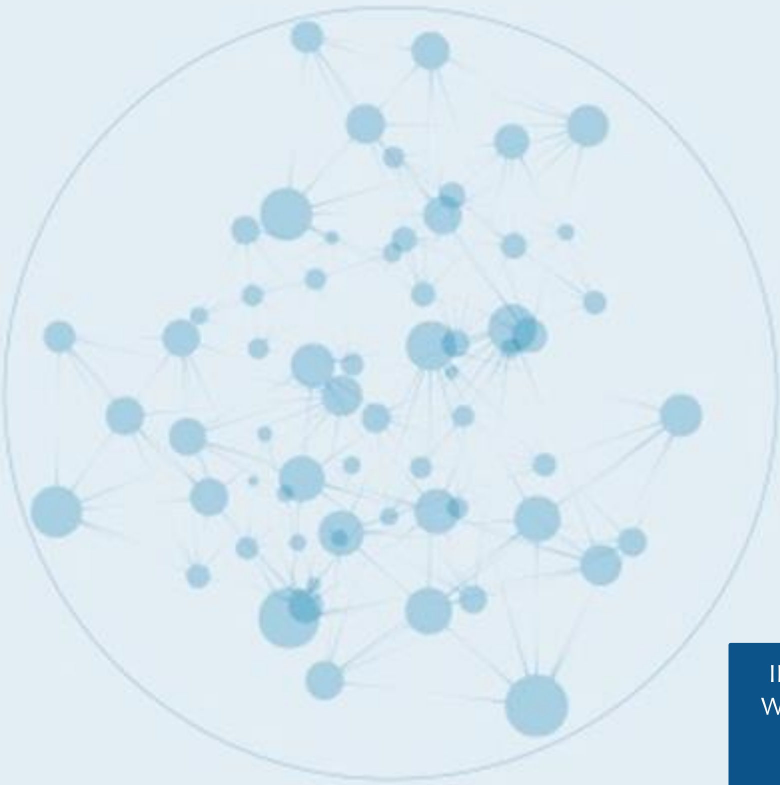
Inquiry: Design of a Sustainable Financial System

UNEP

GREENING THE BANKING SYSTEM

Taking Stock of G20 Green Banking Market Practice



INQUIRY WORKING PAPER

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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report, The Financial System We Need, in October 2015 and is currently focused on actions to take forward its findings.

More information on the Inquiry is at: *www.unep.org/inquiry* and *www.unepinquiry.org* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

About this report

This input paper has been prepared by the authors as a contribution to the G20 Green Finance Study Group (GFSG) but has not been endorsed by it nor does it represent the official views or position of the GFSG or any of its members.

Comments are welcome and should be sent to *nick.robins@unep.org*.

Acknowledgements

Nick Robins and Jeremy McDaniels are the authors of this paper.

Contents

Practice

This paper takes stock of G20 experience with green banking, focusing on market practice. It assesses the evolving green banking agenda, focusing on *mainstreaming* and *mobilization*, drivers of progress, and key barriers. It concludes with a set of options for consideration by the G20.

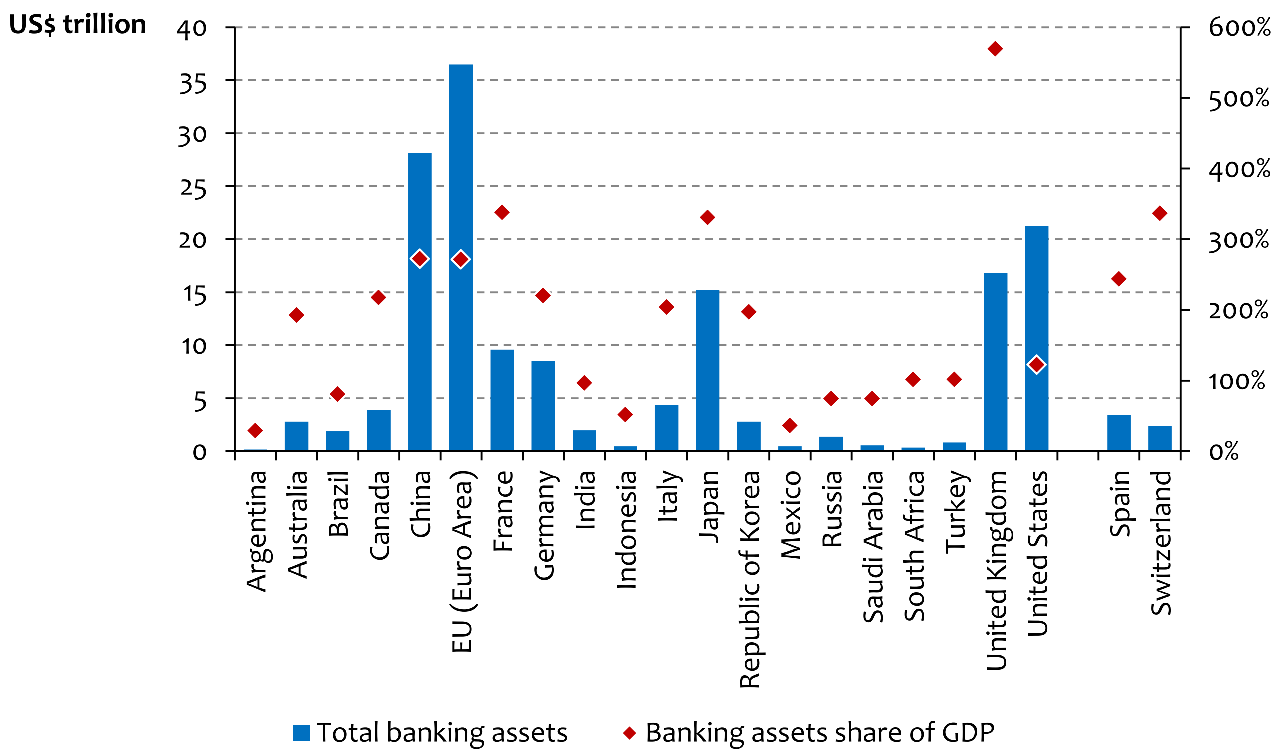
This paper has been developed by the G20 Green Finance Study Group (GFSG) Secretariat, on the basis of:

