

Professor Steve Webb MP
Minister of State for Pensions
Dept for Work and Pensions
Caxton House
Tothill Street
London SW1H 9DA

Friday 30 July 2010

Dear Prof Webb,

Thank you for your letter of 30 June 2010 responding to our supporters' emails about the Deepwater Horizon oil spill and its effect on British pensions. As requested, we have made a copy of this letter available on our website at <http://www.fairpensions.org.uk/oilspill/update>.

We are very grateful to you for taking the time to respond, and for your sympathy with many of the points raised. However, we must disagree with your view that the existing regulations deal adequately with the problems identified. We would appreciate the opportunity to meet with you, on behalf of our supporters, to discuss these concerns more fully.

We wish to be clear that we are not suggesting a knee-jerk policy response to an isolated damaging incident. FairPensions has been calling for these changes for a number of years, including in submissions to the DWP. Our current campaign is based on our view that the Deepwater disaster is a 'canary in the mine': it illustrates the potential consequences of a neglect of environmental, social and governance (ESG) risks which we have found to be pervasive in the investment and pensions industry.

The precise scale of the disaster's impact on UK pension funds is therefore not the central issue – although we continue to believe that this impact is significant enough to warrant concern. Following so closely on the devastating losses suffered by pension funds as a result of the financial crisis - from which global pension fund assets have still not recovered – combined with the fact that many UK pension funds are already in deficit, the loss of even 2% of expected income is likely to be significant for at least some pension funds. The importance of BP to British pensions has been reiterated publicly by many members of the government, including Vince Cable and the Prime Minister.

The real question, however, is whether this episode indicates an underlying trend – and whether that trend presents a risk of worse financial and economic shocks in the future. FairPensions believes that the answer to both these questions is clearly 'yes'. Our research, and our years of experience working with pension funds and fund managers, suggests a worrying level of complacency about ESG risks in the investment community.

Investor complacency on ESG issues

Just weeks before the Deepwater Horizon spill, 90% of investors chose to back BP's management over shareholder resolutions asking for more information about the financial risks associated with the company's tar sands projects. Many of the risks debated bear striking similarities to the Deepwater case: for instance, the reliance on unproven technology that comes with 'unconventional' oil extraction. Yet many investors indicated that they did not feel it was their role to scrutinise management on such issues.

Subsequent events should act as a warning of the dangers this assumption can pose to pension savers. And indeed, as an example of the potential consequences when investors neglect to engage with management on corporate governance issues, one need look no further than the financial crisis – when pension savers paid a heavy price for the failure to challenge risky and short-termist business models. Having said this, we should be clear that the significance of ESG issues goes beyond the need to protect against ‘crises’: there is increasing evidence linking active engagement on ESG issues with improved investment performance.

More generally, as you noted in your letter to us of 23 June 2010, our research shows that many pension funds do little to protect their members’ money from ESG risks – despite accepting that such risks can be material. In our most recent survey, 35% of participating schemes did not integrate their ESG policy into Investment Management Agreements with fund managers; 30% did not assess fund managers’ ability to manage ESG risks; and 35% did not require fund managers to report on their management of ESG risks. Under current regulations, schemes are not required to disclose these facts.

We therefore disagree with the conclusion that the existing requirements under sections 2(3)(b)(vi) and 2(3)(c) of the Occupational Pension Schemes (Investment) Regulations 2005 are achieving the aim of supporting high standards of behaviour in this area.

Disclosure on social, environmental and ethical issues

The current regime is not delivering **transparency for those whose money is at stake**. Ten years after the introduction of this requirement, research shows that many schemes simply provide ‘boiler-plate’ statements to the effect that they instruct their fund managers to take ESG issues into account where financially relevant. FairPensions often helps pension savers to contact their funds about particular ESG issues or shareholder resolutions. Pension funds regularly respond by directing members to this boiler-plate statement, which does little or nothing to answer their query.

This generates a significant accountability gap, which there is little reason to assume will be filled without new disclosure requirements. The current regime gives no means of separating funds that fully integrate ESG issues into their practices from funds that simply insert a generic sentence into their Statements of Investment Principles (SIPs) and forget about them.

Requiring pension funds to report specifically on *which* ESG issues they take into account, and on *how* they are implementing these policies, would guarantee scheme members a right to meaningful information. In the case of stakeholder schemes, such information would allow the market to operate more effectively, by enabling consumers to make informed choices between providers. For occupational pension scheme members, who do not have a choice of provider, the right to know how one’s money is being managed is arguably even more important.

In addition, the significant **gap between policy and implementation**, a consistent finding of our research (as discussed above), strongly suggests that the current requirements are not catalysing higher standards of behaviour. Instead, all too often they are prompting little more than box-ticking, or worse, general statements of concern that mask inaction.

Stronger reporting standards on the implementation of SIPs would address this problem in two ways. Firstly, it would require funds to actively monitor compliance with their policies – and what is monitored is much more likely to be managed. Secondly, it would help drive consumer demand for engagement on ESG issues up the investment chain. In our most recent survey of fund managers, lack of client demand was cited as the primary reason for investors’ poor record on addressing climate risk – the ‘client’ in this case being pension schemes themselves. Our experience suggests that opacity and lack of accountability to end-beneficiaries is a major reason for this. Proper reporting by pension schemes would make it easier for members to transmit their preferences for improved risk-management up the investment chain.

Voting disclosure

As you will be aware, the requirement in section 2(3)(c) requires only that schemes state their *policy, if any*, on the exercise of shareholder rights. This is distinct from our proposal that funds should report on the *actual* exercise of shareholder rights – for instance, by disclosing voting records – and clearly does not deliver the same benefits in terms of transparency.

Here too, research shows that the application of the regulations often amounts to boiler-plate statements that a scheme will seek to vote all shares held, or that voting decisions are delegated to fund managers. This is not helpful to members seeking information about their fund's engagement policy – still less so for members enquiring about a particular voting decision, for instance on executive remuneration or an environmental issue. Indeed, we have known schemes to say in response to member queries that they do not know how their fund managers voted, and do not intend to request details.

The Financial Reporting Council's recently-published Stewardship Code makes clear that it is best practice for institutional investors to disclose their voting records publicly. The government retains a reserve power, under section 1277 of the Companies Act 2006, to make such disclosure mandatory.

The FRC's document on implementation of the Code specifically discusses the role of pension funds, saying that they "can contribute by, for example, mandating their fund managers to [engage] on their behalf and scrutinising with care their reports on engagement." It goes on to say that it is "encouraged" by indications that funds "will devote more time to scrutinising the actions of investment managers on engagement issues in future."

In this context, the fact that pension funds can remain so cavalier in their approach to member enquiries about voting decisions is a growing anomaly in the direction of policy. We can see no obvious reason why pension funds should be excluded from the expectation of increased attention to engagement on the part of institutional investors – and, by extension, no reason why fund members should not have the right to know how they fulfil this expectation.

I hope that this goes some way towards clarifying our proposals. We would be interested to see the results of any research conducted by DWP into the operation of the existing regulations. It is certainly not our experience that they are adequately delivering the objectives to which we all aspire.

Once again, many thanks for your engagement with these important issues; I hope that it will be possible to meet with you to discuss them further.

Yours sincerely,

Duncan Exley
Acting Chief Executive, FairPensions