> Design of a Sustainable Financial System

Swiss Team Input into the UNEP Inquiry

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> Foreword

Fruitful dialogue between the financial sector and sustainability actors

If the world population had the same consumption patterns as Swiss citizens, we would need almost three planets to cover its requirements. There is no question about it: we are living beyond the capacity of our Earth to sustain us. The pressure on natural resources continues to rise due to the growth of the world population and the global economy. A vast improvement in the resource efficiency of production and consumption is urgently required. If we wish to conserve the quality of our environment for present and future generations, our production systems throughout the world must reduce their resource consumption along the entire production chain.

The transformation towards an economy that respects planetary boundaries and natural resources necessitates substantial investment in infrastructure, innovative technologies and smart concepts like the circular economy. A substantial proportion of the finance for these investments is provided by the public sector. Given the scale of investment needed globally and the current strain on public finances, it is crystal clear that private money must be mobilised. Private money must be channelled into investments for a resource-efficient future.

The UNEP Inquiry into the Design of a Sustainable Financial System analyses both the potential that exists for a sustainable financial system and the obstacles that stand in its way, and invites countries to share their best practices. The Federal Office for the Environment supported the UNEP Inquiry from the outset. It actively participated in this promising project by initiating a dialogue with relevant stakeholders from the Swiss financial system. The goal was to identify ways to strengthen the financial system so that it can help to accelerate the transition to a resource-efficient economy. Switzerland is in a very strong position to play an important role here: it not only has a strong financial system, it is also home and host to important pioneers and innovators in the area of sustainable financial products and investment practices.

I am impressed by the enthusiasm of the stakeholders who participated in this dialogue and joined forces to provide insights to the UNEP Inquiry. This report is the tangible product of our fruitful discussions on a financial sector that lies at the heart of a green and inclusive economy. The report provides interesting thoughts on the challenges and opportunities that arise for our financial sector in the context of a green and inclusive economy. It also provides inspiration for action. It is a first step for the relevant decision-makers and stakeholders who can now take action and define a roadmap towards establishing a responsible financial system, a financial system that serves the needs of a resource-efficient real economy.

I would like to thank all of the involved parties sincerely. Their openness to constructive dialogue made this outcome possible. This is an excellent example of the power of proactive and constructive dialogue between stakeholders from business, civil society and government.

Bruno Oberle
Director of the Federal Office
for the Environment

> Management Summary

The UNEP Inquiry into the Design of a Sustainable Financial System identifies financing as one of the greatest challenges in advancing sustainable development. Switzerland is strongly committed to environmental issues. In combination with its advanced financial sector, which includes pioneers in the field of sustainable finance, and its technical expertise, Switzerland is in a unique position to present an opportunity for the transition to a green and inclusive economy. The Swiss team for the UNEP Inquiry gathers representatives of the financial sector, NGOs and academia along with government representatives to reflect on the Inquiry's questions regarding a financial system aligned to sustainable development.

Switzerland is home to some 220 individual firms and organisations which engage in sustainable finance activities. The volume of sustainable investment products in Switzerland had reached CHF 56.7 billion by the end of 2013. The volume of sustainable investments has been growing by an average of about 23 percent each year since 2005. And yet, with a market share of approximately 4 percent, sustainable investments still represent a niche in relation to overall investments. The reasons of why not more funds are invested in sustainable assets are manifold. They extend from market liquidity and the lack of capacity for making effective use of Environmental, Social and Governance (ESG) information in the investment process to a lack of predictability in the regulatory and framework conditions.

We identify three main problems that inhibit the financial system from providing stronger support for a more sustainable economy. These include the failure of prices to reflect true costs, the disconnect between long-term impacts and short-term decisions, and the instability of the financial system. To overcome these problems, the following four pre-conditions should govern the transition towards a sustainable financial system: the establishment of a financial system that serves the needs of the real economy, the valuation of true costs, the application of the precautionary principle of 'doing no harm' when transacting on financial markets, and the adoption of a rule of law involving simple but effective regulation.

