Trillions or billions? Reassessing the potential for European institutional investment in emerging markets and developing economies

Samantha Attridge, Bianca Getzel and Neil Gregory

May 2024

Key messages

Not all insurance companies and pension funds have the capacity to invest in EMDEs. Therefore, the addressable market for mobilising capital into EMDEs is smaller than often assumed in the financing for development discourse. However, we estimate that, with increased ambition, that involves, a doubling of current combined investment flows of Europe’s top 35 largest asset owners would yield an annual EMDE flow of around $120 billion in five years. However, these flows are likely to be highly concentrated in publicly listed and investment grade assets in large emerging markets.

Regulation does not constrain pension fund EMDE investment, but does limit EMDE investment by insurance companies. For pension funds, the barrier to increased EMDE investment allocation appears to be more behavioural in nature.
European pension markets are undergoing reform and shifting from defined benefit to defined contribution schemes. This potentially has both positive and negative impacts on EMDE allocation.

There is a critical role for governments, MDBs and the DFIs that they own to help these institutions allocate more assets to EMDEs.
Readers are encouraged to reproduce material for their own publications, as long as they are not being sold commercially. ODI requests due acknowledgement and a copy of the publication. For online use, we ask readers to link to the original resource on the ODI website. The views presented in this paper are those of the authors and do not necessarily represent the views of ODI or our partners.

This work is licensed under CC BY-NC-ND 4.0.

Acknowledgements

The authors would like to thank the following peer reviewers for providing very helpful critique and comments: Frederique Dahan (ODI), Jerome Depolsen, Chris Eleftheriades (MOBILIST), David Krivanek (UK Impact Investing Institute), Hans Peter Lankes (ODI), Mark Miller (ODI), Dirk Meuleman (Phenix Capital), Gila Norich (Global Steering Group for Impact Investment), Mark Reinisch (IFC), Matthew Robinson (British International Investment), Manfred Schepers (ILX Fund) and Nathan Sussman (Graduate Institute of Geneva). We also thank Aaron Griffiths, Sherry Dixon and Ben Campbell for editing and coordinating production.

The authors gratefully acknowledge the generous financial support of the Bill & Melinda Gates Foundation, which made this study possible.

The authors also thank colleagues from the following institutions for generously engaging in the research, providing comment and data: Allianz Global Investors, British International Investment, Cardano UK, Dimensional, FMO Investment Management, Gastrosocial, The ILX Fund, Mercer UK, MOBILIST, OECD, Pensions for Purpose, Publica, UK Impact Investing Institute, United Nations Principles for Responsible Investment and the Dutch, French, Swiss and German National Advisory Boards for Impact Investing.

All views, errors and omissions in this paper are the sole responsibility of the authors and do not reflect those of the funder, ODI or the institutions analysed in this paper.

About the authors

Samantha Attridge is a Senior Research Fellow at ODI. She specialises in blended finance, public development bank (PDB) and development finance institution (DFI) investment. She has deep understanding and knowledge in the use of development funds to de-risk private investment to mobilise private finance and the strategies, operations and impact measurement and management of PDB and DFI investment. Between 2009 and 2016, she was Head of Development Finance at the Commonwealth. Prior to that, she was the Deputy Director of Sovereign Debt Management and Capital Market Development consultancy at Crown Agents. She holds a Master’s degree in Development Economics from the School of Oriental and African Studies. She is also a Chartered Accountant with the Institute of Chartered Accountants in England and Wales and qualified with PricewaterhouseCoopers.

Bianca Getzel is a Research Officer at ODI. Her research and advisory work focuses on private sector mobilisation in the context of multilateral and national development banks, as well as development finance institutions. Before joining ODI, Bianca worked at the World
Bank's International Finance Corporation and TCX. Bianca holds a Master's degree in Development Economics from the Johns Hopkins School of Advanced International Studies.

**Neil Gregory** is a Senior Research Associate at ODI. He teaches at Johns Hopkins School of Advanced International Studies and advises development finance institutions and impact investing firms. He previously held a variety of senior research, strategy, and operational roles at the International Finance Corporation and World Bank. He holds Masters' degrees in Economics from Cambridge and Oxford Universities and an MBA from Georgetown University.
# Contents

Executive summary ............................................................................................................ 10
1 Introduction .................................................................................................................. 16
2 Market overview .......................................................................................................... 20
  2.1 Size of European pension and insurance markets ........................................... 20
  2.2 Emerging market asset allocation by Europe’s 35 largest institutional investors ................................................................. 21
  2.3 Structural changes in pension markets ............................................................... 25
3 Drivers of ICPF’s investment behaviour: changing stakeholder expectations ................................................................. 29
  3.1 Governments ........................................................................................................ 29
  3.2 Trustees and beneficiaries ................................................................................. 30
  3.3 Shareholders ...................................................................................................... 32
  3.4 Civil society ....................................................................................................... 33
4 Drivers of ICPF’s investment behaviour: financial market conditions, cost and performance ................................................................. 34
  4.1 Recent developments in financial market conditions since 2015 ............... 35
  4.2 Performance in perspective ............................................................................. 37
  4.3 Cost of EMDE investment ............................................................................... 39
5 Drivers of ICPF’s investment behaviour: legal and regulatory frameworks .................................................................................. 45
  5.1 Overview of legal and regulatory frameworks ................................................. 46
  5.2 Behavioural approaches: prudent person principle ..................................... 47
  5.3 Rules-based approaches: quantitative limits on asset allocation .............. 48
  5.4 Capital and solvency requirements for pension funds ................................ 49
  5.5 Capital and solvency requirements for insurance companies .................. 50
  5.6 ESG risks and impacts .................................................................................... 57
  5.7 Climate change ................................................................................................. 63
6 Findings and recommendations .................................................................................. 67
  6.1 Addressable market for mobilising capital into EMDEs ............................. 67
  6.2 Market structure ............................................................................................... 68
  6.3 Regulations ....................................................................................................... 69
  6.4 ESG risks and impacts .................................................................................... 70
  6.5 Investor behaviour and operational practices .............................................. 70
  6.6 Other issues for further research ................................................................... 71
Conclusion ......................................................................................................................... 75
References ......................................................................................................................... 76
Appendix 1 The potential for increased EMDE investments by large European ICPF’s .................................................................................. 81
Appendix 3  Conceptualisation of fiduciary duty by studied country ......86
Appendix 4  Examples of how MDBs and DFIs can help ICPFs invest in EMDEs .................................................................88

Display items

Boxes
Box 1  EMDE terminology/what are EMDEs? ........................................16
Box 2  UK pension funds geographic allocation of assets in EMDE ....23
Box 3  Insurance company preference for investment grade assets ......25
Box 4  An explainer: defined benefit and defined contribution schemes .27
Box 5  Stakeholder terminology ..........................................................30
Box 6  Active versus passive strategies in EMDEs .............................43
Box 7  Studies on Solvency II capital charges for non-OECD infrastructure 52
Box 8  Tied assets ...........................................................................56

Figures
Figure 1 Market coverage 2020 ..........................................................21
Figure 2 Top five markets for pension and insurance, total investments 2020 ........................................................................21
Figure 3 Top pension funds of the sample by assets in developing countries, 2022 .........................................................................22
Figure 4 UK pension fund overseas portfolio allocation, by region, 2022 ..23
Figure 5 Top insurance companies of the sample by assets in developing countries, 2022 .................................................................24
Figure 6 Risk appetite of European insurance companies.....................25
Figure 7 DB and DC asset allocation, by country, 2022 .......................26
Figure 8 EMDE portfolio flows 2018–2022 ..........................................36
Figure 9 The dollar and capital flight away from EMDEs ..................37
Figure 10 Performance of US market, developed markets excluding US, and emerging markets (2002–2021) ........................................38
Figure 11 Emerging market versus developed market bond index performance, 2008–2024 ..............................................................39
Figure 12 Median stated (active) management fees, by region, allocation size, and capitalisation (cap) ..................................................41
Figure 13 Active versus passive management returns net of fees, 2014–2019 .................................................................................43
Figure 14 Estimated capital charge (EIOPA, Solvency II) for 10-year unrated project loans with diversification ........................................52
Figure 15 Emerging market credit rating distribution, December 2023 ......54
Figure 16 MSCI Emerging Markets and ESG Leaders Equity Index, percent allocation to lower- and upper-middle income economies, 2018–2022 ....63
Figure 17 Estimating annual investment flows to EMDEs by the 35 largest European ICPFs .........................................................81
Figure 18 Achieving a $0.5 trillion EMDE allocation in ten years ..........82
Figure 19 Achieving a $0.5 trillion EMDE allocation in five years ..........82
Figure 20 The IFC Amundi deal and the role of MDBs .....................90

Tables
Table 1 Types of regulatory approach.................................................47
Table 2 Additional quantitative restrictions on pension fund investment ....49
Table 3 Spectrum of ESG integration in legal and regulatory rules for ICPFs
........................................................................................................59
Table 4 Overview of studied insurance and pension fund markets.........83
Table 5 Conceptualisation of fiduciary duty by country.........................86
## Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>APG</td>
<td>Algemene Pensioen Groep</td>
</tr>
<tr>
<td>ASIP</td>
<td>Association of Swiss Pension Funds</td>
</tr>
<tr>
<td>CSO</td>
<td>civil society organisation</td>
</tr>
<tr>
<td>DC</td>
<td>defined contribution</td>
</tr>
<tr>
<td>DB</td>
<td>defined benefit</td>
</tr>
<tr>
<td>DFI</td>
<td>development finance institution</td>
</tr>
<tr>
<td>EAFE</td>
<td>Europe, Australasia and the Far East</td>
</tr>
<tr>
<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Authority</td>
</tr>
<tr>
<td>EMDEs</td>
<td>emerging markets and developing economies</td>
</tr>
<tr>
<td>ESG</td>
<td>environment, social, and governance</td>
</tr>
<tr>
<td>ETF</td>
<td>exchange-traded fund</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FINMA</td>
<td>Swiss Financial Market Supervisory Authority</td>
</tr>
<tr>
<td>FMO</td>
<td>Dutch Development Bank</td>
</tr>
<tr>
<td>GEMs</td>
<td>Global Emerging Markets Risk Database</td>
</tr>
<tr>
<td>GHGs</td>
<td>greenhouse gases</td>
</tr>
<tr>
<td>ICPF</td>
<td>insurance companies and pension funds</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>ILX</td>
<td>ILX Management B.V.</td>
</tr>
<tr>
<td>ISSB</td>
<td>International Sustainability Standards Board</td>
</tr>
<tr>
<td>IORP II</td>
<td>Institutions for Occupational Retirement Provision II</td>
</tr>
<tr>
<td>MA</td>
<td>matching adjustment</td>
</tr>
<tr>
<td>MDBs</td>
<td>multilateral development banks</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PGGM</td>
<td>Pensioenfonds voor de Gezondheid en Gezondheidzorg</td>
</tr>
<tr>
<td>PPP</td>
<td>prudent person principle</td>
</tr>
<tr>
<td>PRA</td>
<td>Prudential Regulation Authority</td>
</tr>
<tr>
<td>SDG</td>
<td>Sustainable Development Goal</td>
</tr>
<tr>
<td>SFDU</td>
<td>Sustainable Finance Disclosure Regulation</td>
</tr>
<tr>
<td>SST</td>
<td>Swiss Solvency Test</td>
</tr>
<tr>
<td>TCFD</td>
<td>Task Force on Climate-Related Financial Disclosures</td>
</tr>
<tr>
<td>TCX</td>
<td>The Currency Exchange Fund</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>VaR</td>
<td>Value at Risk</td>
</tr>
</tbody>
</table>
Executive summary

How big a contribution can we expect European institutional investors to make to financing the investment needs of emerging markets and developing economies (EMDEs)? The United Nations estimates that these economies need to make investments on the order of $4 trillion a year. In comparison, European institutional investors collectively manage $25.7 trillion (BCG, 2021). Hence, at first glance it seems that even shifting a small share of this capital towards EMDEs could make a big contribution to financing critical investments.

This argument has been played, and replayed, since 2015 when the Financing for Development agenda was launched by the UN, World Bank and International Monetary Fund (IMF) alongside the establishment of the Sustainable Development Goals (SDGs) and Paris climate goals. But since then, little additional capital has flowed towards EMDEs from institutional investors – and in some areas, net capital allocations are now lower.

At the same time, the context has changed significantly since 2015. We have moved from a cheap money era to an era of high inflation and interest rates, accompanied by greater geopolitical risks and a stalling, if not reversal, of global economic integration. Meanwhile, regulation of insurance companies and pension funds (ICPFs) is evolving, both at the European Union (EU) level and in individual countries. On top of that, growing awareness of environment, social and governance (ESG) risks and the positive and negative impacts of institutional investments have brought new factors into play in making investment decisions. In some countries, the structure of pension provision has also been changing.

Nevertheless, recent discussions at the G20 and in the boards of multilateral development banks (MDBs) have called for these institutions to prioritise mobilising capital from private investors. Given this changed context, what are the prospects of doing so?

To start to answer this question, it is necessary to move to a more granular level understanding by investor type and market given the heterogeneity of investors, pension and insurance markets. We focus our analysis on the European market, which manages 25.7% of total assets under management by institutional investors worldwide (BCG, 2021). We focus on five European countries that are home to the largest ICPF in the region: France, Germany, the Netherlands, Switzerland, and the United Kingdom. Collectively, ICPF in these countries manage $17.56 trillion in assets. We explore what this
changed context may mean for the ability to increase EMDE investment flows from ICPFs across three dimensions: (1) changes in stakeholder expectation; (2) changes in financial market conditions, performance and cost; and (3) changes in legal and regulatory frameworks.

Overall, we observe that the complexity of ICPF asset management means that increasing EMDE allocations is not a simple task and is unlikely to happen quickly. Insurance and pension markets are diverse between countries, reflecting different approaches to the provision of social insurance, and different ways of thinking about the role of the financial sector and regulatory approaches. Efforts to mobilise ICPFs and address investment behaviours to incentivise more EMDE investment will be difficult to disentangle from a broader domestic imperative to balance issues of risk and the need for long-term investment, as well as social attitudes to finance and the provision of social insurance. Notwithstanding this, efforts to address the operational environment of ICPFs in order to enhance their capacity and willingness to invest in EMDE assets can have an impact, but only if tailored to the specific circumstances of each country and institution. Although our research does not identify broad-brush reforms to unlock more ICPF capital, there are specific pinch points that reduce ICPF allocations to EMDEs. Regulators, policy-makers at the national and EU levels, and MDBs and development finance institutions (DFIs) can help address some of these issues. We provide specific findings and recommendations below.

Key findings and recommendations

1 Not all ICPFs have the capacity to invest in EMDEs. Therefore, the addressable market for mobilising capital into EMDEs is smaller than often assumed. Nonetheless, we estimate that, with increased ambition, a doubling of the current combined investment flows of Europe’s top 35 largest asset owners would yield an annual EMDE flow of around $120 billion in five years’ time. However, these flows are likely to be highly concentrated in publicly listed and investment grade assets in large emerging markets.

We find that the original premise of being able to mobilise trillions from institutional investors did not take sufficient account of the regulations, structure and operations of insurance and pensions industries in key European countries. There is a group of 35 asset owners representing the largest ICPFs in the five studied countries, which comprises 40% of the European market. These institutions manage $6.9 trillion and have the potential to increase allocations to EMDEs. The rest is managed by small ICPFs without the capacity or

---

1 Appendix 1 outlines the methodology of our calculation, for ease of communication we have rounded to $120 billion.
risk appetite to invest beyond their own borders, or outside the EU (for those countries within the EU).

We find that regulatory and operational practices limit the size of allocations that even large institutions can make to EMDE investments, especially in higher-risk markets, and illiquid instruments. ICPF investment is therefore highly concentrated in publicly listed, investment grade assets in large emerging markets, with little to no investment in developing economies. As a result, EMDE allocations typically range from 0% to 5% for insurance companies and 5% to 15% for pension funds.

To illustrate the realistic potential scale of ICPF funding, if the 35 largest asset owners across the five countries allocated as much to EMDEs as the 95th percentile, it would yield total EMDE assets of around $0.5 trillion (up from $0.25 trillion in 2022).² Achieving this within the next five years would require $50 billion of additional investment flows per annum on top of current commitments, effectively representing a doubling of annual flows.³ In other words, total EMDE asset allocation would have to increase by 20% each year. The same level of growth has recently been observed in private markets. In fact, over the past five years, the largest institutional investors have grown their allocation to alternative assets by 20% annually, amounting to almost $4 trillion in 2023 – double 2018 levels.⁴ Following the precedent set by alternative investments for EMDEs, this would equate to annual investment of approximately $120 billion per annum by the top 35 largest asset owners in the studied markets. This would be a significant contribution to EMDE financing – coinciding with the $123 billion committed by the World Bank Group in 2023 – but far from transformational in meeting financing needs, especially since these additional flows are likely to be highly concentrated in investment grade, publicly listed assets in large middle-income economies. Realistically, however, a shift of this magnitude would entail testing the bounds of the possible, and without changes to regulations, investor behaviour, or market conditions as an incentive, this level of ambition is unlikely to materialise.

