18th January 2013

Business, Innovation and Skills Select Committee Inquiry
The Kay Review of UK Equity Markets and Long-Term Decision Making and the Government's Response to the Review

Written evidence from the UK Sustainable Investment and Finance Association (UKSIF)

Summary

1. UKSIF welcomes the Committee's decision to conduct their inquiry; we are pleased to note that the issue of long-termism is attracting attention from a wide variety of industry, political and civil society stakeholders.

2. Our response focuses on: the role of asset owners and companies in boosting long-term investment; the need to integrate environmental and social (as well as governance) factors into decision-making; the role of the Government in ensuring stable regulatory and policy frameworks; and the importance of the Stewardship Code.

3. We agree with Professor Kay's analysis and conclusion that not only is short-termism a problem in UK equity markets, but that the principal causes are the "decline of trust and the misalignment of incentives throughout the equity investment chain".

4. This submission draws on feedback from discussions with our members and our previous submissions to the Kay Review, the Financial Reporting Council's consultation on proposed changes to the Stewardship Code (July 2012) and the Labour Party-commissioned Cox Review (August 2012).

About UKSIF

5. The UK Sustainable Investment and Finance Association (UKSIF) supports the UK finance sector to be a global leader in advancing sustainable development through financial services. We promote and support responsible investment and other forms of finance that advance 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.

6. 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 250+ members and affiliates include pension funds, institutional and retail fund managers, banks, financial advisers, research providers, consultants and NGOs. For more information about UKSIF, please visit www.uksif.org.

The Kay Review

7. Responsible investors as a group have been among the first to consider the risks and opportunities from long-term social and environmental challenges. Leading practitioners have a particularly strong understanding of the market failures which sometimes prevent investors from translating this knowledge into investment decision-making.

8. We agree with Professor Kay's analysis of the shortcomings of the current structure of equity markets in promoting long-term decision-making, particularly the short-termist culture and practices across the investment chain and the underlying problems with trust and business relationships.

9. UKSIF also supports his approach to finding a solution to the problem of short-termism by setting out high-level principles to guide the regulation of equity markets. We particularly support his focus on defining and expanding the principles of stewardship.

10. We feel that both Professor Kay's analysis and his set of 10 guiding principles make an important contribution to the debate on long-termism; we hope that both Government and industry will take these principles forward.

11. We also believe that many of Professor Kay's recommendations could have a significant long-term impact on how shareholders engage with companies including:

    - **Clarifying the concept of fiduciary duty:** Recent research has shown that in principle, long-term decision making is consistent with legal obligations but trustee concerns remain.
    - **Encouraging high-quality, succinct narrative reporting:** We know from our members that investors require forward-looking business-relevant strategies and metrics, not simply boilerplate text. There are currently moves at a global level to support better-quality "integrated reporting" which supports value creation over time.
    - **Improving the quality of engagement by investors with companies:** UKSIF members tell us that mandates, investment management agreements and scrutiny by asset owners are all effective tools in driving long-term approaches in the investment chain.
    - **Restructuring directors' remuneration to relate incentives to sustainable long-term business performance:** We were pleased to see that BIS undertook consultations on narrative reporting and executive pay, in addition to commissioning the Kay Review. However, we still feel that the government has yet to facilitate a deep and constructive debate specifically on incentives and pay within the investment chain beyond these consultations.

12. Although we understand the need for any Government review to have a focused remit, we also feel that there were some areas relevant to encouraging long-term decision-making that we feel would have benefited from further examination.

The role of asset owners and companies in promoting long-term investment

13. The Kay Review Final Report focused largely on how to encourage asset managers to better think and act for the long-term as opposed to purely "managing short-term earnings expectations". While the role of intermediaries is important in promoting long-term investment, we believe it is not the whole story.

14. It is asset owners who are best positioned to drive change by incentivizing their managers to invest over a longer horizon than most currently do; genuine demand from pension funds and other asset owners could create commercial drivers for long-term investment practice and it has been a recurring theme amongst the feedback from our asset manager members that it is easier to justify effective implementation of, for instance, the Stewardship Code or the UN-backed Principles of Responsible Investment, if there is a commercial incentive to do so.

15. The need to boost asset owner demand for sustainable investment practices has also been highlighted by the Financial Reporting Council in their December 2012 publication *The impact and implementation of the UK Corporate Governance and Stewardship Codes* [1]. Meanwhile, our most recent *Sustainable Pensions 2011* survey[2] found some excellent examples of best practice among pension funds but many more could do with following their lead.

16. We also feel that the Kay Review insufficiently examined the role of companies in encouraging "long-termism" in the investment chain through their influence on corporate pension funds, employees and other stakeholders. For instance, our *Sustainable Pensions 2011* survey suggested that plan sponsors would have influence if they encouraged their corporate pension funds to require long-term responsible investment approaches. We would also support an approach by companies to educate employees, customers and suppliers about the value of long-term investment practices.

17. In order to boost demand by asset owners and companies for long-term investment practices, UKSIF will be organising the UK's first "Ownership Day" on the 12th March 2013, a national campaign which aims to increase awareness and understanding of active long-term asset ownership and underline how it can protect the value of assets.

18. Our additional recommendations for Government include:

- **Ensuring that UK policymakers act as role models for responsible investment**
  UK policymakers could act as leaders in responsible investment practices; for instance, the government could require all Local Government Pension Scheme funds to drive effective long-

---

[1] www.frc.org.uk/getattachment/47293b70-bd65-485c-bbcd-d9a63688b87d/Developments-in-Corporate-Governance-in-2012.aspx
[2] http://uksif.org/wp-content/uploads/2012/10/UKSIF-Responsible-Business-Sustainable-Pension-2011.pdf

term approaches through their purchasing of investment services; Similarly, the UK Parliamentary Contributory Pension Fund (PCPF) could sign up to the Stewardship Code.

- **Improved co-ordination between The Pensions Regulator (TPR) and other regulators on the Stewardship Code**
  UKSIF have always believed that the Stewardship Code must harness the role of asset owner demand for good stewardship from their investment managers; We feel that there should be greater involvement by the TPR to encourage adoption of the Code throughout the investment chain.

<u>Ensuring stable regulatory frameworks that drive long-term competitiveness</u>

19. We feel that there is a clear role for Government to play in ensuring that regulators and policymakers in or under the oversight of other departments in addition to BIS, such as the Treasury and the Department for Work and Pensions, act in a co-ordinated fashion to reform equity markets.

20. There is also a need for long-term policy stability when it comes to setting the framework for investment opportunities; Government policy has most potential to influence investors and corporate boards to focus on the long-term through its regulation of externalities – such as its policies on climate change. Unanticipated policy changes can damage investor confidence and their willingness to invest for the long-term.

<u>The Government response</u>

21. UKSIF welcomed the Government's response to the Kay Review Final Report and were pleased that it recognised the relevance of Professor Kay's analysis. We also welcome the Government's decision to organise a Progress Review for summer 2014 as we think this could be a promising signal of their commitment to driving forward Kay's recommendations.

22. We hope that there will be a move towards some form of cross-departmental work on stewardship including discussions with the Treasury as well as regulators like The Pensions Regulator and the FSA (and its successor bodies). We feel this would play an important part in spreading good stewardship practices across the investment chain.

Contact details: Caroline Escott, Programme Director & Head of Government Relations
E-mail: caroline.escott@uksif.org
Tel: 020 7749 9950