Boosting Sustainable Investing in Asia and the Pacific by Public Institutional Investors
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The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This policy brief on *Boosting Sustainable Investing in Asia and the Pacific by Public Institutional Investors* is an expanded and updated version of a section on boosting SDG investments by public institutional investors in chapter 5 of the 2021 edition of ESCAP’s *Economic and Social Survey of Asia and the Pacific*. It is prepared by Vatcharin Sirimaneetham. Hamza Ali Malik and Sweta Saxena provided feedback and overall guidance. The graphic layout was created by Pannipa Jangvithaya.

Please cite this paper as: Sirimaneetham, Vatcharin (2021). Boosting sustainable investing in Asia and the Pacific by public institutional investors. MPFD Policy Brief, No. 120. Bangkok: ESCAP.

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Tracking number: ESCAP/1-PB/9
The financing needs and investment requirements to achieve the Sustainable Development Goals (SDGs) were considerably large for many Asia-Pacific economies even before the COVID-19 pandemic. The pandemic has exacerbated such challenges, underscoring the need to explore innovative financing and investment sources. This policy brief explores how to increase investments in sustainable development by institutional investors, which are generally defined as organizations that pool funds from other entities to make financial investments. Different types of institutional investors have different investment strategies based on their fiduciary duties and risk tolerance level. The focus here is on pension funds and sovereign wealth funds, which are often public or quasi-public in nature. Among the various policy options to increase contribution to the SDGs by institutional investors (UNEP, 2015), this policy brief focuses on two policy areas, namely, amending investment rules to boost sustainable investments and incorporating environmental, social and governance factors into investment strategies.

A. POTENTIAL TO INCREASE SUSTAINABLE INVESTMENTS BY PUBLIC INSTITUTIONAL INVESTORS IS CONSIDERABLE

The assets under management by Asia-Pacific pension funds and sovereign wealth funds are very large. The value of these assets amounted to about $8.5 trillion as of end-2020, of which $5.5 trillion was in developing economies. Despite economic disruptions caused by the COVID-19 pandemic, the total asset value increased by 12.5 per cent from $7.5 trillion at end-2019. Among others, developing Asia-Pacific economies with large asset values of pension and sovereign wealth funds includes China, the Republic of Korea and Singapore (figure 1, panel a). As a share of GDP, these assets are sizeable in such countries as Brunei Darussalam, Kiribati, Timor-Leste and Tuvalu, primarily driven by revenues coming from natural resources (figure 1, panel b).

FIGURE 1: ASSETS OF PUBLIC INSTITUTIONAL INVESTORS IN SOME ASIA-PACIFIC ECONOMIES ARE TREMENDOUS IN SIZE

<table>
<thead>
<tr>
<th>a. Billions of United States dollar</th>
<th>b. Percentage of GDP</th>
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</thead>
<tbody>
<tr>
<td>Japan</td>
<td>Timor-Leste</td>
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<td>China</td>
<td>Brunei Darussalam</td>
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<td>Singapore</td>
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<td>Australia</td>
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<td>Taiwan, China</td>
<td>Nauru</td>
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Source: Author, based on OMFIF (2021).
The potential to increase sustainable investments by public institutional investors is considerable. In addition to their large size in terms of asset values, other factors include:

- **First**, the liability profiles of pension funds and sovereign wealth funds are usually long term, which makes them well suited to hold long-term assets in development projects.

- **Second**, institutional investors have demonstrated keen interest in contributing to the achievement of the SDGs. In a survey of 175 Asia-Pacific institutional investors, the share of respondents who did not believe in sustainable investments fell from 23 per cent in 2017 to only 10 per cent in 2019 (Schroders, 2019). About two-thirds of the respondents also noted the increasing role of sustainability among institutional investors in the following five years. The global surveys of institutional investors show a similar trend.\(^1\)

- **Third**, a survey of over 3,000 institutional investors worldwide shows that there are short-term plans to expand or make new investments in emerging and frontier economies, with infrastructure as the most preferred sector among the public respondents (Narayanan, 2018). Relatedly, public pension funds and sovereign wealth funds are also reallocating their assets away from domestic bonds towards equities and alternatives with higher risks such as real estate and private equity (Hentov, Petrov, and Odedra (2018), and Hentov, Elliot, and Alexander Petrov (2020)).

