We welcome the Law Commission revisiting the issue of fiduciary duties applicable to pension schemes, following the Commission’s report *The Fiduciary Duties of Investment Intermediaries* in 2014.

The consultation references the FCA’s definition of Social Investing: *Social investing is a broad concept which at its heart combines the idea that an investment can have a social “impact” or “return” as well as some form of financial return*. We agree with this definition, though note that it encompasses a very wide range of investment approaches, including those seeking positive impact alongside competitive returns. It is necessary to clearly differentiate between investments seeking to sacrifice financial return for social impact and those seeking positive social impact alongside competitive financial returns. There is no impediment in principle to positive social impact flowing from prudent, return maximising investment activities.

As the Commission confirmed in its 2014 report “there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material”¹. It is not the origin of the factor, but rather its financial materiality which is of relevance². As such, all UK pension scheme assets should use investment processes and decision-making that integrate material Environmental, Social and Governance (ESG) factors.

Defined Contribution (DC) funds with social impact objectives is a novel proposal and we welcome innovation in this area. For funds seeking social impact to the detriment of financial returns, we consider there to be more flexibility in Chosen Funds as opposed to Default Funds, provided that appropriate advice is given to beneficiaries. For contract-based schemes, we also recommend enhancing the remit of Independent Governance Committees to include an assessment of long-term value creation, product suitability and engagement practices (in addition to the current value for money test, which is fee-focused).

Throughout this response, we note practical and legal challenges faced by funds considering ESG issues, irrespective of the expected financial implications. We highlight one for the Commission’s particular attention – the absence of clear guidance on determining ‘significant financial detriment’. In our experience, this causes Trustees to be excessively conservative in their approach.

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¹ Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014

² The evaluation of financial materiality is at the well-reasoned discretion of pension scheme trustees having taken appropriate advice.
YOUR DETAILS

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<tr>
<th>Name:</th>
<th>Alyssa Heath</th>
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CONFIDENTIALITY

Do you wish to keep this response confidential?

Yes:  
No:

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) Infrastructure and (b) socially significant infrastructure

Short-term investment horizons have often caused under-investment in infrastructure. ESG analysis can be part of the antidote to investment short-termism by helping to re-orient investors and investee companies towards long-term investment horizons. Many ESG factors are of long-term relevance to sustainable corporate performance and resilient business-models. Through enabling an understanding of a company's business model, its dependencies
and vulnerabilities, ESG analysis can assist in an understanding of the long-term sustainability of existing financial performance.

Infrastructure investment can take the form of listed or private equity or debt securities. Many DC savers will have some exposure to listed infrastructure companies but few will be able to invest directly in underlying assets. For this response, we focus on barriers to DC savers investing directly in private assets.

- **Liability mismatch/time horizon**

  Infrastructure projects can, in theory, provide a good match for the long-term liabilities of pension funds. However, their application to DC funds is not straightforward.

  DC savers are particularly attuned to the short-term performance of their savings. When selecting from the fund range, they are presented with the fund’s short-term past performance – a poor heuristic for judging future performance.

  DC funds often offer same-day mark to market valuation. This reorients savers towards short term performance and imposes restrictions on investing in long-dated assets\(^3\). When investing in private assets, the funds may not be drawn down immediately and the investment may only generate returns after the initial construction phase.

  Finally, DC funds require relatively high levels of liquidity. DC savers have the ability to transfer between funds and to transfer their pension benefits accrued with one employer to another scheme. There may not be an easily accessible secondary market for private assets.

- **Suitability and pipeline**

  Investors will typically have a minimum transaction size which some infrastructure projects do not meet. In our experience, there is currently a lack of investable projects and project pipelines are not transparent. This results in many investors bidding for a small number of projects which drives up prices, exacerbated by slow project development and decision-making.

- **Skills and capacity**

  Specific expertise is required to manage the risks across the time period of the investment. Infrastructure investments may have high transaction costs, high due diligence requirements and be subject to risks such as regulatory uncertainty.

  Trustees may not feel confident identifying fund managers with the appropriate skills, or consider the additional due diligence required to be disproportionate to the benefit.

  Corporate plan sponsors are subject to many of the same constraints, but have no ongoing role in monitoring contract-based schemes. Corporate plan sponsors are therefore unlikely to demand that providers of contract-based DC schemes provide the option to invest in infrastructure. Independent Governance Committees (IGCs) have a relatively narrow remit,

\(^3\) In 2016, Partners Group (a PRI signatory) launched a private assets fund with same day pricing for DC clients. This was advertised as a first of its kind. This suggests that the challenges listed are substantial but not insurmountable.
focussing on value for money. We welcome the introduction of IGCs, but propose their remit be widened (see Q 6).

