



Institute
and Faculty
of Actuaries

Pension funds and social investment

IFoA response to the Law Commission

15 December 2017

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



THE LAW COMMISSION

PENSION FUNDS AND SOCIAL INVESTMENT

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

Freedom of information statement

Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.

If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

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YOUR DETAILS

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CONFIDENTIALITY

Do you wish to keep this response confidential?

Yes:	No: X
If yes, please give reasons:	

QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

- (a) In infrastructure generally?
- (b) In socially significant infrastructure?
- (c) In other forms of social investments?

(a) In infrastructure generally

Debt investment generally provides 80 to 90 percent of the capital for infrastructure projects, with just 10 to 20 percent coming from equity. The small proportion of infrastructure investment coming from equity can be problematic as it is crucial at the early stages of a project and in determining whether the project will go ahead. The imbalance between debt and equity investment is a result of pension funds preferring to invest in projects that are past the early stages of development and are therefore perceived to be lower risk. With investor appetite greater for those projects in their later stages, there is a shortage of an infrastructure 'pipeline'. For many investors it is important to have a sustainable 'pipeline' of infrastructure projects, so that this asset class can fit into a coherent, long-term investment strategy, which maximises long-term returns and provides necessary liquidity.

(b) In socially significant infrastructure and (c) In other forms of social investments

There remains a strong perception that the financial returns on social investments will tend to be lower and risks higher than on similar but unrestricted investments. As noted by the Law Commission, pension scheme trustees generally consider short-term financial returns and risks to be their predominant concern in making investment decisions. In addition, the legal provisions allowing trustees to consider longer-term and other factors are not well understood by trustees, or often by investment advisers.

Socially significant infrastructure and other forms of social investments are less available than other generic asset classes. This forces investors and investment advisers to actively seek these investment opportunities and this remains uncommon.

In addition, 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, which social investments are currently perceived to be.

One way to encourage investors to commit funds to infrastructure or other forms of social investment would be to better able investors to assess whether the investment is 'bankable'. This can be defined as having accurate, up to date, sufficient and wide-ranging information and analysis to allow investors to commit funds to a project. Before committing resources, investors will

undertake their own due diligence assessments and they will need to see evidence of a project's feasibility and expected return. This requires sufficient accurate and up to date information to allow investors to analyse the risk of a project. If those seeking capital for these types of investments were to apply a risk management approach, it would help to generate this information and in turn demonstrate that an investment is 'bankable'. In particular, if the investment were viewed over the longer term, the benefits of social investment would become more apparent.

There are examples where pension funds have committed funds to forms of social investment, which could be useful in setting precedent for other funds. Some local authority pension funds have committed funds to social housing using special purpose vehicles in order to focus investment where they intended.

QUESTION 2: LEGAL AND REGULATORY BARRIERS

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

Yes: those relating to trustees' fiduciary duties to focus on financial returns	No:	Other:
<p>The call for evidence states in Section 1.5:</p> <p><i>The law permits pension trustees to make investment decisions that are based on non-financial factors, provided that:</i></p> <p><i>(1) they have good reason to think that scheme members share the concern; and</i></p> <p><i>(2) there is no risk of significant financial detriment to the fund.</i></p> <p>If it is the intention that consideration of non-financial factors should be acceptable, provided there is not a significant increase in risk of financial detriment compared to similar financial investments, the law, or its interpretation, could helpfully be amended so this is made explicit.</p> <p>As the law is currently drafted, we suggest that it may deter social investment as trustee bodies may be reluctant to state that there was no risk of financial detriment when taking non-financial factors in consideration, even if they were of the opinion that there was no more risk than in a comparable standard investment.</p>		

QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

Yes:	No:	Other: Whilst larger pension funds may be better able to assess social investments, they will be more likely to look for investment managers to do this on their behalf.
At present, only very large pension schemes are likely to have the expertise and interest to assess social investments, particularly as each tends to have different characteristics, meaning comparability remains difficult. In addition, many social investments are themselves relatively small and this can mean they are time and resource consuming to research and manage, as well as making it difficult to divest. Even larger projects are not without difficulty, for example, projects such as HS2 and Hinckley Point require a consortium of investors. We have seen that scale can be achieved through joint investment vehicles, for example, the recent local authority groupings and the Pensions Infrastructure Platform.		

QUESTION 4: ETHICAL PENSION OPTIONS

(Call for evidence, paragraph 1.18)

We wish to hear from employers and pension providers about the ethical options currently on offer (whether positively or negatively screened):

- (a) What ethical DC pension funds are available?
- (b) What proportion of people take them up?
- (c) What sort of returns do they provide?

