Principles for Responsible Investment

PRI RESPONSE

WORK AND PENSIONS COMMITTEE EVIDENCE SESSION ON FIDUCIARY DUTY AND CLIMATE CHANGE

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Work and Pensions Committee one-off evidence session on fiduciary duty and clime change.

ABOUT THIS CONSULTATION

In March 2023 the UK Government published "Mobilising Green Investment, Green Finance Strategy 2023" (2023 GFS), an update to the 2019 Green Finance Strategy and the 2021 Greening Finance Roadmap. The strategy acknowledges that "decisions around investing and systemic risks are complicated and that trustees would like further information and clarity on their fiduciary duty in the context of the transition to net zero". To address this issue, the Government proposed a number of steps including a review of the implementation of Stewardship Guidance and a series of roundtables to engage on how to continue clarifying fiduciary duty. The Mansion House Reforms also highlighted the need to improve trustee understanding of fiduciary duty and changing the "the culture of investment decisions".

The Works and Pensions committee is conducting a one-off evidence session on fiduciary duty and climate change. The inquiry aims to understand how pension schemes take account of climate change risks and whether a legal change to the definition of fiduciary duty is required or if there are other ways of improving pension schemes consideration of climate change risks.

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KEY RECOMMENDATIONS

The PRI welcomes the Work and Pensions Committee one-off evidence session on fiduciary duty and climate change as uncertainty over fiduciary duties and how to address sustainability issues can impede effective decision-making of trustees. Pension funds are required to secure long-term financial interests and therefore have a responsibility to consider whether system-level sustainability risks, such as climate change, are relevant to their ability to meet their legal obligations and objectives and, if so, how they can mitigate these threats.[1]

The PRI has produced a number of analyses of existing fiduciary duty regulations and their interpretations, and recommendations on how to support investors to comply with their fiduciary duties and managing material sustainability risks. Our policy report UK: integrating sustainability goals across the investment industry details our key recommendations for the UK. At this stage, the recommendations focus mainly on clarification of existing regulations, including through the publication of guidance, rather than proposing changes to the definition of fiduciary as a priority. Our response here therefore focuses on the question: "*Are there other ways of achieving the same outcomes (such by improving governance, or providing better tools to help trustees ask the right questions and make decisions)?"*

Our overarching recommendations based on our work to date are set out below.

- **Clarify that the requirement to consider ESG risks encompasses an obligation to consider taking active steps to pursue sustainability impact goals** when this would help achieve financial risk/return objectives.
- Develop **guidance on how pension funds can assess sustainability risks and impacts and how to set and pursue sustainability impact goals**.

We are working with the Department of Works and Pensions (DWP), investors and other stakeholders to support the dissemination of analysis and reports on best practice, highlighting the compatibility between fiduciary duty and investing for sustainability impact. The recent paper from the Financial Markets and Law Committee, Pension Fund Trustees and Fiduciary Duties – Decision-making in the context of Sustainability and the subject of Climate Change, was a helpful step in clarifying uncertainties around fiduciary duty, though further work is needed to mainstream these findings and develop additional guidance on how to address sustainability risks and impacts.

[1] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making

DETAILED RESPONSE

The 2021 report A Legal Framework for Impact, authored by Freshfields Bruckhaus Deringer, and commissioned by the PRI, the United Nations Environment Programme Finance Initiative and the Generation Foundation, identified across 11 jurisdictions, including the UK, that investors are generally permitted to consider pursing sustainability impact goals where this would contribute to their financial return objectives. Following on from A Legal Framework for Impact our UK specific report "UK: integrating sustainability goals across the investment industry" explores how policymakers can support investors' abilities to invest for sustainability impact. The report finds that because the UK legal framework relies on broad interpretation of regulations there is a common misperception that pursuing sustainability impact goals is not prioritising the investor's financial purpose. While financial return is generally regarded as the primary purpose and goal of investors, investors are likely to have a legal obligation to consider pursuing sustainability impact goals, where doing so can contribute to achieving their investment objectives.

