NeF DeF New Frontiers in International Development Finance

Regulating Financial Markets for Sustainable Development Investments

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EXECUTIVE SUMMARY

Financial markets are emerging as important sources for Sustainable Development Goals (SDGs) and climate-related financing in developing countries, replacing traditional public finance, such as grants and official loans. International development organisations, including multilateral development banks (MDBs) and development finance institutions (DFIs), facilitate this shift by providing financial, policy and regulatory incentives to create markets for sustainable debt instruments, such as green, social or sustainability-linked bonds. This brief explores the implications of increasing reliance on capital markets for sustainable development finance in four areas: ownership and alignment of social and economic development programmes; oversight and accountability of public finance; financial stability; and sovereign debt liabilities.

NEF DEF POLICY BRIEF SERIES #3

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SEPTEMBER 2022

The sustainable finance market

The sustainable finance market consists of a variety of debt instruments issued to finance the SDGs and other sustainability and climate-related investments. They include 'labelled bonds', such as green, blue, social or sustainability-linked bonds, that are issued to finance projects or programmes aimed at attaining the SDGs or other social or environmental objectives.

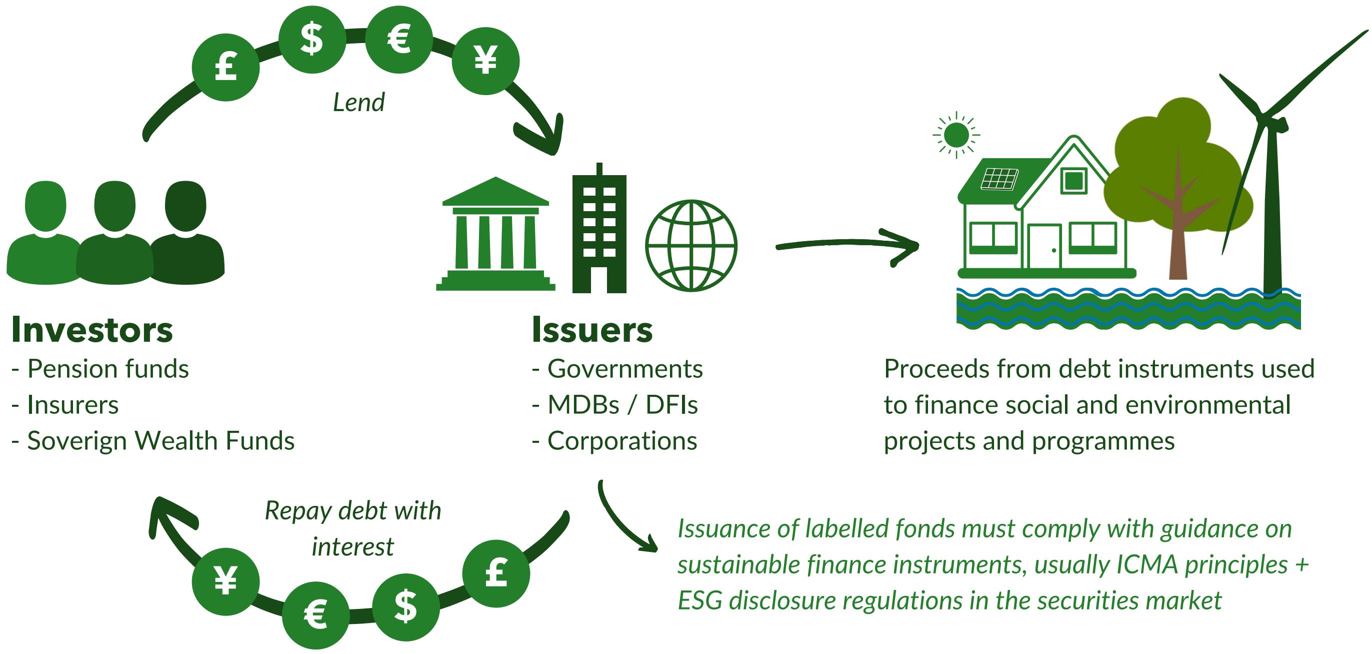

Figure 1. Labelled bonds in the sustainable finance market

Developing countries have been encouraged to issue sovereign bonds to fund SDG sustainability and climate-related expenditure. Official bilateral and multilateral finance are used to provide financial incentives (e.g. guarantees and other risk-sharing instruments) and support broader policy and regulatory reforms (e.g. development of environmental, social and governance 'ESG' standards) to construct sustainable finance markets.

Risks of financial market reliance for sustainable development

Sustainable finance markets have the potential to scale up financing the SDGs and climate action. However, greater reliance on them over other sources of funding is likely to have adverse impacts on developing countries:

1. The shift from public resources to capital market finance can undermine ownership and alignment of national sustainable development plans

Access to funding for SDG, sustainability and climate expenditure will depend on investor appetite and demand for sustainable finance.

Decisions on which sector to prioritise will be increasingly determined not by public institutions or elected representatives or communities but by institutional investors, asset managers, index providers, credit rating agencies other financial actors based in advanced economies.

