"Will a better future be what we leave behind?"

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1 Ideas for action for an enduring and sustainable financial system

SUMMARY: The Business and Sustainable Development Commission's (BSDC) report, *Ideas for Action for a Long-term and Sustainable Financial System*, suggests the global financial sector has the potential to facilitate the successful achievement of the United Nations Sustainable Development Goals (SDG) by 2030. However, this requires co-ordinated efforts by competing capital market participants, asset owners and regulators to change the global financial system, shifting their mind-set and behaviour towards a more long-term focus.

This article explores the BSDC's suggestions. These include aligning policy and regulation with the SDGs, advocating reporting reforms, directing patient capital towards infrastructure development, promoting the creation of long-term pools of risk capital and supporting financial innovation that accelerates financial inclusion.

Aniket Shah

The simultaneous achievement of economic growth, social inclusion and environmental sustainability is the imperative of the 21st century. This imperative can be captured in two important words: sustainable development. That is to say, the complex interrelationship between the physical environment, society and economics. The 17 Sustainable Development Goals (SDGs) agreed by 193 member states of the United Nations in September 2015 embody these principles, with quantitative and qualitative targets and timelines through to 2030.

The concept of sustainable development is taking hold around the world. At the G20 Summit in September 2016, the US and China ratified the COP21 and formally committed to the goal of limiting global temperature rises to less than 2°C from pre-industrial levels. As of December 2016, 118 parties have ratified the Paris Agreement[1]. Despite pervasive political uncertainty, the world has already begun the long and difficult process of decarbonisation, with signs of decoupling between economic growth and carbon dioxide emissions over the past three years.

The global financial sector will be at the centre of humanity's attempt to achieve the SDGs. Even with the required technologies, policies and political will, financing would ultimately need to flow to the demands of sustainable development. Recent estimates indicate that the SDGs will require an additional US$2.4 trillion[2] of annual public and private investment into low-carbon infrastructure, energy, agriculture, health, education and other sustainability sectors, globally. The process of energy decarbonisation alone will likely cost an incremental US$1 trillion per annum in further investments in renewable energy and associated technologies. It is the task of the financial system – public and private – to mobilise this capital for the SDG agenda.

The financing of sustainable development, however, presents a paradox that needs to be solved.

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[1] President Trump announced in June 2017 that the US would withdraw.

[2] http://s3.amazonaws.com/aws-bsdc/BSDC_SustainableFinanceSystem.pdf

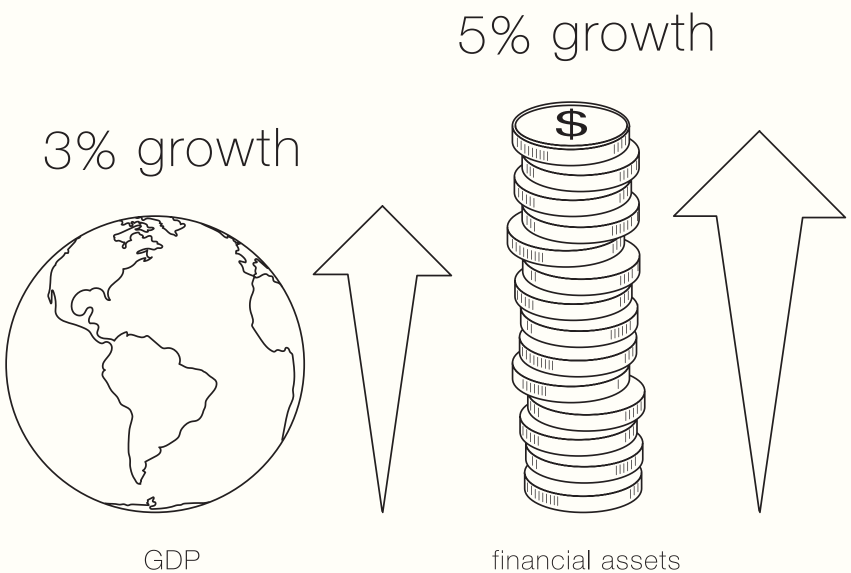
On the one hand, the required increase in global investments is not overly daunting given the size, scale and sophistication of the global financial system. The global economic output (gross world product) in 2015 was US$113 trillion (purchasing power parity (PPP)), and is growing by approximately 3% per annum. In addition, the stock of financial assets globally is over US$290 trillion, and growing by 5% per annum. More than five billion people have access to some level of financial services, thanks to massive improvements in mobile telephony and financial technology. Simply put, the financial system has the requisite size, technological knowledge, dynamism and global reach to help achieve the SDGs.

