



Financing for Sustainable Development Report 2021

Inter-agency Task Force on Financing for Development



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The online annex of the Task Force (<http://developmentfinance.un.org>) provides additional data and analysis on 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.

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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

The COVID-19 crisis has had a devastating socioeconomic impact on employment, poverty and inequality, and derailed private sector investment needed for recovery.

Short-term measures taken by Governments to support private companies have been essential to avoiding bankruptcies and limiting the long-term negative impact on economic activities. **But, for a long-term, sustainable and inclusive recovery, the current business and finance models have to be reimaged.**

- *The current crisis provides an opportunity to build a new business model that works for everyone, that extends to all stakeholders, not only shareholders. But such a paradigm shift requires Governments to change the rules of the game;*

Developing countries require a boost in private investment if they are to achieve sustainable development goals. Investment for a long-term recovery can be reignited by prioritizing sectors that are capable of driving sustainable economic growth and can attract private sector investment, such as telecom and renewable energy. But reducing the risk premium of developing countries is necessary to unlocking more capital-intensive projects.

- *National actions can mitigate some investment risks, for instance, by strengthening the business enabling environment and ensuring timely administrative decisions (e.g., construction permits);*
- *At the same time, the international community should help developing countries (a) benefit from cheaper financing sources; (b) develop a pipeline of investable projects; and (c) use risk-sharing mechanisms to leverage private investment (see chapter III.C). The multiple efforts and assistance of development partners should be further integrated, for instance, through creating a common marketplace for investments in developing countries;*

It is also important to harness the benefits of digital financial inclusion. Digital financial services have gained further importance amid the pandemic. This raises prospects for financial inclusion but accentuates the need for regulatory frameworks to address related risks. Digital financial services can also reduce remittance transaction costs, but are not always available in high-cost corridors.

- *Governments and development partners can promote digital services to reduce remittance transaction costs, but bottlenecks, including digital access gaps, need to be addressed for these technologies to have a greater impact. A corridor-by-corridor approach is also necessary to remove structural barriers, such as the lack of competition and the reduction of correspondent banking relationships;*

Scaling-up access to risk capital is limited by underdeveloped capital markets in many countries; their deepening depends on a range of enabling conditions that developing countries must first address.

- *The international community should provide support to countries with underdeveloped capital markets to put in place market infrastructure and develop action plans tailored to their local circumstances;*
- *Alternative measures, such as blended instruments and innovative financing approaches, can also be considered in order to enhance access to risk capital (see chapter III.C and the Financing for Sustainable Development (FSDR) 2020);*

The current crisis presents an opportunity to build a more sustainable financial system that channels resources to projects and companies with a positive contribution to sustainable development and the SDGs. To this end, a number of actions are necessary:

- *First, all actors in the investment chain should develop incentives that encourage a long-term approach in*

decision-making (such as remuneration structures of asset managers and company executives). Without a long-term approach, risks and opportunities critical for sustainable development will not be properly considered;

- *Second, companies must provide greater transparency regarding their environmental and social impact, as a prerequisite for making them accountable to their financiers and other stakeholders. This can be achieved by further converging existing reporting frameworks, ensuring global coherence and mandating a minimum level of disclosure. Countries could use the strong momentum in this area to realize ambitious changes;*
- *Third, companies should not only provide information on their current impact but also on their plan to shift activities towards more sustainability, and adjust internal governance for this purpose. For climate change, this means that every company should have a plan to reduce carbon emissions in line with the Paris Agreement, and the same holds for social issues, such as gender balance and labour conditions;*
- *Fourth, investors can help spearhead transformation of the companies they invest in, but they need the appropriate incentives, internal capacity, and tools to do so, including coherent taxonomies and credible labelling for sustainable investment projects and financial products;*
- *Fifth, standards and rules must be designed to make sure sustainable finance goes where the financing needs are the greatest. Without a specific attention paid to developing countries constraints, some actions could shift finance further away from developing countries in the short term, as companies would seek to manage sustainability-related risks.*

The first section of this report lays out the need for a business model aligned with sustainable development. The following section provides an overview of investment trends and ways to scale up private investment in recovery. The third section reviews ways to improve financial inclusion, reduce remittance transaction costs and mobilize capital markets. The chapter ends with actions and incentives to make the private sector and financial markets more sustainable. In its analysis, the chapter also builds on the work of the two discussion groups established after the initial High-Level Event on Financing for Development in the Era of COVID-19 and Beyond, respectively on: (i) external finance and remittances, jobs and inclusive growth; and (ii) recovering better for sustainability.

2. Developing a new business model aligned with sustainable development

Despite the growing interest in sustainable finance, it is unlikely that the current business model will achieve the private sector transformation and scale of financing required by the SDGs in the near future. Building a new business model requires a fundamental rethinking of the role of direct investment and financial and capital markets in economies; and of taxation, corporate practices, and infrastructure in promoting sustainable development. While the exact model may differ between countries, there is a universal need for a new business model that supports countries' ability to achieve the SDGs.

2.1 Creating the terms of the new business model

Financial markets are currently too short-term oriented to spur the investments needed for the SDGs. The COVID-19 crisis has highlighted growing systemic risks and interconnections between economic, social and environmental issues (see chapter II). However, the short-term nature of financial markets implies that risks and opportunities critical for sustainable development are often overlooked. Although investors increasingly consider sustainability-related risks, they tend to focus on those with a direct material impact on company financial performance in the near term and often lack the tools to conduct in-depth sustainability assessment of companies they finance.

The current business model, in which firms maximize shareholder value, does not properly account for the effects of private activity on environmental and social impacts (or externalities). The model consumes more natural resources and creates more waste than the planet can regenerate and absorb. It also creates large social inequalities. A new model of capitalism needs to reconcile the objective of profit maximization with the societal goals of sustainable development. To be resilient, the economic system needs to rely on a business model—dubbed as stakeholder capitalism—that works for everyone, including employees, suppliers, customers and local communities.

Government bailout packages in response to the crisis have increased the role of public support in both developed and developing markets. Such support has ranged from loan relief for small and medium-sized enterprises (SMEs) to research and development (e.g., of pharmaceuticals). As a result, taxpayers are subsidizing corporate shareholders. With stock markets at record highs, there is a need to rethink the responsibility of businesses towards society.

Focusing on a broader set of stakeholders can help companies perform better by creating long-term shareholder value,¹ while enabling corporations to give back to society. This rationale pushed 181 chief executive officers (CEOs) in the United States of America to commit, in 2019, to redefining the purpose of a corporation to one that serves not only its shareholders, but delivers value to all its stakeholders. This does not mean foregoing returns for shareholders to deliver more value to other stakeholders.² Rather it is a recognition that considering all stakeholders is essential to maximizing financial performance in the longer run, for instance, by adopting some or all of the following practices:

- Considering **employees** not as a cost but as an investment in human capital that enhances the company's productivity and helps attract talent. Companies with strong employee engagement are estimated to be 23 per cent more profitable than those with lower engagement;³
- Reflecting **customers'** long-term needs and sustainability preferences through innovation and development of new products and services. A survey found that 73 per cent of consumers say they would definitely or probably change their consumption habits to reduce their impact on the environment;⁴
- Improving **environmental** performance to reduce energy and raw material costs and building **resilience** to disasters in order to ensure business continuity;⁵
- Embedding sustainability issues in supply chains to improve **supplier** practices and avoid reputational scandals that could hurt a brand's

reputation, a critical component of intangibles that make up to 84 per cent of company valuation.⁶

These considerations are not new, but they are growing in importance because there is a recognition that the system does not work well for all people—or for the planet—and that companies have a responsibility in addressing these issues. In developed markets, 56 per cent of respondents to a global survey believe that capitalism in its current form is doing more harm than good in the world, and less than 1 in 5 respondents agree that the system is working for them. The same survey found that 74 per cent of respondents believe that CEOs should take the lead on change rather than waiting for government to impose it.⁷ Consumers and investors are also increasingly integrating environmental and social issues into their purchasing and investment decisions. A survey of large Japanese manufacturers confirms that consumer awareness and investor demand are two leading factors that motivate companies to integrate the SDGs into their decision-making—far more motivating than requirements from local authorities.⁸ Companies that do not take sustainability issues seriously may face a higher cost of capital, as they will be perceived as riskier by investors. Another major change is that technology now makes information about companies more widely available. Companies should expect their unsustainable practices to be noticed.

Yet, reality currently falls short of the promise of stakeholder capitalism, as dramatically revealed by the COVID-19 crisis. This is visible in many areas:

- **Capital Markets.** While people were losing their jobs due to lockdowns, shareholders were benefiting from booming capital markets;
- **Taxation.** In the aftermath of COVID-19, private sector companies in many jurisdictions received public subsidies. Yet, at the same time, many large, profitable companies engage in tax avoidance and evasion. It is estimated that \$500 billion to \$600 billion in corporate tax revenue a year is lost from profit shifting by multinational enterprises;⁹
- **Carbon emissions.** Prior to the crisis, direct emissions from corporations increased by more than 10 per cent between 2015 and 2019 (figure III.B.1);
- **Circularity.** Companies are not sufficiently limiting single-use products and improving the circularity of products. Still, 98 per cent of plastic packaging is single use (only 2 per cent is reusable) and more than a third of this packaging is not recyclable;¹⁰
- **Biodiversity.** Agricultural expansion continues to be the main driver of deforestation and the associated loss of forest biodiversity;¹¹
- **Gender equality.** The gender pay gap remains prevalent at 16 per cent globally;¹²
- **Human rights.** The Corporate Human Rights Benchmark, which assesses 229 global companies, found that 104 of them had serious allegations connected to them.¹³

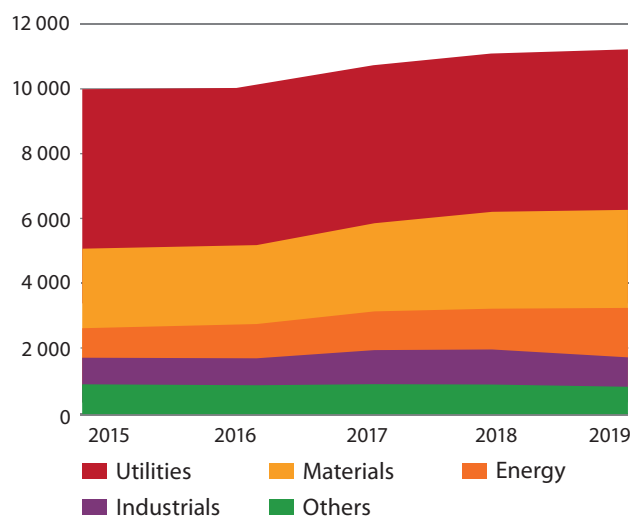
Stakeholder capitalism can only succeed if capital markets and corporate governance push companies to adopt a long-term vision. Companies need a long-term outlook to properly consider most environmental and social elements that do not have an immediate visible impact. Yet, the current economic system has led companies to focus excessively on achieving short-term targets, often at the expenses of

long-term growth and company resilience. This is despite the fact that companies with a long-term approach tend to outperform their peers, with earnings growth of 36 per cent more on average over a 15-year period.¹⁴ Actions are needed to both reshape corporate governance, and to reform capital markets (see section 5.1).

