Ethical Finance in Britain: A Neglected Prerequisite for Sustainability

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Ethical Finance in Britain: A Neglected Prerequisite for Sustainability

Abstract  Financial institutions play a central role in capital and debt markets, providing the finance that shapes development patterns, and thus environmental pressures. Environmental law has traditionally focused on development itself, but not the capital allocation function. Consequently, the underlying market dynamics and growth imperatives are not adequately addressed. To achieve sustainable development in Britain, new legal tools and policies to promote ethical financing in the financial services sector are necessary. This article explains why ethical financing is important to sustainability, surveys the range of financial institutions in Britain relevant to ethical finance, and makes recommendations to improve the regulatory and institutional context for financing sustainable development.

MARKETS AND FINANCING SUSTAINABLE DEVELOPMENT

ROLE OF FINANCIAL INSTITUTIONS AND MARKET GOVERNANCE

So far, in most countries, environmental law has had little to say about the financial aspects of sustainability. The UK, along with other industrial market economies, has propagated complex systems of planning and environmental law that empower regulators to respond to development initiatives and environmental pressures. Such systems do not, by and large, address the underlying market forces that fuel development. From planning law to macro-economic policy, there is an institutional gap between the state and market that reflects societal disenchantment with the command economy model. But, consequently, the raw economic forces that influence investment and growth have remained largely beyond the purview of environmental regulators. This, arguably, is the most worrying lacuna of environmental law.

It is all very well to promote more efficient use of environmental resources, cut back on pollution and so on, but if the economy continues to enlarge, then there may be no net improvement in ecological quality. Markets lack the intrinsic capacity to keep aggregate resource use within biosphere limits. This is the 'scale' problem. Criticisms of uncontrolled economic growth were first dramatically aired in the Limits to Growth thesis of 1972. Recent scholarship by ecological economists posits that market instruments for allocative efficiency

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must be nested within higher order policies on scale. Costanza and others reason that, 'scale should not be determined by prices, but by a social decision reflecting ecological limits.'

The question of how environmental caps on economic growth could be set by governments (for example, pollution caps used in tradeable emission schemes) is not explored in this article – rather, the focus is on the means by which a social decision on ecological limits can be communicated to markets. Is there a way by which the legal system can address market pressures on the environment, without becoming submerged in the minutiae of business decision-making (as in inefficient command economy regulation)? The solution may lie in the financial services sector, which is responsible for providing capital, loans and financial advice to companies and other development entities. Today, large institutional investors (e.g., pension funds and life insurers) dominate capital markets, and banks hold a similar hegemony over debt finance markets. Capital markets are essentially where companies raise money for growth, by selling shares to the public. In debt finance markets, banks lend to businesses for specific projects and activities. Certainly, investment and lending is not confined to the commercial sector. Governments raise money by means of taxation and bond markets to fund major public investment programmes. But public finance is small compared to private financial resources.

The biggest impact of private financiers on sustainable development is not their own ecological footprint, but their strategic role in allocating capital and providing debt finance to others. Because the financial sector sponsors and profits from economic development, it arguably should share responsibility for ensuring such development does not degrade the environment. There are various factors, however, which can inhibit financial institutions' attention to the environment, principally insufficient monetary incentives and inadequate information. If government environmental policy is to tame the growth problem and keep the scale of the economy within ecological parameters, market institutions that drive growth must be fed the right directions, incentives and information to direct financial resources away from polluting industries towards environmentally benign development. Thereby, financial institutions could provide a means of conveying and amplifying core environmental policy aspirations through the economy.

The European Union (EU) acknowledged this potential contribution of financial institutions in its *Fifth Environment Action Programme* (1992-2000), when it declared: 'financial institutions which assume the risk of companies and plants can exercise considerable influence – in some cases control – over investment and management decisions which could be brought to play for the benefit of the environment.' Among the ways that financial institutions appear generically relevant to environmental policy are: as investors, supplying the financial resources for environmental initiatives; as stakeholders, such as shareholders and lenders, exercising influence over corporate management; and as valuers, pricing environmental risks and

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4 Ibid. 81.
predicting the income of companies. In practical terms, such functions may result in financial organisations financing green developments, managing pollution risks, and shaping corporate environmental policy. On the other hand, because of the effects of some market incentives, and the expertise deficits and lack of public participation in their functions, it is inconceivable that banks or insurers, for example, would operate national parks or undertake urban planning.

Harnessing financial service providers to fund sustainable development may dovetail with broader shifts in patterns of governance involving delegation and sharing of responsibilities with the private sector. Due to the perceived advantages of the commercial sector's management skills, efficiency and client knowledge, in various Western countries, private organisations have increasingly been enlisted to furnish social services and implement policy (e.g., in health care and local government). These changes in governance can also be understood in terms of the needs of policy-congested states, unable to satisfy competing societal demands, to off-load responsibilities to civil society and the market. Regulatory theorists emphasise that regulators often operate in a pluralistic setting in which effective administration resides in flexible, collaborative mechanisms in which state functions are shared with or devolved to private interests. Instead of direct government control, policy might be delivered through a combination of rules, incentives and information processes by which the state steers and co-ordinates the non-government sector. Hancher and Moran emphasise that governance in modern Britain not uncommonly involves shared 'regulatory spaces', inhabited by strategic government and private organisations. Financial organisations such as banks and pension funds are germane to such debates, as they are in effect gatekeepers to the economy, supplying development loans for small businesses, equity capital for large public companies, and insurance coverage for companies engaged in risky activities. The financial decisions of investors and lenders may have a much greater bearing on corporate profitability than government environmental regulation. Schemes to more effectively diffuse environmental policy through the market should therefore work with those strategically placed financial institutions that have the capacity to communicate and enforce policy goals and standards.

CONCEPTS OF ETHICAL FINANCING

Among the various ways financial institutions can support environmental policy and regulation, the primary way would appear to be through their ability to finance environmentally sound development. 'Ethical financing', as it may be termed, involves the exercise of environmental, social and other ethical criteria in the selection and management of investment and lending portfolios, and the use of active engagement with companies to persuade them to change. It is not confined to traditional environmental concerns, such as pollution, but extends to a range of societal concerns including animal welfare and the armsments trade (although such concerns, of course, are indirectly relevant to sustainable

14 See, e.g., A. Browne, 'Fines are Failing to Deter the Worst Polluters' (25 July 2002) The Times 2.
Because of the need to promote a socially just and responsible economy to achieve a truly sustainable world, it would appear more appropriate to focus on the broader task of ethical finance rather than merely environmental finance. A society free of pollution but blighted by human rights abuses, for example, could hardly qualify as sustainable.

Underpinning ethical financing is the belief that by taking better account of corporate environmental and social performance, investors and lenders can not only charitably contribute to wider societal aspirations for sustainable development but also achieve financial gains for themselves. Ethical financing may be articulated through 'ethical screening' of companies in investment/lending portfolios on environmental grounds, and, less commonly, stakeholder engagement, whereby investor shareholders or bank creditors seek to improve a company's environmental behaviour by means of engagement with management. Such stakeholder engagement is a key means by which financial institutions can become instruments of environmental governance. Because of fiduciary duties which may restrict the ability of fund managers to use ethical screens that narrow an investment portfolio, and so increase market risk, engagement policies that overlay standard investment policies are beginning to be recognised as a pragmatic way of influencing corporate environmental performance.

