To protect the sustainability of the planet for the generations to come, the United Nations proposed 17 Sustainable Development Goals in 2015 as part of the 2030 Agenda for Sustainable Development. We have reached the midpoint along this 15-year sustainability roadmap. Climate change (Goal #13) has been a major global challenge with a worrying progress. The greenhouse emission from human activities is exacerbating the warming of the atmosphere and driving extreme weather conditions including heatwaves, droughts and tropical cyclones (IPCC, 2021). The devastating impact of climate change has gone beyond the irrevocable environmental damages, but unprecedented humanitarian crisis that threatens the life of climate refugees and the next generations. That makes climate action a key element on the intergenerational contract – instead of asking our offspring to “pay the bill”, all global citizens shall reflect on what actions they could take to ease the pressing situation.

To address the severe climate issues, green finance has been advocated by the international finance community to channel more resources to the green projects that could strengthen climate resilience and achieve carbon neutrality (UNEP, 2019). That triggers a cross-disciplinary discussion on how various stakeholders in the society can attract the investment interest and contribute to the vibrancy of green finance in the private sector.

Ambition - Beta Migration to Green Finance
Endorsing the effectiveness of green finance in lowering the carbon footprint, the new intergenerational contract shall aim to gather the momentum and turn green finance into the mainstream of investment. When green finance was first introduced, the investment community generally saw it as an additional risk factor and would supplement that into the valuation model. A Sustainable Capital Asset Pricing Model (Zerbib, 2020) was introduced to incorporate...
taste premia (ie. preference towards green investment) and exclusion-market premia (ie. negative screening on sin stocks) into the financing model alongside with other classical risk factors – small-minus-big (SMB), high-minus-low (HML) and momentum. While this model set-up recognizes the payoff generated by the green orientation of the investment, I would advocate that we should aim higher by incorporating green finance as the new beta, instead of a supplementary risk factor. Under the classical CAPM model, beta is defined as the systematic market risk. Market practitioners would use some recognized broad-based index as the proxy of market risk, such as S&P 500 and FTSE 100. Such benchmarking has important implications in the fund industry as both active and passive asset managers would compare their portfolio with the benchmark to gauge whether they are out-performing or under-performing the market. The benchmark also serves as the reference point when portfolio managers are designing their own fund. If we could bring a revolutionary change in the financial industry by introducing green indexes as the new benchmark, that could trigger a virtuous cycle to channel more fund for green objectives. I have identified three prerequisites to make the beta migration happens,

(i) Recognized and replicable green indexes in market
(ii) Support from major asset owners and asset managers
(iii) Significant asset under management (“AUM”) on green instruments

The first two conditions are fairly met while we are still on the way in fulfilling the last prerequisite. For the first condition, green indexes are widely available with established index methodology, valid traction in performance and a developing ecosystem with mutual funds, ETFs, index derivatives. Examples include Bloomberg MSCI Global Green Bond Select Index and FTSE Green Impact Bond. Regarding the second condition, leading asset owners and asset managers have shown their commitment in integrating green considerations into their investment mandate. United Nations have convened 69 asset owners with US$10.4 trillion AUM to form a Net-Zero Asset Owner Alliance in 2019. The Protocol states that institutional members are committed to observe the portfolio decarbonization target of lowering the absolute CO2 emission by 49% - 65%, compared to the base year 2020 (United Nations, 2021). International asset managers also indicated their determination on net-zero target. Blackrock, the world largest asset manager with US$9.5 trillion AUM, published its letter to clients to acknowledge the focus on sustainability in its investment stewardship would promote more durable risk-adjusted returns in the long term (Blackrock, 2021). There is a healthy trend that more asset managers are seeing green investment as their fiduciary duty to clients.

With the green indexes well-constructed and asset managers buy-in, the stumbling block lies on the scale of AUM accumulated for climate purposes. Bloomberg Intelligence projected that the amount of ESG asset would account for one-third of the global asset in 2025 (Bloomberg Intelligence, 2021). Although the trend is pointing towards the right direction, the velocity is dissatisfactory. Beta migration would be probable only when green investment falls into the main-stream of the global AUM, ideally at 50% - 70%. The lukewarm responses from the private sector in fostering green finance was one of the highlights in the COP26 Summit. Larry Fink, the CEO of Blackrock, stated that the private sector shall have a larger role to play in combatting the climate change (Financial Times, 2021). Mark Carney, the Co-Chair of Glasgow Financial Alliance for Net Zero, echoed and commented that only 40%of the global financial system had signed up to his climate alliance whereas the remaining 60 per cent shall step up (Financial Times, 2021). Research from World Economic Forum has also suggested that the amount of green proceeds of the European Union is currently falling short from the zero-emission target whereas the private investments shall pick up two-third of
A default option is the pre-specified courses of actions if the decision-makers do not indicate any preferences. In behavioural finance, default option leverages the decision makers’ psychological responses on loss aversion and regret aversion. Some decision makers would be inclined to the default options as they do not want to feel regretful for a wrong decision. Another key feature is that the decision makers maintain the ultimate decision power where they are free to opt themselves out from the default option. The default option theory has been experimented on the arena of retirement savings with the Save More Tomorrow™ study which encouraged people to commit in advance of setting aside part of their future salary for retirement use (Thaler and Benartzi, 2004). The result was positive with the average saving rate of the participants increased from 3.5% to 13.6% in 40 months. The objective of this proposal is to extend the default option from “whether or not to save for retirement” in the Thaler and Benartzi’s study to “what to invest for retirement”.

