Pensions and ESG: The economics is straightforward, but the politics …

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Pensions and ESG: The economics is straightforward, but the politics …

1. The problem: Multiple market failures
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3. Public policy for wider aspects of ESG
4. A process, not an event
5. But the politics …
6. Conclusion: Where does that leave pension fund managers?

The central arguments

- Take it as read that climate science has a rock solid case regarding the broad effects of human activity on climate, hence a rock solid case for acting now
- Objectives for fund managers
  - Currently typically to maximise returns for a given degree of risk
  - Need to add additional objective of ESG compliance

The ‘So what?’ question: Why do we have financial markets?

- A primary purpose of financial markets is to translate the savings of individual savers into productive investment
    - ‘Investment’ means physical capital (factories, machines, infrastructure) and human capital (skills)
    - ‘Productive’ relates to output growth both now and in the future
- Important that market signals should be useful for that purpose
- But in some areas – ESG is one – markets left to themselves will not produce efficient price signals

1 The problem: Multiple market failures

- Assumptions of a ‘first-best’ economy
    - Perfect competition
    - No externalities, public goods, increasing returns to scale
    - Perfect information
    - Rational behaviour
    - Complete markets
    - No distortionary taxation
- The ‘Invisible Hand’ theorem: in such an economy, markets achieve an efficient allocation of resources

Why might markets not do things efficiently?

- Imperfect information (the economics of information, Nobel Prize 2001)
- Behaviour beyond narrow economic rationality (bounded rationality, behavioural economics) Nobel Prize 2002, 2017)
- Search frictions (Nobel Prize 2010)
- Incomplete markets, incomplete contracts (Nobel Prize 2016)
- Distortionary taxation (necessary to finance redistribution; addressed in the literature on optimal taxation (Nobel Prize 1996)

Market failures relevant to ESG considerations (Stern 2022)

- Externalities: negative (greenhouse gases), positive (innovation)
- Uncertainty, e.g. about what innovations and when, and about future government policy
  - Risk and uncertainty – a central distinction
  - Financial markets have problems pricing uncertainty; thus not always easy to finance innovative research and development
- Imperfect information (both fund managers and savers)
  - Lack of awareness of technologies
  - Lack of clarity about ESG-compliance (or not) of different investments
- Co-ordination problems,
  - Many large-scale things must happen at the right time and in the right order
  - E.g. need electric charging stations before introduce widespread use of EVs
  - Co-ordination across countries is even more difficult
- Time inconsistency, e.g. profits now but adverse effects on profits of climate change are in the future. Not least because of uncertainty not all future losses are priced in

2 Public policy responses relevant to pension funds

- In the face of market inefficiencies there are two mechanisms policy makers can use to induce market participants to act more efficiently:
    - Regulation and/or
    - Incentives

2.1 Regulation

- Regulating products
- Regulation and fund managers

What regulation: Labelling and enforcement

- Four elements of regulation
  - Definition of multiple characteristics of ESG funds
    - Technical definitions, for fund managers and regulators; various attempts to do this, e.g. European Commission (2020)
    - A less technical version so that consumers can identify ESG compliance, or lack of it
  - A reporting mandate
    - Requirement to label funds in terms of those definitions (cf definition of credit card interest)
    - World Bank (2020, pp. 33-38) sets out a detailed best-practice disclosure check list, citing CalPERs as a good example
  - Audit
    - Technically competent, and
    - Independent – and seen to be so
  - Enforcement capacity with teeth

What is the purpose of regulation?

- To make it easy for market participants to identify
  - Greenwashing (E), notably the use of fossil fuels
  - Antisocial activities (S), e.g. poor employment practices, gender inequality
  - Faulty governance (G), e.g. lack of diversity, unethical behaviour including corruption
- To create incentives for funds to be genuinely ESG
  - Makes it harder to get away with unsubstantiated claims
  - Makes it more difficult to adopt complexity (cf deliberately complex charging structures for phone or household utility contracts)
- Note that regulation has twin purposes
  - Consumer protection, and
  - Strengthening ESG

Regulation and pension fund managers

- A separate question is what fund managers should do in light of good labelling and enforcement
- Current rule: fiduciary responsibility defined as maximising returns for given degree of risk
- Need consideration of how to widen the mandate on fund managers to take account of ESG considerations
    - Maximise returns taking account both of risk and ESG considerations
    - E.g. the Norway sovereign wealth fund

Who should make the rules?

