



## Chapter III.B



# Domestic and international private business and finance

## 1. Key messages and recommendations

**Private business activity, investment and innovation are major drivers of productivity, employment and economic growth.** Yet, efforts to increase private investment in the Sustainable Development Goals (SDGs) in developing countries, under way even before 2015, have not shown sufficient progress. Unlocking private business and finance is one of the greatest challenges to achieving sustainable development.

**As noted in chapter II, industrial policies aim to turn this around by stimulating investment and business activity aligned with the SDGs.** This includes policies that reduce risks for all firms by strengthening the enabling environment and that encourage investment in target sectors or areas. Ultimately, policy choices will be country-specific and tied to national priorities; however, they should support: i) the SDGs, and ii) areas of competitiveness and dynamism that can stimulate inclusive and sustainable growth.

**Much of the discussion on investment policies has focused on attracting foreign investment; but the analysis in this chapter highlights the importance of developing a dynamic domestic business sector.** Governments can create a thriving and sustainable business environment. In addition to addressing political and macroeconomic risks, this includes:

- Strengthening SDG-aligned legal and regulatory frameworks;
- Implementing or strengthening competition policies to ensure that firms do not stifle innovation, aggravate inequalities and poverty, or impede environmental goals;
- Providing infrastructure services essential for sustainable development and the functioning of the economy; despite many initiatives in this area, infrastructure gaps remain considerable between developed and developing countries;
- Addressing financial constraints, particularly affecting micro-, small- and medium-sized enterprises (MSMEs),

such as by harnessing technological advancements, e.g., to overcome data gaps in credit risk assessments by lenders.

**Building an enabling business environment, however, may not be sufficient to mobilize investment at the speed and scale required to achieve the SDGs, particularly in countries that are most in need and in sectors key for sustainability.** Identifying the types of financial instruments most likely to deliver results given the local context will require a proper assessment of the key constraints to investment. There are a range of policy tools that can help to overcome some of the impediments to private investment, as discussed in chapter II.

- For example, development banks (or public or semi-public venture funds) could support innovative companies by using equity-like instruments, with risks managed by diversification across companies.

**Well-developed infrastructure plans would also help to achieve the SDGs and provide an enabling environment.** Such plans should include adequate stakeholder consultations and incorporate climate impact, disaster risk assessments and resilience as well as gender assessments to provide a long-term vision. This vision will allow countries to avoid having costly stranded assets such as coal-fired power plants or essential infrastructure assets unable to function during and after disasters.

**Major changes are also required in the way that private business and finance works.** The need for a systemic change is evident from the lack of progress in many sustainable areas where companies have a large impact, including in reducing carbon emissions, promoting gender balance and addressing waste.

Business leaders are increasingly acknowledging that taking sustainability factors into consideration will be necessary to achieve long-term financial success and ensure the future

viability of their companies. Nevertheless, turning this awareness into action and addressing the impact of business activities on the SDGs and climate action require the following:

- **First, strengthening company sustainability disclosure.** Reporting requirements for large corporates need to include a common set of sustainable metrics regardless of their materiality impact;
- **Second, designing policy and regulatory frameworks in support of sustainable finance through regulations and/or policies that better link profitability to sustainability.** This includes public policies that support long-term decisions, such as pricing externalities and phasing out harmful subsidies. In addition, corporate governance models need to be adjusted to address the persisting short-termism in capital markets and better align internal incentives with the SDGs;
- **Third, making sustainable investing more credible, including fixing sustainability ratings.** Investment advisors should be required to ask their clients about their sustainability preferences along with other information they already request; and minimum standards are needed for investment products to be marketed as sustainable, following, for example, the definition of Sustainable Development Investing elaborated by the Global Investors for Sustainable Development (GISD) Alliance, which is used in this chapter.<sup>1</sup>

## 2. Private investment and finance for sustainable industrial transformation

**Weak investment in developing countries, following a widespread slowdown in investment growth over the past decade (see chapter I), risks dampening productivity growth and threatens countries' progress towards sustainable industrial transformation.** As noted in chapter II, sustainable industrial policies aim to turn this pattern around by stimulating investment and business activity aligned with the SDGs. As a first step towards reinvigorating investment, policymakers can aim to reduce risks to investment by strengthening the enabling environment, such as through a conducive legal and regulatory framework, investment in necessary infrastructure and access to credit. These are sometimes called horizontal policies since they affect all types of private investment across sectors. The second set of measures include policy instruments (such as public support for investment) that target sectors or areas for investment, sometimes called vertical measures, as discussed in chapter II.

**The challenge for governments is where to focus and how to prioritize these measures.** Ultimately, policy choices will be country-specific, tied to national priorities laid out in sustainable development plans, which can be supported by integrated national financing frameworks (INFFs). As all countries have committed to the SDGs, this should include *investments in SDG-related goals*, such as climate action and decent jobs that the market will not provide on its own. But the choice of instruments will also depend on market structures and the types of firms in the economy, with the goal of *supporting activities with the potential for competitiveness and dynamism* that can lead to productive growth aligned to the SDGs.

This section lays out a simple heuristic to guide thinking on aspects of appropriate regulatory frameworks and potential directions for interventions.

### 2.1 Global foreign direct investment momentum weakened significantly in 2022

**Global foreign direct investment (FDI) momentum weakened significantly in 2022, with downward pressure on investment increasing after the first quarter.** While data for aggregate FDI trends for 2022 is not yet available, new investment project numbers, including greenfield announcements, international project finance deals, and cross-border mergers and acquisitions (M&As), all started falling from the second quarter of 2022 (see figure III.B.1).

**International project finance and cross-border M&As were affected by deteriorating financing conditions, rising interest rates and increasing uncertainty in financial markets.** The global value of international project finance deals fell by over 30 per cent in 2022.<sup>2</sup> Greenfield project announcements also fell after the first quarter of the year but increased by around 6 per cent for the full year due to several megaprojects and an increase in average project size in the renewables sector. Three of the 10 largest announcements concerned chip factories, in response to global shortages and supply chain restructuring trends. Six of the top 10 project announcements were in renewables.

**The increase of FDI in renewable energy, in part due to the energy crisis, could be at risk.** In 2021, climate change investments accelerated, particularly in renewable energy, supported by COVID-19 stimulus investment packages, still-loose financing conditions and high energy prices. This momentum may now be at risk. In 2022, international investment in climate change mitigation and adaptation shrank in value terms and in project numbers (see figure III.B.2). While the higher number of greenfield megaprojects in renewables is encouraging, international project finance in the sector—the bulk of climate change mitigation investment in recent years—is suffering, and concentrated in developed countries, with Europe alone accounting for more than half of all renewable energy projects.<sup>3</sup>

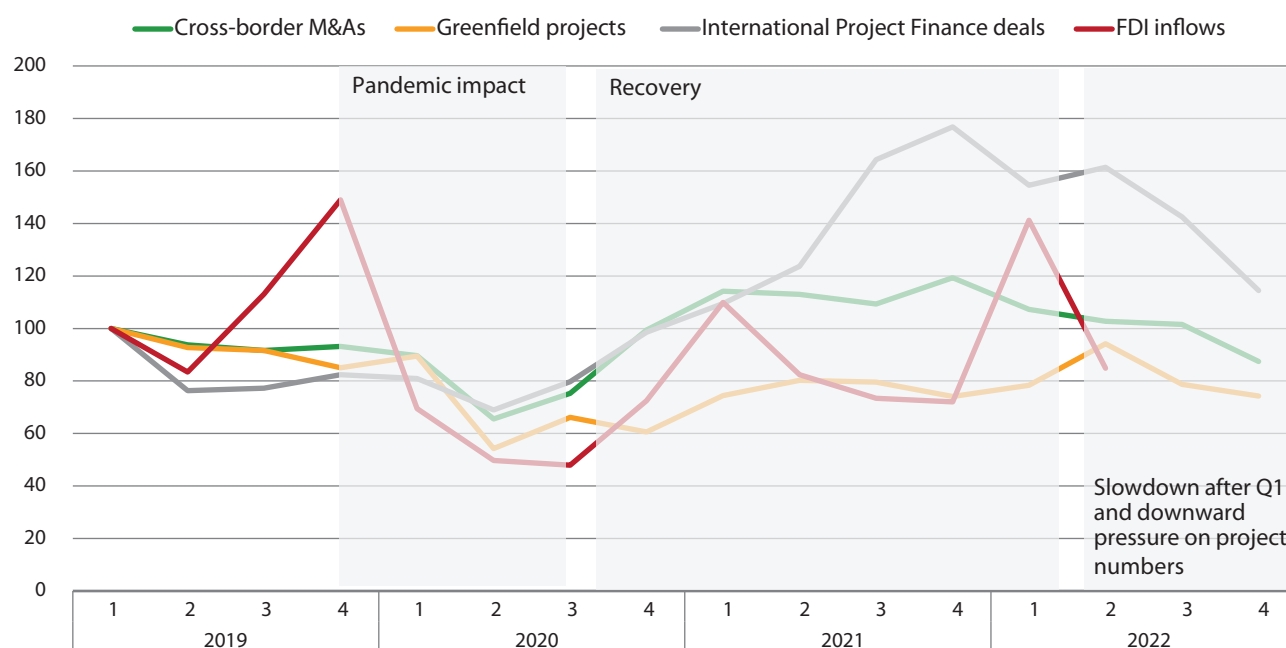
**At the same time, there is also a risk that high oil and gas prices could slow down investments in the energy transition.** For now, the downward trend in investment is also affecting extractive industries and fossil-fuel-based energy generation, with project numbers in these sectors about 16 per cent lower in the first three quarters of 2022. Yet, the high profits of multinationals in these sectors could lead to a renewed push for investments. An early indication is the value of cross-border M&As in the extractive industry, which rose six-fold in the first three quarters of 2022.

**Beyond climate change mitigation and adaptation, the recovery of SDG investment after the 2020 slump remains fragile.** In developing countries, the number of projects across all SDG sectors (including sustainable infrastructure, food security, water and sanitation, and health, among others) increased by about 3 per cent, while values shrank slightly. International investment in agriculture and agribusiness remained stagnant at low levels.

