Fiduciary Duty for a Changing Climate

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Last week the Financial Markets Law Committee (FMLC)[1] published a paper intended to help Pension Fund trustees integrate climate and sustainability issues into their investment decision making processes. This offered an overdue and long-awaited update to the concept of fiduciary duty as we navigate an unprecedented global economic transition.

Background

Fiduciary duty comprises two fundamental components for pension fund governors:

First, the "*duty of loyalty*", requiring fiduciaries to act in the best interests of pension beneficiaries, commonly interpreted as their "*best financial interests*"[2].

Second, a "*duty of prudence*", requiring trustees to undertake their roles with "*skill, care and due diligence*" [3].

To uphold their fiduciary duties, UK trustees must seek appropriate investment advice, ensure portfolio diversification and refrain from imposing their personal political and ethical beliefs to investment decision making processes. Fiduciary duty is not a "*legal barrier to pension funds' consideration of climate change*" as an investment risk or financial opportunity[4]. Yet, prudence has been interpreted in a UK legal setting as conventional trustee conduct based on prevailing market norms, meaning adjustments are gradual and encouraging herding. This is problematic for trustees when dealing with disruptive, novel and urgent economic developments and further complicated when those developments evolve under a social, environmental or Responsible Investment (RI) definition, which may be perceived as non-financial considerations[5].

Empirical research demonstrates trustees have varied interpretations of the purpose of a pension fund, their roles and responsibilities, creating uncertainty over the 'best interests' of beneficiaries, what constitutes a financial or non-financial consideration and what is appropriate RI behaviour[6].

Academics have offered many views on how trustees can navigate the juxtaposition of historical interpretations of fiduciary duty and the current market environment.

Sandberg (2013) found fiduciary duty unsuitable for integrating ESG, proposing pension funds accept "*independent social and environmental obligations*" as a debt to

[1] The FMLC is an educational charity based in the City of London, dedicated to the sound administration of financial law.
[2] Tilba and Reisberg, 2019, pp.467
[3] Woods, 2009, pp.12
[4] Woods, 2009, pp.3; Tomlinson, 2017
[5] Woods, 2009; Sandberg, 2013; Tilba and Reisberg, 2019
[6] Tilba and Reisberg, 2019, pp.459; Sandberg, 2013

society, "*irrespective of*" beneficiaries' interests.

Richardson (2015) called for regulatory change to enable socially responsible investing, arguing transparency reforms leave investors too much discretion.

Tomlinson (2017) highlighted if the financial materiality of an ESG factor is considered ambiguous, trustees can seek legal sanctuary in demonstrating a decision is aligned with beneficiaries' wishes and does not present substantial financial disadvantage.

The FMLC and Fiduciary Duty

In their new paper, "*Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change*"[7], the FMLC aims to address legal uncertainties regarding integration of sustainability concerns in investment decision making.

On the topic of what constitutes a **financial or non-financial factor**, the FMLC clarifies:

- **Motive** for consideration is the key distinguishing issue
- There is substantial **breadth** in financial factors, meaning it may not be immediately obvious that a factor is financial
- It is reasonable that, when identifying financial considerations, pension fund trustees first view sustainability issues as financial factors: "*The **relevant entry point** for consideration of sustainability in the context of pension funds is as a financial factor rather than as a non-financial factor*"

There are two contextual arguments in the paper which could help trustees and asset managers better understand and communicate climate and sustainability risks:

1. A necessary narrative

Our whitepapers on the use of climate data in portfolio construction point to unintended consequences from using limited emissions data as the main indicator of climate risk or opportunity[8]. Climate change is too complex and uncertain a risk to quantify with a single figure risk metric.

The FMLC points out that, "*sometimes financial factors cannot be quantified but it does not follow that they lack weight*" and calls for a focus on qualitative information to proper understand sustainability related risks and returns. It is unlikely that we will be able to effectively judge potential outcomes from climate and sustainability risks without a focus on both **"numbers and narrative"**.

2. It is a matter of time

The FMLC highlights the important context of relevant **time horizons** for a pension fund when it comes to decision making related to climate change, as well as the **scope** – not only asset level or portfolio level but economy wide. Long time horizons, and considerable uncertainty regarding how

[7] Paper-Pension-Fund-Trustees-and-Fiduciary-Duties-Decision-making-in-the-context-of-Sustainability-and-the-subject-of-Climate-Change-6-February-2024.pdf (fmlc.org)

[8] Storebrand Asset Management Insights - www.storebrand.com

climate and other sustainability challenges will be addressed, mean projections for risk and returns are largely hypothetical and can be abstract. The FMLC notes, "*It may be necessary to consider whether a strategy should reject shorter term gains because they create identifiable risks to the longer term sustainability of investment returns in the fund*."

At Storebrand Asset Management sustainable investing is considered a necessary part of enacting our fiduciary duty towards our clients. We support the need for longer term thinking about risks and returns related to sustainability issues, such as climate change. We aim to help our clients better understand those risks using both numbers and narrative, while constantly seeking to improve the landscape for sustainable investing through engagement with companies and policymakers.

We hope that this new paper from the FMLC will help modernise interpretations of fiduciary duty for our changing climate.

References:

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Important Information: