



# Financing for Sustainable Development Report 2020

Inter-agency Task Force on Financing for Development



United Nations

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The online annex of the Task Force (<http://developmentfinance.un.org>) comprehensively monitors progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the Sustainable Development Goals. It provides the complete evidence base for the Task Force's annual report on progress in the seven action areas of the Addis Agenda (chapters III.A–III.G). The report is by necessity more concise and selective and should thus be read in conjunction with the online annex.

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DOMESTIC AND INTERNATIONAL PRIVATE  
BUSINESS AND FINANCE





## Chapter III.B



# Domestic and international private business and finance

## 1. Key messages and recommendations

Unlocking private business and finance is one of the greatest challenges to achieving sustainable development and reinvigorating the economy following the impact of the COVID-19 crisis.

On a country level, Governments have several levers that they can use to create a thriving business environment and reduce investment risks. *To help prioritize actions, policymakers should identify and target binding constraints to private sector development in support of the Sustainable Development Goals.* This could include a range of areas: The first area is strengthening the legal and regulatory environment. The second is providing infrastructure services essential for sustainable development and the functioning of the economy. Despite all the initiatives in this area, infrastructure gaps remain considerable between developed and developing countries. *The international community should further help countries build the internal capacity necessary to deliver cost-efficient and resilient infrastructure solutions, including developing “investible projects” when feasible.* The third is *addressing financial constraints, particularly affecting micro, small and medium-sized enterprises. This requires harnessing technological advancements, for instance to overcome data gaps for credit risk assessment.*

Building an enabling business environment, however, may not be sufficient to mobilize investment at the speed and scale required to achieve the sustainable development goals (SDGs), particularly in countries most in need and in sectors key for sustainability. Identifying the types of financial instruments most likely to deliver results given the local context will again require a proper assessment of the key constraints to investment. This chapter lays out a range of tools and financial instruments that can be used to overcome some of the impediments to private investment. For instance, *international vehicles can be used to manage currency, disaster and political risks, in part through their ability to diversify across countries and risks. Smartly structured private equity and venture funds, including those*

*bringing together public and private investment, could mobilize the additional equity financing needed to support innovative companies in less advanced economies.* But, as discussed in chapter III.C, country ownership and fair risk-reward sharing between public and private partners is necessary for these instruments to be effective. *Innovative models, such as auction systems, can be designed to minimize subsidies and optimally use scarce concessional resources.*

Major changes are also required in the way private business and finance works. The need for a systemic change is evident from the lack of sufficient progress in many sustainable areas where companies have a large impact, including carbon emissions, gender balance, disaster risk, and waste production. Business leaders are increasingly acknowledging that taking sustainability factors into consideration will be necessary to achieve long-term financial success and ensure the future viability of their companies. However, turning this awareness into action requires the following:

- *Adjusting corporate governance, aligning internal incentives (such as remuneration criteria for CEOs), and addressing the persisting short-termism in capital markets;*
- *Making companies more accountable.* This is impossible without meaningful information on companies’ social and environmental impact. *Reporting requirements for large corporates need to include a common set of sustainable metrics regardless of their materiality impact.* Through its analytical work, the Inter-agency Task Force on Financing for Development can facilitate convergence between reporting initiatives and the emergence of harmonized and comparable data. This is key to support sustainability-driven investor initiatives, such as the Global Investors for Sustainable Development (GISD) Alliance;
- *Enabling people to use their money to support changes they believe in.* Every survey shows strong appetite for this from individual investors. However, individuals do

not always have the possibility to do so, either because no one asks them questions about their sustainability preferences; they cannot find credible investment products; or because they are sold products marketed as sustainable with no actual impact. This needs to change. *Investment advisors should be required to ask their clients about their sustainability preferences along with other information they already request;*

- **Establishing minimum standards for investment products to be marketed as sustainable.** A common definition of what constitutes sustainable development investing would be an important step towards setting such standards. *International platforms, such as the United Nations, need to be leveraged to develop a shared understanding at the global level, and avoid the proliferation of competing and possibly conflicting standards.*

The chapter starts by reviewing investment trends and the different components to create an enabling business environment. The chapter then examines financial instruments that can be used to mobilize additional private investment. It concludes by exploring ways to transform private business practices towards more sustainability.

## 2. Investment trends

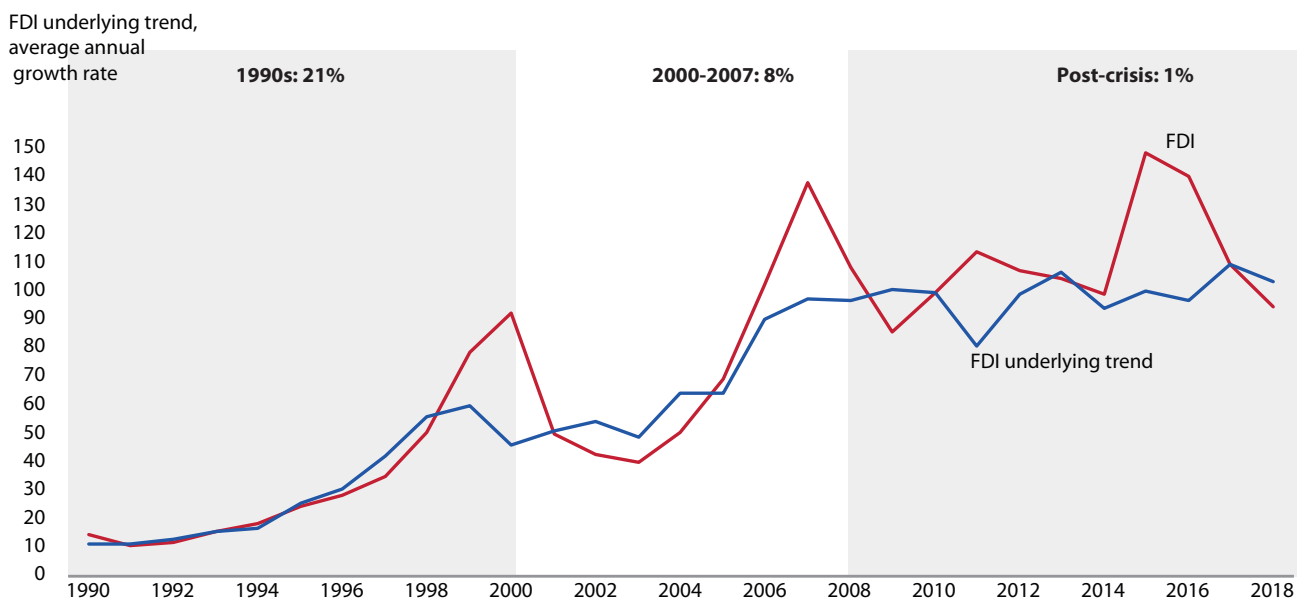
There are several trends in private investment which are important for achieving sustainable development and the SDGs. These include (i) low investment growth in traditional tangible assets and infrastructure, with higher growth in investment in digital technology; (ii) weak foreign direct investment (FDI), but a shift from developed to developing countries; and (iii) a greater interest in sustainability, with a focus on climate-related risks.

As noted in chapter I, investment rates are currently below historical averages, despite record low interest rates. The outlook for private investment has weakened over the last decade amid global uncertainties and declining investor confidence.<sup>1</sup> Investment growth has been particularly weak in areas of traditional investments, such as machinery, construction and other tangible assets. The COVID-19 crisis further clouds investment prospects.

Private investment in infrastructure projects in developing countries has also been low relative to historical averages, at less than \$100 billion a year between 2016 and 2018. While infrastructure commitments increased 14 per cent in the first half of 2019, the yearly figure will remain well below the \$160 billion peak reached in 2012.<sup>2</sup> In particular, since 2014, investment has fallen in sectors with more limited financial returns, such as water, sanitation and hygiene, and education. Investment in the generation, transmission and distribution of electricity has remained flat, while investment in telecommunications, transport and agriculture has increased.<sup>3</sup>

This broader trend is mirrored in FDI, which has experienced anaemic growth since 2008. Adjusted for short-term volatility and fluctuations caused by one-off factors, such as tax reforms, FDI has averaged only 1 per cent growth per year this decade, compared with 8 per cent in 2000-2007, and more than 20 per cent before 2000 (figure III.B.1). In 2019, global FDI remain flat at an estimated \$1.39 trillion.<sup>4</sup> In 2020, the downward pressure on FDI caused by COVID-19 is expected to be -5 to -15 per cent (compared to previous forecasts projecting marginal growth in the underlying FDI trend for 2020-2021). The impact on FDI would be concentrated in those countries that are most severely hit by the epidemic, although negative demand shocks and the economic impact of supply chain disruptions could affect investment prospects globally. Lower profits from many multinational enterprises would also translate into lower reinvested earnings (a

Figure III.B.1  
**FDI inflows and the underlying trend, 1990–2018**  
 (Indexed, 2010 = 100)



Source: UNCTAD, World Investment Report 2019.

major component of FDI).<sup>5</sup>

Technological change has been a driver of the underlying trend of low FDI. Digitalization has enabled multinational enterprises to generate sales abroad with limited local presence. It has also facilitated a shift of international production from tangible cross-border production networks to intangible value chains and non-equity modes of operations, such as licensing and contract manufacturing. This is reflected in the much faster growth of trade in services and international payments for intangibles (royalties and licensing fees) than for tangible production indicators such as FDI and trade in goods. The growth of foreign sales of the top 100 multinational enterprises outpaces growth in foreign assets and employees, suggesting that these enterprises are reaching overseas markets with a lighter operational footprint, which might create challenges for local authorities to collect taxes (see chapter III.A).

Another long-term trend is the growing share of FDI flows towards developing economies. In the ten years prior to the 2008 crisis, developing economies attracted 30 per cent of global FDI flows, on average. This percentage increased to about 45 per cent in the last ten years, and exceeded 50 per cent in 2018 and 2019. Yet, these flows have not benefitted all countries equally. While certain regions have been able to attract more investment, particularly in Central Africa, South-East Asia and East Asia, in other regions, FDI declined below pre-crisis levels.

Notable changes are also happening in investment practices. Sustainability issues are receiving greater consideration, although the impact of such investing is often uncertain. Investment strategies that focus on profit maximization, while considering the impact of environmental, social and governance (ESG) factors have increased by 34 per cent between 2016 and 2018 to reach over \$30 trillion of investment assets across major developed markets.<sup>6</sup> ESG-based indices have mushroomed, increasing by 14 per cent in the twelve months through June 2019.<sup>7</sup> Green bond issuance reached new heights in 2019, at about \$250 billion, representing close to 50 per cent increase from 2018.<sup>8</sup> Yet this still represents only a small part (about 3 per cent) of the fixed-income market issuance.

More funds have also been allocated to impact investment, which aims to generate positive social and environmental impact alongside a financial return (i.e., “doing good” as an explicit investment objective).<sup>9</sup> Respondents to a 2018 industry survey, who collectively manage \$239 billion in impact investment assets, invested over \$33 billion into more than 13,000 impact investment projects, primarily in energy, microfinance and financial services.<sup>10</sup> Yet, while sustainability-aligned investment strategies and impact investment assets have increased, they still represent a small portion of overall financial assets (figure III.B.2).

### 3. Private sector development strategies

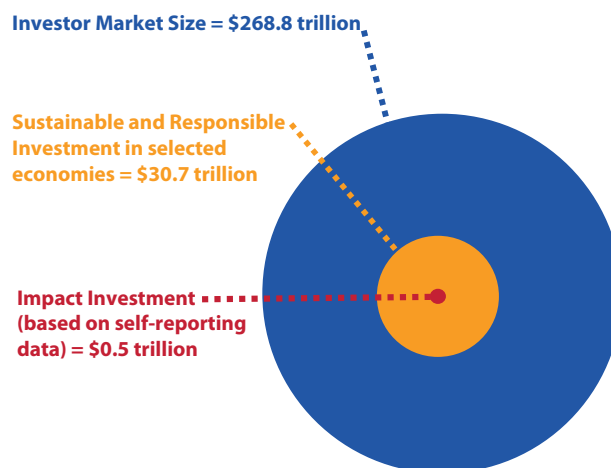
To thrive, private companies need an enabling business environment, including stability, efficient infrastructure services, access to finance, and legal and regulatory frameworks.

