

3 The next frontier to finance sustainable development

Despite the global financial crisis and coronavirus (COVID-19) pandemic, the value of financial assets held by new actors in global capital markets continues to increase. The financing gap to achieve the 2030 Agenda represents only 1% of the hundreds of trillions of dollars held in the global financial system. However, financing is not aligned in support of the global goals, as demonstrated by rising inequalities and the lack of accountability for measures of sustainability. That the root cause of the crisis is not financial makes it all the more urgent to better understand environmental, social and governance factors that impact the long-term risk-adjusted returns on investments. This chapter explores how government leaders are taking action to advance alignment of the global financial system in favour of more resilient, inclusive and sustainable development.

In Brief

The USD 2.5-trillion annual gap in financing for the Sustainable Development Goals (SDGs) outlined in the previous chapters appears small compared to the broader universe of financing – equivalent to only 1% of global financial assets. Financial intermediaries¹ such as banks, institutional investors, and asset managers, own and manage an increasing share of financial assets. These new actors hold financial assets valued at more than USD 378.9 trillion that have grown at 5.9% year on year since 2012. Despite the increase, however, these financial assets did not reduce the SDG financing gap before the COVID-19 crisis. Infrastructure financing, for example, represents only a small portion of investment by long-term institutional investors.

Moreover, financial assets do not meet an assessment of SDG alignment discussed in Chapter 2. First, they are contributing to growing global inequalities and second, they lack accountability for their sustainability impact.

On the first criteria, less than 20% of total financial assets are held by institutions in countries eligible for official development assistance (ODA), and data on financial assets are missing for 95% of these countries. Weak domestic financial and social security systems create hurdles for SDG alignment of financial intermediaries in developing countries. In addition, illicit financial flows, wasteful tax incentives, and the persistently high cost of remittance transfers in many developing countries further drain financial assets.

On the second criteria, investments that integrate some sustainability measurement are estimated to total USD 30 trillion, or 8% of total global financial assets, and roughly USD 3 trillion of those investments seek positive impacts.

In the wake of COVID-19, SDG alignment is an imperative. The pandemic, like climate change, knows no borders and is a global threat. As long as the virus persists in one country, it remains a threat to all countries. Integrating environmental, social and governance (ESG) risks can help to preserve the long-term, risk-adjusted value of assets. Investors are under increasing pressure to measure and disclose their exposure to environmental and social risks. Portfolios that seek to avoid ESG risks may outperform the broader market over the long term and have registered lower losses in the COVID-19 era. However, ESG ratings remains unregulated and estimates are therefore unreliable due to a lack of transparency, proliferation of methodologies and inflation of sustainability performance.

Investing in SDG alignment offers an opportunity to build resilience in the markets. The 2030 Agenda provides a blueprint for economic recovery that benefits people and planet. More than 100 countries have already adopted carbon neutrality goals for 2050. However, fossil fuel subsidies currently cost upwards of USD 4.7 trillion. Resources borrowed and invested by governments today should not contribute to widening inequalities between countries and should leverage SDG market opportunities.

3.1. The unknowns: Mapping the trillions needed to finance the Sustainable Development Goals and respond to the coronavirus (COVID-19) crisis

The annual financing gap to achieve the SDGs is USD 2.5 trillion, coupled with increasing needs and declining resources following the COVID-19 outbreak estimated at USD 1.7 trillion, are seemingly small amounts – equivalent to only 1.1% of global financial assets (USD 4.2 trillion) – relative to the broader universe of financing.² In the era of COVID-19, with its greater spending needs and restricted funding sources, governments rely on financial institutions to help mobilise financing and overcome fiscal constraints. Financial institutions such as institutional investors, banks and asset managers play an important role to ensure the availability of capital and integrate long-term risks into investment decisions. These financial actors guide the market by deciding which kinds of companies to invest in, determining which kinds of risk criteria to assess, and labelling categories of finance and investments.

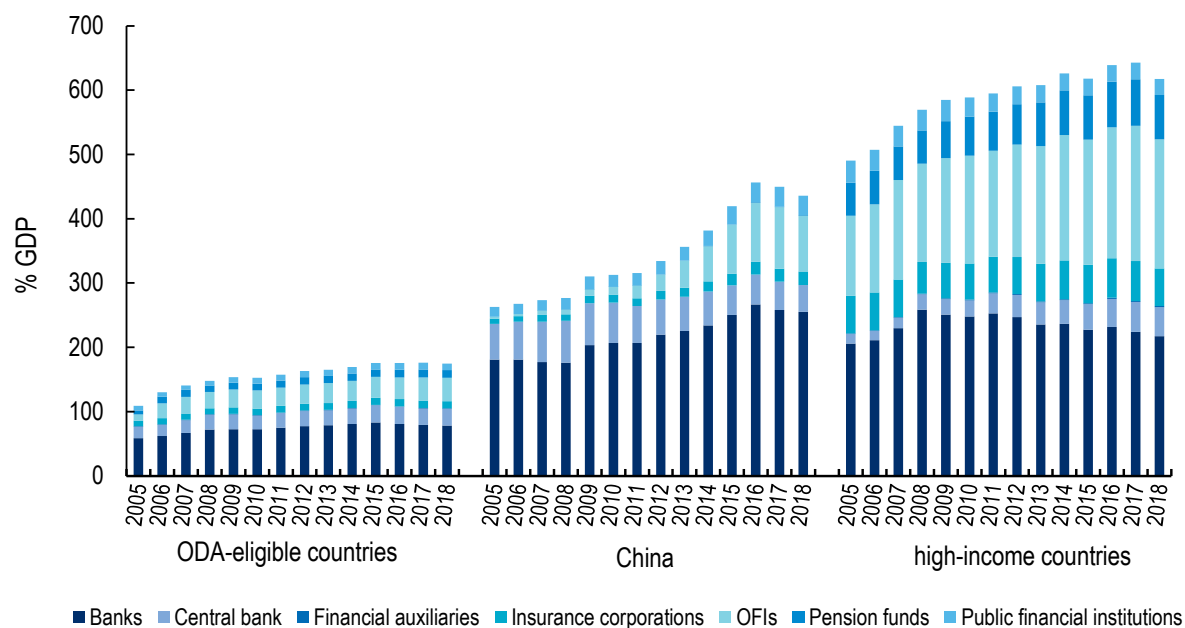
This section looks at the extent to which finance can help shift the global economy towards a more sustainable and equitable growth path. It specifically addresses two key issues: first, the articulation of global financial assets with the SDG financing gap and second, the global trends in financing owned and managed by financial actors.