Figure III.B.1

Scope 1 Direct greenhouse gas (GHG) emissions by sector, 2015–2019

(Million tonnes of carbon dioxide equivalent)



Source: UN DESA based on data of 4,768 companies accessed from S&P Market Intelligence.

Note: GHG protocol defines Direct GHG emissions as those that occur from sources that are owned or controlled by the company, for example, emissions from combustion in owned or controlled boilers, furnaces, vehicles, etc.; emissions from chemical production in owned or controlled process equipment.

2.2 Rebuilding the partnership with the State

COVID-19 has highlighted the role of Governments in the economy, providing a window of opportunity to make bold changes. For countries that were able to afford bailout programmes, stimulus packages can be designed to encourage companies, including multinational corporations, to align their business model with sustainable development—for instance, by requesting commitments to reduce carbon footprints and encouraging investment in workers and better working conditions globally. Governments can also use public procurement to drive changes and increase demand for sustainably produced goods. About twelve per cent of gross domestic product (GDP) globally is spent on public procurement, both in developed and developing countries.¹⁵ Governments can also direct state-owned enterprises to be at the vanguard of changes in corporate practices.

A paradigm shift in the business model depends on ambitious and forward-looking public policies, and a strengthened partnership between government and the business sector. The fact that many companies are embracing the idea of stakeholder capitalism is positive, but it would be unrealistic to think this alone will create the shift required. Many of these changes enumerated below will not be in the company's

financial interest unless the rules of the game are also changed.

- For **employees**, major gains have been achieved through public policies, for instance, on labour rights and minimum wages. Further improvements will require policy interventions, for example, to better protect people working in the informal sector and those with non-conventional forms of employment;
- For **capital markets** to take a more long-term approach to investment, they need to have access to information on the social and environmental performance of companies, which depends on company disclosure requirements put in place by regulators (see section 5.2);
- For **climate change**, it is crucial to penalize unsustainable practices, for example, through meaningful carbon prices (see chapter III.A), as well as regulation (e.g., emissions standards in automobiles);
- Regulations are also needed to foster a **circular economy**, for instance, through bans on single-use products and extended producer responsibility for the treatment of post-consumer waste;
- For **disaster risk reduction**, policymakers can put in place and raise awareness about incentives that encourage companies to build resilience throughout their operations, such as tax rebates and reduced insurance premiums;¹⁶
- Regulation and norms are also key to **consumer protection**, for instance, to prevent predatory lending or ensure product safety;
- Public policies also help shift **consumer demand** towards more sustainable products, for example, by ensuring proper information to consumers (e.g., on-pack carbon labelling), and providing financial incentives (e.g., for energy-efficient retrofits in building);
- For **suppliers**, regulation can require large companies to conduct supplier due diligence, for instance on issues such as labour standards including child labour, forced labour and human trafficking;
- For **taxation**, domestic public policy reforms and international cooperation are necessary to ensure that companies adhere to tax laws and that value is taxed where it is created (see chapter III.A).

Governments, including in developing countries, can also use investment policies to mobilize private investment in the SDGs, for instance, by re-orienting investment promotion and facilitation strategies towards SDG investment.¹⁷ More than 150 countries have adopted national strategies on sustainable development or revised existing development plans to reflect the SDGs, and more than 70 are in the process of developing integrated national financing frameworks (INFFs) to support financing of these plans. Within the context of these frameworks, governments can use tools such as the UNCTAD Investment Policy Framework for Sustainable Development (IPFSD) to attract investment in the SDGs.¹⁸

Government policies set the business framework for investment in the real economy (section 3), for the financial sector and capital markets (section 4), and for aligning these with sustainable development (section 5). National efforts, however, will only be successful if complemented by reforms to the international system, including in the areas of tax cooperation, trade, debt sustainability and systemic issues, along with international support for those most in need (see chapters III.A/C/D/E/F).

3. Encouraging investment and job creation

Investment and business activity contribute to the achievement of many development goals, including through job creation, investment, innovation, and strengthening sustainable consumption and production. The extent of their contribution is in part driven by public policies that govern business activities and create incentives for aligning (or not aligning) business practices with sustainable development. Especially in the current crisis, policies need to be structured around both short-term objectives (e.g., keeping business afloat and preventing job losses), and rebuilding better by investing in sustainability and resilience.

3.1 Investment trends and the impact of COVID-19

The COVID-19 crisis has derailed investment, which was already below historical average. Global foreign direct investment (FDI) plummeted 42 per cent in 2020¹⁹ —a greater drop than occurred during the 2009 global recession (figure III.B.2). Ongoing investment projects were delayed, and foreign affiliate earnings—a significant share of which is generally re-invested in host countries—collapsed.²⁰ Many mergers and acquisitions were also suspended or cancelled. The decline was concentrated in developed economies. Investment in developing and transition economies excluding China also fell in 2020, by 22 per cent.

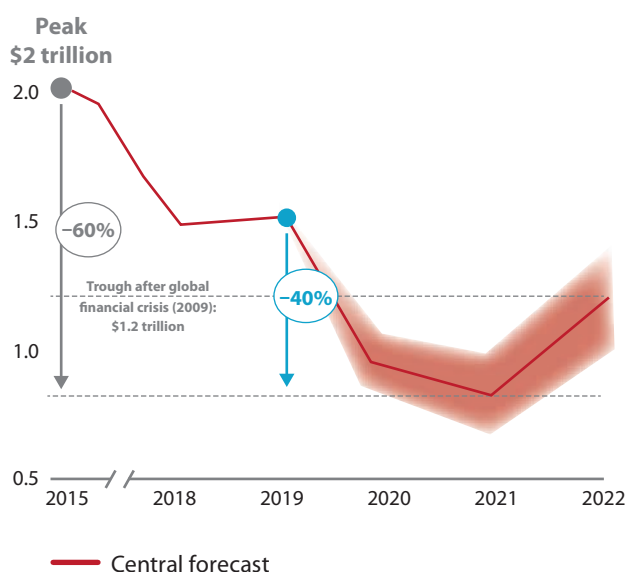
International private investment flows to developing and transition economies have been weak in sectors relevant for the SDGs. These flows are expected to have fallen by about one third in 2020. The decline was particularly strong in poorer regions and in infrastructure-related sectors (excluding renewables). International project finance announcement in these sectors dropped by 62 per cent in value.²¹ Investment in renewable energy was more resilient, although growing more slowly than prior to the crisis.

Investment is expected to remain subdued for some time, not only because the firms are less profitable, and hence need to scale back their investments; the uncertainty about the global economic outlook makes investment riskier than what it would have been without the pandemic. Greenfield investment project announcements, which are indicators for future FDI trends, dropped by 35 per cent in 2020.²² However, future trends in investment will depend on a host of factors, including the level of public spending, the interest rate environment, and the speed of vaccine roll-out, especially in developing countries.

The COVID-19 crisis has accelerated changes that have long-term implications for investment flows and international production.

The pandemic is compounding ongoing changes in global and regional value chains controlled by multinational enterprises. Technological changes, increased protectionism and sustainable development imperatives are having far-reaching consequences for the configuration of international production. For instance, new technologies make the operations of multinational enterprises less dependent on investment in physical assets. Governments and the public may also pressure companies to increase national or regional autonomy in productive capacity. Future investment decisions of multinational companies are likely to be driven by the desire to strengthen supply chain resilience.

Figure III.B.2
Global foreign direct investment inflows, 2015 and 2018–2022
 (Trillions of dollars)



Source: IUNCTAD

3.2 Preserving and creating jobs

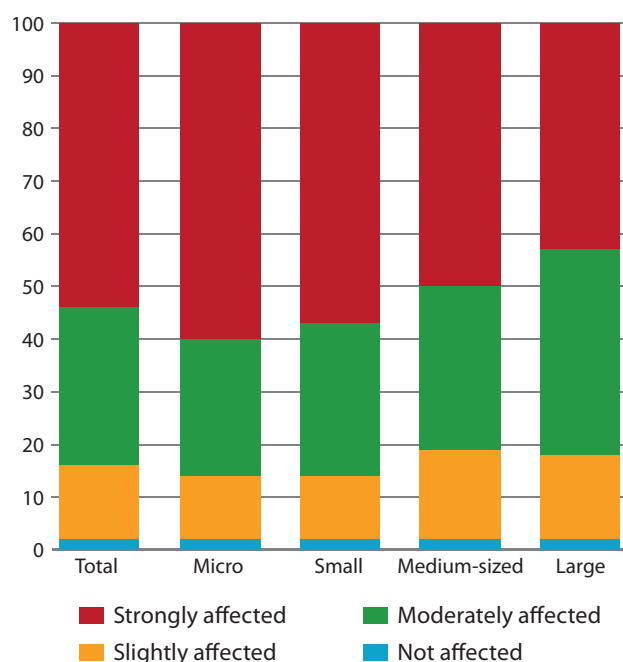
The COVID-19 pandemic has created a major shock to labour markets, exacerbating inequalities (see chapter I). Job losses have been concentrated in low-earning sectors and have disproportionately affected women and young people. While developed countries have been able to adopt large-scale fiscal stimulus, countries with limited fiscal space have not been able to afford the same measures (see chapter III.A).

