UKSIF
UK Sustainable Investment and Finance Association

November 2016

Iain Wright MP
Chair, BEIS Committee
House of Commons
London
SW1A 0AA

Dear Mr Wright,

I am writing in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association in relation to your inquiry on corporate governance. This response is meant to provide some context for the importance of good corporate governance practices from the perspective of the sustainable and responsible investment (SRI) sector and encourage a strengthening of the corporate governance regime in the UK.

We welcome the Committee's focus on the corporate governance regime in the UK, and appreciate this work-stream has stemmed from previous inquiries into failings at BHS and Sports Direct. Indeed, good corporate governance is essential for investors to mitigate many of the risks faced by investee companies and it is right that emphasis is placed here. However the Committee must not lose sight of the many opportunities for investors of well-run businesses. Companies which are able to demonstrate good corporate governance will usually generate superior financial benefits for shareholders, and this is the assumption many of the biggest UK investors operate under.[1] Boosting the corporate governance regime in the UK must be for the dual purposes of making UK companies – and thus the wider economy – more resilient, but also to create sustainable businesses that perform better over the long-term, resulting in benefits for companies, investors and savers.

The importance of good corporate governance has been recognised by responsible investors for many years, and recent policy developments in the UK are worth noting. The Kay Review in 2012 found that short-termism was having a detrimental impact on UK equity markets, particularly affecting long-term performance.[2] One of the recommendations, taken forward by the Law Commission, was a review of the legal concept of fiduciary duty.[3] The final report, published in 2014 was clear: Trustees of pension schemes *should* take into account financially material factors including where these arise from environmental, social and governance factors (ESG), and it recommended the Department of Work and Pensions change the investment regulations to make this clear.[4] This was a vital intervention and helped to dispel the myth that some investors still believe i.e. that they are duty-bound to "maximise profits". This misconception is not as wide-spread as it was in 2012, although some investors still believe it to be true partly because of DWP's failure to clarify the law in-line the Law Commission's recommendations.

The committee should note that despite DWP's official line that there was only "some support" for changes to the regulations the opposite was true.[5] DWP only released the responses to the consultation following a freedom of information request, but this showed that in fact 43 of 47 responses were in favour of changes being made to the regulations, with 37 of these emphasising the importance of long-

[1] http://www.lgim.com/uk/en/capabilities/corporate-governance/
[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
[3] Law Commission, *Fiduciary Duties of Investment Intermediaries*, 2014 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/325509/41342_HC_368_LC350_Print_Ready.pdf
[4] The Occupational Pension Schemes (Investment) Regulations 2005
[5] DWP, *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476447/reducing-regulatory-burdens-and-misc-regs-nov-2015-consultation.pdf*

term risks being taken into account during the investment process. DWP's subsequent justification that no changes were made due to a lack of consensus on how they should be made was completely inadequate; we wonder how many open consultations of this type result in consensus from all respondents on a particular approach. The recently revised code of practice for defined-contribution schemes by The Pensions Regulator has been extremely helpful and lays out an expectation that trustees take ESG factors into account during the investment process. Companies with poor corporate governance standards are therefore less attractive to potential investors that consider these issues. Currently, this only applies to trustees in defined-contribution pension schemes- far smaller than the defined-benefit (DB) and contract portions of the market. Even so, following TPR's recent 21st Century Trusteeship consultation we are hopeful similar rules will be transposed into the DB regulatory framework and we understand there will be a review of Independent Governance Committees (IGCs) – the equivalent of trustee boards for contract-based schemes – next year. It is essential that rules for DB trustees and IGCs are updated to place on them a similar expectation in relation responsible investment.

