Channeling Capital Markets Towards Sustainable Development

The SDG Financing Gap Cannot Be Addressed Without Private Investment

The Fourth International Conference on Financing for Development (FfD4) presents a critical opportunity to address the growing financing gap for sustainable development, estimated at $4 trillion annually for emerging markets and developing economies (EMDE)[1]. This paper describes an industry initiative that envisions an ecosystem to mobilize private capital managed by institutional investors towards sustainable development. FfD4 presents an opportunity to ensure that regulators and public sector institutions create an enabling environment that fosters this initiative to realize its full potential.

Capital Markets Have a Role to Play

Global capital markets are a major source of raising financing; in 2023, the total amount of debt and equity capital raised in global capital markets stood at $25.2 trillion[2]. Amongst capital markets investors, the segment that is seeking financial, environmental, and social returns (sustainable finance) continues to grow and was last estimated at $3.5 trillion assets under management (AUM).[3] Institutional investors in capital markets typically identify sustainable investments through two approaches:

1) **Securities funding sustainable projects:** Investing in securities whose proceeds would be allocated to a pipeline of sustainable projects (e.g., Green Bonds)
2) **Securities issued by sustainable issuers:** Investing in securities issued by entities that receive high ESG ratings (by in-house models or 3rd party ESG rating providers)

Despite the growing demand for sustainable investments, EMDE entities often struggle to access pools of sustainable capital, due to:

1) **Lack of projects:** EMDE entities lack a pipeline of eligible expenditures for asset-level or use-of-proceeds financing
2) **ESG-focus of issuer ratings:** EMDE entities typically receive lower ESG ratings due to less maturity on ESG risk management practices
3) **Lack of consensus on development impact:** Despite an intuitive understanding that development impact is higher in lower-income jurisdictions, there is no common understanding amongst investors on how development impact should be measured and disclosed

These challenges not only impede informed investment decisions but also create a significant barrier to channeling capital towards the SDGs, especially in regions where it's needed most.

The Impact Disclosure Taskforce: An Industry Initiative to Scale Financing for the SDGs

To address these challenges, over 70 of the world's largest capital markets participants (both sell-side and buy-side financial institutions) and industry stakeholders formed the Impact Disclosure Taskforce. The taskforce, co-chaired by J.P. Morgan and Natixis, also receives input from public development banks (e.g., AFD, ADB, DFC) and non-profit and international institutions (GIIN, GISD, ISSB). The taskforce is releasing the Impact Disclosure Guidance[4] on October 23rd, 2024. The guidance lays out a vision for an ecosystem that can channel capital markets towards the SDGs by hundreds of billions of dollars per year.

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[1] UN DESA, Financing for Development Report, 2024
[2] SIFMA, Capital Markets Fact Book, 2024
[3] Morningstar Direct as of April 2024
[4] A draft of the guidance released for public consultation in April 2024 can be found here

In particular, the guidance helps corporate and sovereign entities navigate existing resources (e.g., GRI, SASB, IRIS+) to produce a **Sustainable Development Impact Disclosure (SDID)** that measures the intended development impacts of their business strategies or national development plans and provides a framework for annual impact reporting. The SDID is characterized by being:

- **Entity-level but context-specific:** assesses the entity's overall strategy in countries of focus, measuring how the entity's products, services, and operations are anticipated to address the most acute development gaps in each country
- **Impact-oriented:** focuses on outputs and outcomes, including plans to achieve outputs and the theory of change assumed to lead to outcomes
- **Forward-looking:** establishes targets that measure intended impacts, as well as a commitment to monitoring and reporting progress against targets

The guidance also reflects a consensus amongst a group of asset managers that if issuers meet this standard of impact measurement and management at the entity-level, their securities could be eligible for their sustainable portfolios. By removing the need for sizable bankable projects and shifting the focus from ESG risk-management to impact disclosure, the guidance enables the flow of sustainable capital to general budgetary financing of corporate and sovereign entities with commitments to provide transparency on their SDG impacts.

The taskforce is also building an **Impact Data Platform** to facilitate the creation of SDIDs and to disseminate this information to investors in the format and timing needed to be incorporated in their capital allocation decisions. Furthermore, the guidance envisions a network of ancillary service providers, including independent auditors, monitoring & evaluation agents, and analytics providers, who can help verify and interpret this impact information.

Regulatory Harmonization with Industry Is Key to Success

Capital allocation decisions are increasingly being driven by regulation, particularly in Europe. In order for this initiative to achieve its intended purpose, we must ensure that **sustainable finance legislations and regulations that govern institutional investors (e.g., SFDR) are interoperable with the impact disclosure guidance**. FfD4 is an opportunity to ensure that the regulatory regime works in harmony with this industry effort to realize synergies and avoid unintended consequences of driving capital away from where it's needed most.

Case Study – How Costa Rica Leveraged Impact Disclosure to Raise Capital

In 2023, J.P. Morgan Development Finance Institution (JPM DFI) assisted the Republic of Costa Rica to produce an SDID[5], which was included in the offering documents of the sovereign's two $1.5 billion bonds issued for general budgetary purposes. Over 20% of the investors that submitted orders for the bond told J.P. Morgan that the SDID factored into their investment allocation decisions. The SDID not only helped the sovereign attract an additional quantum of investor capital, but also allowed them to attract a wider profile of investors, including sustainable investors that have stewardship functions that serve as thought-partners supporting the government's sustainable development agenda.

[5] Note that the SDID produced by the Republic followed the JP Morgan DFI methodology, a predecessor to the Impact Disclosure Guidance

Conclusion

FfD4 provides an opportunity for policy makers to consider the key financing policy reforms needed to support the mobilization of private capital towards the SDGs. The Impact Disclosure Taskforce is one of the largest industry initiatives dedicated to this topic. The taskforce has envisions an ecosystem that facilitates the flow of capital toward entities that provide transparency and accountability on their SDG impacts. The effort will further develop the sustainable investing market by broadening the investible universe for sustainable investors, enabling them to grow funds or launch new funds that target eligible investments. As the sustainable investing market develops, the incentives for EMDE entities to adopt the guidance and produce the data necessary to attract the growing pool of sustainable investors will accelerate. We expect this to create a virtuous cycle that can scale capital flowing toward advancing the SDGs by orders of magnitude.

It is essential for the policy environment to work in harmony with the ecosystem envisioned by the taskforce. In particular, *investor disclosure* regulations should be designed in lockstep with the voluntary *issuer disclosure* guidance released by this taskforce. A failure to achieve this harmonization will not only impede the industry's objective of driving more capital towards the SDGs, but can also cause unintended consequences of driving capital away from where it's needed most.