

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

FINANCING FOR DEVELOPMENT: PROGRESS AND PROSPECTS 2018



United Nations

This report is a joint product of the members of the Inter-agency Task Force on Financing for Development (members are shown on page xi). The Financing for Development Office of the United Nations Department of Economic and Social Affairs serves as the coordinator and substantive editor of the Task Force report.

The online annex of the Task Force (<http://developmentfinance.un.org>) comprehensively monitors progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the SDGs. It provides the complete evidence base for the Task Force's annual report on progress in the seven action areas of the Addis Ababa Agenda (chapters III.A–III.G). The report is by necessity more concise and selective, and should thus be read in conjunction with the online annex.

The online annex of the Task Force also covers several key cross-cutting initiatives that build on the synergies of the Sustainable Development Goals in-depth:

- Delivering social protection and essential public services
- Ending hunger and malnutrition
- Closing the infrastructure gap
- Promoting inclusive and sustainable industrialization
- Generating full and productive employment for all
- Protecting ecosystems
- Promoting peaceful and inclusive societies
- Gender equality
- Investing in children and youth
- Addressing the diverse needs and challenges faced by countries in special situations
- Global partnership

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Chapter III.B

Domestic and international private business and finance

1. Key messages and recommendations

Private investment and business activity is integral to development and job creation. The Addis Ababa Action Agenda (hereafter, Addis Agenda), calls on businesses to apply their creativity and innovation to solving sustainable development challenges, and invites them to engage as partners in implementation of the sustainable development agenda.

Two years into the 2030 Agenda for Sustainable Development, the momentum around sustainable investment is growing¹ and private companies are progressively recognizing that sustainability can foster long-term value. Indeed, the 2030 Agenda creates enormous opportunities for commercial finance and investment. The Business and Sustainable Development Commission found that achieving the Sustainable Development Goals (SDGs) could unlock \$12 trillion in market opportunities across just four sectors: food and agriculture; cities; energy and materials; and health and well-being.²

Yet, while investment picked up in 2017, long-term investment in sustainable development, especially in some developing countries (such as least developed countries (LDCs), landlocked developing countries (LLDCs) and small island developing States (SIDS)), remains insufficient; and despite a global consensus on the need to increase investment in infrastructure in particular, private participation

in infrastructure has fallen each year since the Addis Agenda was adopted in 2015.³

Public policies set the enabling environment and the regulatory framework for private sector investment and activity. The Monterrey Consensus tasked Member States of the United Nations with building transparent, stable and predictable investment climates, and many countries have made great strides in this area, though gaps still remain. ***Developing countries should continue to work to build competitive business environments, and develop project pipelines and investible projects, supported by international cooperation and capacity development, especially for vulnerable countries including LDCs, LLDCs and SIDS.***

In the Addis Agenda, countries also underscored the importance of better aligning business activities and investment decisions with sustainable development objectives. Investment in the SDGs requires long-term investing. Indeed, without a long-term perspective, certain risks, such as climate risks, will not be priced into private decision-making. One of the greatest challenges policymakers face in raising resources for sustainable development is how to address excessive short-term-oriented decision-making.

Achieving the SDGs will require a shift to a long-term investment horizon, with sustainability as a central concern. ***Governments can explore ways to incentivize institutional investors to take a long-term approach, including by reviewing***

¹ See for example, the Dutch SDG investing and the CEO of BlackRock's note on contributing to society. Available from <https://www.sdgi-nl.org/> and <https://www.blackrock.com/corporate/en-no/investor-relations/larry-fink-ceo-letter>.

² Business Commission on Sustainable Development, "Ideas for a Long-Term and Sustainable Financial System", (2017). Available from http://s3.amazonaws.com/aws-bsdc/BSDC_SustainableFinanceSystem.pdf.

³ World Bank, Private Participation in Infrastructure database. Available from <http://ppi.worldbank.org/>.

*regulatory frameworks.*⁴ ***The Inter-agency Task Force on Financing for Development (hereafter, Task Force) found that proper interpretation of fiduciary duty of institutional investors with long-term liabilities would include a focus on the long-term, and would incorporate all factors (including environmental, social and governance (ESG) indicators) that have a material impact on returns, as these will drive the long-term performance of investments.***

Asset owners can take the lead in aligning their incentives with long-term investment, such as by linking compensation to longer-term returns; also, rating agencies, consultants and advisors can support investors by evaluating risks and returns over the long-term. ***The United Nations, in collaboration with other institutions, could serve as a platform for bringing together asset owners, managers and other stakeholders to further exchange experiences and disseminate the benefits of SDG investing with the financial community and other stakeholders. The Task Force can develop analytical work to support and contextualize these discussions into the broader SDG implementation and Addis Agenda follow-up.***

Incentivizing the private sector to adopt global standards on responsible business conduct can promote better alignment of social and private goals. ***The Task Force also recognizes the need to improve definitions, standards, measurement and disclosure of ESG impact and of new instruments, such as green bonds. Given the proliferation of competing reporting guidelines for businesses, there is a need to introduce greater standardization in sustainability metrics, and to ensure that metrics are aligned to global standards so as not to duplicate efforts.***

Ultimately, to fully mainstream SDG investing, new products need to be developed. The financial sector excels at innovation when demand is there. This raises questions about the level of demand for ESG investing and whether investment professionals

necessarily know their clients' preferences. As there is no systematic review of investor preferences, ***one simple solution would be for advisors, consultants, brokers and others financial professionals to ask investors and beneficiaries for their sustainability preferences, similar to other know-your-customer requirements.***⁵

The Task Force recognizes that even with long-term horizons, and the incorporation of material long-term ESG drivers of value, markets may provide insufficient financing for sustainable development across countries and sectors. This is the case when the risk-adjusted returns are not competitive with other opportunities, due to high risks or externalities that are not priced into private investment decisions (see chapter II). Risk-sharing tools, such as blended finance, can be used to attract greater private investment (see chapter III.C).

Greater efforts to reduce domestic risks along with partnerships between foreign and domestic investors—and multilateral, regional and domestic development banks, and development finance institutions (DFIs) that understand local context—can help address the difference in risk perceptions.

The achievement of the SDGs is also dependent on finance being channelled to LDCs and other vulnerable countries, such as LLDCs and SIDS, in an inclusive manner, as well as to micro and smaller enterprises, women and poor and underserved segments of society. ***Governments can examine the use of blended finance and similar mechanisms to spur investment, including by broadening the range of financing instruments accessible to small and medium-sized enterprises (SMEs); however, more analysis is required to design financial instruments that respond to the unique situation of countries with special needs, such as LDCs.***

The digitalization of finance offers new possibilities towards advancing inclusive finance and its alignment with the 2030 Agenda for Sustainable Development. Fintech should be included as an integral part of national development plans on the

4 For example, see the European Union's attempt to do this via a "High-level Expert Group on Sustainable Finance", (2016). Available from https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#high-level-expert-group-on-sustainable-finance.

5 For example, in the United States of America, the Financial Industry Regulatory Authority (FINRA) suitability rule includes asking about investment objectives, including "generating income, funding retirement, buying a home, preserving wealth or market speculation". See <http://www.finra.org/investors/suitability-what-investors-need-know>.

financial system. At the same time, ***effective regulation is necessary to monitor any systemic or consumer risks that may arise from digitalization of finance.***

Collaboration between international institutions, regulators and fintech entrepreneurs could help to develop international norms for effective use of fintech. ***The application of financial technology also has the potential to lower the cost of remittances.*** Innovative applications can help address the loss of correspondent banking and provide a boost to developing countries that receive significant remittances from overseas.

2. Trends in investment and cross-border capital flows

Global investment growth hit a low in 2016, having contracted significantly since the global economic and financial crisis, with weak investment in part reflecting the fact that companies were channeling profits to shareholders in the form of dividend distribution or share buybacks, rather than to productive investment. Investment weakness shifted from advanced economies to developing countries over this period.⁶ In developed countries, investment increased in 2017, although from a low base. In developing countries, investment dynamics differed across countries, in large part reflecting commodity-sector developments.

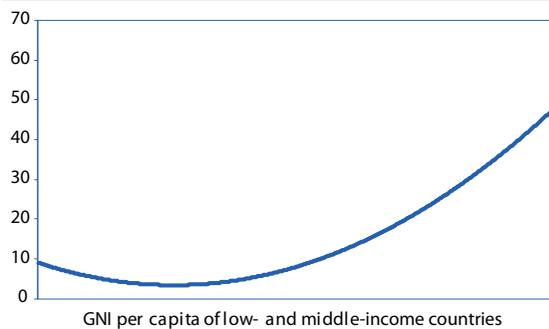
Following broader trends, total FDI to developing countries, which tends to be a more stable form of capital flow, amounted to approximately \$653 billion in gross terms in 2017, with FDI to LDCs estimated to be around \$32.6 billion (or around 2 per cent of total global FDI flows). However, it remains heavily concentrated in a few countries and in the extractive industries, often providing few forward and backward productive linkages within the economy.⁷

Portfolio flows, primarily from institutional investors, remain volatile. Net inflows to most regions were positive in 2017. Overall, however, there was a net outflow from developing countries of \$124 billion in 2017, mainly driven by large outflows from East and South Asia.⁸ Risks of monetary tightening in some developed economies, after several years of near-zero or negative interest rates, could lead to further volatility and outflows of portfolio capital, which could derail SDG investment. Indeed, an analysis of high-frequency data of capital flows in select developing countries has shown that cross-border portfolio and bank flows, in particular, are subject to periodic episodes of high volatility.⁹

Figure 1

Private flows to low- and middle-income countries 2012–2016

(Percentage of total external flows, 2015 prices)



Source: UN/DESA, based on OECD (forthcoming).

Overall, as shown in figure 1, private capital inflows represent up to 50 per cent of cross-border capital flows in upper-middle-income countries, but only 5 to 10 per cent of capital inflows in LDCs and other countries with lower per capita incomes. Thus, challenges for implementation of the agenda include how to incentivize greater investment, and how to ensure that it is long-term, aligned with sustainable development, and reaches those most in need.

6 *World Economic Situation and Prospects 2018* (United Nations publication, Sales No. E.18.II.C.2); World Bank, “Global Economic Prospects” (January 2018).

7 United Nations Conference on Trade and Development (UNCTAD), “Global FDI Flows Slipped Further in 2017”, Investment Trends Monitor, Issue 28 (January 2018). Available from http://unctad.org/en/PublicationsLibrary/diaeia2018d1_en.pdf.

8 United Nations Department of Economic and Social Affairs, based on the International Monetary Fund World Economic Outlook (October 2017).

9 *World Economic Situation and Prospects 2017* (United Nations publication, Sales No. E.17.II.C.2).

3 The investment climate and the domestic enabling environment

The 2002 Monterrey Consensus, 2009 Doha Declaration and 2015 Addis Agenda¹⁰ include a range of commitments on strengthening the enabling environment for private sector business and investment in developing countries. Many countries have made important strides in this area, including reforms to the legal framework, promoting transparency, and reducing red tape. These improvements are reflected in the cost of starting a business, which has fallen by more than 80 per cent on average in LDCs since 2002.¹¹

However, the gap between developed and many developing countries remains significant. Recent surveys show that access to finance is now the most common obstacle to business operations, with tax rates, practices of the informal sector, and political instability also significant (access to finance was only ranked fourth in terms of largest impediments to investment in developing countries at the turn of the century).¹² The issue is particularly acute in LDCs and LLDCs, where the percentage of firms identifying access to finance as a major constraint is higher than in the rest of developing countries.¹³ This underscores the importance of making finance more inclusive, which should allow domestic SMEs to develop (see section 5 on inclusive finance.)

