United Nations Development Programme

UNDP

From Fragmentation to Integration:
Embedding Social Issues in Sustainable Finance

A call for policymakers and market practitioners to advance the integration of social risks and opportunities into financial strategies

United Nations Development Programme, 2023. From Fragmentation to Integration: Embedding Social Issues in Sustainable Finance. A call for policymakers and market practitioners to advance the integration of social risks and opportunities into financial strategies.

September 2023

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The current 'polycrisis' has shed light on the social vulnerabilities of the energy system and the distributional concerns arising from prevailing monetary policies. Moreover, it has accentuated the heightened inequalities visible within and between countries as a result of ongoing environmental degradation. It is imperative for finance Ministers, central bank governors, and financial supervisors to recognize the interconnectedness of socio-economic inequalities with climate- and environmental-related financial risks and align price stability with socio-economic justice in society.

According to the report's view that inequality is a systemic risk that can be generated endogenously by the financial sector, this necessitates macroprudential tools to address the escalating imbalances in the debt market which can be supported by fiscal policies aimed at mitigating the negative impact of inequality. Significantly, this report aligns well with the ongoing discussions surrounding the reform of the international financial architecture. It echoes the need to prioritize environmental and social objectives in political trade-offs in multilateral development programmes, the allocation of financial flows, and the design of macroeconomic frameworks to bring debt justice, as well as development finance that leaves no one behind.

Sustainable Finance Hub

Marcos Neto

Director,
Sustainable Finance Hub ,UNDP

In recent years, the financial services sector has taken great strides to respond to the climate challenge. Against the backdrop of the Paris Agreement and closer scrutiny by governments and regulators, financial institutions are increasingly factoring climate risk into their business, risk and capital allocation decisions. They are adapting their business models, and their lending, investment and underwriting activities. And they are developing new products and services to support their clients' climate strategies.

While welcoming all that has been achieved to date on climate, this timely report encourages the sector to draw 'lessons learned' to accelerate progress on social issues. Recognising the human, developmental and financial materiality of social issues, the report calls on governments, regulators and financial institutions to: support advances in research and data on the systemic risk of socio-economic inequality; adopt and improve social standards, disclosures and tools; and rethink the macroeconomic determinants of sustainable finance scenarios.

An important message of the report is that environmental and social issues and impacts are inextricably linked. Climate, nature and social issues cannot be considered in silos; integrated thinking is essential. The report also emphasises the important roles to be played by all actors across the financial services sector, including governments and regulators: public, private and civil society actors need to come together to embed social sustainability in finance.

FCA FINANCIAL CONDUCT AUTHORITY

Goze Dogu

Sustainable Finance
and ESG Policy and Advisory,
Financial Conduct Authority

A growing body of research demonstrates how inequality manifests as a systematic and systemic risk in financial markets, but policy makers, regulators, and investors need improved tools and further resources to understand, measure, and manage these dynamics.

Is inequality the only social risk to financial stability? What private sector activities – amongst both companies and investors - contribute to inequality, and by how much? At what point does inequality become a threat to financial stability and investors' portfolios, and what financial analysis tools can be leveraged for this assessment? And if investors are going to account for these systematic and systemic risks, then how does that alter traditional interpretations of risk and return?

This report introduces such questions, as well as the proposition that adjustments to the risk return assessment could alter capital allocation decisions toward more regenerative investments, ultimately curing imbalanced markets, reducing polarization amongst people, and supporting policy makers and regulators, as well as investors, in their near and long-term goals and fiduciary duties.

THE PREDISTRIBUTION INITIATIVE

Delilah Rothenberg

Co-Founder and Executive Director,
Predistribution Initiative

Pressure is increasing from multiple sides, not just as the negative impacts of rising global temperatures increase, but also due to increasing negative impacts of social issues such as socio-economic inequalities, supply chain issues, the impacts of war, the cost of living and ongoing migration. Not to mention accelerating biodiversity loss, the impacts of ecosystem degradation and many more. Never before has there been such a need for accelerated and exponential solutions.

Although we have reached a point of relative maturity with regards to the corporate reporting on climate-related issues for investors, and the global finance system is transitioning, there is still a long way to go. Positively, there is a lot of energy from the global accounting community focusing on this issue. However, there is also a risk that the transition may be undermined.

In the real world, social and environmental issues have never been separate, however in recent decades the financial and corporate focus on climate change has been quite singular. While this enabled it to reach the maturity it has today, it is now time to re-couple it with social issues and systems thinking.

This report recognises the interconnectedness between social and environmental issues and encourages policy makers to acknowledge this and enact policies that reflect that one cannot be solved in isolation. With hindsight we can now learn how we accelerated global attention on tackling climate change and apply these lessons to a joined-up approach to sustainable finance.

REGENERATE

Harry Brown

Director,
ReGenerate

The influential 2022 research article "The Economics of Extreme Risk" co-authored by Nicholas Stern and Joseph Stiglitz, in collaboration with Charlotte Taylor, describes the serious shortcomings in understanding of the "deep uncertainty and extreme risk" facing the world economic system from climate change. In our newly published paper, "From Fragmentation to Integration", we shine a spotlight on the parallel need for a better understanding of another of the fundamental risks facing the financial system: social-inequality.

Growing social-inequality between and within communities, countries and continents is propelling political polarisation, driving mass migration and inciting geo-political tension. These dangerous developments will exacerbate the extreme market volatility and dislocations we can already expect over the next few years as the impacts of climate-related physical and transition risks - and of diminishing biodiversity - become ever more acute. Achieving a better understanding of these inter-related risks and integrating them fully into financial stability and disclosure frameworks at a macro-economic and a corporate level should therefore be priorities for policy makers and other leading actors within the global financial system.

Sustainability consultants JS Global Advisory were pleased to contribute to the structuring of this paper, drawing on their collective experience of working with the TCFD Secretariat on the development of the TCFD recommendations and with corporate clients on climate-related risk and reporting as well as broader sustainability issues.

js global

Paul Stuart-Smith

Managing Partner,
JS Global Advisory LLP

The climate crisis is an inescapable reality for policymakers, regulators, and financial institutions. However, growing resolve to address the crisis is threatened by the ongoing injustice of socio-economic inequality, which presents a major barrier to advancing a Green Agenda through the Just Transition.

At Rights CoLab, we are responding to growing investor interest in social risks and the integration of environmental, social, and governance criteria in investment decisions. One way we do this is by creating decision-useful tools that allow investors to understand the systemic and systematic risks posed by inequality, as well as the impacts that corporate behavior can have on the human rights of affected communities.

Throughout our work, we see how investors and companies lack information on how externalizing social costs lead to both enterprise and system-level risks. We welcome this timely paper, which builds on the rapid evolution of the climate change agenda and the successful engagement of the finance sector on climate, and sheds light on the missing element of socio-economic inequality that can accelerate action on the social transformation agenda necessary to achieve climate goals. This paper lays out key recommendations on how financial sector actors can direct capital into more sustainable economic activities. Equally important, it defines an agenda for researchers to elucidate the specific ways in which socio-economic inequality contributes to systemic and systematic financial risk.

Rights CoLAB

Joanne Bauer

Co-Founder,
Rights CoLab

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A Call to Action

This report aims to spur momentum among all actors within the financial system to address inequality and social impacts. Drawing insights from the climate agenda, it sheds light on how to catalyze action at the policy and regulatory levels, building on existing sustainable finance initiatives.

Based on the collective expertise of several institutions[1] and a global consultation, it provides key recommendations for governments, regulators and financial institutions to drive progress in three critical action areas:

A Support research on the systemic risk of socio-economic inequality for financial stability

The following building blocks are proposed for financial regulators[2] to implement the recommendation:

Increase capabilities
for data analysis on inequality and social risks posed by the private sector, including research on the relationship between the private sector and inequality, and on how social risks affect financial stability.

Take precautionary measures
to prevent systemic risk triggered by inequality.

B Adopt and improve social disclosure standards and risk management tools

The following building blocks are proposed for financial regulators and supervisors to implement the recommendation:

Improve
data, disclosure and transparency on social impacts, dependencies, risks and opportunities.

Encourage
investor stewardship and asset allocation based on climate and social analysis.

Evolve
auditing and assurance practices to assess social-related financial risks.

Re-structure
the approaches to accounting value.

C Rethink the macroeconomic determinants of sustainable finance scenarios

The following building blocks are proposed for financial regulators[2] to implement the recommendation:

Re-couple
Climate and Social Risk and Opportunity Analysis.

Mobilize finance
for social projects through the multilateral development bank reform agenda.

1 The United Nations Development Programme (UNDP), the United Kingdom Financial Conduct Authority, ReGenerate, Pre Distribution Initiative, Rights Colab, PRI and JS Global Advisory.
2 Financial regulators include parliaments, governments, ministries and public institutions in charge of determining the direction of the financial system, affecting financial markets, financial actors and financial assets
3 Financial supervisors include central banks and authorities overseeing specific financial sectors.

