

# How do you fund a sustainable tomorrow?

Financial services' role in helping meet  
the UN Sustainable Development Goals



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# Who should read this report and why?

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**This paper examines the ways in which the UN Sustainable Development Goals (SDGs) present a substantial opportunity and responsibility for the financial services (FS) sector to shape a sustainable world. FS plays a key role in enabling corporations and governments to fund initiatives that address the SDGs and plug a US\$2.5t annual funding gap.**

## **This paper helps:**

- ▶ CEOs to understand the transformative impact the SDGs will have on the FS industry, and how to link this to corporate strategy
- ▶ CROs to understand the diversity of risks, such as changing regulations and stakeholder expectations, and build this into risk management
- ▶ COOs to understand the implications of applying the SDGs to business operations, including the opportunities, markets and products created
- ▶ Investors, bankers, insurers, and sustainability or Corporate Social Responsibility (CSR) professionals in FS to identify how opportunities, such as impact investments, blended finance and new kinds of investors will transform the industry

## Methodology

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**The research for this paper comprised a mix of primary and secondary research, and included:**

- ▶ Conducting a desk-based review of academic literature, commercial research, public sector reports and industry publications
- ▶ A series of interviews with sustainability leaders in FS organizations and EY subject-matter professionals

## Acknowledgements

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## SUSTAINABLE DEVELOPMENT GOALS



# Executive summary

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## The SDGs: driving business opportunity

The expertise of the financial services (FS) community in raising, structuring and allocating funding is vital to achieving the UN Sustainable Development Goals (SDGs). For FS, the SDGs represent opportunity and responsibility.

The SDGs are designed to transform the global economy into an engine that will power a truly sustainable planet by 2030. Comprised of 17 goals, the SDGs provide a blueprint for governments, nongovernmental organizations and companies to meet the existing social, economic and environmental challenges facing our world. They are also designed to help tackle the new challenges posed by 21st century disruption.

Technology, globalization and demographics have been identified as the primary disruptive forces that are transforming the way we work and live, and the ways in which society is changing.<sup>1</sup> As these forces interact, they have given rise to a host of new megatrends.<sup>2</sup> These include climate change and the necessity for innovation to make the planet resource-rich instead of resource-scarce. These megatrends also include empowered consumers, rapid urbanization and a new generation of information technology.

Companies and governments typically make plans for the short and medium term. For business, society and ecosystems to survive, long-term thinking and behaviors must be adopted.

## The FS sector is key to achieving the SDGs

This will require US\$4t-US\$6t in investment annually but, on the basis of current investment budgets, there is an estimated US\$2.5t funding gap each year until 2030.<sup>3</sup> Global financial and capital markets currently manage almost US\$300t in financial assets every year.<sup>4</sup> FS has the ability to bridge the funding gap by redistributing funds. Leaders in the industry are already calling for action and setting up sustainable finance funds and mechanisms.

Achieving the SDGs will require long-term commitments from both the public and private sectors:

- ▶ **Governments** need to live up to the pledges that they have made, and create the legislative and regulatory frameworks that enable and promote sustainable economic growth
- ▶ **Regulators** have to assess current legislation for barriers to SDG financing, and integrate

environmental, social and governance (ESG) considerations into finance regulation

- ▶ **Investors** must apply pressure and demand ESG information as they increasingly acknowledge that sustainability is part of their fiduciary duty to shareholders
- ▶ **Companies** need to embed sustainability into “business as usual,” and innovate to create products and services that align with the goals
- ▶ **Banks** have to assess their portfolios for ESG risks and stranded assets, and integrate ESG considerations into their products, services and new instruments, while educating customers and employees
- ▶ **Insurance companies** must protect their customers from ESG risks and invest with a mission to avoid ESG risk throughout their business
- ▶ **Global stock exchanges and rating agencies** need to set more robust and uniform standards for ESG reporting, so that investors have access to consistent and comparable data

The FS industry must use its pivotal role in accessing and influencing the movement of finances which underpin the global economy. This will drive sustainable transformation by ensuring that the SDGs receive the implementation funds required.

## FS is key to closing the US\$2.5t funding gap

The scale of corporate, governmental and nongovernmental organization (NGO) commitments needed to achieve the SDG goals requires the expertise of the FS community to raise, structure and allocate funding.

So, with the funds to achieve the SDGs already in existence, what must FS do to unlock their potential?

### 1. Seize opportunities

The SDGs can be used as a lens to identify the world’s most pressing risks and challenges. It is estimated that addressing the SDGs could unlock US\$12t in business savings and revenue annually, and create 380 million more jobs by 2030.<sup>5</sup>

This could include creating new financial products and services, embracing impact investing as a positive driver of growth, harnessing new technology and innovation for sustainable finance and frameworks, and capturing new ESG-focused consumers.

## 2. Manage risk

FS must understand the risks facing the sector and the world, and identify which SDGs to prioritize and address. This will entail factoring in the risk and cost of externalities, such as carbon, new regulations, financial crime, and the changing demands of increasingly conscious consumers and investors.

It is also important to understand the role of the SDGs in driving regulatory changes, from new requirements in nonfinancial reporting to the impact on products, such as pensions and electric cars, and issues such as modern slavery and gender equality.

## 3. Adopt long-term thinking

FS must continue to transform itself from being an industry that rewards short-term thinking to one that realizes long-term value. This will involve a change of mindset and culture within the sector. It requires new frameworks and consistent measurement and reporting mechanisms.