### 2.2 The roles of public and private investment

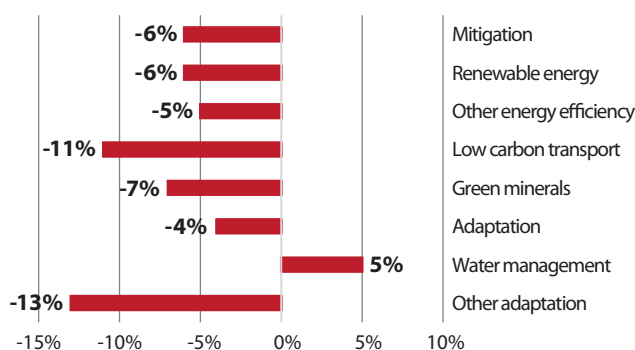
**In general, businesses aim to maximize financial returns.** While a growing number of institutions have double or triple (social

Figure III.B.1  
**Investment trends, 2019–2022**  
 (Indexed, 2019: Q1=100)



Source: UNCTAD, Global Investment Trends Monitor, Issue 44.

Figure III.B.2  
**Climate change investment: greenfield project announcements and international project finance deals, 2022 vs 2021**  
 (Percentage change in project numbers)



Source: UNCTAD, Global Investment Trends Monitor, Issue 44.

and environmental) bottom lines, the large preponderance of private business activity remains profit driven. The goal, however, is generally not to invest in the highest returning asset but rather to invest in well-compensated risks. As a result, the private sector will demand a very high premium for projects perceived as risky and will likely underinvest in public goals when the expected return underperforms other investment opportunities (on a risk-adjusted basis). Hence, it is important to recognize upfront that i) public financing will be necessary for some

public goods; and ii) public policies need to support private investment in many areas of public need.

**Both private and public investments and actions are needed for SDG progress, with the specific roles depending on project, sector and country characteristics.** Previous Task Force reports have highlighted several factors to consider in determining the combinations of private and public ownership, operation and financing of projects, and investments. These include: (i) whether investments will become sufficiently profitable to compensate private investors for the risks they bear; (ii) whether investments produce goods or services that will be effectively supplied by the market, or whether there are public goods to consider, such as whether public intervention is warranted for social equity reasons (or whether the private activity is producing externalities such as carbon emissions that are not reflected in private investors' financial returns); and (iii) whether private investors can bring efficiency gains through the profit incentive.

**Public policy support and interventions may be called for in support of private business activity, including in technological learning and achievement of social and environmental goals.**

A dynamic private sector is not only central to economic growth; it can also contribute to social objectives, especially decent job creation. But unlocking private sector contributions to some sustainable development objectives may require policy support. Firms may not adopt low-carbon technologies and may even cause environmental harm because of market incentives or competitive pressures. They may not invest in technologically dynamic activities or target export markets because they lack the necessary capabilities, or because they are faced with significant external challenges—e.g., poor infrastructure or lack of financing.

There are two primary types of policy interventions: i) policies to improve enabling environments for firms and investments that contribute to sustainable development (e.g., by improving infrastructure, access to credit, governance and policies to internalize externalities such as through carbon pricing); and ii) policies that provide targeted support to firms (e.g., investments in climate action and innovation), with the goal of making investments just profitable enough to compensate private investors for the risks they bear. In these public initiatives, it is important to preserve incentives that reward successful entrepreneurship.

**INFFs, along with technical support, can help developing countries to determine the most cost-effective capital structure for projects and align the private sector with broader development objectives.**

INFFs can help policymakers to highlight areas for private ownership, operation or financing; and technical support can help countries to build institutional capacity for project planning, preparation and negotiation. INFFs can also help countries to prioritize public support across the many different types of projects and businesses, with varying degrees of SDG impact.

**2.3 The many facets (and impacts) of private business and investment**

**Company behaviour and investments are shaped by market structures and competition—which policy support has to consider.**

Competition is a major driver of innovation. Firms with market power (i.e., monopolies and oligopolies) often have less incentive to innovate. These firms can also have negative impacts on social goals, such as inequality and poverty, e.g., by charging high prices for necessary goods. Economic power can also translate into political power, with firms pushing back against regulation, such as environmental regulations. In contrast to firms with market power, other domestic firms may lack the capabilities to succeed in some of the highly competitive and dynamic sectors that support the SDGs. Policy intervention may be needed in both cases—in both highly competitive and uncompetitive environments—but would differ significantly.

**As a simplifying heuristic,<sup>4</sup> and to structure policy options, we divide firms into those with market power and those that operate in more competitive markets.** Since some firms that have market

power domestically are competitive globally, we further categorize firms by whether they predominantly target domestic or global markets (see table III.B.1). This creates four overarching categories:

- a. **Monopolistic/oligopolistic but export-oriented** firms export high-rent products, such as raw minerals or agricultural commodities. These firms are often larger (particularly in mining and fuel) and foreign owned, though there are also examples of publicly owned commodity trading companies (e.g., Botswana’s Diamond Trading Company);
- b. **Domestic monopolies/oligopolies** are companies that primarily serve the domestic market and enjoy a dominant market share for their product or service, often in conjunction with government regulation. Examples include utilities, some financial sectors, real estate and oligopolistic manufacturing sectors;
- c. **Non-tradable/domestic** firms include a wide variety of entities, from large “national champions” to MSMEs as well as informal businesses and other firms focusing predominantly on domestic markets in more competitive settings. Business activities cover many goods or services that are not exported;
- d. **Global value adders** export products or services, e.g., export-oriented manufacturing or tourism. This does not mean they do not also sell locally, but their business model is oriented to compete in international markets. This grouping also encompasses a wide range of firms in terms of size and ownership, from local start-ups and family owned SMEs to large, foreign-owned multinational enterprises.

The boundaries of these categories are not static, as policymakers can shift them, e.g., through competition policy. Most firms seek to achieve market power (so that they can charge higher markups)—and sometimes they succeed, either through innovation or policy support. Competition policies aim to ensure that such positions do not become entrenched. There are also many examples of firms (and industries) that develop from “non-tradable domestic” to “global value adders”, such as film production and distribution companies in Nigeria (Nollywood), the J-Palm consortium in Liberia,<sup>5</sup> and Infosys, an Indian technology and business services company that increased its annual revenue from \$200 million in 2000 to over \$10 billion in 2018.<sup>6</sup>

	High rent	Competitive
Export oriented	<p><i>Monopolistic exporters</i></p> <p><i>Economic:</i> large contributors to GDP in many countries; royalties/taxes (but also tax avoidance); often limited spillovers to the rest of the economy; balance-of-payments support (but also risk of Dutch Disease)</p> <p><i>Social:</i> greater potential for corruption</p> <p><i>Environmental:</i> often risk of air, water, land pollution</p>	<p><i>Global value adders</i></p> <p><i>Economic:</i> can be engines of productivity growth and innovation/including linkages with other firms; potential diversification of the economy; balance-of-payments support</p> <p><i>Social:</i> potential to create decent jobs and human capital development</p> <p><i>Environmental:</i> impact from GVCs</p>
	<p><i>Monopolies/oligopolies</i></p> <p><i>Economic:</i> limited innovation</p> <p><i>Social:</i> risk of generating inequality; potential for corruption</p> <p><i>Environmental:</i> risk of air, water, land pollution (depending on sector)</p>	<p><i>Non-tradable domestic</i></p> <p><i>Economic:</i> broad-based economic activity; includes dynamic innovators as a driver of growth</p> <p><i>Social:</i> in many countries, driver of job creation and poverty reduction (but jobs can be low-paying/insecure); links with local communities</p> <p><i>Environmental:</i> includes potentially polluting informal activities outside of regulatory framework</p>



**“Monopolistic exporters” such as commodity producers can represent a large share of GDP and tax revenues—though without appropriate policy frameworks they rarely give rise to broad-based sustainable development.** Commodity exports also support countries’ balance of payments,<sup>7</sup> though this reliance can create obstacles to economic diversification, e.g., through the Dutch Disease (in which commodity exports raise the currency value, making investments in other areas of the economy uncompetitive even if those sectors could potentially have a more positive impact on productivity growth and employment). Sectors such as mining and agriculture tend to have relatively low employment and productivity growth.<sup>8</sup> Countries that rely on commodity exports—particularly in agriculture—also tend to have lower rates of technological adoption and innovation. In many developing countries, commodity exporters tend to be highly influential with governments because they are among the largest taxpayers (e.g., Firestone in Liberia, Chevron in Nigeria and BHP Billiton in Bolivia), though they also engage in tax avoidance. Furthermore, they do not, on their own, create sufficient business linkages to induce broader private sector growth.<sup>9</sup> Moreover, intensive commodity extraction and trade often cause or accelerate environmental degradation, for example by polluting air, land or water, or by harming biodiversity.<sup>10</sup>

- *Policy responses to commodity firms are complex, but for the purpose of orienting sustainable and inclusive industrial policies rather than aiming to attract foreign investment in commodities directly, tools can be used to help companies develop value addition activities and expand to related competitive value added industries, both of which can create decent jobs.*

**Domestic monopolists/oligopolists can have a large impact on equity and innovation.** Because of their monopoly power, these firms can set prices (often subject to regulation), which can have profound impacts on upstream and downstream firms and hence on broader efforts to achieve more diversified economies. This market dominance can also impact equity and poverty directly through consumer prices. Such domestic monopolies or oligopolies can arise due to characteristics of the specific market (e.g., utilities are considered “natural” monopolies since it is more efficient to have one firm set up and manage infrastructure/networks in a geographic region), or policy decisions (e.g., temporary trade protection for infant industries). Indeed, in many cases, such firms become established or strengthen their market position due to preferential deals with the government—such as the provision of licenses to import key commodities or provide services, and preferential tax deals. For example, in some countries, fertilizer importers established or grew their businesses through government procurement contracts,<sup>11</sup> passing higher prices on to farmers. In many countries, the financial sector also exhibits oligopolistic behaviour, which can have the effect of raising borrowing costs or limiting access to credit. Because of the impact of monopolist pricing power on equity, the prices of utilities providing necessities, such as water and energy, are generally regulated when operated by private entities. Similarly, the operator of infrastructure under a public-private partnership (PPP) regime (e.g., a toll highway) often has a monopoly or an oligopolistic position in a market, which is often done in compliance with the industry’s regulator in setting the size of the toll, sometimes with direct earnings assurances.<sup>12</sup> Because these firms face limited competition, they are often also uninventive and cautious of trade openness. This behaviour can act as a barrier to innovation and to adopting new technologies.<sup>13</sup>

