Allianz Global Investors

Elizabeth Corley CBE
Vice-Chair

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Andrew Bailey
Chief Executive
Financial Conduct Authority
25 The North Colonnade
London E14 5HS

Caroline Wayman
Chief Ombudsman and Chief Executive
Financial Ombudsman Service
1 Harbour Exchange Square
Exchange Tower
London E14 9GE

Dear Mr Bailey and Ms Wayman

I write on behalf of the Advisory Group appointed by Government to look at mainstreaming a culture of social impact investment and savings in the UK. The group was established in January 2017 and on 14 November 2017 reported its findings and recommendations to the financial services industry and government. A copy of the report is enclosed and is available on gov.uk.

The group has undertaken extensive research and engagement activities across the investment and savings industry and with its customer base. Conclusions of particular relevance here include:

- There is increasing demand for investments with a social impact component and products are emerging in response. Financial advisers are largely new to social impact considerations when advising clients on these emerging options. Clients investing with medium to long-term investment horizons increasingly are likely to wish to consider other factors, including social impact considerations, in addition to a financial return.
- Perceptions of regulatory barriers to the inclusion of social impact considerations are frequently cited with reference to various stages of the investment chain both in the advised as well as institutional space and I refer you to evidence of this in the report.

The advisory group has engaged the FCA and FOS throughout the work and is grateful for their active participation. We note the detailed feedback statement (FS16/11) the FCA published in October 2016. This concluded that there are no inappropriate regulatory barriers to the growth of the market for social impact investments. It also concluded that while financial advisers need time to understand this growing market to advise clients appropriately, there is nothing in the current regulatory framework that prevents them from doing so. The advisory group recommends several steps to highlight these helpful findings as well as deal with the perceptions; including that further clarity and education between industry, government and regulators should be provided.

These different positions suggest the existence of some gaps in industry understanding, which we believe merit further attention - these are outlined below. We raise these points in a joint letter to the FCA and the FOS in order to approach them in a holistic manner that supports your ongoing efforts to align your two organisations in this field, as well as support government policy to provide more choice and better outcomes to investors. Furthermore, the FCA has advised in its feedback statement (FS16/11) that it will work with the FOS to clarify for advisers the types of complaints they may consider and how they will be approached.

(1) Suitability

- We understand that the FCA has found the rules around 'suitability' broad enough to allow advisers to ask about a client's non-financial motivations when assessing suitability and therefore the rules do not need to change to allow incorporation of these factors specifically. Nevertheless it would, in our view, be beneficial if more prominence could be given to this position even though we recognise professional indemnity (PI) considerations make precise specification challenging.
- Both the FCA's own RPPD guidance and MiFID II are clear on the need for firms to understand a client's knowledge, experience, financial situation and investment objectives, prior to them investing (nb: we note that MiFID obligations on suitability only arise when firms are giving advice). We suggest that greater emphasis is given to considering the time horizons clients are considering in their financial planning to take account of the Portfolio Approach and Liquidity considerations as set out in (2) below.
- We note that taking account of the time-horizon for expected returns on a short to medium, medium to long-term and long-term basis would allow advisers and clients to bucket the outcomes they desire better. This in turn would allow them to consider products more appropriately to deliver these outcomes over the horizons they require. As such, some of the current perceived barriers to these products would be addressed if the possibility of realisation of better outcomes as well as the portfolio planning approach were discussed during the suitability process.
- We also see institutions and high net worth investors approaching their balance sheet planning on a similar basis via liability driven investing. This approach allows these investors to consider less liquid and higher returning strategies to achieve better as well as more matched outcomes over the medium to long-term. This approach is not universally followed by smaller investors or their advisers and we believe the products, as well as practice, should be democratised where suitable.