- Way beyond scope of this talk (and my skill set) to discuss practicalities
- Ideally
    - Any national body should be long-term and cross-party, e.g. the Sweden pensions group
    - To extent possible the rules should be international

2.2 Incentives

- The time inconsistency problem arises because in the short run, carbon-intensive production may be cheaper
  - E.g. petrol cars cheaper than electric, creating incentives to make profits today at the expense of losses in the future
  - An analogous issue can arise with the sustainability of pensions
- Incentives are designed to help address this time-inconsistency by making future costs evident today
- Better pricing (next slide) is a central element in such incentives

Better pricing of carbon

- Carbon tax (better name carbon dividend)
  - Carbon tax alone is not a complete answer, but is a central element in an overall strategy
  - A carbon tax, *cet. par*. makes carbon-intensive industries less profitable
    - If no action, firms become less profitable, reducing their share price and their value in pension portfolios. Fund managers would vote with their feet
    - The incentive, therefore, leads to firms adopting less-carbon-intensive methods (e.g. effects of the sugar tax in the UK)
    - Thus would knock out Chinese products that are cheap because their production and distribution ignore climate damage

Better pricing of carbon (2)

- Better pricing of risk, i.e. pricing over a suitably long time horizon
    - Regulation has an important role in setting the time frame such that risks like ***not*** complying with ESG considerations adds to pension fund liabilities
    - Analogy: regulation requires funded company pension plans to take proper account of future liabilities
- Another example of the many cases where the economics is relatively straightforward – the main problem is political feasibility of a carbon tax

3 Public policy for wider aspects of ESG

- Talk focuses on pensions and ESG
- Not discuss the wider ESG reform agenda beyond listing them (see New Climate Economy 2018, pp. 6-7)
    - Clean energy
    - Improved urban development
    - Sustainable land use and food production
    - More efficient and equitable water management
    - Industry, innovation and transport

4 A process, not an event

- As noted, take it as read that climate science is broadly right about the effects of human activity on climate
- While nothing that will be learned will invalidate that point, that does not mean that we know it all, given
    - New knowledge:
    - Technical advance, e.g. cheaper, large-scale carbon capture and storage, or ways of sucking carbon out of the atmosphere
    - Uncertainty (not risk) about both of the above
- Thus need a process for monitoring the various measures, e.g. refining definitions, finding new ways of enforcement, adjusting carbon pricing, etc.
- Process probably requires an independent overseeing body with serious teeth

5 But the politics …

- Pushback by market actors
  - Example Spain: note that over a full career an annual management charge of 1% leads to an accumulation that is 20% smaller than without the charge
  - Example: China
- Government failure
  - Too little, too late – too little has been done for decades; time inconsistency also affects governments
  - Inadequate strategic planning, which is necessary to address the collective action problem both within and between countries
  - Inadequate stability of government policy: government-induced policy risk is a major deterrent to investment, e.g. UK sudden withdrawal of subsidies for solar panels

6 Conclusion: Where does that leave pension fund managers?

- What can pension fund managers do?
    - Large funds can be active owners
    - Non-profit funds can act as trustees for younger as well as older generations
    - But in neither case do funds face a level playing field
- If I were a fund manager I would get together with other fund managers to pressure government(s) to do two things:
    - Put in place the sorts of regulation and incentives outlined above
    - Tasking funds with ESG considerations in addition to their current obligations to firms and workers
- Ideally what is needed is co-ordinated international action (an Australian fund manager wants to know whether funds in Japan or Korea that claim to be ESG compliant really are)
- As backup, large pension funds could make side-agreements (a ‘club’) with funds in other countries

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