Climate Change and Investment Duties: a Prisoner's Dilemma?

By James McCreath

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An article for Pensions Barrister I wrote last November concluded with the observation that the direction of travel is very much in favour of climate change playing a greater role in trustee decision-making. A further step down that road came on 6 February this year, with the publication of a paper by a working committee set up by the Financial Markets Law Committee, *"Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change."*

The paper begins by explaining that it is intended to provide a very general explanation of the legal position and uncertainties that exist as to how investment duties, on the one hand, and sustainability and climate change, on the other, interact. Its substantive analysis begins by noting the distinction between financial and non-financial factors, and placing "sustainability" concerns squarely in the former camp. It deliberately avoids attempting to attach a definition to that protean phrase, but the basic thought can, I would suggest, be summarised (but not defined) as a recognition that expected returns from investment need to be considered alongside the risks of those investments, particularly in the long term. In that context, the paper contains a reminder that decision making on investments is not simply picking whichever investment the advisers attach the largest expected return from, but requires a qualitative assessment of risk as well as a quantitative assessment of expected return. It notes that market prices at any given time may not fully reflect sustainability risks that trustees are entitled to take into account.

These are important clarifications, and should assist trustees in being comfortable that it is appropriate to take climate change into account so far as it affects the finances of the scheme. The particular discussion of climate change, in section 6 of the report, delves deeper into how climate change may be relevant to finances, and contains some interesting if alarming observations. Having noted the various facets of climate change risk (changes in behaviour, changes in economies, changes in law and regulation) and the possibility that certain changes may be sudden, it goes on to suggest three levels at which financial factors need to be considered: at the level of a specific asset or investment, at a portfolio level, and at the level of whole economies material to the pension fund.

The first two of these are uncontroversial and easy to understand. Clearly trustees should in their approach to investments take into account the risk both in individual investments and within their portfolio as a whole. They are already required by the regulatory framework to measure and take into account financially material risks associated with climate change, considered at length in my article last year. They must though be careful in that consideration that they do not allow the current focus on climate change – of which the paper is another example – to allow concentration on climate related risks to 'crowd out' consideration of other risks.

The third however poses more of a dilemma. It is easy to see that in considering the risk to specific assets or the portfolio as a whole, one has to consider the broader economic picture. But how are trustees meant to deal with risk more generally at a whole economy level? As the paper says, at para 6.8(V), in an understated way, where climate change risks are systemic, that is not something which the trustees can avoid through diversification.

At the heart of this is a potential prisoner's dilemma: as the paper notes at paragraph 11.5, it is possible that pension funds could manage climate-change associated risk more effectively if they collaborated or co-ordinated with others. The paper suggests, therefore, that trustees may consider with their advisers whether there are steps they could take in collaboration and coordination with other pension funds.

The paper does not set out what these steps might be. What they might be, and what risks there are associated with them, will ultimately depend on investment advice (which may in turn raise issues as to the lawfulness of what is proposed). But the floating of the idea at the very least opens the door to the possibility of trustees acting collectively as what might be termed 'activist' investors seeking to address climate change through their investments.

While the analysis that leads the paper to this point is one that is careful to distinguish between financial and non-financial factors, such a possibility when starkly presented is not one that sits easily with the traditional 'prudent person' test. The paper provides clarity to trustees about their ability to take into account climate risks, but in doing so it provides a further reminder of the difficulties that the subject of climate change poses for trustee investment decisions.

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