



**Law
Commission**
Reforming the law

Pension Funds and Social Investment Summary

**Law Com No 374 (Summary)
12 June 2017**

Part 1: This project and the current pensions landscape

- 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. For the vast majority of people, this results in their money being placed in "default funds" where decisions about how funds are invested 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,¹ a sum equivalent to 15% of the current net wealth of the UK.² 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, or "social impact".
- 1.3 The law is flexible enough to allow some social investment by pension funds. We have identified that there are structural and behavioural barriers to social investment within the pensions industry but no legal or regulatory barriers.

THIS PROJECT

- 1.4 On 3 November 2016, the then Minister for Civil Society, Rob Wilson MP, asked the Law Commission to look at the law governing how far pension funds may or should consider issues of social impact when making investment decisions. We were asked to consider whether there are legal or regulatory barriers to using pension funds for social impact (including investment in social enterprises), and set out options for reform if appropriate.
- 1.5 This project builds on our 2014 report, *Fiduciary Duties of Investment Intermediaries*,³ and accompanying guidance which considered when pension trustees can take environmental and social factors into account when making investment decisions.⁴

¹ The 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>.

² Office for National Statistics, *UK National Balance Sheet 2016 estimate* (August 2016). Available at <https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/bulletins/nationalbalancesheet/2016estimates>.

³ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350. Available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

⁴ 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/>.

Call for evidence

- 1.6 The emphasis on applying existing guidance to new circumstances and the fact that we are not asked to make recommendations has made this an unusual project for the Law Commission. Rather than publish a detailed consultation paper with proposals for reform, we held a call for evidence over five weeks from 7 November 2016. We received 30 responses from a wide range of stakeholders, a compilation of which can be found on our website.⁵ We have also had further face-to-face meetings with around 20 stakeholders and a round table with stakeholders.
- 1.7 We would like to thank all those who responded to our consultation and those who we met with or corresponded with in this project. We are particularly grateful to the University of Birmingham for organising a roundtable event which allowed an open discussion of the issues.

Our conclusions

- 1.8 The barriers to social investment by pension funds that we identified were, in most cases, structural and behavioural rather than legal or regulatory.
- 1.9 It would not be appropriate for us, as a law reform body, to make recommendations in these areas, but we set out options for reform where we have identified steps which could be taken by others to address these barriers.
- 1.10 We make some recommendations where we have identified that the law could be improved so as to reduce the impact of these barriers. These changes were identified in our 2014 report and have been updated in light of the current pensions landscape.

Project documents

- 1.11 This is a summary of a more comprehensive final report, published in June 2017 and presented to Parliament with our recommendations and options for reform.⁶
- 1.12 We have also published a detailed paper describing the different legal forms that social enterprises may take. This is available on our website.⁷

WHAT IS SOCIAL INVESTMENT?

- 1.13 Social investment, or investing for social impact,⁸ encompasses a broad range of investment approaches. Most definitions of social investment involve a mix of financial and non-financial motives – the desire both to “do well and do good”.
- 1.14 We consider that social investment goes beyond taking into account environmental, social and governance factors simply to guard against financial risks. For our

⁵ Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

⁶ Pension Funds and Social Investment (2017) Law Com No 374. Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

⁷ Law Commission, *Background paper: Legal forms for social enterprise* (June 2017). Available at www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

⁸ Although we acknowledge that it may be possible to draw a distinction between ‘social investment’ and ‘investment for social impact’, in this project we use the terms interchangeably.

purposes, we think it involves incorporating some non-financial element into the decision-making (for example, a desire to have a particular positive social impact), alongside a desire for good risk-adjusted returns.

- 1.15 We focus on investment which addresses societal challenges while continuing to generate competitive financial returns. Generally speaking, the central purpose of a pension has to be to make money for retirement. Although individual savers may choose to make investments with a social impact which involve a clear and significant sacrifice in returns, this is not necessarily suitable for all pension savers. In our project, we focus on social investments which do not involve a significant element of charitable giving or a significant sacrifice of competitive market returns.

