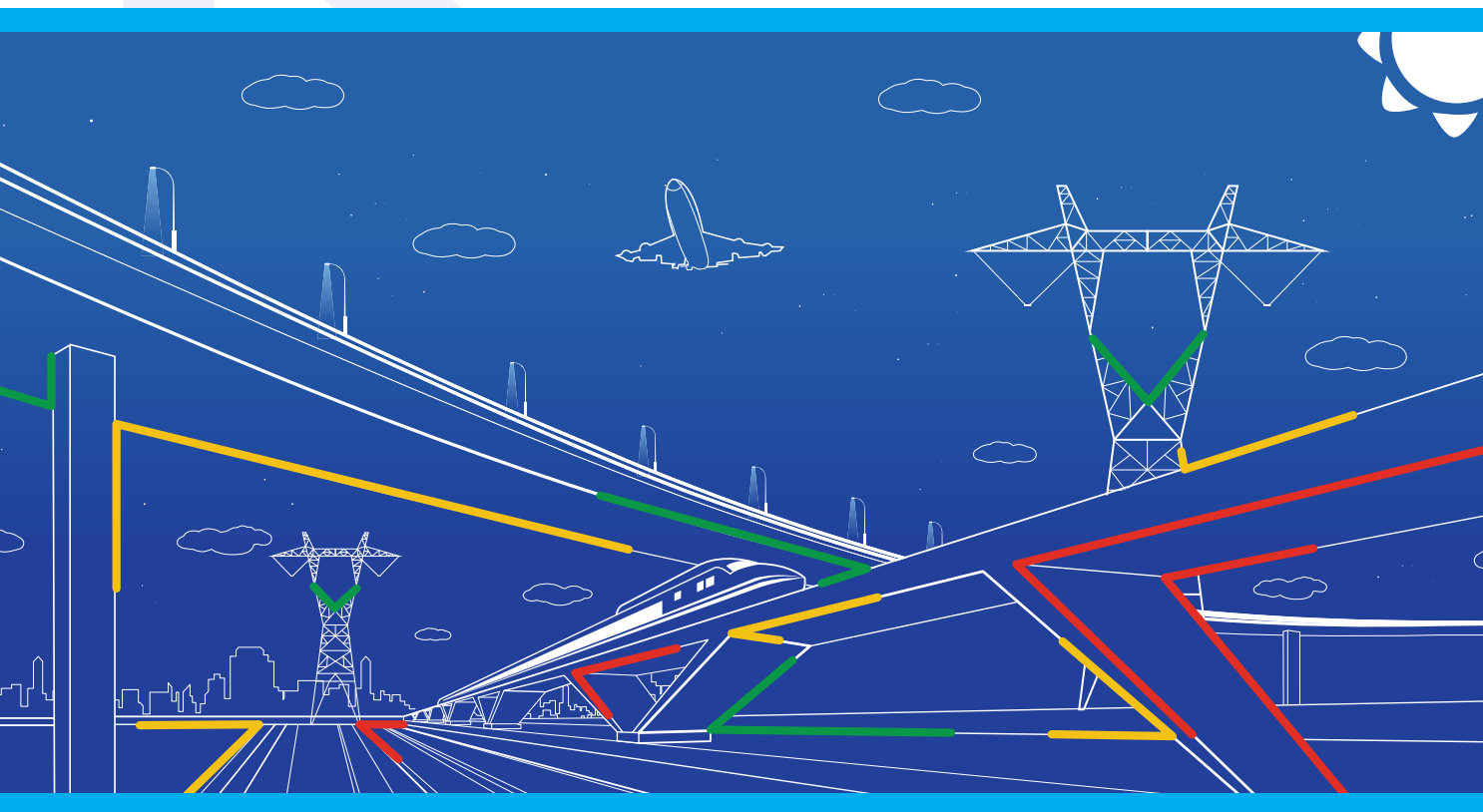


FINANCING FOR DEVELOPMENT: PROGRESS AND PROSPECTS

Report of the Inter-agency Task Force
on Financing for Development 2017



United Nations

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Chapter III.B

Domestic and international private business and finance

1. Key messages and recommendations

The Addis Ababa Action Agenda calls on businesses to apply their creativity and innovation to solving sustainable development challenges, and invites them to engage as partners in implementation of the sustainable development agenda. Private business activity, investment and innovation are major drivers of productivity, employment and economic growth. The Addis Agenda builds on earlier Financing for Development outcomes on the role of the private sector, but broadens them in support of all three dimensions of sustainable development—economic, environmental and social.

Public policies set the enabling environment and the regulatory framework for private sector investment and activity. The Monterrey Consensus tasked Member States of the United Nations with building transparent, stable and predictable investment climates, and many countries have made great strides in this area, though more can be done to create competitive business environments. In the Addis Agenda, countries resolve to continue this work, while also aiming to better align business activities and investment decisions with sustainable development objectives.

In understanding the role of the private sector in financing sustainable development, it is important to recognize that the private sector includes a wide range of diverse actors, from individual households and international migrants to multinational corporations, and from direct investors to financial intermediaries, such as banks and pension funds. Policy frameworks thus need to be designed with an understanding of the incentive structures of different private actors and how each comes together in the sup-

ply chain of capital. While the large preponderance of private business activity remains profit driven, a growing number of institutions have double or triple (social and environmental) bottom lines. Yet, given the large-scale financing needs, as noted in the Addis Agenda, more must be done to better align private business activity and investment with sustainable development.

Domestically, Governments need to support development of both financial depth and financial breadth. Efforts to ensure inclusive finance can be based on a range of interventions, including the use of new technologies, the promotion of credit registries, and involving a range of institutions (such as microfinance, cooperative banks, and development banks.) ***More countries should adopt national financial inclusion strategies (NFIS). Countries should also continue to share experiences of financial inclusion, including for women, through regional and global forums, such as the Financing for Development Forum, and through the Alliance for Financial Inclusion. Moreover, countries should develop financial literacy programmes, including an emphasis on the impact of finance on sustainable development.***

One of the biggest challenges policymakers and stakeholders face in raising resources for sustainable development is how to address excessive short-term oriented decision-making and develop financial markets that are inclusive, long-term oriented, and that support sustainable development. ***The Task Force has begun work on mapping out incentive structures of different actors in the financial system, and will continue to develop this work.*** Task Force members will work on different elements of sustainable financial market development. ***The Addis Agenda emphasizes that the***

different elements of sustainable financial market development are integrated. The Task Force can thus be a platform for building collaborative solutions among its members.

Long-term investment, sustainability and stability of the financial system should be mutually reinforcing. Moreover, without a long-term perspective, firms won't incorporate long-term risks, such as climate change, into their investment decisions. *Efforts by the private sector to better align their internal incentives with long-term investment and with sustainable development indicators should be supported, as should United Nations system initiatives (such as the United Nations Global Compact, the Sustainable Stock Exchange Initiative, Principles for Responsible Investing, and the United Nations Environment Programme Inquiry).*

However, even with long-term horizons, markets may provide insufficient financing in sectors important for sustainable development. This typically happens when market prices do not reflect the full economic cost of environmental and social externalities, and when risk-adjusted financial returns are not sufficient to attract adequate private investment. It is thus the responsibility of policymakers to set the appropriate incentives, which can be done through targeted interventions. *This can be achieved through a package of taxes and subsidies to change relative prices, regulations and standards to guide investment behaviour, and appropriately designed risk-sharing instruments, including co-investments, public-private partnerships, and guarantees, depending on country priorities.*

Corporate sustainability benchmarks, which rank companies on their performances across a range of indicators, have been developed as part of voluntary initiatives. With the adoption of the Sustainable Development Goals (SDGs), there is an opportunity to align these benchmarks to the goals, which would allow companies to take an active role in their implementation. *The United Nations and the financing for development process can provide a forum, with multi-stakeholder inputs, for discussions on meth-*

odologies for corporate sustainability benchmarks aligned with sustainable development.