In measuring the extent of ethical financing, there is the conundrum of defining what is 'ethical'. As views on ethics vary widely in any given society, there is some difficulty in defining with any authority what amounts to an ethical investment or loan. Institutions set their own criteria for what is ethical, and it can be difficult to ascertain the detailed ethical criteria and positions. The preponderance of vague ethical policy statements may reinforce claims that ethical investment products offer a commodified and privatised ethics that eschews serious debate on the philosophical issues at stake. Most ethical investors seem content to contribute to a fund that generally meets their conscience, partly because they lack the time and resources to critically evaluate corporate practice in detail. Passively contributing to ethical investment funds arguably cannot be a substitute for proper ethical deliberation. Ethical consideration within financial markets must take its cues from the broader political system regarding the definition of appropriate environmental uses and standards. An example is the Dutch government's tax incentives for environmental investment that are available for initiatives that meet criteria set by the state environmental agency. Initiatives to publish independent benchmarks or criteria for ethical investment practice can assist in providing a useful reference point for investor activity. Ethical investment associations and research services can also

18 See, e.g., the policy of Friends, Ivory and Sime, which has adopted a 'Responsible Overlay Policy': www.friendsis.com.
meaningfully contribute to this process because they are not tied directly to profit-distorting considerations.25

Presently, many in the financial sector see ethical financing as problematic, naive and unattainable. Financial markets have long been sceptical of ecological concerns and seldom sought environmental information beyond that pertaining to the financial risks associated with project developments that could directly affect the loan security or insurability of a site.26 Institutional investor behaviour has been linked to unidimensional corporate performance indicators such as share price movements and quarterly earnings statements, which can foster myopic decisions.27 Consequently, to the extent environmental issues are considered, they are peripheral rather than an integral factor in financial decision-making.28

The influence of fund managers is also an important characteristic of the investment community that can impede ethical financing. Often, because of the requirement of financial services legislation to be authorised to conduct investment business, investment decisions (particularly of pension funds) are delegated to authorised fund managers, such as a bank or a money management firm.29 Delegating investment strategies to fund managers raises agency problems.30 Usually, pension funds just dismiss their fund managers and hire a new one if they are dissatisfied with investment performance. But trustees’ fiduciary obligations to protect their beneficiaries’ wealth may require recourse to legal action in some instances. Recently, for example, Unilever and Mercury Asset Management settled out of court for £70 million following the decision by the trustees of the Unilever pension fund to sue their former fund managers for under-performing.31 For ethical finance, the challenge is to ensure that desired investment strategies are acted upon. A survey of British pension funds’ implementation of the new socially responsible investment policy disclosure requirements,32 found that 27 per cent of funds delegated authority over ethical investment to their fund manager, and 48 per cent of funds requested that their fund managers take account of ethical concerns if such concerns were seen as financially relevant.33 Obviously, there is considerable potential for subversion of ethical financing objectives through delegation arrangements if there are no adequate monitoring mechanisms.

In addition to the culture of financial markets and its fund managers, ethical financing sits uneasily with reified investment doctrine. Modern investment portfolio theory holds that ethical exclusion-based policy narrows investment opportunities, resulting in a fund putting its eggs in fewer baskets.34 Screening can make investment portfolios less diverse and so

30 Blommestein, above n. 5 at 45.
32 Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.), Amendment Regulations 1999, No. 1849(2)(4)(b) (Eng.).
more vulnerable to market fluctuations, thus possibly generating lower financial returns for beneficiaries. For example, the UK's Association of Unit Trust and Investment Funds (AUTIF) has advised its members to follow only 'light-touch' ethical policies that do not exclude whole industry sectors from investment. Such investment dogma has imbued modern financial services regulation, which commonly emphasises restrictions on concentrated ownership and fiduciary obligations that require extensive portfolio diversification.

However, under certain market and institutional conditions, some investors can be relatively responsive to corporate environmental performance. Because of their extended liabilities, life insurance companies and pension funds are instruments for longer-term investment and both institutional sectors face only small liquidity risks, emanating principally from transfers and withdrawals in the case of pension funds, and from premature surrenders in the case of insurers. Banks also should have an interest in the sustainability of a borrower's business to ensure loan repayment, which can often be contracted over a thirty-year period. Furthermore, for many funds, the growing popularity in index portfolio funds also tends to lock investors into the market and remove the exit option. The problem of fragmented investor shareholdings, which can reduce the leverage of individual financial institutions wishing to engage with corporate management, may also be addressed through institutional shareholder organisations. For example, in the UK, the Institutional Investors Group on Climate Change (IIGCC), initiated by the Universities' Superannuation Scheme in 2001, is working to coordinate investor pressure on global warming issues.

But if ethical financing is to be taken seriously by financial markets, it must ultimately be able to demonstrate a correlation between good corporate environmental performance and good business. Autopoietic theory suggests that given the disaggregation of modern society into discrete subsystems, each with its own culture and vocabulary, attempts by one subsystem to influence another are unlikely to succeed unless the intervention is conveyed in the norms and codes of the subsystem sought to be influenced. Environmental governance through private financiers must be articulated in a way that is reasonably congruent with the norms and structure of financial markets. Accordingly, it would seem that the environmental mores of a civil society would have difficulty influencing market systems unless environmental concerns are presented in financially relevant terms. Although there is literature that suggests ethical investment can match or exceed conventional investment, the evidence is generally equivocal. However, some empirical studies highlight a correlation between corporate

41 See www.ethicsforuss.org.uk/news/01autumn/autumn2001_03.asp.
environmental performance and share price movement. Excessive materials and energy consumption usually increase a firm's production costs, whilst taxed waste emissions obviously can diminish profitability. More seriously, environmental liabilities may result in substantial financial penalties being imposed on culprit businesses. Where lenders could be made vicariously liable for the environmental harms of their borrowers, the incentive to factor pollution risks into loan decisions is more salient. Evidence from the United States suggests the targeting of lenders caused banks to alter quite dramatically their financing practices in response to the Superfund contaminated land cleanup legislation.

ETHICAL INVESTING AND LENDING IN THE UK

SIZE AND STRUCTURE OF THE ETHICAL FINANCING SECTOR

In Britain a myriad of investment institutions are involved to various degrees in ethical financing, including specialist investment funds constituted as unit or investment trusts, as well as large investment houses such as pension funds. Banks are not normally defined as part of the institutional investment community, as they focus on the savings and debt finance markets, although, pursuant to financial liberalisation reforms, banks in Britain are becoming increasingly immersed in capital investment markets. The ability of investment entities to pursue ethical investment is shaped by their legal structures; the two basic legal forms used in UK financial markets are the trust and the company. A combination of contract, property and trusts law governs the relationships between contributors to investment institutions and their managers.

Institutional investment in the UK has surged in recent decades, with domestic and overseas institutional investors holding at the beginning of 1998 almost 70 per cent of the UK share market, up from just over 30 per cent in the early 1960s. Contributing to institutional investors allows an individual investor to spread their risk across a portfolio of investments and benefit from reduced transaction costs offered by the economies of scale of a collective investment scheme. Life assurance companies are the largest institutional investors in the UK, followed by pensions funds and mutual societies. Banks dominate the debt finance markets, but are also increasingly involved in equity investments. Investments are predominantly made in corporate shares (equities), bonds and property.

How much of this investment is devoted to ethical financing? In July 2001 the UK's Financial Times Stock Exchange (FTSE) 4Good was launched as a specialist ethical investment index, following the lead taken in the United States with the Dow Jones Sustainability Group Index.

The FTSE 4Good selection criteria cover three areas: environmental sustainability; human rights; and positive relationships with stakeholders. Several research and advocacy

47 This is complex legal terrain: see generally E. McKendrick, Commercial Aspects of Trusts and Fiduciary Obligations (Clarendon Press: 1992).
50 See www.ftse4good.com.
organisations have arisen to promote ethical financing, notably the Ethical Investment Research Service (EIRIS), established in 1983,51 and the UK Social Investment Forum (UKSIF), established in 1991.52 There is also a tradition of social investment and lending dating from the late eighteenth century when mutual financial institutions (e.g., building societies) arose to improve access to capital for economically marginalised communities.53 Later, credit unions emerged in the 1960s to bolster local community development. These institutions are now increasingly attentive to ecological issues in their investment and lending decision-making, in addition to their social justice remit.

