



# Investor Capitalism, Sustainable Investment and the Role of Tax Relief

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## Abstract

This contribution examines the connection between investor capitalism and sustainable investment. It will be observed in this article that investor capitalism has gone through a structural change. Individual investors have been replaced by funds. Financial service providers have emerged that assist investors in managing and holding investments. This development coincided and was arguably facilitated by the growth in workplace and personal pensions. Pensions are subsidised by the government through tax relief. This financial contribution of the government is justified on social policy grounds. But it has the effect that pension savers, who receive substantial return by saving tax, are deprived of a reason to take an interest in how their money is invested. This not only deprives the service providers assisting pension savers from oversight from their ultimate customers. It also can help to explain why pension savers do not actively select investment products but rely on the default settings suggested by their employers. If the government is serious about encouraging investor capitalism to bring about sustainable business it should start with its own financial contribution, which has coincided with the emergence of the current model of investor capitalism, and connect pension tax relief to sustainable investment practices.

**Keywords** Sustainable investment · Green investment · Social investment · Pension tax relief · ESG · Stewardship · Sovereign wealth funds · Retail investors · Workplace pensions · Personal pensions · Pension trustees · Independent governance committees · Auto-enrolment · NEST · Disclosure · Kay Review

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## 1 Introduction

The aim of this contribution is to examine the connection between investor capitalism and sustainable business. We view investor capitalism broadly as encompassing not only institutional investors dominating corporate governance – as Useem’s book famously promulgated<sup>1</sup> – but also retail investors. Investor capitalism, thereby, refers to all types of investors and their direct or indirect relations with directors and managers rather than merely focusing on intermediaries as a new kind of ‘engaged owners’.<sup>2</sup> We do not take a normative view on the conventional wisdom that investor capitalism has an agency-cost-minimising effect,<sup>3</sup> but we aim to place it within sustainable finance. It is observed that investor capitalism – the ascendant of managerial capitalism in the US and the UK – has gone through a structural change. In the 1960s investors were predominantly individuals, who were assisted by brokers and invested with a strategy that matched their individual preferences. Today investors are mostly nominee companies acting for funds. Since the mid-twentieth century financial service providers – defined broadly as encompassing investment companies, fund managers, pension funds, brokers, proxy advisors, ESG data providers, investment consultants etc. – have emerged that assist investors in managing and holding investments. This development coincided and was arguably facilitated by the growth in workplace and personal pensions. The UK Competition and Markets Authority (CMA) observed in 2018 that 90% of the revenues of investment consultants and fiduciary managers is derived from pensions.<sup>4</sup> Pensions are subsidised by the government through tax relief. This financial contribution of the government is justified on social policy grounds. But it has the effect that pension savers, who receive substantial return by saving tax, are deprived of a reason to take an interest in how their money is invested. This not only deprives the financial service providers assisting pension savers from oversight from their ultimate customers. It also can help to explain why pension savers do not actively select investment products but rely on the default settings suggested by their employers. If the government is serious about encouraging investor capitalism to bring about sustainable business it should start with its own financial contribution, which has coincided with the emergence of the current model of investor capitalism, and connect pension tax relief to sustainable investment practices.

The paper is structured as follows. In Sect. 2 we will examine two factors motivating investment decision: financial return and altruism. We will see that the empirical evidence as to whether sustainable investment practices enhance return is mixed. This suggests that, while there is no clear financial case for investors to favour sustainable investment products, a bias towards such products also does not

<sup>1</sup> Useem (1996).

<sup>2</sup> See also Katelouzou (2018).

<sup>3</sup> But see Gilson and Gordon (2013).

<sup>4</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 29, para. 1.14.

appear to cause significant financial harm. This is encouraging from the perspective of a governmental decision on how tax relief should be best designed. Sustainable investment practices can also be justified on the basis of altruism. Ecological and social consideration play an increasing role in the public discourse and it is possible to justify a decision of the government to bring pension tax relief in line with environmental, social, and corporate governance (ESG) goals.

In Sect. 3 three groups of investors and their investment preferences will be examined. We will distinguish large portfolio end-investors, small portfolio end-investor and beneficiaries of workplace and personal pensions and conclude that in the UK the vast majority of these investors fall into the third category.

Section 4 will discuss the role of the intermediaries serving these investors. We will see that they are bound by contracts that require them to deliver financial results. They are required to integrate sustainability as a risk factor but that does not permit them to prioritise sustainability over return.

In Sect. 5 we will examine the role of the government as a regulator but also as a financial investor and conclude with the suggestion that the government should fully appreciate its role in pension investments and design tax relief in a way that integrates sustainability criteria.

## 2 Motivations for Sustainable Investment

Sustainable investment is rising in popularity and growing in volume, but a clear and universal definition is still missing.<sup>5</sup> The Global Sustainable Investment Alliance – a collaboration of membership-based sustainable investment organisations worldwide – defines sustainable investment as an ‘investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management’.<sup>6</sup> The EU Sustainable Finance Disclosure Regulation adopts an all-round definition of sustainable investment as an ‘economic activity that contributes to’ an ‘environmental’ or ‘social’ ‘objective’, but the ‘G’ of ESG seems to be excluded.<sup>7</sup> Others use the terms sustainability investment, responsible investment, socially responsible investment (SRI), impact investment and ESG investment interchangeably.<sup>8</sup>

In this paper we understand sustainable investment broadly as referring to the consideration of environmental, social but also governance factors in all investment decisions. Sustainable investment includes strategies that seek to improve ESG policies or prevent bad decisions through active (but not necessarily activist) monitoring, voting and engagement.<sup>9</sup> This is often referred to as ‘active ownership’ or

<sup>5</sup> See, e.g., Sandberg et al. (2009) for an early discussion of the ‘heterogeneity’ of SRI.

<sup>6</sup> [http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR\\_Review2018.3.28.pdf](http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf), p 3 (accessed 4 Oct 2021).

<sup>7</sup> Article 2(17).

<sup>8</sup> For a literature review see Talan and Sharma (2019).

<sup>9</sup> Katelouzou (2022).

‘shareholder stewardship’.<sup>10</sup> But sustainable investment also encompasses a broad remit of investment strategies beyond shareholder stewardship, including ESG integration, screening and thematic/impact investing.<sup>11</sup> Sustainable investment, therefore, is a part and parcel of investor stewardship, a term developed in the UK and now adopted across more than 20 jurisdictions around the world.<sup>12</sup>

There are two reasons why investors would be interested in parting with their money to invest in sustainable shareholder stewardship: financial return and altruism. These will be examined in turn below.

