

Briefing Paper On Socially Responsible Investment

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Definition and Development of Socially Responsible Investment

SRI is a generic term covering ethical investments, responsible investments, sustainable investments, and any other investment process that combines investor's financial objectives with their concerns about environmental, social and governance (ESG) issues. This is a very broad definition covering a wide range of values. Concern about the right use of money has a long history, led initially by religious groups. More recent impetus for SRI activities came out of the Vietnam War, and the movements for civil rights against apartheid, and for environmental protection in the 1970's and 1980's. Funds were developed that met the moral requirements of individual investors, but the onus was on the investor to define the moral standards rather than the fund providing a comprehensive definition.

Approaches to Implementing SRI

1. Exclusion or Negative Screens

Exclusion or negative screens are where the portfolio will not be invested in companies engaging in activities such as tobacco, gambling, armaments, pornography, nuclear weapons, the nuclear power industry; or companies with poor labour or environmental records, or are cruel to animals. The above exclusions will usually apply where it is the company's principle business, or the company earns say more than 20% of its revenues from those activities.

2. Positive Screens

This is where preference is given to activities that are considered socially desirable. These can include companies that are environmentally sustainable, have low carbon emissions, provide clean tech or renewable energy, or contribute to public goods such as housing, public transport, and progressive employment practices.

3. Engagement

Engagement uses ownership stakes to engage with those companies that are not meeting desirable standards, through dialogue and shareholder activism. Investors have turned from 'exit' to 'voice' in their relationships with unsatisfactory companies. The classic example of successful engagement is when US investors, through pension, state and religious funds, joined together to pressure US business to end their support of apartheid. This was a major turning point to the end of apartheid.

More recently, in 2002 the pension funds of some religious orders, and other investors, led by a coalition of Catholic nuns petitioned General Electric to report on greenhouse gas emissions and the steps the GE Board could take to promote energy efficiency and deal with climate change. 23% of GE's investors gave support. The management then investigated and found that they could add \$10 billion or more in five years. In 2005 it announced its project called 'ecomagination' to do just that. (Questions need to be asked about strategic business models when one of the world's mightiest corporations, General Electric, needs a coalition of Catholic nuns to draw its attention to the business opportunities of energy efficiency.)

Extent and Limitations of SRI

EuroSIF has estimated that that SRI investment in Europe, Japan, Australia and New Zealand, Canada and the USA totals €4.963 trillion. Of this total 53% is European and 39% is USA based. They state that 17.6% (€2.665 trillion) of the European asset management industry can be classified as SRI. However, only 3.4% of this 17.6% is Core, where Core is defined as having more than two exclusions, a positive screening is applied, or combinations. Broad SRI (14.2% or €2.154 trillion) is where there is a single screen such as weapons (€656), norms-based (€402) or tobacco (€17.5). Broad also includes engagement or integrating the environmental, social and governance issues into traditional investing.

The Social Investment Forum USA estimates that 11% of \$US27.1 trillion under professional management is SRI (Social Investment Forum, 2007), but the bulk of this (77% or \$US2.098 trillion) is simple screening, mainly tobacco, followed by alcohol and gambling.

Because the definition of SRI is so broad, it is able to include investments that deal with only one facet of ethical behaviour. Hence the large majority of SRI includes support for company behaviour that is unethical. For example, only a very small percentage deals with investment that does not harm the planet's ecological systems. Paul Hawken states that SRI it is so broad that it is meaningless.

Sovereign Wealth Funds

Sovereign Wealth Funds, or the investment funds of governments, hold around 2% of traded securities and were estimated to be US\$3.768 trillion. Wealth from oil and gas comprise 60% of this total. Only Norway with US\$396 billion has an SRI policy in place. In terms of disclosure on performance, investment strategy or even basic philosophy, many SWFs rank below the most secretive hedge fund.

Norway has established the Council on Ethics to provide evaluation on whether or not investment in specified companies is inconsistent with established ethical guidelines. The Ministry of Finance makes decisions about its sovereign wealth fund on the exclusion of companies from the Fund's investment universe based on the Council's recommendations. Both the Ministry's decisions and the Council's recommendations are publicly available.

New Zealand Crown Financial Institutions (CFIs)

The Government's investment agencies are the New Zealand Superannuation Fund, The Accident Compensation Corporation (ACC), The Earthquake Commission, and Government's employee pension funds. In 2002 with the setting up of the New Zealand Superannuation Fund, a non-financial criterion was established, namely, to ensure that New Zealand's international reputation was not prejudiced. This criterion falls far short of even limited SRI.