In the speculative financial markets, there are now over 60 retail ethical investment funds in Britain, with an estimated value at £4 billion in 2001.54 Insurance companies and banks provide most of these funds, into which individuals contribute private savings to purchase units or shares. Some pooled screened funds are also managed purely for contributions from institutional investors such as local authority pensions and company pension funds.55 Much ethical financing also occurs through the church and charity sector, in 1997 estimated at £10 billion of investments.56 The Church Commissioners for England have been systematically investing according to ethical criteria since 1948.57 A smaller source of ethical financing in the UK is ‘cause-based’ investment, amounting to some £180 million in 2001.58 But in terms of market share, ethical financing in the UK is still small – about a 3.5 per cent share of the investment market (excluding the church sector), compared to 13 per cent in the United States, although higher than other industrial economies.59

FINANCIAL SERVICES REGULATION

Although UK investors and banks are becoming more attuned to the environmental dimensions of companies, there is a paucity of government laws and policies to encourage them to do so explicitly. Public intervention into capital markets has typically been a response to market failures regarding information asymmetry, externalities and monopolistic practices.60 Financial services in the UK are regulated in various ways, depending on the type of organisation or product.61 Regulation of investment businesses focuses on appropriate prudential procedures and protection of investors. With banks and other creditors involved in collecting savings and providing debt finance, regulation aims at protecting depositors’ funds and avoiding broader risks to money supply in the economy. Financial managers also have fiduciary responsibilities in trusts law or company law to ensure beneficiaries’ funds are not eviscerated by poor management decisions.62

Financial services in Britain are supervised by the Financial Services Authority (FSA) pursuant to the Financial Services and Markets Act (FSMA) 2000 and its regulations. Since 1979 there has been substantial financial market liberalisation in the UK coupled with some re-regulation

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51 See www.eiris.org.
52 See www.uksif.org.
55 Discussed in EIRIS: www.eiris.org/Pages/MediaInfo/MarSta.htm.
56 EIRIS: www.eiris.org/Pages/MediaInfo/MarSta.htm.
58 Referred to by EIRIS: www.eiris.org/Pages/MediaInfo/MarSta.htm.
to address fraud, mismanagement and excessive risk-taking, which culminated in the FSMA 2000. It brought under a single statutory body – the FSA – regulation of deposit-taking, insurance and investment business. In line with international trends, the UK has moved away from prescriptive regulation of financial activities and quantitative control of bank lending. The tools utilised by the FSA include disclosure and auditing requirements, authorisation of firms and approval of individuals, and capital adequacy requirements. Current financial services regulation should not be interpreted as state reassertion of control over capital and debt markets; the state is interested in addressing certain market failures, but avoiding public determination of investment per se.63

The FSA regulates an assortment of institutions relevant to ethical financing, including mutual societies, credit unions and banks. Proposals for inclusion of environmental standards did emerge during the passage of the FSMA 2000. The UKSIF protested to the House of Commons Environmental Audit Committee the absence of any environmental appraisal of the Bill.64 It proposed modifications to the FSA's mandate, including a requirement to facilitate best practice in environmental risk management and to encourage the provision of environmental investment and lending products.65 The government rejected these proposals, leaving the FSA with only the vague remit in the final Act to indirectly address the environment, if it so chose, via its ‘public awareness objective’.66 Without a specific mandate, at best the FSA might issue guidance notes on environmentally prudent investment practices.67 This has already been attempted by the Department for Environment and the Corporation of London. Their London Principles of Sustainable Finance, issued in August 2002, recommends that financiers:

1. Provide access to finance and risk management products for investment, innovation and the most efficient use of existing assets;
2. Promote transparency and high standards of corporate governance in themselves and in the activities being financed;
3. Reflect the cost of environmental and social risks in the pricing of financial and risk management products;
4. Exercise equity ownership to promote efficient and sustainable asset use;
5. Provide access to finance for the development of environmentally beneficial technologies;
6. Exercise equity ownership to promote high standards of corporate social responsibility by the activities being financed;
7. Provide access to market finance and risk management products to businesses in disadvantaged communities and developing economies.68

63 Hudson, above n. 46 at 29.
64 Nor was reference made to the environment in the Treasury's publication, the Financial Services and Markets Bill: A Consultation Document (HM Treasury: July 1998).
66 It specifies to: '(a) promot[e] awareness of the benefits and risks associated with different kinds of investment or other financial dealing; and (b) [provide] appropriate information and advice': FSMA 2000, s. 4(2).
UK financial institutions have been invited to ratify the principles and report annually on their implementation. According to the report, 'the challenge is not so much to encourage the creation of more niche products like "green investment funds", important though they are, but for mainstream investors, lenders and insurers to integrate sustainability into their decisions'. The London Principles, however, are a voluntary code and say little about possible government regulation where there is market failure.

Apart from domestic-sourced rules, the UK is subject increasingly to EU banking and financial law, and, less intrusively, emerging international standards. The EU has issued a plethora of directives and policies to ensure competition in financial services markets. But no EU-wide banking or wider financial services regulator has been established. Ethical financing has hardly been a feature of EU financial services regulation to date. The European Commission's (EC) proposal in 2000 for a directive on the activities of institutions for occupational retirement provision did not include any environmental disclosure provisions, although an amendment of the EC's proposal was later advanced in the European Parliament to provide an obligation to refer to 'ethical and socially responsible investment principles' in the Article 12(1) disclosure of investment policies requirements. Elsewhere, recent amendments to the EU's Eco-Management and Audit Scheme and the Eco-Label Regulation have allowed for their extension to financial services, thereby enabling investment and other financial service products to be more readily assessed and compared in terms of their environmental credentials. Existing international mechanisms in the financial market sector are largely at an embryonic stage of development. The main institutions that provide a semblance of supervision and standard-setting are the Bank for International Settlements, the Basle Committee on Banking Supervision, and the International Organisation of Securities Commissions. An isolated scheme to address the environment is the United Nations Environment Programme's (UNEP) Financial Institutions Initiative. It began in 1992, with the release of the Statement by Banks on Environment and Sustainable Development, to provide a lever for banks to be more positively engaged in environmental policy. There are now over 170 members of the Initiative, representing financial organisations from over 45 countries. Such initiatives will become more important to off-set trends towards international financial liberalisation.

69 Ibid. 3 (my emphasis).
75 For analysis, see B.J. Richardson, 'Implications of Recent Changes to the EMAS and Eco-label Regulations for the Financial Services Sector' (2002) 14(2) Environmental Law and Management 131.
UK INVESTMENT ENTITIES

COLLECTIVE INVESTMENT SCHEMES

Much ethical investment activity in the UK is articulated through collective investment schemes, which raise money from investors to form pool of investment capital and to return investment profits to each scheme’s members in proportion to their contributions. The fiduciary function is typically divided in collective investment schemes between the custodians of the scheme and the investment fund manager who makes day-to-day decisions. There are some 2,000 collective investment schemes in the UK presently, with a choice of three basic models – unit trusts, investment trust companies and open-ended investment companies.

Unit trusts were introduced in the UK in the 1930s and operate under trusts law principles. Many trusts are operated by banks and insurance companies. A unit trust is created by a deed of trust, with a fund manager appointed, usually in the form of a management company. The latter is empowered by the trust deed to make investments according to the terms of the trust deed. This power is subject to general investment duties codified in the Trustee Act 2000. Further, Part XVII of the FSMA 2000 provides for the authorisation and regulation of unit trust schemes by the FSA (e.g., powers and duties of the manager and the trust). Unit trusts function in the retail investment market, being funded largely from the private savings of small investors. A contributing investor holds a unit in a diversified portfolio of financial assets, and will hold an amalgam of rights as beneficiaries under trusts law principles and contract law to a cash return.

Open-ended investment companies (OEICs) were introduced in May 1997 as a more flexible and simplified alternative to the unit trust. Because of the UCITS Directive, the UK was obliged to recognise OEICs created in other EU states. Further, by providing for their creation in the UK, policy-makers hoped that British financial markets could compete with other markets in Europe offering investors corporate forms of collective investment schemes (and where trust structures are uncommon). Instead of acquiring an equitable interest in a trust fund, an OEIC investor acquires shares in a corporate entity that makes investments in the financial markets. The financial activities of OEICs are regulated by the FSA in accordance with Part XVII, FSMA 2000. The Act addresses risk spreading investment requirements, portfolio management, and gives OEIC shareholders the benefit of the results of that investment. An OEIC is bound by any restriction in its instrument of incorporation relating to investment activities, and fiduciary responsibilities are divided between a board of management and a depositary (responsible for management of the entity’s property). An OEIC with an umbrella fund structure has the flexibility to cater to manifold investment preferences, in that it could offer specialist ethical investment sub-funds alongside conventional investment portfolio funds.

81 Some of the foregoing discussion in this section draws upon Hudson, above n. 46 at 191-257.
82 See generally K. Sin, The Legal Nature of the Unit Trust (Clarendon Press; 1997). The FSMA 2000 provides ‘[...] “unit trust scheme” means a collective investment scheme under which the property is held on trust for the participants’ (s. 237(1)).
85 Hudson, above n. 46 at 236.
86 Ibid.
Investment trusts are actually not trusts, but publicly quoted companies that invest in the shares of other companies. Like unit trusts, they pool members' resources for investment, but unlike unit trusts, investment trusts are closed-ended in that they have a fixed amount of capital divided into shares for purchase. The shareholders do not cash-in units but are entitled to the ordinary rights of a shareholder in relation to dividends and sale of shares. As public limited companies, investment trusts are registered under companies legislation and their investment activities are regulated by the FSA. The Companies Act obliges an investment trust to spread the risk of its investments. whereas a unit trust has specific rules on allowable investments, an investment trust may make almost unlimited equity investments (e.g., unquoted shares) subject to the approval of its board. This can give an investment trust more latitude to engage in ethical investment.

The first specialist ethical funds were not established in the UK until the 1980s due to earlier perceived problems flowing from a fund management's fiduciary obligations. In 1973, plans to establish Britain's first ethical unit trust were blocked by the Department of Trade, primarily because it did not feel that ethical funds could serve conscience and profit simultaneously. The majority of the 60 ethical funds extant today are unit trusts. There are a few in the form of an investment trust company (for example, Jupiter Global Green Investment Trust) or OEIC (for example, UK Socially Responsible Equity). The AUTIF's recent guide to ethical investment funds testifies to the growing market share of this sector. It gives examples of negative screens commonly used as: alcohol and tobacco; animal testing; armaments; human rights abuses; occupational health and safety concerns; pollution; and nuclear power. Examples of positive criteria applied are: community involvement; and corporate disclosure and transparency. Both sets of criteria are relevant to sustainability as environmental health is clearly not just a consequence of pollution mitigation but is linked to promotion of social justice and democratic governance.

Whilst most UK ethical funds are simply too small to influence sustainable development by generating a share price differential between more and less sustainable businesses, they can assist with providing liquidity for venture capital and other small, start-up businesses, which in turn can lead to wider environmental benefits. Investment trust companies are best placed in this respect, as ethical unit trusts cannot invest in small, unquoted companies.

**PENSION FUNDS**

Whilst the market influence of specialist ethical funds in the UK remains small, the pensions sector has considerable market presence. Some £800 million of assets are held by the National Association of Pension Funds, and its assets are increasing as individuals make private provision for retirement in the face of declining state support. The government has encouraged this trend through tax incentives. The growing size and clout of the British pensions industry has so far not led to any extensive institutional activism. The 2001 Myners report revealed 'evidence of general reluctance to tackle corporate underperformance in investee

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87 Companies Act 1985, s. 266(2)(a).
88 MacKenzie, above n. 21 at ch. 3, at 4. The application, for the Stewardship fund, was later approved in principle by the Department in 1978 (ibid. 5).
89 See AUTIF, above n. 36.
90 Ibid. 2.
91 Ibid. 3.
92 See www.napf.co.uk.
An occupational pension fund is an investment institution into which members contribute savings or income to make provision for retirement, with the monies managed by a board of trustees in accordance with an investment plan. In making investments, trustees must obtain the best possible financial return for their members. Apart from common law principles and the terms of each pension’s trust, occupational pension funds are governed by the Pensions Act 1995, as supervised by the Occupational Pensions Regulatory Authority. The Act permits the taking of risks and empowers the trustees to deal with the pension scheme property as though absolutely entitled to it (subject to any express provision of the trust). Pension trustees also have powers of delegation, enabling them to use professional fund managers.7 Public sector pension schemes tend to have their own legislative rules.

Because of the centrality of trusts law principles to pension fund operations, trustees and their advisers have traditionally resisted investing along ethical lines for fear that it would contravene fiduciary duties. Notions of fiduciary responsibility in general trusts law were interpreted in the seminal cases of Cowan v Scargill (1984),101 Martin v City of Edinburgh District Council (1988)102 and Bishop of Oxford v Church Commissioners for England (1992)103 as constraining pension fund trustees from considering ethical factors in investment policy. This is because the best interests of trust beneficiaries have generally been considered as their financial interests. The genesis of this approach is in the conception of trusts in the nineteenth century as a means of protecting family wealth over a number of generations.104 A slightly more liberal approach was taken in Church Commissioners, where the court concluded: ‘trustees would be entitled, or even required, to take into account non-financial criteria [...] where the trust deed so provides’.105 There has been little helpful case law in other jurisdictions. In the United States case of Board of Trustees of Employee Retirement System of the City of Baltimore v Mayor and City Councillors of Baltimore,106 the court found that a city ordinance requiring a municipal authority pension fund to disinvest from companies engaged in business in South Africa did not cause trustees to violate their prudential investment duties so long as the cost of investing according to social responsibility precepts was de minimis, as was considered in this case.

94 Ibid. at 40.
95 Pensions Act 1995, s. 34(1).
96 Ibid. s. 34(3).
97 Hudson, above n. 46 at 145.
99 Pensions Act 1995, s. 36(2)/(3).
100 See Hillsdown Holdings plc v Pensions Ombudsman [1997] 1 All ER 862 at 879 per Knox J.
101 [1985] 1 Ch 270; [1984] 2 All ER 750.
104 On the roots of trusts, see A. Hudson, Principles of Equity and Trusts (Cavendish: 1999).
105 [1993] 2 All ER 300 at 304-5.
106 562 A.2d 720 (Court of Appeals of Maryland, 1989).
Presently, ethical financing is less likely to be viewed as incongruous with profit considerations given wide-ranging evidence that ethical investment portfolios can produce financial returns matching conventional investments.\(^{107}\) Overall, the important criteria to satisfy fiduciary obligations are that: the ethical investment policy does not lower the expected return of the pension plan’s assets; there is sufficient portfolio diversification; and the policy can be implemented without burdensome administrative procedures. Alternatively, a pension fund could follow a standard investment process but focus on shareholder engagement strategies to influence investee companies to improve their environmental performance, an approach taken by the Universities’ Superannuation Scheme, for example.\(^{108}\) If a very rigorous ethical investment policy is proposed, pension fund trustees would probably need to secure members’ and their employer’s consent for an amendment of the trust deed.

The prospects for greater environmentally responsible investment by pension schemes have improved following issuance of a new regulation under the Pensions Act 1995. The Act introduced the requirement that pension trustees create an investment plan.\(^{109}\) In July 2000, a regulation clarified this obligation by obliging pension funds to include in their statement of investment principles (the plan) a reference to: the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investment; and the policy (if any) directing the exercise of the rights (including voting rights) attaching to the investments.\(^{110}\) Although the regulation does not require pension funds to have an ethical investment policy, it clearly endorses the use of ethical investment policy and practice, albeit within the broad parameters of trusts law.\(^{111}\)

This UK initiative has inspired similar reforms in Europe and Australia.\(^ {112}\) Legislation requiring pension fund managers to disclose or consider environmental, social or ethical considerations in their investment policies has arisen in France,\(^ {113}\) Germany,\(^ {114}\) Sweden\(^ {115}\) and Belgium.\(^ {116}\) The French and Swedish examples include obligations to actually take the environment into account, although these requirements pertain largely to state-based pension schemes. Another ambitious reform was undertaken in Australia, whereby the Financial Services Reform Act 2001 applied an ethical disclosure obligation on a wider range of investment products including: pensions, managed investment products and investment life insurance products.\(^ {117}\) But like the UK initiative, none of these examples attempts to statutorily define criteria of ethical investment, and all only weakly address the challenge of monitoring compliance.


