as the “receiving scheme” (usually a larger scheme or master trust). This then leaves the transferring scheme as an empty shell which will be wound up shortly afterwards.

8.149 The trustees of both schemes need to satisfy themselves that the merger is in the best interests of the beneficiaries of both schemes.

8.150 Usually such mergers take place without seeking consent from the members of the scheme to be transferred. This is allowed by the relevant legislation, subject to obtaining an “actuarial certificate”.³⁷⁷ The legal requirements for a bulk transfer are found in the Pension Schemes Act 1993 and the Occupational Pension Schemes (Preservation of Benefit) Regulations 1991 (SI 1991/167).

³⁷⁴ The Pensions Regulator, *Ensuring good governance and administration in work-based defined contribution pension schemes* (January 2013), p 19. See also The Pensions Regulator, *Trust-based pension scheme features research: A summary research report on the draft defined contribution (DC) features* (January 2013), p 4.

³⁷⁵ The Pensions Regulator, *Trustee Landscape Quantitative Research* (October 2015).

³⁷⁶ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-II at Ev 21.

³⁷⁷ This is where an actuary (a professional who specialises in statistics and risk, and gives advice on a pension scheme’s assets and liabilities) certifies that, in their opinion, members’ rights in the new scheme are broadly no less favourable than their existing rights in the scheme to be transferred.

Process for bulk transfers without consent

8.151 Where consent from members cannot be obtained, a bulk transfer may still occur if it meets the conditions in regulation 12 of the Occupational Pension Schemes (Preservation of Benefits) Regulations 1991, read alongside section 73 of the Pension Schemes Act 1993. The requirements can be largely grouped into the following five conditions:

- (1) the transfer must be made to an occupational pension scheme (that is, a trust-based scheme);
- (2) the transferring scheme and receiving scheme must be connected to each other, under regulation 12(2);
- (3) members must be given information about the proposed transfer and value of rights to be transferred at least one month before the transfer, but need not consent to the proposed transfer;
- (4) transfer of members' accrued rights must be with a view to acquiring transfer credits of the member under the receiving scheme; and
- (5) trustees must obtain an actuarial certificate under regulation 12(3). The actuary must certify that in their opinion the transfer credits to be acquired for each member under the new scheme are "broadly no less favourable" than the rights to be transferred from the old scheme. There is no definition in legislation of what is meant by "broadly no less favourable".

Criticisms of the requirement for an actuarial certificate

8.152 Several consultees noted that the legislation for bulk transfers is outdated and was drafted for DB schemes. In particular, consultees criticised the requirement for an actuarial certificate and noted that it made little sense in DC schemes. Consultees said that it adds unnecessary cost and can act as a barrier to the consolidation of schemes.

8.153 B&CE Ltd (the provider of the People's Pension) noted that:

The main legal obstacle to the merger of master trusts is the requirement for an actuarial certificate. A requirement inherited from the defined benefit regime but which makes little sense with respect to defined contribution schemes and provides no consumer protection in the latter situation.

8.154 The Society of Pension Professionals commented that:

One difficulty, which can impede so called bulk transfers of members from one defined contribution scheme to another, which could be part of a scheme merger, is the provision of an actuarial certificate as a condition of such a transfer. There can be practical difficulties in providing the certificate, since the terminology associated with it is based on the situation of defined benefit, rather than defined contribution schemes.

8.155 Finally, UKSIF mentioned that:

UKSIF member feedback is that in most cases, particularly where a merger may impact costs, actuarial sign off will be necessary. This is to show that the benefits to be received by members are on the whole no less favourable than those they are entitled to in the current scheme – for some schemes this may be a barrier.

The Department for Work and Pensions (DWP) consultation

8.156 The DWP is currently looking into simplifying the process of bulk transfers without consent in DC schemes. The consultation period ran from 20 December 2016 and closed on 21 February 2017.³⁷⁸

8.157 In particular, they have been looking at how the current provisions on the bulk transfer of DC schemes without member consent could be improved, including whether the actuarial certificate, or an alternative check of scheme quality, still has a role in bulk transfers. We understand that DWP's current intention is to consult on firm policy proposals on the process for bulk transfers of DC schemes in summer 2017.

Other potential barriers to consolidation

8.158 Most consultees focused on bulk transfers, but there may be other barriers to consolidation. Most trust-based schemes have broad rules allowing them to transfer and receive, but some do not. Schemes may lack a straightforward process for amending their rules where this is necessary to allow them to transfer or receive. Scheme rules may also require the consent of members to consolidate, which is often difficult to obtain. Several consultees noted that the process of obtaining consent can in practice prevent consolidation of schemes.

8.159 Apart from bulk transfers, another option to effect consolidation of trust-based schemes is to transfer the assets and liabilities from both schemes to a third, newly established scheme. Often, both schemes are then wound up. However, this usually requires the consent of all the members. This requirement would benefit from further consideration to assess whether it is necessary. Below we suggest an option for reform for DWP to look into this.

8.160 In our 2013 consultation paper on Fiduciary Duties, we drew attention to the way that the Australian Government had encouraged schemes to consolidate, leading to a reduction from 3,810 scheme to 336 over 12 years.³⁷⁹ For example, under the Superannuation Industry (Supervision) Act 1993 (Cth) trustees must “determine on an annual basis” whether the beneficiaries are “disadvantaged, in comparison to the beneficiaries of other funds”, due to insufficient numbers of beneficiaries or pooled assets.³⁸⁰ Below, we propose an option for reform for Government to consider whether such a legal obligation should be introduced for England, Wales and Scotland.

Scale and consolidation: conclusion

8.161 Only the largest DC schemes have the ability to invest in illiquid assets such as infrastructure. This is a key message from consultees and from the Australian experience. In particular, larger schemes find it easier to manage an illiquid element to their investments. They have greater scope to match cash-flows in (from contributions

³⁷⁸ Department for Work and Pensions, *Call for evidence: Bulk transfers of defined contribution pensions without member consent* (December 2016). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/579033/bulk-transfers-of-defined-contribution-pensions-without-member-consent-call-for-evidence.pdf.

³⁷⁹ See *Fiduciary Duties of Investment Intermediaries* (2013) Law Commission Consultation Paper No 215, para 13.77 and background paper from Clayton Utz at Appendix C.

³⁸⁰ Superannuation Industry (Supervision) Act 1993 (Cth), s 29VN (Australia).

and investment switches) and out (for investment switches, transfers and benefit payments). They can also make larger single investments, have greater in-house expertise and more bargaining power.

8.162 We welcome the DWP consultation on bulk transfers, including the need for an actuarial certificate. We hope this will be the start of a more general process to reduce barriers to consolidation and encourage larger schemes, including as proposed in our options for reform.

Option for reform 6.

8.163 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.

Option for reform 7.

8.164 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.

CHARGES AND THE CHARGE CAP

8.165 From April 2015, a cap has applied to limit the administrative charges that pension schemes can pass onto members of default arrangements in DC schemes used for the purposes of auto-enrolment. This is known as the “charge cap”. The charge cap, for trust-based schemes, is found in the Occupational Pension Schemes (Charges and Governance) Regulations 2015 (the Regulations) and is found in COBS chapter 19 for contract-based schemes.

8.166 Default arrangements are only permitted to charge members either a single percentage charge or a combination charge. Both are subject to a maximum cap.³⁸¹

8.167 The charge cap is set, in relation to a single percentage charge, at 0.75% annually of the value of the member's rights under the default arrangement.³⁸² In other words, the administrative charges of a scheme passed onto members, in relation to the default arrangement, cannot exceed 0.75% of the value of the member's pension pot. The

³⁸¹ Occupational Pensions Schemes (Charges and Governance) Regulations 2015 SI 2015 No 879, reg 5(1); FCA Conduct of Business Sourcebook (COBS) 19.6.4(1) R.

³⁸² Occupational Pensions Schemes (Charges and Governance) Regulations 2015 SI 2015 No 879, reg 5(2) and reg 6(1) and (2); FCA Conduct of Business Sourcebook (COBS) 19.6.4 R and 19.6.6(1) R.

combination option allows schemes to deduct a higher percentage of contributions when they are paid, but a lower percentage of funds under management each year.³⁸³

8.168 The cap does not apply to all charges. The charge cap only applies to what are known as “administrative charges”. The Pensions Act 2014 provides a broad definition of what constitutes an “administrative charge”. Transaction costs, and certain other charges,³⁸⁴ are specifically excluded from the definition of “administrative charges” and therefore fall outside the charge cap.³⁸⁵ The same costs are excluded from the charge cap under COBS for contract-based schemes.³⁸⁶

Details of the charge cap

8.169 When the cap was first introduced, it was thought that the costs of insuring, maintaining and managing property fell within the charge cap.³⁸⁷ This led to criticism by Royal London and others, who argued that the inclusion of property management costs made investment directly in property “prohibitively expensive”.³⁸⁸

8.170 The wording of the Regulations and COBS is ambiguous as to whether these costs fall within the cap. The DWP therefore issued guidance in October 2016 to clarify that these costs fall outside the cap. The DWP and the FCA have stated that the rules governing the charge cap should be the same for trust-based and contract-based schemes, albeit that they are found in different sources and enforced by different bodies. The FCA have further informed us that they follow the interpretation as set out in DWP’s guidance in relation to the charge cap for contract-based schemes.