- *Policy responses will vary by industry, but high-level guidance includes: first, removing barriers to new entrants and putting in place strong competition policies to restrict monopolies where possible; second, regulating prices with equity considerations in mind; third, using industrial policy tools to support new entrants, as feasible; and fourth, analysing whether public ownership would be more effective and equitable.*

**Firms in competitive domestic sectors are heterogeneous, but critical: they create employment opportunities and can stimulate innovation.** In many developing countries, a large portion of the working population is employed in MSMEs in sectors such as low-value agriculture, retail services or informal activities.<sup>14</sup> SMEs generally contribute up to 45 per cent of formal jobs and 33 per cent of national GDP in developing countries,<sup>15</sup> with the informal sector representing about 70 per cent of total employment.<sup>16</sup> However, these jobs are often low-paying and highly insecure, with many workers lacking access to social protection. Female entrepreneurs are more likely to work in non-tradable services: 63 per cent of Africa’s female entrepreneurs work in retail trade, hotels and restaurants—traditionally less productive and innovative—compared to 46 per cent of men.<sup>17</sup> MSMEs in developing countries are particularly vulnerable to demand and supply shocks and economic crises. In addition, many MSMEs face severe challenges in raising financing, and often identify access to finance as the main barrier to growth. Nonetheless, because these firms face stronger competition, they have more incentives to innovate—and even change the structure of the economy.<sup>18</sup> Indeed, as noted earlier, there are many examples of firms that started as MSMEs and grew into “global value adders”. A survey of manufacturing firms in China showed that competition from the informal sector also induces formal firms to increase product innovation.<sup>19</sup>

- *Policy responses will vary because of the breadth of the types of firms involved; but high-level policy responses include measures to increase access to credit; investing in entrepreneurial skills and capacity development; and universal social protection and addressing informality;<sup>20</sup>*
- *Policy responses also entail using the full inclusive and sustainable industrial policy toolkit. Targeted policies can include facilitating MSME participation in public procurement, for instance, by dividing contracts into smaller lots, or using public venture capital funds or national development banks, which can take equity stakes in potential innovators while diversifying risks (see chapter II).*

**“Global value adders” have the potential to yield significant rewards for sustainable development.** Their positive spillovers are extensive, particularly around productivity and job creation. Firms that export as part of value chain linkages with multinational enterprises can benefit from increased demand for their goods as well as from learning opportunities and technological upgrading.<sup>21</sup> These firms often contribute to product and process innovation and help the country to diversify its production and exports. From a social standpoint, dynamic exporting firms create employment opportunities for semi- and highly skilled workers, offering the prospect of higher wages, though the demand for specific skills can put pressure on the local professional training and education sectors.<sup>22</sup>

- *High-level policy responses are in line with the overall recommendations for using the inclusive and sustainable industrial policy toolkit: strengthening the enabling business environment to reduce risks; incentivizing productive investment aligned with the SDGs; and increasing access to credit using risk-sharing mechanisms as appropriate.*

**Box III.B.1****Overlooked but essential: The development impact and needs of small and medium agrifood enterprises**

Small and medium agrifood enterprises (SMAEs) constitute an important yet often overlooked part of the agrifood value chain, covering activities from harvest transport to food processing. Domestic SMAEs can make fundamental contributions to **sustainable development** through rural investment, modernization of the agrifood sector and the connection between farms (mainly small land holdings) and the expanding rural-urban continuum.

SMAEs can also contribute to off-farm job creation, and while data on SMAE **jobs** are scarce, the broader agrifood sector in many developing countries employs a growing number of women compared to economy-wide averages. Between 1990 and 2011, female employment in high-value agroprocessing increased tenfold in Bangladesh, and by 137 per cent in Ethiopia and 90 per cent in Kenya.<sup>a</sup>

At the same time, existing SMAEs in developing countries are often scattered, small to very small, informal and family-based and lacking economies of scale. For example, more than 95 per cent of fresh fruit and vegetables consumed in Kenya are grown domestically, mainly by smallholders, and supplied largely by SMEs through informal supply chains.<sup>b</sup> SMAEs face significant obstacles due to neglected infrastructure, insufficient access to finance, poor support for accessing improved technologies and lack of targeted policy initiatives.<sup>c</sup>

The **financing** required for investments by SMAEs usually comes from self-financing (including family and friends), informal credit or from larger firms with stronger bargaining positions. The small size of such enterprises often makes transaction costs associated with formal financing prohibitive. The rise of new intermediaries has the potential to fill the credit vacuum left by the decline, starting in the 1990s, of agricultural credit schemes, which played an important role in developing countries for several decades.

In addition, meeting the **infrastructure** needs of SMAEs (from warehousing to logistics platforms to retail spaces) is the basis for a diversified service industry and a critical step towards more efficient management of food supply chains as well as integrating rural areas into the economic activities of intermediary cities and smaller towns.<sup>d, e</sup>

<sup>a</sup> Food and Agriculture Organization. *The State of Food and Agriculture 2017. Leveraging Food Systems for Inclusive Rural Transformation*.

<sup>b</sup> World Bank. "Growing Africa. Unlocking the Potential of Agribusiness". World Bank Working Paper 75663.

<sup>c</sup> Ilie, E. T., and S. Kelly. "The Role of Small and Medium Agrifood Enterprises in Rural Transformation: The Case of Rice Processors in Senegal". Food and Agriculture Organization.

<sup>d</sup> Food and Agriculture Organization. *The State of Food and Agriculture 2017. Leveraging Food Systems for Inclusive Rural Transformation*.

<sup>e</sup> Gálvez Nogales, E., and M. Webber (eds.). "Territorial Tools for Agro-Industry Development – A Sourcebook". Food and Agriculture Organization.

**2.4 Additional policy solutions**

As noted above, two broad areas of policy intervention can be taken from the above analysis, taking into account that solutions will vary by firm type, sector and country specifics.

**The first is to improve the enabling environment, thus reducing risks for all firms.** This includes building a conducive legal and regulatory environment and investing in necessary infrastructure along with a range of other issues, such as reducing political risks and promoting macroeconomic stability. Importantly, strengthening the enabling environment also includes the application of labour regulations for decent jobs as well as environmental and health standards, and regulatory and policy frameworks to reduce pollution and carbon emissions.

**The second area of policy intervention is to effectively utilize policy instruments, as discussed in detail in chapter II.** An enabling business environment may not be sufficient to mobilize private finance for sustainable development and better develop active domestic business sectors. Reforms take time to materialize, but even countries with strong enabling business environments often fail to attract private finance for sustainable development priorities. Instruments include incentives, such as tax breaks or penalties as well as risk-sharing mechanisms, such as guarantees, public-private-partnerships and subsidized credit. As discussed in earlier Task Force reports, use of these mechanisms is not without challenges (see also chapter III.C on blended finance). Among others, they include the risks of: (i) private sector involvement when it is not the most cost-efficient solution; (ii) perverse incentives, such as excessive risk-taking by financial institutions; (iii) overly generous risk-reward sharing arrangements/subsidies for private investors, with the risk of the public sector holding the risk and the private sector earning all of the returns (and sometimes diverting public funds from other needs); (iv) overleveraging of private companies (i.e., increasing the debt leverage of a company to a point where it jeopardizes its long-term viability); and (v) corruption and state capture. Yet, when done carefully, such actions can help to make projects that are not competitive with other investment opportunities on their own but have a strong public benefit, become attractive for private investors.

**Improving access to credit is critical.** Commodity exporters and, to a lesser extent, monopolies/oligopolies can more easily tap local and international financial markets, given the high rents associated with their business operations as well as earnings in international currencies. For many domestic firms, access to capital markets or corporate bond issuance is more limited. MSMEs generally identify access to finance as a major obstacle to doing business, with women-owned/led firms more often affected by financing constraints.<sup>23</sup> These discrepancies are more pronounced in least developed countries (LDCs), where financial sectors tend to be less developed. Firms in more competitive market segments tend to rely on multiple—sometimes informal—sources of financing, including tapping personal networks, microfinance institutions or savings and credit cooperatives and, more recently, some financial technology (fintech) providers. Public development banks can also play an important role. For innovative businesses in particular these banks (or public venture funds) should use equity-like instruments that allow them to share in the upside (above a threshold) as well as diversify risks and compensate the taxpayer.<sup>24</sup>

The rest of this section covers issues related to the enabling environment, including infrastructure. Access to credit is covered in the following section.

### 2.4.1 Building a conducive legal and regulatory environment

Countries have made strides to reduce administrative hurdles for companies (see earlier *Financing for Sustainable Development Reports*). Nonetheless, impediments remain and there is space for improvement in most countries. One such area would be to remove barriers that deter women's entrepreneurship and labour force participation. Laws limit women's property rights in 40 countries, and women cannot run a business the same way as men in 115 countries.<sup>25</sup>

Lowering the administrative burden of regulatory compliance could also help to encourage domestic entrepreneurs to leave the informal sector, which represents about 70 per cent of employment in emerging market and developing economies. This could translate into significant productivity gains since the average informal firm in these economies is estimated to be only one quarter as productive as the average firm operating in the formal sector. Similarly, strengthening trust in the public administration could encourage entrepreneurs to start new businesses in the formal economy (see chapter III.A).

**Policymakers can also improve the efficiency of business facilitation measures—and gear them to both domestic and foreign investors.** Business facilitation measures, along with any reduction in regulatory standards, need to be coherent with sustainable development objectives. To maximize private sector contributions to sustainable development, these measures should go hand in hand with protecting labour rights and environmental and health standards, and implementing disaster risk reduction standards, regulations and legislation, even if these measures may imply increasing the cost of doing business. For example, some countries have strengthened rules against harmful pesticides in agriculture, raised minimum standards in building codes and established new protected areas (e.g., Palau banned commercial fishing in 80 per cent of its marine territory to protect its ecosystem). These laws raised the costs for businesses but can be necessary to achieve the SDGs, underscoring the importance of developing regulations in an integrated manner (such as through an INFF), which includes an analysis on trade-offs.

