30 September 2009

UKSIF

Response to the Walker Report
from UKSIF – the sustainable investment and finance association

Introduction

UKSIF, the sustainable investment and finance association, promotes responsible investment and other forms of finance that support sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments. We aim to support the UK finance sector to be the world leader in advancing sustainable development through financial services.

UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 200+ members and affiliates include pension funds, institutional and retail fund managers, investment banks, financial advisers, research providers, consultants, trade unions, banks, building societies and non-governmental organisations. For more information about UKSIF, please visit www.uksif.org.

UKSIF supports long-term responsible investment and ownership. It focuses its corporate governance support on the interface between governance on the one hand and social, environmental and ethical issues on the other.

Summary

UKSIF warmly welcomes the focus of the Walker Review on delivering substantive changes to behaviour and culture rather than "box-ticking" (1.23) and on lengthening time horizons (1.24).

We are broadly supportive of the recommendations put forward by the Review on 16th July.

However, there are a number of areas where we would welcome additional focus to address the scale of cultural change required to achieve:

- future effective governance of BOFIs
- a step change in long term responsible asset ownership
- financial stability in the face of future challenges such as climate change, resource scarcity and threats to social stability
- the contribution to sustainable wealth creation and the common good reasonably expected of the finance sector by wider civil society.

Our response specifically addresses the following areas:

- Principles of Stewardship, including their governance and implementation
- Governance of sustainability strategies
- Board diversity and sustainability insight
- Strengthening non-remuneration motivators
- Learning from corporate responses to environmental regulation

Principles of Stewardship: governance and implementation

(in relation to *The role of institutional shareholders: communication and engagement*)

We warmly welcome the proposal for Principles of Stewardship, based on the institutional investor element of the Combined Code and the Institutional Shareholders Committee's Statement of Principles.

The Principles need to be implemented in such a way that there is a “race to the top” in implementation not a compliance-driven approach. We believe that critical success factors to achieve this include:

- Commercial incentives for high quality implementation of the Principles
- A culture of “pride in commitment” and “leadership not compliance” among senior industry executives
- Meaningful transparency, robust implementation measurement and effective external scrutiny.

To deliver these, the support of influential investment institution stakeholders must be harnessed. These key stakeholders include:

- Customers
- Senior Executives and Employees
- Suppliers (“Investees”)
- Civil Society
- Regulators and Government.

In our view, the governance structure adopted should therefore involve:

- Direct customers of investment institutions, such as occupational pension funds
- Professional associations
- Publicly listed companies, particularly those recognised as having a sustainable and responsible long-term approach to wealth creation
- Representatives of consumers, beneficiaries, civil society and the public interest

as well as investment institution executives and regulators.

We would also like to see a broader range of implementation measures in addition to those currently proposed. In our view, these should include:

- Encouragement of stronger customer demand, including by The Pensions Regulator and via the Investment Governance Group. Requiring greater transparency by asset owners such as pension funds and insurance companies about their stewardship requirements and performance assessment could play a useful role in achieving this.
- Transparency requirements, including using the government’s powers under the Companies Act to require mandatory voting disclosure. Disclosure needs to be in a form which allows easy comparison between investment institutions.
- “Soft regulation” measures such as awards or logos based on independent assessment against a minimum standard (“quality mark”) and/or a published ranking (“gold / silver / bronze” standard).

As well as championing these measures, the governance body should consider what further steps might be needed to incentivise high quality practice.

Governance of sustainability strategies

(in relation to *Governance of risk – board risk report*)

It is important that solutions for the governance of risk address tomorrow’s critical risks as well as those of the immediate past. Significant emerging social and environmental risks to financial stability and BOFI profitability include water scarcity, climate change and extreme poverty. We believe that BOFIs and other major companies should be required to produce a forward looking sustainability strategy which is subject to investor vote. This might form part of the board risk report. Alternatively, given that it would be appropriate to address also associated opportunities, a separate vote on the sustainability strategy might be preferable.

Board diversity and sustainability insight

(in relation to *Board composition, functioning and evaluation of performance*)

We welcome the emphasis given in the report to “the importance of other skills and experience” (4.2) on boards in addition to financial industry experience. It is increasingly accepted that a diversity of perspectives, talents and background contributes to a strong board. This includes knowledge and experience drawn from differences in race, religion, gender, etc. Strong understanding of significant areas of social and environmental change (“sustainability megatrends”) are also likely to become of increasing value in setting the strategic direction of BOFIs and managing risk.

Diverse board members may also act as role models to drive important cultural changes, such as greater respect for measures of success not based on remuneration.

In our view, an increased emphasis on financial industry experience must not dilute the importance of diversity and of sustainability insight.

Strengthening non-remuneration motivators
(in relation to *Remuneration*)

Management literature has long suggested that remuneration is a “hygiene factor” rather than a “motivator”, ie. talent may be de-motivated by what is perceived as insufficient remuneration but only transiently motivated positively by remuneration. Other motivators are more effective for delivering high quality sustained performance. The remuneration debate to date has largely failed to reflect this insight.

Restrictions on remuneration introduce the opportunity for BOFIs to shift their corporate cultures and policies towards these more effective motivators of long-term out-performance. We believe that absolute levels of remuneration will cease to act as a dysfunctional aspect of motivation in BOFIs only when they are supplanted by more socially desirable incentives.

We already see a cultural change starting to emerge where contribution to society and the challenges of sustainability are a strong motivator for a significantly greater proportion of young talent in the finance sector today compared with their immediate predecessors. This is particularly visible in areas such as low carbon investing. Attracting and retaining talent less focused on remuneration as a measure of success or a way of “keeping score” compared with, for example, peer esteem or contribution to society may play a significant role in achieving the behaviour change and long-term thinking that Sir David is rightly seeking.

Regulators should look to BOFIs to demonstrate that they are using non-remuneration motivators effectively.

Learning from corporate responses to environmental regulation
Over past decades, corporate sector leaders have moved from viewing environmental regulation as a threat to viewing well-crafted regulation as an opportunity for competitive advantage through innovation, and for value protection through effective risk management.

The boards of BOFIs should draw lessons from this experience, not least because new entrants from other sectors may do so even if incumbents do not.

In “Why sustainability is now the key driver of innovation”, an article in the Harvard Business Review (September 2009), C.K. Prahalad and colleagues propose a five stage model. It may offer a valuable model for BOFI responses to the challenge of rebuilding trust and profitability by delivering socially useful innovation. It consists of the following steps:

Stage 1: Viewing Compliance as Opportunity
Stage 2: Making Value Chains Sustainable
Stage 3: Designing Sustainable Products and Services
Stage 4: Developing New Business Models
Stage 5: Creating Next-Practice Platforms

We hope that the finance sector and its regulators will use tools like this to develop new insights and practices. Sir David’s welcome proposals must form only part of a continuing process in which learning, debate and new thinking improves the resilience and social value of financial services.

With best wishes

Penny Shepherd

Penny Shepherd MBE
Chief Executive
UKSIF – the sustainable investment and finance association