#### 3.1 Building a conducive legal and regulatory environment

Countries have made strides to reduce administrative hurdles for companies, as reflected in the falling cost of starting a business (figure III.B.3).

Figure III.B.2

**Market share of sustainable, responsible and impact investment**  
(Trillions of United States dollars)



Source: UN DESA based IFC report on creating impact: the promise of impact investing.

Last year, 115 economies implemented additional regulatory reforms to ease doing business.<sup>11</sup>

Nonetheless, other impediments remain and there is space for improvement in most countries. One such area would be removing barriers that deter women’s entrepreneurship and labour force participation. Laws limit women’s property rights in 40 countries, and women cannot run a business the same way as men in 115 countries.<sup>12</sup> Increasing female labour force participation could lead to economic gains of an estimated 10 to 80 per cent of gross domestic product, depending on the initial value of female labour force participation.<sup>13</sup>

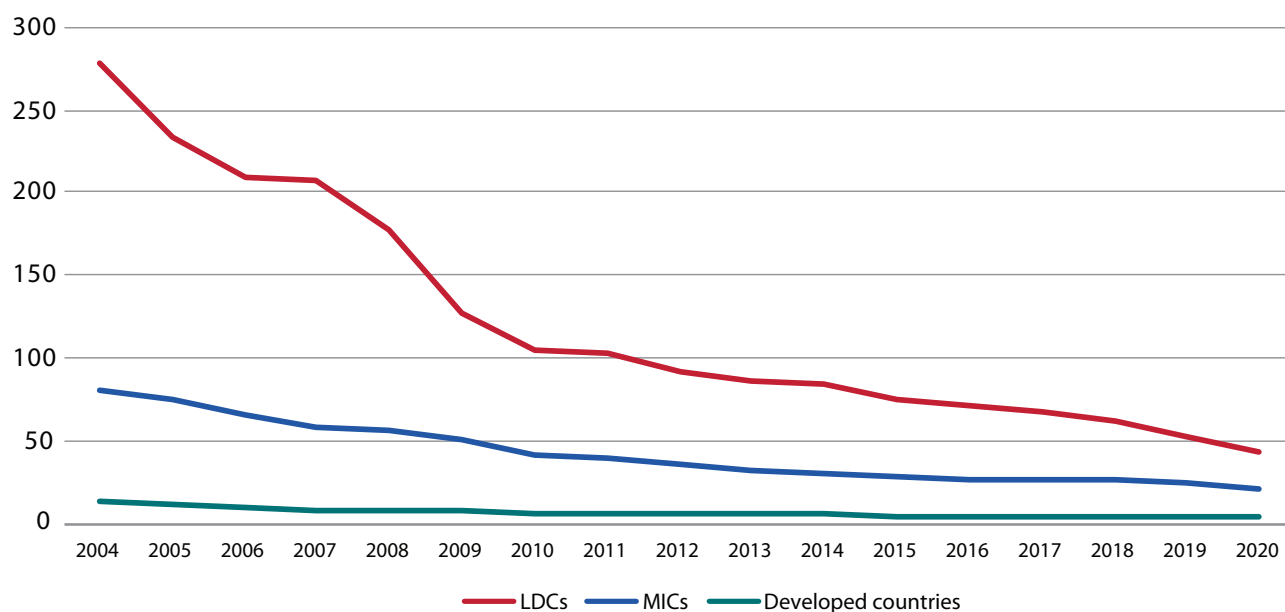
Lowering the administrative burden of regulatory compliance could also help encourage domestic entrepreneurs to leave the informal sector, which represents about 70 per cent of employment in emerging market and developing economies. This could translate into significant productivity gains since the average informal firm in these economies is estimated to be only one-quarter as productive as the average firm operating in the formal sector.<sup>14</sup> By the same token, strengthening trust in the public administration could encourage entrepreneurs to start new businesses in the formal economy.

Policymakers can also improve the efficiency of business facilitation measures. For example, online information portals and single windows have been used to attract foreign investors by making information more transparent. However, the quality of information portals varies. A review conducted in 2017 shows that more than a third of portals contain only the bare minimum amount of information to qualify as business registration portals, and only about 10 per cent of portals contain all (or almost all) the types of information needed in order to register a business or investment.<sup>15</sup>

Business facilitation measures, along with any reduction in regulatory standards, needs to be coherent with sustainable development objectives. To maximize private sector contributions to sustainable development, these measures should go hand in hand with protecting labour rights and



Figure III.B.3

**Cost of starting a business***(Percentage of income per capita)*

**Source:** World Bank, Doing Business database.

environmental and health standards, and disaster risk reduction standards, regulations and legislation, even if these measures may imply increasing the cost of doing business. For example, some countries are strengthening rules against harmful pesticides in agriculture, raising minimum standards in building codes, and establishing new protected areas (e.g., Palau banned commercial fishing in 80 per cent of its marine territory to protect its ecosystem). These laws raise the costs for businesses, but can be necessary to achieve the SDGs, underscoring the importance of developing regulations in an integrated manner (such as through an integrated national financing frameworks (INFF), which includes an analysis on trade-offs). International organizations can support countries in advancing their objectives in these areas. For example, the ILO-IFC Better Work Programme in the garment industry help governments to improve labour laws, suppliers to comply with international standards, and multinationals to become more responsible.<sup>16</sup>

An enabling business environment also requires competition policies to facilitate entrance of new businesses and avoid monopolistic behaviours by dominant firms. Growing market concentration has been greatest in the digital space, where further increase in market power by already dominant firms could deter investment and innovation, as well as exacerbate inequality.<sup>17</sup> Policy measures could include stricter rules for mergers with detrimental impact on competition, for instance when incumbents buy rising competitors (see chapter II).

### 3.2 Providing infrastructure services while leveraging technology

Another lever for policymakers to support private sector development is the provision of efficient infrastructure services, which companies rely on

to operate. Figure III.B.4 shows that the perceived infrastructure quality gap between developed and least developed countries (LDCs) has grown, not shrunk, over time according to surveys of business executives in more than 130 countries.

Well-developed infrastructure plans are needed to address these gaps. They should include adequate stakeholder consultations and incorporate climate impact, disaster risk assessments and resilience, as well as gender assessments in order to provide a long-term vision. This vision will allow countries to avoid having costly stranded assets later on, such as coal-fired power plants, or essential infrastructure assets unable to function during and after natural disasters.<sup>18</sup> Each dollar invested in infrastructure resilience is expected to deliver a \$4 benefit through avoided repairs and disruptions and lower maintenance costs in low- and middle-income countries.<sup>19</sup>

Making the right decision is critical as infrastructure assets typically last for decades and upfront costs should be weighed against operational costs over the asset lifecycle. In fact, infrastructure investment paths compatible with full decarbonization have been found to cost no more than polluting alternatives when accounting for the lifecycle cost of infrastructure assets.<sup>20</sup>

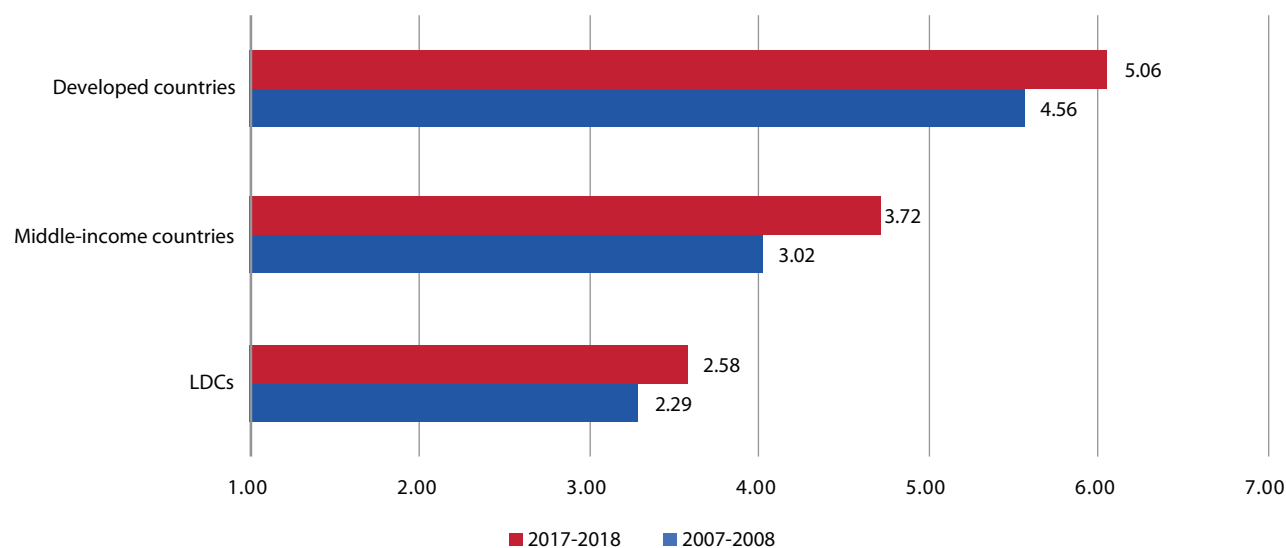
Technological advancements can help project prioritization and planning, for instance, through data analytics and enhanced project management. For example, SOURCE is a customizable software designed to help Governments prepare, procure and implement their infrastructure projects, which is supported by multilateral development banks (MDBs).

Technological change is also influencing the choice of infrastructure by impacting costs. For example, the cost of electricity from solar PV decreased 77 per cent between 2010 and 2018,<sup>21</sup> making clean energy competitive with fossil fuel alternatives, as demonstrated by the vast majority of new electricity-generation projects using renewable-energy sources (more

Figure III.B.4

**Perceptions of infrastructure quality**

(Score 1-7 (best))



Source: UN DESA, based on The World Economic Forum Global Competitiveness Reports (World Economic Forum, 2019).

than ninety per cent for projects with private finance).<sup>22</sup> However, to make solar energy viable in frontier markets, regulatory changes and reforms need to accompany technological advancements. Countries could benefit from international support in this area (e.g., the Scaling Solar initiative from the World Bank Group).<sup>23</sup>

Technology can also enable innovative business models, such as pay-as-you-go systems where a service provider leases equipment (e.g., a solar home system) to a consumer. This allows consumers to pay regular small amounts—via mobile phone, for instance—to obtain access to electricity without having to make a costly upfront investment. It creates a reliable revenue stream for the service provider, and also reduces collection costs (since payments are automated and the system is controlled remotely), which makes it suitable in rural areas.<sup>24</sup> Impact-based business models are also emerging. For example, a firm could improve the energy efficiency of private households and be repaid on-bill through the effective energy savings.<sup>25</sup> This would be a more efficient solution than having individual homeowners figure out what is the most efficient investment to reduce their energy bill. It would also overcome liquidity and credit constraints for households that would not need to put the funds in upfront. Similarly, technology can enable the involvement of private companies in public services delivery (e.g., ridesharing systems in urban areas) (see chapter II). Public policies can, nonetheless, be used to unlock such potential (e.g., tax incentives, urban planning), as well as to manage associated risks (e.g., minimum quality standards, competition policies, information privacy).

Private investment can also be mobilized in large infrastructure projects, for instance through public-private partnerships (PPPs). Structuring these partnerships is complex, however, and requires expertise often lacking in public administration. While PPPs can bring cost-efficient solutions in certain contexts (Financing for Sustainable Development Report 2018), they are often associated with fiscal contingent liabilities, which needs to be properly managed.