Micro, small and medium-sized enterprises (MSMEs), which account for a large share of employment worldwide, have been severely impacted by the crisis, particularly in developing countries. Smaller businesses are more affected by COVID-19 and face higher risk of permanent closure (figure III.B.3). MSMEs are overrepresented in sectors most strongly hit by the crisis, such as accommodation and food services. They also tend to have fewer assets and limited cash reserves to cushion against lockdown-induced liquidity shortages. In August 2020, 22 per cent of MSMEs surveyed reported that they risked shutting down permanently within three months, compared to 9 per cent for large firms; ²³ this percentage rises to 34 per cent for companies operating in LDCs. ²⁴

Prompt actions from Governments and development banks have helped companies stay afloat and preserve employment, but need to be calibrated to reach the hardest-hit groups, including in the informal sector. Without policy interventions, a recent study estimates that the rate of businesses failures for SMEs would almost double. ²⁵ Firms surveyed highlighted tax waivers, temporary tax relief and financial programmes as the most helpful measures to cope with the COVID-19 crisis (figure III.B.4). However, the level of support differs between developed and developing countries. Less than 30 per cent of SMEs in developing countries received

or expect to receive government assistance compared to 75 per cent in developed countries. ²⁶ Support measures may also overlook enterprises operating in the informal economy, which are often difficult to reach through conventional channels and may require tailored solutions, such as delivering support through microfinance institutions.

Figure III.B.3
Impact of Covid-19 on business operations by company size
 (Percentage)



Source: International Trade Centre, ITC Covid-19 Business Impact Survey. Data collected Apr–Aug 2020.

Note: Respondents were asked 'How have your business operations been affected by the coronavirus (COVID-19) pandemic?' Data on 3949 businesses in 123 countries.

Enabling companies to outlive the crisis is key to enabling a strong recovery post-crisis and limiting the long-term impact on economic activities. Without support, sound businesses may be forced to close due to liquidity pressures and factors beyond their control. Recreating these businesses will involve costly and time-consuming activities, such as rehiring workers and re-establishing connections with suppliers and clients. It is estimated that replacing lost employees can cost up to twice their annual salary. ²⁷ Prolonged underemployment may also erode human capital.

Policy reforms can complement short-term support measures to engage entrepreneurs and MSMEs in recovery efforts and foster job creation. The crisis has slowed down entry into entrepreneurship, with business applications down by 40 per cent in some countries. ²⁸ To encourage the resurgence of entrepreneurship and small business activity, countries can

- Strengthen the business-enabling environment and minimize regulatory hurdles for entrepreneurs and MSMEs, particularly those affecting women; ²⁹

Figure III.B.4

Government measures perceived as most helpful

(Percentage of survey respondents)

**Source:** International Trade Centre, ITC Covid-19 Business Impact Survey. Data collected Apr–Aug 2020.**Note:** Respondents were asked 'Please select the top three government measures that would be most helpful as you cope with the COVID crisis. Data on 4035 businesses in 133 countries.

- Invest in entrepreneurial skills, including through trainings aimed at improving entrepreneurial mindset (e.g., Empretec);
- Encourage informal businesses to integrate into the formal system so they can better benefit from public support measures;
- Improve access to technologies by vulnerable groups, such as youth, women, migrants and refugees, by investing in digital infrastructure and education;
- Facilitate MSME participation in public procurement, for instance, by dividing contracts into smaller lots;³⁰
- Support MSMEs through loan programmes (e.g., through public development banks) and couple them with training support (e.g., on financial literacy);
- Provide international support, including capacity-building assistance, to help countries in these efforts.³¹

The transition to a low-carbon economy also provides opportunities for job creation beyond the immediate crisis, but needs to be accompanied with assistance for workers in declining sectors.

It is estimated that 12 million new jobs could be created over a decade through green investment and rising carbon prices.³² Renewable energy, retrofitting of buildings, and other low-carbon sectors tend to be more labour intensive than those with higher emissions such as fossil fuel energy and heavy manufacturing. However, a transition to a low-carbon economy also presents challenges, such as reallocation of the workforce from shrinking to expanding sectors, which requires social dialogue and public intervention (e.g., training and reskilling support).

3.3 Unlocking private investment in sustainable and resilient infrastructure

While unlikely to fill the infrastructure gap on its own, private investment can play a role, particularly in sectors with strong cash flow potential. Closing infrastructure gaps requires investment of trillions of dollars. Public investment will continue to dominate infrastructure spending in many areas—especially in sectors where public intervention is warranted for social equity reasons or where social returns are much larger than private returns. But private investment can more easily be mobilized in other critical sectors, such as renewable energy and digital connectivity, which have the potential to generate returns to repay private investors. Due to the falling cost of renewables, renewable energy has become the default option for new energy investment, representing almost 80 per cent of the net generating capacity added globally in 2019.³³ Across major emerging markets, sustainable investment opportunities, which can be led by private investment, are estimated to be \$10.2 trillion between 2020 and 2030.³⁴ Similarly, rising demand for digital connectivity has spurred investment by telecom companies, but the challenge remains to reach those excluded (see chapter III.G).

A risk-informed approach can help government prioritize quality infrastructure investments.³⁵ Examining risks throughout the project lifecycle is critical to properly strengthening infrastructure resilience against future shocks, ensuring the project relevance in the long run, and maximizing social and environmental impact. For example, it is estimated that making infrastructure more climate resilient can add about 3 per cent to the upfront costs, but has benefit-cost ratios of about 4:1, creating significant savings over time.³⁶

One way for Governments to accelerate private investment is to review risks typically associated with infrastructure projects and address those they can control. Private investors base their decisions on risk-adjusted returns. By mitigating risks, Governments lower infrastructure project financing costs, which impact the viability of capital-intensive projects. For example, Governments can secure land acquisition and streamline construction permits to alleviate regulatory risks for project developers. Additionally, national commitments to renewables targets can also reduce the risks of policy reversal. These actions address the root causes of risk and differ from financial instruments, such as public guarantees, that simply transfer risks from the private to the public sector (see chapter II).

The private sector may seek to transfer more risk to government as the crisis prompts reconsideration of risk allocation, but public guarantees need to be managed with caution. The COVID-19 crisis has derailed many infrastructure projects. For example, the crisis has caused a sudden drop in traffic for transport projects, such as roads and railway. The private sector may be reluctant to support this type of risk in the future. Shifting more risk to government can help make projects viable; but public guarantees can also impact public finance through contingent liabilities and should be managed cautiously. Public development banks (see chapters II and III.A) or guarantee funds (e.g., Indonesia Infrastructure Guarantee Fund) can be used to provide this kind of guarantee and ring-fence government liabilities.

When Governments must bear most risks, public financing might be the appropriate solution. The financing debate is too often oversimplified to imply the main reason countries need to raise private financing is because they lack public resources. Yet, while private finance can alleviate short-term financing constraints, infrastructure services cannot be provided “for free”. If an infrastructure project is to be delivered profitably by a private company, the users and/or taxpayers still pay for it in the end. In addition, the Government could be forced to step in and replace the private partner in case of project failures as it cannot allow for public services interruption. As such, the Government is ultimately the risk bearer of last resort. The decision to seek private sector involvement in infrastructure services delivery needs to be based on a strong rationale as to why this would be a more efficient solution. For example, Governments may see value in having the company building the infrastructure asset being also responsible for its operation over time; or they may consider that the private sector will be more efficient in delivering infrastructure services due to the profit motive.³⁷

Mobilizing private investment also depends on the capacity of Governments to develop a project pipeline, including by leveraging technology and strengthening international cooperation. Governments with limited resources may struggle to find the internal capacity to develop an attractive project pipeline. External support, such as the one provided by the Global Infrastructure Facility, is necessary for helping countries address this gap; it also necessary in optimizing existing resources. Information technology platforms, such as SOURCE, can help government officials strengthen project preparation and enhance project management (and promotion) while providing guidance at every project stage.³⁸ Governments could also discuss ways to further integrate technical assistance support provided by different development partners to improve efficiency and reduce administrative burden—for instance, by creating a type of single window for infrastructure-related technical assistance.

Countries with the greatest needs are also the ones facing the highest financing costs. This is not only true for public borrowing costs; it is also reflected in returns that private investors demand to compensate them for perceived risks. The crisis has amplified this risk premium in many countries.³⁹ Development partners can provide guarantees to help reduce the premium, particularly for countries that have been most impacted by the crisis. They can also provide relatively cheap financing options to private companies willing to invest in more frontier markets and make risk participations in their assets available to private sector investors (see chapter III.C). The development of local financial and capital markets is also required in order to sustain domestic private investment, including that in infrastructure development.

4. Developing local financial and capital markets

Countries need a well-functioning financial sector to support economic development. Financial institutions play an essential intermediation role that help put savings to productive uses. The economic literature has established the linkage between financial sector depth (i.e., the size of the financial sector relative to the economy) and economic growth—although an overly developed financial sector may have negative effects (see FSDR 2019). Today, only 20 per cent of global financial assets are held in developing countries.⁴⁰ Advancing local financial sectors could help channel more resources to these countries.

The financial sector also plays a role in achieving social and environmental goals. The financial sector breadth (i.e., access of the population to financial services or financial inclusion) is an enabler of development goals such as eradicating poverty, job creation and gender equality. Combined with digital access and literacy, the financial sector breadth can effectively boost economic empowerment of vulnerable groups such as youth, women, migrants and refugees. Inclusive financial markets can also lower the cost of remittance transfers. Financial institutions and capital markets may also help accelerate the transition to more a sustainable economy if they direct funds to activities in line with positive environmental and social impacts.

4.1 Improving financial inclusion

Despite notable advances in digital financial services, a significant share of the world’s population remains unbanked, disproportionately affecting women and youth. A total of 1.7 billion adults (or 31 per cent globally) do not have access to a bank account, with inclusion strongly influenced by wealth and income disparities.⁴¹ In higher-income countries, 94 per cent of adults have a bank account, while in developing countries only 63 per cent do. The gender gap also remains considerable. While 72 per cent of adult men globally have a bank account, only 65 per cent of women do;⁴² and almost half of the world’s young people (aged 15–24) do not have access to formal financial services.⁴³ Targeted efforts are required to address the financial needs of women and youth, for instance, by initiating public-private partnerships that focus on

the financial inclusion of these groups. Financial inclusion policies should also consider the needs of marginalized communities such as refugees.

Digital financial services have gained further importance during the pandemic, but this increased importance has also highlighted the risks related to these services.

Digital financial services have allowed many households and MSMEs to access financial resources despite lockdowns and social distancing (see chapter III.G). In Nigeria, 54 per cent of customers increased their financial technology (fintech) usage over the past six months.⁴⁴ Digital financial services present a strong potential to bridge financial inclusion gaps, as two thirds of the unbanked globally have a mobile phone.⁴⁵ However, these services also present risks, including pre-existing risks of exclusion, fraud, identity theft, scams and over-indebtedness. In Indonesia, the Financial Services Authority has recently closed more than 1,000 illegal peer-to-peer lenders that were offering prohibited financial services or operating without a proper license.⁴⁶ While these issues and responses often precede the crisis, the increased resilience on digital financial services post-crisis amplifies them. To address these issues, policymakers can consider bringing mobile lending and other types of unregulated micro non-bank lending under regulatory oversight, as Kenya is currently considering. In doing so, regulators should balance (i) macroeconomic risks; (ii) a high standard for consumer protection; and (iii) limiting disincentives for innovation (see FSDR 2020).