Context

As the world economy recovers from the Covid-19 pandemic, policymakers face a complex web of interconnected challenges including heightened geopolitical tensions, climate change, biodiversity loss, record-high debt, new monetary policies and persistent inequalities. Some global leaders refer to today's challenges collectively as a 'polycrisis'.[4]

At the centre of these challenges are people – communities and nations – who see risks and opportunities for their livelihoods and rights within any proposed solution. Ensuring their economic security while addressing climate change and other critical challenges is essential to avoid increased polarization and foster collaborative, constructive paths forward.

Global leaders are beginning to acknowledge that addressing socio-economic inequality and the cost-of-living crisis is critical to finding sound solutions for a multitude of other problems, including climate change, health inequity and gender inequality.[5] Unfortunately, economies that already lacked resilience going into the pandemic have faced heightened tensions. Between 2011 and 2019, there was a 244 percent increase globally in riots, general strikes and anti-government demonstrations. [6]As socio-economic inequality in developed countries has risen, so too has protectionist sentiment, threatening to reverse recent economic gains in developing countries.

According to the International Monetary Fund (IMF), global financial fragmentation resulting from an escalation of geopolitical tensions can exacerbate the risk of financial stress in the long term.[7] In its 2019 Global Financial Stability Report, the IMF noted that high global debt burdens leave economies unprepared and lacking resilience in the face of potential downturns. As markets and stakeholders have processed the shocks of the pandemic, many leaders have observed that markets have prioritized efficiency and profits over resilience and stability. Sentiment in corporate supply chains appears to be shifting from a 'just-in-time' economic mentality to a 'just-in-case' approach.[8]

Economic fragility has been met with emergency fiscal and monetary interventions, with vast inequalities and inefficiencies at play: as of late 2022, 53 percent of transfers and subsidies were being spent in high-income countries, whereas low-income countries accounted for only 1 percent of the policy response.[9] While government interventions were critically needed in the face of the pandemic, such support arguably would not have been needed had the private sector operated in a more sustainable manner.

4 www.undp.org/asia-pacific/publications/polycrisis-and-long-term-thinking-reimagining-development-asia-and-pacific-foresight-brief
5 www.undp.org/publications/undp-development-future-series-synergies-jointly-addressing-climate-change-health-equity-and-gender-equality
6 assets.kpmg.com/content/dam/kpmg/xx/pdf/2022/05/social-inequality-as-a-business-risk.pdf
7 IMF. 2023. Global Financial Stability Report: Safeguarding Financial Stability amid High Inflation and Geopolitical Risks. Washington, DC.
8 www.ft.com/content/f4fa76d9-aa11-4ced-8329-6fc8c250bc45
9 www.undp.org/publications/dfs-cost-living-crisis-update-diverging-food-and-energy-prices-diverging-policy-responses

Policymakers now aim to navigate even higher global debt levels and persistent inflation by increasing long-term social and environmental resilience while fuelling progress on the Sustainable Development Goals (SDGs). But their work will be difficult without policy and regulatory reform within the financial system and private sector.

Businesses and financial markets have crucial roles to play in the production and distribution of wealth and resources. However, the financial system has evolved in a way that has created vast imbalances, which now pose risks to financial markets and economies.

The 2015 Addis Ababa Action Agenda provided a global framework for financing sustainable development, with the SDGs at its core.[10] This agenda has supported the design of financial instruments, tools and methodologies that channel funding towards SDG-aligned projects, through implementation tools such as UNDP's Integrated National Financing Frameworks (INFFs). Yet according to the 2021 United Nations SDG 2021 report, the COVID-19 pandemic reversed progress – with extreme poverty rising in 2020 for the first time since the Asian Financial Crisis of the late 1990s.

While income inequality had been declining in many countries since the 1980s, it is now on the increase, especially within advanced economies.[11] In 2021, the richest 10 percent globally owned between 60 percent and 80 percent of the wealth, while the poorest half owned less than 5 percent.[12] Other SDG performance indicators on hunger, health, education, and gender equality have also declined globally.[13] According to the United Nations Financing for Sustainable Development Report 2023,[14] shocks triggered by higher food and energy prices, and rising interest rates have triggered economic crises in some countries, pushing many families into hunger and poverty for the first time.

10 un.org/esa/ffd/publications/aaaa-outcome.html
11 Chancel, L. 2019. Ten Facts about Inequality in Advanced Economies. WID Working Paper 2019/15. https://wid.world/document/ten-facts-about-inequality-in-advanced-economies-wid-world-working-paper-2019-15/
12 World Inequality Lab. 2022. World Inequality Report (p.12). https://wir2022.wid.world
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14 developmentfinance.un.org/2023-FSDR-preparatory-materials

A Note on Terminology

This paper supports actions on risks and opportunities for the financial system that cause significant impacts on people.

- 'Social issues' are fundamentally about impacts on people – either positive or negative. These impacts may be on individuals, groups, or societies, and are related to risks and opportunities. This includes the effects of supply chains, workforce compositions (employees, contractors, gig workers, etc.). business operations, products and services. In this paper, social issues refer to states of affairs that present risks or opportunities for the financial system and the institutions within it. Inequality is a critical social issue that presents a risk for financial and non-financial institutions alike.

- 'Inequality' refers to a disparity of distribution, and includes inequalities of income, wealth, opportunity, access to healthcare, education and skills. This paper focuses on socio-economic inequality, which comprises vertical inequality (among individuals or households) and horizontal inequality (between culturally defined groups such as gender, race, ethnicity and ability). Inequality may be measured within countries (e.g. between urban and rural areas) and between them.

Both terms encompass positive and negative impacts on people and society, and related risks and opportunities for business and finance. These concepts will set the backdrop for the evolution of social and inequality disclosure standards, guided by existing human rights standards, which are in turn grounded in the United Nations Guiding Principles on Business and Human Rights, the OECD Guidelines for Multinational Enterprises and other frameworks, principles and commitments.

For more information, refer to:
shiftproject.org/wp-content/uploads/2022/12/Social-standard-proposition_Dec05.pdf.

Why is integration important now?

Investors and companies need a better understanding of social issues through multi-disciplinary research, standards for business management and impact measurement, and collaboration to address the polycrisis by directing capital into more resilient and profitable long-term investment opportunities. To drive progress on the SDGs and maintain healthy and stable markets, it is critical for financial actors recognize the profound links among poverty, inequality, degradation of the planet, unequal and unsustainable economic growth, and social exclusion.[15]

There are three critical reasons for sustainable finance initiatives to pay attention to social issues and inequality:

i. **Socio-economic inequality is a systematic risk and may pose systemic risk.** Numerous studies demonstrate that socio-economic inequality can lead to reduced macro-economic performance, fostering systematic risk in capital markets. The dynamics that contribute to inequality also manifest as systemic risk in financial markets. For instance, concentrations of equity or debt in some markets versus others can lead to inequality and also create asset bubbles or credit crises. In addition, research indicates that the growth of the financial sector is linked to growing inequality [16] and that mouting inequality is driving a cascade of negative consequences for business and society. [17] This is linked to Recommendation A. Support research on the systemic risk of socio-economic inequality for financial stability.

ii. **Impacts on peope present financially material risks to investors and companies.** A growing awareness of business and investment dependencies on people is beginning to shift the private market from a narrow focus on near-term financial profits of individual investments to a recognition that market health depends on the health of human and natural systems. This is linked to Recommendation B: Adopt and improve social disclosure standards and risk management tools.

iii. **Social issues are integral to achieving climate goals.** Considerable progress has been made in mobilizing capital to move away from carbon-intensive industries toward a greener economy. At the same time, there is concern about this transition among those with less power and financial resources, who are most likely to be left behind. While some populations have expressed support for a green and Just Transition, others remain skeptical. Furthermore, there is a growing understanding of the link between inequalities and excess resource use, with wealthier populations contributing the most to consumption and therefore climate change. At the same time, climate change exacerbates inequalities. Sustainable finance strategies will fail to address climate change without simultaneously

15 sdgs.un.org/2030agenda
16 Godechot, O. et al. 2022. Ups and Downs in Finance, Ups without Downs in Inequality, Socio-Economic Review.
17 www.wbcsd.org/Imperatives/Equity-Action/News/The-Business-Commission-to-Tackle-Inequality-makes-the-case-for-business-to-take-a-stand-on-inequality

addressing interdependent social issues like socio-economic inequality. Now is the time to build on the early momentum around climate mitigation and adaptation – and support its continued advancement – by acknowledging the links between social and environmental issues. This is linked to Recommendation C: Rethink the macroeconomic determinants of sustainable finance scenarios.

I. Socio-economic inequality can contribute to systemic and systematic financial risk

Inequalities constrain economic and financial potential.[18] In Italy, the United Kingdom and the United States, the cumulative growth rate would have been six to nine percentage points higher between 1990 and 2010 had income disparities not widened.[19] The Business Commission to Tackle Inequality highlights that closing the living wage gap worldwide could generate an additional US$4.56 trillion in gross domestic product (GDP) every year. Reduced economic performance stemming from socio-economic inequality negatively affects investors' diversified portfolios in the form of systematic risk.