Private investment is thus not always the answer to all infrastructure challenges. The public sector still accounts for 87 to 91 per cent of infrastructure investment spending in developing countries.<sup>26</sup> Public investment will continue to dominate infrastructure spending—particularly in sectors with limited cash flow potential to repay the private investor, such as sanitation and education—when affordable access for all has to be provided. While financial engineering can be used to create instruments that attract private investment even in these cases (see section 4 below), it can be cheaper and more efficient to use public finance.

Technical support can help developing countries determine the most cost-effective capital structure (e.g., public versus private financing models) and build institutional capacity for project planning, preparation and negotiation. In addition to existing technical assistance programmes, private sector specialists could offer to support developing countries in building a pipeline of viable projects targeted towards private investors. This could include support from both developed- and developing-country experts, with some of the support possibly through pro bono assistance from a network of infrastructure specialists (e.g., “infrastructure experts without borders” in the same fashion as “tax inspectors without borders”).

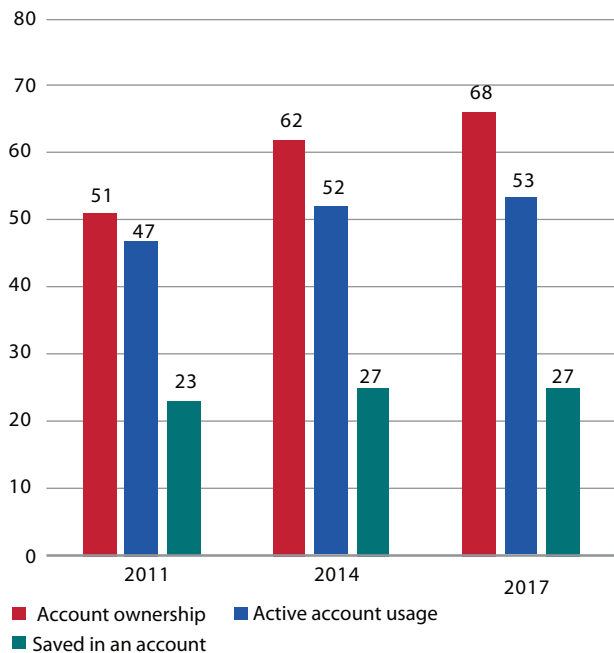
### 3.3 Addressing financial constraints

Without adequate financial services, individuals and companies are unable to fully participate in the economy. In recent years, fintech developments—and particularly mobile money services—have contributed to a rapid increase in account ownership and facilitated financing for micro- small and medium-sized enterprises (MSMEs). Nonetheless, about 1.7 billion adults remain unbanked, and important access gaps persist between men and women, poorer and richer households and rural and urban populations. For example, the financial inclusion gender gap in developing countries remained at 9 percentage points in 2017, unchanged since 2011.<sup>27</sup> Active



account usage, as measured by a minimum of one deposit or withdrawal per year, also increased at a slower rate than account ownership (figure III.B.5).

Figure III.B.5  
**Account ownership and usage, 2011–2017**  
 (Percentage of adults age 15 and above)



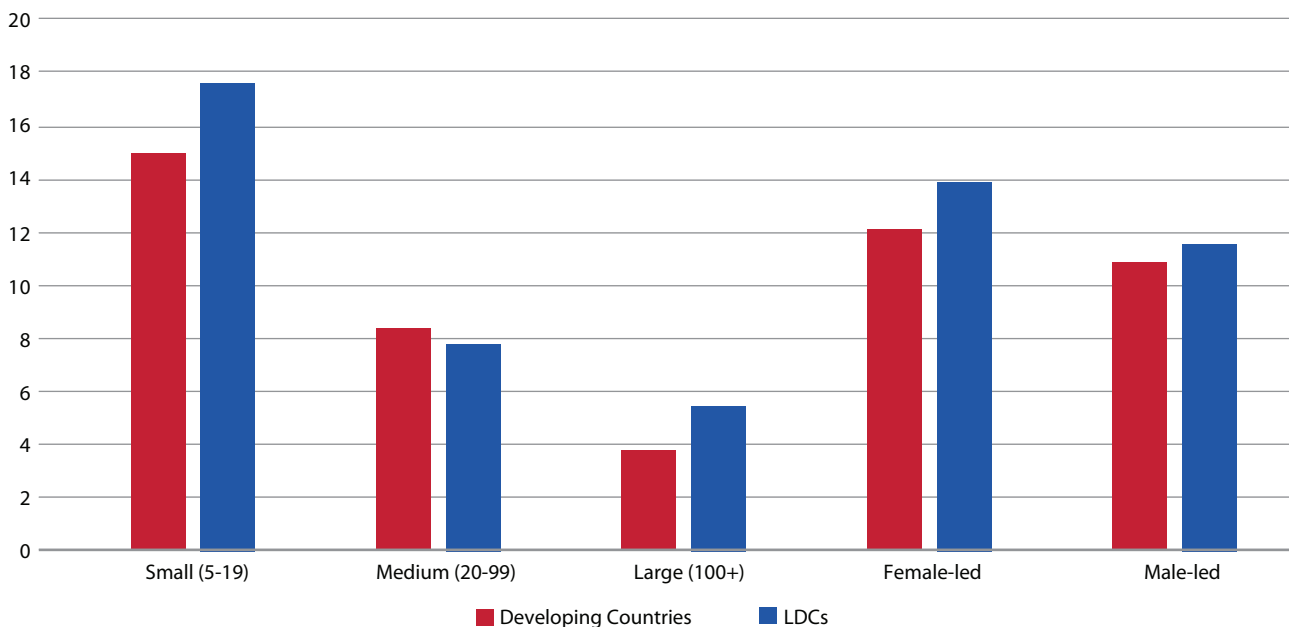
**Source:** World Bank, Global Findex Database.  
 Note: Active account usage means at least one deposit or withdrawal over the past 12 months.

The slow increase in account usage suggests that not all newly opened accounts meet their owners’ needs, be it in terms of affordability, ease of use or effectiveness for routine transactions. It also points to the need for additional enabling factors—particularly in the case of fintech services—such as infrastructure, secure digital identity systems, and digital and financial education. An appropriate regulatory framework is also important, not only for supporting innovation but also to protect the economy against the risk of overindebtedness (for the role of fintech in financial inclusion, see also chapter III.G).

At the same time, about 131 million or 41 per cent of formal MSMEs in developing countries have unmet financing needs.<sup>28</sup> Globally, MSMEs receive less credit, and their loan applications are more frequently rejected than those of large firms (figure III.B.6). A much greater share of MSMEs identifies access to finance as a major constraint in comparison to large firms, and women-owned/led firms are more often affected by financing constraints. These discrepancies are more pronounced in LDCs, where financial sectors tend to be less developed.

Traditional bank lending to MSMEs has long been hindered by a lack of instruments for overcoming asymmetric information, such as credit histories, accounting data and traditional collateral. Another hurdle is the high cost involved in due diligence relative to the size of the loan. In many developing countries, less competitive banking sectors have also played a role, as banks can charge higher prices for services and have fewer incentives to service marginal customers. Financing instruments such as factoring and leasing have gained ground, most likely because they mitigate some of these challenges. For example, leasing allows the lender to retain ownership of the financed good.<sup>29</sup> Some countries have also successfully introduced movable collateral frameworks that enable MSMEs to use their assets (such as equipment and receivables) as non-traditional collateral.<sup>30</sup>

Figure III.B.6  
**Percentage of firms whose recent loan application was rejected, ca. 2013**  
 (Percentages)



**Source:** UN DESA, based on World Bank, Enterprise Surveys.  
 Notes: Data from the most recent survey year was included for each country (between 2006 and 2019, with a mean of 2013). Aggregates are calculated as averages of country data.

## Box III.B.1

## Cost of remittances

Global flows of remittances—mainly wages that migrant workers transfer to their families—are projected to have reached \$707 billion in 2019, a nominal increase of 3.5 per cent from 2018.<sup>a</sup> The average cost of sending \$200 dollars has continued to stagnate at about 7 per cent since the end of 2017 across all regions, well above the 3 per cent target in the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agendas. This has a large impact on receiving families, as each percentage point in transaction costs deprives them of about \$5.5 billion per year.

The costs, however, vary substantially across remittance corridors. According to the World Bank's indicator for the cheapest available transfer options, 60 per cent of all remittance corridors had options costing less than 5 per cent of the transfer amount at the end of 2019. By contrast, the cost of transfers remains particularly high in sub-Saharan Africa, at about 9 per cent on average (figure III.B.7).

Fintech companies, such as mobile operators, systematically charge lower fees than conventional money transfer operators and banks, and have been instrumental in lowering costs in these corridors.<sup>b</sup> Apart from mobile money, blockchain technology could address some of the shortcomings of the traditional payment system, including access, speed of clearing and settlement, and transaction costs; however, issues of compliance with anti-money laundering and countering the financing of terrorism (AML/CFT) regulations still need to be addressed.<sup>c</sup>

The high fee for transfers in some corridors can be related to the cost of compliance with AML/CFT regulations, and in some countries, the loss of correspondent banking relationships. Promoting financial inclusion can help combat the high cost in some countries, as cash remittances can be onerous, in part due to AML/CFT compliance. Many non-bank/fintech solutions rely on banks to meet these regulatory requirements, which limits their use to banked customers. The structure of the remittance market can also keep the cost of remittances stubbornly high—for instance, when exclusivity agreements curb competition and act as a powerful barrier to entry.

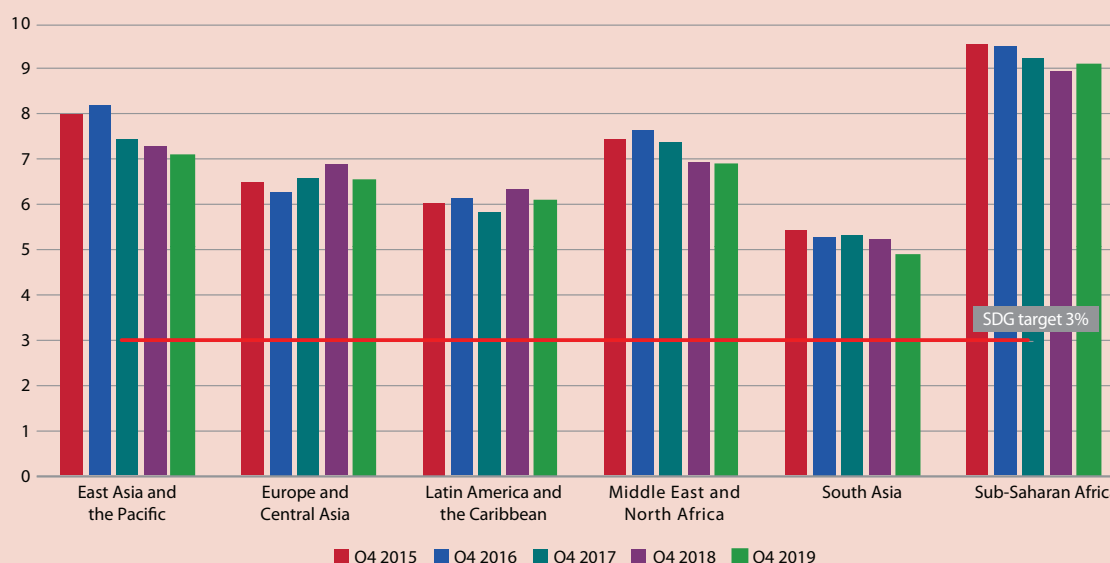
Even when low-cost services are already present in a country, there are other aspects that impede people from adhering to them, including accessibility, awareness, literacy and trust. Countries face different challenges, ranging from poor information and communications technology infrastructure to a strong cash culture, which calls for policy responses tailored to each country-specific context (see chapters II and III.G).

Continued work is needed at the global level to agree on common standards and improve information sharing (including digital IDs) to facilitate compliance with AML/CFT regulations for cross-border payments and counter the decline in the number of correspondent banking relationships, which has had a significant impact on remittance service providers' ability to access banking services.

