ASSOCIATION OF CHARITABLE FOUNDATIONS

Charity Commission for England and Wales' consultation on charity responsible investment guidance

A response from the Association of Charitable Foundations, 13 May 2021

The Association of Charitable Foundations (ACF) is pleased to respond to the Charity Commission for England and Wales' consultation on charity responsible investment guidance.

About the Association of Charitable Foundations

ACF is the national membership body for charitable foundations in the UK. Driven by a belief that foundations are a vital source for social good, our mission is to support them to be ambitious and effective in the way that they use all their resources. We do this through the provision of policy and advocacy, research and information, and a wide-ranging programme of events and learning. Our 410 members collectively hold assets of around £50bn (representing approximately 40% of the charity sector's assets[1]) and give over £2.5bn annually primarily as grants.

About this response

Foundations have played a significant and positive role in pushing forward and mainstreaming responsible, ethical and sustainable investing, helping to move it from a niche activity to a mainstream investment option. This response is informed directly by the range of experiences that members share with us, the knowledge we have gathered through our own policy work, and evidence collected through our Stronger Foundations initiative. It does not necessarily reflect the views of all ACF members. We are pleased that several ACF members are submitting their own contributions based on their own experiences and contexts.

Definitions

A range of terms – 'mission-aligned', 'intentional', 'responsible', 'ethical' – are used in referring to investments. Organisations, including investment managers, will define these in different ways, occasionally to meet their own commercial ends. At ACF we have adapted the Spectrum of Capital

[1] NCVO Almanac 2020 records net assets of £139.2bn for the UK charity sector, of which £110.9bn are investment assets.

(originally created by Bridges Fund Management) to provide a framework for discussing investments as they relate to a foundation's financial and impact goals, set out below (see also page 9 of ACF's Stronger Foundations report on Investment).

Investment Approach	Finance first	Responsible	Sustainable	Impact driven	Impact first
Financial and impact goals	Aiming to maximise financial returns with little or no consideration of negative outcomes for people and the planet	Aiming to maximise financial returns while trying to avoid negative outcomes for people and the planet	Aiming to maximise financial returns while trying to effect positive outcomes for people and the planet	Aiming to balance financial returns with strong positive outcomes for marginalised people and/or the planet	Will accept a lower financial return (and potentially financial loss) to achieve positive outcomes for marginalised people and/or the planet
Examples of where capital is invested	For example investments in companies with a poor record on human rights or environmental protection	For example avoiding investments in companies with a poor ESG record, such as those which damage the environment or have a poor human rights record, often as part of a risk management strategy	For example investing in companies which manage ESG factors in a sustainable long-term way (eg companies with strong governance processes, environmental protection, a focus on human rights)	For example investing in a property fund that provides housing for individuals with learning disabilities or an environmental impact bond funding infrastructure to manage storm waters	For example providing loans to social enterprises operating in deprived communities which will make only a small profit but provide quality jobs for local people
Stewardship and engagement		Both responsible and sustainable investment offer opportunities to engage with companies to seek improvements in ESG performance, for example through voting for ESG related shareholder resolutions or investment managers/investors engaging directly with a company			

Further terms used in relation to foundation investments include 'ESG', which refers to environmental (how a company manages and minimises its environmental impact), social (how a company manages relationships with employees, suppliers, customers and the communities in which it operates) and governance (how a company is run, its leadership, pay, audits, internal controls and relationships with shareholders) factors. Many companies will also refer to how they are contributing to achieving particular UN Sustainable Development Goals (UN 'SDGs').

It is important to note that responsible, sustainable and ESG are frequently used interchangeably. The challenge of definitions and terminology is at the crux of our response, as set out below.

ACF's position on investment

For many foundations, an endowment is their super-power. Financial independence and long-term horizons provide unique opportunities to work towards achieving the foundation's mission, effecting change, and withstanding financial turbulence. A well-managed investment portfolio is the engine that powers a foundation's activity – providing vital resource for grant-making and other activities. Financial returns are important to ensure the ongoing viability of the foundation model. But maintaining the value of a foundation's capital is not a charitable purpose nor an end in itself. All foundation investments exist to serve the mission of the charity.

