Rt Hon Greg Clark
Department for Business, Energy and Industrial Strategy
Third Floor, Spur 1
1 Victoria Street
London SW1H 0ET

17 February 2017

Dear Secretary of State,

We are responding to the Department for Business, Energy and Industrial Strategy (BEIS) consultation on the corporate governance reform green paper.

UKSIF is the membership network for sustainable and responsible financial services in the UK. We promote and support sustainable and responsible investment ("SRI") 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. 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. We have around 240 members and affiliates including financial advisers, institutional and retail fund managers, pension funds, banks, research providers, consultants and NGOs.[1]

Introduction

UKSIF is the network association for responsible investors in the UK; we are not corporate lawyers. As such we intend to provide some context for any changes to the UK corporate governance regime and while we do touch on the issues outlined in the green paper, we do not seek to give detailed answers to specific questions.

Consideration of issues relating to corporate governance requires an understanding of the context and end goal of any measures introduced to strengthen it – the UK already has one of the strongest corporate governance regimes in the world. **The introduction or amendment of policies related to executive remuneration (or indeed any other reforms to the UK corporate governance regime) must have, at their heart, the promotion of better performing companies over the long-term**. The Kay Review dealt with this in detail in 2012 and its conclusions remain relevant. It will be vital to build on the outcomes of this work in any reforms to the corporate governance regime in the UK.

Holding companies to account on executive pay and performance

Professor Kay set out a number of principles intended to lay the foundation for a long-term perspective in UK equity markets and to describe the directions in which regulatory policy and market practice should move.[2] The Kay Review specifically examined the issue of executive pay and set out the following principle:

'Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate

[1] More information about UKSIF and our work is available at www.uksif.org.
[2] The Kay Review of UK Equity Markets and Long-Term Decision Making, 2012 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

decisions in pursuit of long-term value. Any bonuses paid in the equity investment chain should be closely related'.

In its report *Implementation of the Kay Review*, the Government highlighted progress which had stemmed from Kay's recommendations. It highlighted the FRC's revised Corporate Governance Code which was amended to reflect reforms to remuneration reporting and to encourage 'genuinely long-term remuneration structures'.[3] The Code's principles on remuneration are now as follows:

- Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied;
- The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in corporate and individual performance, and should avoid paying more than is necessary;
- They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

Yet research has shown that the design of incentive plans for CEOs can act against the long-term interests of a company. A Big Innovation Centre report[4] has shown that aspects of the "performance pay model", based on bonuses and long-term incentive plans (LTIPs) with performance targets over 1-3 years has resulted in various unintended consequences, including:

- Increased complexity and lack of transparency;
- Incentives for short-term behaviour;
- Pay outcomes which are not clearly understood by stakeholders.

Around two-thirds of the increase in pay of British chief executives over the past 20 years has been driven by LTIPs. UKSIF would support measures to increase transparency throughout the investment chain, one of which may be, as suggested by the Government, publication of pay ratios which would help to boost transparency and accountability within companies. UKSIF members are long-term, responsible investors and work to fulfil their stewardship duties. Feedback shows excessive executive remuneration to be a concern both for UKSIF members as well as the UK public. **The Government should consider whether, in the light of the fact that LTIPs may be driving short-term behaviour, disclosure of fund managers' voting records would help to reverse this trend, and the extent to which pay ratio reporting may boost transparency and accountability.**

<u>Going further for better governance</u>

One way of improving the accountability of companies to shareholders and other stakeholders is by introducing a requirement that asset owners publish policies on their approach to environmental, social and governance factors and stewardship. This approach has been adopted for LGPS administering authorities as part of new rules for preparing the Investment Strategy Statement and

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[3] BIS, Building a Culture of Long-Term Equity Investment – Implementation of the Kay Review: Progress Report, 2014 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367070/bis-14-1157-implementation-of-the-kay-review-progress-report.pdf

[4] Big Innovation Centre, The Purposeful Company – Interim Executive Remuneration Report, 2016 http://www.biginnovationcentre.com/media/uploads/pdf/TPC_InterimExecutiveRemunerationReport.pdf

will be also one of the effects of the IORPs 2 Directive when it is transposed into UK law.[5] It would be helpful, both in addressing the issues set out in this paper and in preparing asset owners for that transition, if the Government took steps to pre-empt the transposition now by amending the Occupational Pension Schemes Regulations 2005 (OPSR). This was the recommendation of the Law Commission when it reviewed the fiduciary duties of investment intermediaries in 2014. It stated that pension fund trustees *should* take into account all financially material factors including those arising from ESG and *may* take non-financial concerns into account in some circumstances. This was a source of significant confusion to some intermediaries and is potentially to the detriment of UK plc.