4.2 Reducing the cost of remittance transfers

Remittances—an important source of income for receiving families in developing countries—are projected to decline by about \$40 billion due to the COVID-19 crisis. Remittances are expected to decline by 7.2 per cent to \$508 billion in 2020, and potentially by another 7.5 per cent in 2021. However, there are large disparities among regions. While remittance flows were almost at the same level in 2020 as in 2019 in Latin America and the Caribbean by year end, they declined by 16 per cent in Europe and Central Asia.⁴⁷ In 2020, the three main drivers affecting these flows were (i) increased unemployment among migrant workers; (ii) restrictions on entry of new migrant labour; and (iii) restrictions on physical access to remittance providers during lockdowns.⁴⁸ To raise awareness about the expected impact of declining cross-border remittances on millions of people, countries, organizations and industry players have joined the Swiss-UK co-launched call to action “Remittances in crisis: How to keep them flowing”.⁴⁹

But even prior to the impact of COVID-19, the high costs of sending remittances remained a challenge. The average costs of sending \$200 remittances was 6.5 per cent at the end 2020, still more than double the Addis Ababa Action Agenda and SDG 10.c targets of 3 per cent by 2030. Costs continue to be highest in sub-Saharan Africa, at 8.2 per cent. Banks are the costliest channels, with average costs of around 10.7 per cent, while post offices recorded an average of 8.7 per cent, and money transfers operate at 5.6 per cent. Mobile operators are the cheapest at 3.1 per cent and thus the only ones on track to meet SDG target 10.c.⁵⁰

Costs could be reduced by better informing customers about the available remittance options and increasing competition. The global average of the three cheapest options in each corridor is 4 per cent, implying that many customers could benefit from reduced transfer costs if they were better informed. Prices also tend to be higher in corridors with

high bank participation, underscoring how important the competition across different provider types is in reducing costs.⁵¹ But cheap options are not available in all corridors: about 6 per cent of the reviewed corridors do not have any remittances services that meet minimum criteria in terms of quality and accessibility.⁵² At the same time, COVID-19 may have the opposite effect of reducing competition by forcing some providers out of business. Declining volumes caused by COVID-19 has had the effect of reducing the profitability of remittance providers, thus risking reducing competition further. About half of executives in remittances service providers indicated that their business will struggle if the crisis lasts more than six months.⁵³

A bottleneck for reducing costs is the decline of correspondent banking relationships in some corridors. The number of correspondent banks fell by 20 per cent between 2011 and 2018, and costs for cross-border payments tend to be higher in countries with more limited access to correspondent banking services.⁵⁴ To avoid the potential risks of becoming involved in money laundering or terrorist financing, cross-border payment service providers terminated business relationships with some regions or classes of customers, thus reducing competition in those corridors. It is estimated that countries with a longer history of anti-money laundering/combating the financing of terrorism (AML/CFT) deficiencies lost 25 percentage points more of active correspondents than the average.⁵⁵ Some banks have also reconsidered their strategy and terminated less profitable relationships—for example, those with smaller countries—because of low volumes and profits.

Digital financial technologies have emerged as a potential solution to the challenge of providing low-cost remittance transfer channels, but their uptake depends on several enabling factors and proper regulatory frameworks. Fintech can help increase competition, facilitate AML/CFT compliance, and ensure that those hardest to reach, especially in rural areas, have access to remittances.⁵⁶ But while much emphasis has been put on the potential of fintech, some bottlenecks need to be addressed for these technologies to have a greater impact. For example, financial literacy strongly affects which remittance channels people are most likely to use.⁵⁷ The lack of appropriate identity documents is another hurdle for migrants, but technology may help, for example, through digital IDs or by leveraging the verification already conducted for SIM card registration (see also chapter III.G).

Group of Twenty (G-20) leaders endorsed a road map for providing a holistic approach to responding to the cost of remittances and enhancing cross-border payments. The objective is to make cross-border payments cheaper, faster, more transparent and more inclusive. The Financial Stability Board (FSB) will report annually on the progress of this road map in the following five focus areas:⁵⁸

- i Committing to a joint public and private vision to enhance cross-border payments (e.g., setting targets at the global level on cost, speed, transparency and access);
- ii Coordinating on regulatory, supervisory and oversight frameworks (e.g., aligning these frameworks across jurisdictions);
- iii Improving existing payment infrastructures and arrangements to support the requirements of the cross-border payments market (e.g., strengthening links between payment systems);

- iv Increasing data quality and straight-through processing by enhancing data and market practices (e.g., promoting the adoption of common data formats);
- v Exploring the potential role of new payment infrastructures and arrangements (e.g., digital currencies).

4.3 Mobilizing capital markets

The Addis Ababa Action Agenda underscores the role of capital markets, which can be supportive of economic growth and sustainable development. Well-functioning capital markets act as intermediaries, transforming savings into capital needed for economic development while providing access to a wider investor base.⁵⁹

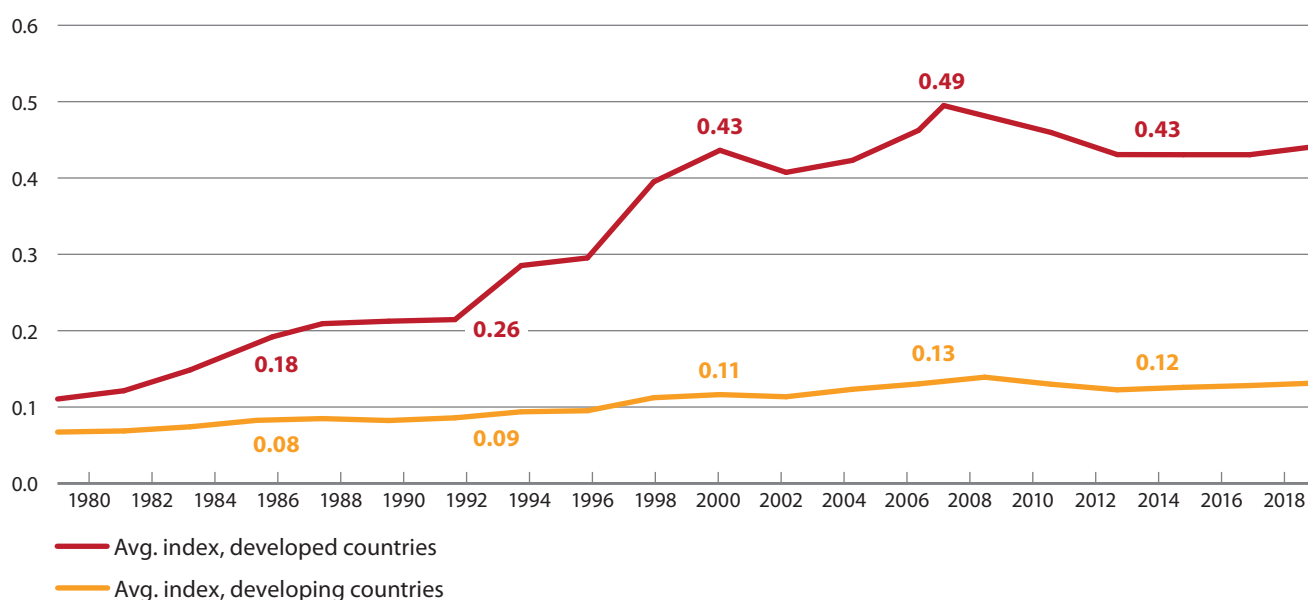
Compared to bank financing, debt markets may increase the availability of long-term and possibly cheaper financing, while equity markets can raise financing that is more risk tolerant and supportive of innovation. In addition, the rise in non-performing loans following the crisis might constrain future bank lending until new capital can be raised, increasing the importance of local capital markets for private sector funding.

Local capital markets in developing countries have grown in recent years, but most remain underdeveloped. In developing countries, market capitalization of listed companies roughly doubled between 2009–2019 to reach almost \$25 trillion,⁶⁰ with debt issued by corporations reaching \$13.7 trillion in 2018.⁶¹ However, growth has been concentrated in a handful of countries. Excluding China, only about 11 per cent of global equity and debt issuances were by companies located in developing countries in 2019.⁶² Issuances in developing countries remain dominated by sovereigns and state-owned companies.⁶³ In most of those countries, only a limited number of companies have used capital markets to fund themselves.

Enabling conditions are critical to sustained capital market development. Past efforts at capital market deepening have not always been met with success. Figure III.B.5 shows that capital markets in most developing countries have remained underdeveloped in terms of size, liquidity and maturity. The divergence in outcomes across countries is usually due to different enabling environments. The preconditions for capital market development include (a) a stable political and macroeconomic environment; (b) a certain level of complexity in the country's financial system; (c) a robust legal framework able to enforce financial contracts; and (d) an independent regulator that ensures fairness and transparency.⁶⁴ In fact, an entire ecosystem needs to be developed (figure III.B.6). Provided that countries work on improving their preconditions and significant commitment is in place, multilateral development banks and development partners can play a role in capital market development through policy advice and technical support, and, depending on country conditions, by participating in catalytic transactions.⁶⁵ One such programme is the Joint Capital Markets Program (J-CAP), implemented by the World Bank Group in select countries, which brings together policy support and transactions in a manner wherein one reinforces the other. Regarding the type of markets to develop first, there is no rigid sequencing. But while capital market development varies by country, debt markets tend to develop first with the emergence of government bond markets, which also build a yield curve. Corporate debt markets can then follow, with long-term debt especially important to finance the long-term investment needed for the SDGs.