Like all registered charities, foundations in the UK have charitable purposes, set out in their governing document. A foundation's mission reflects its strategic choices, values, motivations and history, and a stronger foundation has a clear and comprehensive understanding of its own mission. Whilst a foundation's mission may have formally remained the same for hundreds of years, it is likely that the strategic choices, values and motivations underpinning that mission will have evolved in line with societal norms. In considering investment, many trustees and staff make a distinction between the foundation's mission and the wider societal and environmental impacts of the foundation's investments. A clear and comprehensive understanding of mission will include the wider context within which the foundation operates.

Society is demanding ever greater transparency from institutions and asset holders about the sources of their wealth and how it is invested and stewarded. New approaches to creating a sustainable economy are emerging and the climate crisis means action is both necessary and urgent. Charities will need to move forward to avoid falling behind.

Our report on Investment, part of our Stronger Foundations series, was published in July 2020. It sets out 7 pillars of ambitious practice, stating that a 'stronger foundation':

- Understands that responsibility for its investments sits with each and every member of the trustee board
- Prioritises its mission when setting investment objectives
- Engages with and holds to account those managing its investments
- Pursues transparency and responds to scrutiny
- Actively seeks a variety of research and views to inform its approach to investment
- Reviews its own time-horizon
- Seeks to positively influence the behaviour of others in relation to its investments

Since December 2020, ACF has received information from foundations that have completed one or more of the thematic surveys that comprise the Stronger Foundations self-assessment tool. The results from these surveys, including the one based on the Investment pillars, shows that many foundations are taking steps to implement the pillars and are achieving this ambitious level of practice. Each charity will follow their own path; seeking to integrate their investments with the charity's work, to align their investments with their mission and to consider how to take into account wider societal and environmental factors.

While it is appropriate to consider the variety of contexts in which charities operate and the spectrum of capital, there is a clear direction of travel for the foundation sector away from merely seeking a financial return towards intentional, responsible, sustainable, mission-aligned investment approaches. Proportionality is relevant, and it is reasonable to expect that those with the most assets to invest should also be among the most intentional in how they use investments to pursue public good.

Some foundations in the UK remain invested in a way that primarily or solely focuses on financial return, for whom investments are generally considered as the means to a charitable end, differentiating some of the charity's money (investments) from the 'mission' part (usually in the form of grant-making).

But a growing proportion of foundations are reframing their investments as a core part of their mission – not separating one part of the charity's resources from another but seeing all their resources as part of the charity's toolbox to pursue positive impact. This is a welcome development and one that will continue to grow in the next few years, given the mood music in society and the increased interest in applying considerations of environmental and societal sustainability.

<u>Our central message in response to the proposed changes to guidance</u>

It is crucial that charity regulation keeps pace with societal expectation and the reality of current and future practice. It should ideally offer an enabling and encouraging environment for charities that want to enhance public benefit.

Both the current and proposed guidance make clear that charities are able to pursue responsible, programmatic and mission-focused investments in most circumstances. The more permissive tone is welcome, and should help to remove a degree of uncertainty for some trustees on what is already allowed. However, there remain some fundamental problems.

The proposed guidance conflates 'responsible investment' as a method of incorporating ESG with more intentional, programmatic and mission-focused investment. As a result, it appears that the guidance is implicitly pitching more general 'responsible' investment as an alternative choice to financial return, rather than a methodology for achieving it. This risks creating a false binary. Given the performance of responsible investments in recent years, no longer should the pursuit of financial return be in any way contradictory to being a 'good citizen' investor and investing responsibly. Nor does the implication that it is acceptable (or even standard practice) for charities to invest in ways that are by default 'not responsible' seem in keeping with societal expectation that they put all their assets to good use.