Member States will be presenting voluntary reviews of their progress on implementing the SDGs, including through national sustainable development strategies. Through their intended nationally determined contributions, communicated to the United Nations Framework Conference on Climate Change, (UNFCCC), countries also publicly outline what actions they intend to take to address climate change within the context of their national priorities. The Addis Agenda calls for these strategies and actions to be supported by “integrated national financing frameworks”.¹ National strategies, supported by financing frameworks, can be seen as guideposts for investment priorities, and can showcase opportunities for partnerships. *Member States may wish to consider a global mapping of priority investment areas contained within national development strategies as a way to guide private investors, both foreign and domestic, for SDG-linked investment opportunities. This will also help support the development of pipelines of investable projects.*

2. Promoting inclusive financial systems for sustainable development

The purpose of the financial system is to intermediate credit from those with surplus funds to those in need. Promoting an inclusive financial system for sustainable development includes a wide range of actions on both the international and national levels, emphasizing long-term investment, sustainability, inclusiveness and stability. The Addis Agenda brings these different elements together into a cohesive framework for designing an effective financial system that supports implementation of sustainable development and the SDGs.

2.1 The investment climate

Many countries have made important strides in strengthening the enabling environment for private sector business and investment. These improvements

¹ Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda) (United Nations publication, Sales. E.16.I.7), para. 9. Available from http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

are reflected in the cost of starting a business,² which has fallen by more than 80 per cent on average in least developed countries (LDCs) since 2004 (figure 1). Nonetheless, in many countries, the decreases in costs have levelled off, implying that more can be done to create competitive business and investment climates.

Strengthening the enabling environment entails a range of actions, such as reforms to the legal framework, promoting transparency, and reducing red tape. The most recent World Bank Doing Business survey³ of domestic and foreign companies across 190 economies found that the most common obstacle to business operations was access to finance (in about a quarter of the countries surveyed), with tax rates, practices of the informal sector, and political instability also significant (see chapter III.A on domestic public resources for a discussion of tax incentives). This underscores that an enabling environment must incorporate inclusive

finance as a core component of financial and private sector development.

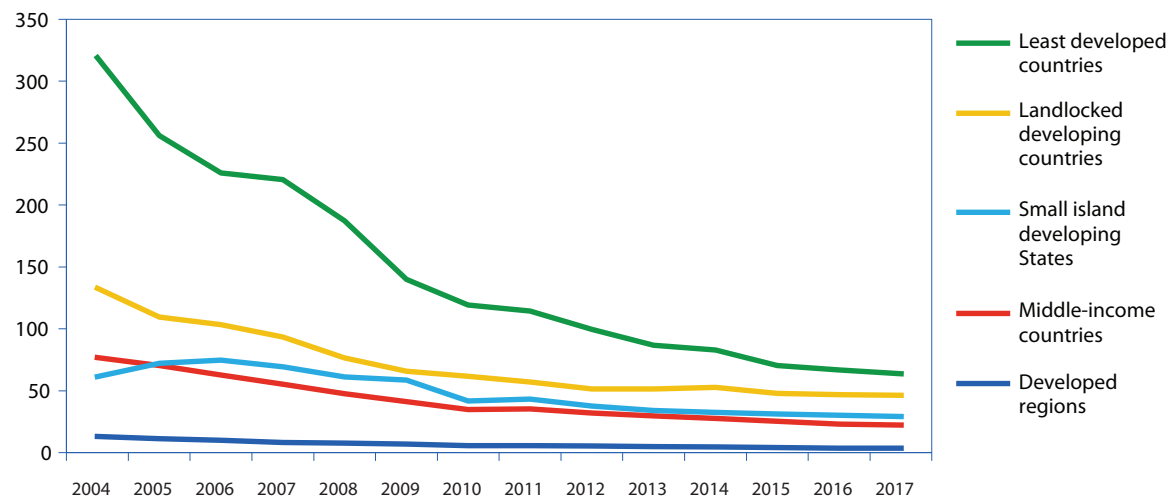
Importantly, strengthening the enabling environment should also include the application of labour, environmental and health standards and the promotion of access to finance. The Addis Agenda supports a dynamic and well-functioning business sector that is committed to the protection of labour rights and environmental and health standards in accordance with relevant international standards and agreements, such as the UN Guiding Principles on Business and Human Rights.⁴

2.2 Financial inclusion

There has been enormous progress in financial market deepening in many developing countries. From 2000 to 2015, the ratio of private credit to gross domestic product (GDP) increased from an average of 11 per cent to 22 per cent in LDCs, and from 30 per cent to 48 per cent in middle-income coun-

Figure 1

Cost of starting a business, 2004–2016 (Percentage of income per capita)



Source: World Bank Doing Business database and UN/DESA calculations.

- 2 The cost of doing business includes official fees as well as additional private fees, such as for legal or professional services if such services are required by law or commonly used in practice. Fees for purchasing and legalizing company books are included if these transactions are required by law.
- 3 World Bank (2017). *Doing Business 2017. Equal Opportunity for All*. Available from: <http://www.doingbusiness.org/-/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB17-Report.pdf>
- 4 Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda) (United Nations publication, Sales. E.16.I.7), para. 37. Available from http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

tries.⁵ However, financial depth is not always linked to financial breadth—that is, financial sectors can become deep without delivering access to financial services to large segments of the population. For example, in some countries where the financial sector exceeds the size of GDP, less than a quarter of adults report having a formal bank account, while in other countries, with much less financial depth, account penetration is over 80 per cent.⁶ Account ownership among women increased across the globe from 47 per cent (versus 54 per cent for men) in 2011 to 58 per cent (versus 65 per cent for men) in 2014.⁷ This raises critical questions on the appropriate size of financial intermediation as financial markets develop and the appropriate set of policies to promote inclusiveness.

As of 2014, 62 per cent of the world's adult population has a bank account, up from 53 per cent in 2011, with the greatest increase in middle-income countries (an average increase of between 31.3 and 40.9 per cent). However, while more than 80 per cent of adults in developed countries have accounts, less than 50 per cent in developing countries and 27 per cent in LDCs do (figure 2). Globally, 2 billion people, primarily in rural areas in developing countries, do not have access to formal financial services.

At the same time, as noted above, surveys indicate that lack of finance is a major obstacle for SMEs in a number of developing countries. The unmet need for credit for SMEs has been estimated to be up to \$2.6 trillion in developing countries and about \$3.9 trillion globally, with 80 per cent of women-owned SMEs remaining unserved or underserved. More

than 200 million micro, small and medium-sized enterprises in developing countries lack adequate financing, with the financing gap particularly wide in LDCs (figure 3).⁸ This is a major constraint to private sector development, as in many developing countries SMEs constitute the lion's share of private businesses. SME and private sector development is therefore irremediably linked to achieving greater financial inclusion.

The Addis Agenda includes a commitment to consider including financial inclusion as a policy objective in financial regulation, as there is evidence that countries that adopt NFIS reduce exclusion twice as fast as those that do not.⁹ To date, there are at least 58 developing countries with NFIS. Other elements that have worked well in promoting financial inclusion across countries include the involvement of a range of institutions in enhancing access to finance (including commercial banks, microfinance institutions, cooperative banks, postal banks and savings banks); the development of credit bureaus for assessing borrower loan-carrying capacity; and the use of new technologies with appropriate consumer protection.