Liquidity remains a stumbling block for capital markets in developing countries. Without a sufficient supply of securities and/or demand from investors, capital market growth is restrained by low liquidity. This cycle of low liquidity is difficult to break. Pension funds are an

Figure III.B.5
Financial Markets (FM) Development Index
(Financial Markets score)



Source: IMF Financial Development Index Database

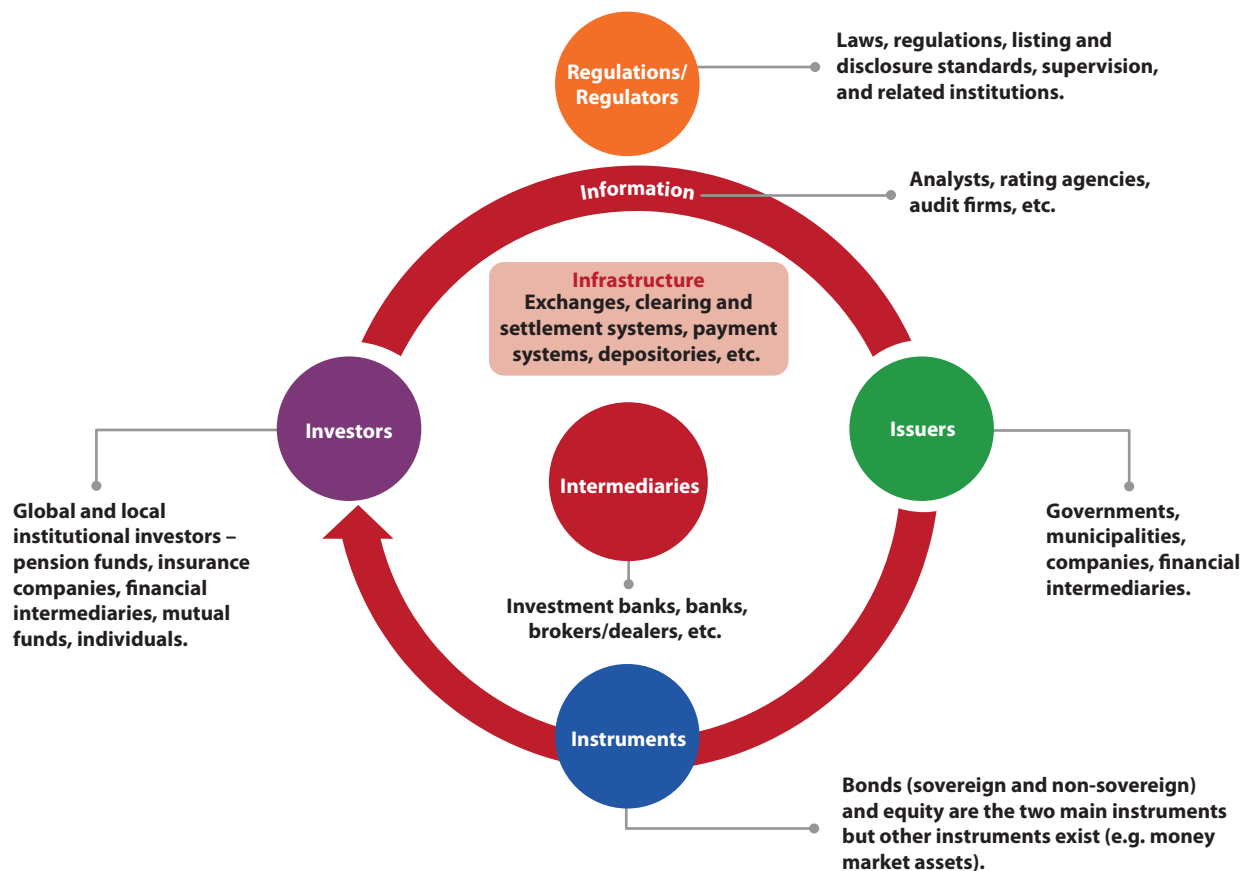
important source of capital market demand, yet they are undercapitalized in developing countries. Pension assets in developing countries totaled less than 20 per cent of GDP, versus 92 per cent in Organization for Economic Cooperation and Development (OECD) countries, in 2019.⁶⁶ In turn, this low demand reduces the supply of securities as potential listers and issuers elect to pursue other financing options, such as offshore listings and non-market financing. Ultimately, the result of this low liquidity results in a higher domestic interest rate due to the “liquidity premium,” and higher volatility when investors risk appetite changes suddenly.⁶⁷

Governments, as well as development finance institutions, can support capital market development by incentivizing both the supply of and demand for securities, especially long duration debt instruments. Public development banks can act as catalysts, by prioritizing the issuance of debt securities on domestic capital markets to meet local currency needs. In terms of equity markets, dual listings—that is, when a company lists or issues a security on two stock exchanges—can boost the supply of securities in some cases, although it does risk creating limited liquidity on the smaller exchange. In one case, a developed- and developing-country stock exchange have committed to cross-listing green bonds.⁶⁸ Measures to promote the growth of pension assets also boost the demand for securities. For example, Turkey’s 37 per cent increase in its

pension assets in 2019 can be attributed to its adoption of automatic enrollment. Countries with large informal sectors (who are otherwise excluded from pension initiatives) can trial micro-pensions for informal workers.⁶⁹

Capital market integration has the potential to increase both supply and demand and has often been recommended for small markets, but progress has been lack-lustre. Over the last decade, several regional initiatives were launched to integrate regional stock exchanges. In Africa, a project has been under way to connect exchanges across the continent,⁷⁰ while another initiative is nearing completion in East Africa.⁷¹ In Latin America, integration has been more successful and dates back to 2010. The limited scope of the existing integration (e.g., only four exchanges in Latin America) and delays in realizing integration speak to the operational difficulties of integration. Integration requires a common institutional and rule-based infrastructure. Market infrastructure must be integrated, for instance, through a technology platform that connects brokers across exchanges and a central securities depository. Financial laws and regulation (including rules on taxes and tariffs) must be harmonized to a certain degree. Given this difficulty, policymakers can explore alternative means of increasing liquidity in the medium term. This could include the creation of an exchange-traded fund composed of local currency bonds.⁷² Such funds can appeal to a wider investor base and bring liquidity to the market without full integration.

Figure III.B.6
Capital Markets Ecosystem



Source: World Bank, Capital Markets Development: A Primer for Policymakers, (2020).

5. Making private business and financial markets sustainable

5.1 Increasing long-termism

Short-term investment horizons contribute to market volatility and shape corporate behavior. A sustainable economy requires investment in people, innovation and physical capital. But these investments need time to come to fruition. If investors are too focused on short-term performance, companies might be reluctant to make the required long-term commitments, even if these are critical for future value creation. Rather, they may seek to improve quarterly financial performance to please investors through means with more immediate impacts, such as cost-cutting. In a recent FCLT Global survey, 70 per cent of company executives said their companies would take actions that do not enhance long-term growth just to meet short-term financial goals.⁷³ This short-termism goes against the interest of most savers (and thus of most shareholders), who have an estimated investment horizon of thirteen years on average because, for instance, they are saving for retirement.⁷⁴

The prevailing focus on short-term financial returns for shareholders meant that companies entered the crisis ill-prepared and vulnerable to adverse demand shocks, such as those created by COVID-19. Over the past decade, many firms used over 90 per cent of profits to buy back shares, pay dividends and boost return ratios for shareholders. In 2019, companies in the S&P 500 bought an estimated \$729 billion of their own stock.⁷⁵ As a result, some of these companies didn't build reserves or invest in their own future. Concerns are especially pronounced when buy-backs are financed by adding leverage to corporate balance sheets, as has been the case in recent years, with up to 50 per cent of buy-backs financed by corporate bonds.⁷⁶

Policymakers have a range of options to disincentivize non-productive investments in favour of investment with positive sustainable development impact. For instance, tax codes could be adapted to reduce the advantage that stock buy-backs (taxed as capital gains) hold over dividends (taxed as ordinary income) in many jurisdictions. Financial regulators could also consider discouraging excessive debt leverage linked to non-productive investments by reviewing capital requirements for loans associated with non-productive investments. The feasibility of these options should be further examined.

Changes in corporate governance are needed to address short-termism. To this end, companies can take the following actions:

- Make public commitments towards long-term objectives linked to all their stakeholders, such as commitments to net-zero emissions, biodiversity conservation, waste reduction, decent work and gender equality. About 1,400 companies have joined the United Nations Race to Zero campaign and should issue a plan to make their business compatible with a net-zero economy;⁷⁷
- Adopt internal carbon pricing to prepare themselves for a low-carbon transition. In 2019, at least 1,600 companies currently use internal carbon pricing or anticipate doing so within two years;⁷⁸
- Ensure that long-term issues, such as environmental and social impacts, are discussed at the board level, and request management to produce sustainability-related strategies with internal responsibilities for implementation;⁷⁹
- Revise compensation packages to link them not only to financial but also to social and environmental targets, and structure them over longer time horizons. This must start with CEOs and be mainstreamed throughout organizations to create a change in corporate culture. Yet, only 9 per cent of the 2,684 companies in the FTSE All World companies link executive pay to environmental, social and governance (ESG) criteria.⁸⁰

Box III.B.1

Credit rating agencies and sustainable development

Credit rating agencies only assess the material impact of sustainability risks on the creditworthiness of an issuer, unlike some environmental, social and governance (ESG) raters, which also aim to assess a company's impact on sustainability issues. Yet, credit rating agencies have inconsistently and partially incorporated sustainability risks into their ratings. This is problematic as the majority of evidence confirms that more sustainable companies have a lower rate of default.⁸¹ Not integrating sustainability can thus lead to the over or underestimation of creditworthiness, as illustrated by Pacific Gas & Electric that declared bankruptcy after being held liable for billions in damages for its role in California wildfires.⁸² There are reasons to believe this is changing. Two of the "big three" credit rating agencies have acquired independent sustainability rating providers in recent years: S&P Global purchased RobecoSAM's ESG rating division in 2019, following the acquisition of Trucost, a sustainability rating and risk provider, three years prior.⁸³ Moody's acquired a majority stake in Vigeo-Eiris, a provider of ESG data

and research, in April 2019 and purchased a climate risk start-up later that year.⁸⁴ This horizontal market consolidation can, over time, reduce institutional barriers to the integration of sustainability risks into credit ratings. According to Moody's, 36 per cent of its rating adjustments of issuers in emerging markets were informed by sustainability risks—a higher rate than in developed markets.⁸⁵ Since many of these adjustments recognize previously unrecognized sustainability risks, on average it could be expected to lower the credit ratings of developing-country borrowers and thus increase their already high cost of financing. For instance, S&P Global reported lowering its forward outlook of a small island developing State (Turks and Caicos) because of increased hurricane risks.⁸⁶ Given these implications, it is important that credit rating agencies increase both the transparency of their evolving methodologies and the integration of ESG risks (for instance, through scenario analysis to account for uncertainties and long-term risks).⁸⁷ If voluntary compliance with these requests is not sufficient, policymakers could consider instituting mandatory transparency requirements.

