United Nations | Department of Economic and Social Affairs

RECENT DEVELOPMENT & ANALYSIS OF SUSTAINABLE DEVELOPMENT INVESTING

Information note provided to the G20 Sustainable Finance Working Group based on the forthcoming 2022 Financing for Sustainable Development Report (FSDR) from the Inter-agency Task-force on Financing for Development

March 2022

This is an extract from the chapter on domestic and international private business and finance of the forthcoming 2022 Financing for Sustainable Development Report (FSDR), which will be officially launched on 13 April and presented at the ECOSOC Financing for Development Forum scheduled from 25 to 28 April. This extract is shared with the G20 Sustainable Finance Working Group given its relevance for and connection with topics covered by the SFWG. The assessment included in the FSDR draws on the expertise, analysis and data from more than 60 agencies and international institutions that make up the Task Force, which is led by UN DESA with the World Bank Group, the International Monetary Fund and the World Trade Organization, UNCTAD and UNDP in leading roles.

1 Key Messages

Capital markets must be an engine for a sustainable shift. Investors are increasingly incorporating sustainability issues in their investment decisions, particularly from a risk management perspective. However, this is not likely to create enough change in companies' sustainability behaviour unless further actions are taken by policymakers, including:

- *Adopting policy measures that make unsustainable businesses no longer profitable, such as carbon pricing, while also encouraging businesses with positive sustainability impact;*
- *Improving the quality and comparability of companies' sustainability reports to provide investors and other stakeholders with the information they need to assess companies on sustainability matters;*
- *Strengthening market integrity by establishing common norms and criteria for investment products to be marketed/labelled as sustainable;*
- *Increasing demand for sustainable investments by requiring pension funds and financial advisors to ask their beneficiaries and clients about their sustainability preferences;*
- *Requesting institutional investors to disclose the environmental and social footprint of and the physical risks within and created by their portfolios; and*
- *Designing standards and norms for sustainable finance approaches in capital markets to incentivize financing flows towards developing countries with large SDG gaps.*

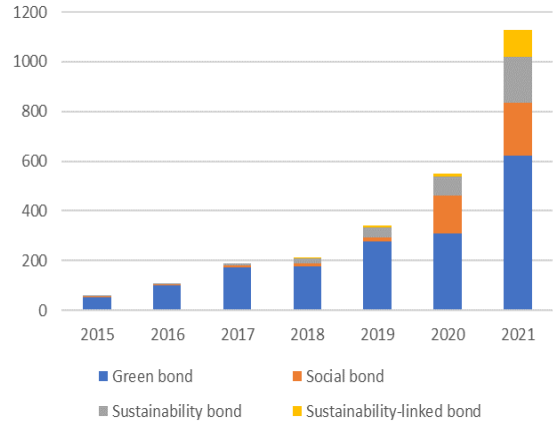
2 Leveraging capital markets for sustainable development

Capital markets need to play a greater role in incentivizing the private sector towards more sustainability. Incorporating sustainability issues into investment decisions has become mainstream, starting with climate change. Investors realize that some sustainability issues impact the financial performance of companies they invest in. This recognition is also reflected by the large number of Principles for Responsible Investment (PRI) signatories, which represent more than $120 trillion of assets under management (that is, roughly 50 per cent of the value of the global equity and bond markets).[1] Climate change has been the driving force behind sustainable investment. In the lead up to the 2021 United Nations Climate Change Conference (COP26), the Glasgow Financial Alliance for Net Zero (GFANZ) managed to gather members with $130 trillion in assets around the goal of accelerating the decarbonization of the economy through the financial sector.

Sustainable investment attracted record-level flows in 2021. In the debt market, sustainable bond issuance doubled in 2021, with green bonds exceeding $600 billion and social bonds gaining importance (see figure 1). The global outstanding amount of sustainability-labelled bonds is now over $2.5 trillion.[2]

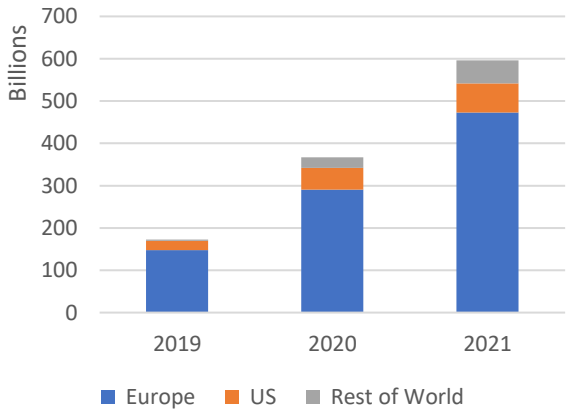
Developing countries accounted for 22 per cent of green bond issuance in 2021 versus 16 per cent the previous year,[3] but issuance remains limited in lower-income countries.[4] Meanwhile, sustainability-themed funds have continued their exponential growth, with a net inflow of about $600 billion in 2021 (a 62 per cent increase compared to 2020 – see figure 2). Total assets in these funds exceeded $2.7 trillion at the end of 2021. This trend is expected to continue. A survey indicates that investors want to double the share of their assets invested sustainably between 2020 and 2025 – from 18 to 36 per cent.[5]

Figure 1
Sustainable bond market issuance
(Billions of United States dollars)



Source: BloombergNEF, Bloomberg LP.