## 2.1 Financial Return

The literature examining the relationship between ESG activism, on the one hand, and financial return for investors, on the other, does unfortunately not support a general claim that ESG activism leads to better returns for investors over time. The evidence is mixed.<sup>13</sup> Some studies conclude that ESG activism is associated with financial benefit for investors. For example, a 2015 study on corporate social responsibility (CSR) engagements focused on a single investment firm in the US finds positive abnormal returns but only for successful engagements.<sup>14</sup> Another recent study concludes that coordinated engagements targeting environmental or social issues are value-enhancing (in the sense of significant abnormal stock returns), especially when they are headed by a lead investor and are successful.<sup>15</sup> On the other hand, another recent study examines 847 engagements around the globe and finds that ESG activism comes only with modest financial returns during the engagement period from the perspective of the activist fund.<sup>16</sup> For index funds, in particular, academic contributors increasingly question whether engagement and stewardship are cost-effective and meaningful from the perspective of beneficiaries.<sup>17</sup> But there is also recent evidence on ESG index fund activism which portray a different and more positive picture of index funds’ role as purported leaders of sustainable shareholder stewardship.<sup>18</sup>

Another body of the empirical literature compares the performance of funds that invest in ESG – previously referred to as socially responsible investment (SRI) funds<sup>19</sup> – with their conventional competitors. The conclusions on the whole are that both types achieve similar returns and that there are at best negligible gains for ESG

<sup>10</sup> For the varieties of shareholder stewardship see Katelouzou and Puchniak (2022).

<sup>11</sup> See further Katelouzou (2022).

<sup>12</sup> Katelouzou and Siems (2022).

<sup>13</sup> For a general review of the literature on the relationship between shareholder activism and firm performance, see Denes et al. (2017).

<sup>14</sup> Dimson et al. (2015).

<sup>15</sup> Dimson et al. (2019).

<sup>16</sup> Barko et al. (2018).

<sup>17</sup> Fisch (2020).

<sup>18</sup> Barzuza et al. (2020).

<sup>19</sup> For the shift from SRI to ESG funds, see Schanzenbach and Sitkoff (2020), pp 395–397.

funds.<sup>20</sup> There is some evidence that sustainable investment acts as a ‘risk mitigation’ tool.<sup>21</sup> But, the overall conclusion from the empirical literature seems to be that ‘at the worst case, investors in ESG mutual funds can expect to lose nothing compared to conventional fund investments’.<sup>22</sup> In addition, there are less favourable empirical studies regarding ‘E’ and ‘S’ factors compared to ‘G’ factors where the link between better governance and firm performance is stronger.<sup>23</sup>

More generally, the CMA has recently investigated the market for investment consultants and concluded that it is not possible to claim that once fees have been taken into account managed funds do better than index trackers.<sup>24</sup>

This creates a situation where there seems to be no clear evidence that ESG activism and sustainable investment more broadly is good for investors, but where there also is no clear evidence that it is bad for them. This is bad and good news. It is bad news because we cannot point to strong financial reasons justifying a sustainable investment strategy. It is good news because such a strategy does also not appear to cause harm to financial results. It will be observed below that these mixed empirical results could explain why beneficiaries and end-investors are generally passive.<sup>25</sup> It will also be suggested that the government is a financial contributor to pension investments.<sup>26</sup> If the government is seriously interested in promoting sustainable investments it should connect its own financial investment to sustainability criteria.

## 2.2 Altruism

In addition to financial return altruism can be a motivating factor inspiring sustainable investment. We have experienced how in our lifetime attitudes towards plastic waste have changed from indifference to a situation where the government now requires plastic bags to be associated with a charge. We also know that smoking attitudes changed from students and staff smoking in offices and corridors to a situation where they are now banished to specific areas outside of public buildings.

We will see below that there exists a group of suppliers of sustainable investment products who believe that their market will grow in the future. They are encouraged by the fact that younger pension beneficiaries and retail individuals say in surveys that they are interested in using their investment to further the common good. For the time being that wholly altruistic investment market is, however, relatively small.<sup>27</sup> In

<sup>20</sup> For comprehensive literature reviews, see Margolis et al. (2009); Barko and Renneboog (2016), pp 268–290; see also Hartzmark and Sussman (2018).

<sup>21</sup> See Gibson et al. (2019). For earlier evidence focusing on the US market see Gibson and Krueger (2018).

<sup>22</sup> Friede et al. (2015), p 226.

<sup>23</sup> For a review of the literature, see Schanzenbach and Sitkoff (2020), p 436.

<sup>24</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 16, para. 50.

<sup>25</sup> Section 3.3.

<sup>26</sup> Section 5.2.

<sup>27</sup> Section 3.3.

addition, there exists a group of investors with large portfolios who actively pursue altruistic aims.<sup>28</sup> In the next three sections end-investors will be divided into three categories and for each of these the respective motivation in relation to sustainable investment will be examined.

### 3 Investors

#### 3.1 Large Portfolio End-Investors

There exists a group of end-investors who have portfolios that are sufficiently large for them to be able to attract the attention of financial services providers. Examples are endowment funds and sovereign wealth funds (SWFs). These are potential candidates from which demand for sustainable investment can emerge.

Empirical evidence systematically surveying the attitudes of these investors in relation to sustainable investment is, however, scarce.<sup>29</sup> A 2019 Schroder survey among institutional investors (pension funds, insurance companies, foundations, endowments and SWFs) confirms that sustainable investing gains traction globally. 50% of the respondents state that they have increased their sustainable investments over the last five years, while 75% believe that ‘sustainability will play a more important role in the next five years’. But performance concerns and a lack of transparency are reported as institutional investors’ biggest sustainability challenges. In fact, 49% of the respondents (up from 34% in 2018) consider performance as the most important driver for future adoption of sustainable investing.<sup>30</sup>

While this survey is not limited to endowment funds and SWFs, it suggests that the extent to which large portfolio end-investors engage in sustainable investment depends on their respective investment strategy. If their focus is on generating a financial return, they will take a view on how this is best achieved. This may lead to interest in sustainable investment products as long as they generate risk-adjusted returns.<sup>31</sup> It may, however, also lead to the conclusion that their financial goals are best served by adopting a neutral strategy. Either way the fact that there is no clear evidence that sustainable investment leads to better financial results means that financial return is hardly going to be a motivator encouraging this group to embark sustainable investment activity.

There are, of course, some large portfolio beneficiaries who pursue investment strategies that, in addition to financial return, are also influenced by wider aims. This has been coined by Schanzenbach and Sitkoff as ‘collateral benefits ESG investing’

<sup>28</sup> Section 3.1.

<sup>29</sup> There is, of course, a body of literature analysing family-controlled businesses but these are not the focus of this paper.

<sup>30</sup> Schroders, Institutional Investor Study: Sustainability (2019), [https://www.schroders.com/en/sysgl-obalassets/digital/institutional-investor-study/sustainability/pdf/Schroder2019\\_SIIS\\_Sustainabilityv2.pdf](https://www.schroders.com/en/sysgl-obalassets/digital/institutional-investor-study/sustainability/pdf/Schroder2019_SIIS_Sustainabilityv2.pdf) (accessed 3 Oct 2021).

