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COMMENT

Freeing pension schemes from the straitjacket of fiduciary duty

By **Professor Oliver Hart |** November 10, 2023

Fiduciary duty needs a rethink. It's time to think about what members actually want

Last month, at the invitation of the responsible investment charity ShareAction, I stood in front of an audience in the medieval grandeur of Gray's Inn to set out my belief that to create a sustainable future for both people and planet we need to look at one of the guiding principles that has driven finance for almost as long as it has existed – the maximization of shareholder profit.

The splendor of the oak paneled hall, decked with portraits of some of the legal professions' greatest judges and Law Lords, may seem an odd setting for a financial lecture on fiduciary duty, one of the great financial shibboleths. But surrounded by the portraits of the greatest jurists of the British legal system, who through their working lives became great instruments for change, I began to see a certain synergy to what we need from the financial sector today.

Conventional wisdom says companies should maximize profit for their shareholders. This argument seems watertight: companies act on behalf of shareholders, shareholders want to become as wealthy as possible, so companies should act in a way that makes them wealthy.

If one accepts this, it's clear what pension managers must do. They must support companies in any actions which increase shareholder value and oppose any actions which don't.

This of course means ESG can only play a limited role in investment decisions. Investors might find it enhances shareholder value, for example, when a company is environmentally friendly and therefore more attractive to consumers.

ESG might make investors look at financial risk differently, for example the effect of incoming environmental regulation on a company that is slow to reduce emissions. But ESG considerations will always be framed in the name of shareholder value. It's never a matter of giving up some profit for the environment or a social cause. No trade-offs are allowed.

Imagine how a shareholder would feel if an oil company produced large quantities of toxic waste as part of its oil exploration. This waste causes long-term impact on the health of local people and the environment. How do you think shareholders would feel about this toxic trade off?

I would hope these shareholders would not have supported it. On an altruistic level, they may care about these victims of the oil company as well as themselves. On a self-interested level, they may care about the financial and personal impact of a heating planet on themselves and their children.

These same shareholders may also be concerned on a global scale about whether their money is supporting oil companies that lobby against incoming environmental regulation. Or ones that finance pseudo-scientific studies with the express aim of casting doubt on climate change.

That's why I believe pension funds should act on behalf of shareholders, but they should recognize that shareholders have more complicated goals than just maximizing financial return. It is about what I like to call shareholder welfare maximization as opposed to shareholder value maximization.

Three options for delivering members' interests

Pension funds can deliver their beneficiaries' interests using three options available to them. The first is by eliciting and aggregating the preferences of pension holders and voting on their behalf.

A second possibility is to pass through these voting decisions directly to the beneficiaries themselves. Ordinary savers could be encouraged to sign companies like Iconik, which streamline the whole process by asking about your preferences before turning your answers into voting decisions.

A third possibility is for an intermediary to set up a fund with a stated engagement strategy. This fund could invest in whatever company it wants to but would clearly state the ways it would be pushing it to change. Savers could choose to use that fund or not.

These changes would require a step-change in how we think of a pension funds' responsibilities towards its beneficiaries. In particular, it requires a change in the way we view fiduciary duty.

Fiduciary duty for both company boards and for pension funds has been interpreted to mean a focus on just financial return. But what it really should mean is acting in the true long-term best interests of their beneficiaries. Organizations like ShareAction have been campaigning for the legal definition of fiduciary duty to change and incorporate this broader meaning.

If your beneficiaries don't just want to maximize financial return but care about other things, then if you don't put any emphasis on these other things, you should be violating your fiduciary duty.

In the great hall of Gray's Inn, surrounded by the images of men and women who have changed the course of history, I wonder who in the financial sector, who from our political parties will show the courage and strength to shake up the norms.

Who will bring forward the laws and regulations that will free pension managers from the straitjacket of fiduciary duty they find themselves in, because only when they're freed can pension funds claim to serve the interests of the ordinary people who trust them with their money.

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