UN environment

A REVIEW OF INTERNATIONAL FINANCIAL STANDARDS AS THEY RELATE TO SUSTAINABLE DEVELOPMENT

Inquiry: Design of a Sustainable Financial System

February 2017

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, it published the first edition of '*The Financial System We Need*' in October 2015, with the second edition launched in October 2016. The Inquiry's mandate currently extends to the end of 2017, with work focused on deepening and taking forward its findings.

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

Corporate Knights

Founded in 2002 by Toby A. A. Heaps and Paul Fengler, Corporate Knights (CK) is a media, research and financial information products company based in Toronto, Canada, focused on promoting "clean capitalism", an economic system where prices fully incorporate social, economic and ecological costs and benefits, and market participants are clearly aware of the consequences of their actions.

About this report

This report has been prepared by Toby A. A. Heaps (Corporate Knights) and Danyelle Guyatt (Collaborare Advisory). This work also benefitted from the support to the Inquiry from the governments of Germany, Italy, Switzerland, the United Kingdom of Great Britain and Northern Ireland, and the European Commission.

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

Acknowledgements

Many experts were consulted as part of the consultation process. They are listed in Appendix B.

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Executive Summary

In a time of heightened global uncertainty and rising social discontent, the opportunity to consider and make progress on addressing global inequality and combating systemic risks such as climate change is ever more pressing. A range of regulatory reforms, policies, standards and processes is being developed internationally to promote a more socially inclusive and fair economic system, including the formal adoption by the United Nations General Assembly of the Sustainable Development Goals (SDGs). This report examines how the international financial standards currently relate to the goals of sustainable development and explores opportunities for better alignment as a way to promote greater stability, resilience and fairness to the financial system.[1]

This report follows the UN Environment Inquiry's finding that a "quiet revolution" is taking place as policymakers and financial regulators address the need to forge robust and sustainable financial systems.[2] Despite this "quiet revolution", it is also evident that the sustainability adjustment process has been relatively fragmented and driven by "bottom-up" considerations at the country level. This has resulted in a lack of standardization across jurisdictions with the unintended consequence of increasing the costs associated with reporting and price discovery to adequately incorporate sustainability into the assessment of risk and materiality.

A fragmented response to sustainable development that is not incorporated into international financial standards also increases the risk that the synergies between fostering sustainable development and the stability of the financial system might be missed, particularly in relation to systemic issues such as climate change and global inequality.

There are parallels with financial inclusion and the commitment that G20 Finance Ministers and Central Bank Governors have expressed through the Global Partnership for Financial Inclusion and the development of the Financial Inclusion Action Plan in 2014.[3] The financial standards have evolved to reflect this growing commitment and priority with the incorporation of the notion of proportionality into the financial standards. This shift provides a platform to consider the wider social and environmental impacts of financing activities and how this might be reflected into financial standards to provide a consistent and socially beneficial outcome.

Synergies also exist with the G8's recent work and efforts in relation to "Impact Investing"[4] and the OECD work on this topic.[5] In particular, there is potential to explore ways to begin to standardize the finance industry's approach to measuring, managing and reporting the social and environmental impacts of their activities in a way that aligns with sustainable development and supports financial stability.

It is against this backdrop that the Inquiry sought to investigate the financial standards further, to consider to what extent they currently relate to sustainable development, how they can support and solidify the various G20 policy commitments and the evolving country-level regulations and industry activities in a way that builds on the synergies that already exist.

Key messages:

1. **Financial standards have a significant impact on achieving sustainable development**: This report suggests that while the omission of sustainable development from the core mandate of the financial standard-setting bodies may not prevent regulators or the finance sector from taking action, it has likely resulted in the actions being more sporadic and less effective than might otherwise be the case.

2. **Financial standards currently relate to sustainable development issues in a fragmented way:** Some activities and initiatives that the standard-setting bodies are participating in relate to sustainable development, although there is no overarching framework or agreement on the principles to guide these efforts, resulting in a somewhat patchy and fragmented approach with significant gaps and unintended consequences that could slow down progress.

3. **Unrealized synergies between financial standards and sustainable development could be built upon**: The 15 international financial standards reviewed in this report do not currently consider sustainable development in an explicit way within their mandate, although there are prevailing synergies between some of the standards on environmental issues, financial inclusion and improving industry culture that could be extended.

