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**Capital for Purpose** / 49<sup>th</sup> St. Gallen Symposium / 8–10 May 2019  
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Systemic Interventions for Sustainable Capital Financing

## Systemic Interventions for Sustainable Capital Financing

Reuben Muhindi Wambui is one of the top three contributors to this year's St. Gallen Wings of Excellence Award. He studies at the Graduate Institute Geneva and attended the 49<sup>th</sup> St. Gallen Symposium as a Leader of Tomorrow.

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Reuben Muhindi Wambui is an aspiring public sector leader with core interests in central banking and financial markets, public finance management, and sustainable investing. Prior to grad school he worked at McKinsey and served diverse client teams across African countries and the UK. He is studying International Economics at the Graduate Institute in Geneva and is recipient of the Credit Suisse scholarship. Prior to McKinsey he was an Economics Teaching Fellow at Strathmore University and has worked on research projects funded by the World Bank, Strathmore University, Utawala Africa and the UNICEF. Previously, he has served as an Executive in the World Youth Government Kenya Chapter and has been hosted on national radio for his economic commentary on Kenya's first Eurobond issuance. He has published articles for the Kenya Banking Research Conference and in the Africa Policy Journal of Harvard Kennedy School. He is keen to serve on global corporate initiatives focused on long-termism and sustainable investing.

Tech giant IBM while commemorating 100 years of existence placed a remarkable ad in the Wall Street Journal and the New York Times to share century-long lessons, in which they remarked "To make an enduring impact over the long-term, you have to manage for the long-term."

Globally, calls for long-termism in business have been long-enduring and there has been persistent assault on "quarterly capitalism" where the obsession with quarterly reporting of corporate earnings is considered harmful to more long-term goals like spending on research and development (R&D) to spur innovation.

Numerous studies have corroborated the narrative that long-termism pays off. A study by McKinsey in collaboration with FCLT Global (formerly "Focusing Capital on the Long Term") found that firms focused on the long-term consistently outperformed their industry peers by growth in revenue, earnings and market capitalization for the study period 2001-2014.

That if all US firms had performed at par with "long-term firms", this would have delivered an additional \$1 trillion in GDP for the US economy with an estimated five million more jobs over that period (McKinsey & Company, 2017).

Seemingly, there is global consensus for the use of private sector capital for sustainable development. While interpretation of what counts as sustainable financing differs, it all points to a long-term investment focus that generates positive social and environmental impact. Thus claims to ideas that "counter excessive short-termism", "bring new and expanded purposes to capital" or "solve complex challenges and address substantial changes" as per the essay question must clearly define the form of sustainable impact targeted and approaches to get there.

This essay focuses on sustainable development goals (SDGs): what actions need to be taken to make capital more

purposeful in financing SDGs and the levers to support this agenda. Being an agreed-upon global framework, the choice of SDGs provides a universally relatable understanding of sustainable impact. As per the SDG Index and Dashboards Report 2018, all countries fall short of target in achieving SDGs targets by 2030, with the top 3 countries having gaps in some goals such as Goal 12 (Responsible consumption and production), Goal 13 (Climate action) and Goal 14 (Life below water).

UNCTAD estimates global funding needs for SDGs in the order of US\$5-7 trillion annually with the gap for developing countries estimated at US\$2.5 trillion per year, given current investment levels (UNCTAD, 2014). Given the constraints on public finances and global aid trends, private sector investment will be core and paramount.

The essay thus pins down four high-impact initiatives that will intensify the

potential of private capital to finance sustainability.

These ideas relate to an overhaul of global accounting standards, changes to banking regulation, reconfiguring bond rating systems and a suggestion for board composition that is SDG-linked. These are systemic interventions – not micro and disjointed solutions – because as it stands, we have many uncoordinated and duplicated business sustainability efforts. What we need are not more, but less-and-efficient high-impact initiatives.

Foremost, I'll highlight current approaches to sustainable financing, the challenges that continue to persist, and then explain the ideas for action.