2. Fragmentation of financing sources and lack of standardisation in the regulatory framework for sustainable finance weakens fiscal accountability and monitoring of public expenditure.

Meanwhile, the earmarking of income derived from sustainable debt instruments, such as through 'use of proceeds' covenants, can place constraints on governments' ability to manage public finance and respond to domestic financing needs and priority sectors that may not fall within eligible parameters.

The sustainable finance market is governed primarily by private regulatory standards developed by industry associations, such as the International Capital Markets Association (ICMA). This increases the risks of regulatory capture by private interest groups and 'green/SDG-washing' of investments.

There remains little recourse for investors or communities from a public accountability perspective if bond proceeds do not meet declared investment objectives. Additionally, as disclosure and reporting are aimed at meeting due diligence requirements for the investor, there is little redress for communities affected by projects or programmes funded through labelled securities as they would have been under ESG safeguards of MDBs or DFIs.

3. Reliance on capital markets further exposes developing countries to shifts in global economic conditions and creates new transmission channels for financial instability

Although labelled bonds target financing in SDG, social or environmental sectors, there are no provisions preventing capital flight if investors divest for financial or political reasons. In a financial or economic crisis, these ramifications can be significant for countries and communities reliant on this income as a means of financing public goods and services.

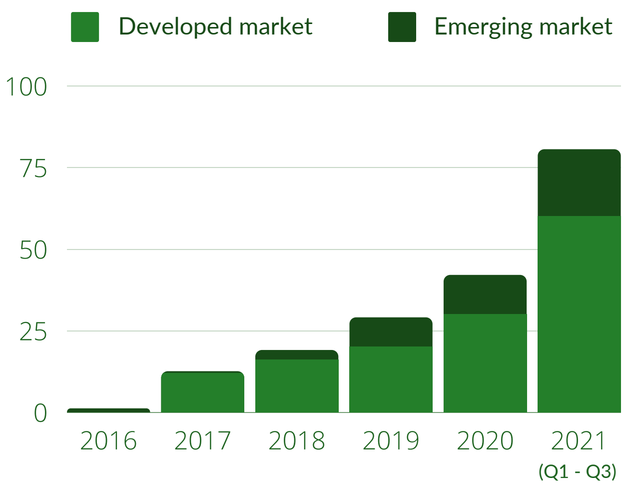

Figure 2. Annual sovereign green, social and sustainability (GSS) bond[1] issuance.

1. Climate Bonds Initiative (2021), Available at: www.climatebonds.net/2021/11/cop26-briefing-sovereign-green-bond-issuance-takes-start-long-boom

Without adequate regulatory safeguards, the rush to replace direct, official sector financing with private debt instruments increases the financial risks and potential for social, economic and environmental harm to developing countries and their communities.

The short-term focus of financial market investors and the absence of contractual or regulatory mechanisms to mitigate systemic gaps in the financial architecture and address the pro-cyclical nature of portfolio flows may result in financial contagion that can jeopardise the attainment of the SDGs.

4. Bond finance can lead to the accumulation of unsustainable debt

The speculative nature of financial markets and the more onerous terms of financing (e.g. shorter maturities, higher interest rates and easier exit terms) mean that sovereign bonds are a more volatile component of public debt compared to official or private loans.

Bond debt is also much harder to restructure in the event of a sovereign debt crisis compared to official sector debt, leading to greater economic stress for developing countries. Private creditors have traditionally demonstrated reluctance to participate in multilateral debt relief measures and there is no evidence to demonstrate that the regulatory regimes governing the sustainable finance market will treat sustainable debt instruments differently from 'plain vanilla' securities.

POLICY RECOMMENDATIONS

1 The promotion of financial markets as a source of financing SDGs and climate action must be embedded within a broader suite of financial options for developing countries and not as a substitute for other more stable forms of public finance, such as official loans, grants and guarantees.

2 There should be adequate debt sustainability assessments before governments, especially in low and middle-income countries, issue sustainable finance securities to ensure that countries can afford the debt.

3 Issuance of sovereign bonds must align with each country's priorities for social and economic development and climate action. Sovereign issuers could consider 'extendable debt' clauses, such as natural disaster clauses, to allow for automatic suspension or lower repayments in the event of an economic shock caused by external factors.

4 There needs to be greater global harmonisation of ESG standards, disclosure requirements and reporting and accountability of sustainable finance. It should include all stakeholders, not only financial actors and policymakers from advanced economies and large financial centres.

About the author

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Professor Tan's research focuses on international development financing law, policy and governance, international financial regulation and the law and governance of sovereign debt. Founding member of The IEL Collective and project lead for the New Frontiers in International Development Finance (NeF DeF).

More on this research

Tan, C (2022), 'Private Investments, Public Goods: Regulating Markets for Sustainable Development', *European Business Organization Law Review*, Vol 23, pp 241–271. Open Access at: link.springer.com/article/10.1007/s40804-021-00236-w

This research was supported by the Institute for Global Sustainable Development (IGSD) and the School of Law, University of Warwick.

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