This will help to integrate and value financial and nonfinancial performance. It also requires a concerted effort at collaboration between the government and civil society, in order to change the system.

How each organization tackles the SDGs over the next 12 years will have a massive impact on their strategy and growth. This is expected to equal or exceed other major drivers of change, such as financial technology (FinTech), regulation and other industry-specific challenges.

FS has a critical role to play in driving the SDG agenda and plugging the funding gap. Examples of how this can be done are explored in this paper. They are also summarized in the infographic below.

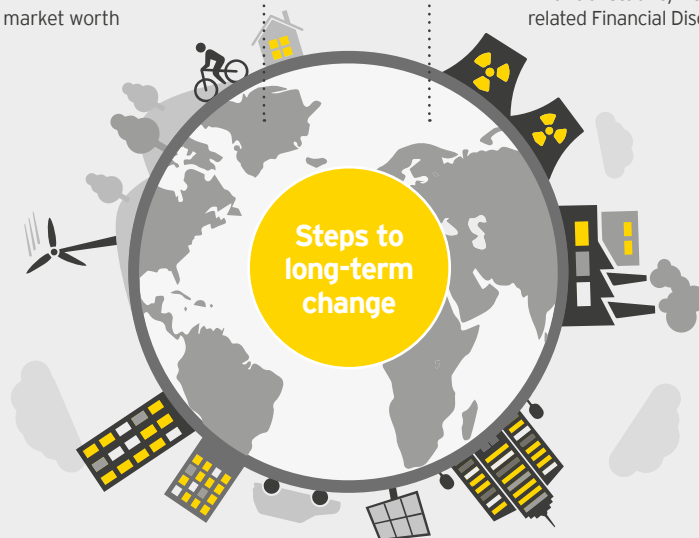
### With US\$300t in capital markets, the FS industry can innovate to close the US\$2.5t annual funding gap by exploring the following:

#### Seize opportunity by using the SDGs to gain business value

- ▶ Capture millennial investment. Millennials are set to inherit US\$30t by 2040; 84% say a focus on environmental, social and governance impact is the central goal
- ▶ Firms worth US\$6.6t have committed to accelerating SDG financing through the United Nations Environment Programme Finance Initiative (UNEP FI) Principles for Positive Impact Finance
- ▶ The potential value of SDG opportunity for the private sector is estimated at US\$12t
- ▶ Islamic finance predicted to grow to US\$3.4t by 2018
- ▶ Tap into a blended finance market worth US\$14.9b

#### Reduce risk by using the SDGs to manage business risk

- ▶ Despite regulation and compliance, corruption, bribery and fraud cost US\$1.26t in developing countries
- ▶ New EU pension rules on environmental, social and governance requirements will affect a US\$3.5t pension market
- ▶ Investors worth US\$5.2t have committed to divestment because of increasing concerns about climate risk
- ▶ Climate change could cut the world's financial assets by US\$2.5t
- ▶ Investors with assets of US\$2.6t support the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD)



All data and sources are cited in the paper

# The SDGs: addressing the challenges of a changing world

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The disruptive forces of technology, globalization and demographics are driving megatrends which are changing society, business and the planet. These megatrends include climate change and the necessity for innovation to make the planet resource-rich instead of resource-scarce. They also include empowered consumers, rapid urbanization and a new generation of information technology spearheaded by the internet of things, cloud computing and artificial intelligence (AI).<sup>6</sup>

Alongside this, hundreds of millions of people struggle to get the right nutrients each day. Millions lack access to fresh water and sanitation, and millions are affected by the changing climate.<sup>7</sup> We are living through a period of historically low interest rates. Global economic growth continues to falter amid widespread geopolitical uncertainty. While the global rush to the cities continues, many rural communities still lack access to financial services and communication technologies.

The SDGs provide a roadmap for governments, NGOs and companies to meet existing social, economic and environmental challenges. They are also designed to tackle the new challenges posed by 21st century disruption.

## The SDGs: identifying opportunity and risks

The SDGs comprise 17 goals, underpinned by 169 targets. The societal, economic and financial risks identified by the SDGs need to be managed as a minimum, but in risk lies opportunities. Research by the Business & Sustainable Development Commission estimates that meeting the SDGs could unlock US\$12t in global business savings and revenue annually in four key sector clusters: food and agriculture, cities and mobility, energy and materials, and health and well-being.<sup>8</sup> The research found that the 60 largest opportunities from these four sector clusters could additionally create 380 million more jobs by 2030.<sup>9</sup>

For the SDGs to unlock this opportunity, an investment of an additional US\$2.5t annually is needed to plug the gap.<sup>10</sup>

## FS checklist: turn SDG opportunity into business reality

### 1. Identify and commit

- ▶ Assess SDG ambition, current alignment with strategy and appetite for further engagement

- ▶ Identify and prioritize the SDGs with the biggest risk and opportunity impacts in the long term
- ▶ Map existing contributions to progress against the SDGs and identify ways to improve impact
- ▶ Publicly commit to the SDGs and communicate action plan and progress