To this day many fiduciaries still conflate financially material and non-financial factors, thanks in part to poor drafting in the OPSR. Despite the previous Government's failure to introduce the required legislative change, welcome guidance has been produced by the Pensions Regulator for trust-based DC schemes which reflects the Law Commission's report. At this point there remains no equivalent for the contract-based pension scheme market. Because of asset owners' position in the investment chain they are "sleeping giants" and rarely exert their influence on these matters to the full. **In our view, few measures would have as significant an impact on addressing corporate governance and other corporate sustainability concerns as a requirement that asset owners state their policy on ESG and on stewardship.**

One clear example of a financially material risk which is not being given enough attention by some investors is climate change. An August 2016 survey found that over half of financial services professionals polled did not consider climate change to be a financially material factor with one describing it as "overblown nonsense".[6] In response, at the 2016 UKSIF Annual Lecture, the Chief Executive of The Pensions Regulator, Lesley Titcomb, said this was "interesting, not to say a little bit disturbing" and that financially material ESG factors "can't be ignored". The survey results remain extremely concerning given the weight of evidence proving the materiality of climate change. This includes but is not limited to:

- The Prudential Regulation Authority - *The impact of climate change on the UK insurance sector*;[7]
- Mercer – Investing in a time of climate change;[8]
- Carbon Tracker Initiative - *Unburnable Carbon 2013*.[9]

We would also draw your attention to the Taskforce on Climate-related Financial Disclosures (TCFD) which recently consulted on a range of recommended disclosures for companies specifically in

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[5] DCLG, Local Government Pension Scheme – Guidance on Preparing and Maintaining an Investment Strategy Statement, 2016 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/553342/LGPS_Guidance_on_Preparing_and_Maintaining_an_Investment_Strategy_Statement.pdf

[6] Klimes M (2016), Climate Change is 'overblown nonsense' and not a material risk, says industry, *Professional Pensions* http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry

[7] Bank of England Prudential Regulation Authority, The impact of climate change on the UK insurance sector, 2015 http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf

[8] Mercer, Investing in a time of climate change, 2014 https://www.mercer.com/our-thinking/investing-in-a-time-of-climate-change.html

[9] Carbon Tracker, Unburnable Carbon - Are the world's financial markets carrying a carbon bubble?, 2013 http://www.carbontracker.org/report/carbon-bubble/

relation to climate risk.[10] We fully support the work of the TCFD, which was set up by Governor of the Bank of England, Mark Carney, and chaired by Michael Bloomberg. The questionnaire asks how far organisations should describe how performance and remuneration take climate-related issues into consideration. We think this is an issue looming on the horizon for companies and something on which BEIS should consider its own position.

Voting powers on pay for institutional and retail investors

UKSIF welcomed the reforms which were introduced in 2013 to give shareholders new rights on executive remuneration, including a binding vote on pay policies and an annual advisory vote on pay awards. As we have said, these rights may be made more effective by increasing transparency throughout the investment chain. Crucially, however, shareholders' ability to hold companies to account ranges beyond voting at AGMs. UKSIF supports the Stewardship Code and the principle-based approach to promote long-term success for companies. UKSIF members believe stewardship benefits companies, investors and the wider economy. The Stewardship Code accurately outlines the kind of stewardship activities UKSIF expects its institutional investor members to carry out as routine:

'For investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.'

The Stewardship Code operates on a comply or explain basis- which UKSIF supports and favours over a regulatory approach on the specific issue of executive remuneration. UKSIF welcomes the approach the Financial Reporting Council (FRC) has taken to tier signatories. **The direction of travel is good: We believe this has the potential to improve outcomes but a review of the impact of the tiering approach would be welcome in the medium-term.**

For retail investors the situation is different. These investors are more easily compared with the beneficiaries that institutional investors represent. In the short-term, the Government should consider how retail investors can better engage with companies and the voting process. UKSIF polling commissioned for Good Money Week 2016 showed that 63% of people back a label to identify ethical or sustainable financial products, while 43% said it would make them more likely to buy a financial product.[11] There is a clear demand from the public for more sustainable companies and financial products. The financial services sector must evolve and adapt in response to this demand. **Any steps taken must be cost-effective: The Government may wish to consider how the rise of fin-tech can help support this goal.**

Over the long-term, the Government must do more to improve financial literacy. While we welcome the introduction of the subject into school curriculums in 2014, not enough has been done to address the lack of financial literacy amongst the UK public. An example is the introduction of automatic enrolment into DC pension schemes. This represented a move to bypass the lack of literacy and engagement amongst savers rather than address it. UKSIF welcomed the introduction of AE, but this was a short-term fix which failed to address the problem: How many of these savers remain unaware they are not saving enough for their retirement by far? **The Government must do**

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[10] Financial Stability Board TCFD, Recommendations of the Task Force on Climate-related Financial Disclosures, 2016 https://www.fsb-tcfd.org/wp-content/uploads/2016/12/16_1221_TCFD_Report_Letter.pdf
[11] UKSIF Good Money Week 2016 Polling, information available at http://goodmoneyweek.com/media/press-releases/new-good-money-weekyougov-poll-results-announced

more to address the lack of financial literacy in the UK, which would help both savers enrolled in pension schemes as well as retail investors to engage more with their investments.