8.171 The revised DWP guidance clarifies that property holding and maintenance costs fall outside the cap.³⁸⁹

8.172 The change to the DWP guidance therefore aims to address the immediate problem raised by Royal London. The DWP, FCA and several consultees have told us that the

³⁸³ The combination charge allows up to 2.5% of annual contributions or a flat fee of £25, together with 0.6%, 0.5% or 0.4% of funds under management, depending on the level of the contribution charge. See Occupational Pensions Schemes (Charges and Governance) Regulations 2015 SI 2015 No 879, regs 6(3), (4); FCA Conduct of Business Sourcebook (COBS) 19.6.6(2) R and 19.6.7 R.

³⁸⁴ Other charges are excluded by reg 2(1)(a) to (e) of the Occupational Pension Schemes (Charges and Governance) Regulations 2015. These include: costs incurred in complying with a court order; charges permitted by regulations made under ss 24 or 41 of the Welfare Reform and Pensions Act 1999; winding up costs; and costs solely associated with the provision of death benefits.

³⁸⁵ Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879), reg 2(1).

³⁸⁶ See definition of “administrative charge”, in FCA Conduct of Business Sourcebook (COBS).

³⁸⁷ Pension Age, *DC charge cap guidance 'could leave many schemes in hot water'* (October 2016). Available at <http://www.pensionsage.com/pa/DC-charge-cap-guidance-could-leave-many-schemes-in-hot-water.php>.

³⁸⁸ Royal London, *Report on growth and funds under management* (November 2016). Available at <https://www.royallondon.com/about/media/news/2016/november/royal-london-reports-strong-new-business-growth-and-funds-under-management-expand-to-over-100-billion/>.

³⁸⁹ Department for Work and Pensions, *The charge cap: guidance for trustees and managers of occupational schemes* (October 2016), para 12. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/557888/charge-cap-guidance.pdf.

interpretation set out in the DWP guidance has been accepted by the industry as the correct interpretation of both the Regulations and COBS.

Consultees' views

8.173 Consultees suggested that the amounts charged by open-ended property, infrastructure and other alternative funds were too high to be compatible with the default fund charge cap applicable to default arrangements and the other competitive pressures on DC schemes.

8.174 The Investment Association put the issue as follows:

The DC charge cap of 75 basis points [0.75%] is a limiting factor because infrastructure is typically more costly to access than the liquid, listed assets more commonly found in DC schemes. While the cap only applies in respect of the default strategy in practice it covers the vast majority of DC membership since participation in the default is so high. This presents asset allocators with problems when it comes to investing in alternative or illiquid asset classes – the budget simply does not allow for it.

8.175 B&CE Ltd pointed out that “all of the large master trusts price at levels well below the price cap in any event”. The need to keep costs down is now the result of market pressures rather than regulation. This is also necessary because “high scheme charges can absorb a significant proportion of an individual’s potential retirement savings”.

8.176 We have been told about open-ended infrastructure funds which provide daily pricing and daily dealing and which on their face appear to be suitable for DC schemes. However, their charges are in the order of 150 to 200 basis points (1.5% to 2%).

8.177 In 2016, Partners Group (UK) launched the UK’s first private markets fund for DC schemes. The fully diversified alternative asset fund provides access to private equity, infrastructure, and real estate, “while at the same time providing daily liquidity and pricing”,³⁹⁰ with a charge of 200 basis points. They pointed out that this would be within the charge cap if blended with other funds.³⁹¹ However, even if a scheme invested only 10% of its assets in the fund, this would still increase its fund costs by 20 basis points – a considerable increase at a time when master trusts are negotiating fund costs down from 15 basis points. The DC schemes we talked to in the course of this project suggested that these costs would be too high.

8.178 USS Investment Management, in relation to its own DC scheme, said that it had attempted to identify infrastructure funds “which could provide an environmental, social or ethical upside for our members”:

We found none available that were within the cost bounds of our funds and suspect that it would be difficult to find this at the charge cap of 0.75%. Most funds of this

³⁹⁰ Partners Group, *Press Release* (2016). Available at http://e3.marco.ch/publish/partnersgroup/36_6361/20160615_UK_DC_launch_EN_FINAL.pdf.

³⁹¹ Partners Group, *Bringing private markets to DC* (2016). Available at https://www.partnersgroup.com/fileadmin/user_upload/Documents/Media_PDFs/201609_Pensions_Insight_Expert_view.pdf.

nature are wrapped in a private equity like fee structure, and thus become very expensive.

Charges and the charge cap: conclusion

8.179 We welcome the clarity that the DWP guidance has brought for the industry in relation to property holding and maintenance costs and confirmation from the DWP and FCA that this interpretation is applied across both trust-based and contract-based schemes.

8.180 Direct holdings in property by pension schemes may produce greater, more diversified returns than shares in property management companies.³⁹² It is important to ensure that the charge cap does not penalise funds seeking to make direct investments in property. The issue may need to be monitored further, as DC schemes make more direct investments in physical assets, in innovative ways.

8.181 In 2014, the Government promised to review the cap in 2017. In particular, as part of its review, it would look at whether transaction costs should continue to be excluded from the charge cap, and whether the cap should be lowered.³⁹³ In our 2014 report, *Fiduciary Duties of Investment Intermediaries*, we welcomed this commitment. We think that the review should specifically consider whether the new cost structure has incentivised short-term trading over long-term investment and if so, what measures can be taken to reduce this effect.³⁹⁴

Option for reform 8.

8.182 The Department for Work and Pensions and the 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.

HERDING

8.183 Herding is the tendency of investment intermediaries to protect themselves from criticism by doing what everyone else is doing. As Lord Myners said in 2010, “in this world, it is fine to be wrong or even lose money, as long as you do so in the company of others”.³⁹⁵ There is considerable literature on herding in pension fund investments,³⁹⁶ suggesting that pension funds tend to hold similar asset allocations

³⁹² We discuss the different ways that pension schemes can hold property at para 8.57.

³⁹³ Department for Work and Pensions, *Better workplace pensions: Further measures for savers* (2014), p 99. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf.

³⁹⁴ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 9.72.

³⁹⁵ Lord Myners, *Speech to the International Corporate Governance Network* (March 2010), quoted in FairPensions (now ShareAction), *Protecting our Best Interests: Rediscovering Fiduciary Obligation* (2011), p 23.

³⁹⁶ For example, A Tilba, M Baddeley, Y Liao, *Research report on the effectiveness of oversight committees: background paper to Financial Conduct Authority Asset Management Market Study* (2016); C Raddatz and S Schmukler, *Deconstructing Herding: Evidence from Pension Fund Investment Behaviour* (2012). Available at <http://siteresources.worldbank.org/DEC/Resources/Deconstructing.pdf>; D Blake, B Lehmann, A

and to change their asset allocations in the same way.³⁹⁷ Below we look at the trustees' duty of care and whether the fear of personal liability leads to herding.

Trustees' duty of care

8.184 Several consultees noted that trustees were personally liable if they failed to exercise reasonable care and skill when making investments. They suggested that this might dissuade trustees from using innovative investment approaches and cause herding.

8.185 The law has long recognised that trustees owe a duty of care to their beneficiaries. A trustee who breaches this duty is personally liable to their beneficiaries for the loss caused. Trustees' duties of care were put on a statutory footing in England and Wales by the Trustee Act 2000.³⁹⁸ Section 1 states that:

(1) Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances, having regard in particular—

(a) to any special knowledge or experience that he has or holds himself out as having; and

(b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

8.186 The statutory duty of care in section 1 of the Trustee Act 2000 does not apply to all the functions of a trustee, but only to those specifically identified in Schedule 1 to the Act.³⁹⁹

8.187 Where the statutory duty applies to pension trustees, it may be excluded by the trust deed.⁴⁰⁰

8.188 The statutory duty found in section 1 has only a limited application to trustees of a pension scheme. Section 36 of the Trustee Act 2000 provides that the statutory duty of care in section 1 has no application to a pension trustee's powers of investment,⁴⁰¹ which are governed by the relevant provisions of the Pensions Act 1995, discussed in Chapter 4.⁴⁰²

Timmermann, *Performance Clustering and Incentives in the UK Pension Fund* (2002). Available at <http://eprints.lse.ac.uk/24945/1/dp425.pdf>.

