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How to unleash the power of social impact investing

A White Paper from the Society of Pension Professionals

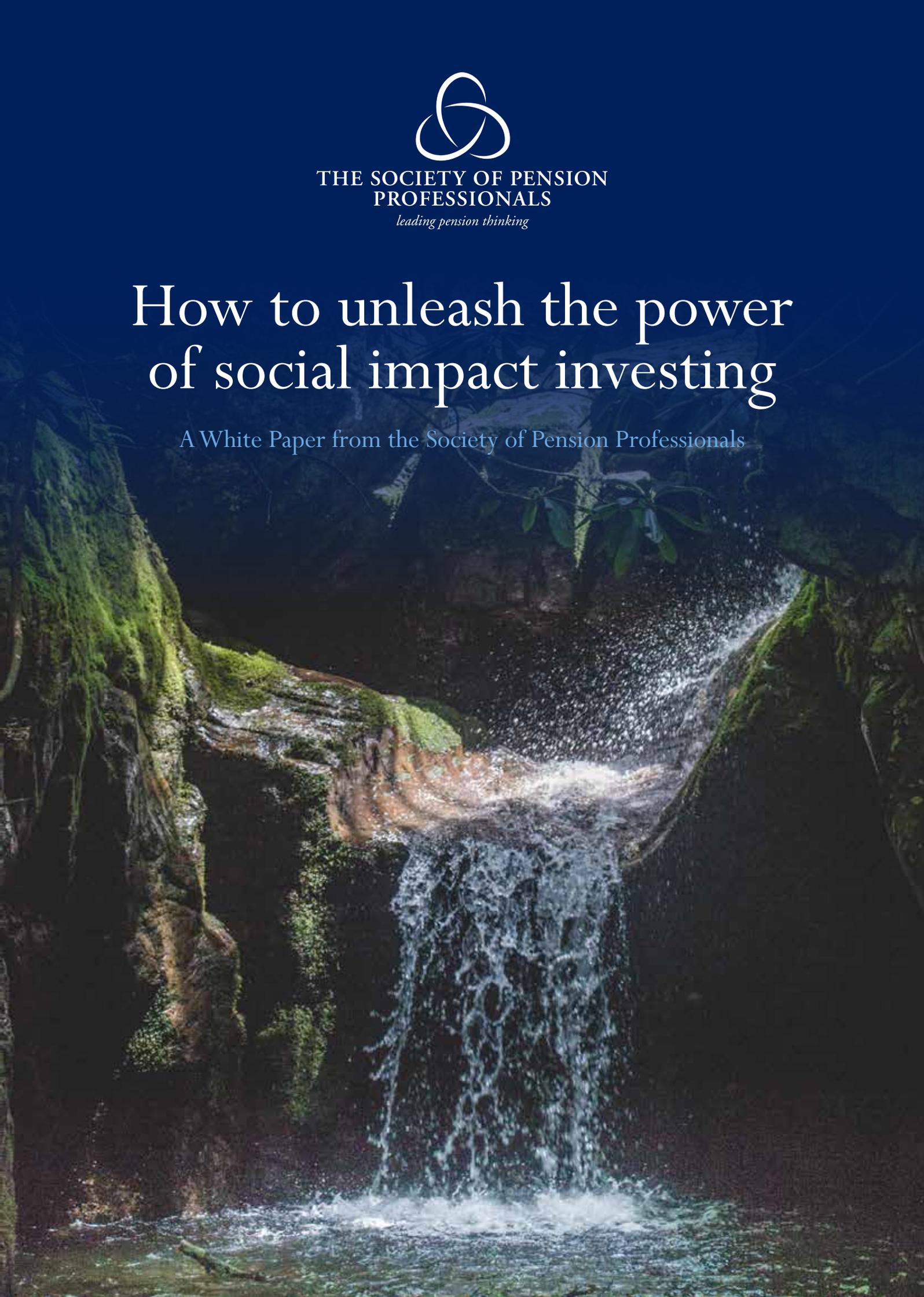


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Introduction

Poor air quality in many UK towns, thousands of workers put out of work by the collapse of their employers and mounds of plastic everywhere – nearly everyone in Britain is affected by environmental, social and governance (ESG) issues.