<sup>31</sup> There is evidence that SWFs do take climate change and sustainability seriously. See, for instance, the One Planet Sovereign Wealth Funds: <https://oneplanetwfs.org/> (accessed 3 Oct 2021).

because it aims to improve ESG for moral or ethical reasons without considering the financial interests of beneficiaries.<sup>32</sup> The Norwegian Government Pension Fund Global, the world's largest sovereign wealth fund, is an example of an early adopter of altruistic sustainable investing practices.<sup>33</sup> Charitable organisations with a large investment portfolio also fall in this category.<sup>34</sup> But charities only own a very small percentage of public equity in the UK and their role as sustainable shareholder stewards is therefore very limited.

It is also important to note that end-investors with large portfolios are not necessarily motivated by solely altruistic considerations. A survey including 75 non-profits in the US finds that while sustainable investing strategies are gaining traction (38% invest in sustainability and a further 12% plan to do so in 2019), 60% of the respondents cite 'concerns about performance' as the key factor preventing them from investing in sustainable investments.<sup>35</sup> Some of them receive scrutiny from the public. In the UK, the Church of England falls in this category.<sup>36</sup> Another UK example is the Duchy of Cornwall which funds the public, charitable and private activities of the Prince of Wales and his family. Investments held by the Duchy of Cornwall have been publicly scrutinised against the values promoted by the current holder of the office.<sup>37</sup>

For end-investors with large portfolios we can assume that, given the empirical evidence, financial return is likely to be a weak factor motivating sustainable investment. Some in this group are nevertheless motivated by altruistic aims. It is doubtful, however, how far their efforts on their own can bring about a shift to more sustainable shareholder stewardship encouraging issuers to adopt sustainable business practices in turn.

<sup>32</sup> Schanzenbach and Sitkoff (2020), p 390.

<sup>33</sup> For the investment approach adopted by the Norwegian Government, see <https://www.nbim.no/en/the-fund/about-the-fund/>. For how stewardship is exercised in Norway, see generally Mähönen et al. (2020).

<sup>34</sup> It is notable that, based on recommendations by the Law Commission, the duties of charitable trustees in relation to social investment have recently been clarified (Law Commission, Social Investment by Charities, The Law Commission's Recommendations (2014); The Charities (Protection and Social Investment) Act 2016, 2016 c 4).

<sup>35</sup> SEI Institutional Investors Sustainable Investment Survey 2018, <https://seic.com/sites/default/files/inline-files/SEI%20Sustainable%20Investing%20Survey%202018.pdf> (accessed 3 Oct 2021).

<sup>36</sup> For the approach adopted by the Church of England, see <https://www.churchofengland.org/more/media-centre/news/finance-news/church-commissioners-england-achieve-positive-return-18-2018> (accessed 3 Oct 2021). On social shareholder engagement by religious organisations in general, see Goodman (2015), p 201.

<sup>37</sup> Hilary Osborne, 'Prince Charles's estate made big profit on stake in friend's offshore firm', The Guardian, 7 November 2017, <https://www.theguardian.com/news/2017/nov/07/prince-charles-profit-best-friend-hugh-van-cutsem-offshore-firm-paradise-papers> (accessed 3 Oct 2021).

### 3.2 Small Portfolio End-Investors

Small portfolio end-investors are individuals who hold financial investments. In 2016, the BIS conducted a study on the intermediated shareholding model.<sup>38</sup> They found that 76% of individual investors had a low interest in voting or attending annual general meetings although there were equity investors who valued their shareholder rights.<sup>39</sup> There exists, however, a group of investors who belong to shareholder representative organisations such as the Shareholders Society (ShareSoc) and the UK Shareholders Association (UKSA). For this group shareholder rights are important. They frequently describe their investment as a ‘hobby’ suggesting that they do not expect the time spent in researching companies and engaging with them to be compensated by returns.<sup>40</sup> Such investors articulate demand for sustainable shareholder stewardship.<sup>41</sup> The study commissioned by the BIS focused on engagement for governance purposes. It did not ask questions about ecological and social motives for engagement.

The market for ESG-active retail investment appears to be currently relatively small. There exists research examining the attitude of retail investors towards altruistic investment strategies. A study making recommendations on how to encourage social impact investing, for example, found that only 13% of respondents have previously invested in impact investments and that only 18% of respondents were more than moderately interested in such investments.<sup>42</sup> A number of suppliers of what can loosely be termed ‘responsible investment products’ have conducted empirical research predicting substantial future growth in the market for responsible investing. Younger respondents appear to be more willing than older individuals to forgo financial return in favour of positive social or environmental outcomes.<sup>43</sup> This stronger focus on environmental and social issues by millennial investors compared to older generations appears to be even more emphasised in the US according to

<sup>38</sup> Department for Business, Innovation & Skills, Exploring the Intermediated Shareholding Model, BIS Research Paper Number 261 (January 2016).

<sup>39</sup> *Ibid.*, p 16.

<sup>40</sup> *Ibid.*, p 16.

<sup>41</sup> For an analysis of the impact of shareholder-sponsored proposals, see Gantchev and Giannetti (2018).

<sup>42</sup> Greg B. Davies and Centapse, SII Attitudinal and Behavioural Research (2017), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/659060/Social\\_Impact\\_Investment\\_Attitudinal\\_and\\_Behavioural\\_Research\\_Centapse.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/659060/Social_Impact_Investment_Attitudinal_and_Behavioural_Research_Centapse.pdf) (accessed 3 Oct 2021), p 6.

<sup>43</sup> IFF Research (Ethex), Understanding the positive investor (2017), [https://www.ethex.org.uk/understanding-the-positive-investor-2017\\_1923.html](https://www.ethex.org.uk/understanding-the-positive-investor-2017_1923.html) (accessed 3 Oct 2021); Annual Triodos Bank Impact Investing Survey: Socially Responsible Investing market on the cusp of momentous growth, Press Release (5 September 2018), <https://www.triodos.co.uk/press-releases/2018/socially-responsible-investingmarket-on-cusp-of-momentous-growth> (accessed 3 Oct 2021); Barclays, Investor motivations for impact: a behavioural examination (2018), <https://www.barclays.co.uk/content/dam/documents/wealthmanagement/investments/impact-investing-product/investor-motivations-for-impact.pdf> (accessed 28 April 2020); AXA Investment Managers UK, Consumer Survey (2018), <https://adviser.axa-im.co.uk/a-more-responsible-approach-to-investing?linkid=consumersurvey2018-navigationbanneramore-responsible-approach-to-investing> (accessed 3 Oct 2021); Newton Investment Management, Matching Strategies to Investors’ Goals (2019), <https://www.newtonim.com/uk-institutional/insights/articles/social-investment-matching-strategies-to-investors-goals/> (accessed 3 Oct 2021).

recent market and research evidence.<sup>44</sup> It is encouraging that there exists a group of suppliers of sustainable and stewardship active investment products who envisage a robust future for their market, including State Street and Blackrock.<sup>45</sup> Either way, however, today the portion of small end-portfolio investors who prioritise sustainable investment rather than returns is relatively small and does not have the economic power to bring about responsible practices in investee companies.