³⁹⁷ Charles Sutcliffe argues that this has the potential to destabilise markets with a risk of creating price bubbles and crashes. See Finance and Occupational Pensions, *Theories and International Evidence* (2016), p 175.

³⁹⁸ This implemented, with minor changes, the recommendations of the Law Commission and Scottish Law Commission in *Trustees' Powers and Duties* (1999) Law Com No 260; Scot Law Com No 172. For the law in Scotland, see Scottish Law Commission Report on Trust Law (2014) Scot Law Com No 239.

³⁹⁹ Sch 1 sets out the functions to which the statutory duty of care applies. For example, it applies to trustees exercising a general power of investment and exercising a power to acquire land. See Sch 1 for the full list.

⁴⁰⁰ Trustee Act 2000, sch 1, para 7. The statutory duty of care under the Trustee Act 2000 applies to the trustees of a pension scheme when: "entering into arrangements" with agents under Part IV of the Act. But it does not apply to trustees authorising a person to exercise their functions in relation to investments (Trustee Act 2000, s 36(2)(i)).

⁴⁰¹ Tolley's Pensions Law Service, *"Trustees and Actuaries"* (Issue 101, March 2017), para E2.46.

⁴⁰² See paras 4.15 to 4.33 above.

8.189 In particular, section 33(1) of the Pensions Act 1995 provides that liability for breach of an obligation to take care or exercise skill in the performance of any investment functions of a pension trustee cannot be excluded or restricted by any instrument or agreement.⁴⁰³ It is important to note that this is in relation to investment powers only. This is an important issue for pension trustees and one reason why trustee insurance is important here.⁴⁰⁴

8.190 This marks a stark contrast to trustees in other contexts, such as trustees of personal property, who may exclude duties of care relating to investment functions.

Does the fear of personal liability add to “herding”?

8.191 Several consultees suggested that personal liability led to trustees becoming particularly risk averse, adding to a herd mentality. For example, John Pickin (trustee of Tintagel House (Sheffield) Ltd Charity) said that one of the main barriers to new forms of investment was “fear that the trustees could be sued if the investment loses money”. One commentator has argued that where trustees seek to protect themselves against criticism by doing what everyone else is doing, the duty of care may become a “lemming standard”.⁴⁰⁵

8.192 Several consultees referred to a herd mentality which prevented trustees from investing in new asset classes. As the Institute and Faculty of Actuaries put it:

Trustees tend to be risk averse and the regulatory framework can encourage herd mentality. This leads to difficulty in encouraging occupational pension schemes to invest in more unusual investments.

8.193 This reluctance was seen as being partly about a lack of knowledge and partly about caution. Columbia Threadneedle Investments stressed the lack of knowledge:

A lack of knowledge and understanding of infrastructure as an asset class also proves to be a barrier. The risk-reward characteristics of infrastructure investments are often not adequately understood and neither are the different options and implications of accessing the asset class through debt or equity.

8.194 The Chancery Bar Association mentioned that trustees were also cautious:

A cautious trustee may consider more traditional investments simply safer and hassle free.

8.195 No one suggested that personal liability should be removed or altered, nor do we think it should be. However, we accept that personal liability is one of many factors which may encourage pension trustees to follow standard, rather than innovative, investment strategies.

⁴⁰³ S 33(1) of the Pensions Act 1995 applies whether the investment function is exercisable by a trustee of the scheme or a person to whom the function has been delegated under s 34 of that Act. This means the restriction also applies to fund managers where the investment function has been lawfully delegated to them.

⁴⁰⁴ *Freshfields on Corporate Pensions Law* (2013), p 660.

⁴⁰⁵ K Johnson, *Back to the Future of Pension Trust Fiduciary Duties* (2010).

“Herding”: conclusion

- 8.196 We do not consider that the law or regulation in this area needs to be amended to remove a barrier to investment in property and infrastructure by DC schemes. We therefore do not suggest any options for reform in this area.
- 8.197 In practice, however, trustees tend to rely heavily on the guidance they are given about how to exercise their investment functions, and about how these can be reconciled with the demands of good administration. This makes the contents of guidance particularly important.
- 8.198 This is why we have proposed as an option for reform that TPR should consider expanding on this in their guidance for trustees in order to encourage them to consider investments in a wider range of asset classes than just equities (shares).⁴⁰⁶

CONCLUSION

- 8.199 A growing body of literature suggests that investments in property and infrastructure can offer advantages to pension schemes. Such investments can provide relatively high risk-adjusted returns within a more diversified portfolio. These asset classes are particularly beneficial for larger schemes, which are able to tolerate more illiquidity in their portfolios.
- 8.200 Consultees said that the main barriers to investment in property and infrastructure relate to market practice and structure, rather than law and regulation. In particular, the industry puts too great an emphasis on liquidity; schemes are too small; and liquid property funds are too expensive. Furthermore, trustees lack knowledge about alternative asset classes and may be reluctant to do things differently.
- 8.201 There are no explicit legal or regulatory barriers to pension trustees investing in infrastructure, either directly or through other investment vehicles. However, pension law is extremely complicated. In the absence of clear guidance that investments are permitted, pension trustees are likely to be risk averse. The law and regulation, and the current interpretation of the regulations, tends to embed existing practice, thus leading to a “herd mentality”.
- 8.202 If the Government wishes to encourage infrastructure investment by DC schemes, the first priority will be to remove barriers to consolidation. We also think that there is a need to keep the regulations, TPR code of practice and FCA guidance under review.

⁴⁰⁶ Above at paras 8.87 to 8.91.

Chapter 9: Engagement and social investment

- 9.1 In this context, “engagement” refers to the extent to which members of pension schemes are interested in their pensions. The more time and thought members give to their pension savings, the more engaged they are.
- 9.2 In general, engagement levels are extremely low. In this chapter, we consider why engagement is low and how this can be a barrier to social investment. We also look at how interest in social investment could be harnessed to encourage engagement and lead to an increase in social investment. We suggest options for reform to achieve this.

REASONS FOR LOW ENGAGEMENT

The role of auto-enrolment

- 9.3 It is helpful to explain engagement levels in the context of auto-enrolment, which is central to the current defined contribution (DC) pensions landscape. As we discuss in more detail in Chapter 3, auto-enrolment represents a radical change in the way in which choices about saving for retirement are made. It is premised on the idea that people fail to make active choices about pension saving; they are therefore automatically enrolled into a pension scheme, where investment choices are made for them by others.
- 9.4 The system works on a series of defaults. First, people are automatically enrolled in a pension scheme unless they make an active decision to opt out. Secondly, participants are not required to make a decision about how much to save. In the absence of a decision, the minimum amount will be deducted. Thirdly, participants are not required to make a choice about how their contributions are invested. Instead, they are placed in the default fund, unless they actively choose another option.
- 9.5 Auto-enrolment has been a major success in increasing retirement saving. The opt-out rate for 2015 to 2016 was only 9%.⁴⁰⁷ Previously, a requirement to fill in a form had dissuaded people from joining workplace pensions, even when it involved no cost to them. For example, in a study of 25 defined benefit (DB) schemes that were fully funded by the employer and required no employee contribution, only half of the eligible employees actually signed up.⁴⁰⁸
- 9.6 Most pension savers fail to make choices over how their money is invested and therefore remain in the default fund. Half of master trusts report that at least 99% of their membership is invested in the default fund.⁴⁰⁹

⁴⁰⁷ Department for Work and Pensions, *Employers’ Pension Provision survey 2015* (2016), p 21. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/584593/rr919-employers-pension-provision-2015.pdf.

⁴⁰⁸ S Benartzi and RH Thaler, “Heuristics and Biases in Retirement Savings Behavior” (2007) 21 *Journal of Economic Perspectives* 81.

⁴⁰⁹ Pensions Policy Institute and Columbia Threadneedle Investments, *The Future Book: Unravelling workplace pensions* (2016), p 22. Available at <http://www.pensionspolicyinstitute.org.uk/publications/reports/the-future-book-unravelling-workplace-pensions.-second-edition-2016>.

