HIGH MEADOWS INSTITUTE

2022 ESG Leaders Forum

Mobilizing a Just Climate Transition – Emerging Topics for Investors

Overview

With the number of corporate net-zero pledges currently topping 1,500, the Canada Pension Plan Investment Board's announcement of net-zero commitment across its portfolio by 2050, and the SEC poised to release its long-awaited climate risk disclosure rule any day, the role of investors in shepherding the transition to a low-carbon economy is increasing. As is the level of scrutiny it comes under.

Investors have a mix of incentives to drive corporate action on "net-zero," but ultimately a core motive is to reduce financial risks to their assets. This has led the public and policymakers to critically examine the private sector's decarbonization commitments, as they will bear the brunt of climate change impacts. As a result, there will be increasing pressure for investors to ensure that capital is directed toward **a transition that is not only rapid and economy-wide but also just**, and this introduces further complexity to an unprecedented challenge.

The Climate Justice Alliance defines a just transition as follows:

> *Just Transition is a vision-led, unifying and place-based set of principles, processes, and practices that build economic and political power to shift from an extractive economy to a regenerative economy. This means approaching production and consumption cycles holistically and waste-free. The transition itself must be just and equitable; redressing past harms and creating new relationships of power for the future through reparations. If the process of transition is not just, the outcome will never be. Just Transition describes both where we are going and how we get there.*

The PRI describes the compounding challenges facing investors in pursuing a just transition, stating "[It] is a complex agenda for investors and other stakeholders, one that requires **strategic engagement both within investment institutions and in multi-stakeholder collaborations where investors can play important roles**. This will frame the context in which challenges arise as climate transition strategies are developed and implemented." This briefing note aims to illuminate some emerging topics for investors as they navigate the evolving transition finance space against a backdrop of cross-sectoral collaboration, justice, and regeneration. The issues explored include:

Source

- Managing and communicating trade-offs
- Shifting from divestment to engagement
- Embracing brown issuers of green debt
- Deploying blended finance
- Prioritizing adaption
- Investing in nature
- Looking beyond the limits of carbon markets
- Shaping policy

Managing and communicating trade-offs

Transitioning to a net-zero economy will require businesses to make difficult choices. Transformational shifts across the value chain will induce a variety of social and economic ripple effects, and as we approach 2030 with progressively fewer options at our disposal to meet our emissions-reduction targets, we will all be faced with increasingly difficult trade-offs. At the core of a meaningful, context-specific, and science-based net-zero strategy lies transparent communication and rationale of its financial, social, and environmental trade-offs. This is not an easy task, but it is a critical one to avoid the risk of unintended consequences and public backlash.

The disclosure of some trade-offs could soon be mandatory as regulators worldwide pursue an approach that aligns with the Task Force on Climate-Related Financial Disclosures (TCFD), which reports on strategy, risk, and opportunities. However, the TCFD is not a socially aligned or informed disclosure framework. It remains to be seen whether asset managers will invest in line with their rhetoric on social issues and be willing to accept the potential costs of a just transition at the scale needed to avert the worst climate impacts on people and the planet.

Transition strategies will pose challenging questions around trade-offs, and transparency around the strategy, rationale, policies, research, and accountabilities to address them will be key to mitigating risk and engaging stakeholders. The 2022 Senior Partner Letter from Generation Investment Management, a boutique sustainable investment firm, is a good example of a well-developed and clearly communicated statement about their approach to "limit global temperature rise to 1.5C and ensure a just transition" (see table below).

Communicating Generation Investment Management – 2022 Senior Partner Letter Analysis	
Strategy	"As it pertains to the just transition to net-zero, investors need to take a sophisticated approach to create system-positive change. This ensures investment decisions are made holistically, with honest conversations about trade-offs."
Rationale	"The world's most vulnerable are being harmed by a problem they did not create."
Research	"The International Energy Association's (IEA) scenarios make it clear that incremental fossil fuel discovery and production is not needed in any part of our energy system to 2050. For those investing in such assets, not only do they pose a climate risk, but they also run the risk of their assets being stranded."
Accountabilities	"At COP26, the finance sector committed $130 trillion to the net-zero transition. To fulfill that commitment, finance must lead with or without government policy." "There is no common understanding of what the term means. We define a just transition to net-zero as one which pursues the necessary shift away from GHG emissions across all industries while proactively addressing the associated social and economic impacts, particularly for marginalized communities." "Since a just transition to net-zero accounts for communities that have historically been subject to underinvestment, the finance industry must look inwards and take greater strides to incorporate voices from these demographics."