Cooperative, savings, postal, and development banks can be vehicles for financial inclusion and employment. For example, in Europe, cooperative banks hold 32 per cent of total bank deposits.¹⁰ Successful cooperatives and savings banks, such as those in Germany, are formal financial institutions with four general characteristics: they are locally based; cater to underserved segments of the population; have dual bottom lines (financial returns and the

5 World Bank (2017). *Domestic credit to private sector (% of GDP)*. Available from <http://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS>

6 CGAP (2012). *Measuring Financial Exclusion: How Many People Are Unbanked?* Available from: <http://www.cgap.org/blog/measuring-financial-exclusion-how-many-people-are-unbanked> and; World Bank (2014). *Global Findex database*. Available from: <http://www.worldbank.org/en/programs/globalfindex>

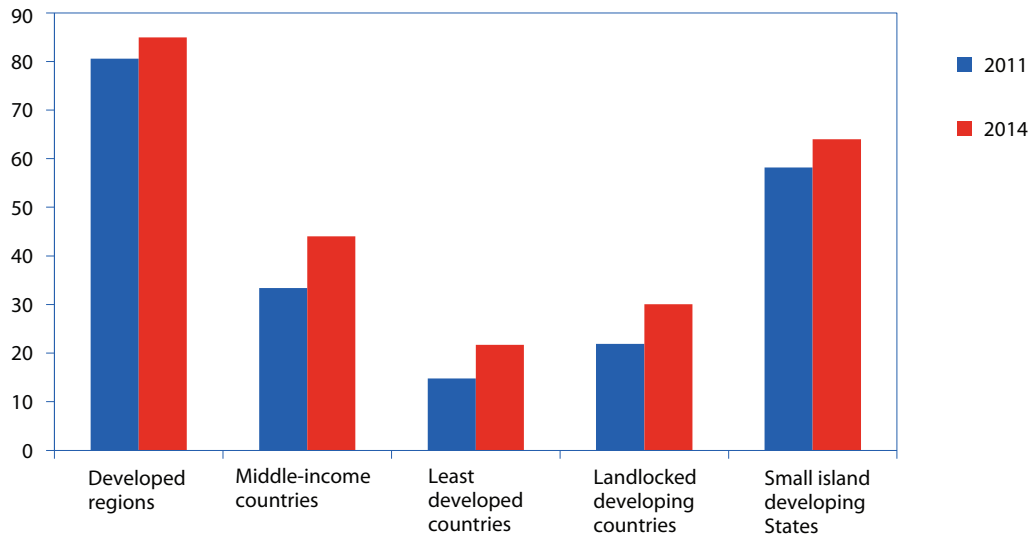
7 World Bank (2014). *Global Findex database*. Available from: <http://www.worldbank.org/en/programs/globalfindex>

8 IFC (2013). *Access To Credit Among Micro, Small, And Medium Enterprises*. Available from: <http://www.ifc.org/wps/wcm/connect/1f2c968041689903950bb79e78015671/AccessCreditMSME-Brochure-Final.pdf?MOD=AJPERES>

9 World Bank (2014). *Global Findex database*. Available from: <http://www.worldbank.org/en/programs/globalfindex> and; AFI (2015) *National financial inclusion strategies: current state of practice*. Available from http://www.afi-global.org/sites/default/files/publications/fisplg-state_of_practice.pdf

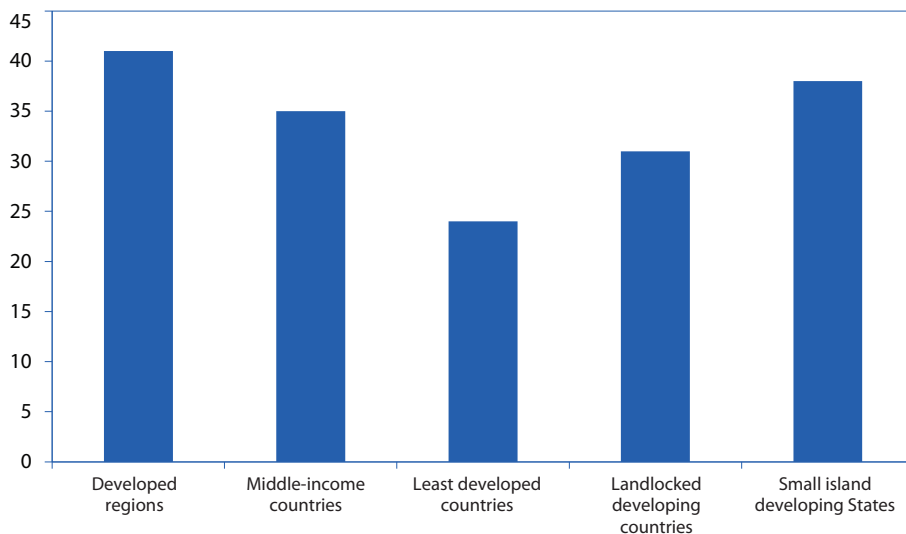
10 Lakshmi, P and S. Visalakshmi (2013). *Impact of Cooperatives in Financial Inclusion & Comprehensive Development*. Available from: <http://pubs.sciepub.com/jfe/1/3/4/>

Figure 2

Proportion of adults with bank accounts, 2011 and 2014 (Percentage of adults, 15+)

Source: World Bank Global Findex Database.

Figure 3

Firms with a bank loan or line of credit, 2002–2015 (Percentage)

Source: World Bank Enterprise Surveys.

welfare of the local clients); and often belong to networks of similar institutions.¹¹ The Task Force has begun work on better understanding the potential of these institutions in financial inclusion.

Public credit registry coverage has increased significantly in both developed and developing countries, rising from 16 per cent to 30 per cent from 2005–2015, though there are differences

¹¹ Schmidt, Seibel and Thomes (2016). *From Microfinance to inclusive banking. Why local banking works*. Wiley, Weinheim, Germany.

across countries and regions.¹² Whereas over 35 per cent of adults are covered in Latin America and the Caribbean, less than 8 per cent are covered in sub-Saharan Africa.

New technologies are increasingly being used to reach underserved communities. Branchless banking and mobile banking technologies can be used in making government-to-person payments (e.g., for wage, pension and social welfare payments) with lower administrative costs and fewer leakages, especially when developed with appropriate regulation to ensure responsible digital finance and avoid abusive practices. For example, in Kenya, where 62 per cent of adults are active mobile money users, financial inclusion rose from 41 per cent in 2009 to 67 per cent in 2014. The effect of access to mobile banking on consumption was much more significant for female-headed households than for male-headed households. The use of mobile-money also helped 185,000 women move from farming to business occupations.¹³

Mobile money has evolved from operating as a purely domestic service to enabling transfers between more than 20 countries globally, and thus can be a tool in the transfer of remittances. In addition, new instruments, such as pooled financing mechanisms that create diversified portfolios of SME loans through securitization, can increase funds available for SME lending, though risks have to be well managed within an appropriate regulatory framework.

Measures to promote access to finance need to go hand in hand with efforts to enhance skills and know-how across enterprises. In addition to entrepreneurship training and business development services, financial literacy is seen as one element of financial capability and has proven to be important for employability, as well as for individuals to start and manage their own enterprises. One of the solutions for improving financial literacy would be for Governments to make it a core component of the school curriculum. This should go beyond basic money management and bank accounts, to include

an understanding of how finance impacts people's lives and shapes the world around us.

2.3 Local currency bond markets

One important way that countries have deepened their financial markets is through the development of local currency bond markets. Deeper capital markets should provide a conduit for the long-term investment necessary for sustainable development. Domestic bond markets in developing countries have grown significantly since the 1990s, totalling \$15 trillion as of 2015, though most of the growth has been in middle-income countries in Asia, Latin America, and Europe, with minimal issuance in Africa and LDCs (figure 4). Outside of Asia, the proportion of domestic debt with maturities of over five years, while rising, remains fairly low.

There are, however, risks associated with growth of domestic debt, which need to be managed. As discussed in chapter I of this report, the increase in domestic debt has mostly been in commodity sectors, and in some countries, debt may soon reach levels that could threaten debt sustainability (see also chapter III.E). Indeed, there is a risk that nascent markets will attract speculative capital, leading to short-term bubbles, which can reverse when global investor sentiment changes, causing negative shocks to the real economy. As such, capital market volatility can fuel volatility in the real economy, rather than contribute to long-term growth.

2.4 Cross border capital flows

To date, private international capital flows have been subject to volatility, driven by trends in the global economy and by short-term investment horizons, as discussed below.

