



Top 100 UK pension funds - how ethical are they?

Pensions & ethics

Twenty million people in the UK are members or beneficiaries of an occupational pension fund. Pension schemes in this country have a combined value of approximately £800 billion and represent the largest pool of capital in the UK economy, controlling a third of the stock market. Simply stated our pension funds make us major shareholders in some of the best known companies in the UK and overseas.

Despite the fact pension funds control a large part of the stock market, many people are unaware what is being done with the money they invest for their personal security and for that of their family. Unless they have specifically chosen to invest in an ethical pension fund, it is very likely that their money is being invested in companies that behave in an ethically, environmentally or socially unsound manner.

Before July 3rd 2001, pension fund members had no right to be informed about their pension fund's ethical, social and environmental stance. However as a result of growing public demand for more socially responsible investment, as well as pressure from NGOs, the Pensions Act was finally amended.

On the 3rd July 2000, a new amendment to the Pension Act 1995 came into force requiring the Trustees of occupational pension schemes to disclose through their Statement of Investment Principles (SIPs) *"the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments"*.

Friends of the Earth believe that the inclusion of Socially Responsible Investment (SRI) considerations in SIPs is an important step to encourage more ethically based investment. However, while recognising the significance of such new regulation, the disclosure of a Pension scheme's stance with respect to SRI considerations, while necessary, is only the first step.

In addition to stating the extent to which ethical, social and environmental (ESE) considerations are taken into account, trustees and fund managers need to be able to demonstrate how ESE considerations are monitored and taken into account.

This is why we have surveyed the largest 100 occupational pension funds and graded them not only on the basis of the ethical considerations contained in their SIPs but also on any evidence of mechanisms for ensuring that trustees and fund managers actually carry out these responsibilities.

The pensions survey

The survey was carried out on the UK's top 100 occupational pension funds by capital value. The choice to limit the survey to these pension schemes was for practical reasons but also to obtain meaningful results. With a capital value of £388 billion, the top 100 pension schemes represent approximately 47 per cent of the total pension fund market. This provides us with a good representative sample of the extent to which ethical, social and environmental (ESE) considerations impact the allocation of UK pension funds' investments.

Fund managers were contacted by Friends of the Earth in a letter after the amendment came into force on July 3rd 2000. We asked the fund administrators to send their SIPs and any relevant supporting information on their SRI policy. The Funds that did not reply to this first request were subsequently contacted by phone. A reminder letter was then sent in December 2000 to those who had not responded to the first requests. The Funds that did not reply to any of the written requests were again contacted by phone. Sixty-eight pension funds responded in some form to our requests, 13 funds explicitly refused to send their SIPs to us, and 19 did not reply at all.

We are aware that the National Association of Pension Funds wrote to all their members requesting that they didn't respond to the Friends of the Earth survey which may have affected the response rate.

Disclaimer

We are aware that SRI is in continuous development and we expect that some of the funds might have updated their policies since this survey has been conducted. However, our analysis was based on the information provided by the Pension Funds at the time

In addition, as mentioned above, we specifically requested that any further information on the funds' SRI policy be sent to us. Only three funds provided additional documents.

Bench marking

The process of analysing and bench marking the SIPs received was a difficult one. This was due to the variety of the information received, which varied from a couple of sentences to a full Statement of Investment Principles and additional documents to complement the SIPs. The vagueness of many statements added to the complexity of the bench marking process.

The analysis was finally carried out on three main issues:

- 1) The statement of investment principles:** the extent to which ESE considerations are taken into account in the selection realisation and retention of investments;
- 2) Engagement:** any undertaken by the trustee or the fund manager including policies on the exercise of the rights attaching to investment (including voting rights); and

3) Monitoring: any mechanisms in place.

Bench marking was then conducted for each issue on the basis of the following framework of comparison:

Policy on the extent (if at all) to which ESE considerations are taken into account (this category scores out of ten):

The trustee does not have any policy on the extent to which social, environmental and ethical considerations are taken into account in the selection, retention and realisation of investments (score = 0).

The trustees either do not take position on ESE factors or believe that ESE considerations might have a negative financial impact on investments, and wish to guard against material negative financial effects of taking ESE considerations into account. If a trustee delegates responsibility to fund managers on SRI with no guidelines (score = 1).