Figure 2
Global sustainable fund flows
(Billions of United States dollars)



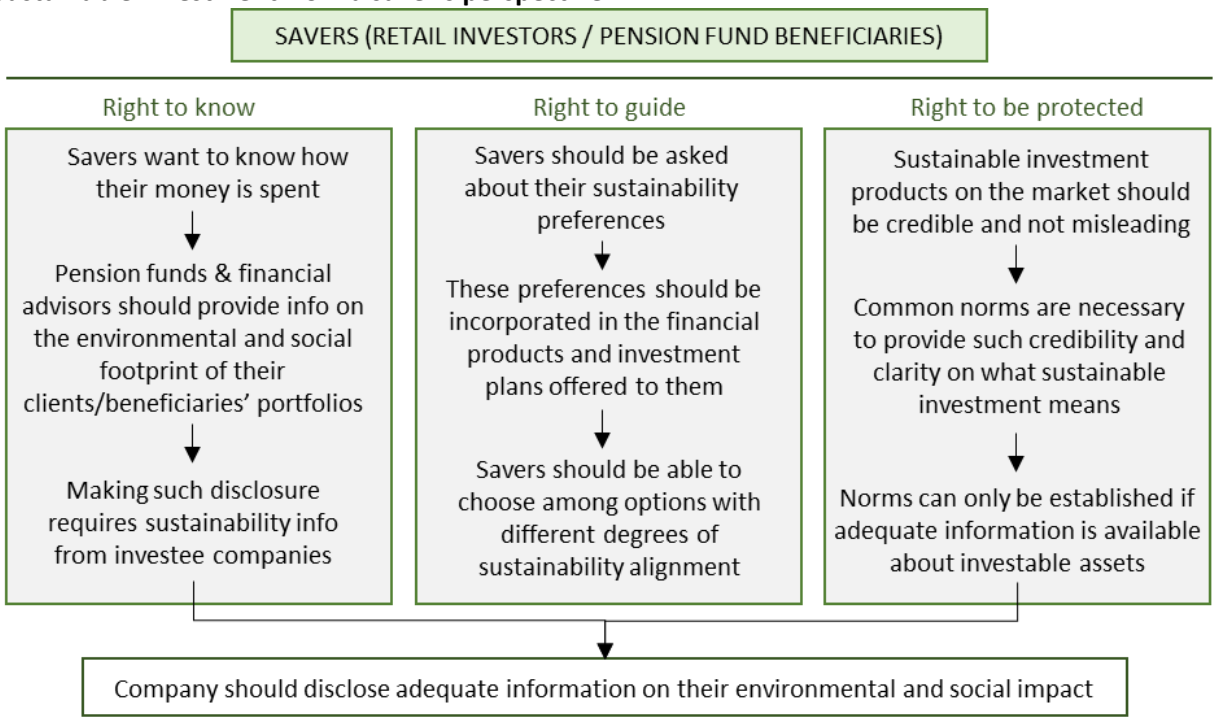
Source: Morningstar.

While these developments represent major breakthroughs and could give the impression that the market has found the solution to combine profit with positive impact, the reality is more complex. Most investors that have invested in products marketed as sustainable have done so because they believe integrating environmental, social and governance (ESG) issues into their investments could lead to greater financial returns or will not affect returns while providing a feel-good sentiment. In other words, ESG investment strategies were not designed to go beyond financial returns. In the European Union, the legislator has created a distinction between funds that explicitly integrate sustainability into the investment process (the so-called Article 8 funds) from those that have sustainable investment as an objective (the so-called Article 9 funds). The latter represent only around 4 per cent of total European Union investment funds, while Article 8 funds account for about 30 per cent.[6] The Global Investors for Sustainable Development (GISD) Alliance has also introduced a definition of sustainable development investing (SDI). The SDI definition outlines criteria that investment should meet to qualify as making a positive contribution to sustainable development, de facto creating a norm against which sustainable investments can be assessed.

Policymakers can explore several avenues to increase the impact of sustainable investment practices (see figure 3). First, they can act to improve companies' transparency about their impact on sustainability issues. Second, they can intervene to protect the rights of retail investors and pension fund beneficiaries to know how their money is being spent by those managing funds on their behalf (e.g., pension fund managers), including whether funds are invested in companies with positive or negative impacts on social and environmental issues. Third, they can ensure that savers are offered financial products and strategies that match their true preferences. Fourth, they can take measures to prevent investment products (e.g.,

exchange-traded funds) from being marketed as sustainable if they are misleading investors about their stated impact.

