Financing for Sustainable Development Report 2022

Inter-agency Task Force on Financing for Development

Bridging the Finance Divide

United Nations

Report of the 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

To meet developmental goals, a country needs a private sector that invests in the future, notably in productive capacity and infrastructure development. Investment by private companies significantly rebounded in 2021 but not everywhere with the same intensity, while future investment trends are uncertain. The pandemic has changed the investment landscape, putting heightened focus on the resilience of global value chains, the consideration of a broader range of risks in private sector decision-making and the increased use of digital technologies. Climate change is also transforming many sectors, such as energy and agriculture.

- *Policymakers need to review priorities for investment promotion in light of structural changes in international productions systems, the digitalization of the economy and climate change impacts.*

Long-term, affordable finance is a prerequisite for the private sector to scale up long-term investment. Access to long-term finance is lacking in many developing countries where capital markets and the local banking sector remain underdeveloped, while the cost of external borrowing is high (see chapter II).

- *Developing local financial systems should remain a focus of the international community, which should also analyse ways to further encourage lending with positive impacts on sustainable development;*
- *Governments and development partners could also seek to better tap private markets, such as private equity and venture capital funds, which now account for trillions of dollars, as a greater source of long-term finance for developing countries.*

While private investment cannot replace public investment in infrastructure, there are opportunities for scaling up its role in certain areas. This requires addressing obstacles preventing greater private investment and moving away from a project-by-project approach to a more systemic one.

- *Governments need to develop strategies for sustainable, inclusive and resilient infrastructure, which identify where public and private investments are appropriate and what policy and institutional reforms are needed to implement these strategies;*
- *Development partners could explore ways to improve the effectiveness of technical support for infrastructure development, for example, by creating a marketplace for technical assistance and further leveraging technology in this area.*

Countries would also benefit from having a more inclusive private sector. If the private sector fails to provide economic opportunities to all population segments, the economy will not only be less productive, but exclusions will create instability in the long run.

- *Governments can foster inclusion by removing obstacles that generate economic exclusions, such as laws discriminating against women, and by creating incentives and policies targeting excluded groups.*

A more inclusive private sector also necessitates improving financial services to those underserved. Financial constraints hinder the development and resilience of small companies, reducing their job creation potential. At the same time, the excessive costs of some financial services create a burden for those in need.

- *Policymakers rightfully put in place measures to avoid a credit crunch for private companies following the COVID-19 crisis and should continue to assess whether these measures are reaching small and micro businesses or whether additional actions are needed;*
- *International cooperation could help countries to learn from each other on how to better address structural issues limiting access to finance, for instance by combining traditional measures (e.g., credit infrastructure) with support for innovative solutions (e.g., technologies for credit assessment);*

- *Attention should also be devoted to regulatory barriers that can unintentionally hold back financial inclusion for the poor, including migrants, and increase costs, such as those for transferring remittances.*

The private sector not only needs to be more inclusive but also more sustainable; capital markets must be an engine for a sustainable shift. Investors are increasingly incorporating sustainability issues in their investment decisions, particularly through risk management. However, this is not likely to create enough change in companies' sustainability behaviour without further actions by policymakers, including:

- *Adopting policy measures that make unsustainable businesses less profitable, such as carbon pricing, while also encouraging businesses with positive sustainability impacts;*
- *Improving the quality and comparability of companies' sustainability reports to provide investors and other stakeholders with the information they need to assess companies on sustainability matters;*
- *Strengthening market integrity by establishing common norms and criteria for investment products to be marketed/labelled as sustainable;*
- *Increasing demand for sustainable investments by requiring pension funds and financial advisors to ask their beneficiaries and clients about their sustainability preferences (the Inter-agency Task Force on Financing for Development could reflect on the questions that should be put to these beneficiaries/clients);*
- *Requesting institutional investors to disclose the environmental and social footprint of their portfolios; and*
- *Designing standards and norms for sustainable finance approaches in capital markets to incentivize financing flows towards developing countries with large SDG gaps.*

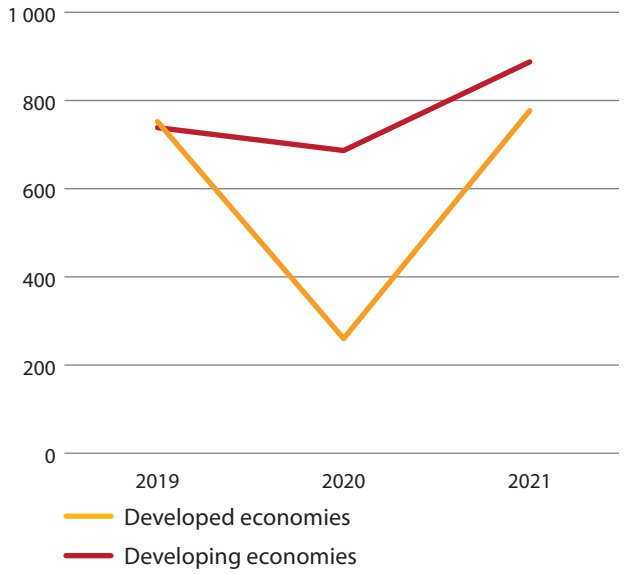
2. Corporate investment trends

Companies relaunched capital expenditure in 2021 after pausing it at the outset of the pandemic. Capital spending recorded double-digit yearly growth in 2021 for the first time in over a decade, according to some estimates.[1] This growth embraced both tangible assets (e.g., machines and factories) and intangibles (e.g., software) and was widespread across regions and sectors. The surge in corporate investment resulted from short-term factors such as a catch-up effect from the previous year and low borrowing costs. But companies must also invest to adapt to structural trends, such as digitalization and the energy transition.

Foreign direct investment (FDI) mirrored domestic trends and rebounded by 77 per cent in 2021 after decreasing by 35 per cent in 2020, but the rebound was uneven across regions and sectors. Most of the rebound was concentrated in developed economies. However, FDI growth was also significant in developing economies at 30 per cent (see figure III.B.1), albeit more modest in least developed countries (LDCs) at 19 per cent.[2] Yet, prospects in industry remain weak, with companies making 30 per cent fewer announcements of new production facilities abroad than prior to the pandemic.[3] In contrast, private investment in renewable energy and utilities has fared better on the back of large stimulus packages.

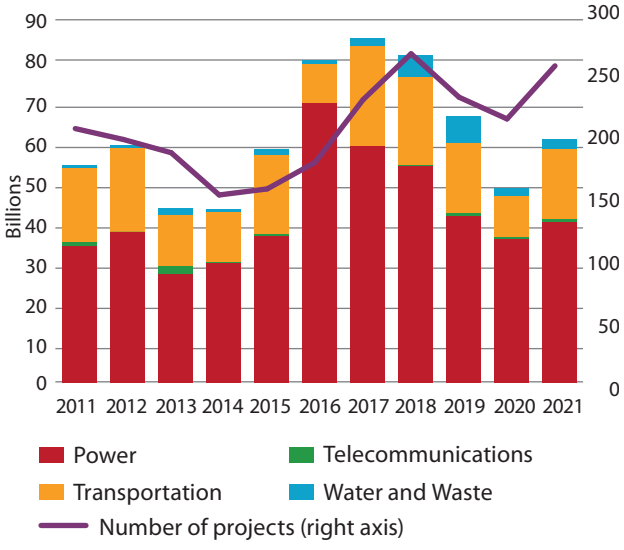
Despite a rebound, private investment in infrastructure in developing countries remains low relative to historical averages. Financed infrastructure deals in developing countries increased by 25 per cent in 2021, exceeding $60 billion but remaining 9 per cent lower than prior to the pandemic (see figure III.B.2). Meanwhile, investments are already above pre-pandemic levels in developed countries. The upward trend in infrastructure investment could continue in the future if the pipeline of projects announced in developing countries—now over 30 per cent higher compared to 2019 –materializes.[4]

Figure III.B.1
FDI inflows
(Billions of United States dollars)



Source: UNCTAD – Global Investment Trends Monitor, Issue 40.

Figure III.B.2
International project finance: financed infrastructure deals in developing countries
(Billions of United States dollars, number of projects)



Source: Refinitiv – Infrastructure 360 database.

Looking forward, future corporate investment will depend on the robustness of the recovery as well as financial conditions and geopolitical stability. Uncertainty about future demand continues to be a drag on companies' investment plans. In a recent survey, 72 per cent of multinationals indicated that they do not plan to change investment plans in their host country over the next one to three years.[5] COVID-19 variants are a contributor to uncertainty, which is expected to continue in the coming months. Meanwhile, rising interest rates in major economies could increase the cost of future investments while growing geopolitical tensions could lead companies to delay investments.

High corporate debt burdens could deter new lenders and stifle investment. Corporate debt in emerging market and developing economies has, on average, risen from about 60 per cent of GDP in 2006 to about 80 per cent of GDP in 2019; [6] and the pandemic may have further increased this level as companies have sought debt deferrals. A negative effect of debt on future investment is expected to be more pronounced for large and highly leveraged firms.

3. Increasing investment in future growth

Long-term investment is crucial to foster productivity growth, transform economies and achieve sustainable development. It differs from short-term investment in working capital, which has a more limited impact on development. Long-term investment includes investment in productive capacity, such as equipment and factories, but also investment in infrastructure projects with long-term social and environmental benefits.

3.1 Private investment in infrastructure

Investment is urgently needed to build sustainable and resilient infrastructure. At the current pace, 660 million people will be without electricity in 2030 and about 2 billion people still lack access to safely managed drinking water. Transport infrastructure also needs to be reshaped to allow for more sustainable and inclusive options. About 1 billion of the rural population remain unconnected to a good quality road network and only 50 per cent of urban residents worldwide have convenient access to public transport.[7] Countries also need to prepare infrastructure to be resilient to a drastically different climate and environment in the future.