We believe that the Commission's investment guidance should be framed around the notion that responsible investing is expected, rather than something to be justified. Responsible investment should be a starting point for investment decisions, not an optional extra. It would make more sense that trustees should be required to justify investments that are not taking this approach. Regulation could also seek to encourage charities to make investments that take account of mission, values and purposes, and discourage investments that are contradictory.

Our key points are:

- The terminology used in the proposed guidance is problematic, conflating responsible with more intentionally programmatic or mission-aligned investment
- The guidance should be reframed – particularly to reflect the difference between more intentional programmatic and mission-aligned investment as distinct from more general responsible investment approaches
- The guidance should reflect evidence that ESG-focused responsible investment is not in conflict with strong financial return, but a methodology for achieving it
- We commend the 2018 guidance of the Scottish Charity Regulator (OSCR), which we believe has clearer wording and could be built on in the Charity Commission guidance

<u>Question 1</u>

As a result of reading this draft guidance, how clear are you about the duties and good practice that apply to decisions about a charity's financial investments, whether or not the charity adopts a responsible investment approach?

We interpret that the substantive changes to the revised guidance are under 'financial investment'. The regulatory impact assessment states: *"For charities with no permanent endowment… there is some saving in the regulatory burden. This is because there is a reduction in the conditions these charities have to satisfy before they take a responsible investment approach."* A relatively small percentage of foundations have a permanent endowment as defined in law[2], therefore for most foundations there is a saving in the regulatory burden. Even for those with a permanent endowment, there is a more permissive framework for responsible investment proposed, which is welcome.

The consultation description notes that in response to the listening exercise *"some trustees felt they are unable to make responsible investments, because they perceive they have an overriding legal duty to maximise financial returns when investing, regardless of any other consideration"*. We agree that this has been expressed as a concern, even though it may not have been the case in the guidance. ACF therefore welcomes the efforts made to make the proposed guidance clearer and more permissive in tone.

However, we think there remain some fundamental problems, particularly with definitions and framing. The field of charity investment has seen rapid developments in recent years as responsible investment approaches become mainstream both within charitable investments and the investment management sector more broadly.

As we said previously in our response to the listening exercise in 2020, we commend the more explicit position of the 2018 OSCR guidance on Scottish charity investment. In November 2018, the Scottish charity regulator produced new guidance on charity investments. This states:

"An investment is intended to generate a return – to give something back to the person or organisation that owns it. In a charity context, investments are charity assets used to help the charity deliver its charitable purposes. Usually investments are intended to provide a financial return in the form of money being earned for the charity to use (income) and/or by the value of the investments increasing over a period of time (capital growth). However, investments can also involve other kinds of return in addition to a financial one, such as a social or environmental return".

This is, in our view, a good approach to financial investment guidance for charities. It is explicit that *"investments are charity assets used to help the charity deliver its charitable purposes"*, not merely a way of funding the charity's activity. That *"usually investments are intended to provide a financial return"*, but there are other forms of return that are also valid *"such as social or environmental".*

This framing encourages charity trustees to do more to put all their resources to work in pursuit of their charitable purposes, but allows flexibility and interpretation in the context of that charity.

Importantly, OSCR highlights its expectation that annual accounts (based on what is required by the Charities SORP, which applies to the UK and Ireland) report on what the charity's approach to investment is, including the aims beyond a financial return, and that this should include: *"An explanation of the charity's investment policy and objectives set where the charity holds material financial investments. This should include an explanation of the extent to which the policy takes into account social, environmental or ethical factors into consideration"*

However, while OSCR's guidance would be a marked improvement on what is currently proposed by the Commission, the OSCR guidance is approaching three years old and the context of both investments and society expectation has evolved quickly in the interim. Therefore, as we set out

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[2] A 'permanent endowment' is where a charity's governing document sets out that its money or property was originally meant to be held by a charity forever. Many foundations intend to exist in perpetuity but are not 'permanently endowed' in a legal sense. https://www.gov.uk/guidance/permanent-endowment-rules-for-charities

below, there is an opportunity for the Charity Commission in England and Wales to go further to encourage a more proactive approach to responsible investing.