In July 2023 DWP and HMT published a call for evidence on Pension trustee skills, capability and culture, seeking information on whether guidance on fiduciary duty is sufficient to help trustees make decisions in the best long-term interest of savers (see the PRI's response here). The government's response to the consultation found that the majority of respondents considered that fiduciary duties are a well-established and well-understood concept, but **there can be some inconsistency in interpretation**. The call for evidence also highlighted that there is **a lack of clarity around how fiduciary duty interacts with sustainability and climate change considerations**.

Policymakers can provide clarity for when investors' legal duties enable or require them to consider pursuing sustainability impact goals by updating standards and guidance. The Financial Markets Law Committee (FMLC) has recently published a paper, Pension Fund Trustees and Fiduciary Duties – Decision-making in the context of Sustainability and the subject of Climate Change. The paper addresses legal uncertainties by providing trustees with an explanation on fiduciary duties in the context of sustainability, specifically climate change.

The FLMC's paper gives clarity around the interpretation of the law as it stands and provides a good basis for trustees to begin to address climate and other sustainability risks in their investments. To build on this work, policymakers and regulators should also **clarify that the requirement to consider ESG risks encompasses an obligation to consider taking active steps to pursue sustainability impact goals** when this would help achieve financial risk/return objectives.

Guidance is also required not just to understand fiduciary duties but also the application of relevant duties. We recommend developing **guidance on how pension funds can assess sustainability risks and impacts and how set and pursue sustainability impact goals.** In addition, the UK government should support and encourage efforts by the investment industry and other stakeholders to **develop and endorse examples of good practice or case studies** of the above-mentioned activities.

ANNEX: LEGAL FRAMEWORK FOR IMPACT

WHAT IS A LEGAL FRAMEWORK FOR IMPACT?

A Legal Framework for Impact, authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, UNEP FI and the Generation Foundation, is a ground-breaking study of 11 jurisdictions around the world on whether the law permits or even requires investors to tackle some of the world's most urgent sustainability challenges by setting and pursuing sustainability impact goals. Building on the legal findings, the Legal Framework for Impact project is working on policy implementation in five jurisdictions:

- European Union: empowering investors to pursue sustainability goals;
- Australia: integrating sustainability goals across the investment industry;
- UK: integrating sustainability goals across the investment industry;
- Canada: integrating sustainability goals across the investment industry; and
- Japan: integrating sustainability goals across the investment industry.

The Legal Framework for Impact supports a shift from "how do investors manage the effect of ESG risks/opportunities on their portfolios?" to also address "how can investors ensure portfolios have positive impacts in the world?"

WHY DOES INVESTING FOR SUSTAINABILITY IMPACT MATTER?

Financial investments drive real world outcomes on issues including climate change, sustainable development and human rights. This is true whether the sustainability impacts of investments are intended or not. Investors increasingly recognise that financial returns depend on the stability of social and environmental systems, especially in the long term. This fact is driving investors to be increasingly focused on what they can do to improve sustainability outcomes and contribute to sustainability goals.

- Investments are not sufficiently aligned with global sustainability goals, including those set out in international treaties like the Paris Agreement and in the SDGs. Consequently, investment portfolios remain exposed to sustainability risks – including system-level risks.
- In some circumstances it is necessary for investors to address sustainability impacts in order to manage ESG risks and opportunities and deliver financial returns for clients and beneficiaries, particularly when sustainability impacts cause system-level risks. But doing so is not currently considered part of mainstream investment practice.
- To address this, investors need to take action to increase positive impacts (and decrease or eliminate negative impacts) from their investments.

WHAT ARE THE KEY LEGAL FRAMEWORK FOR IMPACT FINDINGS?