**An enabling business environment also requires competition policies to facilitate the entrance of new businesses and avoid monopolistic behaviours by dominant firms.** As noted, growing market concentration has been especially significant in the digital space, where further increases in market power by already dominant firms could deter investment and innovation as well as exacerbate inequality. A range of other firms, including in finance, also hold market power and need to be subject to regulatory frameworks. In addition, an enabling business environment would include strengthening institutions and putting in place policies to reduce corruption.

### 2.4.2 Providing infrastructure services

**Another lever that policymakers can use to support private sector development is the provision of efficient infrastructure services, which companies rely on to operate.** This remains predominantly a public sector activity, particularly in sectors with limited cash flow potential to repay the private investor, such as sanitation and education, where affordable access for all is needed. For example, in the water sector, despite a monopolistic market structure and the potential for reliable revenue streams, private investment has been limited due to high sunk costs and consumers' unwillingness to pay high usage fees. Since the 1990s, the

number of projects cancelled or under distress has amounted to 18 per cent of the total in developing countries, a high ratio compared to other sectors.<sup>26</sup> Overall, the public sector still accounts for 87 to 91 per cent of infrastructure investment spending in developing countries.<sup>27</sup> On the other hand, there are areas of infrastructure that have sufficient revenue streams attached to them, such as energy and electricity. Yet, even here there is a role for government to ensure access to energy for all and that environmental impacts are offset. Overall, private investment in infrastructure in developing countries stood at US\$76.2 billion in 2021, a recovery from the previous year but still markedly below pre-pandemic levels.<sup>28</sup>

**Well-developed infrastructure plans are needed to address these gaps.** They should include adequate stakeholder consultations and incorporate climate impact, disaster risk and resilience assessments as well as gender assessments to provide a long-term vision. This vision will allow countries to avoid having costly stranded assets, such as coal-fired power plants, or essential infrastructure assets unable to function during and after natural disasters. Making the right decisions is critical, as infrastructure assets typically last for decades and upfront costs should be weighed against operational costs over the asset life cycle. For example, each dollar invested in infrastructure resilience is expected to deliver a \$4 benefit through avoided repairs and disruptions and lower maintenance costs in low- and middle-income countries.<sup>29</sup> In addition, infrastructure investment paths compatible with full decarbonization have been found to cost no more than polluting alternatives when accounting for the life cycle cost of infrastructure assets.<sup>30</sup>

**Multilateral institutions support governments in infrastructure development by providing capacity development and tools to enhance resilience in business operations and assets.** Technological advancements can help project prioritization and planning, including through data analytics and enhanced project management. For example, SOURCE, a customizable software designed to help governments prepare, procure and implement their infrastructure projects, is supported by multilateral development banks. The Real Estate Resilience Tool of the United Nations Office for Disaster Risk Reduction (UNDRR) offers guidance on disaster risk reduction by looking at investment holistically and considering factors such as financial value, climate change resilience and transitioning to a less polluting economy, as well as the wider social context, the environment and the interactions between nature, society and development. The United Nations Economic Commission for Europe (UNECE) has developed a PPP Evaluation Methodology for the SDGs, which assesses infrastructure projects against the SDGs.<sup>31</sup> The United Nations Economic Commission for Africa (UNECA) has developed a monitoring and evaluation tool—the AfCFTA Country Business Index—to identify bottlenecks, many of which are related to infrastructure, that businesses face under the African Continental Free Trade Area.

## 3. Inclusive financial systems

**Financial inclusion is a prerequisite for the development of SMEs and productive capacities as well as for an inclusive recovery.** As noted in earlier Task Force reports, scaling up access to capital is limited by underdeveloped capital markets in many countries, and such countries should remain focused on developing local financial systems, with international support. But financial breadth, or an inclusive financial system,

is as important as financial depth. An inclusive financial system provides affordable, quality financial services to all individuals, entrepreneurs and small businesses.

### 3.1 Financial inclusion of individuals

**There has been enormous growth in financial inclusion over the past 10 years, driven by digital finance.** In 2021, high-income countries achieved near-universal account ownership,<sup>32</sup> with 96 per cent of adults having a bank account. In developing economies, 71 per cent of adults had an account in 2021, up from 42 per cent in 2011.<sup>33</sup>

**Yet, about 1.4 billion people remain outside the formal financial system, with the financial needs of historically underserved groups disproportionately unmet.** Women, the poor, the young, the unemployed and the less educated are among the groups traditionally underserved by financial service providers. The poorest 40 per cent of households globally were 7 percentage points less likely to own a bank account than the richest 60 per cent. Unemployment is associated with a 12 percentage point lower probability of having an account.<sup>34</sup>

**A gender gap in account ownership persists.** Although the gender gap in developing economies narrowed from 9 to 6 percentage points between 2017 and 2021,<sup>35</sup> women still lack legal protection against gender-based discrimination in access to credit in 104 countries.<sup>36</sup> An important barrier to accessing financial services for underserved groups, particularly women, is that they are far less likely to obtain formal identification (IDs) or own a mobile phone. Investments in gender-sensitive financial inclusion not only build greater resilience for women but also create positive spillover effects. When women obtain accounts, they build savings, have more say in their household finances, spend more on their children's education and invest in business opportunities.<sup>37</sup>

**A shift to mobile money has been a gateway to other financial services.** A significant step towards financial inclusion occurred during the COVID-19 pandemic, when an additional 865 million people in developing countries opened their first financial institution account, in large part to receive payments from the government. Two thirds of workers receiving wages through payments used their accounts to store money. In 2021, using a formal account became the most common method of saving in developing economies for the first time. Borrowing by formal means such as taking a loan from a financial institution, through mobile money accounts or using a credit card, has become as common in developing economies as borrowing from family and friends<sup>38</sup> (see chapter III.G for a discussion of fintech). However, the uptake of digital financial services can bring risks<sup>39</sup> of new exclusions, fraud, identity theft, scams and over-indebtedness (see also chapter III.F on systemic risks related to fintech).

**Government policies can help to facilitate inclusive financial services to reach underserved groups and address risks.** Countries that have been successful at reaching underserved groups have set up agent-based service points, enhanced transaction accounts and payment product designs, and implemented public campaigns to enhance financial and digital literacy. Governments can also foster inclusion by removing obstacles that generate economic exclusions, such as laws discriminating against women.<sup>40</sup> Legal and regulatory frameworks should be developed in tandem with the implementation of digital financial services to address potential risks.<sup>41</sup> Improvements in institutional factors, such as the

issuance of formal IDs and consumer protection regulations, can contribute to building and addressing issues of limited trust in financial institutions.<sup>42</sup>

### 3.2 Financial inclusion of businesses

**The outstanding demand for MSME financing is about 1.3 times the current supply of the global MSME lending market.** The unmet financing need for 131 million MSMEs (or 41 per cent) in developing countries is estimated to be \$5 trillion annually.<sup>43</sup> In the early part of the pandemic, loans to SMEs remained stable or even slightly increased in many countries due to supportive government policies preventing bankruptcies and related employment losses.<sup>44</sup> During the pandemic, 17 per cent of total policy measures and 25.5 per cent of total funding in the form of rescue packages specifically targeted MSMEs. On the other hand, pandemic recovery measures included only 4.1 per cent of policies and 2.2 per cent of funding focusing on MSMEs.<sup>45</sup> Alternative instruments that could have expanded and diversified access to finance for MSMEs, such as factoring and leasing, were growing prior to the pandemic but dropped significantly in 2020.<sup>46</sup>

**Traditional bank lending to MSMEs has long been hindered by the limited information that banks have on borrowers and a lack of instruments for overcoming this—such as credit histories, accounting data and traditional collateral.** As a result, banks in developing countries face a high cost of due diligence relative to loan size. In many developing countries, less competitive banking sectors have also played a role, as banks can charge higher prices for services and have fewer incentives to service marginal customers. Systemic sector-wide initiatives, such as the UNECA-backed development of money and interbank markets in Uganda, can bring down operating costs and increase margins and resilience for the entire banking sector, potentially enabling banks to lend to “riskier” clients.

**Modernizing the MSME lending model, including through fintech solutions, can lower administrative costs and extend reach to more MSMEs.** More commercial banks are looking into opportunities to better serve MSMEs' financial needs through innovative tools and the integration of digital platforms.<sup>47</sup> The use of such services can also create positive feedback loops, as electronic transaction histories can strengthen the information base for risk assessments, and better credit ratings can unlock access to additional services.

**Policymakers can also play a more active role in increasing access to finance for MSMEs.** They can, for example:

- Reduce information asymmetries through enhanced credit reporting systems and technology to provide better information for credit decisions (e.g., open banking technology may allow MSMEs to use their bank account data for seeking loans from third-party institutions);
- Support more efficient collateral systems (e.g., making it possible to use movable assets such as equipment as collateral);
- Create performance-based incentives that reward financial institutions targeting MSMEs;
- Mitigate risks through partial credit guarantee schemes for SME lending institutions (for example 65 countries have launched or expanded existing guarantee schemes since the COVID-19 outbreak);<sup>48</sup>
- Offer loan programmes (e.g., through public development banks) to MSMEs.



## Box III.B.2

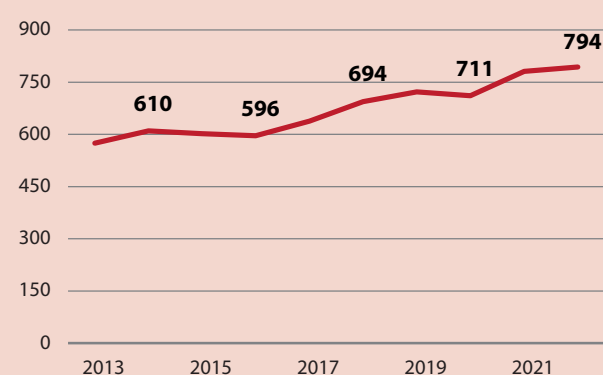
### The cost of remittance transfers

**The growth in global remittances—an important source of income for receiving families in developing countries—is back on track.** Global remittances, which declined in 2019, reached a new high of \$794 billion in 2022 (figure III.B.3).<sup>a</sup> One factor contributing to the increase in 2022 was a gradual reopening of many host-country economies after the pandemic, facilitating the entry of migrant workers and improving their employment situations.<sup>b</sup> Remittances accounted for 50 per cent of GDP in Tonga, and over 30 per cent in Lebanon, Samoa, Tajikistan and the Kyrgyz Republic.