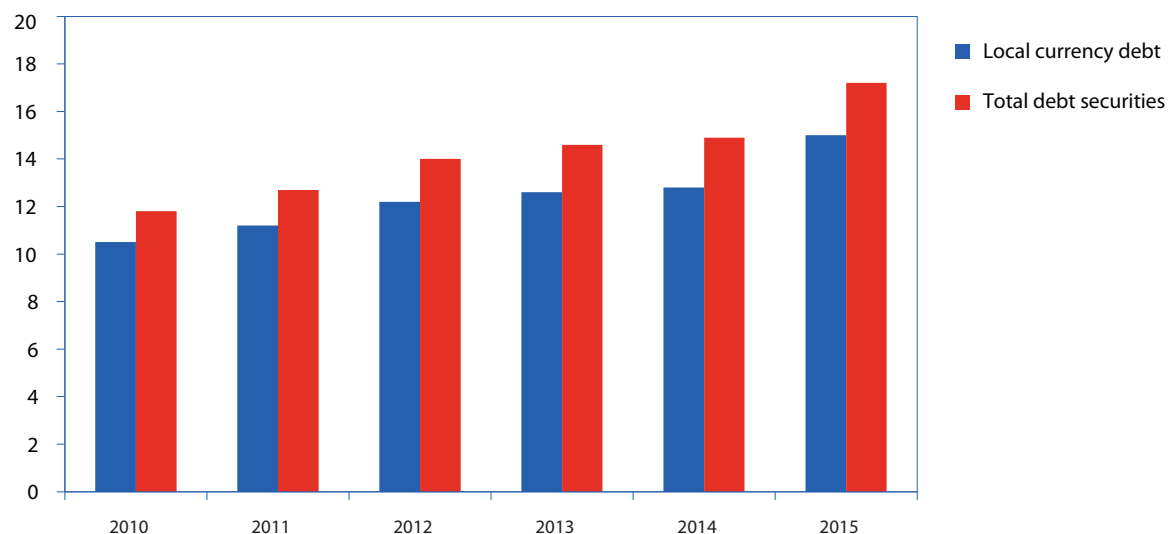
As noted in chapter I, foreign direct investment (FDI) has exhibited the largest trend increase over the last decade. Nonetheless, there are significant differences in the quantity and quality of FDI inflows accruing to different regions and countries, as well as concerns regarding the concentration and development impact of FDI. Greenfield investment

¹² World Bank (2017). *Private credit bureau coverage (% of adults)*. Available from <http://data.worldbank.org/indicator/IC.CRD.PRVT.ZS>

¹³ Matheson (2016). *Mobile-money services lift Kenyans out of poverty*. Available from: <http://news.mit.edu/2016/mobile-money-kenyans-out-poverty-1208>

Figure 4

Outstanding local market debt and total debt, selected developing countries, 2010–2015 (Trillions of United States dollars)



Source: Bank of America Merrill Lynch (2015). *Size and Structure of Global Emerging Markets Debt*. July 2015; BIS; WBG staff calculations.

Note: The countries included are: Africa & Middle East (Bahrain, Egypt, Israel, Kuwait, Lebanon, Morocco, Nigeria, Qatar, Saudi Arabia, South Africa, Tunisia, United Arab Emirates), Asia Pacific (China, Hong Kong SAR, India, Indonesia, Kazakhstan, Malaysia, Pakistan, Philippines, Singapore, Republic of Korea, Sri Lanka, Taiwan Province of China, Thailand), Emerging Europe (Bulgaria, Croatia, Cyprus, Czech Republic, Hungary, Lithuania, Poland, Romania, Russian Federation, Slovenia, Turkey, Ukraine), and Latin America & Caribbean (Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Jamaica, Mexico, Panama, Peru, Trinidad and Tobago, Uruguay, Venezuela (Bolivarian Republic of)).

tends to have a greater impact on jobs and development than other forms of FDI, but the increase in global FDI in 2016 has been principally driven by cross-border mergers and acquisitions. The large majority of FDI to developing countries continues to be invested in Asia and Latin America while flows to Africa, though higher than a decade ago, remain limited. In addition, FDI flows to LDCs and small island developing States (SIDS) remain concentrated in extractives industries, where their development impact is limited (figure 6).

Investment in extractive industries (mining and quarrying, including petroleum and gas) is also significant in LLDCs where FDI in business activities includes extractive industry-related activities such as drilling for oil and creating gas pipelines. In addition, a few large developing countries have become an increasingly important source of outward FDI. From 2010 to 2015, they

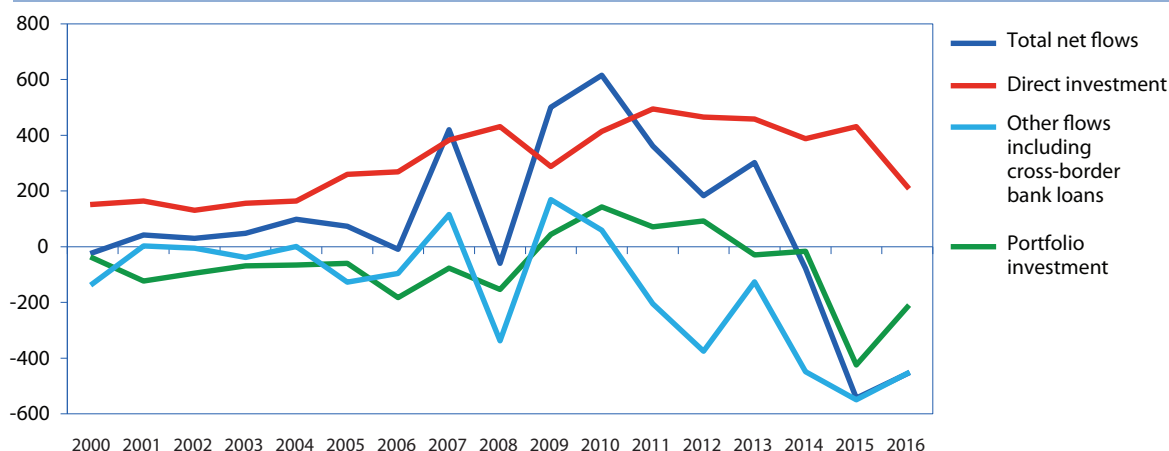
accounted for 28 per cent of world outward FDI on annual average, up from 9.9 per cent in the period 2000 to 2005.¹⁴

Cross-border bank (represented by other flows in figure 5) and portfolio flows to developing countries have been significantly more volatile than FDI. Bank flows have demonstrated particularly high volatility, reflecting deleveraging by a number of international banks since the financial crisis (see chapter II). This has affected long-term financing for infrastructure projects in emerging market and developing countries, a significant portion of which had previously been provided by large developed-country banks. Portfolio flows, which are primarily driven by institutional investors, also remain highly volatile, with net portfolio capital flows to developing countries negative since 2014. Indeed, in the context of the recent sell-off in emerging market assets, emerging market local currency funds have experienced significant losses.

¹⁴ UNCTAD (2017). *FDI Statistics*. Available from: <http://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI-Statistics.aspx>

Figure 5

Trends in cross-border net financial flows to developing countries and economies in transition, 2000–2016 (Billions of United States dollars)

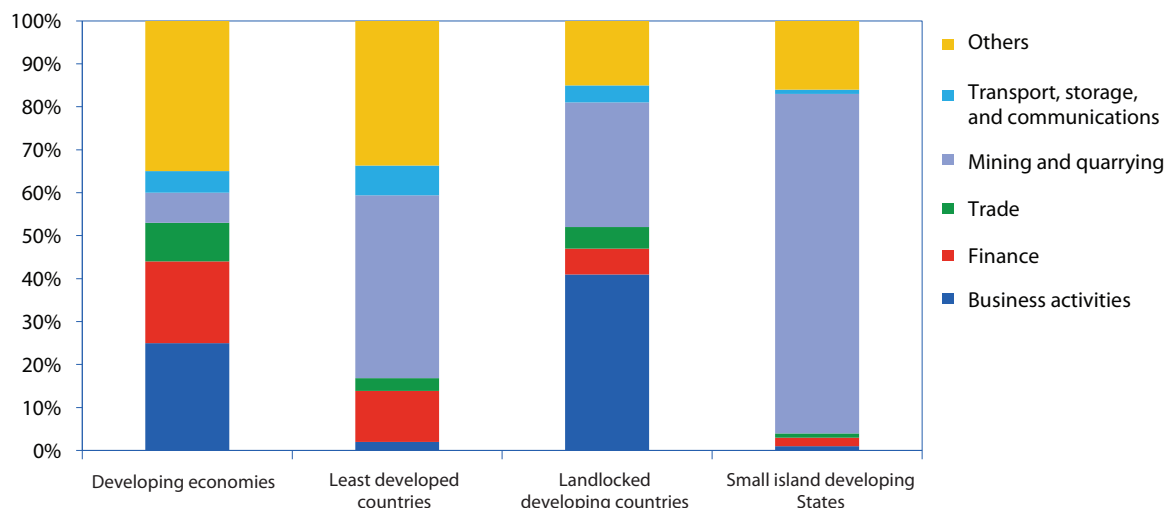


Source: IMF World Economic Outlook database, October 2016, and UN/DESA calculations.