Kiwisaver Initiatives

The background to the Kiwisaver initiative is the rejection by Robert Muldoon of Labour's (initiated by Roger Douglas) government supported superannuation scheme in 1975. Since then this matter has become a history of political expediency. It has been estimated that New Zealand's current superannuation assets are \$24 billion, compared to Australia's \$249 billion, made possible because of their introduction of compulsory savings in 1994. Per capita Australians have A\$56,000 of superannuation funds whereas New Zealanders have just \$5,500.

In 2007 the Government introduced Kiwisaver, a scheme whereby Government provides incentives for individuals to save with contributions from employers. As part of that scheme, Kiwisaver Funds are required to disclose their approach to responsible investing. There are currently four Funds that offer an ethical option. Approximately less than 1% of Kiwisaver Funds are SRI Funds.

New Zealand's Managed Funds Industry

The amount of money invested in this sector has been around \$60 billion. During the recent financial collapse there were no bank failures in New Zealand, but the managed fund industry has seen a loss of around \$6 billion, and nearly 50 finance companies have failed. Some of their directors are facing criminal convictions. This situation demonstrates an abysmal lack of SRI.

New Zealand: Council for Socially Responsible Investment

The Council for Socially Responsible Investment (CSRI) was legally established in 2003 as a charitable trust. It came from a working group of the Conference of Churches in New Zealand, but the trust is open to anyone and any organisation interested in these issues. Its purpose is to educate and advocate for investment necessary for a safe, just and sustainable world.

CSRI's second conference in 2005, assisted with a grant from Treasury, focused on the investing activities of the CFIs and how they were carrying out their responsibilities to invest so that New Zealand's international reputation was not prejudiced. Research on the CFIs found that they were not significantly excluding anything, and carrying out no engagement. It was found that they were all invested in tobacco, and companies with terrible labour and environmental records.

On the day of the conference the ACC announced that they would divest from tobacco. After the Conference a number of the CFIs started to take into account some government policies, and exclude investment in certain activities such as whaling and landmine manufacture, and engage with companies using UN criteria. A member of the New Zealand Parliament, Maryan Street, attended that conference, and during 2006 drafted a private member's bill to change the legislation. The Bill proposed amending individual CFIs governing legislation to ensure that

- a) CFI investment policy must be consistent with and governed by ethics which promote socially responsible and environmentally sustainable economic development;
- b) CFI investment policy must take into account international norms, conventions, declarations, covenants and treaties already supported, signed or ratified by the New Zealand Government.

The draft bill included the Swedish pension fund method of defining what is acceptable behaviour by saying that what the government has signed up to by way of international norms should be followed. When she became Minister of ACC in 2007 Maryan had to pass on her bill to another Member, but she asked the ACC what they would do differently if her bill had been passed. They replied, "We would divest our investments in the nuclear weapons industry". They subsequently did so.

In August 2010 Grant Robertson's private member's bill, aimed at introducing ethical criteria for the CFIs, was defeated in Parliament. The National and Act parties voted against it, mainly on the claim that the market could effectively establish ethical behaviour.

CSRI: Climate Change and Financial Sector Integrity

The issue of climate change has been the concern of a number of pension funds and insurance companies which need to take a longer-term view of their assets. The issue was developed by The Carbon Disclosure Project begun in 2000 is a process of seeking many large institutional investors to disclose information on their greenhouse gas emissions. It was initially sent to FT500 largest companies in the world. This is but one of a number of examples where ecological degradation has become a concern of investors.

During the last few years there has been a serious failure of the financial sector nationally and internationally. ('Financial sector' is used in a fairly broad sense to include financial analysts and advisors, investment and fund managers, managed funds managers, managed fund trustees, trading banks, and traders and aggregators of financial securities.¹) The traditional SRI model is based on the assumption that the financial sector as a whole, and the economic principles on which it is based, do not need to change. This is a false assumption. The international finance sector is a complex, interdependent system that is prone to conflicts of interest. Fraud and unethical behaviour has been rampant in the sale of subprime mortgages and derivative securities. The financial returns to bankers and fund managers tend to favour their interests rather than those of investors and do not adequately take into account risk or performance, or the longer-term consequences of their actions.