The United Nations Secretary-General's SDG Stimulus to Deliver Agenda 2030 highlights that the persistence of global imbalances and the impact of current shocks on developing countries are aggravated by an unfair global financial system that is crisis-prone and focused in the short term, exacerbating intra-country inequalities.[20] Narrowing inequalities can help to alleviate secular stagnation – a dynamic reflecting low aggregate demand relative to an economy's productive capacity. Since the marginal propensity of the wealthy to spend is much lower than for those less well off, many economists have expressed concern that the resulting low growth – particularly in developed countries – has contributed to unusually low inflation and natural interest rates. This poses challenges for central bankers and investors seeking yield and safe assets.

Academics and economists have observed that wealthy people tend to save their excess wealth and lend to poorer people, making what limited growth exists dependent on elevated levels of debt. This in turn makes it difficult for central bankers to raise interest rates when necessary, in an orderly manner (creating a 'debt trap').[21] Rather than leaving poor people dependent on debt to fuel consumption and growth, private-sector activity could be reimagined to embrace 'predistribution', a process whereby returns are broadly shared among workers, corporate management, investors and communities.

18 Bivens, Inequality is slowing US economic growth; Clements et al., Chapter 2. The IMF and Income Distribution; Paul, Historical Patterns of Inequality and Productivity around Financial Crisis; Mian, Straub, and Sufi, The Saving Glut of the Rich.

19 Cingano, F. 2014. Trends in Income Inequality and its Impact on Economic Growth. OECD Social, Employment and Migration Working Papers, No. 163, OECD Publishing, Paris. doi.org/10.1787/5jxrjncwxv6j-en.

20 www.un.org/sustainabledevelopment/wp-content/uploads/2023/02/SDG-Stimulus-to-Deliver-Agenda-2030.pdf

21 Summers, L. 2016. The Age of Secular Stagnation. larrysummers.com/2016/02/17/the-age-of-secular-stagnation

Since the Global Financial Crisis, institutional investors have struggled to maintain balanced portfolios amid low interest rates. Such investors include pension funds, insurance companies, sovereign wealth funds and endowments, which must meet certain return thresholds to cover their liabilities while avoiding excessive risk. Yet given the limited opportunity offered by low yields in traditional segments of fixed-income markets, investors have largely been pushed to migrate up the risk-return spectrum for yield, contributing to elevated levels of corporate debt, sovereign debt, and asset bubbles – potential sources of systemic risk.[22]

In its October 2019 Global Financial Stability Report, High Corporate Leverage Can Exacerbate the Next Economic Downturn, the IMF noted that, "…the outlook for firms has weakened despite very low interest costs. Debt has risen and is increasingly used for financial risk-taking – to fund corporate payouts to investors, as well as mergers and acquisitions (M&A), especially in the United States. In addition, global credit is increasingly flowing to riskier borrowers… Banks and nonbank financial institutions with significant exposures to small and medium-sized enterprises (SMEs), syndicated leveraged loans, direct credit, and high-yield corporate bonds may be particularly susceptible to losses in such an adverse scenario and could amplify the shock by curtailing credit to the economy."

These observations reflect the interlinkages between socio-economic inequality and financial stability, and show how private-sector activities can deepen fragility across the private sector and societies. Without strong macroprudential regulation and responsible private-sector activity, the private sector may engage in high-risk activities that jeopardize communities. High corporate debt levels magnify investors' short-term returns, but constrain companies' ability to offer decent jobs and high-quality, affordable goods and services to consumers. Moreover, in the face of rising interest rates, companies may need to restructure, laying off workers and affecting communities that depend on them. In developing countries, intense debt burdens make it difficult to invest in physical and social infrastructure.

In the height of the pandemic, the IMF stated that, "While there is for now no alternative to continued monetary policy support, there are legitimate concerns around excessive risk-taking and market exuberance". This situation poses a dilemma for policymakers, who must balance financial conditions favourable to economic recovery against unintended consequences and staying within their mandates. Market complacency and uniform investor views increase the risk of a market correction. A sudden asset-price correction resulting from higher interest rates could tighten financial conditions and affect stability. Financial stability risks have been managed thus far, but action is needed to address vulnerabilities from the pandemic such as rising corporate debt, non-bank financial fragilities, increasing sovereign debt, market access limitations and declining bank profitability.[23]

22 Rothenberg, D., Chappe, R. and Feldman, A. 2021. ESG 2.0: Measuring and Managing Investor Risks Beyond the Enterprise-level. ssrn.com/abstract=3820316

23 Adrian, T. and Natalucci, F. Financial Perils in Check for Now, Eyes Turn to Risk of Market Correction. IMF Blog. www.imf.org/en/Blogs/Articles/2021/01/27/blog-financial-perils-in-check-for-now-eyes-turn-to-risk-of-market-correction

The risk that perpetually low interest rates, partially fuelled by inequality, can lead to fragile corporate capital structures, debt traps and even greater inequality highlights the importance of preventing this downward spiral. Private-sector activities that contribute to inequality make the jobs of central bankers harder. Already, central banks face challenges in raising interest rates to combat inflation – largely due to high debt levels.[24] And it is worth noting that some of the 'stickiness' of this inflation has been attributed to large corporations' resistance to lower prices, even as supply-chain bottlenecks (a result of the 'just-in-time' economy) ease.[25]

Rising socio-economic inequality can contribute to heightened protectionism, reduced global trade and social tensions that increase financial instability for developed and developing countries alike. In many developing countries, sovereign debt obligations coupled with rapidly rising interest rates threaten progress on the SDGs. Fiscal policy responses to financial crises in developing countries have often involved austerity measures (such as deep spending cuts and tax increases), which can have far-reaching impacts on the poorest people.[26] Austerity measures disproportionately impact women, people living with disabilities and ethnic minorities in almost all parts of the world.[27] In addition, austerity measures can jeopardize the stability of emerging and frontier markets, where investors depend on opportunities for diversification and growth.

In developed economies, rising inequality and fears of concentrated power in business and financial markets are fuelling polarization and protectionism. This not only contributes to social and financial instability, but to a lack of trust in the private sector – especially related to climate. Along with climate inaction, livelihood crises and the erosion of social cohesion are some of the most severe risks in the next two years according to the World Economic Forum Global Risks Report 2023.[28] Meanwhile, the International Corporate Governance Network, led by investors responsible for managed assets in excess of US$34 trillion, has identified social risks including human rights abuses, income inequality and populism as systemic threats facing the stability of the global financial system.[29] These acknowledgements follow comments made by United States Federal Reserve Chairman Jerome Powell, JP Morgan CEO Jaime Dimon and former head of the world's largest hedge fund Ray Dalio.

Healthy markets and financial stability depend on economic benefits accruing not only to a wealthy minority, but on the wide distribution of those benefits to workers and communities, as well as the companies and investors that take risk and create value. Economic and financial policy-making forums play a necessary role by building momentum for integrating inequality considerations into financial decisions and policy making.

24 www.imf.org/en/Blogs/Articles/2022/10/11/interest-rate-increases-volatile-markets-signal-rising-financial-stability-risks
25 Weber, I. M. and Wasner, E. 2023. Sellers' Inflation, Profits and Conflict: Why can Large Firms Hike Prices in an Emergency? Working Paper 2023-01. University of Massachusetts Amherst, Department of Economics. scholarworks.umass.edu/econ_workingpaper/343
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28 www3.weforum.org/docs/WEF_Global_Risks_Report_2023.pdf
29 www.icgn.org/sites/default/files/2021-05/1.ICGN%20Viewpoint%20on%20Systemic%20Risk.pdf

II. Impacts on people present material risks to investors and companies

Like climate change, there is increasing evidence that many social issues are material.[30] Across developed and developing countries, activism against mining, energy, and agribusiness operations has disrupted production, damaged equipment and in some cases restricted the flow of capital. Such unrest includes protests against wind, solar, and hydropower projects, and critical mineral sourcing.[31] Companies have begun to see investors take action on labour abuses by voting out directors and demanding adequate compensation for migrant workers. Human rights violations related to labour, supply chains and impacted communities can severely hinder a company's license to operate, access to capital markets, reputation and ultimately the value of its investment.[32]

As a result, companies face growing pressure from civil society, labour stakeholders and their own shareholders to become more accountable and transparent, conduct business ethically, avoid exacerbating inequalities, reduce negative social impacts and increase the positive social impacts of their operations. Investors are beginning to demand more information about the social impacts that their investments contribute to. The 2000 Global Reporting Initiative (GRI) guidelines were the first global framework for sustainability reporting, created through a multi-stakeholder process. In 2016, GRI transitioned from providing guidelines to setting global standards for investors, analysts, policymakers and other stakeholders to assess risks. Since then, other standard setters have also focused on environmental, social, and governance (ESG) issues, including the International Sustainability Standards Board (ISSB).

