ShareAction»

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Sent via email: consultation@taskforceonsocialfactors.co.uk

Dear Taskforce,

ShareAction response to the UK Taskforce on Social Factors

I am pleased to respond to the UK Taskforce on Social Factors on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices throughout the financial services sector. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. Among other activities, we work with the financial services sector, including asset management firms, to promote integration of sustainability factors in investment decisions, long-term stewardship of assets and the consideration of the views of clients, beneficiaries and pension scheme members.

ShareAction welcomes the Taskforce on Social Factors' objective to understand, and respond to, the growing need to address social factors within the investment space in the UK. The inclusion of social considerations is critical for economic growth and protection from risks related to the climate crisis, as well as to ensure a higher standard of social protections across domestic and international supply chains. Additionally, social impacts of the climate crisis impose huge costs on governments and the global economy, for example the health effects of air pollution cost the international community 6.1 percent of global GDP[i]. It is in the best interests of pension savers and the government to harness the power of pensions to prepare for a changing future. While ShareAction encourages the Taskforce's efforts to raise awareness of social risks and opportunities, we believe that environmental and social considerations must be incorporated into investment decision-making in a more robust manner by pension scheme trustees, industry and policy makers. Pension trustees must act in their beneficiaries' best interests, which means realising the social purpose and impacts of investments to protect and ensure beneficiaries' futures.

We have responded to questions 1, 3, 4, 5 and 7 below. Please do not hesitate to contact us if you require clarification on any specific points.

1. Do you agree the report will be helpful for pension scheme trustees to better understand social issues and the impetus to act on them?

The report will be helpful for pension scheme trustees to understand how to incorporate social issues into investment decisions, but the demonstration of the need for greater impetus could be stronger. For instance, we welcome that inequality is mentioned as a systemic risk, but it should refer to resources to demonstrate why. The Business Commission to Tackle Inequality 2022 report states that inequality 'undermines social cohesion, erodes trust in institutions and fuels unrest'[ii]. Also, according to the PRI, income inequality can 'negatively impact long-term investment performance; change the risks and opportunities that affect the universe of investment opportunities; and destabilise the financial system within which investors operate, threatening portfolios and bottom lines'.[iii]

ShareAction welcomes the report's recognition that social factors are important and should be considered because they will influence the condition of the world into which savers will retire. We were encouraged to see factors like modern slavery and diversity and inclusion mentioned. However, it would be helpful to outline the business case on diversity and inclusion, to persuade pension trustees further. There are many reports which have found links between financial performance and diversity and inclusion. McKinsey's 2020 study, 'Diversity Wins', for instance, found that companies with the most ethnically and culturally diverse executive teams were the most successful financially. McKinsey's study not only illustrated performance gains from diversity, but also a performance penalty for companies lagging behind on diversity and inclusion. The least ethnic and gender diverse firms were '27% more likely to underperform on profitability than all other companies'.[iv] For further evidence on the business case, see ShareAction's Ethnicity Pay Gap Reporting Investor Toolkit.[v]

Additionally, social factors are intrinsically linked to climate issues, so creating more stringent regulation of pension scheme practices and urging their move to invest more in climate solutions encourages social protections by default. We will not be able to ensure a just transition to net zero without recognising and listening to people from diverse backgrounds and communities throughout the process. The climate crisis is already manifesting as health issues around the globe. For example, dangerously high levels of air pollution are causing respiratory diseases, and in extreme cases fatality, such as the death of nine-year-old Ella Kissi-Debrah in London.[vi] But the scale of health issues facing humans in all countries will continue to grow with the persistence of fossil fuel burning induced by the continued investment in companies that are not scaling back. Everyone has the right to a standard of living adequate for their health and well-being,[vii] which is under increasing threat from the climate crisis. Investments play a crucial role in protecting not only the environment in which people live, but also their human right to live in healthy, safe conditions. Pension scheme trustees have a responsibility to act in their beneficiaries' best interests, incorporating social protection and environmental protection. Through this guide, the Taskforce on Social Factors (TSF) has demonstrated the importance of incorporating social considerations into the pension landscape, which we support.