The Organization for Economic Cooperation and Development (OECD) *Policy Framework for Investment* (PFI), which was updated in 2015, aims to support governments in creating an enabling

environment for investment. The PFI encourages policymakers to ask appropriate questions about their economy, their institutions and their policy settings on twelve different policy areas affecting the investment climate. The PFI has been used worldwide, including within regional economic communities (such as the Association of Southeast Asian Nations and the Southern African Development Community).¹⁴

Other issues often highlighted by investors include the lack of investible projects, particularly in infrastructure. This calls for the development of infrastructure plans, efforts to translate plans into pipelines and pipelines into concrete projects. (This year's Task Force report considers these issues in more detail in chapter II). Again, this is particularly relevant in LDCs and LLDCs where inadequate physical infrastructure and remoteness from world markets is a major obstacle to private investment. Improved infrastructure, combined with sound investment promotion and facilitation policies, should attract more foreign investments into these countries. Continued support to LDCs and LLDCs in these areas is therefore crucial.

Foreign investors tend to highlight domestic risks more than local investors. This has led to a discussion of risk perception vs. actual risks, with some analysts arguing that foreign investors overstate domestic risks. An alternative explanation, however, is that foreign investors lack the ability to analyse intricate political and other risks, such as currency risks, across developing countries. The two notions are thus difficult to untangle since risk

¹⁰ *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02. II.A.7), para. 21; United Nations, "Doha Declaration on Financing for Development: outcome document of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus" (New York, 2009), para. 25; *Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda)* (United Nations publication, Sales. E.16.I.7), para. 36.

¹¹ World Bank, Doing Business database. Available from https://tcdata360.worldbank.org/indicators/cost.start.biz?indicator=460&viz=line_chart&years=2003,2016.

¹² Guy P. Pfeffermann and Gregory Kisunko, "Perceived Obstacles to Doing Business: Worldwide Survey Results" (July 1999). Available from <http://documents.worldbank.org/curated/en/316911468762620790/pdf/302400Preceiv1IFC0discussion0paper.pdf>.

¹³ The percentage is about 35 per cent in LDCs and 29 per cent in LLDCs, while it is 24 per cent in other developing countries. See <http://www.enterprisesurveys.org>.

¹⁴ For further information, see <http://www.oecd.org/investment/pfi.htm> and <http://www.oecd.org/investment/countryreviews.htm>.

and uncertainty are integrally linked. In addition to greater efforts to reduce domestic risks, partnerships between foreign and domestic investors—along with multilateral, regional and domestic development banks and DFIs knowledgeable about the local context—can help address the difference in risk perceptions.

In this regard, national, regional and global development banks can play an instrumental role in mobilizing private capital for specific projects through co-financing, providing risk guarantees and other instruments. They can also use their experience to improve the quality of projects through technical assistance while ensuring that investments are aligned with sustainable development. However, when project risks are too high, the cost of bringing the private sector might become prohibitive. This may explain why the current level of blending instruments in LDCs remains limited (see chapter III. C). More analysis is therefore required to design financial instruments that respond to the unique situation of countries with special needs.

Multilateral development banks can also play a role in advancing the development of domestic capital markets, especially local currency bond markets. Well-developed bond markets can increase access to long-term finance and reduce excessive reliance on foreign debt in both middle-income countries and LDCs. In 2017, the World Bank Group established its Joint Capital Markets Program (J-CAP) initiative, which seeks to further capital market development through advisory and analytical work, structuring and delivering of key financial transactions, and knowledge dissemination.

4. Aligning the global financial system with long-term investment for sustainable development

Aligning investment with long-term sustainable development will require actions, by both private and public actors. This will necessitate reorienting global financial markets through better aligning incentives along the investment chain (as shown in box 1) with long-term sustainable investment.

4.1 Incentivizing greater long-term investment by financial intermediaries

Institutional investors with long-term liabilities, such as pension funds, life insurance, endowments and sovereign wealth funds, have been looked to as a potential source of SDG financing. Infrastructure investment should be particularly attractive to these investors because of its low risk and stable real-return profile, which matches their real liabilities (e.g., many pension funds pay beneficiaries a return over inflation).¹⁵

Long-term institutional investors are estimated to hold around \$80 trillion in assets.¹⁶ However, the potential size of their portfolios that are well-suited for illiquid investments, such as infrastructure, is significantly less than the headline number. For example, in the case of pension funds, around 40 per cent of liabilities are distributed within 10 years, and 60 per cent within 20 years.¹⁷ In addition, the shift over the last two decades from defined benefits to defined contributions has allowed individuals to more easily draw down their pensions and switch between providers, making it more difficult for pension funds to

¹⁵ Since short-term investors that need liquidity are often willing to pay a higher price for liquid assets, long-term investments generally earn a “liquidity premium”.

¹⁶ Willis Towers Watson, “The Global Pension Assets Study 2017” (2017). Available from <https://www.willistowerswatson.com/en/insights/2017/01/global-pensions-asset-study-2017>; PwC, “The Rising Attractiveness of Alternative Asset Classes for Sovereign Wealth Funds” (2018). Available from <https://www.pwc.lu/en/alternative-investments/docs/pwc-sovereign-wealth-funds.pdf>; PwC, “Asset & Wealth Management Insights: Asset Management 2020 Taking Stock” (2017). Available from <https://www.pwc.com/gx/en/asset-management/asset-management-insights/assets/am-insights-june-2017.pdf>.

¹⁷ United Nations Task Team (UNTT), “Challenges in Raising Private Sector Resources for Financing Sustainable Development”, *UNTT Working Group on Sustainable Development Financing* (2014). Available from <https://sustainabledevelopment.un.org/content/documents/2106UNTT%20Chapter%20III.pdf>.

Box 1

A flow-of-funds analysis

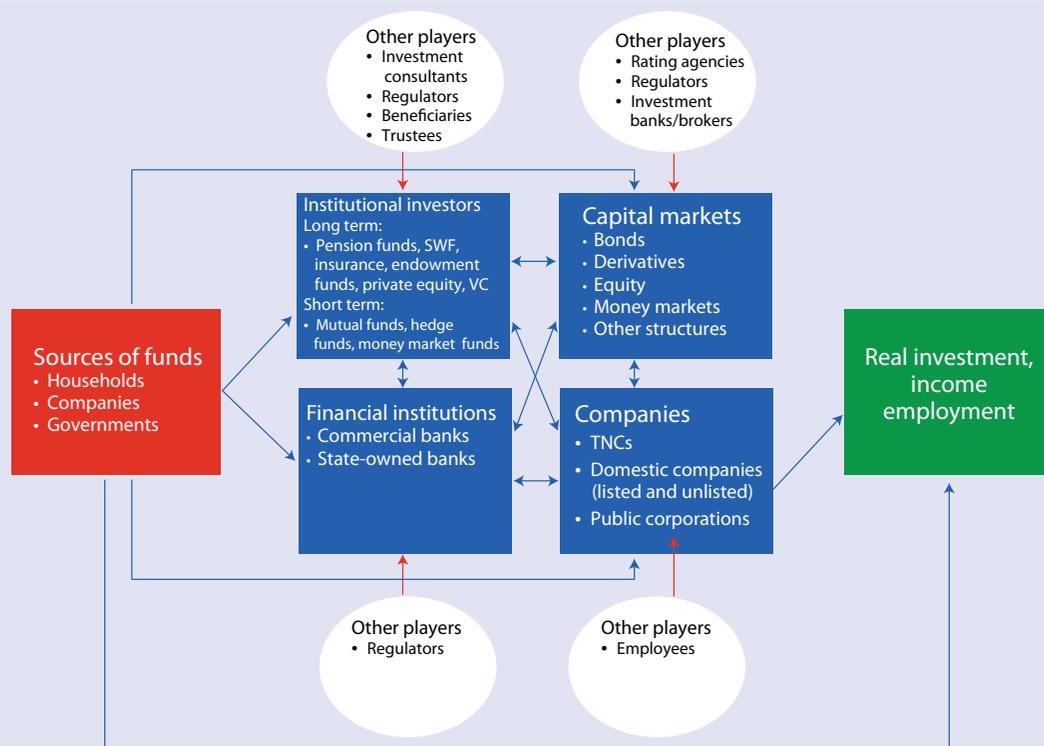
An integrated assessment of the possibilities and impediments to mobilizing long-term investment for sustainable development can be undertaken through a flow-of-funds framework from sources of funds to uses and outcome (see figure 1.1).

The journey from one end to the other end is, however, far from straightforward. Funds can flow through different routes (e.g., directly to companies or through financial intermediaries, such as institutional investors of financial institutions) and investment outcomes create new savings, leading to another round of what is, in effect, a cycle. There is also the possibility for money to circulate in both directions, creating churning in the system. Some asset owners also invest through secondary financial intermediaries (such as a pension fund investing through a money manager). The result is a chain of intermediaries; while the ultimate beneficiaries (e.g., pensioners) may have a long-term outlook, the intermediaries often have progressively shorter-term incentives that are ultimately not aligned with the owners of capital.

Finally, there is a range of other actors, such as investment consultants, rating agencies, brokers, and regulators that help guide investment decisions and set incentives within the system. The incentives and impediments faced by all the actors in the financial chain will determine the magnitude, time horizon and quality of investment, with implications for incomes, employment, and social and environmental outcomes.

Source: UN/DESA.

Figure 1.1

A flow-of-funds framework

Source: UN/DESA.

Note: TNCs stands for transnational corporations, SWF for sovereign wealth fund, and VC for venture capital.

undertake long-term illiquid investments. Overall, in this context, total long-term liabilities are closer to \$40 trillion than \$80 trillion. Nonetheless, a reallocation of a small percentage of assets, say 3 to 5 per cent, towards long-term investment in sustainable development could have an enormous impact. Yet, even this relatively small shift will be extremely challenging as the incentives of asset managers and other financial intermediaries are not sufficiently aligned with long-term investment in sustainable development.