If a trustee delegates responsibility to fund managers after having reviewed and accepted the managers' policy on ESE issues or if the trustee provides only very vague guidelines to managers (score = 2).

The trustees require that the fund managers take account of the financial implications of ESE considerations. In this kind of SRI statement the Trustees imply that social, environmental and ethical performance are associated with good financial impacts on long term investment. (score = 4).

The trustees recognise that the interests of their shareholders are more complex than mere financial ones and that taking ESE into consideration is in the interest also of stakeholders (score = 7).

Trustees' engagement policy;the policy (if any) on the exercise of the rights attaching to investment (including voting rights) on ESE considerations and/or corporate governance (this category scores out of three):

The trustee delegates to manager the exercise of the rights attaching to investments including voting rights with no guidelines. No engagement is mentioned (score = 0).

The trustee delegates to the fund managers responsibility to engage with investee companies on ESE considerations or just on corporate governance or the trustee promotes negative screening of companies (score = 1).

The trustee directs fund manager to engage directly with companies (individually or collectively) or provides specific guidelines to fund managers on positive engagement. (score = 3).

Monitoring Mechanisms (this category scores out of two)

The trustee does not direct the manager to report specifically on ESE considerations (score = 0).

The trustee directs the manager to report specifically on ESE considerations. (score = 2).

Each SIP was analysed on the basis of the numerical values assigned to the above criteria. The values were then summed. The final result therefore combined the stated policy on SRI with the available information on engagement and monitoring mechanisms in place. A poor disclosure policy would also negatively affect the results. This led to all funds receiving a score out of fifteen. On the basis of these scores, pension funds were then divided into four main groups:

Results of survey

Group 1. (Scores 9-12)

Criteria: *The trustee considers SRI to be in the best interest of the scheme's beneficiaries and of stakeholders.*

The trustee directs fund manager to engage directly with companies (individually or collectively) or provides specific guidelines to the manager on positive engagement in order to enhance investment value and improve business behaviour generally.

Monitoring mechanisms are in place and refer specifically to ESE policy.

There were ten pension funds which fell into the top category. While all these schemes present a good record in the three criteria analysed, the degree by which such criteria are satisfied can vary considerably. In general, the SIPs of local authorities in the group show a more pro active attitude towards including ESE considerations into their investment decision process than individual companies. They also support collective action as the best policy to achieve the greatest possible impact on corporate behaviour

For example the *Nottinghamshire County Council Fund* considers that SRI approaches are whole fund issues, applying to all investments, and supports best corporate governance as being in the best interest of beneficiaries as well as other stakeholders. It has engaged an institutional fund manager to evaluate alternative techniques of engagement to improve companies environmental performance and will increase funds to SRI if the evaluation is successful.

Another fund, the *West Midlands Pension Fund* has developed a best practice approach that in particular areas exceeds that of the *Combined Code of the Committee of Corporate Governance*. It also states specific guidelines for investee companies that include commitments to environmental excellence, the production of an environmental policy that is effectively monitored and regular reports to shareholders on progress being made toward improving environmental performance.

The *East Riding of Yorkshire Fund* had established its own SRI sub committee to monitor ESE issues while employing Pensions & Investments Research Consultants (PIRC) to undertake research on SRI. It actively encouraged best practice and where possible sought to work in alliances to maximise its impact.

One of the more explicit statements in support of SRI was that of the *University Superannuation Scheme (USS)* which has also developed its own research capacity 'in house':

"It follows that in so far as the USS is actively managed....., the managers take into account ethical, social and environmental considerations when making their assessments of the merits of a given company, on the basis that they have, or could have, an impact on its financial value"

The *British Telecom Fund* specifically extended the responsibility of the company to its suppliers as well as employees and customers. In its SIP it considers it in the long term interests of the company

"...to manage effectively relationships with its employees, suppliers and customers, to behave ethically and have regard for environment and society as a whole"

The *BBC Pension Fund* had established specific policies for both socially responsible investment and corporate governance. The SRI policy actively discourages socially irresponsible behaviour and asks investment managers *"...to be vigilant against the effects on a companies' long term performance prospects which could arise from any practices that alienate civilised society"*. While the corporate governance policy requires fund managers to produce quarterly reports to ensure compliance with the existing policy as well as identifying cases where relevant Codes of Conduct have been breached and to discussion of any contentious issues.