- We note that the FOS provides an online technical resource on assessing the suitability of investments. This includes how the FOS takes into account the rules set out in the FCA's Conduct of Business Sourcebook on assessing suitability. These rules refer to investment objectives in broad terms but could also reference the need to consider time-horizons, a Portfolio approach and Liquidity considerations when assessing suitability for the reasons set out below.
- We believe that best practice involves financial advisers taking a holistic view of an investor's needs and values as well as time horizons for the returns of different strategies. This should not only match liabilities better with desired outcomes, it should also include some minimum consideration of whether there are relevant non-financial investment factors as well as the current matters that are appropriately reviewed in the existing process.
- **We would welcome any further comment from the FCA and/or FOS.**

We set out the Advisory Group's view on this issue below:

We believe that, as part of the engagement and suitability assessment, it may also be appropriate for advisers to ascertain each customer's non-financial investment goals and preferences, to determine their objectives properly and thereby suitability of advice as well as approaching their planning on a time-horizon or liability-driven basis to achieve more holistic outcomes. Non-financial investment goals and preferences might include personal values, ethics, morals, faith, desire for social impact, care for the environment and sustainability, amongst other things. Understanding an individual's position on these is an integral part of knowing your customer. Without this knowledge there are no means to include non-financial preferences, timing and liability matching parameters within a customer's investment portfolio. For example, individuals could find themselves invested in a fund which has exposure to an underlying asset which is contrary to their personal beliefs or even religiously or morally offensive.

We believe an improved needs assessment and suitability process should determine an individual's approach to his or her timing, liability, non-financial goals and preferences, and then these should form part of the scoping exercise to present an appropriate investment proposition. We would ask the FCA and FOS to consider providing guidance to signal the importance of a greater understanding of each customer's non-financial investment goals and preferences in the same way many of the worlds most sophisticated investors approach their planning. This could be done through various means, for example publishing examples of good and bad practice. These would provide a framework for advisers and help compliance officers to monitor and ensure a robust process of establishing a client's non-financial investment goals and preferences and explaining how they relate to investment objectives and suitability of advice.

- **We would welcome any further comment from the FCA and/or FOS .**

(2) Portfolio and liability driven approach with regard to impact considerations & alignment of FOS/FCA

- In addition to any considerations related to firms acting in accordance with regulatory rules, guidance and principles, we understand that the FCA and the FOS will consider the risk adjusted return of individual investments as part of an integrated client portfolio. That portfolio could include impact investments.
- We recognise that both FCA and FOS subscribe to the portfolio approach and are fully aligned in their intention to apply this to regulation of the impact investment industry.
- However, financial advisers have raised concerns that the FOS does not consistently look at investments on a portfolio basis; and that there is no clear alignment with the FCA on this approach.
- **We would welcome further comment from the FCA and/or FOS, including how these adviser misunderstandings could be best addressed.**
- The FOS has published a technical note on portfolio-management agreements. This outlines the nature of complaints the FOS receives and their response approach, (including information on suitability of a portfolio and the consumer's understanding of the agreement made). We note that this does not include guidance on how non-financial factors will be assessed. Discussion with financial advisers has highlighted that there is uncertainty about how inclusion of non-financial factors might be implemented in practice.
- **We would welcome further comment from the FOS.**

(3) FOS approach to complaints about the social outcome of social impact investment products

- Financial advisers have raised questions about the jurisdiction of the FOS to deal with complaints relating to the delivery of social impact. The concern is the risk that they might become the subject of a complaint to the FOS over social outcomes which could be difficult to predict or measure.
- We understand that while the FOS focusses on complaints about financial loss they would consider complaints about social outcomes by referring to their 'Distress and Inconvenience Guidance'. They would also take into account relevant legal requirements, best industry practice, as well as any guidance from the FCA on the role of non-financial factors,.
- **We would welcome further comment from the FCA and the FOS on how 'distress' in this context would be determined and what possible penalties for the investment manager could look like.**
- In its feedback statement FS16/11 the FCA proposed, in conjunction with the FOS, to carry out a communication programme targeted at social impact investment stakeholders, explaining how the FOS' rules apply in this particular context. The response states that both bodies will work together with stakeholders to find the most effective way of delivering this programme which may include round table meetings, road shows or webinars. We understand that the FCA and FOS have put in place engagement programmes with online and local events that provide a platform for financial advisers to ask questions on these topics. Both organisations attend and

take part in each other's events to advise. Full event schedules are advertised on the FOS and FCA websites:
  - http://www.financial-ombudsman.org.uk/news/events-industry.htm
  - https://www.fca.org.uk/live-local-events
- We appreciate this communications programme, but would highlight the risk that comes with the nature of these events which could (1) further different interpretations through verbal Q&A (2) provide information that's not accessible to advisers that were not able to attend these sessions.
- **We would welcome any further comment from the FCA and FOS.**

