PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

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Direct: +44 (0)20 7601 1719
Email: luke.hildyard@plsa.co.uk

Lucinda Cunningham
Commercial and Common Law team
Law Commission
1st Floor Tower
52 Queen Anne's Gate
London
SW1H 9AG

Dear Lucinda

LAW COMMISSION CALL FOR EVIDENCE ON PENSION FUNDS AND SOCIAL INVESTMENT

I am writing in response to the Law Commission's call for evidence on social investment, on behalf of the Pensions and Lifetime Savings Association (PLSA)

As the trade body for over 1,300 pension schemes with around £1 trillion worth of assets under management and over 20 million members, the PLSA is supportive of the concept of social investment. Pension funds are long-term investors with time horizons that extend over decades, so making sustainable investments with enduring social legitimacy is critically important to our members. We believe that understanding and improving the social and environmental impact of DC pension schemes' default funds is the likeliest way to achieve better social outcomes from DC investments

Scale

The PLSA helped establish the Pensions Infrastructure Platform (PiP) in order to enable smaller pension funds to achieve the scale necessary to access infrastructure investment opportunities – as the Law Commission's 'call for evidence' notes, size is a key barrier to pension funds' capacity to invest in major infrastructure projects, which can require several billion pounds worth of funding.

The interim report of the FCA's Asset Management Market Study found that nearly 33,000 trust-based defined contribution pension schemes have 11 or fewer members. A further 2,300 schemes have fewer than 1,000 members. Only 120 schemes have over 5,000 members. Therefore, many pension savers are invested in schemes that are unable to generate the resources – both in terms of finance and expertise – necessary to invest in infrastructure projects or specialist social investments. The PiP offers a means of overcoming this obstacle. Consolidation of smaller schemes into larger entities would also increase the feasibility of infrastructure and social investment projects for pension funds. Scale matters as there is an association between scale and investment performance in DB schemes that we think will hold for DC also once those schemes achieve sufficient scale . Access to alternative asset classes seems to be important in allowing larger schemes to achieve better returns.

Alongside this proliferation of smaller schemes, automatic enrolment is already building very large master trust pension schemes. For master trusts, the ratio of members to assets under management is not presently conducive to direct investment in infrastructure. For some schemes with large numbers of members but this situation will evolve as contributions rise and the schemes mature. We would anticipate well-run schemes looking to diversify their asset management organically as they grow.

Engagement

The main appeal of infrastructure investments to pension schemes is as a secure source of returns over the long-term. This provides a good match to the shape of the pension scheme liabilities, which are over many decades. Pension funds are also mindful of the space within their fiduciary duties to invest in accordance with the beliefs and values of the beneficiaries and to contribute, through their investments, towards positive outcomes including a fair, inclusive and sustainable society for those beneficiaries to retire into.

Research suggests that many savers are favourable towards the principle of social investment. The Law Commission consultation notes that over one million French citizens are invested in the 'solidarity funds' that designate 10 per cent of assets for social investment. When the PLSA conducted surveys asking pension savers about their priorities for the companies in which their pension savings are invested, financial performance unsurprisingly was the most important factor, but for those aged 18-34, this was level with the pay and condition of employees. Human rights and impact on the environment were also key considerations for a significant number of respondents.

Similarly, polling by IPSOS Mori found that 42 per cent of respondents either somewhat agreed or strongly agreed with the statement 'I would actively avoid investing in a company or industry which conflicted with my own ethical views, even if it offered superior investment performance.' There is, however, some discrepancy between these abstract responses to survey and savings habits as observed in practice.

The PLSA annual survey found that, on average, 92 per cent of DC savers remain in their default fund. This suggests a clear need for research designed to better understand the social and environmental risks and impacts of typical default fund investments. The PLSA has

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commissioned the Sustainalytics consultancy to undertake research to this effect, to be published in early 2016. We'd be very happy to meet with the Law Commission to discuss our findings in more detail.

Similarly, financial advisers quoted in a recent FT Adviser article on a survey suggesting that millennial investors were more interested in ESG issues than older counterparts were sceptical of the finding, stating that 'surveys have fairly consistently shown that many investors are well disposed to the concept of responsible investing, but this has never really translated into actual fund flows' and 'a survey is one thing but in the real world we just do not see this.'

This disconnect between stated preference or intention and actual behaviour is common across almost all areas of pension policy. It is possible, with a lot of effort, for an engaged employer to get employees to take decisions about their pensions. For example, tools now exist that make it easier for people to engage with and then take decisions about the level of their pension contribution. But, more commonly, people say one thing to researchers and then follow the line of least resistance. This is something that pensions providers and policy makers have to find ways of working around.

In general, people struggle to take good quality investment decisions. This is probably for three reasons. First, investment requires people to make judgements about an uncertain future. Second, human judgement is susceptible to a broad range of common biases and decision making short cuts that compromise our ability to evaluate probability and risk. Third, the level of technical knowledge required to exercise good judgement is in excess of that possessed by the average person.

There is a rich and engaging literature showing the extent to which people tend to lose money or otherwise compromise their financial wellbeing through poor investment decisions. Even those with elite educations may be prone to common and very basic errors in judgement.

Potential reforms

For those reasons, those tasked with making policy and running schemes need to think carefully about what their objective is when they encourage engagement with pensions and whether they can get there through another route.

The suggestion posed in the Law Commission call-for-evidence of a standardisation of social investments would be one way of promoting social investment and would make the area much easier for savers to negotiate. However, such an undertaking would be fraught with difficulties. Who would be the appropriate body to define social investment, and how would they do so, given that both the positive and negative impacts of any investment portfolio are likely to be highly subjective?

Although the two options are not mutually exclusive, a focus on the standards of default funds in relation to their social/ethical impact might be more productive than trying to persuade savers to explore options beyond the default fund.

The Law Commission's consultation will be useful in this respect, and we look forward to seeing the evidence gathered as part of the process and engaging with your ongoing work in this area.

Yours sincerely

Luke Hildyard
Policy Lead: Stewardship and Corporate Governance
Pensions and Lifetime Savings Association

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