



**Inquiry:** Design of a  
Sustainable Financial System



# **Sustainability and the Financial System**

## **Imperatives, Innovation and Ideas**

Nick Robins, January 2015



# The long-run story of long-termism

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“It is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks.

Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally”

*J.M Keynes, General Theory, 1936*

# Financial reform & sustainability



- Financial system reforms are **part of the solution** to rapidly scaling capital for sustainable development
- Such interventions can **complement** action in the real economy and deployment of public capital
- Examples of financial **policy innovation** are growing globally, yet remain fragmented
- 2015 could be a **milestone year** for linking financial reform and sustainable development

*“In this age of diminished trust, it is the financial sector that takes last place in opinion surveys... [It] still prizes short-term profit over long-term prudence, today’s bonus over tomorrow’s relationship”*

**Christine Lagarde, Managing Director, IMF**

# Financial reform at the Climate Summit



- **Policy coherence:** USD24trn AUM called on governments to ‘consider the effect of unintended constraints from financial regulations on investments in low carbon technologies and in climate resilience’
- **Market creation:** USD2trn AUM called on governments ‘to act through policy, regulation, risk mitigation, guarantees, tax credits to support issuance of bonds that address climate change’
- **Investor transparency:** The Portfolio Decarbonisation Coalition will engage ‘governments on eventual financial regulatory components’ of portfolio disclosure and decarbonisation for USD500bn AUM
- **Climate stress tests:** A UN and insurance sector coalition will explore how to apply 1 in 100 year solvency tests for natural disasters across the financial system in banking, investment and securities.

“My friends, this is it. We have 15 months to put a regulatory framework in place that is going to guide us over the next 30-50 years.” **Christiana Figueres, Executive Director, UNFCCC**



***“Advance policy options that would deliver a step change in the financial system’s effectiveness in mobilising capital towards a green and inclusive economy”***

**A 2 year mandate,  
reporting in late 2015**

**WHY** should rules governing the financial system be used in pursuit of green & inclusive outcomes ?

**WHAT** rules governing the financial system have been, and might be deployed as effective instruments?

**How** rules can be deployed given the complexities & competitiveness concerns of financial actors and nations ?

*“Financial regulators need to lead. Sooner rather than later, they must address the systemic risk associated with carbon-intensive activities in their economies.”*

**Jim Kim, President, World Bank**

# The Inquiry's Advisory Council



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# Inquiry: a global network of partners



**Working with the IFC and CalPers** to assess policy needs to unlock institutional investors green investment



**Working with Febraban and FGV** to assess the Brazilian experience.



**Working with the Frankfurt School of Finance and Management** to identify and assess good practice green financial policies



**Working with the World Bank** to shape the financial system aspects of their green economy review.



**Working with the Central Bank of Bangladesh** to assess its sustainability-related monetary policy innovations



**Working with the Principles for Responsible Investment** to explore investor engagement on financial policy & regulation