### 2. Develop targets and report

- ▶ Develop and embed the SDG targets across the business, including through KPIs
- ▶ Focus on inclusive growth and true value, monitoring and valuing social and environmental impacts. The Coalition for Inclusive Capitalism is developing a framework that reflects the full value companies create through human, physical, financial and intellectual capital. This can be aided by standards and initiatives like the Global Reporting Initiative, the Sustainability Accounting Standards Board, the Natural Capital Protocol, the Social Capital Protocol and Integrated Reporting
- ▶ Align reporting with the SDGs to discuss performance in the context of the goals, establishing a common dialogue among stakeholders

### 3. Integrate

- ▶ Identify new business models, new products or services to achieve both business goals and the SDGs
- ▶ Invest in education, capacity building and employment opportunities to increase local economic power, while preserving the environment
- ▶ Decouple economic growth from the intense use of natural resources through carbon, energy and water efficiency programs, and circular economy thinking
- ▶ Develop systems to integrate the management of SDG issues into everyday business decision-making
- ▶ Ensure governance and accountability for SDG implementation across the business
- ▶ Participate in collaborations, leverage networks and share responsibility

## Five SDGs key to financial services

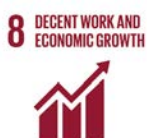
Developing an understanding of the SDGs allows FS organizations to focus efforts on existing and emerging opportunities, while identifying and managing risks.

While FS has the ability to influence all 17 of the SDGs, EY EMEIA Financial Services<sup>11</sup> has reviewed the targets under each goal and identified which SDGs are most important to our business and the industry we work in. These are listed below. Other organizations may have different findings depending on their strategy and approach.



**SDG 5: Gender equality** sets the target of ensuring enforceable legalization “for the promotion of gender equality, and the empowerment of all women and girls at all levels.”<sup>12</sup> This commitment makes transparency about gender equality a priority issue. It requires the FS industry to promote gender equality within its own organizations, by adhering to gender pay laws, for example.

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**SDG 8: Decent work and economic growth** provides opportunity by stipulating the need to free up finance to stimulate the growth of micro- small- and medium-sized enterprises. Target 8.10 even specifies the need to “strengthen the capacity of domestic financial institutions to encourage and expand access to banking, insurance and financial services for all.”<sup>13</sup> It also stipulates an end to forced labour, modern slavery, human trafficking and child labor, highlighting the need for supply chain transparency and robust auditing systems.

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**SDG 10: Reduced inequalities** has a strong regulatory focus.<sup>14</sup> Target 10.5 specifies the requirement to “improve the regulation and monitoring of global financial markets and institutions, and strengthen the implementation of such regulations.” Target 10.6 specifies the need to increase representation for developing countries in “decision-making in global international economic and financial institutions, in order to deliver more effective, credible, accountable and legitimate institutions”.

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**SDG 13: Climate action** is explicitly focused on climate and limiting global temperature change. It outlines the mobilization of US\$100b annually by 2020, and the need to “fully operationalize the Green Climate Fund through its capitalization as soon as possible.”<sup>15</sup> The FS industry will play a key role in mobilizing these funds, as well as in providing the framework for success indicators to be met.

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**SDG 16: Peace, justice and strong institutions** highlight key areas likely to be targeted with increased regulation. It is focused on developing effective, accountable and transparent institutions at all levels, and on reducing illicit financial and arms flows, organized crime, bribery, and corruption. Much of the goal can be linked to good “business as usual” practices.

# Seize opportunity: use the SDGs to gain business value

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The SDGs provide immense opportunity for all businesses, especially for FS. This is because the scale of corporate SDG commitments needed to meet the goals requires the expertise of the FS community to raise, structure and allocate funding.

The industry also has the potential to provide financial advice and the management of funds to NGOs. This could ensure that donor funds reach their intended destination and that their use is effective, impactful and reportable.

The following three actions have been identified as presenting significant **existing** and **emerging** opportunity for the FS industry. They are outlined in more detail below.

- 1. Harness responsible investment and finance**
- 2. Capture new kinds of investors**
- 3. Innovate for a sustainable future**

## 1. Harness responsible investment and finance

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The growth opportunities offered by the SDGs is already changing the FS industry. For example, the number of sustainable investing funds available has tripled to 925 from 338, since 2008.<sup>16</sup> Some of the main components of existing and emerging SDG investment opportunities are summarized below.

“With investment in long-term infrastructure assets needing to quadruple, green investment represents a major opportunity for both long-term investors and macroeconomic policymakers seeking to jump-start growth. For this to happen, however, green finance cannot conceivably remain a niche interest over the medium term.”

Mark Carney, Governor, Bank of England<sup>17</sup>

### Existing – Support green bonds

Green, or climate, bonds were first established 10 years ago to enable new sustainability infrastructure. They have grown exponentially with US\$42b issued in 2015, nearly four times more than the 2013 issuance. In 2017, global issuance reached US\$155b,<sup>18</sup> exceeding expectations and demonstrating the substantial growing market opportunity.

Green bonds are often intrinsically aligned with SDG goals. They “are issued in order to raise finance for climate change solutions: climate change mitigation or

adaptation-related projects or programs. These might be greenhouse gas emission reduction projects ranging from clean energy to energy efficiency, or climate change adaptation projects ranging from building Nile delta flood defences to helping the Great Barrier Reef adapt to warming waters.”<sup>19</sup>

### Emerging – Facilitate blended finance

Private and public sector collaboration will be key in bridging the US\$2.5t SDG funding gap.<sup>20</sup> One such model is “blended finance,” where governments, development banks, philanthropists and companies work together to finance development projects that otherwise would not be funded. This is often in the form of government aid used for underwriting greater private sector investment. Public sector and philanthropic participation help mitigate the risk for private sector investors and, hence, act as a catalyst for much greater private sector financing of projects. One survey on blended finance identified capital commitments of US\$14.9b across 61 funds.<sup>21</sup>

Blended finance is still in its infancy and has been met with some criticism in the development community. This is because of a fear that it diverts aid from poverty reduction programs (which promise no tangible return on investment) in favor of infrastructure projects (where tangible returns are expected).

