Ethical Investment Association

UK Social Investment Forum

Investing Responsibly –

Raising Awareness with UK Financial Advisers

November 2005

This submission is made on behalf of the Ethical Investment Association (EIA) and the UK Social Investment Forum (UKSIF). Further information on each organisation can be found on our respective websites: www.ethicalinvestment.org.uk and www.uksif.org.

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1.0 Executive Summary

The EIA and UKSIF believe the awareness and knowledge of UK financial advisers to responsible investment needs to be quickly and substantially improved. At the present time, there is:

- a low level of consumer awareness and consumer protection aimed at meeting consumers' values-based needs. Yet there is high demand and growth in ethical consumerism and consumer concern for issues such as corporate transparency, environmental protection, sustainability, fair trade, oppressive regimes etc.

- for most adviser firms, there is a related gap in the know your client fact-finding procedures for ethical, social, environmental and religious concerns. Only 14% of 35 top IFA firms surveyed in Summer 2005 were able to quote a fact-find question in this area from their standard client questionnaires. This is combined with misconceptions about performance and charges of responsible investment funds.

- a low awareness of the variety of asset classes available with responsible investment (e.g. cash, corporate bonds, UK equities, overseas equities, commercial property, EIS etc).

- a low awareness of the relevant responsible investment disclosure guidelines for stakeholder Child Trust Funds; group stakeholder pension schemes and occupational pension schemes to take account of social, environmental or ethical considerations in investment decisions.

- a requirement for candidates of the Investment & Risk module in the FSSC Appropriate Examination Standard for Retail Investment Advice "to understand the role of ethical investment and socially responsible investment in financial advice" resulting in chapters on responsible investment in the textbooks for the new Investment & Risk exams. Newly trained IFAs will have a grounding in responsible investment, but there is no similar vehicle to update qualified, practicing IFAs.

- a clause in the draft international standard (ISO 22222) for the competencies of a personal financial planner requiring advisers to ask clients about their 'attitude to social, ethical, environmental and religious considerations'. A similar requirement is included in the proposed consultation for performance standards for generic financial advice provision.

- a demand for training on responsible investment from the Financial Ombudsman Service.

- a potentially substantial conflict with the Treating Customers Fairly initiative for advisers who do not discuss responsible investment with their clients.

The EIA and UKSIF are **NOT** looking for rule changes, fines or a major new initiative. **NOR** are we suggesting that FSA recommends or endorses particular products or services. However, we would welcome the opportunity to engage with the FSA to discuss how we might update and raise advisers understanding of responsible investment. We have identified the following as three potential courses of action:

a) the publication of an Occasional Paper on Responsible Investment, setting out what it is, and how advisers can incorporate it into their advice process. The EIA and UKSIF would be happy for the FSA to draw upon our Toolkit on Responsible Investment for Financial Advisers (enclosed) and to contribute to the drafting of the paper if helpful.

b) inclusion of information or links to an appropriate document, in the FSA Small Business – IFAs Homepage and relevant areas appropriate for other adviser groups including multi-ties.

c) the gentle encouragement of financial advisers to include responsible investment in their advice process as a matter of best practice (e.g. during compliance monitoring visits etc).

2.0 Raising Awareness of Responsible Investment

We wish to engage with the FSA on the matter of raising awareness of responsible investment with financial advisers and also with the public.

In particular, this submission will focus on raising awareness with financial advisers, why we think action should be taken and how we think action might be taken.

For your information, we have written to Callum McCarthy, David Kenmir, Clive Briault and Vernon Everitt on this matter, and have provided copies of correspondence to Deirdre Hutton, John McFall MP, Hilary Armstrong MP, Diane Hayter, the Financial Services Consumer Panel and the Financial Services Practitioner Panel.

3.0 Why Should Financial Advisers Be Aware Of Responsible Investment?

There are a number of reasons why financial advisers should be aware of responsible investment, which we list below.

3.1 Consumer Awareness, Consumer Protection & Growth in Ethical Consumerism

There are over 60 screened responsible investment funds available at the present time, plus engagement-only funds. Consumers are being denied these choices of investments, as most financial advisers either do not ask clients about responsible investment when fact-finding (see 3.2), or are not equipped to deal with a positive response where a client is interested.