Figure III.B.1.1

## Average total cost for sending \$200, by region, 2015–2019

(Percentage)



Source: World Bank, Remittance Prices Worldwide.

<sup>a</sup> Dilip Ratha and others, "Data release: Remittances to low- and middle-income countries on track to reach \$551 billion in 2019 and \$597 billion by 2021", World Bank, (Washington D.C., World Bank, October 16, 2019).

<sup>b</sup> Hongjoo Hahm, Tientip Subhanij and Rui Almeida, "Finteching Remittances in Paradise: A Path to Sustainable Development", Working Paper ESCAP/MPFD/WP/19/08 (October 2019).

<sup>c</sup> OECD, "Can blockchain technology reduce the cost of remittances?" (Paris, forthcoming).

More recently, fintech solutions offer promise in helping MSMEs overcome the financing gap, through the use of greater access to data for credit risk evaluations, peer-to-peer lending and crowd-funding platforms, supply chain financing, and non-cash merchant payments (see chapter III.G). The use of such services can also create positive feedback loops, as electronic transaction histories can strengthen the information base for risks assessments and better credit ratings can unlock access to additional services.<sup>31</sup>

Governments can identify gaps and implement a coherent set of policies to promote solutions that improve financial services to underserved individuals and companies through national financial inclusion strategies, as part of integrated national financing frameworks. Such financial inclusion strategies have been adopted or are being developed by at least 69 countries.<sup>32</sup> Some countries have begun to review past progress and implementation gaps to adjust their strategies to new developments, including fintech. The international community should help countries in developing these strategies.<sup>33</sup>

### 3.4 Entrepreneurship and investment promotion

Policymakers can also take a more active role to support private sector development. Governments can, for instance, help stimulate entrepreneurship by sponsoring incubators in universities, granting seed capital to start-ups and providing technical support to entrepreneurs.<sup>34</sup> For example, the United Nations Conference on Trade and Development (UNCTAD) has provided training to entrepreneurs and MSMEs through its Empretec capacity-building programme.

Governments have also used investment promotion agencies or industrial parks and special economic zones (SEZs) to attract foreign direct investment. There are currently 5,400 zones across 147 economies.<sup>35</sup> Most zones offer tax incentives and business-friendly regulations regarding land access, permits and licenses or employment rules. However, results have been mixed. Only about half of investment promotion agencies worldwide believe the zones in their country have given a significant boost to FDI attraction, and few countries systematically assess the performance and impact of SEZs.<sup>36</sup>

At the same time, new types of SEZs are emerging, including ones that focus on new industries, such as high-tech, that move beyond trade- and labour-intensive manufacturing activities of traditional SEZs.<sup>37</sup> These zones can create linkages between firms to help stimulate technological development and local innovative capacities. There is also a case for building SDG model zones to attract investment in SDG-relevant activities, promote linkages with domestic activities and advocate for high ESG standards. For instance, fiscal incentives can be conditional not only on employment, investment or export performance, but also on social and environmental indicators.<sup>38</sup> This requires being able to assess the sustainability characteristics of FDI—for instance, through country-specific sustainability indicators that can help Governments prioritizing FDI into key SDG sectors.<sup>39</sup> FDI promotions policies should not be considered in isolation but in the context of broader strategies regarding sustainable development and, in particular, innovation (see chapter II).

## 4. Financial instruments to mobilize private finance

An enabling business environment may not be sufficient to mobilize private finance for sustainable development. Reforms may take time

to materialize, but even countries with strong enabling business environments often fail to attract private finance to sustainable development priorities. There are a range of reasons for this, including the following:

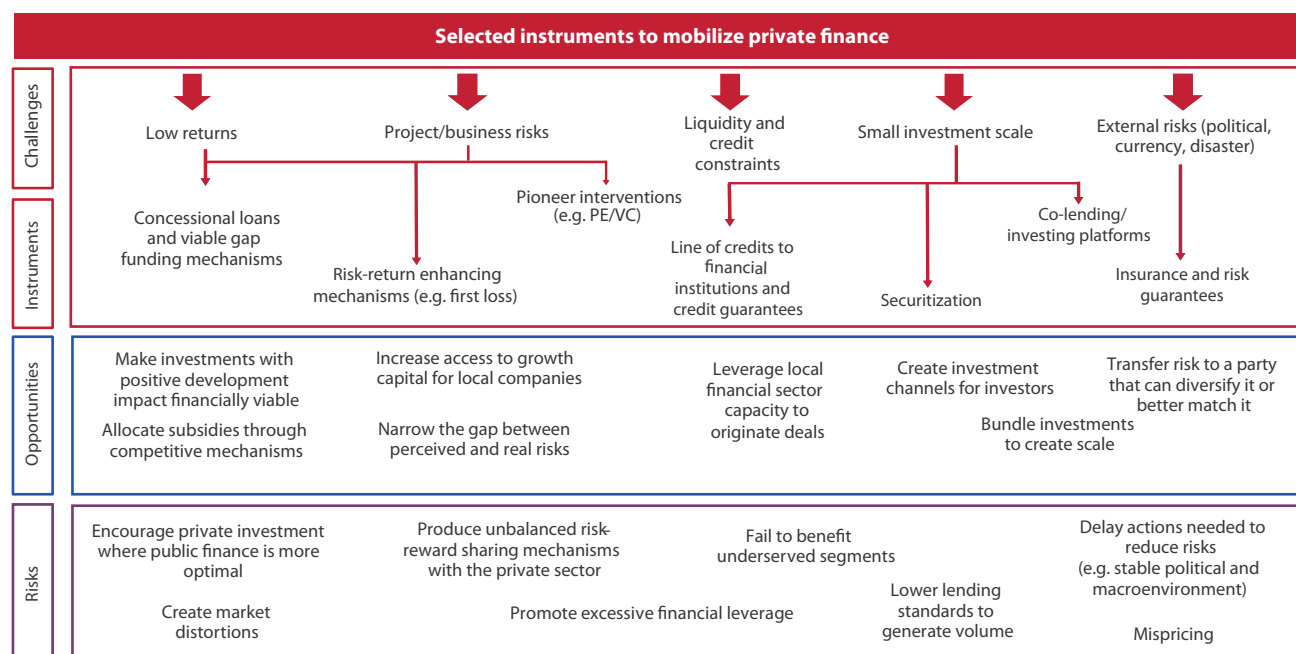
- **Low expected returns.** Despite having positive development impacts and social benefits (e.g., affordable energy or water for all), some investments (which might be profitable) might not be lucrative enough to attract private finance on commercial terms;
- **High project/business/micro risks.** Entrepreneurs and companies may struggle to attract the risk capital they need to grow, for instance if there is no established market for equity financing;
- **Liquidity and credit constraints.** Such constraints can impede lending and limit investment, particularly when local financial institutions are relatively underdeveloped;
- **Small scale.** Large investors require scale to invest as transaction costs on smaller deals can become prohibitive, while many investment opportunities are small by nature (e.g., MSMEs);
- **External/macro risks.** Investors are particularly wary of risks they cannot quantify and/or control. These include political risk and policy changes affecting project viability, volatility of local currencies, or climate-related catastrophes.

Governments have a range of instruments to help solve some of these challenges when financial markets do not provide solutions on their own. Unlike policies which reduce risks (e.g., strengthening the enabling environment discussed above), these instruments tend to share risks between the public and private sectors. However, such public involvement is not without challenges, which have been discussed in earlier reports of the Inter-agency Task Force. Among others, they include risks of (i) private sector involvement when it is not the most cost-efficient solution; (ii) perverse incentives, such as excessive risk-taking by financial institutions; (iii) overly generous risk-reward sharing arrangements/subsidies for private investors, with the risk of the public sector holding the risk and the private sector earning all of the returns (and sometimes diverting public funds from other needs); (iv) overleveraging of private companies (i.e., increasing the debt leverage of a company to a point where it jeopardizes its long-term viability).

Figure III.B.7 lays out instruments that can tackle the challenges, and some of the risks and opportunities linked to them. The figure includes three general types of instruments, those that (i) boost financial returns for investment with positive externalities; (ii) increase the supply of financing (either directly or through financial institutions); and (iii) manage risks through diversified portfolio approaches. These interventions can be warranted to kick-start markets and create investment opportunities with risk-return characteristics that meet different investor requirements.<sup>40</sup> In each area, policymakers need to understand the existing constraints; the tools available; and the risks, opportunities, and trade-offs within the local context. This assessment could be done when countries are developing integrated national financing frameworks (see also chapter III.C for blended finance principles). Opportunities and challenges associated with each of the instruments used to mobilize private finance for sustainable development are further developed in this section.

Figure III.B.7

## Schematic overview of instruments to mobilize private finance



Source: UN DESA.

#### 4.1 Concessional loans and grant co-financing

Subsidized lending is often used to reach underserved market segments. It can also promote pioneering projects that aim to help create markets, with temporary assistance. For example, microfinance firms generally depend on subsidies to cover the difference between the cost of providing services and the revenues generated. While the subsidies are often temporary for pioneer projects, they may be more long term in nature in other cases. A review of more than a thousand microfinance institutions found that such subsidies represent, on average, 13 cents per dollar loaned, and tend to be enduring rather than being phased out over time.<sup>41</sup>

Assessing the level of concessionality required to attract the private partner is more of an art than a science. The availability of subsidies should not undermine policy efforts to make lending to underserved segment more self-sustainable. In addition, beyond a certain level of subsidy, pure public finance is likely to be more efficient than trying to mobilize private finance by any means. When subsidies are used, they should be just sufficient to induce private actors to participate in high-value activities. One way to address this is to make grants part of a bidding process. For example, viability gap funding mechanisms have been created in infrastructure sectors to make projects financially attractive without raising user fees beyond affordability limits. In these mechanisms, the eligible private sector bidder requiring the lowest subsidy is selected. Other mechanisms to assure efficient subsidy allocation are programmatic approaches (predefined programmes in a segment open to all applicants at preset fees), and negotiations under strong governance (e.g., separate teams managing concessional funds and benchmarking levels of concessionality compared to projects in similar industries and countries).

#### 4.2 Private equity and venture capital

Capital markets are a key source of equity financing but remain underdeveloped in many countries and mostly inaccessible to smaller businesses. Private equity and venture capital (PE/VC),<sup>42</sup> are important sources of funds for entrepreneurs and promising companies (which otherwise often rely on friends and family for initial capital). PE/VC fund managers make direct investment in unlisted companies, with the aim of bringing capital, technical and managerial expertise to raise the firm's value and make a profit at the exit (e.g., by selling the company to another industry player after a few years).

These markets also remain underdeveloped in many countries. For example, in Africa, about half of respondents to an industry survey indicated the limited number of established fund managers as a deterrent to investment.<sup>43</sup> When these markets do not develop on their own, development finance institutions can catalyse market creation. For instance, they can strengthen the local PE/VC ecosystem through pioneer interventions and help link private investors with companies seeking growth capital.

The potential is considerable. Globally, private equity funds hold about \$2 trillion in cash, which is more than twice the 2012 level.<sup>44</sup> While the amount invested in emerging markets almost doubled between 2015 and 2018 to reach \$70 billion, it still represents only a fifth of investment made in the United States of America alone (i.e., \$375 billion), and is mainly directed to a few large economies, such as Brazil, China, India and South Africa. PE/VC investment level is particularly low in Africa, where only \$2.5 billion has been invested annually over the last five years.<sup>45</sup>

While PE/VC investors may be interested in looking outside traditional markets for more attractive returns, to date, high perceived risks in developing countries have impeded investment. Development finance

institutions can help in these cases. They can accompany investors in more challenging markets and strengthen their collaboration at the country level to remove barriers to private investment.<sup>46</sup>

Public authorities might also be willing to co-invest in privately managed PE/VC funds to support the local economy and job creation or other public goods. If the objective is to support innovative business models, the right instrument is equity financing through a diversified portfolio. Unlike grants or subsidized loans, equity financing allows the public to capture the upside potential, which could then be reinvested in public goods. While some of the businesses seeking investment may ultimately fail, the gains from a few winners should compensate the failures of the losers. Indeed, this is the model that VC firms and other fund managers have used profitably for many years.