3.1.1. The increasing value of financial assets does not reduce the financing gap

Since 2012, global financial assets have grown at 5.9% per annum and amounted to USD 378.9 trillion in 2019, due mainly to the rise of financial intermediation (International Development Finance Club, 2020^[1]). The value of financial assets now outweighs global gross domestic product (GDP). Over the past 50 years, credit by banks and other intermediaries to households and businesses has grown three times as fast as economic activity (Cournède, Denk and Hoeller, 2015^[2]). Today, financial assets represent six times GDP in high-income economies and 3 times GDP in middle-income countries. Figure 3.1 shows that total financial assets as a percent of GDP increased most rapidly in the People's Republic of China, by 60% from 2006 to 2018, driven by other financial intermediaries (OFIs) which increased 30-fold. Financial assets in developing countries increased by 33% over the same period. In high-income economies, financial assets increased by 20% due to a three-fold increase in central bank assets following implementation of quantitative easing.

Figure 3.1. Financial assets held by new actors as a % of GDP across country groups, 2005-18

Total financial assets by year and country group



Source: Financial Stability Board (2020^[1]), *Global Monitoring Report on Non-Bank Financial Intermediation 2019*, <https://www.fsb.org/2020/01/global-monitoring-report-on-non-bank-financial-intermediation-2019/>.

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However, the growth of financial markets does not automatically result in positive impacts on the real economy. Following the outbreak of the COVID-19 pandemic, financial markets rebounded quickly. Stock markets recovered their pre-crisis levels between February and August of 2020, thanks in large part to government spending and other liquidity support by central banks. The Chicago Board Options Exchange's volatility index also declined rapidly, by 62.5% over the same period. Despite recovery in capital markets, labour markets remain slow to recover (see Chapter 1).

In addition, not all financial assets are directly investable. The rapid growth of many intermediaries OFIs can in part be explained by asset price appreciation (Financial Stability Board, 2019^[3]). There are many potential negative impacts of increasing growth of financial systems, particularly in weakly regulated markets. Examples include misallocation of capital by funding projects with too low profitability, for instance when distortions exist in the tax system; valorisation of assets that does not consider the negative impacts on society, the environment and the economy; and lack of transparency as financial systems, regulations and capacities become increasingly complex, potentially facilitating illicit financial flows, and opacity about underlying credit risk that misleads ultimate investors into funding too much lending.

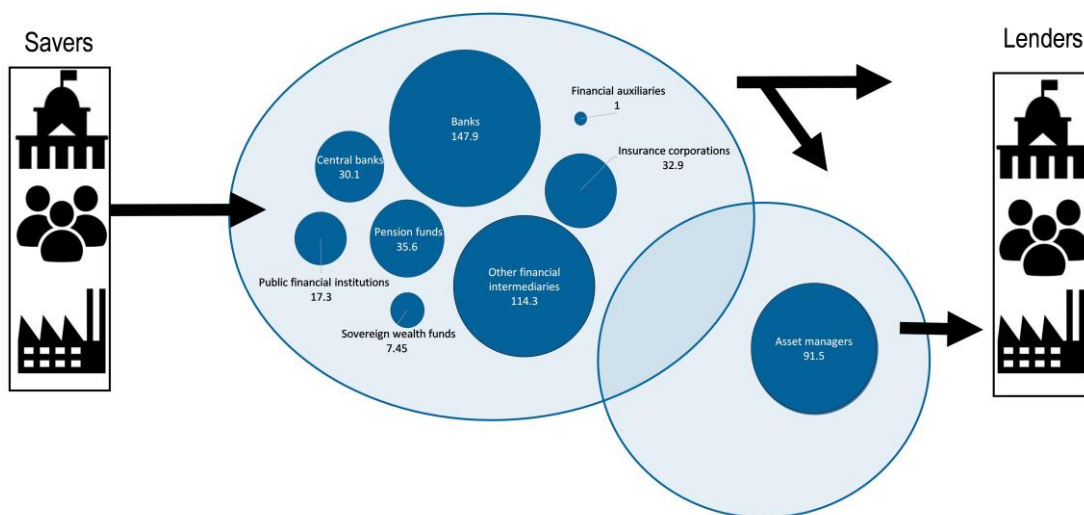
The potential positive contributions of finance to narrow the SDG financing gap remain underexplored. For example, the largest gap in financing to achieve the SDGs is for infrastructure investment needs, estimated at USD 70 trillion through 2030. However, infrastructure asset holdings by institutional investors are low. For example, only 1.3% of financial assets of pension funds are allocated to the sector. A lack of reliable and standardised information is a major barrier to investment and required to channel long-term investment towards the SDGs (see Section 3.2.2.) (OECD, 2020^[4]).

3.1.2. Owners and managers of financial assets are playing different roles to respond to the crisis

This subsection provides an overview of the volumes owned and managed by the new actors, or financial intermediaries. Owners and managers of financial assets have different legal obligations and responsibilities, one of the major distinctions between them. Asset owners are legally responsible for the assets owned (such as savings), while most asset managers are bound by their fiduciary duty to make investments according to the best interest of the institution for whom they manage assets.

Nonetheless, there is significant overlap between asset owners and managers. In many instances, asset owners hold stakes in the asset management firms to which they delegate responsibility for funds (e.g. bank-owned asset management firms). Furthermore, institutional investors can be considered fiduciaries of the resources invested by their clients or citizens. Chapter 4 elaborates in detail the SDG alignment of these actors. Figure 3.2 illustrates both overlaps and differences before the COVID-19 pandemic. In the wake of the crisis, the respective weights of these actors could shift, given that there is greater demand on the financial system's liquidity. However, if loans and other investments are not repaid, the financial system could face losses from default.

Figure 3.2. Mapping of financial asset owners and managers (USD trillions)



Note: The value of assets managed and owned cannot be calculated due to significant double-counting and overlap.

Source: Authors based on Financial Stability Board (2020^[1]), *Global Monitoring Report on Non-Bank Financial Intermediation 2019*, <https://www.fsb.org/2020/01/global-monitoring-report-on-non-bank-financial-intermediation-2019/> and BlackRock (2014^[5]), "Who owns the assets? Developing a better understanding of the flow of assets and the implications for financial regulation", <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf>.

Owners of financial assets are mobilising finance during the crisis

Four kinds of actors own assets conceptually and legally: institutional investors (e.g. pension funds or insurance companies), banks, public financial institutions, and financial auxiliaries.³ Asset owners have varying degrees of freedom to implement investment strategies. Pension funds, for example, are subject to quantitative portfolio restrictions relating to investment in certain asset classes (e.g. foreign investment). Insurance corporations face fewer quantitative investment restrictions and are more often subject to risk-

based capital regulation. Ownership structures also differ, which can influence investment decisions. For example, certain actors are mainly publicly owned (e.g. central banks or sovereign wealth funds) and others are mainly privately owned (e.g. commercial banks and investment funds).

Institutional investors own the largest share of global financial assets, at roughly USD 189.9 trillion or nearly half of total global financial assets.⁴ They collect savings and supply funds to financial markets. They also have considerable influence on companies and banks via their equity and voting rights and generally adopt financing strategies based on long-term investment considerations. Institutional investors' long-term investment considerations can have countercyclical and stabilising effects on financial markets.

