TSSA Staff Reps Bulletin

Ref: PEN/045/Jan 2019

RESPONSIBLE INVESTMENT

Introduction

Many of TSSA's members belong to large occupational pension schemes like the TfL Pension Fund (TfLPF) or the Railway Pensions Scheme (RPS) where pensions are paid for from member and employer contributions as well as from the returns made from significant assets invested around the globe.

The level of investments is large, with the RPS alone managing around £25 billion[i] for the 100 plus sections of the scheme, whilst the TfLPF has over £10 billion invested.[ii]

There are many types of investments that pension schemes can utilise to secure a return for members, including equities, bonds, derivatives, property and hedge funds, many of which will be attached to companies seeking to develop new products or expand their operations. In response to investment, they offer a return to the investor that can make it attractive to pay out money in the first place.

Institutional investors, like pension schemes, can have a lot clout to bring about change that benefits other people – if they want to exercise it.

In this Bulletin we look at the question of responsible investment – sometimes referred to as ethical investing – and how pension schemes can make a difference around environmental, social and governance (ESG) issues. This Bulletin will also highlight ways that reps and members can get involved.

What is the origin of responsible investment?

The origins of responsible investing in the UK can be traced back to the Quakers in the 18th Century whose religious society prohibited its members from involvement in the slave trade. In the same century, members of the Methodist Church started to align their business activities with their faith. Since those beginnings, members of all faiths – and none – have developed investment policies that "recognise the moral and ethical repercussions of their financial decisions."[iii]

What is ESG investing?

Responsible investing is often linked to investments that seek to promote environmental, social and governance factors rather than simply just gaining more money without regard to the effect that may have in any of these areas (eg, investing in a cigarette manufacturer may generate a good return but is likely to have life threatening consequences for the people using the product).

Examples of ESG issues are implicit in the each of the words that make up the acronym but could include:

- Environmental:
  - Climate change
  - Plastic pollution
  - Nuclear energy
  - Sustainability
- Social concerns:
  - Equality and diversity
  - Human rights
  - Consumer protection
  - Animal welfare
- Corporate Governance:
  - Management structure
  - Executive remuneration
  - Employee relations
  - Staff pay and conditions

Looking in more depth at a few of these areas we can see that:

- Climate change: Responsible investment should make pension schemes and their trustees reflect on how their long term investments can help to reduce the greenhouse gas effect that is warming our planet up.

  Agreement at the Paris climate conference (COP21) in December 2015 saw 195 countries adopt the first-ever universally legally binding global climate deal, designed to avoid dangerous climate change by working to limit global warming to well below 2°C.

  Responsible investment could take a view on whether the pension scheme's money should be invested in a company whose products and services disregard this objective – companies that are, for instance, involved in carbon fuel (eg, oil, gas, coal) extraction and use, or the deforestation of landscapes;

- Equality and diversity: The results of the first round of Gender Pay Gap Reporting[iv] showed that "gender pay gaps of over 40% are not uncommon in some sectors; 78% of organisations reporting have gender pay gaps in favour in men. 1,377 employers (13% of the total), including many household names, have gender pay gaps of over 30 per cent."[v] Responsible investment in firms that fail – or refuse – to address their gender pay gap where one gender (usually women) are paid less than the other – should be a factor to consider;

- Employee relations: Many firms give little regard to their workers, opposing trade union recognition, deliberately undermining any collective bargaining and actively denying workers the benefits of agreements that have been reached.

  Responsible, ethical investment in this area has been expressed by Paddy Crumlin, president of the International Transport Workers' Federation (ITF) in the following terms:[vi]

"Pension money is not gifted. It's the hard-earned product of hard work and industrial negotiation and is a deferment of wages that workers decide to make to secure a dignified and decent retirement. It has got to be put to work itself in a way that respects that source. It is only right that it helps build sustainable individual and collective futures, and that it does so ethically."

