The principle of the thing

Niaz Alam of the London Pensions Fund Authority discusses how upholding long term responsible investment principles on environmental, social and governance issues are the challenge for trustees and investment managers today

The last two decades have seen more institutional investors agree that they have a duty to manage the long term sustainability of their investments by ensuring the companies in which they invest take responsibility for upholding internationally recognised social and environmental standards in their operations around the world.

Since July 2000, in a measure since replicated elsewhere, trustees of occupational pension funds in the UK have been legally required to declare in their Statements of Investment Principles (SIPs) “...the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments”; and “the policy (if any) directing the exercise of the rights (including voting is rights) attaching to investments”.

Within five years of its launch the United Nations Principles of Responsible Investment Initiative (UNPRI) had by the start of 2009 secured signatories managing funds approaching US$15tr in assets. These investors explicitly accept that
they have a role to play in ensuring their investments comply with international standards.

Multinational companies in turn have increasingly signed up to codes of conduct accepting that they have a responsibility to proactively ensure compliance with international standards, both within their own operations for their own employees and environmental impacts and also significantly, given the impact of globalisation, across their supply chains within the operations of their suppliers and sub-contractors.

The evolution of the business case for Corporate Social Responsibility (CSR) has driven the improvement of benchmarks and indicators for companies to measure performance on environmental, social and governance (ESG) issues. The role of multi-stakeholder-led organisations such as the Global Reporting Initiative (GRI), the Carbon Disclosure Project and Ethical Trading Initiative in helping to improve performance, impact and reporting on these issues is continuing to grow.

It is something of a paradox, therefore, that while part of this growth is credited to the influence and expectations of investors in 2010 it will remain easier for an individual to assess and compare between the performance and impact of different companies on ESG issues than it will be for them to accurately differentiate and rank the positive impact of most of the pension funds, banks and financial institutions that may be investing money on their behalf. Given the enormous access to resources, data and analysis of the financial services industry, this position is inherently difficult to justify.

Added to this, the fact that poor governance has been implicated in some of the financial mismanagement underlying the global credit crunch and public expectations on ESG issues such as climate change are continuing to rise, ‘business as usual’ and the status quo are not tenable options.

In order to ensure the credibility of public commitments to long term responsible investment principles and for UNPRI signatories not to be seen as merely paying lip service to an aspirational voluntary code, trustees together with their investment managers, actuaries, consultants and advisers all need to raise their level of reporting and transparency on ESG issues and see this as an integral part of good governance. Trustees, in principle, are able to drive this process by taking steps to embed ESG considerations into a responsible investment policy as part of their funds’ investment analysis and decision-making processes. Typically, this can include taking steps such as those recommended by groups such as FairPensions or the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (UNEPFI).

For most pension funds which rely on external investment managers, implementation of the fund’s ESG policy requirements depends on how they are incorporated in Investment Management Agreements (IMAs). To be comprehensive, these should require ESG policy to be applied to non-equity asset classes and ensure that adequate resources are provided to voting and engagement with companies on ESG issues. In practice, however, for all but the very largest funds and those where trustees directly manage 100 per cent of their investments, effective implementation of ESG policies faces bottlenecks and is often far from comprehensive.

Unfortunately, it remains the case that the level of competence and commitment to integrating ESG considerations can vary widely between different fund management houses. Moreover, even where a fund manager is proactively pursuing ESG integration, it may sometimes not be possible for trustees to measure this accurately. For instance, as there is no requirement for funds to publicly disclose their voting records on shareholder resolutions, this is only done voluntarily by a minority of funds, or purely on a 1:1 contractual basis in relation to shares directly voted on for a client.

Similarly, the level of engagement by fund managers with companies on ESG varies significantly and only a minority publish detailed reports on the effectiveness of their engagement. Added to this, institutional factors such as the perceived need for confidentiality in discussions with companies and the fact that in the absence of an industry-wide engagement platform on an issue by, for example, a group such as the Institutional Investors Group on Climate Change, it remains difficult for investors to assess the level and impact of any engagement carried out on their behalf.