In comparison to banks, most institutional investors do not have full banking licenses and are not supervised by a national or international banking regulatory agency. Following the global financial crisis, new regulations were put in place, including through the Basel III accord and the Dodd-Frank law in the United States that, among other changes, introduced new requirements such as liquidity ratios and strengthened the role of credit rating agencies. The unfinished business of financial regulation and gaps in regulation of what is called shadow banking, or non-bank financial intermediation, present compounded risks. These are discussed further in Section 3.3.2.

Commercial and investment banks had a total of USD 147.9 trillion in assets under management in 2018, representing 39% of global financial assets. Banks play an important role by borrowing savings from individuals, companies, governments and other entities and providing loans to purchase other securities. In this way, they ensure the availability of financing and fill the information gap between lenders and borrowers.

The COVID-19 crisis has placed additional strain on commercial banks' liquidity and brought increased risk of default and insolvencies. In the United States alone, the outstanding amount of undrawn credit lines represents, on average, 81% of total committed credit lines and is about eight times the amount of bank debt that was already on firms' balance sheets at the end of 2019 (Acharya and Steffen, 2020^[6]).

Central banks have seen the fastest growth rates among all financial intermediaries, increasing from USD 5 trillion to USD 30 trillion in total assets between 2002 and 2018, or annualised growth, post-crisis of 8.5%. The largest central banks – those of and the European Union (EU), Japan, the United Kingdom and the United States – have grown considerably with quantitative easing that allowed to increase open market operations, i.e. buying and selling government securities (van de Ven and Fano, 2017^[7]). With historically low interest rates and unprecedented negative interest rates, central banks have created a system that is very leveraged and vulnerable to external shocks. To better mitigate risk, central banks promote efforts to integrate climate-related considerations.

To respond to the impact of COVID-19, central banks are front and centre. Large-scale central bank liquidity support has helped supply credit to the real economy and support financial intermediation during the pandemic. Six central banks have enhanced swap lines, and the United States and China have expanded their lists of central banks with swap arrangements. Central bank assets as a ratio of GDP are at record highs in OECD countries while developing countries have little margin for additional currency interventions to respond to the crisis (Section 3.2.1).

Public financial institutions have also played a key role to mobilise finance during the crisis. Public financial institutions own USD 17.3 trillion in financial assets. Public development banks, the largest type of actor in this category including subnational, national and regional development banks, hold an estimated USD 11.2 trillion in assets and have played an important role in the COVID-19 recovery in OECD countries (see Box 3.1). For example, the European Investment Bank plans to leverage more than 1% of the EU GDP which totalled USD 24 trillion in 2019 through a pan-European guarantee with a focus on financing SMEs, throughout the EU (Treasury of France, 2020^[8]).

Box 3.1. Public development banks shift support after the outbreak of COVID-19 to build a more resilient financial system

The International Development Finance Club (IDFC) is a group of 26 major public development banks, including national and regional banks that invest more than USD 600 billion collectively per year.

Before the crisis, in 2015, IDFC and multilateral development banks agreed on common principles for climate finance tracking (mitigation and adaptation) and have been reporting together on this basis. IDFC and the MDBs subsequently committed in 2017 to align finance with the Paris Agreement, and have since developed corresponding methodologies. The IDFC is also examining the compatibility of their activities vis-à-vis the broader SDGs which showed progress to ensure ex-ante and ex-post evaluation mechanisms exist. Yet, few members evaluate impact based on the SDGs.

Following the outbreak of the crisis, public development banks are helping governments implement emergency and recovery programmes using their countercyclical mandate to provide emergency loans, financing facilities and guarantees by reallocating funding or by putting in place easing measures for repayments. Their support to local financial systems helps ensure corporate liquidity and maintain jobs. The businesses and sectors most affected by the crisis, such as small and medium sized enterprises, transport, tourism, energy, industry, commerce, services, etc. are receiving targeted financial support. Finally, some members have issued dedicated bonds that mobilise finance from capital markets to support their interventions in addressing the COVID-19 crisis.

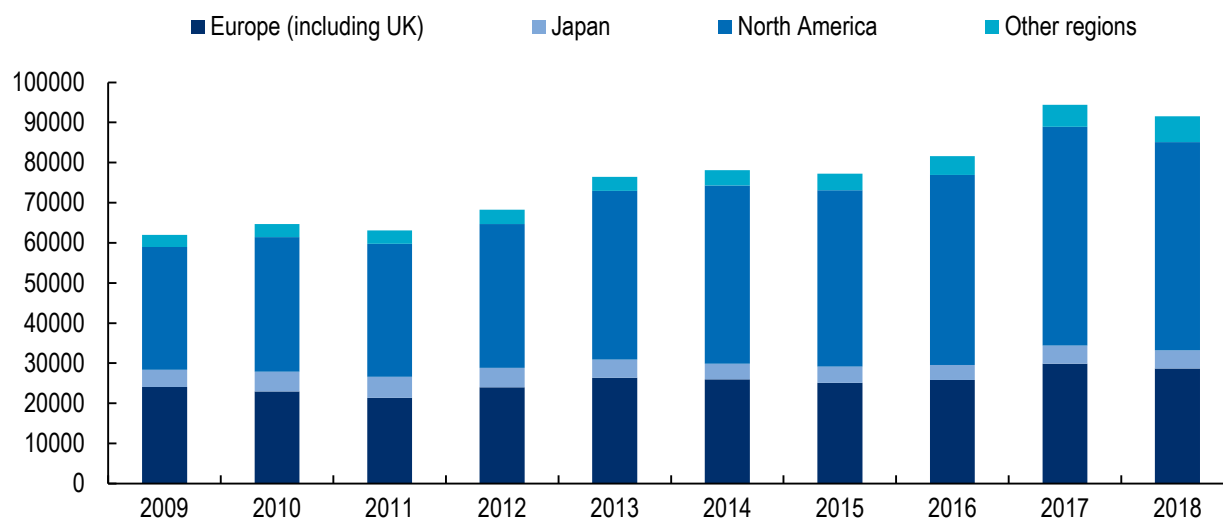
Source: Authors based on International Development Finance Club (2020^[1]), *International Development Finance Club website*, <https://www.idfc.org/publications/>.

Asset managers are reviewing how risks are assessed to ensure financial resilience following the pandemic

Asset managers hold USD 91.5 trillion, an increase over their USD 60-trillion holdings in 2009 and just under a quarter of total global assets. As shown in Figure 3.3, North American asset managers manage more than half of these assets. The five largest asset managers include BlackRock, Vanguard, State Street, Fidelity and Allianz.

Figure 3.3. Share of resources held by asset managers, by country and/or region, 2009-18

Total value of assets managed, by manager domicile, USD billion



Source: Authors based on Thinking Ahead Institute (2019^[9]), *The World's Largest 500 Asset Managers*, https://www.thinkingaheadinstitute.org/-/media/TAI/Pdf/Research-Ideas/a_public/PI500_2019.pdf.