Figure III.B.3

#### Global remittance inflows

(Billions of nominal United States dollars)



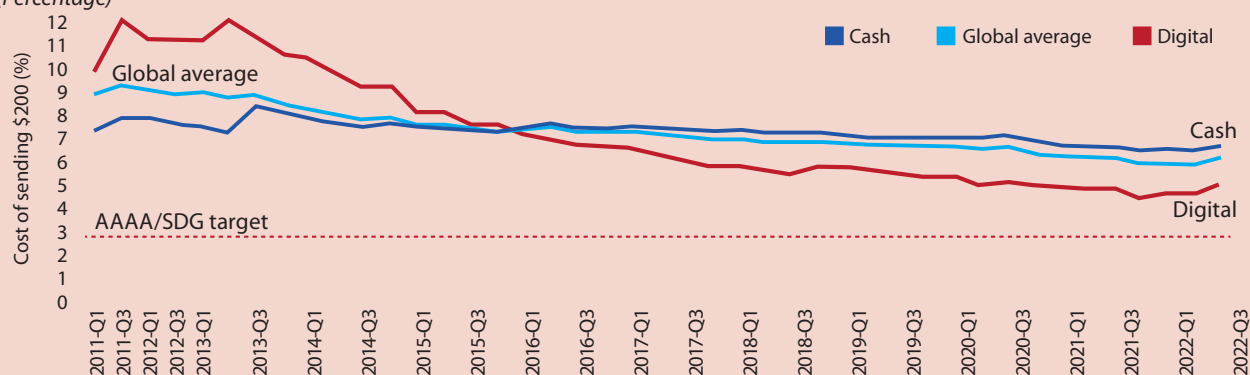
Source: World Bank.

**The global average cost of sending \$200 in remittances is still double the 3 per cent target of the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agenda.** Remittance costs in the third quarter of 2022 were recorded at 6.3 per cent of the amount transferred, which has remained unchanged in the past five to six years. In the 13 years since the statistic was first recorded in 2009, the average cost of remittances has declined by 3.7 percentage points.

Figure III.B.4

#### Trends in the global cost of sending \$200 in remittances

(Percentage)



Source: World Bank, Remittance Prices Worldwide, Issue 43.

The cost of sending remittances varies across developing regions, with South Asia having the lowest cost at about 4.1 per cent, while sub-Saharan Africa continued to have the highest average cost (approximately 7.8 per cent). A high degree of heterogeneity is also observable across individual remittance corridors, with costs above 10 per cent across many African corridors and for Pacific Island nations. Forty-two per cent of corridors still record costs above 5 per cent.<sup>c</sup>

#### The decline in costs is attributed to the use of digital remittances.

The cost of sending cash remained at 6.8 per cent, while the cost for digital remittances decreased from almost 12 per cent in 2011 to 5.2 per cent in 2022 (figure III.B.4). All main types of remittance service providers, except post offices, have seen a decline in costs over time. In 2022, banks were the most expensive channels with an average cost at 11.7 per cent, while transfers via post offices were priced at 6.8 per cent and money transfers operated at 5.9 per cent. Mobile channels were the cheapest at 3.9 per cent (see chapter III.G).

**Policymakers can introduce measures to lower costs.** Shifting remittances to digital channels, which are cheaper than cash (see chapter III.G), promoting competition, implementing transparency requirements for fees and commissions charged and strengthening financial inclusion would lower the cost of remittances. However, some of the highest costs are in corridors without correspondent banking relationships. Governments can lower costs by establishing interconnected payment systems to facilitate cross-border payments in corridors with limited access to correspondent banking services.<sup>d</sup> The decline in correspondent banking services is partly due to the cost of compliance with anti-money-laundering/combating the financing of terrorism (AML/CFT) regulations. Central bank digital currencies (CBDCs), when issued, may be able to lower some of these costs as the relevance of AML/CFT will need to be re-examined in the context of CBDCs (see chapter III.F).<sup>e</sup>

<sup>a</sup> KNOMAD. "Remittances".

<sup>b</sup> World Bank. "Migration and Remittances Brief No. 37".

<sup>c</sup> Ibid.

<sup>d</sup> Ibid.

<sup>e</sup> BIS. "FSI Insights on Policy Implementation No 41 – Central Bank Digital Currencies: A New Tool in the Financial Inclusion Toolkit?".

The international community can also help by providing liquidity through credit lines to local financial intermediaries for on-lending to SME clients, as many multilateral development banks have been doing for many years (e.g., credit lines have represented up to 20 per cent of the European Bank for Reconstruction and Development's total annual business volume).<sup>49</sup> To minimize the risk that banks use these funds to lend to clients that would have received loans even without these credit lines, this can be done in conjunction with incentives to reach underserved groups, such as earmarking at least 20 per cent of loans to women customers and women-led enterprises.<sup>50</sup>

## 4. Leveraging financial markets for sustainable development

**The financial sector not only needs to be more inclusive; it also needs to be more sustainable.** Promoting financial sector alignment to SDG targets will strengthen global resilience to future shocks and help to achieve the SDGs. Incorporating sustainability issues into financial market decision-making has become mainstream, starting with climate change. Most investors and creditors now acknowledge that climate-related sustainability factors impact firms' financial performance. Environmental, social and governance (ESG) considerations were mentioned in about a fifth of earnings calls in 2021, compared to fewer than 1 per cent of earnings calls before 2019. This recognition is also reflected by the large number of signatories to voluntary sustainability principles across different sectors of the financial market (see box III.B.3). There has been an enormous growth in sustainable finance since 2015, with sustainable investing<sup>51</sup> increasing by 15 per cent to reach \$35.3 trillion in 2020 (compared to global financial assets which grew by 11 per cent, reaching \$469 trillion).<sup>52</sup> Yet, sustainable finance is not yet universal (for example, markets continue to fund fossil fuel companies) and questions remain as to its impact, including the risks of green/SDG washing.

**Net inflows to ESG funds were positive in 2022 despite net outflows in the broader market, although they were down significantly from a year earlier.** Net inflows into ESG funds totalled \$89 billion, down from the peak of \$405 billion in 2021 (see figure III.B.5).<sup>53</sup> Nonetheless, debates on ESG labelling may lead to a re-evaluation of the size of the market in the future. For example, a substantial portion of the over 1,000 funds classified as Article 9 (so-called "dark green" funds, representing 4.3 per cent of all products) in Europe are expected to be downgraded in 2023 as a result of the European Union's new classification requirements<sup>54</sup> (see box III.B.4).

**At the same time, sustainable debt issuance declined for the first time, albeit from a record high.** Globally, sustainable bond issuance dropped 11 per cent to \$1.5 trillion in 2022, with the share of developing country issuance remaining at around 16 per cent.<sup>55</sup> Issuance of green bonds and social bonds fell by more than 25 per cent and 38 per cent, respectively, in 2022, from record highs in 2021. Sustainability-linked loans were the only instrument to demonstrate growth in 2022, up 15.5 per cent year-on-year (see figure III.B.6).

**There are several reasons behind the growth and recent plateau of sustainable investments.** Most asset managers who report using ESG considerations in their investment decision-making focus on "ESG

integration", i.e., integrating ESG factors into investment decisions to better manage risk and possibly enhance financial returns (see previous *Financing for Sustainable Development Reports*). On the other hand, while 70 per cent of individual investors in a recent survey believe that sustainable investing implies a financial trade-off, the vast majority (79 per cent) remain interested in this type of investing.<sup>56</sup> Another survey found that roughly a third of respondents are willing to sacrifice returns in order to create a positive impact.<sup>57</sup> To date, it is unclear how much of the growth in ESG funds is due to their recent financial outperformance and how much is due to preferences by consumers. This distinction is important because of the recent turnaround in ESG fund returns.

### Box III.B.3 Voluntary initiatives and private sector commitments continue to grow across financial sectors

- In asset management, *Principles for Responsible Investment* (PRI) signatories represent more than \$120 trillion<sup>a</sup> (roughly 50 per cent of the value of the global equity and bond markets);
- More than 80 asset owners representing over \$10 trillion in assets and financial institutions that are part of the *Glasgow Financial Alliance for Net Zero* (GFANZ), representing some \$140 trillion in assets, are working towards net-zero greenhouse gas emissions by 2050, under the *UN-convened Net-Zero Asset Owner Alliance*;
- In the banking sector, more than 300 banks representing around 49 per cent of global banking assets have signed on to the *Principles for Responsible Banking*, which aim to align banking strategies with the Paris Agreement and the SDGs;
- In insurance markets, insurers representing around 25 per cent of world insurance premiums have signed up to the *UN Principles for Sustainable Insurance* (PSI). Insurers representing more than 14 per cent of world premiums have also committed to transition underwriting portfolios to net-zero emissions by 2050.

<sup>a</sup> PRI. "Annual Report 2022: New and Former Signatories".