Lack of understanding

- 9.7 Research by Ignition House shows that the main reasons members give for their lack of interest include, “pensions are too complex”, “pensions are boring”, “there are more urgent priorities”, “retirement is a long time away”, and a general distrust of the pensions industry due to negative news and media coverage.⁴¹⁰
- 9.8 The research also shows a lack of knowledge about pensions. Members consistently underestimate their life expectancy and how much they need to save.⁴¹¹ They also overestimate the level of retirement income their savings will provide.⁴¹²
- 9.9 Individuals also lack confidence when making investment choices. This is partly due to high levels of financial illiteracy⁴¹³ among members, and a lack of understanding of equity-based products. If left to their own devices, evidence suggests that members would favour investments perceived to be “safe”, or would take the money out of the pension and invest it directly in property.⁴¹⁴

Behavioural barriers to member engagement

- 9.10 In DC schemes, members bear the risks and consequences of their investment decisions. If savers behaved as predicted by economic theory, members would make optimal decisions in their own self-interest.⁴¹⁵ However, behavioural economics shows that people are often “predictably irrational”.⁴¹⁶ They are subject to behavioural biases which result in them making sub-optimal decisions sometimes against their own self-interest. There are two main sets of biases at play which reduce member engagement with pensions. The first set is associated with inertia and procrastination,⁴¹⁷ the second with choice and information overload.

⁴¹⁰ Pensions Policy Institute and Ignition House, *Transitions to Retirement: Supporting DC members with defaults and choices up to, into, and through retirement* (2015), pp 19 to 34. Available at <http://www.pensionspolicyinstitute.org.uk/publications/reports/transition-to-retirement-defaults>.

⁴¹¹ Pensions Policy Institute and Ignition House, *Transitions to Retirement: Supporting DC members with defaults and choices up to, into, and through retirement* (2015), p 17.

⁴¹² Pensions Policy Institute, *Consumer engagement: barriers and biases* (2017), p 12. Available at <http://www.pensionspolicyinstitute.org.uk/publications/reports/consumer-engagement-barriers-and-biases>. Unsurprisingly, members of DB schemes are on average better at estimating the level of retirement income they can expect to receive than members of DC schemes.

⁴¹³ Financial illiteracy means a lack of understanding of the financial aspects of pensions and their working.

⁴¹⁴ Pensions Policy Institute and Ignition House, *Transitions to Retirement: Supporting DC members with defaults and choices up to, into, and through retirement* (2015), pp 19 to 20.

⁴¹⁵ Tapia and Yermo, Implications of Behavioural Economics for Mandatory Individual Account Pension Systems (2007), p 5. Available at <https://ssrn.com/abstract=1217604>.

⁴¹⁶ For further discussion of this concept, see D Ariely, *Predictably Irrational: The hidden forces that shape our decisions* (2008). For discussion of how this affects consumer behaviour, see OFT Consumer Behavioural Biases in Competition 2011 <https://londonconomics.co.uk/wp-content/uploads/2012/06/Consumer-behavioural-biases-in-competition-OFT1.pdf>.

⁴¹⁷ Personal Delivery Accounts Authority (PADA), *Building personal accounts: designing an investment approach* (2009), p 34. Available at <https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Investment-approach-consultation.PDF.pdf>.

Inertia and procrastination

9.11 Inertia is a key behavioural trait present in most rational human beings. People avoid making difficult decisions.⁴¹⁸ This in turn leads to procrastination. People often put off making choices about their pension to the last possible opportunity, with the result that they fail to make any decisions before facing retirement.

9.12 As the Pensions Institute puts it:

Most defined contribution members can be described as ‘reluctant’ or ‘disengaged’ investors. These are the individuals who, for a range of reasons, are not prepared to make an active investment choice and instead passively accept the default fund.⁴¹⁹

9.13 Amanda Wyper in response to our call for evidence commented that her research had found:

Time was used by individuals to justify procrastination. This arose in two ways. First, employees felt that they did not have enough time to read all the relevant information and make a decision and so they put off doing this until they had the time. Secondly, employees felt that the pension was something which related to old age and so they had plenty of time before needing to deal with the decisions such as investment.

9.14 Further, research has shown that decisions about how much to save for retirement, or even whether to save in the first place, involves a trade-off between short-term costs and long-term substantial gains. People value the “here and now” more highly than their future.⁴²⁰

Choice and information overload

9.15 A growing body of economic literature suggests that more choice is not always better. Individuals are prone to “choice overload” and simply fail to act when faced with too many options. Similarly, people can become overloaded with information to the extent that it reduces or eliminates their decision-making ability.

9.16 Choice and information overload increases the likelihood of “regret aversion” and “decision paralysis”.⁴²¹ Regret aversion is where “people are concerned about making the wrong choice in case they regret it afterwards”.⁴²² This in turn leads to decision paralysis, where people fail to make a decision at all in case it is the wrong one.

9.17 Iyengar’s seminal study tested the effects of choice overload by looking at how increasing the number of different varieties of gourmet jam affected consumer decisions to purchase a jam. It showed that the popular notion “the more choice, the

⁴¹⁸ Pensions Policy Institute, *Consumer engagement: barriers and biases* (2017), p 1. Available at <http://www.pensionspolicyinstitute.org.uk/publications/reports/consumer-engagement-barriers-and-biases>.

⁴¹⁹ The Pensions Institute, “Defined contribution pensions: dealing with the reluctant investor” (2008), *Journal of Financial Regulation and Compliance*, p 206. Available at <https://www.pensions-institute.org/workingpapers/wp0808.pdf>.

⁴²⁰ Pensions Policy Institute, *Consumer engagement: barriers and biases* (2017), p 19.

⁴²¹ Pensions Policy Institute, *Consumer engagement: barriers and biases* (2017), p 7.

⁴²² Pensions Policy Institute, *Consumer engagement: barriers and biases* (2017), p 7.

better” was fundamentally ill-conceived.⁴²³ In fact, it found that there can be too much choice. When there is, consumers are less likely to make an active choice or are less satisfied with their choice.

- 9.18 A further study by Iyengar in 2003 in relation to the US 401K pension plan found that participation rates declined as the number of fund options increased.⁴²⁴ When only two options were offered, participation peaked at 75% and declined steadily as the number of options increased. This suggests that pension savers have difficulty coping with a large number of investment options.⁴²⁵
- 9.19 Choice and information overload can significantly affect the investment decisions of DC scheme members if they are faced with numerous options or copious amounts of complex financial information.
- 9.20 We return to this issue below.⁴²⁶

LOW ENGAGEMENT AS A BARRIER TO SOCIAL INVESTMENT

- 9.21 Low levels of engagement can mean that it is difficult for pension schemes, and their managers, to ascertain members’ views on social investment and what types of social impact they may value. The absence of external pressure from pension savers means schemes are more likely to “carry on business as usual”. They may therefore either not consider social investments at all or feel that they cannot make investment decisions based on non-financial factors (such as environmental concerns) because they do not know whether scheme members share the concern.
- 9.22 Lack of member engagement can also impact upon socially responsible investment (SRI) with the result that pension schemes and their managers are less likely to actively exercise their stewardship powers. The perceived lack of customer demand for stewardship by pension trustees has resulted in narrow mandates for asset managers which do not, as standard, include stewardship.⁴²⁷ In particular, the Financial Reporting Council pointed out that:

One barrier frequently raised by pension funds is competing priorities. Corporate engagement⁴²⁸ inevitably slips down the agenda... and busy trustees are not always equipped to hold their asset managers to account. It is important to remember that pension funds themselves do not necessarily need to be directly involved in

⁴²³ Iyengar and Lepper, “When Choice is Demotivating: Can One Desire Too Much of a Good Thing?”(2000) *Journal of Personality and Social Psychology* Vol 79 No 6, pp 995 to 1006. Available at [https://faculty.washington.edu/jdb/345/345%20Articles/Iyengar%20%26%20Lepper%20\(2000\).pdf](https://faculty.washington.edu/jdb/345/345%20Articles/Iyengar%20%26%20Lepper%20(2000).pdf).

⁴²⁴ Iyengar, Jiang, and Huberman, *How Much Choice is Too Much?: Contributions to 401(k) Retirement Plans* (2003). Available at <http://www.nagdca.org/dnn/Portals/45/2015Annual/16.%20How%20much%20choice%20is%20too%20much%20choice.pdf>.

⁴²⁵ Tapia and Yermo, *Implications of Behavioural Economics for Mandatory Individual Account Pension Systems* (2007), p 6. Available at <https://ssrn.com/abstract=1217604>.

⁴²⁶ See paras 9.43 to 9.46.

⁴²⁷ Eva Micheler, “Facilitating investor engagement and stewardship” (2013) *European Business Organization Review* 30, pp 40 to 41.

⁴²⁸ Corporate engagement in this context means stewardship.

engagement and that this task falls more naturally to their asset managers in many cases.