While private investment in infrastructure is no silver bullet, it must play a greater role in some areas.[8] Private investment can lead infrastructure development in market-ready sectors, such as telecommunications, where the public sector's role may be limited to protecting consumers and fostering universal access. Private finance also has great potential for adding power generation capacity and realizing energy efficient improvements. It is estimated that about 70 per cent of clean energy investment globally could come from the private sector (see chapter III.G).[9] Governments can also mobilize private investment in other sectors, including transport and water services, but this entails complex contractual arrangements and often significant fiscal risks. The result can be costly for the public purse and could lead to exclusions of some populations from basic services due to unaffordable tariffs.

To assess the suitability of the private sector's involvement in infrastructure, Governments need to consider the following:

- **Revenue streams:** Does the project have the capacity to generate sufficient cash flows to compensate the investors for the risks they bear? If not, should the Government guarantee/provide a stable revenue stream for a private investor to make the project financially viable or should the Government realize the project itself through public funding?
- **Risk premium:** Do the risks (and risk perceptions) associated with the project lead to excessive risk premia making the project unaffordable? Can legal and regulatory reforms mitigate investment risks without creating fiscal liabilities or compromising national objectives? Are there public investments in related areas that would reduce risks and broaden the scope for private investment?
- **Efficiency gains:** Can the private sector bring efficiency improvements to the way infrastructure services are delivered? Can it be easily held accountable through well-defined output requirements? Does it help to bundle construction with operation and/or maintenance into a single 10- to 20-year contract or does it create unmanageable complexities?
- **Public and private sector capacity:** Do local officials have the required skills for developing, negotiating and monitoring complex Public-Private Partnership (PPP) agreements? Similarly, do local construction companies have the capacity to embark on long-term projects? Is the investor appetite confirmed?

Decisions made on infrastructure investment today will lay the foundations for countries' development paths for decades ahead and should be aligned with the SDGs, climate goals and disaster risk reduction priorities. To improve the sustainability and resilience of infrastructure services delivery, Governments can build on the many initiatives launched in this area, such as: (i) the G20's Principles for Quality Infrastructure Investment;[10] (ii) UNEP's Ten Principles for Sustainable Infrastructure;[11] (iii) UNECE's People-first Public-Private Partnerships;[12] (iv) Inter-American Development Bank's Framework for Sustainable Infrastructure;[13] (v) United Nations Office for Disaster Risk Reduction's upcoming Principles for Resilient Infrastructure; (vi) UN/DESA-UNCDF's Handbook on Infrastructure Asset Management;[14] and (vii) the FAST-Infra public-private initiative.

Policymakers should respond to infrastructure needs with a systemic approach. Infrastructure gaps should not be approached on a project-by-project basis. Instead, Governments need to define a strategy for each infrastructure sector, such as a long-term plan for transitioning energy to be compatible with climate goals. The plan should aim to quantify needs in terms of both supply (e.g., power generation capacity by technologies) and demand (e.g., increase in electric vehicles and energy- efficient buildings). The plan could then identify necessary reforms (e.g., feed-in tariffs) and the possible source of financing for each component (e.g., private investment may be suited for increasing power generation while public investment is likely to be the preferred option for power transmission). Yet, Governments still struggle with the lack of institutional capacity to implement good practices at both national and sub-national levels.

As concessional resources are limited, it is important to consider how to improve the effectiveness of current technical support for infrastructure development. There has been a proliferation of technical assistance facilities. For Africa alone, there are at least 15 different facilities available to countries for infrastructure project development.[15] At the same time, there has been limited support for early-stage/upstream activities. One way to address this issue might be to consider developing a marketplace for technical assistance support on infrastructure, which could provide a single-entry point for Governments to request assistance. However, strong political will is required to bring all development partners to this idea. Leveraging technology is another avenue for enhancing the impact of international support. For example, technology can be used to: (i) guide government officials through every step of an infrastructure project using standardized project preparation templates;[16] or (ii) facilitate access to infrastructure knowledge via online training platforms. Governments could consider asking development partners, including multilateral development banks, to collaborate on improving the effectiveness of technical support for infrastructure development and present progress at the next edition of the Global Infrastructure Forum, which was established by the Addis Abba Action Agenda.

3.2 FDI and productive capacity

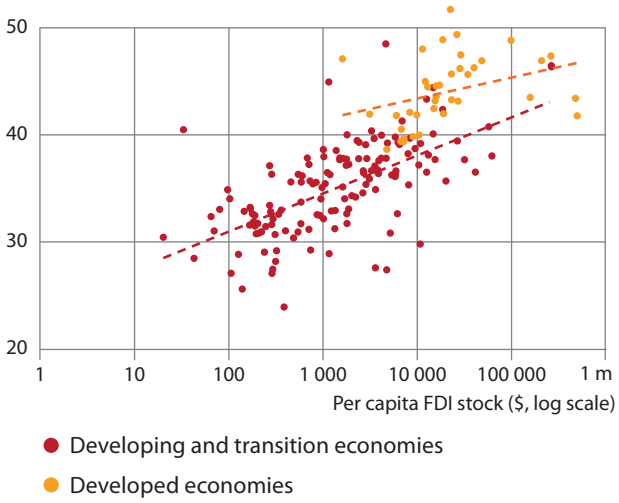
Investment in both manufacturing and services is necessary to expand a country's productive capacity; mobilizing FDI can help achieve this goal. FDI, a source of long-term finance, naturally embodies a transfer of capital, which can be helpful in countries with limited domestic private savings. Furthermore, in many cases FDI embodies the creation of productive assets (e.g., a new factory) and may ideally support the transfer of know-how and technology. Figure III.B.3 shows that the stock of FDI is positively correlated with productive capacity, particularly in developing countries. While it is reasonable to assume that FDI increases the productive capacity of a country, it also possible that more productive countries attract more FDI.

Governments can tailor policies to attract and retain FDI in strategic growth industries while fostering spillovers across local firms. Policymakers have long paid attention to investment from multinational companies for its potential for industrialization, export promotion and structural change. For example, FDI can help commodity-dependent countries transition to manufacturing activities and other higher-value-added activities. FDI can also contribute to job creation, human capital development and the transition to a low-carbon economy.[17] Yet, FDI-related benefits are not automatic and often require appropriate investment policies tailored to the local circumstances. Integrated national financing frameworks (INFFs) may provide a useful tool for Governments to prioritize actions and assess investment policy options through a holistic approach. This, in turn, could allow Governments to align strategic objectives in different policy areas which are sometimes considered separately (e.g., investment promotion, innovation, and entrepreneurship development).

When reassessing their approach to investment, Governments need to consider issues highlighted by the pandemic, including:

- **First, the rebalancing of international production networks.** The pandemic is shifting the way companies look at international production networks. Companies are placing greater emphasis on supply chain resilience and sustainability considerations. A survey of 1,300 supply chain professionals found that 87 per cent of them plan to invest in resilience within the next two years.[18] In another large survey, 59 per cent of respondents declared investing in supply chain sustainability.[19] Governments thus need to review whether sectors targeted for FDI remain a priority and whether other opportunities may have emerged, for example, due to the shortening of value chains;
- **Second, unequal access to vaccines and medical products.** The pandemic has highlighted the benefits of hosting health manufacturing activities. However, less advanced economies face a range of challenges to attracting investment in this sector. The required capital, technology and skills are not readily available in many countries. At the same time, low regulatory capacity and weaknesses in the healthcare system can discourage global investors concerned by compliance issues. Nevertheless, addressing these challenges is possible as evidenced by the number of developing countries that have successfully created a thriving health industry.[20]

Figure III.B.3
Positive correlation between productive capacities index (PCI) and per capita FDI stock
(PCI)



Source: UNCTAD. *World Investment Report 2021*.
Note: The PCI index has eight components, i.e., human capital, natural capital, ICTs, structural change, transport, institutions, and the private sector.

3.3 Access to long-term private finance

To invest in their own development and/or embark on capital-intensive projects, companies need long-term sources of finance. For example, R&D investments can take years to generate profits and cannot be financed with short-term loans. Similarly, companies and households should be able to secure long-term loans to invest in assets that will last for decades (e.g., heavy equipment or real estate). Financing long-term investment with short-term debts exposes borrowers to significant refinancing risks. As both financial institutions and capital markets fail to provide long-term financing in many developing countries, companies and households may either be reluctant to make investments or be forced to self-finance them.

Banks in developing countries, particularly LDCs, continue to provide less credit to the private sector than those in developed economies (see figure III.B.4). Banks in developed markets also provide a much higher percentage of loans with maturities longer than five years.[21] This lack of financial depth makes it difficult for companies to finance long-term investment. Only 18 per cent of companies in LDCs use banks to finance investments compared to 28 per cent in middle-income countries (MICs) and developed countries.[22]

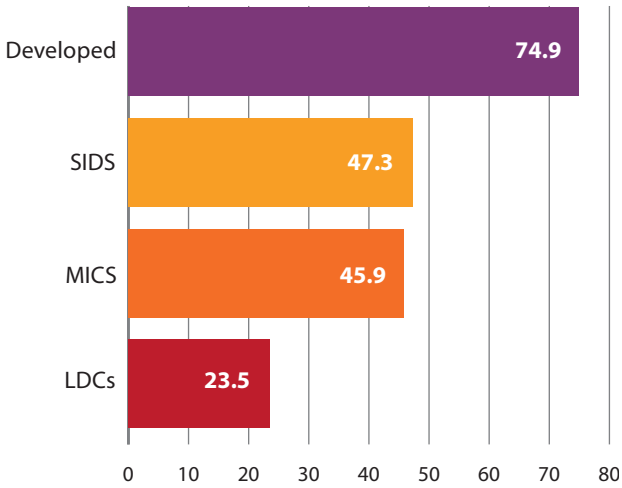
Policymakers need to address the fundamental issues behind the limited supply of long-term credit in many developing countries. These include: (i) limited information about clients' creditworthiness; (ii) underdeveloped financial systems; and (iii) inadequate legal infrastructure such as poor contract enforcement diminishing the value of collateral. Macroeconomic instability is also detrimental to long-term lending, in part because it makes it difficult to forecast inflation over a long time horizon. Governments and development partners could explore ways to further grow the local banking sector, for instance, by shifting the focus of international finance institutions from direct private sector financing to de-risking.