As a result, the ITF working, with the Global Union Federation and the OECD's Trade Union Advisory Committee, has developed a set of guidelines[vii] to help investors to properly evaluate company adherence to workers' rights and collective bargaining.

Those guidelines or indicators are grouped in ten themes:
- workforce composition
- social dialogue
- workforce participation
- supply chain
- occupational health and safety
- pay levels
- grievance mechanisms
- training and development
- workplace diversity
- pension fund contributions for employees

Do pension fund trustees have to adhere to responsible investment?

The fiduciary duty of the pensions scheme trustees is to act in the best interest of the beneficiaries. However, a finding of the Kay Review in 2012 was that:

> "At one time this was interpreted narrowly to mean maximising short-term financial returns over consideration of factors which might be material over the long term."[viii]

Subsequently, the Law Commission published its report into the fiduciary duties of investment intermediaries in 2014, clarifying the situation in these terms:

> "Whilst it is clear that trustees may take into account environmental, social and governance factors in making investment decisions where they are financially material, we think the law goes further: trustees should take into account financially material factors."[ix]

Pension scheme trustees are required to produce a Statement of Investment Principles ("SIP") which describes their investment policy. That policy should include to what extent (if any) "social, environmental or ethical" (SEE clause) considerations are taken into account.

As UKSIF[x]report, the "SEE" clause was identified by the Law Commission as being particularly confusing for trustees which led the Commission to argue for a preference for material factors that are:

- financial
- non-financial

How to define financially material factors?
To clarify the misconceptions about the extent to which the fiduciary duty prevented trustees from taking financially material factors into account, UKSIF report that the Law Commission stated:

> "Trustees may take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as environmental, social or governance factors."

What this means is that there is no legal impediment to trustees taking account of environmental, social or governance factors where they are - or may be - financially material.

But as UKSIF note, the Law Commission went further than this by stating:

> "the law goes further: trustees should take account of financially material risks".

This leads to the conclusion that if the risk is material, it should be considered.

What about non-financial factors?
The Law Commission defined non-financial factors as those that might influence investment decisions motivated by concerns such as:

- improving members' quality of life or
- showing disapproval of certain industries.

What is the distinction between the two factors?
The Law Commission illustrated the distinction in the following terms:

> "Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor."

UKSIF describe how, generally, non-financial factors <u>may</u> be taken into account provided two tests are met:

- Trustees should have good reason to think that scheme members would share the concern and
- The decision should not involve a risk of significant financial detriment to the fund (except in "chosen" DC funds).

The conclusion reached by UKSIF, therefore, is that:

> "Investing in line with the trustees' personal beliefs should be avoided but trustees do have the discretion to think about member views and how these might be reflected. This statement of the law outlined by the Law Commission with regard to both financially material and non-financial factors has been faithfully reproduced in TPR's guidance for DC and DB trustees.

The Pensions Regulator's (TPR) guidance for DB trustees around responsible investment (known as "impact investment" by TPR) can be found in its guidance document but includes:

- The impact of investment decisions is a subordinate concern to the primary purpose of pension investing, which is delivering an appropriate return. There is, however, no barrier to investments that have a social impact as a by-product where that primary purpose is met;[xi]
- The need to take environmental, social and governance factors into account if they're financially significant;[xii]
- Trustees are required to take into account factors that are financially material to investment performance;[xiii]
- Trustees can also choose to actively take account of impact considerations in making an investment decision where they have good reason to think scheme members share their view and there is no risk of significant financial detriment to the fund. They should not choose impact investments where there is a risk of significant financial detriment to the fund.[xiv]

TSSA member activity

All of the above may sound very technical but it is important that reps and members realise that far from trustees of their pension schemes operating within a system with a different set of values to those that many members would want to see come to fruition, official guidance from various authoritative sources now offers a chance to broaden the scope of investment decisions.

In this way, first pension scheme trustees, and then the directors of the corporations that they invest in, are beginning to be held to account. This is an exciting development and one that TSSA members are already playing a part in.