Latent Consumer Demand & Growth in Ethical Consumerism
Lack of advice in this area is particularly significant given the findings of a survey conducted by Friends Provident / NOP (August 2003) which indicate that the majority of the public may be receptive to the concerns addressed by responsible investment. Out of 998 people aged 15 or over, 76% said they did not want to invest in companies with poor Social / Ethical / Environmental (SEE) policies. (Whilst some respondents will profess an interest in ethical issues when surveyed because it appears to be the appropriate answer, this survey - and other similar polls - illustrate significant consumer interest in corporate responsibility, business ethics etc. Even if half the respondents answered yes on impulse, it would still leave a third of consumers concerned about SEE issues). Evidence of consumer interest is supported by the growth in the annual *Co-operative Bank Ethical Purchasing Index* which calculates that ethical consumerism in the UK increased by £3.5bn last year to a new high of £24.7bn.

Lack of Consumer Awareness
Such findings contrast with the fact that less than 5% of the investing population (i.e. 450,000 policy holders) according to the Ethical Investment Research Service (EIRIS) currently invest in ethically screened funds.

It is our view that the current situation whereby consumers are expected to be aware of responsible investment and request advice on it without the prompt of relevant fact-find questions is inappropriate and out of line with the way other products and services are offered. We believe this is directly relevant to the FSA's statutory objective on public awareness and promoting understanding of financial services.

Lack of Adviser Awareness & Consumer Protection
Where advisers are failing to recognise clients' non-financial concerns, consumers are not being well served and may suffer a detriment. Whilst in most cases the detriment will be non-financial, ignorance from advisers could be financially detrimental to the client in some circumstances.

We refer to the Financial Ombudsman Service (FOS) publication Ombudsman News, and Issue 31 dated September 2003. On page 11, the first of the Investment Case Round-Ups refers to an "Ethical" Investment bond. This complaint related to advice received by an elderly couple wishing to invest their life savings with an ethical company(ies).

The adviser's knowledge of ethical investment was restricted to screened equity funds that were named / branded as ethical funds, so he sold them a screened equity investment into an investment bond, which was completely at odds with their low risk profile.

Regrettably, the adviser was completely unaware that deposit based savings accounts were available with banks employing ethical policies such as Co-Op or Triodos.

We believe this point is directly relevant to the FSA's statutory objective on consumer protection. In the FOS case study, consumer protection would partly have been provided by the quality of advice, and we note quality of advice is specifically mentioned in the rationale behind the regulation of transactions.

Government Objectives
Whilst we recognise the FSA's four specific statutory objectives, it may also be appropriate to note Government support and interest in responsible investment e.g. via disclosure guidelines (see 3.4 below), DFID and DEFRA links with UKSIF, and responsible investment's links to Government's objectives on sustainable development, enterprise for all and the financial inclusion agendas.

3.2 Know Your Client

Arguably, the single most important part of the financial advice process is fact-finding. However, a 2005 UKSIF survey of 35 top IFA firms revealed that only 14% (5/35) firms were able to quote fact-find question on ethical concerns from their standard fact-find. None of those quoted included the words environmental, social or religious concerns in their phrasing. Over 70% of firms did not provide training for advisers on ethical and socially responsible investment and 90% of firms did not include it in advisers training needs analysis for CPD.

We believe all financial advisers should ask their clients whether they want responsible investment considerations to be taken into account in any investment advice. This in our view is a true fulfilment of the know your client requirements.

Many clients will not have any concerns or preferences in this area, and in some circumstances there may not be a suitable product for the adviser to recommend. But we believe clients should be asked and advisers should undertake CPD to ensure they have a broad understanding of the investment options available to responsible investors.

A lack of fact finding (i.e. not even asking clients about responsible investment), presumes the adviser knows best for the client, without giving the client the opportunity to state their views.

We believe the failure of advisers to ask about responsible investment is a point of concern on the matter of the FSA's statutory objective on public awareness of financial services and your broader objective of helping retail consumers achieve a fair deal. When consumers receive investment advice, how are they going to know about responsible investment unless their adviser asks / tells them about it? It is a substantial and potentially dangerous presumption to assume investors are that well informed.

