RBS International

Stay the course

Why alternative investment funds should maintain their commitment to science-based targets

Tomorrow Begins Today

Welcome

The urgency of adopting science-based targets (SBTs) may have slipped since last year but belief in their long-term value perseveres.

Climate finance discussions were a key feature at COP27 in November 2022, which highlighted that up to US$6 trillion needs to be invested in renewable technologies and infrastructure by 2030 in order to reach net zero emissions by 2050.[1]

Where this funding comes from remains the subject of intense debate, but greater attention is being given to the influence of alternative investment funds (AIFs) and the role of fund managers in decarbonising the global economy.

In 2022, when we published the first iteration of this study, we sought to understand the extent to which AIFs are adopting SBTs and the barriers that prevent them from doing so. Given the fast-changing nature of industry sustainability discussions, in January 2023 we once again surveyed 125 key influencers within AIFs to see how they are faring as economic conditions continue to worsen.

This latest survey reveals that regulatory pressure remains the main driver for SBT adoption, however an uncertain economic environment threatens to slow progress as fund managers focus on the day-to-day challenges. Nevertheless, the feeling remains that an orderly transition to net zero supports a thriving economy.

[1] 'COP27 ends with announcement of historic loss and damage fund', UN Environment Programme, Nov 2022

We are acutely aware of the economic pressures facing individuals, investors and financial institutions. At RBS International, however, our commitment to net zero and driving positive change through our climate initiatives remains unchanged.

As part of NatWest Group, our own science-based intensity targets – which include aligning our scope 1, 2 and 3 portfolio temperature score, by loan or invested value, to 2.3°C by 2030 – have been validated by the Science Based Targets initiative (SBTi), and we continue to engage with funds as they set their own.

Net zero is about more than complying with regulations or voluntary standards – it's increasingly clear that what's good for the planet is also good for business.

The World Bank points to the need to continue tackling climate concerns even in the face of immediate challenges:

"While countries are facing rising inflation and uneven recoveries from the Covid-19 pandemic, climate change has not slowed down," it says.[2]

Despite murmurs that worsening economic conditions are distracting from decarbonisation strategies, we believe fund managers have an opportunity to act decisively and seize net zero opportunities. Setting SBTs and having clear net zero goals will secure their ability to access capital and remain competitive in the longer term.

Olly Holbourn
CEO, RBS International

Susan Fouquier
Head of Institutional Banking, RBS International

[2] World Bank Group exceeds new climate finance target – $31.7 billion in funding for climate action', World Bank, Sept 2022

Key findings

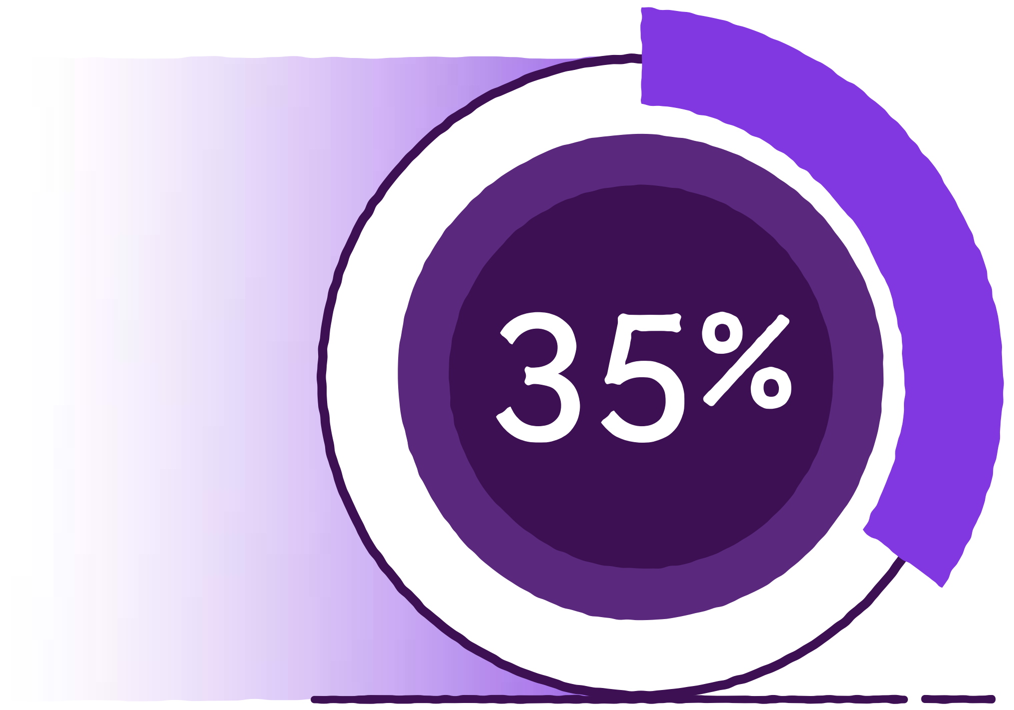
Funds are sold on the long-term value of SBTs, but short-term concerns have distracted some from implementation.

