Inquiry: Design of a Sustainable Financial System

UNEP

New Rules for New Horizons

Report of the High Level Symposium on Reshaping Finance for Sustainability

Paris, 3 July 2015

UNEP Inquiry into the Design of a Sustainable Financial System and AXA

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ABOUT THE EVENT AND THIS REPORT

On July 3rd 2015, the UNEP Inquiry into the Design of a Sustainable Financial System and AXA co-hosted a high-level symposium in Paris to explore the nexus between the long-term challenge of mobilizing finance for sustainable development, and impact of the post-2008 financial reforms. Two further drivers of major change to the financial system were also discussed: the innovative disruption being unleashed by new technologies and business models, and the growing importance of major developing countries in the shaping of the international financial system. Over two hundred participants, including officials from international institutions, central banks and financial regulators, and private sector representatives and academics, debated the current state of the financial system, its purpose for society and the potential and challenges for reshaping it towards sustainability.

→ Replay sessions and highlights on www.axa.com

This report highlights the themes of the debates and their main conclusions, as well as potential avenues for action.

SPEAKERS

Bertrand Badré, Managing Director and Chief Financial Officer, World Bank

Alexander Barkawi, Director, Council on Economic Policies

Mark Burrows, Managing Director and Vice Chair, Global Investment Banking, Credit Suisse

Henri de Castries, Chairman and Chief Executive Officer, AXA

Denis Duverne, Deputy Chief Executive Officer, AXA

Sylvie Goulard, Member of the European Parliament, ECON Committee

Levin Holle, Director General, Financial Policy, Ministry of Finance, Germany

Denis Kessler, Chairman & CEO, SCOR SE

Izabella Kaminska, Financial Times

Jean-Pierre Landau, Professor of Economics, Dean of the School of Public Affairs, Sciences Po

Michael Liebreich, Chairman of the Advisory Board and Founder of Bloomberg New Energy Finance

John Lipsky, Senior Fellow, School of International Studies, Johns Hopkins University

Matu Mugo, Assistant Director, Bank Supervision, Central Bank of Kenya

Ligia Noronha, Director, Division of Technology, Industry and Economics (DTIE), UNEP

Sophie Pedder, The Economist

Luiz Awazu Pereira da Silva, Deputy Governor in charge of Financial Regulation, Central Bank of Brazil

Nick Robins, co-Director, UNEP Inquiry

Rathin Roy, Director, National Institute of Public Finance and Policy, India

Mulya E. Siregar, Deputy Commissioner of Banking Supervision, Indonesia Financial Services Authority (IFSA)

Rintaro Tamaki, Deputy Secretary General, OECD

Christian Thimann, Member of the Executive Committee, AXA

Jean-Claude Trichet, Chairman, Group of Thirty, Former President, ECB; Honorary Governor, Banque de France

Wang Yao, Deputy Secretary General, China Green Finance Committee; Director General, Financial Research Center of Climate and Energy, Central University of Finance and Economics

Simon Zadek, co-Director, UNEP Inquiry

Jean-Pierre Zigrand, co-Director of the Systemic Risk Center, LSE

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Inquiry: Design of a Sustainable Financial System

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 sustainable development.

→ www.unep.org/inquiry

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The paper has been developed by Christian Thimann, Member of the Executive Committee of Axa and Simon Zadek, Co-director of the UNEP Inquiry, with support from Amélie de Montchalin and Maya Forstater. Comments are welcome to simon.zadek@unep.org

New Rules for New Horizons: Reshaping Finance for Sustainability

Finance is the means by which we channel accumulated wealth into productive new activities to generate more real wealth and wellbeing.

As such, finance is critical to sustainable development. But it cannot deliver real wealth without being responsive to the fundamental value of social, physical and environmental capital. As Henri de Castries argued in his opening remarks, "finance is like our blood, it serves a critical function in the body, but it is useless if you separate it from the human system".

When the financial system works efficiently and effectively, it fosters dynamic, inclusive and sustainable economies that in turn reward the owners of capital. But when the system proves defective, economies and societies are weakened by the misallocation of capital across activities and over time, capital owners and savers suffer from low and uncertain returns. Today, the system has become the subject of intense public debate because it is not considered to be fully efficient or effective in either serving the owners of capital or financing inclusive, sustainable development.