However, the World Economic Forum believes blended finance to be a key pillar of the financing framework for the SDGs. Its research showed that every dollar of public money invested attracts between US\$1 and US\$20 in private investment.<sup>22</sup> If blended finance can open the FS sector’s eyes to the potential of sustainable development financing, it could herald a new approach to financing a more sustainable world.

### Emerging – Embrace impact investing

“Impact investing” is an evolution of socially responsible investment (SRI), which tends to be heavily linked to the SDGs. Historically, SRI funds appealed to a small selection of ethical investors who wanted to avoid certain sectors such as fossil fuels and firearms. Yet this type of negative screening failed to resonate with the majority who were primarily focused on solid financial returns.

Impact investing takes a positive screening approach, focusing on sectors, such as energy and technology, and pursuing sustainable growth and returns. This approach is paying off, with research increasingly indicating that positive impact investing does not result in financial trade-offs.<sup>23</sup>



This has stimulated growth in impact investing with investors who want to combine financial return with their values.

Because of the complexity of the sector across various asset classes, and a lack of clarity over what constitutes “impact investing,” the sector hasn’t been fully quantified. However, the Global Impact Investing Network (GIIN), reported US\$77.4b of impact assets under management in their annual investor survey.<sup>24</sup> GIIN is a trade association for the sector which includes leading banks, asset managers and insurers as members.

### Emerging – Nurture SDG investment funds

A new class of investment funds is emerging which has a specific SDG tag. SDG investment funds commit to channeling funds to investments that aim to address SDG goals.

Impact investments have been ahead of the curve with many explicitly linked to the SDGs. For example, the German index provider, Solactive, and BNP Paribas have launched a series of indices that rank companies on the basis of their contributions to achieving the SDGs. The first of these products, called the Solactive Sustainable Development Goals World Index, is made up of 50 companies, equally weighted in terms of size, which have a positive net impact on the goals.

Sustainable investments are also showing strong performance with no financial trade-offs. The *Global Alliance for Banking on Values 2014* report found an increased return on assets 0.68% for sustainability-focused banks versus 0.58% for globally systemically important financial institutions.<sup>25</sup>

However, despite this growth, a far greater mobilization of capital is needed if the SDGs are to be achieved. FS must work to ensure that sustainable investing and banking becomes the norm.

## 2. Capture new kinds of investors

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The investor mindset is shifting. The megatrend of the empowered consumer is having an impact. Social media-savvy and connected consumers and investors are asking tougher questions of FS. They are increasingly making employment, purchasing and investment decisions on the basis of their values and concerns that align with the issues of the SDGs. Being able to meet these investor needs provides significant opportunity.

Three investor demographics have been identified as having a particular SDG focus:

### 1. Existing – Islamic

Islamic investors are starting to have increasing influence, as Islamic banking continues to rise in prominence. One World Bank and Islamic Development Bank report noted that Islamic finance had great potential to enhance prosperity and achieve the SDGs.<sup>26</sup> This is because Islamic investors, and Islamic banking, prioritize financial and social inclusion, prudent governance, and investment into the real economy.

With exponential growth expected in the market, from US\$2t to US\$3.4t by the end of 2018,<sup>27</sup> Islamic finance could make serious inroads into the SDG funding gap, especially as a large part of its activity takes place in emerging markets.

### 2. Emerging – Millennials

Millennials place ESG considerations high on their list of investment considerations and are a growing influence in impact investing. 84% cite investing with a focus on ESG impact as a central goal.<sup>28</sup> It is estimated they will receive more than US\$30t of inheritable wealth in the US alone in the coming decades.<sup>29</sup> Climate change is a concern for millennials, but their biggest ESG considerations are good corporate governance, social responsibility and positive environmental impacts,<sup>30</sup> all of which tie in to the SDGs.

### 3. Emerging – Women

Women are another growing influence in the impact investing community. The global income of women will grow from US\$13t to US\$18t in the next five years – more than the GDP growth of China and India combined during the same period.<sup>31</sup> Women also prioritize ESG as part of their investment considerations – EY research shows that women see transparency as a particularly important driver of trust.<sup>32</sup> Women and girls are also a specific target of SDG 5: Gender equality.

### 3. Innovate for a sustainable future

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Existing and emerging innovations, from FinTech to sustainable stock exchanges, are disrupting FS, creating new markets, new products and new opportunities.

#### Existing – Exploit FinTech

FinTech is causing disruption throughout the FS industry,<sup>33</sup> often by bypassing traditional thinking, allowing new players to enter the sector and threatening the dominance of traditional banking models.

Different forms of financial institutions have emerged with new online platforms enabling peer-to-peer lending, crowd-funding and microfinance, and disrupting and democratizing the traditional access to capital and credit. For example, mobile phones play an increasingly important role in bringing financial inclusion to communities that have traditionally been denied banking services. This directly addresses SDG10: Reduced inequalities, SDG 8: Decent work and economic growth, and SDG 9: Industry, innovation and infrastructure.