The critical point is getting the mandate right and in recognising the different roles played by different players depending on where they are in the investment chain.⁴²⁹

HOW SOCIAL INVESTMENT MAY ENCOURAGE ENGAGEMENT AND VICE VERSA

9.23 In a recent survey conducted by ComRes and Big Society Capital,⁴³⁰ two in five people (39%) said that having a social pension option would make them feel more engaged with their employer, rising to nearly half (49%) of millennials.⁴³¹ Nearly a third (31%) said they would save more if a social pension was offered to them.⁴³²

9.24 The UK Sustainable Investment and Finance Association (UKSIF) in response to our call for evidence commented that:

Polling commissioned for Good Money Week 2015 showed that 54% of people with investments want their pensions or savings to have some positive impact on the world beyond just making money. Our view is that the appetite for responsible investment, which would include social investment, among UK savers is higher than it has been and is likely to grow further.

9.25 There is also interest in avoiding investments which may result in social harm. Research by YouGov for Principles for Responsible Investment in 2015 found that UK savers would prefer to avoid investing in companies involved in fossil fuel production (50%), child labour (79%), exploiting tax loopholes (67%) and excessive CEO pay (68%).⁴³³

9.26 A report by the Social Market Foundation and Big Society Capital argues that people will be more engaged with pension saving (and more inclined to save) if they can see that their money is being used for social good. It draws on survey evidence to show that many savers wish their money to be used for a positive social impact. This is particularly true for younger savers, “millennials”. The argument is that if people see that their pension pot is “doing good things” they may be more likely to engage and ultimately increase their contributions.⁴³⁴

⁴²⁹ Financial Reporting Council, *Developments in Corporate Governance* (2011), p 27. Available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2011-The-impa.pdf>.

⁴³⁰ ComRes interviewed 1,500 UK employees with a defined contribution pension between 21 December 2016 and 3 January 2017. ComRes and Big Society Capital, *Pensions with purpose* (2017). Available at <https://www.bigsocietycapital.com/latest/type/research/pensions-purpose>.

⁴³¹ ComRes and Big Society Capital, *Pensions with purpose* (2017), p 15; “Millennials” are those people who reached young adulthood around the year 2000, see Oxford English Dictionary (3rd ed 2002).

⁴³² ComRes and Big Society Capital, *Pensions with purpose* (2017), p 17.

⁴³³ YouGov and Principles for Responsible Investment (PRI), Summary of PRI’s Response to Law Commission: Defined Contribution Pension Funds and Social Investment. Available at https://www.unpri.org/download_report/28436.

⁴³⁴ Social Market Foundation and Big Society Capital, *Good pensions: Introducing social pension funds to the UK* (2015). Available at <http://www.smf.co.uk/wp-content/uploads/2015/09/Social-Market-FoundationSMF-BSC-030915-Good-Pensions-Introducing-social-pension-funds-to-the-UK-FINAL.pdf>.

- 9.27 Increased member engagement is therefore a benefit for pension savers financially, because they will be saving more for their retirement. Where it is motivated by a desire to see their savings being used for social impact, this may lead to more money for social investment.
- 9.28 As well as encouraging investment in social investments, increased member engagement can also have a positive impact on the exercise of stewardship powers by pension schemes and their managers. Even small amounts of pressure from pension savers can remind pension schemes, and their managers, of the importance of stewardship through voting rights and more informal dialogue with projects and companies invested in. It could therefore lead to an increase in stewardship by pension schemes more generally.

CHOSEN FUNDS

- 9.29 Workplace pension schemes are required to have default arrangements if they are being used for auto-enrolment purposes. They are also permitted, though not legally required, to offer their members chosen funds. Where members are engaged, chosen funds provide them with the opportunity to invest their pension savings in a particular way.
- 9.30 As explained in Chapter 3, pension schemes typically offer up to five chosen funds which could include: an ethical fund, a high-risk fund, a low-risk fund and a sharia fund.
- 9.31 The Pensions Regulator (TPR) currently expects trustees of trust-based schemes to ensure “an appropriate choice of investment arrangements for those members who do not wish to invest in the default arrangement”.⁴³⁵ In doing so, trustees should consider the needs of their scheme’s membership, including any demand for “ethically focused investment”.⁴³⁶ They are not however obliged to consider any demand for “social investment” more generally.
- 9.32 As explained in Chapter 3, ethical funds are funds which use strategies such as negative screening, based on ethical concerns, and positive screening, based on ESG factors, to select their investments.⁴³⁷ These funds do not take what we consider to be a social investment approach. Such an approach would involve the selection of investments based on their positive social outcomes rather than just screening out negative investments or considering ESG factors.
- 9.33 There is an argument that existing ethical chosen funds do not accurately reflect members’ views. Journalist Amie Williams has said that they place too much emphasis on screening out “sin stocks” such as alcohol and gambling while leaving those who (in her words) are “tax-dodgers” or “Libor-riggers” or who “pump out fossil fuels”.⁴³⁸
- 9.34 We therefore consider it good practice and important for pension schemes and their managers to provide members with chosen funds which reflect their values. However

⁴³⁵ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 89.

⁴³⁶ The Pensions Regulator, *Guide to investment governance* (July 2016), p 18.

⁴³⁷ See footnote 51 above.

⁴³⁸ Financial Times, “Why does pension investing have to be a moral dilemma?” 21 September 2016.

due to low levels of engagement, we accept that it is difficult to ascertain members' views. We return to this issue later in this chapter.

A mandatory social investment chosen fund?

- 9.35 A report by the Social Market Foundation and Big Society Capital suggested that all employers should offer DC scheme savers the option to save in a “social pension”.⁴³⁹ In response to our call for evidence, Big Society Capital endorsed the views of the report.
- 9.36 The idea of a social pension is modelled on French “solidarity investment funds”, used for workplace savings. There, up to 10% of funds are used to make social investments in charities, co-operatives and companies with a social mission. The rest is placed in more traditional investments, which are screened for social responsibility.⁴⁴⁰ It is worth noting that these are workplace savings schemes rather than pension arrangements, and therefore savers may be more willing to sacrifice financial returns for social good. As discussed in Chapter 2, in this report we think that, generally speaking, the central purpose of a pension has to be to make money for retirement. Social investment made by pension schemes should not involve a significant element of charitable giving or involve a significant sacrifice of competitive market returns.
- 9.37 In our call for evidence, we asked consultees whether a greater range of chosen options would encourage greater engagement. We were particularly interested to know whether a social investment option (seeking social impact as well as market returns) would encourage engagement. In this chapter we refer to such a chosen fund as a social investment fund. We did not ask consultees for views on chosen funds which provide below market returns.
- 9.38 As we discuss below, the majority of consultees were against the idea of a mandatory social pension for two main reasons: concerns about choice overload, and concerns that chosen funds have little impact. We conclude therefore that a social pension option should not be mandatory, and that more needs to be done around engagement and ascertaining members' views on these issues, before mandating a social pension option.

Consultees' views

- 9.39 In response to our consultation, Big Society Capital recommended that there should be a requirement in law for all DC schemes to offer a “social pension” fund option. They thought that this would overcome “continued inertia driven by trustees' and investment managers' lack of comfort with social investment”.
- 9.40 However, most consultees expressed concern about any increase in pension options. Although polling evidence suggests that pension savers are interested in social pensions, it was said that answers given by savers to pollsters do not necessarily translate into savers investing in chosen funds.

⁴³⁹ Social Market Foundation and Big Society Capital, *Good pensions: Introducing social pension funds to the UK* (2015).

⁴⁴⁰ For a brief guide to French solidarity funds, see Finansol, *Exploring Social Finance in France* (2016). Available at <https://www.finansol.org/dwl/social-finance.pdf>.

9.41 There is evidence of interest in environmental, social and governance (ESG) issues, particularly among those aged under 35. However, in practice, this has not translated into fund flows or active decisions. As the Pensions and Lifetime Savings Association (PLSA) put it in response to our call for evidence:

financial advisers quoted in a recent FT Adviser article on a survey suggesting that millennial investors were more interested in ESG issues than older counterparts were sceptical of the finding, stating that 'surveys have fairly consistently shown that many investors are well disposed to the concept of responsible investing, but this has never really translated into actual fund flows' and 'a survey is one thing but in the real world we just do not see this'. This disconnect between stated preference or intention and actual behaviour is common across almost all areas of pension policy.

9.42 ShareAction agreed:

There is evidence that a significant proportion of pension savers want to invest in things that create a financial return without "causing harm to our future"... These survey results do not in practice translate into people choosing ethical options in DC schemes and it seems likely the same would broadly hold true if more social pension options were available.

Concerns about choice overload

9.43 Most consultees argued that a greater range of options would have little or no effect in terms of engagement. They were concerned that too many options can have the opposite effect, and lead to choice overload, as described above.⁴⁴¹

9.44 B&CE Ltd (the provider of the People's Pension) concluded that:

All the evidence points to a greater range of options having either no or extremely limited effect on engagement with pension saving. It is well-established in behavioural economics that choice beyond a certain level leads to paralysis in decision-making. It may be that when the size of people's pots become much larger that it might become feasible to engage a somewhat larger minority.