QUESTION 5: PENSION SAVER ENGAGEMENT

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) meet the needs of savers:

(a) Would a greater range of options encourage greater engagement with pension saving?

(b) In particular, would options seeking social impact as well as financial returns encourage engagement?

Yes:	No:	Other: We encourage the Commission to gather further evidence, it may be that different approaches are more appropriate in different circumstances
<p>Long-term financial planning is inherently complex. With this in mind, our members had a range of views on which approach would be more appropriate. We therefore encourage the Law Commission to undertake further analysis on whether a separate fund option, or an overall social investment objective, would best achieve its aims. We consider there to be merit and risk in both approaches and we would welcome the opportunity to arrange for the Law Commission to meet with our members to discuss this range of views should it be helpful to the Commission.</p> <p>For a greater range of options:</p> <p>To introduce investments with social impacts, it may be more successful to have them as a separate option. As noted in the call for evidence, many individuals, in particular of the “millennial” group, are likely to be much more engaged in social investment, where standard DC pension investment is of limited or no interest.</p> <p>For options incorporating social impact:</p> <p>In DC schemes, the increasing popularity of target date funds (and other similar investment options), where the provider can manage the asset mix over time within an overall investment objective creates an opportunity to encourage/enable social investment. The target date fund could (at least partly) be invested for social aims, provided this was not expected to be at the expense of financial returns. This seems similar to the French example in the consultation paper.</p> <p>Social investment often has broad aims that are not individualistic in the way that ethical investment aims are. Hence social investment is not as problematic as ethical investment, making it feasible to include in core DC funds like target date ones.</p>		

QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

We are also interested to hear about the returns available for social investment (intended to have a positive benefit):

- (a) Are there sufficient investment opportunities to provide both social impact and market returns?
- (b) How far should savers be prevented or discouraged from sacrificing returns for social impact?

Yes:	No: there are not currently, nor should savers be prevented from sacrificing returns for social impact as long as the trade off is clear.	Other:
<p>The number of investments providing both social impact and market returns remains small, and most potential investors have no easy way of accessing them. It is not clear how far this market could be developed, as there are very few examples at present.</p> <p>However, should this market develop, we consider it important that funds have a clear prospectus, where the objectives and criteria are clearly set out. We believe that savers should not be prevented from sacrificing financial returns for social impact, as long as they understand the trade off being offered. Where an individual has a choice, any investment decision should be informed. To make the difference clear without overwhelming savers with information, it may be helpful to provide separate routes following either 'social-impact first', with decisions available on types of impact and acceptable levels of potential return, or 'financial-return first', with social impact addressed in a method more consistent with current ESG (economic, social, governance) approaches.</p>		

QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

(Call for evidence, paragraph 1.22)

In practical terms, how can financial advisers:

- (a) best explore their clients' social motivations?
- (b) present social investment options in a way that is clear, fair and not misleading?

<p>(b)</p> <p>To do this effectively, an adviser would need considerable knowledge of the social investments available, as well as how those compare both to each other.</p> <p>Until the concept is firmly entrenched in savers' awareness, any exploration of social</p>
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investments is likely to need to be considered as a separate matter from financial investments. In the long-term, a consistent way of comparing social investments that can also be applied to standard financial investments' ESG characteristics would greatly increase transparency. It would also ensure sufficient understanding around the social impact received in exchange for (potentially) reduced returns.

QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS

(Call for evidence, paragraph 1.23)

Should social investment options be labelled or described in a standardised way? Would this be possible given the range of funds which might be regarded by different groups, or in different contexts, as social investment?

Yes: Some kind of standardisation is essential for social investment to become available to a non-specialist audience.	No:	Other:
<p>This is likely to need to start with qualitatively, categorising different types of impact and the (qualitative) level of risk and certainty around both the social and financial impacts. This could be done similarly to how financial investments are categorised by industry, geography, and risk and return profiles. They should be clearly described in terms of objectives and criteria to be adopted in making investment in social projects, the likely impact on returns and any impact on liquidity.</p> <p>Other investment platforms, for example crowd-funding platforms, are already presenting the potential risk and rewards for social investments in an engaging manner, from which DC pension funds can learn.</p>		

QUESTION 10: LAW OF SOCIAL ENTERPRISES

(Call for evidence, paragraph 1.25)

Is there a need to review the legal framework around social enterprises, to make it easier for such enterprises to borrow money and receive investment?

Yes:	No:	Other:

FURTHER COMMENTS:

We also welcome any additional comments you may have beyond the scope of the questions above, particularly where they relate to the legal or regulatory landscape.