\(^{108}\) CoL and DEFRA, above n. 68 at 16, 31.

\(^{109}\) Pensions Act 1995, s. 35(1).

\(^{110}\) Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.), Amendment Regulations 1999, cl. 2(4).


\(^{113}\) Projet de loi sur l’épargne salariale, 7 February 2001. No. 2001-152, article 2; Projet de loi portant diverses dispositions d’ordre social, éducatif et culturel. 28 June 2001, Chapitre Vbis, article L.135-8.

\(^{114}\) Betriebliche Altersvorsorge: article 10, Änderung des Versicherungsaufsichtsgesetzes.

\(^{115}\) Fjärde AP-fonden (Fourth Swedish National Pension Fund), A Presentation of Sweden’s New National Pension Funds (Fjärde AP-fonden: 2001).

\(^{116}\) Projet de loi relative aux pensions complémentaires, article 42.

The crucial empirical question that remains to be authoritatively answered, is how effective such disclosure obligations have been in actually fostering more ethical investment. It is too early to conclusively answer this given the novelty of the reforms. Among the preliminary findings, JustPensions reported in July 2002 that from its survey of 14 large UK pension funds (managing 20 per cent of the sector’s assets), ‘poor practice in relation to socially responsible investment is the norm’. Despite the presence of ethical statements in the majority of pension funds’ investment plans, the survey found poor performance primarily because of ‘pension funds’ reluctance or inability to monitor the activities of their investment managers’. A survey in 2001 conducted by Friends of the Earth revealed that 90 per cent of 100 occupational pension funds contacted mentioned ethics in their statements of investment principles, but also found that the quality of many statements was poor, and that only a minority could demonstrate that they were monitoring and reporting to trustees on ethical issues. Behind statistical ‘averages’, however, there are some notable innovations in pension fund practice.

INSURANCE SECTOR

All insurers in the UK are incorporated and governed by basic companies legislation. Apart from the core requirements of the Companies Act 1985, the 800 non-life and life insurance companies in Britain are subject to two separate regulatory regimes. Firstly, there is prudential regulation through the FSMA 2000 (formerly via the Insurance Companies Act 1982), concerning the solvency of insurance companies and the prudence of their management. Secondly, there is conduct of business regulation, relating to the marketing and sale of retail investment products, which is also governed by the FSMA 2000. Insurers as companies have fiduciary duties to their shareholders, but apart from contract-based obligations, there are no equivalent fiduciary duties in their investment activities owed to policy-holders as such. However, through prudential regulation and solvency controls the FSA seeks to protect consumers and ensure claims can be met. In theory, the FSA could restrict insurers’ freedom to make ethical investments if it felt that such investments were financially unsound and could jeopardise the ability of an insurer to meet its liabilities. The spectacular collapse of Equitable Life has renewed attention on the regulation of insurers, although neither the FSAs Baird Report nor Tiner Report touched on the ethical investment dimension to insurers’ solvency. The FSAs preoccupation is improving transparency in insurance product sales and strengthening the general prudential regime and solvency framework for insurers. Although in relation to environmental issues the insurance industry is normally associated with pollution and natural disaster risk assessment and compensation, it also has a potential role in ethical financing because of the premium income invested in the equity, property and bond markets. Insurers are the largest institutional investors in OECD countries, and the largest within Britain. UK insurers currently hold some £1,147 billion of investments, of which £391 billion is held in domestic corporate stock, accounting for over 20 per cent of

118 D. Coles and D. Green, Do UK Pension Funds Invest Responsibly? (JustPensions: July 2002) 1.
119 Ibid.
120 Friends of the Earth, Top 100 UK Pension Funds – How Ethical Are They? (Friends of the Earth: 2001).
121 E.g., the Universities’ Superannuation Scheme launched a Climate Change Project to engage with investee companies, property managers and policy-makers on addressing greenhouse gas emissions: CoL and DEFRA, above n. 68 at 15.
institutions in the UK equity market. Another £77 billion is invested in unit trusts. Thus, in evaluating the institutional framework for ethical investments made by insurers, one must look at the investment models such as unit trusts through which insurers operate.

Unfortunately, whilst insurers have demonstrated their vested interest to avoid coverage of polluting interests that pose costly environmental liabilities, there is evidence that some insurers still have substantial premium funds invested in environmentally problematic sectors such as the oil and chemical industries. In an effort to highlight the need for a better synergy between the environmental aspects of insurers' investment and insurance activities, the Association of British Insurers (ABI) in 2001 issued investment guidelines that stressed the need to screen companies for environmental and social risks. The ABI asked companies to declare in their annual report the extent to which they consider ethical, social and environmental risks, and whether their boards have effective risk management measures in place. The ABI cajoled members to move beyond mere tick the box style approaches to addressing environmental concerns, in favour of stakeholder engagement. But there remains a paucity of effective practice among British insurers, perhaps because it still remains profitable to invest in certain polluting industry sectors. A 2000 survey found that none of the insurers questioned had any ethical investment policy or practice. Research by EIRIS in 2002 found that whilst many major general insurers had recently adopted formal environmental policies (e.g., Royal & Sun Alliance), virtually none operated ethical funds. A limited number of ethical, niche insurance businesses have arisen in the UK. Naturesave Policies, for instance, provides home and travel insurance policies and earmarks 10 per cent of its premiums to a charitable fund called the Naturesave Trust to support nature conservation and other environmental projects.

**BANKS**

The UK banking sector, which presently comprises some 675 institutions, is divided between commercial (retail) banks, involved in collecting savings and lending to small businesses and project developments, and investment banks, involved in the equity markets and major project finance. The banking sector is therefore enormously important to ethical financing, as it can finance both small unquoted companies for specific developments as well as help fund large companies through equity investments. Lately, banks have extended and diversified their business in response to liberalisation of financial controls, becoming involved in insurance lines for instance. Banks are incorporated entities and hence subject to company law controls. Because of their responsibilities as repositories for people's savings, banks are subject to additional prudential regulation from the FSA (formerly the Bank of England). Banking regulation seeks to balance the conflict between depositors' desire for low risk repositories for their savings, and hence acceptance of relatively low returns, against a bank's shareholders who desire higher returns and hence exposure to greater risk. Current UK banking regulation, based on the Banking Act 1987, does not incorporate environmental standards or obligations, and thus banks' response to the environment is shaped largely by perceived market advantages or environmental regulatory pressures on clients.

126 Cited by Association of British Insurers: www.abi.org.uk.
127 Richardson, above n. 7 at 340.
129 Friends of the Earth, Insurance Firms Named and Shamed (Friends of the Earth: January 2000).
131 See Naturesave Policies: www.naturesave.co.uk.
132 Blommestein, above n. 5 at 33.
For project financing banks, environmental issues are also becoming a stronger concern for several reasons. First, there is the risk of direct lender liability, which can arise where a bank becomes responsible for the environmental liabilities of its client, such as contaminated land cleanup liability under the Environmental Protection Act 1990. Second, environmental problems can generate indirect credit risks for lenders where a borrower experiences financial hardship. Third, there is reputational risk for banks when associated with environmentally controversial developments. As a result of these concerns, banks may reduce lending to environmentally problematic developments. The Co-operative Bank is one of a few banks marketing themselves specifically as ethical lenders.