When the perceived risk is disproportionate vis-a-vis the expected returns, public returns can be subordinated to private returns in co-investment schemes as a way to attract private investment while still benefiting from potential upsides (see box III.B.2).<sup>47</sup> More innovative models could also be tested. For example, public money could be used to make equity investment in firms that generate positive externalities (e.g., quality jobs) but fail to attract private investors. Such investment could be structured to cap the entrepreneur's upside, so that entrepreneurs will not use public money unless they really need it.<sup>48</sup>

Nonetheless, finding the appropriate risk-reward sharing mechanism is difficult, and so is finding the right size of public intervention. One objective is to keep the interests of all investors and the fund manager aligned. Another is to avoid creating market distortion—for instance, for other investors who might not benefit from this kind of risk-reward mechanism. This requires transparency and monitoring systems in place to assess the results of public support mechanisms, as well as innovative mechanisms, such as the bidding process discussed above.

Another risk associated with private equity has been the intensive use of debt leverage to enhance investment returns. Although the lower access to debt finance in most developing countries mitigates such risk, the use of leverage should be monitored, since excessive risk could make companies less resilient to economic downturns and also have systemic implications.

### Box III.B.2 Ontario Venture Capital Fund

In 2008, the Government of Ontario in Canada decided to revive its venture capital ecosystems that had suffered from poor returns. To do so, a joint initiative was launched with institutional investors. A fund of funds managed by a third-party investor was created to invest in local venture capital and growth equity funds. The public sector invested \$90 million, while institutional investors contributed \$115 million. The Government agreed that its capital would be “first in, but the last out”. This meant that public money was invested first. Returns from realized investments were first distributed to private investors until a predefined return rate was achieved. Any returns above that level of returns were shared between the public and private investors. The subordination of government capital made the proposal attractive for private investors. The initiative created a funding source for a new generation of venture capital managers in Canada, while generating returns for both private and public investors. Similar structures could be considered in developing countries.

## 4.3 Line of credit to financial institutions and credit guarantees

Private finance can also be constrained by the lack of liquidity of local financial institutions. To address this constraint, development banks provide these institutions dedicated credit lines for on-lending. These lines of credits can be accompanied by credit guarantees that partly cover local banks against losses on loans targeting underserved market segments. Governments and development partners have widely used these instruments to spur lending to MSMEs and sustainable activities (e.g., green investment) through local partners with greater local knowledge. In 2017, intervention in the banking and financial services sector, primarily through guarantees and credit lines, represented roughly 30 per cent of all private finance mobilized through official development finance interventions (see box III.B.3).<sup>49</sup>

Development financing institutions have begun to examine the impact of lines of credit, although limited data on sustainable development impact makes this difficult to assess. There are several risks which could impact the effectiveness of this type of instrument. First, local financial institutions could gain from cheaper funding, but not change their lending practices. Second, the mechanism could crowd out other sources of domestic finance. Third, it could create macroeconomic imbalances or overindebtedness, especially when the lending is in foreign currency.

Precautions thus need to be taken. First, development finance institutions need to ensure that sufficient information is available on the final beneficiaries of these credit lines (i.e., borrowers from the local banks), for instance by requiring appropriate reporting from these banks. Second, the additionality of credit lines needs to be carefully monitored and assessed to ensure that development bank interventions are contributing to better access to finance for targeted segments and not merely replacing what local financial institutions would have done anyway. A reward system could be introduced to address such risk. For example, the Affirmative Finance Action for Women in Africa (AFAWA) initiative from the African Development Bank offers preferential terms to institutions performing well on predefined objectives regarding women's access to financing. Third, development banks should provide credit lines in local currencies whenever possible and ensure that credit lines do not result in foreign currency risks been passed on to MSMEs with no capacity to manage them. Finally, credit line effectiveness also depends on complementary measures that make MSME lending sustainable in the long run. These measures include regulatory reforms to improve information on borrower creditworthiness. This last area is changing dramatically due to advances in fintech (see chapter III.G).

## 4.4 Co-lending / investing platforms

While some investments are best met by local institutions, institutional investors, such as pension funds and insurance companies, hold trillions of dollars in assets that could support the long-term investments needed for sustainable development, particularly investments with positive cash flows to repay the investors. However, one of the challenges in mobilizing these investors is the lack of scale in many projects, especially in smaller countries. Most institutional investors cannot afford to spend resources on screening small transactions. Financial instruments that bundle smaller deals together could help provide a solution. Another solution would be to strengthen collaboration between global and local institutional investors.



### Box III.B.3

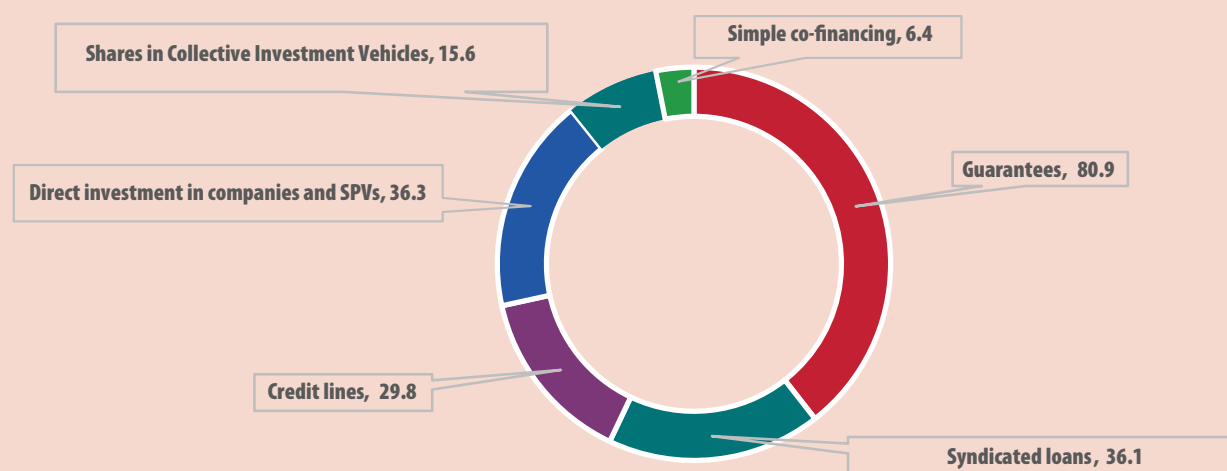
#### Amounts mobilized from the private sector

Recent data from the Organization for Economic Cooperation and Development (OECD) highlight that the amounts mobilized from the private sector by bilateral and multilateral development finance providers reached \$48.4 billion in 2018, representing a 28 per cent increase compared to 2017. These include the amount mobilized by both concessional and non-concessional official development finance interventions. Fifty-five per cent of the amounts mobilized targeted energy and banking sectors, while only 5.6 per cent went to projects in social sectors.<sup>a</sup> Guarantees play a significant role, representing 39.5 per cent of the private finance mobilized for development during 2012–2018. Figure III.B.3.1 also shows the relative importance of each type of instrument.

Figure III.B.3.1

#### Amount mobilized from the private sector by instrument (2012–2018)

(Percentage)



Source: OECD.

Note: Technical assistance is not included, but work is ongoing to capture private finance mobilized through this instrument.

In an effort to enhance transparency and accountability, 27 multilateral development banks (MDBs) and development finance institutions (DFIs) have also reported yearly on their respective mobilization data of private capital since 2016. These institutions follow a common methodology to calculate and jointly report the private capital mobilized in their project activities. The latest report on 2018 data indicates that in low- and middle-income countries, MDBs and DFIs reported over \$69 billion in total private mobilization, a 4 per cent increase in total private mobilization for low-income countries over 2017.<sup>b</sup>

<sup>a</sup> OECD, “Amounts mobilized from the private sector by official development finance interventions in 2017–2018” (January 2020).

<sup>b</sup> MDB Task Force on Mobilization, “Mobilization of private finance by MDBs and DFIs 2018” (August 2019).

Development finance institutions have tools to help investors and banks achieve volume while reducing transaction costs. For instance, MDBs have operated syndicated-loan programmes for decades, which allow financiers, such as international banks, to participate in MDB loans and benefit from the preferred creditor advantage of MDBs. More recently, the IFC has created the Managed Co-Lending Portfolio Program (MCP) that serves as a syndication platform and creates diversified portfolios of emerging market private sector loans. As of 2018, the MCP has raised \$7 billion from eight global investors. The MCP Infrastructure facility—which offers one solution to channel more funding into emerging market infrastructure while demonstrating a path for other investors to follow—allows investors to gain exposure in these markets by co-lending to a portfolio of companies alongside the IFC on commercial terms, while their risk is mitigated through a first loss tranche.<sup>50</sup> SDG500 is another investment

platform launched in 2020 by a coalition of private and public sector organizations, including United Nations entities, which will use debt and equity to bridge the financing gap of businesses in emerging and frontier markets. The platform comprises six funds; each of them will include a catalytic first-loss layer.

#### 4.5 Securitization

Securitization is another way of bundling deals. In these structures, a bank sells a portfolio of loans to investors by issuing a security. In essence, the bank is selling part of its balance sheet of loans to investors. This allows the issuing banks to free up space on its balance sheet, increasing their lending capacity. Such bundling makes use of diversification by combining different assets with idiosyncratic risks. Typically, securitized assets are



also structured in tranches with different risk-reward characteristics to appeal to a diverse range of investors.

Securitization has been a tool to increase lending in the housing market in the United States since the early 1980s. In 2019, the market reached about \$1 trillion, including auto loans, student loans, and SME loans. China is the second largest securitization market with the total value of issuance at about \$300 billion in 2019.<sup>51</sup> MDBs have also entered this field. In 2018, the African Development Bank used synthetic securitization<sup>52</sup> to transfer the credit risks of a portfolio of \$1 billion loans on its balance sheet to a group of investors (see chapter III.C).<sup>53</sup>

Nonetheless, securitization is not without risk as demonstrated by the 2008 financial crisis. For example, for securitization of many small SME loans to be successful, there should be ample diversification. In the lead up to the global financial crisis, many sub-prime mortgage-backed securities were issued with highly correlated loans, so that in an event of a downturn it was likely that most homeowners would default at the same time (which is what happened). Banks also lowered their lending standards, and in some cases, banks sold off their worst performing loans (since investors had more limited information).

Securitizations can be structured to overcome some of these risks, but countries need regulatory and supervisory capacity to issue such instruments effectively. For example, to ensure banks carry out proper diligence in originating loans, they should keep “skin in the game” (i.e., they need to keep a percentage of the loans on their books).

The country context also matters. Securitization is easier when capital markets are developed. It also looks more promising in countries where banks

have large diversified SME lending, which could benefit from securitization to expand their lending capacity. In contrast, securitization is of little use to banks with ample liquidity. A wider application of such financial engineering in developing countries, including risks, warrants more research.