Examples of social investment

- 1.16 In our call for evidence we asked for examples of social investments which pension funds could or should be making.
- 1.17 Overwhelmingly, consultees mentioned property and infrastructure projects as investment opportunities with a genuine potential to have a social impact and provide a market return. While not all property or infrastructure projects will constitute social investment, there are clear examples such as social housing, green energy and sustainable transport initiatives 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.
- 1.18 Consultees also mentioned investments in charities and other social enterprises as constituting social investment which might, albeit in more limited circumstances, be suitable for pension funds.
- 1.19 While we consider the ability of pension schemes to invest for social impact generally, below we consider particular challenges relating to investment in property and infrastructure and investment in social enterprises.⁹

THE CURRENT PENSIONS LANDSCAPE

- 1.20 A “workplace pension” is a pension arranged through an employer. This is distinct from a private personal pension which an individual can choose to arrange themselves directly with a pension provider. In this project, we concentrate on workplace pensions set up by private sector employers.¹⁰

⁹ We discuss investment in social enterprises from para 2.17, and investment in property and infrastructure from para 2.33.

¹⁰ This project 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.

- 1.21 There are two main types of workplace pension from the saver's perspective:
- (1) Defined benefit (DB) scheme: In DB schemes, the employer guarantees scheme members a certain income on retirement, often expressed as a percentage of their final or average salary.
 - (2) Defined contribution (DC) scheme: In DC schemes, the saver's income on retirement depends on the performance of the pension fund investments. The saver, rather than the employer, takes the risk that the investments may not perform well.
- 1.22 Membership of DC schemes has increased rapidly, and DC schemes have now overtaken DB schemes as the primary form of workplace pension in the UK. This is due in large part to auto-enrolment, which we discuss below.
- 1.23 Active membership¹¹ of private sector DB pension schemes has continued to decline since the late 1960s.¹² 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 introduction 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 2015.¹³
- 1.24 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.

Auto-enrolment

- 1.25 Auto-enrolment is a requirement introduced by the Pensions Act 2008. It requires employers 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). Employees have the right to opt out, but they must make a positive decision to do so.
- 1.26 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.
- 1.27 There has been a surge in workplace pensions seen since the introduction of auto-enrolment.¹⁴ It has led to a significant change in the pensions landscape even in the

¹¹ An active member is a member of a pension scheme who is currently contributing to and accruing benefits under that scheme.

¹² Pensions Policy Institute, *The Future Book: unravelling workplace pensions* (2016), p 8; Pensions Policy Institute, *The changing landscape of pension schemes in the private sector in the UK* (2012), p 1.

¹³ Office for National Statistics, *Occupational Pension Schemes Survey UK 2015* (September 2016), ch 7.

¹⁴ 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: Department for Work and Pensions, *Employers' Pension Provision Survey* (2015), p 19.

time since the publication of our 2014 report, *Fiduciary Duties of Investment Intermediaries*.¹⁵

Default and chosen funds

- 1.28 Employees who are auto-enrolled into DC scheme workplace pensions 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” into which employees’ contributions are paid if they fail to make an active choice of fund.
- 1.29 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” and may focus on investment in certain assets or markets, such as property or equities listed on recognised stock exchanges. Alternatively, chosen funds may focus on a particular investment strategy or approach. Schemes tend to provide up to five choices, often including an ethical fund, a sharia fund, a high-risk fund and a low-risk fund.
- 1.30 The great majority of workplace DC scheme members, over 90%,¹⁶ are invested in the default arrangements provided by their scheme, rather than making an active decision to put their pension savings into specific funds.

What asset classes do DC schemes invest in?

- 1.31 The majority of all DC pension investment is in shares listed on a recognised stock exchange. Only 4.6% of DC scheme money is invested in property, or in asset classes other than equities, such as private equity or commodities. This proportion is low compared with the traditional approach of DB schemes, and low compared with pension schemes in other countries, such as Australia.¹⁷

LAW AND REGULATION OF PENSIONS

- 1.32 As well as the distinction between DB and DC schemes, pension arrangements can be further categorised as either being set up through a trust structure or based on contract. This further distinction is a matter of legal form and does not impact the pension saver’s return. DB schemes are set up as trust-based schemes. DC schemes can be set up either as trust-based or contract-based schemes.
- 1.33 The different types of scheme are subject to different legal and regulatory regimes. 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”.

