Socially Responsible Investment – The UK Experience

Law Debenture

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The purpose of the paper is to describe the practical experience of UK pension funds in dealing with Socially Responsible Investment (SRI). Discussions around SRI have been developing over several years, but it was the new law came into effect on 3 July 2000 that triggered the consideration of SRI by the full pension community

The UK scene

Let us first set the background for SRI in the UK. Pension funds in the UK are established as "trusts", i.e. legally separated funds built by contributions of employers and employees and governed by a board of "trustees". Under British Trust Law and statutory legislation, pension trustees are responsible for the proper and secure investment of the scheme's asset. The discipline though is that the trustees have to make their decisions in the interests of their beneficiaries, a term which includes the members.

The general prudent person rule is complemented by more specific rules in the Pensions Act 1995. Trustees must have regard "to the suitability of investments" and "to the need for diversification of investments". UK schemes are funded, and the trustees must normally delegate day-to-day investment decisions to authorized investment managers. This has its implications and we will return to this subject later.

There has been a major change in public attitudes in the UK towards investment. Words like ethical, responsible and sustainable are now in common use. This has encouraged the government to change the law relating to the investment of pension funds.

Problems of definition

What makes the subject of Socially Responsible Investment so difficult is that it means different things to different people. The first thing people think about in this context is tobacco. This is closely followed by alcohol and gambling. After a little thought, other sectors suggest themselves: pornography, armaments, human rights, animal rights, child labour, corruption, pollution, political oppression and the environment. What characterises all these is that they are personal. Each person has a different combination of things that they approve of or disapprove of.

What makes the subject even more difficult is subjects like nuclear power and genetic engineering. At first these were regarded as public benefits but in recent years attitudes towards them have completely altered. It is clear that views can be subject to fashion and can change quickly.

All this has lead the Government in the UK to abandon the phrase 'ethical investment' as it is too loaded with personal attitudes and instead to use the title 'Socially Responsible Investment'.

The new UK regulation

Let us now take a quick look at what the UK law says. Trustees must include a statement in their Statement of Investment Principles (i.e. their investment policy) as to:

a) "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

b) their policy (if any) in relation to the exercise of rights (including voting rights) attaching to investments."

It is very interesting to analyse the new law. It no longer speaks of ethical investment. Nor does it require trustees to follow Socially Responsible Investment. However it does require trustees to consider Socially Responsible Investment. It also requires trustees to discuss this with their sponsoring company.

Equally important, it emphasises the

importance of voting. What lies behind this is that the Government has been concerned for some time that although companies owe their duties to their shareholders, shareholders have not used their power to influence companies by voting share as fully as they should have done.

There is a further very important feature of the UK law. This is that once the trustees have set their SRI policy, they must monitor the investment manager in the application of that policy. If the trustees do not do this, and it can be shown that their pension fund has lost money as a result, the trustees are liable personally to make good the losses.

Difficulties with implementing an SRI policy

It is already clear that trustees have particular difficulties with the new law. These are:

exclusive approach if trustees approach SRI by attempting to remove companies of which they disapprove from the population of companies in which they can invest, they can quickly find themselves unable to gain diversification.

foreign assets foreign companies are not necessarily subject to the same requirements on disclosure and openness, so that it can be more difficult to apply a SRI policy for foreign holdings.

property property has different characteristics from equities, and the SRI issues revolve mainly around the use to which the property is put. It is not always easy for a landlord to control this.

managed funds where trustees invest in managed funds, sometimes called pooled funds, they are generally participating alongside many other investors. No single investor will have a significant stake in the pool. It is therefore not possible for any single investor to influence the SRI policy of the manager.

index tracker funds these are sometimes called passive funds and by definition they do not allow the investment manager to discriminate in stock selection. All the participating pension fund can do is to ask the investment manger to utilise the votes that come with the stocks.

However, the biggest single difficulty facing UK pension fund trustees in setting their own SRI policy is that they must fit it in with their other investment obligations.