It is no surprise, therefore, that the most recent study by the UNEPFI working group observed: “The consultant industry has not yet sufficiently developed measures to assess asset managers’ competence on ESG integration and engagement.”

This can make it difficult, therefore, for trustees to reward those managers that implement ESG commitments more effectively than others and impede investment providers from putting more resources into monitoring, improving and reporting on ESG activities. Yet for long term investors, voting on ESG issues and engagement with the companies in which they are invested are the key tools available to them to influence improvements in corporate behaviour and impact.

Accordingly the level of transparency and commitment by providers still needs to improve. This is particularly apparent if the activity and performance of the few typically very large funds that are leaders in this field — such as Calpers, USS and the Norway Oil Fund — are stripped out of ESG performance studies. The median level of service and reporting on ESG
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issues across the investment industry remains far too low, a fact reflected by the general absence of ESG issues across the content and agenda of most industry conferences and journals.

Even on issues such as corporate governance and directors’ pay, which receive high media profile and where voting agencies have long established policies, it is arguable that implementation of ESG commitments still lags behind desirable levels. The low levels of voting against some of the remuneration polices of financial institutions that have since become controversial in the light of the credit crunch, is just one facet of the limited attention provided to ESG issues.

Clearly, more focus and resources need to be paid to this area. Not least because the level of attention to ESG issues at company AGMs is likely to continue to rise, with 2009 seeing both a major shareholder revolt on core governance concerns at M&S and the first UK shareholder resolution on a labour rights issue brought by a trade union to secure more than 10 per cent of the shareholder vote actively in favour of the union’s concerns.

The fact many funds still do not exercise voting rights on all the shares in which they are invested, or that many managers rely on a small number of voting agencies to act on their behalf and bring issues to their attention, risks some issues being ignored or companies receiving conflicting messages that undermine the proper implementation of ESG commitments. Partly for these reasons, the London Pensions Fund Authority, of which I am
thoughts on governance

a trustee, has this year appointed a full time Responsible Investment Adviser to its small in-house investment team, with a brief to improve the monitoring and impact on ESG issues by the various management houses that invest funds on its behalf. With more funds taking similar steps — and the continued development of collaborative forums such as the Marathon Club — the level of ESG integration across the industry may increase quicker than some expect.

First, this will be because it should become easier for investors to differentiate between providers on ESG integration. More significantly, the growth of the UNPRI and steps recommended by the Myners Principles and the UK Government’s Walker Review of the ISC shareholder principles, all serve to make ESG issues harder to sideline.

While common law in regard to trustee duties has not fundamentally changed since the Cowan v Scargill and Bishop of Oxford cases, with a duty to act in the interests of beneficiaries remaining paramount, the importance of trustees having regard to ESG concerns has become more broadly recognised following the work of the UNEPFI and is given added weight by the fact that more evidence is now available on ESG issues to support and quantify a business case for responsible behaviour by individual companies. Accordingly, the momentum for much needed improvements in reporting and analysis of engagement by investors on ESG issues is gradually building.

With the actions and work of leaders on ESG issues continuing to be highly visible and increasingly seen as effective, public expectations of all funds and their managers will also rise significantly. It will become increasingly essential and possible therefore for a virtuous cycle to emerge of trustees rewarding those managers that take the analysis and reporting of action on ESG issues more seriously than others.

The credit crunch has highlighted governance issues for everyone involved in financial services. Clearly beneficiaries expect and deserve better from the financial services industry when it invests money on their behalf. The effective integration of ESG matters rightly forms a core and growing part of beneficiaries’ concerns. Managers and trustees need to meet these expectations better and should take action to improve the impact and quality of reporting on ESG issues.

Further reading:
http://www.fairpensions.org.uk/Rlguide
http://www.guardian.co.uk/business/2009/jul/03/tesco-trade-unions-workers-rights
www.unpri.org

they are invested are the key tools available to them to