Regulatory pressure remains the strongest driver of SBT adoption.

The proportion of AIFs identifying regulation as their chief driver rose to 38% in this year's survey, and respondents do not expect this pressure to let up.

The economy is weighing on the minds of AIFs.

Worsening economic conditions rank highly as a barrier to the implementation of SBTs, with 35% of respondents citing this as a top-three concern.

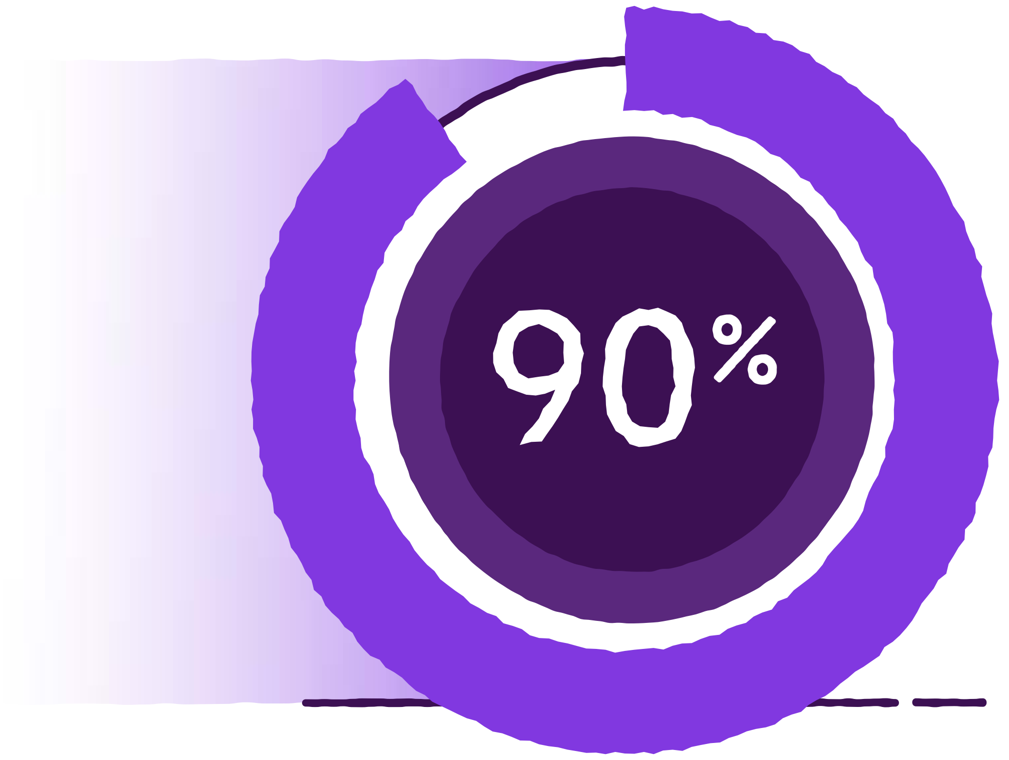


The pace of adoption has slowed.

All funds we surveyed have made some kind of commitment to SBTs, but the timeframe for adoption among those who have yet to do so has slipped since last year.

Funds see the long-term value of SBTs.

While there's little consensus on whether net zero commitments will make a difference to their performance in the short term, 90% see it as important in the long term.



Worsening economic conditions hinder progress

"Regulatory pressure is still the chief driver of SBT adoption, but deterioration in the economic climate is an added barrier."

Climate and the economy are inextricably linked and, according to the World Economic Forum, inaction on climate change threatens to wipe out 20% of global GDP by 2050.[3]

Despite this undeniable economic imperative, progress towards SBTs has been limited among AIFs since last year, with adoption barely moving since the previous edition of this survey.

Around four in 10 respondents (43%) report having already set and verified SBTs, almost identical to March 2022.

The remainder (57%) are actively planning to set targets at some point in the future, but these timeframes appear to be slipping, with a far greater importance attached to SBTs in the future than today.

Challenging economic conditions have resulted in stagnation, it seems, with respondents citing concerns about the economy among the most widespread barriers to implementing SBTs.

