



# Towards accountable and responsible financial services

**RSA**  
[www.theRSA.org](http://www.theRSA.org)

Duncan Exley

Tomorrow's Investor | September 2008

## Alienated and disempowered

In the UK it is a principle fully acknowledged that as individuals we should be allowed and encouraged to inform ourselves about the actions of those who govern us, and to have our views taken into account.

It is also the case that increasingly the actors by whom we are governed are not governments: the number of us living in publicly-owned housing has dramatically declined in the last few decades, as have the utilities provided by publicly-owned organisations, from energy and water to transport; the private sector also plays an increased role in everything from education and health to international development and defence. The potential for individual citizens to hold to account these companies has not kept pace.

The power of the unions has waned over recent years. Consumer power, its supposed replacement, is a very blunt tool – limited to buying or not buying (and even this choice is often absent – for example, very few of us will ever be in a position to buy any of BAE Systems' products). We can be affected by the behaviour of companies of which we are neither consumer nor employee (for example, by the emissions of a factory near our home).

Given the market dominance of big players with big advertising budgets, the number of people who seriously believe in consumer sovereignty is declining. Lucy Kellaway, writing in the Financial Times, summed up the situation thus: "Companies belong to

their shareholders. They do not belong to their customers. They do not belong to their employees. Businesses are run better when everyone is very clear about that”<sup>1</sup>

This picture may seem bleak. Yet it is also true that the vast majority of UK individuals are – if indirectly – the majority owners of companies listed in this country. These ‘individual indirect shareholders’ need to be allowed, encouraged and empowered to hold companies to account, not only as a means of exercising citizenship in a modern political and economic landscape, but also because public involvement is a benefit to the institutional investors as well as to individuals.

## Benefits for institutional investors and indirect shareholders

Many institutional investors (including asset owners such as pension funds, as well as fund managers and other service providers) may not initially welcome the idea of scrutiny from their beneficiaries and customers: most people prefer to be left alone to ‘get on with the job’. Yet greater public engagement could have significant benefits for the institutional investors.

Scrutiny acts as a means of improving performance. Organisations which believe they are under scrutiny tend to practice greater self-scrutiny and self discipline (in the same way that political systems which are more transparent are not only less corrupt but are also less disaster-prone). Pension funds and fund managers recognise the psychology behind this human trait, utilising it for the companies they invest in.

An analogy of the scrutiny-performance link is provided by the correlation between companies with good governance practices (compared to others in their sector) and those with good financial performance.<sup>2</sup> A meta-analysis carried out in 2007 by Mercer, a consultancy, showed that investors who take environmental, social and governance (ESG) issues into account benefit from the increased ability to monitor and manage risks and opportunities.<sup>3</sup>

There are some ESG issues where profit and principle will be at odds (although less than one might think). Responsible investment is not a cure-all, and investors can only take action where there is a business case for doing so. Nevertheless, it is interesting to see that an influential legal review, published in 2005, concluded that if an ESG consideration is “reasonably believed to be the subject of a clear consensus amongst beneficiaries” then it “must be taken into account”<sup>4</sup>

## The arguments against empowerment

People often argue that most individuals do not have a strong understanding of financial services in general, and that efforts should be made to improve financial literacy prior to encouraging individuals to see themselves as indirect shareholders. If this approach is taken we are likely to have to wait a very long time: despite the importance of financial services to everyone in the UK, there are a plethora of areas in which policymakers and others are encouraging the public to become more engaged (in the field of health alone, we are all being urged to learn more –

1 May 8, 2006

2 Selvaggi & Upton, “Governance and Performance in Corporate Britain” Association of British Insurers, 2008

3 Mercer & UNEPFI: “Demystifying Responsible Investment Performance: a review of key academic and broker research on ESG factors” 2007 UNEPFI

4 Freshfields Bruckhaus Deringer, A legal framework for the integration of environmental, social and governance issues into institutional investment, 2005

and do more – about nutrition, exercise, symptoms of cancers and many other concerns) but these initiatives struggle to make headway among a public already bombarded with messages and lacking the time to absorb more.

Institutional investors may worry that scrutiny and input from non-specialists would lead investors to be ‘influenced by the ignorant’ and therefore tend to behave irrationally. We do not let this argument lead us to conclude that democracy should be abolished due to voters lacking expertise – public opinion sometimes can lead governments into unwise decisions, but not nearly as unwise as those routinely taken by non-democratic governments.

} Public opinion sometimes can lead governments into unwise decisions, but not nearly as unwise as those routinely taken by non-democratic governments

Another argument raised against engaging with indirect investors is that there has been little demand from, for example, pension fund members either to be given information about the investments and practices of their fund or to have their voices heard about such matters. If it is true that there has been little interest shown so far, it does not follow that this will not change. In general, people are not interested in a subject unless they are aware of the subject – in my experience with FairPensions, where we have spoken to people about the companies in which they are invested through their pension funds, and the actions that have been taken by their fund to influence the behaviour of companies, they do become interested.

