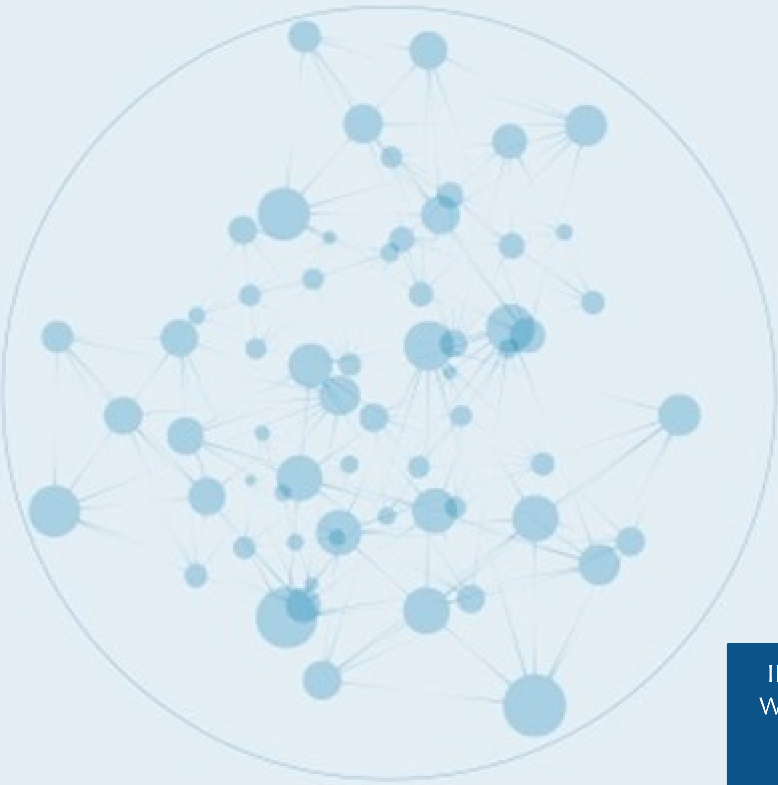
Inquiry: Design of a Sustainable Financial System

UNEP

CREATING A SUSTAINABLE FINANCIAL SYSTEM

A Role for Finance Ministries



INQUIRY WORKING PAPER

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The UNEP 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 will publish its final report in October 2015.

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

About this report

Bart van Liebergen is the main author of this working paper. Errors and omissions are the responsibility of the authors.

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Executive summary

This paper investigates various roles that finance ministries can assume to promote those policies, regulations and standards which help to create a sustainable financial system. Finance ministries typically interact with the financial sector in many ways, from regulator and supervisory mandate setters to tax authority and sovereign debt issuers. All of these points of leverage empower them to play a key role in making financial systems sustainable.

Sustainability is still a relatively new concept in financial sector policy, which has in the past decade been preoccupied with strengthening financial stability and supporting economic growth. In this paper, a sustainable financial system is taken to be a financial system that performs its central functions, such as the provision of savings possibilities and the allocation of capital, while taking into account the demands and needs of the economy, society and the environment.

From this definition, a framework inspired by Cihak et al (2012) is developed to outline key characteristics of a sustainable financial system. They discuss four key characteristics of financial systems in supporting economic growth and poverty alleviation: depth, access to finance, efficiency of intermediation and financial stability. In addition, the extent to which a financial system incorporates environmental externalities into its process for allocating capital, and its ability to provide financing with a structure and maturity fitting sustainable investment needs are proposed here as ways of benchmarking the system's environmental sustainability. Lastly, access to finance and the transparency of the capital allocation process are proposed as indicators of social sustainability.

Sustainability is not often regarded to be part of a finance ministry's policy mandate. Therefore, this paper looks at cases where finance ministries use their mandates to bring about innovation in the space. In conclusion, under the current mandates of finance ministries, much has already been done to begin creating significant openings that stimulate sustainability in the financial sector.

To that end, the paper discusses several cases relevant to financial sector sustainability. First, it takes a look at debt management by the Ugandan Finance Ministry, which uses a new debt management strategy to effectively manage sovereign debt and develop domestic financial markets. Second, it compares the roles of the British and Dutch finance ministries in developing remuneration regulation. A third case assesses the South African Treasury's push for financial inclusion and responsible investment. The fourth case compares the German and French 'energy transitions' based on the roles their finance ministries played in these transitions, and their respective focuses on the financial sector.

