> World Bank:

Will Sovereign Wealth Funds Go Green?

By Håvard Halland, Michel Noël, Jacob Owens, and Silvana Tordo

Sovereign wealth funds (SWFs) currently have a very limited role in climate finance and green investment. According to preliminary estimates by the World Bank Group, SWFs' green investments in 2015 represented less than 1% of the total value of reported deals. SWFs' performance in climate finance is reportedly below the average for institutional investors. According to the Asset Owners Disclosure Project (AODP), which evaluates institutional investors on the basis of their low-carbon performance, five of the ten lowest-rated large investment funds were SWFs.

However, the more progressive SWFs are currently divesting from assets with high climate-related risks, and some countries are pondering whether their SWF should take a more proactive role in green finance. What lies ahead for SWFs in this rapidly changing landscape?

SWFs' IMPACT ON CLIMATE FINANCE

The sheer amount of capital managed by SWFs means that their impact on green finance, while historically marginal, has the potential to become significant. According to the Sovereign Wealth Fund Institute (SWFI), SWFs hold assets worth approximately $7.4 trillion, and the total capital of SWFs has more than tripled over the last decade.

But SWFs' mandate does not typically include green finance. To the extent that they have been active in this area, it has been to reduce climate-related risk to their portfolios – including exposure to fossil fuels. For example, last October the $22.6 billion New Zealand Superannuation Fund (NZSF) announced a strategy to address climate-change risks that represent a "material" issue for long-term investors, and to "intensify its efforts" in areas including alternative energy, energy efficiency and "transformational" infrastructure. Norway's giant Government Pension Fund Global ($900 billion) has adopted similar policies to reduce climate-related risk.

The 2016 annual meeting of the International Forum of Sovereign Wealth Funds (IFSWF), which was held last November, focused on the long-term impact of climate change on SWF portfolios, as well as on new investment opportunities that may arise from the transition to a low-carbon economy.

HOW GREEN ARE SWFs NOW?

"As the global green investment agenda gains further traction, and as pressure builds on investors to green their portfolios, the more transparent and climate-conscious funds could help build initial momentum."

Current reporting on SWFs' investments does not allow for a precise analysis of these funds' role in green finance, but some preliminary numbers can be established. According to preliminary estimates contributed by the World Bank Group to a recent OECD report, only 118 of 30,080 transactions between 2006 and 2016 can be classified as green. This is equivalent to 0.7% of the value of all reported deals during the period, or 3.6% of infrastructure, energy, and utility investments.

According to the same estimates, in 2015 green investments represented 0.9% ($1.2 billion) of the value of all reported deals – up from zero in 2006. The share for 2016 may be higher, at 3.5% – equivalent to 13.4% of infrastructure, energy and utility investments. However, this recent uptick is driven by a small number of large deals, and it could be just a temporary blip. Overall, SWFs' involvement in green finance remains very low.

STRONGER CLASSIFICATION AND REPORTING SYSTEMS NEEDED

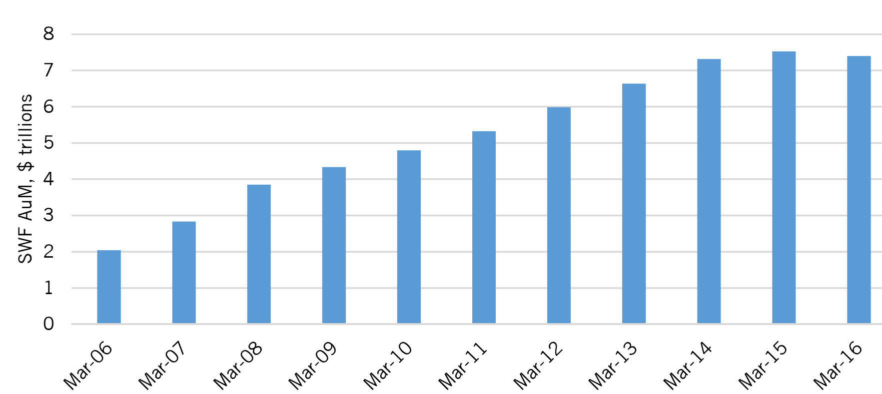
Although some of the more progressive SWFs have recently shown more willingness to take climate change into account, a broader engagement is likely to require a strengthening of SWFs' classification and reporting systems for green investments. Several international standards and classification systems are used to assess investor performance in green finance, including the Climate Strategies and Metrics; the Climate Change Investment Solutions; as well as the AODP Global Climate Index, which provides a standard for assessing how large global investors conduct climate-risk management.