2 Regulation does not constrain pension fund EMDE investment, but does limit EMDE investment by insurance companies. For pension funds, the barrier to increased EMDE investment allocation appears to be more behavioural in nature.

² This estimate assumes all of the 20 largest pension funds allocated around 14% and all of the 15 largest insurance companies allocated around 4% in line with the respective 95th percentile of each respective market.
³ In order to calculate additional annual investment flows to reach $0.5 trillion in total allocation, annual investment flows were first estimated at $40 billion based on the weighted average maturity of bonds and average holding period of equity. By year five these annual investment flows would need to double to reach $0.5 trillion, meaning that on top of steady reflows, $50 billion would need to be allocated to EMDEs each year for the next five years before the stock of assets held by institutional investors reaches $0.5 trillion. See Appendix 1.
⁴ Analysis based on CEM Benchmarking Data also discussed in (McKinsey, 2024)
To get closer to this potential contribution, we find some specific regulatory obstacles that would need to be addressed, especially for insurance companies, who face a regulatory ‘cliff’ that prevents them from investing in higher risk/sub-investment grade, less liquid assets under Solvency II. This severely limits the range of EMDE assets they can hold, and we think that EU insurance regulators should revisit the details of their solvency regulation to remove this binding ‘cliff’, as has been done in the UK. EU, Swiss and UK regulators should review the capital charges for non-Organisation for Economic Co-operation and Development (non-OECD) infrastructure, which are not aligned with actual credit performance of this asset class.

But we think that institutional investor practices and behaviours are currently the binding constraint, not regulations, as most investors’ EMDE holdings are not close to regulatory limits, and we find examples of investors that have been able to make substantially higher allocations than their peers within existing regulations. We find an immediate action agenda for ICPFs themselves to be more ambitious in finding ways to increase their EMDE holdings while meeting their risk-return targets. At the same time, MDBs and DFIs need to make their offerings more visible to ICPFs.

ICPFs are increasingly expected to manage their investments with respect to the risks and impacts of ESG. The legal and regulatory frameworks are evolving to include the integration of ESG risks into fiduciary duties. However, the interpretation and guidance on this matter varies across countries, as does the extent to which it is formalised in the legal and regulatory frameworks for ICPFs. Policymakers should allow pension funds to solicit and integrate the sustainability preferences of members and beneficiaries into investment decision-making while complying with the prudent person principle. They should also provide clearer guidance on fiduciary duty and the extent to which fiduciaries may take into account second materiality ESG factors.

Regulators should also pay attention to the way ESG risk management and net zero/Paris alignment requirements affect the appetite for EMDE assets. We find that the rise in ESG interest may have both positive and negative impacts on increased EMDE investment. It would be ironic if such requirements, intended to protect the environment (including stabilising the climate) and people, ended up starving them of the investments they need for a sustainable future. For example, disclosure requirements under the EU Sustainable Finance Disclosure Regulation (SFDR) may inhibit investors from holding emerging market assets where data availability is weaker.

3 European pension markets are undergoing reform and shifting from defined benefit (DB) to defined contribution
(DC) schemes. This potentially has both positive and negative impacts on EMDE allocation.

As DB schemes close and wind down, we can expect to see a shift in investment from assets chosen for growth potential (including EMDE assets) to assets chosen for risk management (i.e., domestic fixed income) to match known liabilities and reduce volatility. In DC schemes, the objective of return enhancement is likely to be more dominant, providing an opportunity for increased EMDE investment. However, this shift has put increased emphasis on low cost, liquid assets, making it harder to allocate to EMDEs.

ICPFs face an EMDE investment cost premia in terms of asset management fees. This is exacerbated by the limited opportunities to invest in public markets in EMDEs. Larger pension funds can benefit from economies of scale to help overcome the cost barrier to EMDE investment. In the longer term, **consolidation of smaller pension funds into larger funds would increase the capacity to invest in EMDEs**, as larger funds can benefit from economies of scale in terms of spreading the cost premiums associated with EMDE investment. In the near term, **MDBs and DFIs should work to provide low cost, liquid investment options for ICPFs**.

This pressure on costs could be counteracted by **giving beneficiaries more opportunities to select investment strategies which include sustainable investments in EMDEs**, which together with awareness-raising activities may encourage increased EMDE allocation to contribute to the SDGs and climate change goals.

**Governments could also provide tax incentives for ICPFs to invest in priority areas**, including the impact of climate change and the SDGs on EMDEs.

**4 There is a critical role for governments, MDBs and the DFIs that they own to help these institutions allocate more assets to EMDEs.**

Specifically, access to large-ticket, low-cost, long-term investment opportunities in risk-diversified portfolios of assets of moderate risk with good ESG and climate management and impact reporting can be attractive to institutions, as shown by the success of pioneering pooled funding models like the Managed Co-Lending Portfolio Program, ILX Fund and the Allianz/FMO SDG Fund. Where needed, governments, MDBs and DFIs can de-risk asset pools by taking junior, high-risk tranches, and/or by blending commercial capital with concessional capital able to accept certain risks with low or no compensation. They can offer structures that protect against political and currency risks. They can also help by generating and sharing risk information from the performance of MDB and DFI investments, which would help increase confidence in EMDE investment as private investors could better understand and assess the risk of EMDE.
investment. To create portfolios of assets for institutions to invest in, MDBs and DFIs will have to devote more efforts to market development and asset origination, as there currently are not enough available investment opportunities to meet the potential demand from institutional investors (Investor Leadership Network and Sustainable Markets Initiative, 2022).

For example, the Global Emerging Markets Risk Database (GEMs) is a credit risk database of the MDBs and DFIs. It shows that the historic losses of MDBs and DFIs are materially lower than those estimated by ratings agencies.
1 Introduction

Now, more than ever, we need to accelerate efforts to harness the booming interest in sustainable finance and shift private capital at scale toward better supporting the needs of people and the planet. Nowhere is this need more acute than in emerging markets and developing economies (EMDEs) (see 1 for how we define EMDEs).6

In 2021, assets held by institutional investors worldwide surpassed $100 trillion, 25.7% of which were concentrated in Europe alone (BCG, 2021). In theory, the largest pools of institutionally managed capital have the greatest potential to materially contribute to the financing of the SDGs and climate change goals. Indeed, past discussions with institutional investors7 indicated a growing interest in investing in EMDEs, particularly where aligned to the SDGs and/or climate change goals, for three reasons:

1 EMDEs have greater long-run growth potential than higher-income economies, as they catch up with developed markets, so they should generate higher investment returns over time.

2 Investment in alternative and infrastructure assets can provide risk diversification (particularly in frontier markets whose economies are less integrated into the global economy), offer a hedge against inflation, generate stable cash flows, and help buffer returns in a financial crisis as they can earn attractive returns.

3 A growing recognition that investment decisions have systemic and sustainability implications, including on the SDGs and climate change, has led to the adoption of responsible and sustainable investment practices, increasing the appetite for investments that contribute to social and environmental improvements in EMDEs.

Box 1 What are EMDEs?

There is no official definition of what constitute emerging market and developing economies. The IMF World Economic Outlook classifies 39 economies as ‘advanced’ based on income per capita, exports of diversified goods and services, and integration into the global financial system. The other 145 countries are classified as EMDEs.

---

6 For the purposes of this paper, unless specified otherwise, EMDEs refer to the country classification in the IMF World Economic Outlook (IMF 2023a).
7 For example, the 2018 G20 Investor Forum discussed investor appetite for sustainable investing in EMDEs (Klimenko et al., 2019) based on pre-forum interviews with 34 institutional investors.
Of these, 20 are considered ‘emerging markets’ and the remaining 125 are ‘developing economies’. For the purposes of this paper, unless specified otherwise, EMDEs refer to the country classification in the IMF World Economic Outlook (IMF, 2023a).

Another leading definition cited within this report is MSCI’s Emerging and Frontier Market classification, which includes 66 countries. Here, 24 are classified as emerging, and the remaining 42 are frontier.

It is important to note that, despite these notable definitions, most pension funds and insurance companies usually do not specify which classification they refer to in their annual reports. For this reason, the data in Section 2 and the Appendix relies largely on each investor’s reporting standard but generally reflect the MSCI Emerging Markets list.

Since 2015, global policy discussions have pinned and continue⁶ to pin great hopes on mobilising large pools of institutional investor capital towards EMDEs in support of these goals, but progress has been slow, despite considerable innovation in mobilisation structures and mechanisms by MDBs and bilateral DFIs (Gregory, 2023).

More recently, across Europe, there have been substantial changes in national and EU investment regulations, significant shifts in financial market conditions, and several initiatives to encourage greater alignment of institutional investment strategies with the Paris climate change agenda. This lack of progress and the significant changes in context since 2015 raises the questions of whether it is now realistic to expect significant contributions from private capital to financing investments to address climate change and achieve the SDGs in EMDEs, and if so, what it will take to increase investment flows from current levels. Policy-makers, MDBs, DFIs and other stakeholders need to update their understanding of how these developments are affecting institutional investor appetite for EMDE investment and how this appetite is likely to change in the years to 2030 – the target date for the SDGs. Additionally, in contrast to most of the existing literature and high-level policy discussion on this matter, it is crucial to analyse this issue at a more granular level given the diversity of national pension and insurance market structures and regulation.

This study is a first attempt to update and nuance this understanding to help inform better policy making. To do this, we explore what this changing context may mean for private investment flows to EMDEs, across three dimensions:

---

⁶ As seen by the renewed attention to this agenda. For example, the 2022 G7 Impact Task Force, the World Bank Group Evolution Roadmap, the World Bank/IMF High Level Advisory Group on financing climate and development and the G20 Independent Experts Group on strengthening the MDBs, which called for $500 billion per annum in additional private capital to be mobilised by the MDBs.
1 Changes in stakeholder expectations of institutional investor behaviour, including governments, pension beneficiaries and insurance policy holders.

2 Financial performance, costs and changes in financial market conditions since 2015, which affect the risk and return to EMDE assets relative to developed market assets.

3 The significant changes in national and international regulation that have occurred since 2015, which affect the ability of institutions to invest in EMDEs.

We pursue the needed granularity by focusing on a small set of European countries with large pension funds and/or insurance companies: France, Germany, the Netherlands, Switzerland and the UK. These markets represent a dominant share of investable assets throughout Europe, so this limited focus does not materially diminish the insights we can obtain for the whole market (Section 2). It allows us to go beyond review of regulations, policies and overall investment trends, and to dig into the behaviour and perspectives of investors in specific countries.

Similar analyses of the North American and Japanese markets could be made to complete the picture of institutional investors from developed markets, but these are beyond the scope of this study. Likewise, there are growing numbers of assets under management by institutions based in EMDEs, which are also relevant for the financing agenda. These are also beyond the scope of this study.

This study starts by providing a brief overview of the pension and insurance markets in our studied countries to provide a general context (Section 2). It then examines the changing context for asset allocation decisions by European institutional investors, in terms of changing stakeholder expectations (Section 3), changing financial market conditions, financial performance of EMDE investment and cost of EMDE investment (Section 4), and the current and potential impact of changes in EU and national-level regulations (Section 5). Throughout, it reports on perspectives from institutional investors and their advisers on how these external changes are feeding into their asset allocation decisions regarding EMDE allocations, whether specifically targeting climate change or the SDGs or not.

Based on these insights, we identify key constraints and opportunities for increased European institutional investor allocations to EMDEs from now until 2030, and hence make recommendations for policymakers, regulators, MDBs, DFIs and the investors themselves (Section 6). The study concludes with some summary concluding reflections.

---

9 Pension fund trustees hire advisers and service providers to assist trustees in managing their pension scheme. Some advisers must be appointed by law. Trustees can delegate tasks to their advisers and service providers, but they are still responsible for their work. These can include legal advisers, scheme actuaries, consultants and fund managers.
We hope that the analysis presented in this paper will provide a useful ‘reality check’ on the scope for increased investment flows from European institutional investors, as well as providing actionable recommendations that can materially increase these flows.
2 Market overview

Key takeaways

- The 35 largest EU ICPF s collectively managed €6.9 trillion of assets in 2022. This compares to €1.79 trillion held by the World Bank Group.
- The 35 largest EU ICPF s collectively allocated €252 billion to EMDEs in 2022. Pension funds have a higher appetite for EMDE investments, on average allocating 8.9% of their assets in EMDEs compared to 2.2% for insurance companies.
- ICPF investment is highly concentrated in publicly listed, investment grade assets in large emerging markets, with little to no investment in developing economies.
- European pension systems are undergoing reform. The resulting shift from DB to DC provision will potentially have positive and negative effects on pension fund EMDE allocation.
- As DB schemes close and wind down, we can expect to see a shift in investment from assets chosen for growth potential (including EMDE assets) to assets chosen for risk management (i.e. domestic fixed income) to match known liabilities and reduce volatility.
- In DC schemes, the objective of return enhancement is likely to be more dominant, providing an opportunity for increased EMDE investment. However, as DC schemes grow, it will be important to address issues of liquidity and cost of EMDE investment.

2.1 Size of European pension and insurance markets

This study covers Europe’s top five pension and insurance markets, which collectively hold 74.0% (€17.56 trillion) of total investable assets across European pension fund and insurance markets. The five countries were chosen by ranking the sum of total investable assets of the pension and insurance markets using OECD 2020 data (Figure 1). Figure 2 provides a breakdown of the markets,

---

10 This list reflects the overall market closely since, generally, the largest pools of pension fund assets are often recorded in countries where participation into retirement schemes has been (quasi-)mandatory (i.e. Netherlands and Switzerland). Meanwhile, the insurance market tends to be pooled into the largest economies (i.e. France, Germany and the UK). The five countries included in the study are also home to the largest European pension funds and insurance companies.
highlighting the importance and scale of large insurance markets in countries like France, the UK and Germany.

**Figure 1 Market coverage 2020**

![Market coverage 2020 Diagram](image1)

Source: OECD Pension and Insurance Statistics (2020)

**Figure 2 Top five markets for pension and insurance, total investments 2020**

![Top five markets for pension and insurance, total investments 2020 Diagram](image2)

Source: OECD Pension and Insurance Statistics (2020)

### 2.2 Emerging market asset allocation by Europe’s 35 largest institutional investors

The figures in the following subsections show the emerging market asset allocation of 35 of the largest European ICPFs (20 pension funds and 15 insurance companies) for whom public data is available.
available. These ICPFs collectively manage €6.9 trillion or 41% of institutional investor assets across the five studied countries. For context, the 14 major MDBs hold around €1.79 trillion ($1.9 trillion) in total assets.

Most ICPFs do not provide a more detailed breakdown of the geographical allocation of their investments, but some individual asset owners and national regulators do, shedding light on where most investments are held (Box 2).

2.2.1 Pension funds

The 20 pension funds held assets in emerging markets worth €175 billion in 2022, representing 11.2% of their total assets globally. Most of these assets were held by pension funds in the Netherlands (62.9%). Pension funds within the sample on average allocated 8.7% of their total assets to emerging markets.

**Figure 3 Top pension funds of the sample by assets in developing countries, 2022**

Source: Authors’ calculations based on 2022 annual reports, financial statements and investor presentations. EDF does not report on its equity allocation to emerging markets. Emerging markets are defined according to each investor’s reporting standard, but generally reflect the MSCI Emerging Markets list.

---

11 By using trusted industry rankings (most notably Willis Tower Watson’s Top 300 and Pension and Insurance’s Top 300) the top five pension funds and five insurance companies for each of the five largest European institutional investors market were identified. Out of these 50 institutions, 30 (17 pension funds and 13 insurance companies) provide public data on their EMDE allocation.
Box 2  UK pension funds geographic allocation of assets in EMDEs

According to market-level data from the UK Office of National Statistics, less than 1% of the overseas portfolio allocation of UK pension funds is in Africa (Figure 4). Moreover, in 2022, 80% of EMDE investment was concentrated among the five largest markets: India, Mexico, Brazil, South Africa and Indonesia (Figure 5). Only 1.37% of all foreign investments went to lower-middle-income countries and there were no reported allocations to low-income countries.

Figure 4 UK pension fund overseas portfolio allocation, by region, 2022

Figure 5 UK pension fund EMDE portfolio allocation, by country, 2022

Source: Authors’ calculations based on Office of National Statistics data 2022.
Note: In 2022, UK pension fund allocated 4% of their EMDE portfolio to China.

Outside the UK, no other national statistical offices within our studied countries collect data on the geographical allocation of foreign investments by ICPF s. However, some of the top 35 ICPF s within our sample share detailed data on their portfolios. This shows a similar
pattern of where EMDE assets are concentrated. For example, BVK – one of the largest German pension funds – allocated only 0.4% of its overall portfolio to Africa, with 96.9% of its EMDE allocation being dominated by Mexico, India, China and other large Asian economies. Similarly, the largest investments in EMDE bonds from France’s public pension fund, the *Retraite additionnelle de la fonction publique*, are in Mexico, Brazil, China and India – collectively comprising more than 30% of its EMDE bond portfolio.

### 2.2.2 Insurance companies

The 15 insurance companies analysed held assets in emerging markets worth €77.2 billion in 2022, representing 1.5% of their total assets globally. Insurance companies in the sample, on average, allocated 2.2% of their total assets to emerging markets (Figure 5).