Group 2. (Scores 5-8)

Criteria: *The trustees associate good ESE performance with potentially good financial impacts on long term investment (in general related to reputational risk) and therefore require fund managers to take account of the financial implications of ESE considerations in so far as they can enhance investment*

financial performance.

Active engagement is generally encouraged and some guidelines are provided on the exercise of the rights attaching to investments.

Reporting mechanisms are in general not requested on a regular basis or not specifically on ESE issues.

The second group includes those funds that recognise that ESE considerations are among the factors that can affect investment financial returns and require managers to give consideration to these factors as a means to enhance investment returns. The engagement policy of the Funds in this group can vary greatly and goes from negative screening (*Post Office*) to an active collective engagement (*Lancashire County Council*) with the companies in which the fund has invested.

However, it is the link between the financial performance and SRI that characterises the funds in this group. CGNU, for example, requires fund managers to take account of the financial implications of ESE considerations insofar as they can enhance investment financial performance:

“The Trustee recognises that ESE considerations are among the factors that can affect investment financial returns. It has asked the manager to give due consideration to these factors in particular in business sustainability and reputational risk”

Some funds such as the Environment Agency have set up their own ethical investment portfolios managed by SRI institutions. The *Environment Agency Fund* focusses on “...investment in sectors with lower environmental impact” and when investing in higher environmental impact sectors favours companies that “...demonstrate commitment to addressing sustainable development issues”.

Group 3. (Scores 1-4)

Criteria: *Trustees do not take responsibility on ESE issues or by saying that their legal duty is to maximise the financial benefit of the members of the scheme, they dismiss ESE considerations as having potentially negative financial impact on investments. Decisions on the extent (if any) to which ESE consideration should be taken into account are fully delegated to the fund manager with no (or extremely vague) guidelines. No engagement policy and/or monitoring mechanisms on ESE issues.*

Thirty-three pension funds, that is around half of the SIPs received, fell into the last category. Here again there are differences in the degree by which ESE considerations impact investment decisions. In general terms, the funds in this group either fully delegate responsibility to their pension managers with no or vague guidelines or have a poor engagement or monitoring policy.

The *Guardian Royal Exchange Insurance Fund's* wording on SRI is an example of full delegation of responsibility to the investment managers without even reviewing the managers' policy on the issue:

“The Trustees's policy is that the extent to which social, environmental and ethical considerations are taken into account in these decisions [in the selection, retention, and realisation of investments] is left to the discretion of the active investment managers”.

One of the most meaningless statements on SRI was from *Unilever* who instructed fund managers to take into account social, environment and ethical considerations “...to the extent that they are relevant to future investment prospects”.

Another aspect of some SIPs in this group is the strong emphasis put on financial aspects over relevant social, environmental and ethical issues as typified by *Associated British Foods*

“The Trustees consider that they should in all circumstances act in the best financial interests of the beneficiaries. The trustees policy is to ask the Investment Managers that, where the primary consideration is not prejudiced, they should, as appropriate, take account of what they believe to be relevant social,

environmental and ethical issues”.

Group 4. (Score 0)

Criteria: *The trustees explicitly or implicitly declare not to have a policy on ESE considerations.*

Four pension funds either clearly stated or their statement could be easily interpreted as declaring that ESE considerations would not be taken into account. A clear example is the extract sent to us by *Invensys Pensions Fund* that states:

“The Trustee does not currently have an explicit policy in place with regard to the extent to which ESE considerations are taken into account in the selection, retention and realisation of investments. The Trustee does not currently have an explicit policy in relation to the exercise of the rights (including voting rights) attaching to investments”.

Key findings of survey

Most occupational pension funds contained SIPs that included SRI in some form. Of the 68 SIPs received 59 or nearly 90 per cent of those returned made reference to ethics or corporate social responsibility in their investment principles. This is certainly an encouraging response to the recent regulatory developments for pensions and to a growing public demand for socially responsible investment.