However, existing standards allow only for an approximate analysis of SWFs' impact. None of them are comprehensive, and most focus on policy and management rather than transaction-level criteria for green investment. A unified global standard would allow for the aggregate reporting, assessment and analysis of SWFs' involvement in green finance. It would also promote market efficiency through improved transparency.

The successful implementation of a robust classification system depends on the disclosure and thorough reporting of participating SWFs. Ideally, green finance reporting standards for SWFs would build on existing frameworks and guides. The Low Carbon Investment Registry (LCIR) – a database compiled by the Global Investor Coalition on Climate Change – relies on self-reporting by institutional investors. It could become a useful tool for SWFs. However, as of now, SWFs have minimal presence in this database.

THE ROAD AHEAD FOR SWFs

Is the role of SWFs as commercial, return-optimising investment vehicles compatible with a more pro-active stance on green finance? Some think so, though this is a subject of debate. According to a recent paper by Andersson,



Graph 1: Aggregate SWF assets under management (in trillions of US$), 2006–2016. *Source: Sovereign Wealth Fund Institute.*

Bolton, and Samama, long-term passive investors such as SWFs may hedge climate risk without sacrificing financial returns. This can be done by investing in a decarbonised index based on a standard benchmark, such as the S&P 500, while minimising the tracking error with respect to the underlying benchmark. The authors note that decarbonised indices have so far matched or even outperformed benchmark indices, as financial markets still tend to under-price carbon risk.

Oil-rich countries with SWFs could use their funds' capital to help diversify their economies away from oil while also contributing to national saving – for example, by investing in renewable energy. This would require strong and specific institutional, governance, and legal arrangements to ensure that investments are made on commercial terms, and that they crowd in rather than crowd out private investors to domestic green finance.

In light of the large amount of capital managed by SWFs, and thus their potentially significant role in green finance, it is important to strengthen the information available on these funds' green investments. The results of the work now being conducted by the Financial Stability Board's Task Force on Climate-related Financial Disclosures could be of great relevance to SWFs. The task force, chaired by former New York Mayor Michael Bloomberg, aims to develop "voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and other stakeholders."

SWFs differ widely in terms of investment strategy, transparency and disclosure of information. As the global green investment agenda gains further traction, and as pressure builds on investors to green their portfolios, the more transparent and climate-conscious funds could help build initial momentum. In time, traditionally less transparent SWFs might find it in their interest to join them. ❇

This article is based on the authors' contribution, on behalf of the World Bank Group, to the recent OECD Progress Report on Approaches to Mobilizing Institutional Investment for Green Infrastructure. Interested readers can find the details on methodology and estimation within that report. The paper referred to above is "Hedging Climate Risk", by Mats Andersson, Patrick Bolton, and Frédéric Samama, Financial Analyst's Journal Vol. 72, Number 3, 2016. An abbreviated version of this analysis was first published on the Bank's "Private Sector Development" blog.

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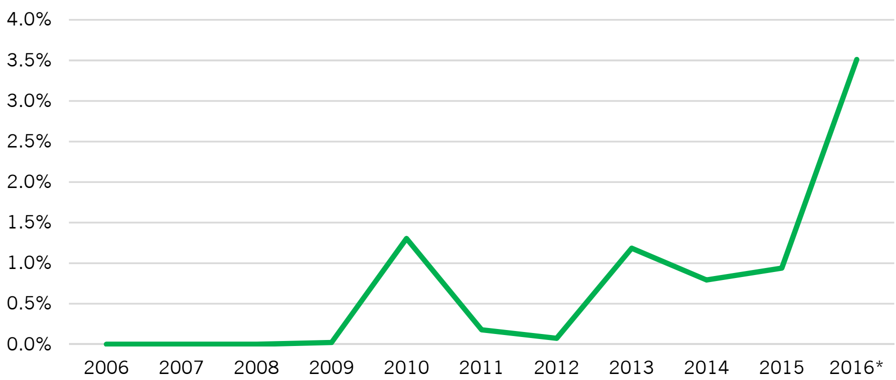

Graph 2: Green investments by SWFs (as a percentage of total investment).

*Source: Sovereign Wealth Fund Institute Transaction Database; internal World Bank Group analysis. *Preliminary estimate.*