Reforming fiduciary duty for today's brave new world

Chris Wagstaff, Senior Visiting Fellow, Finance Faculty, Bayes Business School

1984 was a very different time to now. Thankfully not the dystopian world envisaged by George Orwell in 1949 but certainly one where sustainability simply wasn't on the agenda. Negative externalities - pollution and other ecological damage - were rarely legislated against, taxed or internalised within market pricing, Milton Friedman's, now controversial, 1970 New York Times article *The Social Responsibility of Business Is to Increase Its Profits* was still the conventional wisdom and emerging warnings that the UV-absorbing ozone layer was being decimated by CFCs from aerosols and fridges were largely falling on deaf ears.

So what is the relevance of all this? Well, 1984 was also the year of the landmark Cowan v. Scargill case, which effectively underpinned the central tenet of Trustee fiduciary duty to act in beneficiaries' best financial interest. This was narrowly interpreted as seeking out the best, *short-term* risk-adjusted returns, with no mention of bringing social responsibly or sustainability factors into consideration. Then as now, Trustees' moral and value judgements were to be kept out of the equation.

Fast forward to 2024 and we now inhabit a world with a much greater awareness of the significance of Environmental, Social and Governance (ESG) risk factors and their management. Given conclusive evidence of both planetary boundaries and social foundations being severely and systematically breached, we now know what this ultimately means for the world and the long-term health of pension funds if left unchecked.

Yet, Trustee decision making is still anchored to this landmark case and, as a consequence, the requirement to only take material financial factors into account (those financial factors that can materially impact risk-adjusted returns). This, despite being faced with the imperative of building scheme resilience to manifold ESG risk factors, on both sides of the balance sheet.

This is especially problematic when seeking to manage those systemic risks - i.e. those that can trigger severe instability or collapse in an entire system - such as climate, nature and biodiversity and a whole host of social risks. After all, these are risks with unknown tipping points whose *ultimate* impact on risk-adjusted returns might not be *fully* felt for decades to come but which could materially threaten the viability of a scheme and beneficiary outcomes if not properly managed.

Therefore, sustainability must be embedded in how we invest. After all, businesses cannot thrive in a world suffering from cascading crises and unmanageable risks with unknown tipping points. Indeed, ever-increasing TPR ESG-centric regulatory reporting and guidance, the conclusions of the recent Financial Markets Law Committee report and the recommendations of the DWP Taskforce on Social Factors suggest, undiversifiable and often interconnected, systemic and many other ESG risks pass the material financial factors litmus test.

However, none have the full force of the law. Indeed, legislation has focused on increasing the reporting burden while sidestepping the fundamental issue of law reform. And therein lies the problem. Trustees, in acting as good *long-term* stewards of their scheme's assets, and wanting to

ensure their members retire into a world worth retiring into really do need to have the requisite legal comfort when making ESG-centric decisions, or any other decision, that may *potentially* fail to maximise short-term returns. Ditto in responding to the push from government to invest in UK assets to support the energy transition and the long-term health and stability of the economy. In fact, without this legal certainty, in what is a grey area for many Trustees, fiduciary duty, as currently defined, acts as an unnecessary brake on sustainable and responsible investment, thereby moving the world closer to an irreversible tipping point.

Moreover, given that pension scheme management is a complex *long-term* Integrated Risk Management (IRM) exercise, unless the legal parameters within which Trustees operate better reflect the reality of needing to keep schemes within the guard rails of safe ecological boundaries and social foundations over beneficiaries' lifespans - scheme beneficiaries being impacted by these decisions, not just momentarily, but over their entire lifetimes - IRM and beneficiary outcomes will be severely compromised.

In short, if ever there was a need for formal clarification of what fiduciary duty now comprises, indeed a definition that allows for a degree of pragmatism to reflect the fluidity of change and real-world impact of investment decisions, now is it.