- **Finally**, the COVID-19 pandemic not only piques interest on sustainability among institutional investors (FTI Consulting (2020), and See Tho (2020)), but the low interest rate environment also means that fund managers may need to explore alternative, higher-yield asset classes.\(^2\)

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**B. WHAT IS HOLDING BACK PUBLIC INSTITUTIONAL INVESTORS TO INCREASE SUSTAINABLE INVESTMENTS?**

Despite the large potential, the contribution of institutional investors to sustainable development appears limited. For example, in the world’s major pension markets, up to three quarters of their total portfolio is invested in liquid assets (such as money market instruments) compared with less than 3 per cent in infrastructure projects (United Nations, 2017). Similarly, institutional investors accounted for only 1 per cent of investment in 163 infrastructure projects under public-private partnerships in low- and middle-income countries in 2015 (World Bank, 2016). A large part of such financing still came from traditional bank loans.

Investment rules governing pension funds in many economies are constraining their ability to invest sustainably. According to OECD (2020), certain pension funds in countries such as Armenia, Georgia, India, Kazakhstan, Pakistan, the Republic of Korea and the Russian Federation are not allowed to invest in domestic equities or allowed but with maximum limits and/or only in equities listed in home or developed markets. For investments in sovereign bonds, most of these countries also impose maximum portfolio limits and/or place different caps for bonds issued by central governments and local governments in own and other countries. For investments in corporate bonds, often there are requirements to invest only in bonds with certain ratings or those with State guarantees. For example, in Hong Kong, China, ...

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1 In just one year after the SDGs were announced, a survey of institutional investors worldwide reveals that 75 per cent and 62 per cent of the respondents believed the Goals would bring reputational benefits and higher investment returns, respectively (ShareAction, 2016).

2 Nonetheless, Glossner, et al. (2020) shows that, in the months after the pandemic began, pension funds in the United States decreased their holdings of listed firms rated with favourable environmental and social scores.
there is no portfolio limits if pension funds invest in investment-grade bonds, listed equities, and bonds issued by listed companies. Overall, domestic investment rules for pension funds appear less stringent in such countries as Australia, Indonesia, Japan, Maldives, New Zealand, Thailand and Turkey. For foreign investments, portfolio limits are, as expected, more restrictive. For example, pension funds in India and Indonesia are not allowed to invest in foreign equities and bonds. In Hong Kong, China, at least 30 per cent of the fund must be held in Hong Kong dollar currency investments.

Corporate culture and related rules also explain limited sustainable investing. These include, among others:

- **First**, staff compensation packages incentivize investment managers to prioritize short-term performance over long-term goals (Gottschalk and Poon, 2018). For example, according to a survey by Aviva (2014), while 60 per cent of pension funds are of the view that the key investment period is longer than a year, up to two thirds of them review fund managers’ performance on a quarterly basis. This is also the case when institutional investors outsource their funds to asset management companies, which have short-term orientation.

- **Second**, many institutional investors lack in-house expertise to assess the risks of complicated projects, such as cross-border infrastructure projects.

- **Third**, certain investment regulations limit investments in asset classes that could potentially contribute to sustainable development. For instance, institutional investors in many Asia-Pacific economies are not permitted by law to invest directly in real estate or infrastructure (Biswas, 2016).

- **Finally**, certain fiduciary rules and a home bias in investment decisions, especially among institutional investors in more developed markets, often reduce investments in foreign countries. For example, pension funds in Japan do not hold any debt securities and equities issued by non-residents, while those in the Republic of Korea and the Russian Federation engage less in foreign-issued instruments relative to investment funds and insurance companies in their countries (figure 2).

**FIGURE 2: SHARE OF NON-RESIDENT DEBT SECURITIES AND EQUITIES HELD BY INSTITUTIONAL INVESTORS AT END-2019**

![Graph showing share of non-resident debt securities and equities held by institutional investors at end-2019](image)

Beyond corporate-level factors, the nature of development projects also plays a role. Among others, development projects often have long-term maturity, which imply greater investment risks and uncertainty. Long-term projects are also more vulnerable to political risks, such as sudden changes in a government and its policy direction. More broadly, returns from investing in development projects are usually underestimated because their positive spillover effects, such as greater transport connectivity and energy security, are not fully taken into account.