Figure 3
Sustainable investment from a saver's perspective



Source: UN/DESA.

2.1 Investor regulations

There is evidence that individual investors' interest goes beyond financial performance. A 2020 survey in the United Kingdom found that 80 per cent of pension fund members wished for their pension to do some good (up from 69 per cent in 2018).[7] A survey in the Netherlands found that two thirds of pension fund participants were willing to expand the fund's engagement with companies based on selected SDGs, even when they expected engagement to hurt financial performance.[8] Four out of five Australians wished for their super fund and their bank(s) to communicate the impacts – positive and negative – that their money is having on people and the planet.[9] These surveys demonstrate that investors are not only interested in sustainability issues to enhance their financial performance, but also as goals in and of themselves.

Yet, savers and pension fund beneficiaries are not systematically asked about their sustainability preferences. In the United States, a small majority of investors (56 per cent) have been asked by financial advisors about their goals beyond financial performance, and 59 per cent have knowledge of sustainable investment options offered in employer-sponsored retirement saving plans.[10] The picture is similar in other markets. In a survey across 24 countries, only 59 per cent of surveyed individual investors said their financial advisors had spoken to them about ESG investments.[11]

Several reasons might explain financial advisors' lack of engagement. First, advisors generally have no legal obligation to ask these types of questions as part of their requirements to understand clients' investment risk preferences and profiles. Second, unsupported fears that sustainability preferences could impair financial performance could result in hesitancy to proactively ask clients about their sustainability preferences, especially if advisors' fees are linked to financial returns. A recent survey showed that 43 per cent of advisors who did not currently invest in ESG believed that ESG-branded products perform worse.[12] Third, the absence of standards to define what constitutes a sustainable investment creates confusion for financial advisors. About 80 per cent of financial advisors find it challenging to explain ESG concepts to their clients;[13] the lack of familiarity with ESG is holding back advisors' engagement.

Legislators can amend rules to permit or require institutional investors and advisors to adjust their investment practices to their clients' sustainability preferences. Some jurisdictions are ahead of others in this regard. For example, in the European Union, regulations have been updated to ensure that wealth and portfolio managers incorporate clients' sustainability preferences in the recommendations they provide.[14]

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

- First, regulators should make it unequivocally clear that this duty encompasses the need to consider sustainability considerations as some of these considerations will impact financial performance, especially in the long term (see *Financing for Sustainable Development Report 2019*, pp. 54-55);
- Second, regulators should introduce discretions that allow investors to pursue sustainability goals that reflect beneficiary preferences. For example, if they have enough evidence, regulators could introduce a presumption that each investor wishes for their money to be managed in ways that achieve certain sustainability goals.[15]

Concretely, regulatory changes can target:

- **Transparency in terms of asset allocation and investment decision –** Institutions managing funds on behalf of others currently disclose information on how their funds have been invested. Yet, the way they disclose sustainability-related information about their funds is largely left up to the discretion of the institutional fund managers, although this is rapidly evolving with emerging regulation and industry-led guidance, such as the European Union Sustainable Finance Disclosure Regulation (SFDR) and the CFA Institute's Global ESG Disclosure Standards for Investment Products. Concretely, policymakers could require fund managers to consistently disclose the environmental and social footprint of their clients' portfolios, including both the disaster risk to which they are financially exposed and those that they are creating, and the ways they have taken sustainability issues into account in their investment decisions;
- **Consistency in engagement practices –** Institutional investors could be required to report on how they engage with current or potential investees and use their influence, including with policymakers, to encourage positive changes on environmental and social issues. Stewardship codes have been introduced in 22 jurisdictions to formalize expectations concerning investors and encourage greater transparency on investors' stewardship activities (e.g., voting at shareholder meetings and filing of shareholder resolutions/proposals).[16] These codes can ensure that activities by investment managers reflect asset owners' sustainability concerns. Despite these codes,

