Inquiry: Design of a Sustainable Financial System

UNEP

ALIGNING THE FINANCIAL SYSTEM WITH SUSTAINABLE DEVELOPMENT

THE COMING FINANCIAL CLIMATE

The Inquiry's 4th Progress Report

May 2015

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 deliver a step change in the financial system's effectiveness in mobilizing capital towards a green and inclusive economy – in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

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

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This Progress Report

This briefing is the fourth progress report by the Inquiry. It draws on the Inquiry's partnerships across the world, notably at the country level. We would like to thank the Bangladesh Bank and the Council on Economic Policies; the Brazilian Federation of Banks (FEBRABAN); in China,the Development Research Centre of the State Council and the International Institute for Sustainable Development, as well as the Research Bureau of the People's Bank of China; at the European Union level, the 2 Degrees Initiative; in India, the Federation of Indian Chambers of Commerce and Industry (FICCI); in Indonesia, Otoritas Jasa Keuangan (OJK); in Kenya, the Kenyan Bankers Association; in South Africa, the Global Green Growth Institute; in Switzerland, the Federal Office for the Environment and the wider 'Swiss Team for the Inquiry'; and in the UK, the Bank of England.

We would also like to thank our partners at the international level, including the Association of Sustainable and Responsible Investment in Asia, CalPERS, the Cambridge Institute for Sustainability Leadership, the Climate Bonds Initiative, the Institute for Human Rights and Business, the Institutional Investors Group on Climate Change, the Organisation for Economic Cooperation and Development, the Network for Sustainable Financial Markets, the Principles for Responsible Investment, SwissRe, the UNEP Finance Initiative and the World Bank Group (including the International Finance Corporation).

The Inquiry recognises the contributions made to its work by many individuals and institutions. In particular, the Inquiry would like to acknowledge the support provided by the Government of Norway, the Government of Switzerland and the Government of the United Kingdom of Great Britain and Northern Ireland to its core and country specific work. Furthermore, the Inquiry is most appreciative of the contributions made by the members of our Advisory Council and our colleagues throughout UNEP.

Errors and omissions remain the responsibility of the Inquiry.

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Transitioning to a green economy opens us to many opportunities as well as posing many challenges. Climate change is one of the most multifaceted of these challenges, requiring us to build more resilient societies by reducing and managing risks, and also to stimulate and take advantage of a new generation of opportunities for business and the economy. Finance is a keystone in meeting these challenges and opportunities. The financial system exists to support our choices to save, consume and invest. When it works efficiently and effectively, it deploys finance in ways that creates dynamic, inclusive and sustainable economies that in turn reward the owners of capital. If and when the system proves defective, economies and societies are weakened by the misallocation of capital, and capital owners suffer from low and uncertain returns. Recent experience amply demonstrates how much damage can be done if there are deficiencies in the financial system as well as the real economy.

Going forward, failure of the financial system to take adequate account of climate change could result in extensive damage to financial assets globally, may well threaten the stability of the financial system itself, and most importantly could impose irreversible damage to the underlying state of the real economy and the quality of life for those who depend on it for their livelihoods. Fortunately, we can avoid these effects by correcting the system. The ways in which the financial system prices risks and invests in opportunities can be, and is, shaped by the capabilities and entrepreneurship of market actors and those responsible for the stewardship of the system, including central banks, financial regulators, standard setters and, ultimately, governments.

The UNEP Inquiry into the Design of a Sustainable Financial System was established in early 2014 with a mandate to explore practical policy options for better aligning the system with sustainable development. Supported by a high-level Advisory Council of financial market actors and institutions responsible for governing the financial system, the Inquiry has identified an emerging body of country-level practice in setting rules and norms that increase the relevance of aspects of sustainable development in decision-making. Such leadership practices provide inspiration and guidance as to how the wider financial system can be placed more effectively in the service of sustainable development, and so also in supporting the transition to a low-carbon, climate resilient world.

