

THOUGHT PROVOKING IDEAS OF THE GLOBAL ESSAY COMPETITION 2022

The Role of Pensions to Form the Framework of a New Intergenerational Contract

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Introduction

Now more than ever, generational divides are eroding the social contracts that have been the framework of societal cohesion for centuries. The culmination of record levels of societal inequality, disruptions resulting from globalization, and a planet undergoing climate change has caused societal divides never before experienced in living memory. Unfortunately, much of the differences lie between generations as the concerns and priorities of different age demographics vary greatly. For the Silent Generation and the Baby Boomers, their main concerns involve planning for retirement and anxieties about savings (Tyson, 2021). In Canada, 77 percent of baby boomers are worried about retirement (Wells, 2021). Conversely, for a majority of young people, the most pressing challenge is climate change. In fact, nearly 90 percent of Gen Z youth are worried about the future of the environment (Sustainable Brands, 2019).

Although the priorities of older and younger generations vary greatly, there is a lever tying together their priorities that could reignite intergenerational cohesiveness: public pensions.

Not only do public pensions represent one of the largest classes of funds in terms of capital – with over \$50 trillion USD under management – but their allocation structure is different than other funds as well (OECD, 2021). Unlike private funds or even employer-based funds which rely on individuals contributing to their own retirement, many public pensions rely on the current labour force to fund the pensions of retirees, just as the previous generation did before them. The funding structure of pensions thus increases the power of the current labour workforce to impact the types of investments the pension fund pursues.

A Case for Pension Reform

In this essay, I present an argument for public pension reform as a means to enhance cooperation between age groups and re-establish a collective intergenerational contract. In particular, I advocate for the creation of a global forum to oversee pension funds' divestment from fossil fuel-emitting companies and the re-allocation of capital to net-zero companies by 2050.

This ambitious target will help address the challenge of mobilizing finance to sustainable enterprises while tackling the long-term investment concerns of carbon-emitting companies. The longer time horizons also allow for pensions to work with their portfolio companies directly to eliminate their carbon emissions, which helps address the root sources of climate change. Younger generations will be increasingly enthusiastic about contributing to pension funds while older generations can feel more secure about the long-term viability of their pension plan. There will also be a collective sense of pride in public pensions serving as a lever to fund sustainable enterprises and act as a catalyst towards energy transition. Finally, the transition to renewable investments could trigger a spillover into private funds (private equity and mutual funds) which have so far been reluctant (Harry Bridges Center for Labor Studies, 2021).

Current Challenges with Pensions

Public pensions today are facing numerous challenges that are a result of major changes in demographics. Across much of the developed world, populations are ageing at levels not seen previously. As average life expectancies increase and birth rates decrease, average ages continue to increase. In Italy and Japan, the average ages are now 47 and 48, respectively (Worldometer, 2022). As more people enter their retirement years, the size of the workforce is anticipated to continue shrinking. In the United States, for example, there is already a shortage of 6 million workers (Emsi, 2021). This trend can be seen in other developed countries as well, which will pose a major strain on the public pension system of many countries.

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A second major challenge with pensions involves the long-term return on their investments. A study from Imperial College's Centre for Climate Finance & Investment found that investments in renewable sources of energy saw returns of over 150 percent while investments in fossil fuels saw losses over 20 percent (Imperial College, 2020). This supports other studies on the return on investment (ROI) among renewable and non-renewable energy sources from the UK, which saw returns exceeding 75 percent for green energy compared to 9 percent for non-renewables (Vetter, 2019). With strains on pensions expected to continue increasing, it is imperative for pensions to deliver strong and consistent levels of returns. In this sense, divestment represents a great way to ensure long-term stability.

Despite the climate and financial incentives highlighting the importance of transitioning away from carbon-intensive investments, less than half (46 percent) of pension plans in Europe consider climate change to be a major challenge (Flood, 2021). And only 8 percent have commitments to reach net zero emissions by 2050 (Flood, 2021). The lack of net-zero commitments further exemplifies the differences in priorities between the people managing pension funds and those who will experience the heaviest impacts of climate change.