Not all long-term lending will have the same impact on development. For example, loans used to acquire a company and pay back initial shareholders do not have the same development impact as loans used to invest in more environment-friendly equipment and other productive capacities. Policymakers could thus reflect on how to incentivize loans with a positive contribution to productivity and the SDGs, while disincentivizing those with a limited or negative impact, for instance, because they create heightened financial stability risks or are socially harmful. They could also consider supporting initiatives designed to better align the banking industry with the SDGs, such as the Principles for Responsible Banking.[23]

Developing capital markets, another source of long-term financing, has proven challenging in many countries. Capital markets offer an avenue, mostly for large companies, to access long-term debt and equity financing from a wider pool of investors. However, many developing countries have shallow capital markets, if any at all. Several challenges explain difficulties in developing capital markets, including a narrow investor base, limited supply of issuers and inadequate legal and market infrastructure. Nonetheless, some developing countries have been successful in establishing stock markets and growing them over time (e.g., large economies such as Brazil, China and South Africa - see figure III.B.5). Similarly, corporate bond markets have so far played a limited role in mobilizing financing in most developing countries and these markets remain small in terms of GDP, with some notable exceptions (e.g., Malaysia).[24]

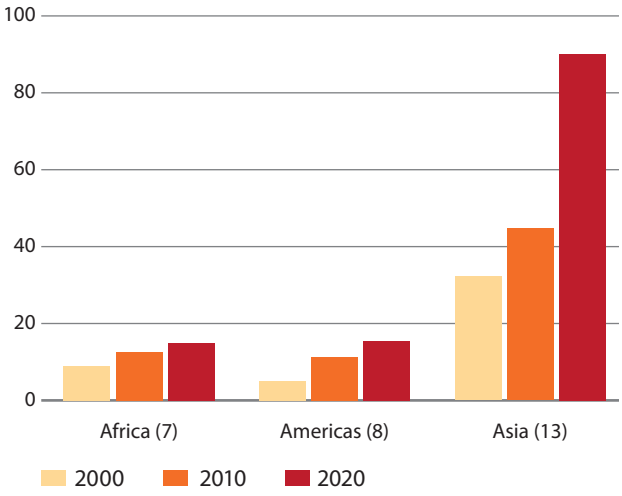
Private markets, such as private equity/debt funds, have become mainstream and may offer an alternative to listed equities and bonds for long-term private financing. Pension funds and other institutional investors have invested heavily in unlisted and privately owned companies as they seek higher returns in a low interest rate environment. Venture capital, a subset of private markets targeting startups, has grown by a factor of 20 since 2002.[25] The largest institutional investors now hold 9 per cent of their assets in private markets, twice as much as in 2011.[26] This surge in private market investment creates considerable competition for deals as well as a record level—at $3 trillion—of funds committed but not yet invested (so-called dry powder).[27]

Figure III.B.4
Private credit by deposit money banks to GDP (average 2019 – 2020)
(Percentage of GDP)



Source: International Financial Statistics (IFS), International Monetary Fund (IMF).

Figure III.B.5
Stocks traded (total value) in selected developing countries
(Percentage of GDP)



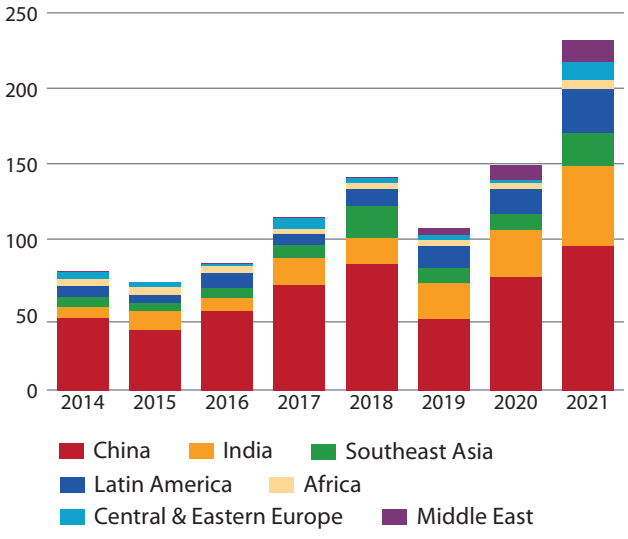
Source: World Federation of Exchanges database.
Note: The number of countries covered by region (i.e., with data available) is indicated in parenthesis.

The rise of private markets could create opportunities for developing countries. Unlike stock exchanges, private markets can operate with less sophisticated market infrastructure. They can also more easily support smaller companies prevalent in developing countries. Private markets are less volatile as investors cannot easily exit illiquid equity investments in downturn periods. Private capital investments in emerging markets have grown rapidly, reaching their highest levels on record in

2021 at about $230 billion (figure III.B.6). Nonetheless, they still represent a small share of the market as a whole (figure III.B.7). Facing heightened competition for deals in mature markets, investors could be tempted to enter more frontier markets with higher economic growth prospects.

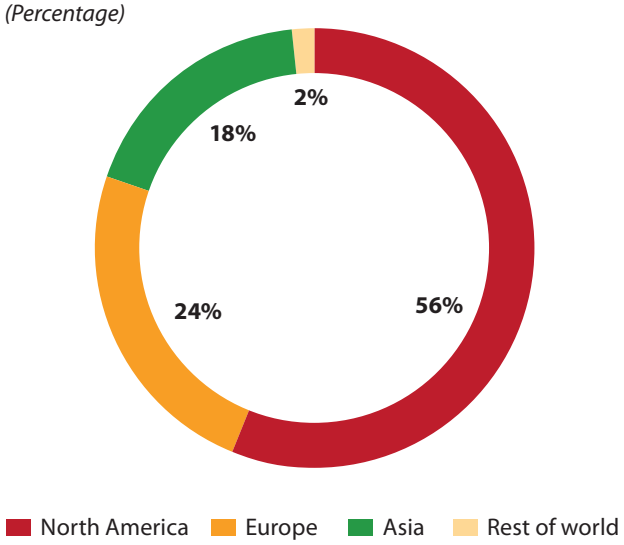
However, investment in these countries is perceived as riskier by investors. International investors cite macroeconomic conditions (including exchanges rates) and political and regulatory uncertainty as some of the greatest obstacles to increasing fund allocations to emerging markets.[28] Unless these risks are mitigated, private equity investments need to compensate investors for these risks in order to be attractive (or competitive with other investment opportunities). Generally, returns will need to exceed sovereign bonds yields, which are already high in many developing countries (see chapter II). Only a limited number of deals might be able to produce high enough returns. Increasing private capital investment in these countries thus requires mitigating country risks. In the medium term, this means strengthening the enabling environment, including macroeconomic policies. It can also include using risk-sharing mechanisms, including from public development banks (see chapter III.C). Investors' risk perceptions are also determined by the trustworthiness of information available to them, which in turn depends on the existence of an ecosystem of ancillary legal and accounting services (see chapter II). The INFF binding constraint methodology can further help countries to think through and prioritize how to address impediments to attracting greater private capital investment. An INFF assessment would also aim to better understand why some domestic investors have been reluctant to invest in local private markets. For example, private equity investments represent less than 1 per cent of local pension funds in several large sub-Saharan African economies.[29]

Figure III.B.6
Private capital investment in developing regions
(Billions of United States dollars)



Source: Global Private Capital Association (GPCA)—see GPCA's methodology for regional groupings

Figure III.B.7
Geographical distribution of assets under management in private markets
(Percentage)



Source: BIS calculations based on Pitchbook Data.
Note: Data as of October 2021.

For private equity investment to be supportive of growth, it should result in an injection of fresh capital in businesses and avoid the pitfalls seen in developed markets. These pitfalls include funds that have loaded businesses with debts to extract value, sometimes leading previously profitable businesses into bankruptcy. A study estimates that companies acquired through leveraged buyouts have a probability of bankruptcy within 10 years that is 18 per cent higher than other firms.[30] The risk of overleveraging is, however, more limited in countries with less developed financial markets.

4. Fostering an inclusive recovery

For economies to be stable and thrive in the long run, they need to work for all segments of the population. This can only be achieved with a more inclusive private sector where economic opportunities are more widely accessible to all social groups. Access to financial resources should also be enhanced for those currently underserved so they can invest in their future. This includes facilitating access to loans for entrepreneurs and small businesses as well as reducing the cost of financial services for the poor.

4.1 Inclusive growth

An inclusive private sector is good for the economy and businesses. Higher participation of women in the workforce increases the pool of talent for employers and can add 35 per cent to GDP in countries with the largest gender gaps.[31] Studies have also shown that diverse companies (in terms of gender and ethnicity) are more likely to financially outperform their peers.[32] Inclusive growth also requires bringing a greater share of the world's 2 billion informal workers into the formal economy. This is necessary not only to improve social outcomes but also to boost growth.

Informal firms tend to remain small, with a labour productivity approximately one quarter of that of formal firms.[33]

The pandemic poses additional challenges in terms of economic exclusion. The pandemic has disproportionally hit populations at the bottom of the income pyramid, including informal workers, as well as other groups already underrepresented in the economy such as youth and women, thereby exacerbating pre-existing economic disparities. [34]

Government actions need to both remove obstacles and create incentives for further inclusion. In the case of gender, laws and regulations continue to discriminate against women in many countries. In 108 countries, women cannot run a business in the same way as men due to obstacles in opening a bank account or registering a business.[35] Fiscal policy is another lever to promote inclusion, for example, by: (i) setting relatively high tax-exempt thresholds to encourage greater formalization of small firms; or (ii) using tax incentives to promote the recruitment of underemployed populations such as youth. Governments can also provide targeted training programmes for low-skilled workers; use public procurement to support organizations with a diverse workforce (see chapter III.A); and promote a new form of business that better integrates economically vulnerable people (see box III.B.1).