Source: UN DESA

But changing incentives along the investment chain will ultimately be necessary to lengthen business horizons. Asset managers need to lengthen their investment horizons in line with the longer-time horizon of their clients, the asset owners. The mandate given to asset managers may not properly align incentives with a long-term investment horizon. This could result from a fee structure that rewards short-term performance, or because asset managers are assessed against short-term benchmarks. To address this issue, the Global Investors for Sustainable Development (GISD) Alliance is working on a new “model mandate” that would seek to define the relationships between asset owners, asset managers and investee corporations with a view to advancing a long-term sustainable perspective. Additional mechanisms that can support lengthening investment horizons include long-term indices and credit ratings that further incorporate sustainability-related risks (see box III.B.1).

5.2 Reporting to make the private sector accountable

The transformation of the private sector cannot be achieved without more transparency on the impact of companies on the SDGs. In 2019, 90 per cent of S&P 500 companies published a sustainability report compared to only 20 per cent in 2011.⁸⁸ Yet, despite the increasing number of sustainability reports issued by companies, it remains challenging for investors and consumers to understand the environmental and social footprint of companies. Information published is often not comparable across companies or time, and tends to focus on qualitative indicators rather than on quantitative data. Companies select the issues they choose to communicate, as sustainability reporting remains largely voluntary. This creates incomplete and even misleading information. Furthermore, sustainability risk disclosures are currently published across several sections of annual reports, including both audited and unaudited sections. The lack of independent assurance of sustainability reports and information reduces their reliability.

Confusion still prevails over the framework companies should follow to provide sustainability-related information. Companies currently face fragmented reporting frameworks (figure III.B.7). Companies also provide sustainability information by responding to surveys and questionnaires, including from investors, data aggregators, indices, and ratings agencies. Large companies may receive more than 100 such queries each year. The same sustainability issue can thus be measured in many ways and reported through multiple channels depending on the framework selected and the specific questionnaire. This creates unnecessary complexity and reporting burdens for companies.

Defining the scope of sustainability reporting is as important as ensuring its harmonization. The more restrictive view is that companies should only disclose information on sustainability risks that are likely to impact their business performance (i.e., what is financially material). This level of disclosure helps financial institutions and investors in decision-making. A more comprehensive view includes disclosure of information on the external impact of company activities on environmental and social issues (what is environmental and socially material). This level of disclosure would provide meaningful information not just to those financing them, such as shareholders, but also to those they impact through their activities, including customers, employees and local communities. For example, on climate change, considering a narrow

or wide reporting scope implies reporting on completely different metrics (see box III.B.2). Providing a comprehensive picture of carbon emissions might not be financially important for all businesses at this stage, but could become financially material in the future if regulations change (see the concept of dynamic materiality from figure III.B.7)

Organizations providing different reporting frameworks must consolidate their work into a single, coherent global set of reporting standards. There is already enormous traction in this area. Corporate executives and investors alike have called for reducing the number of sustainability reporting standards.⁸⁹ The standard-setting bodies recently announced their intent to work together to address the cacophony of metrics and standards.⁹⁰ This welcome development, facilitated by the Impact Management Project, needs to be encouraged by regulators. At the same time, the International Financial Reporting Standards (IFRS) foundation launched a consultation on the establishment of a dedicated Sustainability Standards Board within its institutional and governance structure.⁹¹ Since IFRS standards enjoy worldwide recognition in financial reporting, this could constitute a breakthrough, if the IFRS foundation manages to properly integrate existing frameworks and does not curtail the scope of sustainability reporting to only those that are financially material.

The necessary harmonization of company sustainability reporting requires leadership from policymakers. Security commissions and country regulators specify the use of reporting frameworks, building on global norms. For instance, IFRS became the financial accounting standards used in more than 140 jurisdictions because they were adopted by national regulators. Stock exchanges also have a considerable influence on company disclosure. Out of 102 stock exchanges tracked by the Sustainable Stock Exchange (SSE) initiative, 24 already have mandatory ESG listing requirements (versus 8 in 2016).⁹² To define the scope of sustainability reporting, mechanisms at the national level are needed in order to coordinate stakeholders, including investors and ministries (e.g., environment, planning and finance), and organizations (e.g., associations of accountants and auditors) that have an interest in corporate reporting.

International cooperation is fundamental to developing the basis of a globally coherent solution and avoiding various standards for companies and capital market fragmentation. Governments could use the United Nations intergovernmental platforms for this purpose. Without international collaboration, companies may be required to follow several (possibly incoherent) sustainability reporting frameworks, depending on where they operate and where they are listed. Different initiatives have been launched to facilitate coordination across jurisdictions. The International Organization of Securities Commissions (IOSCO) decided in 2020 to establish a Sustainable Finance Task Force to improve sustainability-related disclosures made by issuers and asset managers.⁹³ The International Platform on Sustainable Finance, launched in 2019, also aims to facilitate multilateral dialogue and now has 17 members representing 50 per cent of world population. These and other coordination efforts could be further brought together and advanced by leveraging the United Nations intergovernmental platforms, particularly the Financing for Development process, United Nations Conference on Trade and Development (UNCTAD)-International Standards of Accounting and Reporting (ISAR) sessions focusing on corporate reporting issues, and the Twenty-sixth United Nations Climate Change Conference (COP26). As

guardian of the SDGs, the United Nations system is well placed to support the development of social and environmental metrics for corporates that are linked to the global Goals.

To promote global harmonization and increased transparency, policymakers could make it mandatory for large companies, both listed and unlisted, to report on a core set of general (or industry-agnostic) metrics. To this end, they could build on the two lists of core metrics developed, respectively, by the UNCTAD-ISAR intergovernmental working group of experts (33 metrics) and by the World Economic Forum International Business Council (WEF-IBC) (21 core metrics and 34 expanded metrics).⁹⁴ It would help if these initiatives, representing the public and private sector respectively, could work together towards aligning their metrics on core indicators, as well as with standard-setting bodies, to converge on a globally harmonized list of core metrics. This list could then be implemented at the national level by appropriate regulatory bodies as a minimum level of corporate disclosure. On the issue of climate change, there are also calls to make reporting in

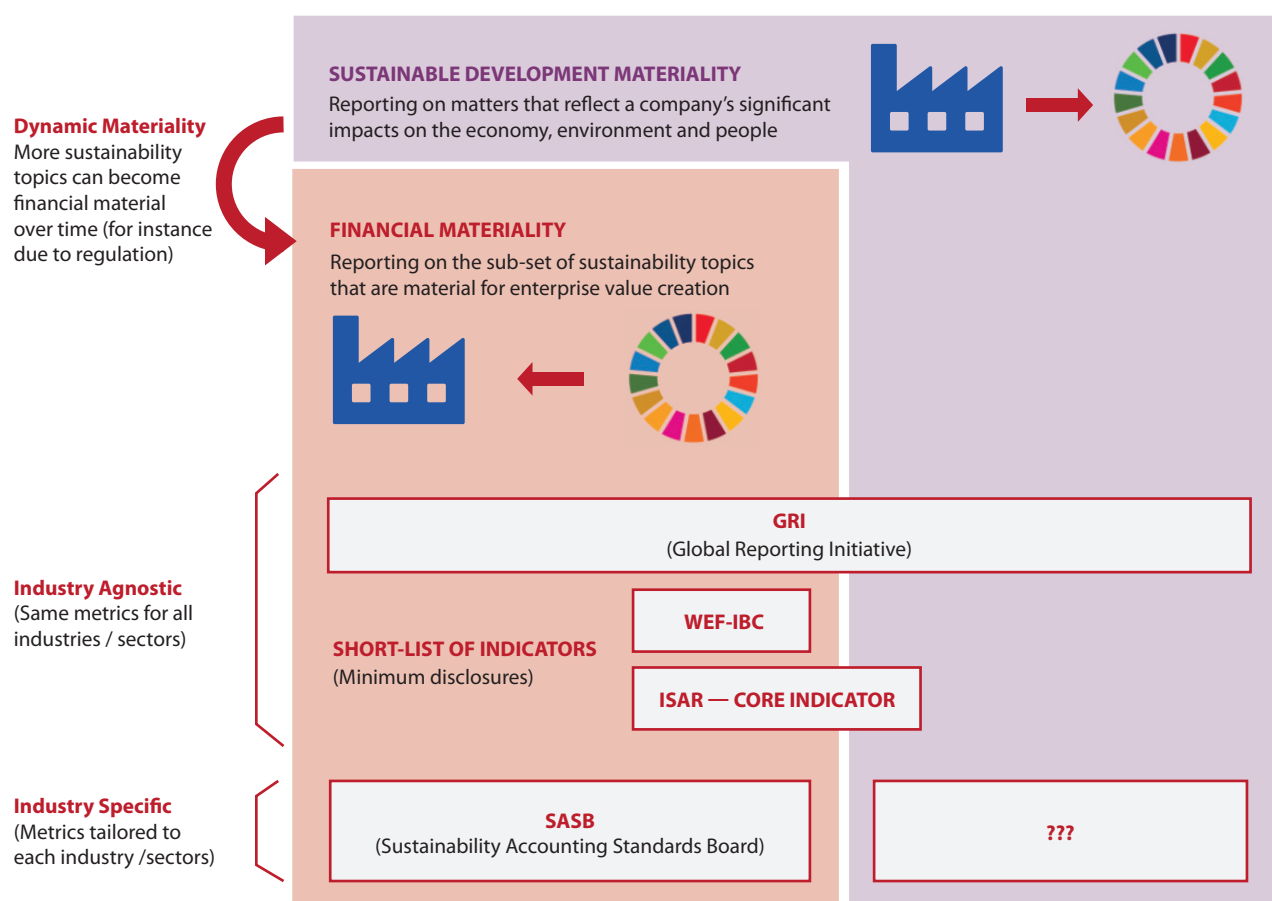
line with recommendations from the FSB Task Force on Climate-related Financial Disclosures (TCFD) mandatory, as recently announced by New Zealand and the United Kingdom of Great Britain and Northern Ireland.