#### 4.6 Insurance and risk guarantees

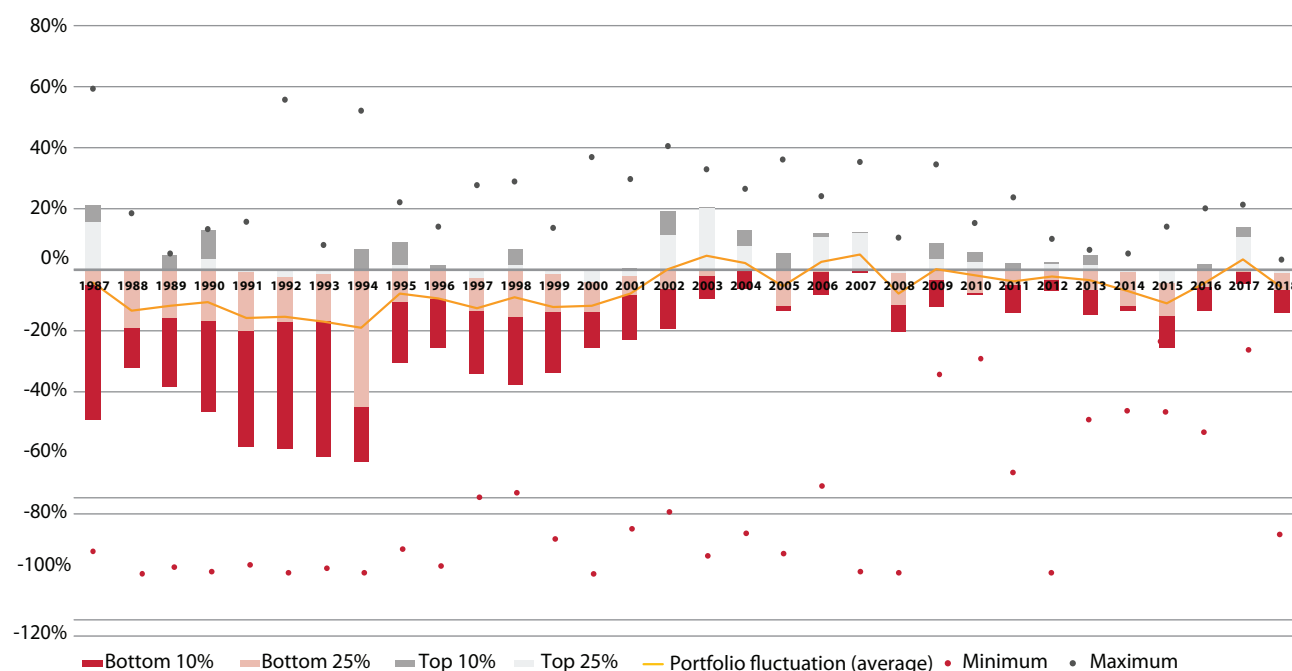
Investors might be reluctant to invest if certain risks are deemed too high and cannot be properly managed. Insurance and guarantees can provide a solution by enabling the transfer of risk to entities that are better equipped to hold that risk, such as foreign investors or institutions holding diversified portfolios (for example, across several countries or currencies)—any one loss would be compensated by returns on other investments. The following examples illustrate the benefits of diversification at an international level and suggest avenues to further develop instruments:

- **Political risks insurance.** Political risk insurance has long existed to protect private investors from expropriation risks, breach of contract or currency transfer restrictions. Export credit agencies and development institutions, such as MIGA, which are large providers of political risk insurance, can better manage these risks than individual investors since they have a diversified portfolio of political risk across countries. MIGA and other public insurance providers may also be in a better position to resolve potential disputes than private providers, given their relationship with local governments. Demand for political risk insurance is strong. MIGA’s gross exposure almost tripled between 2009 and 2018. To boost MIGA’s capacity, the use of private reinsurance, in which MIGA sells part of its portfolio to a private insurer, could be

Figure III.B.8

#### Annual fluctuation vis-à-vis US dollar of individual currencies versus a portfolio of currencies

(Percentage)



Source: Currency Exchange Fund (TCX).

expanded so MIGA could recycle its capital for more projects. Standardizing contracts and processes could facilitate the sale of political risk at a portfolio level instead of a project-by-project level. Indeed, it is much more complex to pool contracts with different terms and conditions.<sup>54</sup> Another solution to increasing MIGA's capacity is to allocate concessional resources to support MIGA in advancing risk insurance in countries where it has reached exposure limits,<sup>55</sup> but such use of concessional resources needs to be weighed against other uses;

- **Currency hedging instruments.** When companies with domestic revenues borrow in dollars or other external currencies, they are subject to currency risk (i.e., they are exposed to losses if the local currency devaluates). This situation typically arises in markets where local currency financing is not affordable or available at required volume and maturities, and where hedging instruments do not exist or are prohibitively expensive. In the medium term, the solution is to develop liquid capital markets. In the near term, a broader array of risk management tools can be used. In particular, diversification across a basket of currencies considerably reduces volatility on a portfolio level (figure III.B.8) and has proven to be a powerful tool for currency risk management. There are several mechanisms funded by donors based on this principle, including the currency exchange fund (TCX) and the Local Currency Facility (LCF). As multilateral development banks lend across countries, it could be possible for them to increase lending in local currencies by managing local currency risk through diversification, or by offloading the currency risk to a reinsurance/international vehicle. This was noted in the Addis Agenda, in which Member States of the United Nations “encourage development banks to make use of all risk management tools, including through diversification”;
- **Disaster risk insurance.** Natural hazards pose another risk to investment. An important instrument for managing this risk is through insurance, which mutualizes it across locations and types of events, again making use of diversification for risk management. Insurers can lay off some of this risk through capital market instruments (i.e., catastrophe bonds), thus freeing up capital for additional underwriting. Nonetheless, disaster risk insurance faces challenges, as both risks and losses are often difficult to evaluate, especially as climate change is altering the frequency, variability and impact of weather-related disasters. Disaster risk insurance never fully covers the losses from disasters. Of particular concern, frequent losses from small-scale and localized disasters do not cross certain parameters while they erode the capital assets and resilience of businesses and communities. Digitalization and the growing availability of data is helping insurers better understand and price disaster risk, which has led to insurance products being offered in areas that were not covered before. In addition, index insurance products, which provide a pre-agreed sum in case specified parameters are met, such as a drought, can be cheaper to operate as there is no need to estimate the actual loss. For example, these can be used to protect small-scale farmers against losses from extreme weather. However, setting the parameters correctly remains challenging. There are cases where companies that buy insurance are not covered during a catastrophic event because certain triggers are not activated. In addition, the products can be expensive and not well understood by consumers. As a result, their uptake has been slow, despite substantial public support.<sup>56</sup> Regulators can try to build trust through consumer protection and information regarding insurance coverage.

However, the low uptake and the need for scale raise questions as to whether this is the optimal approach, and whether public authorities should provide protection to targeted groups (e.g., farmers). In addition, there is also a risk that with greater digitalization and forecasting precision, regions and sectors most at risk will be priced out of insurance markets, and only those with low or moderate risk will be able to find coverage. International cooperation and public intervention may be necessary to make sure these regions and sectors are not excluded from the insurance market and can attract investment (see chapters II and III.C). Alone, disaster risk insurance is not sufficient to counter the full loss due to disasters. To be effective, disaster risk insurance must incentivize disaster risk reducing behaviour in the private sector and include provisions to ensure companies build better from the start and build back better after a disaster. Moreover, disaster risk insurance must be part of a larger disaster risk reduction financing strategy (see chapters III.A and III.C).

## 5. Sustainable corporate practices and financial systems

Unlocking private business and investment is a necessary condition for achieving sustainable development, but unless private business practices become more sustainable, progress towards the global goals will fall short.

There are several reasons why business leaders can no longer ignore sustainability issues:

- **Operational risk.** Sustainability issues can affect companies' operation. For example, frequent and more severe climate hazards alter firms' productivity, disrupt supply chains and destroy infrastructure. Similarly, water is fundamental to many businesses (e.g., to cool or clean or as an ingredient) and shortages can severely impact business operation;
- **Changing regulatory environment.** Companies anticipate future policy changes that will discourage unsustainable practices—for instance, through pricing carbon emissions or putting a higher price tag on waste production;
- **Market opportunities.** Companies not embracing sustainability might miss business opportunities linked to the SDGs (e.g., affordable housing) or changing consumer demand. For example, since 2013 sustainability marketed products have grown 5.6 times faster than conventional products in the US consumer-packaged goods market.<sup>57</sup> Digitalization could also make information about products and suppliers more accessible to citizens, giving them the tools to consider SDG impacts in their purchasing decisions;<sup>58</sup>
- **Reputational risk.** Sustainability scandals, which can be inflated by social media, could hurt a brand's reputation and performance in some sectors (e.g., consumer products). Technology advancement is also making information about corporate practices more accessible and transparent (see box III.B.4).

Individual investors and financiers also realize that the performance of the companies they finance depends in part on how these companies deal with sustainability issues. More individual investors are expressing interest in sustainable investing practices (from 71 per cent in 2015 to 85 per cent in 2019, in one survey).<sup>59</sup> Financiers are increasingly divesting from

companies that are at odds with some of the SDGs. For example, a group of institutional investors representing nearly \$4 trillion of assets under management—the UN-convened Net-Zero Asset Owner Alliance, committed to transitioning their investment portfolios to net-zero greenhouse gas (GHG) emissions by 2050. In the banking sector, 130 banks from 49 countries have committed, through the Principles for Responsible Banking launched in 2019, to work with their clients to encourage sustainable practices.

Yet, the private sector transformation is not happening fast enough nor at the required scale. Such a transformation will require (i) rethinking corporate governance; (ii) raising public policy ambitions; and (iii) making financial system a force for change.

## 5.1 Rethinking corporate governance

Some business leaders have started to rethink their fundamental approach to business. In 2019, CEOs of almost 200 firms, representing nearly 30 per cent of US market capitalization, redefined the purpose of a corporation away from a sole focus on shareholders to include all stakeholders—customers, employees, suppliers, communities and shareholders—based on the idea that each stakeholder is essential to a company’s long-term success.<sup>60</sup> Many companies have also joined initiatives to improve the sustainability of their industry (e.g., the Fashion Industry Charter for Climate Action launched in 2018 and the Getting to Zero Coalition in the maritime shipping sector launched in 2019).

These are important developments, but they alone are unlikely to alter corporate behaviour sufficiently, particularly in the absence of proper accountability mechanisms and change in corporate governance (and internal incentives). To give teeth to the shift in focus from “shareholder to stakeholder”, corporate boards should issue a statement of purpose that recognize their different stakeholders, and put mechanisms in place to oversee the implementation of this statement of purpose.<sup>61</sup> This is similar to the model followed by Certified B Corporations which have been adopted by about 3,000 companies in 64 countries.<sup>62</sup> Media and non-governmental organizations (NGOs) have a critical role to play in monitoring and ensuring that industry commitments deliver results.

Sustainability issues should be discussed at the board level and be part of Director duties.<sup>63</sup> Yet, only 22 per cent of executives believe that their own boards properly oversee these issues.<sup>64</sup> The need to require corporate boards to develop and disclose a sustainability strategy, including measurable targets, is currently being assessed in the European Union (EU).<sup>65</sup> The Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD) already recommends the disclosure of the board oversight and management role in relation to climate-related financial risks and opportunities. Active shareholders have also put pressure on management to consider ESG issues by filing proposals for the annual general meeting and through proxy votes. For example, the median support for environmental and social shareholder proposals increased from 6 to 30 per cent between 2000 and 2019.<sup>66</sup> However, the United States Securities and Exchange Commission (SEC) revision on the rules on shareholder proposals (e.g., by significantly increasing the portion of the vote a proposal must receive to be resubmitted in subsequent years) could have the effect of making this more difficult.<sup>67</sup>

Corporate incentives should also be adjusted. For example, an estimated 71 of the 3,000 largest US-traded stocks include some form of

ESG-related performance goals, such as GHG emission targets, in their executives’ pay.<sup>68</sup> This should be further promoted, for instance, by sustainability-oriented investors or shareholders of state-owned entities who could request companies they invest in to lead the way.