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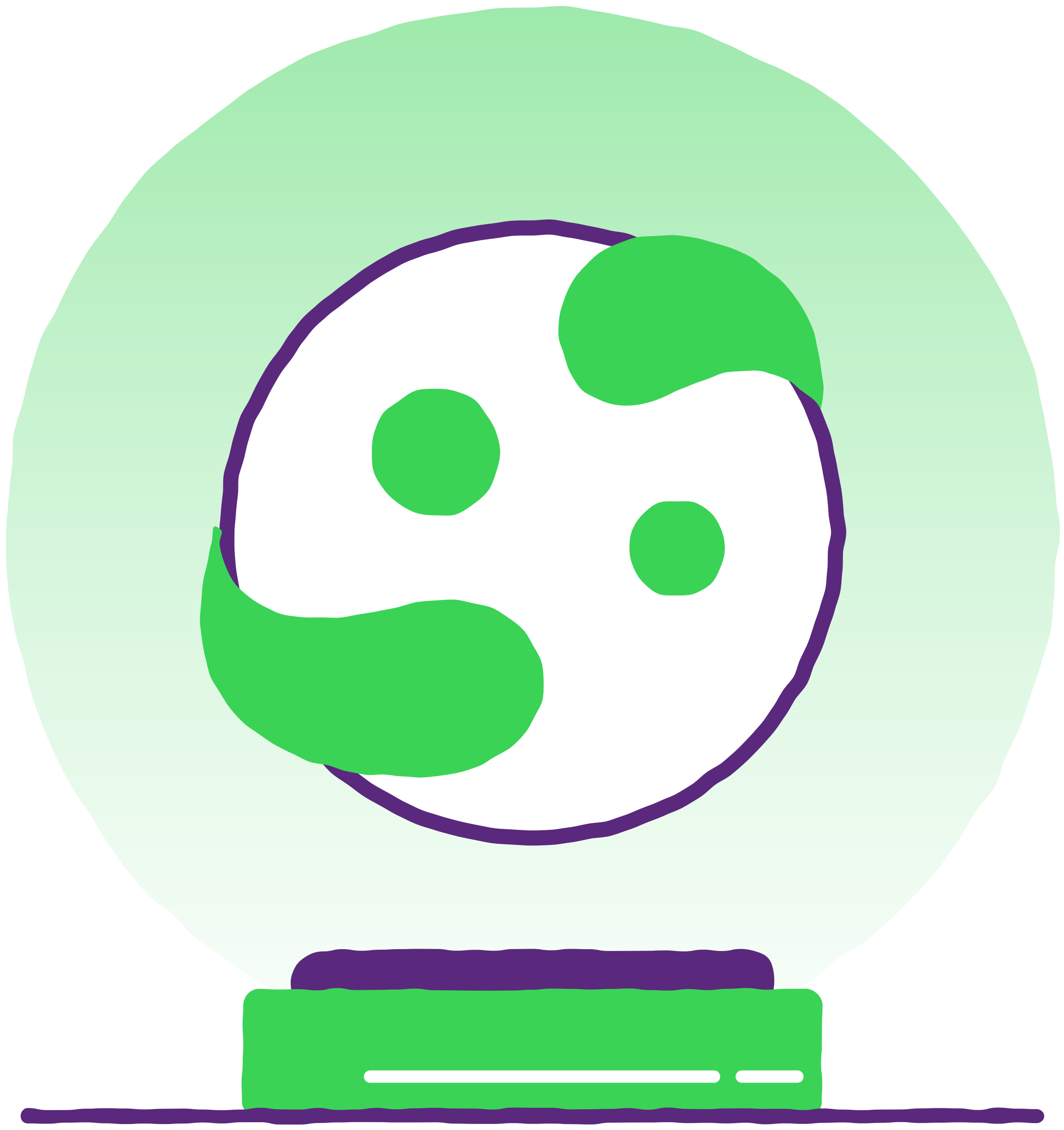


[3] 'This is how climate change could impact the global economy', World Economic Forum, June 2021

Barriers to implementation

The most common barrier to implementing SBTs is not the economic climate, however. It is the time it takes to implement them (37%), suggesting that long-term concerns about delivering net zero initiatives remain prevalent. This echoes a key finding from our prior research: while it may be easy for funds to declare their intentions, it can be difficult for them to put their commitments into action.

Elsewhere, barriers appear to have shifted slightly between the two surveys. Whereas half (49%) of those surveyed in March 2022 identified lack of in-house skills/expertise as one of their top three barriers, making it the number one issue then, the proportion of respondents citing it has since fallen to 18%.