Box III.B.1
Promoting inclusive business in South-East Asia

Inclusive businesses provide goods, services and livelihoods—on a commercially viable basis—to the populations at the base of the economic pyramid, making them part of the core value chain as suppliers, distributors, retailers and/or customers. Member States of the Association of Southeast Asian Nations (ASEAN) have developed various strategies to promote inclusive business, including:

- The integration of inclusive business in national development or industry development plans: For example, inclusive business is an investment priority of the Government of the Philippines, with corresponding incentives and dedicated legislative bills;
- The institutionalization of inclusive business promotion: Governments have identified agency leads and, in the cases of Cambodia, Myanmar and the Philippines, have established a steering committee for promoting inclusive business;
- Promoting inclusive business at the regional level: for example, the Ministers of ASEAN have endorsed the "Guidelines for the Promotion of Inclusive Business in ASEAN", the first region in the world to adopt guidelines of this kind.

The development of enabling environments for inclusive businesses in South-East Asia is still in its early stages. To magnify inclusive growth, it will be critical to establish formal and funded support structures to: (i) promote inclusive business; (ii) articulate these efforts with other development plans; (iii) move into the implementation stage; and (iv) monitor and evaluate the impact of these measures.

Source: United Nations Economic and Social Commission for Asia and the Pacific (ESCAP). 2021. *Frontiers of Inclusive Innovation—Formulating Technology and Innovation Policies that Leave No One Behind.*

4.2 Access to finance

Smaller companies continue to face significant financial constraints as commercial banks have failed to increase lending. Outstanding loans to small- and medium-sized enterprises (SMEs) from commercial banks are below 5 per cent of GDP in LDCs, while they account for over 15 per cent in developed countries (see figure III.B.8). SMEs in developing countries also provide on average 30 per cent more collateral to secure a loan than those in developed countries.[36] Nonetheless, there are positive signs. While close to one third of SMEs surveyed in developing countries identified access to finance as a significant constraint to growth a decade ago, this share has declined to about one quarter in recent years.[37] In contrast, only 7 per cent of SMEs in the euro area report concerns regarding access to finance.[38]

Policymakers have a range of options to address SME financial constraints, including:

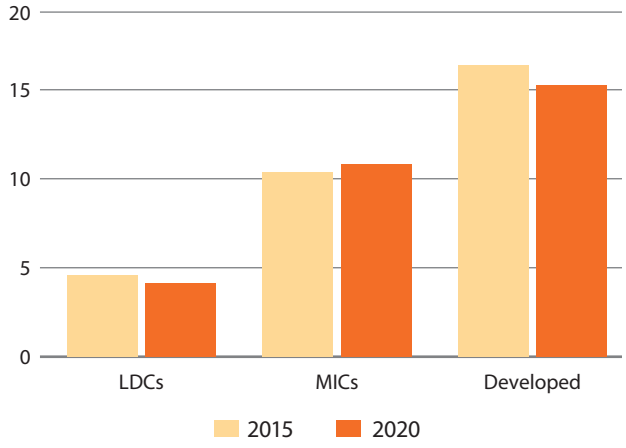
- **Reducing information asymmetries** through enhanced credit reporting systems[39] and technology to provide better information for credit decisions (e.g., open banking technology may allow SMEs to use their bank account data for seeking loans from third-party institutions);
- **Mitigating risks** through (i) partial credit guarantee schemes for SME lending institutions (65 countries have launched or expanded existing guarantee schemes since the COVID-19 outbreak); [40] and (ii) more efficient collateral systems (e.g., making it possible to use moveable assets such as equipment as collateral);
- **Providing liquidity** through credit lines to local financial intermediaries for on-lending to SME clients as many multilateral development banks have been doing for many years (e.g., credit lines have represented up to 20 per cent of the European Bank for Reconstruction and Development's total annual business volume).[41] However, there is a risk that banks use these funds to lend to clients that would have received loans even without these credit lines;
- **Creating incentives** through performance-based incentives that reward financial institutions targeting underserved segments, for example, those earmarking at least 20 per cent of loans to women customers and women-led enterprises.[42]

For Governments to select the optimal tools, they first need to assess the obstacles to SME finance in their country, for instance, through INFFs. Governments and development partners should also continue examining the impact of these mechanisms and how to improve policy design and avoid unintended side effects (e.g., credit schemes that generate excessive losses or incentives for SMEs that lead to loans only for the largest firms among these enterprises).

Enhancing SME access to finance could lead to significant benefits in terms of job creation. These enterprises account for more than half of all formal employment in developing countries. Alleviating SMEs' financial constraints could help to meet the employment challenge facing these countries. A recent study estimated that every $1 million loaned to SMEs in developing countries is associated with the creation of an average of 16.3 direct jobs over two years.[43]

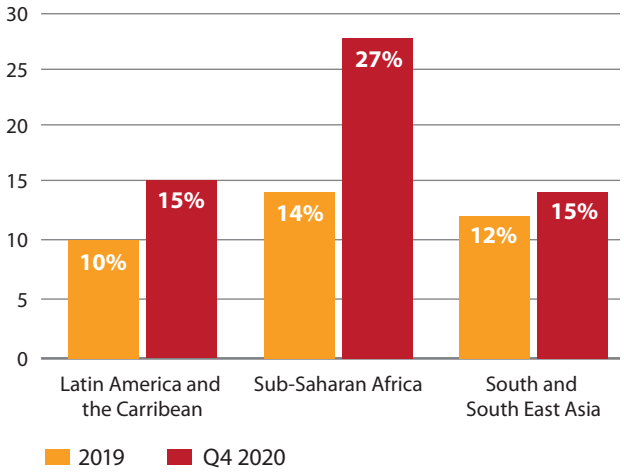
In addition to solving structural issues, policymakers must prevent small and micro companies from facing a credit crunch at the very moment revenues are negatively affected by the COVID-19 crisis.

Figure III.B.8
Outstanding SME loans from commercial banks
(Percentage of GDP)



Source: UN/DESA calculation based on 8 LDCs, 32 MICs and 16 developed countries for which data were available both in 2015 and 2020 in the IMF Financial Access Survey 2021 database.

Figure III.B.9
Microfinance institution loans at risk
(Percentage of outstanding portfolio)



Source: CGAP, "Microfinance Solvency and COVID-19: A Call for Coordination", September 2021.
Note: Credit risk is calculated as an average of loans in arrears for over 30 days, restructured and written off.

A survey of francophone Africa in 2021 showed that smaller enterprises' revenues had not recovered from the pandemic to the same degree as large companies. [44] Meanwhile, figure III.B.8 shows that the crisis led to a decrease in lending to SMEs in developed countries and LDCs. Similarly, microfinance institutions (MFIs) cut lending dramatically at the peak of the crisis, with almost 69 per cent reducing lending (often by more than half) due to liquidity and solvency concerns.[45] By one measure, the share of microloans at risk in sub-Saharan Africa almost doubled from 2019 to 2020 (see figure III.B.9), jeopardizing the future solvency of many MFIs, especially the smaller ones.[46] Equity support, not debt, is needed to ensure that institutions that provide considerable social benefits outlive the crisis. Development finance institutions and donors need to invest and play a catalytic role, while limiting the disruption of services for the poor.[47]

The COVID-19 crisis has also re-emphasized the need to accelerate financial inclusion. Greater access to financial services allows those typically excluded, such as the self-employed and informal workers, to better weather the crisis and invest in their own recovery. Many public support programmes have been channelled through the financial sector in the form of debt moratoria and loan guarantees, de facto excluding those not served by financial institutions. While digital financial services have enabled a remarkable growth in access to financial services[48] (see chapter III.G), many segments of the population remain unserved or underserved with inadequate or expensive solutions. For example, women and rural workers are overrepresented in the unbanked population (e.g., women in developing countries are 9 percentage points less likely than men to have a bank account).[49]

4.3 Cost of remittance transfers

Addressing the high cost of remittances is another way to enhance financial services to those most in need. The high cost of remittances is a toll on the poor. About 50 per cent of global remittances are directed to rural areas, where poverty is concentrated. [50] Every dollar saved on remittances increases the income of migrant families and other recipients and thus their capacity to invest in their future, for instance, via spending on education. This source of funds is also countercyclical as demonstrated by the resilience of remittances during the COVID-19 crisis. Defying initial forecasts, remittances registered just a 1.7 per cent drop in 2020 and are projected to increase by 7.3 per cent in 2021.[51]

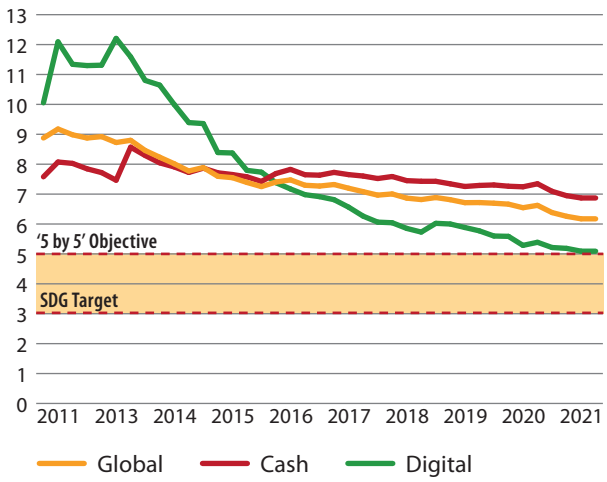
Yet, remittance costs remain far above the SDG target of 3 per cent or lower despite improvements in many corridors. In the second quarter of 2021, the global average cost of sending $200 across international borders was 6.3 per cent of the amount transferred. The difference among receiving regions remains large. On average, it is twice as expensive to send money to sub-Saharan Africa than to South Asia (average cost of 8.7 vs. 4.3 per cent as of second quarter 2021). Globally, 24 per cent of corridors still have costs higher than 5 per cent, while the SDG target is also to eliminate remittance corridors with costs above 5 per cent by 2030.[52]