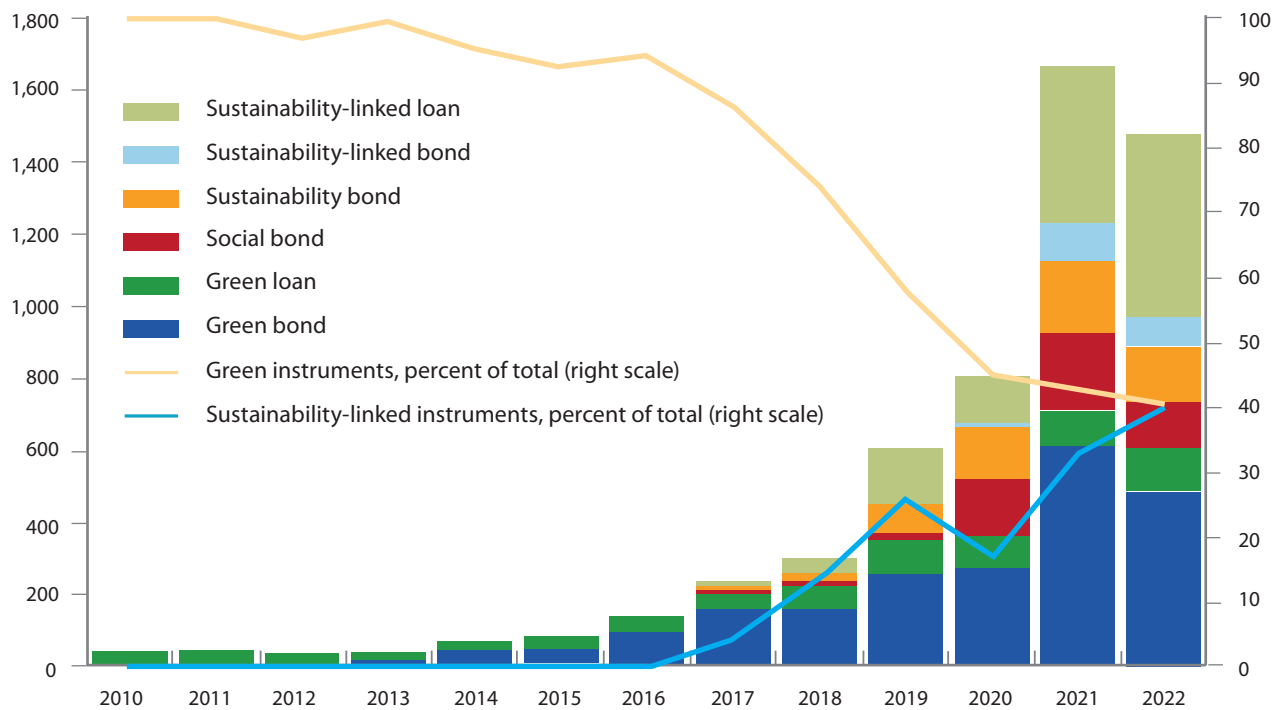
**In terms of financial performance, many ESG funds underperformed in 2022.** Sustainable investing approaches differ widely by strategy and products, making it difficult to measure ESG performance. Nonetheless, prior to the recent rise in interest rates and the outbreak of war in Ukraine, several empirical studies backed the premise that investors could achieve better, or at least equivalent, returns by incorporating ESG information into investment decision processes.<sup>58</sup> The rationale was that companies with better management of environmental and social risks are likely to outperform their peers in the long run. However, ESG funds also tend to overweight technology companies and underweight energy stocks. While trends in commodity prices and technology stocks supported the outperformance of ESG funds through 2021, this reversed in 2022, with eight of the 10 largest ESG funds underperforming the S&P 500.<sup>59</sup> Through November 2022, ESG equity funds lost around 18 per cent of their value, while non-ESG funds were down 15.8 per cent.<sup>60</sup> It is unclear whether these trends will continue and how they will impact demand for ESG products.

Figure III.B.5  
**Equity and bond flows into ESG funds (as of 31 December 2022)**  
 (Billions of United States dollars)



Source: IMF, Climate Finance Monitor, Q4 2022.

Figure III.B.6  
**Global sustainable debt issuance by instrument (as of 31 December 2022)**  
 (Billions of United States dollars)



Source: IMF, Climate Finance Monitor, Q4 2022.

**In terms of a positive contribution to impact, sustainable investing faces an existential crisis due to fears of SDG-washing and greenwashing.** Greenwashing is cited by institutional investors as the greatest challenge to sustainable investing, ahead of financial performance concerns.<sup>61</sup> Many funds which branded themselves as “sustainable” are not fundamentally different from traditional funds.<sup>62</sup> One study found an average of 68 per cent overlap in the holdings of ESG and non-ESG funds in the United States.<sup>63</sup> Some major asset managers have been accused, including by regulators, of exaggerating the sustainability claims of their financial products. Growing awareness of misleading practices is creating disillusion, threatening the entire market’s credibility and leading to an increase in regulatory measures to enhance transparency and accountability.

#### 4.1 Policy and regulatory efforts to reduce the risk of greenwashing

Taking sustainable investing to the next level requires a series of steps:

##### 4.1.1 Strengthen sustainability reporting

**There has been a dramatic increase in corporate sustainability reporting.** While just 20 per cent of S&P 500 companies published sustainability reports in 2011, over 90 per cent did so in 2021.<sup>64</sup> Around 80 countries have taken close to 200 measures to improve corporate sustainability disclosure since 2015 (with 60 per cent calling for mandatory disclosure).<sup>65</sup> The scope of disclosure has also been evolving. For example, more companies are referencing the SDGs in their sustainability disclosures (i.e., 42 per cent of Russell 1000 reporters in 2020 compared to 32 per cent in 2019).<sup>66</sup> Nonetheless, there are still enormous gaps in reporting, including in the availability of sustainability data for unlisted entities, which impedes efforts by financial institutions to align their lending portfolios with sustainable development targets (environmental, social and economic).

**The quantity of reports is not an indicator of quality or usefulness.** Sustainability disclosure is not yet treated with the same rigour as financial reporting. Early sustainability reports were almost promotional brochures, with companies deciding themselves what to disclose and which indicators to use. While there has been some improvement, for instance due to private sector-led initiatives such as the Task Force on Climate-related Financial Disclosures (TCFD), in many jurisdictions companies still decide on the content of their sustainability reports. A vast majority of investors (82 per cent) believe that companies frequently overstate or exaggerate their ESG progress when disclosing results.<sup>67</sup> This sentiment is echoed by senior executives, the majority of whom (58 per cent) consider their own company guilty of greenwashing.<sup>68</sup> Only a minority of sustainability reports undergo some type of audit (35 per cent of Russell 1000 reporters in 2020, up from 24 per cent in 2019),<sup>69</sup> while 97 per cent of investors, according to another survey,<sup>70</sup> demand external assurance to consider these reports as reliable.

**Regulators are responding to greenwashing by strengthening sustainability reporting requirements.** New measures are being taken, including in large jurisdictions. In the United Kingdom, large companies are required to disclose transition plans; in the United States, the Securities

and Exchange Commission (SEC) laid out plans for climate disclosure rules based on the TCFD recommendations, though as of year-end 2022 these are still under discussion; and China recently implemented guidance for ESG disclosure standards, along with data security and cybersecurity laws, as an integral part of governance-related disclosure.<sup>71</sup> China, Mexico and South Africa are among the only developing countries to have developed an ESG taxonomy. South Africa’s taxonomy was only adopted in April 2022, while Mexico launched the first stage of its sustainable taxonomy in March 2023. Just 25 of 60 developing countries’ stock exchanges require ESG reporting.<sup>72</sup> Unlike most reporting frameworks, the European Union’s sustainable finance strategy requires companies to assess “double materiality”—i.e., not only how sustainability risks impact the financial returns of the company but also how the company’s business practices impact sustainability and the planet (see box III.B.4).

**To be useful, sustainability-related information also needs to be comparable across reporting entities over time.** The plethora of reporting frameworks combined with the voluntary nature of many measures has led to inconsistencies, incompleteness and noncomparable sustainability reports (see the *2021 Financing for Sustainable Development Report*). In addition, companies are asked to respond to multiple surveys and questionnaires from data aggregators (e.g., CDP), index providers (e.g., S&P Global Corporate Sustainability Assessment) and networks of private companies (e.g., United Nations Global Compact’s Communication on Progress). The International Sustainability Standards Board (ISSB), launched in 2021, aims to achieve convergence among existing sustainability reporting frameworks to create a common global baseline, although its success will require international collaboration (see box III.B.5). A key requirement of ISSB standards will be corporate disclosures on greenhouse gas emissions, including both direct emissions (Scope 1) and indirect emissions from electricity use and value chains (Scopes 2 and 3).<sup>73</sup> However, the ISSB reporting standards will only include reporting on environmental and social risks that are material to a company’s financial performance; they will not include the impact of a company’s activity on environmental and financial indicators. In addition, the Impact Management Platform, a collaboration between sustainability actors, is aiming to develop globally consistent sustainability impact measurement, assessment and reporting methodologies. The World Benchmarking Alliance aims at providing comparable sustainability disclosure information by developing freely accessible benchmarks of performance on the SDGs of 2,000 influential companies.

**Another challenge is to hold companies accountable for failing to meet their sustainability commitments.** A review of the world’s 30 largest listed financial institutions shows a disconnect between their concrete short-term actions and long-term climate goals. For example, in 2020 and 2021, these institutions provided at least \$740 billion of financing to the fossil fuel production value chain (e.g., companies active in fossil fuel exploration).<sup>74</sup> Similarly, it is important to check the robustness of methodologies used for setting sustainability commitments. According to data from the net-zero tracker, only 38 per cent of companies with net-zero targets include all Scope 3 emissions,<sup>75</sup> and nearly 40 per cent intend to use offsets, which remain controversial.<sup>76</sup> To enhance the transparency and monitoring of net-zero commitments, the French President and the United Nations Special Climate Envoy Michael Bloomberg are leading discussions on creating an open data platform.<sup>77</sup>

**Box III.B.4****The European Union's sustainable finance strategy**

The European Union's sustainable finance strategy has three components: the green taxonomy, which entered into force in July 2020; the Sustainable Finance Disclosure regulation (SFDR), which has been applicable as of March 2021; and the Corporate Sustainability Reporting Directive (CSRD), which entered into force in January 2023.<sup>a</sup>

- 1) The green taxonomy is a classification system for sustainable economic activities. It includes technical screening criteria for six environmental activities, which set the conditions for this activity to qualify for a positive contribution;<sup>b</sup>
- 2) The SFDR requires that investors and insurers disclose how they evaluate ESG-related risks in their investment decisions, in line with the taxonomy.<sup>c</sup> This includes the labelling of "dark green" funds that have sustainability investment as their objective (Article 9) and "light green" funds that promote environmental or social characteristics;

- 3) The CSRD, which companies will start following in financial year 2024, covers a wider range of sustainability topics, including social indicators (such as child labour, gender balance, and corruption). Unlike most other reporting frameworks, the CSRD requires companies to assess "double materiality". In addition, corporate data repositories are being developed in jurisdictions such as the European Union to make data publicly available.

- <sup>a</sup> The European Parliament and Council of the European Union, "DIRECTIVE (EU) 2022/2464 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 December 2022 Amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as Regards Corporate Sustainability Reporting."
- <sup>b</sup> For example, the EU taxonomy specifies that the life cycle greenhouse gas emissions from the generation of electricity from geothermal energy should be lower than 100 g CO<sub>2</sub>e/kWh to qualify for making a substantial contribution to the objective of climate change mitigation.
- <sup>c</sup> S&P Global. "New EU ESG Disclosure Rules to Recast Sustainable Investment Landscape".