- While financial return is generally regarded as the primary purpose and goal of investors, investors are likely to have a legal obligation to consider pursuing sustainability impact goals where doing so can contribute to achieving their investment objectives.
- In some circumstances, investors can pursue sustainability goals for reasons other than achieving financial return goals - i.e. in parallel to them. Investors are legally required to pursue sustainability impacts if the objectives of the financial product commit them to do so.
- Pursuing sustainability impact goals does not entail a departure from prioritising an investor's financial purpose and objectives. On the contrary, in some cases investors need to address sustainability impacts in order to protect or enhance financial returns.
- Stewardship - alongside asset allocation - is a vital tool for investors seeking to improve sustainability impacts, and collaboration between investors is likely to make pursuing sustainability impact goals both more efficient and more likely to succeed.

WHY DO WE NEED POLICY REFORMS?

Investors are increasingly seeking to understand and improve sustainability impacts, but they cannot do so without support from policymakers. Mitigating system-level risks and delivering on sustainability goals committed to by governments, such as Paris Agreement goals on climate change and the Sustainable Development Goals, relies on improving the sustainability outcomes of investments.

Investors face a range of impediments to accelerated action on sustainability goals:

- investors are discouraged by uncertainty about what the law requires or permits. They need greater clarity, consistency, and guidance;
- backward-looking interpretations of legal standards exacerbate inertia, are out of step with trends in leading investment practice and impede innovative approaches to investing for sustainability impact; and
- sustainable finance policy regimes (including disclosure rules, product standards, sustainable taxonomies, and stewardship codes) need to facilitate investing for sustainability impact, but in most cases do not do so sufficiently at present.

Policy reforms are essential to facilitate investing for sustainability impact and to overcome barriers to action, while ensuring a level playing field for market participants.

RECOMMENDATIONS FOR POLICY MAKERS

The solutions proposed by the Legal Framework for Impact project provide the required robust foundations for investors and policy makers to facilitate investing for sustainability impact as a core part of mainstream investment activity. Policy reforms should address both the legal duties investors are subject to and the circumstances in which those duties are applied, which includes sustainable finance policy frameworks and standards.

Policy recommendations for the UK

1. Clarify when sustainability impact goals must or can be considered as part of the duties of loyalty, care and prudence.
2. Clarify that purpose-related requirements (sometimes described as a duty to act in clients'/beneficiaries' "best interests") entail consideration of sustainability impact goals.
3. Ensure stewardship powers are used to achieve sustainability impact goals.

Policy areas for further consideration in the UK

1. Sustainability-related disclosures and labelling/classification of sustainable investment products
2. Competition law
3. Options to enable consideration of certain sustainability impact goals and of individual investors' views on sustainability
4. Guidance for pension schemes on assessing relevance of social and environmental goals

Overarching policy recommendations – global

Clarify investors' legal duties

1. Update standards and guidance to clarify when investors' legal duties enable or require them to considering pursuing sustainability impact goals.
2. Update standards and guidance to clarify that purpose-related requirements (sometimes described as a duty to act in the "best interests" of clients or beneficiaries) may entail consideration of sustainability impact goals.

Ensure sustainable finance policies facilitate investing for sustainability impact

3. Adopt comprehensive corporate sustainability disclosure frameworks which meet the needs of investors seeking to understand material sustainability risks, opportunities and impacts.
4. Ensure that sustainability disclosure and labelling regulations address not only integration of ESG risks, but also how investment entities and products assess sustainability outcomes, set sustainability impact goals, and take steps to contribute to positive sustainability impacts.
5. Implement sustainable taxonomies to help investors understand and promote economic activities that are environmentally and socially sustainable.
6. Strengthen regulatory support for effective and accountable stewardship, including the use of stewardship powers to address sustainability risks and sustainability impacts.

7. Support collaborative action by investors that seeks to improve sustainability outcomes, and provide regulatory guidance and, where required, consider establishing a safe harbour to ensure that sustainability-related collective action by investors does not fall foul of anti-trust rules.
8. Explore ways to enable investors to take client and beneficiary sustainability preferences into account in their asset allocation and stewardship activities.
9. Establish corporate due diligence requirements to ensure that negative sustainability impacts are identified and addressed; ensuring coherence with international standards including the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the Environmental Audit Committee further.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org