We also believe the failure to include responsible investment in the advice process is a point of concern on the matter of the FSA's statutory objective on consumer protection and the rationale behind that on quality of advice.

3.3 Investment Performance & Classes of Investment

There have been various studies to see whether there is any performance disadvantage in adopting a responsible investment approach, the majority of which have found no disadvantage. Many advisers are unaware that screened ethical funds can deliver performance and that such funds do not systematically charge more.

The IMA state on their website that ethical funds perform more or less on a par with non ethical funds.

Recent academic research published in the Journal of Business, Finance & Accounting, 32(7) Sept/ Oct 2005 p1465, has also added to the evidence that there is no systematic under performance by screened ethical funds. Using a matched pair analysis the paper studies the performance of 30 ethical and 30 non-ethical funds between 1995 and 2001. The paper finds that there is no difference between ethical and non-ethical funds according to the performance measures employed.

In 2002 West LB Panmure published a report on responsible investment titled 'More gain than pain', which found that, there was "no sign of a systematic performance disadvantage" in relation to responsible investment.

Additional such research is cited in UKSIF's chapter on performance in the Technical Guide for Financial Advisers enclosed in the toolkit (see pp 17-20).

On the matter of investment risk, it should be noted that at the present time, the following classes of investment are available as responsible investment:

- cash deposit savings
- corporate bonds funds
- commercial property funds
- UK equity funds
- protected/guaranteed funds
- overseas equity funds
- enterprise investment scheme

This means investors interested in responsible investment do not have to be higher risk equity investors.

3.4 Child Trust Funds & Group Stakeholder Schemes & Occupational Pension Schemes

If financial advisers are going to provide competent advice on child trust funds, group stakeholder schemes or occupational pension schemes, we believe they must have a reasonable understanding of responsible investment.

We refer to FSA CP 04/10 titled Child Trust Funds. Page 17 of Annex F Child Trust Funds Regulations 2004, under "Account provider – qualifications and Board's approval", part 14(2)(vi) reads as follows:

"to publicise (and up-date where appropriate) statements of the extent to which social, environmental or ethical decisions are taken into account in selecting, retaining or realising investments".

We also refer to Statutory Instrument 1999 No. 1849 Pensions: The Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc) Amendment Regulations 1999. Under "Amendment of the Occupational Pension Schemes (Investment) Regulations 1996", the following text is inserted after regulation 11:

“Additional content of statement of investment principles
11A. The matters prescribed for the purposes of section 35(3)(f) of the 1995 Act (other matters on which trustees must state their policy in their statement of investment principles) are:

(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; and

(b) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.”

For the purpose of the above amendment, group stakeholder schemes are treated as occupational pension schemes.

3.5 New Financial Planning Exams

Further to the Financial Services Skills Council exam review, responsible investment is now included in the syllabus for the Investment & Risk module in the FSSC Appropriate Examination Standard for Retail Investment Advice. Part U5 in the syllabus for the Investment & Risk module reads:

"On completion of this module, candidates will be expected to demonstrate an understanding of the role of ethical investment and socially responsible investment in financial advice"

“Indicative content for each learning outcome:
1. Socially responsible investment – portfolios with social, ethical, environmental and financial goals, including ethical investment.
2. Ethical investment – portfolios based on ethical, social or environmental values where companies have been specifically excluded or selected as a result of their activities or behaviour, eliminating investments that meet negative criteria, while including those that meet positive criteria.
3. Possible implications for investment performance".

Whilst this should ensure that trainee financial advisers sitting exams from October 2004 onwards should be aware of and have a reasonable understanding of responsible investment, previously qualified financial advisers cannot be guaranteed to have such knowledge.

Responsible investment should be integrated into CPD to ensure previously qualified advisers are made aware of responsible investment, and recently qualified advisers can keep up to date. UKSIF research in summer 2005 found that only 10% (3/30) of the top IFA firms included ethical or responsible investment in advisers training needs analysis.

