Inquiry: Design of a Sustainable Financial System

UNEP

GREEN FINANCE FOR DEVELOPING COUNTRIES

Needs, Concerns and Innovations

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The 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:

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About this report

The report was developed by Maya Forstater, Mark Halle and Simon Zadek from the UNEP Inquiry drawing on interviews with practitioners, regulators and experts from developing countries, including Bangladesh, Colombia, Kenya, Mongolia, Morocco, Nigeria, Peru, Viet Nam. It draws on a meeting co-hosted with the Swiss Ministry of Finance in Geneva on 6-7 April 2016 with practitioners and regulators from Egypt, Honduras, Jordan, Kenya, Mauritius, Mongolia, Morocco, Philippines, Thailand and Viet Nam, and a dialogue with G20 Members co-hosted by the IFC in Washington, D.C. on 12 April 2016.

Unless specifically referenced in the text, quotes in blue come from these interviews and meetings. However, the report does not represent the views of the participants in the dialogue, or the members of the G20 or Green Finance Study Group.

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Comments are welcome and should be sent to *simon.zadek@unep.org* and *mhalle@iisd.org*.

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SUMMARY AND KEY FINDINGS

CONTEXT

THIS BRIEFING outlines key concerns and needs of developing countries in relation to green finance, particularly focusing on developing countries that are not members of the G20. It also highlights emerging innovations, drawing in particular from engagement with practitioners and regulators from Bangladesh, ColombiaEgypt, Honduras, Jordan, Kenya, Mauritius, Mongolia, Morocco, Nigeria, the Philippines, Thailand and Viet Nam, and the findings from the UNEP Inquiry's country studies.[1]

GREEN FINANCE is a strategy for financial sector and broader sustainable development that is relevant around the world. But the context differs considerably for different countries. Developing countries, notably those with underdeveloped financial systems, face particular challenges in financing national development priorities.

FINANCIAL DEVELOPMENT shapes the context for green finance. Different sources of capital and financial institutions are particularly relevant in different countries. Financial systems in developing countries tend to be characterized by a dominant banking sector, and have large areas of the economy that remain unserved by the formal financial sector. Public finance and foreign direct investment can be particularly important as sources of long-term investment.

Broadly, concern and action to align financing to sustainable development is concentrated in three areas:

- **PREVENTING THE FINANCING OF ILLICIT PRACTICES OR PROFITING FROM WEAK ENFORCEMENT**. Weak enforcement of environmental, economic and social policies and regulations can lead to social conflicts and market impacts resulting in losses to lenders and investors, and even macroeconomic stability risks.
- **UNLOCKING OPPORTUNITIES FOR GREEN INVESTMENT.** In many countries, opportunities for green finance such as renewable energy, energy efficiency, agricultural development and Small and Medium-sized Enterprises (SMEs) productivity, as well as insurance markets, are potentially commercially viable, but inadequate owing to barriers in demand or supply.
- **EXPLORING SOLUTIONS TO DILEMMAS AND TRADE-OFFS**. Many developing countries face a tension between the need to expand the electricity supply and reduce fossil fuel intensity. Similarly, SME finance is an area where regulators must be careful that lending requirements do not result in reduced overall lending or higher rates of non-performing loans and financial instability.

KEY FINDINGS

KEY CONCERNS OF DEVELOPING COUNTRIES:

1. **INTEGRATED APPROACH** – It is strongly emphasized that environmental considerations in financing be addressed in conjunction with economic and social issues and priorities, in particular access to finance for SMEs.
2. **DILEMMAS, GAPS AND TRADE OFFS** – International measures to promote appropriate green financing of the transition to a green economy should not come at the cost of developing countries' competitiveness, equity, development and financial inclusion.
3. **IMPACTS OF INTERNATIONAL DEVELOPMENTS** – Developments in the international financial system, including those in major national financial centres, impact on developing countries positively and negatively. This makes G20 country deliberations and actions a key matter for all developing countries seeking to achieve sustainable development.

ACTION BY DEVELOPING COUNTRIES:

4. **NATIONAL COLLABORATION** – National strategies and road maps for aligning financial system development with the needs of sustainable development are being elaborated in a number of countries involving public and private actors, and combining market-driven approaches with policies, regulations and standards. These processes are critical to reduce reliance on pioneering individuals or institutions.
5. **DISRUPTIVE POTENTIAL** – New business models across the financial system, such as those enabled by mobile money and blockchain ledgers, offer the potential for 'leapfrogging' that can drive more inclusive, green financial market developments. These could be promoted while recognizing the need to ensure the integrity and robustness of financial markets.