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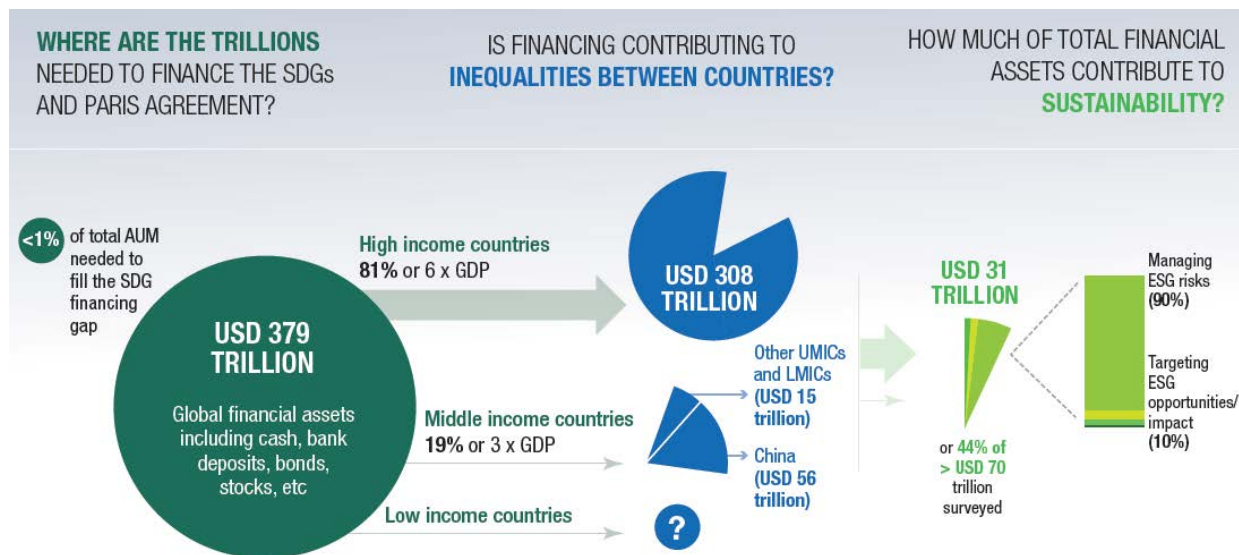
Asset managers play the role of steward and fiduciary to pool savings from large groups of investors including consumers, companies and financial intermediaries. An asset manager that fails in its duty to act in the best interest of its client may be prosecuted, required to make restitution, incur fines and/or suffer severe reputational damage that can prevent them from growing and maintaining their business in the future. Governments regulate fiduciary responsibilities in many ways. For example, some countries do not have a legal definition of fiduciary responsibility; others hold that fund managers must integrate long-term ESG considerations to succeed in their fiduciary responsibility to ensure the long-term value of assets (see Section 3.2.2).

In response to the COVID-19 pandemic asset managers are reviewing how long-term risks are assessed to better ensure financial resilience. For example, BlackRock has placed a greater emphasis on social considerations, like global health, within sustainability frameworks as an area where businesses can distinguish themselves from others on the market. Sustainability-related issues and relevant disclosures are being given a stronger focus in light of the growing impact of these issues on long-term value creation (BlackRock, 2020^[10]). Chapter 4 provide actions to be taken by financial intermediaries and governments to strengthen transparency, accountability and incentives for more robust frameworks for sustainable finance.

3.2. Financing is not aligned to promote equality and sustainability

This section examines the SDG alignment of these financial intermediaries and various hurdles to alignment. As illustrated in the infographic 3.1 below, SDG alignment is assessed across two objectives: the mobilisation of resources to leave no one behind and the acceleration of progress across the SDGs, while doing no significant harm to any single objective. It is an ex-ante rather than ex-post assessment of how resources target the global goals.

Infographic 3.1. How much of the trillions in the system are contributing to equity and sustainability?

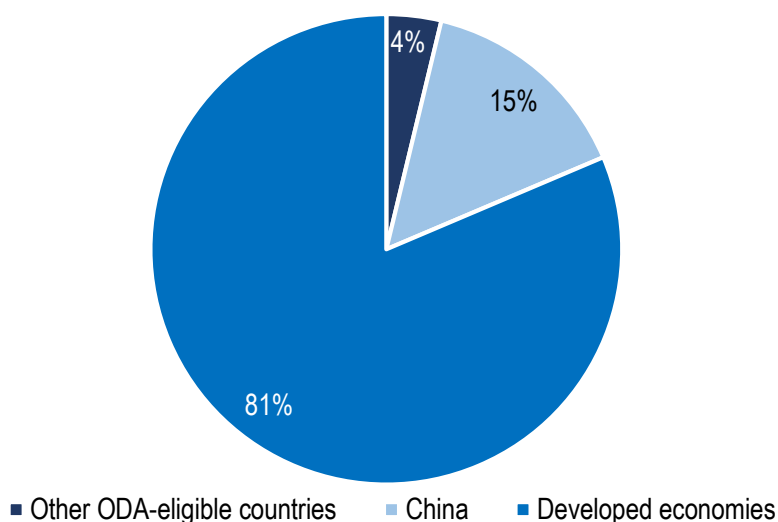


Source: Authors based on Financial Stability Board (2020^[11]), *Global Monitoring Report on Non-Bank Financial Intermediation 2019*, <https://www.fsb.org/2020/01/global-monitoring-report-on-non-bank-financial-intermediation-2019/> and Global Sustainable Investment Alliance (2018^[11]), *Global Sustainable Investment Review 2018*, http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf.

3.2.1. Financial assets are not reaching countries most in need

This subsection examines the extent to which global financial assets are unequally distributed among countries. Developing countries hold USD 75 trillion in assets under management out of the total USD 379 trillion, or less than 20% of total global financial assets (Figure 3.4). Despite the large volume of assets under management, the distribution of assets among developing countries is itself uneven and the countries that have the largest financing gaps are not the countries with the largest share of assets. 80% of assets are held by China. China has succeeded in increasing its share of financial assets due to equity market expansion, including several of the largest initial public offerings in emerging markets, and export-led growth. However, only 5.6% of ODA-eligible countries (8 out of 142) are included in reporting, suggesting their lower level of integration than developed countries in the global financial system and the likely negligible size of their financial assets (Financial Stability Board, 2020^[12]).

Figure 3.4. Shares of global financial assets are unevenly distributed across countries



Source: Authors based on Financial Stability Board (2020^[1]), *Global Monitoring Report on Non-Bank Financial Intermediation 2019*, <https://www.fsb.org/2020/01/global-monitoring-report-on-non-bank-financial-intermediation-2019/>.