Moving remittances to digital channels could help to reduce transfer costs while increasing access and transparency. The COVID-19 crisis has already led to a shift from cash-based to digital channels. International remittances processed via mobile money increased by 65 per cent in 2020.[53] Pursuing this shift will be critical to achieving international goals as digital channels are far cheaper than cash remittances (see figure III.B.10).[54] Remittance service providers are taking actions in this direction: about two thirds of remittance service providers surveyed planned to strengthen their digital channels.[55]

Further adoption of digital solutions will require accelerating access to transaction accounts for the migrant population. There are several reasons why accessing these accounts is currently hindered, including: (i) stringent anti-money laundering and countering the financing of terrorism (AML/CFT) regulations; (ii) lack of financial and

digital literacy; and (iii) inadequate access of non-bank payment service providers to payment infrastructures needed for remittance transfers. Know Your Customer (KYC) requirements included in AML/CFT make onboarding by banks of migrants who may lack the required identification documents more challenging. Policymakers could build flexibility into existing regulations while still ensuring a high degree of financial integrity through, for example, digital identification and verification systems.[56] In addition to regulatory interventions, policymakers could promote cheaper options via price comparison websites and support digital and financial literacy of migrants and their families. [57]

Figure III.B.10
Trends in global cost of sending $200 in cash or digitally
(Percentage)



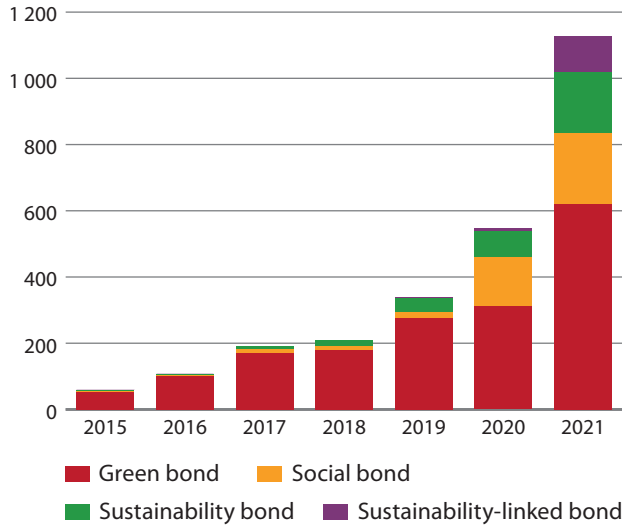
Source: World Bank, Remittance Prices Worldwide, No. 38, June 2021.

5. Leveraging capital markets for sustainable development

The private sector not only needs to be more inclusive but also more sustainable; capital markets need to play a greater role in incentivizing the private sector towards more sustainability. Incorporating sustainability issues into investment decisions has become mainstream, starting with climate change. Investors realize that some sustainability issues impact the financial performance of companies they invest in. This recognition is also reflected by the large number of Principles for Responsible Investment (PRI) signatories, which represent more than $120 trillion of assets under management (that is, roughly 50 per cent of the value of the global equity and bond markets).[58] Climate change has been the driving force behind sustainable investment. In the lead up to the 2021 United Nations Climate Change Conference (COP26), the Glasgow Financial Alliance for Net Zero (GFANZ) managed to gather members with $130 trillion in assets around the goal of accelerating the decarbonization of the economy through the financial sector.

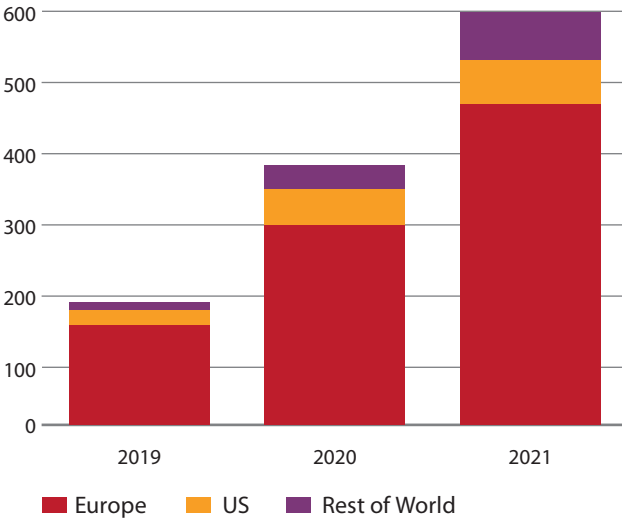
Sustainable investment attracted record-level flows in 2021. In the debt market, sustainable bond issuance doubled in 2021, with green bonds

Figure III.B.11
Sustainable bond market issuance
(Billions of United States dollars)



Source: BloombergNEF, Bloomberg LP.

Figure III.B.12
Global sustainable fund flows
(Billions of United States dollars)



Source: Morningstar.

exceeding $600 billion and social bonds gaining importance (see figure III.B.11). The global outstanding amount of sustainability-labelled bonds is now over $2.5 trillion.[59] Developing countries accounted for 22 per cent of green bond issuance in 2021 versus 16 per cent the previous year,[60] but issuance remains limited in lower-income countries.[61] Meanwhile, sustainability-themed funds have continued their exponential growth, with a net inflow of about $600 billion in 2021 (a 62 per cent increase compared to 2020—see figure III.B.12). Total assets in these funds exceeded

$2.7 trillion at the end of 2021. This trend is expected to continue. A survey indicates that investors want to double the share of their assets invested sustainably between 2020 and 2025—from 18 to 36 per cent.[62]

While these developments represent major breakthroughs and could give the impression that the market has found the solution to combine profit with positive impact, the reality is more complex. Most investors that have invested in products marketed as sustainable have done so because they believe integrating environmental, social and governance (ESG) issues into their investments could lead to greater financial returns or will not affect returns while providing a feel-good sentiment. In other words, ESG investment strategies were not designed to go beyond financial returns. In the European Union, the legislator has created a distinction between funds that explicitly integrate sustainability into the investment process (the so-called Article 8 funds) from those that have sustainable investment as an objective (the so-called Article 9 funds). The latter represent only around 4 per cent of total European Union investment funds, while Article 8 funds account for about 30 per cent.[63] The Global Investors for Sustainable Development (GISD) Alliance has also introduced a definition of sustainable development investing (SDI). The SDI definition outlines criteria that investment should meet to qualify as making a positive contribution to sustainable development, de facto creating a norm against which sustainable investments can be assessed.

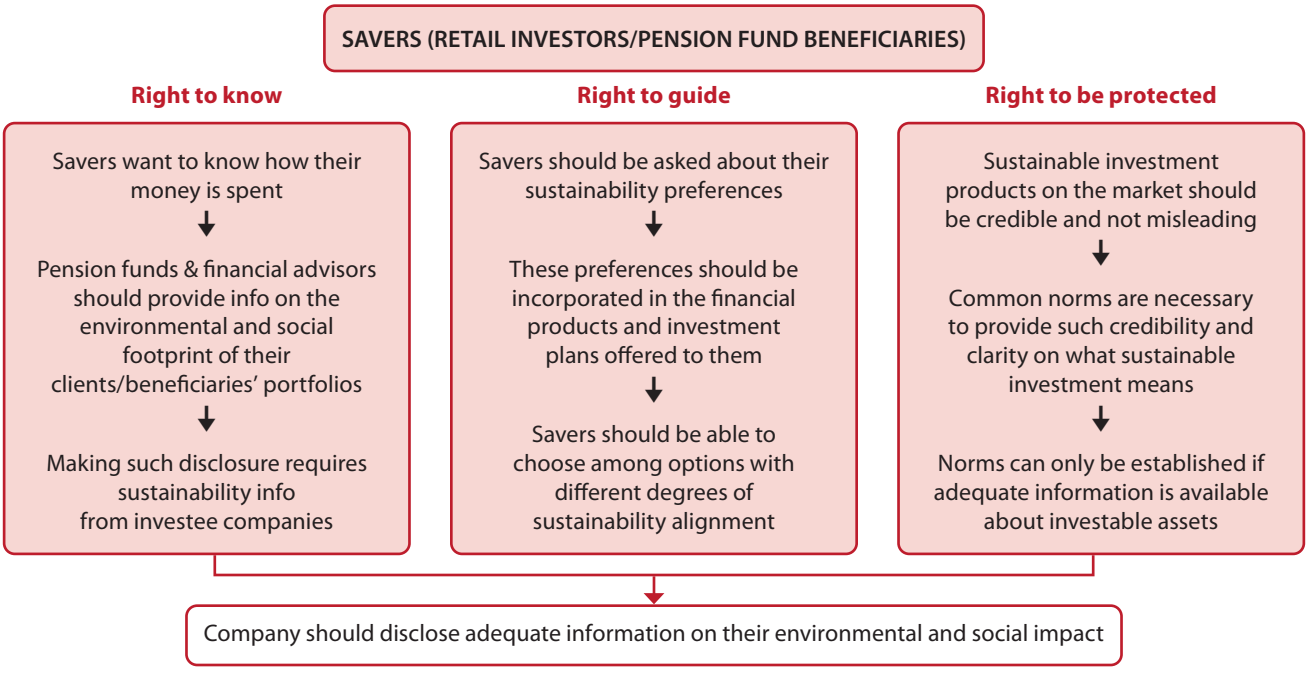
Policymakers can explore several avenues to increase the impact of sustainable investment practices (see figure III.B.13). First, they can act to improve companies' transparency about their impact on sustainability issues. Second, they can intervene to protect the rights of retail investors and pension fund beneficiaries to know how their money is being spent by those managing funds on their behalf (e.g., pension fund managers), including whether funds are invested in companies with positive or negative impacts on social and environmental issues. Third, they can ensure that savers are offered financial products and strategies that match their true preferences. Fourth, they can take measures to prevent investment products (e.g., exchange-traded funds) from being marketed as sustainable if they are misleading investors about their stated impact.