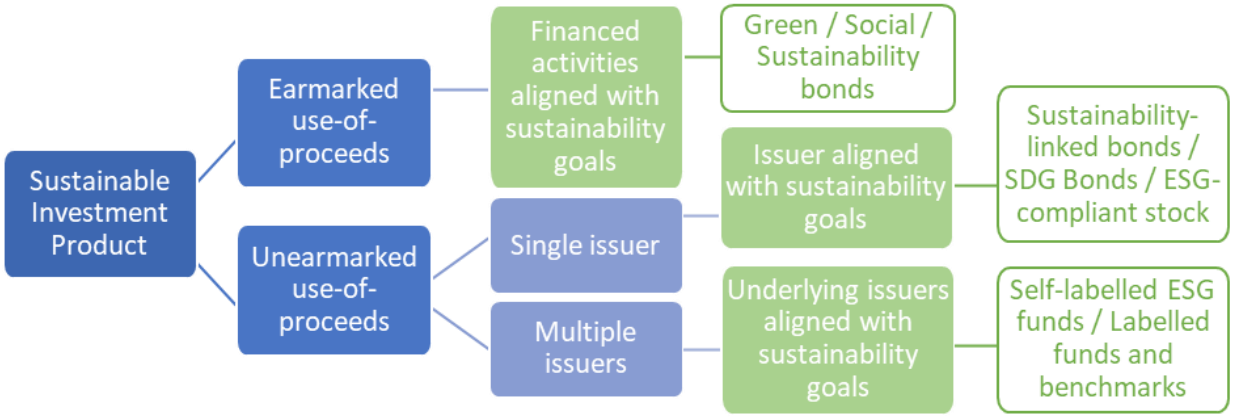
actions by asset managers often diverge from what one would expect. A recent analysis of the voting records of three major asset managers shows that they more often oppose rather than support shareholder resolutions aimed at improving environmental governance of major polluting companies.[17] The Global Investors for Sustainable Development Alliance is trying to address this issue by developing a model mandate that asset owners can use as the basis for negotiating mandates with their asset managers and ensuring that their expectations in relation to sustainability and stewardship are well reflected in investment management agreements;

- **Provision of sustainability-aligned investment alternatives –** In the United States, the Department of Labor, which oversees retirement plans, is proposing to make it easier for employers to offer options in those plans that incorporate ESG factors in investment decisions.[18] Policymakers could consider going a step further and making it mandatory for employer retirement plans to always include, among the possible investment alternatives, one focused on achieving positive impacts on sustainable development.

2.2 Sustainable investment products

Once sustainability preferences are established, the challenge is to put them into practice in a credible way. To meet the demand for sustainable investment, capital market participants have created a range of investment products with sustainability features. Figure 4 outlines the main categories. For policymakers and savers, it is important to understand whether these products are based on sound methodologies and are likely to achieve a positive impact on sustainability issues.

Figure 4
Capital market and sustainable investment products



Source: UN/DESA.

2.2.1 Use-of-proceeds bonds

Green, social and sustainability bonds are debt securities that aim to finance earmarked green or sustainable activities. Over $1 trillion of these bonds were issued in 2021 by corporates, development banks, government-backed entities and sovereigns, among others. In 2014, the International Capital Market Association (ICMA) created the Green Bond Principles (GBP) to recommend a clear process and disclosure for issuers that ensures transparency, tracking and reporting on the use of green bond proceeds. ICMA principles and guidelines were subsequently extended to cover social and sustainability bonds. Specific thematic guidance has also been developed to assist issuers in incorporating gender-equality considerations into social and sustainability bonds in a credible and measurable way. [19] In parallel,

regulators and market-led approaches have emerged to create taxonomies that identify eligible activities for these instruments.

Despite existing principles and taxonomies, the credibility of some green and other sustainability bonds could be enhanced by requesting a certain level of sustainability alignment from the issuer. Companies issuing green bonds may not be aligned with climate goals nor improve their sustainability performance over time. A green bond label certifies that the activities financed are green but does not guarantee the greenness of the firm issuing the bond. Research has shown mixed results on whether green bond issuers reduce their carbon emissions over time faster than other companies.[20] Nonetheless, guidance is evolving. The 2021 edition of GBP recommends heightened transparency for issuer-level sustainability strategies and commitments, although it falls short of requesting company alignment with sustainability goals as a condition for green bond issuance. This alignment could be verified by requesting a minimum rating based on the issuer's carbon emissions or limiting the issuance of green bonds only to companies on a sustainability-aligned trajectory.