Shareholder engagement with remuneration committees

We advocate shareholder engagement with all aspects of a company's governance system especially those which are linked to the company's long-term success. This includes but is not limited to the board, the remuneration committee, the CSR committee, the audit committee, the environmental and sustainability committee and the nomination committee. Ensuring fund houses of all sizes (and others in the investment chain) live up to their stewardship duties is one essential way to support stable financial markets. We would encourage BEIS to consider if more needs to be done here, perhaps by encouraging committees to engage with the appropriate stakeholders on relevant issues before making recommendations to the board. This could include the remuneration committee engaging with the workforce on pay, or the CSR committee engaging with the local community and wider stakeholders on the company's policy relating to the impact of its operations from a social responsibility perspective. **The Government should consider whether further steps are required to improve the effectiveness of all engagements between shareholders and relevant governance committees.**

Stewardship should not be the preserve of active managers who have the ultimate sanction of divestment. Passive managers are permanent shareholders in the indices they track, and increasingly have recognised the impact of being an active steward, particularly in relation to ESG issues. This is what Blackrock CEO, Larry Fink, recently said:

"Environmental, social, and governance (ESG) factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects. We look to see that a company is attuned to the key factors that contribute to long-term growth: sustainability of the business model and its operations, attention to external and environmental factors that could impact the company, and recognition of the company's role as a member of the communities in which it operates. A global company needs to be local in every single one of its markets."[12]

The issue of stewardship by passive managers has gained importance following the introduction of automatic enrolment (AE). The charge cap for AE default arrangements was designed with the intention to protect savers from high charges or paying for unnecessary advisory services.[13] Analysis by the OFT showed that the workplace DC market had a very weak buyer side and that competition alone would not drive good outcomes for consumers. While we feel the cap is an important check on charges, and is clearly intended to be in the interests of savers, we have heard that it may be having some unintended consequences. In particular it has driven many pension schemes to offer cheap, passive equity funds. The result has been less diverse portfolios which tend to be dominated by equities and, potentially, poor service for savers in terms of the stewardship activities of the scheme's chosen fund manager, particularly where they are seeking to reduce costs. We point to the recent ESG Reporting Guidance by the London Stock Exchange Group (LSEG) as an excellent example of a tool that companies can use to provide a foundation for communication with investors on a

[12] Oyedele A (2017), Here is the letter the world's largest investor, BlackRoack CEO Larry Fink, just sent to CEOs everywhere, *UK Business Insider* http://uk.businessinsider.com/blackrock-ceo-larry-fink-letter-to-ceos-2017-1?r=US&IR=T

[13] FCA, Consultation Paper - Charges in workplace personal pension schemes, 2014 https://www.fca.org.uk/publication/consultation/cp14-24.pdf

range of issues, including those related to corporate governance. LSEG is explicit that the guidance represents a basis for dialogue with investors but is not a replacement for it. **We recommend the Government highlights this excellent tool to give it more exposure to large publicly listed companies.**

Strengthening the employee, customer and wider stakeholder voice

We support governance systems which reflect wider stakeholder needs and concerns. Many of the measures we have outlined in section 1 would help to achieve this. In particular, this can be achieved by:

- Expanding the remit of Independent Governance Committees (IGCs) in contract-based schemes to review the performance of funds in relation to long-term and ESG considerations;
- Requiring asset owners to have a policy on ESG and stewardship;
- Doing significantly more to boost levels of financial literacy amongst the UK public.

Corporate governance in large privately-held businesses

Robust governance practices are in the interests of investors, savers and the companies themselves, regardless of their legal status or whether they are listed. While we appreciate there may be some difficulties in apply the Corporate Governance Code to private businesses, we do think it should be replicated as far as practicable, particularly with regard to risk management, reporting and stakeholder engagement. We understand the FRC will undertake a review of the Corporate Governance Code in response to the results of this consultation. **This would be a good opportunity to bring together sector players to examine the feasibility of a new code for private entities.**

It is our view that the term used in the consultation 'non-financial reporting' is a misnomer; many of the issues reported are or have the potential to be financially material over the long-term. We have made this point to BEIS during its consultation on the transposition of the Non-Financial Reporting Directive. We do not consider the legal form of a business to be a material factor in determining whether it should report on these issues. The size of the business is likely to be far more relevant.

I trust the above points are clear, but if you have any questions or require further clarity please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely,

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)