Note: The composition of countries is based on the country classification located in the statistical annex of the United Nations World Economic Situation and Prospects.

Figure 6

Distribution of foreign direct investment, by sector, 2015 (Percentage)



Source: UNCTAD Foreign Direct Investment Statistics database.

3. Addressing risks to financial stability

Given the volatility of capital flows, as well as systemic risks to the real economy from excessive financial leverage, it is important for countries to design robust regulatory frameworks, potentially including

capital account management tools. The emerging market financial crises of the 1990s, along with the 2008 global crisis, underscored the need for regulatory frameworks that consider all areas of financial intermediation, from microfinance to complex derivative instruments.

Box 1

Migrant Remittances

Officially recorded remittances to developing countries are estimated to have totalled \$432 billion in 2015. India was the largest remittance-receiving country, with an estimated \$69 billion in 2015, followed by China (\$64 billion), and the Philippines (\$28 billion). While more stable than other cross-border private capital flows,^a personal remittances have also been affected by the weakened global economy. Indeed, the growth of remittances had slowed considerably, from 3.2 per cent in 2014 to 0.4 per cent in 2015, largely due to economic weakness in the major remittance-sending countries.

The Addis Ababa Action Agenda and the 2030 Agenda for Sustainable Development include commitments to reduce transaction costs of migrant remittances to less than 3 per cent, and to eliminate corridors that charge more than 5 per cent. At the same time, the Addis Agenda also stresses the importance of maintaining adequate service coverage, especially for those most in need. Remittance costs have declined from an average of 8.0 per cent in the fourth quarter of 2014 to 7.4 per cent in the fourth quarter of 2015. Sub-Saharan Africa remains the region with the highest costs, with an average remittance cost of 9.5 per cent in the fourth quarter of 2015 in comparison with 11.5 per cent a year earlier. This is partly a function of the high expenses associated with remittance outflows from South Africa to nearby countries, with costs in some corridors averaging in the 18 to 20 per cent range.

Improved financial literacy and better access to financial services can help lower the high remittance transaction costs in underserved areas. Combining remittance receipts with broader access to other financial services can increase the impact of remittances on individual households' budgets and economic development in general by enabling savings and investments. For example, if the predominantly informal savings of remittance receivers in four Central American countries could be mobilized, it is estimated that formal savings would increase by \$2 billion, representing about 1.7 per cent of gross domestic product in these countries.^b

A major obstacle to expanding the provision of remittance services and reducing their costs arises from engagement by major international banks in de-risking behaviour. Due to concerns regarding money laundering and related financial irregularities, commercial banks have been shutting down the bank accounts of a number of money-transfer companies. There has also been a reduction in the number of correspondent banking relationships, which can impact access to the global financial system by customers in developing countries. In March 2016, the Financial Stability Board established a Correspondent Banking Coordination Group to help ensure implementation of an action plan agreed by the Group of Twenty to address the reduction in correspondent banking relationships. Revised guidance from the Financial Action Task Force in October 2016 sought to clarify the expectations with regard to enhanced due diligence, which has informed a revision of the guidance from the Basel Committee on Banking Supervision that is expected to be published in June 2017.

^a Capital flows refer to flows accounted for in the capital account, including foreign direct investment portfolio flows, and other flows. Remittances are accounted for in the current account.

^b Orozco, Y (2015). Remittances and Financial Inclusion: Opportunities for Central America. Available from: http://www.the-dialogue.org/wp-content/uploads/2015/06/RemitFinancialInclusion_FINAL_223.pdf

At the same time, there is increasing understanding of the impact of financial regulations on incentives (see chapter III.F) for lending and providing financial services. The Addis Agenda emphasizes the importance of bringing together the financial inclusion and regulatory discussions. Enhancing stability and reducing risks, while promoting access to credit and increasing investment in sustainable infrastructure, presents a complex challenge for policymakers, as there can be trade-offs between them. At the same time, stability is a prerequisite for access and investment, while access can support stability through diversification. Policymakers need

to design the regulatory and policy frameworks to strike a balance between these goals and maximize their synergies.

In 2015, the Group of Twenty (G20) requested the Financial Stability Board (FSB) to consider the financial stability risks associated with climate change. As a result of this work, the FSB established a private sector, industry-led Task Force on Climate-related Financial Disclosures (TCFD) in December 2015. The TCFD is developing recommendations for consistent, climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and

other stakeholders. The recommendations focus on voluntary disclosures about the financial risks and impacts of climate change on the business of reporting entities, for disclosure within mainstream financial reporting, and not on sustainability reporting. Appropriate disclosures are a prerequisite for financial firms not only to manage and price climate risks accordingly, but also, if they wish, to take lending, investment or insurance underwriting decisions based on their view of transition scenarios. The final recommendations of the TCFD will be presented to the G20 leaders' summit in July.

The Addis Agenda also notes the impact of regulations on incentives for long-term investment, as well as for investment in sustainability indicators. It calls for regulatory and policy frameworks to encourage long-term sustainable investment.

4. Long-term investment

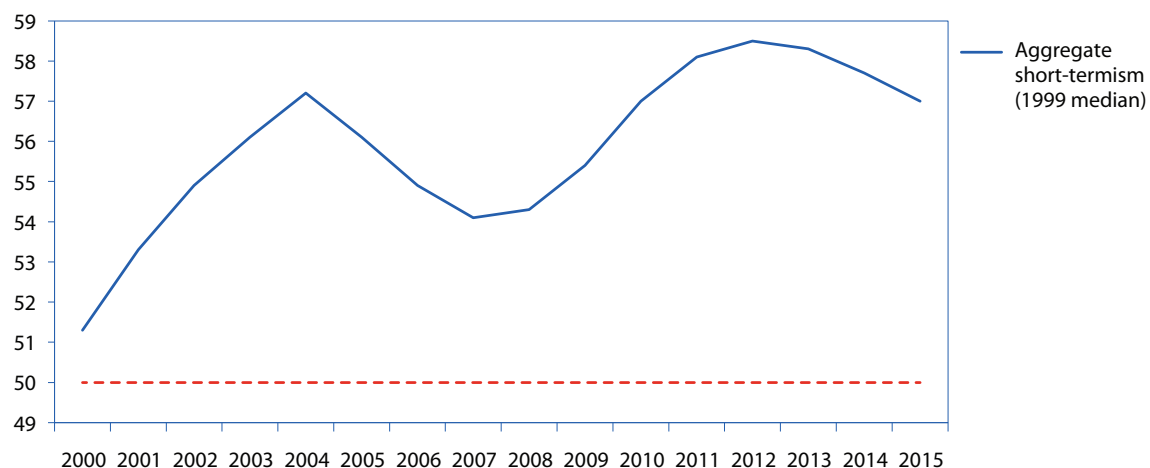
Quality long-term investment is critical for infrastructure and other areas necessary for sustainable development. Long-term investment is also an important element of climate finance, since without

a long-term horizon, investors will not price in the long-term risks associated with climate change that might affect their returns.