ShareAction values the report's keenness to look at the long-term benefits of considering social issues, as well as the long-term risk, and cost, of not. We strongly support the TSF's view on analysis of social factors being considered along the value chain. The report includes a good outline of social systemic risks, workforce protections, human rights considerations and outcomes through supply chains, and healthcare factors. Furthermore, we welcome the acknowledgement of gender pay gap and ethnicity pay gap reporting, which we think should be mandatory.[viii] However, in spite of this, currently there is limited information and guidance for trustees to be able to consider the full breadth of the issues outlined in the report.

ShareAction is pleased that the TSF considers the inclusion of social factors into pension investment decisions is aligned with pension trustees' fiduciary duty, as pension schemes hold vast capital and great investment opportunities. Although there was some regulatory clarification in 2018 on how trustees might incorporate environmental, social or governance (ESG) factors into their decisions,[ix] the existing legal definition of fiduciary duty does not prescribe a clear obligation for trustees to make responsible investments. The law frames ESG factors as relevant but only if they prove to have short-term material financial impact on certain investments. It is important that pension trustees are aware of the longer-term risks influenced by physical, social and environmental impacts of the climate crisis, as well as risks presented by the transition process. Without fully factoring these issues into their saving portfolios, pension trustees could be putting their beneficiaries' money at risk. ShareAction believes that to incorporate ESG factors into trustee decision-making, fiduciary duty needs to be reformed and clearly outlined in law. While the TSF refers to the PRI, UNEP FI, UNEP Inquiry and UN Global Compact's report which outlines that a "failure to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty",[x] there needs to be stronger legal clarification in order to achieve consistent investment decisions across the pension ecosystem regarding all ESG factors.

3. Do you see the proposed systematic materiality assessment framework for social factors as something you can practically implement in your portfolio?

ShareAction is encouraged by the materiality assessment framework as this would be an impactful way of monitoring investment chains. It would incorporate social factors that affect local communities and workforces, as well as those overseas that are often overlooked by asset managers and pension trustees when making investment decisions.

ShareAction would be pleased to see those with investment decision-making power analysing the financially material social risks across the whole chain of investment as this should deter the financing of socially irresponsible funds. We encourage the 'leading practice' level of the report's framework that details voting policy and engagement on social factors with top portfolio companies. This ensures that not only is the asset owner voice heard but also installs demand within the system for portfolio companies to have strong policies on social factors themselves.

4. Do you believe the three-level framework for addressing social factors in pension portfolios provides useful developmental guidance?

ShareAction supports the design for the three-level framework and believes it is a good start for demonstrating good investment practice along the pension chain. However, there would need to be thorough education processes for pension scheme trustees to ensure that the included frameworks are put in place effectively, and to ensure a high level of understanding amongst trustees of what they should aim to achieve through their decision-making. While it is mentioned throughout the report, emphasis should be made on educating trustees when introducing regulatory frameworks.

5. Do you agree with the resulting recommendations for the pensions ecosystem?

It is encouraging that the TSF recommends that pension trustees should have strong engagement with their asset managers to ensure that the investment chain is properly monitored and that social factors, alongside environmental and governance factors, are properly considered and introduced into decision-making. ShareAction believes it will be very valuable to have pension trustees making asks of their investment consultants and asset managers and understanding the way each approaches social factors. If pension trustees have more transparency on where their investments are going, and the positive or negative social consequences of their investments, it would have a huge influence on investment decisions. By strengthening due diligence of asset manager selection and assessing the real-world social impact of investments and stewardship activities,[xi] there will be a greater awareness of socially responsible investments, a change in investment management, and thus, accountability embedded throughout the pension ecosystem.