¹⁵ For further details about our 2014 report, see Pension Funds and Social Investment (2017) Law Com No 374, paras 1.4 to 1.6.

¹⁶ Pensions Policy Institute, *The Future Book: unravelling workplace pensions* (2016), p 22.

¹⁷ Spence Johnson, *Market Intelligence 2016: UK Defined Contribution, Looking beyond the passive approach* (2016).

Trust-based schemes

- 1.34 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. Trust-based schemes are sometimes referred to as “occupational pension schemes”.
- 1.35 Trust-based schemes are subject to multiple sources of law, including the terms of the trust deed and various pensions legislation.¹⁸ These schemes are regulated by The Pensions Regulator (TPR), which issues guidance to explain the statutes, regulations and codes of practice in specific areas.¹⁹ Trustees are also subject to various duties derived from case-law; particularly duties connected to the exercise of a power, duties of care and fiduciary duties.

Contract-based schemes

- 1.36 DC schemes may be set up by means of a contract between an individual and a contract-based pension provider, typically an insurer.
- 1.37 In contract-based pension schemes, 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. 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 is carried out by independent governance committees (IGCs) which assess the ongoing value for money of the scheme for pension policyholders.
- 1.38 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.²⁰ 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 schemes.
- 1.39 Providers are subject to extensive oversight 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.

¹⁸ Including the Pensions Act 1995, the Pensions Act 2004 and the various regulations made under these Acts.

¹⁹ For the purposes of this report, the most important is The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016).

²⁰ 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.

FINANCIAL AND NON-FINANCIAL FACTORS

- 1.40 In 2014, the Law Commission looked at how far pension trustees may take account of factors such as social and environmental impact and ethical factors.²¹ We also published guidance alongside our report, which was intended to assist trustees when they are making investment decisions.²² Our 2014 report, and the guidance, distinguished between financial and non-financial factors.²³ 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.
- 1.41 We draw on this work in considering whether the law allows issues of social impact to influence pension fund investment policy, and apply it to the current pensions landscape.

Financial factors

- 1.42 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.²⁴ Trustees of DB and DC schemes should always take into account financially material factors when making investment decisions.
- 1.43 In this context, issues of social impact should be taken into account where they help trustees assess the long-term financial risks of a particular investment; for example, where a company's negative social or environmental impact could affect its long-term sustainability and financial returns.

Non-financial factors

- 1.44 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, for trustees to take account of non-financial factors when setting investment strategies and making investment decisions, they must apply two tests, taken from the case law:
- (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.²⁵

²¹ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350.

²² 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/>.

²³ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, para 6.22.

²⁴ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, ch 5.

²⁵ 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.

- 1.45 These two tests apply to both DB schemes and DC schemes. They also apply to all investments, including equities, bonds and property. 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. We consider each test below.

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

- 1.46 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 hold the concern.
- 1.47 Finding out members' views does not necessarily require survey evidence. In some cases, trustees may be able to make assumptions. For example, the manufacture of cluster bombs contravenes the Convention on Cluster Munitions. This 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.
- 1.48 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. In 2014, we said that where the issue was clearly controversial, the courts would expect trustees to focus on financial factors, rather than becoming embroiled in disagreements between the members on non-financial factors.²⁶ 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.

Test 2: The decision should not risk significant financial detriment

- 1.49 This test need 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?

- 1.50 Trustees *may* take account of non-financial factors but are not obliged to do so.
- 1.51 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.²⁷ Therefore, trustees cannot simply refuse to take account of non-financial factors in all circumstances, however serious the potential harm to scheme members. Generally, however, the courts allow trustees a very wide margin in deciding what circumstances are relevant and irrelevant, and are therefore reluctant to interfere.

²⁶ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, paras 6.64 to 6.65.

