

Normalizing sustainability in finance

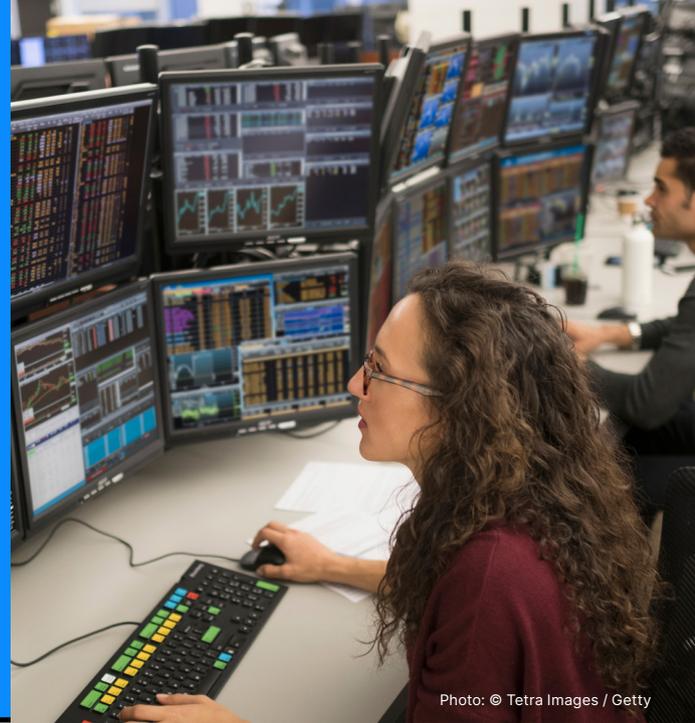


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1. Assessment: Present financial systems are a critical barrier

The present structure and orientation of global and national financial systems is a critical barrier to securing a transition to sustainability.

The volume of gross liquid assets in the world is around USD 400 trillion of which 64% is owned by individuals, 36% owned by governments (through their central banks, sovereign wealth funds and public finance institutions), with less than 1% in endowments and foundations (Force for Good, 2021).

The bulk of these assets are owned, directly or indirectly, by rich individuals in upper-income and middle-income countries. Within each country the flow of finance is also shaped by the pattern of income and wealth inequality. Private financial institutions (banks, investment companies, insurance companies, pension funds) manage around 85% of the liquid assets.

One measure of the deficiency of the present financial system is the large shortfall in the finances required for meeting the 2030 Sustainable Development Goals (SDGs).

The gap in funding required to reach the targeted SDGs by 2030 has recently been estimated as USD 8.4–10.1 trillion in developing countries (Force for Good, 2021). It is estimated that about a quarter of this is met by private financial flows, mainly for sustainable energy. The SDG-positive flows are driven partly by the potential returns and partly by a growing trend in financial institutions to follow environmental, social and governance (ESG) or net zero or similar standards. However, the dominant factor shaping the direction of global and national financial flows is the perceived profitability of the transaction.

The liquid assets in the hands of governments can be used to counteract market pressures. However, the demands for the normal functions of security and administration limit the potential for governments to influence the dynamics of private financial flows. But there are some public asset-holding entities like sovereign wealth funds that have the potential to act to promote sustainable development. One must also note that governments showed huge fiscal potential when they addressed the challenge posed by the Covid-19 pandemic.

The first challenge is to see how governments can be persuaded to include sustainability criteria in their fiscal decisions. One approach that would meet this concern partially is to propose that all regional, national and subnational governmental entities report the proportion of public spending directly devoted to meeting the agreed SDGs. This

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approach is partial because sustainability also requires the use of taxes and subsidies to create incentives for sustainable production and consumption. A simple metric to measure this is difficult, but some progress can be made with the development of fiscal impact calculation methods that take externalities more fully into account.

The scope for substantial shifts in public spending in favour of the SDGs is limited and the most important challenge is to see how the flow of finance in the private market of savers, investors and intermediaries can be shaped to meet sustainability ends.

There is some movement in this direction with the growth in financial flows that have to meet ESG standards, generally defined by private transnational coalitions of financial and non-financial corporations, typically based in the West. These include the United Nations Principles for Responsible Investment (a joint initiative of the United Nations Environment Programme Finance Initiative and the UN Global Compact); a string of climate-oriented initiatives such as the Task Force on Climate-related Finance Disclosures (TCFD), CDP (formerly the Carbon Disclosure Project, which has broadened its aims), Climate Action 100+, which is an investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change; and a string of net zero groups set up by global asset managers, bankers, insurance companies and asset owners.

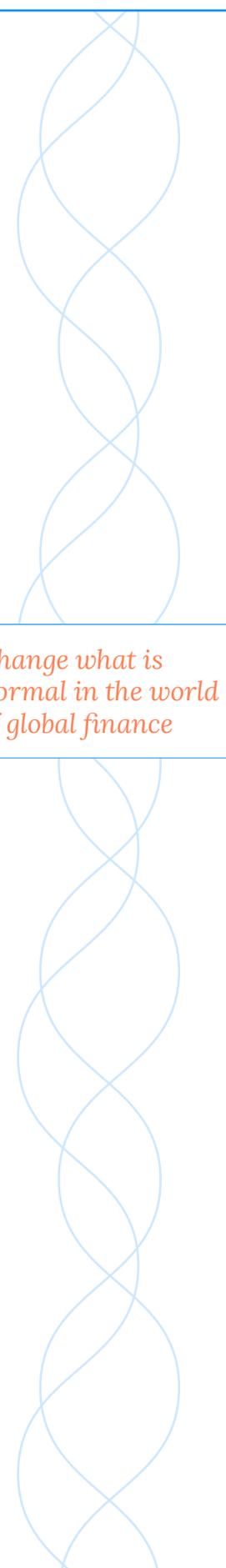
In practice ESG commitments generally involve exclusion of projects that have adverse environmental or social consequences. In recent years this has included certain carbon-emitting sectors like coal-fired power plants and coal mining and, to a lesser extent, petroleum-related activity, perhaps as much for the heightened risk of being stuck with stranded assets as for a commitment to sustainability goals. In any case the real challenge is to move the direction of financial flows to a positive agenda of promoting alternative technologies or business models that will move the global economy and society to a sustainable path, a challenge that has been elaborated earlier in section 4.3 of this report which also indicates specific steps to meet the challenge.

