INTRODUCTION

Achieving the SDGs requires the mobilization and effective use of all available sources of financing. Countries use different mechanisms to manage, allocate and distribute revenues: SWFs are one such mechanism. SWFs are used for different purposes, for example to cover budget deficits when resource revenues decline, save for future generations, support public investments and development objectives, enhance returns on international reserves while minimizing risks over the long term, and reduce spending volatility.

Well-managed SWFs can support delivery of the SDGs by helping to improve the quality of public spending, strengthening international competitiveness, earmarking spending for high impact projects and promoting green or ethical investments. In particular, broadening the mandate of SWFs to include green investment can support long-term sustainable development by diversifying the economy away from hydrocarbons, tapping into burgeoning sectors such as clean technology, renewable energy, and low-carbon transport, and enhancing resilience against climate change. Moreover, the specific characteristics of SWFs (i.e. inter-generational nature, medium- to long-term investment horizon, higher tolerance for risk) make them well-suited to supporting green investments, in particular green infrastructure projects.

There are numerous means through which SWFs can support the SDGs, across the asset class spectrum, including the public and private sphere, debt and equity. It is likely that many SWFs are already supporting some of the SDGs on a secondary, or passive basis in public markets. However, much of the investment required to achieve the SDGs will require deeper exposure into private markets, in regions where capital markets are thin, and where risks are potentially greater. Increasingly, many institutional investors (including SWFs) have been investing in alternative assets in recent years, including through co-

This policy brief is based on the UN Environment working paper (2018), ‘Financing Sustainable Development: the Role of Sovereign Wealth Funds for Green Investment,’ prepared by Javier Capapé at the Sovereign Wealth Lab, IE Business School.
financing arrangements (e.g. with pension funds, private equity, and multilaterals). This is conducive to achieving the SDGs, as accessing sectors such as infrastructure, real estate, agriculture, and forestry show tremendous potential to support sustainable development.

The extent to which SWFs will be able to actively engage with green investments will depend on their risk appetite, overall objectives, and internal capacities. To date, many are arguably already participating in financing the SDGs related to health (3), growth (8), and consumption and production (12) by virtue of their exposure, while there are further opportunities to address climate (13) and conservation (14, 15) goals through adding additional asset or reporting criteria to their portfolios. While social goals (1, 2, 4, 5, 10, 16) typically make for more difficult business cases, there could be excellent opportunities to partner with governments to scale-up investments in water (6), energy (7), infrastructure (9) and cities (11) through targeted funds or structured investment opportunities (Sharma, 2017). To the extent that project ticket sizes are too small for SWFs, innovative bundling mechanisms that aggregate smaller projects, such as the UK’s Pension Infrastructure Platform, could be explored (Braunstein, 2016).

These opportunities notwithstanding, using such funds to support long-term development objectives such as the SDGs faces a number of constraints and risks undermining other macroeconomic objectives. The process thus requires careful coordination with investments carried out through the formal budget process to avoid undermining fiscal rules and circumventing accountability mechanisms like parliamentary oversight, supported by substantive transparency requirements, adequate government capacities, and a balanced growth strategy.

SOVEREIGN WEALTH FUNDS: A HETEROGENEOUS INDUSTRY

SWFs, an emerging institutional investor group, are currently constituted by approximately 80 funds managing US$7.5 trillion in assets, with more being created on a regular basis. SWFs are government-owned funds, which lack pension liabilities and typically serve macroeconomic purposes through long-term investment strategies (Aguilera et al., 2016). Beyond this commonality, however, the group is quite diverse in terms of geographical distribution, wealth sources, and objectives. Indeed, most SWFs are domiciled in developing countries (according to the classification in UN/DESA, 2018), particularly in East Asia and the Middle East (Figure 1), and almost 60% derive their wealth from hydrocarbons (i.e. oil and gas). With respect to their investment objectives, SWFs can generally be categorized into five different groups: 1) stabilisation funds, 2) savings funds, 3) reserve investment funds, 4) development funds, and 5) pension reserve funds, though some funds have hybrid or multiple mandates (Table 1). While all of these fund types are in principle equipped to invest in green assets, different funds’ structures and objectives will determine their risk appetite and level of flexibility in their investments, which may make them more or less suitable to financing activities related to the SDGs (Sharma, 2017). For instance, savings funds are likely to have a longer horizon and higher risk tolerance than stabilisation funds, which have higher liquidity requirements.

SCALING UP SWFS’ GREEN INVESTMENTS: CHALLENGES AND OPPORTUNITIES

With substantial long-term assets under management, SWFs are in principle well-placed to provide a considerable amount of the required investment to finance the green economy transition and deliver the SDGs. Further, asset owners see this, and are increasingly supporting green investment, with almost 75% agreeing that low-carbon is among the most important long-term investment trends and 60% directly engaging with portfolio companies to take climate action, both up from previous years (PRI-Novethic, 2017). Despite these trends, only 17% of asset owners have actually incorporated climate change factors into their allocation decisions.