²⁷ *Snell's Equity* (32nd ed 2010), para 10-016.

Reasons for failing to take account of non-financial factors

1.52 We were asked whether trustees have to provide good reasons for not taking non-financial factors into account. In an extreme case the courts may be sympathetic to members' requests for reasons. 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.

Chosen funds

1.53 Some DC scheme members may independently decide to put their pension savings into a chosen fund with a specific investment strategy which makes investments based on non-financial factors. Pension scheme decision makers will need to take such investment strategies into account when making investment decisions relating to those chosen funds.

Part 2: Recommendations and options for reform

REPORTING ON POLICIES RELATING TO SOCIAL INVESTMENT: RECOMMENDATIONS

Trust-based schemes

- 2.1 Although, as we discuss above, 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.
- 2.2 The Pensions Act 1995 provides pension trustees with a wide investment power. The main substance of how pension schemes should exercise this power is set out in the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations).
- 2.3 In practice, trustees of trust-based pension schemes structure their decision making around a “statement of investment principles” (SIP) which trustees are required to produce under the Pensions Act 1995 and the Investment Regulations. Trustees must provide their members with a copy of the SIP on request.

Financial and non-financial factors

- 2.4 Among other things, the SIP must include, under regulation 2(3)(b)(vi) of the Investment Regulations, a statement of the trustees’ policy on the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. A new regulation 2A was introduced in April 2015 which expanded the SIP requirements. Trustees of DC schemes must now provide this information in a SIP prepared specifically for a scheme’s default arrangements.
- 2.5 In 2014, we were told that the conflation of “social, environmental or ethical considerations” was confusing. 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 not to invest in or withdraw investment from an industry to show ethical disapproval.
- 2.6 This issue is now subject to a new European Union pensions directive on “IORP”, which stands for “institutions for occupational retirement provision”.²⁸ It contains 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”.²⁹ As discussed, schemes are already allowed to take

²⁸ The IORP II Directive came into force in January 2017 and EU Member States must incorporate it into national legislation by 13 January 2019. It will (absent any contrary agreement) require to be implemented before the expiry of the two year period, as 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.

²⁹ IORP II Directive, preamble and art 19(1)(b).

account of the potential long-term impact on investments caused by environmental, social, and governance (ESG) factors. However, we think more needs to be done to require IORPs “to explicitly disclose where such factors are considered in investment decisions”.³⁰

- 2.7 In 2014 we recommended that regulation 2(3)(b)(vi) should be amended to distinguish more clearly between financial and non-financial factors.³¹ We adhere to our 2014 recommendation with updates to reflect the new regulation 2A. Any changes to SIP requirements should cover SIPs prepared under regulations 2 and 2A of the Investment Regulations.³² 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.
- 2.8 Where trustees have no policies in these areas, we would expect this to be stated in the SIP.

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.

Stewardship

- 2.9 We think that pension trustees should be encouraged to consider whether and how they will exercise stewardship. Stewardship is the activity of investors engaging with the underlying investment in order to promote its 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.
- 2.10 Pension savers invest via their pension scheme; therefore it is up to the people managing the scheme to exercise stewardship. 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

³⁰ IORP II Directive, preamble.

³¹ Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, para 7.94.

³² 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.

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

- 2.11 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.
- 2.12 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. We adhere to that recommendation and expand it to cover the SIP produced for the scheme's default arrangement.

Recommendation 2.

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

- 2.13 Contract-based schemes should 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 Financial Conduct Authority's Handbook that deals with business standards.

Financial and non-financial factors, and stewardship

- 2.14 Unlike trust-based schemes, there is no requirement for contract-based schemes to produce a SIP. However, each provider must have an independent governance committee (IGC) 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. 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.
- 2.15 In order to ensure similar outcomes for members of contract-based and trust-based schemes, we recommend changes to the rules for contract-based schemes in relation to consideration of and reporting on financial and non-financial factors and stewardship.

Recommendation 3.

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

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

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

Recommendation 4.

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

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

2.16 Further, TPRs guidance for trustees includes the test set out in the 2014 Law Commission guidance for taking into account non-financial factors in investment decisions. By contrast, we are not aware of any 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.

