Responsible Investment Guidance

The National Association of Pension Funds

March 2009

NAPF
Securing the future of pensions

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Introduction

The aim of this Guidance is twofold: to update the NAPF Corporate Social Responsibility paper, published in 2005; and to assist investors, principally pension funds, in developing their policies.

There is growing evidence that Corporate Responsibility is an important element in assessing investment risk, but it is clear that too few companies and investors are putting sufficient resources into addressing these risks and explaining them to shareholders and clients. The relationship to broader stewardship issues (which includes the impact of corporate activity on society) is particularly important to pension funds with their very long-term time horizons.

The NAPF approach is based on two key principles:

- Corporate responsibility, which encompasses the environmental, social and governance issues managed by the companies and other assets in which pension funds invest, is an integral part of good corporate governance. The development and oversight of an appropriate Corporate Responsibility Policy thus falls to their boards.

- Funds should give careful consideration to the extent to which they wish their managers to take responsible investment issues into account when implementing their investment policies and reporting on them.

This Guidance does not relate to ethical investment, where assets are screened on the basis of moral or ethical decisions made by trustee boards. It does not seek to set standards for responsible corporate behaviour or for responsible investment; nor does it propose benchmarks for reporting by asset managers or disclosures by companies.

Below we describe the framework which has developed to support responsible investment and set out the roles of pension funds, asset managers and companies.

Framework

Over the past ten years, a framework to support the integration of Corporate Responsibility issues into the investment process has evolved.

The key elements of this framework are set out below:

- *Pensions Act Amendment*

  The Pensions Act was amended in 1999 to place a requirement on trustees to declare via their Statement of Investment Principles (SIP) "the extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments; and the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments".

- *Freshfields' Opinion*

  For many years there has been a debate over the ability of pension funds to take social and environmental considerations into account when setting their investment policy. Writing in 2005 for the UNEP (United Nations Environment Programme) Finance Initiative, Freshfields noted in their conclusion:

  ". ……. The links between ESG (environmental, social and governance) factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."

- *Myners' Principles*

  In 2008, the NAPF published its review of the Myners' Principles, which were first set out in 2001. Its recommendations were broadly accepted by the Treasury and now form an important element of good pension trustee governance. On responsible investing the Treasury states:

  "A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities."

- *UN Principles for Responsible Investing*

  In 2006, the UN Principles were published and have now been endorsed by many institutional investors around the world. The preamble states: "As institutional investors, we have a duty to act in the best long-term interests of our

beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following principles:"

- Incorporate ESG issues into investment analysis and decision-making processes.
- Be active owners and incorporate ESG issues into ownership policies and practices.
- Seek appropriate disclosure on ESG issues by the entities in which they invest.
- Promote acceptance and implementation of the Principles within the investment industry.
- Work together to enhance effectiveness in implementing the Principles
- Report on the activities and progress towards implementing the Principles.

- *Institutional Shareholders' Committee*

The ISC's "Statement of Principles" covers a wide range of governance and oversight issues, including a company's approach to corporate social responsibility. It sets out best practice for institutional shareholders and/or agents in relation to their responsibilities in respect of investee companies in that they will:

- set out their policy on how they will discharge their responsibilities
- monitor the performance of, and establish, where necessary, a regular dialogue
- with investee companies
- intervene where necessary
- evaluate the impact of their engagement; and
- report back to clients/beneficial owners.

- *ABI Disclosure Guidelines*

In 2007, the ABI updated its 2001 Guidelines on Responsible Investment Disclosure, which aim to provide companies with guidance as to investors' expectations. The revisions take account of the 2006 Companies Act and are summed up as follows: "They ……… aim to highlight aspects of responsibility reporting on which shareholders place particular value. This is narrative reporting which:

- sets environmental, social and governance (ESG) risks in the context of the whole range of risks and opportunities facing the company
- contains a forward looking perspective, and
- describes the actions of the Board in mitigating these risks.