Environmental banks have become most active in green mortgage services and environmental loans in the small business sector. Merchant or investment banks (e.g., Morgan Stanley) are also sometimes involved in ethical financing when they act as fund managers for pension funds and unit trusts.

Apart from decisions to avoid funding certain developments, the banking sector is particularly active in 'cause-based' investment. Rather than investing in corporate shares, ethically-minded investors may choose to support individual projects or causes. Major UK contributors to cause-based investment are the Triodos Bank and the Co-operative Bank. Some fund managers have established specialist environmental technology funds to invest in listed stocks in sustainable energy, water and resource management, as was done for instance with the Merrill Lynch New Energy Technology. Banks have also become involved in financing trading activity in the UK's new Emissions Trading Scheme.

Banks are increasingly preoccupied with environmental liability risks. As early as 1993 the British Bankers Association issued a statement to members highlighting the need to adopt environmental appraisal procedures to ensure security is not tainted by liabilities. A 1995 survey of eight major British banks found that all had or were changing their lending policies to ensure that 'environmental risk [is] an integral part of the credit appraisal process'.

Whilst there are virtually no instances of UK banks incurring Superfund-style environmental liabilities, there have been occasions when courts have displaced a lender's claims in an insolvency situation to make way for environmental cleanup debts. Some banks are beginning to strengthen their environmental risk capacities, such as UBS Warburg, which introduced an environmental risk management system as part of its credit risk assessment. Specialist ethical banks, notably the Co-operative Bank, go beyond environmental liability risk assessment to apply an ethical policy when screening loan applications. But in relation to factoring environmental risk into the cost of credit through differential interest rates and transaction charges, so far no generic methodology has been developed that can scientifically calculate and translate environmental risks in financial terms.

136 See www.mlim.co.uk/fund-centre/ff-973793.asp.
137 CoL and DEFRA, above n. 68 at 17.
138 British Bankers Association (BBA), The Environment – The Challenge for Business and Banking (BBA: July 1997).
140 See, e.g., Environment Agency v Clark (Administrator of Rhondda Waste Disposal Ltd) [2000] Env. LR 600.
141 CoL and DEFRA, above n. 68 at 17.
To enhance ethical lending among British banks thus requires, firstly, providing for the environmental liability of banks that have a sufficiently close connection to polluting developments—so as to deter future environmentally contentious loans. The EU's draft directive on environmental liability is disappointingly silent on the position of banks, although the question of lender liability was aired in the earlier consultation papers. Secondly, it is important to graft some minimum environmental standards into banking regulation through the criteria governing the authorisation and supervision of banks. For example, there could be requirements for banks to commission environmental audits (perhaps undertaken by borrowers), as part of credit appraisal systems used in loan administration procedures. There could also be an obligation to disclosure lending to high-risk sectors. Further, financial incentives could be offered, such as tax relief for profits earned on environmental-friendly development loans. Overall, the aim should be to embed environmental concerns into lending operations, so that they become a mainstream rather than a niche concern.

COMMUNAL INVESTMENT ENTITIES

An assortment of mutual societies is active in financing ethical and philanthropic causes, in accordance with FSA supervision pursuant to the FSMA 2000 and sector specific legislation. As of March 2002, there were some 65 building societies, 690 credit unions, 237 friendly societies and almost 9,000 industrial and provident societies extant in Britain. Acknowledging their contribution to social investment and community regeneration, in February 2000 the government established a Social Investment Taskforce under the auspices of the Treasury to explore ways of enhancing community financing. The Taskforce's recommendations included: creating a community investment tax credit for mutuals and other financial institutions; and encouraging banks to voluntarily disclose details of their lending in under-invested communities. Because of historical inadequacies in the availability of finance from the banking sector for certain segments of society, institutions such as building societies and credit unions arose.

Building societies, which date from the late eighteenth century, are mutual societies that collect personal sector deposits and offer mortgage-lending services. They are governed by the Building Societies Act 1986, as updated by the FSMA 2000, and supervision is exercised by the FSA (formerly the Building Societies Commission). Building societies are involved in a narrower range of financial activities than banks, being best placed to influence the environmental activities of individuals and households rather than corporations. As mutuals, members of a building society have a voice in its affairs and can vote on major policy decisions. Some UK building societies (e.g., Norwich and Peterborough Building Society) now offer 'green mortgage' products to meet consumer demand for environmentally friendly, energy-efficient houses. The Ecology Building Society also funds mortgages for the renovation of brownfield sites (areas which high street banks often ignore), and loans to support small eco-

146 By way of background, see M. Boldat, The Building Society Industry (Allen & Unwin: 1982).
Although there are some legal restrictions under the FSMA 2000 on where building societies can commit funds, they are less likely to be engaged in unethical financing than banks. Lately, however, a growing number of building societies have 'demutualised' and become incorporated banks (and so come under companies legislation), due to concerns that their mutual structure impeded their ability to function effectively in modern financial markets.

Friendly societies developed in the eighteenth century as a way of improving welfare provisions of the English working class. Friendly societies, which may be incorporated or unincorporated, are registered under the Friendly Societies Act 1992, as updated by the FSMA 2000. The FSA took over supervision from the Registrar of Friendly Societies. Whilst friendly societies typically will have as one of their aims some beneficial purpose, such as assisting members (usually financially) during sickness, unemployment or retirement, since the 1992 Act they no longer need to hold such aims in order to qualify for registration. Consequently, the social investment function of friendly societies has begun to wane in favour of conventional financial investment aims. The extent to which a friendly society wishes to engage in ethical financial activities will be shaped by its corporate memorandum or its trust deed. In each case, they must satisfy the criteria of prudent financial management stipulated in the Friendly Societies Act 1992.

In contrast to friendly societies, an industrial and provident society is an organisation conducting an industry, business or trade, either as a bona fide co-operative (for their members' benefit) or for the benefit of the wider community. The societies are corporate entities, taking deposits from their members to fulfil the purposes specified in each society's objectives. Industrial and provident societies give financial support for various ethical projects and causes relevant to sustainability, such as the work of Shared Interest in financing fair trade with developing countries, or Aston Reinvestment Trust's community regeneration financing. Industrial and provident societies are regulated by the FSA in accordance with the Industrial and Provident Societies Act (IPSA) 1965 and FSMA 2000. To qualify for registration, an industrial and provident society must be organised on co-operative principles or undertake a business 'for the benefit of the community'. Registration confers certain tax and other advantages for a society (for example, limited liability). Under the governing co-operative principles, each member has one vote and the aims of a society must not include the making of profit for the payment of interest or dividends to investors. Thus, in contrast to the capitalist model of corporate investments, the industrial and provident societies are organised on a democratic basis, where the return on investment is the achievement of the communal purpose for which the society was established. The IPSA 1965 is under review and in 2001 the government's Co-operative Commission reported on possible changes to the regulation of societies to improve their commercial success whilst retaining their ethical focus.

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148 See www.ecology.co.uk.
149 Hudson, above n. 46 at 259.
151 Section 50(3), referring, inter alia, to maintenance of adequate margins of solvency and sufficient liquid assets.
153 See www.reinvest.org.uk.
154 IPSA 1965, s. 1(2)(b).
155 Hudson, above n. 46 at 281. IPSA 1965, s. 1(3).
156 Ibid. 279-81.
Credit unions are another distinct co-operative legal model relevant to ethical financing. A credit union is a financial co-operative, owned and controlled by its members, who contribute personal savings into a common fund. The financial advantages of this arrangement are that members can receive competitive low interest loans and annual dividends. The credit union is directed and controlled by a volunteer board of directors, with regulatory supervision by the FSA in accordance with the Credit Unions Act (CUA) 1979 as updated by FSMA 2000. Registration as a credit union removes the need to comply with the more onerous regulation of ordinary banking businesses. But to be registered, members of the union must have something in common, such as being domiciled in the same neighbourhood or working for the same employer. Although credit unions legislation has been progressively revised to provide more flexibility in the kind of necessary 'common bond' among members that would be allowed, and some of the membership and loan restrictions on credit unions have been deleted by the FSMA 2000, the constraints of regulation make this sector a relatively minor ethical financier. Most loans made by credit unions are for small-scale personal credit (for example, home improvements and holidays), although, by catering to local communities and other groups who otherwise suffer reduced access to mainstream financial institutions, credit unions are able to further social justice – an important element in a sustainable society. Unfortunately, British credit union membership remains paltry - only about 280,000 (or 4 per cent of the financially active population), compared to some 25 per cent in Australia and the United States.

