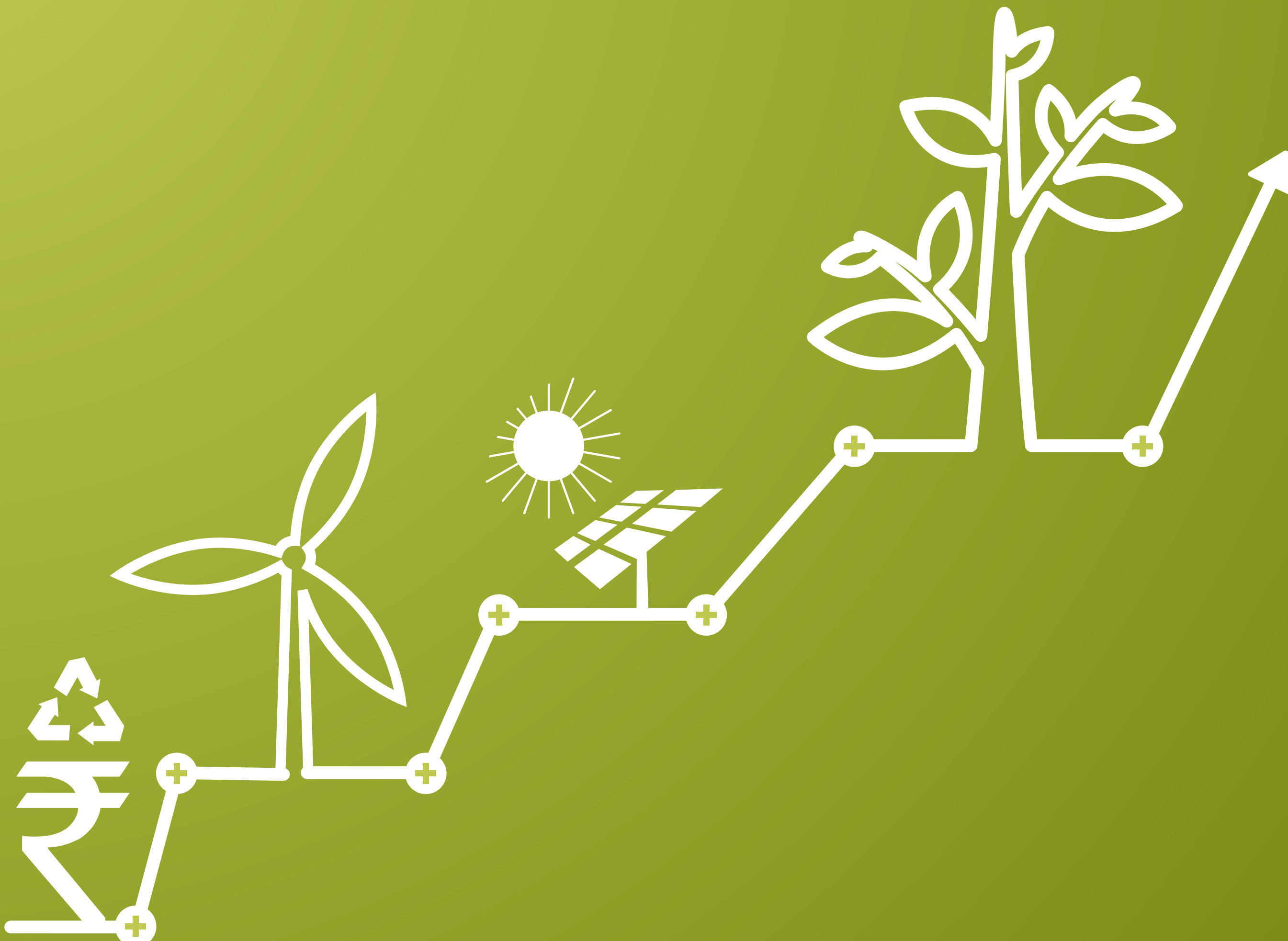
UNEP

Inquiry: Design of a Sustainable Financial System

FICCI

Designing a Sustainable Financial System for India

Interim report



Summary of Key Recommendations

I. It is critical that the financial system's capacity and readiness to respond to climate change and other sustainable development priorities is enhanced, driving innovation across banking, insurance, investments and securities.