UNEP (2017) categorises the key barriers to scaling-up SWFs’ green investment allocation into the following categories:
Table 1: SWFs by objective

<table>
<thead>
<tr>
<th>OBJECTIVE</th>
<th>EXPLANATION</th>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stabilisation fund</td>
<td>Support macroeconomic stability through fiscal impact management driven by commodity/resource price volatility</td>
<td>Mexico, Algeria, and Russia reserve funds</td>
</tr>
<tr>
<td>Savings fund</td>
<td>Preserve and grow the wealth for future generations, i.e. promote long-term savings</td>
<td>Alberta Heritage Savings Trust Fund, Abu Dhabi Investment Authority, Oman State General Reserve Fund, and Alaska Permanent Fund</td>
</tr>
<tr>
<td>Reserve investment fund</td>
<td>Invest excess reserves, including risk management of foreign exchange</td>
<td>Saudi Arabian Monetary Authority, State Administration of Foreign Exchange of China, and Hong Kong Monetary Authority</td>
</tr>
<tr>
<td>Development fund</td>
<td>Promote economic development and diversification, e.g. investments in infrastructure, agriculture, or private equity</td>
<td>Saudi Arabia Public Investment Fund, Ireland Strategic Investment Fund, Kazakhstan Samruk-Kazyna, Malaysia Khazanah, and Morocco Ithmar Capital</td>
</tr>
<tr>
<td>Pension reserve fund</td>
<td>Save and invest surpluses that will be used to finance future retirement liabilities</td>
<td>Australia Future Fund, New Zealand Superannuation Fund, and Norway Government Pension Fund Global</td>
</tr>
</tbody>
</table>

1. Difficulties around perceived green investment opportunities, environmental information and measurement. Faced by institutional investors generally, these challenges stem from perceived scarce green investment opportunities, difficulties integrating them into an asset allocation strategy, poor environmental information and comparability, the costs of engaging with companies (e.g. participating as active owners) and collecting data (e.g. analysing a portfolio’s carbon footprint).

2. Concerns that focusing on ESG criteria will compromise financial returns. Conflicting indications on ESG or clean energy index funds and their performance potentially hamper asset owners’ willingness to shift to greener investments.

3. Lack of clarity on government investment policy and social demands. As SWFs are highly exposed to public opinion, in countries where climate change is not a political priority or it is not viewed as a financial risk, it is considered as a costly issue divorced from their long-term objectives. However, the trends in the wake of the Paris Agreement, including the establishment of the Task Force on Climate-related Financial Disclosures (TCFD), and the establishment of the One Planet Sovereign Wealth Fund Working Group in December 2017, suggest that these attitudes are changing, putting pressure on SWFs to reflect climate risks in their decisions.

SWFs that seek to invest domestically face additional risks, including that undue political influence can interfere with sound macroeconomic management and productive investments, exacerbated by the fact that SWFs lack creditors to exercise independent due diligence. It can likewise undermine public financial management, accountability, and lead to multiple mandates and confused decision-making (Bauer, 2015). However, attractive returns in some developing countries coupled with significant financing needs and fewer long-term financing options since the financial crisis, has driven many SWFs to invest domestically. Further, properly managed, inward-facing SWF investment can support national priorities, such as infrastructure development, which needs its investment most. What is required is a system of checks and balances to ensure solid management, including safeguards to prevent political meddling, a clear mandate, qualified staff, and clear rules and modalities governing allocation decisions (Gelb et al., 2014).

Box 1 highlights some recent trends in SWF activity in financing green assets, including both domestic and international experiences as well as future opportunities for replication or expansion.

GUIDELINES TO SUPPORT SWF GREEN INVESTMENT

Shifting SWFs’ behaviour to support green investments begins with changing attitudes. Given that SWFs take the long-term view, sustainability concerns should align with their mandates, as it will affect their returns. At present, many funds view climate investments more opportunistically (if at all), hence a genuine shift will need to take place both externally (from governments and citizens) and internally (from the board down to managers and investment officers).

Likewise, governance will need to reflect environmental concerns. Concrete steps need to be taken to develop fiscal rules that facilitate decarbonisation and long-term strategies to support the SDGs, promote improved transparency that allows stakeholders to scrutinise and pressure fund managers, build stronger internal investment capacities to develop and execute sustainability strategies, and apply pressure to other investor groups and portfolio companies.

Finally, SWFs can develop tangible investment goals and strategies to be operationalised by integrating relevant criteria into portfolio processes and allocation decisions – which will require resources dedicated to data collection, analysis, and communication – or by joining sustainable investment platforms.

Needless to say, all three steps will incur transition costs, yet these short-term costs are justified in the long term. Such transition could be promoted further through the diffusion of the Santiago Principles, a potentially useful framework for integrating climate risks, as well as via the International Forum of Sovereign Wealth Funds and the newly-established One Planet Sovereign Wealth Fund Working Group.

---

1 The Working Group is composed of six of the largest SWFs and has committed to developing and publishing an ESG framework to inform investors about climate change issues (IFSWF, 2017).
WHAT UN ENVIRONMENT IS DOING

UN Environment undertakes analyses on green fiscal policies, and provides advice to countries on how fiscal reforms can mobilise public finances for green investment, while addressing environmental and social externalities. Given their potential to play a substantial and transformative role in financing the SDGs, UN Environment has undertaken targeted research on the role that SWFs can play globally, as well as in the context of country cases. In this context, UN Environment supports countries in establishing SWFs, or in amending their mandates and governance to support green investment by addressing the key barriers and using regional and international best practices.

In addition, UN Environment is a founding member of the Green Fiscal Policy Network. The Green Fiscal Policy Network is a web-based platform which aims to disseminate knowledge and share country experiences of green fiscal policy reforms to deliver the SDGs. It also promotes policy dialogue on green fiscal policy in order to shape the global agenda in this area.

Further reading


owin-wealth-fund-working-group