9.45 As Legal & General Investment Management (LGIM) put it:

In general it is not the availability of funds that is the prime issue, rather the take up of funds.

9.46 Amanda Wyper suggested that:

More choice does not mean more engagement (as is evident in research about the existing choices available to fund or contribution levels in pensions) unless people understand what the choices are, how to make choices and what the consequences of choices are. Without a different way of disclosing information and making advice available at limited cost, it seems that more choice by itself will not make a significant impact or could lead to detrimental consequences for some.

⁴⁴¹ See paras 9.15 to 9.19.

Concerns that chosen funds have little impact

9.47 The second argument raised by consultees against requiring schemes to offer a social investment option was that it would have little effect. Consultees pointed to the low take up rates for the ethical funds currently on offer and suggested that any change to encourage more social investment should focus on default funds rather than chosen options.

9.48 For instance, B&CE Ltd noted that only 0.21% of pension savers at the People's Pension opted for the ethical fund. This shows that a very small number of savers exercise fund choices. They noted:

Auto-enrolment is a semi-obligatory inertia-based programme. It was adopted because the bulk of the population were and are disengaged from pension saving for a host of well researched behavioural reasons. In the short to medium run, no mechanism or policy is realistically going to overturn these psychological biases, except in a small number of cases. Almost all savers into automatic enrolment go into the default fund because they have exercised no choice.

9.49 It was said that social investment would be better incorporated into the default fund. PLSA commented that:

A focus on the standards of default funds is more productive than trying to persuade savers to explore options beyond the default.

Mandatory social investment chosen fund: conclusion

9.50 Pension schemes are permitted to offer members a social investment chosen fund. The range of funds currently in existence which offer ethical investment encompass different investment strategies and there is no agreed industry standard as to what a social investment chosen fund is.

9.51 There is currently low uptake of the chosen funds which offer ethical investment and which are available to pension scheme members. Consultees did not think that a mandatory social investment option would result in savers taking the active step of choosing to invest in that fund, and were also concerned about choice overload stifling the little engagement there is.

9.52 We also note that offering an additional chosen fund, such as a social investment fund, is likely to increase the administrative burden on schemes. This may be justifiable where schemes are responding to members' views by providing a chosen fund which addresses their wishes or concerns but, at the moment at least, funds are unlikely to know what their members' views are. This being the case, we do not think it is justifiable if it is taking significant resources away from management of default arrangements which are relevant to the majority of members. Below we discuss an option for reform to overcome this lack of awareness of members' views.

9.53 No legal or regulatory reform is necessary to allow pension schemes to offer social investment chosen funds, as this is already possible. The evidence we have received did not suggest that there was any justification for introducing a requirement to offer such a chosen fund.

OPTIONS FOR REFORM

9.54 We have not identified any legal or regulatory barriers to member engagement, but we have identified behavioural barriers. Below, we consider some options for reform which could harness member interest in social investment in order to both encourage engagement and lead to an increase in social investment:

- (1) Labelling;
- (2) Impact reporting; and
- (3) An obligation to ascertain members' views on social investment.

Labelling

9.55 If pension savers are to be offered social investment options, then these options will need to be identifiable. In our call for evidence we asked if social investment options should be labelled or described in a standardised way. For example, in France, funds have been accredited with the “Finansol” label to inform investors that their money will go to projects with strong social or environmental impact. Labelling drew mixed responses from consultees. While some consultees supported an independent accreditation scheme, others urged caution.

9.56 Big Society Capital argued that independent accreditation or labelling of social investment options could increase the confidence of pension savers in selecting such an option. This in turn could facilitate engagement. They said:

a kitemark or label could build early confidence and credibility to grow engagement.

9.57 Big Society Capital said that an accreditation scheme would increase confidence among investors, encourage best practice and provide some certainty for regulators. They drew on the experience of solidarity savings schemes in France, which rely on three stages of accreditation: for organisations which receive funds; for employee saving schemes; and for funds. At the fund level, funds which are accredited by the French Financial Markets Regulator are entitled to apply the well-known “Finansol” label.⁴⁴²

9.58 Several consultees agreed that an accredited label would be helpful to investors and would help bring social investment into the mainstream. For example, Columbia Threadneedle Investments thought that social investment options should be labelled and described in a standardised way. It continued:

There is also merit in considering the establishment of a specialist social investment organisation to develop a government-backed labelling system that will facilitate the awareness and confidence needed to shift social investment towards the mainstream.

9.59 Pinsent Masons LLP said that:

A clear definition and labelling of social investment would assist our clients in taking all relevant decisions.

⁴⁴² Finansol, *Exploring Social Finance in France* (2016). Available at <https://www.finansol.org/dwl/social-finance.pdf>.

- 9.60 UKSIF had mixed views on the issue. It noted moves throughout Europe to develop clearer definitions and labels, including initiatives in Belgium, France, Austria, Germany, Switzerland and Luxembourg. UKSIF explained that traditionally the SRI sector in the UK has tended to shy away from definitions and standards due to the potential to stifle innovation. Too “strict” a label might place such stringent requirements on funds that it would be almost impossible to achieve; whilst a “weak” definition might result in a “race to the bottom” and box-ticking. However, UKSIF acknowledged that an agreed label could be a powerful marketing tool if done well. The standard would need to include a clear reporting framework to evaluate and communicate the social impact of the fund. It would also need to be flexible enough to encourage innovation and prevent a race to the bottom.
- 9.61 Others were less optimistic. PLSA thought that a labelling scheme was “fraught with difficulty”. They asked who would define social investment and how they would do so, given that the “positive and negative impacts of any investment portfolio are likely to be highly subjective”.

A focus on terminology

- 9.62 SRI Services urged “real caution”. They thought that an accreditation system, poorly executed, risked reducing innovation, confusing clients and fuelling distrust. Instead, they argued that the industry should develop agreed terminology about the different subheadings or segments which come within the overarching “label” of SRI:

In general terminology is a challenge for the sector. This is in part because some terms originated in the institution market, whereas others came from the retail - individual investor - market.

- 9.63 Several other consultees agreed that the first priority should be for the industry to develop a set of agreed terminology. This would help in itself and would be a necessary precursor to any labelling or accreditation scheme.

The most pressing step now is to create a definition of responsible investment in general, and a framework for understanding social investments and their varying risk/performance and impact implications. [Legal & General Investment Management]

All of the approaches that we have outlined... carry with them different characteristics on risk, reward, cost, liquidity and scalability. We would suggest that a framework and standard definitions be developed around this that can be easily understood by beneficiaries. [Schroder Investment Management Ltd]

- 9.64 An accredited label can be a powerful marketing tool. However, any accreditation scheme needs to be introduced with great care. If overly prescriptive, it can stifle innovation. If insufficiently rigorous, it can bring the industry into disrepute.
- 9.65 Social investment is still a relatively new concept and there are not clear boundaries to define what it encompasses. We therefore consider that it is too early to develop an accreditation scheme. Instead, as a first step, pension providers should develop agreed terminology for different types of social investment, including investing for social impact and socially responsible investment. However, this is a matter for the industry. For these reasons, we would not favour legal or regulatory reform at this stage.

Option for reform 9.

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

Impact reporting

- 9.67 A second suggestion was to encourage impact reporting, not simply for chosen funds but also possibly for default arrangements. Again, there is some survey evidence to suggest that savers would welcome this. Polling for Good Money Week 2015 has shown that 47% of people with an investment would be interested in an annual update on its social and environmental impact. This figure rose to 58% of people under the age of 35.⁴⁴³
- 9.68 An example of impact reporting can be seen from the Columbia Threadneedle Investments UK Social Bond Fund. The fund invests in corporate bonds that are “assessed to create social benefits and support more balanced and inclusive economic development, primarily in the UK”. The fund is partnered with Big Issue Invest, which publishes an annual report to assess the social performance of the fund.
- 9.69 The fund’s 2016 annual report looks at the primary effect of the investment, in one of eight categories (such as affordable housing; utilities and the environment; or transport and communications). Interestingly, however, it also considers the extent to which the investment has created good quality jobs, and how far it has been targeted at deprived local communities and regions in the UK. Although some bonds are with charities or social enterprises, others are with mainstream companies, including Sainsbury’s and John Lewis, who are thought to encourage job creation.⁴⁴⁴
- 9.70 There are two arguments in favour of impact reporting. First, it tells a story about pension investment which may better resonate with savers than traditional reports about whether investments have gone up or down over the last year. Professor Kay has described much of this information as “noise” – that is “the frequent reporting of data irrelevant to long-term value creation”.⁴⁴⁵ In the short term, increases may be distrusted, while decreases may discourage further savings. Secondly, it may encourage trustees to think about how far the investment is creating wealth in the long term.
- 9.71 In its call for input about regulatory barriers to social investments, the Financial Conduct Authority (FCA) asked financial advisers and other intermediaries whether they had experienced problems advising investors who wish to invest in social

⁴⁴³ Good Money Week, *Make our Money Count* (2015), p 1. Available at: http://uksif.org/wp-content/uploads/2015/10/Main-press-release_final1.pdf.