**Figure 5** Top insurance companies of the sample by assets in developing countries, 2022

Source: Authors’ calculations based on 2022 Bloomberg data, annual reports, financial statements and investor presentations. EDF does not report on its equity allocation to emerging markets. Emerging markets are defined according to each investor’s reporting standard, but generally reflect the MSCI Emerging Markets list.

This shows that only a small share of the assets of large pension funds and an even smaller share of the assets of large insurance companies are held in EMDEs. Smaller ICPF's are likely to have even less exposure, as they have less capacity to manage EMDE investments. However, these assets are highly concentrated in investment grade, publicly listed assets in large emerging markets like Brazil, India and South Africa (Box 3), with few to no investments in developing economies.
Box 3  Insurance company preference for investment grade assets

There is no publicly available data on the risk rating distribution of ICPF’s EMDE portfolios. However, Figure 6 shows that on average 90% of assets in the largest European insurance companies (within our sample) are above investment grade.

Figure 6 Risk appetite of European insurance companies

Source: Authors’ calculations based on Bloomberg data, retrieved January 2024

2.3 Structural changes in pension markets

In all studied countries, there is a three-tier system of pension provision. The first tier is the state provision (pay as you go). The second tier consists of occupational plans, which can be DB or DC, or a combination of both. The third tier consists of individual personal plans. Our study mainly focuses on the second tier. Table 4 in Appendix 2 provides an overview of the pension markets in the countries studied.

Pension systems across Europe are undergoing scrutiny and reform. They have reached an inflection point. Longer life expectancies in European countries have put pressure on policymakers to reform pension systems to ensure that they are financially sustainable and fair within and between generations. Likewise, the low interest rate environment in Europe from 2009 until 2022 meant that DB schemes
became expensive for employers, as they had to make up scheme funding deficits, and many were consequently closed. As a result, countries are changing the structure of second tier provision (Box 4). Globally, DC assets have been growing at 6.5% per annum over the past 10 years, compared to 2.1% per annum for DB assets (Thinking Ahead Institute, 2023). In our studied countries, the largest DC market is France (Figure 7). In contrast, most of the pension fund assets in the Netherlands and UK are held in DB schemes, but this will change over time as a result of the reform to pension systems in these countries (Table 4 in Appendix 2). In the UK, for example, DC schemes have now surpassed DB schemes as the main form of workplace pension. It is expected that DC assets will increase sixfold by 2030 to £1.68 trillion, approximately 15% of the UK’s current net wealth, overtaking the assets of DB schemes (Law Commission, 2017).

Figure 7 DB and DC asset allocation, by country, 2022

Source: Thinking Ahead Institute (2023), Thinking Ahead Institute and Pensions & Investments (2022). Data for Switzerland: Swisscanto (2023). Note: Most pension fund assets in Switzerland are DC and take the form of cash balance plans, whereby the plan sponsor shares the investment risk and the assets are pooled. Pure DC assets have only recently been introduced in Switzerland, and although they have seen strong growth, they are not yet large enough to justify inclusion in this analysis. For Germany, the pension system is comprised of DB schemes; no figures are available on the split since the first ‘pure’ DC scheme was established in 2023.

---

12 The UK government introduced auto-enrolment DC schemes in 2012 which has led to a significant expansion in DC members compared to DB members.
Box 4 An explainer: defined benefit and defined contribution schemes

A DB scheme guarantees members a guaranteed retirement benefit based on a formula, often considering factors such as years of service and salary history. Employers and/or employees (i.e. members) pay into the pension fund. Regardless of the investment performance of the underlying assets of the fund, the member receives a guaranteed income in retirement. The employer/pension fund thus bears the investment risk as the employer is responsible for ensuring that there are sufficient funds to meet the guaranteed retirement benefits. If the pension fund’s investments underperform, the employer may have to contribute more to compensate for the shortfall.

In contrast, a DC scheme does not guarantee the member a specific income upon retirement. Employers and/or employees (i.e. members) pay into the scheme. The retirement benefit depends on the performance of the member’s investment plan and its value on the date of retirement. If the investments in the DC plan underperform, retirement income may be lower than expected. Therefore, the member bears the investment risk.

In most jurisdictions, DC funds are required to maintain segregated accounts for each fund member and to provide regular portfolio valuations, which can be costly. In addition, this imposes higher liquidity requirements and generally means these funds have lower EMDE exposures (Theobald, 2023). Recognising this general point, several developed markets have begun reforms to create long-term investment vehicles that DC funds can access, although the illiquid assets generally targeted are infrastructure and private equity (FCA, 2021; European Commission, 2020).

In general, the investment strategies of DB and DC funds differ. Consequently, the changing structure of pension systems will affect how and where pension funds invest, with potential positive and negative impacts for future EMDE allocation.

As DB schemes mature, they require known cash flows to pay fixed known retirement benefits. The tolerance of investment risk is lower, and the need for cash to be generated from the portfolio to meet benefit payments means that allocation will increase to domestic fixed income instruments, to match assets with liabilities. Thus, we expect DB schemes that are closed or are winding up will reduce their exposure to equities and foreign assets, including EMDEs. In these schemes we can expect to see a transition from investing in assets mainly chosen for their return potential (i.e. assets focused on growth potential including equities, growth focused alternatives and EMDE investment) to assets chosen for risk management (i.e., domestic fixed income) to match liabilities and reduce volatility. For
example, in the UK, there is a general opinion that the prevalence of foreign investment (including EMDE) in DB schemes has now peaked. This reverses the trend of the past 40 years in the UK, where schemes sought increasing international diversification in pursuit of enhanced returns and risk diversification (UK Pension Policy Institute, 2021). Moreover, the improvement in the funding positions of many UK DB schemes\(^\text{13}\) has initiated the market for the transfer of bulk pension risk to the insurance market, where schemes pay insurers to assume responsibility for some or all the pension liabilities of the scheme. According to the Financial Times, JP Morgan has projected that approximately £600 billion of the £2 trillion in liabilities of UK DB schemes could be transferred to insurers in the next ten years (Cumbo et al., 2023).

In contrast, the shift to DC schemes has the potential to become a positive driver for increased EMDE investment, as the objective of return enhancement is more dominant in DC schemes. This translates to a higher tolerance of investment risk and investment strategies tend to focus on growth and return. However, obstacles such as DC liquidity requirements (Box 4) and the higher cost of EMDE investment will need to be addressed to harness this potential positive driver (Section 5.4). As European DC schemes grow in scale and consolidate, they will be better placed to leverage the benefits of economies of scale to reduce the cost\(^\text{14}\) of EMDE investment (Section 4.3). This will be important as our interviews underscored the cost-sensitive nature of DC funds and regulatory charge caps on management fees.

Another opportunity stems from the fact that as investment risk is borne by the beneficiary, more choice can be afforded to beneficiaries to choose how their pension funds are invested, including any preference for sustainability and impact investment. However, despite this potential, beneficiaries do not tend to currently exercise this opportunity, with much DC scheme investment (certainly in the UK) allocated to default funds.

---

\(^{13}\) Rising interest rates have significantly improved the performance of many DB scheme bond portfolios.

\(^{14}\) EMDE investment is relatively more costly as skilled investment expertise is required which is familiar with and can manage the risks of EMDE investment.
3 Drivers of ICPF’s’ investment behaviour: changing stakeholder expectations

Key takeaways

- ICPF’s are influenced by multiple stakeholders, each with changing demands and expectations that influence investment strategies.
- ICPF’s operate in regulated industries where governments play a major role in setting rules on their behaviour.
- Most insurance companies and asset managers are for-profit firms responsible to shareholders.
- Pension funds owe a fiduciary duty to their beneficiaries; in some cases, the beneficiaries may have a voice in the investment strategy, either through making investment choices (in the case of DC schemes) and/or by having representation on the Board of Trustees. In the case of DB pension schemes, the employer is ultimately liable for the ability of the pension fund to meet its liabilities, and so has an interest in how the assets are managed.
- External groups, such as civil society organisations, may also be interested in the management of institutional funds because of their influence on environmental and social outcomes.

3.1 Governments

Most governments see a public interest in ensuring that pensions and insurance provision is well provided by private firms, while the size of assets that they manage make their behaviour relevant to macro-financial stability. For both reasons, these industries are highly regulated.

As large financial institutions, they are also subject to broader financial market regulation to ensure the stability and orderly functioning of financial markets (‘Macro-prudential regulation’), which increased in scope and rigour following the global financial crisis. Much of this regulation is aligned internationally, under the
coordination of the G20, the IMF, the OECD, the Bank of International Settlements and other standard-setting bodies.

The governments of the studied countries have been closely associated with the 2030 Agenda to finance the SDGs and climate change goals, and participate in G20 and/or G7 processes which have promoted greater mobilisation of private capital in support of this agenda (the G20 includes the EU, so involving smaller EU countries like the Netherlands). Although Switzerland is not part of these groupings of countries or the EU, it has endorsed the 2030 agenda as part of the UN. Therefore, governments have sought to varying degrees to encourage or persuade institutional investors to increase their allocations to climate and SDG aligned investments, both in their home countries and in EMDEs. We explore regulation and the impact of regulatory trends country by country in Section 5.

Box 5 Stakeholder terminology

Investors can be divided into retail investors (individuals) and institutional investors (all others). Institutions include asset owners (pension funds, insurance companies, foundations, endowments, sovereign wealth funds, etc.) and asset managers, who manage portfolios on behalf of asset owners. Pension fund assets are owned in trust for the beneficiaries of the pension scheme, so fund managers owe a fiduciary duty to manage the funds in the interests of the beneficiaries. Pension fund managers are typically overseen by a board of trustees, which may include representatives of beneficiaries. Asset owners may manage their own portfolios and/or contract asset managers to manage portfolios on their behalf. Insurance companies may have a mutual ownership structure, in which case the managers owe a fiduciary duty to the policy holders; or they may be for-profit firms with shareholders.

3.2 Trustees and beneficiaries

Traditionally, trustees saw their fiduciary role as narrowly concerned with ensuring that investments were made in the best financial interests of beneficiaries (pension fund holders or policy holders in mutual insurers), and until recently paid little attention to ESG risks which could affect long-term financial performance, or to the impact of their investments on social and environmental goals. As awareness of the financial exposure created by ESG risks has increased, most institutions have adopted investment policies that take into account ESG risks. In addition, driven in the first instance by concerns over climate change, trustees are increasingly challenged to take a broader view of their fiduciary role that considers the broader impact of their investments.

For example, in France, the Fonds de réserve pour les retraites is a de facto default fund with €21.4 billion in assets under management. The fund has been a responsible investor since 2003 and has been
committed to assessing the ten principles of the UN Global Compact in its allocation decision. In 2022, it allocated 4.5% and 6.8% to EMDE equities and bonds, respectively. Emerging market debt, emerging market equities, high-yield corporate bonds and unlisted assets are all invested mostly through active managers chosen after a rigorous selection procedure.

Where beneficiaries are represented on boards of trustees, there are signs that attention to social and environmental sustainability, especially climate impacts, may play a larger role in asset allocation. In the Netherlands, where employers and employees have equal representation on the boards of pension funds, 93% of Dutch pension beneficiaries are in funds that take sustainability issues into account (EU Article 8 aligned).

More jurisdictions require pension funds to take into account beneficiary views on sustainability. In the UK, trustees of trust-based occupational pension schemes are required to specify whether and to what extent they consider members’ views on non-financial matters such as sustainability. Similarly, the UK Pensions Regulator (code 13) expects trustees of DC plans to regularly gauge client preferences regarding investment approaches (Pensions Regulator, 2024). In the EU, the draft pension directive Institutions for Occupational Retirement Provision II (IORP II), which recently underwent consultations, suggests that European pension funds should integrate members' and beneficiaries' sustainability preferences into investment decision-making while complying with the prudent person principle and investing in their long-term best interests (EIOPA, 2023). Meanwhile, within the EU, draft amendments of Solvency II and the Insurance Distribution Directive require EU insurance companies to gauge client preferences and sustainability priorities and provide offers which are compatible (PRI, 2021).

DC pension funds may offer beneficiaries a more direct say in asset allocation, but this has often been limited in practice. For example, in Switzerland, most pension funds offer a default fund with differentiated risk profiles. As an example, the public default pension plan in Switzerland offers three risk-adapted default options. The lower range invests 1.0% in emerging market equities while the upper range invests 3.0% (LPP Fondation Institution Suppletive, 2023).

In markets that are undergoing reforms from a DB to a DC system, there is increasing emphasis on the ability of beneficiaries to choose individualised asset allocation options. For example, as part of the ongoing Dutch pension reforms, two new types of pension plans will be launched. The *Nieuwe pensioencontract* plan will offer different risk profiles and a mandatory ‘solidarity’ reserve of up to 15% of the fund’s assets to buffer steep drops in fund asset values. The other
offering, the *Wet verbeterde premieregeling* plan, more closely resembles a standard DC scheme in allowing participants to individually tailor their risk preferences in line with their age and other life-cycle factors. Most pension funds will fall under the former. Even though the reforms are expected to spark outflow from euro zone government bonds in favour of riskier assets, the new portfolio allocation mix will be determined in 2026 when most funds are expected to transition.

There is evidence that pension plan members have an increasing appetite for ESG and socially responsible investment which should be accounted for asset allocation decisions (Briere and Ramelli, 2021; Bauer et al., 2021; Bauer and Smeets, 2023; University of Cambridge Investment Leaders Group, 2019; Wang, 2022). But there is also evidence that beneficiaries are not well equipped to make investment allocation choices themselves – in DC schemes that provide beneficiaries with a choice between different investment strategies, there is little evidence that they use this choice to change allocations in line with sustainability goals. The majority of DC funds are invested in default funds where investment decisions are made by those managing or administering the schemes, rather than the beneficiaries. And in most countries, DC plan participants, especially lower-income members of large public plans, opt for the default contribution rate and the default asset allocation (Briere, 2021; Seelajaroen and Busaratrakul, 2016). For example, in the UK, the Pensions Policy Institute estimates that about 90% of DC members are in default funds, increasing to 99% of beneficiaries for Master trust funds (Pensions Policy Institute, 2016). These default funds tend to have a homogeneous investment allocation, mainly to low-cost passive investment funds that track a market or a specific benchmark index. Investment allocations to EMDE are correspondingly low, reflecting the EMDE share in global market indices. For example, UK master trusts typically allocate about 7% to EMDEs (UK Pension Policy Institute, 2021).

### 3.3 Shareholders

Shareholders have the most direct influence on the behaviour of the managers of insurance companies. Often, this influence is by proxy through the actions of large asset managers (e.g., BlackRock) who manage large pools of investments in these companies. Managers are more sensitive to the views of large shareholders and asset managers that represent large blocks of shares, who may use engagement strategies to influence management. In general, shareholders have become more sensitised to the risks of climate change in recent years and therefore more demanding that insurance companies take these risks into account in investment strategies.

---

15 In the UK, this reflects the need to keep investment costs low due to a 0.75% charge cap (Law Commission, 2017).
3.4 Civil society

External stakeholders such as the Make My Money Matter campaign in the UK have also encouraged members to pay greater attention to the way their pensions are managed. Such awareness-raising campaigns focus on a range of environmental and social concerns (e.g., climate impacts, human rights). There has been less awareness-raising activity aimed at how insurance assets are invested, although the themes would be similar. Civil society organisations (CSOs) also lobby institutional investors to exclude certain types of investments, or to increase their attention to ESG risks. For example, international coalitions of CSOs have pressured institutions to discontinue investments in oil, gas and coal (IISD, 2021). Stakeholder concerns about ICPF investment strategies have been mainly focused on the potential for investments to either contribute to climate change (by financing new investments in oil, gas and mining, or in industries that are heavy emitters of greenhouse gases – GHGs), or to help finance climate mitigation and adaptation (e.g., by investing in clean energy, resilient agriculture, etc.).

Stakeholders have pressed ICPFs to commit to reducing the GHG emissions of their portfolios over time – commitments variously known as Paris alignment (because they are consistent with Paris climate change targets) or net zero (because they will lead to net GHG emissions of zero across the portfolio at some future date – i.e., any positive emissions by one investment must be offset by negative ones from another). In a 2023 survey, 48% of European ICPFs aimed to achieve net zero, and 43% aimed to be Paris aligned (BNP Paribas, 2023). There have also been growing stakeholder concerns about investment impacts on biodiversity, and on human rights abuses (e.g., human trafficking, slave labour).
4 Drivers of ICPF\'s investment behaviour: financial market conditions, cost and performance

**Key takeaways**

- During the period 2008 to 2021, financial market conditions were favourable to EMDE investment. Low interest rates in developed markets encouraged a ‘search for yield’ in EMDEs.

- Since 2022, risk-free interest rates in developed markets have increased significantly, resulting in higher returns on developed market bond assets. At the same time, deteriorating macro fundamentals in EMDEs have resulted in increased EMDE country risk premia, resulting in a reduced EMDE investment appetite. Thus, the ‘search for yield’ in EMDEs is unlikely to return in the near term as interest rates in developed markets are not expected to fall in the near term.

- However, taking a longer view of performance, EMDE investment represents a meaningful opportunity set within global markets. Since 2008, emerging market bonds have outperformed developed market bonds in most years, due to developed market monetary policy depressing interest rates. Over a 20-year period (2002–2021), emerging market equity returns matched those of developed markets.