To date, much of the investment by institutional investors has been short-term oriented, as reflected in the volatility of capital flows as well as the short holding period of stocks in some developed markets, which has fallen from an average of eight years in the 1960s to eight months today.¹⁸ In addition, as shown in figure 2, the majority of pension and insurance assets are primarily invested in liquid assets, such as listed equities and bonds in developed

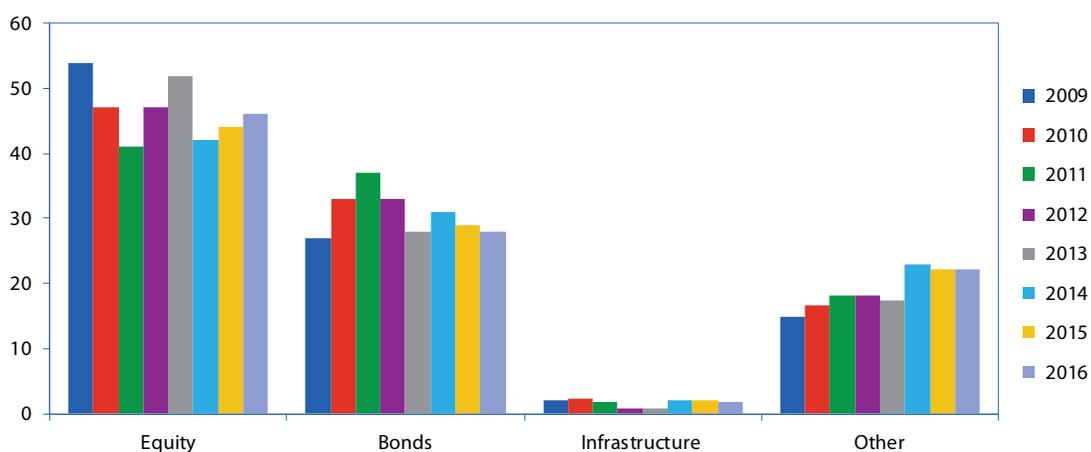
countries. While investment in “other” assets (generally, illiquid investments, such as real estate, hedge funds and private equity) increased somewhat over the past decade, investment in infrastructure still represents less than 3 per cent of pension fund assets, with the majority in advanced economies.

Commercial banks have traditionally been an important source of infrastructure project finance, including in developing countries where long-term bond markets tend to be less developed. However, commercial banks have been scaling back infrastructure finance since the global financial and economic crisis. In addition to regulatory requirements, banks tend to have shorter- to medium-term liabilities, and there is evidence that the decline in infrastructure finance represents a shift in the banks’ business model towards strengthening risk management.¹⁹

There are a range of factors that constrain the ability and willingness of investors with longer-term liabilities to invest in illiquid assets:

Figure 2

Pension fund asset allocation as an aggregate of the seven largest pension markets, 2009–2016
(Percentage)



Source: Willis Towers Watson Global Pension Assets Study, Willis Towers Watson Global Alternatives Survey and UN/DESA calculations.

Note: “Other” includes investment in private equity fund of funds, direct hedge funds, direct private equity funds, funds of hedge funds, and illiquid credit. The seven largest pension markets are Australia, Canada, Japan, Netherlands, Switzerland, the United Kingdom of Great Britain and Northern Ireland and the United States of America.

¹⁸ Ned Davis Research, White paper series (July 2017). Available from https://www.mfs.com/content/en_us/mfs-insights/lengthening-the-investment-time-horizon.html.

¹⁹ Inter-agency Task Force Expert Meeting on Financial and Corporate Incentives for Long-Term Investment (United Nations Headquarters, New York, 15 December 2017). See <https://developmentfinance.un.org/expert-meeting-financial-and-corporate-incentives-long-term-investment>.

- **Prudential regulations and capital requirements.** Solvency II for European Union insurance companies and Basel III for commercial banks impose higher costs for riskier holdings based on maturity and credit ratings, which may have the unintended consequence of impacting investment incentives (see chapter III.F). Institutional investors also often have regulatory limits based on the asset class characteristics (e.g., unlisted securities) or credit rating of their investments. For example, these limits may inhibit their activities in developing countries regarding sub-investment grade assets or their investments in illiquid assets, such as unlisted infrastructure companies.
 - **Insufficient capacity.** Another impediment is that many institutional investors do not have the capacity to do the necessary due diligence to invest directly in infrastructure and other illiquid assets. Other than possibly for the largest asset owners it is generally not cost effective for diversified investors to build this expertise in-house. Instead, they make investments through secondary financial intermediaries, whose incentives tend to be shorter-term and less aligned with the ultimate beneficiary, such as through hedge funds, real estate or private equity funds.
 - **Accounting measures.** Mark-to-market accounting, which values assets based on daily market prices, reflects the most up-to-date valuations, but also incorporates short-term market fluctuations into portfolio asset values. These practices mean that relatively short-term changes in market prices impact performance measurements. Since managers' compensation is often tied to performance, these standards can institutionalize a short-term bias.
 - **Benchmarks.** Many external investment managers are judged on their performance against benchmarks, which are calculated using mark-to-market pricing. This has been shown to lead to a short-term bias and increased herding behaviour.²⁰ In response, efforts have been made to develop long-term indexes, like the S&P Long-Term Value Creation Global Index, which is designed to measure stocks that rank high in global equity markets, using both proprietary sustainability and financial quality criteria. How effectively this can substitute for existing shorter-term benchmarks is not yet clear.
 - **Compensation.** Compensation tied to short-term performance measures and benchmarks can incentivize short-term investment outlooks. The fee structure of some managers (a 2 per cent management fee and 20 per cent performance fee, which is typical in private equity and hedge fund investment) is characterized by asymmetric returns—meaning that managers have a potential upside monetary gain but no downside penalty when losses are realized. This asymmetry provides managers with incentives to increase risk and leverage to boost short-term returns.
 - **Institutional issues and firm culture.** Other factors include high mobility of portfolio managers between firms, which may represent a further disincentive to long-term investing, as managers can earn a high bonus, and then move to another firm before tail risk has materialized. Firm culture can also affect investment strategies. This could include how fiduciary responsibilities and non-financial impacts are viewed and taken into account in performance evaluations of managers, which would impact whether managers invest not only in a long-term manner, but also in line with ESG impacts.
- One way to address the issue of limits on illiquid investments is to try to repackage investment in a liquid form for investors, such as through green bonds or SDG bonds (see box 2). This is behind the call to develop infrastructure as an “asset class.” The expectation is that standardizing infrastructure as an asset class and creating a benchmark of performance would create liquidity and attract greater investment,

20 International Monetary Fund, *Global Financial Stability Report: Market Developments and Issues* (2005). Available from <http://www.imf.org/External/Pubs/FT/GFSR/2005/02/>.

Box 2

Innovative bonds instruments

Green bonds, and other innovative bond instruments, such as Sustainable Development Goals (SDG)-linked bonds,^a have increased substantially since the first green bonds were issued by the European Investment Bank and World Bank in 2007 and 2008, respectively. More recently, the World Bank issued an SDG-bond in 2017, with returns linked to the stock market performance of companies considered to be sustainability leaders,^b while the Seychelles are planning to issue a blue bond to support the transition to sustainable fishing, with guarantees from the World Bank and the Global Environment Facility. Credit-rating agencies are in the process of developing green bond evaluations tools.^c

From 2007 to 2013, multinational development banks issued the bulk of green bonds (above 70 per cent); however corporate bonds have made up the bulk of the market since 2015. Global green bond issuance was \$155.5 billion in 2017,^d at about 3 per cent of the global bond market,^e with Chinese renminbi the third-most important currency of green bond issuance.

Although data is limited, to date, green bonds do not appear to lower the cost of finance for issuers^e compared to conventional bonds.^f One issue that impedes growth of the market is the lack of a clear definition of what type of projects would qualify as green bonds. There are several existing principles and standards to determine whether a bond qualifies as green,^g although these do not have a legal basis and often do not clearly distinguish between conventional bonds and green bonds, or their level of greenness. Proceeds that are currently classified as green include renewable energy, energy efficiency, sustainable waste management, sustainable land use (forestry and agriculture), biodiversity, clean transportation, and clean water. More controversially, green can also include nuclear energy or fossil fuel power plants with decreased carbon intensity. This fragmentation of standards creates uncertainty for investors; there is thus a need to harmonize standards to further develop the market, bringing together multilateral development banks,^h as well as other stakeholders and the private sector. Carbon pricing and other efforts to value externalities would also support the market by creating demand and lowering the cost of financing through green bonds.

Source: UN/DESA.

- a** United Nations Development Programme (UNDP), "The Pros and Cons of Ethical Debt Instruments", 12 September 2017. Available from <http://www.undp.org/content/undp/en/home/blog/2017/9/12/The-pros-and-cons-of-ethical-debt-instruments.html>.
- b** Returns are linked to the "Solactive SDG World Index," which includes 50 companies considered leaders on sustainability, or that dedicate at least 20 per cent of their activities to sustainable products.
- c** S&P Global, "Updated Proposal for a Green Bond Evaluation" (2016). Available from <https://www.spglobal.com/our-insights/Proposal-For-A-Green-Bond-Evaluation-Tool.html>.
- d** See <https://www.climatebonds.net/>.
- e** Climate Bonds Initiative, Global Green Bonds Mid-Year Summary 2017. Available from https://www.climatebonds.net/files/files/Global_Green_Bonds_S1_Summary-2017.pdf.
- f** International Finance Corporation (IFC). *Green Bond Pricing in the Primary Market*, January 2016 - March 2017 (2017). Available from https://www.climatebonds.net/files/files/CBI-Green%20Bond%20Pricing%20Report_Jan16-Mar17_040817.pdf.
- g** The fact that prices of green bonds tend to rise in the first days after they are issued has been pointed to as evidence of outperformance. However, the same patterns emerge with conventional bonds.
- h** See <https://www.icmagroup.org/green-social-and-sustainability-bonds/>; See [https://www.climatebonds.net/standards/](https://www.climatebonds.net/standards;); High-Level Expert Group on Sustainable Finance, *Financing A Sustainable European Economy* (Belgium, 2018). Available from https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en; EIB and China Society for Finance and Banking "The Need for a Common Language in Green Finance", (2018). Available from <http://www.eib.org/attachments/press/white-paper-green-finance-common-language-eib-and-green-finance-committee.pdf>.

particularly by investors who are constrained from buying illiquid assets. Developing this asset class has to be done with care, as it is creating liquid instruments on illiquid assets. This could attract investors with short-term investment horizons, with the potential of creating short-term bubbles that could impede rather than help long-term sustainable development. Indeed, many of the financial market crises over the past 25 years involved some form of mis-pricing of liquidity.

4.2 Aligning investment by financial intermediaries with the SDGs

Aligning investments with the SDGs includes several facets. To the extent that private investment creates decent jobs, it already contributes to the SDGs. To the extent that it includes investment in sustainable productive capacity and sustainable and resilient infrastructure it also contributes to the SDGs. However, while the investment industry has traditionally focused on creating economic value, a short-term investment horizon implies that investors may not be giving adequate attention to long-term risks, and may overlook the long-term value of ESG practices. SDG investing implies a shift to long-term investment horizons, with sustainability at its core.

One approach to promoting alignment of investment with SDGs is through encouraging investors to carry out environmental and social due diligence with respect to their investment portfolios as is recommended under the United Nations Guiding Principles for Business and Human Rights and the OECD Guidelines for Multinational Enterprises. Strong due diligence processes can help ensure that negative impacts of investments on society and the environment are avoided, and furthermore that

investments are channelled towards projects and companies that behave responsibly and ultimately help achieve the objectives of the SDGs.²¹

Growing interest in sustainable investments

There has also been growing interest in sustainable investing. A recent survey of 22,000 investors in 30 countries, found that sustainability investing is more important to 78 per cent of respondents than it was five years ago.²² Other surveys have found that nearly two thirds of respondents between the ages of 18 and 34 said they would like their money to support companies that are making a positive contribution to society,²³ with more than 80 per cent of millennials and more than 75 per cent of women interested in ESG investing.²⁴

An increasing number of asset managers and owners have also committed to integrating ESG criteria in their capital allocation process. In a recent survey of institutional investors globally, 67 per cent use ESG principles as part of their investment approach.²⁵ This is reflected in the increasing number of asset owners who are signatories to the Principles for Responsible Investing (PRI)—principles that include incorporating ESG into investment analysis, decision-making and practices, as well as disclosure and reporting—and who hold a total of \$16.3 trillion in assets under management as of 2017.²⁶

For most PRI signatories, ESG criteria are generally incorporated as additional factors in the investment evaluation to the extent that they have a material impact on financial returns, or as an overlay to investment decisions when all else is equal, along with some ESG screens by some investors. In other words, the objective of most PRI signatories is to maximize commercial returns.