- A literature review of key developments and current themes in green banking, market-led initiatives, and public action;
- A survey process engaging leading banks from G20 countries, including telephone interviews and a written questionnaire (Appendix A),
- An interview process with relevant international initiatives and associations.

Context

G20 banking sectors are highly differentiated in industry structure and concentration, composition of balance sheets, business models, and size in relationship to the broader economy[1] (Figure 1). In certain countries, banking is the dominant financial sector concentration. This is especially the case in G20 emerging markets, where banks remain the primary funding channel.

Figure 1: Banking Assets in G20 Countries



Sources: FSB Shadow Banking Monitoring Dataset 2015,[2] IMF WEO Database 2015.[3] Note: Banks refer to the broader category of deposit-taking institutions. Asset figures refer to financial assets where available, otherwise total assets. Converted to US$ at the end of the period (November 2015) using market rates.

Executive Summary

Green banking practices are at different stages of evolution across the G20. Emerging green banking practices across G20 countries can be grouped into two categories:

- Mainstreaming environmental factors across bank strategy and governance, evolving from an early focus on due diligence at project level to consideration of environmental factors across credit risk functions. Now the focus is shifting to more strategic action, with leading banks exploring environmental stress testing and links between environmental and financial performance.
- Mobilizing capital for specific green assets through loan origination, the provision of credit and savings' products as well as capital markets activities. Banks are the primary source of funding for renewable energy investments, and critical sources of capital for infrastructure and small and medium enterprises (SMEs). Now, banks are moving from "risk to opportunity" in new sectors, such as energy efficiency, with leading banks working to drive positive impact across all activities.

A diverse range of sector-specific market and policy factors has motivated the evolution of the green banking agenda. Key catalysts for action include rising public expectations, the recognition of environmental issues as real drivers of financial risk and identification of green loan origination opportunities. Green banking progress in the G20 has largely been the result of market-led action, including individual institutional leadership, the collective efforts of banking associations, and international initiatives. Some governments and regulators across the G20 are taking action to support the greening of the banking system. Public finance can play a catalytic role in making the business case for green banking, through risk sharing and incentive mechanisms to address market failures and leverage private capital.

Barriers to green banking can be understood in a general hierarchy of importance and challenge:

- A lack of real economy demand, stemming from the presence of unmitigated externalities or policy uncertainty;
- The lack of a clear business case, where risk/return profiles of potential projects are unbankable;
- Negative impacts on competitiveness and a lack of a level playing field;
- A lack of appropriate practitioner capacities or a supportive financial culture;
- A lack of appropriate information flowing between the market and banks; and
- Issues of policy coherence and regulatory alignment.

Several conclusions can be drawn regarding green banking market practice in the G20:

- There is some convergence in practitioner understandings of green banking, but perceptions and priorities vary significantly across the G20.
- The lack of a global framework or body to structure green banking practice (in comparison to investment, for example) may be holding back progress.
- The success of efforts to greening the banking system is contingent on levels of financial system development and broader environmental regulatory contexts.
- There is an emerging rationale for public action to support greening of the banking system – as closely linked to long-term economic growth as it is to sustainability.