ESG investing covers a wide spectrum from the blunt instrument of negative screening, typically excluding firms such as tobacco and armaments companies from portfolios, to a relatively new strategy, social impact investing. This subset of ESG, social impact looks to the positive, investing in socially valuable activities, from providing clean water to fighting poverty and encouraging healthier lifestyles.

The Advisory Group on Growing a Culture of Social Impact Investment's report¹ defines social impact as "investment in the shares or loan capital of companies and enterprises that not only measure and report their wider impact on society – but also hold themselves accountable for delivering and increasing positive impact."²

Government and other business leaders are supportive of social impact. In 2012, the UK Government set up Big Society Capital, an independent institution using money in dormant bank accounts to invest in the social impact investment market.³ The UK (through the Department for International Trade) is a founding member of the Global Impact Investing Network.

The UK was also at the forefront of negotiating the UN Sustainable Development Goals in 2015 which concluded with the mission to eradicate extreme poverty, fight inequality, injustice, and leave no one behind. Then in the same year, under the Paris Agreement, 195 countries agreed to the first global pact aimed at reducing emissions of planet warming greenhouse gases.

Social considerations highlighted in the UK Government's June 2018 consultation on clarifying and strengthening trustees' investment duties,⁴ include working conditions (such as slavery and child labour, health and safety, employee relations and diversity), ageing populations, social unrest, local communities and income inequality.

While capturing the public's imagination, social impact has yet to take off with investors; of all the trillions invested worldwide, only \$114bn⁵ is devoted to social impact. Few pension schemes are active social investors but the field is gaining momentum with implications for pension savers, asset managers and trustees, regulators and the Government. There are, however, still many barriers from the law, finding suitable projects and ways of measuring outcomes. This SPP white paper examines how to overcome these obstacles.

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This white paper is based on the combined views of the individual contributors. Views are not necessarily those of any one contributor, their employer or The Society.

Edited by Stephanie Hawthorne

Executive summary

1. Most pension scheme trustees have limited knowledge of social impact investment.
2. While some pension scheme trustees have a responsible investment or ESG policy which may contain something specific on social impact, in most cases there is no policy on social impact.
3. Despite the Government's and the Law Commission's best efforts, trustees are still confused over their ability to make social impact investments, but there are no insuperable legal barriers to social impact investing.
4. One of the challenges is finding suitable social impact investment opportunities with sufficient scale and demonstrable track record.
5. Implementing a social impact policy means more than simple negative screening. It implies investors moving towards active engagement (collaborating or influencing businesses to change) and engaging with those businesses who are willing to be measured by their social impact.
6. Such proactive engagement, with the conscious targeting of making a social impact, requires a change in investment behaviour towards long-term horizons. It also requires new agreed standards for measurement and reporting.
7. Among the factors which prevent trustees from social impact investing are a lack of guidance from the Pensions Regulator and buy in and motivation from consultants.