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

INVESTMENT IN SOCIAL ENTERPRISES: OPTIONS FOR REFORM

2.17 In response to our call for evidence, stakeholders identified investment in social enterprises as a form of social investment. A social enterprise is a business with a social, charitable or community-based purpose, whose surpluses are principally reinvested for those purposes. A social enterprise is distinct from a commercial business which has been set up principally to make a profit and provide returns to shareholders.

- 2.18 Some potential infrastructure investments are conducted through social enterprises, for example social housing and loans to universities to build new facilities. These may well offer opportunities for pension investment. However, most social enterprises are small and do not provide the scale necessary for pension investment. They may offer some suitable low-risk investments, however, they may be less likely to be able to offer the high-risk, high-return investments offered elsewhere.
- 2.19 Social enterprises can be set up using different legal forms including charities, community benefit societies and community interest companies which are subject to different rules and restrictions as to their activities and use of profits. Some legal forms are more or less restrictive in relation to an enterprise's ability to provide returns to investors. In particular, different forms of social enterprise differ as to:
- (1) whether they are incorporated, and whether they have a separate legal personality;
 - (2) their ability to provide returns to investors via interest and grant security for debt financing; and
 - (3) their ability to provide returns to investors via dividends.
- 2.20 The wide range of possible legal forms provides choice and flexibility for organisations to choose the most appropriate form for them. We do not propose that all restrictions should be lifted as the different legal forms serve different and useful purposes, including that providing financial returns to investors is not the primary purpose of many social enterprises. We suggest three options for reform where we have identified unnecessary barriers to investment in social enterprises.

Lack of a charges register for charitable incorporated organisations (CIOs)

- 2.21 A CIO is a new form of incorporated charity introduced as an alternative to a limited company.³³ It has separate legal personality from its members, but unlike a company it cannot issue shares. It is regulated by the Charity Commission but not by Companies House.
- 2.22 The CIO legal form provides an easily accessible structure, but there is no public register of fixed and floating charges granted by a CIO. This may restrict the ability of CIOs to take on secured loans and issue secured bonds, because lenders will not have access to a single, accurate register to check whether assets are already used as security. Without this comfort they may be reticent about lending larger sums of money, including on a secured basis. Lord Hodgson's review of the Charities Act 2006³⁴ identified that this lack of a register of charges means that the CIO may not be an attractive legal form for larger charities.

³³ The Charities Act 2006 first introduced the CIO legal form, with further provisions in the 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.

³⁴ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012). Available at <https://www.gov.uk/government/consultations/charities-act-2006-review>.

2.23 We therefore suggest that government should consider creating a new register for security interests which can be used by CIOs.

Option for reform 1.

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

Community interest company (CIC) dividend cap

2.24 The CIC is a relatively new form of company, introduced in 2005.³⁵ It was 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 purposely make a profit. CICs can issue shares, but dividends to shareholders are subject to a cap of 35% of profits.³⁶

2.25 In 2013 the CIC regulator reviewed the dividend cap and 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. 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.

2.26 From our responses to our call for evidence we note that there remains some disagreement in the industry over the correct level of the cap, an issue which would benefit from another investigation and consultation in due course.

2.27 We therefore suggest that 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.

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.

³⁵ See the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the Community Interest Company Regulations 2005.

³⁶ 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.

A single regulator for CICs and registered societies

- 2.28 Co-operative societies and community benefit societies (collectively known as “registered societies”) are membership organisations which usually raise funds through selling shares to members of the society.
- 2.29 CICs and registered societies are subject to different regulatory regimes, regulators and degrees of regulatory oversight. This introduces the possibility that organisations will choose their legal form on the basis of the most favourable regulatory regime in order to benefit from the least interventionist regulator.
- 2.30 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.
- 2.31 Oversight by a single regulator could ensure a level playing field in relation to regulation, promote effective enforcement and minimise regulatory arbitrage. It would also allow for more integrated policymaking in this space.
- 2.32 We therefore suggest that Government should consider whether the registration and regulation of registered societies and community interest companies should be overseen by a single regulator.