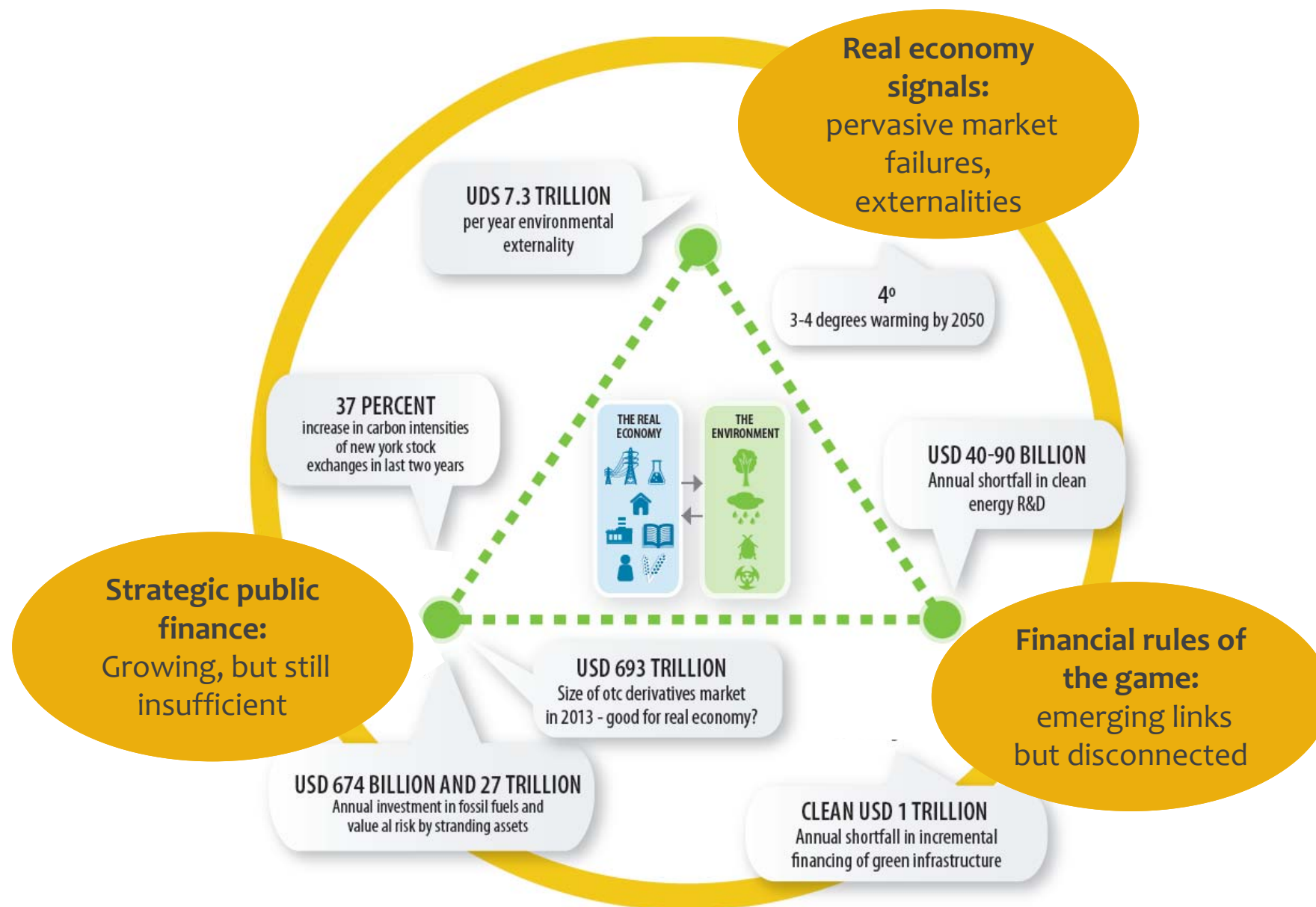


**Working with the People's Bank of China** to identify and progress specific green finance proposals in China



**Working with the Global Green Growth Initiative** to assess the South Africa experience.

# Mobilising finance: the triple challenge



# Why intervene in the financial system?



**Systematic  
market  
failures**

- Overcoming asymmetric information, misaligned incentives, short-termism and associated accountability failures.

**Systemic  
risks**

- Ensuring that the market can respond effectively to a new set of environmental and social risks

**Enabling  
innovation**

- Stimulating the standards and regulations required to catalyze productive financial innovation

**Policy  
coherence**

- Ensuring coherence between financial regulation and wider goals, such as employment, growth, financial inclusion or environmental security.

# Growing examples of policy innovation



## Banking

- **Brazil** - Resolution No. 4.327 (2014)
- **Kenya** – Sustainable Finance Initiative (2014)
- **China** – Green Credit Guidelines (2012)
- **Colombia** - Green Protocol 2012
- **Nigeria** - Sustainable Banking Principles (2012)
- **Bangladesh** – ERM Guidelines (2011)
- **Lebanon** – Reduced reserve requirements for energy efficiency (2011)
- **Indonesia** – Green Protocol (2009)
- **Peru & Mongolia** – developing Guidelines