C. AMENDING INVESTMENT POLICIES AND RULES TO UNLEASH INVESTMENTS FOR SUSTAINABLE DEVELOPMENT

Relaxing some of the investment rules can channel more financial resources into sustainable development. As of July 2021, out of 31 Asia-Pacific economies with available sovereign credit risk ratings, 18 are below investment grade (figure 3). Several other economies are unrated. As a result, corporate and project bonds in these countries are typically non-investment grade because sovereign bonds usually carry the highest rating in any economy. Thus, when institutional investors can invest only in investment grade securities, bonds issued by firms that promote sustainable development in these countries, such as climate-resilient infrastructure, will miss financing opportunities. Meanwhile, partial relaxation of foreign investment rules can help mobilize sizeable financial resources for other developing countries. For example, if only 1 per cent of assets managed by pension funds in India could be invested overseas, this would amount to 1.5 times the size of foreign aid that its neighbouring country Nepal received in 2018. Similarly, in the case of Indonesian pension funds, that would be 2.2 times the size of Timor-Leste’s foreign aid.

**FIGURE 3: SOVEREIGN CREDIT RISK RATINGS ACROSS DEVELOPING ASIA-PACIFIC ECONOMIES**

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Source: Author, based on https://tradingeconomics.com/country-list/rating.
Note: The ratings are based on Moody’s. (1) is prime, (2) is high grade, (3) is upper-medium grade, (4) is lower-medium grade, (5) is non-investment grade speculative, (6) is highly speculative, (7) is substantial risks, (8) is extremely speculative, and (9) is in default with little prospect for recovery.

For example, sovereign wealth funds in Singapore and the United Arab Emirates jointly funded a clean energy holding in India, hence supporting India’s policy towards green electricity (17 AM, 2019).
Adjustments in investment policies of sovereign wealth funds could also mobilize additional financial resources for sustainable development. For example, take the case of Azerbaijan’s State Oil Fund. As of March 2021, the Fund’s assets stood at $42.8 billion, or about the same size of the country’s GDP in 2020. The portfolio is oriented towards fixed-income and money market instruments (64 per cent of total investment), developed countries (59 per cent), and financial instruments dominated in United States dollar, Euro or British pound (94 per cent) (figure 4, panel a). While about a fifth of the Fund’s investments are in emerging economies, they appear to be large economies with strong credit rating, as only 1.3 per cent of its fixed-income investments is in non-investment grade securities (figure 4, panel b). Also, most fixed-income instruments held by the Fund have a maturity of less than three years, which is less well suited to long-term development projects. In essence, adjustments in investment policies that allow larger investments in countries and financial instruments with higher risks would raise sovereign wealth funds’ contribution to sustainable development, although the impact of such investments on portfolio risk should be carefully reviewed at the same time.

In addition to relaxing investment restrictions, a certain amount and share of investments could be allocated directly to sustainable investments through regulatory changes. In Europe, institutional investors set the amount of funds that they would invest in sustainable investments (Phenix Capital Group, 2017). In Japan, the Government Pension Investment Fund, the world’s largest pension fund, allocates a certain share of its investments to environmentally and socially responsible investments. This resulted in more than 300 per cent growth in Japan’s sustainable financial assets between 2016 and 2018 (Bray and Moon, 2019).

**FIGURE 4: AZERBAIJAN’S STATE OIL FUND INVESTS PRIMARILY IN INVESTMENT GRADE FIXED-INCOME INSTRUMENTS**

- a. Investment portfolio breakdown
- b. Breakdown of fixed-income instruments

Source: State Oil Fund of the Republic of Azerbaijan.

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4 For further information, see www.oilfund.az/en.
5 On asset allocation, while transfers to the state budget and the central bank is the largest portion, the Fund has also made sizeable investments in national development projects, especially in social assistances to refugees.
D. INTEGRATING SUSTAINABILITY CONSIDERATION INTO DECISION MAKING TO ENHANCE SUSTAINABLE INVESTING

Asia-Pacific public institutional investors should actively adopt the use of environmental, social and governance (ESG) strategies. Strategies such as social impact investments, direct engagements with companies and full ESG integration into investment analyses and decisions can have a greater impact on sustainable development compared with passive strategies, such as negative screening (e.g. when firms avoid investing in sectors that are deemed environmentally harmful) (Schlaffer, Hobisch and Cavalli, 2020). A recent survey showed that, while 56 per cent of the sample institutional investors from the Asia-Pacific region were already mainstreaming ESG factors into investment processes, that ratio was around 70 per cent for European respondents (Schroders, 2019). Moreover, together with ESG integration, negative screening remains the most popular strategy among institutional investors in the region. Globally, impact investment is now the most widely used investment strategy among ESG-active public pension and sovereign wealth funds (UNCTAD, 2020). Another survey also suggests the use of traditional, passive strategies among institutional investors is expected to decrease over the coming few years (McKinsey, 2019).