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Shifting from divestment to engagement

Engaging with companies that fail to meet sustainability targets instead of divesting can lead to business transformations that yield greater impact toward a just climate transition. While divesting may be the path of least resistance to a net-zero portfolio, the strategy fails to provide sufficient flexibility and support for companies to improve their sustainability efforts. The engagement vs. divestment debate regarding the exclusion of "dirty" assets in heavy-emitting sectors has recently intensified. Engagement advocates point to the fact that excluding and discarding fossil fuel stocks often sends them directly to notoriously opaque private markets, where their business activities are under less scrutiny and less pressure to improve performance on environmental, social, and governance (ESG) issues.

Conversely, engaging with businesses on transforming their business practices toward a just transition can drive innovation (and value creation) to reduce GHG emissions, and patient capital can help ensure that the infrastructure to enable new products and practices is in place long enough to generate expected reductions.

Fossil fuels will play a key role in the transition to net-zero emissions. Firstly, electricity cannot be the only vector for the energy sector's transition. While the renewable electricity market is growing, it accounts for only 20% of energy global consumption. Therefore, prioritizing feasible emissions reductions for oil and gas companies is critical until the renewable market reaches a critical mass.

Secondly, oil and gas will be crucial for capital-intensive clean energy technologies to reach maturity. These efforts include developing carbon capture storage and utilization, low-carbon hydrogen, biofuels, and offshore wind. Thus, optimizing the capacities that exist within industries can prove to be more effective in transitioning to net-zero than dismissing them altogether. This is emphasized by the fact that although we have nearly all of the technology needed to reach the net-zero targets of 2030, almost half of the additional emissions reductions by 2050 will need to come from technologies that are currently prototypes or under development. Innovative firms, including oil and gas companies, are key to investing in the critical technologies needed to reach the Paris Agreement by mid-century. Rather than take the path of least resistance, investors need to develop robust engagement plans for fossil fuel companies to realize the emission reductions that are needed from them as the transition gains speed, as well as invest in critical decarbonization technologies for further reductions after 2030.

Embracing brown issuers of green debt

Transition finance could bridge the gap between traditional and sustainable financing options for the phased, capital-intensive transition pathways of heavy-emitting and difficult-to-abate sectors through targeted, new, business-aligned financial products. But investors must lead on driving demand for these products and holding them accountable for ushering in a just transition with appropriate terms and KPIs. Initially skeptical of "brown issuers" of "green debt," investor interest in transition finance products is now growing as the financial industry and sustainable finance leaders push for these products as essential tools for achieving a low-carbon economy, and investors should accelerate this trend.

While the green bond market grew by more than 500% between 2015 and 2020, (and has continued its trajectory since), the market for transition bonds has grown more slowly than anticipated. However, that is changing as investors warm to the entry of difficult-to-abate industries into sustainable debt markets; some say the transition bond market could outpace the green bond market in less than five years. S&P Global forecasts that this evolving asset class could reach $1 trillion per year as global economies seek to meet 2030 and 2050 targets for decarbonization and as corporates seek financial products that are not linked to specific projects but instead to business-aligned transition pathways, making this space especially ripe for innovation and impact. Enabling business-aligned transition pathways with tailored financing mechanisms has the potential to protect against

job loss, and the linkage of environmental, social, and governance targets to the cost of capital can effectively incentivize a more just approach than even the most complex transition pathways.