While most funds included SRI in their investment principles, many had few or no demonstrable accountability mechanisms for trustees to ensure that the fund managers were taking SRI considerations into account when making investment decisions. In particular there appeared to be virtually no independent stakeholder verification of any claims made.

Most funds fell into the lower category in our survey because their statements on SRI were either vague or ambiguous, and responsibility for delivering SRI objectives were passed down to fund managers typically with no guidance or monitoring mechanisms.

Other funds have used some of their contributions to set up ethical investment portfolios to minimise the perceived risk to the rest of the fund. Alternatively, members of some funds were offered the chance to contribute additional payments voluntarily to separate ethical funds.

Statement of Investment Principles

Of those funds supporting SRI, most stated ethical, social and environmental matters should be considered in their SIP's and a significant majority also made reference to corporate governance.

The SIPs in the top category of our survey (Group 1) show an active commitment in developing a SRI policy. The SIPs in Group 1, and among these particularly the ones from local authorities, recognise the importance of including ESE considerations in the investment process not only for the benefit of their members but also for society at large.

A number of funds made reference to appropriate codes of practice such as the *Combined Code* of the Committee on Corporate Governance and encouraged companies to adopt to a *best practice* approach on SRI and corporate governance. A few made specific reference to the need to consider political as well as reputational and business risks. At least one fund also made specific reference of the need to consider the companies relationship with its suppliers as well as customers and employees.

There were also strong statements in the second group in support of SRI and corporate governance, including best practice.

Unfortunately 33 funds, or more than half of the SIPs received, present weak SRI statements, falling into group 3, the lower category in our survey. Not all SIPs in this group were poor - they just didn't score well in the other categories of monitoring or engagement.

In many cases, from the evidence provided, the trustees have committed to developing a policy on SRI. Typically they pass responsibility fully onto the fund manager, usually without giving any guidelines on how ESE considerations should be taken into account in the selection, retention and realisation of investment.

These statements show a very low interest in incorporating ESE considerations into the investment process. The *standardised* wording of most of the paragraphs on SRI sent to us is also a sign of how little consideration is given to SRI and how most of the statements aim simply at complying with the new legislation with the least commitment possible.

Engagement

The second criteria in our survey related to whether the fund engaged in any way with the companies in which it invested to improve companies' ethical, social and environmental behaviour.

Of those 68 pension funds that responded to our survey around half had some sort of engagement policy (ie. corporate governance policy) and associated monitoring mechanisms, such as voting rights, to influence corporations to take account of ESE issues. All of the top group and nearly all the second group had some sort of engagement policy while less than a third of group three had one.

Some funds developed their own policies for engagement that went beyond corporate governance to include ESE issues. However most funds direct their managers or delegated bodies to limit their engagement to corporate governance issues on which they do not go beyond the guidelines of the Combined Code of the Committee on Corporate Governance.

The exercise of the rights attaching to investment such as voting rights was usually delegated to the fund managers. These were sometimes attached with guidelines (ie. corporate governance policy) but often were not. All funds in the top group and around half the second group made reference to guidelines on voting although these were not necessarily disclosed.

There is a clear lack of transparency when it comes to the disclosure of voting in relation to investments. Most funds do not disclose voting guidelines to members and no funds disclosed to members or the wider public how they vote at AGM's. Keeping this information behind closed doors does little to install confidence in the effectiveness of SRI funds to make a difference.

While some forms of direct relationships did exist between pension fund trustees and companies, it is interesting to note that only a couple of statements said they intended to reflect members concerns and actually put in place a consultation process. These were all Local Authority SIPs. This omission on the part of the majority of the funds analysed is very clear evidence of a gap between the trustees' policy and the concerns of the funds' members and, even more so, of society at large.

Monitoring

The third criteria in the survey related to how companies are monitored and in particular how ethical, social and environmental issues of concern are reported back to trustees.

This was by far the worst scoring category with less than a third of the 68 funds surveyed able to demonstrate how they were monitoring and reporting back on ESE issues. Most of the top group and around

half the second group were monitoring ESE considerations hardly any of group three were.