Financial Standards and Synergies with sustainable development	Not Explicit	Some Synergy (Environment)	Some Synergy (Inclusion)	Some Synergy (Culture)	Scope of Unintended Consequences *
Financial Stability Supervisory Structures					
Financial Stability Board (FSB):	✓	✓		✓	++++
No formal mention of social or environmental factors. Systemic risk posed by climate change prompted new Task Force on Climate-related Financial Disclosures. Due to report on recommended voluntary standards for corporate disclosure in December 2016.					
IMF/World Bank – Financial Sector Assessment Program (FSAP):	✓		✓		++++
Financial inclusion is considered as an explicit part of the FSAP process; environmental factors emerging on a bottom-up basis but not a formal part of the process.					
IMF – Report on Observance of Standards and Codes (ROSC):	✓		✓		++++
The G20/OECD corporate governance standards are one of the 12 recognized areas for assessment within the ROSC assessment.					
Banking regulation and standards					
Basel III – International Regulatory Framework for Banks:	✓	✓	✓		++++
Pillar 1 refers to environmental risks that might arise at the transaction level. Potential synergies with Pillar 2 (Supervisory Review) and Pillar 3 (Market Discipline)					
BCBS – Corporate Governance Principles for Banks:	✓			✓	++++
The Principles refer to culture and values including the promotion of responsible and ethical behaviour. But no explicit reference to social and environmental issues.					
BCBS – Core Principles for Effective Banking Supervision:	✓		✓		++
BCBS has been active on financial inclusion since 2010. Potential wider synergies with principles on corporate governance, risk management and disclosure/transparency.					
Corporate Governance					
G20/OECD Principles of Corporate Governance:	✓	✓	✓	✓	++
References to environmental, human rights and ethical factors, notably in terms of role of stakeholders, disclosure of non-financial information and responsibilities of the board. FSB launched peer review exercise on implementation of the principle.					

Securities Regulation and Standards					
IOSCO – Objectives and Principles of Securities Regulation:	✓		✓		++++
No formal mention of environmental or social issues. Clear synergies with principles on systemic risk, integrity and ethical behaviour, disclosure and certification (e.g. green bonds).					
IOSCO – Code of Conduct for Credit Rating Agencies:	✓			✓	++
Greater focus on improving the quality and integrity of the credit rating process, promoting independence, reducing conflict of interest and improving transparency and disclosure.					
Insurance Regulation and Standards					
IAIS – Insurance Core Principles, Standards, Guidance:	✓		✓		++++
No formal mention of environmental or social issues, but partnership on financial inclusion. Clear synergies with principles on corporate governance, corporate culture, assessment of materiality, internal risk management controls and systemic risk.					
Investment Regulation and Standards					
International Law – Fiduciary Duty:	✓			✓	+++++
France requested OECD to undertake work on the governance of investments by institutional investors in relation to ESG factors and risks, in particular those associated with climate change. Scheduled to publish in December 2016.					
IOPS – Principles for Private Pension Supervision:	✓		✓	✓	+++
No formal guidance on environmental and social factors. Clear synergies with principles of integrity, risk management, governance, alignment of interests, disclosure and transparency.					
OECD Core Principles of Occupational Pension Regulation:	✓		✓	✓	+++
Reference to the need for good governance and the principle of equal treatment. OECD/IOPS Good Practices for Pension Funds' Risk Management Systems makes reference to the possibility to add a socially responsible investment policy.					
Accounting and Financial Reporting Standards					
IASB – International Financial Reporting Standards:	✓	✓			+++++
Reference to impairment test for intangible assets, such as carbon allowances. Synergies with the principles of transparency, accountability and efficiency. Cooperating with the different groups on sustainability reporting.					
IAASB – International Standards on Auditing:	✓			✓	+++++
International Federation of Accountants (IFAC) has been active in exploring the role of the accounting profession in delivering the SDGs and has identified seven of the SDGs that are particularly pertinent to the profession.					

*The extent of the unintended consequences is represented by + signs where more + signs are indicative of a greater gap and unintended consequences. Source: Based on the authors' review of the financial regulations and standards, relevant literature and expert opinion as cited in this report

4. **Climate change is only recently gaining traction within the standard-setting community**: Up until now, the most high profile intervention on climate change issues by the international standard-setting bodies is the establishment of the FSB Taskforce on Climate-related Financial Disclosures that is due to report in December 2016 and is expected to make a valuable contribution to building a framework for improving disclosure and transparency on climate related risks (see Highlight: "FSB Taskforce on Climate-related Financial Disclosures").