It is useful to think of the Fairtrade movement when considering the potential for popular support for responsible investment. Twenty years ago very few UK consumers would have declared themselves to be influenced by anything other than taste and cost, yet by 2005 Fairtrade accounted for 14 per cent of the retail roast and ground coffee market.<sup>5</sup> There are differences, not least that consumers are conservative about their investments, but this very risk-aversion may win them over to responsible investment eventually.

Lack of interest is not only caused by a lack of knowledge, but also by lack of discourse. People engage with subjects if they feel they have some familiarity with them; usually this is a low and uncertain process. But there are tipping points, at which a number of people become very engaged very quickly. One such example of mass rapid engagement followed the broadcast in the Netherlands of a documentary in March 2007 which focused on Dutch pension fund investments in manufacturers of cluster bombs and on the opacity of funds’ investment portfolios and policies.<sup>6</sup> The broadcast caused an immediate outcry and led to a range of actions being taken by managers of Dutch pension funds, including making their portfolios public. It is much better for providers of financial services to have policies and practices that they will not be ashamed of, and to be open about these on their own initiative than to be hounded into disclosure.

## The chain of accountability

The public are not likely to become spontaneously interested in a subject they are unaware of. The other key players in this arena will also have to engage with democratic capitalism.

<sup>5</sup> Redpoint Marketing, Fairtrade Coffee Report 2005, (for Fine Foods International)

<sup>6</sup> Zembla ‘Het Clusterbom Gevoel’ [‘That Cluster Bomb Feeling’] 18 March 2007)

### Asset owners

Institutional asset owners, by which I mean the pension funds, insurance companies, banks etc, overwhelmingly invest on behalf of individual clients and, in most cases, have a duty to act in the best interest of these individuals.

In order that for beneficiaries to play an informed and constructive role as indirect shareholders, the asset owners should put in place certain practices, most obviously in terms of informing clients about matters such as the assets in the portfolio, any policies on engaging with companies about ESG issues, and the track record of these engagements (in terms of issues pursued, meetings with companies, votes cast at AGMs).

Some pension funds are already making such information available on their websites and in their annual reviews, but, due to the fact that clients “don’t know what they don’t know” it is also best practice to approach them with information proactively.

Other asset owners are beginning to put in place means by which clients may feed back information: the London Borough of Lewisham Superannuation Fund, for example, is surveying its members about specific ESG issues relevant to the portfolio.

In addition, for the input of clients to have any impact upon the activity of the asset owner then the asset owner must be active. By this I do not mean that all funds should be actively *managed* (as opposed to ‘passive’ funds invested in index trackers), but that the asset owner should be an active *owner*: one who recognises that as a shareholder they have the potential to improve the medium- and long-term financial performance of investee companies (and other asset-classes) by engaging with them to improve ESG performance.

In order to achieve this, asset owners need to have a clear procedure for recognising potentially financially-relevant ESG issues, identify actions to be taken and (where relevant) mandate intermediaries such as fund managers to act upon them.

### Asset managers and other intermediaries

Most asset owners’ interactions with investees are carried out through asset managers (fund managers). Some of these are leading the movement towards accountability and responsibility. Others have been less exemplary.

Accountability can be achieved by asset owners making sure that asset managers are monitoring and engaging with relevant issues and reporting on progress. A good example (asset managers’ capability to do this should be assessed when asset owners are selecting managers, and also reflected in mandates which are agreed and in reporting and incentives).

This is particularly important for asset owners such as pension funds, which are investors with long-term considerations, to ensure that the short-term performance against which asset managers are assessed does not come at the expense of the longer-term needs of the asset owner or its clients.

In making deliberations about asset managers, asset owners are guided by investment consultants, whose role is therefore crucial and whose record of assessing longer-

term issues is variable. Again, this is in the interest of indirect shareholders as well as asset owners, as most of us have investment needs beyond the next quarter.

Asset owners, though, do need to practice assertiveness: the size of fund management companies can give them an aura of authority and assurance, but asset owners need to ensure that their own interests and those of their own beneficiaries are being pursued.

In order to be accountable for their actions, asset managers need to take action. Recent research by FairPensions showed a wide range of performance between those fund managers who have the resources to monitor and manage potentially financially relevant issues, and those who do not.<sup>7</sup>

There is a facility in the 2006 Companies Act to require institutional investors to disclose information about the exercise of their voting rights; so far this facility has not been used. Opponents of its use point to increasing voluntary disclosure, but given that the FairPensions research cited above found widespread non-disclosure, there is a strong argument for compulsion.

### Investee companies

At the end of the chain of accountability are the investee companies themselves. In the vast majority of cases, the interests of the companies are shared with those of the asset owners (i.e. to achieve sustained growth and long-term survival), but there are sometimes barriers created by lack of transparency about ‘non financial’ issues, despite the tendency of these to *become* financial issues.