Despite, and perhaps because of, the significant size and scale of the financial system, its re-orientation will be not an easy task. The system is comprised of tens of thousands of institutional participants – including regulators, banks, insurance companies, stock and bond exchanges, institutional investors and more – and billions of individual market participants. Changing the behaviour of this panoply of actors, each of whom operate in different geographies and regulatory environments, will require clear thinking, focused analysis and political will.

To solve the paradox, a system-level shift towards long-term, sustainable capitalism is required. Long-term capitalism means a financial system that supports long-term investments, from businesses and governments, for long-term outcomes. It means a general orientation for achievements that can only be measured in decades, not in days. It may even mean taking decisions that cause inconvenience and stresses in the short term for the greater long-term benefit. The challenges of sustainable development will require this orientation if they are to be overcome. To move financial systems in this direction will require many changes in corporate incentives, the regulation of financial institutions, the diffusion of financial technology and more.

The BSDC was formed in 2016 to bring together leading corporate, non-profit and philanthropic leaders to think through how the global business community could accelerate progress towards sustainable development. The BSDC shared the common belief that despite the growing business opportunities (estimated at over US$12 trillion by 2030) in achieving the SDGs, a conscious effort would be needed to re-orient the

Financial assets are growing 2% faster than GDP



Global GDP growth is 3% p.a.
The stock of financial assets globally is growing by 5% p.a

financial system towards the needs of sustainable development. Although members of the BSDC understand the complexity of the changes required for the global financial system, they ultimately agreed on five practical areas of action for the business, policy and investor community.

First, economic policy and financial regulation must be aligned with sustainable development. There is broad recognition that the global economy has still not recovered, structurally, from the 2008 global financial crisis (GFC), and that new economic policy frameworks, including focused efforts on green infrastructure investments, are needed by government. In addition, financial regulation must be developed while keeping the needs of long-term financing in mind. This has not been the case for much of the financial regulation developed in the aftermath of the GFC.

Second, corporate reporting must be standardised and harmonised for sustainable development. Although there has been significant uptake in sustainability reporting in recent years, there is very little standardisation. With a lack of globally accepted standards, businesses report on different indicators, making performance tracking very difficult for investors and the broader public. The creation of an International Sustainability Standards Board and of corporate sustainability benchmarks would be useful initiatives in this domain.

Third, we must get sustainable infrastructure right. There is an annual need of approximately US$6 trillion for green infrastructure investments, with a projected gap of US$2-3 trillion per annum. Although the public sector can finance some of this gap, the critical challenge is how to attract private capital, at scale, into global infrastructure needs. The creation and scaling-up of blended finance instruments can help solve this gap, as can a revisiting of the size and scope of global development finance institutions, a process that is already underway.

Fourth, it is necessary to create and expand truly long-term pools of capital for the required investments in sustainable development. Although it is clear that long-term finance is the outcome of many variables, including financial sector depth, level of economic development, structure and size of savings systems, and more, it is clear that there is not enough truly long-term, patient investor capital that is able to be mobilised for long-dated investments in infrastructure, energy and other real-economy investments.

Fifth, financial innovation must be supported and used to accelerate progress towards sustainable development. Improvements in information and communication technology has enabled extraordinary development in financial inclusion, the democratisation of investments, and the creation of identities for individuals and assets through technologies such as Bitcoin and Blockchain. These innovations have the potential of solving some of the most intransigent problems of sustainable development, including financial inclusion and corruption. Their uses must be guided towards the needs of the SDGs.

There is an important underlying theme for all five areas of action: integration. The world must not waste time in trying to develop a parallel financial system that is sufficiently engaged with sustainable development. Instead, the concepts guiding sustainable development should be integrated with, and permeate, the global financial system and its constituent parts.

