Written evidence submitted by Cushon

27. What market barriers are there to the integration of environmental-related factors into financial decision-making?

In our response, we are specifically referring to pension schemes and the current interpretation of fiduciary duty which is a barrier.

Under current interpretations of fiduciary duty by pension trustees, it is generally only acceptable to make investment decisions (either investment or divestment) to the extent that trustees believe that these decisions optimise long term financial outcomes for pension members. This is typically interpreted as referencing the size of the member's pension pot.

There are derogations from this requirement where fiduciaries have good reason to believe member views are supportive of a particular action, but these derogations are generally not applicable. In almost all cases, it is the fiduciary's view of likely financial outcomes that drives investment decision making.

Consequently, a commitment to a Net Zero portfolio can only be justified if trustees can reasonably evidence that a Net Zero portfolio will match or outperform a conventional portfolio. It cannot be justified on the basis that the global economy must transition to Net Zero and all asset owners have a duty to support that transition in the broader best interests of members. Similarly, any commitment to support "build back better" by investing in a UK hospital or other infrastructure can only be justified on grounds of expected long term financial outcomes.
Trustees who seek to take broader considerations into account therefore feel exposed to a risk of subsequent legal challenge. These risks are exacerbated to the extent we see supra normal profits arising for fossil fuel companies for an extended period as a result of the war in Ukraine. This leads to risk aversion on the part of trustees and is a significant barrier to UK pension funds helping the UK to both build back better and tackle climate change, despite both self-evidently being in the interests of UK pension scheme members.

As an example, the explicit exclusion of the member's quality of life in retirement when evaluating the member interest in advice issued by the Association of Pension Fund Lawyers was particularly unhelpful. Because of this guidance, trustees are consequently inclined to exclude any broader societal or environmental considerations that will demonstrably impact members' quality of life from their decision making. But it seems self-evident to us that a member's standard of living in retirement is a relevant fiduciary criterion. The price of beer will be very much higher in a world of 3 degrees of warming than in a world of 1.5 degrees of warming, because of the impact on the supply and price of barley and wheat. There is little point in delivering a marginally higher pension pot if it can buy the member only half as much beer! There is a potential "free rider" risk here – will my actions as a fiduciary make an identifiable difference to societal outcomes and to my members' standard of living? It is precisely because of this free rider risk that fiduciary duty needs to be addressed.

An effective solution would be to broaden the current interpretation of fiduciary duty through legislation that parallels the type of obligation imposed on companies through Section 172d of the Companies Act of 2006, so that trustees are required to "have regard to the fund's impact on society and the environment."

A pension trustee would then be allowed to consider whether the pension portfolio was contributing positively to society and the environment, and would be allowed to take that into account in their investment decisions. An alternative to the language in the Companies Act of 2006 is language proposed in the Better Business Act, which creates a stronger obligation on directors, including the requirement to act in a manner that benefits wider society and the environment (in proportion to the size of the company), and to reduce harm and costs to society and the environment.

The fact that Section 172 has not led to any shareholder value destruction provides reassurance that this change would not lead to rampant philanthropy on the part of trustees, but rather proportionate consideration of the societal and environmental benefits of a particular investment strategy alongside its expected long term financial risks and returns.

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