Yet, today, much private investment is short-term oriented. As noted above, cross-border portfolio flows (which are driven by institutional investors) have been highly volatile. A short-term investment horizon is also noticeable in investment in developed countries. In the United States of America, the average holding period for stocks fell from 8 years in the 1960s to 6 months in 2010.¹⁵ Indeed, many business executives feel pressure to demonstrate short-term performance. A 2016 survey of senior executives found that more than half of the respondents felt pressure to perform within a year, up from 44 per cent three years earlier. A McKinsey index of corporate performance shows that short-termism has been rising since the turn of the century, though a dip prior to the 2008 world financial and economic crisis most likely reflected increases in fixed investment and strong earnings growth in that period (figure 7).¹⁶

Figure 7

Aggregate gauge of short-termism, 2000–2015 (Annual percentile)



Source: McKinsey, (2017). *Measuring the Economic Impact of Short-termism*.

¹⁵ Kleintop, J. (2012). *Weekly Market Commentary*. Available from: <http://moneymattersblog.com/login/login/wp-content/uploads/2012/08/WMC080712.pdf>

¹⁶ McKinsey (2017). *Measuring the Economic Impact of Short-termism*. Available from: www.mckinsey.com/~/media/McKinsey/Global/Themes/Long-term%20Capitalism%20Where%20companies%20with%20a%20long%20term%20view%20outperform%20their%20peers%20MGI-Measuring-the-economic-impact-of-short-termism.ashx&usg=AFQjCNGz_znrjDqt56YZ8kBEgX4MyBNmQ

There is, however, no clear definition of long-term investment. It is often described as financing with a maturity of one to five years.¹⁷ The one- and three-year cut-offs are somewhat arbitrary and much shorter than what is needed for investments in long-term projects, such as infrastructure, which have life spans that can range from 15 to 100 years. Furthermore, defining long-term by the maturity of an asset can be misleading. Investors can sell longer-duration liquid instruments in secondary markets, turning a long-term instrument into a short-term investment. For example, during the crisis, some investors who were considered to be long-term investors were forced to sell their positions prior to the end of their investment horizon due to a lack of liquidity, causing the price of the assets being sold to collapse.

The Task Force has therefore focused *its* definition of long-term investment on the outlook of the investor rather than the maturity of the instrument. This includes two elements. The first is the investment horizon of the investor or the investor's *willingness* to hold a position. This is in line with the view of

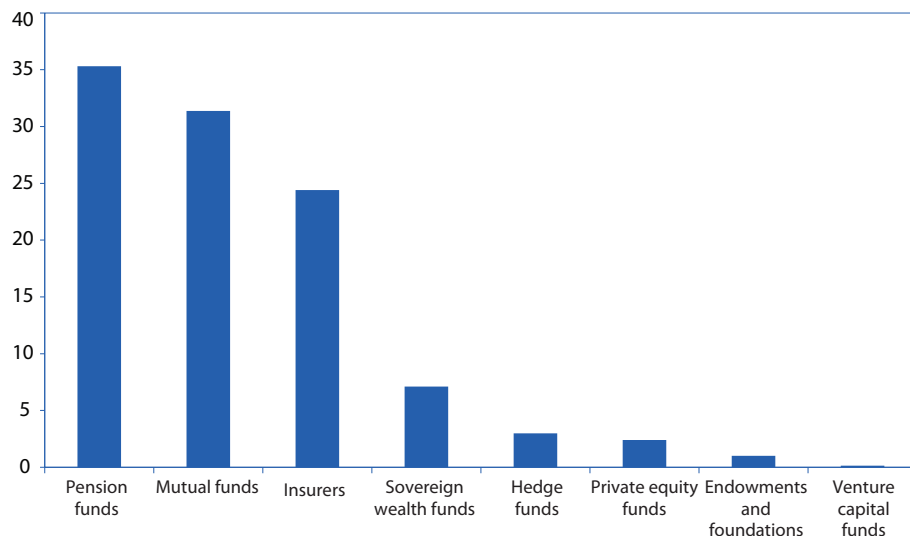
long-term investing associated with “patient” capital and buy-and-hold strategies. The second is the *ability* of an investor to hold a long-term position, which is related to the investor's liability structure, or the degree that investments are financed with borrowing that is significantly shorter term than the investment itself. Thus, pension funds, which have long-term liabilities in the form of future payments to pensioners, tend to be well suited to invest in long-term infrastructure projects.

Yet, to date, most institutional investors, even those with long-term liabilities (such as pension funds, life insurance companies, and sovereign wealth funds, which together hold about \$78 trillion in assets under management),¹⁸ continue to invest in liquid assets, often with a short-term investment horizon. For example, pension funds from the 7 largest pension markets hold about 76 per cent of their portfolios in liquid assets,¹⁹ and less than 3 per cent in infrastructure.

There has, however, been a shift in asset allocation over the past few decades towards more illiquid

Figure 8

Assets under management by institutional investors, 2011–2016 (Trillions of United States dollars)



Source: UN/DESA.

¹⁷ Pu Shen (2005). *How Long Is a Long-Term Investment?* Available from <https://www.kansascityfed.org/publicat/econrev/pdf/1q05shen.pdf>

¹⁸ TheCityUK (2015). *Sovereign Wealth Funds*. June 2015. Available from: <https://www.thecityuk.com/assets/2015/Reports-PDF/Sovereign-Wealth-Funds-2015.pdf>

¹⁹ Willis Towers Watson (2016). *The Global Pension Assets Study 2016*. Available from: <https://www.willistowerswatson.com/en/insights/2016/02/global-pensions-asset-study-2016>

investments, which increased from about 5 per cent of their total portfolios in 1995 to 24 per cent in 2012. This shift partly reflects the “search for yield” in the current low interest rate environment, which would make it temporary and could imply a reversal of investor interest in these asset classes when interest rates rise; but it may also reflect structural changes and some realignment of investor assets and liabilities.

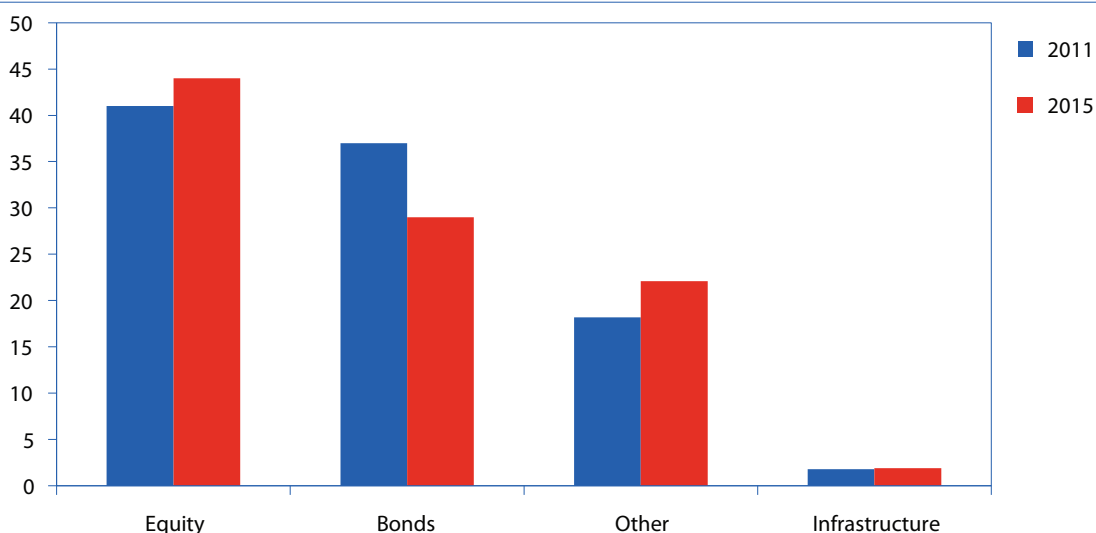
There are several likely reasons for long-term investors’ focus on liquid assets. Many institutional investors lack the in-house capacity and expertise to do the necessary due diligence to invest directly in infrastructure. Internal institutional factors and compensation packages also shape investor incentives. Institutional investors with longer-term liabilities like pension funds, sometimes outsource funds to secondary financial intermediaries, such as hedge funds that can have very short-term liabilities and short-term incentives embedded in their compensation, which are not well suited for long-term investments. Regulations and accounting standards can also reduce the appetite for long-term investment.