The paradox of financing sustainable development is solvable, but will not be solved on its own. It requires a concerted effort from business leaders, investors, regulators, policymakers and the general public in order to be solved. By driving action in a few critical areas, including policy and regulation, corporate reporting, infrastructure, long-term financing and innovation, we believe that the great power and influence of the global financial system can support the world's attempt to achieve a more sustainable future.

Hendrik du Toit and Therese Niklasson

In the context of the sustainable development challenge to the global financial sector set by the BSCD, Investec Asset Management recognises that it has an important part to play as a fiduciary and a manager of institutional assets with a mix of strategies and time-horizons.

We have, therefore, incrementally built our investment resources to better understand and internalise risks and opportunities related to sustainable development. This development is the result of the realisation that the dynamics of economic growth and wealth creation over the past half-decade, to the detriment of natural capital and developing countries, are incompatible with sustainable global development. Long-term business strategies need to become more inventive to continue to maximise sustainable returns for stakeholders, instead of continuing the current zero-sum game of destructive value extraction.

Our own business is long-term, and it is in our stakeholders' interest to protect future value by taking the right decisions today. Ultimately, it is not so much a case of pure altruism, but a shift that has evolved along the lines of an 'enlightened shareholder value' approach. This integrates the risks and opportunities stemming from these areas to protect and grow the value of the investment, and allow our clients to retire in dignity, and leave a legacy of a more sustainable world for future generations.

The report[3] identifies five key areas of focus, and outlines key recommendations for each of them (see page 23). The structural question is: how can the world finance the SDGs? The answer is fluid and wide-ranging: no less than 'orientating the financial sector towards long-term and sustainable outcomes'. To these areas we would argue that a significant number of investors can specifically contribute to the first, second and fourth recommendations by the BSDC by becoming more active in improving transparency, reporting and encouraging regulators and governments to include sustainable development and environmental, social and governance (ESG) issues in their decision-making.

Most governments have not yet made clear links between sustainable

[3] http://businesscommission.org/our-work/new-report-how-the-world-can-finance-the-sdgs

commitments and capital markets, and this articulation of investors' role is key to progressively achieving the SDGs. Examples of how Investec Asset Management has engaged with this initiative include contributing to consultations by governments and stock exchanges around the world. Issues discussed include sustainability reporting and data, and asking finance ministers to push for more clarity around a carbon price.

Few mainstream investors are able to easily expand into sustainable infrastructure investment, given the specialist expertise required. Investec Asset Management has been able to do so through its Emerging Africa Infrastructure Fund (EAIF), which invests in areas in Africa that require development and contribute to jobs, infrastructure, and knowledge transfer in a responsible manner and according to the International Finance Corporation Performance Standards. For the last recommendation from the BSCD, we would argue there is a space for most investors to progress the sustainability transition by considering innovation, ranging from impact bonds and technical assistance funds, to managing their own environmental footprints and investing in projects, such as Gold Standard sustainability projects, to mitigate carbon emissions.

More specifically for our industry, the report suggests that the investment community has three key areas to which a contribution to a financial system, that better values sustainable development, can be made. These include embedding the commitment to the SDGs in the investment process and ESG frameworks, encouraging long-term investment and allocation, and leading by example in the way firms operate.

It is difficult to define the precise value of assets invested in a sustainably responsible fund and perhaps the best proxy for the more than US$60 trillion assets under management is to consider the membership of the United Nations Principles for Responsible Investment (UN PRI). Currently, this membership represents a trillion US dollars and should, in theory, be integrated capital or partly integrated capital because a commitment to the principles includes an expectation around integration.

This development reflects the move that ESG issues have made from a side-line consideration to becoming a central and underpinning issue of any investment case. It is moving from the periphery to a central consideration. That is to say, to just another element in the investment

analysis selection was also aided by the role played by an explosion of literature on the topics, case studies, input from civil society organisations, governments at the national and supra-national levels.

Embedding SDGs into the investment process is effectively emphasising the importance of ESG integration, and this has been a key priority for Investec Asset Management over the past number of years. The integration developments have evolved on the back of key trends and signals for asset managers.

