BACKGROUND NOTE

Making the investment shift 'ineluctable'

The success of the 2015 agendas has seen numerous advances for financing and investing in sustainable development. Numerous initiatives involving the financial sector have also been launched (such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures). But are the expectations of investors really in the process of converging or is there still work to be done? How can the sense of inevitability be reinforced? What barriers must be still overcome?

1. CONTEXT

Sustainable development and climate mitigation will require a significant reallocation of investments. While incremental investment requirements appear small, this investment shift is sizeable, in the order of 5% of capital investment. It should be noted, *en passant,* that oft-quoted numbers for the investments required overlook the importance of consumption choices of households, which must also be redirected and which from a household perspective are better seen as investment choices (in agricultural equipment, transport vehicles or household equipment, for example). Making this shift happen within the time frame of the transformation agenda agreed upon in 2015 represents a significant policy challenge.

Throughout 2015, the national and international policy frameworks necessary for driving this investment shift were at the core of discussions. In many respects, the outcome of these negotiations represent an important paradigm shift: an acknowledgement of the need for a re-allocation of investment; of a shared endeavour of mobilising additional funding for sustainable development; of the importance of domestic resource mobilisation and hence of policy arrangements in terms of fiscal policy and enabling environments; and the emergence of policy focus on greening the financial system, including a focus on better integrating 'traditional' financial governance and sustainable development funding (for example the Financial Stability Board's Task Force on Climate-related Financial Disclosures).

These developments have led to what we might—provocatively—see as two competing narratives about these outcomes. On the one hand, numerous initiatives are sometimes seen as the emergence of a durable and growing shift in policy frameworks, and in investor behaviours and perceptions (the progressive greening of the financial system). JP Morgan's recent announcement to exit coal is just one example; the Financial Stability Board's Climate Disclosure Task Force is another. On the other hand, others argue that this shift remains marginal compared to the size of the financial sector and the challenge at hand is fragile and partial, and must be supported by further policies. Financial markets' short-term reactions to the Paris Agreement were muted.

2. ISSUES/SOLUTIONS

Firstly, it seems important to underscore that policies to promote the 'supply side' of capital for sustainable development must be better complemented by policies on the demand side. A green financial system must be driven by demand from a greener economy. By supply side we mean both the supply of public capital, e.g. from development banks, as well as policy initiatives intervening at the level of investors (such as proposed work on disclosure standards, fiduciary or accounting standards). Without a fundamental shift in the risk/return profile of 'sustainable development assets' it is not reasonable to expect a massive shift of investments. Indeed, one could raise the concern that it has been the slow progress of 'demand side policies' such as carbon pricing, fossil fuel subsidies removal, or regulation favourable to carbon-neutral fertilizers, that has led to the search for creative 'supply side' alternatives. By definition, perceptions are unstable and subject to rapid re-evaluation. To propel the shift of investment and make it irreversible, policies and technology changes must reward early movers without whom no herd behaviour can be expected and no self-fulling prophecies can be grounded.

Secondly, we should pay attention to the wording of this session—'ineluctable'. The implication appears to be that risk/return *perceptions* could be irreversibly altered, such as to make sustainable development investment the new normal. Recent policy and advocacy work has focused on changing perceptions of risk/reward, for example through work focusing on stranded assets and so on. We might describe this as trying to channel the 'herd behaviour' of financial markets to a positive end. Clearly this work has brought important fruits. As Keynes said: “Successful investing is anticipating the anticipations of others”. Convergent expectations about future policy and market conditions are indeed crucial, and perhaps partially self-realising. Nurturing self-fulfilling prophecies is at the core of the design of the Paris Agreement. Supply-side measures like accounting frameworks, carbon stress tests and capital standards can have a real impact on the time horizon of investors, the market value of financial assets and real-economy financial allocation.

But this raises the question of what further needs to be done to converge expectations about the future? Examples include more operational sectoral roadmaps and policy commitments; long-term strategies at national and potentially local level; or differentiated prudential, fiduciary of accounting standards for long-term *versus* short-term assets, and liabilities in the case of insurers. Investment in sustainable development will require massive reinvestment in the physical assets and non-tangible assets (innovation and skills), and in new sectors, new technologies, and new modes of organising economic activity. Continued focus is needed on the creation of new, long-term intermediation vehicles and increasing the capacity of investors to directly engage with sustainable development sectors. It also seems important to renew the focus on households and governments, jointly responsible for more than 50% of long-term investment (notably in real estate and infrastructure) either directly or through investors’ intermediation.

3. OBJECTIVES OF THE SESSION/QUESTIONS

- Cautious optimism regarding an ineluctable investment shift seems possible, provided that the right balance of supply and demand side policies can be found, and that we acknowledge the need to consider the huge diversity of sectors and actions that must adjust.
- Where do speakers position between the two narratives we have briefly summarised?
- What short-term actions or initiatives are to be taken to make the shift “ineluctable” and enter a new cycle of self-fulfilling prophecies?
- What are the constraints facing these long-term investors?
- How build-up or develop further marketplaces for long-term sustainable investment?

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