Managing Environmental Risk:
the Deepwater oil spill & its impact on UK pensions

BRIEFING
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Introduction

The recent oil spill off the Gulf of Mexico is the latest in a growing list of avoidable environmental, social and corporate governance (ESG) crises to have serious negative impacts on UK pension funds. Research by FairPensions has found that although almost all major UK pension funds acknowledge the importance of ESG risks and have a policy commitment to consider them, many do not integrate this policy into their investment practice. In this briefing, we suggest simple and cost-free measures to encourage UK pension funds to effectively monitor and manage those ESG issues with the potential to produce significant future financial risks to beneficiaries.

The Deepwater Disaster

On 20 April 2010, BP's 'Deepwater Horizon' off-shore oil drilling platform caught fire and sank, killing 11 men. The resulting oil spill has now spread to cover an area of several thousand square kilometres and is thought to be the largest in US history.

KEY FACTS

- In 2009, BP accounted for around 12.5% of dividends paid by all UK companies.[1]
- Since the explosion, BP's share value has fallen by around £44 billion – a third of its value.[2]
- The gross direct costs to BP of the response and clean-up operation are already well in excess of $1bn.[3]
- Spending is expected to continue at this rate until the flow of oil stops and for some time after. BP is unable at this stage to estimate the full costs of litigation, fines and environmental clean-up, describing them only as "sizeable".[4]

Impact on UK pension funds

BP is a key stock for almost all UK pension funds. There are already concerns that the precipitous decline in the company's share price could affect UK pension savers. On 31 May, the Yorkshire Post reported that the pension funds of Yorkshire public sector workers had lost an estimated £78.53m of value.[5] If BP becomes a takeover target, as many analysts fear, this could have larger implications for funds.

Of more immediate importance than the share price is the quarterly dividend, on which many pension funds are heavily reliant. In 2009, UK companies paid dividends totalling £56.9bn,[6] with BP responsible for the largest single chunk of this – £7.2bn,[7] or around £1 in every £8 of dividends. In its Investor Briefing on 4 June, BP was unable to confirm its ability to maintain the dividend as it deals with the current crisis. Many analysts believe that it is financially able to do so; however, the company is under significant political pressure from the US authorities, who have issued calls for it to suspend dividend payments.

The potential for the Deepwater spill to adversely impact UK pension savers is therefore significant and growing – and the considerable uncertainty surrounding the company's future looks likely to affect its value for some time to come.

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Should pension funds have foreseen this?

Of course, investors could not have been expected to foresee the precise circumstances of the recent disaster. But it does seem clear that there was sufficient cause for concern about BP's attitude to safety and environmental risk to have warranted more robust engagement from shareholders to safeguard their assets.

BP is traditionally seen as a 'safe' long-term investment, building solidly in value and paying a robust and regular dividend. Yet the dramatic turnaround in the company's fortunes was not entirely unforeseeable.

BP has a track record of environmental and safety failures that have ultimately precipitated financial losses. Following the 2005 Texas City oil refinery explosion, a damning report by US regulators criticised organisational and safety failings at all levels of the company.[8] BP later received a record fine for failing to improve safety procedures when rebuilding the plant.[9]

In the aftermath of the Deepwater spill, a similar story of alleged complacency emerged. In plans for the well filed with the federal Minerals Management Service in February 2009, BP repeatedly dismissed the possibility of an accident of this sort.[10] Chief Executive Tony Hayward recently admitted that the company "did not have the right tools" to respond to the crisis.[11]

Inadequate scrutiny?

FairPensions' research and experience suggests that UK pension schemes' scrutiny of their investee companies' exposure to environmental, social and governance risks remains inadequate. BP is a stark example of this tendency, but the problem is a wider one.

The failure of institutional investors to challenge poor corporate governance, short-termism and risky business models in the run-up to the financial crisis is now well documented, as are the devastating consequences for pension savers - particularly those heavily exposed to equities and on the verge of retirement.

