Building a sustainable financial system: Institutional investors and climate change

BRIEFING
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BACKGROUND

Investors have huge potential influence over corporate emissions policies. It is now widely accepted that one of the causes of the financial crisis was the failure of institutional investors adequately to scrutinise the companies they owned. It is also increasingly recognised that the capital markets are not producing the transition to a low-carbon economy that we so urgently need, with all three main parties committed to some form of Green Investment Bank to rectify this.

Yet there remains a policy lacuna regarding the role of institutional investors in addressing climate change – and, in particular, regarding the importance of ensuring the market has the necessary information for policies like the Green Investment Bank to work. This briefing sets out the evidence base for three simple policy proposals that could make a significant contribution to the UK's efforts to tackle climate change, at little or no cost to government or business.

What is the problem & what are the opportunities?

FairPensions' research (see Box A overleaf), as well as our experience of co-filing shareholder resolutions on environmental issues, has shown that:

- Fund managers overwhelmingly agree that climate change is an important investment issue, but the practical action they are taking to address climate risk in their own portfolios is much less consistent.
- Companies are not disclosing sufficient information about their climate risks to enable investors to take informed decisions.

Investors with long-term horizons (e.g. pension funds) have an interest in investee companies taking action now to reduce emissions in the future – in order to minimise their future costs from developments such as rising carbon prices.

There is also more general evidence that an active approach by investors to environmental, social and governance (ESG) risks can lead to improved financial performance. A 2007 meta-analysis by Mercer found a positive correlation which was particularly strong when investors adopted an engagement approach – exerting influence on corporate behaviour through the exercise of shareholder rights.[1] The recent oil spill off the Gulf of Mexico, which wiped close to $30 billion off BP's share price, provided a stark reminder that environmental risks are also financial risks.

Long-term investors therefore have the potential to be significant drivers of emissions reduction. Yet most pension funds invest through fund management companies, which often operate under short-term incentive structures - leading them to adopt a perpetual wait-and-see approach that effectively suppresses corporate progress on emissions reduction.

There is increasing agreement among investors and others in the field that more needs to be done at a regulatory level to facilitate climate-conscious investment.

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BOX A: KEY FINDINGS FROM FAIRPENSIONS' 2009 SURVEY OF FUND MANAGERS

- An overwhelming majority (89%) of participating fund managers recognise climate change as an "important" or "very important" investment issue.
- However, the extent of action taken to address climate risks varies much more widely: only 29% of fund managers surveyed made use of climate data in their analyses for all companies where such data was available.
- 63% of fund managers cited the low carbon price as the biggest barrier to greater engagement, while 56% felt that lack of client demand was a significant factor.
- Perhaps surprisingly, there is a powerful consensus amongst participating fund managers on the need for greater regulation: 86% stated that they would welcome requirements on companies to report greenhouse gas emissions, while 78% would welcome stock exchange listing rules requiring companies to disclose climate related risks.
- 72% would also welcome regulatory requirements on companies to reduce emissions.

Source: 'Preparing for the Storm', October 2009

Why is regulation necessary?

In 2009, FairPensions surveyed 39 large fund management companies about their attitudes to climate risk (see Box A).[2] The vast majority of those surveyed supported both mandatory disclosure of climate data and mandatory emissions reduction by the companies they invest in.

The present voluntary regime has not delivered the levels of disclosure necessary for investors to factor environmental issues into their investment decisions. At BP's 2010 AGM, 15% of shareholders refused to back management over a resolution (co-ordinated by FairPensions) asking them to disclose more information about their controversial tar sands projects. This is just one recent example of inadequate company disclosures provoking significant investor dissent.

There is also a clear case, in the long-term, for extending the kind of transparency which investors are rightly demanding of their investee companies to investors themselves.

The single biggest barrier identified by survey respondents to greater investor engagement on climate issues was lack of client demand. Yet there is clearly an increasing public appetite for products that help people reduce their carbon footprint, with initiatives like the Carbon Trust's 'Carbon Reduction Label' helping to inform consumer choices.

We believe that this demand remains untapped in the case of personal savings because:

- Most people are unaware of their emissions as indirect shareholders, through pensions, savings, ISAs etc.

- Fund managers and pension trustees typically do not provide the data necessary for scheme members to make informed judgements.