Recommendations

1. Trustees need more guidance from the Pensions Regulator and/or Law Commission specifically on social impact investing, not just as a subset of ESG.
2. Without a clear legal framework, trustees remain nervous about social impact investments. In France⁶, corporate employee savings schemes must offer a solidarity investment fund option, investing between five and ten percent in social investments. The types of investments that qualify are clearly defined and managed. It would be a political judgment as to whether to require UK pension funds to make the same or comparable commitments.
3. To put social impact investing on a level footing with other investment strategies, the Government should set out in statute, or secondary legislation, distinct definitions of what are meant by "social" factors in ESG and "social impact investments" and the steps that pension trustees should take when considering social impact investment.
4. Trustees need to recognise that they will be expected to have a view on whether members' views should or should not be taken into account when making social impact investments.
5. If member views are to be taken into account, the Government should build some safe harbour protections into legislation. For instance, an automatic safe harbour for offering investment options derived from direct member choice in DC plans. Safe harbours are not a new concept, although safe harbours are not widely used in English law.⁷
6. Regardless of legal hurdles, investment consultants' buy-in and motivation to support and provide information proactively on social impact investing is essential.
7. There is a need for a greater distinction within the ESG universe of social impact investment funds and more information around risk/return characteristics of social impact investments, with a clear framework for developing policies and measuring outcomes.
8. There is a need for a consensus on how schemes should approach policy setting, evaluation of managers and monitoring to create universally accepted standards.

Part 1: The legal position: mired in confusion

The legal duties of trustees in relation to social impact investing are mired in confusion. The law has not kept pace with investment practice and terminology can create misunderstanding despite numerous court cases and Government attempts to clarify the law.

Since the case of *Cowan v Scargill*⁸, there have been more than 690 pages published in five different Government reports⁹ on how far trustees can or even should take account of non-financial considerations in investment decision-making.

Whenever *Cowan v Scargill* is quoted, the usual formulation of its main conclusion is that trustees should invest in the best interests of beneficiaries and that this is usually considered to be their best financial interests. The first part of this formula reflects the requirements of the Occupational Pension Schemes (Investment) Regulations 2005 (the “Investment Regulations”) Regulation 4(2). However, it raises the question (which causes confusion in social impact investment) of whether it is ever possible for trustees to take an investment decision that may not be demonstrably designed to produce the best possible financial outcome.

Pension trustees are generally unfettered in the scope of their investment powers¹⁰. They do, therefore, in theory, have the discretion to make social impact investments, so long as doing so is not in conflict with the purpose of the trust.

Despite the Government’s and the Law Commission’s best efforts, pension trustees are often still unsure of their ability to make social impact investments. The law is silent on the need to consider the purely social impact of investments, although, confusingly, the Investment Regulations do require trustees to state “the extent (if any) to which social, environmental or ethical considerations are taken into account in the selection retention and realisation of investments”¹¹ in their statement of investment principles. These factors are commonly referred together as ESG.

Should the law on fiduciary duty be changed to require Members’ views to be taken into account?

At the heart of the matter is whether trustees should take account of the views or wishes of their members when making investment decisions.

In a defined benefit (DB) context, trustees are responsible for investing the whole of the fund (as they own all of the assets) and members do not direct how the assets are invested. Other than with the possible exception of member-nominated trustees, the members do not in fact have a voice. Regardless of this disconnection between DB assets and the members, the consequences of an investment going wrong will fall squarely on the shoulders of the trustees.¹²

Is the legal analysis different in a defined contribution (DC) context, where there is a much clearer link between the members’ interests and the funds invested on their behalf? Surely, here the law should recognise that those funds belong to the members? If they are able to impress upon the trustees that social impact investments are of interest to them (and the members are willing to take the risk of under-performance), there should be no obstacle in making them available? Unfortunately, not.

Trustees of DC schemes are not in the same position as an execution only agent of their scheme members.

Trustees of both DB and DC schemes are legal and beneficial owners of the assets (members merely have a beneficial interest in the schemes). From that fact flow various duties, such as suitability¹³, diversification¹⁴ and the need to ensure that “the powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.”¹⁵

The law expects trustees to have a holistic outlook. While social impact investing may be consistent with each of these duties, it may be difficult for trustees to justify accommodating members’ views in a framework where members do not own the assets invested on their behalf.