3.6 International Standard for the Competencies of a Personal Financial Planner

The draft International Standard includes the following text under ISO 22222 4.3 part j:

“Gathering client data and determining goals and expectations. The financial planner shall request appropriate data that should normally include attitude to social, ethical, environmental and religious considerations”.

The draft goes on to state that the adviser shall use the information to provide to the client with an evaluation that identifies areas of strengths and vulnerability, comparing them against the client’s goals, plans, restrictions and assessment of financial risk tolerance. The adviser should make the legitimate interests of the client paramount, act objectively and recommend solutions that fit the client’s situation, including the client’s goals and preferences (4.4.3 - 5.2.7). This, in our view, represents good practice and we would like the FSA to support similar practices.

3.7 Performance Standards for Generic Financial Advice Provision

The Financial Services Skills Council is currently consulting on the above. The current Consultation Draft 2.2 states that the generic financial adviser should:

“Be aware of products and services that have a religious / ethical theme such as Islamic mortgages, ethical funds”.

(See Draft 2.2 of the National Standard – under “Core specification for knowledge and understanding underpinning the National Standards for providing Generic Financial Advice”, “Knowledge & Understanding”, Item 5 “Savings and Investments”).

If this wording is maintained in the National Standard then the curious situation may arise whereby generic financial advisers will know more about Responsible Investment products and services than most financial advisers.

3.8 Financial Ombudsman Service (FOS)

In February 2004 a representative of UKSIF was invited to provide training to FOS on responsible investment. The training session was one of the most highly attended by FOS case handlers and a further invitation has been issued as a result for another session in the future.

It is our understanding that where relevant, the FOS is now taking into account whether or not responsible investment advice was provided to a client when considering complaints.

3.9 Treating Customers Fairly (TCF)

Under the TCF initiative we believe financial advisers should give consideration to the responsible investment concerns of their clients.

Clients for whom ethical, social or environmental issues are important, should be able to expect them to be taken into consideration in their financial planning in the same way as in other aspects of their life. The difference between financial services and other products and services they use or purchase is knowledge and understanding.

Lack of public knowledge about responsible investment should not be an excuse for the FSA or advisers to ignore the subject or decide that lack of advice in this area is appropriate or fair. To carry out fact-finding without an ethical, social, environmental question, or without being able to explain what responsible investment is when asked, can hardly be described as treating customers fairly.

The FSA’s Consumer Research paper 38 ‘TCF: The Consumers View’ notes consumer views of fairness are inextricably tied up with many aspects of customer service. The paper highlights several case studies where consumers deemed it unfair when they were not advised of the most suitable product (pp17-18). Recommendations in chapter 7 include ‘offering the customer the best product you can’ and being clear about the products (or services) on offer – and what is excluded. Whilst the recommendations have not been written with responsible investment in mind, they are clearly relevant to the provision (or lack of provision) of responsible investment advice.

Furthermore, there is a need to treat customers fairly on religious grounds. Callum McCarthy’s speech to the Financial Inclusion Forum on 27 June 2005 highlighted his concern about “the financial exclusion of those who wish to practice their religion and who find themselves, for that reason, without access to the financial products and services which would meet their needs." In recognition of such concerns, the FSA authorised the first Islamic Bank in Europe in 2004. However, this has had little impact on financial advice.

Other examples of religious concerns impacting on financial services include:

- the Quaker & Methodist movements, whose supporters seek to invest in line with their principals relating to non-violence, disarmament, communities, human rights, education etc.

- the Christian Brethren, who successfully lobbied for amendments to the HMRC (Inland Revenue) pensions simplification proposals which has led to the creation of a new concept – the Alternatively Secured Pension.

3.10 Comments

Whilst each one of the above reasons may not in itself be just cause for FSA to recognise responsible investment, we believe the combination of all nine make for a very compelling argument indeed.

We believe that consumers interested / potentially interested in responsible investment are being ignored at the present time, and hence are being failed by the current financial services advisory regime.

We would like financial advisers to be educated to the extent that they can either:

- identify a client interested in this area and refer them to an adviser with higher levels of knowledge and training on responsible investment, or

- acquire training themselves so that they are able to provide competent advice on responsible investment.