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

2.2.2 General corporate purpose bonds

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

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

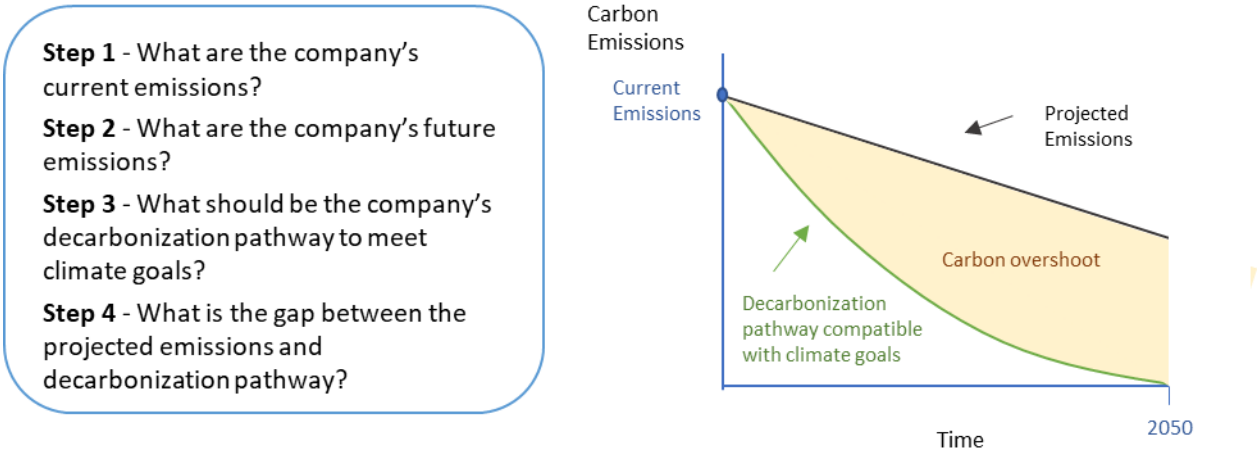
Market participants could also consider creating a new type of bond based on the issuer's overall sustainability performance. For example, one could consider labelling SDG bonds as those issued by companies aligned with the SDGs to differentiate them from those issued by other companies. Similarly, transition bonds could be bonds issued by companies on a credible decarbonization pathway. However, this necessitates having robust methodologies for assessing corporate alignment with the SDG and climate goals (see section 2.3 and box 1).

Box 1
Transition finance and decarbonization pathways

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

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

Figure 5
Steps for computing an implied temperature rise score



Source: UN/DESA.

Figure 5 highlights the different steps for assessing a company's temperature alignment, with Step 4 being conversion of the company's carbon overshoot into a single temperature metric, which indicates the global warming a company is aligned with (e.g., 2 or 4 degrees Celsius).

At each step, decisions need to be made that can influence the outcome. This explains the discrepancy in the methodologies' results.[21] For example:

- Step 1 involves deciding whether to include only emissions from a company's operations (referred to as Scope 1 and 2) or to also include emissions from its value chain (Scope 3) (see *Financing for*

Sustainable Development Report 2021 box III.B.2 for analysis on this issue). The targets should also be decided in Step 1: i.e., reduction in absolute emissions or in carbon intensity per product output/value added;
- Step 2 requires making forecasts, which could be based on past emissions or company targets;
- Step 3 necessitates choosing among different climate scenarios and decarbonization rates. Decarbonization could, for instance, be sector-specific or sector-agnostic. The latter implies that all companies should reduce their emissions at the same pace regardless of their sector of activity.

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

2.2.3 Self-labelled and labelled funds

A third category of sustainable investment are funds branded as sustainable. ESG funds and strategies fall into this category and both have proliferated over the last few years. These funds tend to be self-designated labels with little transparency or consistency in the approach they use to decide which securities are selected and how ESG issues affect the fund's composition. This raises an elevated risk of green/SDG-washing. Regulators are taking note. For example, the U.S. Securities and Exchange Commission (SEC) and German regulator BaFin opened an investigation to check whether an asset manager was overstating its sustainability claims.[22] Similarly, Morningstar, a data provider, has decided to remove 1,200 funds worth $1.4 trillion from its list of European sustainable investment funds after reviewing disclosures provided by these funds.[23]

There are two ways to reinforce this market's credibility:
- **The first is to promote robust practices by investors marketing sustainable investment.** Principles and standards have emerged for this reason. For example, the Operating Principles for Impact Management provide a framework for the design and implementation of investors' impact management systems. Organizations can also use the United Nations Development Programme's SDG Impact Standards to design their internal processes, practices and decision-making to make positive contributions to sustainable development;
- **The second is to define criteria for the type of underlying assets included in the funds**. These criteria can include a series of screenings (absence of controversies, best-in-class ESG practices, compliance with the United Nations Global Compact principles, etc.), such as those recommended in the GISD SDI definition. These criteria can also be more prescriptive, as seen with the French GreenFin label, which requires funds invested in unlisted securities to have at least 75 per cent of assets under management invested in "GreenFin companies" (i.e., companies for which eco-activities represent at least 50 per cent of turnover – a taxonomy is used to define what these eco-activities are).

International collaboration is key to avoid a multiplication of labels and conflicting regulatory burdens for investment managers. If regulators opt for a siloed approach, financial markets will become more fragmented. For example, it would be useful to find ways to globally harmonize how investment managers should disclose information about how they incorporate sustainability issues in their products. Similarly, it would be good to agree on common global principles for funds marketed as sustainable. These principles

could build, for example, on the high-level, voluntary principles put forward by the G20 Sustainable Finance Working Group (SFWG) for approaches to align investment with sustainability goals. Some jurisdictions may opt to go further than others, or adapt to regional circumstances, but the establishment of a global baseline will at least ensure a minimum level of convergence and interoperability amenable to investors.