## Securities

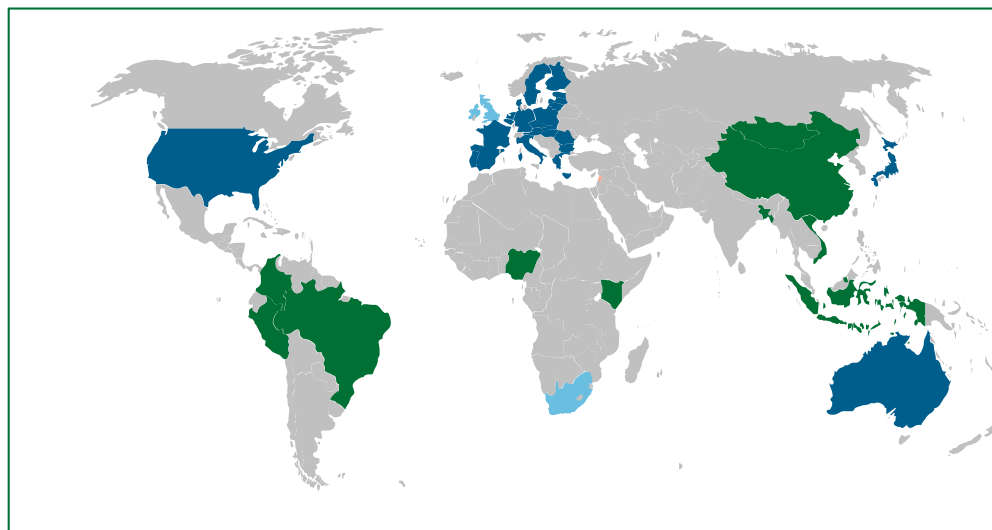
- **Australia** - Stock exchange reporting requirement (2014)
- **EU** - Directive on Disclosure of non-financial information (2013)
- **France** – Grenelle reporting Law (2012)
- **USA** - SEC climate disclosure guidance (2009)

## Investment

- **Malaysia** – Investor Code (2014)
- **Japan** – Principles for Financial Action towards a Sustainable Society (2012)
- **South Africa** - Regulation 28 of the Pension Funds Act (2011)
- **UK** – Pensions Act Reporting (1999)

## Insurance

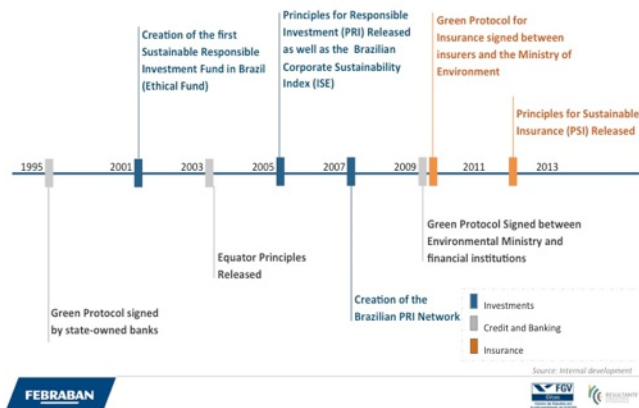
- **UK** – Prudential Regulatory Authority exploring climate change & insurance supervision (2014-5)
- **USA** – NAIC climate reporting (2009)



# Brazil: innovating for sustainability



## Self Regulation and the Financial Industry in Brazil



**Mission directed finance:** Banco do Brazil & BNDES have sustainable development as their goal, driving credit allocation & considering green bonds

**Market disclosure:** The BM&FBovespa stock exchange has promoted sustainability for a decade driving ESG disclosure across all listings.

**Sustainability Risk Regulation:** Brazil's Central Bank (BACEN) issued guidance (2011) on sustainability under Basel III and has mandated (April 2014) that all banks require environmental & social risk systems. Concerns remain on financial liability for environmental damage



The Inquiry is working with Febraban and FGV to establish a baseline on financing for the green economy and identify priorities for further action across the Brazilian financial system

# China: steering the green transition



## Green credit criteria taking shape

Updated: 2012-05-16 17:00

By Zheng Yanpeng ( chinadaily.com.cn)

**CHINADAILY**.com.cn

**System wide focus on green finance:** Strategic intent to install policy framework to steer capital away from resource/pollution intensive sectors, and towards resource efficient innovation

**Green Credit Guidelines:** The CBRC's Green Credit Guidelines now assess the entire balance sheet of licensed entities. Currently c8.9% of China's RMB60 trn lending is compliant; this is expected this to rise to 100%.

**Stranded assets:** China's resolve to rapidly reduce air pollution involves major investments, and enforced closure of iron and steel, cement and coal plants. Discussion of '*environmental stress tests*' to identify assets at risk.