Question 2

As a result of reading this draft guidance, how clear are you about what a responsible investment approach is?

Question 3

Is the phrase 'responsible investment' an appropriate term for the approach to investing in line with a charity's purpose and values?

We would like to address these two questions together.

In our experience, there are many terms used to describe approaches to making 'financial investments' 'in line with charitable purpose and values'. These include: 'responsible', 'intentional', 'ethical', 'impact', 'sustainable' and 'mission-aligned'. All can mean different things, and each has been interpreted in a variety of ways.

During our Stronger Foundations programme, 'intentionality' in investment emerged as a baseline expectation for foundations, rather than necessarily a feature of stronger practice, in that all charities should be intentional throughout their decision-making. Through the Stronger Foundations Investment strand, striving to invest in a way that is consistent with purpose emerged as a clear feature of stronger practice. Improving diversity, equity and inclusion in investment decision-making and transparency around investment activity have also been highlighted as important enabling conditions.

Although the Commission's proposal to replace the phrase 'ethical investment' with 'responsible investment' makes some sense given association of 'ethical' in some quarters with charities with a religious motivation, the proposed changes are insufficient and terminology remains problematic.

Section 2 of the revised guidance indicates that trustees can choose *"whether your charity should invest in a way that reflects your charity's purposes and values (a "responsible investment" approach)".* However, the following section 2.1, is more permissive, and states that charities *"can take a responsible investment approach even if there is no apparent direct conflict with your charity's charitable purposes, if you can show this is in the best interest of your charity".* This difference in tone could give rise to confusion on whether responsible investment in the Commission's view is about your charity's purpose and values, or a wider investment approach.

In addition, suggesting that 'responsible investment' is about *"reflecting your charity's purpose and values"*, does not successfully reflect the term's current usage within the charity or investment management sectors. Typically foundations and investment managers use 'responsible investment' to refer to taking into account environmental, social and governance (ESG) factors which may not be directly linked to the charity's purpose and values but are important considerations in view of long-term stability and financial returns.

At ACF we have grappled with the evolving terminology in the investment space. We would like investment guidance to be framed around the notion that seeking to be 'responsible' with investments is an expectation – the starting point for investment decisions – rather than an optional extra that requires justification. And we would like the guidance to make it clear that mission-aligned or programme-related investment is likely to be permitted in most circumstances but, depending on what it entails, may in some cases require deeper considerations and some justification. This is explored more in our answer to question 5.

<u>Question 4</u>

How confident would you be, as a result of reading this draft guidance, that adopting a responsible investment approach is a valid option?

If a charity wants to take a responsible investment approach, the proposed revised guidance makes clear this is allowed in most circumstances.

However, as discussed above, implying that 'responsible' investment is an alternate choice to financial return is outdated and risks creating a false binary. Given the performance of such investments in recent years, no longer should the pursuit of financial return and taking account of the charity's purposes and values in investments be in any way contradictory, nor does it seem in keeping with societal expectation of charities to put all their assets to good use.

Whilst 'responsible investment' could certainly encompass the case study examples listed in the revised guidance[3], some of these seem more akin to mission-aligned or programmatic investments. This is different to active and responsible investment management of a charity's assets to achieve stable financial returns, which necessitates analysing a company's environmental, social and governance performance to weed out companies which lack strong ESG processes. This is recognised later in the guidance in section 4 which it is suggested should be updated that *"all charities can take into account"* consideration of ESG risks including *"climate, employment practices, sustainability, human rights, community impact, executive compensation and board accountability".*

The Commission's extensive list of ESG risks demonstrates clearly that choosing a 'responsible investment' approach is not an added extra, but a basic requirement of financial stewardship and prudence, social impact, and reputation management. For many ACF members, investment in companies with strong ESG processes, and the associated shareholder engagement and voting to achieve this, are a vital part of achieving the financial returns needed to deliver the *"level of income of growth [they] are aiming for"* as per the Charity Commission's guidance.