Blockchain is an example of an innovation that can help to support the SDGs. The distributed and connected ledger system allows multiple parties to share data in a trusted environment. Blockchain offers an opportunity for transparent financial transactions and accountability, helping to address fraud and corruption that is addressed in SDG16: Peace, justice and strong institutions. It will potentially reshape everything from retail banking to global energy markets to food sourcing and supply chains.

Further innovations, such as AI, robotics and machine learning, could also help to accelerate the rate at which sustainable thinking becomes business as usual within the sector.

#### Existing – Engage with sustainable stock exchanges

The UN Sustainable Stock Exchanges Initiative brings together the world's various stock exchanges to promote sustainable finance. It has 63 partners<sup>34</sup> and represents over 70% of listed equity markets.<sup>35</sup> Some stock exchanges have started to mandate ESG reporting for listed equities, while Frankfurt is planning to become a sustainable finance hub. Being listed and engaged with these exchanges provide opportunities to capture sustainability-focused investment, while improving reputation and demonstrating commitment to addressing corporate transparency and performance on ESG issues.

#### Emerging – Get behind sustainable frameworks

To prevent confusion and ensure initiatives are not limited in their effectiveness, the sector needs an all-encompassing framework for valuing sustainability.

This will help investors understand what long-term value looks like and factor it into short-term business decisions.

The UNEP FI has been convening industry players for exactly this purpose. Its Principles for Positive Impact Finance propose a holistic approach to SDG issues as a means to developing and implementing new business models, and financing approaches that will help address the SDG funding gap. With over 20 leading banks and investors, totaling US\$6.6t in assets, committed to accelerating SDG financing through the Principles for Positive Impact Finance, the initiative represents a substantial opportunity.

#### **The opportunities are already available – each FS business just needs to find the right fit and take action.**

“Achieving the SDGs is going to require a step change in the amount of private investment going toward sustainable business solutions. Stock exchanges are critical in driving efforts to channel investment into sustainable development initiatives.”

**James Zhan**, Director, Investment and Enterprise, UN Conference for Trade and Development

# Reduce risk: use the SDGs to manage business risk

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## Use the SDGs to identify issues and strategy, and inform decision-making.

**The FS industry will be directly affected by the megatrends and sustainability challenges facing global society. The SDGs provide the lens needed to identify and address these risks and challenges.**

These challenges include financial exposure to:

- ▶ Catastrophic climate events
- ▶ Rising shareholder activism
- ▶ The potential overvaluation of companies in fossil fuel and resource-scarce industries
- ▶ Organizations whose business models depend on natural resources such as water, energy and biodiversity
- ▶ The rapid increase in consumer scrutiny on corporate behavior, and the financial implications of these groups using their voice and money to drive sustainable solutions
- ▶ Increased regulation to enforce the SDGs

## For CROs, embracing the SDGs facilitates the management of long-term regulatory, reputational and financial risk.

Some of the ways that the SDGs can help companies reduce these risks are outlined below:

- 1. Identify and understand existing and emerging regulatory issues**
- 2. Manage reputational risk across stakeholders**
- 3. Understand financial impacts**

### 1. Identify and understand existing and emerging regulatory issues

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Sustainably-focused regulation is transforming the global landscape. The Paris Agreement, or Accord, along with the global commitment to achieve the SDGs, are two key examples of regulation and globally agreed frameworks that will influence and transform global businesses.

The Paris Agreement is the outcome from the UN Conference of the Parties in 2015 (COP21). More than 190 countries pledged to cut carbon emissions and keep global warming below 2°C.

Despite the US's recent intentions to withdraw, individuals, businesses and nations have continued to support the goal of limiting global warming.

Regulation is also an explicit component of many of the SDGs (see five SDGs key to financial services, page 7).

The SDGs are already making noticeable impacts on regulation. This will only increase, as governments will need to back up their SDG commitments with action that will create a level playing field for sustainable finance to flourish.

Pressure will also continue to increase from within existing regulatory frameworks. Other regulatory hotspots and recommendations are outlined below.

#### **Incorporating ESG risks into pensions**

In 2016, the European Parliament approved a revised European pension fund directive that requires retirement fund managers, as part of their fiduciary duty, to take into account the ESG risks of investments.<sup>36</sup>

In September 2017, the European Commission proposed that the European supervisory authorities (ESAs) incorporate ESG risks into their stress tests of pension funds.<sup>37</sup> The idea has been met with resistance from the industry so far, but it is an indication of changes to come.

Some pension funds are using the SDGs as a lens through which to invest. For example, a coalition of Dutch and Swedish pension funds have pledged to use the goals as a framework to make investor decisions, citing the need to meet "mounting social and environmental challenges."<sup>38</sup>

#### **Watching out for solvency schemes**

Some long-term investments have been penalized by new capital requirements, solvency schemes and holding requirements. In Europe, for example, some investors highlight how Solvency II, the regulation that requires insurers to retain high levels of capital to reduce risk, is hampering sustainable infrastructure investments and putting them at a disadvantage when competing with companies from other parts of the world.

Aviva's experience in Canada is one such example. Solvency II has required Aviva to hold more than four times as much capital as its Canadian rivals when backing identical low carbon infrastructure projects.<sup>39</sup> Amid global political uncertainty and increased protectionism, these problems may increase.