The Inquiry is collaborating with the Peoples Bank of China and the Development Research Center of the State Council to identify green financial policies, regulations and standards relevant to China

# UK: financial stewardship & sustainability



theguardian

'Carbon bubble' poses serious threat to UK economy, MPs warn

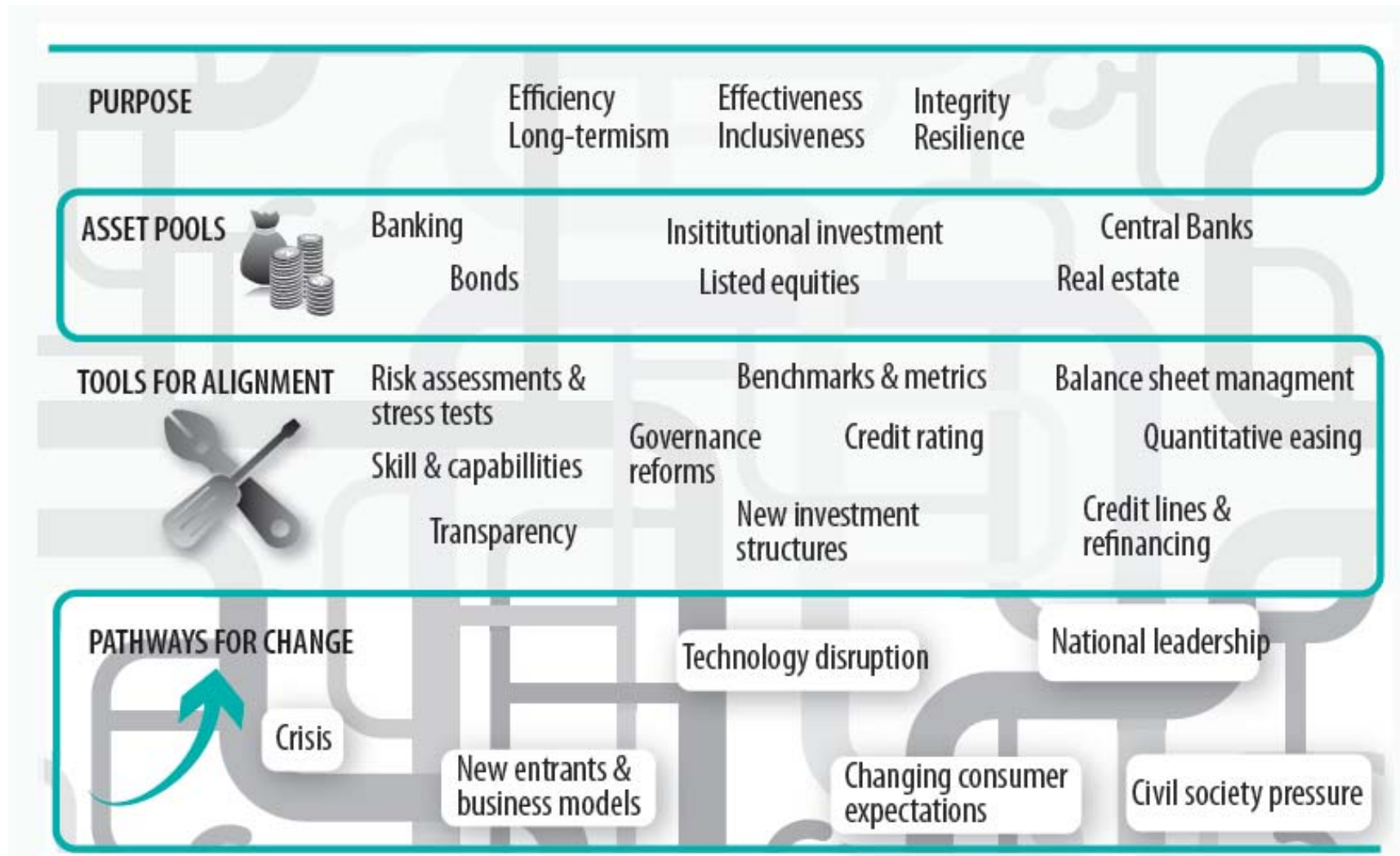
**Extending Responsibility:** The UK has introduced the Stewardship Code and new guidance on fiduciary duty to promote long-term investment incorporating sustainability factors

**Stranded Assets:** Investor concern about the potential threat of '*unburnable carbon*' for fossil fuel' is prompting demands for better disclosure of climate risks

**Insurance Regulation:** The Prudential Regulatory Authority which regulates banks and insurers is exploring the links between climate change and insurance supervision

The Inquiry is working with UK investors, analysts and regulators to explore how to manage the long-term sustainability challenges for the UK financial system

# From system purpose to pathways



# Banking: largest pool of assets



“By failing to address systemic environmental risks, Basel III is arguably overlooking an important source of risk to the financial system”