21 Organization for Economic Cooperation and Development (OECD), “Responsible Business Conduct for Institutional Investors” (2017). Available from <http://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf>.

22 Schroders, “Global Investor Study 2017: Sustainable investing on the rise” (28 September 2017). Available from http://schroders.com/en/media-relations/newsroom/all_news_releases/schroders-global-investor-study-2017-sustainable-investing-on-the-rise/.

23 Legg Mason, “Decoding Investor Behaviour: Bridging the disconnect between hope and reality”, Global Investment Survey” (2017). Available from <http://www.leggmason.com.hk/en/gis/>.

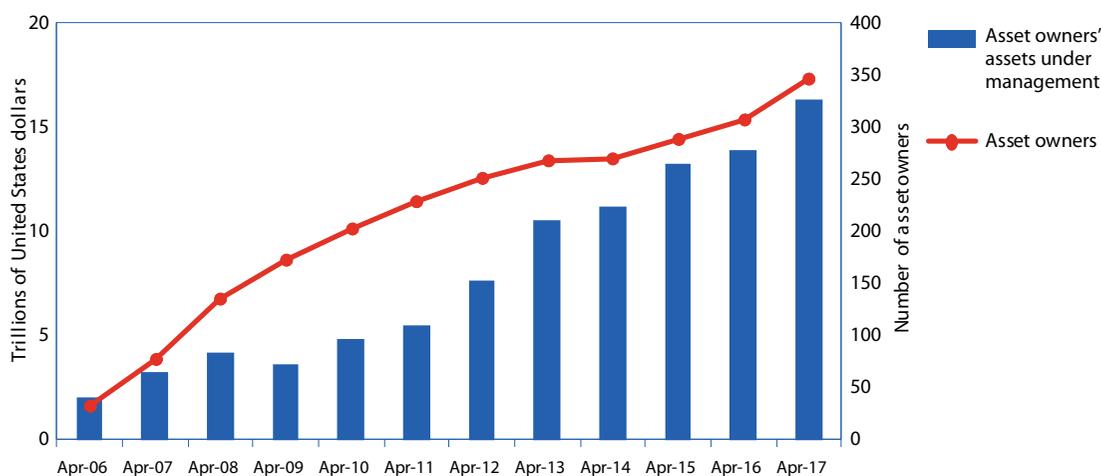
24 Morningstar, “Sustainable Investing Takes Off: A new generation of investors wants strategies that deliver performance and peace of mind” (2016). Available from [Morningstar-Mag_ESG_decjan16_.pdf](http://www.morningstar.com/ESG_decjan16_.pdf).

25 Royal Bank of Canada (31 October 2017). Available from <http://www.rbc.com/newsroom/news/2017/20171031-gam-esg.html>.

26 The data presented is for asset owners (i.e., pension funds, etc.) Assets under management for managers and other financial service providers who are signatories to PRI reached \$68.4 trillion.

Figure 3

Asset owner signatories to the Principles for Responsible Investing, 2006–2017
(Trillions of United States dollars, number of asset owners)



Source: Principles for Responsible Investment (2018).

A smaller but growing class of investors—so-called impact investors,²⁷ who hold assets under management of around \$22 billion²⁸—have the intention to generate ESG impacts alongside financial returns in their decision-making process. Impact investing includes a range of investors, from philanthropists—whose financial return objective might be to earn only sufficient economic return to conserve their capital base—to investors who expect market-risk-adjusted returns alongside ESG impact.²⁹

At the same time, a growing community of financiers and investors are embedding impact analysis (positive and negative) into mainstream financial products and services. This impact-based approach is seen as a way to build new profitable markets while also addressing the SDGs financing gap. In January 2017, a group of bankers and investors under the United Nations Environment Programme Finance Initiative's launched the “Principles

for Positive Impact Finance,” a framework to help banks, investors and their stakeholders transition to impact-based approaches and become significant players in the delivery of the SDGs.³⁰

Trade-off between financial returns and other impacts?

The fact that many investors who consider ESG criteria do continue to pursue competitive financial returns raises the question of whether there are trade-offs between financial return and other impacts, or whether they are mutually supportive. While studies that test the relationship between returns and ESG factors have a range of results, the bulk of analyses indicates that many ESG strategies may boost returns and reduce risk or, at worst, do not have a negative impact.³¹

Yet, in a recent survey of investor managers, around three quarters of those interviewed either doubted or were unsure of how well ESG investing

²⁷ Organization for Economic Cooperation and Development, *Social Impact Investment: Building the Evidence Base* (2015). Available from <http://www.oecd.org/publications/social-impact-investment-9789264233430-en.htm>.

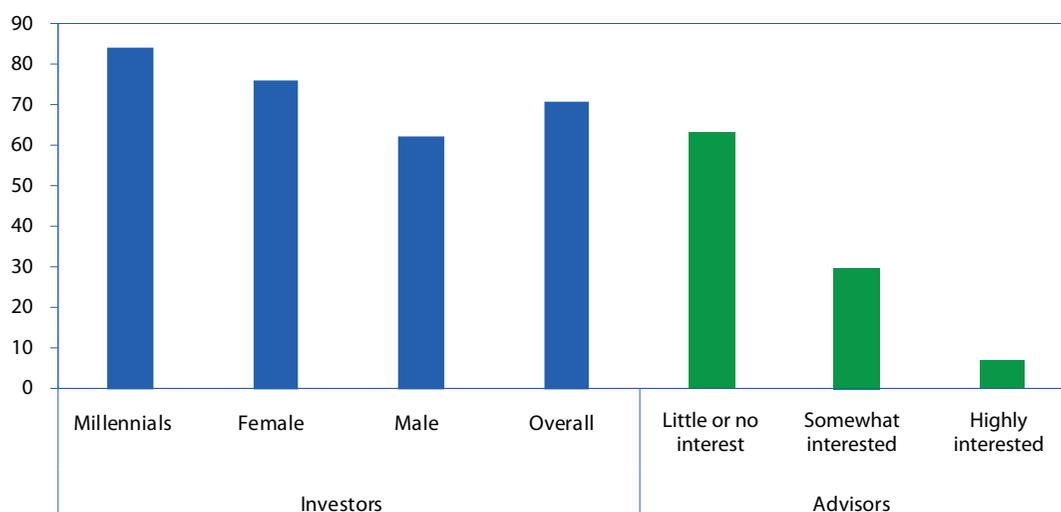
²⁸ Global Intermediary Identification Number (GIIN), “Annual Impact Investor Survey” (2017). Available from https://thegiin.org/assets/GIIN_AnnualImpactInvestorSurvey_2017_Web_Final.pdf.

²⁹ Global Intermediary Identification Number (GIIN) (2018). Available from <https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing>.

³⁰ See <http://www.unepfi.org/positive-impact/positive-impact/>.

³¹ Gunnar Friede, Timo Busch and Alexander Bassen, “ESG and Financial Performance: aggregated evidence from more than 2000 empirical studies”, *Journal of Sustainable Finance & Investment* (2015). Available from <http://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917.e>.

Figure 4
People interested in environmental, social and governance investing, 2016
 (Percentage of survey participants)



Source: Morningstar (2016).

performs.³² Similarly, according to surveys, investment brokers and advisors are also more skeptical of the benefits of ESG than their clients.

This raises a second question: if the relationship between ESG investing and returns is positive, why do so few financial professionals have a high interest in ESG investing? (See, for example, figure 4). If such a relationship was confirmed, portfolio managers should in theory be the first ones to be interested in ESG investing. On the other hand, traditional portfolio theory also argues that by investing only in socially responsible opportunities, managers are limiting the opportunity set, and thus unlikely to earn a competitive market return. Indeed, earlier ESG strategies based on excluding “sin” stocks tended to underperform against purely profit-oriented investments.³³

There is therefore a need to evaluate existing studies to better understand this relationship. A recent study isolated those ESG factors with material impacts on profits from those without material

impacts, and found that incorporating investments with material impacts led to significant portfolio outperformance.³⁴ In essence, the study found that—not surprisingly—incorporating long-term non-financial risks in decision-making (such as climate risks), leads to long-term financial outperformance.

Clarifying definitions

Another impediment to mainstreaming SDG investing is the lack of clear definitions on investment criteria as well as the lack of adequate measurement and reporting mechanisms. It is unclear how officially defined SDG targets translate into private investment criteria, and there is no clear set of rules for ESG disclosures (see box 3), which makes reporting, benchmarking, and comparing studies on the impact of such investing on returns difficult. Improving ESG standards and clarifying factors behind long-term outperformance should drive more investors towards sustainable investments.

³² Royal Bank of Canada, *Responsible investing grows even as opinions remain divided*, RBC Global Asset Management Survey, 31 October 2017. Available from <http://www.rbc.com/newsroom/news/2017/20171031-gam-esg.html>.

³³ CNBC, “How to win in Socially Responsible Investing don’t exclude bad stocks”, 16 June 2017. Available from <https://www.cnbc.com/2017/06/16/how-to-win-in-socially-responsible-investing-dont-exclude-bad-stocks.html>.

³⁴ Mozaffar Khan, George Serafeim & Aaron Yoon, “Corporate Sustainability: First Evidence on Materiality”, (9 November 2016), *The Accounting Review*, Vol. 91, No. 6, pp. 1697–1724.

Fiduciary duties

Long-term institutional investors, such as pension funds, are bound by fiduciary duty to focus on benefits to their participants and beneficiaries. There is no clear agreement on what “benefits” entails, although in most cases it is interpreted to mean purely financial impacts. Some countries, such as South Africa, have introduced regulation that incorporates ESG impacts that affect material long-term financial performance into fiduciary duty. The United States of America updated their regulations in 2015, after the adoption of the Addis Agenda, to state that material ESG considerations should be a component of a fiduciary’s analysis. ESG factors can also be “tiebreakers” between investments with similar risk-return characteristics, although fiduciaries are not allowed to accept a lower expected return for ESG impact.³⁵

Nonetheless, to the extent that fiduciary duty is to focus on benefits, and to the extent that ESG factors are material, one could argue that failing to consider long-term ESG value drivers in portfolio decision-making would be a failure of fiduciary duty. A further step would be to at least allow benefits to be defined more broadly, if so desired by the plan beneficiaries, although this would require managers to have a greater understanding of beneficiary preferences.