⁴⁴⁴ Threadneedle UK Social Bond, *Annual Social Performance Review* (2016). Available at http://www.columbiathreadneedle.co.uk/media/10836369/en_social_bond_fund_annual_report_2016.pdf.

⁴⁴⁵ Kay Review of UK Equity Markets and Long Term Decision Making, *Final Report* (2012), ch 10. Available at <https://www.gov.uk/government/publications/kay-review-of-uk-equity-markets-and-long-term-decision-making-implementation-progress-report>.

enterprises.⁴⁴⁶ In its October 2016 Feedback Statement (FS16/11) in response to this call for input, the FCA noted that “some respondents claimed that the absence of a definitive framework for measuring social impact was a negative factor and one respondent commented that if an impact is not measurable, it can prevent a recommendation being made”.⁴⁴⁷

- 9.72 We would encourage industry to continue work in this area, to see whether different forms of reporting are welcomed by savers and whether it has a positive effect on engagement.

Option for reform 10.

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

An obligation to ascertain members’ views on social investment

- 9.74 Above, we concluded that it should not be mandatory for pension schemes to offer a social investment chosen fund. In many or even most cases, offering an additional chosen fund is likely to increase costs for schemes without a corresponding increase in the number of members moving from the default into chosen funds. However, such costs may be justifiable in cases where pension schemes and their managers are aware that enough members would be interested in such a fund. As discussed in Chapter 5, when applying the Law Commission test for taking into account non-financial factors, trustees must have good reason to think that scheme members share the concern. In Chapter 5 we also set out the challenges which can be faced by pension schemes in ascertaining member views.

- 9.75 If initiatives to encourage engagement start to take effect (including those described above), there may be more opportunities for pension schemes to obtain members’ views on social investment. Schemes could ask all members for their views on non-financial factors relevant to investments (for example environmental issues) and specific investments (for example tobacco and armaments or social housing and transport infrastructure).

- 9.76 Members could also be asked if they would be interested in allocating a percentage of their savings to social investment (for example up to 10%). Pension schemes could ask members for views when they first join the scheme and then periodically, during the period their savings are being invested by the scheme. This data collection would provide pension schemes with not only a source of information about the views of their members but a clear mandate from which they could justify offering a particular chosen fund.

⁴⁴⁶ Financial Conduct Authority, *Call for Input: Regulatory Barriers to Social Investment* (December 2015). Available at <https://www.fca.org.uk/publication/call-for-input/social-investments-call-for-input.pdf>.

⁴⁴⁷ Financial Conduct Authority, *Feedback Statement FS16/11: Call for Input Regulatory Barriers to Social Investment* (October 2016), para 2.24. Available at <https://www.fca.org.uk/publication/feedback/fs16-11.pdf>.

- 9.77 Schemes could then use this information to make decisions about whether to offer a social investment chosen fund. It could also be used by schemes as part of their investment decision-making process for their default arrangements and other chosen funds.
- 9.78 There is a risk that members may not engage with this process, in the same way that they have not engaged with pensions generally up until now. Although people sometimes engage with pollsters on these issues, consultees told us that most members do not even read the literature they are sent by their scheme. Pension savers may become more engaged with their pension and how their pension savings are invested as auto-enrolment is phased in and individuals' contribution levels are increased and if initiatives to encourage engagement start to take effect (including those described above). However, even if this does happen it may take a while for pension schemes to collect sufficient data from members and so the benefits of data collection may only be realisable in the longer-term.

Option for reform 11.

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

Chapter 10: Recommendations and options for reform

This chapter brings together all of the recommendations and options for reform contained in this report.

FINANCIAL AND NON-FINANCIAL FACTORS – RECOMMENDATIONS (CHAPTER 6)

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.

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.

Recommendation 3.

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.

Recommendation 4.

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.

Recommendation 5.

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 to investment governance.

INVESTMENT IN SOCIAL ENTERPRISES (CHAPTER 7)**Option for reform 1.**

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

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.

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.

INVESTMENT IN PROPERTY AND INFRASTRUCTURE (CHAPTER 8)

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.

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.

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.

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.

Option for reform 8.

The Department for Work and Pensions and the 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.

ENGAGEMENT AND SOCIAL INVESTMENT (CHAPTER 9)

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.

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.

(signed)

David Bean, Chairman
Nick Hopkins
Stephen Lewis
David Ormerod
Nicholas Paines

Phil Golding, Chief Executive

12 June 2017

Appendix 1: Law Commission guidance (2014)

“IS IT ALWAYS ABOUT THE MONEY?”

PENSION TRUSTEES’ DUTIES WHEN SETTING AN INVESTMENT STRATEGY: GUIDANCE FROM THE LAW COMMISSION

BACKGROUND

- 1.1 In July 2012, Professor Kay published a review of the UK equity market. Among other things he noted concerns that

some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact.¹
- 1.2 One of Professor Kay’s recommendations was that the Law Commission should review the legal concept of “fiduciary duty” to address uncertainties and misunderstandings on this issue.
- 1.3 In March 2013, the Government asked the Law Commission to examine the fiduciary duties of investment intermediaries. A central concern was the legal duties of pension trustees when they make investment decisions. In particular, how far may (or must) trustees consider interests beyond the maximisation of financial return, such as questions of environmental and social impact, and the ethical views of their beneficiaries?
- 1.4 This short document summarises the Law Commission’s conclusions on these issues. For a full statement, readers are directed to the Law Commission’s final Report, in particular Chapter 6.² The Report follows a Consultation Paper, published in October 2013.³

¹ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 9.20.

² *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350. This is available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>. The Report was laid before Parliament on 30 June 2014 and published on 1 July 2014.

³ *Fiduciary Duties of Investment Intermediaries* (2013) Law Commission Consultation Paper No 215 (CP 215).

DUTIES OF PENSION TRUSTEES

1.5 The legal duties of pension trustees derive from at least three sources.

The trust deed

1.6 The starting point is the trust deed. Looking at the deed, trustees should ask: what is the purpose of the investment power we have been given, and how can we use that power to promote the purpose of the trust?

The pensions legislation

1.7 Next, trustees must act within the confines of the legislation. Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 sets out some general principles. For example an investment power should be exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”; and scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings.”

1.8 Although smaller schemes are excluded from parts of the regulations, we think that these principles apply to all trust-based schemes as a matter of trust law.

Judge-made duties

1.9 The legislation operates alongside a variety of “judge-made” duties, including duties that attach to the exercise of a power, duties of care and fiduciary duties.

1.10 Among other things, the courts require that trustees must consider the right issues. In particular, trustees should:

- (1) act for the proper purpose;
- (2) take into account all relevant considerations, and ignore irrelevant ones;
- (3) take advice; and
- (4) not “fetter their discretion”, by applying a pre-existing judgement.

1.11 In addition, trustees should act “with such care and skill as is reasonable in the circumstances”. Those who act in a professional capacity or who hold themselves out as having special knowledge or experience will be held to a higher standard than lay trustees.

THE PRIMARY PURPOSE OF INVESTMENT POWERS

1.12 In pensions, the purpose of the investment power is usually to provide a pension – with contributions invested to provide a return, often several years into the future. The primary aim of an investment strategy is therefore to secure the best realistic return over the long term, given the need to control for risks.

1.13 The key distinction is between financial and non-financial factors. Financial factors are any factors which are relevant to trustees’ primary investment duty of balancing returns against risks. A non-financial factor is one motivated by other concerns, such as improving members’ quality of life or showing disapproval of certain industries.

- 1.14 Trustees may always take account of financial factors. They may also take account of non-financial factors if two tests are met. These are described below.

FINANCIAL FACTORS

- 1.15 Trustees are required to balance returns against risk. This is not a question of maximising returns: risks matter just as much as returns. Not all risks can be quantified. They often involve questions of judgement, which must be assessed at the time of the decision, not in hindsight.

The risks to a company's long-term sustainability

- 1.16 When investing in equities over the long term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action.
- 1.17 Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk.

Trustees *may* take all these factors into account

- 1.18 Trustees *may* take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors).
- 1.19 The Law Commission's conclusion is that there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.