Various actions can be taken by institutional investors to pursue more active ESG strategies. Among others, a revision in corporate investment guidelines can facilitate such a shift. For instance, Thailand’s Government Pension Fund introduced new guidelines in 2019 that adopted ESG criteria across all investments, such as the use of a scoring tool to assess investment opportunities in bonds and equities (GIIN, 2020). Another factor is solid technical capacity of investment teams, which is required to prepare complex investment analyses, such as quantitative investment models that feature ESG scores. Yet, almost 30 per cent of Asia-Pacific institutional investors in a survey cited that more training would help increase sustainable investing by their organizations (Schroders, 2019). Also, nearly 40 per cent of surveyed institutional investors in the region face difficulty in measuring and managing risks when investing in sustainable development (figure 5). At a broad level, institutional investors should actively participate in national and multilateral initiatives that promote sustainable development. For example, in Japan, the 2014 principles for responsible institutional investors were signed by 281 institutional investors as of April 2020 (GIIN, 2020).

FIGURE 5: UNCLEAR DEFINITIONS OF SUSTAINABLE DEVELOPMENT ARE THE MAIN CHALLENGES FOR SUSTAINABLE INVESTING


6 Incorporating ESG criteria into bond investments can be more challenging than equity investment because it involves multiple bond types and issuers (such as unlisted companies and non-corporate entities) (Inderst and Stewart, 2018).
Financial market regulators can also play an important role. For institutional investors to effectively incorporate ESG criteria into their investment decisions, an important prerequisite is accurate, consistent and regular sustainability reporting by their existing and potential investees. Indeed, the lack of clear, agreed definitions of sustainable development (figure 5) and the transparency of companies’ performance reporting (Schroders, 2020) are often rated by Asia-Pacific institutional investors as the main obstacles to sustainable investing. In this regard, financial sector regulators should seek to ensure common ESG definitions and standards (at least at a national level) and provide incentives for or legally require ESG reporting by firms. Policy effort on this front could be stepped up. For example, only 6 of 18 Asia-Pacific stock markets require ESG reporting as one of their listing requirements and only half of them offer written guidance and ESG reporting or recently conducted ESG-related training (Sustainable Stock Exchanges, 2018).

CONCLUSION

This policy brief examines how to increase sustainable investments by public institutional investors in Asia and the Pacific. To leverage the largely untapped potential of pension funds and sovereign wealth funds in Asia and the Pacific, it calls for relaxing certain restrictions that govern their investment policies. Public institutional investors themselves should aim at adopting investment strategies that are more SDG-oriented. Table 1 highlights specific policy issues for Asia-Pacific economies with development levels. Finally, national policymakers and multilateral development partners should strive for a long-overdue common definitions and reporting standards for sustainable investing.

### TABLE 1: A SNAPSHOT OF RECOMMENDED POLICY ACTIONS

<table>
<thead>
<tr>
<th>Possible policy actions</th>
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<tbody>
<tr>
<td><strong>Less developed countries</strong></td>
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<tr>
<td>• For pension funds, relax investment restrictions on domestic equities and government and corporate bonds</td>
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<tr>
<td>• For sovereign wealth funds, allocate part of investment for domestic development projects</td>
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<tr>
<td>• Increase awareness of sustainable investing</td>
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<tr>
<td><strong>Emerging economies</strong></td>
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<tr>
<td>• Relax restrictions on foreign investments and investments in non-investment grade yet SDG-oriented securities</td>
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<tr>
<td>• For institutional investors, adopt more active ESG investment strategies and enhance technical capacity</td>
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<tr>
<td>• For financial regulators, encourage or require ESG reporting and ensure common ESG definitions and standards.</td>
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Source: Author.

7 While potentially low financial returns of sustainable investing are also a common concern, studies have shown that ESG-oriented investments can offer higher yields. For example, Ben Ameur and Senanedsch (2014) found that investing in Asia-Pacific equities that engage with corporate social responsibility exhibits lower systemic risk and risk premiums than equity investments in the conventional market. Outside the region, bonds issued by American companies with better ESG ratings tend to yield higher rates of returns than the market benchmark (Hoepnerab and Nilssona, 2017).
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