The financial system is emerging from its worst crisis in two generations. Since 2008, national actors and the international community have established new rules and regulatory and supervisory institutions that have secured the international economy from what could have been a far worse collapse than the recession experienced across much of the developed world.

Sustainable development, at the same time, has increasingly become a lens through which to assess economic progress, and an organizing framework through which the role and effectiveness

"The end of the financial crisis is providing space for innovative thinking in how to shape finance to the long-term needs of an inclusive, sustainable economy."

Ligia Noronha, Director, Division of Technology, Industry and Economics, UNEP

“We have seen major changes, with the rise of complexity in the financial system, increasing short-termism and the intensification of climate-related risks. As insurers we are extremely conscious of the need to bring together the agendas of finance and sustainability.”

Henri de Castries, Chairman and Chief Executive Officer, AXA

of finance is considered. Across the world, a growing number of governments, regulators and market participants are starting to incorporate sustainability factors into the design of, and practice across, the financial system. While this shifting focus is to be welcomed, there is widespread recognition that, as John Lipsky highlighted, “reforming the financial system remains an unfinished business – we have a long way to go in designing a financial system that meets the needs of sustainable development”.

Key messages that emerged from the discussions in Paris on July 3rd:

- Post-2008 financial market reform remains an unfinished business, whilst having prevented a financial and associated economic collapse across much of the developed world.
- Such reforms have created unintended consequences, notably increasing short-termism that discourages much needed, longer-term, less-liquid lending and investments.
- The key role of the financial system in enabling societies to meet sustainable development goals remains largely implicit in most major financial and capital markets, whilst being more explicit in many developing countries.
- Today’s financial system governance is not ensuring effective alignment with sustainable development goals, with a need to broaden the treatment of risk to incorporate longer-term, social, economic and environmental factors that impact financial and policy outcomes.

In addition, two specific themes received focused attention:

- Low interest rates have not catalysed long-term investment because of macroeconomic and policy uncertainties, and adverse incentives across the corporate and financial community.
- Technological developments are shaping new financing approaches, opportunities and business models, including for long-term investment approaches.

“While the established wisdom is that developed countries lead and developing countries lag, much of the discussion has revealed that it can be the other way around. Regulators from China, Brazil and India are overseeing the financial system with the national interest for sustainable development in mind.”

Christian Thimann, Member of the Executive Committee, AXA

The state of our financial system

“Finance contributes to society, if it keeps savings safe and enables businesses to grow. Financial regulation is complex, but the principles are intuitive – responsibility and accountability, skin-in-the- game, measures to calm exuberance. To this we should now add increasingly common social and environmental rules for finance, which will make international allocation of capital more efficient.”

Luiz Awazu Pereira da Silva, Deputy Governor in Charge of Financial Regulation, Central Bank of Brazil

Fragile stability and a return to growth

Participants reflected on the unfinished nature of the post-2008 financial reforms. It was explicitly acknowledged that much has been done to achieve stability through new rules for banking, shadow banking and hedge funds, systemic risk supervision and measures to ensure effective resolution of insolvency without recourse to public funding. Financial institutions are reportedly more stable, with strengthened supervision and better financial market transparency. A fragile confidence has returned to the financial system, but remains weak across the real economies in many developed countries.

“Regulatory changes, especially increased capital requirements, have succeeded in improving the stability of individual institutions. More generally, however, the approach to regulatory reform has been like a game of “whack-a-mole”; tackling problems one by one after they occur. We need a better view of what we want the financial system to do, and from there to establish the principles and regulations needed to ensure that it serves that purpose.”

John Lipsky, Senior Fellow, School of International Studies, Johns Hopkins University

“Direct exposure to infrastructure can be an ideal investment for institutional investors, including insurance companies, given their long-term liabilities and the long life of infrastructure assets. Yet today only 1% of their assets go to direct infrastructure investments and only a small proportion of that into green infrastructure.”