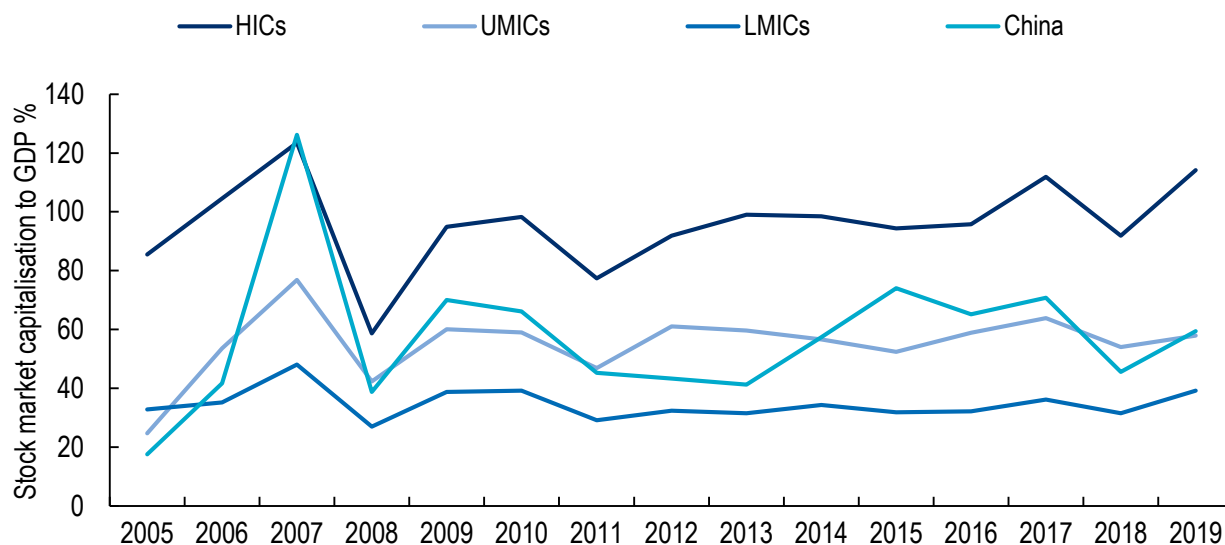
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Hurdles to alignment: Depth of domestic financial systems

COVID-19 highlights the need for stable financial reserves to serve as a buffer during crisis and to finance the recovery. While financial sector development in developing countries has increased, many still lack institutional depth. Foreign investors largely drive financial development in developing countries, but foreign investors also bring more volatility than sustainable, local capital markets.

Stock market capitalisation to GDP provides a measure of the size of local capital markets. As shown in Figure 3.5, values varied significantly across country income groups over the 15-year period of 2005-19. The value of stock markets in high-income countries (HICs) recovered after the global financial crisis now nearing pre-crisis levels of over 110% of GDP. In upper middle-income countries (UMICs), excluding China, stock market size has remained stagnant at around 60% of GDP. In lower middle-income countries (LMICs), stock market size has remained below 40% of GDP. Notably, data are unavailable for low-income countries (LICs), again suggesting negligible local capital markets.

Figure 3.5. Stock market capitalisation to GDP by income level over time



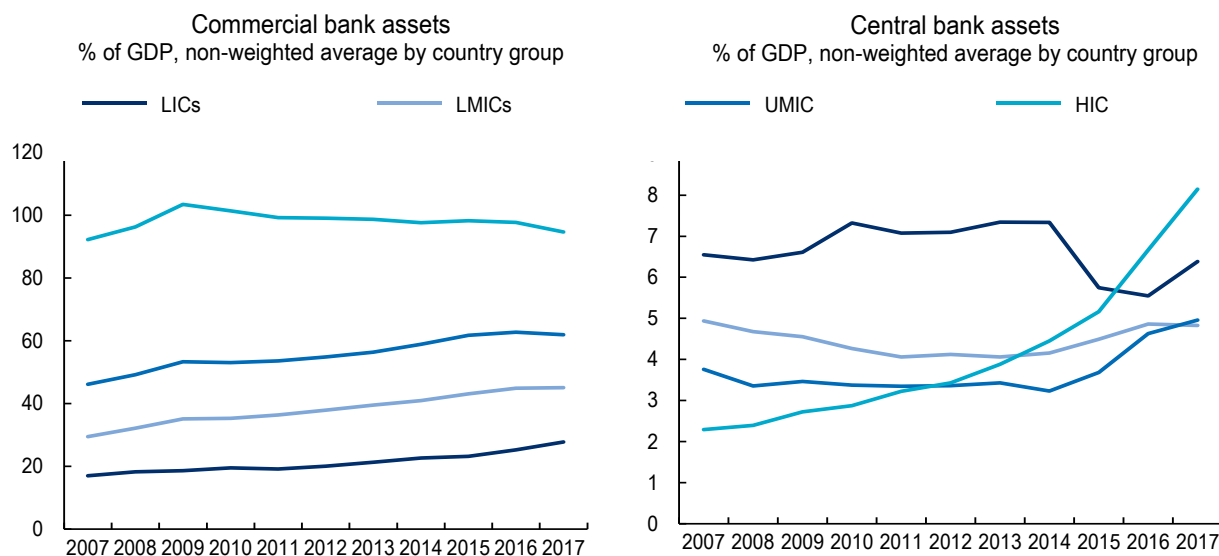
Source: World Bank (2020_[13]), *World Development Indicators* (database), <https://datacatalog.worldbank.org/dataset/world-development-indicators>.

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The banking sector is also needed to expand local capital markets. However, the commercial banking sector's share of GDP is five times lower in low-income countries (roughly 20% of GDP) than in high-income countries (around 100%), as shown in the left panel of Figure 3.6. Regulatory banking restrictions imposed by many developing country governments can excessively favour government securities or require conservative portfolio requirements (Bank for International Settlements, 2019_[14]).

From 2007 to 2010, central banks accounted for a higher share of GDP in LICs, LMICs UMICs than in high-income countries due to their greater reliance on foreign currency reserves. But, as shown in the right panel of Figure 3.6, the increase in central bank assets as a share of GDP following the global financial crisis in 2009 was limited to high-income countries. Most OECD countries, particularly major reserve currency issuers, had a greater margin to increase central bank reserves following the crisis.