## 5.2 Raising policy ambitions

Public policies are key to providing incentives for companies to align their businesses with sustainable development objectives. There are already some positive developments: for instance, the number of carbon-pricing initiatives continues to increase, now covering about 20 per cent of GHG emissions. However, in most cases, the price levels remain too low to change behaviour (less than 5 per cent of the global emissions are priced at a level compatible with the goals of the Paris Agreement) and there has been public pushback against certain initiatives, such as increases in gas prices.<sup>69</sup> A carbon price would create a level playing field so that companies that do take carbon goals into account would not be penalized with lower financial returns in the short run. It would also provide incentives to adopt and develop low carbon technologies without being prescriptive about particular technologies. In 2019, at COP25 in Madrid, 631 investors managing over \$37 trillion called on Governments to put a meaningful price on carbon.<sup>70</sup> In cases where carbon prices might be politically difficult, policymakers should consider offsetting instruments (e.g., distributing part of the revenues). At the same time, carbon pricing should be complemented by additional measures.

Policymakers can use regulation—such as labour standards, minimum wages, disaster risk reduction and environmental norms—to incentivize companies’ alignment with the SDGs. For example, legislation to regulate the use of plastic bags (put into place by 127 countries since the early 2000s) have triggered a rethinking in the packaging industry and a more circular economy.<sup>71</sup> Similarly, government leadership is needed to ensure, for instance, that human rights are upheld in the context of business activities, including by passing and enforcing legislation to protect workers and affected communities. However, the Corporate Human Rights Benchmark, which assesses 200 of the largest publicly traded companies, underlines that the current level of compliance is distressing, as more than half of the benchmarked companies score less than 20 per cent on a set of human rights indicators.<sup>72</sup>

Overall, the level of policy ambition will determine the private sector’s response. Companies may not modify their practices if they are not convinced that Governments will take the required actions to achieve the global goals.

## 5.3 Making financial systems a force for change

Financial systems can accelerate the private sector transformation towards more sustainability if they are long-term oriented. To date, investors have primarily been interested in sustainability issues for their impact on financial returns. However, those who want their money to also do good in the world, also need to know the answer to this question: what is the impact of investing on the SDGs?

### 5.3.1 Sustainable development investing definition

There are a wide range of investment strategies used by portfolio managers, with different impacts and levels of sustainability, under the heading of “sustainable investments”. This creates confusion.

A common definition of Sustainable Development Investing (SDI) could help establish norms that differentiate investment strategies and define minimum thresholds that investment strategies and products should meet to qualify as SDG-aligned.

Without a common understanding, there is a risk that financial products and strategies are presented as sustainable without making a meaningful contribution to the achievement of the Goals (i.e., so-called green- and SDG-washing). For example, some “sustainable” funds include tobacco or fossil-fuel companies, based on their relatively good ESG performance compared to industry peers, while their impact on sustainable development is at least questionable. A set of common norms could counter the risk of SDG washing and misleading investment products that use sustainable development as a marketing tool.

For example, the CEO-led Global Investors for Sustainable Development Alliance, convened by the United Nations Secretary-General, has been working on developing such a definition, building on the spectrum of existing investment strategies while respecting existing definitions of impact investing (figure III.B.9).

Figure III.B.9 shows a range of investment strategies that go beyond impact investing, which has “doing good” as an explicit investment objective, and includes strategies focused on financial return maximization that still align portfolios with the SDGs. It separates strategies likely to create positive change from those that are designed only to do no harm (e.g., negative screening) or mitigate investor risks (e.g., ESG integration and engagement).

Once developed, investors could align their investment with a definition and take actions to increase their portfolio allocation to sustainable development. This could create a strong signal to the market.<sup>73</sup>

To implement such a definition, investors would benefit from

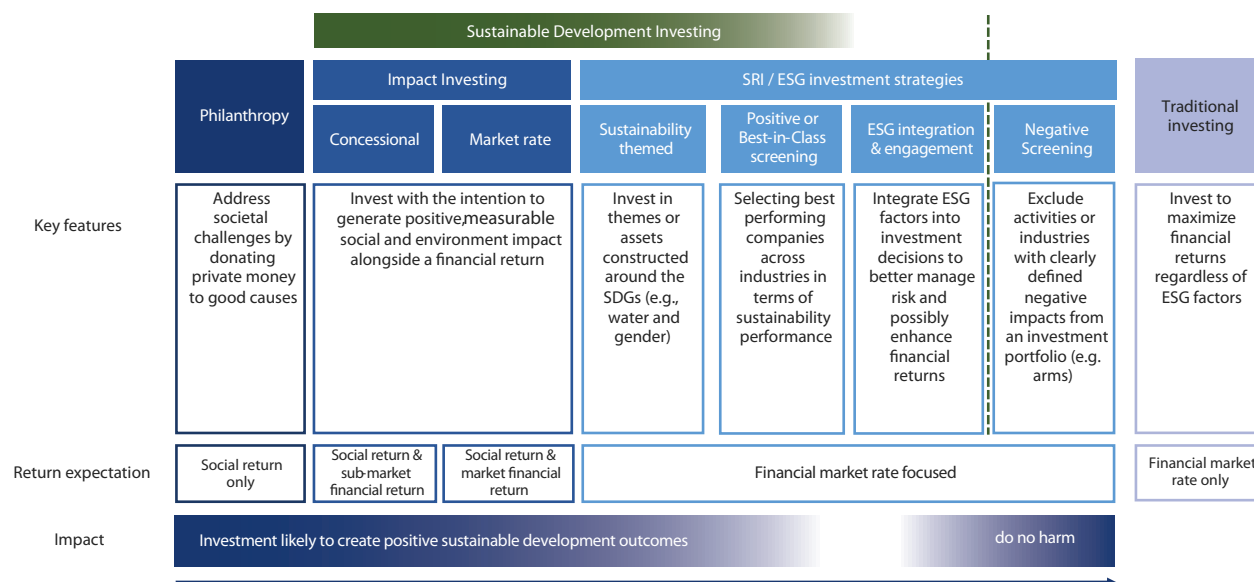
- (i) Principles and guidance to reinforce investment practices. For example, the Operating Principles for Impact Management, launched in 2019, have been created to establish a common discipline to ensure that impact considerations are integrated throughout the investment lifecycle.<sup>74</sup> More than 80 international investors have signed on to these principles. Signatories to these principles commit to annual disclosure of how they implement them, and independent verification of their impact management processes. Meanwhile, the United Nations Development Programme has created assurance standards to guide investors in operationalizing existing principles in this area—for instance for private equity practice<sup>75</sup>—and the United Nations Environment Programme Finance Initiative’s (UNEP FI’s) Positive Impact Initiative has provided principles and tools to mainstream impact analysis and management in finance.<sup>76</sup> The Impact Management project has also created a framework to look at impact around five dimensions;<sup>77</sup>
- (ii) Technical criteria defining what is “sustainable”. For example, standards have been created for green and sustainable-oriented bonds to define the eligible assets (use of proceeds) that can be financed by these instruments, although further harmonization among different frameworks would be welcomed. The ASEAN Green Bond Standards, for example, explicitly exclude all power generation projects based on fossil fuels, while China includes clean coal, for now, as a green category. Being able to assess the contribution of private companies is an important precondition to sustainable development equity investing, which is discussed in the next section.

### 5.3.2 Corporate contribution to the Sustainable Development Goals

Companies affect sustainability in two ways: through the products and services they produce, and through their operational activities. In terms of

Figure III.B.11

#### Sustainable Development Investing (SDI)



Source: UN DESA and Global Investors for Sustainable Development based on RIAA (Responsible Investment Association of Australasia)

Note: SRI stands for Sustainable and Responsible Investing. While ESG engagement plays a key supportive role to SDI, engagement is not sufficient to meet the definition.

production, different taxonomies have emerged to help classify company activities.<sup>78</sup> For example, the EU reached an agreement in 2019 about a classification system, or “taxonomy,” that helps businesses and investors identify what economic activities can be considered environmentally sustainable.<sup>79</sup> These taxonomies provide technical screening criteria that must be fulfilled in different sectors. A minimum set of criteria is important to keep firms from claiming “SDG alignment” because they are broadly present in sectors covered by the SDGs (e.g., health care, education).

Fundamental analysis at the company level is therefore critical to analyse the real impact of individual companies on the SDGs. In this respect, the World Benchmarking Alliance (WBA) plans to rank 2,000 companies, estimated to be the most influential ones, regarding their impact on the SDGs and will make the results freely and publicly available. Assessing the contribution of a private company to sustainable development also necessitates an understanding of where companies operate and who they serve, in particular whether they target countries and people most in need. This is what some methodologies, such as UNEP FI’s Holistic Impact Analysis Tools are starting to do.

An analysis of the MSCI World Index found that 11 and 20 per cent of companies in this index (about 1,700 stocks from 23 countries) have, respectively, a high and medium positive contribution to the SDGs.<sup>80</sup>

In terms of operations, ESG metrics focus on measuring how a company produces (versus the products and services that the company produces).

Figure III.B.10 provides a framework to assess whether a company’s products/services and operations are aligned with sustainable development objectives.

Data availability is critical, including, for instance, information on the distribution of revenues, jobs and/or investments per business lines and country. Investors can also use technology to look at unreported data, such as from social media and news outlets, and check whether a specific company might be involved in certain controversies incompatible with sustainable development (box III.B.4).

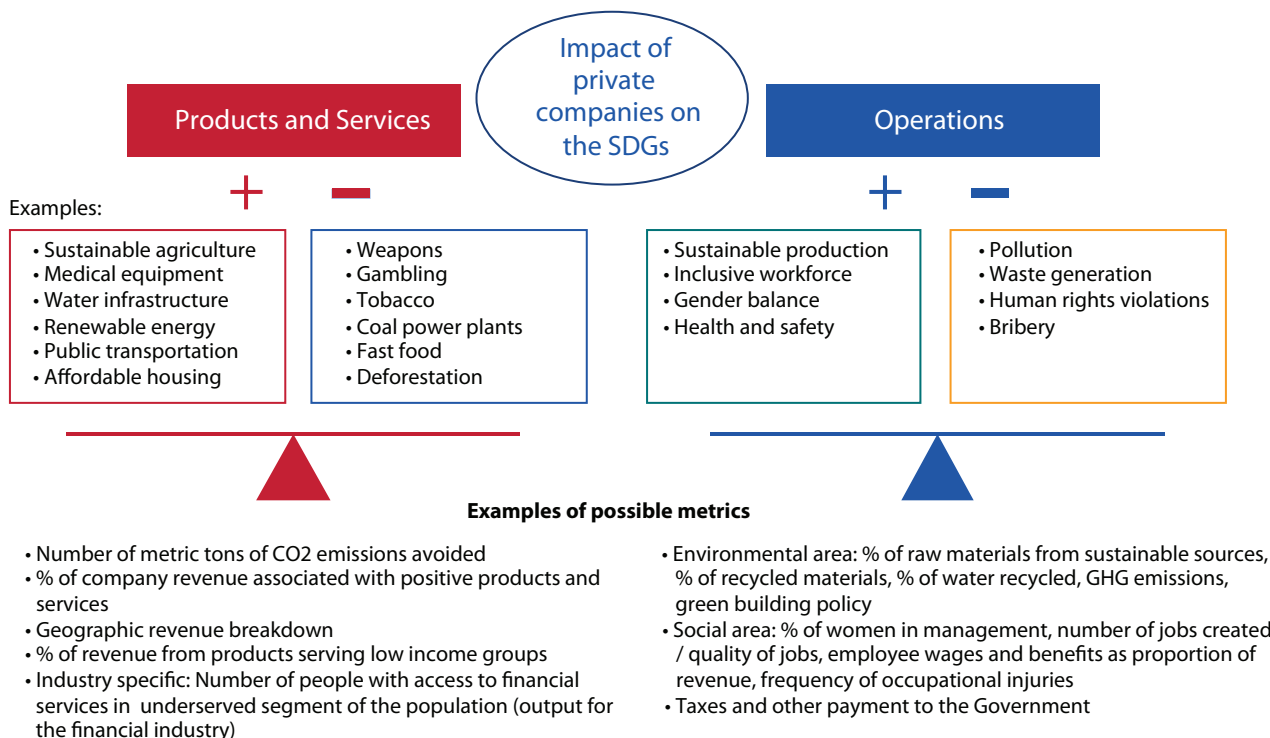
### 5.3.3 Sustainability reporting

Enhancing corporate disclosure is key to reinforcing accountability frameworks. Policymakers and consumers cannot hold companies accountable without proper information both on social and environmental issues. Investors need information to make risk-return analyses (e.g., a company’s exposure to climate change). Financial reporting standards have allowed companies to speak the same language in measuring financial performance. There is a need for similar frameworks and common metrics for environmental and social impact disclosure.