#### 4.1.2 Enhance regulatory and policy frameworks to support sustainable finance

**The financial sector cannot change the economy alone.** The speed of transition in the financial sector depends on the transition of real sector activities to more sustainable operations. Without adequate public policies to support long-term decisions, such as the pricing of externalities and

phasing out of harmful subsidies, the economy will not transition at the scale or pace needed to achieve the SDGs. In other words, if environmental and other costs do not matter for profitability, there are clear limits to the amount of finance that can be mobilized for sustainable development. In 2022, over 600 investors from 33 countries representing over \$40 trillion in assets under management signed the 2022 Global Investor Statement in

**Box III.B.5****International Sustainability Standards Board: Opportunities and challenges**

The ISSB was created in November 2021 by the IFRS Foundation that is responsible for accounting standards used in more than 140 jurisdictions.

Building on the credibility of the IFRS Foundation on financial accounting standards, the ISSB has the potential to create a common baseline for corporate sustainability disclosure standards, which can help to realize the necessary convergence of the many existing sustainability reporting frameworks. This would not only enhance the comparability of data disclosed by companies but also limit companies' reporting burdens. In 2022, the IFRS Foundation succeeded in consolidating three pre-existing disclosure frameworks—the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (which houses the Integrated Reporting Framework and the Sustainability Accounting Standards Board). The ISSB also issued its first two standards for public consultation.

However, the ISSB faces at least four major challenges:

- **The risk that jurisdictions continue to adopt their own approaches.** For example, the SEC and the European Commission both issued their own consultation on sustainability-related reporting standards in 2022, independent from the work of the ISSB. International cooperation is necessary to reconcile national approaches and establish a common baseline or use by all companies;

- **Failure to capture a broad-enough coverage of sustainability issues.** The ISSB's mandate is limited to sustainability risks that are material to a company's financial performance, which de facto means that a company does not have to report on how its behaviour impacts environmental and social matters. The "double materiality" approach would instead require companies to also report on their material impact on society and the planet, even if such impact does not yet affect their bottom line and the company's value. By choosing a more restricted approach, the ISSB standards may be considered by some jurisdictions as inadequate;
- **The reporting entity deciding on what to disclose.** The proposed ISSB standards put the onus for deciding what to disclose on the reporting company, based on what it considers financially material (given its time horizon and own beliefs). This could lead to selective disclosure, including two companies operating in the same industry reporting on different sustainability topics if their materiality assessment differs;
- **Countries' unequal preparedness.** Some countries will need support to adopt emerging standards. It is also important that the standards are developed in such a way that developing countries are protected against negative spillovers (e.g., allowing developing countries time to meet ISSB standards, considering transition pathways from a development perspective, reducing risks that ISSB standards make the price of accessing capital markets more expensive due to the reporting burden).

advance of the 27th Conference of the Parties to the United Nations Framework Convention on Climate Change (COP27), calling on governments to implement policies to address the climate crisis.

**Not all sustainability issues have the same impact on the financial performance of a company.** Some sustainability issues may not have an obvious financial impact (e.g., achieving gender balance or reducing plastic pollution), although they are critical for achieving the SDGs. In the climate space, the fact that policymakers are considering carbon pricing mechanisms is in itself pushing companies towards reducing emissions. Policymakers could consider replicating this approach with other sustainability issues. Alternatively, in some cases direct regulations can also be used to affect company sustainability behaviour. Policymakers can introduce tailored measures, such as (also see chapter II):

- Making companies pay for their pollution (or internalize externalities), either through pricing mechanisms or regulations;
- Prioritizing companies with higher sustainability records in public procurement;
- Revisiting banking regulations to incentivize lending to projects/companies with positive contributions to sustainable development;
- Designing policies to facilitate sustainable consumption and production across sectors and value chains, and which create the conditions to transition from linear to more circular business models.

**While some measures may take time to implement, simply announcing them could already make a difference, as investors seek to anticipate regulatory changes.** Some policies and regulations may not affect the current profitability of an entity but could impact future profitability. The range of issues investors consider will depend on their investment horizon and how quickly the markets price in these factors, such as the increased likelihood of regulatory changes. For example, the likelihood of a sustainability topic being financially material may be negligible when considering a five-year time horizon but it could increase significantly for a 10-year horizon. Actions that policymakers and long-term asset owners can take to lengthen the horizon of investors would be useful, such as internal reward systems for asset managers that incentivize long-term thinking. For this, it is important that policies provide clear and time-consistent long-term signals.

#### 4.1.3 *Make sustainable investment practices credible*

**Policy actions are also needed to restore the credibility of sustainable investing.** A range of investing approaches is grouped under the term “sustainable investing” with vastly different contributions to sustainable development (see the *2020 Financing for Sustainable Development Report* for more details on the different strategies).

**Many investment strategies currently branded as sustainable are unlikely to make a significant contribution to sustainable development.** In part this is because they may have a limited impact on the cost of capital of investee companies,<sup>78</sup> therefore generating insufficient incentives for companies to change behaviours. Other investment strategies may only include superficial/unfruitful engagement with investee companies on sustainability issues, just to tick boxes and claim sustainability features.

**Regulators are creating a distinction between funds with robust sustainability approaches and the rest of the sustainability**

**investment market.** In the United States, the SEC has drafted rules to reserve ESG branding for funds for which ESG is central to investment decisions.<sup>79</sup> In practice this means that funds that simply add ESG signals (such as ESG risks to financial performance) to the pool of information they consider, should not use ESG-related terms in their names. Similarly, the European Union has created categories to distinguish products with a sustainable development objective (the so-called Article 8 and Article 9 funds, also referred to as “light green” and “dark green”) from other funds with lower sustainability credentials (see box III.B.4). As of June 2022, Article 8 and Article 9 funds represented 46 per cent and 5 per cent, respectively, of the funds available for sale in the European Union.<sup>80</sup> The Operating Principles for Impact Management are voluntary standards that look to distinguish between “impact investing funds”<sup>81</sup> that have credible impact measurement and monitoring approaches in place, and those that just have the intent to do so.

**Disclosures by pension funds should be strengthened.** A review of the largest 20 pension funds by UN/DESA has revealed vast differences in terms of sustainability disclosure by pension funds, with various levels of granularity. Surveys have also demonstrated that countries are at different stages in terms of public disclosures by pension funds on sustainability matters (see figure III.B.7). Another survey found that some institutional investors were facing investment restrictions related to risk-based capital requirements. For the 36 pension funds that participated in the survey, assets held in developing countries in 2017 to 2018 amounted to \$263.7 billion, just 8 per cent of global assets.<sup>82</sup>

**To avoid a multiplication of norms and the fragmentation of markets, the international community could seek convergence on international norms and standards for “sustainable” financial products.** International agreements such as the SDGs provide a global consensus on sustainability issues and could be used as the common benchmark for sustainable investing. This is precisely the approach used by the GISD Alliance to develop its Sustainable Developing Investing (SDI) definition, which could act as a norm for the market.

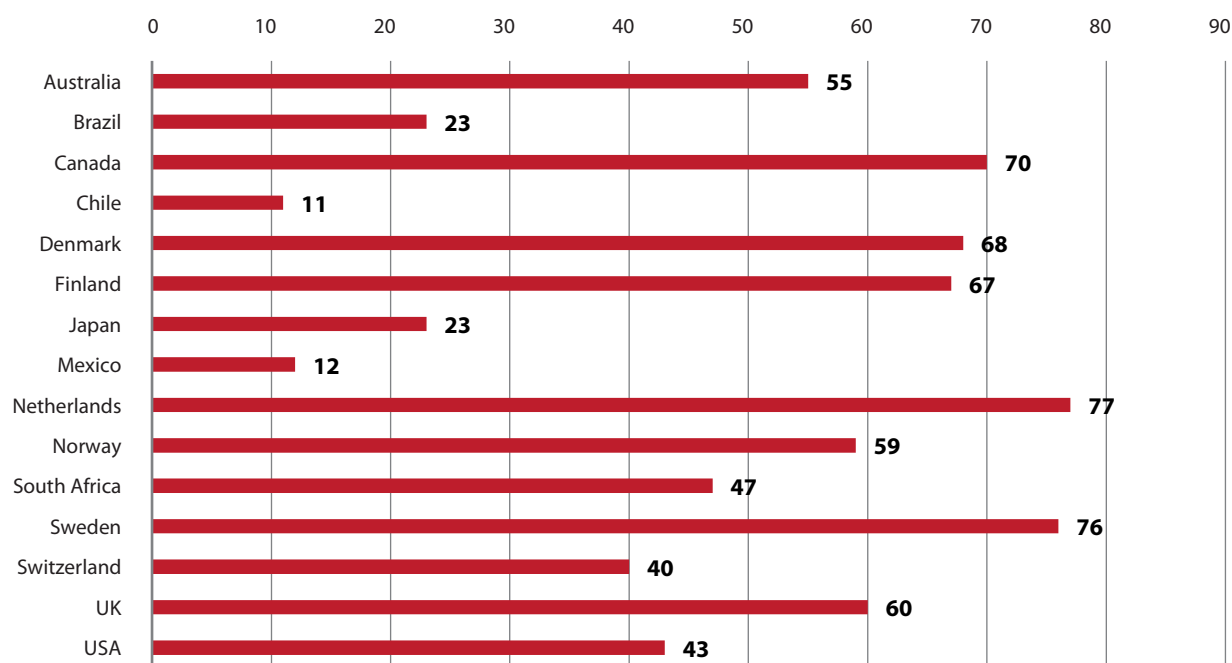
**For funds with higher sustainability claims, regulators are requiring strengthened disclosure.** Funds that make sustainability claims will need to provide more information on how these sustainability claims are delivered. In the United States, the SEC has proposed detailed disclosure for ESG-branded funds. Similarly, in April 2022, the European Commission adopted technical standards to specify the exact content, methodology and presentation of the information to be disclosed for Article 8 and Article 9 funds (the first disclosure is expected by June 2023).<sup>84</sup>