While these pre-conditions are generic recipes for a sustainable economy, the following more specific provisions were also highlighted by the Swiss Inquiry participants:

> The economic, legal and political frameworks should provide the incentives for financial intermediaries to exercise their economic function to mobilise the supply of funds to meet the demand of sustainable investments. The rapidly changing regulatory landscape in the wake of the financial crisis has led to greater uncertainty for market participants, and often does not facilitate the promotion of sustainable investments. Taxes, such as the stamp duty, reduce liquidity in primary and secondary markets and, hence, lead to a lack of tradable asset classes. The inclusion of ESG factors in reporting and due diligence processes and the creation of products geared towards sustainability topics could become a key competitive advantage in the competition for investors. sector will have to meet its clients' needs for transparency and their demand for impact investment.

> Different schemes for quantifying both financial markets' impact and external costs are on the horizon, but they are not fit for mainstream use yet. Integrated figures should be disclosed in annual reports to facilitate access to investor information on sustainability. A key concern that financial analysts raise when it comes to integrating sustainability information into their financial analysis is the lack of transparency, financial relevance and comparability of data. A common understanding of the terminology used in the field of sustainable finance is needed to enable transparency and credibility in relation to investment vehicles.

> To ensure applicability, regulation should be simple, clear, limited in size and focused on key problems and their resolution. Unless regulation is based on generally accepted standards and predictable patterns, uncertainty among market participants may discourage them from committing to long-term investments.

> An indispensable and transversal requirement for facilitating the convergence of the financial system is a paradigm shift in business, economics and finance education. Competence centres for sustainable finance research and education are needed to provide knowledge to consumers, investors, financial analysts and students.

These are some of the provisions from the Swiss Team's input, which would be conducive to establishing the long-term incentives needed to replace the current focus on short-term objectives of managers and board members – but also shareholders – with a view to fostering an inclusive and green economy. The ultimate goal is to mainstream sustainability so that the term 'finance' becomes synonymous with 'sustainable finance'.

The recommendations and ideas presented within this report is the outcome of the Swiss Team's thought process, and it has to be acknowledged that more work is needed to validate some of them and formulate plans for action.

1 Introduction

1.1 The transition to a green and inclusive economy and the financial system – the importance of the UNEP Inquiry into the Design of a Sustainable Financial System

Natural resources are essential to the well-being of our society. If resources like water, soil, clean air and biodiversity, and minerals, such as energy raw materials and metals, are no longer available in sufficient quantities and quality, this poses a threat to the economic system and quality of life.[1]

The quantity of natural resources currently consumed globally greatly exceeds the regenerative capacity of these resources and this is leading to phenomena like climate change, biodiversity loss and increasing soil scarcity. The world population already needs the equivalent of one and a half planets to satisfy its consumption requirements. In view of demographic growth and the increasing purchasing power of many population groups, the pressure on the environment will increase. For this reason, it is becoming gradually clearer at both national and international levels that natural resources must be used more efficiently and sustainably and that thorough consideration must be given to environmental and social interlinkages.[2] The global transformation to a green and inclusive economy is a key challenge of our time. The transition to a resource-efficient world economy with sustainable production and consumption patterns is a multi-generational project that will shape both the international community and Switzerland in the decades to come. It is impossible to establish a green and inclusive economy without mobilising sufficient capital for financing the long-term needs of a resource-efficient future. A variety of investments, in areas such as infrastructure, cleantech and natural conservation, are required.

The UNEP Inquiry into the Design of a Sustainable Financial System[3] identifies financing as one of the greatest challenges and opportunities in advancing sustainable development. In the aftermath of the financial crisis, and against the backdrop of the challenge of financing sustainable development, the UNEP Inquiry sees a unique window of opportunity to better align the financial system with the needs of a green and inclusive economy. The Inquiry explores, in particular, how the rules that govern financial systems – standards, metrics, incentives and regulation – can be reshaped to better mobilise capital for a green and inclusive economy. To this end, the Inquiry aims to identify and possibly scale successful policy innovations and best practices – and has hence addressed an open invitation to a wide range of actors to submit relevant experience and insights.[4]

Definitions

In this report we repeatedly use the terms financial system, financial market, financial institution/intermediary and financial sector. A *financial system*, as we define it in this report, consists of the institutional units (e.g., lenders, borrowers, intermediaries) and markets that interact, typically in a complex manner, for the purpose of mobilising funds for investment and providing facilities, including payment systems, for the financing of commercial and public activity. The main purpose of the financial system is to enable lenders and borrowers to exchange funds. In addition to lenders and borrowers, the financial system includes financial intermediaries, such as banks, insurance companies and investment funds, as well as infrastructure, such as payment and securities settlement systems. The legal and supervisory regime defines the framework, within which the financial system functions. A *financial market* refers to a market in which entities can trade financial claims under some established rules of conduct. *Financial institutions* or *intermediaries* are entities that provide financial services such as investment advice or intermediation between borrowers and savers (e.g., banks, insurance companies, mutual funds, pension funds, and other finance companies). Finally, the *financial sector* refers to the industry which is made up of financial institutions.