For those organisations with a permanent endowment the guidance indicates that they can take a responsible investment approach if certain conditions are met. ACF feels these conditions over-emphasise a 'risk of lower returns' or a 'financial downside'. Research[4] clearly demonstrates that, as noted above, an ESG-focused responsible investment approach provides stable long-term financial returns, particularly as all major economies transition towards carbon neutrality. Investments that are more squarely in the territory of programme-related investments may have financial risks or downsides, but could generate a higher and/or more direct social return.

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[3] *"- a health charity avoiding investments in businesses whose products are harmful to health ('negative screening')*
- an environmental charity choosing to invest in the renewable energy sector ('positive screening')
- a human rights charity using its shareholder rights to influence company practice ('stakeholder activism')
- a heritage charity avoiding investments in fossil fuels because the trustees have evidence that this would damage its reputation, reduce donations and not be in the charity's best interests"

[4] For example *Deutsche Bank (2016) ESG and financial performance: aggregated evidence from more than 2000 empirical studies.*

We believe a responsible investment approach is one that all charities can take. It is fair to expect the level of intentionality in how a charity manages its investment to be in proportion to the amounts they hold, and for the level of time and resource it devotes to managing its investments to be linked to the scale of a charity's assets. For those foundations with the greater capital to invest, it is appropriate that there is greater expectation that they deploy this more intentionally for public benefit. There is plenty of evidence for taking a responsible approach for safeguarding financial returns – and trustees should be able to evidence a responsible investment approach, even if this is relatively light touch for those with smaller capital.

Question 5

In the section 'Check if extra rules apply', we say that there are some situations where a responsible investment approach can be taken only if at least one of five tests is met. As a result of reading this draft guidance, how clear are you about when these tests are relevant to the decision to take a responsible investment approach?

We think this section is not required and incorrectly framed as it stands. Rather than trustees having to pass a test to validate a responsible investment approach, we think that taking a responsible investment approach should be encouraged and perhaps an expectation. Conversely, it would make more sense if choosing not to take a responsible investment approach (merely pursuing financial return without consideration of the charity's mission, values and purposes) were subject to a test, given the financial and reputational harm that might follow, as well as the missed opportunity to achieve social good.

In its current form, we feel that two of the bullet points are particularly unwarranted in their emphasis of a potential financial downside to responsible investment:

- *"You can balance any risk of lower returns (in both the short and longer term) against the risk of losing support or damaging your charity's reputation*
- *taking this approach would not bring a significant financial downside"*

Question 6

Do you have any other comments to make on the draft guidance?

ACF welcomes the Charity Commission's interest in this important set of issues, its willingness to listen and engage prior to drafting the final guidance, and the efforts made in this revised version to clarify existing guidance.

However, we ultimately feel that the central problem of the current guidance remains in the revised version proposed – a false binary between 'responsible investment' and 'financial return'. We also feel it risks remaining increasingly out of step with both current practice and societal expectation.

Many charities are already investing in responsible, impactful and mission-focused ways. Some are field-leaders in ethical and responsible investing. The Charity Commission should seek to encourage charities to use all of their assets for public good. Given that there is no longer a basis for seeing responsible investing as in any way contradictory to strong financial performance, this is a moment for the Commission to be bolder in its guidance to trustees – not just enabling a permissive environment (which should be a bare minimum), but one of encouragement and raised expectation.

Rather than having to justify a responsible approach to investment, charities should be encouraged to pursue this approach as a starting point – straying from that course only if they can justify an alternative. In our view, societal expectation and financial prudence will demand that charities invest more intentionally and responsibly in the years ahead.

The proposed changes may have a fairly limited impact in either persuading or dissuading charities from working differently to how they do already. That would be a missed opportunity, at a time when societal expectations and charities' appetites to deploy their resources for maximum public benefit is greater than ever.

Contact

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