Although the taskforce recommends trustees to consider social impact investment opportunities where financial outcomes align with desired social outcomes, ShareAction believes social impact investment should not be restricted to alignment with financial outcomes. ShareAction believes that clarifying the law and expanding the definition of beneficiaries' 'best interests' would uphold trustees' core duties of loyalty, impartiality and prudence, whilst also giving them the opportunity to act on ESG impacts and risks. As it stands, the law does not encourage pension trustees to consider ESG risks and opportunities, therefore we would like to see fiduciary duty clarified and redefined. Financial return should no longer be the priority over social and environmental considerations: it is in the best interests of beneficiaries for trustees to consider the impact of their investments on society and the environment in addition to financial gain.

ShareAction finds it very positive that the taskforce recommends pension trustees and asset managers to be as responsible as they can be and expect that of the businesses they invest in. We are supportive of the asks of regulators in the ecosystem. However, it would be beneficial to see more robust regulatory frameworks follow in quick succession to the guide so that there can be more impactful enforcement of social factors within pension scheme investment. Moreover, the Pensions Regulator (TPR) needs to raise awareness of ESG issues and should introduce stronger education policies for pension trustees and subsequent monitoring activity to provide support and direction on responsible investment decision-making. For example, updating the TPR's Trustee Toolkit to include social factors would be very beneficial.

Furthermore, there is increasing recognition of the systemic risks posed by growing income inequality. Such risks are particularly pertinent to pension funds, whose portfolios are highly diversified and hence dependent upon the long-term health of wider economy and society, rather than the short-term performance of individual investments. For example, ensuring workers are paid a living wage will increase the cost at one company, but promotes broad economy prosperity and, in turn, overall portfolio value. To mitigate this risk, pension trustees should be empowered to consider full-portfolio impact when engaging with their asset managers and directly with companies.

We are very supportive of the recommendation to government to make ethnicity pay gap reporting mandatory, as well as recommendations to companies on voluntary disclosure. However, the recommendation on ethnicity pay gap reporting should be made explicit for regulators, pension funds and asset managers. Additionally, it should specify that the FCA makes ethnicity pay gap reporting a mandatory disclosure. Financial services companies are an important starting point due to the dual role they have within the economy: not only are they corporate entities, but they are also critical to capital allocation which underpins the broader system. As a result, change from inside companies within the financial services sector can influence the practice of businesses across the economy as a whole through their capital allocation.

Given the power of the sector on the wider economy, racial inequality within these companies could have an outsized impact on society as a whole. One study found that funds managed by White-dominant teams allocate larger portfolio weights to firms led by White CEOs compared to funds managed by minority-dominant teams.[xii] A diverse workforce can "help managers understand and address the needs of a demographically diverse customer base".[xiii]

We strongly recommend that pension trustees engage with their asset managers on ethnicity pay gap reporting and encourage them to prioritise this issue. Owners can specify this in the investment mandates, and place requirement on their managers to report back on both their own ethnicity pay gap, and the work they are doing to enhance DE&I through their investment practices. Beyond engaging and encouraging the prioritisation of ethnicity pay gap reporting in their portfolio companies, it is also worth considering setting targets for their asset managers, such as the number of companies engaged on ethnicity pay gap reporting, and aggregate reporting of ethnicity pay gap data at portfolio level.

Additionally, under the recommendations for asset managers, there is a recommendation that asset managers conduct due diligence on modern slavery. Similarly, we would urge that asset managers also incorporate ethnicity pay gap reporting in their stewardship and engagement strategy, policies and practices. This should include considering ethnicity, diversity and inclusion at all stages of the investment lifecycle. Using investor stewardship as a lever to drive increased ethnicity pay gap reporting within the financial industry and FTSE100 companies would kickstart a movement for ethnicity pay gap disclosure and help tackle some of the underlying issues. This will encourage a more diverse workforce within the financial industry, which in turn could impact on capital allocations made, thus promoting a positive impact on the real economy.

Finally, while we agree with the taskforce's recommendations to the UK government, we would like to see mandatory social-related disclosures by companies and investors. At ShareAction, we are calling on the government to legislate for mandatory sustainability-related corporate disclosures and ensure the new legislation includes mandatory social-related corporate disclosures, which explicitly integrate health disclosures.