(c) other forms of social investments.

We elaborate further on fiduciary duties and social investment in Q2.

As with infrastructure, the core issues of skill, suitability and pipeline are pertinent. Investors will seek to satisfy themselves that the investment team has specific investment expertise, a demonstrable track record and clear commitment to both the financial and social objectives of the fund.

Some innovative social investments do not meet minimum transaction sizes for larger funds, and returns may not be sufficient. While some opportunities offer market rate returns, others target market rate returns without a proven business model, or target below market returns.

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?

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The consultation uses the FCA’s definition of Social Investing: *Social investing is a broad concept which at its heart combines the idea that an investment can have a social “impact” or “return” as well as some form of financial return*. We agree with this definition, though note that it encompasses a very wide range of investment approaches, including those seeking both positive impact and competitive returns (see figure 1). It is necessary to clearly differentiate between investments seeking to sacrifice financial return for social impact and those seeking a combination of social impact and competitive financial returns.

![Figure 1 Spectrum of impact and financial return. Source: Bridges Ventures.](image)

The law distinguishes between “financial” and “non-financial” factors. Environmental, Social and Governance issues can be either.
Where an issue is deemed ‘non-financial’, Trustees must ensure 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.

While there is considerable flexibility for chosen funds to sacrifice returns for social impact, the bipartite test presents obstacles for default funds wishing to do the same. We note:

- **Absence of expressed preference:** In the absence of the beneficiary community having a very clearly defined ethical disposition in relation to a particular issue (such as being employees of an anti-smoking charity), it is very hard for a trustee to reach a conclusion as to the disposition of the beneficiaries as a whole.

- **Equivalence in investments:** As noted above, valuing innovative social investment approaches is difficult. It may be hard for a trustee to form a view as to whether the a Social Investment may be pursued in the absence of material financial detriment, which is tested by reference against an equivalent investment opportunity. In the absence of clear guidance on what constitutes ‘material financial detriment’, many Trustees will be extremely conservative.

However, where an ESG issue is pursued purely for financial return, the above test should not apply. As the Commission confirmed in its 2014 report “there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material”⁴. It is not the origin of the factor, but rather its financial materiality which is of relevance⁵. As such, all UK pension scheme assets should use investment processes and decision-making that integrate material Environmental, Social and Governance (ESG) factors.

**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?

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<td>The UK has a fragmented pensions market. According to 2015 research, there are just under 220,000 workplace pension schemes in the UK, compared to just 4,300 across the whole of the Netherlands, Switzerland, Germany, Denmark, Sweden, Italy and Norway. Consequently, schemes are much smaller - the average UK DC scheme holds assets of under €2m (£1.7m), compared to a European average of €455 million (£383m)⁶.</td>
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⁴ Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014

⁵ The evaluation of financial materiality is at the well-reasoned discretion of pension scheme trustees having taken appropriate advice.

There is evidence that scheme size is positively correlated with good governance and ESG practices. We understand that consideration of ESG factors is as much about priorities and intention as it is about scale; several small schemes integrate ESG very well. Outsourcing to asset managers or through fiduciary management structures can also help overcome scale-related issues. However, where schemes are unable to retain internal expertise, this can result in over-dependence on consultant advice.

Size can convey a number of advantages. It can reduce management and advisory costs through giving asset owners a better negotiating position with service providers. Scale can also embed trustee expertise and enable engagement with investee companies through in-house fund resourcing and size of holding.

It seems unlikely that pension scheme consolidation will occur at scale in the absence of further regulatory encouragement. We also note that the government has identified improving governance as a near-term policy priority. Scheme consolidation has two key sources. Firstly, trustees reflecting on the adequacy of their governance arrangements and secondly, the government ensuring that consolidation methods are less complicated. This will enable schemes to consider consolidation a reasonable option available to them.

The PRI’s recommendation is that schemes should have to reflect on whether scale has a negative impact on scheme governance and performance, including the consideration of ESG factors and costs. This should occur every three years, with the results being reported to both the scheme membership and TPR. The government should simplify the procedures for pension scheme consolidation.

**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?

There has been significant recent growth in the number of workplace pension schemes offering ethical funds. As of 2014, 60% of workplace DC schemes offered an ethical option. However, it is worth noting that the definition of “ethical” or “socially responsible” is not clear. For screened funds, the reduction in investment universe can vary significantly.