- ICPF\'s are faced with EMDE investment cost premiums in terms of asset management fees. This is exacerbated by the limited opportunities to invest in public markets in EMDEs.

- Larger pension funds can benefit from economies of scale to help overcome the cost barrier to EMDE investment.
4.1 Recent developments in financial market conditions since 2015

The 2030 Financing for Development agenda was formulated under market conditions very different from today’s. Following the global financial crisis in 2008–2009, risk-free global interest rates remained around 2% for an extended period that only came to an end when the Covid-19 pandemic disrupted the global economy in 2020. Monetary authorities around the world provided ample liquidity in an attempt to restore growth following the financial crisis.

Low interest rates on developed market debt encouraged a ‘search for yield’, including increased appetite for investments in emerging market debt alongside various ‘alternative assets’. Although emerging market assets continued to attract a risk premium over developed market assets, this was compressed by the flow of capital into these assets. The global recovery from the financial crisis also saw a period of rising commodity prices and exports that benefitted a wide range of emerging markets.

The interest in ‘alternative assets’ also extended to infrastructure, including in emerging markets. While greenfield infrastructure is still too risky for most institutional investors, there has been a growing appetite for operating assets in stable economies, which can offer consistent financial returns over a long period (World Bank, 2018).

These benign financial conditions for emerging market investing raised hopes that more institutional investment would flow into these markets. Feedback from institutional investors during this period, such as the 2018 G20 survey, was consistent with this: large investors reported growing appetite for emerging market assets, including sovereign and non-sovereign debt and infrastructure, but reported facing informational and structural barriers to investing. Such barriers may explain why private capital mobilisation by MDBs and DFIs was $71 billion in 2022, unchanged from 2016 (MDB Task Force on Mobilization, 2024; African Development Bank et al., 2017).

Moreover, following the global supply chain disruptions of the pandemic and the extraordinary fiscal and monetary support provided by developed markets to maintain household incomes during the pandemic, global inflation accelerated in 2021 and 2022, leading to a rapid tightening of monetary policy in most developed markets. This caused risk-free interest rates to climb to more than 4%, a huge change from the post-financial crisis period. As a result, institutional investors were better able to meet their financial return targets by investing in developed market assets, so there was a marked reduction in appetite for emerging market assets and other types of alternative assets (Theobold, 2022) (Figure 8).
Furthermore, the lingering impact of the pandemic combined with a second global shock from Russia’s invasion of Ukraine created adverse macroeconomic conditions for most emerging markets (Figure 9), especially those vulnerable to rising energy and food prices (conversely, energy and food exporting countries benefited from the Ukraine shock). Most emerging markets came out of the pandemic with rising levels of external debt; the ensuing price shocks and global inflation reduced export demand for their products, weakening their ability to service external debt. As a result, the country risk premium of investing in many emerging markets has risen at the same time as the return on developed market assets has increased. This has led to a sharp reduction in appetite for emerging market assets, albeit with considerable variability across countries. Figure 9 shows how the rise in US interest rates coincided with a decrease in the performance of the MSCI Emerging Markets Equity Index.

Looking ahead, there is considerable uncertainty about the future path of global interest rates, but few observers expect an imminent return to low interest rates, so the ‘search for yield’ is unlikely to return.
Country risk encompasses risks that investments may be impaired or generate lower returns due to a variety of country-specific risks, including government performance, application of law and regulations, and climate shocks. Evidence shows that country risk has historically been the biggest driver of EMDE returns. Investors have traditionally reduced their exposure to country risk through cross-country diversification and limiting their exposure to EMDEs as a group. However, global shocks increase correlation of country risk across countries, reducing the risk reduction from country diversification. This may lead to reductions in EMDE allocations as a whole, or greater selectivity in which countries to invest in.

4.2 Performance in perspective

Over the past decade, emerging market equity returns have lagged behind those of developed markets, with emerging markets underperforming US equity by more than 10 percentage points on an annualised basis (Figure 10), largely due to lower returns from China. In contrast, during the preceding decade (2002 to 2011), emerging
market equity outperformed US equity by more than 10 percentage points and other developed markets by 8 percentage points on an annualised basis.

**Figure 10 Performance of US market, developed markets excluding US, and emerging markets (2002–2021)**

Since 2008, emerging market bonds have outperformed developed market bonds in most years, due to developed market monetary policy depressing interest rates (Figure 10).
Figure 11 Emerging market versus developed market bond index performance, 2008–2024

Due to the higher volatility of emerging market equity returns, their performance is best assessed over the long run, especially for investors with long investment horizons – like ICPFs. During the 20-year period (2002 to 2021), emerging markets posted an annualised compound return of 9.7%, matching the return of US stocks and outperforming other developed markets. Over the past six decades, the equity portfolio of one of the largest and longest-operating EMDE impact investors, the IFC, outperformed the S&P 500 by 15% (Cole et al., 2020). However, a lack of data on the performance of EMDE assets, which are mainly private assets with less transparency, has led to a risk perception gap, leading to underinvestment in EMDEs relative to what actual risk-return performance would demand.

EMDEs represent a meaningful opportunity set within global markets. Yet, as discussed below, that opportunity comes at a premium cost. EMDEs have provided positive long-term risk-adjusted excess returns relative to developed markets and have played an important role in diversifying portfolios. In fact, ICPFs have the opportunity to secure a well-balanced and well-performing portfolio by leveraging their scale, long-term outlook, as well as the expertise of asset managers and consultants to navigate these rapidly changing heterogeneous markets, which are often expensive to invest in.

4.3 Cost of EMDE investment

As discussed above, there are clear benefits to investing in EMDEs. It enables ICPFs to diversify risk, reduce concentration, return
volatility and downside risk, as well as enable access to new return opportunities in pursuit of growth.

However, there are a number of challenges related to allocating capital to EMDEs, including higher investment costs. Regardless of geography, the charges that ICPFs face when investing into funds are used to cover the direct costs incurred in running the fund (management fees) and the indirect costs resulting from the purchase and sale of securities, such as trading commissions, including all costs associated with executing the investment strategy (operating expenses). ICPFs looking to increase their EMDE allocation are typically faced with a cost premium relating to these fees. This is exacerbated by the limited opportunities to invest in public markets in EMDEs – so assets tend to be more concentrated in private markets within larger EMDEs. Private markets have higher transaction costs than public markets in both developed markets and EMDEs, as well as offering less liquidity.

Management fees, which are often cited as the first fee to review, tend to be one of the largest cost drivers, even for advanced market funds (Garleanu and Pedersen, 2018; Dash, 2021). Stated management fees can vary depending on capitalisation, style, geography, and currency focus. Recent data from Nasdaq eVestment Analytics on active equity strategies confirm that geography is the main cost driver. EMDE active equity strategies charge the highest fees compared to US and Europe, Australasia and the Far East (EAFE) in turn (Figure 12). The EMDE premium is also seen in passive strategies. To give an example, the expense ratio for the iShares MSCI Emerging Markets exchange-traded fund (ETF) – one of the largest passive, hard currency, emerging market ETFs – is 0.69% compared to 0.07% for its MSCI EAFE ETF. There is a smaller expense ratio premium for ESG funds: the iShares ESG emerging market ETF is six basis points above its EAFE counterpart (0.26% versus 0.20%).

---

18 Asset managers have an easier time selecting active strategies which are concentrated in larger and better understood emerging markets as opposed to smaller developing/frontier economies.
Figure 12 Median stated (active) management fees, by region, allocation size, and capitalisation (cap)

Source: Nasdaq eVestment Analytics (2023). Note: data from stated management fees of 3,864 separate account structures of equity strategies from Nasdaq eVestment Analytics; median manager-reported management fees from Nasdaq eVestment Analytics at various calculated investment amounts (in US dollars).

For active strategies, the EMDE management fee cost premium is attributed to a generally more resource intensive selection process in less developed markets. For asset managers, the process of selecting investable companies in EMDEs is expensive due to poor corporate transparency, weaker corporate governance, and lower data quality. This cost is then translated into the management fees charged to ICPFs, especially for small cap equity strategies whose cost largely does not largely decrease even as allocation size increases.

However, large and sophisticated institutional investors are more likely to find informed asset managers to offset EMDE cost premiums. In theory, ICPFs can circumvent costly selection processes by choosing skilled managers with market-specific
knowledge or by finding locally based managers (Bauer et al., 2022; Dyck et al., 2011). In practice, these benefits tend to be outweighed by the search costs involved in finding skilled active managers (McLaren, 2020). Yet, large and sophisticated institutional investors, who can choose from a global set of managers, are more willing to seek out skilled ones since search costs are low relative to their portfolio size. Large ICPFs benefit from economies of scale and often have built expertise in selecting external managers who specialise in assessing the return potential of individual companies within specified geographies. In turn, ICPFs with low search costs can capture economic rents by identifying informed delegated asset managers to oversee their EMDE allocation.

Size also matters, since the bigger you are, the larger allocations you can make, and the larger your allocations, the lower your management fees. Nasdaq data on management fees for emerging markets allcap, large, and small cap shows that the largest discounts happen only once allocations are above the $100 million mark.

In addition, pursuing an active strategy in EMDEs also comes with high start-up costs for ICPFs. Once an asset manager is selected to delegate a strategy-level allocation, ICPFs must set up an investment vehicle as a segregated account for each fund manager, the cost of which amounts to up to 5% of an investment's value in EMDEs (Theobald, 2023; Gerakos et al., 2019). Thus, asset consultants may struggle to advocate for an EMDE allocation unless it is ‘going to move the needle at the total fund level’ (Theobald, 2023: 18).

For passive strategies, on the other hand, the emerging market cost premium is often attributed to higher trading costs. Passive investors need to trade to track the market, yet the amount of change and volatility in the structure of EMDE indices means that the trading, and hence the charge of a passive indexed approach, is much higher than it is for developed markets. Passive investors operating in EMDEs, especially frontier markets, often have to increase trade volume both to add or delete certain markets (e.g., due to geopolitical risk or tightening capital controls) and to hedge forex exposures by trading futures contracts and other derivatives (Pedersen, 2018: 12). Moreover, in developed markets, the pool of potential investors is much larger than for EMDEs with low liquidity and underdeveloped repo and money markets. In turn, dealers have fewer places to go to manage risk, and as a result, bid offer spreads and asset owner fees increase. However, larger EMDE ETFs, with high average daily volumes, can leverage secondary market transactions to squeeze bid spreads and thus lower operating fees for asset owners looking to extend their geographic horizon.
Box 6  Active versus passive strategies in EMDEs

Investors, asset managers and the accompanying academic literature have long debated the benefits of active versus passive management. In large cap US equities, passive strategies account for over 55% of fund assets under management. In EMDEs, however, the debate continues.

Although, as elaborated above, investing passively in emerging markets is more expensive than doing so in developed markets, the all-in cost of emerging market index tracking, which can be as low as 20 basis points (McLaren, 2020) – is cheaper compared to the costs of active management. Fees have also significantly decreased since the launch of these strategies in the 1980s: emerging market equities ETF have been able to reduce expense ratios through securities lending programmes, the proceeds of which have been able to significantly lower management fees over time. Despite these cost reductions, simple, passive approaches have proven difficult to implement in dynamic and highly volatile markets, and have thus offered underwhelming returns.

However, net of institutional fees, active management outperformed passive products in EMDE between 2014 and 2019 (see Figure 13). This has been attributed to poor coverage. The three largest passive EMDE strategies are benchmarked against dollar-denominated sovereign bond indices. This automatically forgoes two-thirds of the asset class, corporates, and local currencies. Active managers who have a much broader investable universe are highly diversified and can thus better exploit market inefficiencies and ‘mispriced assets’ – which are common in EMDE and rarer in developed markets with deeper and more efficient capital markets, where there are fewer price anomalies to exploit (Bonanni and Mensach, 2023). Active managers are also able to adopt a proactive ESG approach as part of their investment process, which is particularly important for asset owners worried about low governance standards, corporate ownership structures, and high proportions of state-owned enterprises in EMDEs. Although there is mixed evidence on the results of institutional investors’ active management, long-run return expectations and heightened control of strategic direction led institutional investors to increasingly opt for active strategies as they move to EMDEs.

Figure 13  Active versus passive management returns net of fees, 2014–2019
Source: Schroders (2020)
5 Drivers of ICPFs’ investment behaviour: legal and regulatory frameworks

Key takeaways

- The prudent person principle limits investment in assets not traded on regulated financial markets. This means that there is a natural limit to investing in EMDEs due to their underdeveloped capital markets, resulting in a limited supply of investable opportunities.

- In general, pension fund EMDE investment is not constrained by regulation. The barrier to increasing EMDE investment is more behavioural in nature, based on conservative interpretation of legal and regulatory frameworks or market conventions.

- Regulation limits insurance company EMDE investment. In particular, Solvency II or equivalent capital and solvency requirements such as the ‘matching adjustment’ disincentivise investment in sub-investment grade assets. Furthermore, Solvency II capital charges are not always commensurate with the risks of EMDE investing, resulting in a disproportionate treatment of non-OECD infrastructure investment.

- ICPFs are now expected to manage their investments with respect to the risks and impacts of ESG. Legal and regulatory frameworks are evolving to include the integration of ESG risks into fiduciary duties. However, the interpretation and guidance on this matter varies across countries, as does the extent to which it is formalised in legal and regulatory frameworks for ICPFs.

- The financial risks of climate change have led to changes in the laws and regulations of capital markets. These changes affect
ICPFs and require them to address their exposure to climate risks and work toward Paris alignment and net zero objectives. Regulatory requirements vary by country.

- The impact of these legal and regulatory changes on EMDE investment is uncertain, with both positive and negative effects.

This section reviews the legal and regulatory frameworks that govern ICPFs in our studied countries to understand the ‘hard’ and ‘soft’ factors that can influence the allocation of investments to EMDEs. Hard factors are considered as legal or regulatory in nature, while soft factors may stem from self-regulation and/or be more behavioural in nature, often associated with conservative interpretations of legislation and/or regulation or based on market convention.

5.1 Overview of legal and regulatory frameworks

5.1.1 European Union

Three of our studied countries (France, Germany and the Netherlands) are in the EU and are subject to EU-wide regulation. EU pension funds are subject to the EU Institutions for Occupational Retirement Provision Directive II (IORP II)19 that has been transposed into national laws. EU insurance companies are subject to Solvency II – the EU market valuation and risk-based prudential regime for insurers – a review of which has been underway in the EU since 2020, in part to support the greening of the European economy.

5.1.2 Non-European Union

In the UK, following Brexit a new Financial Services and Markets Act in 2023 has paved the way for reform of Solvency II for UK insurance companies, in part also to help boost insurance company investment in infrastructure and green energy in the UK.20 The UK pension market has also seen a major green shake-up with the 2021 UK Pensions Act introducing significant measures to align UK pension fund investment with the government’s green agenda (Section 5.6). Switzerland also has its own standalone regulatory frameworks for its pension funds and insurance companies.

5.1.3 Types of regulatory approaches

Investment by ICPF is regulated by behavioural norms established in principles-based approaches such as the prudent person principle (PPP) or rules-based approaches, or a combination of both (Table 1 Types of regulatory ). The PPP and/or quantitative restrictions impact

19 IORPII is the EU directive which sets out the regulatory framework of EU pension funds. EU countries were required to transpose into national law by January 2019.

20 The new regime will be known as Solvency UK and the Act revokes most EU-derived financial services statute law as it applied to the UK. This will now be covered by Prudential Regulation Authority (PRA) and Financial Conduct Authority rules.
asset allocation to EMDEs and potentially can act as ceilings to allocation.

### Table 1 Types of regulatory approach

<table>
<thead>
<tr>
<th></th>
<th>Pension funds</th>
<th>Insurance companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Behavioural, most notably the PPP</td>
<td>Rules based</td>
</tr>
<tr>
<td>France</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Germany</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Switzerland</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>UK</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

Note: *The two most prominent Solvency II rules that affect EMDE allocation, which this paper focuses on, are the matching adjustment and the risk margin requirement. These rules are discussed in Section 0.

#### 5.2 Behavioural approaches: prudent person principle

At the EU level, the PPP is incorporated in the EU regulatory framework through IORP II for pension funds and Solvency II for EU insurance companies. This is a behavioural principle which refers to the standard of care and diligence that pension funds and insurance companies must apply when managing investments and concerns issues such as diversified portfolios, prudent risk management, proper due diligence, regulatory compliance, and fiduciary duty. Essentially, it means that investments are to be made in a way that ensures the security, quality, liquidity and profitability of the portfolio as a whole. On paper, this approach allows for a greater degree of flexibility in determining asset allocation (where there are no additional specific quantitative restrictions – see Section 5.2). However, in practice, it can constrain EMDE appetite and allocation as it generally means that investments in securities not traded on a regulated financial market are limited to a prudent limit. Given the low level of development of many capital markets in EMDEs, especially in developing economies, this will constrain EMDE appetite and allocation.