2.3 Principles, norms, ratings and taxonomies for sustainable business

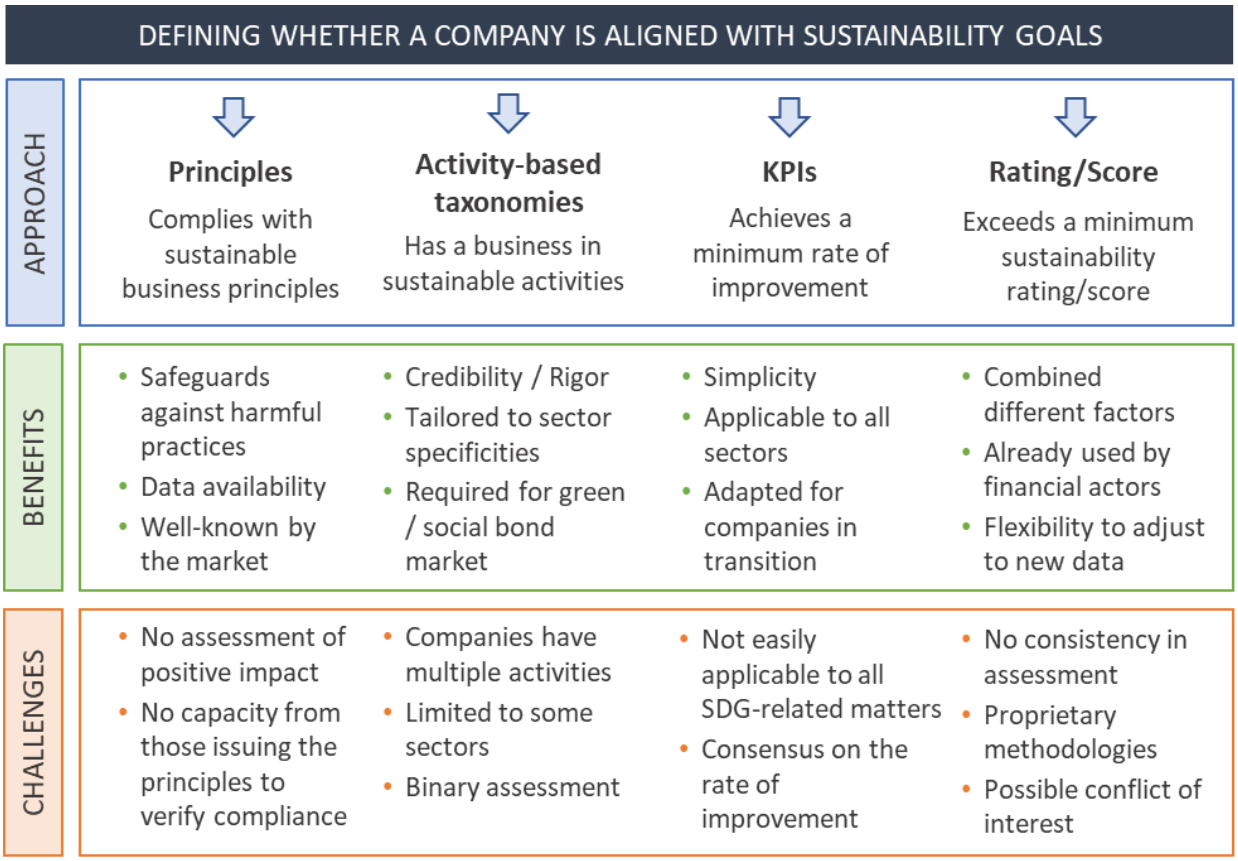
A major challenge with sustainable investment products is to ensure that the underlying assets they finance are compatible with the sustainable objective pursued. This means determining what assets can be considered as sustainable. The success of green bonds is due to the relative simplicity of this determination. But assessing the "sustainability" of a company with multiple activities in different sectors is more complex. Nonetheless, this is necessary to provide credibility for sustainable investment products that are not linked to specific use-of-proceeds. This assessment can also provide investors with information on the sustainability footprint of their portfolios. Figure 6 outlines different approaches, which are sometimes combined, to assess the sustainability of a company.