The Companies Act helped this issue by specifying that environmental and social impacts should be reported on, but there remain areas in which information is not as effective as it might be – one example is the reporting of CO2 emissions, which at present lack comparability due to different methodologies.

If companies belong to their shareholders, then it is vital that shareholders are given the information necessary to work with companies for long-term mutual advantage. There is also a need for more frequent, direct and frank exchanges of views between companies and asset owners to ensure that both parties can work together for long-term mutual benefit.

There is an unmet potential for companies to work with asset owners who do take a longer-term view and are willing to look beyond quarterly results, in order to balance the perception that all investors are focused on the short term – too often companies are driven by a perception of excessive preference for short-term results.

### Policymakers

Policymakers in the UK have a mixed record in terms of encouraging accountability of companies to their shareholders and institutional investors to their clients. Despite guidelines such as the “Myners principles for institutional investment decision making”, commissioned by the Treasury in 2000, the commitment to the *laissez-faire* approach stifles effective government action. The *laissez-faire* approach has been driven by the recognition that the financial services industry accounts for a large proportion of UK GDP, but if the clients of

<sup>7</sup> FairPensions: “Fund Manager Transparency and Engagement on Environmental, Social and Governance Issues” October 2007

financial services companies are to be properly informed and have their assets safeguarded against unnecessary risk, then the government should at least encourage the practice of responsible ownership which thinks beyond the short term.

Recent financial crises show that the reliance of the UK on the financial services industry is a double-edged sword, which has the ability to injure all concerned. The industry can often be reluctant to 'eat their greens' so far as guidelines and regulations on responsible and accountable practices are concerned, but those who do not eat their greens have a tendency to ill-health.

The industry can often be reluctant to 'eat their greens' so far as guidelines and regulations on responsible and accountable practices are concerned

### Civil society

Capital market initiatives have not been in a common tool for civil society groups. NGOs and trade unions are beginning to appreciate that their strategies for holding companies to account by focusing on the customers and employees of those companies are incomplete if they do not also address investors.

The growing expertise of civil society groups in the field of capital market accountability is beneficial for the whole investment chain. Civil society groups can act as an 'early warning system' to identify specific risks and opportunities related to environmental and social issues well before these are picked up by city analysts.

At present, governance issues are over-represented in ESG analysis, perhaps because the data involved is closer to the financial services' industry's comfort zone. This means that environmental and social risks and opportunities tend to be inadequately assessed. Increasing involvement of civil society groups (and concerned individuals), might well prompt investors to increase their monitoring and management of environmental and social issues, covering this unfortunate gap.

### In conclusion

There are distinct benefits to adopting a more accountable and responsible approach to investments: benefits for investors, as well as for the UK as a social and economic unit. There is certainly room to improve, given that individuals typically have significantly less meaningful interaction with financial services as investors than they do as citizens, employees or consumers.

The individual has a huge role to play in this change. But focusing solely on individuals – or even on the parts of the financial services sector with which the individual has direct contact – does not address the scope of the issue. There is work to be done by all parts of the investment chain.

Combined action alone can ensure that everyone's interests are taken into account beyond the short term – and that thinking beyond the next quarter is not somehow a 'luxury'. In the light of the current financial crisis, this is a dire necessity.

**Duncan Exley** is Director of Campaigns at FairPensions, an organisation which works with institutional investors and civil society to promote the business case for responsible investment.

# RSA

The Royal Society for the encouragement of Arts, Manufactures and Commerce  
8 John Adam Street  
London WC2N 6EZ  
T +44 (0)20 7930 5115  
[www.theRSA.org](http://www.theRSA.org)

Registered as a charity in England and Wales no. 212424  
This report is printed on recycled paper.

Copyright © RSA 2008

The RSA is an Enlightenment organisation devoted to finding innovative practical solutions to today's pressing social problems. Through its 27,000-strong Fellowship it pursues its mission: to help people be the people they need to be to see the change they want in the world.

The citizens of the future will need to be self-reliant, engaged and other-regarding if they are to create a principled and prosperous society. This is nowhere more true than in financial matters. The Tomorrow's Investor project, the first stage of a prolonged RSA engagement with these issues, aims to facilitate this goal, both practically and intellectually.

This project would not have been possible without the support of Invesco Perpetual and PricewaterhouseCoopers – many thanks in particular to Sir John Banham, Nick Hamilton, James Rawson, David Phillips and Peter Wyman. Thanks also to Robin Ellison, Paul Myners and John Gray, as well as to all those who participated in the Tomorrow's Investor lecture, expert seminar and deliberative forum. Special thanks to David Pitt-Watson for his support throughout the project.

More information can be found at the RSA website: [www.theRSA.org.uk](http://www.theRSA.org.uk)