Deploying blended finance

Blended finance structures effectively combine public and private interests to attract a larger pool of funding for projects that deliver critical co-benefits aimed at increased community well-being and sustainable development. Blended finance is the strategic use of development finance for the mobilization of additional capital towards sustainable development in emerging economies, i.e., those that stand to lose access to a historically critical development pathway in the form of fossil fuel consumption. The method seeks to attract commercial capital towards projects that contribute to sustainable development while providing financial returns to investors.

In recent years, participation in impact investing has grown significantly, currently accounting for more than USD 228 billion in assets under management. However, there remains a critical need to mobilize capital from private sectors to fund public projects, particularly in emerging economies, where economic advancement is threatened by the transition. It is estimated that the achievement of the 2030 Sustainable Development Goals (SDGs) faces an annual funding gap of USD 5 to 7 trillion. Because it enables the entry of more conventional capital flows into products, companies, and funds that incorporate impact objectives, blended finance structures should be of increased interest to investors across asset classes that seek to drive a just transition.

Prioritizing adaptation

A just transition for adaptation must be pursued alongside a just transition for energy. It is now certain that significant impacts from climate change are unavoidable. We have already experienced this firsthand in the form of rising sea levels, heatwaves, droughts, and wildfires, and projections around food shortages, ecosystem collapse, energy poverty, and mass climate migration indicate increasing challenges in the near term. Globally, businesses, governments, and individuals will have to adapt to changing water availability, temperatures, and natural catastrophes, to name a few. However, the world's poorest people will have the greatest difficulty adapting, in part because they are disproportionately exposed to the brunt of climate change impacts and have the fewest resources to defend themselves or recover from disasters.

Despite the risks to businesses and people across the world, international public adaptation finance is just USD 30 billion (5% of tracked climate funds) annually, yet adaptation costs in developing countries are estimated at USD 70 billion, and this figure could reach USD 280 to 500 billion by 2050. Investing in just adaptation at scale would increase economic, social, and environmental resilience in our deeply interconnected world. Nature-related investments have the potential to provide the multi-stakeholder benefits essential for just adaptation. Restoring ecosystems and building stronger communities can create more productive local economies and reduce social and environmental vulnerabilities.

Case Study

The LDN Fund is an investment vehicle co-promoted by the United Nations Convention to Combat Desertification (UNCCD) and Mirova. The blended finance fund is designed to support scalable land degradation reduction and reversal by leveraging public funding to catalyze private investments at scale. The fund primarily invests in sustainable agriculture and forestry, as well as other LDN-related solutions like eco-tourism and green infrastructure, to restore degraded land, mitigate climate change, and improve livelihoods.

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Investing in nature

Natural capital and biodiversity have emerged at the top of the global sustainability priorities list and as critical, cross-sectoral tools for addressing the climate crisis. As economies and cultures have long been inextricably linked to nature, investing in its protection and the functioning of ecosystem services, i.e., nature-based solutions, has a critical role to play not only in climate regulation but in a just transition that maintains heritage, traditions, and cosmologies alongside economic prosperity.

The growth of natural capital focused funds, creation of new nature-related asset classes, and widespread support for the Taskforce on Nature-related Financial Disclosure indicates that investing in nature is no longer a niche market. Advocates for nature and pioneers of conservation finance have long highlighted the extreme dearth of capital allocation towards the planet's most valuable asset, and the nature funding gap has recently been estimated at nearly $1 trillion. A UNEP report states that approximately USD 133 billion per year currently flows to nature-based solutions, with public funds comprising 86% of that figure. Investments in nature-based solutions will need to at least triple in real terms by 2030 and increase four-fold by 2050 if the world is to meet its climate change, biodiversity, and land degradation targets. In addition to closing the nature funding gap, investors need to close the gap between public and private funding for nature, and novel products and investment strategies provide new opportunities to do so.

Case Study

Wetland impact bonds have attracted the attention of investors aimed at sequestering carbon and improving coastal communities' resilience. Quantified Ventures, an outcomes-based capital firm, worked with federal and state-level public organizations to develop a financing approach for critical wetlands restoration projects in Louisiana's Coastal Master Plan via an Environmental Impact Bond. The bond's structure enabled accelerated funding to more quickly intervene to address erosion, enabling local communities to maximize the benefits that wetlands provide in the forms of flood protection, water supply, water quality, fisheries, and carbon sequestration. On average, restoring wetland ecosystems and protecting the coast is estimated to create over USD 17 of total economic output for every USD 1 spent.