5. **Building on financial inclusion towards social inclusion**: The shift towards considering and integrating financial inclusion into financial standards (through the principle of proportionality) provides a platform to consider opportunities for the finance sector to participate in and support the broader consideration of social and environmental factors.[6] The focus in particular has been on facilitating and encouraging access to financial products and services, with most of the financial standards evolving in some way to reflect financial inclusion. This provides a basis for widening the narrative and consideration of social issues, including the role that financial institutions could play in fostering greater equality and poverty alleviation through, for example, fair and transparent executive compensation packages, avoiding aggressive tax avoidance structures, reducing discrimination in the workplace, promoting and protecting human rights and health and safety standards with stakeholders and across the supply chain.

6. **Transforming culture and values**: The financial standards have evolved since the global financial crisis in an effort to promote higher standards of industry culture, ethics and trust. This has resulted in a range of new measures and additions to the financial standards that relate to codes of conduct, remuneration, governance and risk management processes. These efforts go hand in hand with shifting the mindset and behaviour towards thinking more sustainably and could be built upon to consider how the financial standards might explicitly incorporate sustainable development to underpin and guide the values, beliefs and culture of the industry.

Strategic recommendations:

Financial standards are designed to evolve in order to reflect the changing landscape that impacts the ability of standard-setting bodies to provide a stable, resilient and fair financial system. In this way, the emergence of sustainable development as a priority among policymakers and industry leaders presents an opportunity to consider how the financial standards might evolve to support this shift.

One of the challenges with incorporating environmental and social issues into the financial standards is that they do not explicitly list any particular "issue" or metric that should be taken into account, rather the principles are high-level and intended to offer a light hand, voluntary guidance for regulators to oversee the financial institutions under their purview. Consequently, the addition of sustainable development metrics into the standards themselves is less likely to gain headway than the incorporation of overarching 'principles' to better align the financial system with sustainable development. For this reason, the principle of "maximum social benefit" is proposed, along with some other suggestions as discussed below.

1. **Introduce a principle of "maximum social benefit"**: The introduction of a principle to encapsulate the goals of sustainable development would help to guide how the financial standards might evolve over time in a consistent and coherent way. The principle of "maximum social benefit" is based on the premise that the best financial system is one that produces the maximum social benefit as a result of the activities that it undertakes. In order to achieve this, the positive and negative externalities that are generated as a result of the finance sector's activities require greater attention.

2. **Build sustainable development into the core architecture of the financial standards.** Based on the analysis of the financial standards included in this review, five key "entry points" have been identified as offering the greatest opportunity to build sustainable development into the

frameworks that make up the financial standards, namely: systemic risk, governance, transparency, risk/materiality and culture (summarized below).

Principle of "Maximum Social Benefit": The best financial system is that which secures the maximum social benefit from the activities that the finance sector undertakes				
Five Entry points to integrate sustainable development into financial standards:				
(1) Systemic Risk	**(2) Governance**	**(3) Transparency**	**(4) Risk/Materiality**	**(5) Culture**
Incorporate environmental and social issues explicitly into the guidance for managing systemic risks	Embed environmental and social issues into the governance standards across all the finance sector actors	Measure and report the social and environmental performance and impacts of financial sector activities	Include social and environmental issues as part of the guidance for managing risks and assessing materiality	Align industry culture with sustainable development goals to shift values and behaviour

3. **Incorporate sustainable development into systemic risk considerations**: The pursuit of financial stability and the effective management of systemic risks could be enhanced by explicitly embedding sustainable development into the core narrative and early warning systems that are in place, particularly in relation to seismic shifts emanating from global inequality and climate change.

Possible Action	Regulatory bodies/groups
Incorporate environmental and social issues explicitly into the assessment and guidance framework for regulators to manage and build into early warning of systemic risks	FSB in cooperation with financial standard-setting bodies (Basel, IOSCO, IAIS, IOPS), oversight groups (IMF, World Bank, OECD) and expert groups (UN Environment, PRI, WEF)

4. **Strengthen governance**: There is a greater focus on governance and decision-making processes across the financial standards since the financial crisis to reduce conflict of interest and underpin clear lines of accountability – including through the updated G20/OECD Corporate Governance