5.1 Investor regulations

There is evidence that individual investors' interest goes beyond financial performance. A 2020 survey in the United Kingdom found that 80 per cent of pension fund members wished for their pension to do some good (up from 69 per cent in 2018).[64] A survey in the Netherlands found that two thirds of pension fund participants were willing to expand the fund's engagement with companies based on selected SDGs, even when they expected engagement to hurt financial performance.[65] Four out of five Australians wished for their super fund and their bank(s) to communicate the impacts—positive and negative—that their money is having on people and the planet.[66] These surveys demonstrate that investors are not only interested in sustainability issues to enhance their financial performance, but also as goals in and of themselves.

Yet, savers and pension fund beneficiaries are not systematically asked about their sustainability preferences. In the United States, a small majority of investors (56 per cent) have been asked by financial advisors about their goals beyond financial performance, and 59 per cent have knowledge of sustainable investment options offered in employer-sponsored retirement saving plans.[67] The picture is similar in other markets. In a survey

Figure III.B.13
Sustainable investment from a saver perspective



Source: UN/DESA.

across 24 countries, only 59 per cent of surveyed individual investors said their financial advisors had spoken to them about ESG investments.[68]

Several reasons might explain financial advisors' lack of engagement. First, advisors generally have no legal obligation to ask these types of questions as part of their requirements to understand clients' investment risk preferences and profiles. Second, unsupported fears that sustainability preferences could impair financial performance could result in hesitancy to proactively ask clients about their sustainability preferences, especially if advisors' fees are linked to financial returns. A recent survey showed that 43 per cent of advisors who did not currently invest in ESG believed that ESG-branded products perform worse.[69] Third, the absence of standards to define what constitutes a sustainable investment creates confusion for financial advisors. About 80 per cent of financial advisors find it challenging to explain ESG concepts to their clients;[70] the lack of familiarity with ESG is holding back advisors' engagement.

Legislators can amend rules to permit or require institutional investors and advisors to adjust their investment practices to their clients' sustainability preferences. Some jurisdictions are ahead of others in this regard. For example, in the European Union, regulations have been updated to ensure that wealth and portfolio managers incorporate clients' sustainability preferences in the recommendations they provide.[71]

Fiduciary or related investor duties can no longer be used as an excuse for disregarding sustainability issues. The guiding principle for the investment industry is that pension funds and other institutional investors have the duty to act in the best interests of their clients who entrust them with their savings. This has been interpreted as a responsibility to only focus on financial risk/return, but regulators need to clarify the interpretation of this responsibility in today's context:

- First, regulators should make it unequivocally clear that this duty encompasses the need to consider sustainability considerations as some of these considerations will impact financial performance, especially in the long term (see *Financing for Sustainable Development Report 2019*, pp. 54-55);
- Second, regulators should introduce discretions that allow investors to pursue sustainability goals that reflect beneficiary preferences. For example, if they have enough evidence, regulators could introduce a presumption that each investor wishes for their money to be managed in ways that achieve certain sustainability goals.[72]

Concretely, regulatory changes can target:

- **Transparency in terms of asset allocation and investment decision—**Institutions managing funds on behalf of others currently disclose information on how their funds have been invested. Yet, the way they disclose sustainability-related information about their funds is largely left up to the discretion of the institutional fund managers, although this is rapidly evolving with emerging regulation and industry-led guidance, such as the European Union Sustainable Finance Disclosure Regulation (SFDR) and the CFA Institute's Global ESG Disclosure Standards for Investment Products. Concretely, policymakers could require fund managers to consistently disclose the environmental and social footprint of their clients' portfolios, including both the disaster risk to which they are financially exposed and those that they are creating, and the ways they have taken sustainability issues into account in their investment decisions;
- **Consistency in engagement practices—**Institutional investors could be required to report on how they engage with current or potential investees and use their influence, including with policymakers, to encourage positive changes on environmental and social issues. Stewardship codes have been introduced in 22 jurisdictions to formalize expectations concerning investors and encourage greater transparency on investors' stewardship activities (e.g., voting at shareholder meetings and filing of shareholder resolutions/proposals).[73] These codes can ensure that activities by investment managers reflect asset owners' sustainability concerns. Despite these codes, actions by asset managers often diverge from what one would expect. A recent analysis of the voting records of three major asset managers shows that they more often oppose rather than support shareholder resolutions aimed at improving environmental governance of major polluting companies.[74] The GISD Alliance is trying to address this issue by developing a model mandate that asset owners can use as the basis for negotiating mandates with their asset managers and ensuring that their expectations in relation to sustainability and stewardship are well reflected in investment management agreements;
- **Provision of sustainability-aligned investment alternatives—**In the United States, the Department of Labor, which oversees retirement plans, is proposing to make it easier for employers to offer options in those plans that incorporate ESG factors in investment decisions.[75] Policymakers could consider going a step further and making it mandatory for employer retirement plans to always include, among the possible investment alternatives, one focused on achieving positive impacts on sustainable development.

5.2 Sustainable investment products

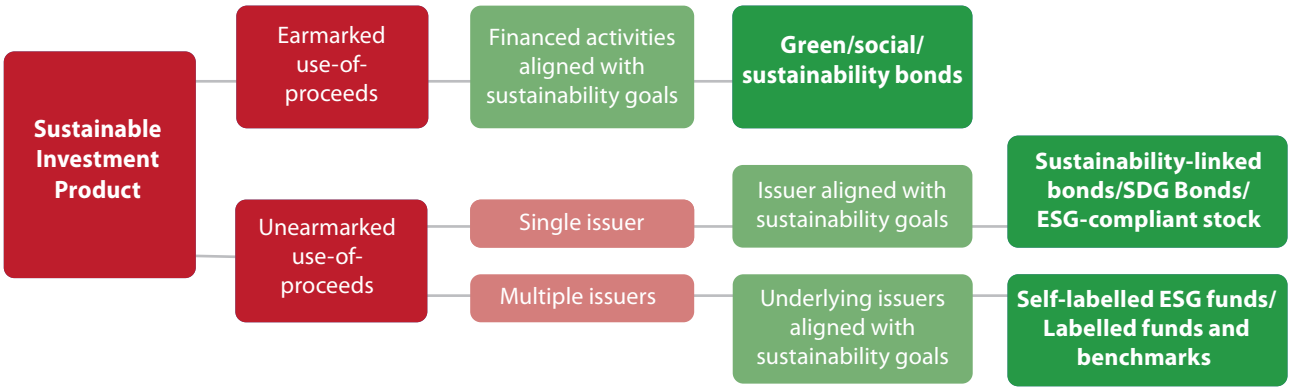
Once sustainability preferences are established, the challenge is to put them into practice in a credible way. To meet the demand for sustainable investment, capital market participants have created a range of investment products with sustainability features. Figure III.B.14 outlines the main categories. For policymakers and savers, it is important to understand whether these products are based on sound methodologies and are likely to achieve a positive impact on sustainability issues.

5.2.1 Use-of-proceeds bonds

Green, social and sustainability bonds are debt securities that aim to finance earmarked green or sustainable activities. Over $1 trillion of these bonds were issued in 2021 by corporates, development banks, government-backed entities and sovereigns, among others. In 2014, the International Capital Market Association (ICMA) created the Green Bond Principles (GBP) to recommend a clear process and disclosure for issuers that ensures transparency, tracking and reporting on the use of green bond proceeds. ICMA principles and guidelines were subsequently extended to cover social and sustainability bonds. Specific thematic guidance has also been developed to assist issuers in incorporating gender-equality considerations into social and sustainability bonds in a credible and measurable way.[76] In parallel, regulators and market-led approaches have emerged to create taxonomies that identify eligible activities for these instruments.

Despite existing principles and taxonomies, the credibility of some green and other sustainability bonds could be enhanced by requesting a certain level of sustainability alignment from

Figure III.B.14
Capital market and sustainable investment products



Source: UN/DESA.

the issuer. Companies issuing green bonds may not be aligned with climate goals nor improve their sustainability performance over time. A green bond label certifies that the activities financed are green but does not guarantee the greenness of the firm issuing the bond. Research has shown mixed results on whether green bond issuers reduce their carbon emissions over time faster than other companies.[77] Nonetheless, guidance is evolving. The 2021 edition of GBP recommends heightened transparency for issuer-level sustainability strategies and commitments, although it falls short of requesting company alignment with sustainability goals as a condition for green bond issuance. This alignment could be verified by requesting a minimum rating based on the issuer's carbon emissions or limiting the issuance of green bonds only to companies on a sustainability-aligned trajectory.

Green and other bonds also suffer from some structural weaknesses due to the way they are constructed. First, green bonds are difficult to scale. Companies may only have a limited number of activities or initiatives that meet the screening criteria of a green bond taxonomy. Also, as alluded to above, green bonds only consider the projects for which the proceeds are used and overlook other, possibly dirty, projects of the issuing firm. Second, they create additional reporting burdens and transaction costs. Companies must track and report on the use of these funds. Certification schemes and Second Party Opinion have also been introduced to ensure a level of independent review. This is positive, but adds costs. Third, they reduce market liquidity for an issuer that also issues regular bonds - even if both green and conventional bonds carry the same credit risk (i.e., the issuer's credit risk). The reduced liquidity can affect the price of both types of bonds. Fourth, issuances of sustainability bonds and regular bonds are not aligned (they are not released at the same times, in the same currency or in the same volumes). It is therefore difficult to develop comparable yield curves and prove the existence of a green or social premium, which can encourage further issuances.