### Current approaches

The world, or even the private sector, has not been short of ideas for financing sustainable development. Some key initiatives to make business operations and investments focused on substantiality in the long-term have included, but not limited to:

- *ESG-aligned business models*: The focus on environmental, social and governance (ESG) issues in business practices is commonplace with many institutional investors pushing for ESG criteria in investment decisions. Focus on ESG extends beyond the company-level with partnerships such as the Global Impact Investing Network (GIIN), a global network of investors focused on impact investing that generates social and environmental impact.
- *Green accounting and auditing frameworks*: Simply, this is accounting for the effect of business operations on the environment. Primarily, this involves factoring in environmental resource use into companies' financial results to arrive at a true "green bottom line"

reflective of environmental and social costs.

- *Green bonds*: These are fixed income securities to fund investments with proven environmental and/or climate benefits. This more directly relates to Goal 13 (Climate action). Green bonds are gaining momentum in developing countries e.g. Kenya is underway to issue the first green bond this year (Business Daily Africa, 2018).
- *SDG-aligned investment strategies and policies*: Many institutional investors and private equity firms have embraced the mapping of investment strategies to SDG targets. For example, the CDC Group used the framework to align its strategy to crucial SDGs where they consider they can have the greatest impact (EMPEA, 2018). In the Netherlands, leading pension fund managers PGGM and APG led the way by aligning their strategies to 13 of the 17 goals (Top-1000funds.com, 2017).
- *SDG-linked bonds*: The World Bank and BNP Paribas issued the first SDG-linked bonds in 2017 – bonds that link the return investors receive to stock performance of firms listed in the Solactive Sustainable Development Goals World MV Index, an index tracking firms' SDG performance. In 2018, the bank issued the first of these bonds in Asia raising US\$3.5 million.

### Persistent challenges

Despite all efforts to realign business practices to sustainability, there are a myriad of pressing challenges which actually give a sense of what areas new ideas should address. Such challenges include:

- *Complexity of sustainability out-*

*comes*: Sustainability is expansive and even the SDG landscape is broad (17 goals, 169 targets, 232 indicators) – it is often difficult to tie specific sustainability goals to specific investments. Further, with corporates having non-standardized ESG metrics and benchmarks, there is ambiguity on what counts as sustainable impact hence the need for comparable standardized frameworks.

- *Global accounting standards are not SDG-aligned*: Global financial reporting is not explicitly aligned to SDGs / sustainability metrics with accounting measures mostly framed as outputs, not outcomes. This has been a concern for many organizations over the years and has led to initiatives such as the Sustainability Accounting Standards Board (SASB).
- *Multiplicity of ESG frameworks and benchmarks*: Multiple non-standardized frameworks in use make comparability difficult and there are challenges of measurability and attribution of ESG impact. Many industry-led initiatives rely on firms' self-reporting and a natural consequence is that some firms result to using "ESG language" for PR purposes, even without any significant contribution to impact. Consider the threat to the 2 degree Celsius target arising from irresponsible production practices (SDG 12) at a time when many global manufacturers are consistently making fancy public statements on green production ethos.
- *Green-washing and insufficiency of green bonds*: Green-washing is commonplace – businesses and investors spending more funds and efforts in looking green than

going green. For the green bonds, the market value is fairly small and limited at scale with the market value projected to have reached only about US\$250 billion by end of 2018 (Morgan Stanley, 2018). For context, the US alone has a US\$41 trillion bond market (Forbes, 2018). A solution that incentivizes the full spectrum of bond issuers and investors globally to finance sustainable development would be a landmark step.

- *Challenge of many actors and duplicated efforts:* As it stands we have many uncoordinated business efforts on SDGs with thousands of participants, and micro-and-disjointed interventions. A reasonable step would be moving away from unregulated non-binding commitments to proactively integrating sustainability within existing regulatory and legal frameworks. There is indication of goodwill by firms through acknowledgement of existing SDG gaps. For instance, CitiGroup recently admitted that female workers at Citi are paid 29% less than men which directly relates to Goal 5 (Gender equality) and Goal 10 (Reduced inequality), with expected externalities on other goals.