4.3 Other actors’ role in the investment chain

Additional actors across the investment chain play a role in streamlining sustainability in investment strategies. These actors include investment con-

sultants, advisors, brokers and credit-rating agencies (CRAs) among others. Investment consultants provide advisory services to asset owners, and often shape investment decisions. To date, consultants do not systematically include ESG considerations in their investment recommendations, even when such factors are material to financial performance.³⁶ CRAs also provide information that guides investments. However, the time horizon for ratings is relatively short—between 2 and 5 years for corporate debt³⁷—and often tend to be procyclical. This means that they also help institutionalize a shorter-term outlook. CRAs are increasingly factoring material ESG risks into their analysis, although this is not done systematically. A longer-term outlook should complement their assessment as sustainability considerations impact long-term performance. Sustainability-rating agencies could also play a complementary role as they give ratings on company ESG performance, although scope and coverage vary widely.³⁸

Sell-side analysts, brokers and advisors of high net worth individuals also consider impact investments. As noted above, investment advisors are sceptical of ESG performance. Similarly, a recent study by Aviva Investors finds that sell-side analysts are not encouraged to produce long-term and ESG-oriented research, due in part to the perception that investors do not require such research and to fears of jeopardizing the commercial relationship between investment banks and the corporates they are analysing.³⁹

Stock exchanges also increasingly include ESG considerations as part of their listing requirements,

³⁵ Employee Benefits Security Administration, “Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments”, Department of Labor (2015). Available from <https://www.federalregister.gov/documents/2015/10/26/2015-27146/interpretive-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically>.

³⁶ European Union High-Level Expert Group on Sustainable Finance, *Financing a Sustainable European Economy* (2018). Available from https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.

³⁷ *United Nations Environment Programme*, “Shifting Perceptions: ESG, Credit Risk and Ratings – Part 1: The State of Play” (2017). Available from <http://unepinquiry.org/publication/shifting-perceptions-esg-credit-risk-and-ratings-part-1-the-state-of-play/>.

³⁸ Harvard Law School Forum on Corporate Governance and Financial Regulation, “ESG Reports and Ratings: What They Are, Why They Matter” (2017). Available from <https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/>.

³⁹ Aviva Investors, *Aviva Investors Investment Research: Time for a Brave New World?* (2017). Available from <https://www.avivainvestors.com/content/dam/aviva-investors/united-kingdom/documents/institutional/research-brave-new-world.pdf>.

usually on a “comply-or-explain” basis. Sixty-eight exchanges have signed up to the Sustainable Stock Exchanges Initiative and the stock exchanges that provide sustainability information and do well in terms of disclosure tend to be found in jurisdictions that have regulatory guidance on sustainability disclosure.⁴⁰

The Addis Agenda called for mainstreaming sustainable development considerations across regulatory and norm-setting bodies. SDG incentives can also be incorporated into regulatory frameworks on a national level. For example, the Central Bank of Brazil focuses on socio-environmental risk management flows as part of its core functions as a prudential bank regulator; the Bangladesh Bank supports rural enterprises and green finance; and the Bank of England has a prudential review of climate risks for the insurance sector of the United Kingdom of Great Britain and Northern Ireland, based on a connection between its core prudential duties and the United Kingdom Climate Change Act.⁴¹

Climate risk assessment

Policymakers have an interest in ensuring that the financial system is resilient to all forms of risk. Disclosure of material climate-related financial information is a prerequisite for financial firms to manage and price climate risks appropriately. The Financial Stability Board’s (FSB) Task Force on Climate-related Financial Disclosures (TCFD) published recommendations for voluntary climate-related financial disclosures in June 2017. To date, more than 240 companies holding a combined market capitalization of over €5.1 trillion have indicated support

for the recommendations.⁴² In addition, the International Monetary Fund (IMF) also analyses the financial stability implications of climate change (see chapter III.F).

4.4 The impact of financial sector incentives on the real economy

Institutional investors also play an important role as shareholders and investors in companies. They have enormous influence in shaping corporate strategy and investment decisions of companies in which they hold equity. There is evidence that short-term pressures from investors are at least partly responsible for inhibiting long-term investment and value-creating behavior by companies. In 2016, S&P 500 companies spent over 100 per cent of their earnings on dividends and share buybacks—which boost stock prices in the short run—rather than raising long-run company value through investments.⁴³ A *McKinsey Quarterly* survey found that 87 per cent of corporate executives and directors feel pressured to demonstrate strong financial performance within two years or less; 65 per cent say short-term pressure has increased over the past five years;⁴⁴ and 55 per cent would delay investments in projects with positive returns to hit quarterly earnings targets.⁴⁵

This short-term focus is due to a combination of factors, including

- Corporate boards, which are often not equipped to evaluate company performance on anything other than short-term results;
- Growing importance of institutional shareholders (see box 4) and pressures from

⁴⁰ See <http://www.sseinitiative.org/sse-partner-exchanges/list-of-partner-exchanges/>.

⁴¹ Business Commission on Sustainable Development, *Ideas for a Long-Term and Sustainable Financial System* (January 2017). Available from http://s3.amazonaws.com/aws-bsdc/BSDC_SustainableFinanceSystem.pdf.

⁴² See <https://www.fsb-tcfd.org/tcfd-supporters-february-2018/>.

⁴³ McKinsey, *Elevating the Customer Experience*, Quarterly Survey (2016). Available from https://www.mckinsey.com/-/media/mckinsey/business%20functions/operations/our%20insights/mckinsey%20quarterly%202016%20number%203%20overview%20and%20full%20issue/q3_2016_mckquarterly_full%20issue.ashx.

⁴⁴ Dominic Barton, Jonathan Bailey, and Joshua Zoffer, “Rising to the Challenge of Short-Termism” (Boston, FCLT Global, 2016). Available from <https://www.fcltglobal.org/docs/default-source/default-document-library/fclt-global-rising-to-the-challenge.pdf>; Dominic Barton and others, “Measuring the Economic Impact of Short-Termism”, McKinsey Global Institute Discussion Paper (McKinsey & Company, February 2017). Available from <https://www.mckinsey.com/-/media/McKinsey/Global%20Themes/Long%20term%20Capitalism/Where%20companies%20with%20a%20long%20term%20view%20outperform%20their%20peers/MGI-Measuring-the-economic-impact-of-short-termism.ashx>.

⁴⁵ McKinsey Quarterly Survey (2016); McKinsey analysis; S&P.

Box 3

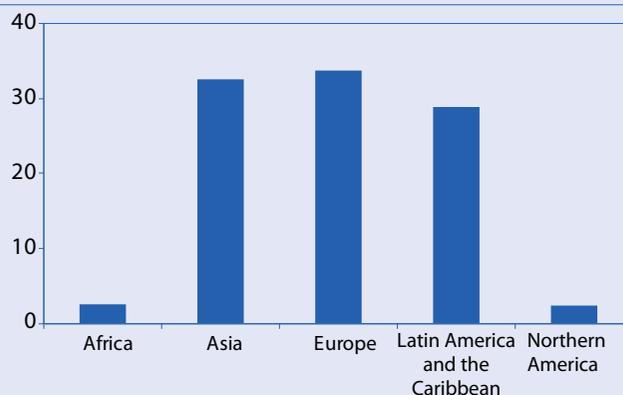
Sustainability reporting and benchmarking

Sustainability reporting by companies has grown significantly over the last decade, but has not been even across all regions (see figure 4.1). According to a recent survey of more than 5000 companies, 3 in 4 companies now publish corporate responsibility reports, with 60 per cent of them including some of that information in their financial reports.^a However, the effectiveness of sustainable reporting is dependent on the quality and clarity of information. In the above study, the majority of institutional investors who employ environmental, social and governance (ESG) criteria across all regions are not satisfied with the disclosure of ESG metrics provided by corporations. Indeed, there is widespread investor confusion — and in some instances frustration — over the wide variety of quality in ESG data.^b

To institutionalize and facilitate SDG investing, it is important to report on ESG indicators in an open, transparent and comprehensible manner. Both Governments and the private sector can help to address this challenge. In France, for instance, article 173 of the energy transition law (the Act of 17 August 2015) now requires listed companies to disclose their climate-related financial risks along with the measures adopted to reduce them.^c Similarly, private-led efforts, such as the Financial Stability Board Task Force on Climate-related Financial Disclosures, as well as efforts led by the United Nations Global Compact and the Global Reporting Initiative, are helping set the ground for a new wave of standardized sustainability disclosure. This is particularly important and welcome given the large number (more than 400) of sustainability reporting policy instruments currently in place globally.^d

Corporate sustainability benchmarks can help investors and other stakeholders use disclosures by translating individual reporting into comparable assessments of the degree to which corporate performance is aligned with the SDGs. This would also help address the proliferation of competing reporting guidelines for businesses and the lack of standardization of sustainability metrics. In this regard, the World Benchmarking Alliance, which would develop, fund, house and safeguard free, publicly available, corporate sustainability benchmarks,^e is being established to rank companies on their performance across a range of SDG-related indicators such as climate change, gender, access to health care. Such indicators and benchmarks would provide investors, including institutional investors and their beneficiaries and trustees, with transparent information that justifies investments in companies that operate in a sustainable manner. If large institutional investors use these in their investment decision-making, it could put pressure on more companies to improve their standing in the benchmarks by better aligning their business activity with sustainable development. The league tables will also help individuals make more sustainable investment choices as they are provided with transparency that usually sits behind a pay wall.

Figure 4.1

Regional distribution of Global Reporting Initiative Sustainability Reports (G4), 2013–2017
(Percentage of reports)


Source: GRI Sustainability Disclosure database (2018).

Note: Data reported according to G4 Sustainability Reporting Guidelines. Available from <https://www.globalreporting.org/information/g4/Pages/default.aspx>.

Source: UN/DESA.

- a KPMG, "KPMG Survey of Corporate Responsibility reporting" (2017).
- b KPMG, "Carrots & Sticks: Global Trends in Sustainability Reporting Regulation and Policy" (2016). Available from <https://home.kpmg.com/xx/en/home/insights/2016/05/carrots-and-sticks-global-trends-in-sustainability-reporting-regulation-and-policy.html>.
- c United Nations Principles for Responsible Investment and others, French Energy Transition Law: Global Investor Briefing (2016). Available from <https://www.unpri.org/download?ac=1421>.
- d KPMG, "Carrots & Sticks: Global Trends in Sustainability Reporting Regulation and Policy" (2016). Available from <https://home.kpmg.com/xx/en/home/insights/2016/05/carrots-and-sticks-global-trends-in-sustainability-reporting-regulation-and-policy.html>.
- e See <https://developmentfinance.un.org/private-sector-efforts-and-initiatives-environmental-social-and-governance-factors>.

