Coalition Programme for Government

BRIEFING
MAY 2010

This document shows FairPensions' initial analysis of the HM Government's 'The Coalition: our programme for government' and its implications for issues relevant to Responsible Investment.[1]

Business, society and the environment

> *"We will reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting, and investigate further ways of improving corporate accountability and transparency."*
>
> *- The Coalition: our programme for government (p. 10)*

FairPensions is pleased to see that the Liberal Democrats' manifesto commitment to **reinstate the Operating and Financial Review** has been included in the coalition agreement. This is extremely welcome news.

The requirement for quoted companies to produce an Operating and Financial Review (OFR) with information about their performance was introduced by statutory instrument in 2005. However, despite general consensus among stakeholders in favour of this move, the Chancellor, Gordon Brown, then announced that the government no longer intended to require an OFR, and the requirement was repealed in the same year.[2]

FairPensions believes that this reversal was unfortunate. Although many of the requirements of the OFR were subsequently introduced by the Companies Act 2006, which provides for a Business Review,[3] the statutory obligations in the 2006 Act are unclear and insufficient, particularly with regard to **reporting on social and environmental matters.**

THE LEGISLATIVE FRAMEWORK

- Section 172 of the Companies Act 2006 introduced 'stakeholder obligations', requiring company directors to have regard to "the impact of the company's operations on the community and the environment."
- Companies are required to report against these obligations: Section 417(2) of the Act states that the purpose of the Business Review is "to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company)".
- Section 417(5) of the Act also requires quoted companies to report on environmental and social matters "to the extent necessary for an understanding of the development, performance or position of the company's business".
- None of these reporting requirements apply to small businesses, and so guidance under these provisions would not subject them to any additional regulatory burden.

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Our own experience and research suggests that many companies are not providing their shareholders and the wider public with pertinent information about the impact of environmental and social factors on their business. We believe there is a case for further guidance to streamline and clarify these reporting obligations, to encourage quality of disclosure rather than quantity, and genuine transparency rather than box-ticking.

We hope that the introduction of the Operating and Financial Review will provide an opportunity to revisit these important issues and get the statutory framework right.

We also hope that the commitment to *"investigate further ways of improving corporate accountability and transparency"* [4] indicates that the coalition will look favourably on the introduction of **mandatory carbon reporting** (currently the subject of a review initiated by DECC and DEFRA under the previous government). We hope that mandatory reporting will be implemented swiftly after the review reports in August, and that the scope will be extended from that of the current voluntary guidelines to include a company's embedded emissions (e.g. emissions arising from a bank's investments) as well as their direct operational emissions.

Research by FairPensions found that 86% of fund managers surveyed supported requirements on companies to report their greenhouse gas emissions, while 78% would welcome stock exchange listing rules requiring companies to disclose their climate-related risks.[5] Such information is essential to enable investors to account for (potential) carbon costs, hold companies to account and make smart and sustainable investment decisions.

In the long-term we also favour reporting of total portfolio emissions by investors themselves, so that individuals can assess the carbon footprint of their retirement savings and other investments.

Banking

We welcome the government's commitment to reform financial regulation so that it "promotes responsible and sustainable banking", and to *"take steps to reduce systemic risk in the banking system"* [6]. We are somewhat concerned by the coalition agreement's lack of detail in this area. Although the focus on promoting sustainable lending and tackling excessive bonuses is welcome, this seems to have led to a neglect of the equally vital question of **corporate governance**.

It is now widely accepted that one of the causes of the financial crisis was the failure of many large institutional investors adequately to scrutinise the companies they owned. Risky business models and poor decisions went unchallenged, with devastating consequences for the economy – including for pension savers, whose funds lost an average of 17% of their value.[7]

The need for institutional investors to practice effective stewardship of the companies they own has never been clearer. This should involve meaningful **exercise of shareholder rights** – including voting rights – and a willingness to challenge management on issues with the potential to affect the long-term returns of beneficial owners. These may include, among other things, environmental, social and governance (ESG) risks.

Despite this, our research shows that investors' level of engagement with these issues is typically poor.[8] FairPensions believes that, in order to fulfil its ambition to *"reform the regulatory system to avoid a repeat of the financial crisis"* [9], it is vital that the government addresses this engagement gap. Among other things, this should entail:

- A willingness to amend or add guidance to the Companies Act (see above).
- Supporting the development of a strong Stewardship Code for institutional investors, and ensuring its enforcement is sufficiently robust and independent.[10]
- Introducing mandatory disclosure of voting records.