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: OPTIONS FOR REFORM

- 2.33 Many consultees who responded to our call for evidence said that property and infrastructure investments had the potential to address societal challenges while generating competitive returns.
- 2.34 We focus on barriers to investment in property and infrastructure by DC schemes, in recognition of the significance of DC schemes in the current pensions landscape as compared with DB schemes.
- 2.35 We have not identified any legal or regulatory barriers to investment in property and infrastructure. However, we have identified certain structural and behavioural barriers to such investment, and suggest options for reform which seek to address them.

The demand for liquidity

2.36 More than half of the responses we received to our call for evidence identified a perceived need for liquidity as a barrier to investment in property and infrastructure.³⁷ Consultees said 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. Listed equities (shares) and bonds are liquid assets and lend themselves to the practice of daily pricing and daily dealing. Property and infrastructure investments can be structured in different ways, some of which do not lend themselves to daily pricing and daily dealing.

Trust-based schemes: Requirement to process transactions promptly

2.37 Trustees of DC schemes are required to ensure that payments on retirement or death and transfers of assets into and out of the scheme and between different investments in the scheme are processed “promptly and accurately”.³⁸ Transfer requests must be implemented within six months. However, The Pensions Regulator (TPR) has said that the six month timescale should be treated as an “absolute maximum” and should not be considered as equivalent to prompt.³⁹

2.38 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, including where these can be obtained by investing in more illiquid assets such as property and infrastructure.

2.39 TPR’s code of practice and guidance for trustees states that trustees should seek to balance the liquidity of assets against investment objectives and does not state that daily dealing is a legal requirement.⁴⁰ However, it does encourage trustees to consider using platforms,⁴¹ which usually provide for daily dealing and daily trading, and stresses the impact upon members where transactions are not processed promptly.⁴²

³⁷ Liquidity means the ease at which assets or investments can be converted into cash to meet short-term obligations. If an asset or investment is described as liquid, it means that it can be readily converted into cash.

³⁸ Occupational Pension Schemes (Scheme Administration) Regulations 1996 SI 1996 No 1715, reg 24(1) and (2).

³⁹ Pension Schemes Act 1993, s 99; The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 75. Available at <http://www.thepensionsregulator.gov.uk/docs/code-13.pdf>.

⁴⁰ The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), para 76; The Pensions Regulator, *Guide to administration* (July 2016), p 17.

⁴¹ 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.

⁴² The Pensions Regulator, *Code of Practice No. 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), pp 12 and 16; The Pensions Regulator, *Guide to administration* (July 2016), p 17.

- 2.40 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”.⁴³ Due to industry practice, rather than regulatory requirements for daily dealing, 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.⁴⁴
- 2.41 In the 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.

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 rules

- 2.42 Several consultees raised issues about the FCA’s rules on “permitted links” and suggested that these rules imposed undue restrictions on the class of assets which DC schemes could hold.
- 2.43 The FCA’s rules on “permitted links” apply to contract-based pension schemes and platform intermediaries used by trust-based schemes to facilitate the purchase of investments.⁴⁵ The rules restrict the assets which schemes can invest in. Permitted assets include approved and listed securities, unlisted securities, some permitted loans and cash. The rules allow investments in interests in land (or any building situated on it), which can be owned directly or indirectly.⁴⁶
- 2.44 The rules require arrangements to be in place for the calculation of the value of a member’s policy fairly and accurately.⁴⁷ Contributions paid by the member and their employer are treated as “premiums”, and in return the member receives “units” in an investment fund.⁴⁸ Unit prices rise and fall, reflecting changes in the value of the

⁴³ Pensions Institute, *Returning to the Core: Rediscovering a Role for Real Estate in DC Pension Schemes* (2013), p 41.

⁴⁴ Pension schemes may benefit from diversifying their investment portfolio to include both liquid and some illiquid assets. Illiquid assets can provide financial returns over the long term and a diversified portfolio may be less affected by market downturn in relation to particular assets. A failure to consider any illiquid assets in investment decisions may also result in missed opportunities for investments which would benefit pension savers.