G20 countries have committed to realignment of growth pathways with sustainable development – as evidenced by recent Intended Nationally Determined Contributions (INDCs) and agreement of the Sustainable Development Goals (SDGs). Meeting these goals while maintaining economic growth is the defining challenge for the G20 over the coming decade. A thriving green banking sector can play a fundamental role in this effort – provided governments are able to deliver a level playing field, share emerging best practices, and unlock new opportunities for investments in sustainable growth.

Emerging policy options include:

- Develop comprehensive voluntary principles;
- Clarify green definitions;
- Develop green securities to support maturity alignment;
- Use public finance to leverage green loans and credit;
- Enhance professional education;
- Develop national collaborative processes;
- Expand global learning networks;
- Collect data and improve disclosure; and
- Support policy alignment.

1 The State of Green Banking Market Practice

1.1 The Evolving Green Banking Agenda

Action to incorporate critical environmental factors into the banking system has been gathering momentum across the G20, with activities in some G20 countries under way for over two decades.[4] Momentum towards a wider sustainable banking shift is accelerating as market and policy factors are driving firms to consider a range of environmental, social, and governance (ESG) risks and opportunities in their operations, financing, and capital raising activities.

Green banking practices are at different stages of evolution across the G20, reflecting variation in broader national financial and economic circumstances. Most green investments across the G20 are financed at least in part through banks. Financing models vary from short-term corporate lending to non-recourse specialized lending – with banks currently providing roughly 80% of green infrastructure finance. In some markets, larger banks provide critical intermediary services to channel institutional capital to green assets.

In certain G20 countries the case for green banking has been clearly made, evidenced by increasing allocations of bank capital to green assets, individual institutional leadership and public commitments, new sector-wide green banking protocols, growing support for international voluntary principles, and the implementation of targeted policy and regulatory actions.[5] While progress has been slower in countries at earlier stages of financial system development, the green banking agenda is now being realized as a critical opportunity to support inclusive and sustainable economic growth.

Emerging green banking practices across G20 countries can be grouped into two categories:

1. **Mainstreaming environmental factors across bank strategy and governance, risk management functions, as well as culture and skills.** These actions are often part of a wider trend to promote sustainable banking practices, managing both the environmental and social dimensions of financial activity. While the driving objective has been to avoid or mitigate financial losses, reputational risk, and social and environmental harm, leading banks are now working to achieve to achieve positive impact across all activities.

2. **Mobilizing private capital for green investments, including funding through loan origination and credit provision, retail savings products, as well as intermediation and capital markets activities.** Notable capital markets actions include the integration of environmental and social (E&S) factors in investment research, and equity and debt raising for green sectors.

This evolving agenda is broad – and while some leading banks are taking comprehensive approaches, most banks are only addressing individual dimensions. Diverse experiences across the G20 suggest that banks' responses to E&S risks and opportunities may be influenced by size, ownership structures and balance of lending vs. capital markets activities – as well as broader market and policy contexts. In countries where banking and securities businesses are still largely segregated, green banking mainly refers to green loan origination. For countries where universal banking is practiced, underwriting of green equity Initial Public Offerings (IPOs) and green bonds as well as sales/trading of green assets are also part of green banking activities.

The breadth of the green banking agenda is summarised in Table 1 below.

Table 1: The Breadth of the Green Banking Agenda

Function	Mainstreaming	Mobilizing
Credit and Lending	Ensuring environmental and social due diligence in credit decisions Assessing loan portfolios for emerging environmental and social risks Enhancing the positive performance and impact of lending	Extending green credit to key retail sectors, such as energy efficient housing Extending green credit to a broadening range of commercial sectors, such clean energy, clean transport, green buildings, water and sanitation
Savings	Reducing environmental impacts of banking operations	Offering green savings products to retail customers
Capital Markets	Integrating environmental and social risks into investment research, including sell-side equity & credit research	Raising capital through equity market placements and IPOs Raising capital through debt market underwriting of green bonds
Overall	Monitoring and reporting environmental risks and performance	Tracking and reporting flows of green credit and financing

1.2 Mainstreaming

Section Overview

Awareness of the importance of environmental factors for banking business models has been increasing across G20 countries, reflecting greater recognition of the importance of sustainable development in environmental and economic policies.

The advance of the mainstreaming agenda has been driven by the need to understand the impacts of environmental risks to credit and lending portfolios. This need has emerged in response to both internal and external pressures – including mitigation of financial risks stemming from loans to higher risk corporate sectors, reputational factors and pressure from civil society groups. In certain G20 countries, this evolution was motivated in part by new legislative frameworks clarifying "lender liability" of financial institutions for environmental harm caused by borrowers.[6]

The mainstreaming agenda has evolved from an early focus on due diligence at project level to consideration of environmental factors across credit risk functions. Now, the focus is shifting within