SPECIFIC NEEDS OF DEVELOPING COUNTRIES:

6. **INWARD DIRECT INVESTMENT** – A key challenge is how to support long-term green finance effectively in advance of mature local bond markets developing. This may include blended finance approaches, drawing on public institutional investment vehicles and integrating green finance considerations into foreign direct investment, as well as pioneer issuance of green bonds.
7. **FINANCIAL SYSTEM DEVELOPMENTS** – Developing countries need to be able to contribute to international debate and practice, through the G20 and other relevant fora.
8. **INTERNATIONAL KNOWLEDGE SHARING** – Enhanced cooperation is needed to share experience between countries by leveraging, extending and connecting existing platforms and initiatives.

1 INTRODUCTION

The relevance of green finance has been steadily growing over the past few years, and has now emerged as a key topic underpinning both the new policy dynamic promoting sustainable development and, increasingly, financial market development. Reflecting this, under China's Presidency of the G20 in 2016, a Green Finance Study Group (GFSG) has been established, co-chaired by China and the UK, with UNEP serving as secretariat.

Box 1: The Green Finance Study Group

The GFSG is mandated to identify institutional and market barriers to green finance, and, based on country experiences, to develop options on "*how to enhance the ability of the financial system to mobilize private capital for green investment*".[2] It is focused on identifying institutional and market barriers within the financial system that prevent the adequate mobilization of private green investment into areas such as pollution control, clean energy, clean transportation and energy-efficient products. Accordingly, the focus is on options for action by market players, central banks and market operators such as stock exchanges and rating agencies. The GFSG is undertaking research in five areas:

Sectoral

1. **Greening the banking system:** A number of market and institutional failures may stand in the way of banks fully incorporating environmental dimensions into decision-making. For example, lack of capacity and absence of "green" performance measurement appear to be constraints for banks in many developing countries.
2. **Greening the bond market:** The growth of green bond markets faces a number of barriers, as does the broader incorporation of environmental considerations into the working of fixed income markets. For green bonds, a lack of clear and comparable definitions could undermine confidence while uncertainty and high costs of verification could prevent a critical mass of issuance.
3. **Greening institutional investment:** A number of market and institutional failures, such as lack of disclosure requirements and weak environmental impact assessment capacity, may prevent full incorporation of material environmental factors into investment decision-making. This could result in inadequate risk management and potentially excess caution over allocations to green investments.

Cross-cutting

4. **Risk analysis:** A range of possible market and institutional failures may prevent the effective incorporation of future environmental risks into financial decision-making by financial institutions such as banks, insurers and other institutional investors. These problems include short-termism, misaligned incentives as well as inadequate expertise and underdeveloped risk assessment methodologies.
5. **Measuring progress:** International cooperation, experience sharing and facilitation of green capital flows requires mapping of definitions and indicators for measuring progress on green finance activities, policy targets, and designing and implementing policy incentives.

Developing economies comprise a large and diverse group whose financial systems have grown in importance over the last decade. The major emerging economies of Argentina, Brazil, China, India, Indonesia and Saudi Arabia are represented in the G20, while Singapore, Egypt, Laos and Kazakhstan are also participating as Invited Countries in the G20 in 2016.

Recognizing the distinct situation of developing countries with underdeveloped or emerging financial markets, the co-chairs and members of the GFSG have supported a process of *engagement with non-G20 developing countries to identify their concerns and needs and approaches to green finance.*

To this end, UNEP co-hosted a meeting in Geneva on 6-7 April 2016, together with the Swiss Ministry of Finance, bringing together stakeholders from non-G20 developing countries. A second meeting was co-hosted with the IFC on 12 April in Washington, D.C., timed to coincide with a meeting of the GFSG.[3]

This paper provides an overview of experiences and perspectives of stakeholders from non-G20 developing countries on green finance and highlights from this dialogue. It has been developed through interviews with practitioners, regulators and experts from developing countries, presentations and dialogue at the meetings as well as from published research, including the global work of the UNEP Inquiry into the Design of a Sustainable Financial System.[4]

A short briefing version of this paper developed in association with the IFC was presented in Washington, D.C. on 12 April 2016 at a meeting with the GFSG co-hosted by UNEP and the IFC.

A panel of experts from Egypt, Colombia and Mongolia explored how green finance is being understood and advanced in their own countries and offered recommendations for international collaboration:

- Dalia Abdel Kadar, Director of Marketing and Communications, Arab African International Bank.
- Nancy Motta, President of the Protocolo Verde (Green Protocol) and sustainability leader (VP risks), Davivienda Bank (Colombia)
- Morgan Landy, Director of Environment, Social and Governance, IFC
- Tumurkhuu Davaakhuu, Vice President of the Mongolian Banking Association and CEO, Arig Bank of Mongolia.

Ma Jun, Chief Economist of the People's Bank of China and Co-Chair of the GFSG welcomed the input from the discussion and the briefing paper.

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