“If we don’t tackle the SDGs, the current insurance business model won’t survive as a financial support mechanism. Interconnected issues of climate change, ecosystem degradation, famine, migration, and political and social unrest, etc., will increasingly impact the ability of people to make a living, and the insurance business model will need to adapt to this new world.”

**Zelda Bentham**, Group Head of Sustainability, Aviva plc

### **Tackling gender inequality**

SDG 5 prioritizes gender equality. Organizations that receive investment will be required to transparently demonstrate action on this. The FS industry must ensure that it is promoting gender equality within its own organizations and complying with new gender pay gap laws as they arise. Gender indexes, such as Bloomberg’s gender equality index,<sup>40</sup> which recognizes FS firms that are actively addressing gender imbalance in their organizations, are emerging. There is evidence that equality equals good business, with companies with better gender diversity 15% more likely to have financial returns above their national industry medians.<sup>41</sup>

### **Addressing modern slavery**

SDG 8: Decent work and economic growth stipulates the need to “take immediate and effective measures to eradicate forced labour, end modern slavery and human trafficking ... and by 2025 end child labour in all its forms.”<sup>42</sup> This means ensuring transparency and high worker standards, especially in the supply chain, for organizations who feature in investment portfolios or as other links in the FS chain.

### **Keeping up with changing industries**

Some industries will be especially affected by the SDGs so, to keep ahead, it is important to understand how this will impact markets and inform investment decisions. For example, the automotive industry is being transformed to an electric vehicle industry by SDG-focused regulation such as SDG 13: Climate action. Norway has set a 2025 deadline for ending sales of new vehicles with internal combustion engines. The UK and France have committed to a 2040 deadline, while Germany, China and India are planning similar commitments.

## **2. Manage reputational risks across stakeholders**

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Incorporating the SDGs into thinking is crucial for managing reputational risks, to avoid losing market share and to support investor engagement. The increased need for transparency will drive risk identification and management. Some examples of SDG-related reputational issues and recommended actions are outlined below.

### **Support the Task Force on Climate-related Financial Disclosures (TCFD)**

The TCFD was established by the Financial Stability Board in 2015. It aimed to develop voluntary, consistent and climate-related financial risk disclosures for use in mainstream financial filings. So far, 11 banks worth US\$7t<sup>43</sup> and 18 institutional investors with assets totaling US\$2.6t have committed to supporting the TCFD.

### **Develop sustainable finance**

The European Commission high-level expert group (HLEG) of pension funds, insurers, asset managers and other finance players has been tasked with creating a pan-European road map for sustainable finance.

FS will need to be ready to act on its findings. Recommendations so far include the development of classification systems for sustainable assets, a European standard and label for green bonds, and other sustainable assets. It also calls for corporate sustainability league tables that rank firms on their performance against the SDGs.<sup>44</sup>

### **Connect with connected consumers and stakeholders**

Using the SDGs to identify and manage reputational risks is increasingly important in an era where social media-savvy and connected consumers and investors are asking ever tougher questions of FS. Consumers and investors are able to mobilize and protect against unsustainable practices faster and with a more powerful voice than ever before.

Consumers and investors are agitating on Facebook and Twitter. More importantly, they are coming together to table activist shareholder motions. Indeed, the largest number of shareholder resolutions filed by investors now concern social and environmental issues.<sup>45</sup> Addressing and preempting these shareholder concerns should be a priority.

## **3. Understand financial impacts**

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Financial criteria often drive decision-making. It is important that the total value of addressing the SDGs is understood and incorporated into financial analysis and reporting. Some examples of recommended actions are outlined below.

### **Factor in intangible assets**

Currently, much of the financial system is working with incomplete information. Financial markets make value judgments on the basis of many externalities, including government policy, legislation and regulation, the corporate reputation of companies, and financial performance. Equal importance should be placed on natural, intellectual, human, social and manufactured capital, with market prices reflecting the full economic



cost of environmental and social externalities. One academic study calculates that 84% of the market value of Standards & Poor's 500 companies comes from intangible assets, such as brand value, intellectual property and people.<sup>46</sup> It is imperative that governments and policymakers create frameworks that allow the market to properly value and account for other nonfinancial factors in investments and business performance.

### Step up nonfinancial reporting

Through integrated performance management, nonfinancial reporting can be a powerful tool to stimulate internal changes and decision-making. It can also build trust externally with investors, NGOs, the media and customers, by creating transparency.

The past two decades have seen a strong increase in nonfinancial reporting, as more companies have adopted external reporting standards, such as the Global Reporting Initiative. Integrated reporting is also on the rise, as companies link business risks directly to their strategy, and adjust their internal management accounting systems to include nonfinancial information.

Nonfinancial reporting is now mandatory for large companies. The European Directive on nonfinancial reporting states that large companies must publish reports on their policies in relation to issues such as environmental protection, social responsibility and treatment of employees.<sup>47</sup> Listing on the UN Sustainable Stock Exchanges Initiative also requires nonfinancial reporting.

From a system-change point of view, progress remains incremental and disjointed. Until consistent measurement and reporting standards are adopted to reflect the real cost of nonfinancial factors, it will be difficult to plan and fund sustainable growth.

Using the SDGs as a common framework for this growth can help companies establish internal reporting frameworks and clear metrics that directly link financial and nonfinancial performance, and align market objectives with long-term value creation and growth. It will also enable more consistent and comparable reporting, which would resonate with investors and banking customers.