In 2020, the World Economic Forum coined the term 'stakeholder capitalism', in which companies not only optimize short-term profits for shareholders, but seek to create long-term value by taking into account the needs of all stakeholders, including society at large and the planet. At the same time, an increasing number of institutional investors worldwide began to identify as 'universal owners', recognizing that the health of their diversified portfolios depends on the health of human and natural systems.[33] These investors consider the materiality of social issues for their investments and portfolios, calling for the development of improved tools to measure and manage these issues.[34]

This shift has been accelerated by: consumer demand for ethical products and services; the evolution of legal frameworks to address ESG issues; pressure from civil society and labour

30 rightscolab.org/project-harnessing-big-data/, https://rightscolab.org/evidence-of-corporate-risk-of-harms-to-workers-in-their-value-chains/
31 www.wider.unu.edu/sites/default/files/Publications/Working-paper/PDF/wp2017-146.pdf
32 www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-top-glove-jan-2021.pdf
33 www.pionline.com/article/20190430/ONLINE/190439999/commentary-universal-ownership-the-world-s-largest-asset-owners-look-differently-at-investing
34 For example, the Department for Work and Pensions' Taskforce on Social Factors (www.lexology.com/library/detail.aspx?g=72e0028d-fc59-4fb9-9546-1d03a05d355e#:~:text=On%2028%20February%2C%20the%20Department,context%20of%20pension%20scheme%20investments) and the Council of Institutional Investors' guidance on human capital disclosure (www.corporatesecretary.com/articles/compliance/31577/cii-targets-better-esg-and-human-capital-disclosure).

advocates; academic research demonstrating the financial materiality of social impacts and risks; and the recognition that sustainable business practices can improve long-term financial and macro-economic performance.[35] The pandemic exacerbated existing inequalities and focused attention on the dynamics that contribute to income and wealth inequality. The rise of private-sector incentives for maximizing profit and shareholder return at all costs accompanied a reduction in bargaining power for workers and an erosion of regulations to protect consumers, borrowers, students and workers, further widening already vast inequalities.[36]

There are numerous examples of how social factors could be integrated into sustainable investment strategies.[37] For example, private equity and venture capital funds in emerging markets, with gender-balanced senior investment teams, have generated up to 20 percent higher returns than other funds. Portfolio companies with gender-balanced leadership teams outperformed others in terms of valuation increases by as much as 25 percent.

A focus on intersectionality – the interconnected nature of social identities – is also an important factor of performance.[38] Top quartile companies in terms of ethnic and cultural diversity were 33 percent more likely to outperform other companies on profitability, while those in the other three quartiles were 29 percent more likely to underperform.[39] Companies with diverse boards of directors were 43 percent more likely to outperform their peers.

Social risks are increasingly visible among companies' and investors' own workforces, supply chains, affected communities and consumers. In April 2022, the Government of the United Kingdom launched the Transition Plan Taskforce to develop private-sector climate transition plans, including guidance on broader sustainability issues such as Just Transition.[40] In December 2022, the ISSB launched the Consultation on Agenda Priorities to determine its 2024-2025 workplan, including proposed research projects to guide standard-setting. In the area of human capital, research could initially focus on diversity, equity and inclusion; in the area of human rights, it could initially focus on labour rights and communities' rights in the value chain.[41]

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35 www.ey.com/en_vn/sustainability/how-to-enhance-long-term-business-value-through-sustainability
36 www.imf.org/en/Publications/fandd/issues/2020/09/COVID19-and-global-inequality-joseph-stiglitz
37 www.undp.org/asia-pacific/publications/polycrisis-and-long-term-thinking-reimagining-development-asia-and-pacific-foresight-brief
38 Hunt, V., Prince, S., Dixon-Fyle, S., and Yee, L., 2018. Delivering Through Diversity. McKinsey & Company.
39 Ibid.
40 transitiontaskforce.net/transition-plan-taskforce-moves-into-next-phase
41 www.ifrs.org/content/dam/ifrs/project/issb-consultation-on-agenda-priorities/issb-rfi-2023-1.pdf

A roadmap for influencing social actions:
Drawing lessons from the climate agenda

As awareness of climate risk has grown over the past several decades, an ecosystem of climate policy and regulatory interventions, green financial-sector initiatives, related academic research, global events and market-driven adjustments has emerged to support a shift in financial flows toward a green economy. While the climate finance agenda has not yet been fully achieved, an assessment of financial sector efforts to address the climate crisis may hold lessons for accelerating progress on social issues.

Recognizing the growing global concern about social issues and inequality, in consultation with 20 sustainable finance, social, and climate practitioners, UNDP its partners developed a database of more than 125 actions and events that advanced or detracted from integrating the climate agenda into global financial systems. By learning from how this relatively mature state of climate reporting has been achieved, one may better understand the possibilities for reporting on social issues.

Data show a steady progression of efforts from a range of actors, including governments, businesses, financial institutions, individuals, civil society and intergovernmental organizations. Whether coordinated or isolated, many of these actions have had ripple effects and even catalyzed new markets. The goal of the database is to draw lessons from the climate agenda in order to identify gaps, opportunities and obstacles to advancing the social agenda within sustainable finance. The goal is to accelerate this agenda's advancement in line with the ambitious climate agenda.

UNDP is looking for a partner that can explore the data through visualization and other interactive tools, with the aim of sharing the database with others. Users could then have a sophisticated means of examining the various market interventions, policy efforts and regulatory measures that can enhance the measurement and management of social risks. Ultimately, this tool can create a common understanding of the relationships among financial systems, global economies, climate, the planet and the social systems upon which the global economy relies.

III. Recognizing social issues is integral to achieving climate goals

The effectiveness of climate measures depends on people. In recent years, the relationship between socio-economic inequalities and economic growth has featured in the Green Agenda through the Just Transition. This concept recognizes the fundamental injustices of the current fossil-fuel-based energy system, the ways in which climate change exacerbates inequalities,[42] the potential risks to rightsholders of a green transition and the opportunities offered by shaping the drive to net-zero so that it helps to overcome these structural failings. From a finance perspective, a Just Transition takes the voices of workers, consumers and communities into account in financing and investment strategies.

The interdependence of climate, biodiversity and social objectives is being recognized more widely. Humans are not only the culprits,[43] but the victims of a warming planet, and the impacts of climate change on different sectors of society are interrelated. Drought can harm food production, food security and human health and well-being. Flooding can lead to disease and damage ecosystems, infrastructure and trade. Human health issues can increase mortality and limit worker productivity, impacting food availability and reducing access to goods and services. Millions of people across the world already face extreme weather events, health effects, food, water and livelihood insecurity, migration and forced displacement, loss of cultural identity and related risks.

In December 2015 at the signing of the Paris Agreement, the G20 requested the Financial Stability Board "to review how the financial sector can better take account of climate-related issues.[44] In January 2016, The Financial Stability Board showed foresight and leadership by creating the Task Force on Climate-related Financial Disclosures (TCFD). Today, TCFD recommendations are playing a catalytic role in reshaping companies' and investors' approaches to addressing climate change and the energy transition. TCFD has also inspired the launch of the Task Force on Nature-related Financial Disclosures (TNFD).

However, these gains will face headwinds without attention to the social implications of investments in climate and nature. The sixth United Nations International Panel on Climate Change (IPCC) synthesis report distills years of climate science into an urgent call for resources to tackle climate change and poverty simultaneously.[45] As the report demonstrates, while climate mitigation will be necessary everywhere, low- and middle-income countries will bear a the greatest burden. Governments need to pursue climate mitigation and adaption at the same time since vulnerable people experiencing extreme poverty face a disproportionate risk of climate catastrophe. Women and girls are expected to experience more severe effects than men and boys, including an increased risk of gender-based violence, dropping out of

42 Healy, N., Stephens, J. C. and Malin, S. A. 2019. Embodied Energy Injustices: Unveiling and Politicizing the Transboundary Harms of Fossil Fuel Extractivism and Fossil Fuel Supply Chains. Energy Research & Social Science. 48. 219–34. DOI:10.1016/j.erss.2018.09.016

43 www.climate.gov/news-features/climate-qa/are-humans-causing-or-contributing-global-warming

44 https://www.bis.org/review/r161216h.pdf

45 www.ipcc.ch/report/sixth-assessment-report-cycle/

school and child marriage.[46] Similar inequalities beset other marginalized groups including young children, elderly people, ethnic and religious minorities, Indigenous Peoples and refugees.[47]

The 2022 IPCC summary report for policymakers on mitigation concludes that mitigation activities "in the context of sustainable development, equity, and poverty eradication, and rooted in the development aspirations of the societies within which they take place, will be more acceptable, durable and effective".[48]

Research organizations have identified climate mitigation solutions that confer shared benefits related to energy, food security, income and work, water and sanitation, health, gender equality, education, access to networks, housing, social equity, peace and justice, and political voice.[49] These benefits are an opportunity to advance interconnected goals such as those set out in the Paris Agreement and the SDGs. As the climate crisis progresses, a siloed approach to mitigation and adaptation makes equality and justice look less and less feasible.[50]

The International Energy Agency Net Zero Emissions by 2050 Scenario (NZE) highlights that behavioral changes – adjustments in everyday life that reduce wasteful or excessive energy consumption – are important for reaching net zero emissions by 2050. In the NZE, behavioral changes result in approximately 4 percent lower CO2 emissions between 2021 and 2050 compared to a scenario without changes that reduce energy demand in buildings, on roads and in air traffic.[51] This has been integrated into India's policy landscape through the Lifestyle for Environment (LiFE) initiative, highlighting the potential for behavioral change and consumption choices to advance energy transitions globally.