Figure 3.6. Commercial bank assets and central bank assets to GDP

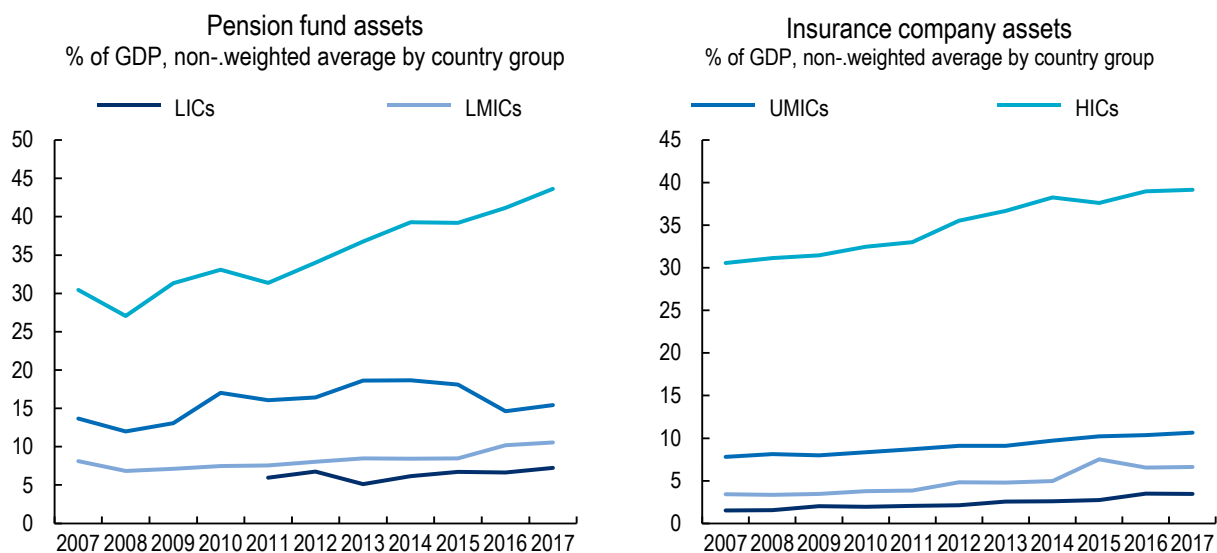


Source: Authors based on IMF (2020_[15]), *International Financial Statistics (database)*, <https://data.imf.org/?sk=4c514d48-b6ba-49ed-8ab9-52b0c1a0179b> (accessed May 2020).

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As Figure 3.7 illustrates, in 2017, pension funds represented less than 20% of GDP in developing countries and insurance companies less than 15%, compared to nearly 45% and 40% respectively in high income countries. In 2017, only one-third to one-half of the global population were covered by essential health services. Large informal sectors prevent financial systems from providing social protection. Informal employment represents 90% of total employment in low-income countries, 67% in middle-income countries and 18% in high-income countries (ILO, 2020_[16]). A lack of access to social protection exacerbates the vulnerabilities of informal economy workers and their families, particularly during COVID-19 lockdowns (OECD/ILO, 2019_[17]).

Figure 3.7. Pension fund and insurance company assets to GDP by income category, 2007-17



Note: Data coverage for both indicators drops in 2017. To avoid a bias from this sudden change of sample composition, the 2016 value for a country is used when the 2017 value is not available.

Source: Authors based on World Bank (2020_[13]), *World Bank Development Indicators database*, <https://datacatalog.worldbank.org/dataset/world-development-indicators> (accessed May 2020).

StatLink  <https://doi.org/10.1787/888934181280>

Hurdles to alignment: Inefficiency of domestic and international financial and taxation systems

Inefficiencies in the global system, among them illicit financial flows and remittance transfers, drain resources domestically. The unequal geographic distribution of financial assets also is linked to inefficiencies in domestic and international financial and taxation systems. These inefficiencies facilitate the outflow of assets and profits from lower-income countries. Aggressive tax avoidance by businesses and wasteful tax incentives by governments can further limit the ability of low-income country governments to align spending and economic activity to the SDGs.

Illicit financial flows (IFFs) are a significant cause of financing leakages in developing countries. Defined as money illegally earned, transferred or used, IFFs are closely associated with and often stem from illegal acts such as tax evasion, corruption, trade mispricing, money laundering and terrorist financing. The exact size of these flows is disputed, but there is broad consensus that a significant share of capital may be illicit. It is estimated that, each year, more than USD 1 trillion is paid in bribes worldwide and that anywhere from USD 20 to 40 billion is stolen by public officials (OECD/The World Bank, 2014_[18]).

It is also estimated that a higher percentage of resident assets are held off-shore from lower-income than from high-income countries, due in part to tax evasion and avoidance. While some financial assets held off-shore are legitimate, a significant proportion are thought to be illicit and/or undeclared for tax purposes. Evidence suggests that at least 44% of African financial wealth is held offshore in tax havens, with tax losses estimated at EUR 17 billion annually (OECD, ATAF, African Union, 2020_[19]). Aggressive tax avoidance by multinational enterprises is estimated to cost countries as much as USD 240 billion annually, and developing countries are disproportionately affected because they rely more on corporate tax revenues than do developed countries. Efforts to reduce the volume of illicit financial flows are discussed in Chapter 4.

Another cause of SDG misalignment resulting from the tax system is the prevalence of wasteful tax incentives. Many developing countries provide significant tax incentives that are poorly designed, with the result that tax revenues are limited and investments are not aligned to the SDGs and Paris Agreement commitments. According to surveys of investors, tax incentives are a low priority in investment decisions, with redundancy rates exceeding 70% in 10 of 14 surveys analysed by the International Monetary Fund (IMF et al., 2015^[20]). Such redundant or wasteful tax incentives are essentially a transfer from a government to the companies.

Persistently high remittance transfer fees further divert resources from households in developing countries. As shown in Chapter 2, remittances are the largest individual source of external finance to ODA-eligible countries (excluding China), surpassing ODA several times over. However, the cost of sending remittances to ODA-eligible countries remains high – between 6.8% and 7% on average in 2017-19 or between USD 30.26 billion and USD 31.15 billion annually. A reason for the persistently high cost of transferring remittances may be lack of access to lower-cost options, particularly mobile banking options, as well as low competition among a small number of providers of remittance transfer services and broader anti-money laundering restrictions (World Bank, 2020^[21]).

3.2.2. Common standards and transparency to define sustainable finance are lacking

This subsection considers how to assess and measure the amount of financing that can be considered sustainable. A growing number of public initiatives seek to develop common language to label and define sustainable finance and investment. Among these are the SDG alignment framework of the Group of Seven (G7), OECD and United Nations Development Programme; the EU taxonomy for sustainable activities; and the UN-led Global Investors for Sustainable Development Alliance.

At the same time, globally, professionally managed ESG portfolios valued at more than USD 30 trillion incorporated some form of sustainability consideration globally in 2018 – an increase of 34% in just two years. This figure may overestimate the value of sustainable investments, however, and should be treated with caution given that fund managers use some measures that lack transparency and intentionally inflate sustainability performance (Boiardi, 2020^[22]).

The proliferation of hundreds of different ESG rating agencies has led to different measurement standards. The construction of ESG scores, for example, can lead to vastly different results for the same company due to a lack of common definitions and reliable data. Fund managers differ as to which companies meet environmental, social and governance standards (Esty and Cort, forthcoming^[23]). However, without a common comparable language, fragmented criteria and standards for non-financial risk criteria, the legitimacy of ESG and other sustainability metrics is reduced. For example, the OECD Business and Finance Outlook finds that a high environmental score accorded by some ESG ratings can correlate positively with high carbon emissions if other environmental factors are given greater weight (OECD, 2020^[24]).

A wide array of financing activities and strategies currently comprise the spectrum of what is considered sustainable finance, ranging from funds that seek to do no harm (i.e. mitigate risks) to those that seek positive impacts based on thematic or geographic focus. In the broadest sense, sustainable finance includes both a do no harm objective and impact-based financing (Figure 3.8). Many of these categories overlap. Private sector actors rely on ESG criteria to assess social and environmental risks. It is important to note that an assessment of ESG risks is not an assessment of how investments actually impact environmental and social issues.

