The challenge of using pension funds to fuel green finance

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The Intergovernmental Panel on Climate Change's latest Synthesis Report is a dire warning that without drastic action, global temperature will rise to 1.5C above pre-industrial levels and the damage will be irrevocable. This report has been called humanity's final warning. If we do not act now, it will be too late. One of the most substantial forms of climate change investment could come from pension funds. These could be immense drivers of green finance, should the funds be responsibly and intelligently employed to key impact and sustainability projects.

Positively, we've seen a big shift in terms of climate change being integrated in investment strategies. Sanlam Benchmark Surveys show us that two years ago, just 10.7% of standalone funds called climate change significant to their strategy; now, this has risen by 22.6% to 33.3%. Umbrella funds have followed a similar path, going from 15% two years ago, to 32% today. In fact, 7% of umbrella funds deem climate change at the centre of their strategy.

Progress is being made, but there's more to be done with some critical challenges to overcome.

The potential of pension funds to fuel green finance

As is the case globally, pension funds make up most of South Africa's assets. According to the National Treasury, the nation has some 5 000 retirement plans (non-operational included) managing the resources of over 16 million contributing members and retirees.

The Association for Savings and Investment South Africa (ASISA) puts South Africa's pension funds' assets under management at approximately R4.6 trillion as of December 2022. In addition to tackling climate change, local pension funds' allocation into climate focused projects can play a role in catalysing international finance, promoting economic growth, contributing to the creation of skills and knowledge fit for a changing working environment, and addressing risks and opportunities for their members. Finally, climate focused projects may offer the added benefits of low correlation and volatility compared to non-climate focused projects.

Some of the challenges of going greener

There are various key challenges that retirement funds cite as hindering them from investing in private market infrastructure. However, over time, many of these are being countered by market innovations.

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Here are some of the core challenges right now:

CHALLENGES | PROGRESS

LACK OF LIQUIDITY

	Challenges	Progress
1	The illiquid nature and long lock-up periods present in most private market infrastructure assets limit the investment amounts invested in these assets. This is important, especially where policyholders expect access to funds at short notice.	The involvement of development finance institutions and banks earlier on in projects has the potential to create a secondary market for retirement funds.

HIGHER FEES COMPARED TO LISTED COUNTERPART

	Challenges	Progress
2	High fees are a challenge, along with making allowance for fees within current fee structures.	Transparent fee structures and the creation of tradable instruments have assisted in addressing this issue.

LACK OF TRANSPARENCY/INFREQUENT VALUATION

	Challenges	Progress
3	Reporting requirements are less stringent than those of traditional assets; as such performance is not standardised, making it difficult to compare different managers.	The introduction of tools and resources such as the Green Finance Taxonomy may assist in standardising reporting and disclosure practices.

LACK OF INFORMATION AND EDUCATION

	Challenges	Progress
4	Alternative assets are complex, and there isn't enough information and education to enable decision makers (such as trustees) to adequately evaluate their inclusion in a portfolio.	The introduction of knowledge sharing and education platforms for trustees such as those supported by Batseta and the International Finance Corporation (IFC) aim to address these issues. Retirement fund trustees have the fiduciary responsibility to ensure that their members are educated about a wide variety of issues, including allocation of their assets towards impact and sustainability projects and how ESG factors are incorporated into their investment decisions.

HIGHER PROJECT RISK

	Challenges	Progress
5	Especially that of corruption, when dealing with government or government linked entities.	

INVESTMENT RISK

	Challenges	Progress
6	Pension fund trustees have the fiduciary duty to ensure good investment returns to members. To a large extent, the returns on private market strategies diverge significantly, so there is the risk that performance hurdles are not met.	This is where access to listed sustainability instruments could make a major difference. The global market has been faster in adopting these; the local market has been held back by lack of knowledge, higher costs, the absence of a green government bond curve to price instruments against, limited track records, the small size of the green bond market which limits liquidity, regulatory uncertainty and the cost of certification.

INTEREST RATE SENSITIVITY

	Challenges	Progress
7	There must be consideration of the impact that a change in interest rates could have on an infrastructure investment, especially if it's highly geared.	

REGULATORY RISKS

	Challenges	Progress
8	There is a greater need to consider whether the outcome of an infrastructure investment is closely linked to any future regulatory changes (for examle, land reform). This is especially challenging given the long term nature of these strategies.	

While it's evident there are obstacles to overcome, the long term benefits of deploying pension fund capital to combat climate change are immense. Now is the time for deliberate, considered action to heed the final warning and move the needle.