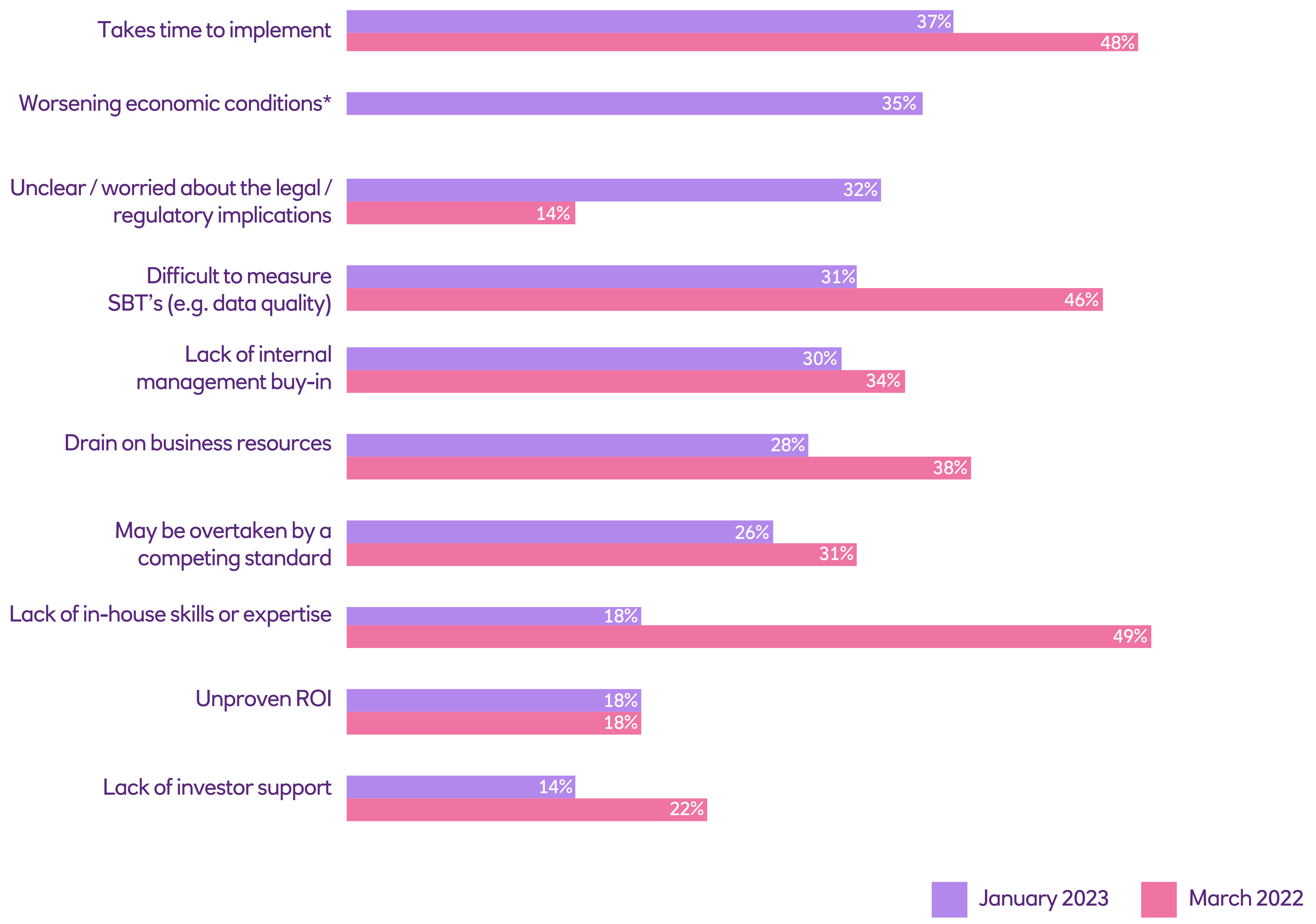
Given the short time between surveys, this is unlikely to reflect progress in internal upskilling in this area. Instead, it is more likely that the deterioration of economic conditions has eclipsed the lack of skills as a barrier to implementation.

18% of respondents say that unproven ROI is a barrier to setting SBTs, despite the widely held belief that SBTs will be the dominant standard and important in the longer term.