As well as mitigating risks to the company and increasing attractiveness to investors, good corporate governance helps to build more successful companies, particularly over the long-term. A recent report by Oxford University and Arabesque Partners (an UKSIF member) has evidenced various studies showing a correlation between good corporate governance and stock market outcomes, better firm valuations and operational performance.[6] The report also specifically focuses on executive pay:

"*Research has also shown that firm performance is directly affected by executive compensation practices. If executive compensation schemes are properly designed (to motivate managers sufficiently not to incite excessive risk taking) the impact on firm performance is generally positive. Poorly-designed executive compensation scheme can tend to have the opposite effect, with higher executive pay resulting in lower firm performance.*"

Several asset-owner initiatives have been set up over the past few years to encourage responsible investment. These are fundamentally based on the belief that incorporating ESG factors into the investment process, and beyond through stewardship of assets, is beneficial particularly over the long-term. These initiatives include:

- The Aiming for A Coalition which has put various high profile shareholder resolutions including two successful resolutions at the BP and Shell AGMs, both of which received over 98% support;[7]
- The Pension Fund Roundtable which consists of 16 funds representing over £200bn and published a guide outlining the type of reporting on environmental, social and governance factors they expected from the asset managers;[8]
- The Red Line Voting Initiative set up by the Association of Member Nominated Trustees which is a series of 'red lines' or voting instructions for fund managers which cover a wide range of environmental, social and governance issues. The governance red lines were developed in accordance with the FRC's UK Corporate Governance Code. These focus some of the areas relevant to the Committee's inquiry including directors' duties and remuneration.[9]

Responsible investment is important enough to investors – both during the investment process through ESG integration and subsequent to it via engagement and stewardship – that it has spawned such initiatives. The high profile cases already discussed like BHS and Sports Direct (but also others including

[6] Oxford University and Arabesque Partners, *From the Stockholder to the Stakeholder,* available at http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11
[7] "Shell bows to investor pressure," 2015: http://www.reuters.com/article/climatechange-investor-shell-idUSL1N0V82IE20150129
[8] Pension Fund Roundtable, *A Guide to Responsible Investment Reporting in Public Equity*, available at http://www.btpensions.net/download/353/Guide+to+Responsible+Investment+Reporting+in+Public+Equity+-+26.01.15.pdf
[9] http://redlinevoting.org/corporate-governance/

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Tata Steel, Tesco and Volkswagen) are good examples of company failings which may have been avoided by responsible investors which either continued to engage with investee companies on ESG issues following their investment or, based on those companies' ESG performance, chose not to invest in them at all. The new Conservative administration has rightly begun to examine the corporate governance regime in the UK, but part of the solution must be to look at the role investors can play in helping to boost corporate performance on governance issues (as well as social and environmental issues). We have already discussed DWP's decision not to amend the investment regulations, something which UKSIF and our members found extremely disappointing, particularly given the strength of feeling amongst respondents that they should be changed. However when a few weeks later DCLG published its new investment regulations for LGPS schemes which explicitly recognised the value in ESG integration and stewardship, DWP's decision became even more bizarre. These rules now require LGPS authorities to develop policies on responsible investment. We now have a situation where a lack of joined up thinking means the Government cannot demonstrate a unified position on whether ESG integration in the investment process is desirable. A simple clarification of trustees' fiduciary duties in the investment regulations as recommended by the Law Commission would be extremely helpful and should be considered a priority for the Government.

Given the above, we think it would be helpful if, in the course of your inquiries, you examine:

- Both aspects of good corporate governance i.e. helping to mitigate risks to companies, but also the role a strong regime plays in boosting long-term sustainable companies that outperform over the long-term and making the wider economy more resilient.
- The reasons why DWP chose not to implement the Law Commission's recommendations in the Investment Regulations 2005 which would have been a boost to responsible investment and the UK corporate governance regime;
- The reasons why, only a few weeks following DWP's decision, DCLG came to the opposite conclusion with respect to its own LGPS investment regulations;
- The need for rules changes in respect of defined-benefit and contract-based schemes to bring them in-line with new rules for defined-contribution and LGPS schemes.
- What steps the Government could take to further boost the UK corporate governance regime by lending its support to some of the asset owner initiatives discussed in this submission.

If you have any questions on this or require any further information please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely,

Simon Howard
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