In 2022, under the Indonesian Presidency, the G20 Sustainable Finance Working Group (SFWG) achieved consensus on rapid action for transition finance. This included a set of principles to guide jurisdictional policies and financial service strategies supporting the transition to net-zero emissions while mitigating the potential negative effects of a disorderly transition. These principles integrate the concept of Just Transition, taking into account the structural changes that affect a wide range of stakeholders. Since then, countries such as China and the United Kingdom, as well as the European Union have begun asking investors to disclose their net-zero transition plans, and some central banks have developed models to quantify adverse low-carbon transition scenarios.

46 Nellemann, C., Verma, R., and Hislop, L. (eds). 2011. Women at the frontline of climate change: Gender risks and hopes. A Rapid Response Assessment. United Nations Environment Programme, GRID-Arendal.
47 www.ipcc.ch/report/ar6/wg2/downloads/report/IPCC_AR6_WGII_SummaryVolume.pdf
48 www.ipcc.ch/report/ar6/wg3/downloads/report/IPCC_AR6_WGIII_SummaryForPolicymakers.pdf
49 www.drawdown.org/publications/climate-poverty-connections-fact-sheet?_ga=2.241780162.1347937672.1680701928-73813991.1680545738
50 pardot.bcorporation.net/climate-justice-playbook-for-business-2021
51 www.iea.org/articles/do-we-need-to-change-our-behaviour-to-reach-net-zero-by-2050

A July 2022 United Nations resolution declared a clean, healthy and sustainable environment as a human right. In March 2023, the United Nations General Assembly adopted a resolution spearheaded by Vanuatu and youth activists to secure a legal opinion from the International Court of Justice that clarifies states' obligations to tackle the climate crisis – and specifies any consequences countries should face for inaction. In addition, the United Nations Human Rights Council passed a resolution that encourages governments to adopt policies and a legal framework for ensuring the right to a healthy environment.[52]

These events highlight the interdependence among climate goals, human rights social issues, and the need to address climate and social crises in an integrated manner.

Building on these underpinning reasons, this paper will now explore each of the following action areas in more detail, with recommendations summarized in the final Action Matrix.

Support
research on the systemic risk of socio-economic inequality for financial stability.

Adopt and improve
social disclosure standards and risk management tools

Rethink
the macroeconomic determinants of sustainable finance scenarios.

52 documents-dds-ny.un.org/doc/UNDOC/LTD/G23/055/72/PDF/G2305572.pdf?OpenElement

A

Support research on the systemic risk of socio-economic inequality issues for financial stability

Background

The following recommendations call for further research to inform improved supervisory and regulatory approaches to social risks. There is a particular need for research on whether socio-economic inequality risks to financial institutions can be transferred across sectors or borders, and whether these risks are amplifying effects on financial stability.

RECOMMENDATION 1

Build research capabilities to understand the relationships between inequality, private sector activity and financial stability

When the private sector harms people, it not only denies people of their human rights, but negatively impacts private-sector entities themselves. Examples of these compounded impacts include lower productivity when workers are harmed and project delays due to community protests. A business that ignores such negative impacts faces not only risks to business performance and limited productivity, but reputational and legal risk, loss of social license to operate, missed market opportunities, reduced consumer confidence and destabilized supply chains.

Rising inequalities can also lead to macro risks that increase uncertainty in the political direction of governments and the regulatory environment, in addition to financial markets. Emerging research on dynamics relating to secular stagnation, a 'savings glut of the rich' and debt traps lend support to the idea that inequality ultimately compromises financial stability.[53] Moody's estimates that over US$8 trillion of the debt it rates is highly subject to social risks, versus US$2 trillion that faces environmental risks.[54]

More data is needed to understand what private-sector activities contribute to inequality, by how much and how these activities create risks for the financial system. Across the world, many companies are burdened with significant leverage as a means to magnify returns:

53 Mian, Atif, Straub, Ludwig and Sufi, Amir, (2021), The Saving Glut of the Rich, Working Papers, Princeton University. Economics Department., https://EconPapers.repec.org/RePEc:pri:econom:2021-70

54 www.moodys.com/research/Moodys-Rising-income-inequality-carries-potential-credit-risk-for-some--PBC_1201809; www.cbsnews.com/news/inequality-is-worsening-and-could-hit-u-s-credit-rating-moodys/

debt service costs can mean cutting investments in decent jobs and high-quality, affordable goods and services. Multiplied across an economy, could such dynamics result in even more widespread socio-economic inequality and the risk a credit crisis?

Even the concentration of capital flows to large companies and asset managers versus smaller companies and asset managers may pose risks to financial stability. Such flows increase the potential for concentrated asset bubbles, while undervalued markets with significant opportunities for diversification and innovation are overlooked.[55] Yet empirical evidence supporting causality between inequality and financial instability on a global scale is still nascent and requires more investigation.

At the macroeconomic level, the relationship between inequality and interest rates is being debated. Some studies on secular stagnation suggest that high inequality in developed countries has suppressed interest rates in recent decades, leading to significant debt burdens or a 'debt trap' when interest rates must rise. If this is the case, how are developing countries and economically distressed communities affected? If the impacts are negative, is there an impact on global markets? Given that nearly half of all global financial assets are now held by non-bank financial intermediaries (NBFIs), which are less regulated than banks, are there systemic financial risks that are not on policy makers' and regulators' radar?[56] Is a more unequal society likely to increase financial vulnerabilities, and if so, through what channels?

The following two initiatives have been instrumental in moving the climate agenda – one multilateral, the other private. These could be models for initiatives that would propel efforts to address inequality:

Intergovernmental on Panel on Socio-Economic Inequality

Just as the growing risks from climate change have been assessed over many years by the IPCC, a global approach to research on socio-economic inequality could be accelerated through the establishment of an intergovernmental panel on socio-economic inequality, which could provide a global framework.

Building upon work by Stockholm Resilience Centre, R3.0 and the Doughnut Economics Action Lab, this research could inform the identification of boundaries, thresholds and allocations for social issues. The research could be conducted in conjunction with private-sector accounting mechanisms in order to capture risks, opportunities and potential impacts; participants might include organizations participating in the work of the Capitals Coalition. Public-sector accounting – a system that collects, records, classifies and summarizes transactions of public-sector entities – can also be leveraged to assess private-sector

55 Rothenberg, D., Chappe, R. and Feldman, A. 2021. ESG 2.0: Measuring and Managing Investor Risks Beyond the Enterprise-level. ssrn.com/abstract=3820316
56 www.fsb.org/2022/12/global-monitoring-report-on-non-bank-financial-intermediation-2022

relationships with the public, tax systems, social and public infrastructure, measures of wellbeing and social stability.

A new understanding of value – one that enables investors and enterprises to account for well-being – could transform capital allocation strategies. With the recognition that such risks to long-term value could affect their portfolios, asset owners may use this research to set less extractive incentives for their asset managers. Finally, there is a need to examine the impact of 'financialization' on inequality, given the increasing evidence that above a certain threshold, financial-sector growth increases inequality and financial instability.[57]

Inequality Tracker

The Carbon Tracker[58] provides independent financial analysis on the risks and opportunities associated with the transition to a low-carbon economy. It conducts research, analyses data and produces reports that inform investors, policymakers and the public about the financial risks of investing in fossil fuels. An 'inequality tracker' could provide insights into how capital is allocated, and risk and return are distributed, as well as the distributional impacts of climate policies and mitigation efforts.

For example, an inequality tracker could assess whether the costs and benefits of proposed low-carbon transition plans are equitably shared among stakeholders based on the risk they assume and value that they create. It could also provide analyses of the globally shared risks of leaving vulnerable communities behind and of investing in these communities' mitigation and adaptation plans.

Previous research[59] has already shown that achieving net-zero in 2050 implies capital value at risk approaching US$50 trillion, three quarters of which is human capital. Further research could assess the social and economic impacts of carbon emissions and climate change on different demographic groups (particularly those most vulnerable and marginalized),and measure the extent to which carbon emissions and climate change exacerbate existing inequalities.

57 Furceri, D. et al. 2019. The Aggregate and Distributional Effects of Financial Globalization: Evidence from Macro and Sectoral Data. Journal of Money, Credit and Banking. Vol. 51.

58 carbontracker.org

59 Mercure J, Chester D, Lynch C, Jarvis S, Jarvis A. Stranded human and produced capital in a net-zero transition. Research Square; 2021. DOI: 10.21203/rs.3.rs-644993/v1.

RECOMMENDATION 2

Prevent systemic risk triggered by socio-economic inequality

Building on the emerging framework for financial disclosures on social- and inequality-related risks and opportunities outlined in Recommendation 4, supervisors can bridge existing data gaps on socio-economic risks and issue prudential rules to limit financial institutions' exposure to harmful activities. This would protect against the buildup of systemic risk related to socio-economic inequalities.