(4) Liquidity
- We understand that liquidity, taken to mean the daily pricing and trading of investment instruments, is not a regulatory requirement but has become a cultural norm for retail investment products. These are sensible considerations but the historically low interest rate environment is impacting the returns of investors when they could be enhancing these with appropriate, but potentially less frequently priced or traded, investments that are just as secure.
- We note and agree with the findings of the recent Law Commission report[1] on pension funds and social impact: that perceived liquidity requirements can be to the detriment of long-term investment because they tend to preclude the use of long-term and less liquid assets such as infrastructure and some social impact investments.
- The Advisory Group has previously submitted a response to the FCA's discussion paper 'Illiquid assets and open-ended investment funds'. This addresses frequently cited concerns around the regulatory regime restricting the development of fund structures that incorporate illiquid assets as part of social impact investment products. We refer to our comments above in this regard.
- We believe that both the regulatory framework and industry norms have a role to play in promoting the willingness of investors to engage meaningfully with longer term, less liquid investments, where these are suitable and offer better returns for equal security. We note the relative success here of Australian DC pension scheme equivalents.
- **We look forward to seeing the FCA feedback statement and welcome any further comments from the FCA.**

(5) The role of the FCA's 'Innovate' in supporting the growth of the social impact investing market
- We understand the role of Innovate at the FCA is to support both new and established businesses who want to introduce innovative financial products and services to the market. This includes a 'direct support' function, which provides help for innovative businesses to understand the regulatory landscape and how this applies to them. It also includes the regulatory sandbox where firms can test innovative ideas in the market on a small scale.
- We have been advised that the FCA has considered requests for regulatory assistance from new social impact investment providers via the Innovation Hub. We

[1] *Pension funds and social investment,* Law Commission, 2017

endorse this approach and would encourage applications from social impact investment providers to the Innovation Hub.

- We also suggest the financial services industry works with the FCA to identify how we can assist and facilitate issuance of new instruments and bonds to bring further choice and diversity to the market place.
- **We would welcome any further comment from the FCA.**

(6) Shared understanding of the 'social impact' concept

- Given the recent introduction and ongoing development of the 'social impact investment' concept we recognise that there is a diverse range of understanding, interpretations, and language in this field.
- In the the detailed feedback statement (FS16/11), the FCA began to articulate its view of social impact investments. However, there were a number of terms that were not included in this feedback; moreover, discussions with various stakeholders indicated that they encountered differing levels of understanding of the topic and were provided differing definitions while engaging with the FCA.
- We recognise the issue of common language and understanding will remain for a period of time, as the field continues to evolve and mature.
- We would endorse continued industry engagement with the FCA and FOS with the aim of setting out, and then maintaining, a current terminology so that a consistent understanding can be established when dealing with these bodies.
- **We would welcome a commitment from the FCA and FOS to continue to engage in this process and any specific actions they would recommend.**

(7) Law Commission reccomendations on social impact investment and pension funds

- We note the recent Law Commission report[2] and welcome its conclusion that barriers to greater use of social impact investment by pension schemes are primarily structural and behavioural rather than regulatory.
- As reflected in the recommendations of the Advisory Group report, we encourage the FCA to implement the three relevant recommendations and to give serious consideration to the further options for reform that relate to the FCA.
- **We would welcome any further comment from the FCA**

We would be happy to discuss any of these points further and look forward to hearing from you.

Yours sincerely

Elizabeth Corley

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[2] *Pension funds and social investment,* Law Commission, 2017