These approaches check whether a company:

- **Complies with high-level, sustainable business principles**. For example, does a company comply with the 10 principles of the United Nations Global Compact, United Nations Guiding Principles on Business and Human Rights, and OECD Guidelines for Multinational Enterprises? These principles provide a reference to check whether companies, at a minimum, meet fundamental responsibilities in the areas of human rights, labour, environment and anti-corruption. Data vendors provide information on whether companies comply with these principles so they can be relatively easily integrated into investment practices. The main issue is that business principles often focus on limiting harmful practices and do not provide information on the positive contribution of these companies to sustainable development. As such, they are more a necessary than a sufficient condition for a company to be considered as contributing to sustainable development;
- **Does business in sustainable activities.** This can be assessed by checking whether a company has revenues, capital expenditures (Capex) or operational expenses (Opex) in activities included in a sustainable taxonomy. For example, large companies in the European Union are requested to disclose the extent to which their activities are environmentally sustainable according to the European Union Taxonomy, while also assessing whether their activities "do no significant harm" to other environmental objectives. This approach allows for rigorous assessment, but it creates challenges, for example, for companies with multiple activities and a global presence, and for sectors falling outside the scope of a taxonomy. This methodology also requires significant data that might not be available in many markets;
- **Achieves a minimum rate of improvement on KPIs.** Instead of specifying criteria by sector, this approach selects an indicator for a defined sustainability matter that can be applied to all companies. A representation of this is the European Union benchmark regulation that requires companies to be on a decarbonization trajectory in order to be included in the benchmarks (for equity securities, the trajectory is set at a minimum 7 per cent reduction of greenhouse gas intensity on average per annum). Similarly, one could consider that companies need to demonstrate a minimum yearly progress rate on the gender balance in their enterprise in order to be compatible with SDG 5 on "Gender Equality".[24] However, finding suitable KPIs for all sustainability matters might be challenging, and so is finding an agreement on the appropriate improvement rate;

- **Exceeds a minimum sustainability rating/score**. One could assume that funds with sustainability objectives should only include companies above a predefined sustainability rating/score. The challenge is that raters do not agree in their assessment of sustainability. One company could be ranked high by one provider and low by another. The correlation among six major providers of ESG ratings is low (54 per cent on average) at the level of aggregated ESG scores (i.e., the scores combining several indicators into a single rating).[25] There is also confusion as to what these ratings are measuring. Most ESG/SDG ratings and scores initially started by assessing ESG risks that companies face in their day-to-day operations, but this does not provide the information needed in order to ascertain if a company contributes positively to sustainable development. This assessment is difficult given the trade-offs that there may be between different goals. More recently, several tools have been developed to measure the impact of companies in relation to the SDGs as well as the alignment of companies with climate goals (see box 1). Greater transparency, comparability and reliability of data and methodologies are necessary to transform ratings of corporate ESG/SDG performance into an objective practice that can be used as a reference for market norms for sustainable investment products.

Figure 6
Approaches to assess company alignment with sustainability goals



Source: UNDESA

2.4 Corporate sustainability disclosure

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

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

- **Mandatory vs. voluntary** – Voluntary reporting has shown its limitations with many companies selectively choosing the issues they want to report on. Comparability across companies can only be achieved if sustainability reporting becomes mandatory. Although several jurisdictions are moving from voluntary to mandatory corporate sustainability reporting, many are limiting such mandatory reporting to climate-related issues, leaving other sustainability matters unaddressed;
- **Public vs private markets** – Sustainability disclosure regulations often apply only to listed companies although certain jurisdictions require disclosure from all companies above a certain size. This is problematic since privately held companies represent the largest chunk of the economy, especially with the growing role of private equity funds. There could be a risk that public companies sell their carbon intensive assets to private equity and sovereign funds or state-owned companies that do not have the same transparency requirements. In the past two years, private equity funds acquired $60 billion worth of oil, gas and coal assets, more than they invested in renewables.[26] Pressure from investors committed to sustainability objectives may be able to partially address this issue. Recently, some of the world's largest investors and fund managers, representing more than $4 trillion in assets under management, came together to agree on six key sustainability issues that they will request all the companies they invest in to report on in a harmonized manner.[27] Private equity fund managers will be responsible for collecting this information;
- **Single vs. double materiality** – Some argue that a company should only report sustainability information that affects its financial performance (i.e., financial materiality); while others believe that companies should also disclose information on their impacts on society and the planet even if these may not have a direct financial impact on the company (i.e., environmental and social materiality). For example, in the case of water, a financial materiality lens would mean assessing whether the local community can provide enough water to a company to operate; while a broader materiality lens will assess whether a company is putting the local water supply under stress. In reality, it is difficult to draw a line between these two concepts as it might not be easy to

demonstrate the financial or non-financial materiality of a sustainability matter in the absence of adequate data. Even when data exists, it might be difficult to define the difference with certainty, since some issues might not be financially material today but could become material in the future due to changes in regulations, long-term impacts or consumer preferences (i.e., dynamic materiality). A practical approach would be for policymakers to decide what issues are important to them (in line with country SDG needs and priorities) and require corporate disclosure on those issues, leaving the market to decide which ones they consider material for investment purposes.