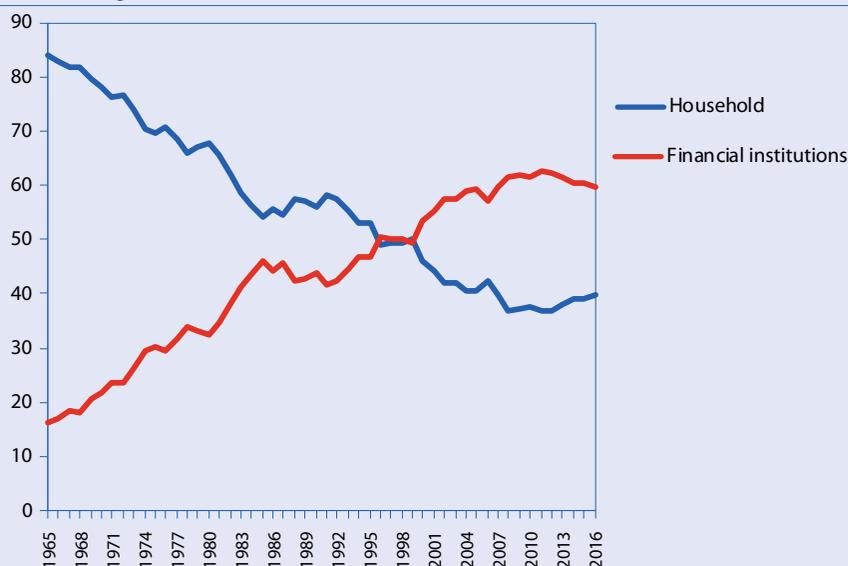
Box 4

Shift in stock ownership

Increasing pressure from investors corresponds to a shift in stock ownership from household and small investors to institutional investors. In the United States of America, for example, the majority of stocks were held by households in the 1960s, with a minority of equities held by financial market players (including institutional investors); by 2000, this relationship had reversed, with up to 70 per cent of stocks held by institutional investors, either directly or through intermediaries.

Figure 2.1

United States holdings of equities by household and financial institutions, 1965–2016 (Percentage of total holdings)



Source: *Financial Accounts of the United States*, Federal Reserve (2018).

Note: "Households" includes non-profit organizations. "Financial institutions" excludes monetary authority.

capital markets, including through quarterly reporting,⁴⁶ and

- Management incentives, such as stock options.⁴⁷

Two thirds of respondents in a *McKinsey Quarterly* survey cited corporate boards and executives and one third cited institutional shareholders as the primary source of short-term pressure. Incentivizing institutional investors to have a longer-term horizon that is aligned with sustainable development, and to engage with companies on their long-term and transition agenda, could have the benefit of encouraging longer-term corporate time horizons, and greater long-term corporate investment. In addition, reforms to corporate boards could reduce short-term pressures.

5. Financial inclusion

There is a growing body of evidence that more inclusive financial markets support economic growth and employment and reduce inequalities.⁴⁸ In the Addis Agenda, Governments committed to “work to ensure that our policy and regulatory environment supports financial market stability and promotes financial inclusion in a balanced manner, and with appropriate consumer protection”.⁴⁹ In essence, much of financial inclusion is outside of the regulatory perimeter. The challenge for regulators is to design rules that control risks while still allowing inclusive finance to flourish.

While there has been enormous progress in increasing access to financial services since the start of the millennium, large gaps remain between countries, regions and genders. According to the World

Bank’s Findex database, 62 per cent of the world’s adult population had a bank account in 2014, up from 53 per cent in 2011. While more than 80 per cent of adults in developed countries have accounts, this percentage drops below 50 per cent in developing countries and below 27 per cent in LDCs. In addition, a gender gap in access to finance persists; account ownership among women is about 58 per cent, versus 65 per cent for men.

The reach of financial inclusion is much greater when innovative measures of financial intermediation are included, such as mobile money agents. These instruments are especially prevalent in economies where traditional financial access is relatively scarce.⁵⁰ Innovative digital services tools helped 700 million adults worldwide gain access to formal financial services between 2011 and 2014,⁵¹ with the number expected to grow. In sub-Saharan Africa, for example, the number of mobile money accounts has almost reached the level of bank accounts as of 2015 (see figure 5).⁵²

Coverage of commercial bank loans, an additional traditional indicator of financial inclusion (figure 6), has also increased over the past decade, although regional differences remain, with coverage in Africa and Oceania particularly low. At the same time, as shown in figure 7, the ease of getting credit has worsened in LDCs, SIDS and LLDCs.

The unmet financing needs of micro, small and medium-sized enterprises (MSMEs), estimated to be \$5.2 trillion in developing countries, or 1.4 times the current level of MSME-lending, is a major constraint to private sector development in many countries. Women-owned businesses comprise 28

⁴⁶ FCLT Global, *A Roadmap for Focusing Capital on the Long Term* (Boston, 2015). Available from <https://www.fclt-global.org/docs/default-source/default-document-library/a-roadmap-for-fclt.pdf?sfvrsn=0>.

⁴⁷ National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report* (2011). Available from http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

⁴⁸ The *Consultative Group to Assist the Poor* (CGAP), “What is the Impact of Financial Inclusion Efforts” (Washington, D.C., 2018). Available from <http://www.cgap.org/about/faq/what-impact-financial-inclusion-efforts>.

⁴⁹ Addis Ababa Action Agenda, para. 38. Available from http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

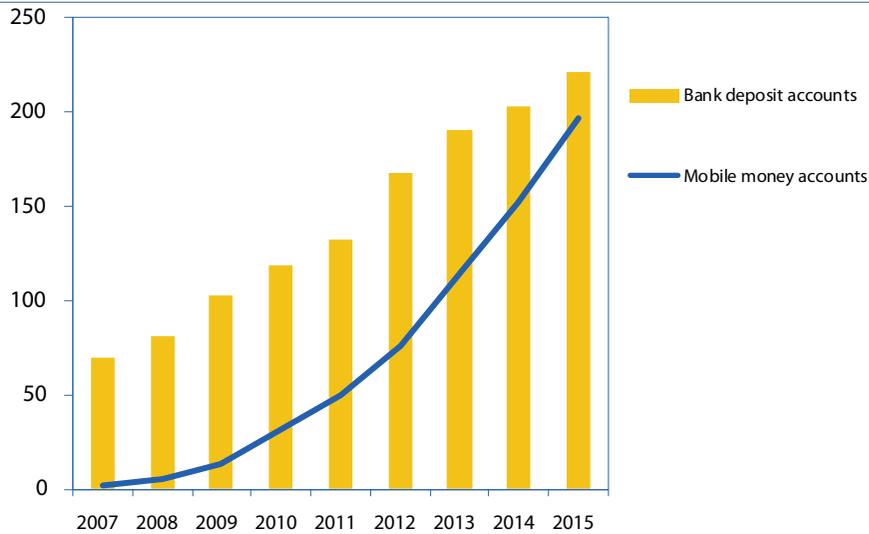
⁵⁰ International Monetary Fund, “Financial Access Survey”, 2 October 2017. Available from <https://www.imf.org/en/News/Articles/2017/10/02/pr17383-imf-releases-2017-financial-access-survey>.

⁵¹ World Bank, Global Findex database. Available from <http://www.worldbank.org/en/programs/globalindex>.

⁵² GSMA, *2016 State of Mobile Money in Sub-Saharan Africa* (2017). Available from <https://www.gsma.com/mobil-fordevelopment/wp-content/uploads/2017/07/2016-The-State-of-Mobile-Money-in-Sub-Saharan-Africa.pdf>.

Figure 5

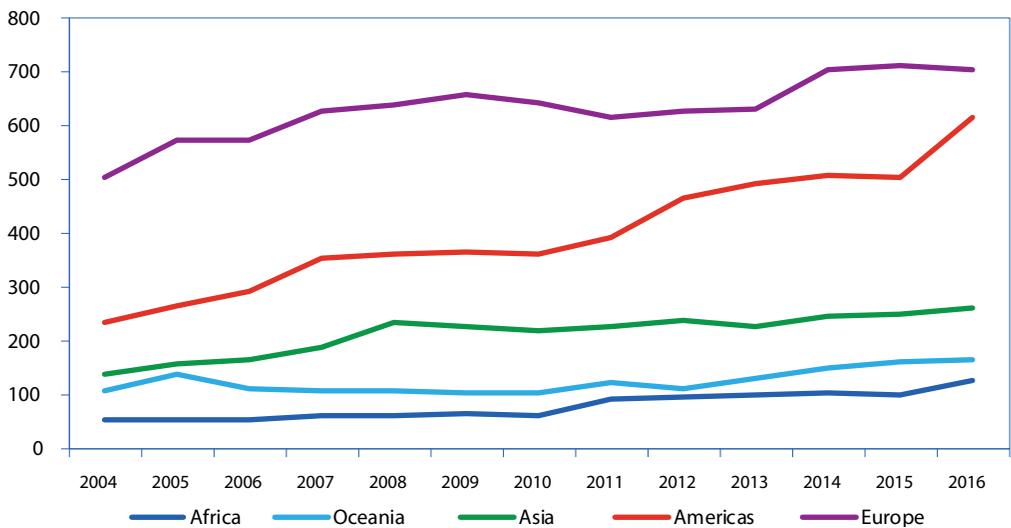
Growth of registered mobile money accounts and deposit bank accounts in sub-Saharan Africa, 2007–2015
(Number of accounts in millions)



Source: IMF Financial Access Survey (FAS) (2018).

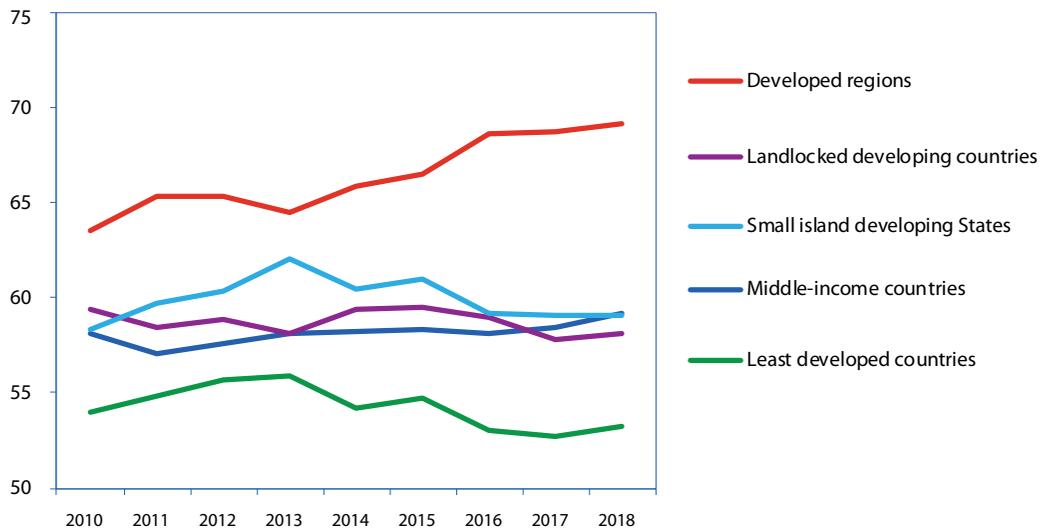
Figure 6

Loan accounts with commercial banks, 2004–2016
(Number of accounts per 1000 adults)



Source: IMF Financial Access Survey (FAS) (2018) and UN/DESA calculations.

Figure 7
Access to credit, 2010–2018
 (Scale 0–100)



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

per cent of MSMEs and account for 32 per cent of the MSME finance gap.⁵³

While banks represent the main source of finance for MSMEs, commercial banks have traditionally found lending to some MSMEs challenging because of information asymmetry, lack of collateral, and the higher cost of serving smaller transactions.⁵⁴ Obtaining credit thus poses particular challenges for MSMEs with high-risk profiles, limited credit history and few pledgeable assets in developing countries, as well as for innovative and high-growth MSMEs in developed countries.⁵⁵ Regulation can also impact incentives, and may have unintended consequences on MSME lending. To ease the capital cost associated with SME lending, the Basel Committee on

Banking Supervision revised the risk weighting on loans to SMEs from 100 to 85 per cent in December 2017⁵⁶ (see chapter III. F).