FIGURE 1

THE ECONOMIC CLIMATE IS AN ADDED BARRIER TO SBT ADOPTION

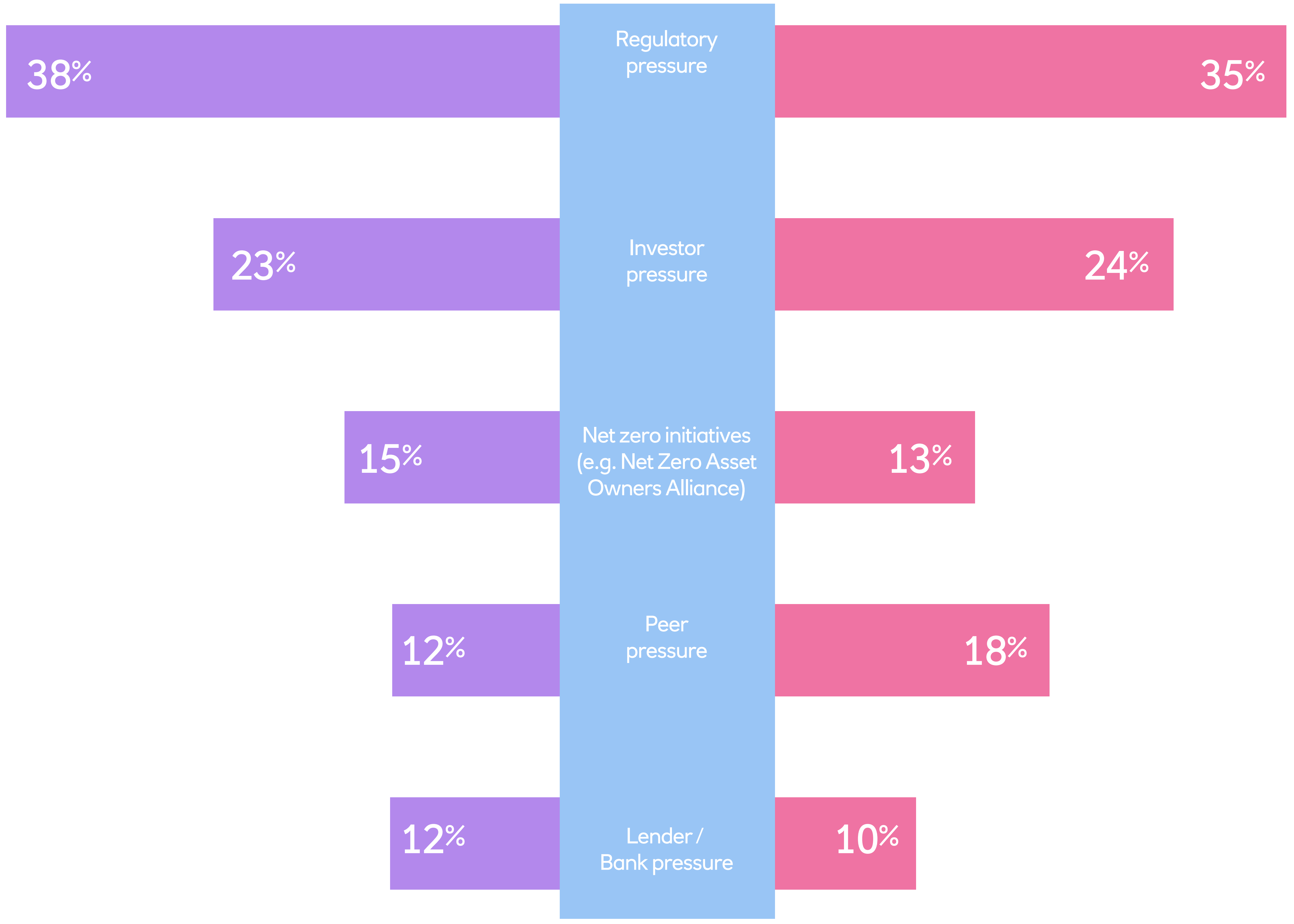
What do you see as the three main barriers to setting SBTs for your firm?



*new answer option in 2023

FIGURE 2
REGULATION IS STILL THE CHIEF DRIVER TO SBT ADOPTION

What is the most significant driver of SBT adoption for your firm?



Regulatory pressure ramps up
Regulatory concerns continue to weigh heavily on AIFs' minds with pressure from regulators ranking as the strongest driver of SBT adoption (38%). This is followed by investor pressure (23%) and net zero initiatives (15%).

Regulatory pressure is further compounded by a lack of clarity around the legal/regulatory implications of setting SBTs. The proportion who say these are unclear has more than doubled, from 14% in March 2022 to 32% in the latest survey.

This confusion was evidenced when, late last year, an estimated 300 funds were downgraded from Article 9 to Article 8, reflecting uncertainty as fund managers grapple with the EU's new Sustainable Finance Disclosures Regulation (SFDR).

This pressure shows no sign of abating with four in 10 respondents (41%) expecting regulators to continue to put pressure on them to demonstrate commitment to decarbonisation despite worsening economic conditions. However, economic turbulence and the other apparent barriers to setting SBTs should not distract from the longer-term importance placed on net zero.

The majority of respondents agree that investors' commitment to sustainability will continue during this period of economic uncertainty and this, coupled with the future importance funds attach to SBTs, provides impetus to continue with net zero strategies.

Funds focus on the future

"The urgency of adopting SBTs may have dimmed for some, but their long-term value is not in doubt."

The proportion of respondents who consider SBTs important to their fund today (82%) is effectively unchanged since March 2022.

However, the future importance attached to SBTs has increased significantly, with nine out of 10 (90%) feeling that SBTs will be important to their fund in three years' time, compared with 79% in March 2022.