#### 4.1.4 *Fix sustainability ratings*

**To gain credibility, the sustainable investment market must be supported by a system that provides transparent assessments of companies’ sustainability credentials.** Sustainability ratings play a particularly important role because investors lack access to audited sustainability reports (similar to audited financial reports), making it hard for investors to conduct their own sustainability analyses. There has been a proliferation of firms that provide sustainability ratings and rankings,<sup>85</sup> with over 100 ESG data providers, of which 39 provide SDG-related data solutions.<sup>86</sup> A few large players dominate the market, especially since major financial players such as credit rating agencies have acquired smaller ESG data providers.<sup>87</sup>

Figure III.B.7

**Average country score on public disclosures from pension fund organizations for the “responsible investing” pillar**  
(Percentage)



Source: Global Pension Transparency Benchmark.<sup>83</sup>

**Yet, sustainability rating companies fail to provide consistent and clear ratings.** Unlike credit ratings, sustainability ratings are weakly correlated across ratings providers. Different providers often give the same company high or weak sustainability scores. Around 38 per cent of the difference in ratings is estimated to be due to different inputs used in the assessments, but the biggest difference (56 per cent) is based on how the ratings companies measure sustainability factors (for example, how they measure biodiversity or labour practices).<sup>88</sup> There are also counter-intuitive results. For example, some companies have a high Environmental (E) pillar score even though their greenhouse gas emissions have remained high over time.<sup>89</sup>

**SDG ratings suffer from structural flaws and a lack of transparency.** SDG raters typically use proprietary taxonomies that link business activities with specific SDGs. These taxonomies, which are generally behind paywalls, are opaque about the exact criteria they use, but often equate a company's presence in a sector, measured through revenues, to a positive contribution to sustainable development. For example, a company active in the health sector might contribute to SDG 3 on good health and well-being even if the company is not necessarily positively contributing to SDG 3, for example because they are excluding low-income patients or focusing on issues with no relevance to SDG 3 (e.g., plastic surgery).

**A public SDG taxonomy could create a common reference for sustainability rating/score providers.** A public taxonomy for SDG-related activities would link each sector/industry to its most material SDGs and include key performance indicators (see box III.B.6). This taxonomy could then be used by rating providers as a starting point to make sustainability

assessments, and by regulators to identify important gaps in corporate disclosure.

**Regulators need to increase oversight of ESG/sustainability rating providers.** The industry of sustainability rating providers remains largely unregulated (outside of self-regulation codes). In line with findings from the International Organization of Securities Commissions (IOSCO), the international body gathering the world's securities regulators, regulations should strive to: (i) provide clarity on what ratings and data products intend to measure; (ii) enhance transparency on methodologies; and (ii) introduce safeguards against conflicts of interest.<sup>90</sup> Regulators could provide a common framework that promotes comparability between different ratings and ensures clarity on what they intend to measure. A public SDG taxonomy could be used as a reference by SDG rating/score providers, who would then need to explain how their approach aligns or differs from it.

**Robust sustainability ratings could be used as a basis for overall rankings.** For example, regulators or market-led norms could stipulate that for a fund to be considered as sustainable it should have at least 75 per cent of holdings with a moderate to strong positive contribution to sustainable development according to a major rating company (see figure III.B.9).

## 4.2 Reflect the investor's true preferences

**Financial advisors should systematically ask clients about their sustainability preferences.** In most jurisdictions financial advisors are requested to ask clients questions (e.g., their age and risk tolerance) to understand their investment needs. As of August 2022, the EU Financial Instruments Directive II (MiFID II) requires financial advisors to include

**Box III.B.6**  
**SDG materiality map and taxonomy**

An SDG materiality map could provide clarity on the linkages between economic activities and the SDGs they most likely impact. The following table provides an illustration of what this map could look like based on an analysis conducted by the GISD Alliance (see GISD Alliance sector-specific metrics report). Dark red boxes indicate SDGs directly linked to certain activities while light red could indicate indirect linkages.

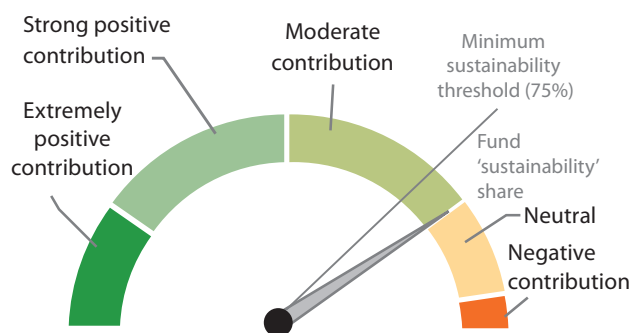
This SDG materiality map could be completed by indicative key performance indicators (KPIs) to determine whether a company active in a sector is making a positive contribution to the SDGs. These KPIs would typically be specific to each activity sector and could build on voluntary commitments made by certain industries (e.g., circular pledges made by the fashion and consumer goods industries).

Figure III.B.8  
**SDG materiality map by industries for products and services**  
*(For illustrative purposes only)*

	Automobiles and Components	Consumer Staples	Financials	IT Software and Services	Real Estate	Telecom	Utilities
SDG 1 – No Poverty							
SDG 2 – Zero Hunger							
SDG 3 – Good Health and Well-Being							
SDG 4 – Quality Education							
SDG 5 – Gender Equality							
SDG 6 – Clean Water and Sanitation							
SDG 7 – Affordable and Clean Energy							
SDG 8 – Decent Work and Economic Growth							
SDG 9 – Industry, Innovation and Infrastructure							
SDG 10 – Reduced Inequalities							
SDG 11 – Sustainable Cities and Communities							
SDG 12 – Responsible Consumption and Production							
SDG 13 – Climate Action							
SDG 14 – Life Below Water							
SDG 15 – Life on Land							
SDG 16 – Peace, Justice and Strong Institutions							
SDG 17 – Partnerships for the Goals							



Figure III.B.9

**Hypothetical investment fund composition**

Source: UNDESA.

Note: In this hypothetical case, fund constituents are sorted by their contribution to sustainable development based on the assessment provided by a sustainability rating provider.

questions related to clients' sustainability preferences in these "suitability assessments".<sup>91</sup> To help advisors lay out an appropriate investment strategy aligned with the preferences of their clients (e.g., minimum share of the investment portfolio invested in sustainable products, alignment of the entire portfolio with a specific goal such as net-zero transition goals), such questions should highlight specific sustainability goals as well as readiness to forego some financial returns in exchange for higher impact.

### 4.3 Link financing to sustainability

#### **Sustainable bonds can increase investment in sustainable development while potentially lowering an issuer's financing costs.**

The demand for green bonds has been increasing, as illustrated by the higher average oversubscription of new issues compared to conventional bonds.<sup>92</sup> If the excess demand translates into lower interest rates, a government or a company could access cheaper financing by issuing these bonds.

#### **Several studies have tried to quantify the "greenium" or premium investors are willing to pay for green bonds, with mixed results.**

While some estimate the greenium at up to 18 basis points,<sup>93 94</sup> others find no evidence of such a premium.<sup>95</sup> A recent IMF study that reviewed green sovereign bonds issued, including from developing countries (e.g., Chile, Columbia, Egypt, Fiji and Nigeria), found that the greenium is significantly larger for emerging market and developing economies than for advanced economies, although additional research is needed.<sup>96</sup> Green issuance has the added benefit of widening the investor base, which may be more marked in the case of emerging markets, thus helping to explain a larger greenium. However, a recent narrowing of the greenium in the European corporate bond market suggests that a rising supply of green bonds may erode the premium over time.<sup>97</sup>

**There is also a demand for SDG bonds.** Responding to the demand from investors, developing countries (e.g., Indonesia, Mexico and

Uzbekistan) have started issuing a more diverse set of sustainable bonds, including SDG bonds. The premium on these bonds compared to conventional equivalents is estimated to be 12 basis points, corresponding on average to more than a one-notch credit rating upgrade.<sup>98</sup>

**Future demand for sustainable assets will depend on the capacity of these bonds to demonstrate credible alignment with sustainable development objectives.** Transparency on the use of proceeds is critical for the secondary market for sovereign or corporate debt, and expectations are growing for disclosure on the impacts of investments. The two main types of sustainable debt present specific strengths and challenges:

- **Green, social and sustainability bonds** are based on the "use-of-proceeds" concept, meaning that they must be exclusively used to finance or refinance projects that meet certain eligibility criteria, sometimes defined in regulation (e.g., China Green Bond Principles). These types of bonds do not require the issuer to improve sustainability performance over time, nor do they prevent the issuer from continuing unsustainable practices financed through other means. There is also a question of additionality. For example, as long as green or social bonds represent a limited share of sovereign borrowers' outstanding debt, it could be relatively easy for them to find eligible projects/expenditures (e.g., in education and health), which would have occurred anyway;
- **Sustainability-linked bonds** differ from "use-of-proceeds" bonds as they require improvements from the issuer on predefined sustainability indicators within a specific time frame. However, their credibility can also be questioned if the selected KPIs are not meaningful or the targets not ambitious enough, or if the penalties for missing them are insignificant. Issuers have no interest in setting targets that are difficult to reach, as they could be penalized. Investor scrutiny and market norms/regulations are needed to raise the bar and ensure that the targets used are meaningful and ambitious.<sup>99</sup> On the step-up/step-down structure, the market seems to have settled for 25 basis points; while this might be meaningful for some issuers, it may be too low to impact behaviour.<sup>100</sup>

**Strengthening the credibility of sustainable debt will not only facilitate demand from investors but could also encourage further policy actions to reduce the cost of borrowing for sustainable activities.** Policymakers could consider a wide range of means to make issuing SDG bonds attractive, such as tax incentives for issuers and investors, and risk mitigating mechanisms (e.g., guarantees). This would reinforce the linkage between profitability and sustainability. So far, most of the green, social, sustainability and sustainability-linked bonds have been issued in developed economies, requiring more effective and targeted incentives in developing country settings.<sup>101</sup> Development partners could also introduce blended finance mechanisms to lower the financing cost of these bonds or link their issuance to technical assistance programmes for debt, investment management and the elaboration of localized standards and guidelines. That said, pricing benefits are not the only incentive for governments or companies, which may also be tempted to issue sustainable debt to signal to the market that they are taking sustainability seriously.

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