Although the PPP is not explicitly mentioned in UK pension legislation, it requires UK pension fund investment to be ‘appropriately diversified’ and be mainly invested in ‘regulated markets’. In contrast to EU and UK pension fund markets, Swiss

---

21 Solvency II Framework Directive, paragraphs 2,3, and 4 of Article 132.
pension funds are regulated using a rules-based approach to allocation rather than a behavioural approach, and specific caps will affect overseas asset allocation including EMDEs (Section 0). The PPP is also applied to UK and Swiss insurance companies, with some additional caps for Swiss insurance companies including a 20% limit on unhedged foreign currency exposure.

5.3 Rules-based approaches: quantitative limits on asset allocation

5.3.1 Overseas allocation restrictions

Except for Switzerland, all studied countries do not have explicit hard caps on overseas asset allocation, and ICPFs are able to independently determine their EMDE allocation. However, there are several other quantitative caps that will influence EMDE allocation and potentially limit it.

5.3.2 Other quantitative restrictions

These place caps on investment in certain asset classes (e.g., real estate equity) and/or on types of investment (e.g., unlisted assets and foreign currency investment). These kinds of regulatory caps will disincentivise EMDE allocation, especially if the country pension and insurance markets are already investing widely in other European or OECD markets abroad. Additional quantitative regulatory restrictions on asset allocation are imposed on pension funds in France, Germany, Switzerland, which will disincentivise EMDE investment (Table 2). In general, Swiss pension funds are very conservative and have very little exposure to emerging markets. An exception to this is Gastrosocial. Some interviewees also suggested that these caps do not constrain EMDE investment in practice and that the issue is more behavioural.

---

22 In Switzerland insurance company investment is subject to the prudent investor test, which has proven to be equivalent to the PPP.
Table 2 Additional quantitative restrictions on pension fund investment

<table>
<thead>
<tr>
<th>Country</th>
<th>Restriction</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>10% and 30% cap on investment in unregulated markets (e.g., unlisted) for French pension funds and <em>Fonds de retraite professionnelle supplémentaire</em>, respectively. The latter are generally subject to more restrictions than pension funds, including a 5% cap on bonds issued by special purpose vehicles. Shares in investment companies or mutual funds not listed in the OECD are also penalised in the valuation system.</td>
</tr>
<tr>
<td>Germany</td>
<td>30% limit on foreign currency exposure(^23) for both <em>pensionfonds</em> and <em>pensionkassen</em> and a 15% cap on unlisted equity, a 15% cap on equity funds and 7.5% on securitisations for <em>pensionkassen</em>.(^24) For <em>Pensionkassen</em> guarantee assets (<em>sicherungsvermögen</em>), additional provisions apply.(^25)</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Four regulatory caps affect overseas allocation including EMDE by Swiss pension funds: (1) a 30% limit on unhedged foreign currency exposure, (2) a maximum cap of 10% allocation to international real estate, (3) a 5% cap on unlisted assets, and (4) a 15% cap on alternative investments (which require the use of collective investment vehicles). Swiss pension funds can request supervisory permission to exceed these caps if the PPP is satisfied and the pension fund can justify the deviation.(^26)</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>No additional quantitative restrictions</td>
</tr>
<tr>
<td>UK</td>
<td>No additional quantitative restrictions</td>
</tr>
</tbody>
</table>

5.4 Capital and solvency requirements for pension funds

While European insurance companies are regulated by Solvency II (section 5.5), European pension funds are subject to IORP II. Both provide guidelines on capital requirements. Solvency II is a fully harmonised directive whereby regulation is set entirely at the EU level. Meanwhile, IORP is a loosely harmonised directive, meaning EIOPA has a smaller scope, and the national regulator, usually the ministry of finance, is primarily responsible for outlining the way IORP capital and solvency requirements are to be interpreted at the national level. Most European pension funds are subject to Article 17

\(^{23}\) In Germany there are two types of pension funds: *pensionfonds* and *pensionkassen*. This limit is applicable to both types of pension funds.  
\(^{24}\) In Germany, *pensionkassen* are more tightly regulated with detailed quantitative rules. See BaFin - Circulars - Circular 11/2017 (VA)\(^{26}\) See BaFin (2017). *Pensionfonds* can invest their assets in a riskier way (BaFin, 2018).  
\(^{25}\) German Investment Regulation (Anlageverordnung – AnlV)  
\(^{26}\) Even though this option was initially used mostly by the largest funds, smaller and medium-sized funds are also taking advantage of this exemption. In its 2023 pension fund study, Swisscanto reports that a full 57% of all pension funds participating in the survey – and 62% of funds with assets under management above 500 million Swiss francs – use the exception (Swisscanto, 2023).
(1) 13 of the IORP Directive, which requires funds to hold a minimum surplus of assets over the technical provisions to serve as a buffer on a permanent basis. Member states often impose additional capital requirements at national level in accordance with Article 17 (3) of the IORP Directive.

Of the studied countries, the Netherlands is the only country to apply additional requirements and a pension fund solvency test. In fact, the Dutch minimum capital requirement, the *Vereist eigen vermogen*, has long been criticised as being overly conservative. According to practitioners interviewed for a study by the Dutch National Advisory Board, it is progressively being replaced by the new national pension agreement, which is expected to grant more flexibility compared to the previous regulation. This update to Dutch legislation is expected to reduce regulatory hurdles for investing in EMDEs, especially in private debt (NAB, 2023).

Aside from the Netherlands, all other studied European countries do not impose additional capital requirements. In these jurisdictions, the capital requirements on pension funds are more flexible than those for insurance companies established under Solvency II. This was clearly illustrated when France introduced the IOPR directive in 2018. Immediately after France adopted IORP and new legislation allowing insurance companies to transfer parts of their entire occupational pension plans into newly established IORP entities, Aviva France transferred €4 billion of its pension fund assets to an IORP to circumvent stringent charges under Solvency II. Insurance group Sacra and several others followed with a similar move soon after.

Similarly, British and Swiss pension funds are subject to more flexible requirements compared to their insurance company counterparts. Swiss and British pension funds are expected to meet a requirement comparable to Article 17(1)13 in IORP II, but there is currently no pension fund solvency test in place in either country.

Overall, the capital and solvency requirements for pension funds within the studied jurisdictions are not a binding constraint limiting the capital European funds can allocate to EMDEs, especially when compared to legislation on European insurance companies, whereby capital charges are not always commensurate with the risks of EMDE investing.

### 5.5 Capital and solvency requirements for insurance companies

In certain jurisdictions, capital and solvency requirements may not be commensurate with actual risk and place burdensome capital charges on non-OECD investments and specific asset classes (e.g., infrastructure, real estate) – see Box 7. In other words, if regulatory

---

27 The minimum amount of those assets is laid down in Article 17 (2) of the IORP Directive.
capital charges are not aligned with actual credit performance, for instance, due to data constraints, they can reduce the internal rate of return and profitability of holding investments. This may restrict capital-efficient investment to certain asset classes for risk categories with imperfectly calibrated capital requirements. In turn, these additional burdens can limit investors from investing in EMDEs.\(^{28}\)

Practically assessing whether capital requirements\(^ {29}\) are, in fact, commensurate with risk, is a complex exercise which involves analysing whether charges reflect the actual credit risk profile/historical credit performance in a way that is balanced across asset classes, while also recognising diversification benefits. Box 7 summarises some of the most prominent studies suggesting that financial regulations on ICPFs should be revised in light of the disproportionate treatment on EMDE infrastructure assets.

As these studies suggest, revising capital requirements in light of actual credit performance could be a key step in orienting capital toward sustainable infrastructure investments in EMDEs.

However, capital charges are not excessively high across all EMDE asset classes. A recent study by the Dutch National Advisory Board found that Solvency II capital requirements for private debt\(^ {30}\) in EMDEs are not excessively high (NAB, 2023). This conclusion implies that when it comes to EMDE private debt regulatory requirements are not the main barrier to investment. In fact, country ratings and the tendency to group the asset class with private equity (which is considered much riskier under Solvency II) may negatively affect how investors perceive private debt in EMDEs. Furthermore, the report concludes that the main barrier limiting ICPF allocation to this asset class is the lack of data, which leads to a lack of understanding within risk management teams and amounts to a negative perception of EMDE private debt. In the Netherlands, making data available that shows the actual risk of this asset class could result in up to €50 billion of additional impact investments in EMDEs (ibid.).

---

28 For most insurance companies, the solvency capital requirement under Solvency II is calculated via a standard formula. Even though Solvency II does allow insurance companies to develop internal models to account for the effect of risk mitigation techniques, internal models are subject to the same requirements under the solvency capital requirement. In turn, an internal model does not change the nature of the capital charges but rather offers greater flexibility in applying capital charges associated with risk mitigation techniques.

29 Under Solvency II, capital requirements are determined on the basis of a 99.5% value-at-risk measure over one year, meaning that enough capital must be held to cover the market-consistent losses that may occur over the next year with a confidence level of 99.5%. Capital charges also depend on the liability of each undertaking, in other words the better the assets proceeds match the liabilities the lower the final capital charge, for example a corporate bond will be subject to lower charges than infrastructure loans of the same credit rating.

30 Private debt is broader than infrastructure investments as an asset class and typically refers to ‘debt investments which are not financed by banks and are not issued or traded in an open market’ (PRI, 2019)
Box 7  Studies on Solvency II capital charges for non-OECD infrastructure

Solvency II charges should ideally be calibrated using data relevant to the likely true performance of EMDE investments. Yet, in the run-up to 2016 when European authorities conducted internal calibration exercises to inform the design of Solvency II, data for several asset classes – especially EMDEs and infrastructure – was very limited. In light of these data constraints, infrastructure debt, in Solvency II, is treated like any other type of long-term exposure, resulting in a relatively high capital charge (IMF, 2016). Unfortunately, the high-quality data ideally needed to conduct adequate assessment of EMDE risk remains difficult to obtain.

However, since 2016, new (imperfect) data on the historical default experience of infrastructure debt securities and project loans that are generally unrated in EMDEs was published by Moody’s. Several studies have now analysed this data (spanning from 1983 to 2018) to perform calibration exercises that preserve the integrity of existing prudential methodologies (see (Jobst 2018; Levy 2017)).

A striking aspect of this data is that infrastructure loan losses from loan defaults (Loss Given Defaults) are relatively low and even lower for low- and middle-income countries than for high-income countries. At 15.80%, the historical Loss Given Default for low- and middle-income countries is a quarter of that observed for corporate bonds more generally. This suggests that the treatment of low- and middle-income country infrastructure exposures within the Solvency II rules is disproportionate to their true risk, especially considering that within the Solvency II framework, EIOPA has introduced lower capital charges for higher rated OECD or European Economic Area (EEA) infrastructure debt. However, this favourable treatment is not extended to infrastructure debt related to projects in less developed non-EEA or non-OECD countries, even though these exhibit superior credit performance in the Moody’s data.

Based on Moody’s data, Figure 14 presents recalibrated capital charges for unrated, 10-year infrastructure loans according to the most recent analysis by Risk Control. As per the Solvency II standard formula, 13.0% is the capital charge applied to 10-year unrated non-OECD project loans.

Figure 14 Estimated capital charge (EIOPA, Solvency II) for 10-year unrated project loans with diversification

---

31 Kutas et al. (2016) conduct Solvency II capital calibration for securitisations and find that that Solvency II capital charges for AAA-rated Type 1 tranches are double what the evidence suggests is appropriate.
5.5.1 EU insurance companies and Solvency II

Under Solvency II, EU insurance companies must meet risk-based capital requirements, which incur a higher charge for riskier investments, disincentivising EMDE allocation. Two issues are particularly important when considering the capital requirements that EU insurance companies face, which impact EMDE appetite and allocation.

Matching adjustment

The matching adjustment (MA) is a countercyclical adjustment mechanism of Solvency II. Currently, to be eligible for the MA, assets must have fixed cashflows. In practice, this eligibility criterion is met primarily by bonds or assets with bond-like cashflow (Article 77b of Directive 2009/138/EC). Typically, as credit spreads widen, these assets decrease in valuation at the risk-free rate. The MA allows insurers to discount the valuation of their long-term liabilities at a more favourable (higher) discount rate than the usual risk-free rate, in the event that the asset’s credit rating does not change. This upward adjustment to the risk-free rate reduces the assets required to be held against these liabilities and protects insurers from the ‘liquidity risk’ of having to sell assets before maturity at an undervaluation.

---

32 Currently, to be eligible for the MA, assets must have cashflows that are fixed and cannot be changed by the issuer or any third party. As part of the UK’s Solvency II reforms, the PRA proposes to expand this to also include assets with ‘highly predictable’ (HP) cashflows, subject to various safeguards including a 10% cap of total MA benefit. To be eligible, assets with HP cashflows would need to be: (1) contractually bound in timing and amount; (2) bonds or have bond-like cashflow characteristics; (3) capable of receiving either an external or internal credit rating.
At first glance, the MA carries many benefits. However, the MA can only be applied to investment grade assets. This creates a BBB cliff edge. Simply put, the MA and its corresponding BBB cliff largely limit an insurer’s allocation to sub-investment-grade assets that do not benefit from the beneficial mechanisms of the MA and thus require significantly higher capital requirements.

In summary, the MA, which alleviates insurers from liquidity risk, is only applicable to investment grade assets, creating a large disincentive to allocate in anything below BBB. Moreover, this BBB cliff is coupled with the ‘country ceiling’ of rating agencies (which largely caps ratings of private assets to their corresponding sovereign rating), creating an even more explicit barrier to EMDEs, which as of December 2023 had an average sovereign rating of around BB- (see Figure 15). Reliance on external credit ratings to calculate risk weights may also affect investments in EMDEs, which are less likely to be rated or have insufficient history to calculate reliable default probabilities.

**Figure 15 Emerging market credit rating distribution, December 2023**

Source: Authors’ calculations based on S&P Global Ratings ([https://disclosure.spglobal.com/sri](https://disclosure.spglobal.com/sri)) as of 11 December 2023. Note: 19 emerging markets were not rated by S&P during this period.
Risk margin

The risk margin is an additional reserve required to be held by insurers on top of their Best Estimates Liabilities.\textsuperscript{33} This determines how much life insurance companies have to hold in technical provisions (reserves) to ensure they have sufficient funds available to pay their technical liabilities when they fall due. Recent debates have concluded that the risk margin leads to two main problems:

- It creates volatility. A small change in interest rates has a huge impact on the capital needed to be held on the balance sheets of insurers. This means short-term balance sheet management is required, increasing costs and management time.
- Various independent calibration exercises, including studies commissioned by the Prudential Regulation Authority (PRA) during the Solvency II consultation process, have evidenced the fact that the risk margin is too high and not commensurate with actual risk (HM Treasury, 2022; Prudential Regulation Authority, 2023a).\textsuperscript{34} This means that insurers underwrite less risk.

With a risk margin that is volatile and excessively high, insurers in the EU can release less capital to EMDEs and the real economy since a large amount is tied up in the name of protecting their balance sheet from risks that are mostly artificial.

5.5.2 Non-EU insurance companies: Switzerland and the UK solvency regimes

Switzerland

Although Swiss insurance companies are not regulated by Solvency II, they are governed by the Swiss Solvency Test (SST), which was the first non-EU regime to gain full equivalence to Solvency II in 2015. Equivalent does not mean equal, yet the SST and Solvency II are conceptually very similar. Both frameworks are risk-based and apply an economic balance sheet approach. Like Solvency II, the SST adds additional capital requirements for fixed income and equity investments based on credit rating and duration, which disincentivises EMDE allocations.

Solvency II, via its MA and the BBB cliff, penalises EMDE assets more explicitly than its Swiss counterpart, yet, in sum, capital charges across the investment portfolio are higher under SST. These increased charges can lead to a significant divergence in solvency ratios, i.e., what is considered an ‘adequate’ amount of solvency

\textsuperscript{33} This is the present value of expected future cashflows, discounted using a ‘risk-free’ yield curve. In other words, it serves as cashflow projection of the firm’s commitments to policyholders based on up-to-date data and discounted at current risk-free interest rates.
\textsuperscript{34} The 2020 review of Solvency II, which started in February 2019 and will be adopted in 2025, also determined in the European Commission’s 2021 Impact Assessment report that the risk margin should be reduced; in 2023 the European Parliament proposed amendments to cement this change by 2025.
capital for the assumed investment risk. Solvency regulations create a natural incentive for insurers to assume fewer risks if the conditions for reporting a high solvency ratio are more stringent. For most insurers, obtaining a high ratio under SST is more difficult than under Solvency II, meaning more capital has to be ring-fenced.

The main difference between SST and Solvency II in terms of materially impacting solvency ratios is the risk measure. Solvency II uses the 99.5% Value at Risk (VaR) measure, which represents the loss that will likely be exceeded only once in 200 years. SST applies the 99% shortfall measure, also called tail VaR, which represents the average of all annual losses that occur less than once in 100 years. For insurance companies, using tail VaR instead of VaR increases the required capital and decreases the solvency ratio. For example, accounting for tail VaR required Swiss Re to set aside an additional $2.4 billion that could otherwise be released into investments.

In addition, to robust solvency requirements Swiss supervision focuses on ensuring sufficiency of liquid assets to meet policy liabilities. Thus, there are statutory accounting methods to determine the technical provisions and value of the assets on a prudent basis for ‘tied asset’ purposes (see Box 8). Policyholders have priority claims over these tied assets. The triple focus on the adequacy of technical provisions, liquidity/safety of tied assets, and the adequacy of capital all compound to require additional capital charges. In fact, insurance companies are required to earmark and ringfence assets designated as tied assets subject to a liquidity test to back the technical provisions plus a risk margin (determined by the Swiss Financial Market Supervisory Authority – FINMA).