From our analysis, it is clear that most statements lack realistic provisions for monitoring mechanisms to ensure that ESE considerations were actually taken into account by managers. For instance some funds delegated responsibility to external organisations to monitor company performance but then had not demonstrated how this was reported back to Trustees or a relevant governance body (eg. pension sub committee on SRI). This shows that incorporating SRI into the investment process is still at its early stages.

In particular there was little evidence of ‘independently verified’ stakeholder reporting to demonstrate that companies were being held accountable for and responding to their own environmental, social and ethical impacts. This is critical to ensure that SRI funds do not become victims of ‘*green washing*’ their own members as to their real impact on influencing corporate behaviour.

The lack of transparency within pension funds in relation to how they monitor how companies take into account ESE considerations is not helpful in demonstrating to fund members and the wider public that ethically based pension funds can make a difference or are indeed fulfilling their objectives to fund members.

It is clear that pension funds will have to significantly increase resources in the area of monitoring and reporting back to trustees and ultimately to members to ensure the effective implementation of the SRI objectives within pension SIP’s.

Local authorities vs company funds

Local authorities show a more pro active attitude towards including ESE considerations into their investment decision process. They support collective action as the best policy to achieve the greatest possible impact on corporate behaviour through participating in the policy set by the Local Authorities Pension Funds Forum (LAPFF) and Pensions & Investment Research Consultants (PIRC). This maybe partly due to the fact that local authorities are democratically accountable and so tend to be more responsive to the concerns of both their members and the local community.

Legal duty vs public duty

The development of SRI pension funds has been hampered by legal debate. Most SIPs refer to the trustees’ legal duty to act in the financial interest of their members, in general to justify the lack of a serious SRI. However, it has been argued that trustees are not required by law to act *exclusively* in the financial interests of the beneficiaries but only *normally*.

Furthermore ethical investment has expanded beyond negative screening to more sophisticated methods of influence such as ‘active engagement’ and ‘best of sector’ approaches along with more accountability mechanisms required for SRI. This undermines the legal argument against SRI based on the traditional ‘negative screening’ approach in which significant industrial sectors may have been excluded which in turn may have had a detrimental financial impact on returns. However, spreading the risk across a range of companies with a comprehensive engagement strategy reduces the likelihood of poorer financial returns.

With industry surveys consistently showing that around three quarters of UK pension holders would like their pensions to be used to influence socially responsible corporate behaviour the important message for trustees and fund managers is not should we be developing SRI within our pension funds but how can we do it better.

What do Friends of the Earth want?

Friends of the Earth welcomes the new pension disclosure requirements as a result of changes to the Pensions Act in July 2000. We are aware that very encouraging developments have taken place since July. However, from the results of the present survey it is clear that a lot still needs to be done and Friends of the Earth believes that critical developments should include:

i) Better implementation mechanisms

To ensure the SRI objectives of the SIP are being met including regular reporting back from fund managers & members (see below) and the use of appropriate sanctions (ie changes to AGM voting policy, shareholder resolutions, disengagement) where these objectives are not being met.

ii) More explicit policies on engagement

To involve investee companies, fund members (see below) and affected stakeholders. This would include the use of appropriate guidance to companies for reporting on SRI issues along with agreed targets and appropriate sanctions. For example some major UK institutional investors now have a graded level of action depending on the adequacy of the response from direct engagement to voting against the company at their AGM.

iii) Better disclosure of trustees' policies & investments in relation to SRI

This could include publishing policies on major SRI issues as well as their current shareholdings. For example some funds have posted their SIP, position on key SRI issues and major shareholdings on their web sites. The funds should also disclose their voting position (including on resolutions) for AGM's, particularly around the areas of corporate governance and major SRI issues.

iv) Allocate more resources

Funds should substantially increase resources to be able to research, engage, monitor and report back SRI issues. Smaller funds will need to act collectively or out source these services to dedicated SRI research and governance organisations.

V) Establish an ongoing consultation with the funds' beneficiaries

There needs to be an appropriate forum established for members to discuss their concerns and to ensure its reported back to trustees or appropriate governing bodies. This could include the members own web site for feedback, regular 'externally run' fund member forums and ongoing surveys around key and emerging issues.