The risk of perpetually low interest rates – potentially fuelled by inequality – leading to more fragile corporate capital structures, debt traps and even greater inequality highlights the need to consider solutions that prevent this downward spiral. Private-sector activities that contribute to inequality make the jobs of central bankers harder. Central banks already face challenges in raising interest rates to combat inflation – largely due to high debt levels.[60]

As seen with recent banking failures, there is a need to regulate market-based finance, given its linkages with the banking system. The Financial Security Board (FSB) developed a definition of shadow banks that includes all entities outside the regulated banking system performing the core banking function – credit intermediation. These regulatory approaches can be expanded to tackle socio-economic risks in NBFIs.

Asset owners and allocators, such as pension funds and sovereign wealth funds, sit at the top of the 'capital markets value chain' among NBFIs, and have the potential to invest in a more regenerative, sustainable manner. But private investment in sustainable projects is often hindered by perceived risks. A better understanding of inequality as a systematic and systemic risk – coupled with a stronger recognition of social value – could reorient how investors analyze risk and return. This could drive greater investment in sustainable and inclusive solutions. In addition, policy and regulatory interventions could reinterpret fiduciary duty as 'inter-generational fiduciary duty', highlighting the systemic and systematic risks and opportunities inherent in investment decision making and capital allocation.

60 www.imf.org/en/Blogs/Articles/2022/10/11/interest-rate-increases-volatile-markets-signal-rising-financial-stability-risks

SUMMARY
A SUPPORT RESEARCH ON THE SYSTEMIC RISK OF SOCIO-ECONOMIC INEQUALITY FOR FINANCIAL STABILITY
RECOMMENDATION 1
RECOMMENDATION 2
B ADOPT AND IMPROVE SOCIAL ...
C RETHINK THE MACROECONOMIC ...
ACTION MATRIX

Social issues, climate vulnerability and sovereign debt risk

Policies and regulations that encourage responsible borrowing and lending practices, and manage debt crises, would help to control precarious levels of sovereign debt, especially in the Global South. Some of these mechanisms are described below.

Debt Sustainability Framework: One approach to debt restructuring is the creation of a debt sustainability framework that sets guidelines for borrowing and lending, taking into account each country's unique economic and social context. This framework would also set criteria for assessing the sustainability of debt, including countries' ability to service debts over the long term, and the potential impact on economic growth. It would benefit from the social and inequality disclosures, and data-analysis capabilities outlined in the recommendations, ensuring continued investment in climate adaptation and avoiding increased vulnerability, which could undermine any progress.

Debt-for-Nature Swaps: These interventions date back to the 1980s but are gaining renewed attention. In debt-for-nature-swaps, a sovereign's debts can be restructured or forgiven in exchange for the preservation of nature. These interventions leverage new forms of value accounting whereby the system-level value of natural capital – upon which businesses and markets are dependent – is recognized by investors. In May 2023, Ecuador sealed the world's largest debt-for-nature swap – a blue blond for conservation of the Galapagos Islands.

Debt-for-nature swaps have the potential to address the interrelated climate, nature and inequality crises along with localized debt crises. While effective debt-for-nature swaps require a stable macroeconomic environment, a better understanding of how to account for social value can support their effectiveness. Finally, these funds should be aligned with the needs of local populations – including Indigenous populations – and monitored using robust standards.

61

61 www.brookings.edu/blog/future-development/2022/07/08/the-debt-and-climate-crises-are-escalating-it-is-time-to-tackle-both/

B

Adopt and improve social standards, disclosures and tools

Background

There is currently no global framework to guide companies and investors in measuring, managing and mitigating the risks to enterprise value and financial stability generated by inequality and social issues. Business, policy and investment behaviour is grounded in international human rights law, as interpreted by the United Nations Guiding Principles on Business and Human Rights,[62] the International Covenant on Economic, Social and Cultural Rights and jurisprudence. Yet investor mobilization on social inequality has been limited by:

- A lack of comprehensive analysis of how social and inequality-related risks can manifest as material financial risks – both to individual enterprises and the health of the entire financial system.
- A lack of understanding about how private-sector activities contribute to inequality, and by how much.
- A lack of tools for investors to integrate social issues into their investment strategies.
- An overwhelming focus on climate and nature by international bodies and investor initiatives.

The G7 Impact Investment Taskforce, under the 2021 United Kingdom Presidency, recommended that new and existing voluntary disclosure frameworks integrate social issues to enable clear visibility of the interdependencies between social and climate outcomes.[63]

62 The Universal Declaration of Human Rights, adopted by the United Nations General Assembly in 1948, notes that human rights are inherent to all human beings regardless of race, sex, nationality, ethnicity, language, religion or any other status. Human rights include the right to life and liberty, freedom from slavery and torture, freedom of opinion and expression, the right to education, work and fair pay. The United Nations Guiding Principles on Business and Human Rights build on these principles, providing guidance on how businesses can respect human rights and emphasizing the importance of collaboration among governments, businesses and civil society in promoting and protecting them.

63 www.impact-taskforce.com/media/io5ntb41/workstream-a-report.pdf

RECOMMENDATION 3

Improve data and disclosure on social and inequality risks and impacts

Investors increasingly understand that when companies cause or contribute to harming people and the planet, these harms can rebound as financial impacts through legal, reputational or operational risks. Large, diversified investors are also beginning to consider how certain social and inequality-related risks – historically considered externalities – can negatively impact their portfolios' financial performance. By the same token, positive impacts on people could create opportunities to build financial value for enterprises, the overall economy and markets. This new understanding has spurred interest in better data collection on social risks and opportunities.

Private-sector climate management is narrowly focused on business responsibility for greenhouse gas (GHG) emissions– and only recently on adaptation and responsible transition to a clean economy. The scope of private-sector management of inequality and social issues is significantly broader, encompassing tax justice, climate justice, Global North-Global South dynamics, labour rights, land and natural resource rights, discrimination, corporate and investor concentration, and more.

While private-sector contributions to climate change are quantifiable as GHG emissions, it is more difficult to quantify – as well as audit and provide assurance of – social impacts and risks. For example, it has been well-documented that using auditing methods to assess the treatment of workers has failed. Instead, there has been an exploration of innovative technologies to enable workers to report conditions directly. The most promising solution is 'worker-driven social responsibility', an approach to worker empowerment that includes such notable examples as the Bangladesh Accord, but that has not yet reached scale.

Unlike climate impacts, the social impacts of corporate operations tend to be more visible and immediate (examples include Rana Plaza, Brumahindo dam and the murders of human rights defenders). This makes it easier to galvanize public opinion for action on social issues than on climate, where risks manifest over longer timeframes. On the other hand, inequality is similar to climate in that it is cumulative and less visible, making public awareness more dependent on academic research or localized 'tipping point' events such as natural disasters and riots.

Principles for Responsible Investment (PRI) data show a clear and growing appetite within the investor community to ensure that investments deliver positive outcomes for people and the planet; however signatories' practices regarding sustainability outcomes could be significantly improved.[64] While half of all PRI signatories reported using the SDGs to identify and benchmark the sustainability outcomes of their activities, just 26 percent referred to

64 www.unpri.org/sustainability-outcomes/sustainability-outcomes-what-does-our-reporting-data-reveal-about-emerging-signatory-practices/10754.article

specific human rights frameworks such as the United Nations Guiding Principles on Business and Human Rights or the OECD Guidelines for Multinational Enterprises.

Asset owners using these international standards held a combined US$12.5 trillion in assets under management (AUM), and investment managers a combined US$62.7 trillion in AUM. This represents 45 percent of the AUM of reporting asset owners, and 58 percent of the AUM of reporting investment managers. These numbers are not surprising given that a lack of outcome-level data is often identified as an obstacle in researching human rights, gender equality and other social issues.

The measurement of social-related risks and opportunities involves the interaction of multiple socioeconomic factors, which are difficult to integrate into financial decision-making. On issues like decent work, issue-specific disclosure frameworks such as the Workforce Disclosure Initiative are paving the way for more systematic analysis.[65] In the area of workforce diversity, some jurisdictions have developed disclosure requirements related to human capital and workforce diversity (including the European Union Corporate Sustainability Reporting Directive and Australian Asset Owner Stewardship code).[66]

Other frameworks take a more comprehensive approach to risk management across different stakeholder groups, issues and countries. But these broad frameworks may only provide investors with mandates to focus on single or double materiality (e.g., the International Sustainability Accounting Standards Board or Global Reporting Initiative) as opposed to both. To date, no frameworks have identified system-level risk and return, or the risks and opportunities from the overall market. And few frameworks assist investors in assessing financial opportunities related to people.[67] These dynamics result in a highly fragmented disclosure landscape, particularly for globally diversified investors working across industries and asset classes.

Only recently have efforts been made to understand investors' own contributions to risks and impacts on people.[68] Existing frameworks focus on corporate behaviour, but social risks and inequality may manifest due to activities of investors themselves. For example:

- If investors set incentives for their investees to maximize financial rates of return through financial engineering (e.g., taking on a significant debt burden to pay dividends or buy back stock), this may leave the company with few resources to offer decent jobs and high-quality, innovative goods and services.
- The structures of funds can be designed to avoid tax responsibility.