How the Proposed Reform Works

The proposed climate reform plan involves the establishment of a global forum to develop criteria for fossil fuel divestment and net-zero targets.

This body would be comprised of leading climate scientists, representatives from the United Nations Framework Convention on Climate Change (UNFCCC) secretariat, the United Nations Youth Delegate Programme and executives from the largest public pensions globally. Their fundamental mandate would be to ensure that public pensions around the world achieve net-zero emissions by 2050. This means ensuring that the overall activities in the value chain of a company have no net impact on climate change (Science Based Targets Initiative, 2021). The diverse representation on the governing body would signify the global nature of this challenge and enable collaboration among pension plans. The inclusion of the UN Youth Delegate Programme would help ensure that the voices of younger generations were expressed and considered when decisions are made about pension reform. Their participation would also be a critical tool to help incentivize pensions to participate, as it would show the intent for pensions to consider future generations when managing their portfolios.

Currently, one of the major challenges inhibiting greater progress towards net-zero investments is fear of losses on investment returns. For example, if one pension were to divest from an oil and gas company, there is the risk that another pension or private fund would reinvest in the same company. This would not only fail to address the objective of progress towards net zero but would also deter pensions from engaging in climate-friendly practices in the future. By creating a forum for public pensions to be transparent about their divestment plans, the risk of re-investment into fossil-fuel emitting companies (or an exchange of ownership) would be mitigated.

Another benefit of establishing an international body is the knowledge-sharing that would arise. Individual pensions that have already committed to net-zero emissions by

2050 would be able to provide expertise and support to other pensions looking to emulate their climate ambitions. For example, in my home country of Canada, four major pensions (OMERS, Ontario Teachers' Pension Plan, Investment Management Corporation of Ontario and Caisse de Dépôt) have already committed to net-zero emissions by 2050 (Shift, 2021). In these cases, one of the key drivers of divestment among Canadian funds is the fiduciary responsibility of pension plans to their beneficiaries to address climate change (Shift, 2021). This follows the Supreme Court of Canada's recognition that pension funds must consider the implications of climate change (Macnab, 2021). Through the global forum, investors can share their own experiences with GHG divestment, along with the impacts of national policies on their decisions.

Another critical aspect of the proposed forum is to prevent the greenwashing of climate investments. Greenwashing refers to misleading investors or the public about the environmental sustainability of investments (Kenton, 2021). Unfortunately, this trend has become increasingly common among pension plans as they look to portray themselves as "climate-friendly" (Pollard, 2021). The rise of ESG metrics has also resulted in some funds "showing" that they are invested in climate action without actually taking meaningful measures to reduce emissions. Through the establishment of a global forum, the criteria for divestment would be clear and there would be less opportunities for pension funds to mislead investors and the public about the climate response plans. And if they were unable to reach the requirements from the global forum or displayed no intent to meeting commitments to net-zero plans, the fund would be removed from the forum's list of participating pensions.

