

Aligning Capital Markets with Sustainable Development

Background Note

The Financing for Development agenda has emphasized the importance of long-term “stable private financial flows to developing countries” since the Monterrey Consensus (para 25.) Indeed, the need for long-term investment to achieve the SDGs is estimated to be in the trillions of dollars. At the same time, there has been a growing focus on the importance incorporating environmental, social and governance (ESG) factors in investing. The Addis Ababa Action Agenda brings these two strands together, emphasizing that sustainability and stability of the financial system are mutually reinforcing. In this regard, governments in Addis Ababa committed to “endeavour to design policies, including capital market regulations where appropriate, that promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators, and that reduce excess volatility.” (Para 38)

Institutional investors have been looked to as a potential source of long-term financing for sustainable development, both because of size of assets under management, and because of long-term liabilities of some investors, which should enable the longer-term investment necessary for sustainable development. Around \$78 trillion of the total \$115 trillion in institutional investor assets is held by ‘primary’ institutional investors, such as pension funds, insurance companies, and SWFs, with long-duration liabilities (TheCityUK, 2015). Sustainable or green investments, in theory, should be attractive to long-term funds, since the risks associated with climate change are a potential long-run liability.

Nonetheless, investment in the long-term illiquid assets necessary for sustainable development has been limited -- in both developed and developing countries. For example, the largest pension funds hold 76 per cent of their portfolios in liquid assets, with direct investment in infrastructure at less than 3 per cent (and even lower in developing countries and for low-carbon infrastructure.) (Willis Towers Watson, 2016) This in part reflects the short-term investment horizon of many institutional investors, which is manifest in the behaviour of investment flows. For example, portfolio flows (which are driven by institutional investors) to developing countries have been highly volatile, with countries experiencing an estimated outflow of \$217 billion in 2016 (UN WESP, 2017). A short-term investment horizon is also noticeable in developed countries. In the USA, the average holding period for stocks fell from 8 years in the 1960s to 6 months in 2010 (Kleintop, 2012).

While there has been significant research on impediments to investment on the country level, including regulatory uncertainty and governance, imperfect information and other market failures, there is less research on impediments on the investor side. In this regard, the IATF held a planning meeting in September 2016 on how to follow-up on paragraph 38 of the Addis Agenda. It also touched on follow-up to related issues, including building capital markets in developing countries in a sustainable and long-term manner. The meeting, along with additional research, identified several factors that shape investor incentives, including: institutional factors and compensation packages, particularly when managers outsource funds to ‘secondary’ financial intermediaries such as hedge funds; firm culture; and regulatory and accounting standards.

For example, many managers lack in-house expertise in certain sectors, such as infrastructure and new technologies. Facing increased pressure to reduce costs, public funds are sometimes unable to

FFDO Background Note

pay salaries and bonuses that compete with other areas of finance. While this has benefits from the perspective of incentives as discussed above, it makes it difficult to attract the best talent and build expertise, especially in new areas. As a result many primary intermediaries are increasing their exposure to alternatives by investing through external managers.

External managers, on the other hand, were often designed for high net worth individuals willing to take high risks. Many have short-term liabilities and/or incorporate a greater degree of short-term incentives in compensation, neither of which is conducive to long-term sustainable investment. The fee structure (of a 2 per cent management fee and 20 per cent performance fee) is characterized by asymmetric returns – managers have a potential upside monetary gain but no downside penalty when losses are realized. This asymmetry provides incentives for managers to increase risk and leverage in order to boost short-term returns.

Other institutional factors can also have an impact. For example, in the case of a publicly traded insurance company, shareholders may have shorter time horizon than policyholders and may encourage managers to shift the portfolio towards a shorter horizon. Second, both long-term and riskier investments will have losses in the short-term. If trustees, senior managers, or in the case of public pension funds and SWFs, politicians, do not have appetite for short-term losses, it will be difficult for managers to maintain longer-term positions. Third, 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. 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 (WEF, 2011). 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.

Regulations and accounting standards can also reduce the appetite for long-term investment. In the insurance sector, Solvency II in the European Union includes new capital adequacy and risk management requirements, which impose higher costs for riskier holdings, based on maturity and credit rating, thus penalizing both long-term investment and investment in riskier assets. Mark-to-market accounting, which value assets based on daily market prices, incorporate short-term market fluctuations into portfolio asset values. Managers, who have internal incentives linked to the value of assets under management and their returns, are often incentivized to readjust their portfolio based on these short-term movements.

Many pension funds are subject to minimum funding and other requirements. While these rules are important for ensuring solvency, combined with mark-to-market accounting, they can inhibit long-term investment. For example, during the crisis, some pension funds breached their funding ratios due a collapse in prices. The decline in prices was largely due to the liquidity crisis, not to solvency of the underlying assets, and many asset prices later rebounded. Nonetheless, some pension funds had to reduce risk to meet ratios, forcing some to sell.

In addition to the long-term horizon of investments, investor incentives are not generally aligned social and environmental factors. Despite the growing field of impact investing, the fiduciary responsibility of most investment managers is still to maximize financial return. Policy to address this include: pricing externalities and direct regulations, as well as through guarantees, and leveraging

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private investment through public intermediaries, such as development banks. It can also be included in the 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 UK's insurance sector based on a connection between its core prudential duties and the UK Climate Change Act (for example, see United Nations Environment Programme, 2016 and 2015).

Finally there are important efforts in this area on the investor side. Some public pension funds have been taking a lead in new areas, such as building infrastructure groups internally, and ESG reporting. Benchmarking combined with efforts from public pension funds can have an enormous impact. These areas will be explored by the Task Force. With regard to next steps, the Task Force working group can map out incentives along the investment chain, building on existing work in this area (including updating a 2013 UN-DESA/UNTT paper), and showcase models and initiatives that try to overcome misalignment at various points.