CHARITIES

A charity is an organisation established for exclusively public philanthropic purposes. They are registered with and supervised by the Charity Commission pursuant to the Charities Act 1993. Charities have the benefit of tax preference and eligibility for public grants, but these privileges come with a cost of restrictions and regulatory supervision. Each charity is managed by a board of trustees, which must exercise their powers, including in relation to making investments, in accordance with the Trustee Act 2000, in addition to their governing trust instrument. The restrictions applied by the Trustee Investment Act 1961 were replaced by a new mandate to trustees, authorising them to make investments of any kind as if they were absolutely entitled to the assets of the trust. However, sections 4 and 5 of the Trustee Act 2000 posit certain investment duties, namely that trustees must be mindful of the need for diversification (reflecting modern portfolio theory) and the suitability of investments to the trust. Further, they have a duty to obtain and consider 'proper advice' when making or reviewing investments. The Act also obliges trustees to issue a policy statement where delegation occurs to agents who provide asset management services. The Charity Commission's guidance advises that the question of 'suitability' of investments includes 'any relevant ethical considerations as to the kind of investments that are appropriate for the trust to make'. Furthermore, the Commission's guidance on 'Programme Related Investment' emphasises that charities can...
make investments that do not have to seek the best financial returns, providing they accord with the organisation's charitable objects as set out in the trust deed.\textsuperscript{165}

Charities are not merely conduits for aid, but manage and protect their donations and funds through investments. As of September 2002, there were almost 162,000 charities registered in England and Wales, although assets are concentrated in a few large charities.\textsuperscript{166} A wide range of registered charities is involved in environmental financing. The Joseph Rowntree Charitable Trust applies an ethical screening policy, excluding traditional 'sin' stocks, as well as evaluating companies against criteria of environmental reporting and adoption of environmental management systems, and its ethical criteria are periodically reviewed to address potential new concerns, such as genetic engineering developments.\textsuperscript{167} EIRIS conducted in September 2001 a survey of the investment practices of the largest 100 UK charities, and found that 25 had a formal ethical investment policy and six had a policy of active engagement and lobbying with investee companies.\textsuperscript{168}

**A NEW ETHICAL INVESTMENT INSTITUTION?**

Overall, the evidence suggests that although there are some legal and institutional barriers to ethical finance in the current range of investment entities in the UK, these barriers do not appear to be fundamental or incurable. There are two main potential barriers with current approaches. First, ethical investment funds face regulatory restrictions investing in certain sectors, such as unquoted companies. However, restrictions on where ethical funds can invest appear to be diminishing, such as due to the recent UCITS amendment Directive of 2001, which widens the scope of assets in which funds (for example, OEICs) can invest to include bank deposits, money market instruments and financial derivatives, for example.\textsuperscript{169} Second, where a fund is constituted as a unit trust, it is subject to the restrictions of trusts law. Because trusts law demands that financial return be the primary consideration in the management of funds, it can restrict ethical investment unless the trust instrument makes explicit ethical investment goals. The intricacy of trusts law was a factor behind the introduction of OEICs.

Whilst a diversity of mutual institutions in Britain is engaged in the financing of environmental and other ethical causes, there could be scope to create a specific ethical financial institution. Some commentators have suggested that the UK could legislate a new ethical investment entity, drawing on the model of OEICs, which would be a pooled investment company suitable for larger-scale ethical financing operations.\textsuperscript{170} Mayo and Mullineux suggest such an institution could function as a mutual investment fund that is open-ended, unauthorised and working under contract law, and thus able to give priority to environmental and social returns over financial returns. It could accept an investment strategy agreed by the participants without being required (in pursuit of 'fiduciary duty') to maximise financial returns. Such a model would require enabling legislation, but, once instituted, it could also then allow existing ethical investment funds and mutual societies to be reconstituted if desired by their members.

\textsuperscript{165} See Charity Commission: \url{www.charity-commission.gov.uk/supportingcharities/ccpri.asp}.
\textsuperscript{166} Charity Commission, *Quarterly Facts & Figures and Tables for 2002* (Charity Commission: 2002). About 6 per cent of charities receive almost 90 per cent of the sector's total annual income.
\textsuperscript{167} See \url{www.irct.org.uk}.
\textsuperscript{168} EIRIS, 'Charity Survey', *The Ethical Investor* (2001) at \url{www.eiris.org/Files/EIRISnewsletterPDFs/2001/wintersupp.pdf}.
\textsuperscript{170} E. Mayo and A. Mullineux, 'Regulation of Social Investment' (New Economics Foundation: 2000).
Whilst there appears to be some merit in legislating for a specialist ethical financing vehicle, it poses the risk that mainstream investors (e.g., pension funds) would see the environment as an issue not directly relevant to their own operations. For ethical finance to be integrated into financial markets, it must become embedded in the culture of mainstream financiers. At a minimum, this would seem to require maintenance of ethical investment disclosure obligations for the pensions sector; and extension of this obligation to other investment entities, including unit trusts and OEICs. In September 2002, the Cabinet Office Strategy Unit recommended that charity trustees (with an annual income exceeding £1 million) should be obliged to disclose their policies on ethical investment. Disclosure obligations should also be complemented with more rigorous compliance monitoring, given current evidence of perfunctory responses by pension funds. But arguably, investors and lenders should further be obliged to take into account social and environmental issues relevant to companies or projects they finance. In effect, this would be a model of environmental appraisal, complementing existing governmental systems of environmental impact assessment. The aim would be not to duplicate the latter; but to provide a point of initial screening, and projects or companies could be denied finance or be compelled to make operational or policy changes to improve environmental performance in order to receive finance. Already, the insurance sector undertakes a similar surrogate environment regulatory role in relation to the availability of pollution liability risk policies. To empower other financial institutions to do so would require statutory guidance, perhaps from the FSA, on criteria of ethical finance, and obligations on investors and lenders to maintain an adequate level of in-house or contracted environmental expertise, as part of basic authorisation requirements.

Harnessing financial organisations as instruments of environmental law and policy clearly raises complex issues of regulatory design, including accountability and compliance mechanisms, all warranting further research if ethical finance is to be developed into a meaningful pillar of sustainable development policy. In addition to direct regulation of financial organisations, there is the question of the wider context within which they operate.

FURTHER REFORMS FOR ENHANCING ETHICAL FINANCING

Some reforms to the context in which financial institutions operate are arguably necessary if an effective reorientation of investment and lending patterns towards sustainable development is to be achieved. If governments wish to harness financial institutions as a key driver for sustainability, they should institute further measures that give investors and lenders much stronger financial incentives, clearer environmental information and means of leverage in corporate affairs.

First, governments should introduce a wider array of economic instruments, notably pollution taxes and tradeable emission permits, so that the financial costs or benefits of corporate environmental behaviour are made more transparent and relevant to the calculations of investors and lenders. Asset prices need to reflect environmental performance if ethical financing is to have an objective basis. Economic instruments should also be applied directly

173 See especially Richardson, above n. 7.
to ethical investments to create tax advantages for such practices. The success of the Dutch tax incentives to promote investment in environmental businesses has been noted.\textsuperscript{175} Eco-taxes directly affect company balance sheets, and financial institutions should support polluter pay charges since as low-energy users they would not be heavily penalised by new charges. With tradeable permits, companies that are able to generate cost savings through trade in pollution permits could become more attractive investment opportunities for financial organisations. Creating new markets for environmental goods could significantly augment ethical financing. The UK government's recent Climate Change Levy and Emissions Trading Scheme are in this respect welcome initiatives, but more extensive use of economic instruments as a means of environmental policy in Britain is lacking.\textsuperscript{176} Until equity and debt prices reflect environmental performance, then ethical financing will remain somewhat arbitrary in determining which businesses to favour or reject.