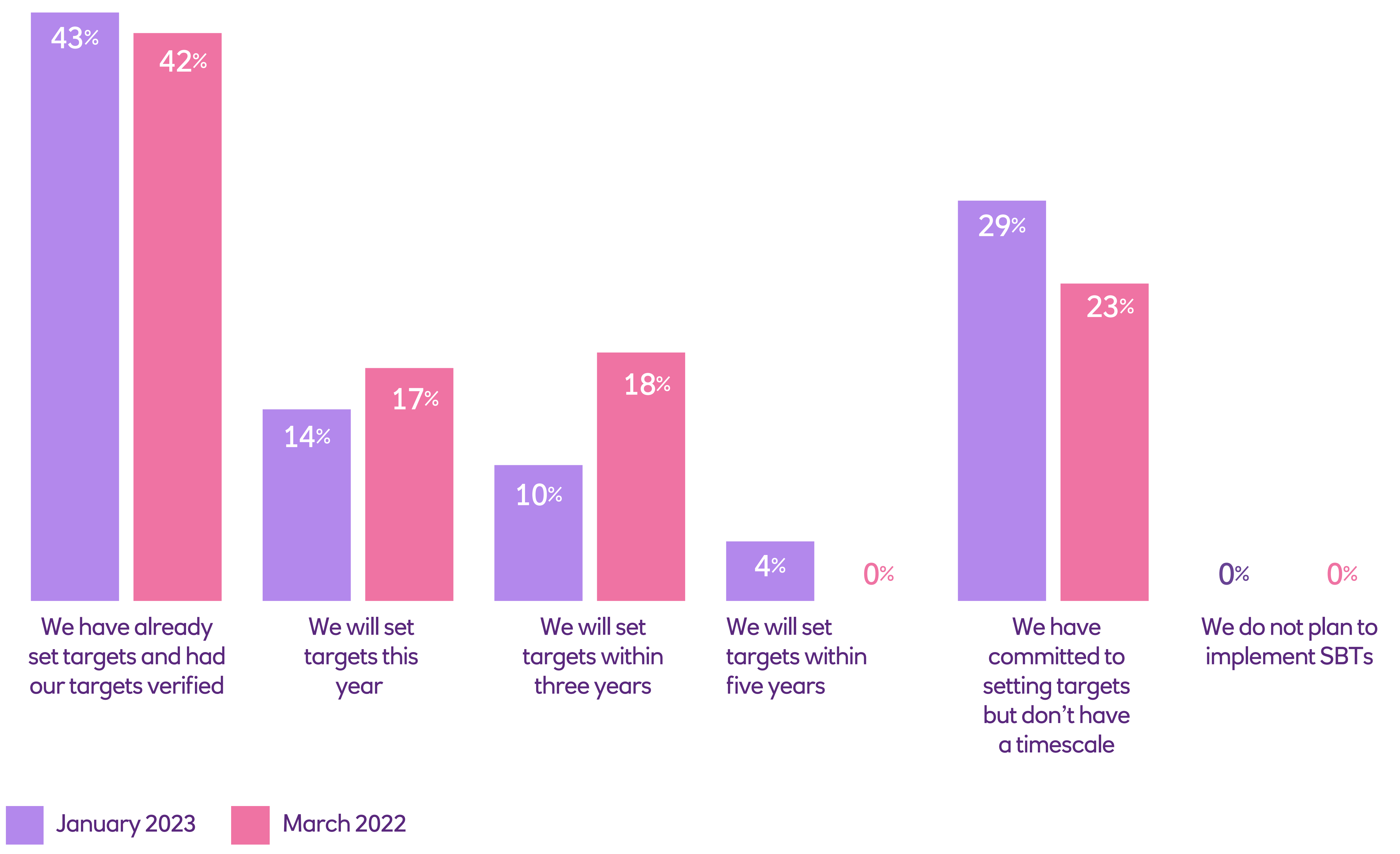
This is good news for funds' long-term commitment to SBTs, although it is perhaps another indication that worsening economic conditions have dimmed the urgency of SBT adoption.

This is evident in other findings: among respondents that have not had their targets verified, for example, only a quarter (24%) expect to do so in the next 1-3 years, down from 35% in March 2022. And the proportion who are planning to set targets in the next five years, or who don't have a timescale at all, has grown from 23% to 33%.

Nine out of 10 (90%) of AIFs feel that SBTs will be important to their fund in three years' time.

FIGURE 3
FOR SOME, THE URGENCY TO ADOPT SBTS HAS SLOWED

Have you implemented or are you planning to implement SBTs?



Timeframes differ

Funds focused on private equity and debt indicate the longest timeframe for setting targets, perhaps owing to their short-hold strategies and the medium-to-long-term view required for SBTs.

Unsurprisingly, renewables-focused funds are the most likely to have set and had their targets verified already, with nearly two-thirds (64%) having done so, followed by real estate and infrastructure funds (48% and 40% respectively). This corresponds with these sectors' relatively longer investment timeframes and, therefore, their comfort in the commitment to SBTs.

The scope of SBTs has expanded since last year, the survey indicates, with the proportion of funds that plan to apply SBTs to their legacy funds rising from 23% to 30%. This is almost certainly a result of the EU's SFDR, which requires all funds to be classified based on their sustainability objectives.

Long-term value

Funds' focus on the future is also reflected in their assessment of the value of their net zero commitments and of SBTs.