For instance, our members in TfL have been lobbying the trustees in the TfLPF about issues connected with climate change on the basis that it poses a long term risk to the finances of the scheme.

As such, the demand that has been laid down is that the trustees take due consideration of this ESG issue by embarking on a series of actions, including to:

- develop a low carbon investment strategy after conducting a carbon audit of existing investments
- encourage companies that it invests in to develop low carbon business plans.

The work of ShareAction

TSSA is also one of a number of member organisations that supports ShareAction[xv] whose goal is to secure a responsible investment system, geared towards the long-term interests of savers, society, and the environment.

Core to ShareAction's objectives is the realisation that there is an immense power vested in the capital markets which, if it could be unlocked, could mean that companies operate sustainably and responsibly. But to achieve this, ShareAction has identified three mutually reinforcing elements, each of which are woven into the organisation's programmes. Those three elements are:

- Building a movement for responsible investment;
- Reforming the rules, governance, and incentives inside the investment system; and
- Unlocking the power of investors to catalyse positive social and environmental change.

TSSA Reps and member action

TSSA members have already been involved in some of these activities and one of the key messages from this Bulletin is to encourage greater participation. Ultimately, to achieve its objectives, ShareAction requires members of pension schemes to take part in activities that hold their pension schemes to account for their investment decisions.

Of course, some schemes already have developed policies but when was the last time, formally or informally, that you were asked what you felt about a particular environmental, social or governance issue?

Acknowledgements and further reading

This Bulletin was prepared using documents mentioned in the end notes.

RPMI RailPen responsible investment can be viewed at: https://www.rpmirailpen.co.uk/sustainable-ownership/

TfLPF ESG matters can be seen at: https://tfl.gov.uk/pensions/environmental-social-and-governance-matters

A TfLPF ESG report can also be downloaded from: https://tfl.gov.uk/pensions/news-and-publications/publications

---

[i] Page 13, Railway Pension Scheme: 2017 Annual Report and Audited Financial Statements at: https://www.railwayspensions.co.uk/docs/default-source/Report-Accounts/report-and-accounts-2017-(web-version-with-hyperlinks).pdf?sfvrsn=6

[ii] See page 27, TfL Pension Fund: Report and Accounts for the year to 31 March 2018 at: http://content.tfl.gov.uk/tflpf-report-and-accounts-2018.pdf

[iii] https://www.iccr.org/our-approach/connection-between-faith-investing

[iv] Firms with more than 250 employees are required to annually publish figures about the gender pay gap that exists in their organisation. The duty is on both private and public sector organisations and began on 5th April 2017 with the first reports being made in April 2018. See: http://www.equalpayportal.co.uk/gender-pay-gap-reporting/

[v] See: http://www.equalpayportal.co.uk/gender-pay-gap-reporting/

[vi] See: https://sustainablebrands.com/read/supply-chain/what-about-the-s-in-esg-new-guidelines-for-evaluating-companies-social-performance

[vii] "Guidelines for the Evaluation of Workers' Human Rights and Labour Standards" downloadable from: https://www.workerscapital.org/cwc-guidelines-for-the-evaluation-of-workers-human-rights-and-labour-standards

[viii] Reported by UK Sustainable Investment and Finance Association (UKSIF) in: "Understanding and applying fiduciary duty" downloadable from: http://uksif.org/wp-content/uploads/2017/05/Understanding-and-Applying-Fiduciary-Duty-2017-Guide.pdf

[ix] See previous note.

[x] UK Sustainable Investment and Finance Association (UKSIF) - see Note viii

[xi] See page 34 of TPR's "Investment guidance for defined benefit pension schemes" downloadable from: https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-investment

[xii] See page 21 of TPR guidance

[xiii] See page 23 of TPR guidance

[xiv] See page 34 of TPR guidance

[xv] See: https://shareaction.org/