Prof. Kern Alexander, CISL/UNEPFI

- ⊙ **Innovative regulatory approaches** – Bangladesh, Brazil, China introducing a range of ‘green credit’ guidelines and requirements
- ⊙ **Valuing natural capital** – Incorporating externalities into capital requirements
- ⊙ **Data & Models** – Building methodologies to undertake quantitative assessment of sustainability factors & key risks



*How to better link national innovation in banking with the global financial policy architecture?*

# Bonds: fastest moving theme



“Worsening financial performance as a result of climate event risk can negatively impact both short-term liquidity and long-term debt financing, leading to an increase in credit risk.”

Standard & Poor's

- ⊙ **Growing materiality** – Climate change is one of the two megatrends that will impact sovereign bonds in the 21<sup>st</sup> century
- ⊙ **Rapid growth of green bonds** – USD36bn issued so far in 2014 compared with USD11bn for the whole of 2013.
- ⊙ **Catalysing scale** – Expanding the market via principles, standards, credit enhancement, fiscal incentives

*What are the key policy options to mainstream sustainability in the world's largest asset class?*



“Investing for the long-term requires strategies that create sustainable value, mitigate risks and strengthen economies. The common denominator is having a stable and forward-thinking policy foundation.”

**Anne Stausboll, CEO, CalPERS**

- ⊙ **Capital allocation** – Developing a tradeable asset class for investors to access green infrastructure and reviewing capital charges
- ⊙ **Investor governance** – Embedding sustainability in fiduciary duty, stewardship and transparency
- ⊙ **Market incentives** – Benchmarks, metrics and remuneration failing to reward efficient and sustainable value creation



*How to align separate agendas around long-term financing and sustainable development?*

# Central banks: stability & sustainability



*“The central bank time horizon is relatively short - 1.5-2 years – but the real challenges to prosperity and economic resilience from climate change will manifest well beyond this. We face a 'tragedy of horizon'.”*

**Mark Carney, Governor, Bank of England**

Growing (and often controversial) role of central banks following the financial crisis – and embryonic links to sustainability

- Refinancing facilities
- ‘Green QE’
- Environmental ‘stress testing’

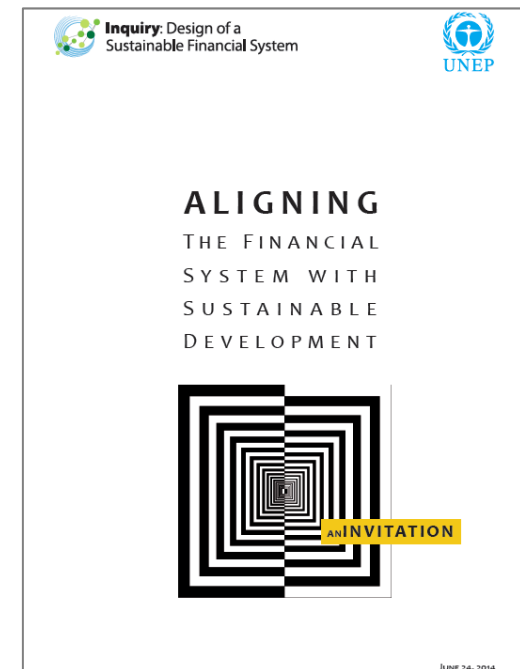


*How to explore the emerging developmental role of central banks and how this relates to core goals of financial and monetary stability?*

# Themes for discussion



- **Purpose:** incorporating sustainability into financial system purpose and policy mandates
- **Institutional:** broadening the institutions involved in the sustainability transition (eg central banks)
- **Risk:** extending time horizons and risk factors in regulatory and institutional decision-making
- **Innovation:** harnessing the positive potential of markets for sustainability
- **Culture:** relinking financial culture to real economy, customers and citizens



**2015 - A Triple Convergence:  
Financing (Addis), Global Development (SDGs) & Climate (Paris)**

# Optimism and confidence



“There is no reason why we should not feel ourselves to be free to be bold, to be open, to experiment, to take action, to try the possibility of things.

And over against us, standing in the path, there is nothing but a few old gentlemen, tightly buttoned up in their frock coats, who only need to be treated with a little friendly disrespect and bowled over like ninepins.

Quite likely they will enjoy it themselves – once they have got over the shock”

**J. M Keynes, 1931**



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