65 shareaction.org/investor-initiatives/workforce-disclosure-initiative
66 For more information, see the PRI investment policy database.
67 The few examples of these frameworks include IRIS+ (although it was designed as a metrics catalogue and not a comprehensive framework) and the Impact Management Platform.
68 impactfrontiers.org/work/investor-contribution-2.0

- Fund manager compensation can be so high that it exacerbates inequality.

- Investors may allocate capital in ways that squeeze out diverse and emerging managers, as well as small-and-medium-sized enterprises, leading to corporate concentration, market underdevelopment, loss of innovation, deteriorating consumer well-being and monopsony dynamics that erode workers' bargaining power.[69]

More needs to be done to support investors in understanding the financial materiality of social and inequality-related risks – as well as opportunities for investing in solutions. Policymakers have a critical role in making the data available by mandating corporate and investor disclosures. Accessibility can be enhanced through better data tagging based on agreed taxonomies (digital corporate reporting is an important emerging objective for policymakers). With these tools, regulators can gain better insights into the complex and interconnected risks associated with different policies and market developments.

A global framework on social- and inequality-related risks

What socio-economic data are needed to accelerate the achievement of the SDGs?

Can we envision an open and free data repository that would allow all stakeholders to easily access socio-economic data in order to measure impacts?

Just as the Task Forced on Climate-related Financial Disclosures TCFD and on Nature-related Financial Disclosures (TNFD) have delivered insights for investment decision making on climate and nature, the Taskforce on Inequality-related Financial Disclosures (TIFD) and the emerging Taskforce on Social-related Financial Disclosures (TSFD) are developing a global framework for risk management and financial disclosures that encompasses social- and inequality-related risks and opportunities affecting financial stability and long-term value creation. This risk management and disclosure framework will contribute to the future work of these standard-setting bodies and ensure interoperability with the TCFD and the TNFD.

Governments can partner with this initiative to improve the quality, usability and accessibility of economic, environmental and social dat sets. This is an opportunity for development organizations that have strong partnerships with governments and the private sector to harness the potential of Artificial Intelligence and open data to link datasets on social and environmental issues to economic outcomes.

69 Rothenberg, Delilah and Chappe, Raphaele and Chappe, Raphaele and Feldman, Amanda, ESG 2.0: Measuring & Managing Investor Risks Beyond the Enterprise-level (April 6, 2021). Available at SSRN: https://ssrn.com/abstract=3820316 or http://dx.doi.org/10.2139/ssrn.3820316

RECOMMENDATION 4

Encourage investor stewardship and asset allocation based on both environment and social analysis

Climate disclosures have gained traction, due largely to the success of the Carbon Disclosure Project reporting standards. Building on this momentum, investors can use social disclosures to start (or increase) capital allocations towards achievement of social outcomes – in addition to de-risking.

Much interest in ESG is not from lenders evaluating credit risk, but from investors evaluating equity risk and return. Equity investors typically focus on capital appreciation and upside return potential, not just risk mitigation. Simply de-risking ESG exposure is unlikely to help investors make solid bets on which companies will outperform the market. Yet improved disclosure can create incentives to invest in and structure financial mechanisms that mitigate social risks. Investors may set less-extractive incentives for companies and less-extractive terms for sovereigns, building on information and guidance gathered from social disclosure tools.

By pursuing sustainability outcomes through stewardship, asset owners and allocators such as pension funds and sovereign wealth funds can mitigate systematic risks including socio-economic inequality, improving the long-term performance of their investment portfolios. At the same time, they can improve social and environmental outcomes in line with their public policy goals and the needs of beneficiaries.

A regulatory framework for effective stewardship[70] would formalize stewardship activities as regulations or other guidance, and define expectations for investors' stewardship practices and reporting. PRI defines stewardship as "the use of influence by institutional investors to maximize overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend".

There are two main reasons for regulators to establish this kind of framework:

- The need to align investor stewardship with investors' duties to their clients or beneficiaries
- The desire to facilitate stewardship as a tool to support public policy objectives.

70 www.unpri.org/policy-toolkit/how-policy-makers-can-implement-reforms-for-a-sustainable-financial-system-stewardship/11190.article

Through these frameworks, policymakers can clearly identify where stewardship activities could be useful to create enabling environments for reducing socio-economic inequality, promoting diversity and inclusion and digital rights, ending human slavery, providing living wages and enforcing fair labour standards.

Collaborative engagements, such as the PRI's Advance initiative and the Global Investor Commission on Mining 2030 allow investors to increase their leverage in line with OECD guidelines for institutional investors. Policymakers should also consider the benefits of revising existing regulations, such as the application and enforcement of anti-trust laws, for investor stewardship.

RECOMMENDATION 5

Evolve auditing and assurance practices to assess social-related financial risks

Financial markets currently face structural shortcomings in managing systemic risks – characterized by capital market imbalances that require central bank interventions, socialization of losses[71] and short-term-focused managerial incentives. Given this situation, financial regulators can focus on preventive action to build financial and economy-wide resilience. There is an opportunity to reform market structures in a way that revises the cost of capital for investments to incentivize outsized social returns.

In order to foster financing for social impact, regulators are looking towards assurance and audit practices that can prevent 'greenwashing' and 'social washing'. The fields of auditing, accounting and assurance can lead the way in objectively assessing practices and performance, supported by disclosure and analysis initiatives.

To support with this goal, policymakers should strive to:

- Regulate ESG and impact investing data providers with a view to improve the transparency of social and human rights assessments, and avoid conflicts of interest between ratings and advisory services.
- Mandate private sector social and human rights performance and reporting for both companies and investors (e.g., the European Union Corporate Sustainability Due Diligence Directive)

71 In such cases, investors may expect to keep their profits in good times and shed their losses during a crisis. See Bental, B. and Demougin, D. 2016. Privatizing Profits and Socializing Losses with Smoothly Operating Capital Markets. European Journal of Political Economy. 44 (179-194) 2016. doi.org/10.1016/j.ejpoleco.2016.06.004

- Enhance the quality of assurance services for private sector social and human rights performance and reporting.
- Acknowledge the links between climate and social disclosures within existing auditing and assurance practices.

Credit-rating agencies assess the creditworthiness of companies and sovereign entities, and their evaluations can significantly impact investment decisions. Policymakers must also ensure that credit ratings reflect the social performance of issuers and incentivize agencies to include sustainability indicators in their assessments. Greater regulation could incentivize the creation of guidelines for ESG rating methodologies, indicating clearly what they capture and how they are measuring socio-economic inequality.

Recent research on credit rating methodologies highlights the need for ESG ratings agencies to provide stand-alone sustainability ratings for environmental, social and governance factors. This would bring much-needed clarity on what is being assessed (i.e. financial returns versus real-world impact). [72]Sovereign credit ratings have begun to consider social impacts, indicating that economic and budgetary factors are not the only criteria being considered. Some of these ratings now incorporate political factors, demonstrating a broader perspective on evaluating a country's creditworthiness.[73]

RECOMMENDATION 6

Re-structure the approaches for accounting of value

The fact that inequality caused by the private sector comprises a systematic risk – which can lead to systemic risks among financial institutions – underscores the need for greater coordination across the fiscal, monetary, policy and regulatory arenas. In this way, financial regulators and policymakers function within their mandates, but in coordination.

Interventions already underway to address climate risk may be stymied by the lack of strong social measures that support a Just Transition. Enhancing market practices and transparency through standards, disclosure and accounting can be only a starting point. Macroprudential policy and regulation could encourage financial institutions to consider system-level risks to be 'financially material', rather than focusing exclusively on idiosyncratic financial risk and return of each individual portfolio company, regardless of positive or negative externalities.

72 Finance Watch. 2023. Regulating ESG ratings to Strengthen Sustainable Investors. Policy brief: May.
73 Financial Times. Fitch Cites Civil Unrest in Downgrade of France's Credit Fating. www.ft.com/content/6027589e-90fd-4fb1-a3a7-d6bd29bdb704

The integration of social impacts into accounting systems is limited by prevailing fair value accounting systems, where corporate finance dominates in maximizing shareholder value. This excludes extra-financial performance from the value, and therefore from decision making. Structural changes to profit calculations should be considered, particularly since many current definitions of profit do not account for people.

In Action:

The System of Environmental-Economic Accounting (SEEA) and the International Public Sector Accounting Standards Board (IPSASB)

The System of Environmental-Economic Accounting (SEEA) integrates economic and environmental data to provide a comprehensive and multipurpose view of the interrelationships between the economy and the environment – and the stocks and changes in stocks of environmental assets that bring benefits to humanity. It contains internationally agreed standard concepts, definitions, classifications, accounting rules and tables. As the accepted international standard for environmental-economic accounting, the SEEA provides a framework for presenting statistics on the environment and its relationship with the economy. It brings together economic and environmental information into a standard set of concepts, definitions, classifications, accounting rules and tables to produce internationally comparable statistics.

The SEEA was established by the United Nations Secretariat, the European Commission, the Food and Agriculture Organization of the United Nations (FAO), OECD, IMF and the World Bank Group.