Trustees' other investment obligations

The general law of the UK requires trustees to aim for the best financial interests of their beneficiaries, i.e. the people for whose benefit they are working. In the UK, therefore, it is not possible for trustees to use their own personal prejudices or enthusiasms to set an investment policy for a trust fund like a pension scheme. Such personal considerations must be put on one side, as the trustee's overriding objective must be the best financial interests of their beneficiaries.

An exception is if the beneficiaries have a uniformly 'green' attitude then it is possible for the trustees to adopt a green investment approach. However, the difficulty here often is that trustees are required to act in the interest of all beneficiaries, not only a vocal minority.

Another investment obligation for trustees is that they must use specialists. The general law of trusts in the UK does not expect trustees to be experts in any particular field. They are therefore expected to use specialists in areas such as investment management where expertise is required.

The other dangerous area that trustees must avoid is taking 'day to day' investment decisions unless they are authorised as an investment manager. This obligation is found in the Financial Services Act 1986, which was created to protect the interests of investors. It is therefore not open to trustees to interfere in the detailed workings of the investment manager.

Squaring the circle: a practical solution

In a nutshell, there are tension and potential conflicts between a trustees' specific SRI policy, the general investment duty (to effectively generate the best possible investment return) and the requirement to use an investment manager.

But there is a way through the maze. Our advice to all the schemes where we are involved is that trustees should consult their investment manager in setting the trustees' own SRI policy. This is for four reasons:

technology the investment manager already has the resource for analysis and research

they are doing it anyway it is not credible that investment managers can be successful if they disregard social trends, take a short-term view, or act irresponsibly. Successful managers are applying, consciously or subconsciously, tests and screens in their decision-making processes that are consistent with a socially responsible approach.

trustees need to understand the implications
discussing the matter with the investment manager at an early stage prevents the trustees from setting an SRI policy that simply cannot be applied, or may harm investment performance.

aim for the possible investment managers are realists, and will encourage trustees to aim for what is possible, and not to damage the accountability which the investment manager should have to the trustees.

It is already clear that large investment managers operating in the UK have identified those parts of their decision making process that are consistent with SRI. Here are extracts from the policy statements of three of the largest UK investment managers:

"the idea that quality companies, operating at an environmentally and socially sustainable level, are more likely to survive and deliver long term shareholder value suggests that an analysis and understanding of non-financial criteria should actually offer additional assistance in identifying the long term winners."

"it is clear to us that taking ethical and environmental considerations into account in an investment decision can enhance returns available."

"we believe that we should focus on a few key issues...where we believe there could be genuine impact on shareholder value. The key issues we will focus on will be:

- corporate environmental policy, management and reporting
- human rights
- employment standards

Two case studies

We are involved in the pension scheme of a very ethical company, which has taken a high profile public stance on its own business ethics. It was natural for the trustees to use the corporate stance as the trustees' own starting point when setting a SRI policy for a pension fund. However, in talking with the investment manager it quickly became clear that the use of the company's own criteria excluded 70% of the Financial Times All-Share Index. This was clearly not a viable proposition given the trustees' other investment obligations which I described earlier.

There was therefore then a full debate at the trustee body. The trustees decided that they should ask their investment mangers to look positively at SRI, rather than negatively by means of excluding companies from the investable population. The main area of concern was environmental issues, as it was felt that disregard of these would have adverse investment consequences. The investment managers were therefore told to operate a 'tie-breaker' system, so that if their stock selection process gave a choice of two equal companies for investment, they should choose the one with a better environmental policy. The managers have been told that they will be monitored in their application of this policy.

In another case, we are involved in the pension scheme for a socially aware company with explicit and well-publicised policies in this area. Other than us, all the trustees are on the company payroll and feel bound by the corporate policies on social awareness, partly because they are on the payroll, but mainly because they all believe in them.

It was first necessary to establish that these policies were corporate, and did not bind the trustees. It was necessary for the trustees to recognise that the duties of the company were to its shareholders, but the duties of the trustees were to the beneficiaries, and it was therefore not appropriate for them simply to adopt the company's own criteria.