Data on companies' health-related impacts, practices and relevant risks is limited, incomplete and poor quality. This lack of comparable data makes it difficult for investors to meaningfully assess internal and external health-related risks and direct stewardship accordingly. There is a clear and urgent need for an integrated and streamlined reporting framework.

7. Is there anything else that you would like to see covered?

As stated in the Taskforce on Social Factors (TSF) Guide, the pensions industry has grasped that climate risk is highly significant but has yet to respond sufficiently to this associated social imperative. We welcome this guidance and hope it will lead to an increase in trustee understanding of social factors and the financially material effects they can have. While we are supportive of the attention it brings to social factors generally, we would like to see more focus on health and its need to be taken into account in investment activities.

Population health represents a systemic risk and can affect entire markets. Good health is a driving force for economic prosperity, but poor health exposes investors and many of the businesses they are invested in to elevated and preventable financial risk. The Office of National Statistics (ONS) UK Labour Force Survey shows that the sickness absence rate in 2022 was the highest it has been since 2004. An estimated 185.6 million working days were lost because of sickness or injury. [xiv] Improved population health would lead to a decrease in the number of sickness absences, which would boost productivity, increase labour supply, and reduce healthcare expenditure.

Specifically, we would like to see health more broadly represented in the corporate assessment section beyond workforce well-being. The TSF Guide states that there are four key areas to understand where particular social factors come to the fore: direct workforce, supply chains, affected communities, and consumers or end users. Under consumers, we would like to see product quality and safety expanded to include product healthiness, and under communities, we would like to see air pollution listed. The health effects of air pollution cost the global economy at least US $8.1 trillion per year, or 6.1 percent of global GDP.[xv] Investors, both asset managers and asset owners, have substantial influence not only in allocating capital but also by stewarding companies towards reducing air pollution and promoting healthier foods. Both of these additions would strengthen the case for health as a vital factor in the investment decision process.

In addition to health considerations, we would like to see legal reform and a more clearly defined fiduciary duty. Although the TSF Guide makes some very encouraging recommendations about the incorporation of social factors, along with environmental factors, into investment decision-making processes, it is very difficult to monitor and implement the expectations of pension trustees without stricter clarification of the law. ShareAction believes that a reform of fiduciary duty would ensure better responsible investment that considers long-term social and environmental impacts, not just financial return.

Finally, as previously mentioned, we strongly support the recommendations for companies to voluntarily report their ethnicity pay gap and for government to make it mandatory. As companies continue the journey in tackling racial inequality, we recommend that firms report on employee ethnicity, broken down into the most appropriate categories and quartile pay bands, in addition to the overall pay gap. A quartile pay band should provide the proportion of different ethnicities within each of the quartile pay bands, the average pay levels and any gaps within each quartile. This would address under representation in senior management and overrepresentation in low paid jobs.[xvi]

Where possible, we would ask for companies to disaggregate data by ONS ethnicity categories. This is important as broad ethnicity categories can mask vast discrepancies within them. For instance, in 2019, Chinese and Indian groups earned a higher hourly pay than White workers, whereas Pakistani and Bangladeshi workers earned 16% and 15% less than White workers respectively.[xvii] An employer's ability to provide such granulated data will be dependent on the makeup of their workforce, and the demographics of the geographical area. Following government guidelines published this year10, we would expect employers to only publish this information where there is a minimum threshold of 50 staff members of that ethnicity. However, this could be phased in time – it's better to begin this journey and start reporting. The process itself encourages accountability, the creation of an action plan and monitoring of progress.

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[vii] UN General Assembly, *Universal Declaration of Human Rights*, 10 December 1948, 217 A (III). Available at: https://www.refworld.org/docid/3ae6b3712c.html
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[xvii] Office for National Statistics, *Ethnicity Pay Gaps: 2019*, 2019.