### 3.3 Beneficiaries of Workplace and Personal Pensions

Beneficiaries of pension schemes are a significant group of investors. In the UK they make up 90% of the revenues of investment consultants and fiduciary managers.<sup>46</sup> In terms of motivation they mainly focus on financial return and tax benefits. For instance, the Law Commission cites a study carried out by Ignition House for the Financial Conduct Authority (FCA). The respondents to this study report that they interact with pension providers to enquire what their fund is currently worth, to find out whether they could access tax-free cash, and to let the providers know they wanted access to their pension money due to a change in circumstances such as redundancy or health issues.<sup>47</sup>

The purpose of a pension scheme is to accumulate money for retirement, so it is not a surprise that financial value, including employer contribution levels, investment returns and tax allowance, is a dominant factor for beneficiaries. When asked to describe what they were thinking about when they were making retirement plans, the most common unprompted consideration was how much tax-free cash they can have and what the maximum level of income was that they can generate with the rest. Beyond this, respondents needed to be prompted to consider factors such as longevity, health and inflation.<sup>48</sup>

We have seen above that the empirical evidence as to whether sustainable investment enhances the financial performance of funds is mixed.<sup>49</sup> It is therefore no surprise that pension beneficiaries in the UK revert to default investment choices. This default option bias is well-documented across many countries.<sup>50</sup> In addition pension beneficiaries report that they are 'uncertain about their ability to make equity-based investments'.<sup>51</sup> They also felt that

<sup>44</sup> Barzuza et al. (2020), p 1289.

<sup>45</sup> See, e.g., Fearless Girl, McCann Worldgroup, <https://www.mccanworldgroup.com/work/fearlessgirl> (accessed 3 Oct 2021).

<sup>46</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 29 para. 1.14.

<sup>47</sup> Ignition House, Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, prepared by Ignition House for the Financial Conduct Authority (FCA) (December 2014), p 40.

<sup>48</sup> *Ibid.*, p 45.

<sup>49</sup> See Section 2.1.

<sup>50</sup> For Singapore see, e.g., Fong (2020).

<sup>51</sup> Ignition House, Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, prepared by Ignition House for the Financial Conduct Authority (FCA) (December 2014), p 16.

they received too much narrative information that was difficult to navigate and full of jargon.<sup>52</sup>

The Law Commission observes further that members of pension schemes view pension decisions as ‘complex, unpleasant, boring, time consuming and something to be put off indefinitely’.<sup>53</sup> In addition, most pension savers do not appear to know how much of their pension is invested ethically.<sup>54</sup> This suggests that most beneficiaries of pensions are, at the moment, not likely to view their pension investment as a means through which they actively contribute to the common good.

There exists industry-funded empirical research showing that only a small proportion of investors are prepared to sacrifice return with a view to ensuring that their savings support a good cause.<sup>55</sup> Younger respondents (18–24 year olds) express a greater interest in investing responsibly than older individuals.<sup>56</sup> It remains to be seen if this interest translates into decisions that prioritise ESG factors over returns once the members of this group begin to make investment decisions in relation to pension. It is nevertheless encouraging that the investment industry has identified sustainable investment as a market with growth potential.

From the perspective of this paper we need to conclude that the beneficiaries of workplace and personal pensions while collectively very significant are currently unlikely to be a source for demand for sustainable investment. This is a shame because they are the major source for the assets invested through investment consultants and fiduciary managers.

It is worth noting, however, that for this group tax is a critical factor. It will be argued below that through tax relief the government is an investor in its own right.<sup>57</sup> At present the government makes pension tax relief available irrespective of whether ESG factors are taken into account. It will be argued in this paper that a good way of integrating sustainability into financial markets is to design pension tax relief in a way that favours sustainable investment products.

<sup>52</sup> *Ibid.*, p 40.

<sup>53</sup> Law Commission, Pension Funds and Social Investment, Law Com No. 374 (2017), paras. 1.41 and 9.7.

<sup>54</sup> Madeleine Dates, ‘Savers blind to how pensions are invested’, Church Times, 28 September 2018, <https://www.churchtimes.co.uk/articles/2018/28-september/news/uk/savers-blind-to-how-pensions-invested> (accessed 3 Oct 2021).

<sup>55</sup> Movement Research, ‘Identifying new ways to engage with savers in Defined Contribution Pensions’, Defined Contribution Investment Forum (2013), <https://www.dcif.co.uk/wp-content/uploads/2017/06/identifying-new-ways-to-engage-with-savers-in-defined-contribution-pensions-.pdf> (accessed 3 Oct 2021).

<sup>56</sup> ‘New Good Money Week/YouGov poll results announced’, <https://www.goodmoneyweek.com/media/press-releases/new-good-money-weekyougov-poll-results-announced> (accessed 3 Oct 2021); Madeleine Dates, ‘Savers blind to how pensions are invested’, Church Times, 28 September 2018, <https://www.churchtimes.co.uk/articles/2018/28-september/news/uk/savers-blind-to-how-pensions-invested> (accessed 3 Oct 2021); Franklin Templeton and Adoreboard, The Power of Emotions: Responsible Investment as a Motivator for Generation DC, <https://www.franklintempleton.co.uk/download/en-gb/common/k03xuf49> (accessed 3 Oct 2021); there also exists experimental evidence that investors value sustainability: Hartzmark and Sussman (2018).

<sup>57</sup> Section 5.2.

## 4 Investment Service Providers

### 4.1 Pension Trustees and Members of Independent Governance Committees

Most workplace pension schemes are overseen by trustees.<sup>58</sup> There are also pension schemes which operate on the basis of a contract rather than a trust. The providers of personal pensions are overseen by the FCA, which has imposed a requirement for an independent governance committee. The committee has the duty to scrutinise the value for money of the provider's pension schemes taking into account transaction costs. They must act solely in the interests of the relevant scheme members and independently of the provider.<sup>59</sup>

Both pension trustees and members of governance committees are appointed to ensure that pensions are adequately managed. They have the mandate to protect the interests of beneficiaries. Pension trustees identify the service providers who manage pension assets. They rely on advice from investment consultants in taking these decisions. They also appoint and oversee fiduciary management services.

Pension trustees and committee members are bound by the terms on which they have been appointed. Invariably the core focus of their mandate is the generation of financial return. They have to consider ESG factors when these are financially material.<sup>60</sup> The law is sufficiently flexible to permit pension trustees to make investment decisions that are based on non-financial factors (such as environmental and social concerns) provided that they have a good reason to think that the scheme members share the concern, and that there is no risk of significant financial detriment to the fund.<sup>61</sup> Investment by a default fund therefore should not provide a significantly lower return than one available elsewhere.<sup>62</sup>

In relation to sustainable investment, trustees and committee members are likely to tread carefully.<sup>63</sup> Financial materiality is an over-riding factor and there is no evidence that ESG activity leads to generally better financial returns. Even if pension trustees have good reasons to think that beneficiaries hold values that favour investments with a certain impact, they cannot risk significant financial detriment. Trustees are therefore only able to integrate ESG in their assessment of financial risk. They are likely to be more acutely aware of short-term risk factors. These are easier to identify and require a timely response. Medium- or long-term risk factors

<sup>58</sup> Pensions Act 1985, section 16–21; Pensions Act 2004, sections 241–243.