Climate Impacts

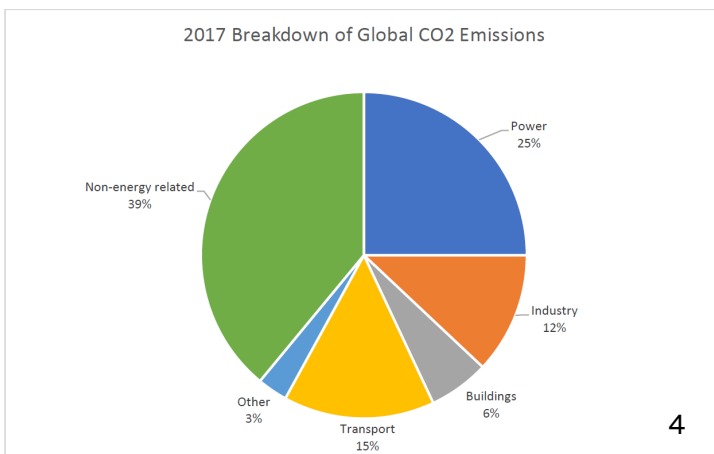
The climate impacts of a global forum to oversee the emission-reduction programs of pension funds would be significant. With over \$50 trillion USD managed by pension funds globally, the re-allocation of capital would significantly contribute to reaching the Paris Agreement targets (OECD, 2021). Currently, there is a major shortage of funding for environmentally sustainable investments. For example, among Canada’s largest pension funds (some of whom have committed to net-zero reductions), only seven percent of assets are placed in sustainable investments (Institute Smart Prosperity, 2021). With the global share of investments in climate-friendly enterprises set to increase through the forum, the necessary capital would be mobilized to help scale up sustainable enterprises.

The increase in capital directed to sustainable investments would be especially beneficial for renewable energy sources. Currently, energy emissions account for over 60 percent of global carbon emissions (Morgan Stanley, 2019). The same report estimated that the capital required to fund technologies that allow us to meet the Paris Agreement goal of 1.5°C is approximately \$50 trillion USD (Morgan Stanley, 2019). If pension plans can collectively re-direct funds away from energy-intensive sources towards sustainable investments, there would be enough capital in renewable energy sources to meet the Paris Agreement targets. The table below from IPCC contains a more detailed breakdown of the sources of carbon emissions.

Financial Impacts

An often-overlooked benefit of climate reform to pension funds are the increased financial returns resulting from a more sustainable portfolio. Over the past few years, renewable investments have greatly outperformed fossil fuel investments. In 2021, investments in renewable energies had seven times higher returns than investments in fossil fuels (Jackson, 2021). Part of the reason for increased returns among renewable, clean-tech investments is that many companies are still in the earlier stages of development. Unlike traditional oil and gas companies, which are more mature investments with lower expected returns, many clean-tech companies are in the growth phase and offer a higher potential ROI. Furthermore, what many clean-tech companies need most is funding to support scaling up. Pensions can provide the necessary capital to help these companies reach economies of scale.

As populations across much of the developed world continue to age and pensions become increasingly strained, it is imperative for these funds to become more open to high-growth opportunities. Traditional portfolios consisting of mature asset classes will not provide the long-term financial returns necessary to guarantee payments to the growing number of retirees who are increasingly living longer and depending on expensive care services (Ligaya, 2013). Not only will the global forum on pension reform assist with the necessary carbon reduction needed to meet the Paris Agreement targets, but it will also support the long-term financial sustainability of pensions.



Spillover Effects

Over the past few years, pension funds have become increasingly open to diversifying their portfolios and investing more in environmentally sustainable companies. Unfortunately, this trend has yet to transfer to private equity and mutual funds. Since 2010, private equity funds have invested over \$1 trillion USD into the energy sector, with nearly 90 percent of these investments directed into fossil fuels (Tabuchi, 2021). What is especially concerning is that a key driver of the uptick in fossil fuel investments among private equities is divestment in these companies from other funds. Only by aligning global pension funds and their cumulative \$50 trillion USD to divest from fossil-fuel companies will divestment result in a substantial decrease in carbon emissions. Otherwise, private equities will continue to view these assets as undervalued opportunities for large financial returns, at the expense of climate change.

Although major obstacles need to be addressed to incentivize pensions plans to participate, including concerns about short-term financial impacts, there is broad public support for climate reform. In the United Kingdom, nearly 75 percent of the population is supportive of transitioning pension funds to become more climate-friendly (Defined Contribution Investment Forum, 2020). This trend is consistent with other countries as well. Should a global forum be successfully implemented, it will not only represent an opportunity for funds to re-direct the necessary capital into climate-friendly investments, but also offer greater long-term returns. Pension plans will once again become a source of cohesion between retirees and the current labour force.

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