There is widespread support in the private sector for mandatory, legally binding sustainability disclosures. Without mandatory requirements, disclosure will remain partial and non-harmonized. Whereas in the past business leaders preferred voluntary disclosure, that view has shifted due to the proliferation of reporting standards and the increasing focus and importance of sustainability issues since the adoption of the SDGs. A survey conducted with corporate executives and investors indicated strong support for mandatory sustainability reporting for companies; 82 per cent of investors and 66 per cent of executives agree with this.⁹⁵

Harmonized, industry-specific impact metrics can provide a complete picture of a company's sustainable development impact. Existing reporting frameworks focus on measuring the impact of company operations (how they produce). Assessing company contributions

Figure III.B.7

Scope of reporting frameworks



Source: UN DESA based on the “Statement of Intent to Work Together Towards Comprehensive Corporate Reporting, CDP, CDSB, GRI, IIRC and SASB, September 2020” – more information on reporting frameworks are available on the Navigator (<https://gisdaalliance.org/navigator>).

Note: Regarding climate change, the TCFD provides a framework to help companies disclose climate-related risks and opportunities but does not provide standards for defining metrics/targets. These standards are provided by other organizations such as the GHG protocol and the Science Based Targets initiative (SBTi), which respectively provides a methodology to measure emissions and one to set reduction targets.

to the SDGs also requires accounting for the impact of products and services (what they produce). For example, an information technology company may provide information on its energy consumption but not on the number of people granted Internet access for the first time. This information is inherently specific to an industry and is not captured by general sector-agnostic metrics. Therefore, it would be useful to identify a list of industry-specific reporting metrics, and integrate these into existing reporting frameworks. This list could benefit from the increasing willingness of companies to use the SDGs as a benchmark for impact. Out of 150 sustainability reports reviewed, 20 per cent aligned key performance indicators (KPIs) with the SDGs in 2020, while only 6 per cent did so in 2019.⁹⁶ The GSD Alliance has initiated work to address this gap.

Sustainability-related information mostly remains hidden behind paywalls and is not in the public domain; policymakers

could change this. A great deal of sustainability data is collected by private companies, through company questionnaires or by using technology powered by artificial intelligence (AI) to search thousands of public sources for real-time information on companies (e.g., the OECD plans to use AI technology to assess private companies' alignment with the United Nations Global Compact principles and the OECD/UNDP Framework for SDG-Aligned finance). An open repository for company sustainability data

would create more transparency and help consumers and investors make purchasing and financing decisions. The World Benchmarking Alliance aims at providing this transparency by developing freely accessible benchmarks that will compare the performance on the SDGs of 2,000 influential companies. Policymakers could support this push for transparency by making corporate filings easily accessible to the public.

Box III.B.2

Why do we need to move beyond Scope 1 and Scope 2 GHG emissions disclosures?

The focus of company carbon disclosure has so far been on

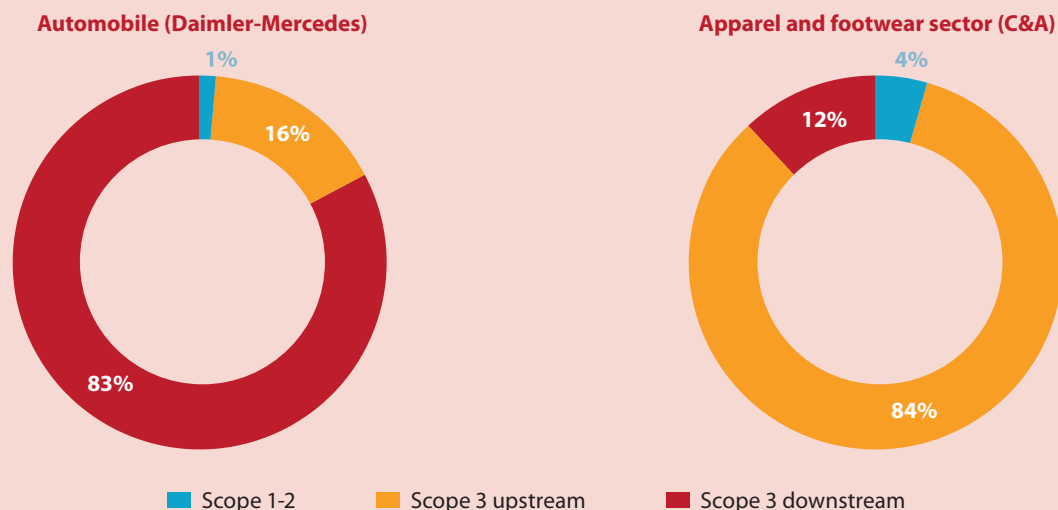
- Scope 1 emissions, which are direct emissions from sources controlled by a company, such as emissions from combustion in owned vehicles or emissions from chemical production; and
- Scope 2 emissions, which are the emissions linked to the electricity purchased by a company.

However, carbon emissions for many sectors come from indirect emissions (Scope 3), such as those from suppliers (Scope 3 Upstream) or those related to the products that a company produces (Scope 3 Downstream). Figure III.B.8 demonstrates the importance of Scope 3

emissions for two selected industries. For automobiles, most carbon emissions result from downstream activities, which capture the emissions from the cars sold. For the apparel and footwear sector, the opposite holds true. Most emissions come from upstream activities, which represents the emissions in the supply chain. Among the 69 industries reviewed, Scope 1 and Scope 2 combined account for most of company emissions for only 8 industries (including airlines, utilities and construction materials). For 38 of them, Scope 3 accounts for more than 80 per cent of GHG emissions.⁹⁸ Yet, disclosure has been poor so far and most data comes from estimation models. As of March 2020, only 18 per cent of the 8,982 companies that make up a large market index had reported Scope 3 emissions.⁹⁹ While measuring Scope 3 emissions is a complex endeavour, it is essential to understanding the carbon footprint of many companies.

Figure III.B.2.1

Scope 1-2-3 emission for selected sectors
(Percentage)



Source: UN DESA based on Daimler Sustainability Report 2019 and C&A Global Sustainability Report 2018.

To mitigate regulatory burden, disclosure requirements should be proportional to company size and sophistication.

Large multinational companies have deep social and environment footprints, as well as the resources to assess and disclose the impact of their operations, products, and services. Imposing the same standard on small and medium-sized enterprises (SMEs), and most companies in developing countries, would not be proportional to their footprint and means. Such companies could be subject to a “disclose-or-explain” standard, similar to the “comply-or-explain” standard used in regulation: they can choose to disclose their impact or justify why they did not. The annual reporting requirements for signatories of the United Nations Global Compact present another complementary approach, where multinationals are subject to a broader array of questions while SMEs have the option to respond to a condensed version of the questionnaire. For all companies, a transitional period during which they are excluded from legal liabilities arising from the collection and disclosure of new data categories should be considered, until they become familiar with new methods. Strengthening the infrastructure for corporate reporting may also be necessary in countries lagging behind in this area, and countries could consider using existing tools developed for this purpose, such as the UNCTAD Accounting Development Tool.⁹⁷

5.3 Embedding sustainability in lending practices

Financial institutions’ interest in integrating sustainability issues into their lending practices has been driven by the need to obtain a comprehensive picture of the risks they are taking.

Climate change has been a catalyst for financial institutions to integrate sustainability-related risks into their risk management system. For example, loans to coal power plants may suffer write-offs from stricter carbon emission standards or higher carbon prices (referred to as transition risks). Similarly, extreme weather events can affect mortgage loan values and lead to defaults (referred to as physical risks) (see chapter III.F). TCFD published recommendations for voluntary climate-related financial disclosures in 2017. The uptake since then has been considerable, with financial institutions responsible for assets of \$150 trillion expressing support for TCFD.¹⁰⁰ Yet, among 236 banks reviewed in 2019, less than a quarter disclosed climate-related metrics and targets.¹⁰¹ Company credit risks, particularly for loans with longer maturities, can also be influenced by sustainability issues broader than climate change, such as unsustainable labour practices. Banks need to adapt their risk assessment models accordingly, and international organizations could develop tools to help lenders include these risks in their decision-making processes.

The need to manage sustainability risks, combined with calls from stakeholders and society, has pushed banks to voluntarily commit to sustainability targets.

These commitments have been publicized through initiatives such as the Principles for Responsible Banking, which 200 banks have now joined, representing one third of the global banking industry. The United Nations Environment Programme Financial Initiative (UNEP FI) has developed a tool for banks to analyse the impact associated with their retail and wholesale loan portfolios on core elements of the SDGs.¹⁰² In 2020, a group of 26 financial institutions also signed on to a Finance for Biodiversity pledge, wherein they committed, by 2024 at the latest, to engage on this topic with companies they finance, assess their own impact, and set

targets.¹⁰³ An informal working group is also developing a workplan for a Taskforce on Nature-related Financial Disclosures, modelled after the TCFD approach. Regarding climate change, major banks have made pledges to reach net-zero financed emissions by 2050. To meet this pledge, banks will need to measure emissions associated with their loan portfolios, encourage clients’ own reduction efforts, and offset the remaining emissions (see box III.B.3).

Methodologies for assessing the carbon emissions of bank portfolios are still evolving; reaching consensus on these is critical to ensuring that climate commitments by banks are meaningful.

Banks are trying to assess the level of their financed emissions (i.e., the GHG emissions associated with their loans and investments). This is a complex endeavour; for instance, many small client companies do not disclose emissions, making it harder for banks to aggregate the data. To create a more standardized approach, the Partnership for Carbon Accounting Financials (PCAF) launched its first accounting and reporting standards for the financial industry in November 2020. Guidance has also been issued to help the financial sector set science-based targets.¹⁰⁴

Banks can also positively contribute to society’s goals by financing activities with positive impact, such as through green loans and sustainability-linked loans.

A sustainability-linked loan ties the interest rate to the sustainability rating of the borrower. While modest, such lending has grown in importance, reaching \$120 billion in 2020.¹⁰⁵ The advantage for banks to provide green or sustainability-linked loans—beyond, arguably, the lower risk of such lending—is that they help the bank prepare for potential policy changes, such as lower capital charges for sustainable lending or tax incentives aimed at encouraging sustainable lending in the future. Industry standards have been established to better define and create a shared understanding of these instruments in the market, including Green Loan Principles and Sustainability-Linked Principles in 2018 and 2019, respectively. Such a standardized approach could facilitate future intervention by regulators.

5.4 Promoting sustainable investment

The COVID-19 crisis has bolstered investor interest in sustainable finance by highlighting risks posed by non-financial factors.

ESG funds performed better during the financial market turmoil than comparable non-ESG funds and experienced record inflows in 2020.¹¹¹ On the debt market, alongside green bonds, issuance of social bonds increased 7 times between 2019 and 2020 (to about \$150 billion), mainly to fund relief packages by government agencies and development banks. Meanwhile, green bonds continued to increase, reaching more than \$300 billion in 2020 (compared to \$271 billion in 2019).¹¹²

Investors interest in sustainable finance has been driven by the conviction that companies need to manage sustainability-related risks and opportunities to create long-term value.

