Net zero and just transition for pension funds

The Conference of the Parties (COP) 26 in Glasgow represents a new milestone in the global fight against climate change, with a more climate-friendly US administration and growing mobilisation in favour of "Net Zero". Six years on from the Paris agreement, the objective is clear: limiting temperature rise to well below 2°C above pre-industrial averages, which means reaching net-zero carbon emissions by 2050, and halving them by 2030.

Pension funds and net zero

Accordingly, pension funds are progressively receiving demands from their different stakeholders to do their "fair share" in the global fight against climate change. Contrarily to other institutional investors, a key stakeholder a pension fund needs to account for is its members.

Plans, especially those representing industries or activities that are related and/or severely impacted by climate change, are coming under pressure to consider climate change in their investments, in terms of risk management, but also in terms of contribution towards a low-carbon economy.

Governments and regulators are also initiating inquiries and issuing laws and regulations making the consideration and disclosure of climate change risks (and opportunities) mandatory for the largest pension funds. Interestingly, in the UK, leading companies such as IKEA and Ernst & Young have signed the "Green Pensions Charter" committing their pension funds' investments to reach Net Zero emissions, thus anticipating an evolution in regulatory requirements.

The "Net Zero Pensions Summit" took place in June, with renowned speakers such as Mark Carney and Alok Sharma encouraging pension providers and funds to join the "Race to Net Zero" wagon, using their impressive $50tn financial firepower in favour of climate action.

It is thus clear that pension funds will not long be able to ignore these strong pressures from multiple directions. A number have started actively mobilising, for instance by joining the UN-Convened Net-Zero Asset Owner Alliance (NZAOA). It is also expected that a global industry-specific initiative dedicated to pension funds will be introduced, such as those for central banks or insurers.

Having a well-defined ambitious science-based plan, like that promoted by NZAOA, to cut portfolios' emissions in line with Paris Agreement objectives is the necessary starting point. "Well-defined" in terms of clarity of measurements used and of intermediate and final objectives; "ambitious" in terms of alignment with the Paris Agreement; "science-based" in terms of using commonly used measures, such as the Science Based Target Initiative (SBTi) sectoral decarbonisation objectives, to which many corporates are committing.

Furthermore, the transition should not be considered solely from an investment standpoint. Indeed, as scheme liabilities stretch over long periods, there is potential for the long-term effects of climate change to affect the liability side of pension funds' balance sheets. Notably, climate change could have important implications for the funding of health and social care services and therefore lead to a variation in mortality, especially for vulnerable and elderly populations relying heavily upon these services.

A just transition: integrating the social dimension

However, there is more to this than climate risks and achieving net zero by 2050. Consequently, upholding fiduciary duty also means accounting for these social impacts when making investment decisions.

In fact, the transition towards greener economic models will only be successful if it is made socially acceptable. Recent events have increasingly demonstrated this: from rejections of carbon tax increases in France, to job losses in certain fossil fuel areas that are not directly compensated by 'green' jobs. The current Covid-19 crisis, which is still unfolding and whose socioeconomic ramifications remain uncertain, will only compound this problem.

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So, what is a 'Just Transition'? In stylised terms, it is a transition where the negative social impacts, such as job losses, are minimised while the positive social impacts are maximised. The concept is not entirely new: its roots date back to the 1970s in the US, when unions fought for workers whose livelihoods were threatened by new environmental regulations. Since then, it has taken different forms. In international climate negotiations, some states or regions have called for a 'just' contribution to fight climate change, one reflecting that developed countries have overwhelmingly contributed to high levels of pollutions since the Industrial Revolution. The 2015 Paris Agreement notably called for actions that consider "the imperatives of a just transition of the workforce and the creation of decent work and quality". Finally, the 2018 Silesia declaration called for special consideration of fossil fuel intensive regions.

So what's different this time? For one, the climate crisis has been amplified by a social crisis: poverty and inequality rates have risen, and may rise further if debt levels constrain support for the poor and redistribution policies. Secondly, if we are to deliver on ambitious climate promises, words will need to be transformed into actions, potentially making their social impacts more salient and abrupt than ever. This is exacerbated as the longer we fail to act decisively, the more we risk a brutal transition. Nonetheless, the Covid-19 crisis also presents a formidable opportunity to 'build back better', thereby including the social dimension in new sustainable policies.

What next for pension funds?

The debates around the 'Just Transition' testify to its complexity. Such a transition has ramifications for all. One way to explain it is to look at it through four dimensions: workers, consumers, local communities and societies. A Just Transition must ensure that workers in industries undergoing restructuring can find new employment in sustainable industries, and/or have adequate social safety nets. Goods and services must also be aligned with the objectives of the Paris Agreement, and accessible to all. Local communities will be affected differently, and so sharing the benefits and costs equally will be crucial. The Just Transition must ensure that every stakeholder fully contributes through constructive dialogue to coordinated actions.

Adopting a Just Transition framework can allow pension funds to link their climate risk strategies to the transition that lies ahead for these different stakeholders. This can take many forms, including through company engagement or policy advocacy. French pension fund, Ircantec, for example, has included the Just Transition as one of its main engagement axes, encouraging companies to integrate social issues in their climate decisions, and has led several working groups to share best practices.

Moveover, Just Transition principles are aligned with fiduciary duty, in that long-term investment decisions that serve the interests of beneficiaries should be considered. In that regard, embedding labour, consumer and community rights in investment beliefs can be a way to integrate Just Transition into capital allocation decisions for pension funds.

In 2020, Amundi developed a just transition score allowing performance of listed corporates to be evaluated on this dimension. This methodology will continue to be refined as just transition metrics become more available and data becomes more granular. Using such scoring as a constraint for portfolio construction can be a good way for pension funds to identify just transition leaders, i.e. companies that integrate the transition's social considerations while being on a trajectory to meet climate objectives.

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