**Box 8 Tied assets**

In the absence of a general policyholder protection fund, tied assets back all claims liabilities for all direct insurers. These tied assets are subject to limits and rules to provide security, liquidity, diversification, and legal access to make sure that they can be liquidated under Swiss law. In case of insolvency or liquidation, policyholders and insured persons have a priority claim against these restricted assets. For investments to qualify as tied assets, they have to comply with requirements (as per ISA, ISO and Circular 08/18). Sub-investment-grade investments are not eligible for recognition as tied assets.

---

35 If the available capital is greater than the required capital, the company holds regulatory excess capital and has a solvency ratio above 100%.

36 Other than the National Guarantee Fund for motor insurance.
UK

Following the UK’s exit from the European Union (Brexit), the UK is in the process of reforming Solvency II with the objective of increasing innovation in the insurance market and unlocking capital to support UK growth and the government’s drive to increase investment in infrastructure and clean energy and ‘levelling up’ between regions in the UK. Although the focus has been to support increased long-term productive investment in the UK economy by insurers, there are two important potential reforms to Solvency II which may positively impact the appetite of UK insurance companies to invest in EMDEs. The new regime will be known as Solvency UK and is currently being consulted on by the PRA.

The first reform concerns a change in the methodology to calculate the risk margin, which will result in a sizeable reduction in the risk margin, allowing release of capital from reserves. The reform will reduce the risk margin for the long-term life insurance business by 65% and for general insurance by 30% (Chaplin and Belcher, 2022). The reform will also change the cost of capital calculation and use a modified cost of capital method to calculate the risk margin.

The second proposed reform concerns the MA (Prudential Regulation Authority, 2023b). The proposed changes would expand the range of eligible assets, allowing assets with highly predictable cash flows (rather than fixed cash flows) and those with prepayment risk, such as construction assets. This adjustment aims to encourage investments in infrastructure. Additionally, the PRA is also proposing to remove the limit on the amount of MA that may be claimed from sub-investment grade assets (i.e., the BBB cliff). This alteration would facilitate investments near or below the line between investment and sub-investment grade. In theory, these adjustments could have a favourable impact on EMDE investment. It is expected that this reform will take effect from 31 December 2024.

5.6 ESG risks and impacts

The greatest change in how ICPFIs are expected to manage their investments has come from increased attention to the relationship between investments and ESG risks and impacts. ESG factors are material for investments in two ways:

1. The first materiality concerns the financial risks that ESG factors can pose to investment returns. Awareness of such risks has grown with the scale of environmental disasters, such as large oil spills and social concerns that affect corporate profits (e.g., consumer boycotts). Awareness of governance risks has grown with high-profile failures of previously highly performing companies and banks – from Enron to FTX – that went bankrupt due to malfeasance or mismanagement not controlled by corporate governance structures.
2 The second materiality concerns the positive and negative environmental and social impacts that investments can create. Awareness of these impacts has been driven mainly by the acceleration of climate change, which has become a priority issue for a wide range of stakeholders, and to a lesser extent by the adoption of the SDGs as a set of collective environmental and social impact goals.

Many institutional investors have put in place responsible or sustainable investment policies that aim to avoid creating negative environmental and social impacts (first materiality). According to a recent survey, 43% of European institutional investors integrate ESG risks into their risk management process (BNP Paribas, 2023). Most ICPF s have signalled their commitment to responsible investment practices by adopting the UN Principles of Responsible Investment. The number of signatories and assets under management (which include both asset owners and asset managers) has more than doubled since 2015 and represents more than half of global assets under management. There are 2,123 PRI signatories in the five European countries covered by this study (plus Ireland, Belgium, Luxembourg, Austria). However, adoption of these broad principles leaves a lot of room for variation in actual investment practices.

Some investors go further and seek to achieve positive environmental and social impacts through their investments (second materiality): in 2023, 44% of European ICPF s surveyed by BNP indicated intent to make an allocation to impact (BNP Paribas, 2023). Unlike sustainable investment policies, which typically apply to the entire portfolio, impact investing strategies are often applied to a part of the portfolio. Indeed, this is typically the approach taken by institutional investors, where increasing numbers have dipped their ‘toe in the water’ of impact investing and made a small initial allocation – typically less than 5% of the portfolio. Some have increased their allocation over time as they have become more comfortable with their ability to find impact investments which meet their financial risk-return requirements. A 2023 survey by Vontobel found that 70% of European institutional investors plan to increase their allocation to impact assets in 2024 (Vontobel, 2023).

However, pension fund managers and managers of mutual insurance funds are bound by fiduciary duties to their beneficiaries and policyholders (see Appendix 3 for a description of the interpretation of fiduciary duty in our studied countries). This limits their ability to take non-financial factors into account unless their relevance to financial performance is clear. The potential of ESG risks to affect long-run financial returns is increasingly recognised by the investment community. As such, it is now widely recognised that ESG risk assessment is consistent with a modern interpretation of fiduciary duties (PRI and UNEP FI, 2019). However, investing for positive impact is generally seen as consistent with fiduciary duty only if either
it does not diminish expected financial returns or beneficiaries (or their representatives on boards of trustees) have given their consent.

Legal and regulatory frameworks are changing to require the integration of ESG risks in the fulfilment of fiduciary duties (PRI and UNEP FI, 2019). But the interpretation and advice to pension fund trustees on how to do so varies across countries, as does the extent to which this is explicit and formalised in legal and/or regulatory pension fund frameworks (Table 3).

Table 3 Spectrum of ESG integration in legal and regulatory rules for ICPF

<table>
<thead>
<tr>
<th>ESG: the legal and regulatory requirement</th>
<th>Current requirement status by country ICPF</th>
</tr>
</thead>
<tbody>
<tr>
<td>No legal requirement (section 5.6.3)</td>
<td>✓UK ICs</td>
</tr>
<tr>
<td></td>
<td>✓Swiss PFs and ICs (federal level)</td>
</tr>
<tr>
<td>Increasing legal requirements to explain extent to which ESG is incorporated into investment policy and disclosure (section 5.6.4)</td>
<td>✓EU PFs (France, Germany and the Netherlands). Requirement of EU IORPII</td>
</tr>
<tr>
<td></td>
<td>✓EU ICPF (France, Germany and the Netherlands). Requirement of EU SFDR</td>
</tr>
<tr>
<td></td>
<td>✓UK PFs (mainly a first materiality approach)</td>
</tr>
<tr>
<td>Permitted to take environmental and social outcomes of investment into account (section 5.6.5)</td>
<td>✓UK trust-based PFs allow a second materiality approach.</td>
</tr>
</tbody>
</table>

5.6.1 No legal and/or regulatory ESG integration requirement

At one end of the spectrum, current Swiss legal and/or regulatory frameworks do not make any connection between fiduciary duties and ESG risks, and there is no legal obligation for pension funds to take ESG into account in the investment process. Switzerland adopts a self-regulatory and voluntary approach to this issue. Legal opinions do, however, state an implicit obligation to take climate-related risks into account under the requirement to follow a risk-based approach. This is also the view of the Federal Social Insurance Office and the Association of Swiss Pension Funds (ASIP). In line with this self-regulatory approach, ASIP published in December 2022 a recommended ESG reporting standard for Swiss pension funds. The recommended reporting guidelines include disclosure on ESG policy,
as well as quantitative information. ASIP recommends that the reporting standards be applied to 2023 financial statements. Uncertainty persists among Swiss pension funds about their responsibilities in ESG risk management and the necessary steps to be taken (PwC, 2022). However, it is important to note that the absence of hard legal or regulatory requirements does not mean that Swiss pension funds have not integrated ESG issues into their investment practice. For example, a recent study of 160 Swiss pension funds by ASIP found that ‘60% to 80% of studied pension funds take ESG risks into account in equities and fixed-income investments and 39% have embedded sustainability in their investment regulations’ (ibid.). While most Swiss pension funds have acknowledged the necessity for action, there exists significant variation in the extent of comprehension and execution of sustainability criteria in asset management.

Similarly, for UK insurance companies, there is no explicit regulation or guidance on ESG integration in investment processes in place by UK regulators. Although the Financial Conduct Authority has an ESG strategy and has consulted on ESG integration, its focus is mainly on building trust in sustainable finance markets and integrity in ESG-labelled instruments, products and the supporting ecosystem, rather than regulating integration of ESG in the investment process. For pension funds, trustees of trust-based schemes must state in the statement of investment principles the extent to which social, environmental or ethical considerations are taken into account in investment decision-making processes. UK regulations also require pension funds to take into account ESG risks when they have a material financial impact on the financial performance of the portfolio (i.e., ‘first materiality’).

5.6.2 Legal and/or regulatory ESG integration requirement

In the middle of the spectrum and in line with a growing and broader trend of incorporating ESG risks in the financial sector, most countries have expanded their legal and/or regulatory frameworks to include explicit requirements on ESG risk assessment and clarify that consideration of ESG risk is consistent with fiduciary duties. These requirements usually require an explanation of the extent to which ESG is incorporated in and guides ICPF investment policy, for example, in a Statement of Investment Principles set by pension fund trustees. However, this is mainly considered and applied through a ‘first materiality’ lens where ESG factors are considered to the extent that they present a material financial risk to investment performance.

At the EU level (relevant to Germany, France and the Netherlands), there are several important directives/regulations which touch on these issues, namely IORP II for EU pension funds and the SFDR applicable to both pension funds and insurance companies. In France, Germany and the Netherlands, these new
regulations supersede the previous national regulations that were already progressive in mandating the integration of ESG factors in investment policies. The IORP II directive serves as a blueprint for incorporating ESG factors, although the manner in which member states transpose these requirements into national law may vary. It promotes the integration of ESG factors into the risk management and investment procedures of pension funds. Trustees of pension funds are expected to take into account long-term sustainability risks, such as environmental and social risks, that may affect the fund's ability to fulfil its obligations. The directive also highlights the importance of transparency and disclosure regarding ESG issues. Pension funds must disclose how they incorporate ESG into their investment decision-making processes, providing clear and comprehensive information to members and beneficiaries about their approach to sustainable finance. Pension funds are encouraged to create and document an investment beliefs statement that can encompass their stance on ESG considerations, sustainability and responsible investment.

The EU SFDR, which took effect in 2021, has a phased implementation approach. Its purpose is to encourage sustainable finance and incorporate sustainability considerations into financial decision-making and the assessment of ESG risks within the financial sector. An important requirement is to improve transparency and consistency in the disclosure of ESG factors. European pension funds and insurance companies are obliged to disclose how sustainability factors are incorporated into investment processes, how sustainability risks are integrated into investment processes, the potential financial impact of sustainability risks on investment performance, and the sustainability characteristics of investment products. Consequently, European pension funds and insurance companies must address ESG risks in their investment processes and risk management.

Some countries have gone further by adopting a double materiality approach. In the United Kingdom, for instance, trustees of trust-based pension funds are permitted to take into account non-financial ESG factors. However, this is only allowed if the members of the fund share these concerns and if it does not ‘involve a risk of significant financial detriment’ (Law Commission, 2017). Our interviews revealed that, due to regulatory requirements, pension funds and asset managers often tend to rely on advisers who often provide conservative advice in this regard, focusing on first materiality (ESG risk) rather than a broader double materiality view. The financial performance of the investment and the portfolio overall remains paramount in the investment decision-making processes of pension funds and insurance companies.
5.6.3 Implications for EMDE investments

The implications of institutional investors’ commitment to sustainable and responsible EMDE investing are mixed. A greater focus on ESG risks may deter investors from EMDE exposure because weaker regulatory frameworks and a lack of data may make such investments more exposed to ESG risk. For example, an investee firm with manufacturing capacity in a low-income country may be subject to less robust labour standards, either in the law or in its enforcement, and there may be less data available on labour outcomes (e.g. employment of women, discriminatory practices). So, aversion to the risk of breaching good labour standards could lead investors to avoid such investments. Governance risks may also be higher in countries with weak regulations and disclosure rules, and fewer listed companies (listing generally increases transparency and the influence of shareholders). On the other hand, since there are greater gaps in the achievement of most SDGs in EMDEs compared to developed markets, ICPFs that take into account second materiality may seek to increase investments in EMDEs.

A 2022 PRI study found that institutional investors find it difficult to reconcile EMDE investments with ESG investment guidelines (including compliance with the Principles for Responsible Investment) due to the following:

- a lack of ESG policies and regulations in many EMDEs;
- limited availability of ESG data for EMDE companies;
- the tendency of ESG indexes to give low weights to EMDE assets due to data/quality requirements;
- difficulty in actively engaging with investees on ESG issues in EMDEs because asset owners do not know the context well (PRI, 2022).

Similarly, a 2022 study commissioned by Mobilist (Theobold, 2022), which interviewed 50 institutional investors about their emerging market investment strategies, found that a growing focus on ESG risk may divert capital away from EMDEs, which tend to lack ESG data or score poorly on ESG metrics as presently constructed. Interviewed investors were unhappy with the influence of benchmarks for EMDEs, which lead to dominance of a few markets: the global MSCI index gives only 12% weight to EMDEs (which account for 59% of global GDP), of which two-thirds consists of China, Taiwan and Korea. The difficulty in getting good quality ESG data for EMDE investments becomes more significant with the introduction of EU and global sustainability reporting standards. ICPF may avoid EMDE investments if they are unable to meet sustainability reporting

---

37 On a purchasing power parity basis.
requirements. A recent survey of European ICPF\(s\) (BNP Paribas, 2023) found that the lack of accurate data was a barrier to ESG investing for 70\% of European investors. During our interviews, concerns were expressed about ESG risk assessment leading to capital diversion away from EMDE\(s\).

Analysis by Fitch Solutions (2023) shows that EMDE\(s\) are currently under-represented in ESG investment flows and that allocations to ESG-focused indices to these countries have been decreasing since 2018 (Figure 16). For example, in 2018, the MSCI Emerging Markets ESG Leaders Index allocated 68.2\% of its weight to countries classified as EMDE by the OECD, but this had decreased to 62.9\% by 2022. If China and India are excluded, which collectively represented more than one-third of the index's total market capitalisation, this share decreased even further over that period, from 33.2\% to 21.7\%.

Figure 16 MSCI Emerging Markets and ESG Leaders Equity Index, percent allocation to lower- and upper-middle income economies, 2018–2022

![Figure 16 MSCI Emerging Markets and ESG Leaders Equity Index](chart)

Source: Fitch Solutions (2023) from MSCI, Bloomberg, Fitch Solutions. Note: This data includes China and India.

### 5.7 Climate change

Widespread awareness of the significant financial risks of climate change has led to changes in the laws and regulations that govern capital markets. This has significant implications for ICPF\(s\). Legal and regulatory measures have been implemented to ensure that ICPF\(s\) acknowledge and address their exposure to climate risks (first materiality). Additionally, some of these measures aim to encourage ICPF\(s\) to work towards achieving Paris alignment and net zero objectives (second materiality). As with other ESG issues, regulatory requirements vary by country.
5.7.1 No legal and/or regulatory requirements on climate change

At the one end of the spectrum, Swiss legal and regulatory frameworks do not yet require pension funds to explicitly consider climate change (PwC, 2022). As with ESG risks, more generally, Switzerland adopts a self-regulation approach. In November 2020, the Federal Council recommended that financial institutions publish methods and strategies that show how they take into account climate and environmental risks, in accordance with their fiduciary duties. Since July 2021, FINMA has required Swiss insurance companies to report on climate-related risks in line with the Task Force on Climate-Related Financial Disclosures (TCFD) reporting framework, and FINMA provides template guidance on climate-related risk. The guidance is principles-based, allowing flexibility in implementation. It is expected that over time it will also focus on new and/or increasing sustainability risks such as the loss of biodiversity. In November 2022, TCFD disclosure became mandatory for large companies, including large insurance companies. Under this disclosure, insurance companies must report on both financial risk as a result of climate change, as well the GHG emissions of their business activities.

5.7.2 Legal and/or regulatory requirements on climate change

The EU is in the middle of the spectrum. Its legal and/or regulatory frameworks require the consideration and integration of climate risks and opportunities into investment decision processes. This has been primarily implemented through mandatory disclosures as specified by the International Sustainability Standards Board, which has adopted standards developed by the TCFD. The European Commission has proposed to make TCFD/ISSB reporting mandatory for all EU pension funds and insurance companies. Although not yet mandatory within the EU, several EU countries studied have moved in this direction. Furthermore, the EU taxonomy introduced in 2021 established a framework for the classification of sustainable investments. EU pension funds are required to disclose how their investments align with this taxonomy.

Some countries have gone further in pushing their financial institutions to work towards Paris alignment and net zero objectives. France was the first country to introduce legislation in support of the Paris Agreement. This law requires French pension funds and insurance companies to report on how their policies align with the

---

38 Most reporting on climate risk exposure is aligned with voluntary global reporting standards, initially developed by the Task Force on Climate-Related Financial Disclosures (TCFD), and now integrated into emerging global sustainability reporting standards under the International Sustainability Standards Board (ISSB). The ISSB/TCFD framework requires the disclosure of greenhouse gas emissions and related risks.
national strategy for ecological and energy transition. These reports must specifically address ESG integration, as well as the integration of climate risks. Additionally, the reports must include an evaluation of the pension funds and insurance companies’ contribution to meeting international targets for limiting global warming, as well as achieving the objectives outlined in the French Low Carbon Strategy. The Law on Energy and Climate passed in 2019 requires pension funds and insurance companies to report on how they are taking climate change into account in their investment strategies.