5.2.2 General corporate purpose bonds

A second category of sustainable investment are bonds issued for general corporate purpose that have sustainability characteristics. These bonds take a holistic approach vis-à-vis an entity's impact on sustainability goals. They are not earmarked to specific activities in the same way as conventional green and social bonds. Therefore, they are more easily scalable and do not require separate reporting from a company's overall sustainability reporting.

Sustainability-linked bonds are the most prominent example, with issuance at about $130 million in 2021. The issuer of these bonds commits to improvements in overall firm performance against environmental or social key performance indicators (KPIs). The indicators could be linked to a company's transition to net-zero emissions or a specified increase in the number of women in management. The accountability mechanism is clear as the coupon could increase if the company fails to meet its targets. However, KPIs chosen by companies may still only reflect a limited sustainability issue or may lack ambition. These KPIs vary from company to company, which make them difficult to interpret for investors. Standardizing the KPIs used for these bonds could help to address these challenges, an idea that is currently being pursued by the Chief Financial Officer (CFO) Taskforce convened by the United Nations Global Compact.

Market participants could also consider creating a new type of bond based on the issuer's overall sustainability performance. For example, one could consider labelling SDG bonds as those issued by companies aligned with the SDGs to differentiate them from those issued by other companies. Similarly, transition bonds could be bonds issued by companies on a credible decarbonization pathway. However, this necessitates having robust methodologies for assessing corporate alignment with the SDG and climate goals (see section 5.3 and box III.B.2).

5.2.3 Self-labelled and labelled funds

A third category of sustainable investment are funds branded as sustainable. ESG funds fall into this category and have proliferated over the last few years. These funds tend to be self-designated labels with little transparency or consistency in the approach they use to decide which securities are selected and how ESG issues affect the fund's composition. This raises an elevated risk of green/SDG-washing. Regulators are taking note. For example, the U.S. Securities and Exchange Commission (SEC) and German regulator BaFin opened an investigation to check whether an

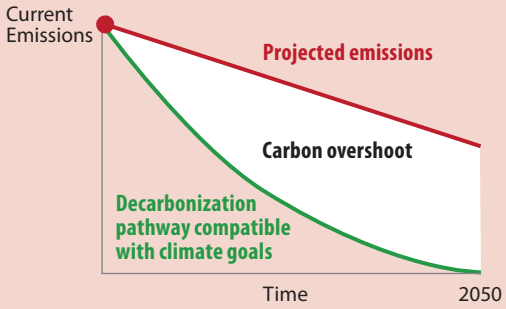
Box III.B.2
Transition finance and decarbonization pathways

Assessing the alignment of a company with climate goals is complex and the results may differ widely depending on the assumptions made. Yet, this assessment is necessary to understand if companies are making the necessary shifts towards a low-carbon economy and to allow investors to direct resources to companies with credible decarbonization plans.

The idea behind transition finance is that it is not enough for financiers to fund companies that are already "green". They also need to help "brown" companies to realize a low-carbon transition, especially those active in sectors key to the reduction of global emissions. To help investors identify companies that are making the necessary efforts, data providers have developed "implied temperature rise" methodologies, which complement carbon footprint and other more static indicators of carbon performance.

Figure III.B.15
Steps for computing an implied temperature rise score

Step 1	What are the company's current emissions?
Step 2	What are the company's future emissions?
Step 3	What should be the company's decarbonization pathway to meet climate goals?
Step 4	What is the gap between the projected emissions and decarbonization pathway?



Source: UN/DESA.

Figure III.B.15 highlights the different steps for assessing a company's temperature alignment, with Step 4 being conversion of the company's carbon overshoot into a single temperature metric, which indicates the global warming a company is aligned with (e.g., 2 or 4 degrees Celsius).

At each step, decisions need to be made that can influence the outcome. This explains the discrepancy in the methodologies' results.[78] For example:

- Step 1 involves deciding whether to include only emissions from a company's operations (referred to as Scope 1 and 2) or to also include emissions from its value chain (Scope 3) (see *Financing for Sustainable Development Report 2021* box III.B.2 for analysis on this issue). The targets should also be decided in Step 1: i.e., reduction in absolute emissions or in carbon intensity per product output/value added;
- Step 2 requires making forecasts, which could be based on past emissions or company targets;
- Step 3 necessitates choosing among different climate scenarios and decarbonization rates. Decarbonization could, for instance, be sector-specific or sector-agnostic. The latter implies that all companies should reduce their emissions at the same pace regardless of their sector of activity.

Methodologies may need to become more consistent and transparent to be useful for investors. As of now, the implied temperature metrics resulting from different methodologies are not comparable. The ICMA's Climate Transition Finance Handbook sets minimal disclosure requirements to ensure transparency but does not advise on a specific methodology. The Inter-agency Task Force on Financing for Development could explore how to define minimum technical criteria these methodologies should fulfil in order to advise regulators in this area.

asset manager was overstating its sustainability claims.[79] Similarly, Morningstar, a data provider, has decided to remove 1,200 funds worth $1.4 trillion from its "sustainable" list after reviewing disclosures provided by these funds.[80]

There are two ways to reinforce this market's credibility:

- **The first is to promote robust practices by investors marketing sustainable investment.** Principles and standards have emerged for this reason. For example, the Operating Principles for Impact Management provide a framework for the design and implementation of investors' impact management systems. Organizations can also use the United Nations Development Programme's SDG Impact Standards to design their internal processes, practices and decision-making to make positive contributions to sustainable development;
- **The second is to define criteria for the type of underlying assets included in the funds.** These criteria can include a series of screenings (absence of controversies, best-in-class ESG practices, compliance with the United Nations Global Compact principles, etc.), such as those recommended in the GISD SDI definition. These criteria can also be more prescriptive, as seen with the French GreenFin label, which requires funds invested in unlisted securities to have at

least 75 per cent of assets under management invested in "GreenFin companies" (i.e., companies for which eco-activities represent at least 50 per cent of turnover—a taxonomy is used to define what these eco-activities are).

International collaboration is key to avoid a multiplication of labels and conflicting regulatory burdens for investment managers. If regulators opt for a siloed approach, financial markets will become more fragmented. For example, it would be useful to find ways to globally harmonize how investment managers should disclose information about how they incorporate sustainability issues in their products. Similarly, it would be good to agree on common global principles for funds marketed as sustainable. These principles could build, for example, on the high-level, voluntary principles put forward by the G20 Sustainable Finance Working Group for approaches to align investment with sustainability goals. Some jurisdictions may opt to go further than others, or adapt to regional circumstances, but the establishment of a global baseline will at least ensure a minimum level of convergence and interoperability amenable to investors.

5.3 Principles, norms, ratings and taxonomies for sustainable business

A major challenge with sustainable investment products is to ensure that the underlying assets they finance are compatible with the sustainable objective pursued. This means determining what assets can be considered as sustainable. The success of green bonds is due to the relative simplicity of this determination. But assessing the "sustainability" of a company with multiple activities in different sectors is more complex. Nonetheless, this is necessary to provide credibility for sustainable investment products that are not linked to specific use-of-proceeds. This assessment can also provide investors with information on the sustainability footprint of their portfolios. Table III.B.1 outlines different approaches, which are sometimes combined, to assess the sustainability of a company.

These approaches check whether a company:

- **Complies with high-level, sustainable business principles.** For example, does a company comply with the 10 principles of the United Nations Global Compact, United Nations Guiding Principles on Business and Human Rights, and OECD Guidelines for Multinational Enterprises? These principles provide a reference to check whether companies, at a minimum, meet fundamental responsibilities in the areas of human rights, labour, environment and anti-corruption. Data vendors provide information on whether companies comply with these principles so they can be relatively easily integrated into investment practices. The main issue is that business principles often focus on limiting harmful practices and do not provide information on the positive contribution of these companies to sustainable development. As such, they are more a necessary than a sufficient condition for a company to be considered as contributing to sustainable development;
- **Does business in sustainable activities.** This can be assessed by checking whether a company has revenues, capital expenditures (Capex) or operational expenses (Opex) in activities included in a sustainable taxonomy. For example, large companies in the European Union are requested to disclose the extent to which their activities are environmentally sustainable according to the European Union Taxonomy, while also assessing whether their activities "do no significant harm" to other environmental objectives. This approach allows for rigorous assessment, but it creates challenges, for example, for companies with multiple activities and a global presence, and for sectors falling outside the scope of a taxonomy. This methodology also requires significant data that might not be available in many markets;
- **Achieves a minimum rate of improvement on KPIs.** Instead of specifying criteria by sector, this approach selects an indicator for a defined sustainability matter that can be applied to all companies. A representation of this is the European Union benchmark regulation that requires companies to be on a decarbonization trajectory in order to be included in the benchmarks (for equity securities, the trajectory is set at a minimum 7 per cent reduction of greenhouse gas intensity on average per annum). Similarly, one could consider that companies need to demonstrate a minimum yearly progress rate on the gender balance in their enterprise in order to be compatible with SDG 5 on "Gender Equality".[81] However, finding suitable KPIs for all sustainability matters might be challenging, and so is finding an agreement on the appropriate improvement rate;
- **Exceeds a minimum sustainability rating/score.** One could assume that funds with sustainability objectives should only include companies above a predefined sustainability rating/score. The challenge is that raters do not agree in their assessment of sustainability. One company could be ranked high by one provider and low by another. The correlation among six major providers of ESG ratings is low (54 per cent on average) at the level of aggregated ESG scores (i.e., the scores combining several indicators into a single rating).[82] There is also confusion as to what these ratings are measuring. Most ESG/SDG ratings and scores initially started by assessing ESG risks that companies face in their day-to-day operations, but this does not provide the information needed in order to ascertain if a company contributes positively to sustainable development. This assessment is difficult given the trade-offs that there may be between different goals. More recently, several tools have been developed to measure the impact of companies in relation to the SDGs as well as the alignment of companies with climate goals (see box III.B.2). Greater transparency, comparability and reliability of data and methodologies are necessary to transform ratings of corporate ESG/SDG performance into an objective practice that can be used as a reference for market norms for sustainable investment products.