In both these cases, the neglect of ESG risks could constitute a breach of fiduciary duty, following the landmark Freshfields legal opinion.[12]

The recent collapse of Prudential's bid to take over the Asian arm of AIG is perhaps an indication that, post-crisis, there is a greater willingness to engage with company management over strictly financial issues. By contrast, most institutional investors still appear reluctant to engage in similar scrutiny over extra-financial risks.

Only weeks before the Deepwater disaster, BP's AGM considered a shareholder resolution co-ordinated by FairPensions. It asked for more information about the risks associated with BP's tar sands projects – a method of oil extraction with many of the same risks as deepwater drilling. Yet the resolutions received only limited support from UK pension funds (in contrast, several large US funds voted in favour). Perhaps more worryingly, pension fund members who contacted their funds about the resolutions were routinely told that such decisions are delegated to fund managers, with no chain of accountability to those whose money is at stake.

This degree of delegation might be less of a cause for concern if pension funds were taking steps to ensure that their fund managers monitor ESG risks. Unfortunately, FairPensions' research suggests that this is not generally the case. Our most recent survey of pension schemes found that, despite universally acknowledging the importance of ESG issues in their Statements of Investment Principles:

- 35% of participating schemes did not integrate their ESG policy into Investment Management Agreements with fund managers;
- 30% did not assess the ability of fund managers to manage ESG risks;
- 35% did not require a regular report on what is being done to manage ESG risks.[13]

This is likely to be an optimistic picture, given that the sample of participating funds is inherently self-selecting.

Policy Recommendations

FairPensions believes that reporting has an important role to play in encouraging schemes to take risk management seriously in both their policy and practice. There is an emerging evidence base linking stricter disclosure regulation to both improved transparency and, in turn, improved scheme governance in the interests of members.

FairPensions' surveys of both pension schemes and fund managers consistently find a link between investment transparency and higher standards in relation to Responsible Investment. Moreover, in both of our last two surveys of pension schemes, even the lowest-performing local authority funds have outperformed the highest-scoring funds in the banking sector by a clear margin. Local authorities are required by law to provide a high level of public disclosure.[14]

OECD guidelines also suggest that improving disclosure can improve scheme governance by enhancing accountability to members.[15]

Occupational and stakeholder pension schemes are already required by law to state in their Statements of Investment Principles *"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 to state their policy on the exercise of voting rights.[16] [17]

However, there are no requirements to report on how these policies are implemented. Although occupational schemes are required to disclose any investments made in contravention of their SIPs, this does not appear to extend to the exercise of rights attaching to those investments.[18]

The evidence suggests that most pension schemes are responding to the existing requirements by recognising ESG risks in their SIPs, but that this is not translating into concrete action to manage ESG risks. The statutory framework is in need of strengthening to ensure that scheme members are protected from emerging risks, and are able to assess the extent to which their pension fund's own policies are being implemented.

FairPensions recommends that funds should be required to disclose:

- Exactly what environmental, social and governance issues are taken into account in their investment policy
- How that policy is being implemented
- How their shareholder rights are being exercised

For some types of scheme, we believe this can be achieved by relatively straightforward amendments to the existing regulations governing SIPs. However, given the increasing proportion of the UK population who are covered by pension arrangements not subject to these regulations, we recommend that a review be undertaken to ensure that these protections are extended as widely as possible.

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, fairpensions.org.uk

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14. Ibid. See http://www.fairpensions.org.uk/research for full details of all our research reports.
15. 'Guidelines for the Protection of Rights of Members & Beneficiaries in Occupational Pension Plans', OECD (2003). http://www.oecd.org/dataoecd/36/39/34689939.pdf
16. The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, section 2(3).
17. The Stakeholder Pension Schemes Regulations 2000, SI 2000/1403 as amended.
18. The Occupational Pension Schemes (Disclosure of Information) Regulations 1996, SI 1996/1655, Schedule 3, para 14.