A 2009 survey of 16 US and 24 non-US banks representing more than 60 percent of the total market capitalisation of the global publicly traded banking sector showed that many of the 40 banks have done little or nothing to elevate climate change as a governance priority. It was concluded that the actions to date are the tip of the iceberg (a telling metaphor) of what is needed to reduce greenhouse gas emissions consistent with targets scientists say are needed to avoid the dangerous impacts of climate change. Other surveys provide similar findings.

The challenge of climate change, the failures of the international financial sector, with the realisation of the unethical nature of many SRI funds, has led CSRI to re-examine the basic assumptions under which it began. In particular, there has been a focus on risk. The broad assessment of climate change and ecological degradation is well established in the scientific community: there are major threats to large parts of the planet's capacity to support human life and a significant part of that is due to human economic activity. The Business As Usual model is not sustainable. The investment community is therefore facing unprecedented challenges that mean that the normal business cycle is being overtaken by more fundamental shifts that will drive global economic activity. The major global change drivers to 2030 and beyond will include critical issues around population; climate change; price increases for hydrocarbons; water; food; toxins; geopolitical shifts; wide swings in economic activity; technological advances.

¹ There is a wide array of interdependent matters pertaining to the financial sector which impact decisions relating to financial investments and financial markets. Some examples are: the excessive and uncontrolled creation of debt, speculative international trading of sovereign currencies, globalisation, transfer pricing, the presence or otherwise of exchange controls, the quality of financial reporting and especially the non-inclusion of a wide range of intangible assets and liabilities, the absence of reporting on the stocks and flows of environmental and social capital, the scope of audits of financial reports and the transparency and fairness of fees charged to investors. Other issues relate to the scope of the jurisdiction of market regulators, their level of pro-activity and the speed at which they act. Other dimensions include the level of fees and charges of receivers and liquidators and other advisors, and remuneration of directors and senior personnel. Overarching all of this is ethics.

CSRI has tried to address the challenges of ecological degradation into how to invest in a socially responsible and environmentally sustainable way. The discussions have focussed on likely and desirable scenarios, and how to transition to such futures that will be complex and turbulent. How to hold the tension of the need to face a difficult future, with the immediate demands of the BAU requirements, has not been easy. In 2009 CSRI, with Sustainable Aotearoa New Zealand, ran workshops on how to incorporate these global drivers into risk analysis for investors. In 2010 the CSRI Conference was titled *Investment Solutions for a World in Jeopardy: How to invest to Save the World rather than Destroy it*.

Policy Issues for New Zealand

During the last few years national and international financial systems have demonstrated their inability to carry out one of its basic functions, namely, to receive deposits from investors and channel those safely and efficiently to organisations which provide goods and services for the benefit of society at large. Investors seek a financial system which adequately identifies risk and gives fair protection and return. The current system does not do this. In addition to the need for proper regulations, the financial sector needs to take into account the threat to human life on Earth posed by serious and substantial ecological and social deterioration. The current system does not do this either. Unless there is a rapid switch of investment away from activities that cause and contribute to ecological and social degradation, towards investment that provides solutions, then the future for humans is bleak. Investment in such a turbulent future will be difficult.

Reforms of the current New Zealand financial sector should include the introduction of proper regulation of the managed funds industry, including greater transparency and accountability. The CFIs should have ethical criteria. The establishment of a Council like Norway's Council of Ethics should also be considered: recommendations for exclusion would then be made by a group of people with appropriate skills and knowledge, and who represent a wider section of the community other than the financial sector. There is also advantage in the wider debate and dissemination of the issues involved.

The financial sector should be required to adopt policies that include criteria for lending that adequately identify risks, including environmental degradation and resource depletion risks. The creation of credit and where that credit is directed should be more closely controlled. Where the market does not provide socially responsible investment that is environmentally and socially sustainable, consideration should be given to appropriate taxes and other incentives, together with the establishment of a Sustainability bank.

Consideration should again be given to the Government setting socially responsible and environmentally sustainable standards and policies for all its departments, agencies and enterprises, and to territorial local authorities. These should be extended to all its suppliers, distributors and agents. Kiwisaver and New Zealand Superannuation Fund funds should be part of the mix of policy initiatives. There should be strategies adopted for the transition to a more sustainable future, by encouraging initiatives such as clean technology and renewable energies.

References

Many of the references are available via www.csri.org.nz. Otherwise contact Dr Robert Howell howellnz@gmail.com