### Curb financial crime

According to the *EY EMEA Fraud Survey*, 77% of company directors and senior managers feel that unethical behavior is justified to ensure survival of the company.<sup>48</sup> With corruption, bribery, theft and tax evasion costing approximately US\$1.26t in developing countries every year,<sup>49</sup> the money is flowing through the international financial system.

Every single organization should be managing these risks as part of its standard business practice but, despite stringent anti-money laundering, anti-bribery and know-your-client processes, the problems persist.

SDG 16: Peace, justice and strong institutions is designed to highlight and tackle these key areas of risk.<sup>50</sup> It is focused on reducing illicit financial and arms flows, organized crime, bribery and corruption, and building accountable and transparent institutions with good governance.

Regulation is also coming to the fore to stop it. For example, the UK recently introduced Unexplained Wealth Orders, a provision of the Criminal Finances Bill. This enables institutions to question the source of funds for purchases over £50,000. If there is no documentation, the funds will be presumed to have come from unlawful activity.

Further industry commitment to curb illicit financial flows and fight corruption would result in an added opportunity for the sector to bridge the US\$2.5t funding gap. It would also be a tangible demonstration that the sector is working in society's best interests.

### Identify potential stranded assets

Stranded assets are assets that have become valueless because of devaluation and premature write-downs, or because they have become a liability.

Achieving the Paris Agreement's goal of keeping global warming below 2°C will have a significant impact on the fossil fuel industry and the banks and investors that fund it. It will necessitate capping the amount of coal, oil and natural gas that can be extracted from the earth. The sources are left untouched and therefore "stranded."

The assets are at further risk of becoming stranded because the US\$5.3t annual global subsidies for the fossil fuel industry<sup>51</sup> are directly targeted by SDG 12 (c): Rationalize inefficient fossil-fuel subsidies. Subsidy withdrawal could make extraction financially unviable. SDG 7 also specifies that international cooperation and investment in energy infrastructure and clean energy technology must happen as a global priority.

These "stranded assets" could destabilize the fossil fuel sector and those dependent on it, including some of the world's biggest companies. Wealth and asset managers are also concerned that investing in carbon-intensive assets may increasingly be at odds with fiduciary duties.<sup>52</sup>

Climate change could cut the value of the world's financial assets by US\$2.5t, according to a London School of Economics study.<sup>53</sup> The impact will cross all financial sectors from banking and insurance to wealth and asset management.

Divesting from carbon-intensive industries, such as fossil fuels, to invest in sustainable enterprises, such as green technologies, is becoming increasingly common. For example, the world's biggest banks reduced their investment in fossil fuel by 22% between 2015 and 2016.<sup>54</sup> Divestment has even become a campaign slogan, with conscious consumers, investors and the media lobbying for investment to be moved away from climate-damaging industries.

A focus on the SDGs could lead to further types of assets becoming stranded. For example, global banks currently hold up to US\$400b in shipping debt, which could be vulnerable to climate risks as the industry transitions to a low-carbon transport system.<sup>55</sup> From a banking standpoint, capital investments and loans in many industries need to be assessed carefully to limit exposure to potential stranded assets.

For the insurance industry, stranded asset risks could be wide-ranging and include:

- ▶ Potential third-party liability claims against upstream energy companies
- ▶ A change in government energy policies induced by climate change concerns
- ▶ A change in the property sector, including litigation for negligence for failure to disclose climate change impacts on property investors

“Climate change risk has arrived as an investment issue and the momentum behind mitigating climate risk in portfolios is increasing.”

**Blackrock Investment Institute**<sup>56</sup>

# Conclusion: take the steps to long-term change

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The megatrends of climate change, globalization, technology and demographics will continue to transform and challenge business, society and our planet. The SDGs provide a blueprint for how to navigate these challenges sustainably and successfully, but they cannot do this with a US\$2.5t funding gap.

FS underpins all sectors and, as an industry, can have the single biggest impact toward achieving the SDGs by redistributing funds and plugging this gap.

Finding the US\$2.5t needed to meet the global goals is achievable considering that US\$300t is already available in capital markets. This figure is based on bank lending and the value of shares on stock exchanges and bonds.<sup>57</sup>

By managing the risks adequately and taking advantage of the opportunities, the global financial system will reshape other industries. It will influence the redeployment of funds from unsustainable to sustainable activities and projects. In today's global financial system, large institutional investors have holdings so broad and diverse that they own, in effect, a slice of the economy as a whole. Therefore, these large-scale influencers should take a leadership role in maintaining a stable, well-functioning and well-governed social, environmental and economic system.

## Focus on long-term value and inclusive growth

FS must help to drive a shift from short-term to long-term value. The current system hampers companies' abilities to plan for the future because they are tied down by the short-term profit expectations of shareholders, analysts and the media. Short-term thinking and reporting usually result in a focus on quarterly earnings, and tend to exclude sustainability risks that would have a financial impact. This results in poorer decision-making and prevents the creation of strategies that actually focus on creating value in the long-term.