⁴⁵ Trust-based schemes often use a platform run by an insurer. In these cases, the insurer is an intermediary in the investment chain and is effectively making the investments. It will exercise its investment powers in line with the mandate agreed with trustees, and can only make investments which comply with the FCA regulations on unit-linked funds.

⁴⁶ See definition of “permitted land and property”, in FCA Conduct of Business sourcebook (COBS).

⁴⁷ FCA Conduct of Business sourcebook (COBS) 21.2.1 R.

⁴⁸ These are units of account and the member receives no proprietary rights in the underlying assets of the fund.

fund's underlying assets. The value of a member's policy could be calculated by reference to the price of the underlying assets determined by the market, for example, the price of equities (shares) listed on a stock exchange. However, the rules are broad enough to allow insurers to use "mark-to-model" which is the practice of determining the price of a portfolio by reference to financial models, rather than allowing the market to determine the price. The rules do not require daily pricing.

- 2.45 In practice, many DC schemes invest in UCITS compliant funds⁴⁹ and are nervous about using other possible structures, even when they are permitted to do so under the permitted links rules. UCITS do not permit direct investment in property and infrastructure, only indirect investment via property funds. Based on information we have received during the course of this project, we believe that some schemes incorrectly operate on the basis that the restriction on UCITS investing in property also applies to DC schemes more generally.
- 2.46 UCITS also require greater levels of liquidity than other permitted links.⁵⁰ Investors have the right to redeem their shares (that is, sell them back to the fund).⁵¹ In order to meet this liquidity requirement, the underlying investments must also be liquid.⁵² The need to ensure liquidity to meet demand for redemptions therefore prevents UCITS compliant funds from obtaining the full benefits of illiquid investments.⁵³
- 2.47 We have not found that the permitted links rules prevent pension schemes investing in property and infrastructure, 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. Given the uncertainties and worries around this issue, we think that 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.

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.

⁴⁹ 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.

⁵⁰ FCA Collective Investment Sourcebook (COLL) 5.2 sets out the eligible assets that a UCITS may invest in. It does not include direct investments in property.

⁵¹ FCA Collective Investment Sourcebook (COLL) 6.2.16 R.

⁵² 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.

⁵³ 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.

Scale and barriers to consolidation

- 2.48 Many consultees said more should be done to allow and encourage consolidation of trust-based schemes.
- 2.49 Only the largest DC schemes have the ability to invest in illiquid assets such as infrastructure. In particular, larger schemes find it easier to manage an illiquid element to their investments. They can also make larger single investments, have greater in-house expertise and more bargaining power.
- 2.50 Under the current legislation, a trust-based scheme may undertake a “bulk transfer” in order to merge schemes. This involves the transfer of assets and liabilities from one scheme to another. Usually such mergers take place without seeking consent from the members of the scheme to be transferred, subject to the requirement to obtain an “actuarial certificate”.⁵⁴ However, this requirement can add costs and act as a barrier to the consolidation of schemes.
- 2.51 We welcome the DWP consultation on bulk transfers, including the need for an actuarial certificate.⁵⁵ We understand that DWP’s current intention is to consult on firm policy proposals on the process for the bulk transfer of DC schemes in summer 2017. 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.
- 2.52 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, which is often difficult to obtain and can therefore prevent consolidation of schemes.

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.

⁵⁴ 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.

⁵⁵ 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.

- 2.53 The Australian Government has encouraged schemes to consolidate,⁵⁶ for example, by requiring trustees to “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.⁵⁷

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.

Charges and the charge cap

- 2.54 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.⁵⁸ This is known as the “charge cap”.
- 2.55 When the cap was first introduced, it was thought that the costs of insuring, maintaining and managing property fell within the charge cap.⁵⁹ This led to criticism that the inclusion of property management costs made investment directly in property “prohibitively expensive”.⁶⁰ The DWP subsequently issued guidance in October 2016 to clarify that property holding and maintenance costs fall outside the cap.⁶¹
- 2.56 Direct holdings in property by pension schemes may produce greater, more diversified returns than shares in property management companies.⁶² 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.