After careful study, the trustees have decided to adopt the SRI policies of the investment manager. These have now been identified and it is well understood that although they have been freshly stated, the policies themselves are not new and almost certainly underlie the good past investment performance of that manager.

The trustees also took a very important decision: that SRI is a fast developing topic and that they should leave room for their own SRI policy to evolve.

What we have learnt from these two exercises is the importance of clarity of objectives and clarity of process. In both these cases, the trustees have a clear position that was reached after clear debate. This is a good way of achieving a decision that is likely to be effective, and which would be defensible if put under public scrutiny.

Conclusions

- The UK law in effect from 3 July 2000 has forced all pension plans to consider SRI without imposing it. Other European countries take similar "disclosure" approaches, e.g. Belgium, or discuss more "activist" approaches.This area is in continuous evolution.

- Pension investing is about long-term decision-making under great uncertainty for a large number of people affected. All this is subject to a commitment by a sponsoring company, continuously changing regulation/legislation as well as volatile market conditions and investment fashions. The pension boards' SRI policies need to be seen in the full context of the framework they operate in.

- While SRI policies are the responsibility of pension scheme trustees, the introduction has lead to a much wider involvement of the boards of sponsoring companies (that need to be consulted) and the actual investment managers (who need to implement such policies).

- There are conceptual and practical problems with implementing SRI policies in the UK. The general investment duty of trustees - to invest in the best (financial) interest of the beneficiaries - can potentially conflict with specific views on SRI. Also, the delegation of investment management to fund managers, who may have their own SRI policies, requires a clear implementation and monitoring process. However, in practice these hurdles appear surmountable in most circumstances.

- According to a recent survey, 59% of the top 500 occupational and local authority pension funds - representing a total of £236bn in assets, were found to have incorporated SRI in their investment strategies.

- So far, most UK pension funds have decided to take a positive and constructive approach to SRI rather than a negative approach by exclusion. SRI policies tend to be expressed in very general terms while fund managers and analysts "engage" in SRI-related discussion with listed companies.

- The major impact of the new law appears to be in the exercise of voting rights (e.g. some specific active dissenting votes in companies invested; regular reporting on actions by fund managers to trustees).

- More specific, and sometimes stricter, approaches are taken by pension plans where the company or members express strong and homogeneous preferences or in pension schemes of public authorities.

- DC schemes are increasingly offering SRI options but it is too early to assess the pick-up and results of those.

UPCOMING CONFERENCES...

... *with IIR Ltd*

Offshore Funds
28/29 November 2001, Hilton, Dublin.
IIR Contact: Rosy Key 020 7396 6280

Performance Measurement
5/6 November 2001
Earl's Court Conference Centre
IIR Contact: Christina Leong-son 020 7915 5011

Risk and Active Loan Portfolio Management
12/13 November 2001, The Rembrandt Hotel, London.
IIR Contact: Christina Leong-son 020 7915 5011

Global Custody Forum
12/13 November 2001, Hotel Russell, London.
IIR Contact: Christina Leong-son 020 7915 5011

Fund Manager Selection
14/15 November 2001, Hotel Intercontinental, Zurich.
IIR Contact: Christina Leong-son 020 7915 5011

Multi-Manager Funds and Funds of Funds
13/14 December 2001, Waldorf Meridien, London.
IIR Contact: Rosy Key 020 7396 6280

Transfer Agency Forum
12/13 December 2001, Thistle Westminster, London.
IIR Contact: Rosy Key 020 7396 6280

Leveraged Finance
3/4 December 2001, The Selfridge Hotel, London.
IIR Contact: Christina Leong-son 020 7915 5011

Asset Allocation
10/11 December 2001, Millennium, Knightsbridge, London.
IIR Contact: Christina Leong-son 020 7915 5011

Outsourcing Financial Services
11/12 December 2001, Mayfair Conference Centre
IIR Contact: Christina Leong-son 020 7915 5011