Proposal – Incorporating green investment into the default option of pension plans

To reach the critical mass in AUM for a global beta migration movement, a proposal is outlined to deepen the penetration of green finance in the investment portfolio of retail investors. I would like to advocate all corporates to provide more green alternatives in their employees’ pension plans and incorporate the green alternatives in their default option.

Rationale

Pension plans can be considered as one of the most accessible financial tools that connects households with the financial system. Regardless the jurisdiction is using a defined benefit or defined contribution plan, a mandatory or voluntary regime, pension plans would cover a decent proportion of the working population. The size of pension plans reached US$35 trillion in 2020, which accounted for 100% of the overall OECD GDP (OECD, 2021). Tapping into this gigantic asset pool would allow us to channel valuable financial resources for green purposes.

The current practice regarding the choice of pension plan is that employers would first select a handful of pension providers based on the asset managers’ suitability and performance. The employer, the pension funds investment committee (usually led by employee representatives) and the pension providers would then reach a consensus on the pre-selected funds that are available on the list of pension funds. The employees could then indicate and state the asset allocation over the preferred pension plans based on their investment preference and risk appetite. In some jurisdictions like United Kingdoms and Hong Kong, if the employees do not state their preference, a default option would be applied.

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Implementation

Corporates could consider adopting a phased approach to gradually increase the green elements in the default pension. Although the company’s senior management holds a strong decision power in proposing what to be included in the pension fund list, various stakeholders have a role to play for a smooth implementation.

Phase I: Selecting green funds

While doing the fund search, corporates shall be careful in distinguishing a genuine green fund from greenwashing practices. A true green instrument should exhibit solid legal ground as stipulated on the clauses and provisions stated in the offering documents. Although there is no universally agreed definition on green instruments, various international organizations put forward several framework and guidance to assist issuers and investors in distinguishing genuine green products, including the EU green taxonomy. One global standard that frequently quoted by market practitioners is the Green Bond Principles issued by International Capital
Market Association. The Green Bond Principles outline the green provision on the “Use of Proceeds” which brings a binding contractual obligation for issuers to limit the utilization of the proceeds to projects which could reach the pre-defined environmental objectives (ICMA, 2021). Some offering documents also stipulate that regular reporting is required to monitor the Key Performance Indicators (KPIs) and perform independent green impact assessment. For instance, Apple Inc. raised a EUR 2 billion green bond in November 2018 and the bond prospectus stated that the net proceeds would only be deployed to projects meeting the Eligibility Criteria, including carbon migration and low carbon design. Such ringfencing mechanism protects the investors from the misuse of proceeds.

**Phase II: Incorporating green funds into default options**

After shortlisting the suitable green funds, the corporates shall proceed to the design of the default options for the pension schemes. The senior management is responsible to fulfill their fiduciary duty in protecting the long-term interest of their employees. In United Kingdom, the Department for Work and Pensions has published a guidance stating that the default option shall observe the principles of suitability, affordability and risk management. The inclusion of green fund aligns with the principles as climate-related events such as floods and droughts would lower the payoff of the securities (Campiglio et al., 2019) and raise concern over the fund’s risk profile. By strengthening the portfolio’s climate resilience, the default fund could generate a greater risk-adjusted returns in the long run when compared to its brown equivalent. Senior management shall make full disclosure on the methodology of incorporating green funds, including the percentage of asset allocation and criteria of fund selection. It is imperative to communicate the rationale of introducing such change to the employees and ensure that they are well-informed.

**Phase III: Monitoring and reviewing the fund performance**

The objective of the regular review is to ensure the ongoing suitability of such default option in terms of the governance framework, investment strategy and portfolio performance of individual components (DWP, 2011). Corporates are encouraged to engage third-party vendors such as Sustainalytics to perform an independent impact report in assessing the impact of the green funds. Disciplined reporting would enhance the transparency between the fund administrator and the investors to make sure that the green fund is serving its purpose.

**Conclusion**

Climate change has been the most pressing issue that threatens the sustainability of our planet. By fostering the green beta migration, green finance would be recognized as the mainstream of investing and induce more financial resources to achieve the net-zero target. Collaborative effort from corporates, asset managers, index companies, independent impact assessors and individuals is necessary to promulgate green finance in the private sector. Incorporating green investment into the default option of pension plans would be the first step, and the viable step, to bring green finance into our new intergenerational contract.
References