Also, the law provides no automatic safe harbour for offering investment options derived from direct member choice. This is partly down to the nature of trusteeship and the fact that there is an irreducible core of trustee obligations, but we suggest that trustees might be more willing to embrace social impact investments if there were such protections.¹⁶

The two stage test

In 2014, the Law Commission published its first report, “Fiduciary Duties of Investment Intermediaries” Law Com No 350, and then in 2017 it published a further report, “Pension Funds and Social Investment” Law Com No 374. In brief, the Law Commission concluded that there were no legal barriers to pension trustees investing in social impact investments.

At paragraph 5.14 of its 2017 report, the Law Commission noted as follows:

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

The Law Commission condensed the circumstances in which pension scheme trustees may take account of non-financial concerns into a ‘two stage’ test.

“For trustees to take account of non-financial factors when setting investment strategies and making investment decisions, they should apply two tests, taken from the case law:

- (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.”

“Regardless of this disconnection between DB assets and the members, the consequences of an investment going wrong will fall squarely on the shoulders of the trustees.”

The Government originally proposed that trustees should produce a statement setting out the extent to which the views of members (including the views they hold on non-financial matters) will be taken into account in preparing or revising the statement of investment principles. This was diluted after consultation and representations made by the SPP among others, but although there will be no compulsion to take into account members’ views in the statement of investment principles, such views are now to be formally recognised for the first time in legislation as embodying the “non-financial matters” that the Law Commission proposed. These new requirements will come into force on 1 October 2019, so trustees and their advisers should be thinking about their policy on this issue now.

The practical implications of taking member’s views on investment matters are obvious for a scheme of any size. Consider a DC master trust with a million members, for instance, where the whole rationale of the scheme’s day to day operations is supported not by member engagement but by inertia. In a DB context, where most schemes are now closed to accrual, member engagement is even more of a challenge, notwithstanding advances in digital communication platforms.



Part 2: Scheme management: how to implement a social impact investing policy

One of the challenges for investors is finding suitable social impact investment opportunities with sufficient scale and demonstrable track record. This was highlighted by the Advisory Group in *Growing a Culture of Social Impact Investment*¹⁷ and is one of the areas being explored by the Implementation Taskforce set up to bring the recommendations of the Advisory Group to life.¹⁸

Pension trustees who wish to adopt social impact investing need to think carefully about the most appropriate options for their scheme in light of its size and available resources, financial considerations such as specific funding and performance targets they need to meet, as well as member views.

Trustees wishing to establish and implement a social impact investment policy should decide on its focus, their level of ambition, then formalise the policy and the governance arrangements with ongoing monitoring and reporting.

Scope of social impact investment

The scope of social impact investment is very broad: trustees of a furniture retailer's pension scheme may want to support projects related to forestry conservation while those of a publisher may prefer schemes to help advance educational opportunities around the world.

There is a wide range of frameworks and systems to help define the types of social impact that an investment strategy could have. The United Nations' Sustainable Development Goals provide a good example of a framework.



Global frameworks like the UN's Sustainable Development Goals are not the only options.

Some pension funds have chosen to make an impact on local goals. For example, the Greater Manchester Pension Fund's (GMPF) Impact Portfolio seeks to generate a commercial return while also delivering a positive local impact. So far, c£250m has been committed to investments, including the provision of supported living accommodation, renewable energy, loans to small and medium sized businesses and private equity with a focus on impact investing.¹⁹

GMPF has also committed up to £650m to the Greater Manchester Property Venture Fund, which targets property development in the North West of England, with a particular focus on Greater Manchester.

What is the level of ambition?

Options range from simple exclusion (which is actually demonstrative of responsible investment rather than social impact investing) to targeting direct investments. **Negative screening** is the quickest – and crudest – way of enhancing the environmental and social performance of a portfolio. It categorises certain industrial sectors as undesirable, such as armaments for pacifists, so trustees with strong conviction can opt out of these areas.

However, it is a crude approach that treats all companies within a sector in exactly the same way. This can be sub-optimal where concerns only relate to individual companies rather than the sector as a whole. In some instances, negative screening can increase portfolio risk by reducing the diversity of choices for investment.