Firstly, and perhaps most importantly, there is an economic reason for considering material ESG issues in an investment case. As was highlighted earlier in this article, economic growth has contributed to hugely beneficial developments to our societies and their wellbeing, but such growth has also come at a great natural cost.

Today, environmental management is a regulated space, and if properly penalised when mismanaged, an internalisation of the environmental externalities may soon become evident. For example, the BP Macondo spill in the Gulf of Mexico is an illustration of how close a company, that had survived many blow-ups and accidents in the past, could come to face its downfall with a US$61.2 billion (pre-tax) bill. This has had an impact on all its stakeholders and the value of the business.

Other issues that have grown in value to the detriment of other global financial systems include bribery and corruption, labour slavery, trafficking and drugs industry. Bribery and corruption are estimated to be worth US$1.5 trillion, about 2% of global GDP[4]. The investment industry has a significant role to play alongside governments and regulators to allocate capital responsibly, with proper due diligence and scrutiny. Investec Asset Management, therefore, looks closely at governance and business integrity before investing in any listed or alternative asset investment.

By integrating ESG issues into the investment process we are able to better understand where these risks reside, how exposed companies are to them, how well-positioned companies are to manage them, and how we can set priorities that allow us to have an impact through engaging with management. This platform will be important for integration of the

[4] World Bank, 2017

SDGs and, over time, will have more sophisticated tools to measure and incentivise impact.

In addition to the growing focus by asset owners, there has also been a growth in policies and initiatives supporting and regulating the space around ESG. For example, a joint report by the UN PRI and the MSCI ESG Research team in 2016 identified almost 300 policy instruments (over half of which were created between 2013 and 2016) which support investors to consider long-term value drivers in the 50 largest economies in the world. These included, for example, local Stewardship Codes (such as the Code for Responsible Investing in South Africa (CRISA)[5] and the UK's Stewardship Code), which Investec Asset Management is a leading supporter and signatory to. Investec Asset Management has prioritised ESG integration in recent years and all its teams and strategies now have an integrated and evolving ESG process. The framework explores the relevance of ESG through five key steps; universe, fundamental analysis, portfolio construction, engagement and reporting.

In terms of the second area – encouraging long-term investment – there are a number of ways we work to achieve this, as has been highlighted earlier. In addition to the advocacy work and engagements we have with the pension industry and our clients and policymakers, our investment professionals are invested in their own funds over the long term. This facilitates an alignment with the underlying long-term performance. Further, Investec Asset Management also offers clients a wide range of options to match their different stewardship preferences and engages and shares insights with pension fund trustees to encourage the understanding of these issues.

Ultimately, it is critical for asset managers to participate in the debate about the need for a shift in the global financial system, encouraging and valuing managers and investors who prioritise an emphasis on incorporating SDGs.

On a very practical level, we can vote against management at general meetings, where we have reason to believe that SDGs commitments or pledges are not being honoured, or are being rejected or ignored. We can

[5] http://www.iodsa.co.za/?page=CRISACode

also promote and lift the governance of SDGs by asking companies to strengthen the board skills matrix, by adding specific SDGs skills at board level.

We believe it is important to not only manage our clients' assets in a responsible, long-term manner, but also to proactively engage our clients and stakeholders on the subject of sustainability. We recognise that the sustainability imperative means that we cannot afford to wait passively for our clients to ask for sustainable investing, but rather we have a responsibility and opportunity to lead the conversation and encourage them on their journey towards more sustainable investing. Over the past year, we have engaged our clients through the Investec Investment Institute, client roadshows, thought leadership, and initiatives, such as our engagement with the BSDC.

We also mitigate our own carbon footprint, manage our waste, train and develop our staff, and contribute to our communities and conservation across Africa. We have also improved our policy towards diversity, which has recently been articulated as a coherent framework following a process of internal dialogue to support our wider commitments to progressive engagement in the global marketplace towards sustainability.

The financing of the SDGs will encompass attitude and mentality changes, coupled with financial regulation changes, and on-the-field changes. Guided by our actions in the past, Investec Asset Management is aware that overcoming these hurdles may well be a burdensome and slow process. But we are inspired and committed to contribute to sustainability across the world. We have the incentive, people, skills and tools to do so.