Access to diversified financial instruments can increase MSME resilience to changing conditions in credit markets.⁵⁷ For instance, leasing, which can enable firms without a credit record or eligible collateral to fund equipment investment, can be of particular interest in developing countries where credit infrastructure is not yet fully established or eligible collateral is still largely restricted to land or real estate. The provision of guarantees has been one of the most widespread government policies to lower costs and improve MSME access to credit.⁵⁸ In this regard, blended finance facilities, and national,

⁵³ See <http://www.smefinanceforum.org/data-sites/msme-finance-gap>.

⁵⁴ International Finance Corporation, *The SME Banking Knowledge Guide* (Washington, D.C., 2010). Available from <https://www.ifc.org/wps/wcm/connect/b4f9be0049585ff9a192b519583b6d16/SMEE.pdf?MOD=AJPERES>.

⁵⁵ International Finance Corporation, *Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises* (Washington, D.C., 2013). Available from <https://www.ifc.org/wps/wcm/connect/4d6e6400416896c09494b79e78015671/Closing+the+Credit+Gap+Report-FinalLatest.pdf?MOD=AJPERES>.

⁵⁶ See <https://www.bis.org/bcbs/basel3.htm>.

⁵⁷ Organization for Economic Cooperation and Development, “New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments” (Paris, 2015). Available from <https://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf>.

⁵⁸ Organization for Economic Cooperation and Development, *Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard* (Paris, 2018). Available from <http://www.oecd.org/cfe/smes/financing-smes-and-entrepreneurs-23065265.htm>.

international and multilateral development banks have an important role to play, such as through the World Bank Group's \$2.5 billion Private Sector Window⁵⁹ (see chapter III.C). Other elements that have worked well in promoting MSME financing in some countries include utilizing a range of institutions in enhancing access to finance (such as microfinance institutions and cooperative banks), along with the use of new technologies (such as mobile money and agent networks) with appropriate consumer protection, as discussed below.

In parallel to these supply-side measures, policies aiming at improving MSME capacity to successfully seek affordable finance include awareness programmes to increase the knowledge of MSME owners and managers of all available financing options. Some countries have put initiatives in place to improve investor readiness, including accelerators or incubators, which provide startups and MSMEs with training (finance and pitching training in

particular), as well as mentoring, coaching and networking opportunities.⁶⁰ With the increasing digitalization of finance, enhancing financial and digital literacy is also becoming more important to achieving financial inclusion.

5.1 Digitalization of finance and financial inclusion

The digitalization of finance offers new possibilities for greater financial inclusion, including for women and MSMEs, and alignment with the 2030 Agenda for Sustainable Development and implementation of the SDGs. Digital finance or fintech (financial technology) offers financial products directly to users without intermediation, thereby reducing costs and possibly reaching populations without access to commercial bank branches. Mobile money services have grown into major payments services, with over 6 billion transactions annually (e.g., M-Pesa in Kenya and the United Republic of Tanzania, Ecocash in Zim-

Box 5

Trends in global private philanthropy for development

The 2030 Agenda for Sustainable Development emphasised private philanthropy's role in advancing the SDGs. The modalities and magnitude of foundations' giving has long been subject to various interpretations, due to limited availability of statistical evidence. Recently, the Organization for Economic Development and Cooperation (OECD) Development Co-operation Directorate (DCD), in collaboration with the OECD Global Network of Foundations Working for Development (NetFWD), carried out a large-scale survey on global private philanthropy for development that collected comparable, activity-level information on developmental activities of over 140 foundations from all over the world for 2013–2015.^a The survey analyses the sectoral and geographic focus of philanthropic giving and its modalities.

The preliminary survey results show that during 2013–2015, philanthropic giving amounted to \$23.8 billion, with an upward trend over the survey period. India was the largest recipient country, resulting particularly from significant giving by the Bill and Melinda Gates Foundation, Tata Trusts and the IKEA Foundation. Whereas Africa was by far the most targeted region, at 28 per cent, the largest share of giving (45 per cent) was global or multi-continental in scope. In terms of sectoral allocation, philanthropic giving predominantly targeted health and reproductive health, which together accounted for 53 per cent of the three-year total, followed by education (9 per cent), agriculture (9 per cent) and government and civil society (8 per cent, including human rights, gender, civil society development and transparency and accountability). The OECD-DCD will continue efforts in 2018 to reach out to the most influential philanthropic foundations for more regular reporting.

^a See <http://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/beyond-oda-foundations.htm>.

⁵⁹ See <http://ida.worldbank.org/financing/ida18-private-sector-window>.

⁶⁰ Organization for Economic Cooperation and Development (OECD), *Towards Effective Approaches to Support Implementation of the G20/OECD High-Level Principles on SME Financing*, OECD Working Party on SMEs and Entrepreneurship (Paris, 2017); OECD, "Fostering markets for SME finance: Matching business and investor needs", in *Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard* (Paris, 2017). Available from http://www.oecd-ilibrary.org/industry-and-services/financing-smes-and-entrepreneurs-2017/fostering-markets-for-sme-finance-matching-business-and-investor-needs_fin_sme_ent-2017-6-en.

babwe). In Kenya, the expansion of mobile money lifted two per cent of households in the country above the poverty line; the effect of access to mobile banking on consumption has been more significant for female-headed households than for male-headed households, with the use of mobile money helping 185,000 women move from subsistence farming to higher-return business occupations.⁶¹

In many developing countries, inadequate financial infrastructure, such as private credit bureau and public credit registries, has hampered the expansion of financial inclusion. The increased availability of digital data—whether from digital records of financial transactions, digital records from mobile phone use, or non-individualized big data—can enable providers to lower costs and reach more clients while saving clients time and money.⁶² Fintech firms can use data to predict creditworthiness and borrower performance using algorithms based on big data,⁶³ thus bypassing credit bureaus and other intermediaries and increasing lending.

However, there are risks associated with the rapid advance of digital finance. Consumers who may have relatively lower financial literacy may also have relatively lower digital literacy, and therefore are less able to make sound decisions regarding appropriate financial services. There are a number of new players, particularly fintech providers, and many new products and services and delivery channels that

are not currently covered by regulatory frameworks and authorities. If not appropriately regulated, they can pose risks to customers, as well as potentially broader systemic risks. Effective financial regulation has several roles, including (i) monitoring institutional as well as systemic risks, including providing incentives for institutions to take systemic risk into account; (ii) providing consumer protection; and (iii) supporting competition and impeding monopolistic and oligopolistic behaviour.⁶⁴

Through better data and speed, technologies can make risk management more effective, but they also raise new risks or change the nature of risks, such as in data protection and privacy, keeping client funds safe, responsibility of providers across the value chain, and client recourse, among others.⁶⁵ Digital channels can change the nature of fraud, with providers and agents also exposed to different risks: throughout several countries in Africa, 10 to 50 per cent of agents have suffered from fraud, which can lead to a loss of consumer confidence.⁶⁶ As a result, there is increasing attention to “regtech,” that is, using technology for better regulation. In a number of cases, regulators are using “regulatory sandboxes” so as not to hamper innovation while not exposing the broader market to unknown risks. Regulators from around the world—particularly in developing and emerging markets—are collaborating through the Alliance for Financial Inclusion⁶⁷ and other mechanisms to share lessons learned, and are continuing to engage with

61 Tavneet Suri and William Jack, “The Long-Run Poverty and Gender Impacts of Mobile Money”, *Science* Vol. 354, Issue 6317, pp. 1288-1292 (9 December 2016). Available from <http://science.sciencemag.org/content/354/6317/1288.full>.

62 Gregory Chen and Xavier Faz, “The Potential of Digital Data: How Far Can It Advance Financial Inclusion?”, *Focus Note 100* (CGAP, Washington, D.C., 2015). Available from <http://www.cgap.org/sites/default/files/Focus-Note-The-Potential-of-Digital-Data-Jan-2015.pdf>.

63 International Monetary Fund, “Banking on Change”, *Financing & Development*, Vol. 54, No. 3 (September 2017). Available from <http://www.imf.org/external/pubs/ft/fandd/2017/09/griffoli.htm>; Bank for International Settlements and Financial Stability Board, *Fintech Credit: Market Structure, Business Models and Financial Stability Implications* (Basel, 2017). Available from <http://www.fsb.org/wp-content/uploads/CGFS-FSB-Report-on-FinTech-Credit.pdf>.

64 International Monetary Fund (2017); Financial Stability Board, *Financial Stability Implications from Fintech: Supervisory and Regulatory Issues that Merit Authorities’ Attention* (Basel, 2017). Available from <http://www.fsb.org/2017/06/financial-stability-implications-from-fintech/>.

65 Better Than Cash Alliance, “Responsible Digital Payments Guidelines”, 15 July 2016. Available from <https://www.betterthancash.org/tools-research/case-studies/responsible-digital-payments-guidelines>.

66 The *Consultative Group to Assist the Poor*, “Fraud in Mobile Financial Services: Protecting Consumers, Providers, and the System” (Washington, D.C., 2017). Available from <http://www.cgap.org/sites/default/files/Brief-Fraud-in-Mobile-Financial-Services-April-2017.pdf>.

67 See <https://www.afi-global.org/>.

the global financial standard-setting bodies to ensure that global standards take different country contexts into consideration.

The FSB, IMF and others have reported on financial sector guidance, regulatory policies and supervisory practices to support the stability and integrity of the financial system with the emerging digitalization of finance.⁶⁸ Financial system regulation needs to take fintech into consideration. Given its cross-border nature, it is important to ensure that discussions are happening between different national regulatory authorities. Such dialogue is already underway as part of the Financial Inclusion Global Initiative (FIGI), led by International Telecommunications Union, the World Bank Group and the Committee on Payments and Market Infrastructures.⁶⁹ Among other objectives, FIGI aims to enable national authorities in developing and emerging markets to better harness the potential of digital technologies for financial inclusion, and to manage associated risks.

5.2 Supporting women entrepreneurship

According to available estimates, approximately one fourth to one third of the world's formal sector enterprises are owned and operated by women. Women entrepreneurs tend to experience far more difficulties than men in starting and expanding their businesses, which can be linked to laws that have a differential impact on men and women—those related to land ownership and inheritance, for example—as well as cultural norms and social attitudes. Data show that women are less likely than men to start businesses and grow their small firms into larger enterprises.⁷⁰ Lack of access to finance and financial services is repeatedly identified as the major constraint for women business owners.⁷¹

In light of this, Governments in both developed and developing countries have introduced policies and programmes to develop women entrepreneurs. For example, in Africa, technical and financial support have been provided to Burkina Faso, Burundi, Liberia, Kenya, Sudan and Swaziland as part of a project to develop business incubators that empower women entrepreneurs. The project will impact more than 50,000 women and youth, according to the New Partnership for Africa's Development (NEPAD). In 2017, the World Bank Group created a new facility, Women Entrepreneurs Finance Initiative (We-Fi), with more than \$1 billion to help women in developing countries gain increased access to the finance, markets and networks necessary to start and grow a business. In addition, programmes for women's empowerment that increase cultural acceptance, highlighting female entrepreneurs as role models and raising public awareness, have proved successful.