5.4 Corporate sustainability disclosure

The cornerstone of sustainable investing is corporate sustainability disclosure, which is currently inadequate. If companies do not provide meaningful information on their environmental and social impact, nor details on the sector(s) and geographic locations of their activities, investors do not have the information they need to realize sustainable investment. Similarly, data vendors cannot produce sustainability ratings if they do not have access to robust data. Sustainability surveys, which are often used by vendors to collect specific data outside of reporting cycles, are also limited in their coverage and isolate data behind paywalls. The issues with corporate sustainability reporting are well known: (i) lack of comparability across companies; (ii) voluntary and selective disclosure by companies; (iii) outdated and backward-looking data; and (iv) multiplication of competing reporting frameworks (see *Financing for Sustainable Development Report 2021*, pp. 70–71).

Table III.B.1
Approaches to assess company alignment with sustainability goals

	Principles	Activity-based taxonomies	KPIs	Rating/Score
Approach	Complies with sustainable business principles	Has a business in sustainable activities	Achieves a minimum rate of improvement	Exceeds a minimum sustainability rating/score
Benefits	▪ Safeguards against harmful practices ▪ Data availability ▪ Well-known by the market	▪ Credibility/Rigor ▪ Tailored to sector specificities ▪ Required for green/social bond market	▪ Simplicity ▪ Applicable to all sectors ▪ Adapted for companies in transition	▪ Combined different factors ▪ Already used by financial actors ▪ Flexibility to adjust to new data
Challenges	▪ No assessment of positive impact ▪ No capacity from those issuing the principles to verify compliance	▪ Companies have multiple activities ▪ Limited to some sectors ▪ Binary assessment	▪ Not easily applicable to all SDG-related matters ▪ Consensus on the rate of improvement	▪ No consistency in assessment ▪ Proprietary methodologies ▪ Possible conflict of interest

Source: UN/DESA.

Major developments in this area could address these long-standing issues. The most striking initiative that seeks to achieve convergence among existing reporting frameworks is the launch of the International Sustainability Standard Board (ISSB) in 2021. Created by the IFRS Foundation, the ISSB seeks to achieve the same level of global standardization as the Foundation achieved with its widely accepted financial accounting standards. This Board could help consolidate the existing fragmented reporting frameworks and facilitate companies' adoption of harmonized metrics. Its impact will depend on how policymakers use the standards developed by the ISSB and whether they will require the ISSB to cover a broad set of sustainability matters with a more impact-oriented lens than its current focus on enterprise value creation. More specifically, policymakers must take a stand on three main questions:

- **Mandatory vs. voluntary**—Voluntary reporting has shown its limitations with many companies selectively choosing the issues they want to report on. Comparability across companies can only be achieved if sustainability reporting becomes mandatory. Although several jurisdictions are moving from voluntary to mandatory corporate sustainability reporting, many are limiting such mandatory reporting to climate-related issues, leaving other sustainability matters unaddressed;
- **Public vs private markets**—Sustainability disclosure regulations often apply only to listed companies, although certain jurisdictions require disclosure from all companies above a certain size. This is problematic since privately held companies represent the largest chunk of the economy, especially with the growing role of private equity funds. There could be a risk that public companies sell their carbon intensive assets to private equity and sovereign funds or state-owned companies that do not have the same transparency requirements. In the past two years, private equity funds acquired $60 billion worth of oil, gas and coal assets, more than they invested in renewables.[83] Pressure from investors committed to sustainability objectives may be able to partially address this issue. Recently, some of the world's largest investors and fund managers, representing more than $4 trillion in assets under management, came together to agree on six key sustainability issues that they will request all the companies they invest in to report on in a harmonized manner.[84] Private equity fund managers will be responsible for collecting this information;
- **Single vs. double materiality**—Some argue that a company should only report sustainability information that affects its financial performance (i.e., financial materiality); while others believe that companies should also disclose information on their impacts on society and the planet even if these may not have a direct financial impact on the company (i.e., environmental and social materiality). For example, in the case of water, a financial materiality lens would mean assessing whether the local community can provide enough water to a company to operate; while a broader materiality lens will assess whether a company is putting the local water supply under stress. In reality, it is difficult to draw a line between these two concepts as it might not be easy to demonstrate the financial or non-financial materiality of a sustainability matter in the absence of adequate data. Even when data exists, it might be difficult to define the difference with certainty, since some issues might not be financially material today but could become material in the future due to changes in regulations, long-term impacts or consumer preferences (i.e., dynamic materiality). A practical approach would be for policymakers to decide what issues are important to them (in line with country SDG needs and priorities) and require corporate disclosure on those issues, leaving the market to decide which ones they consider material for investment purposes.

5.5 Policy incentives

Financial markets can accelerate a sustainable transformation of the private sector, but only if the rules of the game also change (see *Financing for Sustainable Development Report 2021*, pp. 60-62). If it is profitable to run an unsustainable business, companies are less likely to change their practices. Policymakers have several levers with which to align sustainability and profitability. They can prohibit activities with negative impacts (e.g., single-use plastics), price negative externalities (e.g., carbon pricing mechanisms—see chapter III.A) or subsidize activities with positive impacts (e.g., energy-efficient buildings, clean vehicles or investment in low-income neighbourhoods).[85] They can also promote business models and opportunities with a positive impact on sustainable development.[86] While doing so, Governments should assess how the proposed regulations for sustainability will affect smaller firms.

Policymakers can also support the demand for sustainable investment products through tax incentives and other regulatory measures. If one can assure that sustainable investment products have a credible, positive impact on development, then Governments could consider providing tax incentives for these investments, for example, by linking the tax deduction rate for pension plan contributions to the plan's sustainability performance. Central banks also have the means to support demand for sustainable investment products. The People's Bank of China decided in 2018 to include green financial bonds as eligible collateral assets for its Medium-Term Lending Facility. The policy is estimated to have created a spread of 46 basis points between green and non-green bonds.[87] The design of the sustainable finance approaches and tools should be considered to ensure that they incentivize investment in developing countries, which is the focus of the next section.

5.6 Implications for developing countries

Developed country approaches to sustainable investment may have unintended consequences if not enough attention is paid to developing country constraints. Channelling institutional capital to developing countries can significantly fill the sustainable development financing gap. Research from Morgan Stanley shows that global investors allocate just 6 to 8 per cent of their portfolios to emerging markets. However, fundamental analysis suggests that an ideal equity portfolio would include from 13 to 39 per cent of emerging markets exposure.[88] The current limited allocation may be due to home bias or risk misperception. While sustainable finance holds some promise for increasing alignment, it also presents constraints for developing countries, although the degree to which constraints occur varies based on factors such as domestic capital market depth.

These constraints include:

- **Absence of data.** Taxonomies, labels and other tools ostensibly apply to investors domiciled and regulated in developed country jurisdictions, but many of these investors have global investment mandates that cover developing countries. The lack of verifiable data could mean that investors are unable to account for the sustainability of investments in developing countries with the same degree of certainty as investments made in developed countries. For example, investors could struggle to determine the level of taxonomy alignment for investments located in developing countries, which could de facto be considered as non-aligned. One way to address this issue is to allow investors to use estimates for assessing the taxonomy-alignment of their exposures to undertakings established in a third country or allow references to local taxonomies designed with similar principles and objectives;
- **Relative lack of capital market development.** While different avenues exist through which developing countries can attract investments, developed capital markets offer the liquidity, scale and diversification expected by institutional investors. For instance, institutional investors look to allocate at least $150 million per debt investment and $50 million per equity investment—thresholds not easily exceeded outside of capital markets.[89] As long as some developing countries have undeveloped or underdeveloped capital markets, large institutional investors will struggle to direct funds to investments located in these countries. Sustainable finance policies applied to institutional investors in developed countries will therefore not affect these countries to the same degree as developing countries with greater capital market development. Nonetheless, investors can rely on other vehicles—such as impact-driven private equity funds that invest directly in private companies—even if those funds do not offer the liquidity benefit of capital markets;
- **Current focus of ESG on risk management.** Is sustainable investing about managing risks or creating positive impacts? The difference in these two approaches cannot be more striking than in the case of developing countries. If the focus is on managing risks, taking ESG issues into account is likely to disincentivize some investments in developing countries. Indeed, developing countries face a range of climate-related and other transition risks that leave them more exposed than developed countries. These risks are already incorporated into risk assessment. According to Moody's, 60 per cent of its sovereign credit ratings of developing countries are currently negatively affected by ESG considerations.[90] In the short term, this narrow focus on risk is more likely to increase the cost of financing for developing countries. On the other hand, if ESG/SDG investing is about creating a positive impact, then investors should target investments in countries with higher needs where their impact will be greater. This is not yet happening. Moreover, it seems that sustainable funds actually have less exposure to emerging markets then non-sustainable funds.[91] Asset managers may be incentivized to increase exposure to developing countries if they receive an impact mandate from their clients or if the expected financial returns are commensurate with the risks.

Donors and international organizations should raise awareness regarding the actions that developing countries can take to benefit from the sustainability shift in developed capital markets. While China holds 15 per cent of global financial assets, other developing countries hold only 4 per cent of them.[92] Therefore, they largely depend on actions taken in more advanced economies. At the same time, developing countries with more developed capital markets may wish to deploy their own sustainable finance policies and approaches. Capacity-building assistance from donors can also focus on integrating sustainable investment approaches in capital market development plans, while working at the regional/global level to avoid market fragmentation.

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