1 Introduction

Thought leadership around the financial sector went through some profound changes in the past decade. While a well-developed financial sector was said to support economic growth and stability, the financial crisis reminded us that advanced financial systems could also pose a threat to the economy. A lot of policymaking has tried, in the meantime, to bolster financial stability and strengthen the sector's ability to support economic objectives. The UNEP Inquiry takes this discussion further by investigating how we can develop a financial system that not only supports the economy, but takes the needs of the environment and society into account as well in executing its core functions, in other words, a sustainable financial system.

Stimulating sustainability in the financial sector requires the involvement of a wide range of actors. Of course, financial institutions are at the centre of any transition to sustainability. Yet supervisors, regulators, sector associations, different institutions of government and civil society also need to play an important role.

This paper investigates various roles that finance ministries can assume to promote those policies, regulations and standards which help to create a sustainable financial system. It will first examine the concept of sustainability itself in order to better define and specify some of the requirements of a sustainable financial sector. Based on this theoretical framework, it will then take a look at empirical cases where finance ministries are using their mandates to move the financial sector towards sustainability objectives.

Assessing the effectiveness and efficiency of the measures brought forward by finance ministries discussed in the case studies is beyond the scope of this paper. The goal of reviewing the case studies is rather focuses on showcasing the creativity displayed by finance ministries working within their mandates, whether it is in sovereign debt management or political agenda setting: it can hold lessons for the advancement of sustainable financial systems, as it reveals the space for action within their mandates.

2 A framework for financial sector sustainability

This section will first propose a framework for assessing the sustainability of a financial sector, based on definitions of sustainability and a review of existing literature on the functions of the sector in relation to the economy. Second, it will briefly discuss the selection of case studies in this paper.

2.1 Sustainability and the financial sector

In the wake of the financial crisis of 2008-09, a lot of attention turned to the relationship between the development of the financial sector and the health of the economy. Policymakers and academics identified financial stability as a key precondition for economic growth and stability. The crisis had shown that excessive risk-taking combined with a low loss-absorbing capacity of the financial system could threaten the stability of the financial sector and have enormous costs for the economy as a whole. Hence, post-crisis financial policy has concentrated on improving financial stability. Increased capital requirements should bolster the resilience and stability of the sector, while too-big-to-fail policies such as resolution requirements should curb excessive risk-taking. Improved financial stability should support economic growth and stability by dampening the impact of financial shocks on the real economy, curbing excessive lending and minimizing the externalization of costs of failure of financial institutions.

Due to the central role of the financial sector in the economy, an increasing body of literature, including the UNEP Inquiry into the Design of a Sustainable Financial System, takes the view that the sector should not only bolster stable economic growth, but sustainable development at large. Following the classic Brundtland definition, sustainability concerns "development that meets the needs of the present without compromising the ability of future generations to meet their own needs".[1] The UNEP Inquiry applies this definition in its broadest form, covering the three dimensions of the economy, society and the environment.[2] A sustainable financial system is then taken to be *a financial system that performs its central functions, such as the provision of savings possibilities and the allocation of capital, taking into account the demands and needs of the economy, society and the environment*.

What characteristics should such a system have? Based on existing literature, one can construct a framework to help determining these characteristics. Such a system might also be used to assess the effectiveness of the financial system in this regard. Cihak, Demirgüç-Kunt, Feyen and Levine (2012) discuss four key characteristics of financial systems in supporting economic growth and poverty alleviation:[3]

- *Depth:* empirical research shows a strong positive influence of financial depth (often approximated by the ratio of private credit to GDP) and economic growth.
- *Access:* As Cihak et al. write, "a well-functioning financial system allocates capital based on the expected quality of the project and entrepreneur, not on the accumulated wealth and social connections of the entrepreneur."
- *Efficiency* concerns the cost of intermediating credit between savers and investors. An efficient financial system should be able to provide debt financing to be available for productive investments against a reasonable price.
- *Financial stability* is a precondition for economic stability (as discussed above). This factor can be a trade-off with depth and access: while a higher credit-to-GDP ratio implicates a greater availability of finance for investors, excessive lending can lead to financial and economic booms and busts when excessive finance is channelled into unproductive investments.