This conviction has been backed by several studies (see FSDR 2019) and its rationale is explained in section 2 above. For investors, it starts with a question of risk management. For instance, some investors have started to stress-test their portfolios against higher carbon prices. A Swedish pension fund estimated that its equity portfolio could lose up to 48 per cent of its value as a result.¹¹³

Box III.B.3**Net-zero emission pledges and voluntary offset markets**

The purpose of voluntary carbon markets is to allow companies and individuals to purchase carbon credits through independent mechanisms if they wish to offset carbon emissions to achieve their own climate targets. These markets differ from compliance markets, such as the EU Emission Trading Systems (ETS) and China ETS. Compliance markets are linked to mandatory reduction regimes that typically do not accept voluntary offset market credits for compliance purposes.

Voluntary carbon credits have had mixed success and remain relatively small (voluntary offset transaction values reached \$320 million in 2019).¹⁰⁶ However, the demand for these credits could increase as more companies, including banks, make pledges to net-zero emissions. The demand for future carbon credits could also benefit from the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), whose pilot phase starts in 2021. It is estimated that a minimum of 2 gigatons of emissions will need to come from sequestration and removal to reach the 1.5° Celsius goal. This would require a fifteen-fold scaling up of voluntary offsetting in 2030 versus 2019.¹⁰⁷

The supply of carbon credits will need to match an increase in demand. Carbon credits issuance can come from investing in carbon capture technology and nature-based solutions, which leverage forestry and land-based activities for carbon storage. Over the past five years there has been a large increase in the absolute amount and share of forestry credits, which makes up 42 per cent of the global total.¹⁰⁸ The World Bank is providing support to low-income countries to convert emissions reduction into carbon credits, in particular through the Carbon Initiative for Development (Ci-Dev) that mobilizes private finance for clean energy access projects. The World Bank has developed the Standardized Crediting Frameworks to simplify processes and lower transaction costs for national carbon crediting mechanisms, by learning from the Bank's experience with the clean development mechanism (CDM).

To scale up, voluntary markets need to be cost-effective and transparent, with credible carbon credits exchanged. Technology such as blockchain could help limit the risk of double counting and make carbon credits more easily tradable. Satellite imagery can also help monitor offsets and strengthen credibility, for example, by monitoring how many trees have been planted. Yet, the low price observed on voluntary markets raises concerns on whether cheap offsets may discourage a company's effort to cut emissions, which is the only way to address climate change (the average price in 2019 on voluntary markets was about \$3 per ton of CO₂).¹⁰⁹ Offsetting measures supplement but do not substitute the need to reduce value chain emissions in line with science.¹¹⁰ In addition, it is important to put safeguards in place so that projects eligible for carbon credits do not harm local communities.

Source: UN DESA

However, institutional investors are increasingly unable to fully diversify away from climate and other complex systemic risks.

Investors generally manage risk by diversifying across uncorrelated asset classes, so that when one set of assets underperform, another might outperform. However, the nature of climate change and other global systemic risks makes this strategy increasingly futile: these risks affect all asset classes and cannot be diversified away in the long term. While some smaller investors are able to rebalance their portfolio and/or divest entirely from exposed industries, institutional investors with universal investment mandates are unable to do so.¹¹⁴ Investing only in companies aligned with a 1.5°C scenario would mean excluding around 90 per cent of listed companies (or 60 per cent for a 2.0°C scenario).¹¹⁵

Instead, large investors are building resilience into their portfolios.

Because they cannot manage risks using traditional tools, institutional investors are compelled to increase the resilience of their portfolio to climate-related risks, for example, by working with investees to reduce their carbon intensity and leveraging their ownership position to influence company management.¹¹⁶ Climate Action 100+, a group of over 500 institutional investors, engages with the world's 161 highest-emitting companies and demands them to publish strategies to reduce emissions.¹¹⁷ Active ownership is an increasingly important tool, with investors privately engaging corporate managers on ESG matters as well as exerting public pressure through filing shareholder resolutions and (proxy) voting at annual meetings.

The growing investor interest in sustainability has led to the proliferation of sustainable investment funds and products, but their impact remains difficult to quantify.

Some of these funds go beyond management of the sustainability-related risks discussed above to focus on achieving sustainable development impacts alongside financial returns. About \$415 billion of assets are managed by private funds with the intent for sustainability impact.¹¹⁸ To demonstrate that assets are being managed for impact in a disciplined and transparent way, these funds can adhere to common principles for impact management, including the Operating Principles for Impact Management and the United Nations Development Programme SDG Impact Standards. But impact funds, while growing, only represent a small subset of investment strategies that focus on profit maximization, while considering ESG factors. The impact of these broader investment strategies on sustainable development is often uncertain; this is compounded by the absence of agreed standards for labelling ESG funds or "sustainable development investment," which raises concerns about the robustness of selection criteria used to choose investments for inclusion in these funds. It is common for ESG funds to include companies whose impact on sustainable development is doubtful. These funds are also concentrated in developed markets, whereas the developmental impact is likely greater if these funds could have a stronger focus on companies active in developing countries (which may require blended finance in some circumstances (see chapter III.C). In the same vein, green bonds have been a great

success in creating momentum around green investments, but it remains unclear to what extent they have changed the way issuers operate. A green bond label certifies that the activities financed are green, but does not guarantee the greenness of the firm issuing the bond. There is currently no strong evidence that green bond issuance is associated with reduction in carbon intensities over time at the firm level (i.e., in the issuer's overall activities).¹¹⁹

Policymakers can support sustainable development investing and increase its impact. Directing funds to companies and projects aligned with the SDGs requires providing investors with the appropriate tools:

- **First, there is a need to improve the quality and comparability of data/metrics on the impact of companies on social and environmental issues.** Without comparable data, investors cannot properly incorporate sustainability issues into their investment decisions and allocate capital to companies aligned with the SDGs. In addition to corporate reporting (see section 5.2), rating agencies could help inform market participants. However, sustainability is not fully incorporated into traditional credit ratings (see box III.B.1), and ESG rating providers often have different views on the same companies. ESG scores show a correlation of just 61 per cent among the leading ESG score providers;¹²⁰ and for some ESG rating providers, it has been found that high E scores positively correlate with high carbon emissions. This raises concerns about the suitability of current ESG scoring for helping investors align their portfolios with a low-carbon economy.¹²¹
- **Second, there is a need for a greater clarity on which economic activities positively contribute to sustainable development, for instance, through a globally harmonized taxonomy.** Different regulators have started developing taxonomies of activities with positive impacts to sustainable development, including Bangladesh, Canada, China, India, Malaysia, Mongolia, New Zealand, Singapore and the European Commission.¹²² Developing taxonomies at the global level would help avoid investor confusion and financial markets segmentation. Also, the scope of existing taxonomies could be broadened to cover all the SDGs, as most of them currently focus exclusively on green activities. Development impact should also be considered, meaning that activities in countries with large SDG gaps should be favourably regarded when creating sustainable taxonomies or setting standards for sustainable financial products;
- **Third, there is a need to advance a common understanding of sustainable development investing to mitigate the risk of greenwashing or SDG washing.** Too many investment products and strategies claim to be sustainable without making a meaningful contribution to the SDGs. Without minimum standards or criteria, any investment can make such a claim and use sustainable development as branding. This can be misleading for investors and hurt the credibility of the industry. To address this issue, the GISD Alliance has developed a common definition of what constitutes sustainable development investing.¹²³ This definition could serve as an effective norm for the market if widely adopted by market participants and policymakers. The definition goes beyond broad principles and includes concrete steps for its operationalization in an investment portfolio centred around the SDGs. These steps build on the many initiatives under way to reinforce investment practices, as well as on existing sustainability-related standards and taxonomies (see box III.B.4);
- **Fourth, there is a need to strengthen over time the impact of sustainable debt products, such as green bonds.** For policymakers, as the green bond market matures, it is important to understand whether these bonds create additional positive outcomes and carbon reduction, or finance activities that would have been realized anyway. Complementing green bond labels with “green” ratings (e.g., attesting to a company's compatibility with a 2°C pathway) may be necessary to better align incentives and provide a complete picture to investors. Rather than focusing on the bond's use of proceeds, other approaches could also be promoted, such as sustainability-linked bonds where the issuer commits to improvements in overall firm performance against green or social metrics, or the labelling of bonds issued by companies aligned with the SDGs at the corporate level.

Policymakers can also encourage the demand for investment aligned with sustainable development.¹²⁴ For example, Governments could provide tax credits or regulatory relief for sources of financing directed towards sustainable investment. Central banks could also accept suitable sustainable debt instruments as collateral, and include these bonds in their asset purchase programmes.

Regulation could also enable individuals to express preferences on the way their money is spent. For retail investors, this would mean requiring investment advisors to ask their clients about their sustainability preferences along with other information they already request. For

Box III.B.4

Sustainable Development Investing (SDI) Navigator

The growing interest in sustainable finance has resulted in a multiplication of initiatives. To provide for the first time a structured overview, the Global Investors for Sustainable Development Alliance has developed the Navigator. This online tool makes it easier for market participants to operationalize the Sustainable Development Investing (SDI) definition, developed by the Alliance, by mapping about 70 existing principles, practice standards, and tools. Investors can find resources to help them deploy capital that makes a positive contribution to sustainable development. Finance institutions can locate resources to mainstream sustainable development objectives in their lending practices. Corporates, with the support of the investors and finance institutions, can build on existing work to reorient their business models towards the SDGs. This Navigator will hopefully help create synergies among these initiatives, avoid duplication, and lead to more coherent approaches.

Source: Global Investors for Sustainable Development. See <https://gisdalliance.org/navigator>.

institutional investors, this could mean adding a sustainability focus in the default pension plan or adding more sustainable options from which pension fund participants can choose. Employers may also be asked to conduct research on their employee views on these issues to better reflect the preferences of beneficiaries in pension plan investment strategies. A survey of pension fund participants in the Netherlands revealed that sustainable investments are commonly favoured by participants, even if they harm financial interests.¹²⁵

Transforming businesses and financial markets should start with a fundamental rethink of firm-level reporting. The need to move beyond enterprise value to a more holistic understanding of a business's impact on people and the planet is necessary. Bringing corporate reporting in line with this reality has a multiplier effect, as the data provided in reports informs consumer purchases as well as lending and investment decisions. Ultimately, the reimagining of reporting forms the basis for a new partnership between business and society.

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