2015 is a milestone year in progressing sustainable development, particularly the financing aspects. Many approaches and instruments will be needed to deliver the financing needed for sustainable development, including that part addressing the climate challenges. Public finance, funded by tax revenues, will provide part of the solution, domestically and internationally, as well as through public investment vehicles such as development finance institutions. Such finance will alone, however, be inadequate. Private capital will be needed to scale up investments, particularly in financing long-term, low-carbon, resilient infrastructure needs. Financial innovations that blend private and public institutions and resources will take us further in closing the gap, as of course will improved economic and industrial policies that, for example, more effectively price carbon.

Reshaping key rules governing the financial system can and indeed must complement such sources, tools and processes in ensuring adequate and timely financing for sustainable development. The Inquiry, together with its growing number of national and international partners, is providing a map, grounded in experience, that locates which rules can be changed, by whom and with what expected consequences. This briefing focuses on such measures that can support collective efforts in addressing the climate challenge as a key aspect of sustainable development. We hope that it will encourage greater focus on what we believe to be a promising and to date under-explored set of complementary actions that could be deployed going forward to considerable effect.

Achim Steiner
Under-Secretary-General
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THE COMING FINANCIAL CLIMATE

HIGHLIGHTS

ACROSS THE WORLD, A GROWING NUMBER OF GOVERNMENTS, REGULATORS, STANDARD-SETTERS AND MARKET ACTORS ARE STARTING TO INCORPORATE SUSTAINABILITY FACTORS INTO THE RULES THAT GOVERN THE FINANCIAL SYSTEM. The Inquiry was established in January 2014 to understand this fast-moving trend and to produce a set of policy options to advance good practice. Our work with a range of partners including central banks, financial institutions and international organisations has highlighted a diversity of catalysts and approaches across banking, capital markets, insurance and investment. In Brazil, integrating environmental and social factors into risk management is becoming viewed as a way of strengthening the resilience of the financial system. Better disclosure of environmental and social performance - for example through stock market and securities' requirements in Singapore and South Africa - is now seen as necessary to deliver market efficiency. And to serve lasting value creation in the real economy, work is underway to upgrade the effectiveness of the financial system, exemplified in the emergence of new principles, standards and incentives for the fast-moving 'green bond' market.

2015 LOOKS SET TO INTENSIFY THIS PROCESS AS GOVERNMENTS CONVERGE TO AGREE A GLOBAL FRAMEWORK FOR FINANCING SUSTAINABLE DEVELOPMENT. Critical steps include the Financing for Development conference in July, the launch of the new UN Sustainable Development Goals in September and the UN Climate Change Conference in Paris in December. Across the Inquiry's work at both the country and international levels, harnessing the financial system to deliver climate security has emerged as a key cross-cutting issue. As a result, we are focusing this document – the Inquiry's fourth progress report – on financial reforms that can reduce the risks of high carbon assets, scale up capital for the low-carbon transition and invest in protecting economies from natural disasters and climate shocks.

THE COSTS OF HIGH CARBON GROWTH INCLUDE SEVERE HEALTH IMPACTS AND DISRUPTION TO INFRASTRUCTURE, WATER AND FOOD SECURITY, ALL CONTRIBUTING TO INCREASING MARKET VOLATILITY, AS WELL AS LIVELIHOOD AND ECONOMIC IMPACTS, PARTICULARLY IN DEVELOPING COUNTRIES. In Kenya, for example, existing climate variability is already costing 2.4 per cent of GDP per year. In essence, market and policy failures have resulted in the structural mispricing of climate risks, exacerbated by short-termism, misaligned incentives and information asymmetries. This damage is expected to deepen and risks becoming unmanageable if emissions of greenhouse gases are not reduced to net zero levels between 2055 and 2070.

A COMPREHENSIVE APPROACH TO FINANCING THIS TRANSITION IS REQUIRED. Stronger action is needed to drive the demand for green finance – for example, through carbon pricing and incentives for clean energy. Public finance will also be crucial but can only provide a portion of the capital required nationally and internationally. In China, annual investment in green industry could reach US$320 billion in the next five years, with public finance estimated to provide no more than 10 to 15% of the total. To address this challenge, a task force, co-convened by the People's Bank of China and the Inquiry, has recently published a comprehensive set of recommendations for establishing China's 'green financial system'.