### Ideas for action

Having highlighted current practices and challenges, here are the ideas for action to intensify the potential of private capital to finance SDGs. As earlier stated, the choice of system-wide overarching ideas is because, what will really make a difference are not more initiatives, but less-and-efficient interventions:

1. *Refine financial reporting standards to explicitly align them to SDGs through an International Accounting and Sustainability Stand-*

*ards Board (IASSB):* Until sustainability is at the core of financial reporting, capital will fall short of achieving long-term impact. In the face of capitalism and shareholder activism, it is naïve to expect self-regulation and industry-led sustainability efforts to deliver desired outcomes outside a binding regulatory framework. With many initiatives already in place including the Global Sustainability Standards Board (GSSB), I propose consensus between IASB<sup>1</sup> and FASB<sup>2</sup> to have a central International Accounting and Sustainability Standards Board (IASSB). Basically, refining of global standard-setting to incorporate sustainability. A good place to start would be leveraging the progress made by the US non-profit SASB<sup>3</sup> and the work of the GSSB. Practically, an overhaul of current standard-setting bodies would mean reviewing and expanding current standards to incorporate SDG targets – and keeping it simple to one central body with enforceable standards.

2. *Realign banking regulation to sustainable financing:* Given the size and pivotal role of banks, banking regulations e.g. the Basel Committee standards should proactively pursue sustainability in addition to risk management. Further, central banks and capital market authorities should incentivize banks to allocate capital to projects with clear sustainability outcomes. Already industry groups like the Sustainable Banking Network (SBN) are promoting information sharing on sustainable financing among banking practitioners. This approach can be adopted at a global industry-level led by bank-

ing regulators and banking associations. At national level, in China for example, an initiative led by the People's Bank of China and the UNEP enquiry led to assimilation of sustainability outcomes into financial regulation to promote a green financial system.

3. *Explicitly incorporating sustainability metrics into bond ratings, alongside promoting green bonds:* As the largest financial asset class globally, the bond market is indispensable. Although green bonds are trendy, their value contribution is minute and there is need for an intervention that covers the full breadth of corporate and government bonds – in essence, a systemic intervention would be more impactful. By rethinking and reviewing bond rating systems to incorporate SDG-linked metrics, the bond market could dramatically propel progress on sustainable development even in developing economies given the magnitude of the bond market. A practical starting point is for rating agencies (especially the Big 3 - Standard & Poor's, Moody's, and Fitch Group) to adopt rating nomenclature that distinguishes "sustainability-enhanced" ratings from other corporate credit ratings, so investors can tell the difference. These sustainability-linked ratings could offer good signaling to institutional investors particular about responsible investing.
4. *Finally, as part of regulatory reforms, have a non-executive board member entrusted fully with SDG monitoring, attribution and verification:* Re-aligning business models and regulation to sustainability can be daunting giv-

en the challenges of monitoring, attribution and verification of impact. For example, SDG impact measurement for a micro-finance bank would be different, and probably more difficult compared to a hospital or school, given the latter two have more directly aligned SDGs while the bank's impact would largely depend on uses of borrowed funds. The risk of impact misattribution is inherent and this is a common problem among impact investors. A dedicated board member would mean having an in-house resource person who has/builds expertise on sustainability compliance. Ultimately, this would be a skill transferable within and across industries.

Overall, for all the four to work – re-vamping reporting standards, re-aligning banking regulations, reconfiguring rating systems and dedicated sustainability board members – there is need for global advocacy and goodwill from multiple stakeholders including governments, regulators, corporates, investors, academia and civil society.

Meaningful implementation would have to be preceded by goodwill and ownership by industry influencers such as bank CEOs, the Financial Stability Board (FSB), rating agencies, the Bank of International Settlement (BIS), among others.

No doubt, these are bold moves that will be unsettling for many and thus require strategic approach and transparent consultations.

## Remarks

<sup>1</sup> International Accounting and Standards Board

<sup>2</sup> Financial Accounting Standards Board

<sup>3</sup> Sustainability Accounting Standards Board

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