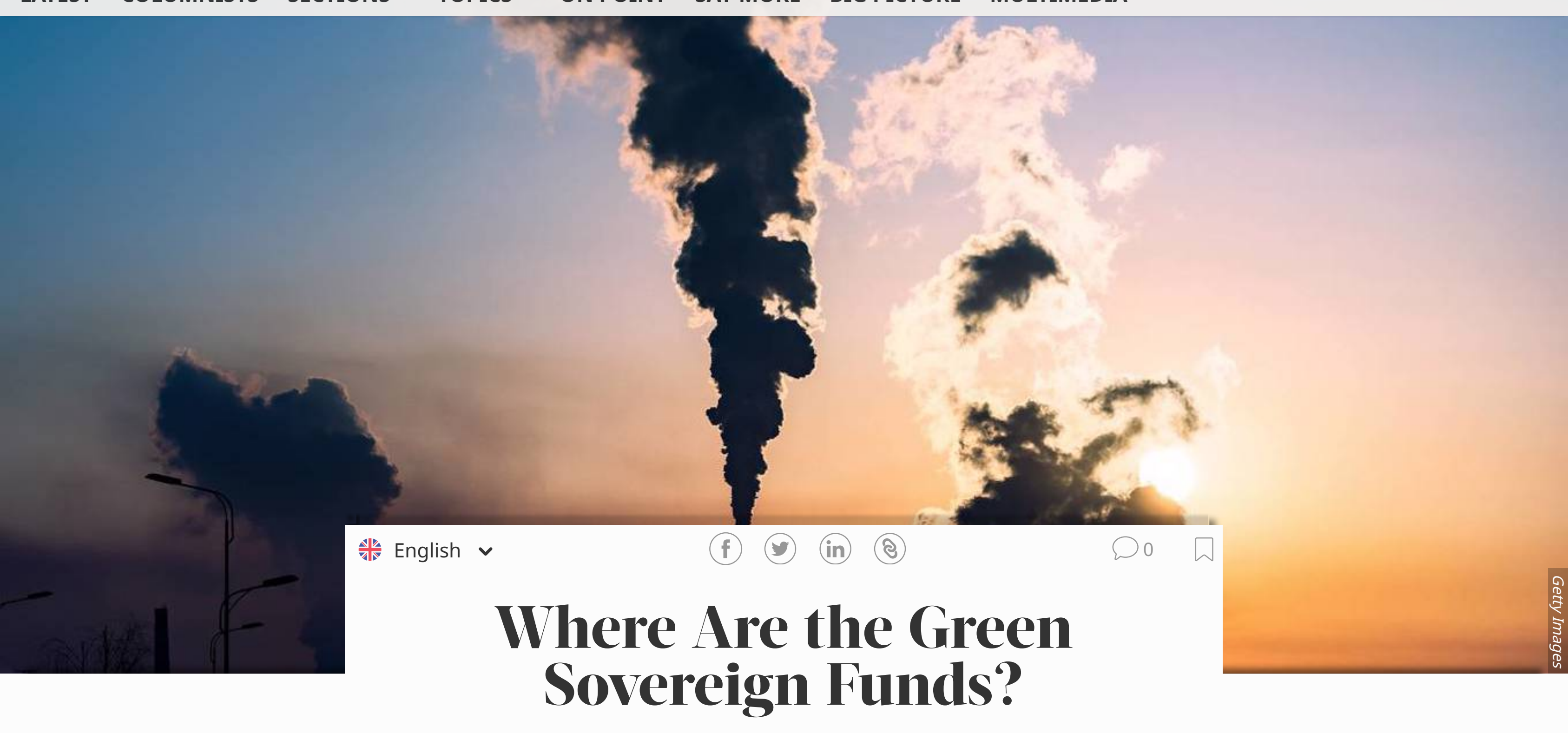

English

Where Are the Green Sovereign Funds?

Aug 9, 2021 | **HÅVARD HALLAND**, **GÜNTHER THALLINGER**

Much of the global financial sector is mobilizing behind mid-century net-zero emissions targets, recognizing the opportunities that will come with the transition to a low-carbon economy. The longer that sovereign funds remain on the sidelines, the more they and their countries stand to lose.