Looking beyond the limits of carbon markets

Carbon offsets are a useful accounting tool for climate finance, but the climate transition will not be realized on a single firm's balance sheet. Low carbon prices have sent weak price signals to market participants, which can ultimately lead to further GHG pollution outpacing carbon offset projects, demonstrating the enormous challenges in reaching scale. While the voluntary market reached the much-anticipated $1 billion milestone in 2021 and could reach $50 billion by 2030, this is a drop in the bucket in terms of what will be required to a) meet emissions-reduction targets and b) finance the transition.

Even as efforts continue to address near-term solutions for the limited capacity for scale, market integrity issues present additional obstacles. Ongoing controversies about the credibility of real emissions reductions and carbon removal projects have driven key figures – including the former head of the US SEC Annette Nazareth and former Bank of England Governor Mark Carney – to voice that their focus is shifting from *expanding* voluntary markets to *scaling them down* and ensuring their quality.

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Like any market, the voluntary carbon offsets market requires clear rules and assurance to create the required trust and minimize friction. Yet to date, it remains unclear whether the difficulties of creating global voluntary carbon markets can be overcome and whether credibility and scale can be achieved in time to keep us on track with critical short-term emissions reduction targets. The necessary investment in infrastructure, R&D, business transformation, community development, and human capital that a just transition demands will require novel, tailored financial instruments with relevant KPIs.

Shaping policy

In response to the mainstreaming of ESG investing and the growing severity of the climate crisis, policymakers have directed their attention to standardized and regulated climate-related disclosures. While some governments have opted for country-specific disclosures, others have selected frameworks widely used by investors, like TCFD. This highlights the fact that there is no universally agreed-upon definition of "corporate climate change-related information." As the global market's response to the EU Sustainable Finance Disclosure Regulation indicates, unstandardized reporting creates headaches for markets.

However, the widespread support for TCFD from both the investment community and policymakers provides hope for standardized disclosures in an otherwise fragmented sustainability reporting environment. Investors and governments alike value the market efficiencies created by standardized, decision-useful climate disclosures, which are critical to driving timely investments in decarbonization. A common climate disclosure can allow governments and socially-minded investors to allocate more of their attention to the justice-related aspects of the transition, which are likely resource-intensive and time-consuming. For example, the Biden administration has pledged a justice-based approach to tackle the climate crisis and spur economic activity for disadvantaged communities. This is an ambitious promise but the difficulties of delivering on it have become evident. For instance, there are no answers to stakeholders' questions about how the federal money will be distributed to address both racial inequities built into the American highway system and the need for new green transportation.

However difficult for investors, there is no time to waste waiting for regulators and governments to act on climate change. It is on the private sector to lead, and investors are well-positioned to drive change through active stewardship to create pressure on firms to chart their path to net zero. Anything less, which includes divestment or waiting for policy to catch up with markets, is taking a path of least resistance that creates compounding negative financial, environmental, and social effects.

Conclusion

Deadlines to reach critical sustainability goals including the UN SDGs and the Paris Agreement targets are rapidly approaching. A socially-oriented approach to financing the climate transition is needed and creates unique opportunities to drive positive social impacts and decarbonization. However, it is unclear whether the investment community will aim to improve equity or equality through their just transition investments. As touched upon in this briefing note, addressing historical power imbalances to shift from an "extractive economy to a regenerative economy" is a time and resource-intensive task for an average investor ultimately concerned with their financials. Although niche investment firms and pure-play just transition funds may dedicate their focus toward justice and equity, it currently seems more likely that mainstream investors will target benefits for *all* (stakeholders in the broader sense) rather than direct capital and efforts to improving the lives of those most severely impacted by climate change and the net zero transition. To recall the words of the Climate Justice Alliance - *If the process of transition is not just, the outcome will never be.*

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