<sup>59</sup> FCA, COBS 19.5.

<sup>60</sup> Law Commission, *Pension Funds and Social Investment* (2017), Law Com No. 374, p 2, p 5, para. 1.25 and p 130, para. 1.20; Law Commission, *Fiduciary Duties of Investment Intermediaries* (2014), Law Com No. 350, paras. 6.99–6.102; there exists, for example, empirical evidence that climate risk is a factor that institutional investors including pensions funds incorporate into their decision making (<https://ecgi.global/working-paper/importance-climate-risks-institutional-investors> (accessed 3 Oct 2021)).

<sup>61</sup> Law Commission, *Pension Funds and Social Investment* (2017), Law Com No. 374, p 2; Law Commission, *Pension Funds and Social Investment* (2017), Law Com No. 374, p 5, para. 1.26.

<sup>62</sup> *Ibid.*, p 5, para. 1.26.

<sup>63</sup> Barriers, for instance, are posed by the 'interpretative pluralism' of the concept of fiduciary duties. See Tilba and Reisberg (2019).

are more difficult to integrate into decision making. They are harder to predict. Moreover, it is for the trustees' discretion to evaluate which risks are material and how to take them into account.<sup>64</sup> From the perspective of financial return the most likely strategy may be to avoid exposure to issuers associated with these risks rather than exercising stewardship to mitigate these risks. The Church of England has, for example, recently announced that it will withdraw from investing in carbon intensive industries.<sup>65</sup>

From 1 October 2019, trust-based defined contribution pension schemes have been required to set out in their Statement of Investment Principles (SIP) how they take into account financial material considerations, including those arising from ESG.<sup>66</sup> A survey by the UK Sustainable Investment and Finance Association (UKSIF) finds that two thirds of trustees have not complied with the new requirement to publish their policies by mid-November 2019. Among those who have published their SIPs, policies are mostly vague and they have all given their investment manager full discretion for managing financially material ESG risks. The survey concludes that 'building a market in stewardship will require a step change in trustees' approaches'.<sup>67</sup>

Most recently, the government has put forward the Occupational Pension Schemes (Climate Change, Governance and Reporting) Regulations 2021, coming into force on 1 October 2021.<sup>68</sup> They focus on climate change and require trustees of the UK's largest occupational pension schemes (with £5 billion or more in assets) to put in place new governance and risk management arrangements and to fulfil certain reporting requirements in line with the recommendations by the Task Force on Climate-related Financial Disclosures (TCFD).<sup>69</sup> TCFD-aligned disclosures – part of the broader TCFD roadmap published by the government in 2020 – aim to cause

<sup>64</sup> Law Commission, *Pension Funds and Social Investment* (2017), Law Com No. 374, p 130, para. 1.20.

<sup>65</sup> John Gabbattiss, 'Church of England votes to withdraw funds from companies that contribute to climate change', *Independent*, 9 July 2018, <https://www.independent.co.uk/news/uk/home-news/church-of-england-climate-change-investment-withdraw-paris-agreement-fossil-fuels-a8437781.html> (accessed 3 Oct 2021).

<sup>66</sup> See the Occupational Pension Schemes (Investment) Regulations 2005, 2(3)(b)(vi) and 2(3)(c) for financially material ESG considerations and stewardship, respectively. On the relationship between these new rules and the UK Code 2020, see Katelouzou and Micheler (2022).

<sup>67</sup> UK Sustainable Investment and Finance Association (UKSIF), *Changing course? How pensions are approaching climate change and ESG issues following recent UK reforms* (February 2020), <https://www.responsible-investor.com/reports/uksif-or-changing-course-how-pensions-are-approaching-climate-change-and-esg-issues-following-recent-uk-reforms> (accessed 3 Oct 2021).

<sup>68</sup> Department for Work & Pensions, *The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021: Consultation outcome* (18 June 2021), <https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations/the-occupational-pension-schemes-climate-change-governance-and-reporting-regulations-2021> (accessed 3 Oct 2021).

<sup>69</sup> Occupational Pension Schemes (Climate Change, Governance and Reporting), Regulations 2021, regs 3-6 and Schedule 1.

trustees to integrate the short-, medium- and long-term risks and opportunities associated with rising global temperatures into their decision making.<sup>70</sup>

The Regulations identify climate change as an ESG factor of particular importance. The government points out that they do not intend for trustees to solely focus on climate change and further observes that climate change is linked to wider social factors.<sup>71</sup> They do, however, not undermine the financial materiality requirement. The government expressly states that it does not intend to direct the investment decisions or strategies of trustees of pension schemes. They ‘will never exhort or direct private sector schemes to invest in a particular way. Trustees have absolute primacy in this area’.<sup>72</sup> Notwithstanding the work that went into the clarification of the duties of trustees, financial materiality continues to be the over-riding factor.

In addition, there exists a structural problem. The new mandatory climate-related disclosures only apply to the UK’s largest occupational pension schemes. The CMA finds that trustees of small schemes and trustees of defined contribution schemes are less engaged.<sup>73</sup> Less engaged trustees do, for example, not set objectives against which the quality of their investment consultants can be judged.<sup>74</sup> This observation that engagement is difficult for small scheme trustees and trustees for defined contribution schemes seems to still exist notwithstanding the 2019 regulatory changes.<sup>75</sup>

Small schemes are likely to suffer from the fact that they do not have sufficient resources. Defined contribution schemes suffer from the limited oversight by their beneficiaries. In defined contribution schemes the beneficiaries are the individual members and we have already seen that they do not take great interest in their pensions. In defined benefit schemes members receive retirement income depending on the years worked and depending on their final salary. The employer thus bears the risk of poor investment outcomes.<sup>76</sup> It is possible that trustees of such schemes benefit from greater engagement by employers. The CMA has made recommendations addressing the lack of engagement by trustees.<sup>77</sup> These however do not modify the mandate of trustees to prioritise in the financial interest of their beneficiaries.

<sup>70</sup> <https://www.gov.uk/government/publications/uk-joint-regulator-and-government-tcf-taskforce-interim-report-and-roadmap> (accessed 3 Oct 2021).

<sup>71</sup> Department for Work & Pensions, Government response: taking action on climate change: improving governance and reporting by occupational pension schemes (8 June 2021), Ministerial Foreword, <https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations> (accessed 3 Oct 2021).

<sup>72</sup> Department for Work & Pensions, Clarifying and strengthening trustees’ investment duties (September 2018), p 3.

<sup>73</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 13, para. 32.

<sup>74</sup> *Ibid.*, p 11, para. 24 and p 15, para. 48.

<sup>75</sup> *Ibid.*, p 13, para. 32.

<sup>76</sup> *Ibid.*, p 17, paras. 58-59. For an analysis of decisions taken by pension trustees acting for defined benefit schemes, see Cocco and Volpin (2007).

<sup>77</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 7.