4.0 What Action Might Be Taken?

The EIA and UKSIF are **NOT** looking for rule changes, fines or a major new initiative. **NOR** are we suggesting that FSA recommends or endorses particular products or services. However, we would welcome the opportunity to engage with the FSA to discuss how we might update and raise advisers understanding of responsible investment. We have identified the following as three potential courses of action:

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The toolkit is geared towards introducing financial advisers to responsible investment and helping them to incorporate it into their advice process. The toolkit contains a 5-step advice path, two ethical fact finds, a 24-page technical guide and letter of endorsement from Paul Smee, former Director General at AIFA. It is available at www.uksif.org for free and a copy is enclosed.

b) inclusion of some type of informative document or link to an appropriate document, in the FSA Small Business – IFAs Homepage and other relevant areas appropriate for other adviser groups including multi-ties.

c) the gentle encouragement of financial advisers to include responsible investment in their advice process as a matter of best practice (e.g. during compliance monitoring visits etc).

5.0 About the EIA and UKSIF

The EIA is a not-for-profit training and membership organisation established in 1998 by financial advisers practising responsible investment for the benefit of financial advisers active in this area. The EIA holds training days in London and Birmingham each year. Therefore there is an existing resource dedicated to training financial advisers on the subject of responsible investment.

The UK Social Investment Forum is a not-for-profit membership organisation that also offers support for advisers, including training and a Toolkit on Responsible Investment for Financial Advisers developed with input from fund providers and advisers. Outreach activities with IFAs have recently included working with IFA Promotion, MoneyMarketing, the Personal Finance Society (PFS) and individual interested adviser firms.

We hope you will give this submission reasonable consideration and would welcome the opportunity to meet with you to discuss these matters and any related issues further.

Yours sincerely

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Steering Group, Ethical Investment Association

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Chief Executive, UK Social Investment Forum

Appendix 1 What is Responsible Investment?

There is no single universally accepted definition of responsible investment, but the following is offers a reasonable summary. Further information about responsible investment is available in UKSIF's Technical Guide for Financial Advisers.

Responsible investment is the construction of investment portfolios whose objectives combine social, environmental, ethical and financial goals. Responsible investment strategies may be employed for a variety of reasons, such as individual client values, performance or investor responsibility.

Responsible investment also often includes responsible share ownership, where there is direct communication between the asset management firm and investee companies on social, environmental and ethical matters.

Ultimately, asset management firms can use the voting rights attaching to the shares held as a further method of persuasion. The purpose of engagement may be to encourage investee companies to build or protect shareholder value through highlighting social, environmental or ethical risks and opportunities or to adopt a better approach overall to business ethics. A high profile example of engagement in practice was the shareholder revolt against the proposed 'fat cat pay deals' for executives at Glaxo Smith Kline in 2003.

Responsible investment is increasingly being viewed as an effective force for positive change. Some funds/ fund managers employ an engagement-only strategy, where stock picking is not normally affected by ethical screening decisions, but rather where improvements in shareholder value are sought.

By comparison to the above, the traditional retail form of responsible investment, commonly referred to as 'ethical investment' involves screening, usually on the basis of Avoidance or Support. Avoidance, or negative screening, is the practice of excluding companies from the list of allowable shares or bonds on the basis of specific criteria, which might include one or more of the following:

- alcohol production and sales and youth drinking
- animal testing (including or excluding pharmaceutical trials)
- directors' pay awards unrelated to performance (fat cat pay deals)
- genetically modified food / organisms
- global warming
- hole in the ozone layer
- human rights violations
- nuclear power / waste
- pesticides in food and water
- pornography and the exploitation of women
- poverty at home and abroad
- racial, sexual or age discrimination
- selling arms to military regimes
- tobacco and youth smoking
- unequal opportunities and workers conditions in poor countries

Support, or positive screening, is the practice of including companies on the basis of specific criteria, which might include the adoption of good policies on some of the above issues, as well as one or more of the following:

- community involvement
- adopting an environmental policy and reporting on that policy
- environmental management
- packaging reduction
- sustainable forestry

You will quickly grasp from the above that responsible investment is not rocket science. It is fairly easy to pick up the basic concepts and understand them.