In the **United Kingdom**, the 2021 Pension Schemes Act requires that UK pension funds consider resilience to climate change and report using the TCFD/ISSB framework. The Financial Markets Law Committee recently published a paper (2024) to help provide some clarity on fiduciary duties in the context of climate change and sustainability and explore when and how sustainability factors, including climate change, can be appropriately considered in investment decision-making. TCFD/ISSB reporting is also mandatory for UK insurance companies. Furthermore, the 2023 Financial Services and Markets Act includes a new regulatory principle that requires the PRA and the Financial Conduct Authority (the UK regulators) to contribute to achieving the UK’s net zero emission target commitments in line with the UK Climate Change Act 2008.

Some institutions have also made voluntary commitments to reducing the climate impact of their investments (second materiality) by pledging to reduce the net GHG emissions of their portfolios to zero by 2050, with intermediate targets for 2025 and 2030. However, there has been significant attrition in the participation of European ICPF’s in the Net-Zero Asset Owners Alliance since its launch in 2022, partly due to concerns about regulatory and reputational risks.

5.7.3 Climate change as a driver for increased EMDE allocation?

The degree to which legal and regulatory changes and voluntary commitments will affect EMDE investment allocation is not yet clear, but some potential outcomes can be gleaned from interviews with ICPF investment staff and with their external investment advisers. In many of our interviews, it was apparent that climate change would change the nature of what pension funds and insurance companies invest in domestically and in other high-income countries, but not necessarily change EMDE appetite. In the UK, for example, interviews suggested there is a focus on local but not global sustainability issues and impact. Furthermore, there will be different portfolio impacts depending on whether pension funds and insurance

---

companies adopt a first materiality or second materiality perspective, or both, especially in EMDEs. First materiality considerations could, for example, reduce investments in countries exposed to extreme weather events, whereas second materiality considerations would reduce investments in oil, gas and mining. Such considerations will have differentiated effects on EMDEs, depending on their exposure to climate risks and their dependence on extractive industries.

Some interviewees noted a possible tension in the framework with the ambition to meet net zero targets and investments in EMDEs. The tension arises from a focus on a headline carbon footprint of an investment portfolio and the higher carbon footprint of a number of EMDEs rather than a focus on supporting the climate transition. Several advisers interviewed mentioned that they have been asked about reducing EMDE allocation to meet net zero objectives.
ICPFs in the five European countries studied are evolving their investment strategies in ways that do not currently lead to increased allocations to EMDEs. In some cases, they have led to reductions in allocations. But there is growing interest from ICPF managers in the sustainability and impact of their investment strategies, which has the potential to drive increased EMDE allocations. There is also growing interest from pension fund beneficiaries in the sustainability and impact of their pension investments, which could encourage a shift in the same direction, especially in the case of DC funds, where beneficiaries can have more direct voice in investment strategy selection.

6.1 Addressable market for mobilising capital into EMDEs

Based solely on structural issues, we find that the ‘addressable market’ of assets that could, in principle, be invested in EMDEs in the five countries studied is effectively $6.9 trillion managed by the top 35 institutions. The rest of the market is managed by smaller ICPFs, which mostly lack the capacity or risk appetite to invest beyond their own borders or outside the EU (for those countries within the EU).

For this subset of the market that has the capacity to invest in EMDEs, we find that a combination of regulatory and operational practices limits the size of the allocations that they can make to EMDE investments, especially in higher risk markets, and illiquid instruments. As a result, allocations to EMDEs typically range from 0% to 5% for insurance companies and 5% to 15% for pension funds.

To illustrate the realistic potential for greater ICPF investment flows to EMDEs, if the 35 largest asset owners across the five countries were to allocate as per the 95th percentile, it would yield a total stock of EMDE assets of around $0.5 trillion (up from $0.25 trillion in 2022).\(^40\) Achieving this within the next five years would require an additional $50 billion in annual investment flows on top of current annual investment flows.\(^41\) Appendix 1 outlines the methodology of

---

\(^{40}\) This estimate assumes all of the 20 largest pension funds allocated around 14% and all of the 15 largest insurance companies allocated around 4% in line with the respective 95th percentile of each respective market.

\(^{41}\) Assuming a weighted average maturity of 10 years for bonds and a 10-year average holding period for equity.
our calculation. In other words, in the medium term total annual investment flows would have to double from $40 billion to $80 billion. This implies that, under existing regulatory conditions, European ICPF
could make significant positive, yet not massive, contributions to filling the SDG financing gap (of a similar scale to what the World Bank Group contributes).

Realistically, however, a shift of this magnitude would entail testing the bounds of the possible, and without changes to regulations, investor behaviour, or market conditions as an incentive, this level of ambition is unlikely to materialise.

### 6.2 Market structure

Smaller pension funds typically do not have the capacity to assess investments in EMDE funds. Not all countries have pension funds aggregated into large pools that have the capacity to make allocations to EMDEs. In Germany, there are few funded pension funds of any scale. In France, pension funds are typically small with limited investment capacity. In Switzerland, despite a recent trend towards consolidation,

the pension market is very fragmented with many small pension funds that hold the lion’s share of the country’s total pension assets. The UK has a range of sizes, with smaller pension funds relying on external advisers to guide their investment strategy. Meanwhile, the Dutch pension market, which is among the most mature in Europe, is highly concentrated among the ten largest funds. Cognisant of the benefits of pooling private sector DC funds, as well as local government pension schemes, the UK government announced that it would explore options to consolidate pension fund schemes.

Consolidation of pension funds into larger asset pools would make it easier for them to take on the costs and risks of investing in EMDEs. Following the Dutch and British experience, regulators and pension fund administrators in markets that remain highly atomised – like France and Germany – should consider merging or consolidating smaller funds into larger investment pools. Even though asset size alone does not guarantee a shift toward greater EMDE allocations, it enables pension funds to capture economies of scale, choose more effective management and implementation styles, and in turn be more prone to invest overseas.

The shift from DB to DC schemes in the UK has put increased emphasis on low-cost, liquid assets, making it harder to allocate to EMDE assets. This could be counteracted by giving beneficiaries

\[\text{42 Total World Bank Group 2022/23 commitments came to $128 billion.}\]
\[\text{43 While there were 2,935 active pension funds in 2004, this number dropped to 1,438 in 2020 (Swisscanto, 2022).}\]
\[\text{44 In Switzerland, the 15 largest pension funds hold only 33\% of the country’s total pension assets (McKinsey, 2020).}\]
\[\text{45 In the Netherlands, the ten largest funds hold 74.5\% of Dutch pension fund assets (PwC, 2020).}\]
\[\text{46 The primary driver for this move is to unlock more UK pension fund investment in British economy but it would also have a potential positive spillover benefit for EMDE investment. See Aldrick (2023).}\]
more opportunities to select investment strategies that also include sustainable investments in EMDEs.

6.3 Regulations

There is a natural ceiling to EMDE allocation because in all pension markets studied (except for the Swiss) the prudent person principle essentially requires most investment to be in tradeable and regulated markets. Where there are specific quantitative restrictions (France, Germany and Switzerland), it is not clear how close pension funds are to these regulatory limits. However, in Switzerland, it was observed that these limits are not binding and funds that have chosen to increase allocations have been able to do so.

In general, we do not find legal and regulatory frameworks as they have evolved to date to be a binding constraint on the ability of pension funds to increase their allocations to EMDEs. The barrier to increasing allocation to EMDEs appears to be more behavioural in nature, often based on conservative interpretation of legal and regulatory frameworks or based on market convention. This is especially the case in Swiss and UK pension markets. In the UK, interviews revealed that legal and pension fund advisers often have different opinions on what would be considered a sensible EMDE allocation under the PPP. However, there is also a lack of clear guidelines in legislation and regulation regarding fiduciary duty and consideration of the environmental and social impact of investments (second materiality). As a result, there is a common perception, often supported by consultants and legal advice, that fiduciary duty only allows for the pursuit of the maximisation of financial returns.

**Government and policy-makers should allow pension funds to solicit and integrate members’ and beneficiaries’ sustainability preferences into investment decision-making while complying with the prudent person principle. They should also provide clearer guidance on fiduciary duty and the extent to which fiduciaries may take into consideration second materiality ESG factors.**

At the EU level, Solvency II and IORP legislation should reflect the findings of technical consultations and allow ICPFIs to integrate members’ and beneficiaries’ sustainability preferences into investment decision-making while complying with the prudent person principle.

Insurance companies face more binding constraints from application of Solvency II and equivalent regulations on their investment allocations, with a regulatory cliff preventing them from investing in higher risk, less liquid assets. This severely limits the range of EMDE assets they can hold. The UK has introduced two important reforms to Solvency II to alleviate this cliff. **EU insurance regulators should also revisit the details of their solvency regulation to eliminate or alleviate it. EU and Swiss regulators, with similar capital requirement as part of their Solvency frameworks, should also**
consider reviewing the capital charges for non-OECD investments, especially Solvency II charges for non-OECD infrastructure, where recent data on the risk of EMDE investments confirms the need for a recalibration exercise.

Similarly, the UK Treasury should review the capital charges for non-OECD infrastructure as part of Solvency UK and clarify the impact of agreed changes to the matching adjustment and risk margin on non-OECD investments, especially in infrastructure and alternative assets.

6.4 ESG risks and impacts

Increased awareness of the risks of ESG and the opportunities for positive social and environmental impact, along with increased regulation and voluntary standards, have made ESG issues a greater factor in asset selection. This rise in ESG interest is often assumed in Financing for Development policy discussions to be a driver for increased ICPF EMDE investment appetite. However, we find that this cuts two ways, and the net effect is not obvious. On the one hand, opportunities to demonstrate positive impact, especially on climate and the SDGs, are seen as welcome by many pension fund managers and insurance companies. On the other hand, the need to screen investments for ESG and climate risk, and to gather and report on ESG metrics, acts as a disincentive to hold EMDE assets. The disincentive effect is strongest for smaller pension funds with limited capacity to evaluate and monitor ESG risks, and for whom the easiest way to demonstrate Paris alignment and a net zero portfolio is to avoid assets with significant negative climate impacts. One country where there has been a positive effect is the Netherlands, where it has been driving large pension funds towards greater impact investments.

It is important that the evolving national and EU regulations related to ESG and climate risk management and reporting take into account the challenges of compliance when investing in EMDE assets. This can reduce the risk of the unintended consequence of deterring investors from EMDE investments. ESG and climate regulations should make room for transition investments which increase investor exposure to ESG risk and increase carbon footprint, so long as there are credible, measurable paths to improving the ESG performance and/or reducing the carbon footprint of the asset.

6.5 Investor behaviour and operational practices

The PPP, institutional investor practices and behaviours play a key role in determining allocations to EMDE assets. There is an old cliché that says no one ever got fired for selecting IBM computers; today, no investment manager gets fired for allocating to developed markets. There is a higher burden of proof when making allocations to EMDEs given the limited experience of most investors with this
asset class. And there are fewer liquid public market assets available to invest in, deterring investors who place a high weight on liquidity. Currently, the emerging markets share of global equity market capitalisation is 30%, and it is expected that emerging market capitalisation will exceed the US by the end of this decade, according to Goldman Sachs (2024). Public market assets provide not just liquidity, but more transparent, comparable information on historical performance, both of individual assets and of the market as a whole. Most European institutional investors limit their investments in alternative assets which are less liquid and more opaque, and for which information on financial and ESG performance is more costly to acquire. This limits their ability to invest in EMDEs given the lack of public market assets.

Traditionally, investors have focused on financial performance, but they are also increasingly concerned with ESG performance. Here, too, transparent, comparable information is less available in EMDEs, both in public and private markets. **Capital market development that creates more liquidity and encourages greater use of tradable securities to raise finance can expand the range of investable assets.**

The cost of sourcing and managing EMDE assets is a particular obstacle to DC pension schemes, which tend to be more cost-sensitive than DB funds. EMDE funds typically charge higher fees, which reflect the smaller size of these funds and the additional costs of origination and portfolio monitoring. To encourage them to offer investment strategies with larger allocations to EMDEs, they need to be able to find **low-cost vehicles to gain exposure to EMDEs.** **MDBs and DFIs can play an important role here (Section 6.6.1). It would also help to change the default investment option to a strategy that includes EMDE assets,** since large proportions of DC contributions follow the default strategy.

The experience of Dutch pension funds suggests that it is possible for larger pension funds to substantially increase their exposure to emerging market assets (including in illiquid/infrastructure investments), driven by beneficiary demand for sustainable assets that contribute to SDG and climate change goals. APG and PGGM have been in the vanguard of pension funds in seeking out sustainable investments that contribute to specific impact goals. They have been prepared to invest in illiquid assets in EMDEs, in conjunction with MDBs and DFIs. For example, APG invested $0.75 billion in ILX Fund, which offers exposure to a set of EMDE loans originated by MDBs and DFIs (Appendix 2).

### 6.6 Other issues for further research

There are several issues touched upon during our research that have not been fully explored in this paper. These issues deserve further study and analysis. We briefly flag them here and offer our initial observations.
6.6.1 Opportunities for governments, MDBs and DFIs to support increased EMDE investments

There is a role for governments and the MDBs and DFIs that they own to help ICPFs allocate more capital to EMDE assets. ICPFs generally do not have the capacity to source individual private market investments and alternative assets such as infrastructure. They need access to low-cost, investment grade, diversified pools of assets with good ESG management and impact reporting, which they can invest in at scale (ticket sizes of $0.5 billion or more), as shown by the success of pioneering pooled funding models like the Managed Co-Lending Portfolio Program, ILX Fund and the Allianz/FMO SDG Fund (Appendix 4). This creates a role for intermediaries to create de-risked, diversified pools of EMDE assets. Private asset managers can play a structuring role, but most do not have sufficient presence in EMDEs to be able to source assets for these portfolios.

**MDBs and DFIs are well positioned to originate these assets, which they can pool and syndicate individually, collectively or in partnership with private asset managers. Governments, MDBs and DFIs can de-risk asset pools by taking junior, high-risk tranches, and/or by blending commercial capital with concessional capital able to accept certain risks with low or no compensation. They can also help by generating and sharing risk information from the performance of MDB and DFI investments. To create these portfolios of assets, MDBs and DFIs will have to devote more effort to market development and asset origination, as there are currently not enough investment opportunities available to meet the potential demand from institutional investors.**

In the longer term, national governments have a role to play in developing domestic capital markets to increase the availability of listed equities and bonds to meet ICPF appetite for liquid assets, and which provide greater transparency and comparability than private market assets. These national efforts must be supported by MDBs, DFIs and donors.

6.6.2 Currency risk

ICPFs have little appetite to take on EMDE currency risk, so they rely on the availability of hard currency assets (mainly US dollars and euros) for EMDE investing. In fact, the current EMDE allocations of ICPF are dominated by investments in hard currency denominated (sovereign) bonds. If the aim is to increase EMDE allocations via a hard-currency listed investment route, then currency risk is not the main constraint, but there are limited available assets to invest in. Similarly, some ICPF may be comfortable holding local currency assets in larger middle-income countries where hedging is available on the local market (e.g. Brazil, Indonesia, Vietnam). However, if the

47 MOBILIST (2024)
objective is to shift institutional capital directly toward growth-enhancing infrastructure and equity investment projects, then currency risk becomes unavoidable for institutional investors.

Efforts to expand the availability of these assets need to address the problem of who can bear the unavoidable currency risks – leaving EMDEs exposed to the risks of hard currency financing has proven to be unsustainable. For loans and bonds, denominated in local currency, hedging mechanisms like The Currency Exchange Fund (TCX) can help but are currently too small to enable market growth, especially in low-income countries. In the long term, local capital market development that creates forward foreign exchange markets will help mobilise a wide range of investors. Adding to this, TCX has been mobilising ICPFs by on-selling the currency risks it onboards (via cross-currency swaps or on the back of investment grade bonds indexed in local currency) to institutional investors. In turn, TCX can be a productive avenue to channel institutional capital into frontier currencies. Meanwhile, for more mature developing economies, such as Kenya, further promoting the issuance of local currency bonds by public development banks or other national financial institutions could help strengthen capital markets while also advancing products that can attract ICPFs, both locally and internationally. FSD Africa has been a pioneer in this space and should continue working with blended finance to support local currency bond issuance and ensure follow-on transactions that mobilise private capital. In the long term, the unavoidable risks from financing investments in foreign currency can be most effectively reduced by greater mobilisation of capital from local ICPFs.