Selective negative screening: This is similar to regular negative screening but adds nuance. Taking the example of screening for arms, this approach could allow a charity to screen for specific arms companies that it deems problematic, rather than avoiding the entire sector. The services of online specialists can help with analysis but gathering data can be time consuming if the screening applies to a lot of companies. External providers can speed this process but they will of course add cost, which should be factored into the risk-return equation.

Another option is **selective negative screening to avoid sectors/companies as well as shareholder action and proactive stakeholder engagement** with companies in relation to their ESG-related activities or using positive screening to proactively tilt a portfolio towards funds focused on social impact (e.g. investment in one of the small but growing number of dedicated social impact funds).

This requires a due diligence process to be established. Executed effectively, it allows a significant level of oversight for a moderate investment in time and cost but requires more resources than trustees of smaller pension schemes can usually spare.

Directly investing in projects and companies of a sufficient size is also possible if they align to the vision and social aims of a pension fund. At a basic level, companies' social impact is fairly obvious; investing in wind energy, for example, contributes to reduced carbon emissions and the generation of new energy sources but the range of their impacts can take in a slew of other factors, such as the treatment of the workforce.

Formalise policy and establish governance arrangements

Once trustees have determined their areas of focus, level of ambition and 'what good looks like', they need to articulate their approach in a social impact investment policy and establish governance arrangements (for example, a standing item on an investment committee agenda, or a sub-committee in its own right) to implement, manage and oversee the policy. Organisations such as the UN PRI provide example frameworks and guidance for drafting a social impact investment policy.²⁰

Ongoing monitoring and reporting

A well-designed monitoring and reporting process is essential for the effective implementation of a social impact investment policy. Its purpose should be to assess the impact generated, identify under-performance relative to the market and to identify whether there have been any material changes in external factors that influence the way that members' money has been invested.

Some specifics are suggested below:

- How often are trustees reviewing these decisions and is this sufficient to ensure that they are managing them effectively? Are the KPIs that they are using on a regular basis fit for purpose?
- How well are the investments performing relative to the traditional funds that schemes may have previously been invested in? Can trustees account for the differences in performance and do they represent an issue (or success) for the investment strategy or is it just part of the natural flux in the market?
- How well are the investments performing against similar funds within the same sector?
- Have any internal or external factors changed that should be factored into trustees' overriding investment strategy?
- Are trustees' investment policies still consistent with the investment strategy in terms of what they are trying to achieve and, if not, are they happy with the changes?
- Have the regulatory requirements surrounding the social impact of pensions changed and if so, what changes do trustees' need to incorporate into their approach to accommodate them?

The other side of the monitoring and reporting coin is that investee companies should be required to disclose against common standards. As a report of the European Union's High Level Expert Group on Sustainable Finance put it, it is necessary to "upgrade Europe's disclosure rules to make climate change risks and opportunities fully transparent".²¹

For best practice, trustees should review their strategy annually with a more comprehensive review every three years, aligning with their regulatory responsibilities to review their SIP over that time period.

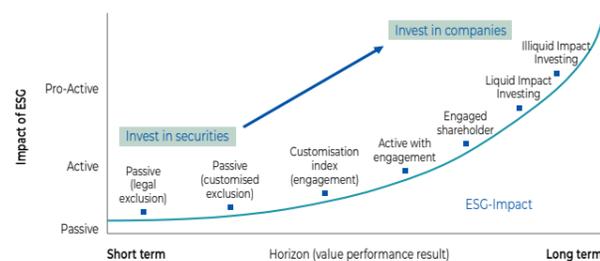


Part 3: Investment: overcoming the barriers to social impact

The Government is supportive of social impact investing. Most of the investing public would like their money to be used for good. The legal obstacles are not insurmountable but few pension schemes are considering social impact investments, let alone implementing them.