A second topic for reform should be corporate environmental reporting obligations, which currently do not exist in UK company law. Financial institutions must have timely, meaningful and relevant information available to support efficient investment decisions. Mandating disclosure of environmental liabilities and costs under securities laws and other company-directed legislation can facilitate investors' and lenders' scrutiny of the environmental behaviour of businesses. In theory, if accurate information is made public, market forces can respond by feeding environmental costs and performance into company valuations. Corporate environmental reporting so far has occurred mostly on a voluntary basis, and consequently, the scope and quality of corporate disclosure has been uneven. In Europe, mandatory environmental reporting has been established in several countries, including France, the Netherlands, Sweden and Denmark.\textsuperscript{177} Recently, the EC published a \textit{Communication on Corporate Social Responsibility}, which referred to the desirability of corporate environmental reporting standards.\textsuperscript{178} Probably the leading example of an environmental disclosure regime contained in financial services regulation is that established by the United States' Securities and Exchange Commission since the early 1970s.\textsuperscript{179} Environmental reporting requirements are most likely to succeed when regulators provide detailed guidance on reporting criteria and ensure that reports reflect an enterprise's entire operations, including relationships with subsidiaries and franchisees that may otherwise be exploited by the parent company to disguise its environmental impacts.

The UK government's Company Law Review Steering Group proposed a new framework of statutory accounts and reports that would cover environmental issues as part of the objective to widen the scope of reporting to cover 'the qualitative, or "soft", or intangible, and forward looking information'.\textsuperscript{180} The July 2002 White Paper on \textit{Modernising Company Law} recommended that 'major companies' (meeting threshold size conditions) be obliged to

\textsuperscript{175} Novem, above n. 23.
\textsuperscript{180} Company Law Review Steering Group, \textit{Modern Company Law for a Competitive Economy: Developing the Framework}, Consultation document (Department of Trade and Industry: March 2000) 181. It recommended that 'where and to the extent material' companies must disclose 'environmental costs and liabilities' which 'may substantially affect future performance', and disclose 'environmental policies and performance, including compliance with relevant laws' and 'policies and performance on community, social, ethical and reputational issues' (at 185).
include, in the proposed new Operating and Financial Review (OFR) report, information on their policies on environmental issues relevant to the company's business, and that company directors need to consider their enterprise's impact on the environment 'as first among equals' in the issues to be covered in an OFR.\textsuperscript{181} Until the UK adopts such measures, financial institutions will have to rely on stock exchange listing requirements and market pressures for voluntary environmental reporting coupled with the information services provided by bodies such as EIRIS.\textsuperscript{182}

Thirdly, reforms should be made to systems of corporate governance to enable or direct investee shareholders to be more active in corporate decision-making. Most UK ethical funds use a screening approach, which tends to reduce their influence on corporate environmental practice. As Miller suggests, 'the main arguments against [socially responsible investment] are that: one cannot hope to change the ways of a major institution simply by buying or selling its shares'.\textsuperscript{183} Shareholder proposals sponsored by institutional investors are a key means by which institutions can influence company policy.\textsuperscript{184} In some jurisdictions, significant barriers to shareholder activism persist, such as investor portfolio diversification obligations and proxy contest rules. The Enron scandal has highlighted the potential huge damage that malfunctioning corporate governance can inflict on pension savings. Various reforms are possible, although the subject raises thorny economic and political concerns to overcome. In theory, financial regulators could require investment institutions to register their share votes, so as to encourage institutions to formulate and express a view on all issues put to a vote at shareholder meetings. Another possibility is the appointment of minority independent directors to corporate boards, nominated by institutional investor groups rather than enterprise management. Beyond measures to stimulate accountability and shareholder involvement, there is the persistent question of whether corporate liability should be broadened, so as to discourage environmentally risky activities.\textsuperscript{185} Thus, in principle, imposing liability on institutional shareholding investors for the environmental impacts of their portfolio companies could promote ethical investment because of the lower liability risks offered by green companies.

The UK government has recently proposed legislation imposing a fiduciary duty on pension funds to monitor companies they have invested in. Following the recommendations of the Myners report, which was critical of the 'culture of non-intervention' among British institutional investors, the Department of Work and Pensions (DWP) proposed a duty that: 'any person who is responsible for the investment of the assets of a retirement benefits scheme must, in respect of any company or undertaking ...' in which they invest such assets, use such rights and powers as arise by virtue of such investment in the best interests of the members and beneficiaries of such scheme'.\textsuperscript{186} The DWP also mooted that the fiduciary duty could

\textsuperscript{181} Department of Trade and Industry (DTI), Modernising Company Law, Cm. 5553 (DTI: 2002) cl. 4.13.

\textsuperscript{182} EIRIS has a database of over 1,000 major companies, drawn from the FTSE, maintaining information about each firm's environmental performance, which can be measured against some 300 ethical criteria. See www.eiris.org.

\textsuperscript{183} A. Miller, Socially Responsible Investment: The Financial Impact of Screened Investment in the 1990s (Financial Times Business Information: 1991) 7.


\textsuperscript{185} On this debate, see F.H. Easterbrook and D.R. Fischel, 'Limited Liability and the Corporation' (1985) 52 University of Chicago Law Review 89.

\textsuperscript{186} Department of Work and Pensions (DWP), Encouraging Shareholder Activism: A Consultation Document (DWP: 2002) 8. Even without this specific duty, arguably under existing law, where investments are made in company shares, this includes a duty to exercise any votes and use shareholder powers so as to maximise the value of investments made for the beneficiaries of their scheme.
apply to other types of investments. But how this requirement would be reconciled with the UCITS Directive is unclear. Article 25 of the UCITS Directive, which applies to UK unit trusts and OEICs, stipulates that an investment entity may not acquire shares carrying voting rights that would enable it to exercise significant influence over the management of the investee company.\textsuperscript{187} The EU's motivations for this requirement have been interpreted as based on a desire to ensure investment entities focus on pure investment trading and profit maximisation decisions rather than be distracted by the details of corporate management.\textsuperscript{188} Institutional investor associations, concerned that such a general duty of intervention could be problematic in the absence of specific directions as to when to intervene, have instead issued their own voluntary code in an attempt to stave off government regulation.\textsuperscript{189}

CONCLUSION

Financial institutions have a central role in capital allocation, which in turn shapes development patterns and environmental pressures. Environmental law has traditionally focused on development itself, but not the capital allocation function. The problem is that underlying market pressures and growth imperatives are not addressed. The development of new legal tools and policies to promote ethical financing in the financial services sector is a critically important new frontier for UK environmental law reform. Ethical finance of course is a broader concept than environmental finance, but because the achievement of sustainable development is inexorably linked to supporting socially just and humane institutions and activities, it is more appropriate to stress the broader goal of ethical finance.

This article has surveyed the range of financial institutions in Britain, their involvement in ethical financing and applicable regulations. Ethical financing is not a mainstream feature of UK capital and debt market institutions, being largely confined to a few specialist funds and mutual societies. Apart from the need to review the structure of regulation that can impede ethical financing, broader reforms to environmental reporting, economic instruments and corporate governance appear necessary. In forging a viable institutional framework for promoting ethical financing, it is vital that there be more empirical research into the effectiveness of existing legal and policy mechanisms. Further research is needed into how and to what extent ethical investment and lending actually persuades companies to change.

\textsuperscript{187} UCITS Directive, above n. 169.
\textsuperscript{188} McCormack, above n. 83 at 11.
\textsuperscript{189} See E. Clark, 'Trouble in Pension Land' (21 October 2001) \textit{BBC News}. 