6.6.3 Country risk

The perception of country risks may exceed their actual severity, due to the lack of transparent data, especially for private market assets. Some of this performance evidence has been made publicly available, but some is held within MDBs and DFIs, which are key investors in EMDEs. Initiatives such as the GEMs database, which collates loan default risk information from 25 development finance institutions to private investors, can help share this information with ICPFs, helping them to get comfortable with the risk profile of EMDE assets. So too can the creation of publicly listed emerging market investment vehicles, which bring more transparency to the performance of emerging market assets. Investors also learn by doing – so de-risking investments through blended finance structures can help investors build a track record of EMDE investing that can lead to further investments which do not need de-risking. Political risk insurance can also help mitigate some country risks.
Conclusion

An examination of the complexity of ICPF asset management shows that mobilising more of their assets for investments in EMDEs is neither straightforward nor likely to change quickly. The way countries approach providing social insurance and the role of the financial sector are reflected in the diversity of insurance and pension markets. Efforts to mobilise ICPFs and address investment behaviours to incentivise more EMDE investment will be difficult to disentangle from a broader domestic imperative to balance issues of risk and the need for domestic long-term investment, as well as social attitudes to finance and the provision of social insurance.

ICPFs are subject to national and supranational regulations, fiduciary and prudent person obligations, the interests of their stakeholders, financial market developments, and changes in market structure. This context is far from static, and ICPFs are currently managing through a period of rapid change in regulations, financial conditions, and market structure against a backdrop of growing attention to ESG and climate risk. As we have described, some of these changes will increase appetite for EMDE assets, others will reduce them.

We draw two overarching conclusions. First, that expectations of a rapid shift in allocations (‘from billions to trillions’) cannot be counted on to fill the SDG and climate financing gaps in the short- to medium-term. Second, that efforts to address the operational context of ICPFs to increase their ability and willingness to invest in EMDE assets can make a difference, but only if they are fine-tuned to the specific context of individual countries and types of institutions. We have not identified broad-brush reforms that will unlock more ICPF capital, as the research does not point to any, but we have identified many specific pinch points that serve to reduce ICPF allocations to EMDEs. Some of these can be addressed by regulators and policymakers at national and EU levels. There is also a role for MDBs and DFIs to facilitate EMDE investing through co-investment platforms, de-risking structures, and sharing risk data.
References


Appendix 1 The potential for increased EMDE investments by large European ICPFs

Section 2 lays out the current EMDE allocation of the 35 largest ICPFs in France, Germany, the Netherlands, Switzerland, and the UK. Based on this data, we know that currently asset owners are allocating around $250 billion, pension funds, $180 billion, and insurance companies the remaining $80 billion.

To translate these allocations into annual investment flows we first determine the asset composition of the EMDE portfolio of insurance companies and pension funds respectively. Then assets held in bonds are divided by their average weighted maturity and equities are divided by their average holding period. This calculation is performed to estimate the level of new annual investment required to maintain the EMDE portfolio at its current level (see Figure 17).

Figure 17 Estimating annual investment flows to EMDEs by the 35 largest European ICPFs

Source: Authors’ calculations
A transformational effort to get the 35 largest asset owners across the five countries to allocate as per the 95th percentile would yield total EMDE assets of around $0.5 trillion. Achieving this within the next ten years would require an additional $25 billion in investment flows per annum on top of current commitments. Figure 18 and Figure 19 show the additional flows required to increase investments over five and ten years when starting with annual investments of $40 billion and assuming a steady reflow throughout the period.

**Figure 18 Achieving a $0.5 trillion EMDE allocation in ten years**

<table>
<thead>
<tr>
<th>EMDE asset allocation:</th>
<th>250</th>
<th>275</th>
<th>300</th>
<th>325</th>
<th>350</th>
<th>375</th>
<th>400</th>
<th>425</th>
<th>450</th>
<th>475</th>
<th>500</th>
<th>500</th>
<th>500</th>
<th>500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual investment flows to EMDEs (US$ bn)</td>
<td>40</td>
<td>40</td>
<td>44</td>
<td>48</td>
<td>52</td>
<td>56</td>
<td>60</td>
<td>64</td>
<td>68</td>
<td>72</td>
<td>76</td>
<td>80</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Reflows</td>
<td>Additional investment flows</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Figure 19 Achieving a $0.5 trillion EMDE allocation in five years**

<table>
<thead>
<tr>
<th>EMDE asset allocation:</th>
<th>250</th>
<th>300</th>
<th>350</th>
<th>400</th>
<th>450</th>
<th>500</th>
<th>500</th>
<th>500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual investment flows to EMDEs (US$ bn)</td>
<td>40</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>80</td>
</tr>
<tr>
<td>Reflows</td>
<td>Additional investment flows</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Authors’ calculations

48 Allocations were modelled as per the 95th percentile to estimate EMDEs shares that are between best in class and moderate targets. Due to the small sample size estimating a 100th percentile would only cover a couple ICPFs.

49 This estimate assumes all of the 20 largest pension funds allocated around 14% and all of the 15 largest insurance companies allocated around 4% in line with the respective 95th percentile of each respective market.
## Appendix 2 Overview of the five insurance and pension markets studied

### Table 4 Overview of studied insurance and pension fund markets

<table>
<thead>
<tr>
<th>Country</th>
<th>Pension market</th>
<th>Insurance market</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Three-tier system – state pension (which is a DB pay-as-you-go scheme), compulsory supplementary pension, and voluntary private pensions, dominated by the first tier. The French government is currently transforming the pension landscape in a country without many private pension funds. The private pensions market is small and highly atomised. Pension market assets = 5.2% of the country’s GDP Total assets: $344 billion</td>
<td>France has one of the largest and most sophisticated insurance industries globally, hosting: Credit Agricole, AXA, and BNP Paribas Cardif. AXA was the largest insurance company in Europe in terms of gross written premiums in 2021. Recent reform, which has increased the state pension age paired with uncertainty surrounding the sustainability of the French pension system, could also create increased interest in life insurance as a form of retirement saving. Insurance market assets = 50% of the country’s GDP Total assets: $3.3 trillion</td>
</tr>
<tr>
<td>Germany</td>
<td>Three-tier pension system (i.e. state, occupational and private). The Deutsche Rentenversicherung (DRV) state pension system is a pay-as-you-go system and is mandatory. Occupational pension schemes (Pensionskassen and Pensionfonds) are voluntary and often seen as a company benefit. Pensionskassen are typically DB schemes. Pensionfonds are primarily DC schemes. They are regulated differently. A stricter regime is in place for Pensionskassen. Pensionfonds have more flexibility and can invest in a riskier way The private pension market is small and highly atomised.</td>
<td>Germany has Europe’s largest domestic non-life market and fourth largest life market and is home to some of the largest insurers globally, such as Allianz Group and Munich Re. German insurers have historically been conservative investors that are highly exposed to fixed-income investments. Insurance market assets = 59% of the country’s GDP Total assets: $2.44 trillion</td>
</tr>
<tr>
<td>Country</td>
<td>Pension market assets</td>
<td>Total assets</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------</td>
<td>--------------</td>
</tr>
<tr>
<td></td>
<td>= 8.2% of the country’s GDP</td>
<td>$338 billion</td>
</tr>
<tr>
<td></td>
<td>Total assets: $338 billion</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

50 DC cash plans are when plan sponsors share the investment risk and the assets are pooled.
The UK is one of the largest insurance markets in the world, being home to both a very large domestic market, and many multinational insurers who provide insurance services around the world. In 2022, the UK was ranked third by life and non-life direct premiums written globally – surpassed only by the United States and China.

The number of insurance companies in the UK has dropped significantly over the past decade. One reason for this is mergers and acquisitions activity in the sector.

The raising of the retirement age for the state pension will increase the demand for supplementary retirement savings and investment products.

Before Brexit, the UK insurance market was regulated by Solvency II; now regulators are in the process of reforming UK insurance regulation, providing opportunities for leading life companies to diversify their product offerings.

Insurance market assets = 24% of the country’s GDP
Total assets: $497 billion

United Kingdom
Three-tier system. The first tier is the state provision (pay as you go). The second tier is occupational provision, and the third tier consists of individual private plans.

Historically, DB schemes dominated the market, but recent reforms to UK pension funds include a market wide shift from DB to DC schemes51 and a consolidation effort among local government pension schemes. As part of this reform, the government introduced auto-enrolment DC schemes in 2012. These reforms have resulted in a significant increase in DC members compared to DB members.

Pension market assets = 127% of the country’s GDP
Total assets: $3.5 trillion

The UK is one of the largest insurance markets in the world, being home to both a very large domestic market, and many multinational insurers who provide insurance services around the world. In 2022, the UK was ranked third by life and non-life direct premiums written globally – surpassed only by the United States and China.

The number of insurance companies in the UK has dropped significantly over the past decade. One reason for this is mergers and acquisitions activity in the sector.

The raising of the retirement age for the state pension will increase the demand for supplementary retirement savings and investment products.

Before Brexit, the UK insurance market was regulated by Solvency II; now regulators are in the process of reforming UK insurance regulation, providing opportunities for leading life companies to diversify their product offerings.

Insurance market assets = 108% of the country’s GDP
Total assets: $3.0 trillion

Note: Total assets and total assets as percent of GDP are based on 2022 OECD Pension and Insurance Market data.

51 Although DB schemes hold the majority of assets, it is expected that this will change over time as DC assets are expected to increase sixfold by 2030 to £1.68 trillion, equivalent to 15% of current UK net wealth (Law Commission, 2017).
Appendix 3  
Conceptualisation of fiduciary duty by studied country

Table 5 Conceptualisation of fiduciary duty by country

<table>
<thead>
<tr>
<th>Country</th>
<th>Meaning of fiduciary duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>In French civil law, the concept of fiduciary duty is not widely recognised. Nevertheless, French investors are well acquainted with the principles that form the foundation of fiduciary duties. These principles include obligations of loyalty and prudence, as well as the need to act with due care. As a result, the move towards incorporating ESG factors into investment decisions has been driven by specific regulations that required companies to disclose their ESG practices (PRI and UNEP FI, 2019).</td>
</tr>
<tr>
<td>Germany</td>
<td>Although fiduciary duty is not explicitly defined in German law, the Capital Investment Code (Kapitalanlagegesetzbuch-KAGB) does outline obligations to act in the best interest of the ultimate investor. Additionally, the Pension Insurance Act (Versicherungsaufsichtsgesetz-VAG) incorporates the principle of prudent person, further emphasising the importance of responsible decision making (PRI and UNEP FI, 2019).</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>Although fiduciary duty is not explicitly defined in the Dutch Pensions Act, Article 135(1) requires a pension fund to set its investment policy and invest its assets in the interest of its participants, act in accordance with the so-called ‘prudent person rule’ and act in the best interests of beneficiaries and pensioners.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Although fiduciary duty is not explicitly defined, the Law on Occupational Pension Schemes states requirements concerning security of the investment, risk diversification, sufficient return (normal market return), sufficient liquidity and execution of shareholder rights.</td>
</tr>
</tbody>
</table>
According to the Law Commission, fiduciary duty in common law refers to the obligation of loyalty. This has a specific legal definition, which entails acting honestly and in good faith, refraining from personally profiting from the trust placed in them, avoiding conflicts of interest, and obtaining informed consent from their principal before acting for their own or another person’s advantage.

However, the Law Commission notes that the law regarding fiduciary duties is complex, challenging to locate, and lacking widespread awareness. It sits alongside other duties on fiduciaries stemming from several sources of UK law, including contract law, Financial Conduct Authority rules, pensions legislation and ‘judge-made law’ which cover non-fiduciary and fiduciary duties. For example, a duty to exercise reasonable care and skill as set out in S33 of the UK Pensions Act 1995 is not a fiduciary duty, using a strict legal meaning (Law Commission, 2014). Likewise, the requirement to ensure ‘the security, quality, liquidity, and profitability of the portfolio as a whole’ and ensure that assets are properly diversified, would not be a fiduciary duty using a strictly legal definition, but would be seen as a non-fiduciary duty.

The Law Commission (2014) also concluded that ESG integration is consistent with fiduciary duty.

This lack of familiarity can result in trustees adopting a narrow perspective when considering investment factors, ESG factors and the interests of their beneficiaries.

To provide some clarity, the Financial Markets Law Committee (2024) has recently published a paper to help provide some clarity on fiduciary duties in the context of climate change and sustainability. This paper gives an explanation of the legal position on sustainability, which is integral to decision-making by pension fund trustees where it may affect financial return or risk. The paper makes clear the importance of sustainability, specifically climate change, for pension funds. It underscores the obligation of trustees as part of their duties to adopt a ‘broad perspective and long-term outlook’.
Appendix 4  Examples of how MDBs and DFIs can help ICPFss invest in EMDEs

As discussed in the study, MDBs and DFIs can play an important role in helping overcome some of the pinch points constraining ICPF allocation to EMDEs. They can help source investment opportunities at a lower cost; can help overcome issues associated with lack of familiarity with EMDE markets, and can originate EMDE assets and structure vehicles and instruments which meet the requirements for ICPFss to have access to investment grade, diversified pools of assets, and large ticket sizes.

Included in this appendix are three examples of the important role that DFIs and MDBs can play.

Example 1 – The ILX Fund

The ILX Fund is an SDG focused emerging markets private debt fund designed to provide institutional investors access to investment opportunities in a diversified portfolio of private debt investment opportunities originated by MDBs and DFIs in emerging markets. It is managed by ILX, a fund manager. The ILX Fund I has mobilised $1.05 billion in commitments from pension funds, which will be co-invested pari-pasu\(^{52}\) in syndicated loans offered by MDBs and DFIs. This includes $750 million from Dutch pension provider APG, on behalf of its pension fund clients ABP and bpf BOUW.\(^{53}\) One of the attractions is the legal, ESG and political risk mitigation as a result of co-investing with MDBs and DFIs but also a fund manager who can source and offer an investment strategy which has a low correlation with typical emerging market bond indices, thus providing real diversification benefits. The fund does not use blended finance.

---

\(^{52}\) The investor has the same level of risk and return as the MDBs and DFIs.

\(^{53}\) See website, [www.ilxfund.com](http://www.ilxfund.com).
Example 2 – The SDG Loan Fund 1

The SDG Loan Fund is one of the largest blended finance funds in the market to date. The fund aims to promote the SDGs in EMDEs, targeting investment in agribusiness, financial inclusion and renewable energy. Allianz Global Investors manages the fund and FMO’s Investment Management company originates FMO loans and manages the loan portfolio. For each loan, FMO keeps the higher of $10 million or 20% of each loan the Fund participates in on its balance sheet.

Through an innovative blended finance model, the fund has mobilised $1.1 billion of investor capital including from institutions including Allianz Global Investors, and Skandia. The fund benefits from credit enhancement in the form of (1) $111 million first-loss investment from FMO in the form of Class B shares and (2) FMO’s investment benefits from a $25 million first loss guarantee from the MacArthur Foundation. Institutional investors hold $1 billion in class A preference shares that are senior to FMO’s class B shares. The fund will be invested as participations in FMO originated loans.

Example 3 – The Amundi Emerging Green One (EGO) Fund

In 2017 IFC developed the concept for a green bond fund which would mobilise institutional capital to finance climate investments in emerging markets. The IFC network of partner banks in emerging markets was able to make green loans to their client companies but was unable to access global capital markets on their own. If IFC could set up a green bond fund to buy green bonds issued by these banks to finance their climate lending, then the banks could expand their lending. Some of IFC’s corporate clients were also in a position to issue green bonds with the support of these banks.

54 The fund specifically targets SDG 8: decent work and economic growth; SDG 10: reduced inequality; and SDG 13 climate action.
55 The Class B investment size is designed to be big enough to meet the credit risk tolerance of institutional investors, while also using the least amount of capital necessary from FMO. Additionally, the size of the first-loss investment provides significant protection for senior investors, which is not usually found in other types of assets (Convergence, 2023).
To make green bonds investable by institutional investors in high-income countries, they would need to offer an investment grade product. To make emerging market green bonds investment grade, credit enhancement would be required through a fund structure in which some investors take a junior tranche with higher risk and return, while institutional investors take a senior tranche, which is investment grade, but with lower returns. IFC also saw a need for technical assistance to help banks prepare to issue green bonds and to support the development of green bond markets.

IFC recognised that it needed to work with a leading asset manager to manage the fund and market it to institutional investors. It undertook a competitive selection process, resulting in the selection of Amundi Asset Management, the largest European asset manager with over $2 trillion assets under management.

In 2018 IFC and Amundi launched the Emerging Green One (EGO) Fund, with an initial close at $1.42 billion, and it is expected to deploy $2 billion into emerging markets green bonds over its lifetime, as proceeds are reinvested during seven years. The fund is listed on the Luxembourg Stock Exchange, providing liquidity for investors who wish to sell before the end of the fund’s life. It is classified as an Article 8 (sustainable) fund under EU SFDR regulations.

IFC made an anchor investment of $256 million in the junior tranche of the fund, alongside other MDBs and DFIs (EBRD, EIB, Proparco). The senior tranche was invested by European and Middle Eastern pension funds and insurance companies. The fund was accompanied by an IFC-managed TA programme, initially funded by a $7.5 million grant from the Swiss government (SECO) to support capacity-building in participating banks and the creation of green bond markets.
In 2022, the fund held 24 green bonds, which financed green projects in 14 emerging markets. As the concept proved successful, it was replicated in 2021 by the BEST Fund, a $2 billion fund to invest in a broader range of sustainable bonds issued by banks and corporates from emerging markets, again managed by Amundi.