From the perspective of this paper, we therefore need to conclude that the financial materiality requirement presents a barrier to the ability of most trustees to make a contribution for the benefit of the public good and prioritise altruism over financial return.

## 4.2 Investment Consultants and Fiduciary Managers

Investment consultants provide advice in relation to strategic asset allocation, manager selection, fiduciary management. Fiduciary managers make and implement investment decisions including but not limited to the responsibility for asset allocation and fund/manager selection.<sup>78</sup>

These services providers are able to integrate ESG factors into their decisions. But the conclusion of the previous sections has been that they currently receive limited demand from their clients for sustainable investment.<sup>79</sup> Beneficiaries of workplace and personal pensions contribute 90% to the revenue of these providers.<sup>80</sup> But their focus is on financial return and there is no equivocal evidence that responsible investment increases the return of investors. Small portfolio end-investors who care about stewardship are unlikely to use the services of investment consultants or fiduciary managers. They are more likely to put together their own portfolios and hold securities directly or, alternatively, invest in savings accounts or ISAs.<sup>81</sup> There is a hope that the market for sustainable investment will grow in the future when younger individuals, who have expressed an interest in sustainable investment products, come into money. Some large portfolio end-investors care about sustainability but, while their efforts can serve as role models, their market share is too small to bring about a shift towards responsible business practices. On the whole, therefore, the terms on which investment consultants and fiduciary managers are appointed are very likely to focus on the generation of financial return without substantially integrating sustainability factors.

<sup>78</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 8, para. 3.

<sup>79</sup> For previous literature highlighting the lack of incentives to engage in stewardship arising from the perspective of the internal governance and business structures of funds, see Barker and Chiu (2017). Davies (2020) and Fisch (2020) also highlight the limited ability of institutional investors and index funds (respectively) to deliver stewardship activity.

<sup>80</sup> Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 3 Oct 2021), p 29, para. 1.14.

<sup>81</sup> See, e.g., IFF Research (Ethex), Understanding the positive investor (2017), [https://www.ethex.org.uk/understanding-the-positive-investor-2017\\_1923.html](https://www.ethex.org.uk/understanding-the-positive-investor-2017_1923.html) (assessed 3 Oct 2021) (finding that most of the UK population are most interested in less sophisticated savings and investment products (44% interested in savings accounts, 43% in current accounts and 40% in a positive ISA) as the method of making a positive investment).

## 5 The Role of the Government

It will be argued in this section that the UK Government falls short of fully appreciating its role in relation to sustainable investment. It commits substantial resources to overseeing the market for sustainable investment but does not give sufficient weight to the fact that it makes a significant financial contribution by subsidising the provision of pensions through the tax system. It will first be shown how the government currently oversees the market and then suggested that the government is an investor in its own right. It should do what it expects of other market participants and insist on sustainable investment.

### 5.1 The Government as a Facilitator of the Market for Responsible Investment

The approach of the UK Government in relation to the interface between investor capitalism and sustainable investment is nicely illustrated in a video explaining NEST, the workplace pension scheme set up by the UK Government. That scheme was created to support auto-enrolment into workplace pensions. The video is 47 s long and can be found on YouTube.<sup>82</sup> The animated video visualises the following text, which is read out by a narrator:

Welcome to Nest. We are a workplace pension scheme set up by the government helping millions to earn a better retirement. You can save with Nest by making contributions to your pension pot, that you may receive tax relief on. You will also benefit from employer contributions. We believe in investing all your contributions responsibly, including with companies we encourage to meet high standards of environmental, social and corporate governance, not only because it is the right thing to do, but because it has been shown to give you better returns over time.

The video articulates the mindset the government would like investors to adopt. In the government's analysis, investors play a key role in shaping the behaviour of the companies that they have bought securities in. Investors are encouraged to invest in companies which display 'high standards of environmental, social and corporate governance'. They are encouraged to do this for two reasons. It is 'the right thing to do' and it 'has been shown to give you better returns over time'.

This suggests that ESG investment is associated with better returns. In light of the empirical evidence discussed above, it is not wrong to claim that 'it has been shown' that high ESG standards give better returns over time. There are studies which reach this conclusion. Because there are, however, also studies to contest this conclusion,<sup>83</sup> it would be better to tell investors that, given that it does not appear to make a difference either way, investors should do the 'right thing' and invest responsibly. Admittedly, that message is less attractive.

<sup>82</sup> Nestpension, Welcome to Nest, <https://www.youtube.com/watch?v=tQA4dBxTt14> (accessed 3 Oct 2021).

<sup>83</sup> Friede et al. (2015), p 226.

Connected to this urging of investors to ‘do the right thing’, the government then puts in place disclosure requirements for issuers, who are encouraged to generate information that investors can rely on and use to make their respective (responsible) investment decisions. It also sets up reporting requirements for fiduciary managers and other financial service providers encouraging them to support sustainable investment strategies.

The government’s overall strategy can be further illustrated by the reference to the recent reforms relating to climate change. We have already seen that pension trustees are now required to implement certain governance measures and report on climate risks and opportunities.<sup>84</sup> To perform this task, pension trustees need information on the assets contained in their portfolios. The government explicitly notes that trustees were concerned that they had to undertake ‘analysis and report, whilst other parts of the investment chain on which trustees rely for data were not held to the same regulatory standards’.<sup>85</sup> It has further announced that the disclosure requirements drafted by the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD) will be made mandatory for issuers.<sup>86</sup>

The FCA is also planning on putting in place rules for asset managers and for workplace and personal pension schemes that align with the TCFD rules. Subject to consultation, final rules will be published by the end of 2021 and come into force in early 2022.<sup>87</sup> The aim is to ensure that the ‘right information on climate-related risks and opportunities is available across the investment chain—from companies in the real economy to financial services firms, to end investors’.<sup>88</sup>

Indicative of the government’s overall strategy in the area of sustainable investment are the UK Corporate Governance Code and the UK Stewardship Code, which are published by the Financial Reporting Council, soon to be transformed into the Audit, Reporting and Governance Authority.

The UK Corporate Governance Code is addressed to premium listed companies, which are required to either adopt certain governance measures or explain why they have decided to implement alternative solutions.<sup>89</sup> In its introduction, the authors of the Code observe that companies do not exist in isolation. ‘Successful and sustainable businesses underpin our economy and society by providing employment and

<sup>84</sup> Section 4.1.

<sup>85</sup> Department for Work and Pensions, Government response: taking action on climate change: improving governance and reporting by occupational pension schemes (8 June 2021), Ministerial Foreword, para. 8, <https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations> (accessed 3 Oct 2021).

<sup>86</sup> HM Treasury, Interim Report of the UK’s Joint Government-Regulator TCFD Taskforce (November 2020), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/933782/FINAL\\_TCFD\\_REPORT.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933782/FINAL_TCFD_REPORT.pdf) (accessed 3 Oct 2021), pp 4–5.

<sup>87</sup> *Ibid.*, p 16.

<sup>88</sup> *Ibid.*, para. 2.3.