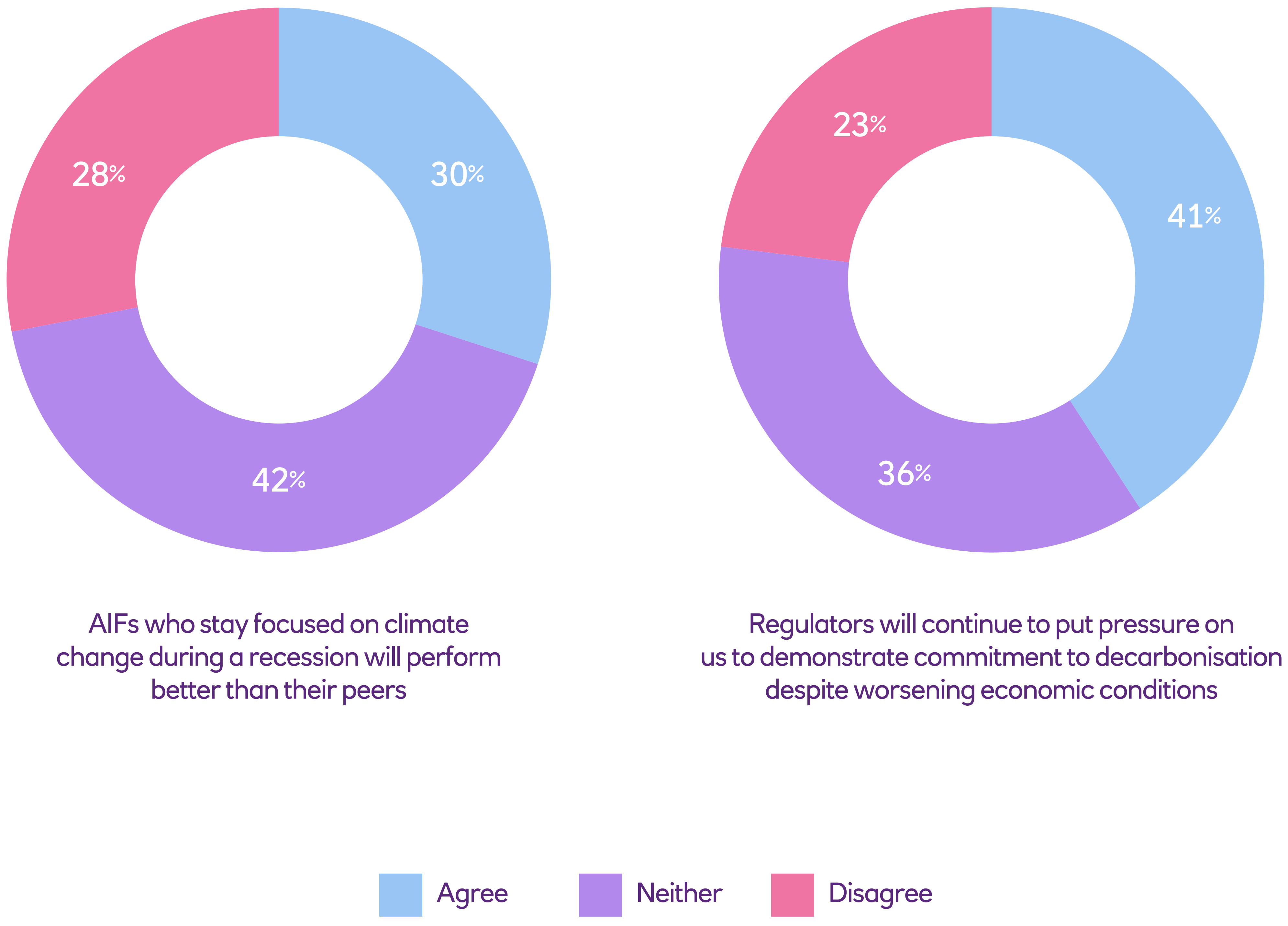
There is little consensus on whether such commitments will benefit funds in the short-term: one in three (30%) agree that AIFs who commit to climate initiatives during a recession will perform better, while 28% disagree. The largest group (42%) is not convinced either way.

Nevertheless, net zero is widely viewed as a performance driver and remains important to the majority of funds surveyed. As only 18% of respondents cite a lack of ROI as a barrier to SBT adoption this implies that others see it as a route to sustainable growth – albeit in the long term.

Meanwhile, less than a quarter (22%) feel that investors' commitment to sustainability will diminish during an oncoming recession.

FIGURE 4
REGULATORY PRESSURE TO DECARBONISE WILL CONTINUE

To what extent do you agree or disagree with the following statements?



When it comes to choosing a framework with which to manage and monitor emissions, there is widespread support for SBTs.

Fewer than a quarter of respondents (23%) feel that other frameworks for measuring the environmental impact of investments are better suited to their needs.

This, and the fact that nine out of 10 AIFs feel SBTs will be important to their fund in three years' time, means there is no better time to set SBTs.

As our previous report detailed, the process can take as long as two years, and getting started today will enable funds to track their progress against criteria backed by what is quickly becoming the industry leading standard.

There is widespread support for the SBTi framework.

From risk, to compliance, to opportunity

"Funds must hold steady in their commitment to net zero and SBTs."

This study highlights a clear long-term interest in SBTs and net zero goals more broadly. For funds to make true progress, however, the rhetoric around net zero must mature from 'nice-to-have' to business critical.