Pension savers' preferences and perceptions of their own long-term interest are therefore not being transferred through the investment chain. Fuller disclosure of information about climate risk would unleash the potential of millions of indirect shareholders to support the transition to a low-carbon economy.

BOX B: CASE STUDY - VICSUPER

The VicSuper is one of Australia's largest pension funds, with over 251,000 members and net assets of over $7.3billion (as at 31 March 2010). It has put sustainability at the heart of its investment strategy, monitoring investee companies and engaging with them to improve performance. Reasoning that 'you can't manage what you don't measure', it now gives all its savers an estimate of the emissions exposure of their personal savings pot, as part of their Annual Benefit Statement.

The fund's Chief Executive, Bob Welsh, has said: "To give super fund members the full picture, they need to know how dependent their super returns are on carbon emissions. If super fund members are only told their financial returns, in a global economy moving to a carbon constrained economy, they are only getting half the story. Reporting carbon emissions of a member's account balance should become standard practice in the not too distant future."

Source: VicSuper website – www.vicsuper.com.au

RECOMMENDATIONS
Three steps to sustainable investment

1. Total GHG emissions must be reported by companies, and – eventually – institutional investors as well

- 86% of fund managers surveyed by FairPensions said they would welcome requirements on companies to report their GHG emissions.
- Defra is currently conducting a review into the case for mandatory emissions reporting, as required by section 84 of the Climate Change Act 2008, which is due to report in August 2010. Under section 85 of the Act they will then have to introduce mandatory reporting or explain why not.
- Carbon management is already treated as a proxy for operational efficiency by many investors; this information is therefore vital to enabling the market to operate effectively.
- We believe that mandatory reporting must be introduced as a matter of urgency, and that it should cover companies' embedded emissions (eg. a bank's investments) as well as their direct emissions.
- In the long-term, institutional investors not constituted as companies – such as trust-based pension schemes – should also be required to report on the emissions embedded in their investments. Once corporate emissions reporting is made mandatory, this should not be unduly burdensome.
- Indeed, some pension funds already disclose information about their portfolio carbon emissions – such as the Australian VicSuper (see Box B).

2. DBIS should provide guidance on company directors' duties to disclose information about environmental risks

- Under section 417 of the Companies Act, directors' reports must include a business review containing "a fair review of the company's business, and a description of the principal risks and uncertainties facing the company."
- Under subsection (5)(b)(i), this must include relevant information about "environmental matters (including the impact of the company's business on the environment)".
- However, no guidance has been published pursuant to these requirements, and it remains unclear what these broad obligations mean in practice.
- Guidance is urgently needed to ensure that companies disclose adequate qualitative information about their exposure to climate risk, as well as quantitative information about their GHG emissions.
- The coalition government has committed to reintroducing an Operating and Financial Review (the predecessor to the business review).[3] This provides an ideal opportunity to reconsider these issues.
- Simpler, more streamlined reporting requirements would provide greater clarity for business about their obligations, while ensuring that investors and the public get the information they need.
- Section 417 does not apply to anyone subject to the small companies' regime, so this would not impose any burdens on small businesses.

3. Pension funds should report not just on their policies, but on what they've done about them

- A recent survey by FairPensions found that although all pension schemes surveyed acknowledged the importance of environmental, social and governance issues in their Statements of Investment Principles, this was not universally acted upon.[4]
- For instance, only 14 of the 25 schemes surveyed said that they took these issues into account when appointing fund managers.
- Pension schemes are currently required by law to make their Statements of Investment Principles (SIPs) available to their members.[5]
- FairPensions recommends that schemes should also be required to disclose how they have *implemented* their SIPs, with particular regard to their policies on management of ESG issues and engagement with investee companies.
- Together with reporting on total portfolio emissions, this would ensure that individual consumers have the information they need to assess the carbon footprint of their retirement savings.

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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. Asset Management Working Group of the UNEP Finance Initiative and Mercer, Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors (2007), 13-14. Available at http://www.mercer.com/referencecontent.htm?idContent=1332560
2. Full report available at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/PreparingStorm2009.pdf
3. The Coalition: Our Programme for Government, p10
4. Full report available at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/documents/ResponsiblePensions_2009.pdf
5. The Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SI 1996/1655)

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