<sup>89</sup> Financial Reporting Council, The UK Corporate Governance Code (July 2018), <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> (accessed 3 Oct 2021) (hereinafter: UK Corporate Governance Code 2018); Listing Rules, DTR rules 7.2.2, <https://www.handbook.fca.org.uk/handbook/DTR/7.pdf> (accessed 3 Oct 2021).

creating prosperity. To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders'.<sup>90</sup> The Code also stresses that the 'value of good corporate governance to long-term sustainable business' is at its 'heart'.<sup>91</sup>

In a complementary fashion, the Stewardship Code aims at encouraging investors to have regard to environmental, social and governance factors when making investment decisions and undertake shareholder stewardship.<sup>92</sup> Stewardship is defined as the 'responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society'.<sup>93</sup> The Code provides 12 principles for asset managers and asset owners and 7 principles for service providers which operate on an apply-or-explain basis.<sup>94</sup> Asset owners and asset managers are asked to integrate 'material' ESG issues, including climate change, while undertaking stewardship.<sup>95</sup> Among others, asset owners are asked to ensure that when they award their mandates they require ESG integration in alignment with the investment horizon of their beneficiaries.<sup>96</sup> When they outsource stewardship activities, both asset owners and asset managers need to ensure that their service providers 'have received clear and actionable criteria to support integration of stewardship and investment, including material ESG issues'.<sup>97</sup> Service providers are asked to support clients' stewardship, including ESG integration.<sup>98</sup> Asset owners, asset managers and other service providers are encouraged to adopt the Code and publish information on how they implement it.<sup>99</sup> These disclosures are designed to supply ultimate investors with the information they need to make their investment choices. But the degree to which ultimate investors make informed decisions based on these reports and the degree to which these reports are tied to an overarching sustainable strategy on the part of the issuer is questionable.<sup>100</sup>

The UK Government defines its role as facilitating a market for sustainable investment by encouraging investors, issuers and financial services providers to act

<sup>90</sup> UK Corporate Governance Code 2018, introduction.

<sup>91</sup> Ibid.

<sup>92</sup> Financial Reporting Council, The UK Stewardship Code 2020, introduction, [https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code\\_Final2.pdf](https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf) (accessed 3 Oct 2021).

<sup>93</sup> Ibid.

<sup>94</sup> Only FCA-authorized asset managers are obliged to sign up to the Code. See FCA Handbook, COBS Conduct of Business Sourcebook, 2.2.3R (06/12/2010).

<sup>95</sup> UK Stewardship Code 2020, Principle 7, [https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code\\_Final2.pdf](https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf) (accessed 3 Oct 2021).

<sup>96</sup> Ibid.

<sup>97</sup> Ibid.

<sup>98</sup> Ibid., Principle 5 for service providers.

<sup>99</sup> The first list of signatories to the UK Stewardship Code 2020 was published in September 2021 and their statements can be found here: <https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-signatories>.

<sup>100</sup> See, e.g., [https://www.investmentexecutive.com/inside-track/\\_shilpa-tiwari/esg-reporting-a-means-to-progressor-a-means-to-an-end/](https://www.investmentexecutive.com/inside-track/_shilpa-tiwari/esg-reporting-a-means-to-progressor-a-means-to-an-end/) (accessed 19 Oct 2021).

responsibly. This is supported through disclosure requirements. These are designed to create a process of self-reflection on those responsible for producing reports, stimulate clients to seek more information from their managers and also to ultimately impress end-investors allowing them to invest their savings in a way that can be described as ‘responsible’. The government wants to discourage an attitude that solely focuses on short-term economic return without directly intervening with how businesses are run.

The problem with this approach is that it relies on the weakest participant in the investment chain doing the heavy lifting. The approach can only work if ultimate investors decide to do two things: first, become actively involved in their work-related pension savings, and, secondly, decide to take these active investment decisions with a view to enhance environmental, social and governance aims. In light of the observations made earlier this will require a significant shift in the attitudes of pension savers. The next section will show that the government can contribute to this shift. It will be argued that the government itself is part of the problem. It contributes to the reluctance of ultimate investors to engage with investment decisions. The government is a financial contributor to the investment markets and the government’s contribution undermines the ability of ultimate investors to actively select investment products.

## 5.2 The Government as Financial Investor

Since the mid-twentieth century, UK securities markets have undergone a significant structural change. In the 1960s, investors were individuals, who were assisted by brokers at fixed and high rates of commission.<sup>101</sup>

This changed with the advent of occupational pension schemes. By the 1990s, UK insurance companies and pension funds together held about half of UK issued shares.<sup>102</sup> Since then globalisation has encouraged UK equity investors to hold more overseas assets, and many more UK shares are held by foreign institutions. In addition, sovereign wealth funds have become important institutional investors.<sup>103</sup>

We can also note that this structural change in financial services was not driven by spontaneous demand from individual savers. It was rather caused by the government’s own policy measures. The design of pension tax relief has had an important impact on the current structure of investor capitalism.

Pension tax relief was introduced by the Finance Act 1921. It was originally made available for contributions made to ‘superannuation funds’.<sup>104</sup> From the 1960s the coverage of occupational pension schemes among UK employees was greatly

<sup>101</sup> The Kay Review of UK Equity Markets and Long-term Decision Making, Final Report (July 2012), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf) (accessed 3 Oct 2021) (hereinafter: Kay Review), para. 3.2.

<sup>102</sup> Kay Review, para. 3.3.

<sup>103</sup> *Ibid.*, para. 3.3.

<sup>104</sup> 1921 ch 32 (11 and 12 Geo 5), s 32.

extended.<sup>105</sup> In the late 1970s/early 1980s the tax treatment of institutionalised pension investments was so generous that it had the effect of multiplying investment returns.<sup>106</sup> Auto-enrolment has recently further widened the scope of occupational pensions.<sup>107</sup> The current design of tax relief continues to encourage individuals to save for retirement through funds and other institutional forms of investment.<sup>108</sup> Individuals who decide to opt for a self-invested personal pension, can, for example, invest their pension money in real estate investment trusts, but will not benefit from tax relief if they invest directly in residential real estate.<sup>109</sup>

This tax policy is justified by policy aims. It encourages and helps individuals to save for their retirement. It provides funding to issuers, which benefit from deep capital markets. The way the policy is designed has also subsidised the rise of institutional investors and other financial intermediaries.<sup>110</sup> These businesses would probably not exist if it were not for pension tax relief.<sup>111</sup> They provide employment and also contribute tax to the public purse.

Professor John Kay observes that many ‘insurers and pension funds have outsourced their investment to specialist asset managers’.<sup>112</sup> In some cases these are ‘spin offs from the sponsoring insurance company or pension fund’,<sup>113</sup> which encouraged the ‘divested business to seek external customers’.<sup>114</sup> Asset managers are supplemented by a myriad of other service providers. Examples of these are advisors who allocate funds to specialist asset managers, trustees, investment consultants, agents who ‘wrap’ products, retail platforms, distributors, independent financial advisors, registrars, custodians and proxy advisors.<sup>115</sup>

Unsurprisingly, the replacement of individual investors with investment intermediaries has given rise to a set of problems of its own. The Kay Review observed in 2012 that the current structure of the investment landscape has the effect of turning the long-term interests of savers into short-term signals to issuers. This is because asset managers and other service providers operating in the investment chain report to their respective clients in line with the short-term time frames contained in their

<sup>105</sup> Kay Review, para. 3.2.