PARIS/MUNICH – Institutional investors are increasingly embracing the effort to achieve net-zero greenhouse-gas (GHG) emissions by 2050. Some are already implementing portfolio measures and incorporating climate factors into their decision-making. The United Nations-convened Net-Zero Asset Owner Alliance (which one of us chairs) has already welcomed 46 members, comprising pension funds and insurance companies representing some $6.7 trillion in assets under management (AUM).

The steps taken this decade will be decisive as regards hitting the mid-century target. Of the Alliance's members, 23 have publicly issued GHG-reduction targets for 2025, which means they are committed to acting immediately. The remaining five members that are required to set targets this year will declare similar interim goals soon. Net-zero initiatives are also being established in the investment-management and banking industries, representing $43 trillion and $37 trillion in AUM, respectively. And yet, sovereign wealth funds (SWFs) – representing AUM totaling around $10 trillion – are conspicuously absent, even though some are owned by governments that have adopted ambitious climate objectives.

Under existing international agreements, GHG emissions are measured at the country level, which understates the potential climate impact of countries with large foreign-asset holdings. For example, the Norwegian SWF's total asset holdings are three times the size of Norway's economy, and its equity-portfolio carbon emissions are around twice the country's own total emissions.

Norway is not alone. A recent report by the International Forum of Sovereign Wealth Funds (IFSWF) shows that SWFs around the world are lagging behind. About three-quarters report having less than 10% of their holdings in climate-related strategies, while only 14% have made divestment decisions related to climate or environmental targets. While 24% of SWFs consider climate action part of a broader ESG (environmental, social, and governance) framework, only 12% have an explicit climate-change policy.

To be sure, IFSWF's own Generally Accepted Principles and Practices (the "Santiago Principles") do not specify sustainability requirements for SWFs. But governments of countries that have SWFs should view the UN Climate Change Conference in Glasgow (COP26) in November as an opportunity to commit fully to the net-zero program.

There are several reasons why they should do this. For starters, 2050 net-zero targets are becoming a mainstream expectation for all large institutional investors. If a government chooses not to commit its SWF to this goal, it will be free riding on the growing share of the private financial sector that is already going green – a paradox of climate finance if there ever was one.

Moreover, it makes little sense for governments seeking to be consistent in their climate commitments to separate SWF portfolio emissions from overall climate objectives. The domestic focus of international climate agreements should not be interpreted as a free pass for emissions associated with foreign investments. Instead, governments should be using their SWFs' financial weight to drive climate action internationally.

Last but not least, the transition to a low-carbon economy represents the biggest investment opportunity in decades. Shifting from "brown" to "green" will require changes on the scale of another industrial revolution; those who create new markets or enter them early stand to reap massive returns.

As one of the few SWFs with an explicit emissions-reduction objective, the New Zealand Superannuation Fund has already begun to seize these new opportunities. Between 2017 and 2020, the fund's low-carbon benchmark portfolio, which comprises 40% of its total assets, generated returns that were 0.6% higher than its standard benchmark portfolio. By contrast, Norway's SWF missed out on $126 billion in potential returns during the same period, because it invested in oil and gas instead of green stocks.

Because many countries with SWFs have historically been heavily dependent on their oil and gas sector, the transition away from fossil fuels exposes them to larger economic risks. But governments can mitigate these risks by aligning their SWFs with climate targets. A total portfolio approach would enable these governments to start delinking domestic economic growth from SWF returns, thereby enhancing the robustness of the economy as a whole.

For SWFs, as for other institutional investors, staying on the sidelines of the global climate-mitigation effort is no longer an option. But nor is it enough to focus solely on climate-related portfolio risk while ignoring a fund's broader climate impact. Were SWFs to get serious and join the Net-Zero Asset Owner Alliance, they would be required to set stronger emissions targets every five years, reporting annually (alongside the usual financial disclosures) on their progress toward meeting them. They would also be expected not only to invest in green assets but also – and more importantly – to develop new sustainable assets themselves.

Countries like France, Ireland, New Zealand, Norway, Singapore, and the United Arab Emirates are well placed to lead a global SWF movement toward net-zero commitments at COP26. If they do, other funds with large investment teams and sophisticated operations may soon follow, and those with fewer resources would, one hopes, be close behind them.

Most SWFs were established as savings vehicles for future generations. It stands to reason that these funds should contribute to the conservation of the climate on which those generations will depend.

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