This framework can be extended to cover the performance of the financial system within the two other dimensions of sustainability. The following section proposes some key characteristics that would make financial systems more sustainable in an environmental and societal sense. This should be seen as an initial proposal – the characteristics proposed are, for the most part, hard to observe empirically. Yet, they might add some considerations to the debate on financial sector sustainability.

Environment

Impacts that the financial system has on the environment primarily take the shape of externalities of investments. In economics, externalities constitute a side effect or consequence of an industrial or commercial activity that affects other parties without this being reflected in the cost of the goods or services involved.[4] A classic example of an environmental externality is pollution from a factory financed by the financial system. Externalities can also be positive, such as the creation of a waterway which brings added benefits for biodiversity. However, most of the economic growth in the past decades has been unsustainable, with externalities of economically productive investments leading to environmental degradation and climate change.[5] As externalities, the costs and consequences of pollution or biodiversity degradation are not borne by the investors, but are outsourced to society and the environment.

It follows that the environmental sustainability of a financial system should be assessed by *the extent to which it incorporates environmental externalities in the capital allocation process*. However, this variable is very hard to verify empirically.

Economy

Another characteristic may concern the structure of the financing supplied by the sector. Short-termism and a preference for liquidity are often argued to be inherent to the financial sector's investment behaviour.[6] Liquidity ensures that investors can quickly shift portfolio allocations when financial risks materialize. Often, the investment behaviour of institutional investors is guided by short-term performance benchmarks. Short-termism and liquidity preference may discourage investors from investing in sustainable investments.[7] At the same time, sustainable investments generally may require financing with long maturities. Low-carbon infrastructure often requires high upfront costs for investment, but "has significantly lower operating expenses and a longer expected lifespan than fossil fuel assets".[8] Renewable energy investments, for example, have no intrinsic fuel price risk, as opposed to traditional energy investments. Since their initial costs often make a higher proportion of total costs, longer maturities are needed for repayment.

As a result, the *ability to provide financing with a structure and maturity fitting sustainable investment needs* (for example, measured by an institution's ratio of financing supplied to the real economy with a maturity longer than a year over total assets) could be another defining characteristic of an environmentally sustainable financial system. At the same time, one could argue that a financial system which incorporates environmental externalities into its capital allocation would naturally adapt its financing to match the needs of sustainable investment, as unsustainable investment would be relatively unattractive due to the incorporated externalities.

Society

The third dimension of sustainability is society. One can argue that a financial system that promotes societal sustainability should contribute to equal opportunities for all citizens, be accountable to and reinforce the rule of law (i.e., not contribute to corruption or crime) and allows the State to perform its core functions. Crucial here is that all citizens have equal *access to finance*.

Access to finance is, of course, also part of the economic dimension of sustainability. Yet where it serves the function of supporting economic growth, access to finance should, from a social perspective, be provided as an equal opportunity for all people in society.

Also, a financial sector's workings (the way it supplies savings products and allocates capital) should be *transparent* in order to prevent money laundering or the financing of corruption and crime. Banking secrecy is a clear example of diffusion in the financial system, creating opportunities for crime and corruption. Transparency should improve the system's accountability and the ability of the government to tax its citizens.

2.2 A framework for assessing the role of finance ministries in promoting financial sector sustainability

The question this paper ultimately attempts to answer is where finance ministries fit in this framework, and how they use current mandates to contribute to sustainability in the financial sector. As a first step, this section briefly takes stock of the different interactions between the financial sector and finance ministries, and explores how these roles could, in theory, be used to promote sustainability in the sector.

2.2.1 Regulator

Finance ministries are often the primary regulator of the financial sector on a wide range of topics ranging from prudential requirements to remuneration, reporting requirements, anti-money laundering, conduct and fiduciary duty. This regulation is instrumental in shaping the structure and behaviour of the sector. Many also participate in negotiations on international regulatory standards, such as accounting standards (International Accounting Standards Board, Financial Accounting Standards Board and Solvency II (EU)). With the central role attributed to the Financial Stability Board in the post-crisis international regulatory architecture, finance ministries are now also involved in setting international prudential standards, such as Basel III and systemically important financial institution (SIFI) policies.

2.2.2 Member of international financial institutions

Institutions such as the IMF and the World Bank monitor risks in the international financial system and promote economic and financial development. Ministries could use their membership to push for the monitoring of environmental and social risks on the global agenda. For example, in its most recent country assessment of China, the IMF has paid prominent attention to environmental risks, articulating