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Energy and Climate Change

> *"As part of the creation of a green investment bank, we will create green financial products to provide individuals with opportunities to invest in the infrastructure needed to support the new green economy."*
>
> *- The Coalition: our programme for government (p.17)*

We welcome this recognition of the role of financial services in facilitating the transition to a low-carbon economy, and of the need to harness the appetite of individuals to make green choices to support this transition.

We would suggest that this needs to be extended throughout the financial services sector, and not just the creation of dedicated 'green' financial products. It is crucial that the financial markets as a whole have the necessary information and incentives to act on climate risk. Mandatory carbon reporting (see above) must be a key element of this.

In particular, pension funds, which are responsible both for the allocation of significant amounts of capital and for the wellbeing of their members in retirement, must be much better incentivised to take climate change into account in their investment decisions. FairPensions' most recent survey of fund managers found that although almost all of those surveyed recognise the importance of climate risk to investment returns, the extent of action to manage those risks varies widely, with pension fund clients placing little demand on fund managers for such action.[11]

Pension funds are already required by law to disclose in their Statements of Investment Principles (SIPs) the extent, if at all, to which they take environmental, social and governance (ESG) risks into account. However, in our experience pension funds' SIPs often tend to be vague and are poorly reflected in funds' investment practices.

We recommend that pension funds should also be required to state exactly which such factors they take account of, and how they have implemented their policies on managing ESG risks, in particular through their voting and engagement activities. This would allow individual pension savers to monitor and assess their pension fund's environmental performance, as well as prompting self-assessment (and hopefully self-improvement) by funds themselves.

Pensions and Older People

> *"We will simplify the rules and regulations relating to pensions to help reinvigorate occupational pensions, encouraging companies to offer high-quality pensions to all employees, and we will work with business and the industry to support auto enrolment."*
>
> *- The Coalition: our programme for government (p.17)*

On this front we would merely urge that 'simplification' of pensions regulations does not have the unintended consequence of watering down members' rights, as has sometimes been the case with previous 'deregulatory' proposals.

FairPensions believes that, particularly given the heavy losses suffered by pension savers due to inadequate stewardship of their retirement savings in the run-up to the financial crisis, fund members need strengthened rights to hold to account those responsible for their money. In particular, fund members' rights to access information about their fund's investment policy and how it has been implemented must be significantly strengthened.

In relation to auto-enrolment, we believe that the National Employment Savings Trust – which, if it goes ahead in its current proposed form, will rapidly become one of the biggest pension funds in Europe – must embed best practice in relation to responsible investment at the heart of its decision-making. FairPensions has had constructive discussions with NEST (previously known as the Personal Accounts Delivery Authority) on this issue and will continue to do so.

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ABOUT FAIRPENSIONS

FairPensions is of the operating name of the Fairshare Educational Foundation, a registered charity (no 1117244) established to promote Responsible Investment (RI) by pension schemes and fund managers, and to ensure that the ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.

In the case of pension funds, RI most often entails engagement with investee companies i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers. We advocate a strategy of active ownership to manage environmental, social and corporate governance (ESG) risks with the potential to affect the long-term value of investment portfolios.

FairPensions counts among its members organisations representing the beneficial owners of pension schemes, such as the National Federation of Occupational Pensioners, UNITE and Unison, as well as thousands of individual pension fund members.

Further information about FairPensions and our approach to RI can be found on our website.

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fairpensions.org.uk

1. http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf
2. http://www.companieshouse.gov.uk/promotional/financialReview.shtml
3. See section 417 of the Companies Act 2006: http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_26
4. The Coalition: our programme for government. Page 10
5. 'Preparing for the Storm?', October 2009. http://www.fairpensions.org.uk/sites/default/files/uploaded_files/PreparingStorm2009.pdf
6. The Coalition: our programme for government. Page 9
7. OECD: http://www.oecd.org/dataoecd/52/52/42204972.pdf
8. See, for example, http://www.fairpensions.org.uk/sites/default/files/uploaded_files/documents/ResponsiblePensions_2009.pdf
9. The Coalition: our programme for government. Page 9
10. The Financial Reporting Council recently consulted on a Stewardship Code but has yet to publish its response. FairPensions' submission can be found at http://www.tinyurl.com/FairPensionsStewardship
11. 'Preparing for the Storm?', October 2009. http://www.fairpensions.org.uk/sites/default/files/uploaded_files/PreparingStorm2009.pdf