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8 Source: Towers Watson 2014 pension survey
We have found little evidence of their widespread uptake. As noted elsewhere, the vast majority of DC savers use the default fund.

Five-year financial results from 91 ‘ethical and sustainable’ funds are available from Trustnet⁹, though we note that this relies on the fund’s own classification – they do not use a uniform definition of ‘ethical and sustainable’.

**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?

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<td>a) Would a greater range of options encourage greater engagement with pension saving?</td>
<td>(a) In particular, would options seeking social impact as well as financial returns encourage engagement?</td>
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Public scrutiny of the investment industry has increased with concern regarding its impact on society and the environment more generally. We anticipate that beneficiaries, particularly millennials¹⁰, will want to engage with their retirement providers on environmental and social issues¹¹. This will add to the rising demand for ESG information and methods. We would expect this to occur whether or not Social Investment options were provided as fund options.

There is evidence that a majority of UK savers prefer their investments to minimise negative impacts. Research conducted by YouGov on behalf of the PRI 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%). However, we note several barriers to further engagement:

- Scheme members lack the information to evaluate whether the funds on offer comply with these preferences. The PRI/YouGov survey found that just 19% of scheme members know all of the companies in which their pension is invested. Around 60% would like more information from their fund manager - this could include more

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¹⁰ [Millennials, Women and the Future of Responsible Investing: https://riacanada.ca/millennials-women/](https://riacanada.ca/millennials-women/)

information on the companies they are invested in, a description of how they manage environmental and social risk, or greater consultation about their interests and needs.

- Some traditional exclusion-based SRI funds would not exclude companies involved in these activities as they screen out specific sectors (e.g. tobacco, weapons manufacture) rather than controversial business practices.
- Lack of trust in the industry. The 2016 Edelman trust barometer continues to find that finance is the least trusted industry\(^\text{12}\). Almost a quarter of UK millennials do not trust financial service providers with their money\(^\text{13}\). Offering impactful investment will not alleviate the industry-level trust barrier. Furthermore, beneficiaries do not think the industry is responsive to their concerns. PRI’s research suggests only 3% of savers feel their fund manager would be responsive if they raised concerns around the impact of their investments.

**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?

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As noted above, chosen funds have considerably more flexibility to pursue social impact objectives to the detriment of financial returns. Provided that appropriate advice is given to beneficiaries, we consider this a welcome innovation.

We also recommend reforms to the IGCs. As noted by the OFT, the buy side market for DC funds is extremely weak\(^\text{14}\) and DC arrangements have historically been associated with less efficient investment profiles and higher costs.

We welcome the introduction of IGCs for contract-based DC schemes. Fiduciary duties and associated governance structures have developed for trust-based scheme to bring greater rigour and expertise to investment decision-making.

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\(^{14}\) OFT study
If Social Investment options are added as a feature of the chosen funds within contract-based schemes, it will be necessary for there to be a mechanism in place for monitoring their on-going suitability as a fund investment option.

In our recent UK roadmap for Fiduciary Duties, we propose that the remit of IGC’s should be extended to include an assessment of long-term value creation, product suitability and engagement practices (in addition to the current value for money test, which is fee-focused). This is a consistent extension to recent policy making, which has sought to improve the oversight of DC investment practices in contract-based schemes.

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?

No PRI response

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?

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As noted in our response to question 5, beneficiaries hold ethical preferences but have limited information regarding their investments.

Social Investment is also part of a broader category of investment, namely Social, Responsible and Impact investing. An extremely broad range of investment products, across different asset classes and maturity profiles, exists in this investing universe.

DC funds that are presented as “ethical” or “green” apply negative screens to exclude from their investment universe particular disfavoured sectors, such as alcohol, tobacco, weapons and, in some cases, carbon intensive industries. These funds might be characterised as “ethical” but do not seek to achieve specific outcomes, therefore could not also be characterised impact investing, social or otherwise. However, the language used to characterised these different investment approaches is not settled or subject to an industry standard and there is often a conceptual blurring between categories.
We note several industry initiatives have already begun the process of certifying ‘responsible’ funds. These industry standards have tended to focus on assessing the quality of investment processes to ensure they are in line with a stated responsible investment policy.

We emphasise that the quality of the advice received and the clarity of information provided to beneficiaries is crucial in determining outcomes in DC schemes where the beneficiary exercises an active choice. We do also third party accreditation of schemes as having a role in adding an additional layer of information to enable beneficiaries to assess minimum scheme quality, such as PLSA’s quality mark scheme15.

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?

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No PRI response.

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.

15 http://www.pensionqualitymark.org.uk/