OUR FINDINGS POINT TO A NEW WAY OF THINKING AND PRACTICE THAT IS TAKING SHAPE. The task for those charged with governing the financial system is to enable the orderly transition from high- to low-carbon investments and also from vulnerable to resilient assets. This transition is already underway – for example, with global investments in renewable energy growing 17% in 2014, so that clean energy now makes up nearly half of net power capacity added worldwide. But the financial needs of low-carbon and resilient economy go far beyond renewables and require a system-wide response. As with all financial shifts, this is generating a set of transition risks for incumbent assets – risks that are not reflected in conventional models for delivering financial stability and so hold out the prospect of stranded assets.

Placing the financing challenge around climate change within the broader context of the green economy and sustainable development is essential to mobilise the trillions that are needed. Drawing from the array of policy innovations at the country level, we have identified a set of measures that can make climate security part of the overall performance framework of a sustainable financial system. These covers risk, capital mobilization, transparency and culture. Each country will need to decide how these options relate to its financial system and the priorities for action.

A. Expand the scope of risk management

1. **Banking:** Place long-term sustainability and climate factors in risk management systems and prudential approaches for lending and capital market operations ('green credit')
2. **Investment:** Ensure that institutional investors (including pension funds) manage long-term climate factors as part of core risk, fiduciary and other investment obligations
3. **Insurance:** Integrate long-term climate factors into wider insurance frameworks for inclusion, solvency, underwriting and investment
4. **Stress Testing:** Across financial sectors and markets, develop scenario based tools to enable a better understanding of the impacts of future climate shocks on assets, institutions and systems

B. Enable the orderly reallocation of capital

5. **Capital Markets:** Upgrade debt and equity capital markets through standards, regulatory refinement, indices, enhanced analysis and fiscal incentives
6. **Green Banks:** Establish green investment banks to strengthen the structure of the financial system and crowd in private capital
7. **Central Banks:** Review monetary operations including collateral, refinancing, asset purchases and others to incorporate green finance and climate assets