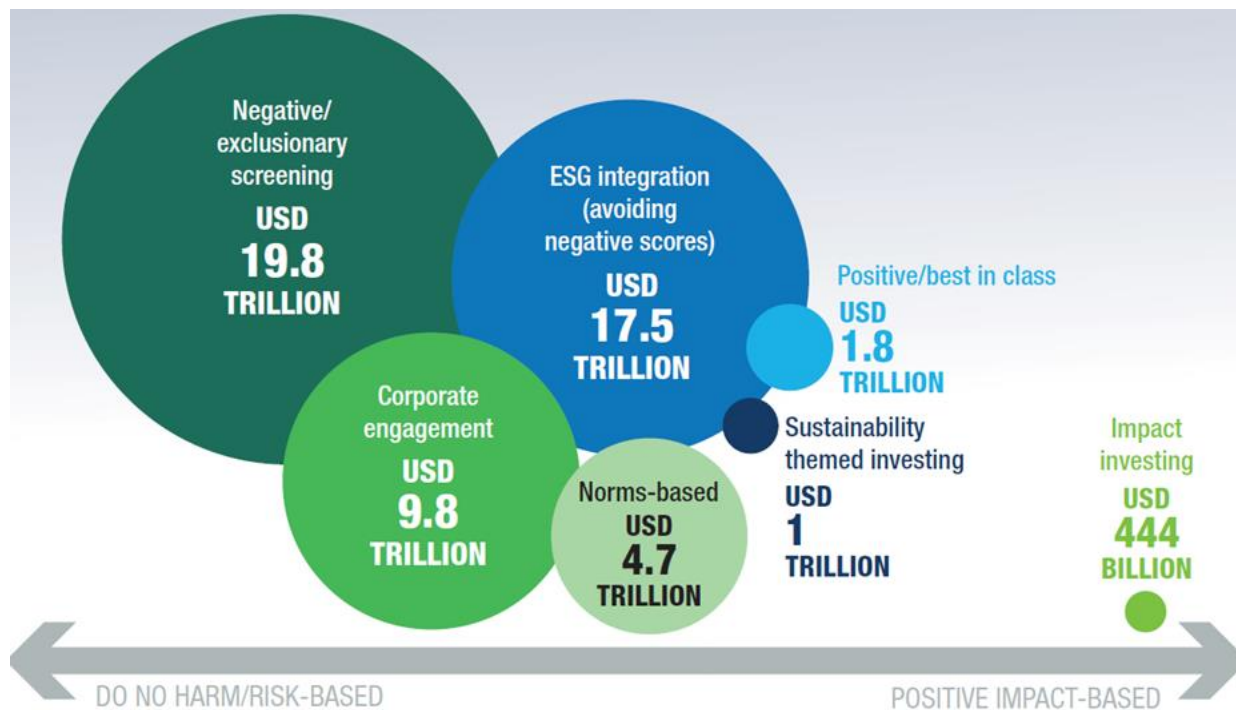
- Negative or exclusionary screening is the largest category of sustainable finance and is estimated at USD 19.8 trillion, which suggest this is the most accessible sustainability strategy.
- ESG integration is the next largest category, estimated at USD 17.5 trillion and including the integration of environmental, social and governance factors into financial analysis.

- Other categories include corporate engagement and shareholder action, estimated at USD 9.8 trillion, and norms-based screening, estimated at USD 4.7 trillion and including screening based on norms such as the UN Global Compact, the OECD Guidelines for Multinational Enterprises and the International Labour Organization conventions, among others. Many of these strategies overlap.

Roughly 10% of sustainable finance, or USD 3 trillion, is defined as seeking to achieve positive impacts. These forms of financing are more challenging to implement. They include positive/best-in-class screening (USD 1.8 trillion); sustainability-themed investing (USD 1 trillion), consisting mainly of green bonds; and sustainability-themed equity funds, social bonds and COVID-19 response bonds, and impact and/or community investing (USD 444 billion) (UNCTAD, 2020^[25]).

However, impact investing is the only form of financing that requires an actual assessment of positive impact and is also the smallest category (UN DESA, 2020^[26]). Increasingly public and private initiatives promote the 2030 Agenda as a common impact assessment framework to guide investors in directing financing towards achievement of the global goals. A survey of the 75 largest asset managers found that only 48% of investors are developing an approach to the SDGs (ShareAction, 2020^[27]).

Figure 3.8. Few types of sustainable investment are based on non-financial impacts



Note: The amounts in the figure do not add up to the estimated USD 30-trillion estimate sustainable investments due to double-counting across several categories.

Source: Authors based on Global Sustainable Investment Alliance (2018^[11]), *Global Sustainable Investment Review 2018*, http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf; European Sustainable Investment Forum (2018^[28]), *European SRI Study 2018*, <http://www.eurosif.org/wp-content/uploads/2018/11/European-SRI-2018-Study.pdf>; Responsible Investment Association Australasia (2019^[29]), *Responsible Investment Benchmark Report: Australia 2019*, <https://responsibleinvestment.org/wp-content/uploads/2019/07/RIAA-RI-Benchmark-Report-Australia-2019-2.pdf>.

3.3. The coronavirus (COVID-19) pandemic reinforces the economic case for SDG alignment

The global pandemic shows that SDG alignment is an economic imperative. Like climate change, the pandemic recognises no borders. It is a global threat, and as long as the virus persists in one country, it remains a threat to all countries. The risks that result from a global health crisis and subsequent lockdowns – economic recession, rising poverty levels, unemployment and debt distress – are far reaching. This section explores how accounting for environmental and social risks can secure the value of assets over the long term, and how investing in SDG alignment is an opportunity to build resilience in the markets.

3.3.1. Integrating environmental, social and governance risks is essential to preserve the long-term value of assets

Uncertainty and volatility of markets ultimately lower the long-term value of assets. Following the 2015 Paris Agreement on climate change, and before the COVID-19 crisis, green finance was gaining prominence as a means to align finance towards more sustainable development. The pandemic, though, has created a level of economic uncertainty reminiscent of the 2008-09 global financial crisis. Against this backdrop, a wide range of actors – citizens, clients and shareholders alike – are calling for the integration of not only climate-related risks but also risks related to global health issues, human rights abuse and gender equality, to name but a few.