Another initiative, established by the Women's Empowerment Principles (WEPs), a partnership initiative of UN Women and the United Nations Global Compact, provides a set of considerations for the private sector to focus on to promote gender equality in the workplace, marketplace and community. The WEPs include a range of considerations relating to the establishment of high-level corporate leadership to advance gender equality: fair treatment of all women and men at work; ensuring the health, safety and well-being of all women and men workers; promotion of education, training and professional development for women; and the implementation of enterprise development, supply chain and marketing practices that empower women, among other principles. More than 1,775 business leaders around the world have demonstrated leadership on

⁶⁸ Financial Stability Board, *Summary Report on Financial Sector Cybersecurity Regulations, Guidance and Supervisory Practices* (Basel, 2017). Available from <http://www.fsb.org/wp-content/uploads/P131017-1.pdf>; International Monetary Fund, "International Monetary Fund and Fintech" (Washington, D.C., 2018). Available from <http://www.imf.org/en/About/Key-Issues/Fintech>.

⁶⁹ FIGI is a three-year programme initiated in 2017 with support from the Bill and Melinda Gates Foundation.

⁷⁰ Andre Sammartino and Sarah Gundlach, "Women, Global Trade and What It Takes to Succeed", (Women in Global Business, 2015). Available from https://minervaaccess.unimelb.edu.au/bitstream/handle/11343/145370/FINAL%20WIGB_MLB_Uni_Report_2015.pdf?sequence=5&isAllowed=y.

⁷¹ International Finance Corporation, "Solutions to Increase Access to Finance for Women-Owned Businesses in the Middle East and North Africa" (Washington, D.C., 2012). Available from <http://www.ifc.org/wps/wcm/connect/156534804f860a72be27fe0098cb14b9/12316-vv-sme-report.pdf?MOD=AJPERES>.

gender equality through the WEPs. The work of the United Nations Secretary-General's High-level Panel on Women's Economic Empowerment (WEE) led to the establishment of the Group of Champions for WEE, comprised of 20 Member States that have come together to advance WEE.

5.3 Connecting remittances to fintech and financial inclusion

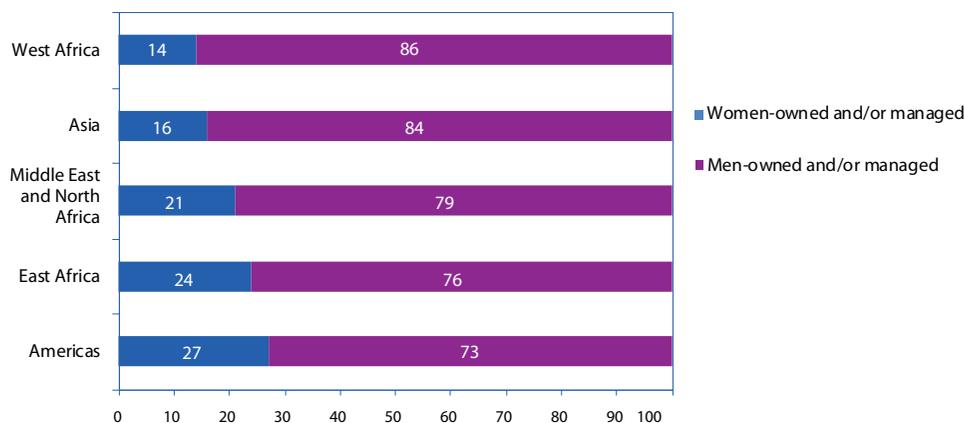
In 2017, remittance flows to developing countries are projected to have totalled \$596 billion,⁷² up from \$573.6 billion in 2016,⁷³ following a decline in 2015 and 2016 generally following global growth trends. According to the African Development Bank, remittances have been the largest source of cross-border flows to Africa since 2010, accounting for about a third of total external inflows to Africa. At the same time, the levels of remittances are likely to be higher than reported, as underreporting and flawed estima-

tion methods (particularly around informal flows) prevent an accurate measure.⁷⁴

Remittances have an important impact on growth in recipient economies. Similar to domestic wages, remittances increase the disposable income of households, stimulating consumption with a multiplier effect on the economy. Their impact on savings and investment, and hence on growth, will depend, to a large extent, on financial inclusion.⁷⁵ Linking remittance financial flows to beneficiary accounts with financial service providers translates into more formally sent remittances,⁷⁶ and enables recipients to store and save their remittances and to leverage them for building entrepreneurial capital.

In 2017, the average cost of sending remittances was around 7.2 per cent.⁷⁷ Although there has been a sustained downward trend in the average cost of sending remittances in the last decade, it is still far from the 3 per cent committed to in the Addis

Figure 8
Women-owned and managed companies, by region, 2010–2014
(Percentage of total)



Source: ITC, *Unlocking Markets for Women to Trade* (2015).

- ⁷² World Bank, "Migration and Remittances" Brief No.28 (Washington, D.C., 2017).
⁷³ World Bank, "Migration and Remittances Data" (Washington, D.C., October 2017). Available from <http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data>.
⁷⁴ *International Fund for Agricultural Development, Global Forum on Remittances, Investment and Development 2017 Official Report*. Available from https://www.ifad.org/documents/38714170/39135645/GFRID2017_official_report.pdf/a9e52e66-7c93-4217-9896-86099e73afa5.
⁷⁵ *World Economic Situation and Prospects 2018* (United Nations publication, Sales No E.16.II.C.2)
⁷⁶ Organization for Economic Cooperation and Development, *Interrelations between Public Policies, Migration and Development* (OECD Publishing, Paris, 17 February 2017). Available from <http://dx.doi.org/10.1787/9789264265615-en>.
⁷⁷ World Bank, "Migration and Remittances" Brief No. 28, (Washington, D.C., October 2017).

Agenda and in the means-of-implementation target under SDG 10c. Policymakers can introduce measures to stimulate competition to lower costs and expand access to regulated service providers. Collaboration between sending and recipient countries can be fostered to create cross-border partnerships that influence the market structure and reduce costs. In general, the establishment of operational partnerships among policymakers and regulators, financial industry representatives and technology entrepreneurs, both at national and global levels, would be important in increasing transparency and competition in the remittance market and, subsequently, in bringing down high remittance costs and enhancing financial inclusion.⁷⁸

Correspondent banking is an important means of facilitating cross-border movements of funds, and enables financial institutions to access financial services in different currencies and foreign jurisdictions, thereby supporting remittances flows. The number of worldwide correspondent banking relationships continues to decline, active correspondent relationships declined by 8 per cent across all currencies from 2011 to mid-2017. Regionally, there are increases in the average number of active corridors per country for North America and Eastern Europe and declines in all other regions, including Africa, Asia, and Latin America and the Caribbean.⁷⁹

The fixed costs associated with opening and maintaining a correspondent banking relationship, particularly the application of know-your-customer (KYC) requirements, is one of the drivers behind the decline in the number of relationships, at least when there is not sufficient volume of business to compen-

sate for these costs.⁸⁰ Relationships are most affected in smaller countries and jurisdictions for which the compliance with standards for anti-money laundering and combating the financing of terrorism (AML/CFT) is insufficient or unknown. The decline in relationships appears to lead to a greater concentration, where countries and banks rely on fewer correspondent banks, and longer payment chains, which means that an increasing number of intermediaries are involved in processing the same payment.

The FSB has coordinated an action plan to assess and address the decline in correspondent banking, including through domestic capacity-building and strengthening tools for due diligence in correspondent banks.⁸¹ Improving the regulatory alignment across countries—including consistent implementation of AML/CFT and KYC regulations, and encouraging greater collaboration and sharing of information among financial institutions, as called for in the Addis Agenda—could reduce the unintended consequences of regulation on correspondent banking.⁸² There are ongoing private sector efforts in this regard. As an example, the Wolfsberg Group (an association of 13 global banks) has created a questionnaire that aims to standardize KYC due diligence processes, which has been welcomed by the standard-setting bodies.⁸³

The application of financial technology and improved financial inclusion has the potential to significantly lower the cost of remittances, as the more that people adopt digital channels to transact with the formal financial system, the lower the cost to receive remittances is for them.⁸⁴ In particular, Fintech can be used to lower the cost of

⁷⁸ International Fund for Agricultural Development, *Global Forum on Remittances, Investment and Development 2017 Official Report*.

⁷⁹ Financial Stability Board, *FSB correspondent banking data report*, updated (Basel, 6 March 2018). Available from <http://www.fsb.org/wp-content/uploads/P060318.pdf>.

⁸⁰ Financial Stability Board, *FSB correspondent banking data report* (Basel, 4 July 2017). Available from <http://www.fsb.org/2017/07/fsb-correspondent-banking-data-report/>.

⁸¹ Financial Stability Board, “FSB action plan to assess and address the decline in correspondent banking, Progress report to G20 summit” (Basel, July 2017). Available from <http://www.fsb.org/wp-content/uploads/P040717-3.pdf>.

⁸² Financial Action Task Force, *Guidance. Private sector information sharing* (Paris, 2017). Available from <http://www.fatf-gafi.org/media/fatf/documents/recommendations/Private-Sector-Information-Sharing.pdf>.

⁸³ Financial Stability Board, “BCBS, CPML, FATF and FSB welcome industry initiative facilitating correspondent banking”, 6 March 2018. Available from <http://www.fsb.org/2018/03/bcbs-cpml-fatf-and-fsb-welcome-industry-initiative-facilitating-correspondent-banking/>.

⁸⁴ GSMA, “Mobile money is driving a price revolution in international remittances”, 31 October 2016. Available from <https://www.gsma.com/mobilefordevelopment/programme/mobile-money/new-gsma-research-shows-that-mobile-money-is-driving-a-price-revolution-in-international-remittances>.

cross-border transfers, thereby helping to address the loss of correspondent banking relationships that many developing countries have seen in recent years (see chapter III.D). This could provide a significant boost to developing countries that receive significant

remittances from overseas.⁸⁵ Innovative solutions as described in box 6, could potentially be replicated on a large scale.⁸⁶ Finally, technologies and financial instruments can be used to attract diaspora investments.⁸⁷

Box 6

A remittance mobile wallet in Nepal

Nepal has a high dependence on remittances. As a percentage of gross domestic product, remittances have the broadest reach of any financial flow, especially to the rural areas. In Nepal, the United Nations Capital Development Fund provided technical assistance to the largest remittance service provider in the country, IME Ltd., to launch a remittance mobile wallet, IME Pay. Through IME Pay, IME partnered with its subsidiary IME LIFE Insurance to provide general and life insurance to all remittance recipients at a nominal premium. The insurance is provided as a default opt-in along with the mobile wallet and has led to insurance penetration in an otherwise highly fragmented informal insurance market. Within a month of launch in March 2017, IME Pay was adopted by over 25,000 customers.

Source: UN/DESA.

⁸⁵ International Monetary Fund, “Leveraging Financial Technology for the Underbanked”, 19 September 2016. Available from <https://www.imf.org/en/News/Articles/2016/09/17/NA091916-Leveraging-financial-Technology-for-the-Underbanked>.

⁸⁶ See <http://imeremit.com.np>.

⁸⁷ International Fund for Agricultural Development, *Global Forum on Remittances, Investment and Development 2017 Official Report*.