Top 100 UK Pension Funds benchmarked on social, ethical and environmental criteria		
Group	Score	Pension Fund
Group 1 Good statement on SRI. Direct engagement. Monitoring mechanisms in place. (Total Scores 9-12)	12	East Riding of Yorkshire
	12	University Superannuation Scheme Ltd.
	12	Merseyside Pension Fund
	12	Nottinghamshire County Council
	12	British Broadcasting Corporation
	10	West Midland Metropolitan Authorities
	10	Lancashire County Council
	10	British Telecommunications plc
	9	Environment Agency
	9	South Tyneside Metropolitan District Council

<p>Group 2 SRI associated with potentially good financial performance. Active engagement encouraged with some guidelines. Monitoring mechanisms either rare or not included. <i>(Total scores 5-8)</i></p>	7	Derbyshire County Council
	7	The BOC group
	7	City of Edinburgh Council
	7	Strathclyde City Council
	7	Hampshire County Council
	7	BNFL Magnox Generation
	7	Leicestershire County Council
	7	West Yorkshire Pension Fund
	7	AstraZeneca
	6	CGNU
	5	Prudential plc
	5	BP
	5	Post Office
	5	Bath and North East Somerset Council
	5	London Pensions Fund Authority
5	London Regional Transport	
5	Nestle' UK Ltd.	
5	ICI Speciality Chemicals	
<p>Group 3 Poor statement on SRI, Trustees do not take responsibility on taking ethical, social and environmental issues(ESE) into consideration. No engagement policy and/or monitoring mechanisms for ESE issues. <i>(Total scores 1-4)</i></p>	4	The Co-operative Wholesale Society Ltd.
	4	Greater Manchester Pension Fund
	3	NatWest
	3	Vauxhall & Associated Companies
	3	Centrica
	3	CMT Pension Trustees Services
	2	Lloyds TSB
	2	United Utilities
	2	National Power
	2	South Yorkshire Pension Fund
	2	Guardian Royal Exchange Assurance Ltd.
	2	Shell Contributory Pension
	2	CMT Pension Trustee Services Ltd
	2	Merchant Navy Officers Pension Fund
	2	BICC Group (Balfour Beatty)
	2	Railways Pension Fund
	1	Staffordshire County Council
	1	Essex County Council
	1	Phillips
	1	Carnaud Metal Box Group
	1	Cable and Wireless plc
	1	Marconi
	1	Unilever
	1	The National Grid Group
	1	Hertfordshire County Council
	1	Scottish & Newcastle Pension Scheme
	1	Scottish Power
1	Boots	
1	Nortel Networks	
1	Associated British Foods	
1	The Royal Bank of Scotland Group	
1	Tesco	
1	The Pension Trust	

Group 4 No policy on ESE considerations. <i>(Total score 0)</i>	0	Invesys Pension Scheme
	0	Marks & Spencer plc
	0	The Rover Group Ltd.
	0	Pilkington plc
Refused or did not send	n/a	Abbey National
	n/a	British Steel Ltd.
	n/a	BG
	n/a	Mars
	n/a	Kavaerner
	n/a	Allied Domecq
	n/a	BAe Systems
	n/a	Barclays Bank
	n/a	Bass
	n/a	Cheshire County Council
	n/a	Diageo
	n/a	Esso UK
	n/a	Exel
	n/a	Ford Motor Co
	n/a	GKN
	n/a	Glaxo Wellcome
	n/a	Halifax Group
	n/a	IBM UK Ltd
	n/a	Interbrew UK
	n/a	International Computers Ltd
	n/a	J. Sainsbury plc
	n/a	NEC (UK) Ltd.
	n/a	Pearl Assurance
	n/a	PowerGen UK
	n/a	Ranks Hovis McDougall Ltd
	n/a	Reed Elsevier (UK) Ltd.
	n/a	Rolls-Royce
	n/a	Royal & SunAlliance Insurance Group
	n/a	Royal Insurance
	n/a	The Co-operative Insurance Society Ltd.
n/a	T & N Ltd	
n/a	Bank of Scotland	
n/a	Zurich Financial Services (UKISA) Ltd Group Services	
n/a	Scottish Office Pension Agency	
n/a	TI Group	

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