Capital requirements (e.g., Basel III on banking and Solvency II on insurance), which impose higher costs for riskier holdings based on maturity and credit rating, can penalize long-term investments, such as in infrastructure. Mark-to-market accounting, which values assets based on daily market prices, incorporates short-term market fluctuations into portfolio asset values. Investors are often incentivized to readjust their portfolio based on these short-term movements. In addition, high mobility of portfolio managers between firms may represent a further disincentive to long-term investing, as managers can earn a high bonus, and then move to another firm before the tail-risk has materialized.²⁰ For instance, the average tenure of a chief investment officer of a public pension plan is four years, with even shorter periods for more junior staff.²¹ Firm culture can affect investment strategies, including how fiduciary responsibilities and non-financial impacts are viewed and taken into account in performance evaluations of individual managers.

In order to incentivize institutional investors to scale up longer-term investments in areas such

Figure 9

Institutional investment (pension funds) asset allocation, 2011 and 2015 (Percentage)



Source: Willis Towers Watson, 2016, *The Global Pension Assets Study 2016*, and UN/DESA calculations.

Note: “Other” includes investment in private equity fund of funds, direct hedge funds, direct private equity funds, funds of hedge funds, and illiquid credit.

²⁰ Acharya, Viral, Marco Pagano and Paolo Volpin (2016). Seeking Alpha: Excess Risk Taking and Competition for Managerial Talent, *Review of Financial Studies*, Vol. 29 (10), pp. 2565–99.

²¹ World Economic Forum (2011). *The Future of Long-term Investing*.

as infrastructure, efforts may be needed in a number of areas. Public actors, such as multilateral and bilateral development finance institutions can help set up joint investment platforms that enable institutional investors to pool resources. Mechanisms such as public-private partnerships, equity investments, guarantees and insurance have become increasingly looked to as ways to use official resources to leverage private investment through risk-sharing between the public and private sectors, as discussed in chapters I, II and III.C of this report. There is also interest in promoting an “infrastructure asset class”, which would allow investors to sell their positions if they choose, thus attracting investors that are wary of holding long-term illiquid assets. However, this would need to be done with care; there is a risk that short-term capital attracted to an infrastructure asset class would lead to increased volatility and risk creating bubbles during boom periods, which could then increase the probability of defaults in times of global risk aversion when the bubbles burst.

The presence of institutional investors in developing countries is significantly lower than in high-income countries, though it has been growing. Developing-country pension funds are estimated to manage \$2.5 trillion in assets.²² Building a long-term domestic institutional investor base could help provide a stable source of investment finance. A sizable portion of these portfolios is invested in domestic sovereign debt, though in some developing countries national pension funds have also been investing directly in national or regional infrastructure, including in Chile, Ghana, Mexico, Peru and South Africa. In most developing countries, building an institutional investor base will require upgrading expertise and skills, as well as reforms in licensing, portfolio requirements and changes to security laws. Good governance and an enabling environment are crucial for effective mobilization of domestic finan-

cial resources. Developing countries should learn from developed-country experiences, and lessons learnt among themselves, with the aim of building institutional investor bases and capital markets that are long-term and that “promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators, and that reduce excess volatility,” as called for in the Addis Agenda.²³

5. Aligning private investment with sustainability indicators

Alignment of private activity with the SDGs can be seen as a continuum from pure financial investment to philanthropy. The vast majority of investment is focused purely on financial returns. Indeed, many pension plans are bound by fiduciary duty to “run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses,”²⁴ which is generally interpreted by pension trustees, investors and others as a duty to maximize financial returns to the exclusion of environmental, social and governance (ESG) considerations, even though taking ESG considerations into account often provides benefit to the beneficiaries. The resulting situation acts as a barrier to the consideration of ESG in investment decision-making.

Nonetheless, a growing number of investors are considering social and environmental factors in their investment decisions. Some large public pension funds have been incorporating “do no harm” criteria into their investment guidelines for over a decade. The area of impact investing, where investors aim to maximize both financial and non-financial factors, such as environmental, ESG, is also growing. In this context, philanthropy can be viewed as focusing exclusively on ESG. Data on philanthropy is incomplete; however, statistics from the Organiza-

²² Inderst, G. and Stewart, F. (2014). Institutional Investment in Infrastructure in Developing Countries: Introduction to Potential Models, World Bank. Available from: <http://documents.worldbank.org/curated/en/238121468325297049/pdf/WPS6780.pdf>

²³ Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda) (United Nations publication, Sales. E.16.I.7), para. 38. Available from http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

²⁴ This is how the United States Department of Labor described the primary responsibilities of fiduciaries under the Employee Retirement Income Security Act (ERISA). See <https://www.dol.gov/general/topic/retirement/fiduciaryresp>.

tion for Economic Cooperation and Development show that, as of 2010, annual net private grants from developed to developing countries were approximately \$30 billion.

Just because investment is profit oriented does not mean that it is necessarily opposed to sustainable development. Quality private investment has always been a critical element of most development models. More recently, studies have shown a positive relationship between ESG compliance and long-term corporate financial performance.²⁵ In this regard, the SDGs can also open new business opportunities. Over the next year, countries will be presenting voluntary national reviews of their progress on implementing the SDGs through national sustainable development strategies. National strategies, supported by financing frameworks can serve as guideposts to priority areas for investment and partnerships. Indeed, the Business and Sustainable Development Commission found that achieving the SDGs could unlock \$12 trillion in market opportunities across three sectors: food and agriculture; cities, energy and materials; and health and well-being.²⁶

SDG 12 on ensuring sustainable consumption and production patterns encourages companies to adopt sustainable practices and to integrate sustainability information into their reporting cycle. The Addis Agenda takes this further and encourages greater accountability by the private sector to embrace business models that have social and environmental impacts, and that operate sustainably.

A recent study found that there were almost 400 sustainability reporting policy instruments in 64 countries in 2016, up from 180 instruments in 44 countries in 2013.²⁷ In over 80 per cent of countries studied, Governments had implemented some type of sustainability reporting policy instrument, with about two-thirds of the instruments mandatory, and

one-third voluntary. Stock exchange and financial market regulators accounted for almost one-third of all those instruments. Today, more than 92 per cent of the world's 250 largest companies report on their sustainability performance in one form or another. More than 9,000 businesses participate in the UN Global Compact and are required to report to their own stakeholders on an annual basis on their ESG performance, including on their actions to respect and support human rights. In addition, more than 2,000 businesses in 90 countries adhere to the guidelines of the Global Reporting Initiative (GRI).²⁸ Organizations setting the standards for sustainability reporting include the GRI, the International Integrated Reporting Council, the Sustainability Accounting Standards Board, the Carbon Disclosure Project, and the UN Guiding Principles Reporting Framework on Business and Human Rights. As shown in figure 10, GRI reporting has grown rapidly since the first GRI compliant report published in 1999.