2.5 Policy incentives

Financial markets can accelerate a sustainable transformation of the private sector, but only if the rules of the game also change (see *Financing for Sustainable Development Report 2021*, pp. 60-62). If it is profitable to run an unsustainable business, companies are less likely to change their practices. Policymakers have several levers with which to align sustainability and profitability. They can prohibit activities with negative impacts (e.g., single-use plastics), price negative externalities (e.g., carbon pricing mechanisms) or subsidize activities with positive impacts (e.g., energy-efficient buildings, clean vehicles or investment in low-income neighbourhoods). [28] They can also promote business models and opportunities with a positive impact on sustainable development.[29] While doing so, Governments should assess how the proposed regulations for sustainability will affect smaller firms.

Policymakers can also support the demand for sustainable investment products through tax incentives and other regulatory measures. If one can assure that sustainable investment products have a credible, positive impact on development, then Governments could consider providing tax incentives for these investments, for example, by linking the tax deduction rate for pension plan contributions to the plan's sustainability performance. Central banks also have the means to support demand for sustainable investment products. The People's Bank of China decided in 2018 to include green financial bonds as eligible collateral assets for its Medium-Term Lending Facility. The policy is estimated to have created a spread of 46 basis points between green and non-green bonds.[30] The design of the sustainable finance approaches and tools should be considered to ensure that they incentivize investment in developing countries, which is the focus of the next section.

2.6 Implications for developing countries

Developed country approaches to sustainable investment may have unintended consequences if not enough attention is paid to developing country constraints. Channelling institutional capital to developing countries can significantly fill the sustainable development financing gap. Research from Morgan Stanley shows that global investors allocate just 6 to 8 per cent of their portfolios to emerging markets. However, fundamental analysis suggests that an ideal equity portfolio would include from 13 to 39 per cent of emerging markets exposure.[31] The current limited allocation may be due to home bias or risk misperception. While sustainable finance holds some promise for increasing alignment, it also presents constraints for developing countries, although the degree to which constraints occur varies based on factors such as domestic capital market depth.

These constraints include:

- **Absence of data**. Taxonomies, labels and other tools ostensibly apply to investors domiciled and regulated in developed country jurisdictions, but many of these investors have global investment mandates that cover developing countries. The lack of verifiable data could mean that investors are unable to account for the sustainability of investments in developing countries with the same

degree of certainty as investments made in developed countries. For example, investors could struggle to determine the level of taxonomy alignment for investments located in developing countries, which could de facto be considered as non-aligned. One way to address this issue is to allow investors to use estimates for assessing the taxonomy-alignment of their exposures to undertakings established in a third country or allow references to local taxonomies designed with similar principles and objectives;

- **Relative lack of capital market development**. While different avenues exist through which developing countries can attract investments, developed capital markets offer the liquidity, scale and diversification expected by institutional investors. For instance, institutional investors look to allocate at least $150 million per debt investment and $50 million per equity investment – thresholds not easily exceeded outside of capital markets.[32] As long as some developing countries have undeveloped or underdeveloped capital markets, large institutional investors will struggle to direct funds to investments located in these countries. Sustainable finance policies applied to institutional investors in developed countries will therefore not affect these countries to the same degree as developing countries with greater capital market development. Nonetheless, investors can rely on other vehicles – such as impact-driven private equity funds that invest directly in private companies – even if those funds do not offer the liquidity benefit of capital markets;
- **Current focus of ESG on risk management.** Is sustainable investing about managing risks or creating positive impacts? The difference in these two approaches cannot be more striking than in the case of developing countries. If the focus is on managing risks, taking ESG issues into account is likely to disincentivize some investments in developing countries. Indeed, developing countries face a range of climate-related and other transition risks that leave them more exposed than developed countries. These risks are already incorporated into risk assessment. According to Moody's, 60 per cent of its sovereign credit ratings of developing countries are currently negatively affected by ESG considerations.[33] In the short term, this narrow focus on risk is more likely to increase the cost of financing for developing countries. On the other hand, if ESG/SDG investing is about creating a positive impact, then investors should target investments in countries with higher needs where their impact will be greater. This is not yet happening. Moreover, it seems that sustainable funds actually have less exposure to emerging markets then non-sustainable funds.[34] Asset managers may be incentivized to increase exposure to developing countries if they receive an impact mandate from their clients or if the expected financial returns are commensurate with the risks.

Donors and international organizations should raise awareness regarding the actions that developing countries can take to benefit from the sustainability shift in developed capital markets. Countries that are eligible for overseas development assistance or those that face the largest SDG financing gap hold only 4 per cent of global financial assets.[35] Therefore, they will largely depend on actions taken in more advanced economies. At the same time, developing countries with more developed capital markets may wish to deploy their own sustainable finance policies and approaches. Capacity-building assistance from donors can also focus on integrating sustainable investment approaches in capital market development plans, while working at the regional/global level to avoid market fragmentation.

END NOTES

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