As of now, corporate sustainability reports are difficult to compare and the hundreds of ESG data points per company are overwhelming, sometimes meaningless, and often behind paywalls. The quality of sustainability reporting also needs improvement. A recent study of more than 700 multinational companies found 72 per cent of published sustainability reports mentioned the SDGs, but just 23 per cent included meaningful key performance indicators (KPI) and targets.<sup>81</sup> While at least 24 stock exchanges across developed and developing countries are now requiring ESG disclosure as a listing rule,<sup>82</sup> globally, ESG disclosure for listed companies has not significantly improved since 2013.<sup>83</sup> Without numbers, sustainability

Figure III.B.10

#### Framework to assess the impact of (listed) companies on the SDGs



Source: UN DESA based on MSCI/OECD joint discussion paper on institutional investing for the SDGs (December 2018).



### Box III.B.4

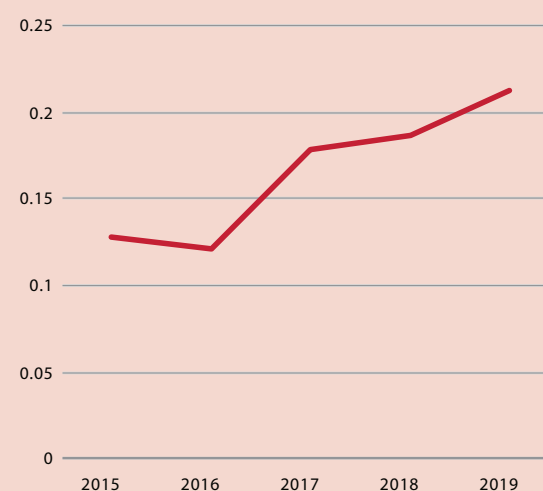
#### Leveraging technology to assess the SDG footprint of the private sector

There are two main challenges with using self-reported data by companies. First, data might be biased since company are likely to report only on positive elements. Second, data are updated infrequently (typically once a year). This makes them less relevant for investors who need to react quickly to emerging negative sustainability issues.

Artificial Intelligence (AI) and natural language processing help address these challenges by analysing and interpreting unstructured data from thousands of sources, in multiple languages, such as news, social media, regulatory filings, government reports, blogs, industry-specific publications, and NGO websites. To analyse these data, an algorithm uses a sustainable development goals (SDGs) taxonomy to identify relevant SDG-related information across large amounts of unstructured content. The algorithms can then extract, filter, and analyse text and syntax structure to detect positive and negative signals on SDG issues.

The resulting time series data can then be transformed into SDG scores. The higher the score, the more positive the text is in relationship to each SDG. For example, for SDG 5 (on gender equality), an algorithm would give a better score to a company that doubles the number of women on their board of directors than a company that announces the hiring of two female analysts. Figure III.B.4.1 illustrates how AI can be used to monitor the SDG footprint of private companies over time, and shows a relative improvement in the way corporates are integrating SDG considerations.

Figure III.B.4.1  
SDG footprint score, global average  
(Score -1 (min) to +1 (max))



Source: Global A.I. Corporation  
Note: The SDG footprint incorporates data from 19,819 companies across Africa, Asia, Europe, Oceania and the Americas.

reporting quickly becomes a public relations exercise. Making the sustainable impact of companies more transparent and readable should help inform investor, consumer and regulator decision-making.

The Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) recommends companies disclose the impacts of climate-related risks on their business, taking into consideration different climate-related scenarios. As of February 2020, support for the TCFD has grown to over more than 1,000 organizations, representing a market capitalization of nearly \$12 trillion. Yet, the implementation of TCFD recommendations remains partial. Only about 25 per cent of companies disclosed information aligned with more than 5 of the 11 recommended disclosures (based on a review of 1,100 companies from 142 countries).<sup>84</sup> Similar to climate risks, other sustainability issues can be financially material. The Sustainability Accounting Standards Board (SASB) has identified which sustainability issues are likely to impact the financial condition or operating performance of a company by industry.<sup>85</sup> Investors use this information to guide their decisions. As an example, Blackrock, the world's largest asset manager is asking the companies that they invest in to publish a disclosure in line with industry-specific SASB guidelines and disclose climate-related risks in line with TCFD recommendations.<sup>86</sup> As more investors follow Blackrock's lead, corporates will need to be more transparent on sustainability questions to attract capital.

Increasing transparency is a powerful mechanism to trigger changes. Figure III.B.11 provides evidence that what gets measured, gets managed. Countries with the highest level of disclosure are the countries where

companies rank the highest in terms of environmental, social and governance performance.

Financial materiality has so far been the compass for deciding what companies should be disclosing (i.e., a company needs to disclose events or facts that could impact its financial performance and would affect the judgment of investors). However, if corporates are accountable not just to investors but to a broader audience, this compass also needs to cover information required to understand the impact of companies' activity on issues that matter to the whole society, such as the global goals.

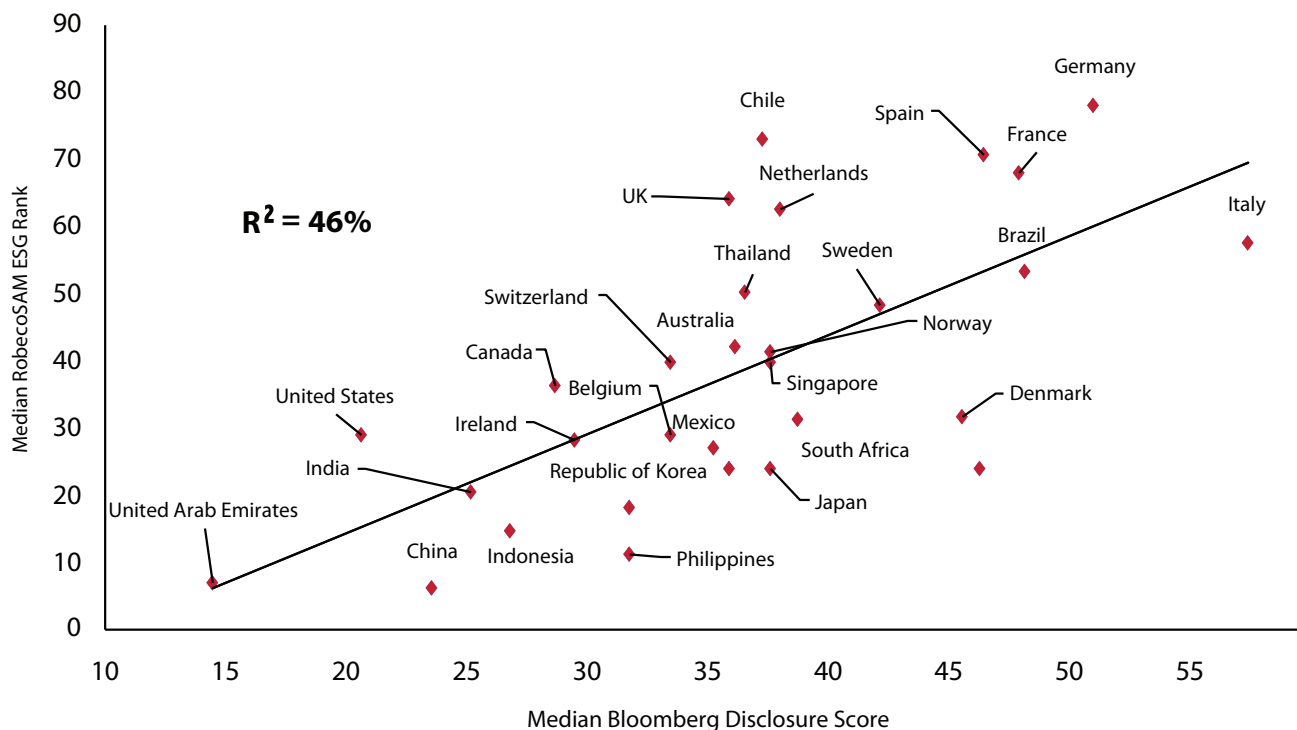
The largely voluntary nature of sustainability reporting is also problematic. While standards from the Global Reporting Initiative (GRI) are widely used,<sup>87</sup> companies can still choose to report only on positive results and avoid communicating on negative impacts. The time has come to shift from voluntary to mandatory sustainability reporting, building on industry-led efforts and reporting standards which provide a better understanding of how such reporting can be efficiently done. Mandatory reporting also helps create a level playing field for all.

To ensure a minimal level of disclosure, as well as consistency around metrics used for corporate reporting on SDG impact, policymakers could include in reporting requirements a list of criteria, possibly per industry. To this end, they could, for instance, use the guidance issued by UNCTAD on core indicators for entity reporting on contribution towards the implementation of the SDGs,<sup>88</sup> as well as the GRI standards.<sup>89</sup> The former contains 33 indicators on companies economic, environmental, social and governance performance, which are common to all businesses, such as use of



Figure III.B.11

ESG disclosure vs performance



Source: Bloomberg intelligence.

Notes: ESG disclosure score: Proprietary Bloomberg score based on the extent of a company's ESG disclosure. This score measures the amount of ESG data a company reports publicly, and does not measure the company's performance on any data point. RobecoSAM Total Sustainability Rank: Total sustainability percentile rank, converted from the total sustainability score, based on the RobecoSAM Corporate Sustainability Assessment. Country aggregate represents the median score of all the companies within the FTSE all world index domiciled in each respective country.

water, energy, generation of waste and carbon emissions, gender equality and work place safety among others. Several case studies have confirmed the applicability of these core indicators in different geographical areas, industries and companies of different sizes.<sup>90</sup>

5.3.4 Sustainable finance strategies

To structure policy actions, Governments can develop a strategy to promote sustainable finance and consider designating an institution in charge of implementing it. This creates a momentum and support from within a Government. For example, in 2016, public authorities in China issued guidelines for establishing the green financial system, which resulted in major progress in green financial products and standards. In the same vein, at least ten countries have adopted a national strategy for impact investing.<sup>91</sup> In Brazil, the implementation of such a strategy is assigned to a multi-stakeholder committee composed of several ministries, development and commercial banks, financial market regulators and representatives from civil society. This kind of platform creates a structure for stakeholder consultations that are necessary before the adoption of regulations or policy reforms. Governments have also established expert panels to come up with recommendations to scale up sustainable finance.

For example, Canada created an expert panel on sustainable finance in 2018, which outlines fifteen recommendations to mobilizing finance for sustainable growth.<sup>92</sup> Central bankers are also considering how to address financial stability risk that sustainability issues may create (see chapter III.F)

These initiatives have led to concrete results. For example, forty-eight of the world's 50 largest economies now have some form of policy to foster investors to consider sustainability issues.<sup>93</sup> Since there is growing evidence that some ESG factors are financially material,<sup>94</sup> particularly over long investment time horizons, regulation should explicitly require that pension funds and insurance companies, known as fiduciaries, consider these factors in their investment decisions. Regulation should also include disclosure requirements from pension funds to explain how they incorporate ESG factors into their investment policies to ensure that these issues are seriously considered and that beneficiaries are properly informed. It is equally important to make it mandatory for financial advisors and fiduciaries to ask their clients/beneficiaries about their sustainability preferences and empower people in their financing decisions. Technological advancement should be leveraged to strengthen communication between clients and those who manage money on their behalf.

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