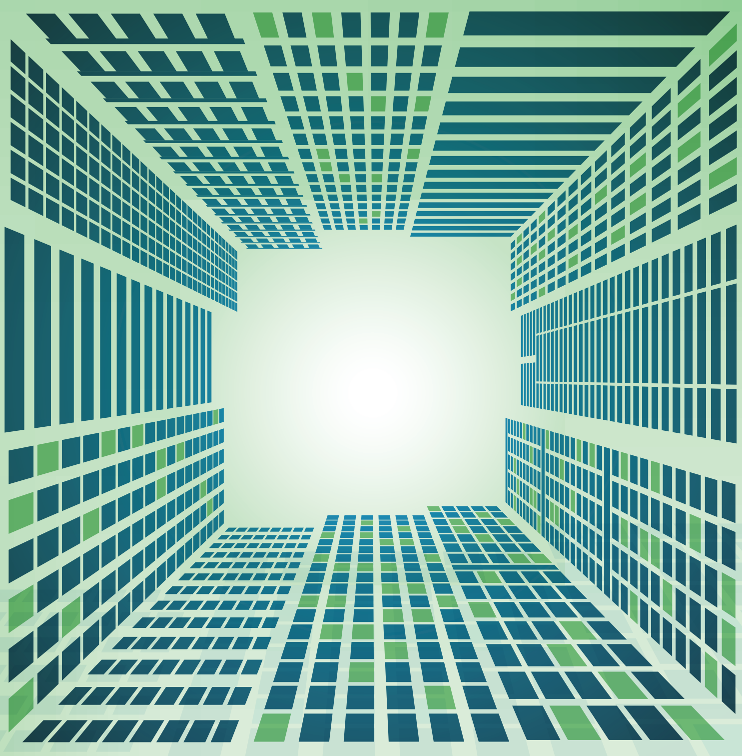
UN environment

Inquiry: Design of a Sustainable Financial System

MOBILIZING SUSTAINABLE FINANCE FOR SMALL AND MEDIUM SIZED ENTERPRISES

REVIEWING EXPERIENCE AND IDENTIFYING OPTIONS IN THE G7



G7 2017 ITALIA

MINISTERO DELL'AMBIENTE E DELLA TUTELA DEL TERRITORIO E DEL MARE

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The UN Environment Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme (UN Environment) 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, the Inquiry published its first global report, 'The Financial System We Need' in October 2015, with the second edition launched in October 2016. The Inquiry has worked in around 20 countries and produced a wide array of briefings and reports on sustainable finance.

More information on the Inquiry is at: *www.unep.org/inquiry* and *www.unepinquiry.org* or from:

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About this report

This report has been commissioned by Italy's Ministry of the Environment (MATTM) to explore the emerging links between financing for small and medium sized enterprises (SMEs) and sustainable development A first draft was prepared as a background paper for a G7 Environment meeting held in Venice on 5-6 April 2017. It has been written by Jeremy McDaniels and Nick Robins of the UN Environment Inquiry.

The report has benefited considerably from the presentations and discussions at the Venice meeting. Participants included Silvia Ascone, Antonella Baldino, Carlo Baldocci, Paulo Bersani, Sofie Blakstad, Mark Campanale, Gionata Castaldi, Francesco Confuorti, Giulia Cosulich, Davide Dal Maso, Bruce Davis, Giovanni De Luca, Barbara Degani, Julie Evain, Julian Frohnecke, Sean Kidney, Michelle Kosmidis, Dirk Kramer, Francesco La Camera, Pascal Lagarde, Gildas Lame, Francois Lecavalier, Sara Lovisolo, Marie-Geneviève Loys, Regina Maltry, Jeremy McDaniels, Karima Oustadi, Alessandra Palma, Daniela Pasella, Sandra Peloquin, Aldo Ravazzi, Nick Robins, PierCarlo Sandei, Henry Schaefer, Corrado Topi, James Vacarro, Raphaëlle Vallet, Tetsuro Yoshida and Simon Zadek.

The authors would also like to thank PwC for providing valuable insights and perspectives for this report.

The opinions expressed in this report remain those of the authors alone.

Feedback on this report is welcome. Comments should be sent to *nick.robins@unep.org*.

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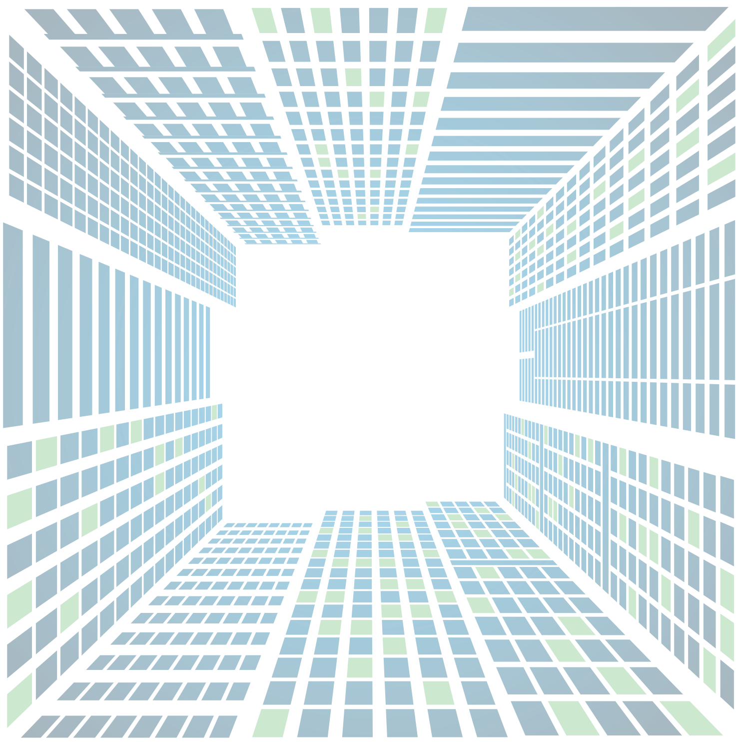