II. Developing a Sustainability Oriented Market Framework would require

a. Banking on Sustainability: Investing in sustainable infrastructure and increase the long term viability of infrastructure projects.

b. Enabling the Institutional Finance Ecosystem: There is a need for skill enhancement of the financial sector.

c. Incentivising Public Sector Investments: An enabling institutional framework for sustainable infrastructure financing requires financing decisions to take into account sustainability as a parameter.

d. Catalysing Efficiency Gains in Small and Medium Enterprises: There is a need for capacity building in the SME sector for better energy use disclosure and also for soliciting funding support for bridging enterprise efficiency linked capacity gaps.

e. Redirection of Cross Border Financial Flows: Stakeholders should be made aware of long term positive efficiency gains through evidence based awareness building.

III. Regulations and Incentives

a. Incentives and initiatives which could lead to an increase in domestic equity investment through equity tax credits, production tax credits and development of energy service companies.

b. Strengthening existing institution such as IREDA to become the green development financing institution in the country and enabling it to garner additional lines of credit and long tenor financing.

c. Deregulations to increase external commercial borrowing funding of green projects by exempting withholding tax, replacement of construction finance and refinancing and innovative solutions for hedging

d. The renewable energy sector should be put under Priority Sector Lending (PSL) category and unutilized amount under PSL should be diverted to clean energy.

e. There is need to provide incentives in particular sectors such as output based support or result based financing for the waste management sector.

f. The existing guidelines of National Clean Energy Fund need to be amended in order to sharpen its operational framework and improve its effectiveness and performance. A separate window should be created to allocate funding for specific types of projects that improve energy access.

IV. Market Innovation

a. There is a need for credit rating and credit enhancement facility within the Government or Financial Institutions that would encourage the Pension Funds or Insurance Funds to invest in clean projects.

b. Green Bonds market is characterized by longer tenure and hence, it could be an attractive option of investment in the clean energy space. To grow the Green bonds market in India, the global bonds market and the savings in India or the private capital market could be tapped to address this agenda.

c. Yield Company, an income oriented investment vehicle being adopted by the companies to unlock value of long-term contracted assets that may be undervalued in existing business, access broad yield focused public investor base and create a buyer/ long-term owner for project developers. YieldCo enable access to low cost, liquid and repeatable capital source and generate predictable cash flows by bundling up renewable assets with long-term Power Purchase Agreements (PPAs).

UNEP India Inquiry on Designing a Sustainable Financial System for India

Interim Report

Across the world, governments are searching for new policy measures to mobilise investment for long-term sustainable development. The UNEP Inquiry is working across 15 countries to identify practical policy options and in India is partnering with FICCI, which has formed a national advisory committee, chaired by Ms Naina Lal Kidwai, Chairman HSBC India and Executive Director HSBC Asia Pacific. The first report of the UNEP India Inquiry work was an Executive Briefing, which laid down the challenges faced in financing low-carbon, the barriers and options in deploying and mobilising credit for clean energy and developing sustainability policies for banks and financial institutions. This is the Interim Report of the UNEP India Inquiry work, a recommendatory report for developing a long-term sustainable financial system. It is critical that the financial system's capacity and readiness to respond to climate change and other sustainable development priorities is enhanced, driving innovation across banking, insurance, investments and securities. UNEP India Inquiry in partnership with FICCI is proposing practical options to meet this challenge. Three working groups under the UNEP India Inquiry are investigating solutions and looking at the larger context for transformation of Indian financial regulatory landscape, the regulations and incentives that will channel finance into sustainable development priorities, and innovative markets for clean energy financing.

With rapidly evolving economies it has been realised that an efficient system to allocate scarce economic resources is very important given the increasing social inequities, environmental impacts and other externalities. In the Indian context there is a need for developing a sustainable financing policy for banks and financial institutions, exploring the role of capital markets in India in efficiently allocating capital to key green economy priorities, and factors that enhance flow of finance into clean and green projects, including innovative mechanisms that could increase availability and accessibility of funds for clean energy, climate change mitigation and sustainability initiatives.