<sup>106</sup> Cheffins (2008), pp 346–347.

<sup>107</sup> See <https://www.gov.uk/workplace-pensions/joining-a-workplace-pension> (accessed 22 June 2021).

<sup>108</sup> Tax on your private pension contributions, <https://www.gov.uk/tax-on-your-private-pension> (accessed 22 June 2021); The Pensions Advisory Service, Tax relief and contributions, <https://www.pensionsadvisoryservice.org.uk/about-pensions/saving-into-a-pension/pensions-and-tax/tax-relief-and-contributions> (accessed 3 Oct 2021).

<sup>109</sup> The Money Advice Service, Self-invested personal pensions (SIPPS), <https://www.moneyadviceservice.org.uk/en/articles/self-invested-personal-pensions> (accessed 3 Oct 2021).

<sup>110</sup> Cheffins (2008), pp 346–349.

<sup>111</sup> The CMA concluded that pension schemes contribute 90% to the revenue of investment consultants and fiduciary managers: Competition & Markets Authority, Investment Consultants Market Investigation, Final Report (2018), [https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI\\_Final\\_Report.pdf](https://assets.publishing.service.gov.uk/media/5c0fee5740f0b60c8d6019a6/ICMI_Final_Report.pdf) (accessed 22 June 2021), p 29, para. 1.14.

<sup>112</sup> Kay Review, para. 3.3.

<sup>113</sup> *Ibid.*, para. 3.3.

<sup>114</sup> *Ibid.*, para. 3.3.

<sup>115</sup> *Ibid.*, para. 3.7.

respective contracts. They pass this pressure on to investee companies. This has the effect of bringing short-term results into sharper focus.<sup>116</sup> The requirement to identify a benchmark against which financial services providers can be assessed has also supported the shareholder-primacy model that has been dominating the corporate governance debate starting from the later twentieth century.<sup>117</sup> A short-term focus on generating value for shareholders can distract issuers from paying attention to the long-term consequences of their business for their ecological and social stakeholders. The analysis above has shown that the obsession with short-term value is currently fading and sustainable investment is gaining traction especially among millennials.

Yet, we are coming full circle. The government's tax contribution not only supports a structure that inadvertently prioritises short-term shareholder return. It also causes beneficiaries to disengage. Pension savers receive return through tax savings. This discourages them from paying close attention to selecting their investment portfolios. This in turn deprives the investment consultancy and fiduciary management industry of oversight. It also means that the hope that investors will step up to the task of exercising demand for responsible investment practices is optimistic.

In so far as the government makes a financial contribution to investments it is entitled to involve itself in how investment decisions for pensions are taken. It also has a responsibility to engage and act as a steward. Like all other beneficiaries of and contributors to the market, the government should act responsibly in relation to its own investment.

Finally, the government is a financial stakeholder as a residual loss bearer. When the financial system collapsed in 2008 the government bore the financial burden of the rescue. The government is likely to feel obliged to intervene if the pension system experiences a shock.

## 6 The Way Forward

Investor capitalism and sustainable investment are coming closer together with both the demand and the supply sides of the market for sustainable investments expanding exponentially. Yet, there are still loose ends, and the government has a key role to play in tying them up. A well-discussed solution to the problem of self-regulation of the market for sustainable investment is that of the imposition of regulatory duties on financial service providers to integrate stewardship.<sup>118</sup> Such a duty would, however, cover all investments, in particular also those to which the government has not made a financial contribution. For these the government has no right to insist on any particular investment strategy. An indiscriminate regulatory duty also does not resolve the problem that the government is currently distorting the market. This

<sup>116</sup> *Ibid.*, paras. xiv-xv.

<sup>117</sup> Lund and Pollman (2021).

<sup>118</sup> See Chiu and Katelouzou (2017) and Chiu and Katelouzou (2018).

paper therefore looks at the role of the government as an investor itself rather than as a regulator.

The view advanced in this paper is that the government's decision to invest, by granting tax relief, its own money into the pension sector without insisting on sustainable investment is a significant barrier preventing a shift to sustainable investment practices. There is no doubt that long-term sustainable investment is more difficult in defined contribution schemes which tend to concentrate on conventional asset classes. Yet, the government should acknowledge that it is an investor in the industry. In that capacity the government has its own responsibilities. It should take these seriously and ensure that its own money is invested responsibly. The proposal advanced in this paper is that pension relief should be attached to conditions that funds invested through these schemes be invested responsibly.<sup>119</sup> Whilst we acknowledge that our proposal falls within the concurrent, but still infant debate of how to best inform appropriate metrics and meaningful standards for sustainable investment,<sup>120</sup> it is out of the scope of this paper to draw the specifics of a sustainability- or ESG-benchmark to justify pension tax relief. What we aim, however, is to direct the future of pension tax relief as a long-standing policy instrument by realigning it as a solution to a new problem.<sup>121</sup>

Originally pension tax relief was introduced to support private pension saving. Today pension tax relief can serve an additional purpose: it can motivate retail investors to pay attention to 'G' as well as 'E' and 'S'. Given that a bias towards sustainable investment does not appear to generate financial harm for investors, it would seem that the government should also 'do the right thing' in its capacity as a financial contributor to the financial markets. Reforming pension tax reliefs is already the subject of intense debate in the UK.<sup>122</sup> But no attention has been given so far to the potential social value of pension tax reliefs.<sup>123</sup> Connecting pension tax reliefs to sustainability criteria will help to promote the sustainability of the financial system and redeem the 'soul' of investor capitalism: the stewardship potential of retail investors.

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<sup>119</sup> For similar tax proposals in the UK and the US connecting tax reliefs to the mitigation of climate change, see Baker and Murphy (2020); see also the special tax relief available for social investments: <https://www.gov.uk/government/consultations/social-investment-tax-relief-call-for-evidence/social-investment-tax-relief-call-for-evidence#contents> (accessed 3 Oct 2021).

<sup>120</sup> On the EU debate on ESG benchmarks, see [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-climate-benchmarks-and-benchmarks-esg-disclosures\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-climate-benchmarks-and-benchmarks-esg-disclosures_en) (accessed 20 October 2021).

<sup>121</sup> On the evolution of social investment policy instruments in the UK, see Nicholls and Teasdale (2021).

<sup>122</sup> House of Commons, Reform of pension tax relief (7 February 2020), <https://commonslibrary.parliament.uk/research-briefings/cbp-7505/> (accessed 3 Oct 2021).

<sup>123</sup> Note that the social value of tax relief in the UK has already been utilised in relation to community investment and the aim to develop a 'social impact investment market'. See, e.g., Wiggan (2018).

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