CONTENTS

EXECUTIVE SUMMARY

Small- and medium-sized enterprises (SMEs) contribute significantly to growth, employment, innovation and social cohesion across the G7. They are also a major driver of innovation for sustainable development. In order to accelerate the sustainability transition, further attention should be given to the financial needs of SMEs. To address this opportunity, Italy's Ministry of Environment included the issue of how to improve access by SMEs to green and sustainable finance as part of its 2017 G7 programme. This report takes stock of existing activities in G7 countries, identifies a range of emerging lessons and suggests possible next steps for action by G7 countries. This report focuses on green and sustainable finance – in other words finance that delivers environmental benefits, within the context of the wider shift to sustainable development.

Sustainable finance is rising up the agenda as a key tool to deliver the Sustainable Development Goals (SDGs) and the Paris Agreement on climate change. At a national level, countries are exploring the strategic implications, for example, through Italy's National Dialogue on Sustainable Finance. Internationally, the G20 has identified a series of shared policy options to mobilize private capital for green investment. Private sector engagement is also growing, highlighted by the rapid growth of the green bond market. Alongside this, governments are placing greater attention on the financing needs of SMEs to stimulate economic development, improve financial inclusion and address social priorities. At the international level, the Global Partnership for Financial Inclusion, for example, is exploring how innovative financing models can promote the integration of SMEs into sustainable global supply chains.

To date, however, the SME financing and sustainable finance agendas have operated largely in parallel. This represents a missed opportunity. Well-tried mechanisms to improve SME financing may well have important insights for how the sustainable finance needs of small enterprises can be met more effectively. Likewise, the sustainable finance arena offers fresh approaches to mobilizing capital that can contribute materially to SME financing more broadly.

Simply put, the green and sustainable finance agenda for SMEs comprises two core priorities:

- First, enabling finance for conventional SMEs to improve their sustainability performance, what could be described as the 'green performer' category.
- Second, allocating finance for SMEs that are focused on expanding sales of sustainability-related goods and services, a category that could be termed the 'green innovators'.

Beyond the well-established financing constraints that often face SMEs, specific barriers linked to insufficient green and sustainable finance can include:

- **Data**: a lack of robust data on the sustainable financing needs of SMEs among banks and other financial institutions.
- **Risk**: incomplete integration of environmental performance into the assessment of risks facing SME funding decisions.
- **Product**: a limited set of sustainable financing products both across the enterprise life cycle (including early-stage capital) and focused on specific opportunities (such as energy efficiency).

- **Institutional:** insufficient diversity of financial institutions offering long-term patient capital for the sustainable finance needs of SMEs.
- **Awareness and capacity**: A lack of awareness among SMEs themselves regarding sustainability-related investments as a way to lower costs and enhance competitiveness, as well as a lack of technical capacity and financial literacy.

Over the past decade, a growing number of solutions have been developed to help overcome these barriers. This report provides a first review of G7 experience in five main areas:

- **Public Financial Institutions (PFIs):** PFIs, such as state-owned promotional banks, have often been the first to fill financial gaps in the market for SMEs. The Montreal Group has profiled a range of debt and equity financing solutions ranging from the establishment of cleantech venture funds through to targeted green lending programmes.
- **Banking:** Commercial and stakeholder banks have increased their commitment to sustainability across their loan book. New initiatives such as the Principles for Positive Impact could help to close the funding gaps facing SMEs. However, disclosure on how banks are responding to the specific sustainable finance needs of SMEs is generally low.
- **Debt Markets:** Green bonds offer a range of options for SME financing, including the issuance of green bonds from banks that aggregate SME loans, the securitization of SME loans into asset-backed securities and the issuance of mini-bonds by medium-sized enterprises. An added advantage of green bonds is greater market transparency.
- **Impact Investing:** Assets dedicated to investment products that intentionally seek out enterprises delivering social, environmental and financial returns are growing. These often build on traditional private equity and venture capital financing models for both growth stage companies and traditional SMEs.
- **Fintech:** Fintech provides the newest source of green finance solutions for SMEs. Fintech applications can help to improve the efficiency of capital intermediation, with specific applications including crowdfunding for renewable energy projects. Fintech innovations – such as blockchain, learning algorithms, and smart contracts – could lower risk for financial institutions, reduce transaction burden, and ultimately lower costs of capital for SMEs to deliver sustainability.

What becomes clear from this review is the need to look strategically at the overall sustainable finance 'ecosystem' for SMEs. SMEs need tailored solutions that respond both to the diversity of their life cycle needs (including for start-ups) and to the range of actions they may take to pursue sustainability goals. In addition, the five financing strategies do not stand in isolation, but can build on each other if the links are made effectively. For example, public financial institutions can be pivotal for direct financing and crowding in private capital for both 'green performers' (*e.g.* energy efficiency) and 'green innovators' (*e.g.* cleantech) across a range of channels, including grants, guarantees, loans, equity, business advisory