Climate change is well understood by investors as a systemic risk to the global economy that undermines the ability of the financial system to deliver long-term returns. A survey of 231 Group of Twenty (G20) economists from finance ministries and central banks finds that respondents saw a green route out of the crisis as also being highly economically effective (Hepburn et al., 2020^[30]). More than 100 countries have already adopted carbon neutrality goals for 2050. Investors are coming under increasing pressure to measure and disclose their exposure to climate-related risk. Among the reasons:

- As temperatures rise, economic damage becomes more costly. On a global scale, damages from global warming could reach USD 30 trillion per year by 2100, representing more than 4% of global GDP. Some scenarios project as much as a 50% loss of annual GDP by 2100 due to temperature increase (Ens and Johnston, 2020^[31]).
- Fossil fuel subsidies cost upwards of USD 4.7 trillion in 2019, or 6.3% of global GDP (IMF, 2019^[32]). Fossil fuel subsidies act as negative carbon price signals. In 44 OECD and G20 countries, an estimated USD 178 billion was spent on fossil fuel in 2019 (OECD, 2020^[33]).⁵ In addition, a conservative estimate places average commitments of official development finance for upstream and downstream fossil fuel activities at USD 3.9 billion annually over 2016-17 (OECD, 2019^[34]).
- Renewable energy is becoming more affordable. Wind and solar unit prices have more than halved since 2011. It is now cheaper to build new solar and wind farms than to run existing coal plants.

Portfolios that seek to overcome environmental, social and governance risks can outperform the broader market over the long term and are registering lower losses in the COVID-19 era. ESG-rated funds often outperform non-ESG funds, suffer less volatility and experience lower losses. During the COVID-19 period, all three emerging market sustainable index funds outperformed the iShares Core MSCI Emerging Markets ETF by 1.58 percentage points (Freyman, 2020^[35]). In a survey of 3 750 investors across 15 countries, 81% of respondents indicated they view COVID-19 as a risk for markets, while 79% also view COVID-19 as presenting opportunities (UBS Wealth Management, 2020^[36]). New issuances of COVID-related bonds could further bolster the social bond market (Hube, 2020^[37]).

3.3.2. SDG alignment provides opportunities to build resilience in the markets

The SDGs provide the blueprint to build back better through an economic recovery that benefits people and planet. Today, world leaders are signalling their commitment to invest in safeguards against future disasters while also promoting a more sustainable and inclusive future (OECD, 2020^[38]). A window of opportunity for a “great reset” in favour of broader SDG alignment has emerged (Schwab, 2020^[39]).

However, resources borrowed by governments today should not contribute to widening inequalities across countries. OECD economies had more capacities to react (Chapter 1), and they injected 9% of their collective GDP in the recovery, while low-income countries only injected 1% of their GDP in stimulus packages. Developing countries face challenges to finance a response to COVID-19. High debt levels will increase if lockdowns are again needed in the future. The potential USD 700-billion decline in external private resources to developing countries, outlined in Chapter 2, raises the question of whether these countries will slip further behind.

However, responses to the crisis must not sideline investment in the SDGs. Before the pandemic, countries were taking steps to make SDG-conscious investments. For instance, more than 16% of all fiscal stimuli related to the global financial crisis (a total of more than USD 500 billion) were directed at green activities (Agrawala, Dussaux and Monti, 2020^[40]). In addition, the United Kingdom began formulating restrictions for pension fund trustees who disregard the long-term financial risks or opportunities from ESG. To receive public finance, businesses in Canada are required by the Canadian government to publish annual, climate-related disclosure reports consistent with the Task Force on Climate-related Financial Disclosures – that describe how they manage climate risks in corporate governance.

Nonetheless, post-COVID-19 economic recovery strategies, at least as now envisioned and implemented, do not rise to the step-change needed. Countries’ commitments to the 2030 Agenda also collectively fall short of what is needed to shift towards a pathway consistent with carbon neutrality (OECD, 2020^[41]). In addition, there is unfinished business from the global financial crisis including shadow banking, or non-bank financial intermediation, which represents more than half of the financial system (Adrian and Jones, 2018^[42]).

Pandemic recovery must harness the broader SDG market opportunities. The SDGs create USD 12 trillion in private sector investment opportunities annually (10% of GDP), mainly in food and agriculture, cities, energy, and materials. Health and well-being and could generate up to 380 million jobs. Achieving SDG 5 (gender equality) alone could unlock up to USD 28 trillion for global GDP by 2025 (Business and Sustainable Development Commission, 2017^[43]).

Following the pandemic, governments can create incentives for investment and job creation in SDG-aligned sectors. Some examples include:

- **Health** - For every USD 1 invested in preparedness, the average return was USD 2.10, with some projects providing returns upwards of USD 18.70 (Boston Consulting Group, 2015^[44]). COVID-19 has accelerated public spending on health research to design a vaccine and prevent future pandemics.
- **Sustainable infrastructure** - Globally, an estimated USD 59 trillion in infrastructure investment will be needed over the next 15 years to replace aging facilities and keep up with population growth and economic development (Citigroup, 2018^[45]). Implementation of the International Energy Agency’s Sustainable Recovery Plan could create roughly 9 million jobs, including jobs related to improving energy efficiency as well as jobs in the electricity sector, particularly in grids and renewables in three years (IEA, 2020^[46]).
- **Tourism** – In OECD countries, tourism represents an estimated 4.4% of GDP; domestic tourism represents 75% of the sector (OECD, 2020^[47]). Governments across the world are seeking to rebuild tourism infrastructure to rebound faster and reassure travellers to boost their post-COVID-19 recovery. Conditionality of financing can further help reduce carbon emissions in this sector.

- **Digitalisation** – Following the pandemic, remote working will become more normalised and online commerce will continue to grow, presenting new possibilities. In recognition of the potential, the European Commission has introduced the European Recovery Plan, which includes EUR 750 billion for investments in digital infrastructure (e.g. 5G networks), artificial intelligence, the circular economy, etc.

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Notes

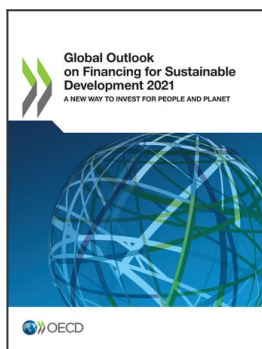
¹ Financial intermediaries are defined as institutions (banks, institutional investors, asset managers, etc.) that liaise between different actors to facilitate financial transactions, transforming the savings of individuals into financial assets (for the saver) and liabilities (for the borrower).

² The SDG financing gap is measured on a flows basis as an annual investment gap and is useful to assess recent developments in financing. This chapter examines a complementary measure – the stock of global financial assets. The measure of stocks presents the accumulation of holdings of assets and liabilities at a given time and is better suited for structural analysis of financial risk. For example, climate-related risk assessment and disclosure, notably championed by the Task Force on Climate-related Financial Disclosures, relies on a stock-based assessment of climate-related financial risks.

³ Financial auxiliaries hold USD 1 trillion in assets. They are corporations or quasi-corporations that take part in activities such as insurance brokerage and investment advice and corporations providing infrastructure for financial markets.

⁴ Financial assets are defined as intangible or non-physical assets whose value is derived from a contractual claim. The four main types of instruments are bank deposits, stocks, bonds and loans.

⁵ It is also important to recognise the potential trade-offs of a low carbon transition. In the context of COVID-19 and historically low fuel prices, governments are increasingly looking to cut fossil fuel subsidies to raise resources for spending. If and when fuel prices increase again, the question will arise as to how to ensure public support for subsidy cuts that transfer costs to households. Many low-income households may not be able to absorb higher fuel costs.



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