Yet, despite these trends, it is unclear whether reporting alone is enough to change investment and business behaviour. This raises two sets of issues. The first relates to whether the quality of reporting needs to be strengthened, either with regard to the areas covered or whether the material is presented in a way that is easily understandable to investors and consumers. There has been a proliferation in competing reporting guidelines for businesses and a lack of standardization in sustainability metrics. A recent survey found that 82 per cent of investors were dissatisfied with the comparability of sustainability reporting between companies in the same industry, while 74 per cent were dissatisfied with the relevance and implications of sustainability risks being reported.²⁹ At the same time, the available analysis of relative corporate performance today is inaccessible to individual asset owners and civil

25 McKinsey (2016). *Sustaining sustainability: What institutional investors should do next on ESG*. Available from: <http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/sustaining-sustainability-what-institutional-investors-should-do-next-on-esg>

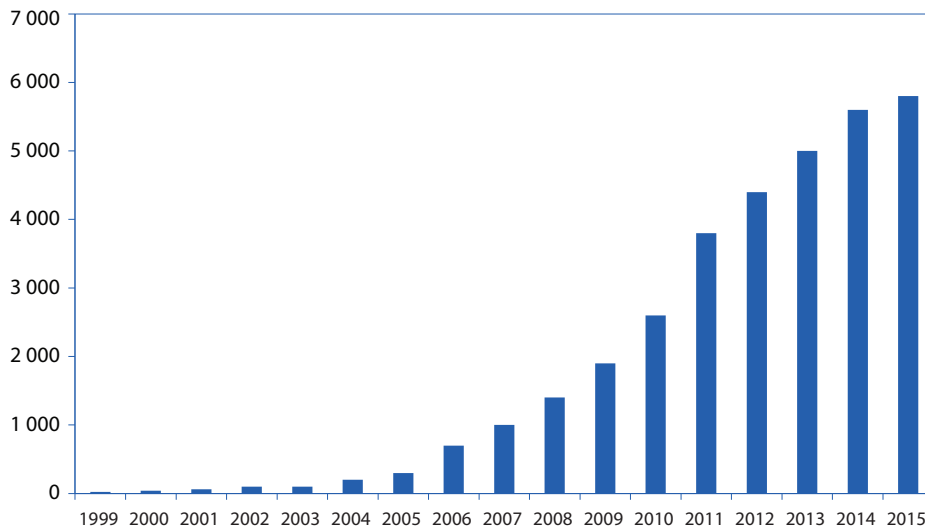
26 Business Commission (2017). *Better Business, Better World*. Available from: <http://report.businesscommission.org/report>

27 Carrots & Sticks (2016). *Global trends in sustainability reporting regulation and policy*. Available from: <http://www.carrotsandsticks.net/wp-content/uploads/2016/05/Carrots-Sticks-2016.pdf>

28 Business Commission (2017) *Better Business, Better World*.

29 PwC (2015) *Sustainability disclosures – is your company meeting investor expectations?* Available from: <http://www.pwc.com/us/en/cfodirect/assets/pdf/in-the-loop/sustainability-disclosure-guidance-sasb.pdf>

Figure 10

Number of GRI sustainability reports, 1999–2016

Source: GRI Sustainability Disclosure Database, October 2016.

society, due to high paywalls, lack of transparency in methodology and complexity of reporting. The report of the World Business Council for Sustainable Development recommends, among other things, the creation of an International Sustainability Standards Board to oversee progress towards global sustainability, which should be a multi-stakeholder initiative.³⁰ The second issue concerns whether reporting on its own is sufficient to change behaviour. More research is needed, but what is clear is that reporting is a necessary step to understanding the impact of business activity on society and the environment.

There has also been a range of complementary initiatives, in partnership with the private sector, geared to encouraging businesses to incorporate ESG criteria into their decision-making (box 1). While there are a number of existing sustainability indices (for example, Dow Jones Sustainability Index, FTSE4Good), efforts are being made to create a set of publicly available corporate sustainability benchmarks that are more closely linked to the SDGs. These would rank companies across a range of indicators such as climate change, gender, access to health care and other key aspects of the SDGs. This would go a step further in providing transpar-

ent information to investors and civil society and investors on how companies are aligning their activities with sustainable development objectives.

The Addis Agenda calls for promoting incentives aligned with sustainable development across the investor chain, this includes credit rating agencies, stock exchanges, brokers, investment advisors, standard-setting bodies (see chapter III.E on addressing systemic issues), and the full range of investors, from hedge funds to sovereign wealth funds. Globally, first steps have been taken in this direction, with developing countries taking the lead in many areas. Several countries are including ESG in their financial governance architecture. For example, the Central Bank of Brazil focuses on socio-environmental risk management flows as part of its core functions as a prudential bank regulator; the Bangladesh Bank supports rural enterprises and green finance; and the Bank of England has a prudential review of climate risks for the insurance sector of the United Kingdom of Great Britain and Northern Ireland, based on a connection between its core prudential duties and the United Kingdom Climate Change Act.³¹

Overall, much is happening in the sphere of private investment, but more is needed if we are to

³⁰ WBCSD (2015). *World Business Council for Sustainable Development Report*.

³¹ UNEP (2016). *The financial system we need: from momentum to transformation. Inquiry: Design of a sustainable financial system*. Second edition, October 2016. Available from http://unepinquiry.org/wp-content/uploads/2016/09/The_Financial_System_We_Need_From_Momentum_to_Transformation.pdf

achieve sustainable development within one generation. This can be achieved by partnerships between the public and private sector, and with policy and

regulatory frameworks aimed at better aligning incentives with long-term sustainable development.

Box 2

Examples of initiatives to align business activity with sustainable development

Major initiatives to incorporate environmental, social and governance (ESG) criteria into their decision-making include the following:^a

The United Nations Global Compact. Encourages businesses to adopt sustainable and socially responsible policies, and to report on their implementation. The Compact has two objectives: i) to mainstream its ten principles on human rights, labour, the environment and anti-corruption in business activities and ii) to catalyse actions in support of broader United Nations goals, such as the Sustainable Development Goals (SDGs). Currently 9,269 companies from 164 countries are signatory to the Principles.

The United Nations Guiding Principles on Business and Human Rights. A set of guidelines for countries and companies to prevent the risks of adverse of human rights linked to business activities. They apply to all businesses everywhere and guidance on the state's duty to protect human rights from corporate abuse, on corporations' responsibilities to respect human rights and on remedying human rights abuses committed in business operations.

The Principles for Responsible Investment (PRI). Six voluntary and aspirational principles for incorporating ESG issues into investment practice. PRI currently has nearly 1600 signatories, from over 50 countries, representing \$60 trillion of assets under management.

The Equator Principles. 10 principles for financial institutions for determining, assessing and managing environmental and social risk in projects. They apply globally to all industry sectors and to four financial products: (i) Project Finance Advisory Services; (ii) Project Finance; (iii) Project-Related Corporate Loans; and (iv) Bridge Loans.

The United Nations Environment Programme (UNEP) Inquiry. Maps the practice and potential for advancing a transition of the financial system towards a sustainable, low-carbon economy.

The UNEP Finance Initiative (UNEP FI) Principles for Sustainable Insurance. A global framework for the insurance industry to address environmental, social and governance risks and opportunities.

The Sustainable Stock Exchanges (SSE) initiative. Co-organized by United Nations Conference on Trade and Development (UNCTAD), the United Nations Global Compact, UNEP FI and the United Nations PRI. The SSE is a peer-to-peer learning platform for exploring how exchanges, investors, regulators, and companies, can enhance corporate transparency on ESG issues. SSE currently includes 61 exchanges in 59 countries.

The Green Bond Principles (GBP). Voluntary principles, led by the International Capital Markets Association, that promote the development of the Green Bond market.

The Global Reporting Initiative (GRI). Maintains a database that monitors the progress of ESG reporting and the number of sustainability reports disclosed in each country.

The ESG Credit Rating initiative. Initiated by eight credit rating agencies across the world, (including Moody's Corporation and S&P Global Ratings). The signatories recognize that ESG factors are important elements in assessing the creditworthiness of borrowers.

The World Business Council for Sustainable Development (WBCSD). A CEO-led, global association of about 200 companies dealing with business and sustainable development.

The SDG investing (SDGi). An initiative of 18 Dutch financial institutions that collaborate to unlock greater SDG investment.

Innovative Finance. A World Bank and BNP Paribas initiative to promote the 2030 Agenda for Sustainable Development through Innovative Finance.

^a Initiatives are described in greater detail in the online annex to the Inter-agency Task Force report.