⁵⁶ 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. Available at http://www.lawcom.gov.au/wp-content/uploads/2015/03/cp215_fiduciary_duties.pdf.

⁵⁷ Superannuation Industry (Supervision) Act 1993 (Cth), s 29VN (Australia).

⁵⁸ Transaction costs, and other certain charges, fall outside the charge cap; Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879), reg 2(1); FCA Conduct of Business sourcebook (COBS) glossary definition of “administrative charge”.

⁵⁹ 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>.

⁶⁰ 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/>.

⁶¹ 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.

⁶² We discuss the different ways that pension schemes can hold property in Pension Funds and Social Investment (2017) Law Com No 374 at para 8.57.

2.57 In 2014, the Government promised to review the cap in 2017.⁶³ 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.⁶⁴

Option for reform 8.

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

ENGAGEMENT AND SOCIAL INVESTMENT: OPTIONS FOR REFORM

- 2.58 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.⁶⁵ Although many schemes offer savers a choice of funds other than the default option, few people take these up.
- 2.59 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. We were told that pension scheme members frequently do not read the literature they are sent about their pensions and therefore would not even be aware of different fund options.
- 2.60 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. They may therefore either not consider social investments at all or feel that they cannot make investment decisions based on non-financial factors because they do not know whether scheme members share the concern. Lack of member engagement can also mean that pension schemes and their managers are less likely to actively exercise their stewardship powers.
- 2.61 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.

⁶³ 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.

⁶⁴ *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, para 9.72.

⁶⁵ 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>.

A mandatory social investment chosen fund?

- 2.62 Pension schemes are already permitted to offer members a social investment chosen fund. A report by the Social Market Foundation and Big Society Capital went further and suggested that all employers should be *required* to offer DC scheme savers the option to save in a “social pension”.⁶⁶
- 2.63 However, the evidence we have received did not suggest that there was any justification for introducing a requirement to offer such a chosen fund. The majority of 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. A mandatory requirement to offer a social investment option would also be likely to increase the administrative burden on schemes.

Labelling

- 2.64 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.
- 2.65 Several consultees agreed that an accredited label would be helpful to investors, building confidence and credibility in the market and would help bring social investment into the mainstream. However, there was concern about how the definitions could be framed. 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.
- 2.66 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 that would benefit the social investment market. Instead, as a first step, pension providers should develop agreed terminology for different types of social investment. At this stage therefore, this is a matter for the industry, rather than legal or regulatory reform.

Option for reform 9.

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

⁶⁶ 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>.

Impact reporting

- 2.67 Pension scheme members tend to receive an annual statement telling them whether their investments have gone up or down over the last year. This may not mean very much to savers who are not due to draw their pension for many years. Decreases may even discourage further contributions.
- 2.68 Impact reporting tells a story about pension investment which may better resonate with savers than these traditional reports. An impact report would let scheme members know about the social and environmental impacts of their investment. It might also consider the extent to which an investment has created good quality jobs, or how far it has been targeted at deprived local communities and regions in the UK.
- 2.69 The FCA has noted that some stakeholders have “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”.⁶⁷
- 2.70 Impact reporting also encourage trustees to think about how far the investment is creating wealth in the long term.
- 2.71 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.

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

- 2.72 As discussed above,⁶⁸ pension schemes must have good reason to think that scheme members share a non-financial concern before it can be taken into account in an investment decision. In order to ascertain members’ views, schemes could ask members for their views on social investment and non-financial factors.
- 2.73 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.
- 2.74 There is a risk that members may not engage with this process, in the same way that they have not engaged with pensions generally. Even if auto-enrolment and the initiatives described above eventually lead to increased engagement, it may take a while for pension schemes to collect sufficient data from members and so the benefits

⁶⁷ 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>.

⁶⁸ See para 1.44.

of data collection may only be realisable in the longer-term. Nevertheless, it may assist in the longer-term to increase the opportunities for pension investment with social impact.

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.