The key issue is how this 'greening' of market-based investment flows can move from ad hoc voluntary initiatives to working practices that are considered normal by investors and fund managers, such as avoiding investments in activities involving child labour, which is common today. The standard working practice is the pursuit of profit. This motivation can be influenced by fiscal measures that reflect externalities through taxes and subsidies and hence shape the prospects of profit. With the risks of climate change looming large in public consciousness, carbon pricing is an important example. But unilateral moves in this direction can affect the competitiveness of a country's producers if they are not part of an agreed global norm. Hence, global agreements where possible, clearer methodologies for measuring the costs and benefits of externalities, and support to poorer countries that may face serious short-term costs if they were to do this are some of the measures that would help to change what is normal in the world of global finance.

The working practices of financial firms are shaped by shareholders and investors and a systematic effort to build an ethic of social and environmental responsibility among people can increase the pressure on profit-seeking financial intermediaries to incorporate this ethic in their working practices.

Reorienting the working norms of private financial institutions will be a long haul.

This is where multilateral development finance institutions, aid agencies and sovereign welfare funds can accelerate adoption of sustainability standards by making sustainability norms a condition for their own activities and, more importantly, for co-financing operations.



Change what is normal in the world of global finance

3 Normalizing sustainability in finance

Today, providing resources for sustainability looks like a form of forward-looking venture funding. But if pursued systematically it could become the norm as happened with the funding of internet-based activities after starting as a high-risk venture operation in the 1990s. In the immediate future this normalization of sustainability criteria in financial operations may only be accepted in climate mitigation activities. But with coordinated multilateral persistence it can extend to other areas like water conservation, biodiversity protection, air quality improvement and other areas of concern outlined in this report.

Four shifts – in scale, regulation, balance and risk – are critical for emerging markets to access investments for sustainable infrastructure.

Far more capital is needed than has been negotiated: the USD 100 billion included in the Paris Agreement must be a floor rather than a ceiling, when trillions of dollars are needed by countries that have yet to build the infrastructure and energy systems to meet the developmental aspirations of their people (Ghosh & Raha, 2022).

Multilateralism will have a critical role to play in scaling up investment flows towards pertinent technologies in developing countries.

Emerging multilateral platforms and processes should not only bolster the capacity of catalytic finance interventions but also create enabling environments that maximize the effectiveness of financial and fiscal interventions that aim to direct capital towards sustainability (Ghosh et al., 2022).

2. Recommendation: harmonize international financial regulation

While financial and fiscal regulation discussed in section 4.3 could be key enablers of cross-border sustainable finance flows, it is essential that the regimes in various developing countries are mappable to international standards. In the absence of international harmonization of such standards, these could hinder rather than accelerate capital flows. Therefore, central banks and financial supervisors in developing country jurisdictions must engage with their counterparts in multilateral forums during the development of regulation to ensure international harmonization (Ghosh et al., 2022).

Various platforms exist to facilitate coherence in the adoption of sustainability in financial regulation.

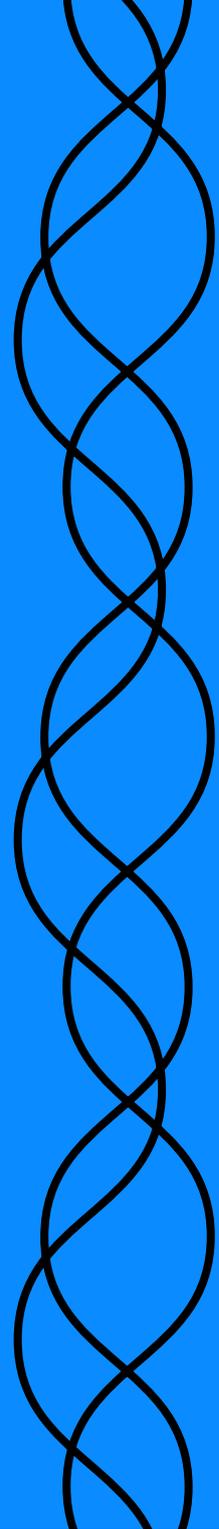
- The International Platform on Sustainable Finance offers a multilateral platform for dialogue between policymakers and regulators for the development of sustainable finance regulation. Membership comprises countries representing 55% of both gross domestic product and greenhouse gas emissions (as of November 2021) (European Commission, 2021d).
- The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) connects 102 central banks and regulators on matters of climate risk management (as of November 2021) (NGFS, 2021).
- The TCFD, constituted by the G20's Financial Stability Board, offers recommendations on climate-related disclosures (TCFD, 2021).

In order to be effective, emerging sustainable finance forums must learn from the experience of mainstream multilateral finance processes, which have been criticized for under-representation of developing country interests. Given that developing countries will be the major destinations of sustainable investments, in order to be truly effective, sustainable finance platforms must include developing countries as equal partners in shaping the global sustainable finance architecture.

If pursued systematically, providing resources for sustainability could become the norm

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