One difficulty with social Impact is that it requires a long-term commitment whereas the time horizon for negative screening can be shorter. Figure 1 shows a relative view of the required time horizon compared with the ESG implementation.

Figure 1: How does the horizon correlate with impact?



Source: Kempen

There is still much work to do to familiarise pension schemes with the topic. Allenbridge's Social Impact Investment and Pensions Survey, October 2017²² (based on 65 UK pension scheme respondents) revealed that almost half of the respondents had only limited knowledge on social impact investment and 15% said they had no knowledge at all.

Of the 65 respondents, five had allocated assets to social investments and a further seven were committed to increasing their understanding or canvassing their members on social impact. 33.9% of respondents said that they did hold investments in social housing and/or infrastructure related to education, health or renewable energy. Social housing investments were perceived as poor performers and the Government was seen as needing to do a significant amount to support investment in this sector.

Barriers to investing

The key factors which prevent trustees from social impact investing are:

- a lack of guidance from the Pensions Regulator;
- given the reliance on investment consultants by trustees (70% of those surveyed), any lack of buy in on their part or motivation to support and provide information proactively on social impact investing;
- a need for a greater universe of social impact investment funds;
- a need for more information around risk/return characteristics of social impact investments.

While some pension scheme trustees have a stated responsible investment or ESG policy which may contain specifics on social impact, in most cases there is no social impact policy. Some schemes have proactively pursued policies because of their unique beliefs while others have created policies in reaction to negative publicity.

To get a feel for the specific policies or processes UK pension schemes may be using, Kempen conducted a survey of UK pension schemes in conjunction with Winmark, a global market research company.

All of the respondents (10) were trustees of UK corporate pension schemes and almost all had heard of social impact investing. Most were engaged in some way with it (8) and considering it as part of their Statement of Investment Principles. One respondent said they didn't want to learn more about it and the extent of understanding of social impact investing varied.

Conclusion

Only a few pension schemes are implementing social impact policies. While large schemes can access these investments on a segregated basis, smaller schemes have to rely on limited pooled fund options.

The main barriers appear to be lack of understanding and therefore a need for guidance from the Pensions Regulator. More evidence on the risk/return characteristics of these investments is also needed.

More needs to be done to provide evidence of the benefits of these investments with a greater universe of products that span asset classes, a clear framework for developing policies and measuring outcomes, shared with the asset management industry to create universal standards.

Given that the pensions market in the UK is heavily intermediated, especially for smaller and medium sized schemes, investment consultants, fiduciary managers and asset managers must engage with trustees so that they can make informed decisions about long-term sustainable investment.

Some pension schemes are also looking for more guidance on measurement tools and formats of reporting on social impact, but there is a strong need for universal approaches to measuring and reporting on social impact. A possible next step would be to require corporates to report on agreed disclosure rules and then for pension schemes to report on their social impact, as well as financial return, within an agreed methodology.

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- 2 Growing a Culture of Social Impact Investing in the UK - November 2017 - <https://www.gov.uk/government/publications/growing-a-culture-of-social-impact-investing-in-the-uk>
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- 6 Information taken from https://www.bigsocietycapital.com/sites/default/files/Social%20pensions_Technical%20paper_Oct16.pdf
- 7 For instance, an employer offering employees access to a stakeholder arrangement has no duties in relation to the product offered (Section 3(8) Welfare Reform and Pensions Act 1999). Likewise, employers in the United States have safe harbour protections from the requirements of ERISA when they offer voluntary plans to their employees provided certain conditions are met.
- 8 [1985] Ch 270
- 9 Growing a Culture of Social Impact Investing in the UK - November 2017 - <https://www.gov.uk/government/publications/growing-a-culture-of-social-impact-investing-in-the-uk>
- 10 Section 34(1) of the Pensions Act 1995 gives them the powers of absolute beneficial owners, subject to any express constraints imposed by their trust.
- 11 Regulation 3(b)(vi)
- 12 See Pensions Act 1995, section 33(1).
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