Rintaro Tamaki, Deputy Secretary General, OECD

Despite all the regularity improvements, the panellists all noted in different ways that financial stability remains vulnerable, with pockets of under-regulated activity and risk remaining, and new areas of `shadow’ financial activity developing. At the same time, the approach that has been taken to stabilize the financial system - based on voluminous detailed regulations and administrative complexity - is difficult to scale or to change in response to on-going innovation, and future disruptions to the financial system. Financial reforms that have driven greater risk aversion, liquidity preference and uniformity in investment have created the unintended impacts of short-termism and continuous sense of fragility in the financial system. Additionally, the continued uncertainty about the permanent enlargement of the regulatory scope is seen as a barrier to long-term investment, despite low interest rates.

Disruptors and warning signs

While regulation has been the primary force for change in the financial system over recent years, participants highlighted other sets of disruptive forces coming to the fore:

- Technological and business model changes in both the real economy (such as energy and transport) and in the financial system itself - disrupting incumbent business models, institutions and markets, in mature and emerging economies. These disruptions could revolutionise the relationship between the citizen and finance, and yet also introduce new risks and associated governance and accountability issues that require attention.
- Leadership changes largely due to the rise of major emerging markets and their growing importance in financial and investment terms, which may lead to a strengthened development and sustainability agenda at the heart of future financial market reform.

> ***“The traditional financial system discriminates against green investment – the way people interpret fiduciary duty, the capital requirements and credit weightings of Basel III - all of this will need to change to enable green investment to reach its potential.”***
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> *Michael Liebreich, Chairman of the Advisory Board and Founder of Bloomberg New Energy Finance*

- Expectation changes regarding the purpose and functioning of financial markets, with recognition of the need for greater alignment between finance and sustainable development to ensure that:
  - Finance serves the needs of the real economy over the long term;
  - It supports a more inclusive and stable growth model;
  - And it can cope with the disruptive impacts of historic patterns of unsustainable development, including climate change.

To this were added other disruptors – urbanization and the role of cities as hubs for investment and environmental impacts, the nature and role of cross border conflict, illicit flows and associated anti-money laundering controls.

> ***“There is a relationship between financial stability and growth. As well as financial stability, sound public finance and structural reforms are critical as a foundation for economic growth. But there can also be a trade-off between growth and stability focused regulation. There are policy choices to be made. How much safety or how much dynamism and risk taking do we want?”***
>
> *Levin Holle, Director General, Financial Policy, Ministry of Finance, Germany*

"If we go back eight years, the financial system was characterized by distress, disruption and discontinuities. Stability then became the key word. Regulation was driven by very high risk aversion. Now growth is a major concern again. The regulatory framework is good but we have to adapt the parameters in order not to prevent economic recovery."

Denis Kessler,
Chairman & CEO, SCOR SE

Christian Thimann, Member of AXA's Executive Committee, reflected on five 'warning signals', issues that are still unresolved in the financial system:

- A sense of fragile financial stability, stemming from the continuous creation of unchecked pockets of risks despite progress in regulation and supervision in the different markets and jurisdictions;
- A perceived lack of control, as illustrated by a growing complexity of financial regulation, despite numerous new standards and behaviours aimed at increasing the reporting and transparency of financial actors;
- Inefficient liquidity, as ultra-abundant liquidity on all financial markets and extremely low interest rates are not boosting public and

These warning signals are mirrored by growing concerns in the real economy and the natural environment, on which the activities and economies of societies depend. Some examples are the challenges triggered by climate change, water scarcity and land contamination, as well as unemployment, inequality and the intergenerational issues related to rapidly ageing societies.

These environmental, social and economic warning signals reinforce the importance of ensuring that the financial system is effective in serving its purpose in financing an inclusive, sustainable economy, while also highlighting the fact that such effectiveness is a pre-condition, but not a sufficient condition for such a positive outcome. A financial system fit for purpose needs to comple-

A conclusion from this stock-taking is that a shift is warranted in the conception of risk in finance to better take into account the new and expanding nature of the major challenges societies and economies face today, including climate change. Such a reflection would aim at incorporating social, environmental and long-term sustainability questions into regulatory and prudential frameworks and to guide decision-making of large financial institutions with revised pricing methods of risk.

Moreover, a reorientation of financial regulation towards the long-term is needed, which should also foster investments in new technologies, private sector activities and lessen the focus on government bonds and real estate that are contributing to bubbles in these