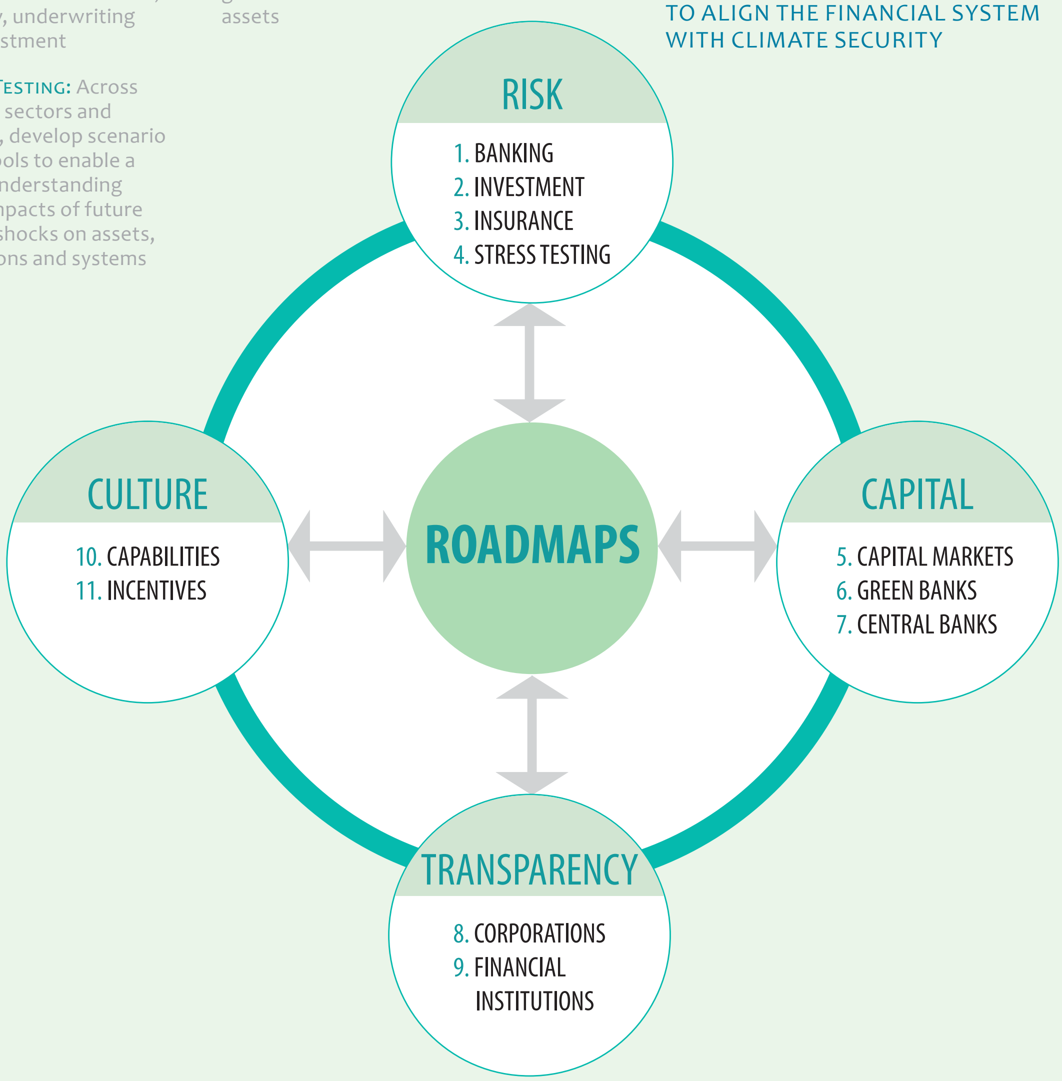
C. Make transparency systemic

8. **Corporations:** Ensure that corporations and issuers of securities publicly report on critical sustainability and climate factors to investors and other stakeholders
9. **Financial Institutions:** Enhance disclosure by financial institutions on allocations to green assets, climate performance and exposure to risk, as well as integration in investment analysis

D. Strengthen financial culture

10. **Capabilities:** Build capabilities among financial professionals and regulators on sustainability and climate factors
11. **Incentives:** Link remuneration, compensation and broader incentive structures with sustainable value creation over the long-term

FIGURE 1: **An emerging framework to align the financial system with climate security**



Policies to improve risk management and prudential approaches by banks, insurance companies and institutional investors are key. Examples include work by state insurance commissioners in the US to improve disclosure of climate factors and a review of climate implications for the insurance sector being conducted by the Bank of England's Prudential Regulatory Authority. A range of policy tools is also available to mobilise capital. Beyond 'green bonds', the Inquiry's work in India has highlighted considerable scope for listed investment trusts (or 'yieldcos') for clean energy finance. Central banks can also target their monetary operations at the green economy, as the Bangladesh Bank is doing with its refinancing mechanisms.

Improved reporting frameworks of sustainability and climate factors are also critical to ensure accountability. Market forces on their own have proved insufficient to deliver the necessary breadth, depth or consistency of corporate disclosure, prompting a proposal for a 'model reporting convention' in a submission to the Inquiry from the Climate Disclosure Standards Board (CDSB). Greater disclosure by financial institutions on green finance flows, carbon footprints and climate risk is also needed. To make this all happen, financial culture will need to be strengthened through improved skills and capabilities as well as by aligning incentives to sustainable value creation – both priorities that were highlighted in Switzerland's contribution to the Inquiry.

Reinforcing the financial system in these ways is a strategic exercise that will involve sustained effort. At the national level, the introduction of long-term strategies, roadmaps and national coordination mechanisms can have important signalling effects, building market confidence in long-term policy direction. Indonesia's financial regulator, OJK, for example, has developed a comprehensive Roadmap for Sustainable Finance, containing a package of measures to be sequenced over the next decade.

Based on this bottom-up experimentation at the country level, a number of promising avenues for international cooperation are now opening up. This could help to evaluate the impacts of existing initiatives, share good practice and ensure coherence with international regimes. Beyond the formal negotiations under the UN Framework Convention on Climate Change (UNFCCC), discussions are now underway on how to reflect climate factors in the global financial architecture. For example, the G20 Finance Ministers and Central Bank governors have asked the Financial Stability Board to explore how the financial sector could address climate issues. Other opportunities include the potential for