1.2 Relevance of the UNEP Inquiry for Switzerland

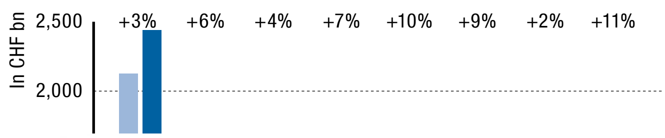
Strong environmental commitment – a global hub for sustainability

Switzerland is embracing the challenge of the transition to a green and inclusive economy accompanied by a successful national and international environmental policy. The fundamental principles for the making and enforcement of environmental law are the precautionary principle, the polluter pays principle, the principle of addressing the root cause, the holistic approach principle and the cooperative principle.[5] Stringent domestic environmental standards – e.g. in the areas of air pollution control, forest and water management, natural hazard prevention and biogenic fuels – and technical expertise testify to the pioneering role played by Switzerland in the area of resource management. At the international level, Switzerland pursues the development of an active and successful international environmental policy. In doing so, it contributes to the global protection and sustainable use of the world's natural resources.[6]

Switzerland is also home to many international institutions active within the field of sustainability, for example the IPCC, ILO, IISD, UNCTAD, UNECE, WEF, WBCSD, WWF, the UNEP's Economic and Trade Branch and the Green Growth Knowledge Platform. Geneva forms a green economy cluster. It is also home to UNEP's core initiatives for examining the role of the finance sector in greening economies, the UNEP Finance Initiative, and, last but not least, the UNEP Inquiry into the Design of a Sustainable Financial System.

Economic strength

In terms of economic development, Switzerland's performance is impressive. Thanks to its strong economy, Switzerland has ranked number one in the World Economic Forum's Global Competitiveness Index for five consecutive years. The reasons for this top ranking are Switzerland's macroeconomic and political environment. At a time when many neighbouring economies continue to struggle in this regard, the Swiss economy is among the most stable in the world. The successful implementation of the 'debt brake' a decade ago – a measure supported by a large proportion of the population – was one of many measures taken towards ensuring a stable macroeconomic environment. With its longstanding democratic tradition, its dynamic economy and strong research infrastructure, Switzerland is one of the most innovative countries in the world. This robust innovative capacity is reflected in its high rate of patenting per capita, for which Switzerland ranks



second globally,[7] and is a key precondition for the transition to a resource-efficient economy.

Financial centre of global relevance

The financial sector is an important pillar of Switzerland's economy. Switzerland's financial centre makes a significant contribution to gross value added and employment. In 2014, total value added of approximately CHF 66 billion was generated through the provision of financial and insurance services. This equates to a 10.2% share of gross domestic product (GDP), which is similar to the level found in most other major financial centres: 7.2% in the United States, 8% in the United Kingdom, 11.8% in Singapore and 26.9% in Luxembourg.

Relative to the Swiss economy, the financial sector has grown at an above-average rate over the past 20 years: while GDP grew by a factor of 1.6, the added value of the Swiss financial centre almost doubled.[8] Some 210,000 people were working in the Swiss financial sector at the end of 2014, which corresponds to an almost 6.0% share of total employment.[9]

The prominent role played by asset and wealth management is a unique characteristic of Switzerland as a financial centre of global relevance. With its market share of around 26% (figure 1)[10], Switzerland is the number one destination for cross-border asset management.

In addition to banks, insurers, pension funds and independent asset managers also form part of the financial sector. The insurance sector in Switzerland is growing much faster than the banking sector, and its contribution to GDP is almost equal to that of the banking sector.[11] The capital investments of Swiss insurers amounted to some CHF 540 billion at the end of 2013. Half of this sum was invested in fixed-income securities. Likewise, almost 2,200 pension funds and some 2,300 independent asset managers are also important players in the financial sector. At the end of 2013, the assets managed by pension funds amounted to CHF 720 billion, one third of