ESG has, for many AIF managers, become a compliance concern rather than a key performance driver. This is demonstrated by the many barriers to implementation, particularly the regulatory pressure that funds feel is driving them to adopt SBTs.

We believe it's time to advance the narrative. Given the broad trend towards increased disclosure on ESG performance and the fact that the EU's SFDR is now established, pressure is growing for financial institutions to reduce the carbon impact of their investments and to align capital with the transition to net zero. The SBTi provides a framework for AIFs to measure progress across scope 1-3 greenhouse gas reductions in line with the Paris Agreement goals. Focusing on scope 1 and 2 alone will not be enough, and funds will be required to gather sophisticated and robust data in order to deliver against scope 3.

AIFs must be compliant with regulations and avoidant of greenwashing. But it's also vital that the industry looks beyond what is required today and broadens its horizons to identify opportunities to accelerate the transition, whether by directly funding a sustainable economy or using its influence with stakeholders to drive real-world outcomes.

Funds that have sufficiently managed the risk of environmental and social factors to date will begin to seize these opportunities.

Pressure is growing for financial institutions to reduce the carbon impact of their investments and to align capital with the transition to net zero.

Revisiting the rationale for SBTs
As shown in 2022, financial institutions play a significant role in aligning private capital with global climate commitments. Regulators, investors and capital providers have continued to increase pressure to embed and evidence robust climate strategies, including science-based decarbonisation targets and transition plans.

Failure to show decarbonisation strategies aligned with an AIF's financial ambition will put pressure on lenders to increase the cost of capital for those that do not comply. In some cases, it will become a barrier to doing business.

The various pressures that drive the adoption of SBTs will change over time – we have already seen a reprioritisation over the relatively short time between our 2022 and 2023 surveys – but the pressure remains even if the causes shift.

Whatever prevails as the dominant standard for setting net zero targets in the years to come, the message is clear: funds must focus on future performance and the competitive advantage that solid climate-change strategies aim to bring.

An action plan to implementation

1 Step one: continue climate conversations

- **Discuss SBTs internally:** familiarise stakeholders with the roadmap to verification, working closely with the SBTi.
- **Communicate with your stakeholders:** keep channels open with your banks and your investors to understand their expectations and individual paths to net zero.
- **Assess your competitors:** avoid being caught out if they deliver something more advanced and you face investor challenges.
- **Engage industry bodies:** the Net Zero Asset Managers Alliance, for example.

2 Step two: adopt a sense of urgency

- **Make a public commitment to adopt SBTs:** you have 24 months from signing your commitment letter to submitting your targets to the SBTi.
- **Address your resources:** do you need to hire ESG specialists? Or will you look for external support?
- **Understand the roadblocks ahead:** which barriers are most likely to impact you on the path to net zero?

3 Step three: maintain focus on the future

- **Submit your targets for validation:** set milestones to net zero across the mandated SBTi timeframe – a minimum of five years and maximum of 10 years.
- **Communicate the validation criteria with stakeholders:** add credibility to your climate targets.
- **Disclose and monitor:** disclose your companies' emissions annually and monitor progress on reaching your targets.

How we can help

At RBS International, part of NatWest Group, we've made tackling climate change a strategic priority and continue to champion a more sustainable economy for the customers and communities we serve.

We had our own science-based emissions intensity targets validated by the SBTi in 2022.

These targets have been assessed by the SBTi against the latest available climate science and have been used in the development of our first ever climate transition plan, which demonstrates how we plan to reduce the climate impact of our financing activity while delivering sustainable growth.

We believe that net zero presents an opportunity and should not be viewed as a compliance exercise to fear, or a process to procrastinate over.

We recognise that the transition must be a collaborative effort, and supporting our customers in their own journey to net zero sits at the heart of our purpose-led strategy.

We encourage you to get in touch with either your relationship director or our in-house ESG specialists to find out more.

"We believe that open dialogue is a key enabler of future success, and we share our own experiences readily as all financial institutions grapple with the complex and pervasive impact of climate change."

Bradley Davidson, Director, Climate & ESG Lead at RBS International

Methodology

In December 2022 and January 2023 RBS International conducted a survey of 125 decision-makers in AIFs. The sample covered funds domiciled across five jurisdictions and five sectors.

Primary domicile

34%	28%	13%	13%	13%
Other Western Europe	United Kingdom	Jersey	Guernsey	Luxembourg

Value of assets managed

26%	22%	14%	16%	23%
Up to £5bn (€6bn)	£5bn-£10bn (€6bn-€12bn)	£10bn-£20bn (€12bn-€24bn)	£20bn-£30bn (€24bn-€36bn)	£30bn-£50bn (€36bn-€60bn)

Sector specialism

20%	20%	20%	20%	20%
Real estate	Private equity	Infra-structure	Renewables	Private debt

Job title

20%	18%	18%	18%	17%
Finance director	CFO	Fund manager	ESG manager	Portfolio manager

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