A developer of accounting standards and guidance for use by public-sector entities, IPSASB aims to strengthen public financial management globally through increasing the adoption of accrual-based International Public Sector Accounting Standards.

Its work increases the transparency and reliability of public-sector financial information, ensuring responsible and effective use of public resources. IPSASB established a Sustainability Task Force to advance research on non-financial disclosures related to climate and natural resources.

C

Rethinking macroeconomics determinants of sustainable finance scenarios

Background

Research demonstrates that the majority of institutional investors' returns come from systematic factors, rather than idiosyncratic factors.[74] Given that institutional investors and NBFIs now provide approximately half of all financing, they are critical actors when considering financial stability. Moreover, the retirement industry is a major subset of the NBFI sector and therefore capital markets. As the cost-of-living crisis threatens pension funds and retirement accounts around the world, it will be a crucial stakeholder in the coming years. All actors in this sector should have mandates to consider both systematic and systemic risks.

RECOMMENDATION 7

Re-couple climate and social risk and opportunity analysis

Inequality intersects with climate through both physical impacts and transition impacts, and through both mitigation and adaptation dynamics. For example, in the transition to a low-carbon economy, who will lose their jobs? How will job losses impact communities where there is predominantly a single employer? Who loses their land to renewable power plants? How is labour treated in the supply chain for critical minerals needed for batteries? How will low- and middle-income workers, and small businesses manage a carbon tax or reduced supply of oil and gas if the supply is phased out faster than renewables are phased in? How will energy-efficiency retrofits of homes affect housing costs? What are the implications in terms of inflation and employment – two key mandates of central banks?
In terms of adaptation, how can one ensure that areas with lower wealth and income have the resources they need to protect their populations and the planet from natural disasters? At the same time, how can they grow in a manner that that offers comparable growth opportunities to those that have benefitted developed countries?

Capital market regulators could partner with central banks to embed improved disclosure on social issues and inequality into models like those developed by Network for Greening the Financial System.[75] Central banks such as the European Central Bank are seeking to

74 Lukomnik, J., & Hawley, J.P. 2021. Moving Beyond Modern Portfolio Theory: Investing That Matters (1st ed.). Routledge.
75 Networking for Greening the Financial System. 2021. Progress Report on Bridging Data Gaps. www.ngfs.net/en/communique-de-presse/ngfs-publishes-progress-report-preliminary-findings-climate-related-data-gaps

integrate sustainability indicators into financial stability monitoring in order to model the effects of climate change on households and economic sectors. For example, recent economic events in the United Kingdom have pushed the Bank of England to announce the world's first stress tests examining underlying risks in key financial markets where NBFIs are major participants.[76]

By simulating economic and financial outcomes, policymakers and financial institutions can anticipate and prepare for financial shocks. Improved models of the social impacts of transitions will inform scenario analyses and stress tests. Taken together, the integration of social risks into financial stability supervision and prudential regulation has the potential to transform traditional approaches to risk management. Moving from a focus on historical risk data, these new approaches can incorporate emerging transition and physical risk data.

Prudential regulation could focus on ensuring that financial firms and products are secure and resilient for markets as well as individuals. Financial stability monitoring could extend beyond the banking sector to include NBFIs – evaluating how socio-economic inequalities and market concentrations can manifest as systematic and systemic risks, leading to market instability and the need for central bank interventions.

RECOMMENDATION 8

Mobilize finance for social projects through the multilateral development bank reform agenda

The Multilateral Development Bank (MDB) reform agenda is expected to address an increasing number of challenges in a time of polycrisis, including unsustainable debt burdens, the escalating climate emergency, the COVID-19 pandemic and geopolitical tensions. These shocks require funding to build resilience and prevent future failures. The United Nations is calling for a significant increase in affordable long-term financing by aligning all financing flows with the SDGs and improving MDBs' lending terms. This will require a new international financial architecture that drives finance in just, inclusive and equitable transitions for all countries.

This overarching framework should be integrated into national and global policy frameworks – influencing risks, shaping incentives, impacting financing needs and affecting the cost of financing. These incentives could be used to channel finance towards projects with positive social impact. For example, the 2X Challenge calls for the G7 and development finance institutions to collectively mobilize US$3 billion for improving the access of women in developing countries to leadership opportunities, decent employment, finance, enterprise support and other services that enhance their participation in the economy. [77]

76 www.bankofengland.co.uk/stress-testing/2022/key-elements-of-the-2022-stress-test
77 www.2xchallenge.org/criteria

At the international level, the social agenda is driven by UNDP as the leading United Nations organization fighting to end injustice, poverty, inequality and climate change. A recent report by UNDP stated, “countries that fail to recognize the opportunities afforded by a ‘green revolution’ run the risk of increasing social inequality, civil unrest, and less competitive economies if proposed transitions to net-zero emissions pathways are not well managed”.

MDBs apply environmental and social safeguards in their approval processes, but often fail to monitor them throughout the project cycle. This brings significant risks to communities.[78] There is a need for increased governance of this monitoring process and more funding for building resilience. MDBs can expand their financing capacity for grants focused on technical advisory services and resilience building, along with incentives for product development linked to climate and inequality.

78 odi.org/en/insights/bigger-but-also-better-why-mdb-reform-must-go-further

Action Matrix

Action Matrix	A. Support research on the systemic risk of socio-economic inequality for financial stability	B. Adopt and improve social disclosure standards and risk management tools	C. Align stakeholders on the social and climate implications of financial decisions
Ministers of Finance	Bridge existing data and information gaps on socio-economic risks.	Report regularly on socio-economic risks. Integrate human capital into accounting systems	Influence the allocation of financial capital towards SDG-aligned projects. Mainstream a social lens in work with the private sector.
Central Banks and supervisors	Identify transmission channels and spillovers for the materialization of socio-economic risks. Integrate socio-economic risks into prudential regulation and financial stability monitoring.	Conduct supervisory assessment of institutions' social risk disclosures.	Reform the international monetary system, recognizing social issues, their implications and the interactions between climate and socio-economic systems.
MBDs	Support empirical research to determine the causality between inequality and financial instability on a global scale. Explore interlinkages between socio-economic inequality and financial stability, including how private-sector activities affect market fragility.	Identify and resolve social and inequality data gaps at the country and sector levels. Support joint Just Transition Principles (such as those developed by the European Bank for Reconstruction and Development).	Mobilize private-sector finance for investments with positive social impact. Engage with stakeholders to understand the obstacles impeding private investment in social action. Mitigate negative socio-economic impacts and increase opportunities associated with the transition to a low-GHG economy. Increase governance of social and environmental monitoring, and increase funding for building resilience. Expand capacity for financing technical advisory services and resilience building through grants, and create incentives for product development linked to climate and social issues.
Policy-makers	Identify transmission channels and spillovers for the materialization of socio-economic risks. Integrate socio-economic risks into prudential regulation and financial stability monitoring.	Conduct supervisory assessment of institutions' social risk disclosures.	Reform the international monetary system, recognizing social issues, their implications and the interactions between climate and socio-economic systems.
Capital market regulators		Encourage investors and rating agencies to break down ESG performance by environmental and social issues, including interdependencies. Use data to gain better insights into the complex and interconnected risks associated with different policies and market developments.	

Action Matrix	**A. Support research on the systemic risk of socio-economic inequality for financial stability**	**B. Adopt and improve social disclosure standards and risk management tools**	**C. Align stakeholders on the social and climate implications of financial decisions**
Standard-setters	Build on emerging research to set thresholds on socio-economic inequality and other social issues.	Develop frameworks that support investors in understanding the financial materiality of social and inequality-related risks, as well as investment opportunities.	
Asset owners		Drive stewardship and asset allocation based on both climate and social analysis.	Revise investors' remuneration incentives, focusing on the long-term need to address climate change and inequality.
Asset managers		Improve disclosure on socio-economic inequality and other social issues. Optimize socio-economic impacts and increase opportunities associated with the transition to a low-GHG economy.	
Businesses		Include disclosures on social issues in business model evaluations and communications with investors.	(For credit rating agencies) Assess the creditworthiness of companies and sovereign entities, generating data that can impact investment decisions.

Building on the climate agenda

This paper builds on research that identifies opportunities to learn, improve and accelerate progress on the climate agenda, integrating social and inequality issues within the financial system. These opportunities include the following:

Carbon Tracker...
could there be an Inequality Tracker?

IPCC...
what would stakeholders need to develop an Intergovernmental Panel on Socio-Economic Inequality?

Taskforce on Climate-Related Financial Disclosures...
how do we build momentum and inclusive leadership for a taskforce on socio-economic inequality-related disclosures?

Carbon Disclosure Project...
how do we build on issue-specific initiatives like the Workforce Disclosure Initiative to create a more holistic view of social and environmental performance?

GHG Protocol...
what is the international standard for corporate reporting on social issues?

United Nations Development Programme, 2023. From Fragmentation to Integration: Embedding Social Issues in Sustainable Finance. A call for policymakers and market practitioners to advance the integration of social risks and opportunities into financial strategies.

September 2023