



Ethical Investment Association

This submission is in response to the Inland Revenue's second consultation document, and is made by Dr Robin Keyte on behalf of the Ethical Investment Association (EIA) (www.ethicalinvestment.org.uk).

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1. Addressees

The content of this submission also contains details of relevance to HM Treasury, so the intended recipients can be listed as follows:

- David Dodd, Policy Officer, Pensions Simplification Team, Inland Revenue, Room 134, New Wing, Somerset House, Strand, London WC2R 1LB
- Keith Davis, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ

2. Introduction

This submission has two objectives:

- 1) Respond to the Audit & Pension Scheme Services Second Consultation Document on matters of concern to the EIA.
- 2) Engage with HM Treasury on the matter of the existing tax treatment of retail pension funds that adopt the approach of ethical investing / socially responsible investing (EI/SRI).

There is significant overlap in our response on the above, and we are keen for both the Inland Revenue and HM Treasury to be aware of our submission.

3. Pension Investments

We are mostly in favour of the proposals to allow pension funds broadly unlimited powers of investment.

There are unquoted shares in sustainable forestry projects and social housing schemes that many EI/SRI clients have previously been unable to invest in. Under the proposed new rules, these unquoted shares will become allowable investments.

However, we do have one major concern which relates to the idea of a Statement of Principles (SIP). We are concerned that if retail pension investors are given the widest possible powers of investment, they will not give due consideration to the ethical, social or ecological return associated with their underlying pension assets.

At the present time, it is only institutional pension funds that have to declare a SIP, as a result of the Welfare & Pensions Reform Bill 2000, which amended the Pensions Act 1995. The SIP requires the pension scheme trustees to declare:

- a) "The extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments"
- b) "The policy (if any) directing the exercise of rights (including voting rights) attaching to investments"

Unfortunately, retail pension funds are not subject to any such requirement at the present time. We are concerned about this, especially since the results of research carried out by Friends Provident / NOP (August 2003) clearly indicate that the majority of the public harbour concerns over EI/SRI.

Indeed, out of 998 people aged 15 or over, **a massive 76%** said they did not want to invest in companies with poor Social / Ethical / Environmental (SEE) policies.

Taking a very simple example, one of the most common EI/SRI concerns is pornography, and yet most retail UK equity pension funds hold shares in BSkyB, which is a distributor of pornography.

If the proposals for unlimited powers of investment for pension funds are to proceed, we would like to see clear disclosure guidelines for retail pension funds brought in at the same time. The guidelines should ideally force all retail pension funds to declare a SIP, and to print it in their key features / key facts literature.

4. Low Profile of EI/SRI

Further to the above, we are concerned that SIPs for retail pension funds and clearer disclosure may not be enough to effectively raise the profile of EI/SRI.

It is our belief that at the present time, most financial advisers either:

- do not ask clients if they are interested in ethical investment
- ask their clients about ethical investment in a negative and closed manner, using phrases like:
 - i) ethical investment is considered to be higher risk, do you want that?
 - ii) ethical investments are usually poor performers, you don't want that do you?
 - iii) you are not interested in ethical investment, are you?

In reality, UK ethical funds are not necessarily higher in risk, or worse in performance, than any other typical UK equity funds. Indeed, West LB Panmure published a report in November 2002 on SRI titled 'More gain than pain', which found that, in relation to SRI, there was "no sign of a systematic performance disadvantage".

However, the problem remains that members of the public, the majority of whom do not want to invest in companies with poor Social / Ethical / Environmental (SEE) policies, are not getting information about EI/SRI, or advice on EI/SRI.

We believe an effective solution to this problem would be to allow the reclaim of the dividend tax credit for EI/SRI retail pension funds holding UK shares.

5. Dividend Tax Credit

The reclaim of the dividend tax credit on EI/SRI retail pension funds would elevate the profile and attraction of EI/SRI funds so that more investors would become aware of them and interested in investing in them. Equally more financial advisers would be forced to advise their clients about them, as they would represent a more tax efficient option compared to 'mainstream' pension funds.

We conservatively estimate the total screened EI/SRI retail pension funds in the UK at £2 billion, and believe in reality that they may be comfortably less.

Most UK equity holdings in EI/SRI funds are medium sized companies with small dividend yields or no dividend yields at all. Normally, only 15 – 30 FTSE 100 companies will pass the ethical screening process.

As a consequence, there are only 2 EI/SRI UK equity income funds in existence, which are Friends Provident Stewardship Income and NPI Global Care Income. All other EI/SRI UK equity funds fall into the UK All Companies category.

We therefore conservatively estimate the average gross dividend yield on the UK share holdings in an EI/SRI pension fund to be around 3%.

Applying the estimates for retail pension funds invested and average dividend yield, we can estimate the annual cost to HM Treasury in lost tax revenue in relation to a reclaim of the dividend tax credit as:

$$£2 \text{ billion} \times 0.3\% = \underline{\underline{£6 \text{ million}}}$$

In relative terms, this is a very small and insignificant cost to HM Treasury. Furthermore, it should be borne in mind that amongst other things, EI/SRI funds encourage companies to adopt:

- i) satisfactory controls that will help to avoid the pollution of the environment
- ii) a responsible approach to employee / welfare rights

The successful performance of these two areas alone will help to reduce the potential cost to the taxpayer (i.e. HM Treasury) in the areas of environmental pollution and employees falling out of work and drawing on the state benefit system. We therefore believe the ‘net cost’ to HM Treasury would actually be less than £6 million.

6. EI/SRI Fund Information

We propose that the reclaim of the dividend tax credit should only be applied to retail EI/SRI funds that adopt negative screening. Briefly, EI/SRI can work in three ways:

- a) negative screening, which excludes shares / companies on the basis of certain specific criteria
- b) positive screening, which includes shares / companies on the basis of certain specific criteria
- c) engagement, which involves contact with companies and the use of shareholder voting rights

In reality, most UK EI/SRI retail pension funds adopt negative and positive screening, and many engage. Furthermore, if there was a desire to show this approach as a force for good, eligible funds could be those that apply negative screening AND engagement.

7. Pensions Good News Story?

Pensions in general have received a lot of bad press lately, so this could make a very good positive news story for pensions, which could encourage the public to think again about investing in pensions. EI/SRI retail pension funds could be held up as truly tax free pension funds, that:

- vote against fat cat pay deals (e.g. GlaxoSmithKline, HSBC)
- pressurised pharmaceutical companies into relaxing patent restrictions on anti-AIDs drugs in Africa
- do not support environmental pollution, oppressive regimes, pornography etc

This concludes our submission, which we hope you will view in a sympathetic and positive manner.

About the Author

On leaving university in 1996 with a PhD in Chemistry, Robin Keyte joined the family firm and trained as a fee based financial planner. Robin is now one of the most highly qualified financial planners in the UK, holding the Associate of the Society of Financial Advisers (ASFA) qualification.

Robin was one of the founder member's of the Ethical Investment Association, and sits on the following committees:

- Ethical Investment Association Steering Group
- UK Social Investment Forum Retail Sub-Committee
- British Standards Institute SVS6 Technical Committee (ISO for Competencies of a Personal Financial Planner)

Robin is also closely involved in the Business Ethics Forum, the Exam Review run by the Skills Council for Financial Services and a number of examination bodies that provide financial planning exams.