Trustees *should* take financially material factors into account

- 1.20 The law goes further: trustees should take account of financially material risks. But the law does not prescribe a particular approach. It is for trustees' discretion, acting on proper advice, to evaluate which risks are material and how to take them into account.
- 1.21 It is not necessarily helpful to say that trustees "must" take an ESG approach. The ESG label is ill-defined: it covers a wide variety of risks, and many different approaches. The fact that a particular factor is conventionally classified as an "ESG" factor will not be conclusive as to whether it is financially material to the particular investment.
- 1.22 Instead the duty may be put in the following terms. When investing in equities over the long term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability.

NON-FINANCIAL FACTORS

- 1.23 “Non-financial factors” are factors which might influence investment decisions that are motivated by other (non-financial) concerns, such as improving members’ quality of life or showing disapproval of certain industries.
- 1.24 The distinction between financial and non-financial factors may be illustrated with an example. Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non financial factor.
- 1.25 In general, non-financial factors may be taken into account if two tests are met:
- (1) trustees should have good reason to think that scheme members would share the concern; and
 - (2) the decision should not involve a risk of significant financial detriment to the fund.
- 1.26 This means that if trustees wish to consider non-financial factors, they should ask two questions.

Question 1: Do we have good reason to think that scheme members share the concern?

- 1.27 Trustees may not impose their own ethical views on their beneficiaries. If trustees wish to take account of a non-financial factor, they must have good reason to think that scheme members would share their concern.

Is survey evidence required?

- 1.28 Not necessarily. In some cases trustees may be able to make assumptions: an example might be activities which contravene international conventions, such as manufacturing cluster bombs. The fact that these are banned by the Convention on Cluster Munitions, ratified by the UK, may give trustees reason to think that most people would consider them to be wrong. When coupled with letters from members agreeing, and no letters disagreeing, trustees would have good reason to think that they were acting on members’ concerns rather than their own.
- 1.29 In other cases, it may be necessary to consult members more formally.

Must all members agree?

- 1.30 We do not think that there needs to be 100% agreement. That will usually be unachievable. If a majority are opposed to an investment while the rest remain neutral, that may be enough.
- 1.31 The more difficult question is where a majority think that the disinvestment should take place but a minority disagree strongly. 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.

Do trustees have to consider members' views?

1.32 No. Trustees *may* consider the views of the beneficiaries when making their investment decisions, but there is no legal requirement for them to do so.⁴ However, they should only take account of non-financial factors if they reflect members' views and interests – rather than the views of the trustees.

Question 2: Does the decision risk significant financial detriment?

1.33 If trustees wish to take a decision motivated by non-financial factors, they should seek advice from their financial advisers on the effect of the decision on returns to the fund. They should not proceed if the decision risks significant financial detriment to the fund.

1.34 Often excluding a sector of the market will not risk significant detriment. The law does not require a portfolio to be diversified to the fullest extent possible. Instead it is a question of degree. For example, in *Harries*, the Church Commissioners reached the view that excluding 13% of the market would be acceptable, while excluding 37% would not be. The court held that this decision did not err in law.⁵ It was the trustees' discretion and the court would not interfere.

1.35 However, if trustees are advised that a decision would risk significant financial detriment, they should not normally proceed.

The interaction between the two tests

1.36 Any decision made on non-financial grounds is subject to both tests. However, the ultimate decision should be looked at in the round, considering the evidence on both questions.

1.37 For example, if trustees are faced with compelling evidence that members feel very strongly about the issue, then they may be justified in accepting a risk of some possible detriment, so long as that detriment is not significant. Conversely, if trustees receive clear professional advice that the decision is financially neutral, with some members agreeing and some indifferent, the trustees may still go ahead. The position may be different where only a modest level of agreement is combined with some risk of detriment.

Exceptions: when can significant financial detriment be justified?

1.38 There are two clear exceptions where significant financial detriment is permitted:

- (1) where the decision is expressly permitted by the trust deed; and
- (2) in DC schemes, where the member has chosen to invest in a specific fund.

1.39 Different considerations may also apply to “affinity groups”, as we discuss below.

⁴ Unless the trust instrument provides otherwise.

⁵ *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1250 to 1251.

A more flexible approach for affinity groups

- 1.40 We use the term “affinity groups” to describe schemes where members share a particular moral or political viewpoint. An example would be a pension scheme set up by a religious group, other charity or political organisation.
- 1.41 Here trustees should still ask the same questions, but the answers may be applied more flexibly. It may be easier to establish a consensus among members. If faced with compelling evidence that all members of the scheme felt strongly about an issue, trustees may be justified in accepting a greater risk of detriment than would otherwise be the case.
- 1.42 For further information on this issue, please see Chapter 6 of the Report.⁶

THE STATEMENT OF INVESTMENT PRINCIPLES (SIP)

- 1.43 Pension trustees are required to prepare a SIP stating their policy on the kinds of investments to be held and the extent (if at all) to which social, environmental or ethical considerations are taken into account when making investment decisions.⁷ This does not give trustees any special authority to consider non-financial factors. Any investment strategy in the SIP must accord with the general law.
- 1.44 The reference to “social, environmental and ethical issues” may be confusing. It would be preferable to think in terms of financial and non-financial factors.

1 July 2014

⁶ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350 paras 6.91 to 6.98.

⁷ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(3).

Appendix 2: List of consultees

The following bodies and individuals responded to our consultation, which ran from 8 November 2016 until 15 December 2016.

Academics

Amanda Wyper, University of Edinburgh
Anna Tilba, University of Newcastle

Asset managers

Columbia Threadneedle Investments
Fincch
Schroder Investment Management Ltd

Charities and social enterprises

Sainsbury Family Charitable Trust
Somerset Co-operative Services CIC
Tintagel House (Sheffield) Ltd Charity

Industry advisers

ARC Pensions Law
Bates Wells & Braithwaite London LLP
Burgess Salmon LLP
Pinsent Masons LLP
SRI Services
Worthstone

Professional bodies

Association of Pension Lawyers
Chancery Bar Association
Pensions and Lifetime Savings Association (PLSA)
The Investment Association
The Society of Pension Professionals
UK Sustainable Investment and Finance Association (UKSIF)

Pension schemes

B&CE Ltd

Legal & General Investment Management (LGIM)

Standard Life

USS Investment Management

Research groups

Institute and Faculty of Actuaries

Principles for Responsible Investment (PRI)

ShareAction

Vigeo Eiris

Individuals

Madeleine Pickett

Other

Big Society Capital

Between September 2016 and May 2017, the Law Commission met or otherwise corresponded with the following people and organisations with respect to the pension funds and social investment project.

Academics

Centre on Household Assets and Savings Management, University of Birmingham

Anna Tilba, University of Newcastle

Professor David Blake, Pensions Institute, Cass Business School

Asset managers

Cheyne Capital Management

Partners Group (UK) Ltd

Pensions Infrastructure Platform (PiP)

State Street Global Advisors

Individuals

Charles Scanlan

Michael Cook

Industry advisers

Bates Wells & Braithwaite London LLP

Other

Big Society Capital

Companies House

Department for Business, Energy and Industrial Strategy

Department for Culture, Media and Sport

Department for Work and Pensions

HM Revenue and Customs

HM Treasury

Scottish Law Commission

Pension schemes

B&CE Ltd

Legal & General Investment Management (LGIM)

National Employment Savings Trust (NEST)

USS Investment Management

Professional bodies

Pensions and Lifetime Savings Association (PLSA)
Social Enterprise UK
UK Sustainable Investment and Finance Association (UKSIF)

Regulators

The Charity Commission
Financial Conduct Authority
Office of the Regulator of Community Interest Companies
The Pensions Regulator

Research groups

Ignition House
Pension Policy Institute
ShareAction

Appendix 3: Table of legal forms for social enterprise

	Registered societies		Community interest companies (CICs)		Limited companies		Charitable Incorporated Organisation (CIO)	Trust	Unincorporated Association
	Cooperative Society	Community Benefit Society	CIC Limited by Shares	CIC Limited by Guarantee	Company Limited by Guarantee	Company Limited by Shares			
Does this form have limited liability?	✓	✓	✓	✓	✓	✓	✓	✗	✗
Is this form subject to a restriction on the use of assets?	Can adopt a voluntary asset lock	✓	✓	✓	Yes, but only if a charity	✗	✓	✓	Yes, but only if a charity
Can this form grant a fixed or floating charge over its assets?	✓	✓	✓	✓	✓	✓	✗	✗	✗
Can this form give a return on shares?	Yes, but cannot be the main purpose of the society	Yes, but only by way of interest on share capital	Yes, subject to a dividend cap	✗	✗	✓	✗	✗	✗
Can a charity use this form?	✗	✓	✗	✗	✓	Yes, but rare	✓	✓	✓
Can a non-charity use this form?	✓	✓	✓	✓	✓	✓	✗	✓	✓

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