According to the UN Global Compact, "many companies respond to these pressures by reducing expenditures on R&D and foregoing investment opportunities with a positive long-term net present value. As a result, companies are discouraged from developing sustainable products, investing in measures that deliver operational efficiencies, developing their human capital or effectively managing the social and environmental risks to their businesses."<sup>58</sup>

Yet, switching to a long-term value mindset can have considerable benefits. Reporting and accounting for long-term value enable better understanding of macro issues and lead to better allocation of capital and stronger investment strategies. It also improves communication with investors and other stakeholders.<sup>59</sup>

This is why many industry experts make the case for inclusive growth. This means choosing to focus on growth that provides equal opportunities for all sectors of society, focusing on creating long-term value in order to deliver sustainable business growth and a more equitable society.

The SDGs provide a framework for understanding the long-term value of an organization and can be used to guide reporting on this. A number of market-led initiatives already exist that support this.

- ▶ The Coalition for Inclusive Capitalism aims to develop a framework that reflects the full value companies create through human, physical, financial and intellectual capital deployment. The ambition is to create a new reporting mechanism for corporations to measure and communicate the value created for shareholders. EY has supported this by creating a proof-of-concept framework that helps stakeholders to understand, measure and compare the investments made by asset creators in their purpose, brand, intellectual property, products, employees, environment and communities.
- ▶ The Natural Capital Protocol, with its finance sector supplement, was set up to provide guidance for financial institutions in considering the impacts of geology, soil, air, water and ecosystems on lending, investment, and insurance practices and processes.

Meanwhile, nonprofit organizations, such as the Asset Owners Disclosure Project, aim to increase disclosure around climate change risk by working with pension funds, sovereign wealth funds and insurance companies.

## Embracing opportunity, reducing risk

The FS industry is in a unique position to move the dial on the SDGs and, in so doing, support the shift to a more sustainable society and system. Failure to act will have long-term repercussions not just for society, but for FS organizations themselves. Their social license to operate will increasingly be benchmarked against the SDGs, and regulators, investors and the public will continue to hold the sector to account as ESG issues grow in importance. Companies will be measured by commitments to the SDGs.

Our role is to address our own impacts and encourage and support the industry, because the SDGs can be achieved with the banks, investors and insurers behind them. Faced with historic low-interest rates, the time is right for private capital to take a calculated risk on the future of sustainable finance. For that to happen, the entire community will need to do its part to integrate sustainable thinking and take action.

**Governments** have already made a firm commitment to sustainability through the SDGs. Now they have to back up that commitment with actions that create a level playing field for sustainable finance to flourish. This includes mandating that all departments integrate the SDGs, where relevant, and pursuing the potential of blended finance and other ways of working constructively with the private sector.

**Regulators** have to raise the bar when it comes to evaluating ESG risks. That will entail assessing current legislation for barriers to SDG financing and integrating ESG considerations into finance regulation. There has been a shift from voluntary to mandatory regulation and this trend is expected to continue.

**Global stock exchanges** and **rating agencies** need to set more robust and uniform standards for ESG reporting so that investors have access to consistent and comparable data.

**Investors** must apply pressure and demand ESG information as they increasingly acknowledge that sustainability is part of their fiduciary duty to shareholders. Investment always has an impact – the impact institutional investors have should be positive. A recent EY investor survey found that 60% of respondents did not think companies adequately disclose their ESG risks; yet 95% said that a company's nonfinancial performance played a pivotal role in investment decision-making.<sup>60</sup>

**Banks** have to assess their portfolios for ESG risks and stranded assets, integrate ESG considerations into their products and services, and create new instruments to satisfy rising consumer demand. They also have a duty to educate customers and employees by improving

sustainable financial literacy and access to sustainable finance products. By improving transparency, banks should show their customers and clients exactly how their money is being invested.

**Insurance companies** have a dual task. They must protect their customers from ESG risks and they must invest with a mission to avoid ESG risk throughout their business. The reinsurance sector plays an important role to provide stability to the FS community through a forward-looking assessment of the risks faced by the planet and society.

## Combined effort for mutual benefit

There is no magic bullet. A combination of the solutions provided in this paper is required. Through actions such as minimizing the downside risks of stranded assets, shareholder activism and changing regulation, and maximizing the upside opportunities of new mechanisms like blended, Islamic and impact finance, the FS industry can innovate to achieve the SDGs.

For the future of business and society, the SDGs cannot fail. The FS industry is uniquely placed to ensure their success by playing a key role in enabling corporations and governments to fund initiatives which tackle the SDGs and bridge this US\$2.5t funding gap. This is undoubtedly FS's responsibility, but it is a responsibility that represents substantial opportunity and reward across the board, for the people, planet and profit.

**For long-term success, FS organizations must identify and address their most relevant opportunities and risks, then raise, structure and allocate funding in alignment with the SDGs.**



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# Contacts

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If you would like to discuss this report, please contact:



## **Gulenn També**

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Partner, Head of Finance Analytics  
EMEIA Financial Services,  
Ernst & Young LLP  
gtambe@uk.ey.com



## **Velislava Ivanova**

---

Partner, Climate Change and  
Sustainability Services  
Ernst & Young LLP  
veli.ivanova@ey.com



## **Shipra Gupta**

---

Senior Manager, Corporate  
Sustainability  
EMEIA Financial Services,  
Ernst & Young LLP  
sgupta@uk.ey.com



## **Andrea Dudas**

---

Manager, Corporate Sustainability  
EMEIA Financial Services,  
Ernst & Young LLP  
adudas@uk.ey.com



## **Nicola Ruane**

---

Senior Manager, Corporate  
Sustainability  
EMEIA Financial Services,  
Ernst & Young LLP

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