- *UN Global Compact*

  The United Nations' Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment, and anti-corruption.

Pension Funds/Asset Managers/Companies

Pension Funds

Pension schemes and their advisers, have an important role to play in encouraging higher standards of corporate responsibility and, under the Pension Act Amendment of 1999, should outline their approach to addressing these issues in their investment process - where they have decided to adopt a policy to do so. They should also communicate their actions in this area with members where such policy operates.

Where a scheme has not yet developed specific Responsible Investment (RI) policies the UN Principles for Responsible Investing provide a framework upon which to base such a policy. Trustees may also wish to consider whether their sponsor's Corporate Responsibility (CR) policy is relevant in the development of their plan's RI policy.

Where schemes invest through pooled funds there may not be the opportunity to set their own guidelines. In those instances they may choose to add RI capabilities to their selection criteria. In the case of an index tracker provider this can be a key differentiating factor between managers.

Where a policy has been established, funds should incorporate an assessment of RI policy into their manager selection process and, with their advisers, should develop tools for monitoring how managers apply that policy and how they hold companies to account on behalf of the pension scheme. They should be aware of the risks of this becoming a "tick-box" exercise. A good manager report can be expected to include some or all of the following elements:

- A description of how RI policy is integrated into the investment process and the materiality of such issues for portfolio performance;
- A summary of the outcomes from engagement activity during the review period;
- Details of investments which are considered to have high CR risks; and
- Details of voting activity arising from engagement.

Asset Managers

The managers to whom schemes delegate responsibility for investment should be encouraged to sign up to the UN Principles of Responsible Investing and to report to trustees on their application of the Principles, as part of their reporting on non-financial issues. This may include how the companies in which they invest have applied the principles of the UN Global Compact, where they are signatories, and what steps they have taken to encourage companies to adopt the Compact. There are clear practical difficulties around reporting on large portfolios and it should normally be sufficient for a manager to report on the general application of policy and to highlight exceptions.

Asset managers who apply the Institutional Shareholders Committee's (ISC) "Statement of Principles of the responsibilities of institutional shareholders and their agents". are expected to engage with companies on CR issues, as they do on financial results and corporate governance, and to report on the outcome of their engagement

In addition, asset managers should make clear to trustees the extent to which RI is integrated into their investment process and be prepared to demonstrate the effectiveness of their approach.

The above considerations apply to all investment vehicles and not only the more conventional investment methodologies. Clearly their relevance will vary somewhat (eg certain hedge funds), but where a pension scheme has adopted an RI policy it should explain how it is applied to its overall investment strategy.

Companies

Ultimate responsibility for the formulation and execution of CR policy rests with companies and their boards. The International Corporate Governance Network guidelines on non-financial reporting, published recently, represent best practice as currently seen by leading international investors.

While the UN Global Compact sets high-level principles, UK companies are required by the 2006 Companies Act to report on social and environmental matters as a part of the Business Review. In addition the Act widens directors' duties to encompass the interests of a broader group of "stakeholders", including "the impact of the company's operations on the community and the environment" (CA 2006 s.172). The impact of each company's activities will clearly vary, but it is reasonable to expect that companies define the key issues and risks and as far as possible measure their impact.

Investors should note that signatory companies are reviewed periodically for their reporting on compliance with the UN Compact and those who have failed to report over two years are removed from the register of signatories. This in itself provides investors with a simple monitoring tool.

Appendix

Useful Links:

- UN Principles for Responsible Investing (www.unpri.org)
- UN Global Compact (www.unglobalcompact.org)
- International Corporate Governance Network (www.icgn.org)
- UKSIF (www.uksif.org)
- Tomorrow's Company (www.tomorrowscompany.com)
- Association of British Insurers (www.abi.org.uk)
- United Nations Environment Programme (www.unep.org)
- HM Treasury – Myners Review 2008 (www.hm-treasury.gov.uk/d/consult_myners_response)
- Institutional Shareholders Committee (www.institutionalshareholderscommittee.org.uk)

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March 2009

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