The nascent Indian capital markets have not yet begun to put a risk premium on large listed companies that are not efficient consumers of factor inputs. There are three factors in the current policy and market environment that open a window to do this:

i. The recent decline in global oil prices provides financial space to explore sustainability financing.

ii. The new government is looking at ways to scale up public investment in infrastructure finance.

iii. A number of market participants have begun to recognize that capacity to sieve investments through a sustainability lens needs to be created.

I. Developing a Sustainability Oriented Market Framework

In the Indian context, a strategy to incentivise a more robust and resilient 'sustainability oriented market framework' can be based on five pillars as outlined below:

1. Banking on Sustainability

The banking sector plays a critical role in financing infrastructure growth in India (approximately 15 per cent of Gross Non Food Credit by Scheduled Commercial Banks is deployed towards infrastructure). Indeed nearly all institutional lending towards the sector is through banks. At the same time there is an acute infrastructure deficit in the country. Estimates place the quantum of funds required towards bridging the infrastructure deficit in the next five years at around USD 1 trillion.

Investing in sustainable infrastructure increases the long term viability of infrastructure projects. However, infrastructure credit protocols do not take this into account. This can be secured by incorporating the returns from efficient sustainability enhancing investments in infrastructure into lending protocols. This would require collaborative actions at the international level to reform the international financial architecture. Nationally this process can be incentivised by

- Making certain efficiency benchmarks mandatory and instituting the requisite monitoring and contract enforcement frameworks.
- Reworking the Priority Sector Lending (PSL) policy towards facilitating identification of 'sustainable' businesses and business models, thereby improving the viability of priority sector lending.

2. Enabling the Institutional Finance Ecosystem

To meet the evolving financial needs of India, there is a need for skill enhancement of the financial sector. There are a number of factors that are extraneous to the financial system including accuracy and predictability of certain data - like resource data and performance data of various projects. The existing commercial and technological ecosystem has made lenders risk averse, in an economy where rapid credit expansion is required for growth. Growth in gross bank credit has declined from 23.5 per cent in September 2011 to 9.5 per cent in September 2014.

The Ministry of Environment, Forest and Climate Change and Ministry of Finance need to meet the challenge of building skill sets to further enhance sustainable finance. Ways in which could be done include

- Incentivize the evolution of market instruments based on frameworks such as the National Voluntary Guidelines, or the extant energy disclosure formats in Form A of the Companies Act.
- 'Green flag' investments into companies that are transparent and efficient. An example of such a mechanism, based on objective assessment framework, is the S&P BSE GREENEX, a benchmark financial and energy efficiency performance index on the Bombay Stock Exchange.
- Carry out Climate Public expenditure Review of Central and State budgets, to identify existing public expenditures that promote climate change adaptation and mitigation. Using this evidence, pipeline global climate finance to augment these activities through the budgetary mechanism rather than through fragmented projects as is presently the case with the GEF.

3. Incentivising Public Sector Investments

An enabling institutional framework for sustainable infrastructure financing requires financing decisions to take account of finance needs to take sustainability as a parameter. This requires many innovations in the financial ecosystem, particularly in the public sector institutions that account for about 23 per cent of the total capital stock of total investment in the Indian economy. Actions to this end include

- Enable financial sector participants to recalibrate extant risk assessment frameworks to account for business risks arising from inefficiency of resource use.
- Develop a strategy based on sustainable finance to attract long term investment funds around the world from long term investment funds like Government Pension Fund of Norway (USD 860 billion) and California's public pensions fund CALPERS (USD 296 billion) These have adopted proactive policies towards sustainable financing.

4. Catalysing Efficiency Gains in Small and Medium Enterprises (SMEs)

Multiple studies have shown that good energy governance is linked to good governance. There are performance gaps between leading Indian and global companies in energy consumption that holds true for the SME sector, where 95 per cent of companies do not have access to institutional credit. Sustainable growth of India has to be driven by the SME sector which would require encouraging new SMEs to move towards energy efficiency through benchmarking and soliciting funding support for bridging enterprise efficiency linked capacity gaps.

In this context, financial institutions such as Small Industries Development Bank of India (SIDBI) are helping in capacity building of MSMEs and are effectively working towards their resource transformation. SIDBI has extended